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“Free and Clear” Collides with “Perfectly Clear”: Delaware District Court Imposes Successor Liability on Buyer in 363 Sale

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Navigating the Bankruptcy Code can present many traps for unsuspecting debtors, creditors, or asset buyers. The Delaware District Court recently reminded bankruptcy participants of an often overlooked pitfall involving the collision between (i) an unstayed bankruptcy sale order authorizing an asset sale free and clear of successor liability and (ii) federal labor law imposing successor liability on the buyer. See *United Steel, Paper and Forestry, Rubber, Manufacturing, Energy Allied Industrial and Service Workers International Union, AFL-CIO, CLC v. Buyer Alloy Steel LLC*, Civ. No. 22-1563 (GBW) (D. Del. Sept. 18, 2023) at Docket No. 18 (the “Order”).

Chapter 11 debtor, CCX, Inc. (“Debtor”), sold substantially all of its assets to Braeburn Alloy Steel LLC (“Buyer”) in a sale under section 363 of the Bankruptcy Code. The Debtor had a unionized workforce and a Collective Bargaining Agreement (“CBA”) with the United Steelworkers Union (the “Union”). The Buyer declined to assume the CBA, which the Debtor later rejected under section 1113 of the Bankruptcy Code. The sale was approved pursuant by the Bankruptcy Code as part of a sale order (the “Sale Order”) that included market standard findings that the sale was “free and clear” of all claims and rights, including successor liability and enjoining creditors from asserting successor liability against the Buyer. Post-closing, the Buyer hired essentially all of the Debtor’s former workforce under new terms of employment and continued the same business.

On the day of the closing, the Union requested that the Buyer “as the perfectly clear” successor employer under the National Labor Relations Act (“NLRA”) recognize the Union as the collective bargaining representative of the Buyer’s new employees. The Buyer refused. In response, the Union filed a charge with the National Labor Relations Board (“NLRB”) alleging that the Buyer was a “perfectly clear” successor to the Debtor under the NLRA, and accordingly, despite the “free and clear” Sale Order, was compelled to bargain with the Union.

In response, the Buyer sought to enforce the "free and clear" and injunction provisions of its Sale Order by filing an emergency motion in the Bankruptcy Court. The Bankruptcy Court agreed with the Buyer and held that the Union had consented to the sale free and clear of any interest in property — which included the CBA — and that the Union waived any sale objections by failing to raise them at the sale hearing (the "Sale Enforcement Order"). Specifically, the Bankruptcy Court held the Union was barred from asserting any claim that Buyer was bound by the CBA.

The Union appealed, and after applying a limited view of the Bankruptcy Code's statutory mootness provision and allowing the appeal to proceed, the Delaware District Court agreed with the Union and reversed the Sale Enforcement Order to the extent that it enjoined the Union from seeking relief under the NLRA.

Bankruptcy Code Section 363 – Free and Clear

Section 363(f) of Bankruptcy Code allows assets to be sold "free and clear of *interests* in such property," provided that certain conditions are met. The Bankruptcy Code, however, does not define the term "interest." Consequently, courts have had to determine what "interests" can be extinguished by a free and clear sale under section 363. While the term certainly includes a property interest in the asset itself (like a lien or mortgage), many courts (including the Second, Third and Fourth Circuit Courts of Appeals) have adopted a broad interpretation that considers "interests" to include obligations that are connected to, or arise from, the property being sold. Under this view, "interests" includes successor liability claims.[1] The U.S. Supreme Court has yet to weigh in on this issue.

"Perfectly Clear" Successors Under the NLRA

While CBAs impose varying degrees of obligations on the successor to the original employer, the NLRA may also impose obligations on successor employers — as a matter of law, rather than contract — under a variety of scenarios. Generally speaking, under federal labor law, a buyer of the original employers' business is considered a successor employer when (1) the buyer employs a majority of the seller's employees, (2) the buyer continues the same business without a significant interruption, and (3) there is "substantial continuity" between the seller's old business and buyer's new business. *Fall River Dyeing & Finishing Corp. v. NLRB*, 482 U.S. 27, 43 (1987).

Successor employers are generally free to set initial terms and conditions of employment and may do so without bargaining with the union that represented the employees under the prior regime. There are exceptions, however, to this general rule.

One such exception is when the buyer is a "perfectly clear" successor to the predecessor. Under this doctrine, which the Supreme Court adopted in *NLRB v. Burns International Security Services, Inc.*, 406 U.S. 272 (1972), when it is "perfectly clear that the new employer plans to retain all of the employees in the unit," the new employer becomes obligated to bargain with the incumbent Union *before* making changes to wages, hours, or working conditions. NLRB decisions have established that an employer may also be a "perfectly clear" successor if it plans to retain a *majority* of the predecessor's employees.

The Delaware District Court Decision

As a threshold matter, the Buyer argued the Union's appeal was moot under section 363(m) of the Bankruptcy Code, which provides that an appeal of a section 363 sale order is moot when the reversal or modification of the sale order would affect the validity of the sale. The majority of courts have interpreted section 363(m) broadly, holding that after a sale has closed, an appeal seeking to modify a material term of the sale is statutorily moot.[2] The Third Circuit, however, has adopted a narrower view of section 363(m) which permits a material term to be modified on appeal so long as effective relief can be granted without affecting the validity of the sale.[3] Following the minority view, the District Court construed section 363(m) more narrowly, finding it "does not moot every term that might be included in a sale agreement, even if each is technically integral to that transaction." Order at 11–12 (internal quotation omitted). The District Court ruled that the ultimate question in determining whether an appeal would affect the validity of the sale, and thereby render the appeal moot, is "whether the grant of relief requested on appeal would, in effect, claw back the sale from the purchaser." Order at 11 (internal quotations omitted).

The Buyer argued that allowing the Union to pursue relief under the NLRA would affect the validity of the sale because it would not have purchased Debtor's assets if the Bankruptcy Court did not extinguish its successor bargaining obligations. However, the District Court found that the Union's claim arose from the Buyer's voluntary post-sale actions, implicating federal labor law, rather than the sale itself. Specifically, the asset purchase agreement approved by the Sale Order did not require the Buyer to hire any of the Debtor's employees. Rather, the Buyer chose to hire substantially all of the Debtors' employees under new terms and conditions of employment after the sale closed, triggering successor liability under federal labor law. Accordingly, the District Court found "Buyer cannot insist that a labor law claim, which arose *after* the sale closed as a result of its own conduct, affected its deliberation about whether to buy Debtor *before* the sale closed," holding "the Union is not seeking to reverse or modify the sale itself, only to assert its rights based on Buyer's post-sale conduct." Accordingly, the District Court found "[t]he appeal in no way involves reversing the sale of CCX's assets nor would it otherwise affect the validity of the sale" and "there is no request for relief that would in any way 'claw back' the sale of the Debtor's assets to [Buyer]," therefore section 363(m) was inapplicable.

The District Court turned to the merits of the Union's argument. The District Court disagreed with the Bankruptcy Court's view that an "interest in property" under section 365(f) of the Bankruptcy Code included the legal obligations related to the CBA and that the sale was therefore free and clear of those obligations. The District Court explained that "Buyer's status as a successor is not dictated by the CBA but rather determined under federal labor law based on its post-sale conduct and that any statutory obligation to bargain with the Union before altering terms and conditions of employment was not an "interest in property" that could be extinguished." Order at 16. Specifically, the District Court found that whether an obligation is an "interest in property" under section 363(f) turns on whether the obligation is connected to or arises from the property being sold and that successor bargaining obligations do not arise from the transfer of property but instead arise under federal labor law from the post-sale conduct of hiring employees and maintaining continuity of business operations.

Analysis and Takeaways

The District Court's decision is important for any buyers of distressed assets in bankruptcy, and particularly for buyers of a distressed business with a unionized workforce.

First, the District Court's narrow interpretation of the benefits of section 363(m) suggests that a buyer may not be protected against an appeal seeking to impose a liability that was extinguished by a free and clear sale order or to otherwise modify a material term of the sale. By limiting section 363(m)'s applicability to appeals that would "claw back" the assets sold to the buyer, the District Court imposes a potentially unworkable standard. Modifying material terms of a sale without clawing back the assets strikes at the heart of a sale transaction. Such an interpretation would dramatically impact bankruptcy sales and the reliance on the finality of an unstayed sale order.

Moreover, the decision highlights practical advice for buyers. Having a plan for the incumbent workforce is paramount to any successful acquisition. To protect itself from the outcome here, the buyer could have undertaken a non-discriminatory[4] hiring process in which it conditioned offers of employment upon the applicants' acceptance of the terms of employment offered by the buyer. If prior union members did not comprise a majority of the post-acquisition workforce resulting from that hiring process, the buyer would have no obligation to recognize the union or negotiate the terms of employment. Even if union members did comprise a majority, though the buyer would be a successor with an obligation to recognize and bargain with the union, it would have been able to maintain the terms and conditions of employment it unilaterally established at the time it hired its post-acquisition workforce while it negotiated with the union.

Alternatively, buyers that intend to retain an existing unionized workforce but desire greater certainty with respect to post-acquisition terms of employment may insist that the asset purchase agreement include a closing condition that the buyer reach an acceptable agreement with the union representing the workforce. In many cases, such a buyer may also be well-advised to require that the debtor seek rejection of the existing collective bargaining agreement under section 1113 of the Bankruptcy Code before or concurrently with the approval of the sale.

The decision highlights a tension between the Bankruptcy Code and National Labor Relations Act that can become a pitfall for the unsuspecting buyer. "Free and clear" may not always be as simple as it seems, particularly when an unwitting buyer allows itself to become a "perfectly clear" successor under the NLRA.

[1] *See, e.g.*, *In re Chrysler LLC*, 576 F.3d 108, 119–27 (2d Cir. 2009), *vacated as moot sub nom. Ind. State Police Pension Trust v. Chrysler LLC*, 558 U.S. 1087 (2009), *appeal dismissed as moot In re Chrysler LLC*, 592 F.3d 370 (2d Cir. 2010) (affirming asset sale to newly formed acquisition entity free and clear of debtor's liability for certain vehicle defects); *In re Trans World Airlines, Inc.*, 322 F.3d 283 (3d Cir. 2003) (affirming asset sale free and clear of employment discrimination claims); *UMWA 1992 Benefit Plan v. Leckie Smokeless Coal Co. (In re Leckie Smokless Coal Co.)*, 99 F.3d 573 (4th Cir. 1996) (affirming asset sale free and clear of successor liability under Coal Industry Retiree Health Benefit Act of 1992). While not squarely addressing the scope of "interests" under Section 363(f), the Seventh Circuit arguably adopted a more narrow approach when it permitted a successor liability action under ERISA to proceed against a secured creditor's newly formed acquisition entity after it obtained stay relief to foreclose on its collateral in the bankruptcy case. *Chicago Truck Drivers, Helpers & Warehouse Workers Union (Indep.) Pension Fund v. Tasemkin, Inc.*, 59 F.3d 48, 51 (7th Cir. 1995) (a "second chance [of recovery] is precisely the point of successor liability, and it is not clear why an intervening bankruptcy proceeding, in particular, should have a *per se* preclusive effect on the creditor's chances.").

[2] *See, e.g., In re Trism, Inc.*, 328 F.3d 1003, 1007 (8th Cir. 2003) ("[A] challenge to a related provision of an order authorizing the sale of the debtor's assets affects the validity of the sale when the related provision is integral to the sale of the estate's assets. A provision is integral if the provision is so closely linked to the agreement governing the sale that modifying or reversing the provision would adversely alter the parties' bargained-for exchange."); *In re Polaroid Corp.*, 611 F.3d 438, 441 (8th Cir. 2010) (same); *In re Fieldwood Energy III LLC*, 2023 WL 2402871 at *3 *S.D. Tex. Mar. 7, 2023) (same); *In re Pursuit Holdings (NY), LLC*, 845 Fed.Appx. 60, 62 (2d Cir. 2021) (explaining statutory mootness applies to challenges to any integral provision of the sale order) abrogated on other grounds by *MOAC Mall Holdings LLC v. Transform Holdco LLC*, 598 U.S. 288 (2023); *In re Stadium Management Corp.*, 895 F.2d 845, 849 (1st Cir. 1990) ("one cannot challenge a central element of a purchase . . . without challenging the validity of the sale itself"); *In re Gardens Regional Hospital and Medical Center, Inc.*, 2018 WL 1229989 at *5 (C.D. Cal. Jan. 19, 2018) (holding a challenge to a material term of a sale, including that a sale is effectuated "free and clear" of others' interests in the property, necessarily affects the validity of the sale and section 363(m) applies).

[3] *See, e.g., In re Pursuit Capital Management, LLC*, 874 F.3d 124, 138–39 (3d Cir. 2017) (explaining two-pronged test pursuant to which an appeal of a sale is moot if (i) the sale order is not stayed, and (ii) the challenge will not affect the validity of the sale); *In re C.W. Mining Co.*, 641 F.3d 1235, 1239 (10th Cir. 2011) (same); *In re Brown*, 851 F.3d 619, 623 (6th Cir. 2017) (adopting the Third and Tenth Circuits' approach).

[4] Though a buyer has the right to hire its own workforce, it is unlawful to discriminate against applicants on the basis of their prior union membership.

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