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Buyers beware of 'free and clear' sale

As a general rule, purchasers of another company's assets do so without risk of assuming the selling company's corresponding liabilities. The fear of successor liability leads both buyers and sellers to seek contract language and court orders waiving any liability for such claims.

After all, few and far between are the buyers who want to acquire almost guaranteed litigation and liability and the attendant expense and headache. Many buyers continue to believe that contract language or a court order, even one entered by a bankruptcy court in furtherance of a so-called "363 sale," provide them unfettered protection from successor liability claims.

Unfortunately, that belief runs contrary to the law. And as one recent 7th U.S. Circuit Court of Appeals case reminds us, buyers of these types of assets still need to engage in pre-purchase due diligence to ensure they know exactly what they may be buying along with what they intend to be buying.

Back in March, the 7th Circuit issued an opinion reminding practitioners of this very fact. In *Brian Teed, et al. v. Thomas & Betts Power Solutions LLC,* Judge Richard A. Posner, applying federal law, found that successor liability could be imposed on an asset buyer as a result of the seller's presale violations of the Federal Labor Standards Act despite contract language expressly disclaiming any successor liability.

While most successor liability claims are based on state law (which normally limit the specter of successor liability), Posner concluded that where there is a violation of a federal statute relating to labor and employment, a stricter federal common-law standard for successor liability should apply.

Following that logic, the 7th Circuit found that unless good reasons exist to reject successor liability in cases involving violations of federal labor and employment statutes, it is not appropriate to do so, even where the parties have expressly disclaimed any such liability.

While the *Teed* case was decided under a fairly specific set of facts and circumstances — namely, an asset sale arising out of a Wisconsin state law receivership involving the seller's known prior violations of the FLSA — its impact could be much further reaching.

The parties in *Teed* identified the potential successor liability issues and, in an attempt to resolve them, included as a condition to the sale that the purchase be "free and clear of all liabilities." The "free and clear of all liabilities" language used by the parties in Teed mimics the "free and clear of any interest in property" language employed by the Bankruptcy Code and Section 363 of the Bankruptcy Code in particular. But regardless of the "free and clear" language used, the 7th Circuit imposed successor liability on the buyer in *Teed*.

In the last two decades, Section 363 of the Bankruptcy Code has become an increasingly popular way to transfer assets through a court-supervised bankruptcy process. For those unfamiliar with Section 363, with certain conditions, Section 363(f) authorizes the sale of a debtor's assets "free and clear of any interest" in the assets.

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Because of the section's seemingly broad language, it can be argued that the purchaser of an asset sold pursuant to Section 363 purchases that asset wholly unencumbered. Unfortunately, what exactly constitutes an "interest" in the asset is a topic still subject to much debate in bankruptcy circles.

And while the *Teed* decision does not specifically apply in a bankruptcy context, it looks like should the issue be presented to them, the 7th Circuit would certainly be willing to expand its decision to exclude violations of a federal statute such as the FLSA from its definition of "interest" and justify successor liability in that situation.

If the 7th Circuit were to take such a position, it would seem to place the 7th Circuit in direct conflict with at least one other circuit on this basic issue. In *United States v. Knox-Schillinger (In re Trans World Airlines, Inc.)*, 322 F.3d 283 (3rd Cir. 2003), the debtor attempted to sell its assets "free and clear" of various employment discrimination claims under Title VII and the Age Discrimination in Employment Act (as well as several other employment claims) pursuant to Section 363(f) of the Bankruptcy Code.

The 3rd Circuit found that such claims, even though brought under a federal labor and employment statute, were interests within the meaning of Section 363(f) and were thus excluded from the purchased assets.

Again, the 7th Circuit opinion in Teed is limited to its facts and circumstances, including most notably that it applies narrowly to claims involving violations of federal labor and employment statutes and not other federal statutes. However, the argument is easily made that the same policy considerations justifying the decision in Teed are equally applicable in many other matters involving federal statutes.

Thus, it is not difficult to envision the expansion of *Teed* beyond claims based on violations of labor and employment laws and into claims based on myriad other federal statutes. Using those very same policy considerations, it is also not difficult to envision the expansion of *Teed* from nonbankruptcy matters into the Chapters 7 and 11 context.

While *Teed* is specific and limited, it seems that any buyers of assets in the 7th Circuit may not only want to be careful in the drafting of their sales agreements and orders but also take a little extra time to fully analyze any and all claims that might potentially give rise to successor liability and make their bids accordingly.