
Third Circuit Concludes Personal Injury Causes of Action Against a Successor to Debtor's Business are Generalized Claims

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*In a novel decision, the United States Court of Appeals for the Third Circuit held, in its ruling *In re Emoral, Inc.*, 740 F.3d 875 (3d Cir. 2014), that personal injury claims of individuals allegedly harmed by a bankrupt debtor's products cannot be asserted against a pre-petition purchaser of the debtor's assets, as they are "generalized claims" which belong to the debtor's bankruptcy estate rather than to the individuals who suffered the harm.*

Background

In August 2010, Aaroma Holdings, LLC ("Aaroma") acquired certain assets and liabilities of Emoral, Inc. ("Emoral"), which until 2006 had manufactured diacetyl, a chemical used in the food flavoring industry. Because of potential claims against Emoral arising from diacetyl exposure, the asset purchase agreement specifically provided that Aaroma was not assuming any of Emoral's liabilities for personal injury claims based on exposure to diacetyl.

After Emoral filed for chapter 7 bankruptcy protection in the United States Bankruptcy Court for the District of New Jersey in June 2011, its bankruptcy trustee challenged the validity of the sale to Aaroma as a fraudulent transfer. The trustee and Aaroma thereafter entered into a settlement agreement pursuant to which Aaroma agreed to pay \$500,000 to the bankruptcy estate in exchange for a release from any "causes of action ... that are property of [Emoral's] Estate."

Certain individuals (the "Diacetyl Plaintiffs") alleging injury from diacetyl exposure objected to the release to the extent it would bar their assertion of claims against Aaroma in its capacity as Emoral's successor. As a result of the objections, the parties agreed that the release would not bar any claims against Aaroma other than those belonging to the bankruptcy estate. The settlement was approved by the Bankruptcy Court in October 2011.

The Diacetyl Plaintiffs thereafter initiated state-court actions against Aaroma in the Superior Court of New Jersey, claiming that Aaroma, as a “mere continuation” of Emoral, was liable for their personal injury and product liability claims. In response, Aaroma moved the Bankruptcy Court for an order enforcing the settlement agreement’s release provision by compelling dismissal of these actions.

The lower courts conflict regarding the characterization of the Diacetyl Plaintiffs’ claims.

The Bankruptcy Court ruled against Aaroma and refused to compel dismissal of the Diacetyl Plaintiffs’ state-court claims. *In re Emoral, Inc.*, No. 11-27667 (Bankr. D.N.J. Sept. 26, 2012) [Dkt. No. 264]. The Bankruptcy Court explained that only “general” claims (*i.e.*, those that do not arise from a particularized injury) are property of the estate; “particular” injuries are personal to the creditor.¹ Reasoning that the Diacetyl Plaintiffs suffered “a particular injury not ... suffered by all shareholders or creditors of Emoral,” the Bankruptcy Court concluded that Diacetyl Plaintiffs’ claims were not property of Emoral’s bankruptcy estate. Accordingly, these claims were not released pursuant to the settlement agreement.

After Aaroma appealed the Bankruptcy Court’s ruling, the District Court for the District of New Jersey reversed. *In re Emoral, Inc.*, No. 12-07085 (D.N.J. Jan. 23, 2013) [Dkt. Nos. 16, 17]. While the Bankruptcy Court’s decision focused on the personal injury claims underlying the successor liability cause of action to find that the plaintiffs had alleged “a particular injury,” the District Court held that—notwithstanding the underlying tort claim—the claim for successor liability against Aaroma was a “generalized” claim belonging to the estate. The Diacetyl Plaintiffs, left without a remedy against Aaroma, appealed.

A divided court of appeals holds that the Diacetyl Plaintiffs’ successor liability claims are “general” claims that are property of the bankruptcy estate.

The Third Circuit Court of Appeals affirmed the District Court’s decision, thereby insulating Aaroma from liability for the Diacetyl Plaintiffs’ personal injury claims. The Court’s opinion focused on an examination of the differences between the Diacetyl Plaintiffs’ personal injury causes of action and the “mere continuation” theory of successor liability under which those causes of action were brought. Unpersuaded by arguments that the Diacetyl Plaintiffs’ claims were “particular” rather than “general,” the three-judge panel found that the claims against Aaroma were property of Emoral’s estate and therefore released under the terms of the settlement agreement. *In re Emoral, Inc.*, 740 F.3d 875, 882 (3d Cir. 2014).

The Court determined the successor liability claims were “general,” notwithstanding the underlying personal nature of their injuries, because Aaroma itself was not the alleged source of injury. *Id.* at 880. While a cause of action asserting successor liability necessarily arises from an underlying injury that is “personal” in nature, the successor liability claims—which require plaintiffs to “establish that there is continuity in management, shareholders, personnel, physical location, assets and general business operation between selling and purchasing corporations following the asset acquisition”—were grounded in facts generally available to all of Emoral’s creditors. *Id.* at 882.

The Court also noted that the successful assertion of the Diacetyl Plaintiffs’ claims would transfer the estate’s liabilities to Aaroma, thereby increasing the pool of funds available for distribution to Emoral’s creditors. *Id.* at 880. Because the resulting benefits would inure to *all* of Emoral’s creditors, not just the Diacetyl Plaintiffs, the successor liability claim was a generalized one.

¹ See *In re Emoral, Inc.*, 740 F.3d 875, 878 (3d Cir. 2014) (discussing outcome of the Bankruptcy Court hearing on Aaroma’s motion, held September 18, 2012).

The Court further supported its conclusion by arguing that a corporation can pierce its own veil to expand the pool of assets available to the bankruptcy estate's creditors, allowing the trustee to pursue successor liability claims against a pre-petition purchaser of the debtor's assets. *Id.* at 885. The Court described successor liability for the tort of a predecessor corporation as "an equitable remedy to satisfy an individual damage claim," *id.* at 882, which may be pursued by the bankruptcy trustee "because it benefits all . . . [creditors], promotes the orderly distribution of assets in bankruptcy, and comports with the fundamental bankruptcy policy of equitable distribution to all creditors that should not be undermined by an individual creditor's claim." *Id.* at 879 (citing *Koch Refining v. Farmers Union Cent. Exch., Inc.*, 831 F.2d 1339, 1348-49 (7th Cir. 1987)).

In a strongly-written dissent, Judge Cowen disagreed with the majority's separation of the Diacetyl Plaintiffs' personal injury claims from those for successor liability against Aaroma. *Id.* at 882-884. Judge Cowen noted that the successor liability claims were "inextricably tied to—and cannot be considered separate or apart from—their underlying personal injury and product liability allegations." *Id.* at 883. Consequently, Judge Cowen aligned himself with the Bankruptcy Court's ruling that the Diacetyl Plaintiffs' claims alleged a "particularized" injury and were not properly characterized as property of Emoral's estate.

Further, the majority's ruling seems inconsistent with the well-established rule of *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972), which prohibits a trustee from bringing private actions for the benefit of some but not all of an estate's creditors. In *Caplin*, the Supreme Court held that a bankruptcy trustee could not sue an indenture trustee on behalf of the bondholders under the trust indenture.² Thus, it is incongruous that the *Emoral* bankruptcy trustee could take an action which had the effect of releasing personal injury tort claims of certain creditors against Aaroma, a third party.

Implications of the Third Circuit's ruling for asset sales and tort claimants.

While recognizing that the ruling left the Diacetyl Plaintiffs with no recourse against Aaroma, the Court noted that it did not foreclose assertion of these claims against Emoral in the Bankruptcy Court. *Id.* at 882. The implications of the Third Circuit's ruling, however, extend far beyond the parties in the case.

In the context of asset sales under 11 U.S.C. § 363, *Emoral's* successor liability analysis affords entities purchasing a distressed debtor's assets greater protection from later liability. These protections, however, come with a price. While the Diacetyl Plaintiffs may pursue their claims against Emoral's liquidation estate, they have no opportunity to obtain further recovery from the assets that were sold prepetition even if New Jersey law would otherwise have permitted such a successor claim.

Moreover, while potentially increasing security for purchasers of a debtors' assets, *Emoral* casts doubt on the ability of a bankruptcy trustee to effectively negotiate a general release of estate claims in settlement of third party litigation. The negotiations underlying the settlement agreement between the trustee and Aaroma clearly indicate that the settlement was not intended to release the Diacetyl Plaintiffs' claims: at a Bankruptcy Court hearing, a representative of the Trustee stated "that the Diacetyl Plaintiffs' successor liability claim against Aaroma 'does not belong to the Estate' and that the Trustee accordingly 'can't

² Although *Caplin* was decided under sections 70c and 70e of the former Bankruptcy Act, its holding remains applicable under the Bankruptcy Code. See *In re Ozark Rest. Equip. Co.*, 816 F.2d 1222, 1227-28 (8th Cir. 1987). In its 1978 overhaul of the Bankruptcy Act, Congress consolidated former sections 70c and 70e of the Bankruptcy Act into Bankruptcy Code sections 544(a) and (b), respectively. However, as originally proposed by the House, section 544 was to contain a subsection (c), which was intended to overrule *Caplin*. See *Report of the Committee on the Judiciary, to accompany H.R. 8200*, H.R. Rep. No. 95-595, 95th Cong., 1st Sess., 370 (1977). However, this provision was deleted from the final version of section 544, see *House Debate on Compromise Bill*, 124 Cong. Rec. H11047-117, H11097 (daily ed. Sept. 28, 1978), indicating that Congress did not intend to overrule *Caplin*.

release it.” *Id.* at 887.³ The Third Circuit Court of Appeals’ ruling, however, worked a result contrary to what the trustee and the bankruptcy court apparently believed they were approving.

Conclusion

On March 20, 2014, the Third Circuit denied the Diacetyl Plaintiffs’ motion for rehearing before the original panel and the Third Circuit *en banc*. Of the fourteen judges, five voted in favor of a rehearing (four judges cast their vote in favor of an *en banc* rehearing, in addition to Judge Cowen’s vote for a panel rehearing). As the divided Court’s decisions illustrate, classification of any particular claim is far from an exact science. However, absent a successful appeal to the Supreme Court, individuals harmed by a bankrupt debtor’s products may find themselves without a remedy against a pre-petition purchaser of the debtor’s assets, at least in the courts of the Third Circuit.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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³ See also *id.* at 878 fn. 1 (“The Trustee’s representative stated: ‘I would like to sell someone the Brooklyn Bridge, but I don’t own it so I can’t sell it. I cannot, the Trustee cannot release claims that he doesn’t own. It was never contemplated that he would be releasing claims he doesn’t own.’”).

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