Portfolio Media, Inc. | 648 Broadway, Suite 200 | New York, NY 10012 | www.law360.com
Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Successor Liability: Corporate Asset Buyers Beware

Law360, New York (May 12, 2009) -- As the economy continues its downward spiral, more and more companies are faced with increased liabilities that they simply cannot pay. When faced with this predicament, a majority of these companies will consider the more common options of developing payment plans with creditors or filing for bankruptcy protection.

However, certain companies may believe that they can escape their financial obligations by simply conveying their assets to a newly formed company owned by the same shareholders and employing the same personnel, while leaving the liabilities behind in a judgment-proof shell. However, this strategy may run afoul of New York law.

Both New York law and common law support the general rule that "a corporation that purchases the assets of another corporation is generally not liable for the seller's liabilities." State of New York v. Nat'l Serv. Indus. Inc., 460 F.3d 201 (2d Cir. 2006).

However, this general rule is subject to certain well-defined exceptions. Within the context of these exceptions, courts have held that the buyer of a corporation's assets will be liable as its successor if: (1) it expressly or impliedly assumed the predecessor's liability; (2) there was a consolidation or merger of seller and purchaser; (3) the purchasing corporation was a mere continuation of the selling corporation; or (4) the transaction is entered into fraudulently to escape obligations. See Id.

To the extent that a creditor can establish any one of the above exceptions, it is likely that a court will enforce against the successor company the obligations owed to that creditor by the predecessor company. A brief discussion of each exception is set forth below.

Express or Implied Assumption of Predecessor's Liability

Perhaps the least litigated of the four exceptions to the general rule against successor liability is the express or implied assumption of predecessor liability.

All Content Copyright 2003-2009, Portfolio Media, Inc.

As might be expected, a purchasing corporation that expressly agrees to assume the liabilities of a selling corporation will be held responsible for the seller's liabilities.

Indeed, a cursory analysis of the underlying asset purchase agreement (the operative document that memorializes the transfer of corporate assets) will often identify the existence of such an express agreement. See Desclafani v. Pave-Mark Corp., 2008 U.S. Dist. Lexis 64672 (S.D.N.Y. 2008).

However, this exception is less apparent in situations where there is no such express agreement for the assumption of liabilities, but the purchasing corporation voluntarily pays certain debts of the selling corporation.

In certain circumstances such payments, coupled with the existence of other external factors, can serve as a basis for a creditor to argue that the voluntary assumption of some debts by the purchasing corporation obligates the purchasing corporation to compensate creditors for all debts of the selling corporation.

To determine whether an implied assumption of liabilities has occurred, the acquirer must manifest an intent to pay the debts of the selling business. This requires a case-by-case analysis of the facts and circumstances of the transaction.

Importantly, the fact that a buying corporation has paid certain debts of the selling corporation on a voluntary basis is not, standing alone, grounds to find an implied assumption of liability.

However, voluntary debt payments coupled with admissions on the part of a buying corporation that it assumed liability for the predecessors' debt may yield a different result. The impact on the creditors of the selling corporation is also factored into the analysis. See 15. W. Fletcher, Private Corporations (1983).

Consolidation or Merger of Seller and Purchaser

Frequently, corporations do not dispute the existence of a consolidation or merger and/or there is no dispute that the purchasing corporation will be responsible for the selling corporation's liabilities. However, this obligation is not as apparent where the parties engage in what is referred to as a "de facto merger."

"A de facto merger occurs when a transaction, although not in the form of a merger, is in substance a consolidation or merger of a seller and purchaser." Cargo Partner AG v. Albatrans Inc., 352 F.3d 41 (2d Cir. 2003).

The law treats the de facto merger as a traditional consolidation or merger and will hold the successor corporation responsible for the predecessor corporation's liabilities.

Courts conduct an analysis of four independent factors to determine whether businesses have engaged in a de facto merger. Under common law, the four hallmarks

All Content Copyright 2003-2009, Portfolio Media, Inc.

of a de facto merger are: (1) continuity of ownership; (2) cessation of ordinary business and dissolution of the acquired corporation as soon as possible; (3) assumption by the purchaser of the liabilities ordinarily necessary for the uninterrupted continuation of the business of the acquired corporation; and (4) continuity of management, personnel, physical location, assets, and general business operation. State of New York, 460 F.3d at 209.

Although the establishment of the first criterion is essential to a finding of a de facto merger, the court will balance each of the remaining factors before determining whether a de facto merger has taken place. Cargo Partners, 352 F.3d at 46-47. See also, In re New York City Asbestos Litigation, 15 A.D.3d 254, 256, 789 N.Y.S.2d 484, 486 (1st Dep't 2005)(the court found that "possible satisfaction of only the third and fourth criteria does not suffice to create a trial de facto merger issue.")

Mere Continuation of the Selling Corporation

The mere continuation exception seeks to address successor liability within the context of a corporate reorganization. To that end, successor liability will attach to the acquiring company if it is no more than a mere continuation of the selling company and the focus of the transaction is simply to effect a corporate reorganization.

As stated by one court, "[t]he mere continuation exception refers to a continuation of the selling corporation in a different form, and not merely to a continuation of the seller's business. It applies where a purported asset sale is in effect a form of corporate reorganization." Cargo Partner AG v. Albatrans Inc., 207 F. Supp. 2d 86 (S.D.N.Y. 2001).

In determining whether the purchasing corporation is a mere continuation of the selling corporation, courts look to several factors including: (1) a common identity of directors; (2) a common identity of stockholders; and (3) whether only one corporation exists at the conclusion of the transaction. Id.

A finding of successor liability is likely where the selling corporation ceases to exist after the transaction, as this is indicative of a corporate reorganization. An unsuccessful attempt to establish liability of a successor corporation under this exception was made by the plaintiff in Alvarado v. Dreis and Krump Manufacturing Co., 781 N.Y.S.2d 622 (NY. Sup. Ct. Bronx Cty. 2004).

In Alvardo, the plaintiff was injured while operating a sheet metal machine press. The plaintiff brought suit against multiple defendants, including a technology company that purchased the corporation that sold the machine press to the plaintiff's employer. The plaintiff brought suit against the technology company under a "mere continuation" theory.

All Content Copyright 2003-2009, Portfolio Media, Inc.

The court declined to extend successor liability under the "mere continuation" exception, finding that "[f]or this exception to come into operation, the purchasing corporation must represent merely a 'new hat' for the seller."

The Alvardo court concluded its analysis by finding that the technology company had submitted sufficient evidence establishing that it was a corporate entity completely distinct from the corporation that it purchased since its only involvement with a predecessor corporation was "the purchase of substantially all its physical assets."

Fraudulent Transaction

A successor company will be responsible for the obligations of the predecessor company if a court determines that the transaction was entered into fraudulently in order for the predecessor to escape certain liabilities.

To determine whether successor liability attaches under this exception, courts analyze certain "badges of fraud" which include: 1) a close relationship among the parties to the transaction; 2) a secret and hasty transfer not in the usual course of business; 3) inadequacy of consideration; 4) the transferor's knowledge of the creditor's claim and the transferor's inability to pay it; 5) the use of dummies or fictitious parties; and 6) retention of control of the property by the transferor after the conveyance. Kaur v. Royal Arcadia Palace Inc., 2007 U.S. Dist. Lexis 94556 (E.D.N.Y. 2007).

The essence of this exception has been codified by the New York State legislature under Section 276 of the N.Y. Debtor and Creditor Law. This provision states that "[e]very conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay or defraud either present or future creditors, is fraudulent as to both present and future creditors."

Conclusion

Businesses must carefully consider their course of conduct if they find themselves in situations where they are encumbered by liabilities that they simply cannot afford to pay. Acquiring companies must be mindful of the fact that any conduct that is perceived to be an attempt to defraud creditors will be scrutinized.

--By Stuart I. Gordon, Matthew V. Spero and Michael C. Cannata, Rivkin Radler LLP

Stuart Gordon is a partner with Rivkin Radler in the firm's Uniondale, N.Y., office. Matthew Spero and Michael Cannata are both associates with the firm in the Uniondale, N.Y., office.

The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

All Content Copyright 2003-2009, Portfolio Media, Inc.