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Shedding light on corporate successor liability

Recent litigation offers insight to businesses buying assets or seeking to collect a significant debt

By Andru H. Volinsky and Talesha Caynon| June 13, 2014

Depending on your point of view, corporate successor liability is either the bane of a company that buys assets or a strong protection for a creditor fighting fraud.

Ordinarily, a business that buys the assets of another business, as opposed to buying its stock, need not worry about the liabilities of the company selling the assets. Of course, there are exceptions for assets that serve as security for a loan, but this aside, generally the reason to buy assets and not stock is to avoid taking on the seller's liabilities.

The concept of successor liability allows the creditor to have its claims pulled through to the new buyer and seeks to have that buyer made liable for the seller's existing debt.

We recently tried a successor liability dispute in Rockingham County Superior Court (Celestica LLC v Communications Acquisitions Corp.), and some of the rulings of Judge Will Delker, the trial judge, may be helpful to any business buying assets or seeking to collect a significant debt.

We represented Communications Acquisitions Corp., a company in the telecommunications field. It acquired all of the assets of a failing telecom company at a public auction. The seller had a $2 million court judgment against it. The judgment was not secured. The creditor tried to enforce its judgment against the buyer, and we ended up in court.

The trial judge explained the standard factors that are considered in deciding successor liability claims:

1. Is there a continuation of the selling business with the buyer in terms of management, personnel, physical location, assets and general business operations?

2. Are the shareholders the same in the buyer and seller, and did the buyer purport to pay for the assets by issuing stock in the new business?

3. Did the seller cease its ordinary business operations, liquidate and dissolve as soon as legally and practically possible?

4. Did the buyer assume those obligations of the seller necessary for the uninterrupted continuation of normal business operations?

The court also considered the adequacy of the consideration paid in the asset sale and whether there is evidence the purchase was made in good faith.

Guidance for all

Ultimately, the court found that successor liability was not proper and denied the claims of the creditor. We believe the strongest factors that helped our client avoid successor liability were the following, but they were not without some uncertainty and, in that uncertainty, there is guidance for sellers, buyers and creditors:

- First, the most helpful fact was that the seller's assets were sold because a secured lender called its note. Our client did not arrange for the sale, and the sale was in the form of a public auction where our client paid the secured lender hundreds of thousands of dollars in cash. The secured lender was represented by its own law firm. The creditor was invited to participate in the public auction and declined. This was not a stock-for-stock sale, and the creditor did not show at trial that the assets were undervalued when they were bought at the auction.

The complication here is that the seller operated a functioning company and had much more value if it remained functioning then if just its hard assets were sold in a liquidation.

In order to keep the seller in business while awaiting the public auction, the buyers infused the company with capital and arranged to have this capital refunded if it was not the high bidder at the public auction. Ultimately, the court concluded this process preserved value for the secured lender as well as for the buyer even though the creditor cried foul.

- Second, although two of the original shareholders in the selling company also owned the buyer, many of the former shareholders did not participate in buying the company. They dropped out of the process. Further, the shareholders took concrete steps to correct the problems with the seller's business model as soon as they practically could do so.

This put the assets to better use and reduced the cash flow problems that were endemic to the old business. In other words, it was helpful that the buyers reduced economic waste and created a more functional business.

- Third, our judge was very practical. We believe he considered the fact that the creditor sat back and did not participate in the auction. The creditor also did not perfect a security interest in the seller's assets.
- Finally, there would have been severe implications for the buying, selling and potentially, merging of businesses in New Hampshire had the judge ruled the other way, as startups and tech businesses require some flexibility until they have fully solidified their business models, it is not always the founders who ultimately make businesses successful.

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