Successor Liability for Asset Purchasers

by Robert E. Witwer

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Column Editors:

David P. Steigerwald of Sparks Willson Borges Brandt & Johnson, P.C., Colorado Springs—(719) 475-0097; Column Ed. for Bankruptcy Law: Curt Todd of Lottner, Rubin, Fishman, Brown & Saul, P.C., Denver—(303) 292-1200

About The Author:

This month's article was written by Robert E. Witwer, an associate in the Denver office of Hogan & Hartson L.L.P.—(303) 454-2422; rewitwer@ hhlaw.com. The author is in the firm's Business and Finance Practice Group.

This article provides an introduction to the Colorado law of successor liability, under which an asset purchaser can be held liable for the debts and obligations of a seller.

Can one company purchase the core business of another company while avoiding liabilities associated with that business? In most cases, the answer is yes. Because liabilities typically attach to entities, a purchaser can buy only the assets (as opposed to the stock) of a seller, thereby taking the core business and leaving the liabilities behind. Nonetheless, in some circumstances, a purchaser of assets might find itself responsible for the debts and obligations of the selling entity—even long after the asset sale is complete. A small but important area of law known as "successor liability" has the potential to create unexpected headaches for purchasers, who may suddenly find themselves on the hook for obligations they never anticipated.

This article addresses the law of successor liability in Colorado. It is intended not only as a guide to interpreting successor liability issues as they arise, but as a resource for counsel representing asset purchasers who wish to avoid successor liability problems in the future.[1]

The General Rule: Non-liability

In general, an asset purchaser is not liable for the debts or liabilities of a seller.[2] The leading Colorado case, *Ruiz v. ExCello Corp.*, involved a plaintiff's product liability claim against a corporation that had not manufactured the product in question, but subsequently had acquired the assets of the manufacturing corporation. According to the *Ruiz* court,

> where one company sells or otherwise transfers all its assets to another company, the latter is not liable for the debts and liabilities of the transferor, except where: (1) the purchaser expressly or impliedly agrees to assume such debts; (2) the transaction amounts to a consolidation or merger of the seller and purchaser; (3) the purchasing corporation is merely a continuation of the selling corporation; or (4) the transaction is entered into fraudulently in order to escape liability for such debts.[4]

Oliver Wendell Holmes famously noted that a young person may know the rules, but an old one knows the exceptions. As illustrated above, the general rule of non-liability is heavily qualified by some important exceptions. Because the judicial application of any one of these exceptions could lead to unexpected—and potentially substantial—liability, asset purchasers' counsel are well advised to consider the circumstances under which each of these exceptions could arise.

Exception #1: Express Or Implied Assumption Of Liability

Under this exception, a purchaser is liable for debts and liabilities it expressly or impliedly assumes from the seller.[5] If the plain language of an asset purchase agreement clearly allocates responsibility for post-closing liabilities, this will be a relatively straightforward inquiry[6] under the standard rules of contract interpretation.[7] However, in the event an agreement is ambiguous or completely silent with respect to risk allocation (or if there is no written agreement at all), courts are likely to ask whether the purchaser's conduct shows that it "impliedly" agreed to assume the liability in question.[8] If the answer is yes, the purchaser will be held liable.

Whether or not a purchaser "impliedly" assumed a given liability turns on the purchaser's intent. As one court has said, "in order that a promise may be implied on the part of a corporation to pay the debts of another corporation, to the property and franchises of which it has succeeded by valid purchase, the conduct relied upon must show such an intention."[9] Intent is a question of fact for the court and will depend on the specific circumstances of a given transaction.[10] Courts also have found that persuasive evidence of intent to assume liabilities includes the following: (1) a discounted purchase price[11] or lack of consideration altogether;[12] (2) the purchaser's assumption of a large category of liabilities (even if there is no written agreement on the particular liability under dispute);[13] or (3) the fact that the successor corporation continued to insure liabilities arising from the predecessor's products.[14]

Exception #2: Merger Or Consolidation

Under this exception, a purchaser is liable for debts and liabilities of a seller if the asset sale amounts to a consolidation or merger of the seller and purchaser.[15] Also known as the "*de facto* merger doctrine," this exception is rooted in the general rule that merged or consolidated entities remain liable for the obligations of their predecessors.[16] Whether a transaction amounts to a merger or consolidation is a question of fact. One court noted that "[s]trictly speaking, a consolidation signifies such a union as necessarily results in the creation of a new corporation and the termination of the constituent ones, whereas a merger signifies the absorption of one corporation by another, which retains its name and corporate identity with the added capital, franchises and powers of a merged corporation."[17] Facts showing that any of the foregoing has occurred may be persuasive evidence that a transaction amounts to a merger or consolidation.

To minimize risk of successor liability under this exception, the purchaser and seller should take steps to maintain separate corporate existence and activities both before and after the transaction.[18] Counsel should be especially cautious where officers or shareholders of the seller will become officers or shareholders of the purchaser or where all or some of the purchase price is paid in purchaser stock—resulting in shareholders of the seller becoming shareholders of the purchaser.[19]

Exception #3: Purchaser Is "Mere Continuation" Of Seller

A purchaser is liable for the seller's debts and liabilities if it is deemed a "mere continuation" of the seller.[20] Determining whether the purchaser is a mere continuation of the seller depends on whether there has been a continuation of ownership or corporate structure between the seller and purchaser. The general rule has been characterized as follows:

> A mere continuation, or reorganization of an existing corporation, may be found to exist where there is a continuation of directors and management, shareholder interest and, in some cases, inadequate consideration. The gravamen of the traditional 'mere continuation' exception is the continuation of the *corporate entity* rather than continuation of the business operation.[21] (*Emphasis in original.*)

As with the merger/consolidation exception, counsel should ensure that seller and purchaser maintain an independent and separate corporate existence before, during, and after the transaction. For example, one Colorado court has held that there was no continuation where the seller "continued to exist after the sale and there was no common identity of stock, directors, officers or stockholders" between the seller and the purchaser.[22]

Exception #4: Fraud

A purchaser is liable for debts and liabilities of a seller if the transaction was entered into fraudulently in order for the seller to escape liability for its debts.[23] This exception is a judicial attempt to prevent a seller from orchestrating an asset sale for the purpose of escaping its own obligations. In other words, it is essentially an application of the rule against fraudulent conveyances. Inadequate consideration, bad faith, or intent to defraud creditors are factors that will support a finding of fraud.[24]

Two Additional Exceptions (Applied Outside Colorado)

Counsel for Colorado-based companies that do business outside of Colorado should be aware that several states have recognized two additional exceptions to the traditional rule of non-liability, each typically applying in the product liability context: the "continuity of enterprise" exception and the "product line" exception.[25] If a plaintiff sues a Colorado-based company in one of these jurisdictions, the risk of successor liability will be increased accordingly.

"Continuity of Enterprise" Exception: The "continuity of enterprise" exception[26] enlarges the "mere continuation" exception. Under this exception, a court may find successor liability, regardless of whether the consideration for assets was stock or cash, where "the totality of the transaction demonstrates a basic continuity of the enterprise."[27] Courts have found that a "continuity of enterprise" exists when the following facts are present: (1) there exists a continuity of management, personnel, physical location, assets, and general business operations; (2) the selling corporation ceases its ordinary business operation and liquidates and dissolves as soon as legally and practically possible; and (3) the purchasing corporation assumes those liabilities and obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operations.[28] Colorado has not adopted the "continuity of enterprise" exception.[29]

"Product Line" Exception: The "product line" exception generally applies to purchasers that acquire the manufacturing business of a seller and continue the output of a line of seller's products after the sale. In such cases, purchasers may be held liable for defective products in the same line, despite the fact that such products were manufactured and distributed by the seller before the sale.[30] In 1992, the Colorado Court of Appeals considered, and rejected, adoption of the "product line" exception.[31]

Related Issues

In addition to the exceptions identified above, counsel should be aware that the U.S. Court of Appeals for the Tenth Circuit has held that successor corporations may have a "duty to warn" consumers about defects in products that were manufactured by the seller.[32] Whether or not such a duty exists depends on circumstances: "[s]uccession alone does not impose a duty to warn the predecessor's customers of recently-discovered defects";[33] rather, the duty "stems from the existence of the relationship between the successor and the customers of the predecessor."[34]

In determining whether such a relationship exists, courts may consider "factors such as the succession to service contracts, coverage of the particular machine by a contract, service of that machine by the successor, and the successor's knowledge of the defect and of the machine owner's location."[35] If any of the foregoing is likely to apply, a successor corporation might be duty-bound to warn customers of dangerous or defective products.

Finally, although it is beyond the scope of this article, counsel should be aware that additional successor liability issues might arise under bankruptcy law[36] or the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA").[37] In such contexts, counsel should undertake additional research to determine the scope of potential successor liability.

Practical Suggestions

There is no way to preclude altogether the possibility of successor liability. However, if counsel are aware of where the hazards lie, they can help clients minimize the risk of being held liable for obligations they did not expect to assume. Following are a few practical suggestions.

Due Diligence

Potential asset purchasers should evaluate thoroughly the target company's assets and business in light of successor liability rules. For example, if the business involves the manufacture and distribution of products, purchasers should give special attention to the states in which the asset seller distributes such products, as the laws of these jurisdictions may expand the scope of successor liability in the event of a product liability claim.[38] In some cases, purchasers may want to consider creating a distinct corporate entity to house manufacturing elements of the acquired business so as to limit exposure for the purchaser and its affiliates.

Asset Purchase Agreement

An asset sale should be subject to a written asset purchase agreement that clearly allocates responsibility (including appropriate indemnifications) for post-sale liabilities (regardless of when the events giving rise to such liabilities took place).[39] Specifically, the asset purchase agreement should: (1) identify the known debts and obligations of the seller with as much precision and as little ambiguity as is possible; and (2) provide clear guidance about how the parties intend to allocate responsibility for liabilities that are undetermined (or undeterminable) at the time of sale.

For example, a purchaser may agree to assume only specific "assumed liabilities" of the seller, which will be listed in the agreement itself or on a schedule to the agreement. Liabilities of the seller other than these "assumed liabilities" (including undetermined liabilities) will not be assumed by the purchaser and will be retained by the seller. In the alternative, a purchaser may agree to assume all debts, liabilities, or obligations of the seller (including undetermined liabilities), except for specific "excluded liabilities," set forth in the agreement or on a schedule to the agreement. Such "excluded liabilities" will not be assumed by the purchaser, and will be retained by the seller.

Either way, the effect of such contractual language will be to delineate which of the seller's liabilities are intended to become liabilities of the purchaser. If the seller's business includes manufacture, counsel may want to consider also including specific language addressing the allocation of product liability claims.

Finally, in the event the selling entity will either dissolve or become substantially insolvent following closing, it is desirable that the selling entity's owners also indemnify the purchaser for post-closing costs or claims related to unassumed or excluded liabilities. Such indemnification should be effective for as long a period as possible, but should at least mirror applicable statutes of limitations.

Arm's Length Relationship And Post-Closing Conduct

To minimize the appearance and reality of a fraudulent conveyance, consideration for acquired assets should bear a reasonable relationship to the fair market value of such assets.[40] The purchaser should strive to keep an arm's length relationship with the seller at all times, especially after the assets have been conveyed. For example, following the sale, the purchasing and selling entities should maintain separate and distinct corporate identities. The parties also should avoid, to the extent possible, a high degree of post-sale continuity of shareholders, management, personnel, physical location, and general business operations, as well as the immediate post-sale dissolution of the selling entity. Finally, purchasers who wish to act on the side of caution should not make insurance payments on, or otherwise assume contractual obligations with respect to, assets for which they do not wish to be held accountable.

"Tail" Insurance Policy

Depending on the risk of successor liability exposure and other economic considerations, it may sometimes be desirable for a purchaser to include in the asset purchase agreement a pre-closing covenant or condition requiring the seller obtain a "tail" insurance policy. A typical tail policy extends the seller's existing coverage to include post-closing claims, but only to the extent the events giving rise to such claims occurred before closing.

Although a variety of tail policies may be available, the seller should obtain a policy that covers the types of claims that are most likely to arise given the nature of the business. The policy should become effective immediately prior to closing and should continue for a reasonable period of time following closing (for example, a period that mirrors applicable statutes of limitations).

Finally, as discussed above, it is important that the seller (or the seller's owners, if they provide indemnification under the asset purchase agreement or if the selling entity plans to dissolve during the tail period)—rather than the purchaser—obtain the policy. This shows that the parties intended the seller (or its owners) to bear ultimate responsibility for the insured risks.

Conclusion

The chances of minimizing successor liability risk will improve if purchasers identify potential problem areas early in the transaction and structure the asset sale accordingly. The best place to start is with a good working knowledge of the exceptions to the general rule of non-liability.

Counsel should ensure that asset sale transactions are properly memorialized by written agreements that clearly and unambiguously allocate responsibility for liabilities, whether actual or potential. Before, during, and after closing, the parties should maintain an arm's length relationship (including the continuation of separate and distinct business entities). Consideration for the purchased assets should bear a defensible relationship to their fair market value. Finally, when asset acquisitions involve businesses that operate or distribute products outside of Colorado, counsel should review the law of other jurisdictions in which successor liability questions may arise.

NOTES

1. For a discussion of successor liability, mergers, and related topics pertaining to technology businesses, *see* Trelease *et al.*, "The Sale of Technology-based Businesses in a Challenging Market," 31 *The Colorado Lawyer* 9 (April 2002).

2. *Ruiz v. ExCello Corp.*, 653 P.2d 415, 416 (Colo.App. 1982) (general rule is "one of non-liability"). *See also Beaver Park Co. v. Hobson*, 86 Colo. 559, 573 (Colo. 1929) (subject to certain exceptions, asset purchaser "takes the property without liability" for seller's obligations), *citing Denver & S.F. Ry. Co. v. Hannegan*, 43 Colo. 122, 129 (Colo. 1908); *Florom v. Elliott Mfg.*, 867 F.2d 570, 574 (10th Cir. 1989) (following "general rule of non-liability of successor corporations"; applying Colorado law); *Kloberdanz v. Joy Mfg. Co.*, 288 F.Supp. 817, 820 (D.Colo. 1968) ("where one company sells or otherwise transfers all its assets to another company the latter is not liable for the debts and liabilities of the transferor"; applying California law).

3. *Ruiz, supra*, note 2 at 416.

4. *Id.*, citing *Kloberdanz, supra*, note 2 at 820.

5. *Id.*

6. *See, for example, Kloberdanz, supra*, note 2 at 821 (where asset purchase agreement included exhibit designating liabilities to be assumed by seller and liability for torts was not included on such exhibit, "it follows that [seller] was to retain that liability"). *See also Colorado Springs Rapid Transit Ry. Co. v. Albrecht*, 123 P. 957, 960 (Colo.App. 1912) ("no allegation or proof" that purchasing company expressly agreed to assume seller's obligations); *Florom, supra*, note 2 at 575 ("An unambiguous contract between the seller and purchaser corporations, with explicit provisions which exclude any liability for the debts and liabilities of the predecessor, weighs against [the court's] finding that an exception can be implied.").

7. *See Florom, supra*, note 2 at 575 ("Unless the words used by the parties to express their agreement are found to be ambiguous in some material respect, the court should give them legal effect according to their plain, ordinary and popular meaning.").

8. *Id.* (inquiry into whether assumption occurred directs court "both to the terms of the purchase and the successor's conduct").

9. *See Beaver Park Co., supra*, note 2 at 575. *See also Florom, supra*, note 2 at 576 (making inquiry into "how the two corporations intended that postacquisition liabilities would be handled").

10. *See generally* 19 Am. Jur. 2d *Corporations* § 2709 (St. Paul, MN: West Group, 1986).

11. *See Leyman Corp. v. Piggly-Wiggly Corp.*, 103 N.E.2d 399, 403 (Ohio Ct.App. 1951) (purchaser given purchase price deduction because of its agreement to pay seller's debts).

12. *See* 19 Am. Jur. 2d, *supra*, note 10 at 2709, n.29, *citing Diamond A Cattle Co. v. Tschirgi*, 181 F.2d 991 (8th Cir. 1950) (in absence of evidence to the contrary, intention to assume liabilities found where corporation's assets have been taken over without consideration and are used to continue predecessor's business for successor's benefit).

13. *See Kessinger v. Grefco, Inc.*, 875 F.2d 153, 155 (7th Cir. 1989) (agreement of purchaser "to pay, perform and discharge all debts, obligations, contracts and liabilities" of seller showed intent to assume unforeseen product liability claims, although not specifically addressed in agreement); *Lee-Thomas, Inc. v. Hallmark Cards, Inc.*, 275 F.3d 702, 705 (8th Cir. 2002) (assumption of liability provision that called for successor to assume "all the liabilities of" seller existing on date of closing, and "liabilities arising solely out of the business conducted by" seller prior to closing, reflected intent by purchaser to assume all of seller's prior liabilities arising from its business, including any liability of seller from claims for defective products).

14. *Florom, supra*, note 2 at 576.

15. *Ruiz, supra*, note 2 at 416.

16. "The relevance of the *de facto* merger doctrine to the issue of transferee liability stems from the general principle of law that, absent a governing statute or contract provision, a corporation that absorbs another corporation by merger or creates a new corporation by consolidation, is liable on the debts and obligations of the merged or consolidated corporation, while a corporation that merely acquires the assets of another is not liable for the obligations of the transferor." *See* 19 Am. Jur. 2d, *supra*, note 10 at 2718.

17. *Kloberdanz, supra*, note 2 at 821, *citing* 15 Fletcher, *Cyclopedia of the Law of Private Corporations*, rev. vol. (St. Paul, MN: West Group, 1961) § 7041 at 6.

18. *See Kloberdanz, supra*, note 2 at 821 (no merger or consolidation where "two corporate entities were completely separate and distinct before and after the sale"). *See also Beaver Park Co., supra*, note 2 at 573; *Colorado Springs Rapid Transit Ry. Co., supra*, note 6 at 960. Continuation of the seller as a legal entity after the sale also may be an important factor; *see Kloberdanz, supra*, note 2 at 821 (no merger or consolidation where seller "continued its corporate existence, until its liquidation many months after the sale").

19. *See generally* 19 Am. Jur. 2d, *supra*, note 10 at 2713.

20. *Ruiz, supra*, note 2 at 416. This exception is sometimes referred to as the "reincarnation" exception. *See, e.g., Beaver Park Co., supra*, note 2 at 571.

21. *Florom, supra*, note 2 at 578, n.3. *See also Kloberdanz, supra*, note 2 at 821.

22. *Kloberdanz, supra*, note 2 at 821.

23. *Ruiz, supra*, note 2 at 416.

24. *See Denver & S.F. Ry. Co., supra*, note 2 at 129 ("where . . . nothing appears in the record either by pleadings or proofs tending to show that the sale was made upon inadequate consideration, or that it was

characterized by bad faith in any manner, the purchaser takes without any liability for payment of the [seller's] debts").

25. For general discussion of exceptions to the rule of non-liability in product liability cases, *see* Pollak, "Successor Liability in Asset Acquisitions," 1187 *PLI/Corp.* 125, 141 (June 2000). For general discussion of product liability issues in Colorado, *see* Oldham, "The Product Liability Case," 26 *The Colorado Lawyer* 3 (March 1997). *See also* the Colorado Product Liability Act of 1977, CRS §§ 13-21-401 *et seq.*

26. For general discussion of the "continuity of enterprise" exception and a list of states that have adopted it, *see* Pollak, *id*.

27. *Turner v. Bituminous Casualty Co.*, 244 N.W. 2d 873, 875 (Mich. 1976).

28. *Id.* at 879 and 883.

29. *See Johnston v. Amsted Industries, Inc.*, 830 P.2d 1141, 1147 (Colo.App. 1992) (expressly declining to adopt the "continuity of enterprise" exception). *Accord Florom, supra*, note 2 at 579 (applying Colorado law and declining to adopt the "continuity of enterprise" exception).

30. *See Ray v. Alad Corp.*, 560 P.2d 3, 11 (Cal. 1977). For general discussion of the "product line" exception and a list of states that have adopted it, *see* Pollak, *supra*, note 25.

31. *See Johnston, supra*, note 29 at 1146 (declining to adopt the "product line" exception). *Accord Florom, supra*, note 2 at 579 (declining to adopt the "product line" exception). *But see Hickman v. Thomas C. Thompson Co.*, 592 F.Supp. 1282 (D.Colo. 1982) (applying Colorado law, predicting that Colorado courts would adopt the "product line" exception and apply the "product line" exception).

32. *See Florom, supra*, note 2 at 576-577.

33. *Id.* at 577.

34. *Id.*

35. *Id.*

36. *See generally* Holden and Jones, "Representing Purchasers of Assets from Bankruptcy Estates," 20 *The Colorado Lawyer* 2259 (Nov. 1991).

37. For general discussion of successor liability under CERCLA, *see* Mank, "Should State Corporate Law Define Successor Liability?: The Demise of CERCLA's Federal Common Law," 68 *U.Cin.L.Rev.* 1157 (Summer 2000).

38. For a survey of successor liability standards by jurisdiction, *see generally* Pollak, *supra*, note 25.

39. *See, for example, Kloberdanz, supra*, note 2 at 821 (where asset purchase agreement included exhibit designating liabilities to be assumed by seller, and liability for torts not included on such exhibit, "it follows that [seller] was to retain that liability"). *See also Colorado Springs Rapid Transit Ry. Co., supra*, note 6 ("no allegation or proof" that purchasing company expressly agreed to assume seller's obligations). *See also Florom, supra*, note 2 at 575 ("An unambiguous contract between the seller and purchaser corporations, with explicit provisions which exclude any liability for the debts and liabilities of the predecessor, weighs against [the court's] finding that an exception can be implied.").

40. *See* above discussions, "Exception #2: Merger or Consolidation" and "Exception #3: Purchaser is 'Mere Continuation' of Seller." ■