12
Buying the Assets of Financially Distressed Businesses

Jonathan S. Green
Donald J. Hutchinson

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I. Introduction

§12.1 A financially distressed or failing business presents an opportunity and potential bargain for persons interested in purchasing its assets. With the imminence of creditor foreclosure and other collection activity, the financially distressed business often becomes a highly motivated seller. Even after the troubled business seeks protection under the U.S. Bankruptcy Code, the pressures from creditors to sell the business assets as a going concern or to liquidate in a piecemeal fashion so as to provide for an immediate return to creditors is enormous. However, along with the bargain prices come certain risks. These arise from the likelihood that the seller's creditors will not be paid in full from the proceeds of the sale or that the buyer may unwittingly find itself or its assets liable to the seller's creditors.

This chapter discusses the legal theories that have been used to hold the purchaser of assets from a financially troubled business liable for the claims of seller's known and unknown creditors and how the purchaser can minimize the risks faced in this situation. This chapter is, of necessity, confined to the purchase of *personal* property from a distressed business and the risks associated with that sort of purchase. The risks associated with the purchase of *real* property from a distressed business, the purchase of the distressed business's common stock or other

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equity interests (e.g., potential liability for environmental cleanup costs, which is discussed in chapter 5), and the methods for minimizing those risks are beyond the scope of this chapter. Consequently, in this chapter, *assets* refers to personal property owned by the distressed business unless otherwise specifically noted.

To protect the seller's creditors, state statutes impose restrictions on the terms of any asset sale if the sale is out of the ordinary course of a seller's business or will render the seller insolvent. Many of these provisions are contained in the Uniform Fraudulent Transfer Act. Failure to take into consideration the Uniform Fraudulent Transfer Act may result in the purchaser's liability for seller's debts to its creditors, perhaps in an amount that greatly exceeds the purchased assets' perceived value at the time of the sale and the actual purchase price paid. Moreover, even when terms of the sale do not give rise to liability under the Uniform Fraudulent Transfer Act, if there is a substantial continuity of the seller's original business in the hands of the purchaser, the purchaser may still inherit many of seller's liabilities under the common-law doctrine of successor liability. Although these threats need not necessarily kill a deal from the purchaser's standpoint, they may make it less sweet. Because these issues are not generally at the forefront of the purchaser's mind when negotiating with the seller, you should be sure to counsel clients during the negotiation process on potential issues arising under the Uniform Fraudulent Transfer Act and the common-law doctrine of successor liability. The earlier the parties are aware of these concerns, the more likely it is that the concerns will become negotiated elements of, instead of deterrents to, the deal.

Although the seller's bankruptcy is often thought of as a deal-killer, purchasing assets from a bankruptcy estate offers significantly greater protections to the *successful* bidder. Unfortunately, therein lies the rub: in bankruptcy, the interested purchaser is perhaps more likely to find itself in an auction situation or bidding war with other potential purchasers. However, the winner is almost certain to walk away with better title to its assets and more certain rights with respect to its purchase than could be accomplished in a nonbankruptcy purchase, albeit often at a higher cost and almost always with greater public scrutiny.

With these considerations in mind, if an attorney properly advises the purchaser-client of the pitfalls and deal-killers associated with buying assets from a distressed business, their effects may be mitigated, if not eliminated entirely, and the informed purchaser can intelligently adjust its bid more accurately to reflect these risks.

II. Successor Liability

A. Overview

§12.2 Before purchasing or acquiring an entire company, its assets, or a significant portion of its stock or equity, the purchaser must seriously consider any of the seller's existing or potential liabilities that the purchaser might inherit as a result of the transaction. Existing liabilities may include outstanding debt obligations, tort claims, contractual obligations, liability for environmental cleanup costs, and a whole host of other claims, both liquidated and contingent, known and unknown. Generally, the purchaser attempts to limit its liability by expressly

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outlining, in a written agreement, the debts and obligations it has agreed to assume. Unfortunately, these agreements are not always honored by the courts, and many purchasers find themselves at the mercy of the unforgiving common-law doctrine of "successor liability." Potential successor liability makes a due diligence investigation a matter of prime importance for the purchaser, although, as noted below, even the most diligent investigation cannot uncover every possible claim that might attach to the purchaser under the doctrine of successor liability. See chapter 3 for a discussion of the due diligence investigation.

B. The General Rule of Nonliability for Asset Purchasers

§12.3 When a purchaser acquires a seller's assets, the general rule is that the purchaser is not responsible for any of seller's obligations existing at the time of the purchase. *Stevens v McLouth Steel Prods Corp*, 433 Mich 365, 370–371, 446 NW2d 95 (1989); *Denolf v Frank L Jursik Co*, 54 Mich App 584, 221 NW2d 458 (1974), *aff'd in part and rev'd in part on other grounds,* 395 Mich 661, 238 NW2d 1 (1976). Like most general rules, there are established exceptions. See §§12.4–12.8.

C. Exceptions to the General Rule of Nonliability

1. In General

§12.4 A purchaser will be liable for the seller's obligations that existed before consummation of the sale (1) where there is an express or implied assumption of liability, (2) where the transaction amounts to a consolidation or merger, (3) where the transaction was fraudulent, (4) where some of the elements of a purchase in good faith were lacking, or where the transfer was without consideration and the creditors of the transferor were not provided for, or (5) where the transferee corporation was a mere continuation or reincarnation of the old corporation. *Foster v Cone-Blanchard Mach Co*, 460 Mich 696, 702, 597 NW2d 506 (1999) (citing former 19 Am Jur 2d *Corporations* §1546 at 922–924, now 19 Am Jur 2d *Corporations* §2705 at 515).

2. Express or Implied Assumption

§12.5 Obviously, a purchaser will succeed to the seller's liabilities if it expressly agrees to pay the liabilities. An express agreement to partition existing liabilities between parties buying and selling assets also presents no difficult issues. However, the determination of whether a corporation *impliedly* assumed responsibility for another corporation's debt poses difficult questions.

Even though a purchaser does not *expressly* assume the seller's liabilities, a court may find that the purchaser impliedly assumed the seller's liability to a creditor if (1) the purchaser's conduct toward, or representations made to, the creditor indicated an intention to pay the liability, and (2) the creditor relied on the purchaser's conduct or representations. *See Antiphon, Inc v LEP Transp, Inc*, 183 Mich App 377, 454 NW2d 222 (1990) (where seller and purchaser regularly engaged in conduct such that creditors could reasonably assume that the two were related in some manner, and where purchaser took no affirmative step to quiet these assumptions despite its knowledge that creditors relied on this conduct, purchaser

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impliedly accepted responsibility for debts and was estopped from denying successor liability); *Weldon v Great White North Dist Servs, LLC*, 197 F Supp 2d 893 (ED Mich 2002) (parent corporation could be estopped from denying liability for plaintiff's employment contract with subsidiary when parent purchased subsidiary's assets, continued subsidiary's business, and continued to accept plaintiff's services without explicitly disavowing liability under the employment contract). *See also Conrad v Rofin-Sinar, Inc*, 762 F Supp 167 (ED Mich 1991) (purchaser of assets from employer corporation may be liable for impliedly assuming just-cause employment contract if it continued seller's business with employees and simply announced that employer entity had changed without notifying employees that it disavowed liability on their existing contracts); *Kerns v Dura Mech Components, Inc*, No 95-006678 NZ, 1997 Mich App LEXIS 1888 (Dec 5, 1997) (unpublished), *remanded on other grounds,* 461 Mich 906, 603 NW2d 782 (1999), 242 Mich App 1, 618 NW2d 56 (2000) (in case of oral employment contract, successor corporation should not be held liable for obligations of its predecessor when it was not aware, nor had reason to be aware, of the contract obligations).

3. Mergers or Consolidations

§12.6 Liability follows the assets where there has been a merger or consolidation between the seller and the purchaser. *Jeffrey v Rapid American Corp*, 448 Mich 178, 189, 529 NW2d 644 (1995); *Turner v Bituminous Cas Co*, 397 Mich 406, 420, 244 NW2d 873 (1976). A merger occurs where two or more companies agree to unite in interest but only one of the uniting companies retains its corporate identity. MCL 450.1701. In effect, one company absorbs the capital, franchises, and powers of the others. In contrast, a consolidation creates an entirely new corporate identity that is different from any one of the combined companies. Like a merger, a consolidation also involves the assumption of each individual company's rights, privileges, and property under the authority of law; however, unlike a merger, none of the original companies' corporate identities are preserved.

The rule inherent in either a merger or consolidation is that the surviving or newly created company assumes all the assets and liabilities of the extinguished companies. *Turner,* 397 Mich at 420. Indeed, this concept is so deeply embedded that the surviving corporation's successor liability is codified at MCL 450.1724(1)(a), (d), (e). The obvious rationale is that a corporation that huddles under the umbrella of another corporation has changed in form, not substance.

4. Fraudulent Sales and Sales Without Consideration

§12.7 Under the rubric of *Foster v Cone-Blanchard Mach Co*, 460 Mich 696, 702, 597 NW2d 506 (1999), a purchaser may theoretically succeed to the seller's liabilities if the sale was "fraudulent," if some of the elements of a purchase in good faith were lacking, if the transfer was without consideration and the creditors of the transferor were not provided for, or if the sale is not made in exchange for reasonably equivalent value at a time when the seller was insolvent or left insolvent as a result of the transfer. Under the Uniform Fraudulent Transfer Act, creditors of the seller may disregard fraudulent transfers of this sort and execute on the property transferred as if the transfer had not occurred, or they may have the

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transfer set aside, MCL 566.37, but the act does not impose general liability on the purchaser for the claims of the seller's creditors. (see §12.25, §12.34).

At one time, a purchaser may have succeeded to the seller's liability if the sale was not conducted with fair notice to the seller's creditors under Michigan's former Bulk Transfers Act, but the Bulk Transfers Act has long since been repealed in Michigan.

It is unclear what sort of fraud or lack of good faith apart from the application of the Uniform Fraudulent Transfer Act, if any, would render the purchaser of a corporation's assets liable for the selling corporation's debts.

5. Continuity of Enterprise—From the de Facto Merger to General Principles of Successor Liability

§12.8 Even if a transaction does not amount to a formal or de jure merger or consolidation, the purchaser of the assets of a corporation may be subject to successor liability for the selling corporation's debts. If the sale of a corporation's assets is followed by a substantial continuation of the seller's business after the sale, the courts may find that a "de facto merger" has occurred and impose successor liability on the asset purchaser. The underlying principle for imposing successor liability on a de facto merger is that if, after the sale, the same owners are running the same business under a different name, the surviving new entity should be liable for the old entity's debts.

Traditionally, courts may impose a de facto merger if

1. there is a continuation of the seller corporation, so that there is a continuity of the seller's management, personnel, physical location, assets, and general business operations of the predecessor corporation;
2. there is a continuity of shareholders resulting from the purchasing company paying for the acquired stock with shares of its own stock, this stock ultimately coming to be held by the seller corporation's shareholders so that they become a constituent of the purchasing corporation;
3. the seller corporation ceases its ordinary business operations, liquidates, and dissolves as soon as legally and practically possible; and
4. the purchasing corporation assumes those liabilities and obligations of the seller ordinarily necessary for the uninterrupted continuation of the seller corporation's normal business operations.

Craig v Oakwood Hosp, 471 Mich 67, 97–98, 684 NW2d 296 (2004); *Shannon v Samuel Langston Co*, 379 F Supp 797, 801 (WD Mich 1974). If the purchaser acquires the seller's assets for cash rather than shares of the purchaser, there is not the requisite continuation of the former shareholders in the purchaser's enterprise, and a de facto merger does not arise. *Craig,* 471 Mich at 98.

In *Turner v Bituminous Cas Co*, 397 Mich 406, 420, 244 NW2d 873 (1976), the court went one step further and said that the second element, the continuity of the corporation's owners from the selling corporation to the acquiring corporation, is not necessary to hold the acquiring corporation liable for the selling corpora-

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