

AVOIDING SUCCESSOR LIABILITY IN AN ASSET SALE

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**BUSINESS
FOR
SALE**

TYPES OF TRANSACTIONS

The first question, when approached with a transaction involving the sale of a privately held business, is whether to structure the transaction as a merger, stock sale or asset sale.¹ A merger is governed by NRS Chapter 92A. In a stock sale, a buyer may purchase all of the stock, membership interest or other interest of the seller (depending on the type of entity). In an asset sale, a buyer may purchase all or substantially all of the assets of the seller.²

In a merger, pursuant to NRS 92A.250, the surviving entity assumes all the liabilities of the former entities.³ In a stock or membership sale, only the seller's ownership is transferred. The seller remains the same legal entity that existed prior to the transaction. Accordingly, seller's obligations and liabilities are unaffected by the stock or membership sale, whether such obligations or liabilities arose prior or subsequent to the stock/membership sale (subject to contractually negotiated indemnifications).

On the other hand, in an asset sale, there is a clean break in liability between the seller and the buyer. The general rule is that a successor entity is not liable for the acts of its predecessor, unless the elements of certain exceptions have been met.⁴ This is the reason why most practitioners, especially those representing buyers, prefer an asset sale.

SUCCESSOR LIABILITY

The following are the four exceptions to the general rule that when one company sells all of its assets, the purchaser is not liable for the liabilities of the seller: (i) where the purchaser expressly or impliedly agrees to assume such debts, (ii) where the transaction is really a consolidation or a merger, (iii) when the purchasing corporation is merely a continuation of the selling corporation, and (iv) where the transaction was fraudulently made in order to escape liability for such debts.

Agreement Exception

In order to ensure that the first exception is not triggered, an asset purchase and sale agreement should state clearly which, if any, of the seller's obligations or liabilities the purchaser is

assuming. If there are none, the agreement should so state. To date, the Nevada Supreme Court has not discussed any such issues in great detail. Practitioners should expressly state whether or not any liabilities are to be assumed by the purchaser, and if so, expressly identify each of those liabilities in an attempt to avoid the admissibility of any evidence outside the four corners of the agreement.

De Facto Merger Exception

The de facto merger exception states that the purchaser can be held liable for the seller's liabilities if the parties have essentially achieved a merger although they did not follow the statutory requirements. In order to determine whether there has been a de facto merger, the following four-factor test is considered: (i) whether there is a continuation of the enterprise, (ii) whether there is a continuity of shareholders, (iii) whether the selling company ceased its ordinary business operations, and (iv) whether the purchasing company assumed the seller's obligations. All four factors are to be weighed equally. A de facto merger does not exist when only two of the four factors exist, especially where adequate consideration was provided, thereby negating any argument that the sale was a sham intended to shelter the selling entity.

Continuation of Enterprise

A continuation of the enterprise may exist if there is a continuity of the management, personnel, physical location, assets and general business operations between the purchaser and the seller. In making this determination, the Nevada Supreme Court has looked to whether the purchaser hires most of the seller's employees, whether such employees retain similar positions, whether the same physical locations are utilized, whether letterhead is changed, whether logos are changed and whether a common clientele exists.

Continuity of Shareholders

In determining whether there is a continuity of shareholders, there must be common ownership between the seller and purchaser. Also, a negligible amount of commonality may not arise to continuity of shareholders.

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Cessation of Operations

Whether the seller was maintained as an entity after the consummation of the asset purchase and sale transaction is relevant in deciding whether the seller corporation continued to exist after the sale of the assets. It is unclear whether the seller needs to maintain operations regardless of whether or not its affairs have been wound up. However, if the seller is dissolved despite outstanding liabilities, there is an argument for de facto merger. In practice, a seller would prefer the ability to wind up its affairs and dissolve the entity immediately after the consummation of an asset transaction in order to trigger the commencement of the statute of limitations.

Assumption of Obligations

In determining whether the purchasing entity has assumed the obligations necessary for the normal business operations, the court has looked to what assets were purchased, such as leases, vendor and customer contracts, receivables, phone numbers, computer software, sales and promotional literature, trade rights, licensing agreements and assumed liabilities. Seemingly, unless the parties are clear as to which liabilities will be assumed by the purchaser, if the parties' agreement is silent or some liabilities are assumed by the purchaser, the purchaser may be liable for all of the seller's obligations.

Mere Continuation Exception

A plaintiff must meet the following two requirements to justify bringing a sale of assets within the purview of a mere continuation exception to the general rule: (i) only one company remains after the transfer of assets and (ii) there is an identity of stocks, stockholders and directors between the two corporations.⁵ The mere continuation exception is based upon the continuation of the corporate control and ownership rather than the continuation of business operations. As set forth above, this is largely decided upon whether the shareholders of the selling entity retain a substantial portion of the stock in the purchasing entity.

Fraudulent Transaction

A purchaser may be liable for the obligations of the seller if it is determined that the asset purchase/sale transaction was made in order to escape the liability for such obligations. This exception can arise if the seller's owners accept stock in the purchaser in consideration for the assets, ultimately resulting in the distribution of the seller's assets to its stockholders to the exclusion of its creditors. To avoid this exception, the stock can be issued directly to the seller (as opposed to the seller's owners), thereby keeping the seller solvent for the benefit of its creditors.⁶

AVOIDING SUCCESSOR LIABILITY

The first question when approached with a transaction involving the sale of a business is whether to structure the transaction as a merger, stock sale or asset sale. As set forth above, a purchaser in a merger will be liable for the obligations

of its predecessor subject to negotiated contractual rights such as indemnification. Similarly, in a stock sale, the liabilities of the entity being acquired will remain unaffected. In an asset sale, the general rule is that the purchaser is not liable for the obligations of the seller except in certain circumstances.

In order to avoid an exception to the general rule, the parties should negotiate and enter into an asset purchase and sale agreement that specifically contemplates the exceptions to the general rule. Seemingly most important, if all of the seller's obligations and liabilities are disclosed in the agreement, the parties can decide which, if any, obligations that the buyer is assuming.

The most convoluted exception to the general rule is the de facto merger exception. Generally, an asset sale results in satisfaction of several of the elements of the de facto merger exception. Accordingly, it is extremely important that the asset purchase and sale agreement provide representations and warranties by the seller indicating the current liabilities of the seller. Additionally, a buyer should be indemnified by seller for any liabilities arising prior to accepting the assets. A mutual indemnification is often negotiated, wherein the seller indemnifies for obligations arising pre-closing and the buyer indemnifies for obligations arising post-closing.

Pursuant to the above, many of the arguments for imposing successor liability stem from the seller or the seller's principals accepting stock or interest in the buyer company in consideration for the assets. In the event that this is a material part of the transaction, the applicable case law should be reviewed to ensure that the transaction does not subject the buyer to successor liability. Again, representations and warranties should disclose all liabilities of the seller and the agreement should expressly state any liabilities that the buyer has agreed to assume. If the buyer has not agreed to assume any liabilities of the seller, the agreement should so state. ■

- 1 This article is intended to discuss transactions involving privately held companies. If dealing with a publically held company, securities counsel should be consulted.
- 2 The tax effects of a business purchase/sale transaction are not discussed in this article. Tax advisors should always be consulted in the context of a purchase or sale of a business.
- 3 See also *Lamb v. Leroy Corp.*, 85 Nev. 276, 279, 454 P.2d 24, 26 (1969).
- 4 See *Vill. Builders 96, L.P. v. U.S. Labs., Inc.*, 121 Nev. 261, 112 P.3d 1082 (2005). This case is used throughout this article.
- 5 *Vill. Builders* at 274, 1091. This two-part test maybe expanded to an eight-part test in the context of the Comprehensive Environmental Response, Compensation, and Liability Act or products liability. The court did not indicate whether or not such expanded test would be applied to such CERCLA and products liability cases but left the decision for another day.
- 5 *Lamb* at 279-80, 27.



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