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Getting the Bad with the Good – Successor Liability

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The general axiom in the process of buying and selling a business is that "sellers sell stock, and buyers buy assets." A buyer of a business generally prefers an asset purchase (as opposed to a stock purchase) because in such a transaction the purchaser is generally not held responsible for the liabilities of the seller. However, buyers should be wary of the potential situations where such buyers could be unknowingly taking on certain liabilities of the seller.

Such liabilities may be in the form of contractual obligations to secured and/or unsecured creditors of the predecessor, product liability claims which stem from products sold or manufactured by the predecessor, implied or express warranties associated with goods sold, and even taxes owed by the predecessor to taxing authorities. The theory under which such claims against a successor business are asserted is known as "successor liability". Successor liability can be imposed by a governmental entity or by a private third party when certain exceptions to the general rule that the buyer of assets does not take on liabilities of the seller are met.

Under the governmental entity category, recent amendments to Pennsylvania Statutes that deal with bulk sales have expanded the liability of purchasers. Generally, under Pennsylvania law, a purchaser can be held liable for unpaid taxes (corporate sales tax) and contributions to Pennsylvania's Unemployment Compensation Fund owed by the seller if the purchaser fails to take certain steps. This law has recently been expanded to impose additional liability on purchasers that acquire business-related assets from individuals and companies which owe unpaid sales and use tax and employer withholding taxes to the Commonwealth.

A private third party individual or entity can also hold a successor responsible for the liabilities of the seller where: (1) the purchaser expressly or *impliedly* agrees to assume an obligation; (2) the transaction amounts to a de facto merger; (3) the purchasing successor entity is merely a continuation of the selling corporation; (4) the transaction is fraudulently entered into to escape liability; or (5) the transfer is without adequate consideration and no provisions are made for creditors of the selling corporation.

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Generally, in order to impose liability upon a purchaser as a "successor" to the Seller, a third party individual or entity must demonstrate that certain circumstances exist. These circumstances are commonly referred to as exceptions to the general rule that the seller, in the sale of the assets of his business, retains all the liabilities, which the purchaser does not specifically assume. The two exceptions most likely to arise are the "de facto merger exception" and the "mere continuation exception".

These two exceptions are likely to arise where the enterprise, which is conducted by the purchaser after the transaction, is substantially the same as the business conducted by the seller prior to the transaction. This occurs where there is continuity of ownership, management, personnel and where the seller immediately ceases to exist; (i.e. the seller dissolves its corporate entity). To a large degree, whether or not the exceptions apply is dependent upon the similarity between the two companies after the asset sale.

Unfortunately, the indicia of a de facto merger or a mere continuation quite often mirror the circumstances common to many asset purchases. Often, the logic behind the transaction is to immediately benefit from the goodwill of the seller. Therefore, in many cases it makes sense to retain employees, management and personnel from the seller in order to effectively maintain stability and grow the business. The result is that the company which emerges after the transaction is often very similar to the seller's business, paving the way for successor liability.

So what can a purchaser do in order to avoid imputation of successor liability? Careful transaction structuring and planning is the most effective means of ensuring that these exceptions are not imposed upon your transaction. Additionally, due diligence, careful drafting and proper use of contractual mechanisms such as indemnification provisions can be helpful tools in avoiding the imputation of successor liability.

The moral of the story is that before acquiring an existing business, many factors must be considered over and above the seller's EBITDA ("Earnings Before Interest, Taxes, Depreciation, and Amortization").

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