Client Alert

Business Restructuring & Bankruptcy Department May 2011

Friendly Foreclosures May Not be so Friendly: Beware of Successor Liability in Article 9 Sales

In the recent downturn, insolvency practitioners representing secured creditors with a borrower hopelessly in default have increasingly turned to the use of Article 9 secured party sales, as well as other non-judicial remedies available under the Uniform Commercial Code (UCC) such as an asset surrender commonly known as "friendly foreclosure". Relying on Article 9 remedies is generally viewed as a quicker and less expensive alternative to bankruptcy. This process is best utilized when the borrower agrees to a sale or surrender of the collateral, usually all of its assets, to its senior secured creditor or to a third-party buyer for the benefit of the secured creditor. Done properly under Article 9, such a sale in a commercially reasonable manner typically wipes out all junior security interests and does not require any judicial process.

Concern regarding successor liability has always been a mitigating factor when considering a non-judicial sale rather than a sale through bankruptcy. Successor liability – holding Newco liable for pre-sale debts, despite the fact that the business is now owned by the former secured creditor, or its assignee or purchaser, who lawfully foreclosed on its collateral under the UCC – is of greatest concern when the secured creditor intends to "credit bid" at the UCC sale, acquire the assets, and continue the borrower's business (Newco), sometimes with the participation of existing management. Such successor liability can be asserted by general unsecured creditors as well as pre-sale junior secured creditors whose security interests have been wiped out by the sale.

As a general rule, when one corporation sells or otherwise transfers all its assets to another, the acquiring corporation does not become responsible for the debts and liabilities of the transferor. However, there are four exceptions under which successor liability has been found: (1) Newco's express or implied assumption of the selling corporation's liabilities; (2) the transaction is a *de facto* merger or consolidation of the seller and purchaser; (3) Newco is a mere continuation of the selling corporation; or (4) the transaction is entered into fraudulently in order to escape liability for the selling corporation's obligations.[1] The "*de facto* merger" and "mere continuation" exceptions often arise in the UCC sale context and require careful consideration by a secured party. In *Call Center Technologies, Inc. v. Grand Adventures Tour and Travel Publishing Corp.,*[2] the Second Circuit Court of Appeals recently considered the "mere continuation" exception. It is an important decision for secured creditors to understand.

In *Call Center*, the court of appeals reversed the district court's grant of summary judgment in favor of Newco and directed a trial to determine if there was a mere continuation that rendered Newco liable in favor of the pre-sale creditor asserting successor liability. Thus, the decision is a guide to what the trial court must consider, not a final determination on the merits.

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[1] *Cargo Partner v. Albatrans, Inc.*, 352 F.3d 41 (2nd Cir. 2003)
[2] 2011 WL 832909 (C.A.2 (Conn.)) (March 11, 2011)

The court of appeals held that the proper test for determining successor liability under the mere continuation exception pursuant to Connecticut law is "continuity of enterprise".[3] As explained by the Second Circuit, the inquiry is alarmingly simple: "successor liability attaches where the successor maintains the same business, with the same employees doing the same jobs, under the same supervisors, working conditions, and production processes, and produces the same products for the same customers." The court also clarified that continuity of ownership is not a requirement.[4]

A review of the facts highlighted by the court of appeals is important because those facts are found in many foreclosure sale situations where secured creditors intend to continue the defaulting borrower's business - a legitimate strategy for maximizing the value of the collateral. The court considered the following facts relevant in finding that there were issues that required a trial as to whether there was continuity of enterprise sufficient to support the imposition of successor liability on Newco:

- Some members of senior management of the borrower were working for Newco.
- 31 of 51 of Newco's full-time employees were from the borrower and there was "lack of evidence that any new employees were promptly brought in."
- Newco's operation continued in the same building as the borrower.
- All of the borrower's assets were acquired and some of its liabilities were assumed by Newco.
- Newco was providing some but not all of the same services as the borrower. Notably the core business was the same and there was little or no interruption of services.
- Finally, Newco was created just for the purpose of continuing the borrower's business and acquiring its assets and Newco contributed little if any assets, employees or operations to the business continuation.

While a complete discussion of the balancing of the risks and rewards of an Article 9 sale versus a bankruptcy filing is beyond the scope of this Alert, *Call Center* highlights the risk of successor liability in the Article 9 sale context. A bankruptcy court order provides much stronger protection against most claims of successor liability.

When analyzing whether an Article 9 sale is appropriate, a secured creditor may consider the extent to which it can ameliorate the risks underscored by *Call Center.* First and foremost, can the involvement in Newco of the borrower's management and ownership, as either equity or management of Newco, be eliminated or kept to a bare minimum? In *Call Center*, a key fact that may have swayed the Court was that a former director who became an unpaid consultant to the borrower, along with another consultant to the borrower, subsequently purchased secured debt and acquired the assets as the "secured party". This prior "connection" of the secured party to the borrower may have raised red flags to the Court; however, it is important to note that it was not a part of the Court's holding. Clearly, any connection to and continuation of former officers, directors, senior management in Newco is a risk factor to be considered in the context of an Article 9 sale.

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[3] *Id.* at *4. Successor liability is a state law issue. While most states recognize the four exceptions, not all apply them in the same way. So investigation of the applicable state law is an important factor to be considered when deciding if acceptance or purchase of foreclosure assets is viable.

[4] *Id.*

Call Center also makes clear that any steps the secured party takes, no matter how small, to distinguish Newco from the borrower can be important, *i.e.*, new name, tax identification numbers, bank accounts, leases, etc. The Court's decision also leads to consideration of replacing the borrower's employees. Finally, since assumption of the borrower's liabilities is another factor that was considered in *Call Center*, acquiescing to critical vendors' payment requests on old debt has risk and requires creativity.

Finally, in considering an Article 9 foreclosure that will result in the secured party operating Newco, the secured creditor should realistically assess which of the borrowers' creditor(s), either formerly secured or unsecured, might mount a successor liability challenge. It may be worthwhile to consider dealing with them individually either before the sale or immediately thereafter.

The appellate court's analysis and decision in *Call Center* reinforces the notion that creditors should perform a fact-specific analysis, including potential successor liability claims and the associated costs of defending such claims, and consider applicable state law in determining whether a non-judicial, Article 9 sale is likely to be a cheaper and faster alternative to bankruptcy and its much greater insulation from successor liability claims.

Please feel free to contact either of the attorneys listed below if you would like to discuss this matter.

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