Buyer Beware: Buyer's Assumption Of Seller's Ordinary Liabilities In Asset Purchases

By Alan E. Davis and Jeffrey M. Shapiro

Scenario: *Senior management just left your office after disclosing to you, the general counsel of ABC Inc., that ABC is negotiating to acquire all of the assets of XYZ Inc. ABC anticipates that the purchase of XYZ's assets and facilities will increase substantially ABC's competitiveness and profitability. You were advised that the purchase price was agreed to and that XYZ wants it to be paid in full at closing. Your opinion has been requested regarding ABC's potential liability for XYZ's debts, obligations, etc. after the closing and techniques to minimize ABC's exposure for XYZ's obligations. What do you say?*

Until December 1997, the traditional thinking in New Jersey was that ABC, as the purchaser of XYZ's assets, would not be held responsible for XYZ's ordinary debts and liabilities. The Superior Court of New Jersey, in *Woodrick* v. *Jack J. Burke Real Estate*, Inc., 306 N.J. Super. 61 (App.Div. 1997), *certif. granted.*, 153 N.J. 214 (1998),[1] radically changed the traditional thinking regarding this issue by imposing on a buyer of assets liability for a judgment debt of the seller arising from the seller's breach of duty to one of its clients. Every buyer of assets in transactions governed by New Jersey law must now consider this issue before negotiating the terms of an acquisition.

With the explosion in the number of acquisitions among corporations today, the issue of successor liability in asset purchases is not an academic issue, nor is it an issue limited to products liability, employment or environmental concerns. Rather, it is a central issue which must be confronted head-on by buyers who wish to avoid responsibility for the debts and liabilities of sellers without having clear means of recouping payments made to sellers' creditors. While not expressly addressed in the *Woodrick* decision, its rationale arguably extends to all ordinary debts and obligations of a seller including traditional torts.

A. Background

Typically, buyers want to buy assets and sellers want to sell stock. The rationale for this view is that buyers want fully priced assets which can be depreciated and do not want to assume seller's debts and liabilities. Sellers want to sell stock to minimize their tax liabilities (*i.e.*, capital gain versus ordinary income tax treatment) and to sever their ties to the corporation and its obligations. Implicit in this analysis is that, absent special circumstances where strong public policy has dictated a different result, debts and liabilities usually do not follow assets, only stock.

Traditionally, in an asset purchase transaction a buyer's liability for a seller's debts has existed only where (i) the buyer assumed the liabilities expressly or implicitly, (ii) a de facto merger occurred, (iii) the buyer was merely a continuation of the seller, or (iv) the transfer of the assets was done fraudulently to escape responsibility for liabilities.[2] Customarily though, the purchase of assets in place, as part of a going concern, by a third-party in an arms-length sale for valuable consideration did not invalidate the buyer's liability shield with respect to most debts and liabilities of the seller. Rather, courts respected the separate legal identify of the buyer and the seller in such circumstances.

B. The Erosion Of Traditional Principles

Unfortunately, the distinction between asset and stock purchases with regard to liability assumption has been eroding. In recent years, based on public policy grounds, courts and legislatures have imposed liability on buyers of assets as successors for sellers' products liability, employment discrimination and environmental obligations.[3] The *Woodrick* decision now goes a step further and imposes successor liability on the buyer of assets for an ordinary debt, a breach of duty which resulted in a judgment in excess of $100,000 against a dissolved seller. The *Woodrick* court theorized that the buyer had effectively continued the operations of the seller and should, thus, be treated as its successor for liability purposes.

C. *Woodrick* v. *Jack J. Burke Real Estate, Inc.*

The facts of *Woodrick* are relatively simple. Fox & Lazo, Inc. purchased substantially all of the assets of Jack J. Burke Real Estate, Inc. Lazo paid $250,000 in cash to Burke and forgave $300,000 of debt owed by Burke to Lazo in consideration for substantially all of Burke's assets. Lazo then hired substantially all of Burke's employees, including a principal shareholder of Burke, and assumed continuing obligations of Burke respecting the acquired assets (*e.g.*, lease obligations, etc.). Following the asset sale, Burke used the cash portion of the purchase price to pay certain of its creditors and then dissolved with no remaining assets to be distributed and with unpaid creditors. A judgment creditor of Burke, a disgruntled seller of a home who allegedly suffered harm as a result of Burke's breach of duty as its broker (a claim sounding in contract and tort), claimed that Lazo, as the purchaser of substantially all of the Burke assets, succeeded to Burke's interest and became liable for the judgment debt. The Superior Court of New Jersey, Appellate Division, affirmed the trial court's determination that because Lazo acquired substantially all of the assets in place, employed most of Burke's employees and assumed on-going operating expenses, that the Burke business had been continued and that Lazo became responsible for the judgment debt. The theory relied on by the court was that the transaction amounted to a de facto merger, resulting in the mere continuation of Burke's business. In the court's words, "[t]his transaction resulted in nothing more than a change of hat for Burke, thus constituting a mere continuation of the predecessor's business."[4]

D. Possible Means Of Reducing Buyer Risk[5]

While the *Woodrick* decision marks a turning point in the treatment of buyers of assets in arms-length transactions among third-parties, and may not currently be a majority view, buyers should not assume that its rationale will not be applied to them by other courts. Moreover, it is difficult to predict in what circumstances an asset buyer of a going-concern, in place, will be considered a successor for liability purposes. Thus, buyers should now consider treating asset purchases no differently than stock purchases for purposes of contractually allocating the risk and responsibility of the seller's liabilities. The general counsel in the above scenario might consider the following options in protecting ABC:

1. The buyer should attempt to negotiate for representations by the seller as to the existing debts, obligations, liabilities, litigations, etc. of the seller such that if any unknown claim is asserted, the buyer may have a breach of contract claim against the seller. The strength of a contractual representation is only as strong as the party standing behind it, though. Thus, if the seller is to sell all of its assets and subsequently dissolve, the representation will have minimal value unless the shareholders of the seller join in the representations and warranties and such shareholders have the ability to satisfy a claim.

2. The buyer should attempt to obtain indemnification from the seller as to all claims which relate to any act or omission of the seller. As with contractual representations, the strength of a contractual indemnity is only as strong as the party standing behind it. Thus, if the seller is to sell all of its assets and subsequently dissolve, the indemnity will have minimal value unless the shareholders of the seller join in the indemnity and such shareholders have the ability to satisfy a claim.

3. The buyer should attempt to require that a portion of the purchase price be held in escrow for a period of time to be used to satisfy any debts, liabilities, obligations, etc. of the seller. Two issues which will arise if an escrow arrangement is used are what portion of the purchase price is to be escrowed and for how long is the escrow to exist.

4. If any portion of the consideration is to be paid over time pursuant to a promissory note and/or employment agreement, lease, consulting agreement, non-competition agreement, etc., the buyer should attempt to negotiate and obtain the right to offset against any future payments under any agreement any amount which the buyer is obligated to pay to satisfy any of the seller's debts, liabilities, obligations, etc. This right may also exist at common law, but generally it is advantageous to obtain an express contractual right. It should be noted that issues may arise under state law regarding the right of an employer to offset against salary owed under an employment agreement.

5. If the seller has the means and has any continuing operations after the asset sale, the buyer may attempt to require the seller to obtain a letter of credit in favor of the buyer which the buyer can draw against in the event that it is required to satisfy any obligation of the seller.

6. The buyer should conduct sufficient due diligence of the seller to investigate the seller's business and its obligations.

7. The buyer may attempt to negotiate for the preparation of certified financial statements of the seller to further identify the seller's debts, liabilities, obligations, etc. Such financials may give the buyer additional comfort as to the future claims which may be asserted against the seller.

E. Conclusion

Every acquisition of assets is different and no generalities exist as to the best way to protect a buyer. However, since many acquisitions of assets do not involve the relocation of assets, but rather involve the continuation of an on-going business with new management, but the same employees, the *Woodrick* decision should not be ignored. An acquisition which is welcomed as a means of improving competitiveness and profitability may cause more harm than good if the right risk/responsibility techniques are not used. The expression "buyer beware" has now taken on an additional meaning.

*Alan E. Davis is the chair of, and a Partner, and **Jeffrey M. Shapiro** is an Associate, in the Corporate Department at Greenbaum, Rowe, Smith, Ravin, Davis & Himmel LLP in Woodbridge, New Jersey.*

[1] *It should be noted that the Supreme Court of New Jersey granted the Petition for Certification from the Appellate Division decision. Oral argument is not yet scheduled. Irrespective of the eventual appellate outcome of the Woodrick decision, it signals a readiness by the courts to ignore the traditional distinction between asset and stock purchases respecting successor liability and should put all buyers on notice of the new risks associated with asset purchases.*

[2] *De facto mergers and mere continuation of businesses are commonly analyzed by courts together as one issue.*

[3] See e.g. Ramirez v. Amsted Industries, Inc., *86 N.J. 332 (1981)(products liability claims),* E.E.O.C. v. MacMillan Bloedel Containers, Inc., *503 F.2d 1086 (6th Cir. 1974)(employment discrimination claims) and 42* U.S.C. *9607 (CERCLA) and* Resolution Trust Corporation v. Polmar Realty, Inc. *780 F.Supp. 177 (S.D.N.Y. 1991)(environmental claims).*

[4] Woodrick, *306 N.J. Super. at 77.*

[5] *The below techniques are meant to be illustrative and not exhaustive of the possible ways that a buyer can reduce risk and uncertainty.*

GREENBAUM, ROWE, SMITH, RAVIN, DAVIS & HIMMEL (732) 549-5600