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An Ounce of Prevention: Avoiding Liabilities in Asset Purchase Transactions

Jun 06 2014

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Practice Area: Business and Corporate Law & Mergers and Acquisitions

The General Rule
When buying a business, it can often be in the buyer's best interest to purchase the assets of a business rather than the equity. Conversely, the seller's best interest is often to sell stock/equity or merge with the buyer's entity. From a buyer's viewpoint, asset purchases have the advantage of specifying which assets will be acquired, the price of those assets for tax purposes, and which liabilities will be assumed. The most common reason for structuring a transaction as an asset purchase is to limit the buyer's assumption of the seller's liabilities, which is especially important with contingent or unknown liabilities. As a general rule, courts traditionally have not shifted the liabilities of the seller to the buyer, absent the buyer's expressed assumption or other extenuating circumstances. However, this "tradition" has been eroding for a number of years (most notably in product liability cases), and the trend toward unexpected successor liability continues to grow in a number areas of law. Courts are increasingly writing opinions that provide exceptions to the general rule that liabilities do not follow the assets in an asset purchase situation. Buyers who unexpectedly have seller liabilities thrust upon them often turn to the seller's insurance carrier for coverage with mixed results, and all parties to a transaction are now paying closer attention to the possible shifting of liabilities when negotiating asset purchase agreements.

Exceptions to the Rule
The general rule against shifting liabilities from seller to buyer has four widely recognized exceptions that most jurisdictions have adopted:

1. where the buyer assumes the obligations of the seller, either expressly or implicitly;
2. where the asset purchase can fairly be re-characterized as a de facto merger;
3. where the transaction is such that the buyer is a mere continuation of the seller; or
4. where the asset purchase transaction is fraudulently used to avoid liabilities of the seller.

1. Assumption of Liabilities. The express assumption by the buyer of a seller's liabilities is generally a straightforward proposition. In fact, certain liabilities of the seller are commonly assumed and these assumptions are explicitly included an asset purchase agreement, for example, the completion of a seller's obligations to fulfill existing contracts for servicing or manufacturing. A more troublesome proposition is the implied assumption of a seller's liabilities. However, in many instances this is no surprise to the buyer. The implication generally arises from those activities of the buyer following closing that are consistent with the seller's ordinary and necessary practices for conducting the purchased business.

2. De Facto Merger. A second exception to the general rule against transferring liabilities from seller to buyer is where an asset purchase transaction is deemed to be a de facto merger. The determination is made on a facts and circumstances basis, and courts generally review four factors when inquiring whether a de facto merger has occurred. These factors are: (i) whether there is a "continuation" of the seller, as indicated by continuity of management, location, general operations and/or personnel; (ii) whether there is continuity of ownership equity, which might be indicated by common shareholders or members of the buyer and seller; (iii) whether there is a complete ceasing of the seller's business operations and an entity dissolution within a commercially reasonable time following the close of the asset purchase; and (iv) to what extent the buyer agreed to assume the seller's liabilities as required for continued operation of the seller's former business. Not all courts require each of these factors to be present to find that a de facto merger will be deemed to have occurred.

3. Continuation of Seller. A third exception to the general rule against transferring liability from seller to buyer is where the buyer is found to be a mere continuation of the seller. A continuation of the business can result in the seller's liabilities following the buyer when the buyer is actually a "flush and switch" seller operating under a different name. While common elements between the businesses of buyer and seller do not necessarily stick the buyer with the seller's liabilities, attributes such as substantially identical assets, location, management, employees, equity holders, equipment and clients will be considered as substantive factors that can operate to impose the seller's liabilities onto the buyer.

4. Fraudulent Transfers. A fraudulent transfer determination is usually made by referring to the Uniform Fraudulent Transfer Act. In short, a good indication of fraudulent intent is where assets are transferred for little or no consideration for the benefit of the seller and to the detriment of creditors. The indication of fraud becomes clearer where the same (or related) individuals are the beneficial owners of both the seller and the buyer.

Addressing the Issue

The solution to this entire problem, of course, is to conduct thorough due diligence, careful document drafting, including proper representations, warranties, indemnification and escrow provisions in the agreement itself. A complete understanding of the intention of both parties, the operations of the business holding the assets to be purchased and many other industry-specific factors are critical in consummating an asset purchase without assuming unwanted and unexpected liabilities of the seller. And all transactional documents should be carefully reviewed by the buyer so that any potential problem areas can be addressed and resolved prior to execution. An ounce of prevention is worth a pound of cure.

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