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Imposition of Successor Liability Law Negatively Impacts Free Market Economy

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A company purchasing assets at a foreclosure sale is potentially liable for the debt of the foreclosed-upon company, according to Massachusetts successor liability law. This doctrine permitting the transfer of liability from one company to the next constitutes an exception to the general rule that liabilities do not transfer with the purchase of a company's assets. However, the doctrine has the unintended consequence of changing the decision-making paradigm for all parties associated with an insolvent company.

As described below, no longer can boards of directors, secured creditors, unsecured creditors or would-be purchasers of an insolvent company's assets make decisions guided solely by their fiduciary duties and/or business judgment regarding the value of the insolvent company's assets. Instead, because of successor liability law, duties and judgment must give way to a legal assessment of the potential buyer's business to determine if the purchased assets will be used to *continue the business* of the insolvent company and, thereby, trigger the judge-made rule that transfers the predecessor company's debt to the buyer. In this manner, the imposition of successor liability law ostensibly limits the sale of insolvent companies in the free market and artificially decreases the value of its assets.

Massachusetts Successor Liability Law
It is a settled rule of Massachusetts corporate law that, when one company purchases the assets of another, the purchaser does not acquire the debts and liabilities of the seller. This "no liability" rule spurs on the free market by permitting companies to dispose freely of their assets without encumbrances. The rule, at least in theory, insures that those assets will be allocated to their most efficient use, thus benefiting the economy as a whole.

Massachusetts recognizes three exceptions (called successor liability laws) to this rule: (1) where the asset-purchasing company expressly or impliedly assumes liability of the predecessor; (2) where there exists a "mere continuation" of the asset-selling company; and (3) where the transaction is a fraudulent effort to avoid liabilities of the asset-selling company. Under these exceptions, liability of the foreclosed-upon company can transfer to the purchasing company.

This article focuses on the most common exception called "mere continuation." The factors involved in determining the existence of this successor liability exception are: whether there is a continuation of the enterprise, whether the seller corporation ceases its ordinary business,

and whether the purchasing company selectively assumes obligation of the seller for the uninterrupted continuation of normal business. This exception can lie in absence of any fraudulent conduct. In other words, an "innocent" purchaser of assets of an insolvent company may unwittingly acquire the predecessor company's liabilities.

Insolvent Company

The "mere continuation" exception most frequently arises in the context of insolvent companies. Take, for example, a privately-held technology company teetering on the thin line that separates success from insolvency. While the directors share a strong belief that the company's products simply need more time to develop and grow, recently, the company's revenues declined significantly due to reduced capital spending on technology infrastructure, and investor interest has waned. Cost cutting measures including lay-offs have not produced the anticipated stability. Seeing that the company could not sustain itself, the board of directors sought offers to purchase the company, but received no viable offers. With a lien on its assets pursuant to a single secured creditor, and millions of dollars in unsecured debt, the company's CFO announces that, based upon the revenue projections and cash burn rates, without a new round of financing the company will not make payroll in the next few months, and can no longer pay its monthly obligation to the secured creditor. As result, the company has to make final decisions, and act quickly. This profile is not unlike what many small, privately-held technology companies face in the current economy.

Board of Directors Analysis

Traditionally, when a company reaches the point of insolvency, the company's directors owe fiduciary duties to the company's creditors. By definition, the fact of insolvency places the creditors in the shoes normally occupied by the shareholders - that of residual risk-bearers. The elimination of the shareholders' interest in the corporation and the increased risk to creditors justify imposing fiduciary obligations towards the company's creditors on the directors. This reasoning has given rise to the "trust fund doctrine," *i.e.*, the corporation becomes akin to a trust for the benefit of creditors. The directors become trustees obligated to preserve capital for the benefit of creditors who are deemed to have an equity-like interest in the firm's assets. So as to act in the best interests of the creditors, **the directors must attempt to maximize the economic value of the firm**. The "insolvency exception" gives creditors of an insolvent firm standing to assert that directors breached their fiduciary duties by improperly harming the economic value of the firm, to the detriment of creditors who had legitimate claims on its assets. Therefore, as a matter of law, directors must focus on maximizing value of the insolvent company's assets, or face potential claims against them.

At this critical stage, the board must take into consideration its end-of-life options: bankruptcy, liquidation or a foreclosure sale pursuant to the Uniform Commercial Code ("UCC"). Bankruptcy is often expensive and time consuming, and may have the effect of driving the company's employees and/or customer base away. A liquidation may ultimately have little or no pay-out because most of the value in technology companies lies in its intellectual property, which has value only in the hands of people who know how to use it. Furthermore, selling a company piecemeal guarantees a significantly decreased value compared to selling the company as an on-going concern.

Oftentimes, a foreclosure sale of assets to a company who knows the industry, the specific business, and the technology most effectively maximizes the value of the assets, especially if the insolvent company's products may be sold as-is by the purchasing company. Generally speaking, a purchasing company will pay more for an on-going business, especially when it is already familiar with the products and/or service of the insolvent company. Accordingly, it is not unusual for a company purchasing these assets to hire employees from the insolvent company.

However, herein lies the rub: the closer the asset-purchasing company comes to using the assets to *continue* the business of the insolvent company, even in context of a foreclosure sale, the closer the company comes to acquiring successor liability and independently owing creditors for the insolvent company's debt. Therefore, even though the board's fiduciary duties and the marketplace would otherwise dictate that insolvent companies should

be purchased through a foreclosure sale by those who can use the assets in the continuation of business operations, successor liability law alters that analysis because those are the exact situations that trigger successor liability. Indeed, Massachusetts courts have decided that buying in a foreclosure sale affords the buyer no automatic exemption from successor liability.

Effects On Creditors

Under many circumstances, secured creditors can be the inadvertent victims of successor liability law. For example, a potential buyer in a foreclosure sale may forego a purchase if it fears that the most economically feasible manner to use an insolvent company's assets (by continuing the company's business) would risk incurring successor liability. That's enough to scare off many buyers, lower market demand, and decrease the value of the assets. It is secured creditors who suffer these harms. Effectively, successor liability law promotes piecemeal sale of an insolvent company's assets over the sale of insolvent company as an on-going business. This runs contrary to the basic tenets of UCC foreclosure sales, which were designed to promote the sale of businesses on a going-concern basis in order to maximize the sale price for the benefit of the seller and its creditors.

Instead, successor liability law favors unsecured creditors. Typically, none of the options for an insolvent company as described above (bankruptcy, liquidation or foreclosure sale) permit secured creditors to recover all of their debt, leaving unsecured creditors with little or nothing. While secured creditors have collateral as a measure against this risk, it is said that unsecured creditors have built the risk of non-payment into the transaction itself. Under these circumstances, unsecured creditors have a right to demand that a sale of the debtor's assets will not decrease the amount available to pay creditors. But the imposition of successor liability on a purchaser goes beyond that. It requires that an Article 9 purchaser who continues the seller's business would not merely give an insolvent seller's unsecured creditors what they could have obtained in a bankruptcy or liquidation (which is typically nothing). But rather, it gives the unsecured creditors a windfall by increasing the funds available for collection had no foreclosure sale taken place. Whereas the unsecured creditor would never have had any funds available to it had the insolvent company simply been liquidated, the unsecured creditor in the context of a foreclosure sale would acquire new funds (via successor liability). It is difficult to see any fair basis for giving unsecured creditors this advantage.

A Solution?

Successor liability law embodies the tension between respecting corporate structure and the fair remuneration of corporate creditors. While it is a "judge-made" rule, its effects artificially (and sometimes unfairly) change the marketplace relating to insolvent companies. In Massachusetts, the factors in determining the "mere continuation" theory of successor liability do not include an analysis relating to the existence of fraud. They should. An "innocent" creditor who did not purchase assets in a fraudulent effort to help an insolvent company avoid paying debt should not be treated the same as one who did. Yet, in Massachusetts, the law makes no distinction. Massachusetts courts would go a long way in correcting the unfair impact of successor liability as described above if they included this factor in the "mere continuation" theory.

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