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How to Avoid Successor Liability When Buying a Business

In this article, I explain how to avoid successor liability when buying a business. It's a nasty surprise to discover, after you've paid the purchase price for the business, that you must pay the seller's debts and liabilities from before the closing.

Rule of Thumb: Buyer Assumes Liabilities in a Stock Deal, not an Asset Deal

The structure of the purchase initially determines whether the buyer will assume the liabilities of the seller. As a rule of thumb, the buyer assumes liabilities in a stock deal, but not an asset deal.

- In a stock deal, you buy the stock of the target corporation. The corporation does not change, other than getting you as the new owner. The corporation and all its assets and liabilities remain in place. This means the corporation keeps all liabilities that it had before you purchased it. In sum, you become the shareholder of the target corporation, which keeps its assets and liabilities in place.
- In an asset deal, your shell corporation buys the assets of the target company, and your shell only assume the liabilities and debts that you want. The buyer can pick and choose among the assets and liabilities of the seller. Hence you do not buy the target corporation; instead your shell corporation buys its assets, but leaves unwanted liabilities behind in the target company. After the deal, the seller still owns the target corporation, which keeps its debts and liabilities.

Most deals are structured as asset purchases to avoid the automatic assumption of unwanted debt. You only do a stock deal if you need the target company itself. For example, the target company might have contracts that you can't get assigned over to your shell corporation, or you need its tax ID number.

When Buyers Automatically Assume Liability in an Asset Purchase

The general rule is that, in an asset purchase, the buyer doesn't automatically assume the liabilities of the purchased business. Here are some exceptions to the rule, where the buyer assumes, by operation of law, certain liabilities of the seller.

Doctrine of Successor Liability. The buyer will assume liabilities if the sale was “unfair” to the creditors of the purchased business. The doctrine of successor liability protects creditors in the following scenario: the buyer takes all assets out of the business, but pays an unreasonably small price for the assets. This leaves the creditors with no assets in the business on which to foreclose. In successor liability, you also frequently see the buyer continuing the business without substantial change in its directors, employees, name and location. No one on the outside would even know there was a sale. Add up all of these factors, and it looks like a fraud on the creditors.

Bulk Sales. The CA bulk sales law applies to companies for which the principal business is the sale of inventory, including restaurants. Service businesses, or businesses in which the sale of merchandise is only incidental, are not subject to the bulk sales requirements. If you acquire a business that is subject to the bulk sales law, then you must notify the creditors of the purchased business. Failure to provide the bulk sale notice permits the creditors to sue you for the debts owed by the business. Again, this law protects the creditors of the purchased business.

Taxes. Taxes are a big exception to the general rule that, in an asset purchase, the buyer does not automatically assume the seller’s debts. The buyer corporation (and even you, its shareholder, personally) can be liable, by operation of law, for a number of the target corporation’s tax obligations. Remember that the king writes the law, and the king gets paid his taxes no matter what, even by making the buyer responsible for the seller’s taxes. Here is a list of the primary taxes for which successor liability applies:

- Federal income and social security taxes.
- CA sales taxes, both for the target corporation’s prior sales to customers, and for the sale of assets in the acquisition deal.
- CA payroll taxes including unemployment insurance contributions.

Conclusion: Protect Yourself

How does the buyer protect itself from the liabilities of the seller (in an asset deal)? You, the buyer should perform an extensive due diligence on the purchased business, and demand representations in the purchase agreement for things that might attach liability. Consider getting bulk sale clearances and tax clearances. Lastly, the buyer can leave a portion of the purchase price in escrow, or can pay a portion of the price via promissory note, to ensure that funds are available to cover any undisclosed liability flowing through seller.

Call me if you want to talk more.



Thanks to Dan Kiser for this one.