

**ALERTS**

## Update on Alter Ego and Successor Liability Claims

**November 23, 2015**

An unsecured creditor had “adequately alleged a *de facto* merger” between a corporate defendant and a purported asset acquiror, held the U.S. District Court for the Southern District of New York when refusing to dismiss the defendants’ “alter ego and *de facto* merger claims.” *John Deere Shared Services Inc. v. Success Apparel LLC*, 2015 WL 6656932, at \*5-7 (S.D.N.Y. Oct. 30, 2015) (Furman, J.). According to the court, the corporate defendants’ owner (“G”) could also be personally liable for the entity’s debt because of her “domination and control.” *Id.* Nevertheless, reasoned the court, because the creditor had failed “to plead that it was injured by any of the [selling entity’s] allegedly fraudulent” transfers, the creditor’s fraudulent transfer claims had to be dismissed. *Id.*

### Relevance

Alter ego, successor liability and fraudulent transfer claims are regularly litigated in bankruptcy courts. Most recently, the U.S. Supreme Court, in *Wellness International Network Ltd. v. Sharif*, 135 S. Ct. 1932, 1939 (2015), held, when reversing the Seventh Circuit, that bankruptcy courts could hear a trustee’s state law alter ego claim. In that case, the trustee, on behalf of creditors, alleged that assets purportedly held by the debtor in trust for a third person were, in fact, the debtor’s property. *See also In re Johnson*, 960 F.2d 396, 400-02 (4th Cir. 1992) (bankruptcy court could determine whether property belonged to debtor’s estate under state law); *In re Eufaula Enters.*, 565 F.2d 1157, 1160-62 (10th Cir. 1999) (court found property held by debtor’s alter ego was property of estate).

The unsecured creditor in *Deere* also asserted a successor liability claim against a successor corporation (“A”) in the corporate defendant’s ostensibly routine asset sale. Courts have been wrestling with the application of state law successor liability issues in the bankruptcy context over the past 15 years. *See In re Motors Liquidation Co., f/k/a General Motors Corp.*, 529 B.R. 510, 564-68, 583 (Bankr. S.D.N.Y. 2015) (referring to the “fundamental principle of bankruptcy law that a buyer of assets cannot be required to take on liabilities it doesn’t want”; claimants who were denied adequate notice could file late claims against estate, but court stayed successor liability claims against asset purchaser), *appeal docketed*, No. 15-2844 (bk) (2d Cir. 2015); *In re Trans World Airlines, Inc.*, 322 F.3d 283, 290 (3d Cir. 2003) (discrimination claims by employees of debtor not assertable against acquiror of debtor’s assets because of sale order in “free and clear” sale); *In re Grumman Olson Inds., Inc.*, 467 B.R. 694, 696 (S.D.N.Y. 2012) (bankruptcy court sale order could *not* extinguish claims against asset purchaser based on successor liability).

## Facts

The plaintiff unsecured creditor (“Deere”) had a license agreement with Success. When Success failed to pay royalties under the license agreement, Deere sued it, G and A, the entity that acquired the assets of Success. Under the asset purchase agreement, certain employees of Success would continue working for A, and A would make a cash payment plus “earn-out payments” in connection with the asset sale.

Success had also entered into an agreement with its secured lender (“L”), which held a lien on all of its assets, including those sold to A. L consented to the sale and released its lien in exchange for receiving the purchase price for the assets plus the earn-out payments made by A. According to the complaint, Success made only a few payroll, fringe benefit, travel and entertainment expense payments to G and another employee “for little or no consideration.”

Deere asserted fraudulent transfer claims against Success and A; contract claims against Success and A “on the theory that [A] is liable as Success’s successor”; a fraudulent transfer claim against A; and a contract claim against G “on the theory that she was liable as Success’s alter ego.” 2015 WL 6656932, at \*2. The defendants moved to dismiss the fraudulent transfer, alter ego and successor liability claims.

# Alter Ego

“[A] court may pierce the corporate veil and hold a corporation owner’s liable for its debts when ‘(1) the owner exercised such control that the corporation has become a mere instrumentality of the owner, who is the real actor; (2) the owner used this control to commit a fraud or “other wrong”; and (3) the fraud or wrong results in an unjust loss or injury to the plaintiff.’” *Id.* at \*5, quoting *In re Vebeliunas*, 332 F.3d 85, 91-92 (2d Cir. 2003).

Deere essentially alleged that G had “dominated Success and — through payments to herself or [another insider] that were disguised as corporate expense payments ... siphoned off Success’s assets, rendering the company insolvent and unable to meet its obligations, including the royalty payments due to [Deere] under the License Agreement.” *Id.* According to Deere’s complaint, G not only owned “at least an eighty percent interest in Success while her children owned a minority interest[, but also] failed to observe corporate formalities[,] co-mingled personal and corporate funds[,] personally guaranteed Success’s debt to [L ] [and] was the only employee of Success when she fraudulently transferred to herself ... corporate assets in the form of expense payments ... ; and the transfer [to G] made Success unable to meet its financial obligations to [Deere].” *Id.* If true, reasoned the court, these allegations “are sufficient to plausibly allege that [G] exercised domination and control over Success to commit a wrong that injured Deere.”

## Successor Liability

New York law insulates the buyer of a corporation’s assets from the seller’s liabilities. *Cargo Parker AG v. Albatrans, Inc.*, 352 F.3d 41, 45 (2d Cir. 2003). But the so-called “*de facto* merger doctrine ... provides an exception to that rule.” *Id.* When a purported asset sale “is in substance ‘a consolidation or merger of seller and purchaser,’” courts will treat it as a *de facto* merger. 2015 WL 6656932, at \*6, quoting *Schumacher v. Richards Shear Co.*, 59 N.Y. 2d 239, 245 (1983). Moreover, “continuity of ownership is a necessary precondition to finding a *de facto* merger.” *Id.*

As the acquiror of Success’s assets, A was allegedly “subject to successor liability because the [purported asset transfer] was not an asset purchase, ... but a *de facto* merger.” *Id.* Deere sufficiently alleged a *de facto* merger, found the court. “Success conveyed all or substantially

all of its corporate assets to [A] ... ; ... [A] took over and continued the business operations of Success ... ; [A] and [Success] share the same vendors and customers, as well as the same management and personnel ... ; [and] after the *de facto* merger, 'Success promptly ceased operations' and fired all staff save for [G] and [one other employee]." *Id.* On these alleged facts, the court held that Deere's "allegations are sufficient to survive" the defendants' motion to dismiss.

## Fraudulent Transfer Claim

The court granted the defendants' motion to dismiss Deere's fraudulent transfer claim because of its failure to show any prejudice to itself as a result of the *de facto* merger. According to the court, "for an *unsecured* creditor to make out a fraudulent [transfer] claim, the creditor 'must first plead ... that ... some portion of the debtor's assets would have been available to satisfy the unsecured creditor's claims had there been no conveyance.'" *Id.* at \*4, quoting *Chemtex, LLC v. St. Anthony Enters., Inc.*, 490 F. Supp. 2d 536, 542 (S.D.N.Y. 2007). *See also Lippe v. Bairnco Corp.*, 99 F. App'x 274, 281 (2d Cir. 2004) (liability requires "some prejudice to a creditor of ... transferor"); *HBE Leasing Corp. v. Frank*, 48 F.3d 623, 640 n.10 (2d Cir. 1995) (no liability unless transfer "prejudices ... complaining creditor").

Deere failed, reasoned the court, "to allege that Success's assets exceeded the value of its secured debt to [L]." Also, Deere failed "to explain how [L's] taking a new lien on some of the assets sold to [A] says anything, one way or another, about the remaining amount of Success's [secured] debt ... as compared to the overall, true value of Success's assets." Moreover, Deere's argument about future non-payment "is simply too conjectural and remote to satisfy the injury requirement." *Id.* Finally, "if the value of Success's assets were less than, or equal to, its debt to [L], then it would not matter what consideration Success received from [A]; whether it was adequate or not, the assets would not have been available to satisfy the unsecured debt to" Deere. In short, Deere failed "to allege that Success's assets exceeded the value of its secured debt to [L]." *Id.* at \*4.

## Comments

Transferees in bankruptcy cases have avoided successor liability claims by relying on Bankruptcy Code ("Code") Section 363(f), which permits a

trustee to sell a debtor's assets "free and clear of any interest," including the debtor's pre-existing liabilities. *See, e.g., In re Trans World Airlines, Inc.*, 322 F.3d 283, 292-93 (3d Cir. 2003) (without protection given by Code Section 363(f), buyer might "have offered a discounted bid" for debtor's assets, resulting in plaintiffs' receiving greater distributions than other creditors, contrary to the "Code's priority scheme"); *In re Chrysler LLC*, 576 F.3d 108, 126 (2d Cir. 2009) (Code "§363(f) permitted the bankruptcy court to authorize the Sale free and clear of appellants' interest in the [debtor's] property"); *judgment vacated and appeal dismissed as moot*, 558 U.S. 1087 (2009); *In re Ormet Corp.*, 2014 WL 3542133, at \*4 (Bankr. D. Del. July 17, 2014) ("[T]he Congressional policy favoring multi-employer pension plans in ERISA and MPPAA does not trump the express provisions of the ... Code permitting the sale of the Debtor's assets free and clear of the Trust's liability claim.").

A persuasive fact pattern, though, can convince a court to override Code Section 363. *See, e.g., Grumman Olson Inds.*, 467 B.R. at 708 ("Enforcing the Sale Order against the [claimants] to take away their right to seek redress under a state law theory of successor liability when they did not have notice or an opportunity to appear ... would deprive them of due process."), citing *Schwinn Cycling and Fitness Inc. v. Benonis*, 217 B.R. 790, 797 (N.D. Ill. 1997); *In re Johns-Manville Corp.*, 600 F.3d 135, 153-54, 158 (2d Cir. 2010) (party who does not receive adequate notice cannot be bound by bankruptcy court order); *In re Savage Inds., Inc.*, 43 F.3d 714, 720, 722-23 (1st Cir. 1994) (rejecting argument that enforcing "free and clear" provision of asset purchase agreement and sale order would "chill" Chapter 11 asset bidding"); *Zerand-Bernal Group, Inc. v. Cox*, 23 F.3d 159, 163 (7th Cir. 1994) ("[N]o one believes ... that ... a bankruptcy court enjoys a blanket power to enjoin all future lawsuits against a buyer at a bankruptcy sale in order to maximize the sale price [or] that it could ... extinguish the rights of ... future tort claimants, without notice to them or (as notice might well be infeasible) any consideration of their interests.").

*Authored by Michael L. Cook.*

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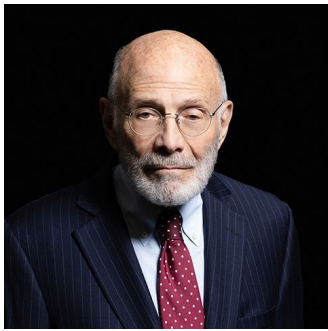
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