LJN LAW JOURNAL NEWSLETTERS

The Bankruptcy Strategist®

An ALM Publication

Volume 28, Number 8 • June 2011

Buyer Beware

Purchasers of Assets in UCC Article 9 Foreclosure Sale May Be Subject to Claims of Debtor's Unsecured Creditors

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Secured lenders often consider an out-of-court foreclosure as a faster and more efficient alternative to a credit bid sale under Chapter 11. The Second Circuit Court of Appeals has thrown a monkey wrench into the foreclosure alternative, especially for those secured lenders that foreclose on collateral with the goal of preserving value by operating the business until a strategic buyer can be located. The court held that a secured creditor that purchases a debtor's assets in an out-of-court foreclosure sale under the Uniform Commercial Code ("UCC") and continues to operate the debtor's business may be liable for the debtor's debts. *Call Center Technologies, Inc. v. Grand Adventures Tour & Travel Publishing Corporation, Interline Travel & Tour, Inc.*, Docket No. 09-1224 (2d Cir. Mar. 11, 2011) ("*Interline*"). The Second Circuit reversed the lower court's grant of summary judgment in favor of the foreclosing lender because the issue of successor liability is fact-specific and the lower court erred by granting judgment as a matter of law. *Id*. at 1. A foreclosure conducted in accordance with the UCC will not automatically insulate the purchaser, as a matter of law, from a state law successor liability claim, even though under Section 9-617 of the UCC, a sale of collateral after default discharges the security interest of the foreclosing creditor and "any subordinate security interest or other subordinate lien." UCC Section 9-617(a)(3). This decision means that a potential asset purchaser in an out-of-court foreclosure sale (whether it be the secured creditor through a credit bid or other independent party) must consider whether an unsecured creditor may seek to collect unpaid liabilities of the debtor from the purchaser, on the grounds that "the purchaser is a 'mere continuation' of the seller."

Successor Liability Doctrine Generally

The general rule is that a purchaser of assets does not assume the seller's liabilities. *Interline* at 7. Courts have established exceptions to this general rule. Generally, "a corporation which purchases all the assets of another company does not become liable for the debts and liabilities of its predecessor unless (1) the purchase agreement expressly or impliedly so provides; (2) there was a merger or consolidation of the two firms; (3) the purchaser is a 'mere continuation' of the seller; or (4) the transaction was entered into fraudulently for the purpose of escaping liability." *Interline* at 7. The court in *Interline*, applying Connecticut law, determined that the third exception — the "mere continuation" prong — was in question. Under Connecticut law, courts consider two theories to determine whether a purchaser is a "mere continuation" of the seller: "continuity of ownership" and "continuity of enterprise."

- Under the "continuity of ownership" theory, courts evaluate whether there is an identity "of stock, stockholders and directors between" the buyer and seller. *See Chamlink Corp. v. Meritt Extruder Corp.*, 899 A.2d 90 (Conn. App. Ct. 2006).
- Under the "continuity of enterprise" theory, courts evaluate whether the "'successor maintains the same business, with the same employees doing the same jobs, under the same supervisors, working conditions, and production processes, and produces the same products for the same customers.'" *Interline* at 9 (citing *Kendall v. Amster*, 948 F.2d 1041, 1051 (Conn. App. Ct. 2008)).

UCC Section 9-617

The purchaser of assets in a UCC foreclosure sale "takes all of the debtor's 'rights' in the collateral, and the sale discharges the security interest under which the sale is made and any subordinate liens." Clark on UCC ¶ 4.09[c], citing Section 9-617. The UCC § 9-617(a) provides that "[a] secured party's disposition of collateral after default … discharges any subordinate security interest or other subordinate lien other than liens created under any law of this state that are not to be discharged." Public policy supports this result: "[b]y providing the transferee with immunity from the foregoing title claims, it is hoped that the disposition will attract additional prospective transferees and result in higher prices. In this manner the statute benefits not only the transferee but also the foreclosing creditor and the debtor." Timothy Zinnecker, "The Default Provisions of Revised Article 9 of the Uniform Commercial Code: Part II," 54 *Bus. Law.* 1737, 1750 (1999).

Interline Facts

In June 1998, Call Center Technologies, Inc., an unsecured creditor ("Call Center"), sold a refurbished telecommunications systems to Grand Adventures Tour & Travel Publishing Corporation ("GATT"), the debtor, for $130,090. Two consultants of GATT — Duane Boyd and Lawrence Fleischman — also made loans to the company, and GATT granted a

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security interest in its assets to the consultants to secure the loans.

Aside from a $35,000 deposit on the telecommunications system from Call Center, GATT made no payments to Call Center. In April 2001, GATT had financial difficulties, which escalated after the September 2001 terrorist attacks. Boyd and Fleischman resigned as consultants, notified GATT of defaults on their loans and assigned the loans and security interests to Interline Travel & Tour, Inc., a corporation they formed ("Newco"). After sending notices to GATT's secured creditors and GATT of a public foreclosure sale and publishing notice in a local newspaper, Newco held the public foreclosure sale on Oct. 30, 2001. Newco purchased the assets in the foreclosure sale.

Call Center sued GATT for balances owed, and added Newco as a defendant. Call Center alleged that Newco was a successor in interest to GATT, and asserted a successor liability claim against Newco. The latter moved for summary judgment to dismiss the successor liability claim. The district court granted Newco's motion and Call Center appealed.

The Second Circuit vacated the grant of summary judgment and the holding by the district court that Newco was not a mere continuation of GATT, because in the court's view, the issue of whether a "continuity of enterprise" existed between GATT and Newco involved disputed issues of fact that could not be resolved by summary judgment. The Second Circuit proceeded to compare the management, employees, physical location, assets, liabilities and services provided by Newco with those of GATT. Although there were significant differences, in the view of the Second Circuit, sufficient commonality existed to warrant further examination by the lower court of all the facts. For example, although the management of Newco consisted of Boyd and Fleischman, who were merely consultants at one time to GATT, the court noted that they "were not strangers to GATT." *Interline* at 9. Of Newco's employees, 31 of 51 were former GATT employees. The Second Circuit remanded the case back to the district court for a trial on the merits.

Analysis

Mere Continuation Theory

The Second Circuit in *Interline* did not expressly hold that a foreclosing lender is liable under Connecticut law as a successor under the "continuity of enterprise" theory. The court was clearly disturbed that the trial court resolved the matter without a trial and on a summary basis. It is worth noting that the Second Circuit (in a footnote) indicated that that the "facts of [*Interlink*] bear a strong resemblance to those in *Chamlink*, where the Appellate Court of Connecticut upheld a finding of non-liability." *Interlink* at 12 n.3 The court distinguished *Chamlink* on procedural grounds because that case "involved review of the factual findings following trial." *Id*.

Foreclosure Does Not Bar Successor Liability Claims

The Second Circuit in *Interline* did not directly address whether a foreclosure sale conducted in accordance with the UCC should preempt any successor liability claims. Other courts, however, have addressed this issue. In *Ed Peters Jewelry Co., Inc. v. C & J Jewelry Co., Inc.*, 124 F.3d 252 (1st Cir. 1997), the court held that "an intervening foreclosure sale affords an acquiring corporation *no automatic exemption from successor liability.*" *Id.* at 267 (emphasis added). The court explained that a foreclosure process, by its very nature, could not preempt a successor liability inquiry because "[w]hereas liens relate to assets (viz., collateral), the indebtedness underlying the lien appertains to a person or legal entity (viz., the debtor)." *Id*. The successor liability doctrine is founded on equity, and UCC Section 1-103 provides that unless expressly preempted, general principles of equity shall supplement the provisions of the UCC. *Id*. at 268.

New York Cases

Few New York cases have dealt with this subject, though federal courts have considered what they think New York law would be. In one case, a federal district court held that it was "not persuaded that … the loan, security and statutory foreclosure process under the New York Uniform Commercial Code automatically preclude[d] the imposition of successor liability on Defendants." *Perceptron, Inc. v. Silicon Video, Inc. and Panavision Imaging, Inc.*, 2010 WL 3463098 at 6 (N.D.N.Y. Aug. 27, 2010); *see also Miller v. Forge Mench Partnership Ltd.*, 2005 WL 267551 at 12, 55 UCC Rep. Serv.2d 1022, 1027 (S.D.N.Y. Feb. 2, 2005)).

Practical Implications and Suggestions

The Second Circuit's decision in *Interline* and the other similar cases hold that a purchaser in a foreclosure sale may get more than what it bargained for. Even if the sale satisfies all UCC requirements and cuts off all subordinate liens, unpaid unsecured creditors may sue the purchaser and assert that the purchaser is liable for obligations owed by the debtor based on a successor liability theory. To the extent that the threshold for granting a motion by the purchaser for summary judgment is high, the purchaser faces the prospect of becoming embroiled in litigation. This decreases the attractiveness of an out-of-court foreclosure sale when the secured creditor seeks to sell the debtor's business as a going concern, and increases the attractiveness of a bankruptcy sale. The Bankruptcy Code generally permits a bankruptcy court to authorize a sale of assets free and clear of successor liability claims. *See* 11 U.S.C. § 363(f). *See, e.g., In re Chrysler LLC*, 576 F.3d 108, 119 (2d Cir. 2009), vacated as moot sub nom.; *Ind. State Police Pension Trust v. Chrysler LLC*, 129 S. Ct. 2275 (2009), appeal dismissed as moot; *In re Chrysler LLC*, 592 F.3d 370 (2d Cir. 2010) (holding that § 363(f) of the Bankruptcy Code permitted the bankruptcy court to authorize the sale of assets free and clear of successor liability claims); *In re Motors Liquidation Co.*, 428 B.R. 43 (S.D.N.Y. 2010) (same). This is clearly not a result that furthers the goals of the foreclosure provisions of Article 9 of the UCC: attracting prospective purchasers and obtaining a higher purchase price in foreclosure sales.

A foreclosing secured creditor should take steps to avoid a finding that the acquisition vehicle is a "mere continuation" of the debtor. Assuming the secured creditor wishes to sell the debtor as a going concern, any acquirer (other than a strategic buyer already in the business) will probably retain the same employees, operate the same business and provide goods and services to the same customers. Thus, the buyer should change the composition of the board and members of senior management, and to the extent possible contribute some additional assets to the acquisition vehicle and the target market of the business. The case also provides another reason for a lender to avoid participation in a debtor's business (in addition to the ordinary lender liability concerns); the Interline court focused on this in finding that "Boyd and Fleischman were not strangers to GATT." *Id*. at 9. In short, buyer beware.

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