Private Foreclosure Sales: Successor Liability Risks For Buyers—Mere Continuation Theory

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ABSTRACT

Successor liability is a common law doctrine invoked by courts to protect creditors from having a debtor’s assets put beyond their reach through manipulation of corporate forms. Successor liability may also ensnare a buyer (including a credit bidding secured creditor) in an out-of-court foreclosure sale. Secured creditors often consider an out-of-court foreclosure as a faster and more cost-efficient alternative to a sale (and possible credit bid acquisition) under chapter 11 of the

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Bankruptcy Code (the “Code”). By avoiding the length, cost and uncertainty associated with a bankruptcy case, a foreclosure sale may decrease the risk of collateral value impairment. The specter of successor liability may, however, undermine those benefits and defeat the goal of the Uniform Commercial Code (“UCC”) of promoting foreclosure sales as a means of obtaining maximum value. In this article, we address the risk of successor liability for buyers at a foreclosure sale under the so-called “mere continuation” doctrine. This risk is a serious concern in those jurisdictions that do not impose a requirement that there be a “continuity of ownership” between the buyer at a foreclosure sale and the borrower.

We highlight two recent cases to illustrate the application of the mere continuation theory of successor liability: (i) Call Center Technologies, Inc. v. Grand Adventures Tour & Travel Pub. Corp., 635 F.3d 48 (2d Cir. 2011) (“Interline”) and (ii) In re Acme Sec., Inc., 484 B.R. 475 (Bankr. N.D. Ga. 2012) (“Acme”).

BACKGROUND

Article 9 Foreclosure Generally: Release of Liens

A foreclosure sale by a secured creditor of personal property is governed by Article 9 of the UCC. In the event of a default by the borrower, a secured creditor has the right to (i) obtain possession of the collateral securing the borrower’s obligation and (ii) dispose of the collateral to satisfy the obligation. All aspects of the disposition must be commercially reasonable, including its “method, manner, time

1U.C.C. § 9-601(a)(1).
2U.C.C. § 9-609(b)(1) (with judicial process); UCC § 9-609(b)(2) (without judicial process if there is not breach of the peace).
3U.C.C. § 9-609(a)(1) (Upon a default, a secured party “may reduce a claim to judgment, foreclose, or otherwise enforce the claim [or] security interest . . . by any available judicial procedure.”), § 9-610(a) (“After default, a secured party may dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing.”), § 9-615(governing application of proceeds from disposition of collateral under Section 9-610).
and place.” Specifically, UCC 9-610 provides that “[a]fter default, a secured party may sell, lease, license or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing.” Upon disposition of collateral in a foreclosure sale, UCC 9-617 provides for the automatic discharge of the foreclosing lender’s lien on the collateral subject to the foreclosure sale in addition to any “subordinate security interest or other subordinate lien other than liens created under [state law that are not to be discharged].” In other words, the buyer at 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.” 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.”

State law has long recognized secured lenders’ right to credit bid for collateral at non-judicial foreclosure sales. Indeed, given that the proceeds of a foreclosure sale are applied to the debt owed to

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*U.C.C. §§ 9-601(a)(1), 9-610(b) (“Every aspect of a disposition of collateral . . . must be commercially reasonable.”).

*U.C.C. § 9-617.


*See Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 594–95, 55 S. Ct. 854, 79 L. Ed. 1593, 97 A.L.R. 1106 (1935) (holding that statute violated Takings Clause because, *inter alia*, it effectuated the taking of secured creditor’s right to bid at sale of collateral); Small Business Loan Source, Inc. v. F/V ST. MARY II, 361 F. Supp. 2d 570, 572, 2005 A.M.C. 1792 (E.D. La. 2005) (recognizing that credit bids qualify as required receipt and pay over of money for purposes of determining commission to which U.S. Marshals are entitled for selling seized property under 28 U.S.C. § 1921); In re Finova Capital Corp., 356 B.R. 609, 624–25, 61 U.C.C. Rep. Serv. 2d 413 (Bankr. D. Del. 2006) (“Although [UCC] section 9-504 falls short of granting secured creditors a right to credit bid, it does grant them a right to ‘buy’ without limiting the form of acceptable payment. Given that the statute allows secured creditors to buy and neither the statute nor the [relevant agreement] prohibit credit bidding, it would be overly-formalistic to prohibit credit bidding in this situation.”).
the secured lender, “it would be useless to require [the secured lender] to tender cash which would only be returned to him.”

Successor Liability Generally

The general rule regarding successor liability is that a purchaser of the principal assets of the seller does not assume the seller’s liabilities. Recognizing, however, that “a rigid nonassumption rule can be bent to evade valid claims,” a majority of states have established exceptions to the general rule in order to safeguard the seller’s creditors. Successor liability is governed by state law. To resolve conflict-of-law questions that may arise in the successor liability context, courts generally apply the so-called “interests analysis.” The “interests analysis” is a “flexible approach

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9 Cornelison v. Kornbluth, 15 Cal. 3d 590, 607, 125 Cal. Rptr. 557, 542 P.2d 981 (1975). See also In re Finova Capital Corp., 356 B.R. at 625 (“As the proceeds of a sale under [UCC] section 9-504 are used to pay the debt owed to the secured creditor, it is ultimately inconsequential whether a secured creditor pays with cash or with the reduction of debt. The end result is the same.”).

10 See e.g., Golden State Bottling Co., Inc. v. N.L.R.B., 414 U.S. 168, 182 n.5, 94 S. Ct. 414, 38 L. Ed. 2d 388, 84 L.R.R.M. (BNA) 2839, 72 Lab. Cas. (CCH) P 14124 (1973) (“We recognize that . . . the general rule of corporate liability is that, when a corporation sells all of its assets to another, the latter is not responsible for the seller’s debts or liabilities . . .”); Ed Peters Jewelry Co., Inc. v. C & J Jewelry Co., Inc., 124 F.3d 252, 266, 47 Fed. R. Evid. Serv. 997, 33 U.C.C. Rep. Serv. 2d 664 (1st Cir. 1997) (“Under the common law, of course, a corporation normally may acquire another corporation’s assets without becoming liable for the divesting corporation’s debts.”); B.F. Goodrich v. Betkoski, 99 F.3d 505, 519, 43 Envtl. Rep. Cas. (BNA) 1481, 45 Fed. R. Evid. Serv. 1303, 36 Fed. R. Serv. 3d 500, 27 Envtl. L. Rep. 20329 (2d Cir. 1996), decision clarified on denial of reh’g, 112 F.3d 88 (2d Cir. 1997) (“The traditional common law rule states that a corporation acquiring the assets of another corporation only takes on its liabilities if [an exception applies].”). “As a general rule, when one company transfers all of its assets to another company, the transferee company is not responsible for the liabilities of the transferor. That’s black-letter law.” Clark on UCC, ¶ 4.09[c].

11 Ed Peters Jewelry Co., Inc., 124 F.3d at 266.

12 See e.g., Cargo Partner AG v. Albatrans, Inc., 352 F.3d 41, 44 (2d Cir. 2003) (“It is undisputed that New York law applies to this case [concerning successor liability].”).

intended to give controlling effect to the law of the jurisdiction which, because of its relationship or contact with the occurrence or the parties, has the greatest concern with the specific issue raised in the litigation. Applying the interest analysis to successor liability claims, New York courts, for example, enforce the law of the state in which the defendant was formed, unless it is the same as New York law.

While state law on successor liability differs from jurisdiction to jurisdiction, a buyer at a foreclosure sale (which may include the secured creditor if it acquires the collateral by credit bidding its secured claim) will generally be held liable for the seller’s liabilities under the doctrine of successor liability in four circumstances:

1. the purchase agreement expressly or impliedly provides for the buyer’s assumption of the seller’s debts;
2. there was a merger or consolidation of the buyer and seller;
3. the buyer is a “mere continuation “of the seller; or
4. the transaction was consummated fraudulently for the purpose of escaping seller’s liabilities.

“Mere Continuation” Exception
A plaintiff seeking to impose successor liability on the

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14 *Planet Payment* at 6.

15 *Planet Payment* at 7 (finding Georgia, as defendant’s state of incorporation had greatest interest because defendant was both incorporated and headquartered in Georgia); See also Soviet Pan Am Travel Effort v. Travel Committee, Inc., 756 F. Supp. 126, 131 (S.D. N.Y. 1991) (“[Q]uestions of corporate liability for the acts of others . . . are of greater interest to . . . the state of incorporation and residence of the defendants.”).

foreclosure sale buyer, in the absence of fraud, is most likely
to invoke the third exception above, or the so-called “mere
continuation” theory. The ‘mere continuation’ exception is
typically applied to transactions in which a single entity is
taking on a new corporate form in the guise of an asset
purchase. In these asset purchases, the purchasing corpora-
tion is effectively the same company as the selling corpora-
tion, as many of the same executives of the organization are
on both sides of the transaction. Therefore, to apply the
“mere continuation” exception, courts typically examine
whether there is: (i) continuity of ownership and (ii) continu-
of enterprise.

To determine continuity of ownership, courts generally
focus on whether the successor entity is “merely a ‘new hat’
for the seller.” Courts thus evaluate whether there is an
identity “of stock, stockholders and directors between” the
buyer and seller.

To determine “continuity of enterprise,” courts generally

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evaluate whether the successor continues the business of the predecessor. Courts thus analyze 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.’”

Courts also consider whether the predecessor ceased its business operations and whether the successor assumed those liabilities “ordinarily necessary for the uninterrupted continuation of normal business operations of the seller corporation.”

Courts, however, are not uniform in whether the mere continuation theory requires both continuity of enterprise and continuity of ownership. Most jurisdictions have refused to adopt a rule that imposes successor liability where a plaintiff establishes solely continuity of enterprise. The majority view requires a plaintiff to demonstrate continuity of ownership between buyer and seller. For example, in *Welco Indus., Inc. v. Applied Cos.*, the Supreme Court of Ohio refused to impose successor liability on a buyer where the buyer and seller did not have continuity of ownership, but did maintain the seller’s physical plant, officers, employees and product lines. A few jurisdictions impose successor liability when a plaintiff can establish continuity of enterprise

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22 See e.g., Foster, 460 Mich. at 703.

23 See Winsor v. Glasswerks PHX, L.L.C., 204 Ariz. 303, 63 P.3d 1040, 1045, Prod. Liab. Rep. (CCH) P 16514 (Ct. App. Div. 1 2003) (finding that a substantial majority of jurisdictions have refused to adopt the continuity of enterprise exception in the products liability setting). Winsor noted that cases applying the laws of the following jurisdictions expressly rejected the continuity of enterprise exception: Arkansas, Colorado, Florida, Georgia, Illinois, Iowa, Kentucky, Maryland, Massachusetts, Minnesota, Missouri, Nebraska, North Carolina, North Dakota, Ohio, Oklahoma, South Dakota, Texas, Vermont, Virginia, West Virginia, Wisconsin, District of Columbia.

24 See *Welco*, 67 Ohio St. 3d at 350. See also *Graham v. James*, 144 F.3d at 240 (requiring plaintiff to demonstrate existence of single corporation after the transfer of assets, with an identity of stock, stockholders and directors between the successor and predecessor corporations) (internal quotations and citations omitted); Societe Anonyme Dauphitex v.
even without continuity of ownership. For example, in Medina v. Unlimited Systems, LLC, the District of Connecticut held that a buyer was liable under a theory of successor liability because the successor entity continued the predecessor’s enterprise, maintaining the same “management, personnel, physical location and general business operations.” The Medina court held that Connecticut law did not require the plaintiff to demonstrate a continuity of ownership between the buyer and seller in order to enforce a judgment resulting from the predecessor’s failure to pay wages.

**CASE LAW APPLICATION OF MERE CONTINUATION THEORY**

**Interline**

The Second Circuit Court of Appeals (applying Connecticut law) held that a secured creditor who purchases a debtor’s assets in an out-of-court foreclosure sale under the UCC and continues to operate the debtor’s business may be liable

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Schoenfelder Corp., 2007 WL 3253592, *5–6* (S.D. N.Y. 2007) (requiring continuity of ownership and continuity of enterprise); Harris v. T.I., Inc., 243 Va. 63, 413 S.E.2d 605, 609 (1992) (Refusing to impose successor liability in absence of continuity of ownership even though successor “acquired all of its predecessor’s assets, including the goodwill; undertook essentially the same manufacturing operation as that of its predecessor and at the same location; held itself out to the world as the ongoing concern of its predecessor; maintained, for a time, essentially the same personnel; made an active effort to maintain the same customers; required its predecessor to cease its ordinary business operation and to liquidate its business as soon as practicable; and assumed some of its predecessor’s liabilities.”); Magnolia’s at Bethany, LLC v. Artesian Consulting Engineers, Inc., 2011 WL 4826106, *3* (Del. Super. Ct. 2011) (holding that the primary elements of continuation “include the common identity of the officers, directors, or stockholders of the predecessor and successor corporations, and the existence of only one corporation at the completion of the transfer.”).

The Second Circuit reversed the lower court’s grant of summary judgment in favor of the foreclosing lender, finding that successor liability is a fact-specific inquiry and that the lower court erred by granting judgment as a matter of law.  

1. FACTS

In June 1998, seller (“Creditor”) sold a refurbished telecommunications systems to the debtor (the “Debtor”) in exchange for a $130,090 promissory note (the “Note”). Two consultants of the Debtor (the “Insiders”) also made loans to the Debtor, secured by liens on the Debtor’s assets.

Aside from a $35,000 deposit on the telecommunications system, the Debtor made no payments to Creditor on the Note. In April 2001, the Debtor had financial difficulties, which escalated after the September 2001 terrorist attacks. The Insiders resigned as consultants, notified the Debtor of defaults on their loans and assigned the loans and security interests to a newly formed corporation, which they owned (“Newco”). After sending notices to the Debtor’s secured creditors and Creditor of a public foreclosure sale and publishing notice in a local newspaper, Newco held the public foreclosure sale on October 30, 2001. Newco purchased the assets in the foreclosure sale.

Creditor sued the Debtor for the balance due on the Note and added Newco as a defendant. Creditor alleged that Newco was a successor in interest to the Debtor and asserted a successor liability claim against Newco. Newco moved for summary judgment dismissing the successor-liability claim. The district court granted Newco’s motion and Creditor appealed.

2. COURT’S RULING

The Second Circuit vacated the grant of summary judgment and the holding by the district court that Newco was not a mere continuation of the Debtor. Applying Connecticut law, the Second Circuit found that the issue of whether a “continuity of enterprise” existed between the Debtor and Newco involved disputed issues of fact that could not be resolved by summary judgment. The Second Circuit pro-

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26 Call Center Technologies, Inc. v. Grand Adventures Tour & Travel Pub. Corp., 635 F.3d 48 (2d Cir. 2011).
27 Call Center Technologies, Inc., 635 F.3d at 56.
ceeded to compare the management, employees, physical location, assets, liabilities and services provided by Newco with those of the Debtor. 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 the Insiders, who were consultants at one time to the Debtor, the court noted that they “were not strangers” to the Debtors.28 The Second Circuit also found that the remainder of the two companies’ management teams was substantially identical, thus favoring continuity of enterprise. Of Newco’s employees, 31 of 51 were former employees of the Debtors. The Second Circuit remanded the case back to the district court for a trial on the merits, which is scheduled to commence in July 2013.29

The Second Circuit 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, however, that the trial court resolved the matter without a trial and on a summary basis. The court noted that that the “facts of [Interline] bear a strong resemblance to those in Chamlink, where the Appellate Court of Connecticut upheld a finding of non-liability.”30 The court distinguished Chamlink on procedural grounds, saying that Chamlink “involved review of the factual findings following trial.”31

Acme

In Acme, a bankruptcy court in Georgia (applying Georgia law) held that a foreclosing secured creditor was not liable as a successor even though (i) the foreclosing creditor and the borrower had common ownership and (ii) the foreclosing creditor continued the business of the borrower. In denying liability, the court was heavily influenced by “equitable factors,” including the fact that the plaintiff (an unpaid unsecured creditor of the borrower) had no prospect of

28 Call Center Technologies, Inc., 635 F.3d at 53.
30 Call Center Technologies at 55, n. 6.
31 Call Center Technologies at 55, n.6.
recovering from the borrower and recovery in the successor liability action would have resulted in a windfall.

1. Facts

ALK Holdings (the “Borrower”) borrowed approximately $550,000 from a bank (the “Bank”), which was secured by a first priority lien and personally guaranteed by Borrower’s sole shareholder (the “Shareholder”). Borrower’s business began to decline and it ultimately filed a chapter 11 petition. During the course of Borrower’s bankruptcy case, Shareholder formed a new company (“Newco”) that bought Bank’s secured claim against Borrower. Thereafter, the United States Trustee moved to dismiss Borrower’s chapter 11 case or to convert it to a liquidation under chapter 7 of the Bankruptcy Code. In May, 2009, the bankruptcy court dismissed Borrower’s case without opposition from any party in interest. At the time of dismissal, the Borrower could not generate profits and “had no realistic prospects of continuing its operations and remaining in business,” and Borrower’s assets were worth considerably less than the debt that encumbered them. The bankruptcy court found that it was “clear” that Borrower’s creditors had “no prospect whatsoever” of any recovery.

After its bankruptcy case was dismissed, Newco agreed to accept the collateral in full satisfaction of Borrower’s obligations under the note. This transaction “had the same consequence as the secured lender’s repossession and sale of the assets under other provisions of Georgia’s Uniform Commercial Code.” Newco used the collateral in the same manner that the Borrower had before the transaction; did not

33In re Acme Sec., Inc., 484 B.R. at 479–80.
34In re Acme Sec., Inc., 484 B.R. at 481.
35In re Acme Sec., Inc., 484 B.R. 475.
36In re Acme Sec., Inc., 484 B.R. 475.
37Id. The bankruptcy court deferred to the findings of the examiner appointed during the course of Borrower’s chapter 11 case regarding the value of Borrower’s assets. The examiner concluded that Borrower’s assets were worth approximately $200,000. In re Acme Sec., Inc., 484 B.R. 475 at 480.
38In re Acme Sec., Inc., 484 B.R. at 481.
39In re Acme Sec., Inc., 484 B.R. at 482.
intermingle those assets with its existing business; and, but for a few de minimis exceptions, did not assume any of Borrower’s liabilities.40 In 2010, one of the Borrower’s unpaid creditors (a landlord) (“Creditor”) sued Newco under a successor liability theory, arguing that Newco was a “mere continuation” of the Borrower.41

2. Court’s Ruling

The court found that Newco was not liable as a successor to the Borrower under Georgia law although (i) Newco and the Borrower were both wholly owned by Shareholder; and (ii) Newco operated the same business as the Borrower. Instead, the court focused on equitable factors and the policy rationale underlying the successor-liability doctrine (e.g., to protect the Borrower’s creditors). It was influenced by the fact that (i) Newco acquired the Borrower’s assets through a valid exercise of its rights as secured creditor under the UCC; (ii) the Borrower was “hopelessly insolvent” at the time of the acquisition; (iii) there was no evidence that the acquisition was intended to avoid payment of the Borrower’s debt to Creditor; and (iv) had there been no acquisition, Creditor would have been unable to recover on its claim against the Borrower.42

Relying on equitable criteria, the court held, however, that state law “does not automatically insulate a corporation from the imposition of successor liability as a mere continuation of a previous entity when the corporation acquires its assets through exercise of its rights as a secured creditor under the

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40 In re Acme Sec., Inc., 484 B.R. at 483–84. Newco was engaged in a separate business prior to acquiring Borrower’s assets. The bankruptcy court found that Borrower could not have been engaged in Newco’s existing business as it did not have the required licenses. In re Acme Sec., Inc., 484 B.R. at 483.

41 Creditor also argued that Newco’s acquisition of Borrower’s assets satisfied a separate basis for successor liability insofar as the acquisition was a “fraudulent attempt to avoid liabilities.” The court found that the acquisition was not fraudulent vis-à-vis Creditor, given that Creditor was not harmed by the transaction. At the time of the acquisition, Borrower’s assets were worth significantly less than its liabilities. Had Newco liquidated Borrower’s assets, Creditor would not have received a distribution.

In so holding, the court expressed its concern that per se exculpation would lead to mischief in situations where, as here, an insider controls both the buyer and seller.

**Conclusion**

A foreclosure sale does **not** automatically bar liability under a theory of successor liability. This risk has a twofold impact on out-of-court foreclosure sales. For one, it decreases the attractiveness of out-of-court sales for the secured lender seeking to sell the debtor’s business as a going concern and increases the attractiveness of a bankruptcy sale. Second, the possibility of successor liability may force a discount to

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43 Miller 5 U.C.C. Rep. Serv. 2d at 489–90.


the value a foreclosing lender can expect to obtain in an out-of-court sale. Although the UCC does not bar the imposition of equitable doctrines such as successor liability, that doctrine is arguably inconsistent with the UCC's goals of attracting prospective purchasers and obtaining a higher purchase price in foreclosure sales. The risk of successor liability is particularly heightened in those jurisdictions where courts are willing to impose liability even without a showing of continuity of ownership.

A foreclosing secured lender who elects to acquire collateral by way of credit bid should act to avoid a finding that its acquisition vehicle constitutes a 'mere continuation' of the debtor's business. Assuming the secured creditor wishes to sell the collateral as a going concern, any acquirer (other than a strategic buyer already in the business) will likely retain the same employees, operate the same business and provide goods and services to the same customers. Thus, the buyer should, at a minimum, 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.

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