Insights

Indiana Supreme Court Curtails Attempted Expansion of Exceptions to General Rule Regarding Successor Liability in Corporate Transactions

May 7, 2021

By: C. Daniel Motsinger and Robert A. Greising

The Indiana Supreme Court recently issued an opinion in *New Nello Operating Co., LLC v. CompressAir* that clarifies the elements to be met when establishing that a buyer of a business will be liable as the successor to the obligations of the target. Now, to fall under either of two exceptions to the general rule in asset deals that the seller keeps its liabilities, continuity of ownership between the target and the successor must be established. In reaching this determination, the Indiana Supreme Court overruled the holdings of the Indiana Court of Appeals and the trial court in this case.

As a general rule, a buyer of a business in a transaction that is structured as an asset sale will not be liable for the obligations of the seller that are not expressly assumed by the buyer in that transaction. One exception to this general rule that has long been recognized under Indiana law arises when the transaction is found to be a *de facto* merger of the seller into the buyer. With *de facto* mergers, courts will impose the obligations of the seller on the buyer as if a merger had occurred. Another long recognized exception has similarities to the first and is referred to as the "mere continuation" doctrine – basically finding that not enough has changed for the buyer to be considered as separate from the seller. (Two other exceptions typically listed are express assumption of liabilities and fraud, neither of which were part of the *New Nello* analysis.)

Successor liability under the *de facto* merger exception was a central point of the holdings in the *New Nello* case by the Indiana Court of Appeals. In a prior ***Alert*** , we discussed this March 2, 2020 decision that held a lack of continuity of ownership between the seller and the buyer, and the failure to dissolve the seller corporation, were not fatal to a finding of a *de facto* merger – and thus upholding the buyer's liability for a judgment rendered against the seller before completion of the sale.

Many considered this holding a significant expansion of a buyer's risk in this context. The analysis of the Court of Appeals allowed a creditor to ignore what is considered to be a critical element of many mergers, namely that the owners of the selling business will have ownership in the buyer. Equity continuity was one of many factors that Indiana courts had recognized when evaluating whether the *de facto* merger exception should apply. Continuity of ownership has also been a mainstay of many aspects of mergers, such as mergers used to accomplish a tax-free reorganization under the Internal Revenue Code. However, the requirement of continuous ownership will not be

found in the Indiana statutes for a transaction to be a merger. Rather, Indiana law allows nearly any type of consideration to be exchanged as part of the merger transaction. This has resulted in many such deals using all cash or an assortment of equity, cash, non-cash assets and assumption of indebtedness, in addition to a stock for stock exchange.

In the successor liability context, the *de facto* merger exception that permitted the target's liabilities to be collected from the buyer seems to use a "looks like a duck" approach. If the transaction had substantially all of the markings of a merger, the target's creditors could argue that they should have the benefit of a merger where the surviving entity has responsibility for all of the liabilities of the parties to the merger. Courts, in Indiana and elsewhere, have endorsed this concept even though the transaction was not technically a merger. This seemed to be a key underpinning of the analysis of the Indiana Court of Appeals in the *New Nello* case when the Court highlighted multiple elements of business continuity despite the absence of ownership continuity.

On April 22, 2021, the Indiana Supreme Court refined this concept when it vacated the *New Nello* decision, reversed the trial court's earlier decision and ruled that "continuity of ownership between two companies is necessary" for the application of either of two exceptions to the "general rule" that in a typical asset purchase, the buyer acquires the seller's assets but not its liabilities. The exceptions addressed by the Supreme Court were "first . . . when the acquisition of assets amounts to a de facto merger; [and] the second, when the buyer is a mere continuation of the seller."

New Nello involved the following facts: Nello, Inc. ("Old Nello") was managed by four officers who also owned nearly all of Old Nello's shares. Old Nello's debt structure included a $10 million loan to a senior secured creditor ("Senior Lender"), a $3.4 million loan to a mezzanine secured lender ("Mezz Lender"), and a $1.4 million debt to the City of South Bend's Industrial Revolving Loan Fund. The officers of Old Nello each personally guaranteed the loan to Senior Lender. Old Nello defaulted on its loan to Senior Lender. Senior Lender then called the loan and made a demand under the guaranty of Old Nello's president. Meanwhile, CompressAir installed thousands of feet of compressed air and oxygen piping within Old Nello's South Bend facility, and by the spring of 2017, approximately $39,000 of Old Nello's debt to CompressAir remained unpaid. CompressAir then sued Old Nello, and six other creditors also filed complaints against Old Nello seeking payment for outstanding bills.

Close in time to the filing of these complaints, a private equity firm engaged by Mezz Lender created an entity ("New Nello Acquisition") to buy Senior Lender's credit and collateral documents. New Nello Acquisition then bought Senior Lender's position at a substantial discount, and thereafter formed New Nello Operating Co., LLC ("New Nello"), as a wholly-owned subsidiary. Shortly thereafter, New Nello Acquisition and New Nello entered into a strict foreclosure agreement with Old Nello, whereby New Nello acquired Old Nello's assets.

Following this deal, New Nello conducted the same business as Old Nello, operated from the same physical location as Old Nello, and retained approximately ninety percent of Old Nello's employees, including Old Nello's officers. These officers, however, had no ownership interest in New Nello. There was no announcement to either the public or the employees concerning New Nello's assumption of Old Nello's business, apparently for fear of marketplace upheaval. New Nello also operated under the name "Nello" in the same manner as had Old Nello. New Nello also used the same website as Old Nello and held itself out to the public as the same company by claiming to have been founded in 2002.

After its acquisition of Old Nello's assets and business, New Nello negotiated with Old Nello's vendors and creditors that it deemed were essential to the operation of the business and paid them. Included among these essential creditors were the former officers of Old Nello. New Nello paid all obligations owed to them and released them from the personal guarantees they previously had executed in favor of the note New Nello purchased from Senior Lender. Other creditors of Old Nello, were listed as "unassumed liabilities" in the strict foreclosure agreement.

During the period in which this note purchase / strict foreclosure deal was unfolding, one of the former officers of Old Nello (and now a new officer of New Nello) continued to negotiate with CompressAir to come up with a payment plan, but this officer never informed CompressAir of the note purchase / strict foreclosure deal. These negotiations failed, and CompressAir shortly later obtained summary judgment against Old Nello. Following entry of judgment, CompressAir learned through proceedings supplemental of the note purchase / strict foreclosure deal and the existence of New Nello and sought garnishment against New Nello. Following an evidentiary hearing in which the PE representative testified that New Nello chose to pay only those creditors of Old Nello that were essential to running New Nello, the trial court entered findings of fact and conclusions of law determining that New Nello was a mere continuation of Old Nello and that there was a *de facto* merger of the companies.

However, in reversing the trial court, the Indiana Supreme Court noted that "New Nello and Old Nello shared the same name, business, location, employees, customers, products, and management team . . . [w]hat the two companies did not share, though, was the same ownership." Indeed, the Supreme Court noted that "the two companies have zero overlapping ownership: no shareholder of Old Nello owns an equity interest in either New Nello or its parent company." Accordingly, the Supreme Court ruled that "[f]or purposes of the de-facto-merger exception . . . this difference makes all the difference – continuity of ownership is a required element of a de facto merger." Emphasizing the point, the Supreme Court held "we now make explicit: continuity of ownership between transacting companies is essential to the de-facto merger exception in Indiana." Moreover, the Supreme Court noted "it is irrelevant to the de-facto-merger inquiry that" New Nello, as Senior Lender's successor in interest, had foreclosed on Old Nello's assets, because there was no continuity of ownership between Old Nello and New Nello.

Likewise, the Supreme Court rejected the trial court's finding that New Nello was liable to CompressAir as a "mere continuation" of Old Nello, ruling instead that "[c]ritically, because the mere-continuation exception applies only where there exists this common identity of equity holders, continuity of ownership is a necessary element." Accordingly, the Supreme Court held that "New Nello is not a mere continuation of Old Nello for the same reason the de-facto-merger exception does not apply namely, because none of Old Nello's shareholders holds an equity interest in New Nello." In conclusion, the Supreme Court held that "continuity of ownership is necessary for each of the de-facto-merger and mere-continuation exceptions to apply."

Takeaways

The Supreme Court cautioned that "[h]aving concluded that continuity of ownership is necessary for the [de facto merger] exception to apply, we leave for another day whether continuity of ownership alone is sufficient and how much overlapping ownership is required[, n]or do we decide today whether the de-facto-merger exception would apply in situations like this one – a strict foreclosure – even were there continuity of ownership between lender and borrower," noting that "a transaction's structure or label is not dispositive of its legal treatment . . . [u]nder our law, we penetrate a transaction's form to its substance and treat it as a stock purchase or merger if its 'economic effect

. . . makes it a merger in all but name'" (citation omitted).

While the Supreme Court's decision in *New Nello* provides welcome clarification to the applicability of the so-called "*de facto* merger" and "mere continuation" exceptions in the context of an asset purchase transaction involving a distressed seller, the fact that this clarification occurred only following many years of litigation and a trip through the Indiana appellate courts again highlights the potential risks to a buyer seeking to acquire the assets of a distressed entity. And while Old Nello was in financial distress, the Indiana Supreme Court did not base its conclusions on that variable. This holding will almost certainly apply in non-distress settings as well.

Several risk mitigation suggestions offered by the Indiana Court of Appeals in its now-vacated decision – e.g., issuing a press release announcing the buyer's acquisition of the distressed seller's assets, noting that the former business was "under new management," and trying to dissolve the former corporate entity with the Indiana Secretary of State – remain relevant. Another possible buyer risk mitigation approach might have been for Old Nello to have filed a so-called "liquidating chapter 11 bankruptcy case," and then to have sought to sell its assets to New Nello through the bankruptcy case (which likely would have required the consent of at least Senior Lender under the valuations involved in this matter).

If you have questions regarding the information found in this alert, please contact **C. Daniel Motsinger** or **Robert A. Greising**.

If you would like to learn more about our **Creditors' Rights and Bankruptcy Professionals**, please click **here**, or more about our **Mergers and Acquisitions Professionals**, please click **here**.