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Insights

Indiana Court of Appeals Expands De Facto Merger Exception to the General Rule Regarding Corporate Liability for Debts

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On March 2, 2020, in *New Nello Operating Co., LLC v. CompressAir*, the Indiana Court of Appeals expanded the so-called "de facto merger" exception to the general rule that when one corporation purchases the assets of another, the buyer does not assume the debts and liabilities of the seller, holding that a lack of continuity of ownership between the seller and the buyer, and the failure to dissolve the seller corporation, are not fatal to a finding of a *de facto* merger – and thus upholding the buyer's liability for a judgment rendered against the seller.

New Nello involved the following facts: Nello, Inc. ("Old Nello") was managed by four officers who also owned 95-99% 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 guarantied the loan to Senior Lender. Old Nello defaulted on its loan to Senior Lender, and Senior Lender called the loan and 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," 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

In affirming the trial court, the Court of Appeals noted that the "long held" general rule in Indiana is that "when one corporation purchases the assets of another, the buyer does not assume the debts and liabilities of the seller". The Court noted that there are four general exceptions to this rule against successor liability, namely "(1) an implied or express agreement to assume liabilities; (2) a fraudulent sale of assets done for the purpose of evading liability; (3) a purchase that is a de facto consolidation or merger; or (4) where the purchaser is a mere continuation of the seller. Successor liability is implicated only when the predecessor corporation no longer exists, such as in the case of dissolution or liquidation in bankruptcy."

Affirming the trial court's application of the third and fourth exceptions, the Court noted that "[c]ourts sometimes treat asset transfers as *de facto* mergers where the economic effect of the transaction makes it a merger in all but name", noting that factors supporting a finding of *de facto* merger include "(1) continuity of ownership; (2) continuity of management, personnel, and physical operation; (3) cessation of ordinary business and dissolution of the predecessor as soon as practically and legally possible; and (4) assumption by the successor of the liabilities ordinarily necessary for the uninterrupted continuation of the business of the predecessor."

Finding that the facts at bar clearly supported a finding of *de facto* merger, the Court – citing non-Indiana and federal case law – held that "[e]ven though there was no continuity of ownership [and although Old Nello was apparently never officially dissolved], we do not consider this to be fatal to a finding of a de facto merger" given the presence of most of the other required factors for the application of this exception. Accordingly, the Court affirmed the liability of New Nello for CompressAir's judgment against Old Nello.

Takeaways: *New Nello* highlights the potential risks to a buyer who purchases the assets of a corporation when acquiring a business. While *New Nello* involved a financially distressed business, the Court never identified the financial distress of Old Nello as a contributing factor in determining that a *de facto* merger had occurred. The Court's decision suggests some steps that New Nello might have taken to perhaps mitigate this risk – e.g., issuing a press release announcing New Nello's assumption of Old Nello's business, noting that Old Nello was "under new management", and trying to dissolve Old Nello with the Indiana Secretary of State. Another possible avenue might have been for Old Nello to have filed a so-called "liquidating chapter 11 bankruptcy case", and to have then 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 case).

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