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The mere continuation approach to successor liability

April 2020 | By **Thomas J. Hall** and **Judith A. Archer**

In their Commercial Division Update, Thomas Hall and Judith Archer discuss the "mere continuation" doctrine as one exception to the general rule in New York that the liabilities of a selling business do not travel to the acquirer.

Ordinarily under New York law, when one business acquires the assets of another, the liabilities of the selling business do not travel to the acquirer with the assets sold. New York courts, however, have recognized several exceptions to this general rule that can result in successor liability. This column addresses one such exception, the "mere continuation" doctrine, where the acquirer is found to be a mere continuation of the seller's business and therefore effectively has assumed its liabilities. While this exception has been frequently litigated across the country, its precise application in New York has not always been uniform and continues to evolve.

General standard

An entity that acquires the assets of another generally is not liable for the claims against the seller. *Schumacher v. Richards Shear*, 59 N.Y.2d 239, 244 (N.Y. 1983). While acknowledging that general rule, the Court of Appeals in *Schumacher* set forth four recognized exceptions: "(1) [the successor] expressly or impliedly assumed the predecessor's tort liability, (2) there was a consolidation or merger of seller and purchaser [also known as de facto merger], (3) the purchasing corporation was a mere continuation of the selling corporation, or (4) the transaction is entered into fraudulently to escape such obligations." *Id.* at 245.

The mere continuation exception has a long history in the United States, though not always a clear one. Academics have noted that the mere continuation exception, and its close relative the de facto merger exception, "focus on one or both of (i) some indicia of a fraudulent-transaction-like scenario or (ii) the successor's enjoyment of the benefits of continuing to operate the business as it was before the transfer." George W. Kuney, *A Taxonomy and Evaluation of Successor Liability (Revisited)*, 18 Trans.: The Tenn. Journ. Of Bus. Law 741, 751 (2017). Professor Kuney analyzed the four different approaches that courts around the county have followed in applying the mere continuation exception, and placed them in four different buckets. Citing *Schumacher*, he placed New York in the "undefined" bucket, meaning that while its courts have adopted the mere continuation exception, they have not clearly defined the test for applying it. *Id.* at 774 n. 61.

The predecessor's continued existence

In *Schumacher*, the plaintiff sought recovery for personal injuries suffered when a shearing machine ejected metal into his face and blinded him. Ten years before the accident, the manufacturer of the machine had sold all of its assets, including its tradename, to Logemann Brothers and discontinued its business. In addition to suing the original manufacturer, the plaintiff named Logemann Brothers as a defendant asserting successor liability under a mere continuation theory. After laying out the traditional rule and its exceptions, the Court of Appeals held that the mere continuation exception could not apply here because the predecessor entity still existed. Citing precedent from New Jersey and the Southern District of New York, the court held: "The [mere continuation] exception refers to corporate reorganization, however, where only

one corporation survives the transaction; the predecessor must be extinguished." Because the predecessor still existed, albeit with no business and no employees, plaintiff's successor liability claim failed.

Since that decision, this bright-line rule has frequently been applied. For example, in *Ring v. Elizabeth Found*. for Arts, 136 A.D.3d 525 (1st Dept. 2016), the First Department affirmed the dismissal of a mere continuation claim because the predecessor company had not been extinguished. In *Ivory Dev., LLC v. Roe*, 135 A.D.3d 1216 (3d Dept. 2016), the Third Department likewise held that the mere continuation exception did not apply in a dispute over real property where rights under a contract were assigned to the successor party because the predecessor company "continued to exist as a separate entity and remained active for several years thereafter." *See State Farm Fire & Cas. Co. v. Main Bros. Oil Co*., 101 A.D.3d 1575, 1577 (3d Dept. 2012) ("Main Brothers correctly asserts that the third exception, 'mere continuation,' cannot apply because it requires that the selling/predecessor corporation be fully extinguished for there to be successor liability."); *see also Hoover v. New Holland North America, Inc*., 71 A.D.3d 1593 (4th Dept. 2010).

A different approach

A divergence from this approach can be traced to a 1995 unpublished decision out of the Southern District of New York in *McDarren v. Marvel Ent. Gp*., 1995 WL 214482 (S.D.N.Y. April 11, 1995). There, the court allowed the successor liability claim based on the mere continuation theory to proceed even though the predecessor was still in existence. In doing so, the court distinguished *Schumacher* from the allegations at hand: "In *Schumacher*, the seller transferred all its assets to the purchaser who continued the seller's business. Here, TB–I transferred not only its assets, but also its business location, employees, management and good will to TB–II. Under these facts, the Court finds *Schumacher* distinguishable." The court based its holding on "the policy consideration to discourage corporate transactions performed solely for purposes of avoiding liability."

The court in *McDarren* cited *Ladjevardian v. Laidlaw–Cohadggeshall, Inc*., 431 F. Supp. 834, 839 (S.D.N.Y. 1977), to support its holding. Curiously, in reaching a contrary result, the *Schumacher* Court had also cited *Ladjevardian* for the proposition that the mere continuation exception could not apply unless the predecessor was extinguished. *Ladjevardian* involved a dispute regarding securities transactions. Defendant was alleged to be the successor in interest to LAC, a brokerage firm that allegedly improperly churned plaintiff's accounts.

In finding the defendant was a mere continuation of LAC, the Southern District held that "[a] continuation envisions a common identity of directors, stockholders and the existence of only one corporation at the completion of the transfer." *Lagjevardian*, 431 F.Supp. at 839 (citing *Kloberdanz v. Joy*, 288 F. Supp. 817, 820 (D.Colo.1968)). The court found no such common identity, and concluded that "[t]he fact that the vendor corporation continued to exist after the sale and apparently received fair consideration for its assets is sufficient to take this case out of the 'mere continuation' exception."

From this holding, both lines of analysis can be supported—a set of factors that would impose successor liability if the predecessor's existence continued, and an bright-line rule that the predecessor must be extinguished.

Commercial division cases

The case of *47 E. 34th St., LP v. BridgeStreet Worldwide, Inc*., No. 653057/2018, 2019 BL 433881 (N.Y. Co., Nov. 6, 2019), is the most recent Commercial Division case to address the mere continuation doctrine. In that case, defendant BridgeStreet leased units in a building owned by plaintiff 47 East. This building was receiving favorable tax treatment under Section 421 of the New York Real Property Tax Law which required, among other things, units receiving such tax treatment be rented for at least six months.

Through foreclosure, co-defendant Domus acquired BridgeStreet's assets, though BridgeStreet remained the tenant at 47 East. Shortly after this transfer, the New York Attorney General initiated an investigation into 47 East's tax benefits, alleging that units leased to BridgeStreet were being rented out on a nightly basis in violation of Section 421. After paying penalties to the State, 47 East brought this indemnification action against BridgeStreet and Domus, as the acquirer of BridgeStreet's assets, alleging that Domus was liable under successor liability as a mere continuation of BridgeStreet.

In denying Domus' motion to dismiss, Justice Andrew Borrok of the New York County Commercial Division ruled that "[t] o invoke the mere continuation exception to the rule against successor liability, a plaintiff must establish that the acquiring corporation has obtained the business location, employees, management, and good will of the acquired corporation." *47 E. 34th St*., 2019 BL 433881 at *9 (citing *NTL Capital, LLC v Right Track Recording, LLC*, 73 A.D.3d 410, 411 (1st Dept. 2010)). The court found that 47 East's complaint alleged a prima facie case that Domus had done just that.

In earlier cases addressing mere continuation claims, Commercial Division and Appellate Division courts have echoed this approach. For example, in *RCPI Landmark Props., LLC v. Adam Harwood, D.M.D., P.C.*, No. 151832/2015, 2015 BL 391246 (N.Y. Co., Nov. 23, 2015), a dentist leased an office from plaintiff RCPI and thereafter defaulted on his lease. After a default judgment was entered against his first company, the dentist formed a new company to continue operations.

Justice Cynthia Kern of the New York County Commercial Division held that the mere continuation exception applied when the successor company acquired the location, employees, management, and goodwill of the predecessor, and that a prima facie showing of such had been made here. In *Tap Holdings, LLC v. Orix Fin. Corp.*, 109 A.D.3d 167 (1st Dept. 2013), a case involving a dispute over a loan default, the First Department affirmed the holding of Justice Charles Ramos of the New York County Commercial Division that the plaintiff adequately pled successor liability on a mere continuation theory. Because the defendant had acquired the "business location, employees, management and goodwill" of the obligor, it was liable as successor, even though the predecessor entity still existed in "meager form."

The principles on which these decisions relied can be traced in part to the First Department's 2010 decision in *NTL Capital, LLC v Right Track Recording*, 73 A.D. 410 (1st Dept. 2010). Addressing the defendant's breach of an equipment lease and plaintiff's claims against defendant's alleged successor, the First Department held that plaintiff sufficiently pled mere continuation.

Citing *Schumacher*, the court found that the documentary evidence submitted "does not conclusively establish" that the predecessor was still in existence. The court went on: "In any event, plaintiff sufficiently pleaded the mere continuation exception to the rule against successor liability by showing that Legacy has acquired Right Track's business location, employees, management and goodwill." Id. at 411 (citing *Societe Anonyme Dauphitex v Schoenfelder Corp.*, 2007 WL 3253592, *5-6 (S.D.N.Y. 2007)).

Conclusion

The mere continuation doctrine remains an evolving area of New York law. Since the Court of Appeals decided *Schumacher* 30 years ago, lower courts appear to have softened a hardline approach that the doctrine does not apply unless the predecessor has been extinguished, and appear to have become more willing to allow plaintiffs access to successor liability. While it makes sense for plaintiffs to continue to plead the "fully extinguished" rule where applicable, they are well-advised also to address the factor-based analysis on which the New York courts, including in the Commercial Division, have increasingly focused.

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