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News & Types: Corporate, Finance & Acquisitions Update

Another Illinois Case Decides When an Asset Purchaser is Responsible for Liabilities as a Mere Continuation of the Seller

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Practices: Corporate, Finance & Acquisitions, Litigation

In our Risk Management Update of December 23, 2015, we discussed an Illinois case that had to decide when a successor entity purchasing the assets of its predecessor became liable for the debts of the predecessor. ("Mere Continuation" Doctrine Applied to Transfer Liability to Successor Entity). In that case, the issue was whether an intermediary who purchased the assets of a business was a mere "straw man" to cleanse the transaction to avoid the claim that the ultimate purchaser was responsible for the liabilities of the seller. In that case, the Illinois Appellate Court decided that the intermediary was a straw man and the successor could not escape liability for the predecessor entity's obligations. *(Advocate Financial Group, LLC v. 5434 North Winthrop, LLC, et al. Appellate Court of Illinois, Second District, No. 2-15-0144, November 23, 2015)*

Recently, an Illinois court dealt with a similar case. The result was different, but the issues were the same. As did *Advocate Financial Group*, the decision presented an interesting case study in the application of the "mere continuation" doctrine. *(The Groves of Palatine Condominium Association v. Walsh Construction Company, Defendant and Third-Party Plaintiff-Appellant K & K Iron Works, LLC, Third-Party Defendant-Appellee, 2017 IL App (1st) 161035, March 31, 2017)*

On May 17, 2012, the Groves of Palatine Condominium Association filed a complaint against Walsh Construction Company (Walsh) alleging defect in the construction of the condominium's four buildings. Walsh Construction, in turn, filed a third-party complaint against K & K Iron Works, Inc. (Corporation) alleging that the Corporation, as subcontractor, was responsible for the defects alleged. (Confusingly, the court refers to Walsh as the "plaintiff", although the original plaintiff was the Condominium Association. In this case, the disputing parties were Walsh and the K&K entities. So the Condominium Association can be disregarded.) However, unfortunately for Walsh, the Corporation was defunct, involuntarily dissolved in 2012. Fortunately for Walsh, it appeared the business of the Corporation was continued by another entity, similarly named K & K Iron Works, LLC (LLC). So Walsh went after the LLC as the successor of the Corporation.

The trial court dismissed Walsh's claim against the LLC, rejecting the claim that the LLC was the "mere continuation" of the Corporation. Walsh appealed.

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Typically, these types of "mere continuation" cases present very complex fact situations. For the plaintiffs, it is because the perpetrators carefully hid their tracks. For the defendants, it is because the evidence for continuation is weak. However, to show the continuation, there is usually an individual or entity which is present throughout the various permutations of the entities involved. It is often helpful to track the process through a timeline. By "following the bouncing ball", we can at least see the arguments for continuation. In this case, the "bouncing ball" is an individual named Jerry Kulhanek, the LLC's manager. Keep your eye on him. Below is a rough timeline of the evolution from the Corporation to the LLC.

- 1976 – The Corporation is formed as K & K Ornamental Iron Works, Inc.
- 1990 – The name is changed to K & K Iron Works, Inc.
- Between 1991 and 1998 – The owners of the Corporation transfer their shares to Karl F. Kulhanek and to Jerry Kulhanek.
- September 2006 – The Corporation is sold to K & K Iron Works Holding, Inc. (Holding Company). The Holding Company's owner is H.I.G. Iron Works, Inc. At the time, Jerry and Karl each acquire 125 common shares of the Holding Company by selling their capital stock and contributing their remaining shares in the Corporation to the Holding Company.
- September 2006 – After the dust settles, the shareholders of the Holding Company are H.I.G. Iron Works, Inc. (750 shares), Karl Kulhanek (125 shares) and Jerry Kulhanek (125 shares).
- December 31, 2009 – Jerry resigns as an employee of the Corporation.
- May 28, 2010 – Jerry resigns as a director of the Corporation.
- May 28, 2010 – The Holding Company issues 342 shares of preferred stock to four different entities, none of which had any connection with Jerry or Karl Kulhanek.
- October 28, 2010 – The Holding Company issues an additional 12,872 common shares to H.I.G. Iron Works, Inc. so that both Karl's and Jerry's interest is reduced to less than 1%.
- 2011 – The Corporation is in financial difficulty, with an anxious creditor, Fifth Third Bank. The Corporation begins to look for a buyer.
- June 6, 2011 – The LLC files its certificate of formation. Jerry owns 100% of the LLC. The LLC was admittedly formed to purchase the assets of the Corporation.
- June 21, 2011 – The LLC purchases the assets of the Corporation from the Holding Company. Liabilities are excluded. The Holding Company has no interest or ownership in the LLC.

On appeal, Walsh argued that the LLC was a "mere continuation" of the Corporation. The basis for Walsh's argument was: a) there was a continuity of ownership of the two entities through Jerry who retained some indirect ownership in the Corporation and who then controlled the LLC; b) the LLC conducted the same business out of the same locations as did the Corporation; c) a majority of the LLC's employees worked for the Corporation and the Corporation's president became president of the LLC after the 2011 sale; and d) the LLC was holding itself out as the successor entity by listing several projects on its website that were actually completed by the Corporation.

Of course, Jerry's version was much different. The locations were his family's business properties owned independently of the Corporation or the LLC and were not involved in the transfer of any assets. Jerry and his brother decided to sell the Corporation in 2006 and, thereafter, he was basically in an advisory role. Then in

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2009 he resigned from the Corporation and, as noted below, his ownership interest in the Holding Company shrunk to less than 1%.

Jerry became re-engaged in 2011 when he learned that the financially distressed Corporation was up for sale. So he formed the LLC to acquire the assets (not the liabilities) of the Corporation. He acknowledged there was some overlap between the management and employees of the Corporation and the management and employees of the LLC. He also acknowledged that the LLC's website had photos of past projects that were actually projects of the Corporation.

In its analysis, the court cited the default rule that a purchaser of assets is not liable for the seller's liabilities. It cited the four exceptions to this default rule, namely: 1) an express or implied agreement to assume the liabilities; 2) a consolidation or merger of the buyer or seller; 3) when the purchaser is a mere continuation of the seller; and 4) a fraudulent transaction intended to avoid the seller's liabilities. Here, only the third exception, mere continuation, was at issue.

The court defined the exception very narrowly. Citing earlier cases, the court said the exception "is designed to prevent a situation whereby the specific purpose of acquiring assets is to place those assets out of the reach of the predecessor's creditors… to allow the predecessor to escape liability by merely changing hats would amount to fraud." (Here, the court seemed very close to failing to distinguish between the mere continuation exception and the fraud exception.) In Illinois, the courts have consistently looked to a continuation of the corporate entity of the seller, not the seller's business operation. Illinois courts have "consistently required identity of ownership before imposing successor liability under [the continuation exception]."

In this case, the court concluded, "Examining the entire ownership history of the [Corporation] establishes that there was no identity of ownership that would make the LLC merely a continuation of the [Corporation]."

There were a number of gaps in Walsh's argument to argue for a continuation of the Corporation's business. First, after the sale in 2006, Jerry Kulhanek was not a shareholder of the Corporation and was only a 12.5% shareholder in the Holding Company. Jerry never had an ownership interest in the ultimate parent, H.I.G. Iron Works, Inc.

Second, Jerry resigned as an employee in December 2009 and from the board of directors in May 2010. The LLC was formed and purchased the assets of the Corporation over a year later in June 2011.

Third, there was a clear break in leadership. Although the president of the Corporation was also the president of the LLC, this factor was not sufficient to impose successor liability.

But, in the end, wasn't it Jerry Kulhanek who ended up with the business? Not enough, said the court. "Examining the entire ownership of the history of the [Corporation] makes clear that there was no continuity of ownership due to the significant period of time in which the [Holding Company] owned the [Corporation]." As noted, Jerry only had a small ownership in the Holding Company throughout this time. "Thus we cannot find Jerry's minimal ownership interest in the [Holding Company] to translate to the type of continuity of ownership necessary for the imposition of successor liability."

But what about the LLC's use of the Corporation's facilities and use of the Corporation's earlier projects to advertise their capabilities? The court returned to the point made early in the decision. Whether one entity is a

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continuation of another depends on the continuation of the entity, not on the continuation of the business. So using the same facilities as the Corporation and using photographs of the Corporation's earlier work (properly attributed to the Corporation) showed a continuation of the business, not a continuation of the entity.

Reviewing the facts as described in the court's opinion, the result is understandable and correct. The LLC properly excluded the liabilities when it purchased the assets of the Corporation. The court honored the contract as written. If anything, by defining the continuation exception narrowly, the court's analysis and opinion will make future claims of successor liability based on continuation more difficult.

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