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News & Types: Corporate, Finance & Acquisitions Update

"Mere Continuation" Doctrine Applied to Transfer Liability to Successor Entity

12/23/2015

Practices: Corporate, Finance & Acquisitions, Litigation

It is an often-cited principle that an entity that purchases the assets of another entity is not liable for the debts and liabilities of the transferring entity. There are exceptions to this principle. One of the exceptions is the "mere continuation" exception where the purchasing entity is the mere continuation of the transferring entity. The Appellate Court of Illinois recently applied this exception to transfer liability to a successor entity in an interesting case that had a unique twist. (*Advocate Financial Group, LLC v. 5434 North Winthrop, LLC, et al*. Appellate Court of Illinois, Second District, No. 2-15-0144, November 23, 2015)

The twist in the Advocate case was the presence of an intermediary who purchased the assets of the entity before transferring them to still another entity that was virtually identical to the original transferee. Did this intermediary "cleanse" the entity that ended up with the assets from claims against the original transferee? Although a close case, the answer was not in this transaction.

The best way to understand the complicated situation is by means of a timeline.

- December, 2006 – 5434 North Winthrop, LLC (North Winthrop) is formed in Illinois. It purpose is to develop a residential building in Chicago (Property) and sell condominium units there. It has several individuals as members. The highest percentage is owned by two brothers, James and William Cartwright who were also the LLC's managers.
- 2007 – PNC Bank (formerly National City Bank) loans North Winthrop $1.7 million, secured by a mortgage on the Property. The loan is also personally guaranteed by most of North Winthrop's members.
- 2008 – North Winthrop defaults on the loan.
- January, 2010 – Advocate Financial Group, LLC (Advocate) (also the plaintiff in this case) and North Winthrop enter into a "working agreement" under which Advocate would assist North Winthrop to obtain financing to pay PNC and to complete the project. It is not clear what specific services Advocate actually provided.
- 2011 – Advocate obtains an arbitration award against North Winthrop for $50,896.23 and an additional $36,550 for attorneys' fees. In September, 2011, Advocate files a complaint to confirm the award, resulting in a judgment against North Winthrop for this amount.
- December, 2011 – North Winthrop and PNC sign a settlement agreement under which PNC releases North Winthrop and the personal guarantors. The debt to PNC is reduced to $750,000 from the original $1.7 million. It appears the personal guarantors also separately paid to PNC $140,000 to "get off" the personal guarantees. In return, North Winthrop sold the Property to CSM Capital, LLC (CSM) for $650,000. CSM

takes title in the name of Winthrop Real Estate, LLC. CSM and Winthrop Real Estate have no affiliation with North Winthrop or with the eventual owners of the Property.

- Before January 9, 2012 – A title commitment is obtained to facilitate the sale of the Property to an entity yet to be formed called Steward Apartments LLC (Steward).
- Early 2012 – James Cartwright, one of the managers of Steward and a former manager of the dissolved North Winthrop, claims that Winthrop Real Estate (formerly CSM) is having trouble obtaining permits and a water meter. Mr. Cartwright has a solution. Why not let Steward take over developing the Property? After all, the Cartwrights, former managers of North Winthrop and had obtained these items under North Winthrop. This sounds like a good idea to Winthrop Real Estate.
- March 6, 2012 – Steward Apartments LLC (Steward) is formed. All of its members are former members of North Winthrop. The stated purpose of Steward is to "own and operate" the Property.
- March 8, 2012 – Winthrop Real Estate sells the Property to Steward.

To Advocate, the presence of Winthrop Real Estate was a sham and Steward was formed to avoid paying Advocate the amount it was owed. Advocate sought a turnover order against Steward to satisfy its judgment. The trial court agreed. Steward appealed and the appeals court reversed and remanded, holding that the trial court must determine whether the transfer of assets from North Winthrop to Winthrop Real Estate was a *bona fide* transaction or a subterfuge.

Back at the trial court, the trial judge reviewed more closely the background and facts of the various transactions involving the Property. Steward argued vehemently that the sale to Winthrop Real Estate was a *bona fide* transaction and asserted, apparently correctly, that the members and managers of Winthrop Real Estate had no affiliation with the former members and managers of North Winthrop, the now defunct former owner, or with Steward, the future owner.

However, in the end, the trial court came to the same conclusion. The trial judge said its earlier characterization of Winthrop Real Estate as the "middle man" was not accurate. Rather, Winthrop Real Estate was better characterized as a "straw man." The trial court explicitly called the testimony "not believable" that Winthrop Real Estate decided to sell to Steward because the permitting process was too difficult.

The timing also raised suspicions. In January, 2012, less than one month after settling with PNC, the individuals who would later form Steward began the process of obtaining a title commitment to facilitate the sale of the Property to the entity yet to be formed. Steward's acquisition of the Property in March, 2012, just 2 months after the title commitment and 4 months after the settlement with PNC, was all part of a subterfuge to avoid the judgment obtained by Advocate. Noted the appeals court:

> "Steward emphasizes that the parties to both sales [sale from North Winthrop to Winthrop Real Estate and the sale from Winthrop Real Estate to Steward] were independent of each other and that in neither sale was the consideration suspiciously low. But Steward overlooks that the whole can be greater than the sum of its parts. The trial court reasonably concluded that, when North Winthrop sold the property to CSM/Winthrop Real Estate, both parties had already settled on what would (and did) happen soon thereafter – a resale of the property to North Winthrop, now known

> as Steward, to the perceived benefit of both CSM/Winthrop Real Estate (which made money on the deal) and North Winthrop/Steward (now freed from its earlier obligations)."

With the evidence available, the appeals court affirmed the trial court's conclusion that the sale to the intermediary, Winthrop Real Estate, was not bona fide. As a result, the general rule that a purchaser of assets does not become subject to the liabilities of the seller did not apply. Rather, the "mere continuation" exception applied to make Steward liable for the judgment obtained by Advocate against North Winthrop. The presence of the intermediary (characterized by the trial court as a "straw man") did not successfully "cleanse" Steward from this liability.