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Successor Liability Under Colorado Law

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This article summarizes applicable Colorado law regarding the liability of a purchaser of substantially all of the assets of a business for liabilities arising out of the prior owner's business operations, including possible transferee liability for unpaid federal and state income taxes of the seller.

Common Law Successor Liability

Under traditional corporate law, the liability of a successor entity depends on the nature of the transaction which gives rise to the change of ownership. Generally, a corporation that purchases the assets of another corporation is not liable for the debts and liabilities of the seller unless:

(1) the purchaser expressly or impliedly agrees to assume such debts;

(2) the transaction amounts to a consolidation or merger of the seller and purchaser;

(3) the purchasing corporation is merely a continuation of the selling corporation; or

(4) the transaction is entered into fraudulently in order to escape liability for such debts. [1]

Various attempts to expand these exceptions in Colorado have failed. For instance, in Ray v. Alad Corp., [2] the California Supreme Court created the "product line" exception to the traditional rule on nonliability of successor corporations. However, in Johnston v. Amsted Industries, Inc., [3] the Colorado Court of Appeals declined to adopt the so-called "product line" exception, along with the majority of other courts in the country.

Similarly, the court in Johnston also declined to adopt the so-called "continuity of enterprise" exception to the traditional rule of nonliability of successor corporations. [4] In contrast to the "mere continuation" exception of traditional corporate law, [5] this proposed exception would allow liability to be imposed even though the sale of assets is for cash and there is no continuity of shareholders. It has been characterized as an expansion of traditional de facto merger rather than as an exception to the doctrine of successor liability. [6] The decision in Johnston to reject the “continuity of enterprise” exception also conforms to the majority of courts addressing the issue. [7] Accordingly, the above four exceptions are the only known ones in Colorado.

Of the four exceptions, whether or not the factual prerequisites exist for the first two exceptions is usually fairly clear. The third, known as the "mere continuation" exception applies only when there is a continuation of directors and management, shareholder interest, and, in some cases, inadequate consideration. [8] The fourth exception, concerning fraudulent transfers, is discussed in more detail below.

Colorado Uniform Fraudulent Transfer Act

The Colorado Uniform Fraudulent Transfer Act was adopted in 1991. [9] It is almost a verbatim adoption of the Uniform Fraudulent Transfer Act, which many states have adopted. The Act creates three general categories of transactions that defraud creditors:

First, the Act prohibits transfers that are made with an actual, subjective intent to hinder, delay, or defraud both present and future creditors. [10] The Act lists several objective factors that a court may consider in determining a debtor's and transferee's subjective intent, but they do not create presumptions. [11]

Second, the Act creates a category of transactions that are deemed constructively fraudulent. Such transactions are voidable without regard to the actual intent of the debtor. Specifically, a transaction is constructively fraudulent if (1) it is made without an exchange of reasonably equivalent value and (2) the debtor is in, or is placed in, as a result of the transaction, a condition of financial difficulty. [12]

Third, the Act invalidates certain transfers to insiders. [13]

The Act provides a defrauded creditor with a number of remedies, including the recovery of a money judgment from a transferee of the debtor's property. [14] A transferee's primary defense is usually that it has given reasonably equivalent value for the assets in good faith. [15] If so, a transaction is not voidable under the Act, even if the debtor acted with the actual intent to hinder, delay, or defraud. [16]

Unfortunately, the Act does not define the meaning of "reasonably equivalent value," except to note that a noncollusive foreclosure of a lien is declared to be a transfer for equivalent value. [17] "Value" is given if property is transferred or an antecedent debt is secured or satisfied, but value does not include an unperformed promise made otherwise than in the ordinary course of the promisor's business to furnish support to the debtor or another person. The comment to Section 38-8-104 indicates that "[c]onsideration having no utility from a creditor's viewpoint does not satisfy the statutory definition." Obviously, these guidelines are very general, largely because the intent was to implement a very fact-specific approach, similar to that taken under the Bankruptcy Code in similar situations. In fact, the Act's general definition of "value" was adopted from §548(d)(2)(A) of the Bankruptcy Code. Courts construing the bankruptcy definition have concluded that the fact finder must have wide discretion to determine if value has been given. [18]

The federal Bankruptcy Code provisions concerning fraudulent transfers are very similar to most nonbankruptcy fraudulent transfer statutes, including the Uniform Fraudulent Transfers Act upon which the Colorado Act is based. Essentially, the Bankruptcy Code permits the bankruptcy trustee to avoid transfers made with the intent to hinder, delay, or defraud creditors. It also allows for the avoidance of transfers where the debtor receives less than a reasonable equivalent value and becomes insolvent as a result of the transfer, or was engaged in a business transaction with unreasonably small capital or intended to incur debts beyond his ability to pay. [19]

Independent Duty to Warn

It merits mention that even though the four traditional Colorado exceptions to successor liability should not apply, an independent successor duty to warn may exist under Colorado law. In Florom v. Elliott Mfg., [20] the Tenth Circuit Court of Appeals, while applying Colorado law, held that in certain circumstances a successor manufacturer may have an independent duty to warn about the use of a predecessor's product so as to prevent it from being unreasonably dangerous. The court noted that under traditional tort principles, this duty is not dependent upon the terms of the purchase and sale agreement between the predecessor and successor. Succession alone does not impose a duty to warn the predecessor's customers of recently discovered defects. Where such a duty arises, it stems from the existence of the relationship between the successor and the customers of the predecessor. "The successor corporation's liability stems not from its status as a successor, but from its establishment of a relationship with the customer that imposes certain duties and responsibilities." [21] A court will examine factors such as the succession to service contracts, coverage of the particular machine by a contract, service of that machine by the successor, and the successor's knowledge of the defect and of the machine owner's location. [22]

Article 6 of the Colorado Uniform Commercial Code (Bulk Sales)

Article 6 of the Colorado Uniform Commercial Code concerning bulk sales was repealed effective July 1, 1991. Therefore, compliance is no longer necessary. Creditors are now essentially left with remedies under the Colorado Uniform Fraudulent Transfers Act discussed above.

Transferee Liability for Transferor's Tax Liability

Section 6901 of the Internal Revenue Code of 1986, as amended, provides the Internal Revenue Service with administrative procedures designed to collect unpaid federal taxes and corresponding interest and penalties from transferees of taxpayers. The transferee liability would be collectible when a third party is secondarily liable in equity or at law for the unpaid taxes. [23] State law generally determines whether there is transferee liability and the extent of liability. [24]

Furthermore, because transferee liability for federal taxes is derivative in nature, it is required that the transferor be liable for the taxes both at the time of the transfer and at the time the transferee liability is asserted. [25] Therefore, if no tax liability exists at the time of the closing of the sale of the assets, then yet a basis exists to preclude transferee liability.

There appears to be no Colorado case law concerning the liability of successors for Colorado state income tax. C.R.S. §39-22-304 provides that the net income of a C corporation for Colorado income tax is the corporation's federal taxable income with certain adjustments, none of which relate to successor liability. [26] Therefore, the above-described principles would probably also apply for state income tax purposes. [27]

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[1] Johnston v. Amsted Industries, Inc., 830 P.2d 1141, 1142-43 (Colo.App. 1992)(citing Ruiz v. ExCello Corp., 653 P.2d 415 (Colo.App. 1982).

[2] 19 Cal.3d 22, 136 Cal.Rptr. 574, 560 P.2d 3 (1977).

[3] See Johnston, 830 P.2d at 1144.

[4] 830 P. at 1146.

[5] See Ruiz v. ExCello Corp., 653 P.2d 415 (Colo.App. 1982).

[6] See 1 L. Frumer & M. Friedman, Products Liability, § 7.04[5] (1991); Cyr v. B. Offen & Co., 501 F.2d 1145 (1st Cir.1974).

[7] 830 P. at 1146.

[8] See Alcan Aluminum v. Electronic Metal Prod., 837 P.2d 282 (Colo.App. 1992).

[9] C.R.S. §38-8-101 et seq.

[10] C.R.S. §38-8-105(1)(a).

[11] C.R.S. §38-8-105(2).

[12] C.R.S. §38-8-105(1)(b). Once a creditor establishes that the consideration received by the debtor was inadequate, the creditor must also prove one of three additional factors involving the debtor's lack of adequate net worth (in a general sense) in order to invalidate the transaction:

1. First, the Act provides that both present and future creditors may void a transaction or a business investment that the debt made for inadequate consideration, if the transfer left the debtor with "unreasonably small" assets in relation to the business or transaction. C.R.S. §38-8-105(1)(b)(I). This provision focuses on whether the assets retained by the debtor were adequate in light of the needs of the business or transaction in which the debtor was engaged.

2. Second, the Act authorizes present and future creditors to void a transfer for inadequate consideration if the debtor "intended to incur, or believed or reasonably should have believed that he would incur," debts beyond his ability to pay. C.R.S. §38-8-105(1)(b)(II).

3. Third, present creditors (but not future creditors) may avoid transfers if the debtor received inadequate consideration and the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer. C.R.S. §38-8-106(1).

[13] C.R.S. §38-8-106(2).

[14] C.R.S. §38-8-109(2).

[15] C.R.S. §38-8-109.

[16] C.R.S. §38-8-109(1). Furthermore, when a good faith transferee gives inadequate consideration, the Act still protects the transferee to the extent of the value actually given to the debtor. C.R.S. §38-8-109(4). The Act's protection of good faith transferees for value also is available to subsequent transferees who do not deal directly with the debtor. C.R.S. §38-8-109(2)(b).

[17] C.R.S. §38-8-104(2).

[18] 4 Collier on Bankruptcy ¶ 548.09 (1996).

[19] 11 U.S.C. §548.

[20] 867 F.2d 570, 576-77 (10th Cir. 1989).

[21] Id. (citing Polius v. Clark Equipment Co., 802 F.2d 75, 84 (3rd Cir. 1986); Mozingo v. Correct Manufacturing Corp., 752 F.2d 168, 177 and n.12 (5th Cir. 1985); Travis v. Harris Corp., 565 F.2d 443, 449 (7th Cir. 1977)).

[22] Florom, 867 F.2d at 577.

[23] Elliot, Federal Tax Collections, Liens, and Levies, ¶18.01 at 18-2 (2d ed. 1995).

[24] Commissioner v. Stern, 357 U.S. 39, 78 S.Ct. 1047, 2 L.Ed.2d 1126 (1958); Hagaman v. Commissioner, 100 T.C. 180, 186 (1993). This general principle is subject to certain qualifications. First, state law may not answer all questions relating to a transferee's liability, and where there are questions not definitively answered by state law, federal law is consulted. Second, although state law controls, federal courts determine independently the results under state law. Third, certain transferee liability issues are not controlled by state law because the supremacy of the federal government prevents the application of state law. For example, Section 6901(c) establishes a statute of limitations for the assessment of transferee liability on claims by the IRS. This applies even though a state may have a different period of limitations for claims by other creditors. Finally, in certain situations involving estate and gift taxes and in cases of bankruptcy, the IRS may proceed under other Internal Revenue Code and Bankruptcy Code provisions rather than state law. Saltzman, IRS Practice and Procedure, ¶17.01[3] at 17-5 (2d ed. 1991)[hereinafter "Saltzman"].

[25] Saltzman, ¶17.02[2] at 17-8.

[26] Assumes the transaction involves two corporations, both of which are taxed under Subchapter C of the Internal Revenue Code.

[27] Successor liability under the following statutes has not been examined:

Federal wage withholding, FICA, FUTA, and Medicare taxes;

Colorado real property tax, personal property tax, wage withholding tax, unemployment insurance taxes, and sales and use taxes; or

Potential successor liability under the Colorado wage statutes for the nonpayment of employee compensation.