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Summary of Village Builders 96

Patty Roberts
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COMMERCIAL LAW – SUCCESSOR LIABILITY

Summary

In September 1995, Ray Brannen formed Buena Nevada. In December 1996, Brannen sold 100% of Buena Nevada’s shares to Geofon, Inc, which formed a new company named Buena Engineers, Inc., a Division of Geofon, Inc. (Buena Geofon). In the sales agreement, Brannen reserved the right to repurchase the shares of Buena Geofon.

In 1997, Buena Geofon submitted a proposal to Village Builders, LP (Village) to perform an environmental site assessment, which Village accepted. Acting on Buena Geofon’s assessment, Village purchased the property only to discover in December 1998 that Buena Geofon’s assessment failed to identify contaminated soil and ground water on the property.

In May 1999, Brannen bought all of Buena Geofon’s stock, thereby resuming ownership of the company known as Buena Nevada. Brannen then sold all of Buena Nevada’s assets and good will to U.S. Labs, excepting any stock and limiting specific liabilities, and Buena Engineers, Inc., a Delaware Corporation (Buena Delaware) was formed to hold Buena Nevada’s assets. After the sale, Buena Nevada continued to operate as a separate corporate entity. For Buena Nevada’s assets and good will, Brannen received $14,000 as the cash value of 3,333 shares of U.S. Labs stock, which Brannen later used to purchase U.S. Labs stock. Additionally, U.S. Labs hired many Buena Geofon employees, including Brannen, to work for Buena Delaware; Buena Delaware continued to use the same facilities and logo and to offer the same services; further Buena Delaware did not alter the contracts it obtained as part of the asset purchase transaction.

In August 1999, Village filed an action against Buena Nevada to recover its clean-up costs. When Village discovered that U.S. Labs had purchased all of Buena Nevada’s assets and good will, Village amended its complaint and brought breach of contract, negligence, and negligence per se claims against U.S. Labs. Village contended that U.S. Labs and Buena Delaware were proper parties to the suit based upon the doctrine of successor liability.

The district court granted U.S. Labs’ motion for summary judgment, determining as a matter of law that U.S. Labs was not liable under a successor liability theory. The district court also awarded $3,108 in costs to U.S. Labs and Buena Delaware. Village appealed both orders.

The Nevada Supreme Court held that Village failed to make out a prima facie case establishing an exception to the general rule precluding successor liability. However, the Nevada Supreme Court reversed and remanded with regard to costs, holding that U.S. Labs failed to submit a verified memorandum of costs and that U.S. Labs’ motion for attorney fees and costs did not sufficiently satisfy the trial court’s award.

1 By Patty Roberts
Issues and Dispositions

Issue

1) Does a company who continues the enterprise of its predecessor and assumes the obligations necessary for the seller’s normal business operations fall within the de facto merger exception to the general rule against successor liability, even though the successor did not have a continuity of stockholders and the seller continued to exist after the sale?

2) Does a claim of general negligence against a successor corporation support adoption of a more expansive test for the mere continuation exception to the general rule against successor liability?

3) Is a successor entitled to a costs award based upon a motion for costs without a supporting memorandum verifying the costs?

Disposition

1) No. Four factors must be considered to establish successor liability under the de facto merger exception to the general rule against successor liability: (1) continuity of the enterprise, (2) continuity of shareholders, (3) cessation of ordinary business operation, and (4) assumption of the obligations necessary for normal business operations. The court should weigh all four factors evenly. When only two of the four factors are satisfied, a de facto merger does not exist.

2) No. Only two traditional factors should be considered when determining whether a sale of assets falls within the mere continuation exception to the general rule against successor liability: 1) only one corporation remains after the transfer of assets and 2) there is an identity of stock, stockholders, and directors between the two corporations. A more expansive test, known as the continuity of the enterprise doctrine, may be justified as a matter of public policy in cases asserting products liability or CERCLA\(^2\) claims, but is not appropriate in a general negligence action.

3) No. In order to be awarded costs, Nevada law requires that a prevailing party must submit a verified memorandum of the items of costs which states the items are correct and that costs have been necessarily incurred in the action or proceeding. Absent such a memorandum, a district court would abuse its discretion in granting an award of costs.

Commentary

State of the Law Prior to Village Builders

\(^2\) Comprehensive Environmental Response, Compensation, and Liability Act
Prior to Village Builders, Nevada followed the general rule that when one corporation sells all of its assets to another corporation, the purchaser is not liable for the debts of the seller.\(^3\) Nevada has recognized four exceptions to this general rule: (1) where the purchaser expressly or impliedly agrees to assume such debts; (2) where the transaction is really a consolidation or merger (de facto merger); (3) when the purchasing corporation is merely a continuation of the selling corporation (mere continuation); and (4) where the transaction was fraudulently made in order to escape liability for such debts.\(^4\)

In Village Builders, the Nevada Supreme court clarified the elements a plaintiff must demonstrate in order to establish a prima facie case for the de facto merger and mere continuation exceptions to the general rule against successor liability.

The Nevada Supreme Court adopted a four-part test, used by other courts, which considers whether: 1) there is a continuation of the enterprise; 2) there is a continuity of the shareholders; 3) the seller corporation ceased its ordinary business operations; and 4) the purchasing corporation assumed the seller’s obligations.\(^5\) Nevada decided that the should weigh the factors equally such that no single factor is “either necessary or sufficient to establish a de facto merger.”\(^6\)

Finally, as to the requirement that costs be supported by a verified memorandum, the Nevada Supreme Court looked to the language of NRS 18.110(1) and Nevada cases interpreting that statute. Those authorities dictate that costs awarded be only those actually incurred\(^7\) and that costs must be reasonable.\(^8\) Until the prevailing party provides proper documentation, a district court can not determine if the amount spent was reasonable. Therefore, a district court would abuse its discretion in awarding costs without such documentation.

Other Jurisdictions

The holding of this case largely reflects the state of the law in other jurisdictions. Several other courts use the same four-part test to analyze whether a de facto merger has occurred. However, the courts vary in how they weigh the factors and do not always weigh them equally.\(^9\) As for the mere continuation exception, most courts, including Nevada, adhere to the traditional two part test.\(^10\) The more expansive “continuity of the enterprise doctrine” considers eight factors: (1) retention of the same employees; (2) retention of the same supervisory personnel; (3) retention of the same production facilities in the same location; (4) production of the same product; (5) retention of the same name; (6) continuity of the assets; (7) continuity of general business operations; and

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\(^4\) See id. at 279, 454 P.2d at 27.
\(^7\) See Bobby Berosini, Ltd. V. PETA, 114 Nev. 1348, 1352, 971 P.2d 383, 386 (1998).
\(^9\) See, e.g., Louisiana-Pacific Corp. v. Asarco, Inc., 909 F.2d 1260, 1264 (9th Cir. 1990) (placing emphasis on continuity of the shareholders) (citations omitted).
8) whether the successor holds itself out as the continuation of the previous enterprise.\textsuperscript{11} Like Nevada, other courts have refused to adopt the continuity of the enterprise doctrine with regard to contract or tort contexts,\textsuperscript{12} and most have limited its use to claims such as CERCLA violations\textsuperscript{13} and products liability.\textsuperscript{14}

\textbf{Effect of Village Builders on Current Law}

The effect on Nevada law of this case is that it provides multi-factor tests consistent with those used in other jurisdictions for analyzing whether a de facto merger or mere continuation exception to successor liability exists. However, the tests cannot be mechanically applied and case-by-case examination will be necessary to determine whether the facts fit within the various factors. Further, the Nevada Supreme Court leaves unanswered whether the de facto merger test requires the existence of all four factors or whether the presence of three factors would tip the scale in favor of finding a prima facie case for the existence of a de facto merger.

\textbf{Conclusion}

A plaintiff who wishes to establish successor liability under the de facto merger exception will have to satisfy a four-part test showing that: 1) there was a continuity of the enterprise; 2) there was a continuity of shareholders; 3) there was a cessation of business operation of the seller corporation; and 4) the successor corporation assumed the obligations necessary for the normal business operations of the seller. All four factors are weighed equally, and a de facto merger does not exist when only two of the four factors are satisfied.

To establish a mere continuation exception, a plaintiff must demonstrate: 1) that only one corporation remains after the transfer of the assets and 2) that there is an identity of stock, stockholders, and directors between the two corporations. Together these rules will make it more difficult for a plaintiff to present sufficient evidence to establish a prima facie case and overcome summary judgment thereby further protecting the general rule that a successor corporation is not liable for the debts of the seller. Finally, in order to be awarded costs, the prevailing party must submit a verified memorandum of costs actually incurred in the action, and the costs must be reasonable.

\textsuperscript{11} See Kleen Laundry & Dry Cleaning v. Total Waste Mgmt., 867 F. Supp. 1136, 1140 (D.N.H. 1994) (citations omitted) ("Kleen Laundry II").
\textsuperscript{13} See, e.g., Kleen Laundry II, 867 F. Supp. at 1140; Kleen Laundry I, 817 F. Supp. at 230.