Avoiding Successor Liability in Distress Sales

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“Successor liability” is a phrase that strikes fear in the hearts of would-be distress buyers. Why? The goal of most distress sales is for the buyer to acquire assets at less than the value of all of the obligations owed by the seller. Successor liability threatens this goal, because it allows unpaid creditors to pursue the deep pockets of the buyer in the attempt to get paid in full.

When it comes to the world of mergers and acquisitions, there are three primary ways to acquire a company: the merger, the stock sale, and the asset purchase. Existing liabilities of the seller transfer with the company in a merger or stock sale, so the acquisition method of choice in most distress sales is the asset purchase.

An asset purchase allows the buyer to acquire specific assets and exclude liabilities. The idea is simple: the buyer pays fair value for the assets, and the seller then uses the proceeds from the sale to pay its liabilities, or some portion of them if the company is insolvent. When creditors are not paid in full, however, successor liability is often the theory they will use to attempt to collect the shortfall from the buyer. It is an exception to the general rule that an asset purchaser can exclude liabilities and allows creditors to override the language of the asset purchase agreement to attach liabilities to the buyer in some circumstances.

Traditional Theories
Successor liability was originally a creation of the courts and developed as a way to prevent owners of corporations from playing shell games with corporate assets to commit fraud on creditors.

This original goal is apparent in the four traditional theories of successor liability. They consist of:

1. Assumed Liabilities. A buyer is liable to third-party creditors for liabilities that it assumes (expressly or implicitly) as part of its asset purchase.

2. Fraudulent Transfer. The buyer can be liable to third-party creditors (and the sale can even be unwound) if the sale was intended as a fraud to defeat creditors, or if the buyer paid less than fair value for the assets when the seller was insolvent.

3. De Facto Merger. Liability attaches when an asset sale has mimicked the results of a statutory merger except for continuation of liability. The elements are often described as (1) continuity of the selling corporation evidenced by the same management, personnel, assets, and physical location, and (2) continuity of stockholders, accomplished by paying for the acquired corporation with shares of stock.

4. Mere Continuation/Substantial Continuity. Similar to the de facto merger doctrine (and often confused with it), liability attaches under the mere continuation theory when the buyer is continuing the business of the seller with little change. The primary elements include use by the buyer of the seller’s name, location, and employees; a common identity of stockholders and directors; and dissolution of the seller following the transaction. While the central element in a de facto merger is ownership continuity through the transfer of stock, the central element in mere continuation is the continuation of the corporate identity.

In the last several decades, a fifth basis for successor liability has developed and is known as the product line theory. This theory finds its genesis in 1977 in the Ray v. Alad case in California. Under the product line theory, when the buyer continues to manufacture the same product line(s) as the seller, and the seller is no longer available to pay the claims of consumers injured by goods previously manufactured by the seller, the buyer can be liable for product liability claims that otherwise would have been owed by its seller.

The elements of the product line theory are often described as: (1) the virtual destruction of the plaintiff’s remedies against the original manufacturer caused by the successor’s acquisition of the business, (2) the successor’s ability to assume the original manufacturer’s risk spreading role, (3) the fairness of requiring the successor to assume a responsibility for defective products that was a burden necessarily attached to the original manufacturer’s goodwill being enjoyed by the successor.

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in continuing the business, and (4) the continued manufacture of the seller’s products by the buyer. While the doctrine has been followed by some additional states, it remains the minority rule; only a limited number of states accept the product line theory as a valid basis for successor liability.

**Statutory Successor Liability Schemes**

Some of the more dangerous areas of successor liability for buyers in recent years have become statutory obligations, which stem from major federal and state programs.

For example, federal environmental laws impose significant successor liability obligations on parties in the chain of title of polluted land. Under the Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA), which is also known as Superfund, all that may be necessary for a buyer to be lassoed with the environmental liabilities created, either by its direct predecessor or even a predecessor many times removed, is for the buyer to own the property. This is the reason that environmental reports known as “Phase I” reports have become central to the acquisition process of land in the U.S. since the 1980s. A buyer’s ability to demonstrate “appropriate inquiry” before purchasing the property can help establish a defense to environmental successor liability.

Federal labor law is another area in which a buyer can find itself caught in the gravitational pull of successor liability. One major federal statutory scheme likely to impose successor liability is the Employee Retirement Income Security Act of 1974 (ERISA), which provides for employee health and pension plans. A buyer can be held responsible under ERISA for paying the seller’s withdrawal liability from a multiemployer plan. Other federal statutes for which buyers may find themselves liable as successors include the Fair Labor Standards Act, which imposes wage and hour requirements on employers, and federal employment discrimination laws, such as Title VII, the Americans with Disabilities Act, and the Age Discrimination in Employment Act.

A buyer that continues the business operations without interruption or substantial change can also find itself liable for health insurance obligations owed by its seller to former employees under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA). Further, if they hire and continue using a unionized workforce, buyers can be liable for union obligations under the collective bargaining agreements of their predecessors.

The federal courts have developed their own tests for successor liability under many federal statutes. The tests derive from the development of federal labor law and are more favorable to creditors than traditional state law. While there are a number of factors, the primary issues for finding federal labor successor liability are that (1) the buyer has notice of the claim before the acquisition and (2) there be substantial continuity in the operations and workforce before and after the sale. In one recent decision, a federal circuit court of appeals suggested that a buyer is presumed to have successor liability under federal labor laws “unless there are good reasons to withhold such liability.”

When it comes to state laws, many states have successor liability statutes that make a buyer liable for unpaid sales taxes and unemployment taxes of the seller. For example, if a seller has outstanding sales taxes that it has not remitted to the state, a buyer can be liable to the state for up to the full amount of compensation it pays for the acquisition, or the full amount of taxes and penalties owed, whichever is less. These statutes essentially create a double-payment bind for the buyer, if the buyer does not ensure that the sales taxes are cleared as part of the sale, the buyer ends up paying to the state revenue cabinet the same amount of consideration it already paid for the company.

Unemployment taxes can have similar successor liability obligations, as can workers compensation fund taxes.

Under these state tax successorship statutes, the amount of consideration paid for the acquisition is often calculated to include debts assumed by the buyer, so even in a “no cash” distressed acquisition, the buyer can end up paying substantial taxes under a successor liability doctrine.

A further issue for consideration by a buyer is the claims rating of its distressed seller for workers compensation insurance and unemployment insurance schemes. In some instances, buyers can inherit the albatross of their seller’s former rating, resulting in much higher contribution rates going forward. Distressed companies often have unfavorable ratings due to operational difficulties that may accompany their financial problems.

Some successor liability rules are industry-specific, such as liability under the Medicare and Medicaid programs in the healthcare arena. For example, when a buyer assumes the Medicare provider agreement of its seller, it has successor liability for prior overpayments to (and in some instances, bad acts of) its predecessor.

**Structuring the Sale**

For avoiding successor liability, one of the favorite methods of purchasers is the bankruptcy 363 sale, so named because of the section of the U.S. Bankruptcy Code from which it derives. The popularity of 363 sales derives from the fact that the sale is approved by a court order. Bankruptcy Courts are often willing to include language in their sale orders that protects purchasers from successor liabilities, including creating injunctions that prevent creditors from asserting successor liability claims.

The law is not fully settled on the issue of successor liability in bankruptcy, but 363 sales appear to be emerging as the favored method of avoiding certain successor liabilities. In recent cases, courts have allowed successor liability claims against buyers in out-of-court situations when a 363 sale through bankruptcy may have produced a different result.

For example, in the 2011 case of *Einhorn v. M.L. Ruberton Constr. Co.*, the 3rd U.S. Circuit Court of Appeals found that a buyer in a distress sale completed outside of bankruptcy was liable for underfunded multiemployer plan pension obligations. By comparison, in 2015, the Bankruptcy Court for the District of Delaware in *In re: Ormet Corp.* found, in a case of first impression, that a buyer in a Section 363 sale can purchase free and clear of underfunded pension obligations.

In addition, in *Teed v. Thomas & Betts Power Solutions, LLC*, the 7th U.S. Circuit Court of Appeals found that a buyer in a state court receivership distress sale was liable as a successor for a wage class action under the federal Fair Labor Standards Act (FLSA) being asserted against the seller at the time of the sale. Under the reasoning of Ormet, and *In re Transworld Airlines, Inc.*, buyers may be able to avoid similar successor liability through the 363 sale process.
The recent final report and recommendations of the ABI Commission to Study the Reform of Chapter 11 proposes that successor liabilities under federal labor laws, such as the FLSA, pass through 363 sales so that buyers are not able to escape them. For the moment, however, courts appear to be moving toward protecting against successor liability to facilitate bankruptcy sales that maximize value.

Finally, in the context of the product line theory of successor liability, even California may not apply the doctrine when the sale has been conducted through the 363 process. The rationale for this outcome is that the buyer is not causing the loss of the tort plaintiff’s remedies against the seller, but instead, this loss is a result of bankruptcy law.

**Major Consideration**

Successor liability comes in many shapes and sizes, and purchasers in distress scenarios often find themselves caught by surprise when they are sued by the creditors (sometimes known, sometimes unknown) of their seller after the fact for liabilities that were expressly excluded in the purchase agreement. The potential for successor liability claims should be a major consideration in structuring acquisitions in the distress space.

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3. Teed v. Thomas & Betts Power Solutions, LLC, 711 F.3d 763, 769 (7th Cir. 2013).
5. Id.
6. 632 F.3d 89 (3d Cir. 2011).
8. 711 F.3d 763 (7th Cir. 2013).
9. 322 F.3d 283 (3d Cir. 2003) (finding that the buyer of TWA’s assets in a 363 sale was not subject to successor liability for federal employment discrimination claims).