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M E M O R A N D U M

TO: Judicial Interpretations Working Group of the M&A Committee

FROM: Jon T. Hirschoff,[1] John H. Lawrence Jr. and Daniel H. Peters

RE: Successor Liability in Asset Acquisition Transactions

DATE: January 12, 2019

I. Introduction.[2]

A frequently cited advantage of an asset purchase over a merger or stock purchase is the flexibility that the parties have in this structure to agree, as between themselves, on which debts and liabilities of seller will be assumed by buyer and which will be retained by seller. This flexibility is based on the long-standing common law principle

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1 The authors would like to dedicate this Memorandum to Jon T. Hirschoff, a colleague and close friend who encouraged us to embark on this ambitious project several years ago but who unfortunately passed away before we were able to finish our task.

2 We also wish to gratefully acknowledge the comments and insights provided by Andrew Davis, John Wertam, Raymond Casella, Eric Goldstein, Miriam Lewis, Laura Fisher, Stephanie Gomes-Ganhao, Niha Parikha and Patricia Chouinard at Shipman & Goodwin LLP, and by Rachel Fisher at Katten Muchin Rosenman LLP. Our thanks also to Jim Lotstein and to David I. Albin at Finn Dixon & Herling LLP for their final review and comments; Scott B. Cohen at Engelman Berger, P.C. for his comments on buying distressed assets in bankruptcy, and Joseph Quarantello, Mike Vitulli, and Iyan G. Alfredson at Risk Strategies Company and Nicholas Kalist at Aon for their comments on the insurance issues. We want to especially thank Frederic L. Smith Jr. at Bradley Arant Boult Cummings LLP and the other members of the M&A Jurisprudence Subcommittee, as well as Byron F. Egan at Jackson Walker LLP, for their support and encouragement throughout the project, and finally we want to thank Chanwon Pio Yoon and Harry Burgess at Shipman & Goodwin for their invaluable cite checking and careful proofreading.

that a buyer of the assets of a business does not thereby become liable for the debts and liabilities of seller that were not expressly assumed by buyer. This is commonly referred to as the "rule of non-liability."[3] However, the rule is subject to a number of exceptions, the scope of which has expanded dramatically over the past 25 years, to the point where transaction planners can no longer predict the outcome of a successor liability claim with confidence or rely upon the structure of the transaction alone to shield buyer from the liabilities of seller, both known and unknown, that are not expressly assumed by buyer. The rise in the number of successor liability claims[4] and the lack of predictability of the outcome dictate that due diligence and pre-transaction planning with respect to seller's retained liabilities be as comprehensive in an asset purchase as they are in any other transaction structure. This is especially true where the transaction involves all or substantially all of seller's business assets, some or all of seller's equity owners continue as owners of buyer, and/or seller will be dissolved after the transaction and thus unable to respond to claims of its creditors.

This Memorandum discusses the application of the rule of non-liability in asset purchase transactions in the United States and the many confusing exceptions to that rule. It suggests an analytical framework for assessing and minimizing successor liability risk. The suggested approach does not rely on predicting which law will govern successor liability claims in any given transaction or how a court might weigh the many factors that have historically influenced judicial decision on successor liability claims. Rather, it is based on identification of areas of successor liability risk and pre-transaction planning to eliminate some elements of risk and use of various types of general and specialized insurance products to address identifiable risks. Our overarching goal is to make M&A practitioners and their clients aware of the variety of successor liability risks in asset purchase transactions and provide practical guidance on how to navigate this difficult area

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[3] Byron F. Egan, *Asset Acquisitions: Assuming and Avoiding Liabilities*, 116 PENN. ST. L. REV. 913 (2012); John H. Matheson, *Successor Liability*, 96 MINN. L. REV. 371 (2011) (hereinafter, "Matheson"). *See generally*, AM. BAR ASS'N, MODEL ASSET PURCHASE AGREEMENT, EXHIBITS, ANCILLARY DOCUMENTS AND APPENDICES (VOLUME 2), Appendix A, Successor Liability (2001) (hereinafter, the "Model Asset Purchase Agreement"); 15 FLETCHER, CYCLOPEDIA OF THE LAW OF CORPORATIONS § 7122 (perm. rev. ed. 2008 & Supp. 2017) (hereinafter, "Fletcher").

[4] A Westlaw search on June 25, 2018 for court decisions that used the word "*de facto* merger" (success! /2 liab! /10 ("de facto" or defacto)) & DA(bef 6/25/2018) identified over 755 such cases in the past five years. The following table shows the number of such *de facto* merger cases in each five year period ending on June 25 of the year shown. You will note that the number of such cases has increased over 60% in the past 10 years and over 180% in the past 20 years.

1998	2003	2008	2013	2018
266 cases	359 cases	470 cases	623 cases	755 cases

and minimize and address the risks of post-closing claims based upon the pre-closing acts and omissions of seller and its predecessors.

Judicially created exceptions to the rule of non-liability are fact-specific doctrines that have been developed to provide an equitable remedy to creditors of an asset seller under circumstances where the creditor does not have an adequate post-closing remedy against seller. Provisions in the asset purchase agreement stating that buyer is not assuming any liabilities of seller, except those expressly identified in the agreement, or identifying the governing law of the transaction, are of no use to a buyer in defending against successor liability claims because the creditor is not a party to the agreement. Unfortunately for transactional counsel, the courts have taken widely varying approaches in defining and applying these exceptions and the applicable choice of law principles. The decisions tend to be very fact driven, with courts often using shorthand descriptions that do not clearly describe all the relevant facts or the weight given to the relevant factors. One prominent commentator described how confusing the exceptions to the law of successor liability have become:

> [V]aried and unpredictable that it is not only a trap for the unwary, but a trap for the very wary, as well. Transactional asset-acquisition planning today faces the worst of all possible worlds: uncertainty as to whether successor liability applies, together with an enormous range of potentially applicable monetary liabilities that may be brought on an asset-purchasing entity after the transaction is completed. . . . More than a century of common law experimentation has resulted in the "doctrinal morass and high degree of uncertainty that now surround successor liability."[5]

A buyer of business assets will typically assume specific liabilities of seller relating to the ongoing operation of the business, such as trade payables and the post-closing obligations of seller under existing contracts and leases, and will expressly disclaim responsibility for other liabilities, such as liabilities for any products manufactured and sold prior to the closing, seller's pre-closing tax liabilities, environmental, health and safety liabilities, employee benefit plan liabilities, and other liabilities arising out of seller's pre-closing acts or omissions.[6] In the sale of a product line or division, buyer will ordinarily acquire only the tangible and intangible assets related to the acquired line of business and ordinary course liabilities related to the acquired product line or division, and seller will continue in business after the transaction and therefore be available to be responsible for the retained liabilities.

A business entity that sells all or substantially all of its business assets will often dissolve shortly after the sale and distribute the sale proceeds to its owners, net of any funds held in escrow or in reserve for contingent liabilities and transaction expenses. Occasionally, the asset purchase agreement will prohibit seller from dissolving or making

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[5] *See* Matheson, *supra* note 3, at 373 (footnotes omitted).

[6] The Model Asset Purchase Agreement, *supra* note 3, Vol. 1, § 2.4(b).

any distribution to its owners until seller has paid or made adequate provision for its debts and other obligations.[7] Creditors of a dissolved entity can generally pursue their claims against owners of the entity under the applicable dissolution statute. There are, however, important limitations on an owner's liability to creditors of the dissolved entity. An equity owner's total liability for all such claims may not exceed the total amount of assets distributed to such owner after the dissolution.[8] Moreover, by publishing newspaper notice of the dissolution, the dissolving corporation and its equity owners may be entitled to the benefit of a shorter statute of limitations on post-dissolution claims.[9] All of this may leave a post-closing claimant against seller without an adequate legal remedy, which can seem particularly harsh in the case of a claim for injury or death where the parties knew or should have known of potential claims in the future and buyer continues seller's business without interruption.[10] The lack of an adequate remedy for injuries and death caused by a defective product under these circumstances has been one of the primary driving forces that have led courts to expand the exceptions to the traditional rule of non-liability.[11]

The rule of non-liability has four traditional exceptions, where: (i) buyer expressly or impliedly assumes seller's liabilities, (ii) the transaction is a consolidation or merger of seller and buyer; (iii) buyer is a mere continuation of seller, and (iv) the transaction is entered into with the intention of defrauding seller's creditors. The most commonly cited exception in an asset purchase is the *de facto* merger doctrine where some or all of the following facts are present: continuity of share ownership between seller and buyer; continuity of management, personnel, physical location, assets and/or general business operations between buyer and seller; seller is dissolved shortly after the

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7 *Id.* at Vol. 1, § 10.4.

8 *See* MODEL BUS. CORP. ACT § 14.07(d)(2) (Am. Bar Ass'n 2010); Del. Code Ann. tit. 8, §§ 282(a) and (c) (West, Westlaw through 81 Laws 2018, chs. 200-253 Rev. to 2018 Acts); REVISED UNIFORM LIMITED LIABILITY COMPANY ACT § 704(d)(2) (Nat'l Conference of Comm'rs on Unif. State Laws 2006). *Cf.* Del. Code Ann. tit. 6, § 18-804(c) (West, Westlaw through 81 Laws 2018, chs. 200-253 Rev. to 2018 Acts).

9 *See* MODEL BUS. CORP. ACT § 14.07(d)(2) (Am. Bar Ass'n 2010); Del. Code Ann. tit. 8, § 282(b) (West, Westlaw through 81 Laws 2018, chs. 200-253 Rev. to 2018 Acts); REVISED UNIFORM LIMITED LIABILITY COMPANY ACT § 704(d)(2) (Nat'l Conference of Comm'rs on Unif. State Laws 2006).

10 *See, e.g.* Elliott v. Gen. Motors LLC (In re Motors Liquidation Co.), 829 F.3d 135, 156 (2d Cir. 2016), *cert. denied*, 137 S.Ct. 1813 (2017).

11 The lack of an adequate remedy for *bona fide* creditors of a seller in an asset sale has generated numerous proposals for statutory solutions. *See, e.g.,* Matheson, *supra* note 3; Richard L. Cupp, Jr., *Redesigning Successor Liability*, 1999 U. ILL. L. REV. 845 (1999); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L. J. 1879 (1991); Michael D. Green, *Successor Liability: The Superiority of Statutory Reform to Protect Products Liability Claimants*, 72 CORNELL L. REV. 17 (1986).

sale; and buyer assumes seller's ordinary course liabilities. The doctrine *de facto* merger is frequently linked to and confused with the mere continuation doctrine, which focuses on whether buyer is substantially the same as seller based upon commonality of officers, directors and equity owners and the fact that seller ceased to exist after the sale. In addition to these exceptions, some states have adopted the continuity of enterprise exception, which represents an expansion of the traditional successor liability rules in product liability cases and focuses on whether there is a continuation of seller's business operations. There is no requirement under this exception for continuity of ownership or management. Finally, California and several other states have adopted the product line exception for product liability claims, which imposes liability on a successor manufacturer that continues manufacturing a product line that included a defective product, even where there is no continuity of equity ownership or management. We discuss these exceptions in greater detail and related areas, such as the federal common law of successor liability, in Section III.I below. This Memorandum does not discuss the fraud exception or entity piercing rules, which are related and are often corollary issues in any successor liability claim and should not be disregarded by transactional counsel.

Where does this leave a transactional lawyer? Advising clients on potential successor liability risk in an asset acquisition is challenging, not only because of the complex and confusing nature of the case law, but also because of the difficulty in predicting the jurisdiction where an injury may occur or what other jurisdictional contacts might be relevant and thus which law might govern. Unfortunately, these are not issues that can be addressed directly in the transaction documents because the injured party or other claimant is not likely to be a party to any of the documents. This Memorandum is intended to provide a guide to transactional lawyers in planning, structuring, and documenting asset acquisitions where there are significant successor liability risks as indicated by the factors most frequently cited in successor liability decisions. The discussion focuses primarily on asset purchase transactions. However, the discussion also applies to corporate restructurings involving asset transfers within an existing group of affiliates and to drop-down transactions that frequently accompany private equity and venture capital investments in an existing business.

This Memorandum is organized into the following Sections: Section II provides a suggested approach for assessing and minimizing successor liability risk in asset acquisitions based on current successor liability law; Section III presents a brief summary of the common law and statutory rules governing successor liability; Section IV discusses buying distressed assets in bankruptcy, and Section V discusses choice of law principles for successor liability.

II. Assessing and Minimizing Successor Liability Risk in Asset Acquisitions.

In an asset purchase transaction, the liabilities of seller that will be assumed and discharged by buyer are typically covered by a provision in the asset purchase agreement that explicitly describes which liabilities are being assumed by buyer. This provision is usually accompanied by a provision that states that if a liability of seller is not expressly assumed by buyer it is retained by seller and remains the responsibility of seller.[12] The buyer's protection against post-closing claims for seller's retained liabilities is typically provided by indemnification obligations in the purchase agreement that require seller to indemnify and defend buyer against any claims based on retained liabilities. Such indemnification obligations are not usually subject to a basket, a cap or a *de minimis* claim exclusion ("mini-basket"), and they are often secured by an escrow deposit or set off rights against seller and its equity owners with respect to the purchase money note and any earn-out payments. Indemnification is not generally an effective remedy, however, for "long-tail" liabilities, such as product liability and environmental claims, which may be asserted long after the closing and after seller has been dissolved and liquidated and any escrow funds have been released. Moreover, for these types of claims set off rights are typically ineffective because there is no purchase money note or the note has been paid in full.

Long-tail claims are the primary source of successor liability risk and are most relevant to buyer and its counsel. However, case law developments over the past 25 years have made successor liability risk difficult to predict, and typical asset acquisition structures are not well-suited to entirely insulate buyers from that risk. Understanding when successor liability risk is present, what factors increase the risk, and what mitigating measures are available are all important parts of current acquisition planning.

Although successor liability doctrines for non-fraudulent asset acquisitions have been developed primarily by judicial decisions in the areas of product liability, environmental claims and labor law, the principles of successor liability that have developed in those areas have been applied generally across all areas of the law, including contractual and statutory liabilities and regardless of whether seller or buyer is a corporation or limited liability company.[13] Unfortunately, as explained in Section III, the case law is of little predictive value because of the multiplicity of factors used to determine successor liability and the difficulty in some areas, such as product liability, of predicting which law will apply.

Buyer's counsel should engage in an early client discussion that includes a warning that the risks of successor liability cannot be fully eliminated by structuring the transaction as an asset purchase. This discussion should ideally take place prior to negotiations regarding the purchase price; however, this rarely happens in practice because successor liability risk often becomes apparent only after the due diligence process is well underway. Nevertheless, even before specific successor liability risks can be identified there are certain indicia of successor liability risk that will be known and should be

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[12] *See*, Sections 2.4(a) and (b) of the Model Asset Purchase Agreement and the related Comment.

[13] *See, e.g.,* In re Gen. Motors LLC Ignition Switch Litig., No. 14-MC-2543 (JMF), 2017 WL 6509256 (S.D.N.Y. Dec. 19, 2017), *on reconsideration in part*, No. 14-MC-2543 (JMF), 2018 WL 1989572 (S.D.N.Y. Apr. 25, 2018); Springer v. Nohl Elec. Prod. Corp., 381 Wis. 2d 438, 912 N.W.2d 1 (2018).

discussed with buyer early in the negotiation process. This discussion should identify the elements of the acquisition transaction that may create successor liability risk and the steps that can be taken to identify and minimize that risk. Specifically, buyer's counsel should consider advising buyer that it may no longer be prudent to rely solely on the traditional rule of non-liability where seller may not be able to satisfy all of its retained liabilities, including contingent liabilities. Accordingly, where there are multiple successor liability risk factors present, discussions with buyer should cover ways to mitigate those risks, such as the various types of insurance coverage for buyer and seller and the impact of such risks on the purchase price.

The numerous theories of successor liability, conflicting judicial decisions, and difficulty in predicting which law will govern successor liability claims make it impractical to use any single theory or look to any single governing law to evaluate successor liability exposure. The following is a suggested approach to assessing and minimizing successor liability risk regardless of the theory of successor liability that may be applied or the choice of law.

A. Factors Increasing Successor Liability Risk.

The risk of successor liability increases as the number of the following factors in any potential transaction increases:

1. Seller Is Likely to be Subject to "Long-Tail" Claims, Such as Product Liability and Environmental Claims. The risk of successor liability is generally greater if the acquired business involves manufacturing or product distribution because much of the expansion of common law theories of successor liability has involved "long tail" product liability claims made long after the product was manufactured and sold. Environmental, health and safety, and data breach claims are also potentially long-tail claims. One of the difficulties of planning for such long-tail claims is that they are often made long after the expiration of the typical escrow or survival period for indemnification of breaches of representations and warranties. Service businesses, other than health care and construction, typically do not present the same long-tail claim risk as a manufacturing business.[14] Another reason that successor liability risk is higher for product liability is the product line exception to the rule of non-liability, which imposes liability on a successor manufacturer without looking to any of the indicia of a *de facto* merger or another exception to the rule of non-liability. A similar risk exists for many environmental claims which follow the owner or operator of the property, without regard to any of the typical exceptions.

2. Seller Will Be Liquidated and Dissolved Shortly after the Sale. Successor liability risk is highest where seller sells all or substantially all of its assets and

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[14] *See* Monarch Bay II v. Professional Service Industries, Inc., 75 Cal. App. 4th 1213, 89 Cal. Rptr. 2d 778 (1999) (noting the court declining to extend product line exception to negligence by a service business).

ceases doing business, dissolves and distributes its remaining assets shortly after the closing. Cessation of business and dissolution of seller after the transaction is one of the most important indicia of a *de fact*o merger, i.e. the existence of only one corporation at the end of the transaction.[15] As one court succinctly stated: "[Seller] continued to operate as a completely independent business entity subsequent to the Asset Purchase, with its own officers, directors, and shareholders. . . . Presented with the evidence before it, no reasonable juror could find that [buyer] was a continuation of [seller] after the Asset Purchase."[16] Successor liability risk decreases significantly if seller continues in business after the sale, as it would in a typical carve-out or divisional sale, because seller would be available to pay the retained liabilities and respond to buyer's indemnification claims.

3. Equity Owners of Seller Will Receive Equity in Buyer as Purchase Consideration. Successor liability risk increases if the transaction is not an all-cash transaction and the consideration includes shares or other equity interests of buyer or its parent. In such case, seller's shareholders or other equity owners would become equity owners of buyer after the transaction, and that continuity of ownership, even as little as twelve percent of buyer's equity, may support a *de facto* merger finding, especially when seller's upper level executives continue in the management and operation of the acquired business.[17] The risk presented by continuity of ownership may be reduced if the equity interests in buyer are awarded after the sale, are subject to vesting and are not a part of the transaction, for example, stock options or restricted stock granted after the closing but not contemplated by the purchase agreement.

4. Buyer Will Continue Seller's Business Operations with Few Changes. The risk of successor liability increases if buyer continues to operate the acquired business after the sale using some or all of the management and employees of seller and uses the same physical plant and equipment. Other indicia of potential successor liability are the assumption by buyer of liabilities ordinarily necessary for the continuation of seller's

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15 *See* Tabor v. Metal Ware Corp. 182 F. App'x 774 (10th Cir. 2006).

16 Herrod v. Metal Powder Products, Inc., No. 1:07-CV-23TS, 2008 WL 5191702, at *4 (D. Utah Dec. 10, 2008). *See* Desclafani v. Pave-Mark Corp., No. 07 CIV. 4639 (HPB), 2008 WL 3914881 (S.D.N.Y. Aug. 22, 2008); *Herrod,* No. 1:07-CV-23TS, 2008 WL 5191702 ("It is not enough that the successor benefit from the predecessor's name and good will, or that the successor produce essentially the same product as the predecessor. . . . [Predecessor] continued to operate as a completely independent business entity subsequent to Asset Purchase, with its own officers, directors and shareholders."); RESTATEMENT (THIRD) OF TORTS § 12 (Am. Law Inst. 2000).

17 *See* Goguen v. Textron Inc., 476 F. Supp. 2d 5 (D. Mass. 2007) (discussing continuity of share ownership, which is essential for a finding of successor liability under the Massachusetts *de facto* merger doctrine. Massachusetts has not adopted the continuity of enterprise theory, which does not require continuity of share ownership).

business, such as trade payables and seller's post-closing contractual and lease obligations.[18]

5. Buyer Will Hold Itself Out as a Continuation of Seller and Trade on Seller's Goodwill. Successor liability risk increases where buyer holds itself out as a continuation of seller and benefits from seller's name and goodwill. This continuation element may be sufficient standing alone under the product line exception, the rationale being that the continuing sale of the product using the name and goodwill of seller puts the successor in the best position to spread the risks associated with the continuing sale of the product.[19]

6. Buyer Has Prior Knowledge of the Successor Liability Claims. Although it is not a specifically identified factor in any of the successor liability doctrines, all of these doctrines are based on equitable principles. Accordingly, many judicial decisions seem to be influenced by whether the court determines that buyer knew or should have known of potential successor liability claims and did not require seller to make adequate provision for payment of such claims though insurance or otherwise.[20] This is of particular concern where the asset transfer is between related parties, such as recapitalization.

B. Minimizing Successor Liability Risk.

1. Use a Separate Acquisition Sub. By using a separate, newly created limited liability entity to acquire seller's assets, the parent acquirer will create a separate liability shield against successor liability claims based on seller's retained liabilities. Assuming that there are no grounds for piercing the entity's veil, the acquisition subsidiary will quarantine any successful successor liability claims at the subsidiary level. If the acquired business involves environmental risk, the parent should avoid participating in the management or direction of any operations by the subsidiary that involve hazardous waste or becoming involved in decisions about environmental compliance because such

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18 *See* Broydo v. Baxter D. Whitney & Sons, Inc., 24 Misc. 3d 1207(A), 890 N.Y.S.2d 368 (2009) (noting succinct statement of the *de facto* merger rule).

19 *See* Payne v. Saberhagen Holdings, Inc., 147 Wash. App. 17, 190 P.3d 102 (Wash. Ct. App. 2008)(holding that successor had not benefited from predecessor's good will or held itself out as a continuation of seller); Bussell v. DeWalt Prod. Corp., 259 N.J. Super. 499, 614 A.2d 622, 632 (App. Div. 1992) (discussion of purchase of less than all assets); Schmidt v. Boardman, 2008 Pa. Super. 203, 958 A.2d 498 (2008), *aff'd on other grounds*, 608 Pa. 327, 11 A.3d 924 (2011) (recognizing a change in products after purchase of product line, "essentially the same manufacturing operation" is enough). *Cf.* Pesce v. Overhead Door Corp., No. Civ. A. 291CV00435JCH, 1998 WL 34347073 (D. Conn. Aug. 17, 1998) (holding that purchase of less than all of the assets or changes in product line do not necessarily defeat the product line exception).

20 *Cf.* Ninth Avenue Remedial Group v. Allis-Chalmers Corp., 195 B.R. 716, 734 (N.D. Ind. 1996).

acts may increase the risk of liability as an "operator." The same would be true with respect to violations of federal labor and employment law if the parent exercises significant authority over the subsidiary's employment practices. Although any successor liabilities of the acquisition subsidiary would be reflected on the consolidated financial statements of the parent, they will not be actual legal liabilities of the parent and the parent will have the option in the worst case of putting the acquisition sub into bankruptcy. If no unknown or undisclosed liabilities are discovered within six years or some other appropriate "quarantine period," the subsidiary can be merged into or its assets otherwise acquired by the parent.

2. Due Diligence. The breadth and depth of due diligence depends not only on the nature of the operations and assets of the acquired business but the constraints on timing and cost imposed by the nature of the transaction itself. For example, where the transaction involves third-party financing, lender requirements will dictate the minimum scope of due diligence. In an asset acquisition there is often less rigorous due diligence than in a stock purchase or merger because the risk of unknown or undisclosed liabilities is typically thought to be lower; however, where the transaction involves a risk of successor liability, the due diligence should focus on the areas of identified risk, such as product liability or environmental conditions, and transaction planning should include consideration of a consultation with an insurance adviser who is knowledgeable and experienced in M&A transactions.

a. Product Liability Risks. In most states, a manufacturer, distributor or retailer is liable if a defect in the manufacture or design of its product causes injury while the product is being used in a reasonably foreseeable way.[21] Liability is based upon strict liability and tort principles, all of which have dramatically expanded since Justice Traynor expressed his view that a manufacturer should be strictly liable for marketing a defective product that causes personal injury.[22] His view was ultimately adopted by the California Supreme Court in *Greenman v. Yuba Power Products, Inc.*[23] and embodied in Section 402A of the RESTATEMENT (SECOND) OF TORTS. Since then strict product liability has been expanded to cover distributors, suppliers, component manufacturers, retailers and anyone else that is an "integral part of the overall producing and marketing enterprise"[24] and has also been extended to cover property damage and

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[21] RESTATEMENT (SECOND) OF TORTS § 402A (Am. Law Inst. 1965). *See, e.g.,* Conn. Gen. Stat. §52-572m (West, Westlaw through 2018 Reg. Sess.); Soule v. GM Corp., 8 Cal. 4th 548, 560, 882 P.2d 298, 303 (1994). *See generally*, LOUIS R. FRUMER & MELVIN I. FRIEDMAN, PRODUCTS LIABILITY §11.03 (2015).

[22] Escola v. Coca Cola Bottling Co. of Fresno, 24 Cal. 2d 453, 461-68, 150 P.2d 436 (1944) (Traynor, J., concurring).

[23] Greenman v. Yuba Power Prod., Inc., 59 Cal. 2d 57, 377 P.2d 897 (1963).

[24] Arriaga v. CitiCapital Commercial Corp., 167 Cal. App. 4th 1527, 1534 (2008). *See also,* Cronin v. J.B.E. Olson Corp., 8 Cal. 3d 121, 130, 501 P.2d 1153 (1972) (distributors and suppliers); Jimenez v. The Superior Court of San Diego County, 29 Cal. 4th 473, 58 P.3d

economic losses in some jurisdictions.[25] Many states have addressed product liability by statute, either adopting statutory strict liability as the exclusive remedy for defective products or abrogating or limiting strict product liability.[26] The *de facto* merger, mere continuation and continuity of enterprise exceptions to the rule of non-liability have all been applied to strict product liability cases using the same analytical framework that is used for other types of claims but with more flexibility than in other areas. The product line exception has been applied only in the context of product liability claims.

Where there is a risk of future product liability claims, due diligence should include a careful review of seller's product liability insurance coverage and its claims history files, as well as regulatory notices, annual audit inquiry letters and litigation files, as well as on line data bases such as the Recall List of the Consumer Product Safety Commission (CPSC)[27] and the list of Recalls, Market Withdrawals, & Safety Alerts of the Food and Drug Administration (FDA).[28] Due diligence should also include an inquiry as to whether seller knows of any latent defects in its products or any unreasonably dangerous conditions associated with its products. If so, has seller fulfilled its legal duties to warn, recall or retrofit its products, or notify customers of safety advances, especially where buyer may be subject to a post-sale duty to warn because of its continuing relationship with seller's customers? Where buyer assumes seller's service contracts or is continuing to service products manufactured or sold by seller prior to the closing, buyer may be subject to a post-sale duty warn, recall or retrofit seller's products, or notify seller's customers of safety advances.[29]

450, 127 Cal. Rptr. 2d 614 (2002) (component part manufacturers); Vandermark v. Ford Motor Co., 61 Cal. 2d 256, 391 P.2d 168 (1964) (retailers).

[25] In a majority of jurisdictions, a plaintiff cannot recover purely economic damages in tort. Arkansas, Colorado and Connecticut follow the minority rule that allows recovery for economic losses; and Alaska, California, Georgia, Montana and West Virginia allow for recovery of economic losses under certain circumstances based upon the nature of the defect or the manner of the product failure.

[26] *See, e.g.,* Conn. Gen. Stat. § 52-572m (West, Westlaw through 2018 reg. sess.) (strict product liability); Ind. Code Ann. § 34-20-2-1 (West, Westlaw through 2018 First Regular Sess. of 120th Gen. Assembly) (general product liability statute applicable to anyone who sells or otherwise puts into the stream of commerce any defective product); Ind. Code Ann. § 34-20-2-3 (West, Westlaw through 2018 First Regular Sess. of 120th Gen. Assembly) (strict liability statute limiting strict liability to manufacturer); Ky. Rev. Stat. Ann. § 411.300, *et seq.* (West, Westlaw through end of 2018 Reg. Sess. of 120th Gen. Assembly).

[27] The CPSC's recall searchable The liability exclusion and indemnification provisions of the purchase agreement data base is available at https://www.cpsc.gov/Recalls.

[28] The FDA list provides information gathered from press releases and other public notices about certain recalls of FDA-regulated products https://www.fda.gov/safety/recalls/. *See* https://www.fda.gov/Safety/Recalls/ArchiveRecalls/default.htm for the FDA's searchable archive of recalls, market withdrawals and safety alerts that are more than three years old.

[29] *See infra* Section III.G., Post-Sale Duty to Warn

b. Environmental Risks. A buyer can inherit legacy environmental liabilities resulting from past activities at buildings and real property currently or previously owned or operated by the acquired business. Although there is a clear trend among federal courts away from more expansive federal common law principles in finding successor liability under CERCLA, courts are not uniformly following the same standards. If the acquired business or its predecessors may have disposed of released hazardous substances at its properties, the most common due diligence tool is the Phase I Environmental Site Assessment (ESA). Although the form of the assessment report can vary, the majority of ESAs in M&A transactions are based on the ASTM standard protocol, which focuses on identifying conditions indicative of releases of hazardous substances (commonly known as "recognized environmental conditions"). If warranted, the Phase I ESA may recommend a Phase II ESA. A Phase II ESA typically includes sampling or other invasive environmental investigations. Phase II ESA reports often raise more questions than they resolve and can create unacceptable closing delays and complicate negotiations if performed prior to the closing. If the deal is terminated after a Phase I ESA is completed, seller may also be left with a known environmental condition that it may be required to remediate or otherwise address. Buyers will typically request that the Phase I ESA report include the results of a limited compliance review designed to identify potentially material environmental noncompliance and the need for permit transfers, if applicable. Recently, sellers in auction sales have been providing prospective buyers with current Phase I ESA reports and, where appropriate, limited compliance reviews to streamline the due diligence process. A word of caution: seller-commissioned due diligence reports should be prepared by a consulting firm that has a national or regional reputation to minimize the risk of challenge by buyer and the possibility that buyer will commission its own Phase I ESA.

c. Taxes. Successor liability for federal income taxes is based on the same common law principles as successor liability in other areas. The risk of successor liability is greatly reduced if seller is a pass-through entity, but verification of seller's tax classification should not be overlooked. If the tax election has not been made properly or the applicable S corporation rules have been violated, even inadvertently, seller may be responsible for income taxes at the entity level and this would pose a significant successor liability risk. Accordingly, due diligence of a pass-through seller should include verification of seller's tax classification and compliance with the applicable classification rules. Where seller has been a member of an affiliated group (within the meaning of IRC Section 1504(a)) or any similar group defined under a similar provision of state, local or foreign law) filing a consolidated federal income tax return, other than a group the common parent of which is seller, consideration should be given to expanding the scope of tax due diligence to other members of the group and obtaining appropriate indemnification obligations of the ultimate parent entity because of the potential for successor liability for unpaid income taxes of the group under Treasury Regulations Section 1.1502-6.

Successor liability is generally provided by state statute for unpaid sales and use taxes, and state income tax withholding (so called "trust fund taxes") following a bulk sale of the whole or any part of seller's business assets outside the ordinary course of business.[30] In order to protect buyer against successor liability for state taxes, seller or buyer must provide the state taxing authority with notice of the proposed sale or request a tax clearance certificate, which provides the state taxing authority with an opportunity to audit seller's sales tax and other tax histories and collect any outstanding taxes before seller discontinues its business. Unfortunately, the audit process can take several months to complete. Upon completion of the audit and payment of any taxes due, the state will typically issue a tax clearance certificate that protects buyer from future claims for unpaid taxes of seller.[31] The tax clearance procedure is often dismissed as unduly burdensome by seller's counsel or ignored by buyer's counsel in multi-state transactions or where the pace of the transaction does not permit the required statutory notice. Even where there is not sufficient time to complete a state audit and obtain a tax clearance certificate before the closing, the required notice or request for a tax clearance certificate should be given or requested (as early in the process as possible) because it always is better to learn of a tax claim and withdraw the funds from the escrow account than to learn of the claim after release of the escrow or other security. In any case, the decision not to give notice or seek a tax clearance certificate from state taxing authorities is a decision that the client should make after a discussion of the risks.

The tax clearance certificate should not be confused with a tax status letter, which provides information on whether a business has overdue tax returns or has outstanding tax liabilities, but does not involve an audit or any statutory protection against successor liability for seller's unpaid taxes.[32] Where seller has contacts with a number of jurisdictions, consideration should be given to having an accounting firm perform a "nexus" review to ensure that seller has filed tax returns in all jurisdictions where it is required to file. Failure to properly withhold amounts for employees or "independent contractors" residing or working in jurisdictions where seller is not qualified to do business may create significant complications and liabilities, including personal liability.

d. Labor and Employment Law. In an asset purchase, the purchase agreement will typically require seller to terminate its employees at closing, and buyer will rehire those employees who it wants to continue with the business. This differs

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30 *See e.g.,* Cal. Rev. & Tax Code, § 6811 (West, Westlaw through Ch. 13 of 2018 Reg. Sess.); Conn. Gen. Stat. § 12-424 (West) (discussing sales and use tax); N.Y. Tax Law, §1141(c) (McKinney, Westlaw through L. 2018 Chap. 1 to 72); Texas Tax Code Ann. § 111.020 (West, Westlaw through 2017 Reg. and first Called Sess.).

31 Raymond P. Carpenter Sr., *Avoiding Successor Tax Liability in a Sale of Business Assets: Protecting the Purchaser's Interests*, BUS. LAW TODAY (November/December 2008), https://www.americanbar.org/publications/blt/2008/11/07_carpenter.html.

32 *See e.g.* CONN. DEPT. OF REV. SERVS., INFORMATIONAL PUBLICATION 2016(17), STATUS LETTERS (2016).

from a stock purchase where the acquired entity is the employer and its employees will continue as its employees after the change in ownership and a merger where the employees of the terminating entity will become employees of the surviving entity by operation of law. The federal common law doctrine of successor liability, which is generally more favorable to plaintiffs than most state-law standards, has been applied in the appropriate circumstances to hold buyer liable for seller's violations of federal labor and employment laws, notwithstanding a disclaimer of such liability in the purchase agreement.[33]

In an asset acquisition of a business with unionized employees, buyer is not normally bound by the terms of seller's collective bargaining agreements.[34] However, a buyer that continues seller's operations and hires a majority of its unionized employees will be considered a "successor employer" and will be obligated to recognize and bargain with the union. In order to avoid successor employer status under the NLRB's *Spruce Up* decision[35] and the attendant duty to bargain in good faith with the union, buyer must clearly announce its intention to establish new terms and conditions of employment prior to, or simultaneously with, expressing its intention to retain seller's employees after the closing. In the recent *Nexeo Solutions* decision[36] the NLRB followed this rule and held that certain reassuring statements by seller to its employees prior to the closing made it "perfectly clear" that buyer intended to retain seller's entire unionized workforce and that buyer unlawfully failed to bargain in good faith with the union by unilaterally setting the initial terms and conditions of such employment. The holding resulted in buyer's being bound by the terms of seller's existing collective bargaining agreement.[37] This result should cause asset buyers to be cautious about any pre-closing statements to unionized employees and strictly limit seller's pre-closing statements to its employees. Both parties should carefully avoid any pre-closing statements to seller's employees that could be viewed as evidence of buyer's commitment to employ all or a majority of seller's unionized workforce without clearly stating that such future employment will not be on the same terms and conditions as their current employment. If seller makes any inaccurate or incomplete statements to its employees prior to the closing, buyer should promptly correct or qualify those statements.

In recent years federal courts have extended the federal common law doctrine of successor liability to claims arising under the Fair Labor Standards Act (FLSA) and other labor and employment laws to hold buyers liable for seller's pre-closing violations.[38] Accordingly, the parties to an asset purchase transaction should consider

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[33] *See infra* text accompanying notes 137 through 139.

[34] NLRB v. Burns Int'l Sec. Servs., 406 U.S. 272, 282 (1972).

[35] Spruce-up Corp., 209 NLRB 194, 195 (1974), *enforced,* 529 F.2d 516 (4th Cir. 1975).

[36] Nexeo Sols., LLC, 364 NLRB No. 44, 2016 WL 3903008 (July 18, 2016).

[37] *Id.* at 12.

[38] *See infra* note 138.

and address issues relating to seller's termination of its employees immediately prior to the closing, including WARN Act issues, and buyer's due diligence should include a thorough review seller's compliance with labor and employment laws similar to due diligence in a stock purchase or merger transaction, including identification of each independent contractor and exempt employee, and review of contractor and consulting agreements, compensation data, job duties and job qualifications with a view to addressing misclassification issues, among others.

e. WARN Acts. The federal Worker Adjustment and Retraining Notification (WARN) Act of 1988[39] requires employers with 100 or more employees to provide at least 60 days advance notice of certain plant closings and mass layoffs.[40] The notice must be given to either affected workers or their representatives (e.g., a labor union), to the dislocated worker unit of the state, and to the appropriate unit of the local government.[41] In the sale of a business, the employer is responsible for giving the statutory notice. If a sale by a covered employer results in a covered plant closing or mass layoff, the required parties must receive the notice. The seller is responsible for providing notice of any covered plant closing or mass layoff which occurs up to and including the time of the sale. Buyer is responsible for providing notice of any covered plant closing or mass layoff which occurs after the sale. An employer who violates the WARN Act provisions by ordering a plant closing or mass layoff without providing appropriate notice is liable to each aggrieved employee for an amount, including back pay and benefits, for the period of violation, up to 60 days.[42] A number of states have mini-WARN Acts that are similar to the federal act and require separate analysis and compliance.[43]

Liability of a seller under the WARN Act can pass to an asset buyer with respect to employees that are terminated by seller and not hired by buyer. For example, a post-closing reduction in force by seller may impose WARN Act liability on buyer.[44] Accordingly, if a buyer is not hiring all or substantially all of seller's workforce,

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[39] 29 U.S.C.A. § 2101 (West, Westlaw through P.L. 115-46).

[40] U.S. Dep't of Labor, Employment and Training Administration, Fact Sheet, The Worker Adjustment and Retraining Notification Act, A Guide to Advance Notice of Closings and Layoffs, https://www.doleta.gov/programs/factsht/warn.htm

[41] *Id.*

[42] *Id.*

[43] *See e.g.*, California Worker Adjustment and Retraining Notification Act, Cal. Lab. Code § 1400 et seq.; Illinois Worker Adjustment and Retraining Notification Act, 820 Ill. Comp. Stat. Ann. § 65/1 *et seq.*; Maryland Economic Stabilization Act, 11 Md. Code Ann., Lab. & Empl. Code § 11-301 *et seq.*; and Millville Dallas Airmotive Plant Job Loss Notification Act, N.J. Stat. Ann. § 34:21-1 *et seq.*

[44] *See* 29 U.S.C.A. § 2101(b)(1) (West, Westlaw through P.L. 115-79); Day v. Celadon Trucking Servs., Inc., 827 F.3d 817, 825 (8th Cir. 2016).

seller's WARN Act obligations for post-closing termination of its retained employees—and the parties respective responsibilities and liabilities therefor—should be specifically addressed in the purchase agreement.

f. Foreign Corrupt Practices Act (FCPA). The Foreign Corrupt Practices Act (FCPA)[45] prohibits bribery of foreign government officials by a broad range of domestic and foreign companies and has record-keeping and internal control requirements that apply to public companies. The *Resource Guide to the U.S. Foreign Corrupt Practices Act* (the "FCPA Guide")[46] published by the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) encourages an acquirer to do the following:

- conduct thorough risk-based FCPA and anti-corruption due diligence on potential business acquisitions;

- ensure that the acquirer's code of conduct and compliance policies and procedures regarding the FCPA and other anti-corruption laws apply as quickly as is practicable to newly acquired companies;

- train the directors, officers and employees of the acquired company, and when appropriate, train agents and business partners of the acquired company on the FCPA and other relevant anti-corruption laws and buyer's code of conduct and compliance policies and procedures;

- conduct an FCPA-specific audit of the seller's business as quickly as practicable; and

- disclose any corrupt payments discovered as part of its due diligence of newly acquired companies.[47]

The FCPA Guide states that the DOJ and the SEC will give meaningful credit to companies who undertake these actions, and, in appropriate circumstances, they may decline to bring enforcement actions against them. In a significant number of instances, the DOJ and the SEC have declined to take action against companies that voluntarily disclosed and remedied misconduct and cooperated with the DOJ and the SEC. If FCPA issues are discovered in connection with an acquisition, the buyer may seek an opinion from the DOJ, either before or after the acquisition, pursuant

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45 15 U.S.C.A. §§ 78dd-1(a), 78dd-2(a), 78dd-3(a) (West, Westlaw through P.L. 115-79) (hereinafter, the "FCPA").

46 Criminal Div. of the U.S. Dep't of Justice and Enf't Div. of the U.S. Sec. and Exch. Comm'n, *A Resource Guide to the U.S. Foreign Corrupt Practices Act* (Nov. 4, 2012) (hereinafter, the "FCPA Guide"), https://www.sec.gov/spotlight/fcpa/fcpa-resource-guide.pdf.

47 *Id.* at 29.

to the FCPA's opinion procedure. In one acquisition where pre-acquisition due diligence was not possible, the DOJ announced that it would not take enforcement action against buyer for (i) the acquisition of the target in and of itself, (ii) any pre-acquisition unlawful conduct by the target disclosed to the DOJ within 180 days after the closing, and (iii) any post-acquisition conduct by the target disclosed to the DOJ within 180 days after the closing, which does not continue beyond the 180-day period or, if in the judgment of the DOJ the alleged conduct cannot be fully investigated within the 180-day period, which does not continue beyond such time as the conduct can reasonably be stopped. [48]

g. Successor Liability for Seller's Contractual Obligations. The application of the traditional exceptions to the rule of non-liability are not limited to cases involving product liability, environmental contamination or labor and employment law issues. Although the strong public policy concerns inherent in those areas often result in more expansive exceptions to the general rule on non-liability, courts also routinely apply the traditional successor liability theories to protect the rights of parties to commercial contracts.[49] Accordingly, buyer's due diligence should include identification and analysis of any contracts that will not be assumed by buyer in the transaction and the purchase agreement should address how seller will settle any retained contractual liabilities.[50]

h. Successor Liability for Prior Acquisitions by Seller. Buyer's due diligence planning should also include consideration of potential successor liability risk from prior acquisitions by seller because successor liability may be imposed on an indirect successor and over a series of acquisition transactions or transfers. Buyer should ensure in the appropriate cases that indemnification rights under prior acquisition documents are expressly assigned to it and that it obtains any required consents to such assignment.

3. Purchase Agreement Provisions. The purchase agreement is the first line of defense against a successor liability claim because the rule of non-liability applies only where buyer has not expressly (or impliedly) assumed seller's liabilities. Accordingly, the most critical provisions of the purchase agreement with respect to

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[48] Foreign Corrupt Practices Act Review, Opinion Procedure Release No. 08-02 (2008), https://www.justice.gov/sites/default/files/criminal-fraud/legacy/2010/04/11/0802.pdf. The SEC does not have an opinion procedure, but it will follow the guidance issued through the DOJ's FCPA Opinion Release Procedure. *See* Exchange Act Release No. 34-17099 (Aug. 29, 1980), http://www.sec.gov/news/digest/1980/dig082980.pdf.

[49] *See* Glynwed, Inc. v. Plastimatic, Inc., 869 F. Supp. 265, 271 (D. N.J. 1994) (citing Polius v. Clark Equipment Co., 802 F.2d 75, 78 (3d Cir.1986)) (stating that "The successor [liability] rule was designed for the corporate contractual world where it functions well. It protects creditors and dissenting shareholders, and facilitates determination of tax responsibilities, while promoting free alienability of business assets.").

[50] *See* Post v. Killington, Ltd., 2010 WL 3323659 (D. Vt., May 17, 2010)(Court holds that the *de facto* merger doctrine did not require buyer of ski resort to honor ski passes that seller granted to investors because there was no evidence of continuity of ownership.)

successor liability are the descriptions of included and excluded assets, the scope of assumed and retained liabilities and any related disclaimers, and the corresponding indemnification provisions. In addition, successor liability risks should be carefully considered when negotiating indemnification and related security provisions, such as holdbacks, escrows and set-off rights.

Buyer should consider each type of potential successor liability claim and specify in the purchase agreement which party will be responsible for those post-closing claims and whether seller's existing insurance coverage for such claims should continue to be maintained by seller after the closing and for what period of time. Consideration should also be given as to whether buyer should be added as an additional insured on such policies and whether to assign seller's rights under prior policies to buyer and the effect of any anti-assignment clauses in such policies.[51] For example, if the purchase agreement for a manufacturing business identifies seller as the party responsible for post-closing claims for bodily injury or property damage caused by a product manufactured or sold by seller or any other allegation of seller negligence prior to the closing, the agreement should require the seller to maintain its existing occurrence-based product liability insurance to cover post-closing claims based on pre-closing occurrences,[52] and consideration should be given as to whether buyer should be added as an additional insured to such policy. Conversely, if buyer is responsible for all post-closing claims, its policy should cover post-closing claims based on occurrences prior to the closing. Buyer should be aware that it is often difficult to determine when an occurrence has taken place and that some types of injuries or illnesses develop over time. Generally speaking, seller's existing insurance should stay in place for claims based on occurrences prior to closing.

The governing law provisions of the purchase agreement will not typically be applied to determine a successor liability claim because the claimant is not a party to the agreement, but the successor liability statutes and decisions in the chosen jurisdiction are not irrelevant because they may be considered by the court in determining what substantive law to apply in assessing the successor liability claim.[53] From a successor liability perspective, a choice of Texas or Delaware law as the governing law of the

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51 *See* note 68.

52 An "occurrence" is typically defined in liability insurance policies as "an accident, including injurious exposure to conditions, which results, during the policy period, in bodily injury or property damage neither expected nor intended from the standpoint of the insured." *See, e.g.* Fluor Corp. v. Superior Court, 61 Cal.4th 1175, 191 Cal.Rptr.3d 498, 354 P.3d 302, 334 (2015) (citing the commercial general liability policy at issue in that case).

53 *See* In re Asbestos Litigation (Bell), *infra* note 191.

contract should be considered because Texas has eliminated successor liability by statute[54] and the Delaware successor liability doctrines have rarely been applied absent fraud.[55]

a. Product Liability. Representations and warranties should be used in appropriate circumstances to identify potential successor liability risks. For example, where there is a risk of future product liability claims, it may be advisable for buyer to require that seller represent, in addition to customary representations regarding pending and threatened claims, that seller is not aware of any latent defect in its products or any dangerous condition associated with its products and is not aware of any condition or other circumstances which would give rise to a duty to warn or a duty to recall. *The liability exclusion and indemnification provisions of the purchase agreement should make clear that buyer is not assuming any liability for products manufactured and sold by seller and that buyer's indemnification obligation for post-closing claims does not extend to products manufactured and sold by seller or its predecessors.* Some courts have held that if buyer's assumption of seller's liabilities is too broad, or buyer's indemnification obligations to seller cover post-closing claims for products manufactured and sold by seller, it may be evidence that buyer has expressly or impliedly assumed liability for all post-closing claims against seller.[56]

b. Environmental. Where the parties seek more certainty as to the division of pre- and post-closing environmental liabilities, they should commission a Phase I environmental site assessment (ESA) as a baseline study to identify any areas of concern and establish the environmental condition and compliance status of the property or properties at the time of the closing. The parties should ideally allow at least 60 days for the consultant to complete its report. Based upon the findings in the report, seller may seek to exclude from the indemnity any environmental costs arising from the sale, transfer or redevelopment of the property or establish an escrow to cover any potential liabilities resulting from buyer's acts or omissions after the closing. The parties may also negotiate over which party has the right to defend claims, initiate any required corrective actions, and control communications with the regulators and third-parties. If post-closing remediation responsibilities are assumed by buyer, it may be advisable for the parties to negotiate a written agreement regarding post-closing access, remediation standards, confidentiality obligations and incentives to complete the work in a timely manner. If the Phase I ESA identifies significant areas of concern (AOCs), the parties should

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54 Tex. Bus. Org. Code Ann. § 10.254 (West, Westlaw through 2017 Reg. 1st Called Sess.).

55 See the court's discussion of choice of law issues in In Re General Motors LLC Ignition Switch Litigation, *supra* note 13 at *9 (S.D.N.Y. Aug. 3, 2017); Maine Retirement System v. Countrywide Financial Corp., 2011 WL 1765509 at *3 (C.D. Cal. May 20, 2011)(Delaware courts use the doctrine of de facto merger sparingly, "only in very limited contexts.").

56 Kessinger v. Grefco, 875 F.2d 153 (7th Cir. 1989) (holding that an asset purchase agreement in which buyer assumed and agreed "to pay, perform and discharge all debts, obligations, contracts and liabilities of the seller" included the assumption of seller's unforeseen liability for future product liability claims).

consider dealing with such issues, whenever possible, through creative solutions and specialized insurance products rather than further environmental studies and testing, which may raise intractable issues and substantially delay the closing.

c. Employment Claims. In an asset sale, unlike a merger or stock purchase, the employees of seller who will continue as employees of the acquired business will be terminated as employees of seller and rehired at the closing as employees of buyer. This does not necessarily insulate buyer from liability for pre-closing employment matters. Numerous cases have applied a federal common law standard for determining successor liability in labor and employment matters and such standard is less restrictive than many state law successor liability standards.[57] Accordingly, where buyer hires seller's labor force, buyer should carefully negotiate the allocation of risk for employment related matters. In the case of a unionized workforce, buyer should consider requiring that it be involved in reviewing and approving pre-closing communications with seller's employees because seller's reassuring words to its workers regarding the transaction could end up compromising buyer's ability to negotiate a new collective bargaining agreement with seller's former employees.[58]

d. Employee Benefit Claims. The law of successor liability in labor and employment cases has been extended to Employee Retirement Income Security Act of 1974 (ERISA) matters.[59] Accordingly, a buyer should not assume that a negotiated allocation of risk for matters such as multiemployer withdrawal liability under ERISA or continuation of group health plan coverage under COBRA,[60] will necessarily insulate buyer from liability.

e. Taxes. The tax classification of seller is relevant to successor liability risk, even in an asset acquisition, and seller's representations and warranties should cover seller's tax status as well as the customary tax return filing and payment representations.[61] Also, because of the risk of successor liability for unpaid taxes of other members of seller's affiliated group (within the meaning of IRC Section 1504(a)) or any similar group or seller's status as a member of a pass-through entity, buyer should consider addressing those issues in seller's representations and warranties. Buyer should also consider the definition of "Taxes" in the purchase agreement and whether the

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57 *See, e.g.,* Thompson v. Real Estate Mort. Network, 748 F.3d 142 (3rd Cir. 2014); Golden State Bottling Co. v. NLRB, 414 U.S. 168 (1973).

58 *See* Nexeo Sols., LLC, 364 NLRB No. 44, 2016 WL 3903008 (July 18, 2016).

59 *See, e.g.,* Tsareff v. ManWeb Services, Inc., 794 F.3d 841 (7th Cir. 2015); Upholsterers' Int'l Union Pension Fund v. Artistic Furniture, 920 F.2d 1323 (7th Cir. 1990); Resilient Floor Covering Trust Fund Bd. of Trustees v. Michael's Floor Covering, Inc., 801 F.3d 1079 (9th Cir. 2015).

60 26 C.F.R. § 54.4980B-9, Q-7 and A-7, Q-8 and A-8 (current through August 27, 2017).

61 *See generally,* E. Daniel Leightman, *Tax Due Diligence*, https://www.law.uh.edu/faculty/bwells/cit/duediligence.pdf.

definition should include a reference to any "transferee or secondary liability in respect of any tax" and "any liability in respect of any tax as a result of being a member of an affiliated, consolidated, combined, unitary or similar group."[62]

f. Extension of Statute of Limitations. Where there is a risk of long-tail claims for future product or environmental liability claims, consideration should be given to extending the statute of limitations for contractual indemnification claims beyond the statutory limitation for contractual claims to the extent permitted under applicable law.[63]

g. Contractual Indemnification Rights and Obligations of Seller. The due diligence review of seller's contracts should include a review of contractual indemnification obligations owed to seller, either in connection with prior acquisitions by seller or otherwise, and consideration should be given to requiring seller to assign any such indemnification rights to buyer. By the same token, due diligence should also include a review of any potential indemnification obligations owed by seller in connection with any prior carveout sales.

4. Insurance Coverage. Insurance is an important tool for addressing successor liability risks for tort and strict liability claims. Such insurance can take any number of forms: product liability insurance, completed operations insurance, pollution legal liability (PLL) insurance and other specialized liability insurance products. Representation and warranty (R&W) insurance for an acquisition transaction can provide an additional measure of protection. Liability insurance will not cover successor liability for breach of contract claims against seller; however, properly structured R&W insurance may provide protection based on representations and warranties in the purchase agreement that seller is not in breach or default under any existing contract, including a breach or default that would be triggered by the sale transaction.

Buyer's due diligence process should include a review by buyer's insurance advisers and risk management personnel of the policy language and limits of the current and prior policies of seller and its predecessors and their claims histories to ensure, among other things, that there have been no gaps in coverage, such as a prior "claims-made" policy that was terminated without purchasing an "extended reporting period" ("ERP") endorsement, commonly known as "tail" coverage, or having an appropriate "retroactive date" in the replacement policy. Due diligence should also cover the potential liability of seller and its predecessors for claims within the deductible or self-insured retention to evaluate the financial impact of such claims on seller and ensure that sufficient reserves have been established by seller for these claims. If any of seller's

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[62] *See infra* text accompanying note 157.

[63] *See* Del. Code, tit. 10, § 8106(c) (West, Westlaw through 81 Laws 2017), which gives parties to a written contract the freedom to agree to a limitations period longer than the typical three or four years from accrual of the cause of action, without the need to resort to the technical requirements under Delaware law for a contract under seal.

liability policies are written on a claims-made basis, buyer should consider requiring seller to purchase tail coverage for post-closing claims for losses or injuries based upon occurrences prior to the closing. Whenever possible, buyer should be added as an additional insured to seller's liability insurance policies, both occurrence-based policies and claims-made policies. Such coverage is usually available without significant additional costs.

a. Product Liability Insurance. Product liability insurance policies are written on both a "claims-made" basis and an "occurrence" basis. A claims-made policy covers losses and injuries that take place after the inception date of the policy and are reported during the policy period. An occurrence-based policy covers occurrences, i.e. losses and injuries, during the policy period, even if the claim is presented after the policy has expired. If seller's product liability insurance is written on a claims-made basis, buyer should consider requiring seller to purchase appropriate tail coverage for post-closing claims based products occurrences prior to the closing.[64] If seller's policy is written on an occurrence basis, buyer should consider requiring seller to maintain the policy for an appropriate period of time to cover claims for post-closing accidents and injuries caused by defects in products manufactured and sold prior to the closing, regardless of whether seller or buyer is responsible for such claims. In such case buyer should consider the need for discontinued products and operations insurance to insure against post-closing losses and injuries from discontinued products manufactured or sold by seller prior to closing. Discontinued product coverage may be difficult to obtain or cost prohibitive, but if it is available buyer should consider it as supplemental protection for losses and injuries that would not otherwise be covered under buyer's product liability policy. In the alternative, buyer should ensure that its product liability insurance covers discontinued products in the stream of commerce and that the carrier has acknowledged coverage. Claims for post-closing losses and injuries should be covered by buyer's policy regardless of whether buyer or seller manufactured and sold the defective product. Buyer's and seller's liability policies should dovetail so that seller's policies, with appropriate tail coverage, will cover pre-closing occurrences and buyer's policies will cover post-closing occurrences; however, the purchase agreement should be clear that seller retains all liability for products manufactured and sold by it or its predecessors. Buyer should be named as an additional insured on seller's liability

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[64] If unlimited tail coverage is not be available or is not cost justified, the length of the tail period should be evaluated based upon the claims histories of seller and its predecessors and the likely statutes of limitations and statutes of repose. Statutes of limitations for product liability claims vary from state to state but typically require that an action be brought within two to four years after the time when the loss or injury is or should have been discovered. In addition, some states have enacted statutes of repose for product liability and other "long-tail" claims that require that an action be brought within a designated period, typically ten to twelve years, after the initial sale of a product, delivery to the first owner or other specified event. Ideally, the tail period should be at least equal to any applicable statute of repose period.

insurance policies to ensure that seller's carriers respond to covered post-closing claims even after dissolution of seller.[65]

b. Other Liability Insurance. Most liability insurance policies terminate upon a change of control or will be cancelled by seller after a sale of the business. This would typically be the case for a commercial general liability (CGL) insurance policy as well as specialized liability insurance products, such as director and officer (D&O) liability insurance,[66] employment practices liability (EPL) insurance, fiduciary liability insurance, and technology and data security liability insurance. Buyer should also review seller's workers compensation coverage, especially with respect to potential claims for occupational diseases such as carpal tunnel syndrome and asbestosis, which cover multiple years. These can be assigned to one or multiple insurers, depending on the state case law.

c. Representation and Warranty Insurance. R&W insurance covers damages and losses suffered by an insured buyer as a result of a breach of one or more specific representations and warranties in the purchase agreement, such as the representations regarding financial statements, no undisclosed liabilities, intellectual property, taxes, and compliance with law. R&W policies can be tailored to address a client's specific needs in a transaction, including the amount of coverage (including coverage that takes into account any knowledge or materiality scrapes in the purchase agreement), duration of coverage and scope of loss, and are typically structured so as to achieve the economic results of a traditional indemnity/escrow structure, with the goal being to put buyer in the same or better position regarding financial loss exposure as traditional indemnification provisions. R&W insurance policies can cover most representations and warranties in the purchase agreement, including both general and fundamental representations, as well as pre-closing tax indemnities. In many cases, including an asset purchase transaction, coverage can extend to some potential successor liabilities as well. R&W policies allow for flexibility in negotiating the transaction structure by back-stopping seller's indemnification obligations or functioning as buyer's sole source of recovery. R&W policy coverage is contingent upon buyer's performing normal due diligence in the transaction and will not cover any matters known to buyer or disclosed on the disclosure schedules, forward looking statements, covenants, working capital adjustments, asbestos and PCB liabilities, or pension underfunding or withdrawal liabilities. An R&W policy offers a number of advantages over a typical seller indemnification obligation: It can extend for a longer period than the customary escrow

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65 Insurance policies of a dissolved corporation will generally be available to respond to third party claims so long as the corporation is still subject to suit. *See, e.g.*, Anderson v. Krafft-Murphy Company, Inc., 82 A.3d 696 (Del. Sup. Ct. 2013).

66 D&O coverage presents its own special issues. For example, the Foreign Corrupt Practices Act (FCPA) exclusion, sometimes called the "bribery" or "commissions" exclusion should be deleted before the run-off policy is put in place; successor in interest coverage should be added to the run-off policy to cover the buyer for wrongful acts of seller prior to the closing; and the "insured vs. insured" exclusion should be deleted for buyer.

period; it will avoid buyer's having to litigate indemnification claims, which can be especially problematic where the claims would be against continuing management; and it will likely provide more liquidity and a deeper pocket than seller.

d. Environmental Insurance. The parties may cover environmental risk, for known and unknown conditions, with a separate pollution legal liability (PLL) policy or a remediation cost cap policy. PLL policies protect against losses from unknown sources of pollution liability, either undiscovered contamination or contamination resulting from future releases. Coverage applies to third-party claims for damage or bodily injury, onsite and offsite mandated cleanup costs and associated expenses for legal defense and investigation. Coverage terms can extend up to ten years, but three to five year terms are more typical. Cost cap insurance is designed to minimize uncertainties associated with estimating the cost of known cleanup obligations by covering unanticipated cost overruns that may arise from discovery of additional contamination, underestimation of project costs or changes in regulatory requirements, among others. The principal challenge in acquiring environmental insurance coverage in connection with an acquisition transaction is often allowing adequate time for the underwriter to evaluate the due diligence information.

e. Other Insurance Coverages. There are various specialty insurance policies available to cover specific transactional risks, such as:

> ***(1) Successor Liability Insurance.*** A successor liability insurance policy (SLIP) can be used in any asset purchase agreement where there is a risk of successor liability, however, cost may be an issue. These policies are relatively rare and are typically intended to provide contingent coverage where there is a concern about seller's creditworthiness or other inability to pay any retained liabilities and otherwise meet its indemnification obligations. An SLIP is particularly useful in a Section 363 sale where there is a risk that unsecured creditors without adequate notice of the sale or with another defense will seek to impose successor liability for a claim against buyer.
>
> ***(2) Fraudulent Conveyance Insurance.*** A fraudulent conveyance (or fraudulent transfer) insurance policy (FCIP) insures a buyer from a financially distressed seller against subsequent allegations that the sale was a fraudulent conveyance or transfer under federal law in violation of section 548 of the Bankruptcy Code or similar provisions of state law, such as Section 7 of the Uniform Fraudulent Transfer Act. An FCIP will cover defense costs and financial losses where a successful challenge results in a claw-back of assets or a requirement that an additional amount be paid by buyer to satisfy the "reasonably equivalent

value" standard. An FCIP can also be used to insulate the original (distressed) asset buyer in a subsequent sale of those assets.[67]

(3) Litigation and Contingent Liability Insurance. A litigation and contingent liability insurance policy reduces the risk of a catastrophic loss by covering existing litigation or known contingent risks. It typically covers existing fiduciary duty litigation involving directors and officers, employment or product liability claims, IP issues, and even lost share certificates and can eliminate thorny valuation issues.

f. Availability to Buyer of Seller's Insurance Coverage. Where seller has product liability or other liability insurance coverage that is written on an occurrence basis, buyer should tender any post-closing claims directly to seller's carrier. Buyer may be entitled to defense and indemnity from seller's insurance carrier under the "operation of law" doctrine even if seller's insurance policy has a non-assignment clause.[68] However, there are cases to the contrary, and buyer should consider definitively resolving this issue as part of the transaction by a obtaining a separate insurance policy covering such risks or by an express assignment of the rights under seller's policies or any assignment of insurance proceeds to cover liabilities assumed by buyer. An assignment of rights under an existing policy will likely require the consent of the carrier, which may be difficult to obtain, and should be considered a lead time item.[69] An

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[67] *Securing a Better Deal: Facilitating M&A Transactions with Insurance and Due Diligence* (Chicagoland Risk Forum, September 29, 2015), http://www.chicagolandriskforum.org/img/Benvenuto-ppt.pdf.

[68] Glidden Co. vs. Lumbermens Mut. Cas. Co., No. 817822004, WL 2931019 (Ohio Ct. App. 2004) (holding that a successor which is liable for pre-acquisition operations of its predecessor acquires rights to coverage under the predecessor's liability insurance policies by operation of law even where the rights under the predecessor's policies were not expressly assigned to it); Northern Ins. Co. v. Allied Mut. Ins. Co., 955 F.2d 1353 (9th Cir. 1992) (holding that an asset purchaser that was liable for product liability claims under the product line theory was entitled to a defense under the predecessor's occurrence-based liability insurance policies because the benefits of those policies transferred by operation of law to the purchaser even though the asset purchase agreement excluded the liability insurance policies from the acquired assets). *But see,* Henkel Corp. v. Hartford Accident & Indem. Co., 29 Cal. 4th 934, 129 Cal. Rptr. 2d 828 (2003) (consent-to-assignment clause in an occurrence-based liability policy held enforceable under California common law, precluding transfer of the right to defense and indemnification without the insurer's consent even if the transfer occurred after the coverage-triggering event), *rev'd* in Fluor Corp. v. Superior Court, 61 Cal.4th 1175, 191 Cal.Rptr.3d 498, 354 P.3d 302, 334 (2015) (holding that Section 520 of the California Insurance Code requires an insurer to honor an insured's express assignment of the right to defense and indemnification coverage under an occurrence-based liability policy, without the insurer's consent, if the assignment occurs after the injury resulting in the claimed loss).

[69] *See Henkel Corp.,* 29 Cal. 4th at 941.

alternative is to add buyer as an additional insured to seller's policies, both claim-made and occurrence-based.

5. *All Cash Transaction.* Where there is no continuity of interest between shareholders of seller and buyer, the *de facto* merger doctrine and mere continuation will not apply. However, a lack of continuity of ownership will not protect buyer against successor liability in states that have adopted the "continuity of enterprise" theory or the product line exception, neither of which requires continuity of ownership to establish successor liability.[70] *See infra* Sections III.E and F.

6. Require Seller to Make Adequate Provision for Payment of Creditors. Although many successor liability decisions state that the dissolution and liquidation of seller shortly after the sale is a factor leading to the imposition of successor liability, the underlying issue seems to be that seller has liquidated and distributed the purchase consideration to its owners without making adequate provisions for future creditors. Accordingly, it may be prudent in some situations to require seller to continue in existence and obtain an appropriate "tail" policy for its claims-made liability policies. Where the transaction covers all or substantially all of seller's business and assets, buyer should consider requiring seller to make adequate provision for its creditors and for unknown or contingent liabilities, either by establishing a reasonable reserve for future claims and known creditors or by purchasing a tail policy with a reporting period that is at least as long as the applicable statute of limitations or statute of repose period. In addition, if seller intends to dissolve and distribute its assets shortly after the transaction, consideration should be given to requiring that seller follow applicable statutory dissolution procedures, which may establish a shorter statute of limitations period. For example, a seller organized in a state which has adopted the Model Business Corporation Act (the "Model Act") could avail itself of the procedure set forth in Section 14.07 of the Model Act, which bars claims against the dissolved corporation that are not commenced within three years after publication of the dissolution notice.[71] The statutory bar includes claims, such as product liability claims, that are contingent or based on an event occurring after the date of dissolution. The approach is not available to Delaware

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[70] *See* Morgan v. Power Timber Co., 367 F. Supp. 2d 1032 (S.D. Miss. 2005); Payne v. Saberhagen Holdings, Inc., 147 Wash. App. 17, 190 P.3d 102 (2008) (holding that continuity of share ownership means that the shareholders of seller must own shares of buyer after the transaction); Desclafani v. Pave-Mark Corp., No. 07 Civ. 4639 (HPB), 2008 WL 3914881 (S.D.N.Y. Aug. 22, 2008) (evidence lacking that shareholders of seller became shareholders of buyer as part of the purchase transaction because stock options were acquired after the transaction).

[71] *See* Section 14.07(c) of the Model Business Corporation Act (2016 Revision) and the Official Comment.

corporations because the Delaware General Corporation Law does not provide a statute of limitations for claims against dissolved corporations.[72]

As an additional precaution, seller can require buyer to continue in existence for specified period of time, three to six years, and provide cash flow for future claims against seller through having a deferred purchase price or by leasing any real estate from seller, which is also an effective mechanism for shielding buyer from pre-existing contamination on seller's property. In such case, the lease should deal with the possibility of future remediation claims for pre-existing contamination of the property.

7. Seller's Jurisdiction of Organization. Some jurisdictions follow the internal affairs doctrine to determine which law governs questions of successor liability and in such jurisdictions courts will apply the law of the seller's state of organization to decide successor liability claims.[73] Accordingly, consideration should be given to effecting the sale transaction using a seller organized under Texas or Delaware law to take advantage of the Texas statute eliminating the doctrine of successor liability[74] or the Delaware courts' "sparing use" of successor liability doctrines.[75] For this reason, in the appropriate situation buyer and its counsel should consider converting seller to a Texas or Delaware corporation or limited liability company.

8. Post-Closing Precautions. Buyer should also be aware that its advertising, websites, press releases, and other public relations initiatives may be used by a post-closing claimant as evidence of buyer's intention to continue the business of seller and benefit from its goodwill. If that is buyer's intent, it may be relevant to a holding that there is successor liability under several of the traditional exceptions to the rule of non-liability.

III. General Rules of Successor Liability.

There are four traditional exceptions to the rule of non-liability.[76] The most common statement of the exceptions is that an asset buyer will be liable as a successor of seller if:

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72 *See Anderson,* 82 A.3d at 705 (holding that Section 278 of the DGCL governing corporate dissolutions was not intended to operate as general statute of limitations and does not extinguish the corporation's potential liability to third parties by time-barring those parties' claims).

73 *See supra* note 65.

74 Tex. Bus. Org. Code Ann. § 10.254 (West, Westlaw through 2017 Reg. 1st Called Sess.).

75 *See Maine Retirement System* at *3 *supra* note 55.

76 RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 12 (Am. Law Inst. 1998), which restates the rule for product liability claims as follows:

(1) it expressly or impliedly agrees to assume seller's liability;

(2) there was a consolidation or merger of seller and buyer;

(3) the purchasing corporation was a mere continuation of the selling corporation; or

(4) the transaction is entered into fraudulently to escape liability.[77]

These four exceptions are cited in almost all of the judicial decisions on successor liability, including tort claims, strict liability claims, contractual claims, and statutory and regulatory claims. The exceptions are generally invoked where there is no longer an adequate remedy against seller, either because seller has been dissolved or because it is insolvent, regardless of whether buyer disclaimed liability in the asset purchase agreement.[78] The exceptions are often applied with more flexibility where a strict product liability or a tort claim is involved, as opposed to a contract claim.[79] Liability of the successor under these exceptions is derivative in nature, and thus a successor will generally be held liable only for the conduct of seller only to the same extent as seller

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> A successor corporation or other business entity that acquires assets of a predecessor corporation or other business entity is subject to liability for harm to persons or property caused by a defective product sold or otherwise distributed commercially by the predecessor if the acquisition:
>
> (a) is accompanied by an agreement for the successor to assume such liability; or
>
> (b) results from a fraudulent conveyance to escape liability for the debts or liabilities of the predecessor; or
>
> (c) constitutes a consolidation or merger with the predecessor; or
>
> (d) results in the successor becoming a continuation of the predecessor.

77 *See* New York v. Nat'l Serv. Indus., Inc., 460 F.3d 201, 209 (2d Cir. 2006); Medina v. Unlimited Sys*., LLC*, 760 F. Supp. 2d 263 (D. Conn. 2010) (Fair Labor Standards Act case).

78 *See* Gorsuch v. Formtek Metal Forming, Inc., 803 F. Supp. 2d 1016 (E.D. Mo. 2011); Guerrero v. Allison Engine Co., 725 N.E.2d 479 (Ind. Ct. App. 2000).

79 The Pennsylvania Supreme Court noted that courts in various jurisdictions have relaxed successor liability requirements in certain limited contexts, for example, to address injuries caused by defective products manufactured by a predecessor corporation or to vindicate policies incorporated in federal statutes in areas such as labor law, environmental law, and employment discrimination law. Fizzano Bros. Concrete Products, Inc. v. XLN, Inc., 615 Pa. 243, 42 A.3d 951, 965 (2012) (citing Glentel, Inc. v. Wireless Ventures, LLC, 362 F. Supp.2d 992, 1001 n. 20 (N.D. Ind. 2005)).

would have been liable. The liability of a buyer under these exceptions is not considered a new cause of action but rather a transfer of the liability of seller to buyer.[80]

In addition to each of the four traditional exceptions, a number of additional exceptions have been developed by the courts over the last forty years, primarily in the context of product liability claims. These additional exceptions include the following: continuity of enterprise (aka substantial continuation), product line, duty to warn, inadequate consideration of the transfer coupled with the failure to make provision for seller's creditors, and liability imposed by statute.[81]

The following is a brief summary of each of these various exceptions as they may be relevant in planning for a negotiated, arms-length transaction.

A. Express or Implied Assumption of Seller's Liabilities. Whether a buyer has expressly or impliedly assumed the liabilities of seller is a matter of contract interpretation and will depend upon the language of the purchase agreement and related documents as well as the court's interpretation of the surrounding circumstances and the conduct of the parties after the closing.[82] As a cautionary note, buyers and their counsel should be careful in drafting notices to the public or to seller's customers announcing the purchase and consider whether there is any implication that buyer is continuing the business or has assumed the liabilities of seller. Buyers should also be wary of performing any obligations of a seller under contracts that were not expressly assumed in the purchase transaction because such voluntary performance may give rise to an implication that buyer is continuing the business of seller in all respects and that buyer has implicitly assumed all of the liabilities of seller necessary to continue its business.[83]

B. De Facto Merger. The doctrine of *de facto* merger was originally created to provide dissenters' rights to shareholders in an asset sale where the shareholders would

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80 Robbins v. Physicians for Women's Health, LLC, 311 Conn. 707, 715, 90 A.3d 925, 930 (2014); Russell v. SunAmerica, Civ. A. No. E90-008(L.), 1991 WL 352563, at *2 (S.D. Miss. March 6, 1991).

81 Egan, *supra* note 3, at 934.

82 Ladjevardian v. Laidlaw–Coggeshall, Inc., 431 F. Supp. 834, 839 (S.D.N.Y. 1977) ("While no precise rule governs the finding of implied liability, the authorities suggest that the conduct or representations relied upon by the party asserting liability must indicate an intention on the part of the buyer to pay the debts of the seller."); Beck v. Roper Whitney, Inc., 190 F. Supp. 2d 524, 537 (W.D.N.Y. 2001) ("The presence of such an intention depends on the facts and circumstances of each case."). *See also*, Safeco Ins. Co. v. Pontiac Plastics & Supply Co., No. 214079, 2000 WL 33538535, at *3 (Mich. Ct. App. Jan. 21, 2000); Fletcher, *supra* note 3, at § 7122.

83 *See, e.g.*, Carlos R. Leffler, Inc. v. Hutter, 696 A.2d 157, 160-61 (Pa. Super. Ct. 1997). *See generally*, Matheson, *supra* note 3, at 385-87.

have been entitled to appraisal rights in an equivalent merger transaction.[84] However, the doctrine has been expanded to become the primary common law test for successor liability for all manner of successor liability claims.[85] Application of the doctrine is fact specific with many courts rejecting a rigid, mechanical test, citing the need to examine the purposes and consequences of the transaction to determine whether a "merger" has occurred.[86] The following four factors are typically used determine whether an asset sale is the "functional equivalent" of a statutory merger:

- ***Continuity of Ownership***. Is there continuity of share ownership resulting from buyer's using its own shares as consideration for the acquired assets, so that the shareholders of seller become shareholders of buyer upon completion of the transaction? In many jurisdictions, especially in cases based on a breach of contract or an express warranty, continuity of ownership or shareholder interest is an essential ownership requirement. It does not require a complete identity of share ownership between buyer and seller, and some courts have held that it can also be satisfied if the shareholders of seller continue to directly or indirectly control buyer.[87] Moreover, some courts have held that the continuity of ownership element is satisfied if buyer has on-going payment obligations to seller's equity owners in lieu of equity in the surviving entity because corporate merger statutes now permit all-cash mergers.[88] On the

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84 In Farris v. Glen Alden Corp., 393 Pa. 427, 143 A.2d 25 (1958) (reasoning that if an asset sale could be structured to be the functional equivalent of a statutory merger or consolidation, then the rights of the dissenting shareholders should be the same in either case).

85 The *de facto* merger exception is not accepted in all states. Texas has rejected the *de facto* merger exception by statute. *See infra* text accompanying notes 121 through 124. Although a number of courts have stated in dicta that Delaware recognizes the four common law exceptions to the rule of non-liability, we have found no decision under Delaware law that applies the *de facto* merger exception to find successor liability in the absence of fraud or other equitable considerations. *See* Energy Intelligence Group, Inc. v. Cowan & Co., LLC, No. 14-cv-03789, 24 - 25 (S.D.N.Y. July 15, 2016) (Delaware courts use the de facto merger doctrine sparingly and only in very limited contexts.)

86 Fizzano Bros. Concrete Products, Inc. v. XLN, Inc., 615 Pa. 243, 243, 42 A.3d 951, 965 (2012).

87 North Shore Gas Co. v. Salomon Inc., 152 F.3d 642 (7th Cir. 1998) (holding that in a CERCLA liability case there was continuity of ownership and control and therefore a *de facto* merger where a selling shareholder who held a 35 percent ownership interest in buyer after the transaction was in control because the other ownership was fragmented. Conversely, a 40 percent stake in buyer by a shareholder of seller was found not to constitute a *de facto* merger because the other shareholder held the remaining 60 percent of the shares); Commercial Nat. Bank v. Newtson, 39 Ill. App. 3d 216, 349 N.E.2d 138 (1976).

88 *See, e.g.,* Lehman Bro. Holdings Inc. v. Gateway Funding Diversified Mortg. Services, L.P., 942 F. Supp. 2d 516 (E.D. Pa. 2013) (holding that continuity of share ownership or shareholder interest is not the determinative factor in finding successor liability under the *de facto* merger exception, but some form of continuity of interest must be shown through

other hand, there are many cases that hold that continuity of ownership and control is not an essential element of a *de facto* merger.[89]

- ***Continuity of Management, Personnel, Physical Location, Assets and General Business Operations***. Did buyer continue to use the same management and other personnel and the same physical location and conduct the same general business operations as seller? The courts ask these questions and may also look to other related factors for this continuity element, such as whether buyer acquired seller's goodwill, trademarks, patents, customer lists, and the right to use seller's name.[90]

- ***Prompt Dissolution of Seller.*** Did seller cease its business operations, liquidate and dissolve as soon as legally and practically possible after the closing? The continued existence of only one corporation after the sale is often cited as another key element of a *de facto* merger.[91]

- ***Buyer Assumes Seller's Ordinary Course Liabilities***. Did buyer assume those obligations of seller ordinarily necessary for the uninterrupted continuation of normal business operations of seller? [92] The assumption of ordinary course liabilities, those that are necessary for buyer to continue the business of seller without interruption, may be considered evidence that buyer impliedly assumed al of seller's liabilities.

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promissory notes or payments to seller's former shareholders. *See also,* Cargill, Inc. v. Beaver Coal & Oil Co., 424 Mass. 356, 676 N.E.2d 815 (1997) (holding under Massachusetts law that there is no requirement that there be complete shareholder identity between seller and a buyer and the shareholder continuity requirement for a *de facto* merger is met where sole shareholder, officer and director of seller became a director and 12.5% shareholder of buyer).

89 *See* Dominguez v. Ruland Mfg. Co., Inc., No. 20081564, 2010 WL 3083865 (Ma. Super. Ct. Aug. 13, 2009) (holding that lack of continuity of share ownership does not preclude a finding of a *de facto* merger in a products liability case).

90 Florio v. Manitex Skycrane, LLC, No. 6:07-CV-1700-ORAL-28KRS, 2010 WL 5137626 (M.D. Fla. Dec. 10, 2010) (holding that there was no *de facto* merger where there was no continuity of officers, directors, or shareholders). *See Dominguez*, 2010 WL 3083865 (holding that the fact that seller's sales manager and sole product designer continued working for buyer but there was no continuity of directors or shareholders does not preclude a finding that there was a continuation of management, personnel and general business operations).

91 Goguen v. Textron, Inc., 476 F. Supp. 2d 5 (D. Mass. 2007).

92 *See, e.g.*, Fizzano Bros. Concrete Products, Inc. v. XLN, Inc., 615 Pa. 243, 243, 42 A.3d 951, 965 (2012); Philadelphia Elect. Co. v. Hercules, Inc., 762 F.2d 303, 310 (3d Cir. 1985), *cert. denied*, 474 U.S. 980 (1985); Cargill, Inc., 424 Mass. 356, 676 N.E.2d 815 (1997).

The application of these factors varies from state to state, with some states requiring all of the elements to be satisfied and others making the determination based upon less than all of the elements.[93] The flexibility of the judicial approach to a case very often depends on whether it is a commercial or contractual liability or whether it involves a claim where public policies are predominant, such as product liability or environmental claims.

C. Mere Continuation. The mere continuation exception is similar to the *de facto* merger doctrine, so much so that the two exceptions are often applied interchangeably, typically with very confusing and unpredictable results.[94] The mere continuation exception "is generally applied whenever the successor corporation more closely resembles a reorganized version of its predecessor than an entirely new corporate entity."[95] The objective is:

> [T]o 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. Thus, the underlying theory of the exception is

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[93] *Compare* Energy Intelligence Group, Inc. v. Cowan & Co., LLC, No. 14-cv-03789, 2016 WL 3939747 (S.D.N.Y. July 15, 2016) ("First, the elements of a *de facto* merger in Delaware are clearly more rigorous [than in New York]; they require a transfer of *all* of the transferor's assets and an assumption of *all* of its liabilities, in exchange for payment made in the *stock* of the transferee *directly* to the shareholders of the transferor." Emphasis in the original.) *with* Pegler & Assocs., Inc. v. Prof'l Indem. Underwriters Corp., No. X05CV970160824S, 2002 WL 1610037 (Conn. Super. Ct. June 19, 2002) (Not every one of the indicia of a *de facto* merger must be established, but the court should apply more of a balancing test); and Miller v. Forge Mench P'ship Ltd., No. 00-CV-4314 (MBM), 2005 WL 267551, at *8 (S.D.N.Y. Feb. 2, 2005) (Analysis of the necessary factors to support a finding of *de facto* merger or "mere continuation" under New York law must be undertaken in a flexible, realistic manner, focusing on the "intent of [the successor] to absorb and continue the operation of [the predecessor]"). In Village Builders 96, L.P. v. U.S. Laboratories, Inc., 121 Nev. 261, 267, 112 P.3d 1082, 1086, (2005), the Nevada Supreme Court held that each of the four factors of the *de facto* exception should be weighted equally and the existence of two of the four de facto merger factors is not sufficient to support a finding of successor liability.

[94] Collins v. Olin Corporation, 434 F. Supp. 2d 97, 103 (D. Conn. 2006) (holding that there is no successor liability under the *de facto* merger and mere continuation exceptions where there was no continuity of management or shareholders even though many of the products of the predecessor continued to be produced by the successor in the same plant with the same personnel). *See, e.g.,* Cargo Partner AG v. Albatrans, Inc., 352 F.3d 41 (2d Cir. 2003) (holding that the *de facto* merger doctrine in New York does not make a corporation that purchases assets liable for seller's contract debts absent continuity of ownership); DeJesus v. Park Corp., 530 F. App'x 3, 6 (1st Cir. 2013) (stating that the distinction between the *de facto* merger and the mere continuation exceptions is more apparent than real).

[95] 2 LOUIS R. FRUMER & MELVIN I. FRIEDMAN, *Products Liability* § 7.04[4] (1993).

> that, if a corporation goes through a mere change in form without a significant change in substance, it should not be allowed to escape liability.[96]

The mere continuation test focuses on whether buyer is substantially the same as seller, as evidenced by the continuity of officers, directors and equity owners between seller and buyer and the fact that seller ceased to exist after the sale.[97]

> The test for a mere continuation of seller[']s business is not the continuation of the business operation, but rather the continuation of the corporate entity. An indication that the corporate entity has been continued is a common identity of stock, directors, and equity owners and the existence of only one entity at the completion of the transfer.[98]

This exception is also applied where the predecessor and successor are not corporations, such as where the predecessor was a sole proprietorship and the successor was a limited liability company.[99] Although none of the factors is determinative, the common identity of officers, directors and stockholders is the key factor.[100] Complete identity of shareholders, directors and officers is not required, but there must be sufficient identity to demonstrate that the successor is so dominated and controlled by the predecessor that their separate existence should be disregarded.[101]

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96 Diguilo v. Goss Int'l Corp., 389 Ill. App.3d 1052, 906 N.E.2d 1268 (2009) (quoting Vernon v. Schuster, 179 Ill. 2d 338, 688 N.E.2d 1172 (1997)); Baltimore Luggage Co. v. Holtzman, 80 Md. App. 282, 562 A.2d 1286 (1989).

97 *See, e.g.,* McCarthy v. Litton Indus., Inc., 410 Mass. 15, 570 N.E.2d 1008, 1012 (1991) (holding there is no successor liability in a product liability case where seller continued to exist after the sale).

98 Guerrero v. Allison Engine Co., 725 N.E.2d 479 (Ind. Ct. App. 2000) (citing Travis v. Harris Corp., 565 F.2d 443, 447 (7th Cir. 1977)).

99 LiButti v. United States, 178 F.3d 114, 124 (2d Cir. 1999). Accord Crane Constr. Co. v. Klaus Masonry, LLC, 114 F. Supp.2d 1116, 1119 (D. Kan. 2000); Baca v. Depot Sales, LLC, No. 06-CV-00714-EWN-PAC, 2007 WL 988061 (D. Colo. March 30, 2007).

100 Helms v. Prime Tanning Corp., No. 09-6081-CV-SJ-GAF, 2010 WL 1935952, 10 (W.D. Mo. May 11, 2010).

101 Royal Ins. Co. v. Smatco Indus., Inc., 201 B.R. 755, 758 (E.D. La. 1996) (holding that a transfer of assets in a bankruptcy sale does not preclude a finding of successor liability); Ross v. Desa Holdings Corp., C.A. No. 05C-05-013, 2008 WL 4899226 (Del. Super. Ct. Sept. 30, 2008) (holding that no continuity of ownership, other than certain employee stock options granted to certain shareholders of seller who continued as employees of buyer, retention of five of seven officers and continuation of only one of six directors is not sufficient continuity to impose successor liability under Delaware law).

D. Fraud Exception. The fraud exception is most often raised in the sale of a financially distressed business or a leveraged buyout where there is an allegation of actual or constructive fraud in connection with the sale.[102] In determining whether there is successor liability as a result of fraud in the transaction, the courts will generally look to the Uniform Fraudulent Transfer Act (UFTA).[103] However, as the Supreme Court of Wisconsin explained, the fraud exception to the rule against non-liability is not limited by the provisions of the UFTA:

> Whereas the [Wisconsin Uniform Fraudulent Transfer Act (WUFTA)] is designed to assist creditors in collecting on claims that may be frustrated by recent asset transfers, the fraudulent transaction exception [to the rule of non-liability] is a doctrine that prevents successor companies from avoiding obligations incurred by their predecessors. This difference in purpose is reflected in two of the Act's specifics. First, the statute of limitations for claims under the Act can be as short as one year after learning the asset was transferred. As such, the Act is incapable of ensuring that liability continues to reside in the proper entity, especially when the injuries are latent and discovered years after the corporation is known to have restructured. And second, the remedies available under the Act center on the fraudulently conveyed asset, rather than the successor company. The Act allows the creditor to avoid the transfer to the extent necessary to satisfy its claim, attach the asset in the hands of the transferee, obtain an injunction or appointment of a receiver to prevent loss of the asset, or levy execution on the asset or its proceeds in the hands of the transferee. So, whereas the Act focuses on recovering the asset or its value, the fraudulent transaction exception focuses on the business entity

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[102] Claims of successor liability by virtue of the fraud exception may raise issues under seller's D&O policy. The policy should cover allegations of fraud and reimburse for defense costs until there is a final non-appealable adjudication that fraud or criminal activity occurred or the policy limits are exhausted. In *Stein v. Axis Insurance Company*, 10 Cal.App.5th 673, 682, 2018 WL 1804902 (2017) the California Court of Appeal considered a D&O policy that required a "final adjudication" in order for the exclusion to be triggered and held that the exclusion did not preclude coverage while the insured's appeal was pending, despite the insured's criminal securities fraud conviction.

[103] Uniform Fraudulent Transfer Act (UFTA). The Uniform Fraudulent Transfer Act was adopted in 1984 to replace the Uniform Fraudulent Conveyance Act (UFCA). The UFTA has been enacted in most states. Both the UFTA and the UFCA share the same underlying principle that title to assets conveyed to a third party for the purpose of placing such assets beyond the reach of creditors is fraudulent. On July 16, 2014, the Uniform Law Commission adopted amendments to the UFTA, which, among other things, renamed the UFTA as the Uniform Voidable Transactions Act (UVTA).

> itself and its liability for its predecessor's obligations. [Citations omitted.][104]

In the appropriate circumstances the court will look at Section 548 of the Bankruptcy Code, which provides that a transfer of property made by a seller/debtor is fraudulent as to a creditor and may avoided if made within two years of the bankruptcy filing and the transfer was made with actual intent to defraud, hinder, or delay its creditors, or seller received less than "reasonably equivalent value" for the transfer and it was insolvent at the time of transfer or became insolvent as a result of the transfer . . . ."[105] In an asset sale by a financially distressed business, the relevant issues will generally be whether seller was paid "reasonably equivalent value" and whether seller was insolvent at the time of the sale or as a result of the sale.[106]

E. Continuity of Enterprise (a/k/a Substantial Continuation). The continuity of enterprise exception represents an expansion of the traditional successor liability rules in product liability cases and focuses on whether there is a continuation of seller's business operations. There is no requirement under this exception for continuity of ownership or management. However, it has been adopted in only a few states.[107] The key factors under the "continuity of enterprise" exception, first articulated in *Turner v. Bituminous Casualty Co.*[108], are:

- continuity of key personnel, assets, and business operations;
- speedy dissolution of the predecessor corporation;
- assumption by the successor of those predecessor liabilities and obligations necessary for continuation of normal business operations; and
- continuation of the corporate identity.[109]

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104 Springer v. Nohl Elec. Prod. Corp., 381 Wis. 2d 438, 457 - 458, 912 N.W.2d 1, 10 - 11 (2018).

105 11 U.S.C.A. § 548 (West, Westlaw Through P.L. 115-79).

106 Alleged fraud in connection with the sale of a financially distressed business can be an issue, and particular attention should be given to the scope of fraud exclusion in the D&O policy to ensure that the insurer's defense obligations continue until there is a final non-appealable adjudication that fraud occurred or the policy limits are exhausted.

107 *See, e.g.,* Savage Arms, Inc. v. Western Auto Supply Co., 18 P.3d 49, 55-58 (Alaska 2001); Turner v. Bituminous Cas. Co., 397 Mich. 406, 244 N.W.2d 873, 881-82 (1976). The American Law Institute (ALI) declined to adopt either the "continuity of enterprise" or the "product line exception" because the vast majority of courts considering them have rejected them.

108 *Turner,* 244 N.W.2d at 873.

109 *Id.* at 883-84.

This is a limited exception that looks past the identity of shareholders and directors, and focuses on whether the business itself has been transferred as an ongoing concern.[110]

The *Turner* case [111] was a product liability case where the court began its analysis of the successor liability issue by asking whether there is a reasonable legal or logical difference, all other things being equal, to justify products liability recovery where an acquisition is made using buyer's stock, not cash, as consideration. It concluded that it does not make sense or promote justice to require a buyer following a statutory merger or a *de facto* merger to respond to products liability suits, and then to leave a buyer following a transfer of assets for cash free from liability, when the needs and objectives of both the injured party and the corporation are the same in all three alternative acquisition structures.[112] The court seems to have been motivated, at least in part, by a sense that cash transactions were being used to avoid liability for defective products and that the successor was holding itself out to the world as the effective continuation of seller.[113]

F. Product Line Exception. The product line exception was created by the California Supreme Court in *Ray v. Alad Corp.*[114] and imposes liability on a successor manufacturer that continues manufacturing a product line that included a defective product, even in all-cash transactions where there is no continuity of equity ownership or management. The product line exception is often expressed as a three prong test, whether:

(1) buyer's acquisition of seller's business virtually destroys the plaintiff's remedies against seller;

(2) buyer had the ability to assume seller's role in spreading the risk of injury as a cost of doing business; and

(3) buyer's assumption of the responsibility for defective products was a fair result when considering whether buyer enjoyed the manufacturer's goodwill in continuing the business.[115]

Under this exception, a buyer that acquires the assets of a product line and continues to manufacture the same products with the acquired assets will be liable for

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[110] *Savage Arms, Inc.,* 18 P.3d at 49 (footnotes omitted).

[111] *Turner,* 244 N.W.2d at 873.

[112] *Id.* at 883.

[113] *Id.* at 880.

[114] Ray v. Alad Corp., 19 Cal. 3d 22, 560 P.2d 3 (1977).

[115] Peterson Mfg. Co. v. Titan Int'l, Inc., B176630, 2005 WL 1971260 (Cal. Ct. App. Aug. 17, 2005).

defective products produced by seller if there is no adequate remedy for injured consumers because seller has gone out of business. The product line exception has been adopted in only seven states, all of which recognize strict liability for defective products, and it has been applied only in product liability claims.[116]

G. Post-Sale Duty to Warn. At least thirty states have imposed some form of duty on manufacturers to warn consumers of a latent defect or unreasonably dangerous condition associated with their products. In addition, federal law imposes a duty on manufacturers to report safety problems to the appropriate regulatory agency and take remedial action when appropriate.[117] The majority of judicial decisions that recognize such a duty have held that a product seller may be obligated to warn consumers of a latent defect and unreasonably dangerous condition associated with the product that was unknown at the time of initial sale, but which was discovered after sale. Section 10 of the *Restatement (Third) of Torts: Products Liability* provides that regardless of whether there was a latent defect at the time of sale, a post-sale advisory duty may be imposed when "a reasonable person in seller's position would provide such a warning." A third approach recognizes a post-sale duty to warn where a seller learns or should have learned of significant hazards associated with product misuse or alteration, whether the misuse or alteration of the product is by the user or a third party, if it renders the foreseeable use of the product unreasonably unsafe.

A successor manufacturer may be liable to consumers where it discovers a defect in its predecessor's product and fails to warn, recall or retrofit a product or notify customers of safety advances. In *Harris v. T.I., Inc.*, the Virginia Supreme Court stated that in the proper case the court would recognize a successor corporation's post-sale duty to warn where the plaintiff proved that there was a "special relationship" between the consumer and the successor that would support a finding of such a duty. Section 13(a) of the *Restatement (Third) of Torts: Products Liability* adopts a similar approach and provides for successor liability for failure to provide post-sale warnings when:

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[116] The six states, other than California, that have adopted the product line exception are Connecticut, Mississippi, New Jersey, New Mexico, Pennsylvania and Washington. *See* Kendall v. Amster, 108 Conn. App. 319, 948 A.2d 1041 (2008); Huff v. Shopsmith Inc., 786 So.2d 383 (Miss. 2001); Ramirez v. Amsted Indus. Inc., 86 N.J. 332, 431 A.2d 811 (1981); Garcia v. Coe Mfg. Co., 123 N.M. 34, 933 P.2d 243 (1997); Dawejko v. Jorgensen Steel Co., 290 Pa. Super. 15, 434 A.2d 106 (1981); Martin v. Abbott Labs., 102 Wash. 2d 581, 689 P.2d 368 (1984). *See generally*, Fletcher, *supra* note 3, at § 7123.30.

[117] *See generally*, ABA, *Post-Sale Duty to Warn, A Report of the Products Liability Subcommittee* (2004) (providing a comprehensive summary of the current U.S. common and regulatory law on a product seller's duty to warn customers and users following the initial sale of a product). *See also,* Patton v. TIC United Corp., 77 F.3d 1235, 1240-41 (10th Cir. 1996); Tucker v. Paxson Mach. Co., 645 F.2d 620 (8th Cir. 1981) (quoting Gee v. Tenneco, Inc., 615 F.2d 857, 866 (9th Cir. 1980)).

(1) the successor undertakes or agrees to provide services for maintenance or repair of the product or enters into a similar relationship with the purchasers of the predecessor's product giving rise to actual or potential economic advantage to the successor; and

(2) a reasonable person in the position of the successor would provide a warning.[118]

Succession alone does not impose this duty. What is required is evidence showing the continuation of the relationship between the successor and the customers of the predecessor. Factors which may be considered in order to determine whether a duty to warn exists are whether the successor assumed the predecessor's service contracts, whether the particular product was covered under a service contract with the predecessor's customer, whether the successor actually serviced the product, and whether the successor knew of the alleged defects and knew how to reach the predecessor's

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[118] RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY §13 (Am. Law Inst. 1998), which provides as follows:

> (a) A successor corporation or other business entity that acquires assets of a predecessor corporation or other business entity . . . is subject to liability for harm to persons or property caused by the successor's failure to warn of a risk created by a product sold or distributed by the predecessor if:
>
> (1) the successor undertakes or agrees to provide services for maintenance or repair of the product or enters into a similar relationship with purchasers of the predecessor's products giving rise to actual or potential economic advantage to the successor; and
>
> (2) a reasonable person in the position of the successor would provide a warning.
>
> (b) A reasonable person in the position of the successor would provide a warning if:
>
> (1) the successor knows or reasonably should know that the product poses a substantial risk of harm to persons or property; and
>
> (2) those to whom a warning might be provided can be identified and can reasonably be assumed to be unaware of the risk of harm; and
>
> (3) the warning can be effectively communicated to and acted on by those to whom a warning might be provided; and
>
> (4) the risk of harm is sufficiently great to justify the burden of providing a warning.

customers.[119] With respect to prescription drugs, the courts typically impose a continuing duty to test and monitor a product after sale to discover product related risk.[120]

H. Statutory Provisions. Some states have endeavored to legislatively repeal the *de facto* merger doctrine. For example, Texas Business Organizations Code § 10.254 provides:

> (a) A disposition of all or part of the property of a domestic entity, regardless of whether the disposition requires the approval of the entity's owners or members, is not a merger or conversion for any purpose.
>
> (b) Except as otherwise expressly provided by another statute, a person acquiring property described by this section may not be held responsible or liable for a liability or obligation of the transferring domestic entity that is not expressly assumed by the person.[121]

In *C.M. Asfahl Agency v. Tensor, Inc.,*[122] the Texas Court of Civil Appeals, quoting Article 5.10 of the Texas Business Corporation Act (the statutory predecessor of Texas Business Organizations Code § 10.254) and citing two other Texas cases, wrote as follows:

> This transaction was an asset transfer, as opposed to a stock transfer, and thus governed by Texas law authorizing a successor to acquire the assets of a corporation without incurring any of the grantor corporation's liabilities unless the successor expressly assumes those liabilities. [citations omitted] . . . . Even if the Agency's sales and marketing agreements with the [grantor] purported to bind their "successors and assigns," therefore, the agreements could not contravene the protections that article 5.10 . . . afforded [the

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119 Burroughs v. Precision Airmotive Corp., 78 Cal. App. 4th 681, 696, 93 Cal. Rptr. 2d 124, 135 (2000). *See* Redman v. Cobb Int'l Inc., 23 F. Supp. 2d 1372 (M.D. Fla. 1998); Gee v. Tenneco Inc., 615 F.2d 857, 866 (9th Cir. 1980).

120 Wooderson v. Ortho Pharm. Corp., 681 P.2d 1038, 1049-50 (Kan. 1984).

121 Tex. Bus. Org. Code Ann. § 10.254 (West, Westlaw through 2017 Reg. 1st Called Sess). Subsection (b) was added by the Texas legislature during its first session after the decision in Western Resources Life Insurance Co. v. Gerhardt, 553 S.W.2d 783, 786-87 (Tex. Civ. App. 1977), which held an acquiring corporation responsible for all liabilities of a seller whose assets it purchased notwithstanding that there was no express or implied assumption of such liabilities. Pennsylvania attempted to repeal the *de facto* merger doctrine but the statutory repeal has been held to apply only to cases involving appraisal rights. 15 Pa. Cons. Stat. Ann. § 1904 (West, Westlaw through 2018 Regular Session Act 16).

122 C.M. Asfahl Agency v. Tensor, Inc., 135 S.W. 3rd 768, 775 (Tex. Ct. App. 2004).

> successor] in acquiring the assets of the [grantor] unless [the successor] expressly agreed to be bound by [grantor's] agreements with the Agency.[123]

Thus, Texas Business Organizations Code § 10.254 is applied literally to mean that under Texas law a buyer of assets from a Texas corporation or limited liability company takes the assets free of claims, subject to applicable statutes such as fraudulent transfer and environmental statutes, unless buyer contractually assumes the liabilities.[124]

I. Federal Common Law of Successor Liability. Although there is no federal general common law, federal courts have developed common law in certain circumstances involving the rights and obligations of the federal government. In *United States v. Kimbell Foods, Inc.* the Supreme Court established a three part test to determine whether federal common law should displace state law: "(1) whether the federal program, by its very nature, required uniformity; (2) whether application of state law would frustrate specific objectives of the federal program; and (3) whether application of uniform federal law would disrupt existing commercial relations predicated on state law."[125] Following the *Kimbell Foods* decision, federal courts have addressed the federal common law of successor liability in cases under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA),[126] federal labor and employment laws and the enforcement of patent infringement judgments.

1. CERCLA. Successor liability under CERLCA is anything but straightforward. CERCLA itself is silent on the matter,[127] causing some federal courts to develop and apply a federal common law "substantial continuity" standard for finding liability.[128] Also referred to as the "continuity of enterprise" theory (see discussion in Section III.E. above), "substantial continuity" or "substantial continuation" in the context of prior CERLCA cases, which involved consideration of several factors to determine successor liability:

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[123] *Id*. at 780-81.

[124] *See* Byron F. Egan, *Egan on Entities: Corporations, Partnerships and Limited Liability Companies in Texas*, § 1.4.1(c) (2d Edition 2018).

[125] United States v. Gen. Battery Corp., 423 F.3d 294, 299 (3d Cir. 2005) (citing United States v. Kimbell Foods, Inc., 440 U.S. 715, 728-29 (1979)).

[126] 42 U.S.C.A. § 9601 *et seq.* (West, Westlaw through P.L. 115-79).

[127] *See* Gen. Battery Corp., 423 F.3d at 298 ("CERCLA is not, however, 'a model of legislative draftsmanship'. . . and successor liability is one of its puzzles") (quoting Exxon Corp. v. Hunt, 475 U.S. 355, 363 (1986)).

[128] *See, e.g.,* United States v. Carolina Transformer Co., 978 F.2d 832, 838 (4th Cir. 1992); Atlantic Richfield Co. v Blosenski, 847 F. Supp. 1261, 1287 (E.D. Pa. 1994); Gould, Inc. v. A & M Battery & Tire Serv., 950 F. Supp. 653, 657 (M.D. Pa. 1997).

- retention of the same employees;
- retention of the same supervisory personnel;
- use of the same production facilities in the same location;
- production of the same product;
- use of the same name;
- continuity of assets;
- continuity of general business operations; and
- buyer's holding itself out as the continuation of the previous enterprise.[129]

However, those prior decisions have been called into question by the Supreme Court's decision in *United States v. Bestfoods*,[130] which cautioned courts to avoid creating "CERLCA-specific rules" to supplant common law.[131] As the Second Circuit noted in *Nat'l Servs. Indus.*, insufficient uniformity existed among the states in the use of "substantial continuity" to allow the doctrine to be adopted as settled federal common law.[132] As a consequence, courts have declined to apply the "substantial continuity" concept beyond cases where buyer had substantial ties to seller or pre-closing knowledge of the particular environmental issues.[133] Some courts seem to require the parties to have purposefully engaged in the transaction in order to circumvent CERCLA liability.[134] Other courts have declined to apply the "substantial continuity" theory

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[129] Carolina Transformer, 978 F.2d at 838. *See also* United States v. Mexico Feed & Seed, Co., 980 F.2d 478, 488 (8th Cir. 1992).

[130] United States v. Bestfoods, 524 U.S. 51 (1998).

[131] *See, e.g.,* Gen. Battery Corp., 423 F.3d at 309 ("'substantial continuity' is untenable as a basis for successor liability under CERCLA"); Dixon Lumber Co. v. Austinville Limestone Co., Inc., 256 F. Supp. 3d 658 (W.D. Va. June 9, 2017) (declining to follow Carolina Transformer).

[132] New York v. Nat'l Servs. Indus., Inc., 352 F.3d 682, 687 (2d Cir. 2003).

[133] *See* United States v. Atlas Minerals and Chemicals, Inc., 824 F. Supp. 46, 51 (E.D. Pa. 1993) (finding a defendant to have no "substantial ties" to predecessor where predecessor ceased transfer of hazardous waste to landfill 13 years prior to sale to successor); City Envtl., Inc. v. U.S. Chem. Co., 814 F. Supp. 624, 640 (E.D. Mich. 1993) (holding that "substantial continuity" extension was improper where substantial ties could not be established because successor never dumped waste, did not merely consist of the assets of predecessor, and was already a larger, pre-existing corporation). *Cf.* Atlantic Richfield Co., 847 F. Supp. at 1287 (rejecting the knowledge requirement of *Atlas* in its adoption of the "substantial continuity" theory).

[134] *See* K.C. 1986 Ltd. P'ship v. Reade Mfg., 472 F.3d 1009, 1022-23 (8th Cir. 2007) ("Ultimately, the proper application of the substantial continuity test requires a consideration of whether 'CERCLA-defeating conduct' is present") (quoting Nat'l Servs. Indus., 1352 F.3d at 694 (Leval, J., concurring)).

altogether.[135] Much depends on whether a court chooses to apply state or federal common law principles.[136] All of this evidences a lack of uniformity among federal courts when considering the question of successor liability under CERCLA, not unlike the confusion that exists in other areas of successor liability law.

2. Labor and Employment: A federal common law standard has developed over the course of the past several decades to determine when successor liability exists for labor and employment matters. The standard, which is generally less-restrictive than state successor liability law, involves examination of the following factors: "(1) continuity in operations and work force of the successor and predecessor employers; (2) notice to the successor-employer of its predecessor's legal obligation; and (3) ability of the predecessor to provide adequate relief directly."[137] In recent years federal courts have extended the federal standard to claims arising under the Fair Labor Standards Act (FLSA) and other labor employment laws.[138] This is particularly noteworthy as liability arising from pre-closing employee misclassification is a common risk that buyers must evaluate. Practitioners should recognize that strong public policy motivations underpinning labor and employment laws can tip the scales heavily in favor finding successor liability in such cases.[139]

In the case of liability under the Worker Adjustment and Retraining Notification (WARN) Act of 1988, the statute itself imposes successor liability, providing that "[a]fter the effective date of the sale of part or all of an employer's business, the

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135 *See, e.g.,* Atchison, Topeka, and Santa Fe Ry. Co. v. Brown & Bryant, Inc., 159 F.3d 358, 364 (9th Cir. 1998) (declining to "extend the 'mere continuation' exception to include the broader notion of a 'substantial continuation' exception" and casting doubt on the need for any uniform federal common law standard for successor liability under CERCLA).

136 *Compare* United States v. Davis, 261 F.3d 1 (1st Cir. 2001), with *Gen. Battery Corp.,* 426 F. 3d at 294.

137 Brzozowski v. Corr. Physician Servs., Inc., 360 F.3d 173, 178 (3d Cir. 2004) (quoting Rego v. ARC Water Treatment Co. of Pa., 181 F.3d 396, 402 (3d Cir. 1999)).

138 Teed v. Thomas & Betts Power Solutions, L.L.C., 711 F.3d 763, 765 (7th Cir. 2013) (Judge Posner holds that purchaser of assets is subject to successor liability for seller's violations of the FLSA and other federal labor and employment laws, even though the successor disclaimed liability when it acquired the assets.). *See also* Thompson v. Real Estate Mortg. Network, 748 F.3d 142 (3rd Cir. 2014); Steinbach v. Hubbard, 51 F.3d 843 (9th Cir. 1995). *See e.g.*, John Wiley & Sons, Inc. v. Livingston, 376 U.S. 543, 548–49 (1964) (Labor Management Relations Act); Golden State Bottling Co. v. NLRB, 414 U.S. 168 (1973) (National Labor Relations Act); Wheeler v. Snyder Buick, Inc., 794 F.2d 1228, 1236 (7th Cir. 1986) (Title VII); Upholsterers' Int'l Union Pension Fund v. Artistic Furniture, 920 F.2d 1323, 1327 (7th Cir. 1990) (ERISA); EEOC v. G–K–G, Inc., 39 F.3d 740, 747–48 (7th Cir. 1994) (Age Discrimination in Employment Act); Sullivan v. Dollar Tree Stores, Inc., 623 F.3d 770, 781 (9th Cir. 2010) (Family and Medical Leave Act); *cf.* Musikiwamba v. ESSI, Inc., 760 F.2d 740, 746 (7th Cir. 1985) (42 U.S.C. § 1981, racial discrimination in contracting).

139 *Id.*

purchaser shall be responsible for providing notice . . ." under the act.[140] The Eighth Circuit in *Day v. Celadon Trucking Svcs., Inc.*, noting the plain statutory language, determined that an asset buyer had WARN Act liability even though it did not hire the employees of the acquired business because the employees remained employed after the closing and buyer's failure to hire them constituted effective termination requiring notification once seller ultimately terminated their employment.[141]

3. Other Areas of Federal Law. The more expansive "substantial continuity" test adopted by some federal courts under CERCLA and in labor and employment cases has not been adopted as the federal common law of successor liability in other areas.

a. Enforcement of Patent Infringement Claims. In *Mickowski v. Visi-Trak Worldwide, LLC,*[142] a case involving a claim of successor liability against buyer in an all-cash asset purchase, the Sixth Circuit Court of Appeals held that the "substantial continuity" test did not apply to patent infringement claims because the plaintiff failed to show that there is a federal policy or interest in extending the substantial continuity test to enforcement of patent judgments stating that "to date, that test has largely been limited to the 'few and restricted' areas of labor and employment law and pension benefits, where the need for a uniform, broader rule of successor liability is more apparent."[143] The Court based its decision on the Supreme Court's opinion in *Atherton v. Fed. Deposit Ins. Corp.*,[144] in which the Court stated that "when courts decide to fashion rules of federal common law, 'the guiding principle is that a significant conflict between some federal policy or interest and the use of state law . . . must first be specifically shown.'"[145] "Indeed, such a 'conflict' is normally a 'precondition.'"[146] In the absence of a showing by the plaintiff that there was a federal policy or interest in extending the substantial continuity test to the enforcement of patent judgments, the court concluded that successor liability should be determined under Ohio's more restrictive "mere continuation" test and held that the successor was not liable for patent infringement claims against its predecessor because there was no common ownership between buyer and seller.

b. False Claims Act. The Fourth Circuit recently reached a similar conclusion with respect to the False Claims Act (FCA). In *United States ex rel.*

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140 *See* 29 U.S.C.A. § 2101(b)(1) (West, Westlaw through P.L. 115-79).

141 Day v. Celadon Trucking Svcs., Inc., 827 F.3d 817, 830 (8th Cir. 2016).

142 Mickowski v. Visi-Trak World Wide, LLC, 415 F.3d 501 (6th Cir. 2005).

143 *Id.* at 512.

144 Atherton v. Fed. Deposit Ins. Corp., 519 U.S. 213 (1997)

145 *Id.* at 218 (quoting Wallis v. Pan Am. Petroleum Corp., 384 U.S. 68, 68 (1966)).

146 *Id.* (quoting O'Melveny & Myers v. FDIC, 512 U.S. 79, 87 (1994)). *See generally*, *The Federal Common Law of Successor Liability and the Foreign Corrupt Practices Act*, 6 WM. & MARY BUS. L. REV. 89 (2015).

Bunk v. Gov't Logistics N.V.[147] the Court held that the use of the federal "substantial continuity" test was precluded by the Supreme Court's 1998 decision in *Bestfoods*.[148] In *Bestfoods*, the District Court had imposed derivative liability under CERCLA on a parent corporation for the costs of cleaning up a chemical plant owned by its subsidiary based upon on "a relaxed, CERCLA-specific rule of derivative liability."[149] The Supreme Court refused to apply such a relaxed veil piercing standard as a matter of federal common law stating that the "failure [of CERCLA] to speak to a matter as fundamental as the liability implications of corporate ownership demands application of the rule that, to abrogate a common-law principle, a statute must speak directly to the question addressed by the common law."[150] In reliance on that guiding principle, the Fourth Circuit held that the FCA does not speak to successor corporation liability and thus should not be held to abrogate the traditional common law principles governing successor corporation liability.[151]

c. Foreign Corrupt Practices Act (FCPA). The Foreign Corrupt Practices Act (FCPA)[152] is a broad anti-corruption statute that applies to a wide range of domestic and foreign companies and their directors, officers and employees.[153] It prohibits bribery of foreign government officials and has record-keeping and internal control requirements that apply to "issuers," which is defined as any company that has a class of securities registered under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act") or is required to file periodic and other reports with the SEC under Section 15(d) of the Exchange Act. The anti-bribery provisions of the FCPA prohibit

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147 United States *ex rel*. Bunk v. Gov't Logistics N.V., 842 F.3d 261 (4th Cir. 2016).

148 United States v. Bestfoods, 524 U.S. 51 (1998). *See also, e.g.*, United States ex rel. Klein v. Omeros, 897 F. Supp.2d 1058, 1065 -1067 (W.D. Wash. 2012); United States ex rel. Pilecki–Simko v. Chubb Institute, No. 06–3562, 2010 WL 1076228, at *15–16 (D.N.J. Mar. 22, 2010).

149 *Bestfoods,* 524 U.S. at 51-52.

150 *Id.* at 52 (citing United States v. Texas, 507 U.S. 529, 534 (1993)).

151 *Bunk,* 842 F.3d at 274.

152 FCPA, *supra FCPA at note* 45.

153 The FCPA applies to an "issuer," which is defined as any domestic or foreign company that has a class of securities registered under Section 12 of the Exchange Act or are required to file periodic and other reports with SEC under Section 15(d) of the Exchange Act. The FCPA also applies to "domestic concerns, which is defined as any individual who is a citizen, national, or resident of the United States, or any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship that is organized under the laws of the United States or its states, territories, possessions, or commonwealths or that has its principal place of business in the United States. Officers, directors, employees, agents, or stockholders acting on behalf of an issuer or a domestic concern (whether U.S. or foreign nationals), and any co-conspirators, are also subject to prosecution under the FCPA.

payments intended to induce or influence a foreign government official to use his or her position "in order to assist . . . in obtaining or retaining business for or with, or directing business to, any person" and apply to conduct both within and outside the United States. In 2012, the Department of Justice and the Securities and Exchange Commission jointly published *A Resource Guide to the U.S. Foreign Corrupt Practices Act* (the "FCPA Guide"), which explains the provisions of the FCPA and discusses the potential liability of an acquirer for FCPA violations of an acquired company. It also provides "practical tips" to reduce FCPA risk in mergers and acquisitions and gives guidance on hypothetical situations. The discussion of successor liability in the FCPA Guide is based on the premise that, as "a general legal matter, when a company merges with or acquires another company, the successor company assumes the predecessor company's liabilities."[154] However, the discussion does not distinguish between stock purchases and mergers, on the one hand, and asset purchases, on the other. According to the FCPA Guide, the DOJ and SEC have only taken action against successor companies in limited circumstances, generally in cases involving egregious and sustained violations or where buyer directly participated in the violations or failed to stop the misconduct from continuing after the acquisition.

J. Successor Liability for Unpaid Taxes.

1. Federal Taxes. Under IRC Section 6901(a)(1)(A), the IRS may collect unpaid income taxes, penalties and interest from the transferee of an asset seller under either state fraudulent conveyance law or state law principles of successor liability.[155] The term "transferee" includes a "shareholder of a dissolved corporation" and the "successor of a corporation."[156] The tax classification of

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154 FCPA Guide, *supra* note 46.

155 Atlas Tool Co. v. Comm'r, 614 F.2d 860, 870-71 (3d Cir. 1980) (holding transferee liable under New Jersey *de facto* merger doctrine for transferor's liability for the federal accumulated earnings tax); 28 IRS CCA 200840001, 2008 WL 4449746 (Aug. 28, 2008) (stating that IRS may rely upon state law doctrine of successor liability to collect federal income tax liability from a successor entity). TFT Galveston Portfolio, Ltd. v. C.I.R., 144 T.C. 96 (T.C. 2015) (declining to adopt a federal common law of successor liability for employment taxes and applied the Texas statute that provides that a buyer is not a successor in interest unless it expressly agrees to assume the liabilities of seller) (citing Tex. Bus. Orgs. Code Ann., § 10.254 (West, Westlaw through end of 2017 Regular and fist Called Sessions of the 85th Legislature)). *But see,* Whelco Indus., Ltd. v. United States, 526 F. Supp.2d 819 (N.D. Ohio, 2007) (applying a federal common law of successor liability and disregarded Ohio law requiring continuity of ownership for successor liability). *See also* Int. Rev. Man., Part 5, Ch. 17, Section 14. *See generally*, 628 ELLEN S. BRODY ET AL, TRANSFEREE LIABILITY.

156 20 C.F.R. § 301.6901-1(b) (Current through June 7, 2018). *See* Salus Mundi Foundation v Comm'r, 776 F.3d 1010 (9th Cir. 2014) (stating that shareholders of a dissolved corporation may be liable for taxes of the dissolved corporation if they were "transferees" under IRC §6901 and were liable under state fraudulent transfer law for the debts of the corporate seller).

seller can have a significant impact on the exposure of the asset purchaser for income tax liabilities. If seller is a pass-through entity, it is not liable for unpaid federal income taxes or prior year adjustments because its income and losses are passed through to its shareholders or members who are responsible for federal taxes on the income, except entity-level taxes such as the built in gains (BIG) tax applicable to S corporations.

a. Tax Elections. Certain elections allow taxpayers to characterize a transaction for tax purposes as an asset transaction but do not affect the legal form of the transaction. For example, if a Section 338(h)(10) election is made in connection with the purchase of S corporation stock, the transaction will be treated as an asset purchase for certain federal income tax purposes but for state law purposes it would still be a stock purchase. Accordingly, the liability of the acquired corporation for federal and state taxes, for pre-closing tax periods or arising in connection with the transaction, including the built-in gains tax, will continue to be liabilities of the acquired corporation even though an election has been made to treat the transaction as an asset purchase for tax purposes.

b. Liability for Taxes of Other Members of Seller's Consolidated Group. A seller that is a member of an affiliated group (within the meaning of IRC Section 1504(a)) is severally liable with respect to taxes owed by the group for tax periods during which seller was a member of the group under Treasury Regulations Section 1.1502-6. When the stock of a consolidated subsidiary is purchased, a buyer might expect that the subsidiary's income tax liabilities would to be limited to its own activities; however, the subsidiary is actually liable for the tax obligations of the entire consolidated group for each year that it was a member of the group, including the year of the sale.[157] Liability for unpaid taxes of seller and other members of the consolidated group is of particular concern where seller or other members of the consolidated group may be in financial distress or otherwise unable pay its tax obligations. In such case, the IRS may proceed against an asset buyer as a transferee of property of seller as discussed above.

2. State Taxes. Almost all states impose some form of statutory successor liability for a seller's unpaid taxes following a sale of the business or stock of goods, to the extent of the purchase price, if buyer fails to withhold from the purchase price an amount sufficient to pay seller's unpaid taxes.[158] This is a statutory liability and is not based on any of the theories of successor liability described in Section III above. Successor liability for state taxes is generally limited to "trust fund taxes" such as sales and use taxes, excise taxes collected by

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[157] 26 C.F.R. § 1.1502-6 (Current through June 7, 2018). Globe Prods. Corp. v. United States, 386 F. Supp. 319 (D. Md. 1974).

[158] *See* Carpenter, *supra* note 31.

retailers, including admissions and dues taxes, event fees and taxes; however, several states extend this to income taxes and income-based franchise taxes.[159] Trust fund taxes may also include state unemployment taxes and state income taxes withheld from employees. The liability for seller's unpaid trust fund taxes is a derivative liability. It is not an independent tax liability of buyer with respect to its own operations. Successor liability only arises if seller's trust fund taxes have not been reported correctly and paid by seller. A buyer in an asset purchase transaction may also be liable as a "successor" or "transferee" under other state statutes for income and other unpaid taxes of seller that are not trust fund taxes.[160]

K. Bulk Sales. State bulk sales laws based on Article 6 of the UCC generally apply to any non-ordinary course transfer of a major part of the inventory and supplies of a business subject to the statute. These laws impose liability on a transferee that does not comply with statutory notice and other pre-sale requirements.[161] Bulk sales laws are no longer a significant issue in most transactions because they have been repealed in all but two states, California and Maryland.[162] California has the revised version of Article 6 which provides that a buyer who fails to comply with the statutory requirements will be personally liable for certain claims against seller and that liability will not be limited to the value of the purchased assets.[163] Maryland has the original version of Article 6, which renders a bulk transfer ineffective against creditors of seller if buyer has not complied with the statutory procedures.[164]

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[159] *See, e.g.,* 35 Ill. Comp. Stat. Ann. § 5/902 (West, Westlaw through 2018 Reg. Sess.) (stating that buyer may be liable for the unpaid income taxes of seller when a "major part" of seller's business is purchased outside the usual course of business); 72 Pa. Cons. Stat. Ann. § 1403 (West, Westlaw through P.A. 100-118 of 2018 Reg. Sess. Act 16) (noting that buyer may liable for seller's unpaid corporate income taxes, as well as other unpaid tax obligations, when the purchaser buys 51% or more of seller's stock of goods, wares or merchandise of any kind, fixtures, machinery, equipment, buildings or real estate). Successor liability may be avoided by giving at least ten days' advance notice of the sale to the state taxing authority.

[160] *See* Gottsch Feeding Corp. v. Nebraska, 261 Neb. 19, 28-29, 621 N.W.2d 109, 116-17 (Neb. 2001).

[161] *See generally*, 7B LARY LAWRENCE, ANDERSON ON THE UNIFORM COMMERCIAL CODE (3d Ed. 2009 Rev.).

[162] The National Conference of Commissioners on Uniform State Laws (NCCUSL) and American Law Institute (ALI) recommended repeal of Article 6 in 1989 because they concluded that the benefits of a bulk sales law to creditors were no longer justified by the burdens and risks imposed on good faith buyers. See Revised UCC, Article 6, Official Prefatory Note to 1989 Recommendation, Background (Am. Law Inst. and Unif. Law Comm'n 2015).

[163] Cal. Com. Code §§ 6101 *et seq*. (West, Westlaw through Ch. 13 of 2018 Reg. Sess.).

[164] Md. Code Ann., Com. Law §§ 6-101 *et seq*. (West, Westlaw through legislation effective June1, 2018).

IV. Buying Distressed Assets in Bankruptcy.

Where seller is in financial distress, buyer should consider acquiring seller's assets through a sale process under Section 363 of the Bankruptcy Code[165] or pursuant to a Chapter 11 plan. A Section 363 sale is generally the preferred approach because it can be accomplished relatively quickly and results in a "free and clear" sale. The process typically begins with the filing of a motion to approve a sale to a "stalking horse" bidder. In this case, the debtor is required to conduct a marketing process and auction to offer third parties the opportunity to bid against the stalking horse bidder. Following selection of the winning bidder, the Bankruptcy Court will be asked to approve the proposed sale by a "free and clear" order authorizing the debtor to sell its assets to buyer free and clear of any pre-petition liens, claims, encumbrances, and other interests against the debtor, including successor liability claims and enjoining creditors from asserting such claims against buyer. Depending on the circumstances, including the extent of the marketing efforts, the sale can typically be accomplished within two to three months and even more rapidly where a quick sale is necessary to maximize the value for creditors.[166]

A sale of assets pursuant to a "free and clear" order of the Bankruptcy Court under either Section 363 or a Chapter 11 plan will allow the debtor's assets to be sold free and clear of liability for pre-petition liens, claims and other encumbrances. Although a sale pursuant to a Chapter 11 plan may provide greater protection against successor liability because the language of Section 1141(c) of the Bankruptcy Code[167] is broader than the language of Section 363 as it relates to the claims of creditors, a Section 363 sale may be the preferred approach for the reasons stated above.[168]

The actual sale process under Section 363 can vary greatly depending on local procedures and customs. In certain instances, the auction process can vary from judge-to-judge within the same district. Moreover, counsel and clients should not generalize

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165 See 11 U.S.C.A. § 363 (2010) (Westlaw through P.L. 115-79).

166 *See generally*, A. Raykin, *Section 363 Sales: Mooting Due Process?* 29 Emory Bankr. Dev. J., 91, 93 - 96 (2012-2013).

167 See 11 U.S.C.A. § 1141 (2016). Section 1141(c) provides, with certain exceptions, including exceptions in the plan or in the order confirming the plan, that "after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor." The Second Circuit has rejected the argument that the difference in the language between Sections 363(f)(5) and 1141(c) indicates a Congressional intent to allow tort claims to be extinguished in the reorganization context, but unwilling to do so in a Section 363 sale, stating that, "[g]iven the expanded role of § 363 in bankruptcy proceedings, it makes sense to harmonize the application of § 1141(c) and § 363(f) to the extent permitted by the statutory language." In re Chrysler LLC, 576 F.3d 108, 125 (2d Cir. 2009).

168 *See generally*, Raykin, *supra* note 166; Michael H. Reed, *Successor Liability and Bankruptcy Sales — A New Paradigm*, 61 Bus. Law. 179 (2005); Michael H. Reed, *Successor Liability and Bankruptcy Sales Revisited*, 51 Bus. Law. 653 (1996).

about a current sale process based upon past experience because no two sales are exactly alike. Accordingly, more so than most practice areas, buyers should retain experienced local counsel who are familiar with the local rules and customs.

Section 363(f) of the Bankruptcy Code provides that a bankruptcy trustee "may sell property . . . *free and clear of any interest in such property* of any entity other than the estate" (emphasis added) if any one of five conditions is met.[169] The phrase "interest in such property" is not defined in the Bankruptcy Code. Some courts have interpreted the phrase to mean only *in rem* interests in the property, such as a lien or other encumbrance, and held that general unsecured claimants, including tort claimants, have no specific interest in a debtor's property and therefore are not precluded by the free and clear order. However, it is now generally agreed that the phrase should be read more broadly and Section 363 may be used to extinguish claims that "arise from the property being sold."[170] The policy behind this broad reading is twofold:

> First, allowing tort claimants to sue Section 363 purchasers directly—rather than seeking relief from the estate itself—would subvert the Bankruptcy Code's priority scheme by allowing low-priority, unsecured claims to leapfrog over other creditors in the bankruptcy. (Citations omitted.) Second, allowing sales of debtor assets free and clear of liabilities of the debtor induces a higher sale price for the assets, thereby maximizing the value of the estate and maximizing potential recovery to creditors."[171]

A Section 363 sale order has been held to afford protection for an asset purchaser against liability for a seller's underfunded multi-employer pension plan notwithstanding the successor liability provisions of ERISA and the Multiemployer Pension Plan

169 The five alternative conditions set forth in Section 363(f) are: (1) applicable non-bankruptcy law permits sale of such property free and clear of such interest; (2) such entity consents; (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property; (4) such interest is in a bona fide dispute; or (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest. All of the cases relating to the power of the Bankruptcy Court sell to property free and clear of the claims of unsecured creditors have all focused on meaning of clause (5).

170 *See* United Mine Workers of America Combined Ben. Fund v. Walter Energy Inc., 551 B.R. 631, 641 (N.D. Ala. 2016) (authorizing a sale under Section 363 free and clear of successor liability for future assessments for medical benefits to retired coal miners); In re Trans World Airlines, Inc., 322 F.3d 283, 289-90 (3d Cir. 2003) (affirming a sale under Section 363 free and clear of successor liability claims for employment and sex discrimination).

171 Morgan Olson LLC v. Frederico (In re Grumman Olsen Industries, Inc.), 467 B.R. 694, 703 (S.D.N.Y. 2012) (citing *Chrysler,* 576 F.3d at 126).

Amendments Act of 1980 (MEPPA).[172] In a case in which the State of New York Department of Labor attempted to use seller's experience rating to calculate the unemployment insurance tax premiums of the purchaser, the Bankruptcy Court interpreted the term "interest" broadly and held that the experience rating was an "interest" and that seller's assets could therefore be sold free and clear of the experience rating.[173] The court relied in part on the First Circuit B.A.P. decision in In re PBBPC, Inc., which reached the same result.[174]

With respect to a Section 363 sale of environmentally contaminated real property, the purchaser will likely be held liable for such contamination under CERCLA and comparable state statutes based on its ownership of the property because the Bankruptcy Court order will not affect any CERCLA liability imposed on the property owner, but the purchaser would not be precluded from asserting the bona fide prospective purchaser (BFPP) defense under CERCLA.[175] If contamination is known or suspected at the time of the sale, buyer should evaluate the potential liability and negotiate with the debtor and the relevant government agencies to address the liabilities as part of the transaction.[176] Unlike non-bankruptcy sales, representations, warranties, and indemnification from the seller/debtor are worthless. Rather, the buyer must seek to reduce the purchase price to account for the increased risk of being in the chain of title.

Although a Bankruptcy Court has the power to sell assets free and clear of any claim that could be brought against the debtor in the bankruptcy proceeding, either through a Section 363 sale or through the powers of the Bankruptcy Court under other sections of the Bankruptcy Code, a sale free and clear does not include future claims that do not arise until after the bankruptcy proceedings. The Second Circuit recently

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172 *Id.* at 702-03*;* In re Ormet Corporation, No. 13-10334 (MFW), 2014 WL 3542133 (Bankr. D. Del. July 17, 2014).

173 In re Tougher Indus., Inc. No. 06-12960, 2013 WL 1276501 (Bankr. N.D.N.Y. March 27, 2013).

174 Mass. Department of Unemployment Assistance v. OPK Biotech, LLC, 484 B.R. 860 (B.A.P. 1st Cir. 2013). *See also,* In re USA United Fleet, Inc., 496 B.R. 79 (Bankr. E.D.N.Y. 2013).

175 The BFPP defense allows potential purchasers to purchase property after performing a Phase I environmental site assessment, provided no concerns for releases for hazardous substances are identified. See CERCLA §§ 101(40) and 107(r).

176 Illustrative of this approach is the case of *Dune Energy, Inc.*, Case No. 15-10336 (Bankr. W.D. Tex.), where the purchaser assumed certain environmental liabilities of the debtor and the debtor agreed use its best efforts to complete the clean-up prior to the closing. If the debtor was unable to complete the clean-up prior to the closing, it agreed to pay the deductible on its insurance policy and assign the policy to the purchaser. *See* Julie A. Wilson-McNerney, *Environmental Liabilities in Oil & Gas Sales Under Bankruptcy Section 363*, PerkinsCoie News-Insights (August 1, 2016), https://www.perkinscoie.com/en/news-insights/environmental-liabilities-in-oil-gas-sales-under-bankruptcy-code.html.

summarized the power of the Bankruptcy Court to order a sale of assets free and clear of future claims as follows:

> a bankruptcy court may approve a § 363 sale "free and clear" of successor liability claims if those claims flow from the debtor's ownership of the sold assets. Such a claim must arise from a (1) right to payment (2) that arose before the filing of the petition or resulted from pre-petition conduct fairly giving rise to the claim. Further, there must be some contact or relationship between the debtor and the claimant such that the claimant is identifiable.[177]

Examples of claims that may not be precluded by a Section 363 sale order are claims based upon allegedly defective products manufactured and sold by the debtor prior to the sale but which do not cause injury until after the Section 363 sale or claims based on exposure to a substance, such as asbestos, where exposure occurs prior to the sale but the injurious effects of which are not identifiable until after the sale. Since claimants with these types of claims are unknown and unidentifiable prior to the sale and thus cannot be given notice of the sale, the preclusion of their claims would raise significant due process issues.[178] In any event, where there is a risk of claimants with unmanifested claims the debtor should provide reasonable publication notice of the bankruptcy and sale process and the nature of the potential claims in order to provide a basis for later asserting that the free and clear order bars such claimants from bringing successor liability claims.[179] In an appropriate case, a future claims representative may be appointed by the Bankruptcy Court and authorized to negotiate for the creation of a special trust where funds could be set aside to pay claims that are asserted for injuries caused by the debtor's pre-petition conduct that did not manifest themselves until after the closing of the bankruptcy.[180]

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[177] Elliott v. Gen. Motors LLC (In re Motors Liquidation Co.), 829 F.3d 135, 156 (2d Cir. 2016), *cert. denied*, 137 S.Ct. 1813 (2017).

[178] Morgan Olson, 467 B.R. at 703-10. *But cf.* In re Motors Liquidation Company, 568 B.R. 217 (Bankr. S.D.N.Y. 2017).

[179] *See* In re Energy Future Holdings Corp., 522 B.R. 520, 537 (Bankr. D. Del. 2015) (holding that "[a]lthough the case law reaches disparate conclusions, the weight of developing authority holds that publication notice *may* be sufficient to satisfy due process and, thus, would allow for the discharge of the [un]manifested [c]laims); Ninth Avenue Remedial Group v. Allis-Chalmers Corp., 195 B.R. 716, 734 (N.D. Ind. 1996).

[180] *See generally,* In re Kewanee Boiler Corp., 198 B.R. 519, 540 (Bankr. N.D. Ill. 1996); *Id.* at 540 (internal citations omitted) ("In all cases found where a trust was created out of which future claims against the estate were to be paid, some assertedly injurious contact between the future victim and the product occurred pre-petition. Only the manifestation of a disease was lacking. In those cases, the existence of pre-petition physical contact, such as inhalation of asbestos, or insertion of a contraceptive, or implantation of a breast implant, more or less fixed the class of potential victims.").

Claims are only precluded, however, to the extent that the Bankruptcy Court's order approving the sale expressly precludes them. Accordingly, a prospective purchaser should ensure that the order specifically provides that the assets are being sold "free and clear" and the sale extinguishes the right to pursue claims "on any theory of successor or transferee liability, whether known or unknown as of the closing, now existing or hereafter arising, asserted or unasserted, fixed or contingent, liquidated or unliquidated" and includes a non-exclusive list of precluded claims that tracks the list of excluded liabilities in the asset purchase agreement.

In order to prove a successor liability claim against a purchaser in a Section 363 sale, the claimant must not only show that it has a claim that is not barred by the sale order but must also prove that the purchaser is liable under an applicable theory of successor liability. To address this issue, the sale order should include a finding that the purchaser is not the debtor's successor and findings of fact that support that conclusion. For example, in the recent asset sale in the case of *Quicksilver Resources Inc.*,[181] the sale order contained findings that, among other things:

- there was no common identity of the directors or stockholders between the purchaser and seller;
- the purchaser was not purchasing all the assets of the debtor;
- the purchaser was not holding itself out to the public as a continuation of the debtor; and
- the transactions were not being undertaken for the purpose of escaping liability for the debtor's debts.

Although such findings would not ensure that the purchaser would be able to avoid successor liability, they would provide an additional layer of protection to the purchaser.[182]

V. Choice of Law.

Added to the tangled mess of successor liability jurisprudence is the uncertainty parties to an asset sale face regarding which jurisdiction's law will ultimately determine liability. Unlike other aspects of the transaction, parties cannot and should not rely on the application to a successor liability claim of the governing law designated in the acquisition agreement. The nature and type of a successor liability claim usually drive the outcome of the choice of law analysis. Choice of law determinations in the context of successor liability may also involve questions of federal preemption of state law, further complicating the assessment of liability exposure.

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[181] In re Quicksilver Res. Inc., 544 B.R. 781 (Bankr. D. Del. 2016).

[182] *See* Wilson-McNerney, *supra* note 176.

The parties to an asset sale will usually negotiate and delineate in the asset purchase agreement the extent to which buyer assumes liabilities of seller relating to the acquired business. However, a person or entity bringing a third party claim against buyer on a theory of successor liability is by definition not a party to the asset purchase agreement. Indeed the very point of successor liability is to impose liability for a third party claim on a purchaser of business assets notwithstanding any contrary terms of the acquisition agreement.

Successor liability claims often arise in the context of products liability cases. Most courts considering such cases have evaluated the choice of law for successor liability using rules governing tort law rather than considerations of corporate or contract law. However, this is not always the case. The analysis can often be complicated and compartmentalized.

For example, in *Ruiz v. Blentech Corp.,* [183] a products liability case involving an injured Illinois resident in which the choice of law analysis was outcome-determinative on the question of whether an assert buyer would be under California's product line theory, the Seventh Circuit employed the analytical approach of the *dépeçage* rule prescribed by the RESTATEMENT (SECOND) OF CONFLICTS OF LAWS, which requires a separate choice of law analysis for each issue. In *Ruiz* the asset sale occurred in California between two California companies while the injury occurred in Illinois. The Seventh Circuit, applying the principle of *dépeçage*, found that California corporate law governed the issue of what liabilities, if any, buyer would acquire in connection with the asset sale. However, since California courts have treated the product line theory as a matter of tort law applicable only to strict liability cases and not as matter of corporate law, the court held that Illinois law applied to the tort issues and denied plaintiff's successor liability claim based on the product line theory because Illinois had not adopted the product line theory.

The Alaska Supreme Court used a similar choice of law approach in *Savage Arms*, engaging in a *dépeçage* analysis but declined to follow the Seventh Circuit's determination in *Ruiz* that successor liability was a matter of corporate law. In finding that Alaska law applied to the determination of successor liability arising from an injury to an Alaska resident from a defective rifle sold in Alaska, the court held that in a products liability case successor liability becomes "a creature of tort law."[184]

The logic used in *Savage Arms* and similar cases involving products liability claims has also been extended beyond the area of products liability. In *American*

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[183] Ruiz v. Blentech Corp., 89 F.3d 320 (7th Cir.1996).

[184] Savage Arms, Inc. v. Western Auto Supply Co., 18 P.3d 49, 53 (Alaska 2001) ("We decline to follow the Fifth and Seventh Circuits, because we believe that when a defective product causes personal injury, successor liability is most appropriately characterized as a torts question.").

Nonwovens, Inc. v. Non Wovens Engineering, S.R.L.,[185] the Alabama Supreme Court found that Alabama law applied to the determination of successor liability of a foreign company arising from a contract dispute. The case involved an Alabama company that entered into a contract with an Italian company that subsequently sold its assets to another Italian company in a transaction consummated in Italy under Italian law. In a breach of contract claim brought by the Alabama company, the Alabama court cited numerous products liability cases and found them to be "persuasive authority for holding that the law of the state whose law applies to the claim also applies to the issue of corporate successor liability."[186]

Two federal district court cases illustrate the sometimes differing choice-of-law outcome in cases involving matters governed by federal law when the question is whether to apply the law of the jurisdiction of incorporation of the predecessor company. In *Chrysler Corp. v. Ford Motor Co.*,[187] a federal court in Michigan in a CERLA liability case concluded that because the ability to incur CERLA liability is not peculiar to corporations, the internal affairs doctrine should not be applied to determine choice of law.[188] However, in a case involving liability for securities law violations, a federal court in California held that Delaware, the predecessor's jurisdiction of incorporation—rather than California—law applied to the determination of successor liability.[189] In that case the court reasoned that because a determination of successor liability under a *de facto* merger theory was peculiar to corporations, the state of incorporation had the most significant relationship to the matter.[190]

Sometimes even the choice of law provided in the acquisition agreement is applied to the successor liability determination. In In re Asbestos Litigation (Bell),[191] the Delaware Superior Court applied Pennsylvania law, which was the governing law of the applicable asset sale, rather than Delaware law, where the asbestos injury occurred. The Delaware court determined that the question of negligence and determination of tortious

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185 American Nonwovens, Inc. v. Non Wovens Engineering, S.R.L., 648 So. 2d 565 (Ala. 1994).

186 *Id.* at 570.

187 972 F. Supp. 1097 (E.D. Mich. 1997).

188 *Id.* at 1102.

189 Maine State Retirement Sys. v. Countrywide Fin. Corp., 2011 WL 1765509 (C.D. Cal. 2011).

190 *Id.* at *4.

191 In re Asbestos Litigation (Bell), 517 A.2d 697 (Del. Super. Ct. 1986).

conduct was a matter for Delaware law, but that the legal effect of the asset sale determines the outcome in the question of successor liability.[192]

Further complicating successor liability considerations, many types of third party claims may be brought under federal law. As we discussed above, federal common law applicable to successor liability has developed over time. In some cases, but not all, courts will apply federal common law rather than state law in determining successor liability for claims brought under federal statutes.[193]

VII. Conclusion.

The increasing number of cases involving successor liability claims and the confusing case law in this area, as well as the difficulty in predicting what will be the governing law for any particular successor liability claim, all lead to the conclusion that a buyer in an asset purchase transaction and its counsel should consider conducting a risk analysis of potential successor liability claims based on the factors that are typically cited in successor liability decisions rather than relying primarily on the traditional rule of non-liability.

Our review of the cases on successor liability suggests that the risk of successor liability claims increases as the number of the following factors in any particular transaction increases, regardless of what theory of successor liability may be applicable:

- Seller is likely to be subject to "long-tail" claims, such as product liability and environmental claims.
- Seller will be liquidated and dissolved shortly after the sale.
- Equity owners of seller will receive equity in buyer as purchase consideration.
- Buyer will continue seller's business operations with few changes.
- Buyer will hold itself out as a continuation of seller and trade on seller's goodwill.
- Buyer has prior knowledge of the successor liability claims.

Where three or more of these factors are present in a proposed transaction, buyer and its counsel should identify the specific areas of potential successor liability risk, such as product liability and known and unknown environmental conditions, and tailor the due diligence investigation to focus on those areas of risk, including a review of seller's existing and prior insurance policies and claims histories. Product liability risks should

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[192] *Id.* at 699. *See also* Lockheed Martin Corp. v. Gordon, 16 S.W.3d 127 (1st Dist. Tex. 2000) (finding that the governing law of the asset purchase agreement applied to the determination of successor liability for a contingent tort claim).

[193] *See* United States v. Gen. Battery Corp., 423 F.3d 294, 298 (3rd Cir. 2005) (referring to a "uniform federal law" applying to successor liability determinations under CERLCA).

be analyzed with a view to the potential application of the product line exception, which has been adopted by California and several other states and imposes liability on a successor manufacturer that continues a product line that includes a defective product, even where there is no continuity of equity ownership or management.[194]

Opportunities to adjust the structure of a transaction to reduce the number of these successor liability risk factors are usually relatively limited, so buyer's primary focus should be on (i) thorough due diligence to evaluate the nature and timing of potential successor liability claims; (ii) negotiation of provisions in the purchase agreement specifically defining seller's and buyer's respective responsibilities for post-closing claims, including claims based on occurrences prior to the closing that are not made or reported until after the closing and claims based on post-closing occurrences; and (iii) planning for post-closing insurance coverage for buyer and seller in consultation with an insurance advisor who has experience with mergers and acquisitions. The results of the due diligence investigation should be reflected in the representations and warranties in the purchase agreement, which will often need to be tailored to the specific risks of seller's business or industry, and in seller's post-closing covenants and indemnification and security provisions. Representation and warranty (R&W) insurance can often be helpful in protecting against unknown and undisclosed pre-closing claims and liabilities and other risks that can be the covered by a representation or warranty by seller, but the inherent limitation of R&W insurance is that it will not cover claims or occurrences that do not constitute a breach of a representation of warranty. One of the advantages of R&W insurance is that it can be written for a period that is longer than the survival period for the underlying representations and warranties.[195]

In summary, as a result of the growing number of successor liability claims and the often confusing, fact-specific judicial decisions on successor liability, asset purchase transactions now deserve a wider scope of due diligence and analysis of successor liability risks than in the past and increased focus by buyer's counsel and other advisers on minimizing the risk factors in the transaction structure and planning post-closing insurance and other long-term liability protections for buyer. Also, buyer's post-closing actions can affect successor liability risk and consideration should be given to providing written guidance to buyers in appropriate circumstances, particularly with respect to post closing announcements of the acquisition[196] and the possible existence of a potential duty to warn with respect to acquired product lines.[197]

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[194] *See supra* text accompanying notes 114 through 116.

[195] *Id*.

[196] *See supra* Section II.B.8, Post-Closing Precautions.

[197] *See supra* Section II.B.4.c, Representation and Warranty Insurance.