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Successor Liability in Distressed M&A Transactions: Mitigation Strategies

Due Diligence, Entity Structuring, Contractual Indemnities, Insurance, Post-Closing Transition

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Today's faculty features:

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SUCCESSOR LIABILITY IN DISTRESSED M&A TRANSACTIONS: MITIGATION STRATEGIES

Presented to:

STRAFFORD WEBINARS

Presented by:

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February 8, 2023

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Mr. Singer practices in the areas of corporate and commercial law, including finance, financial restructuring, capital recovery, and bankruptcy. He negotiates senior and subordinated financing arrangements and has experience with structuring credit facilities, perfecting finance documentation, and closing secured and lease finance transactions. Mr. Singer regularly represents lenders, lessors, funds, committees, business debtors, guarantors, and creditors in financial workouts, restructurings, distressed-sale transactions, intercreditor disputes, lender liability claims, successor liability issues, and preferential and fraudulent transfer litigation. He has been practicing for over 20 years and regularly advises publicly and privately held companies on corporate governance, debt and equity financings, licensing issues, and risk management. Mr. Singer serves as corporate counsel on behalf of buyers and sellers and venture capitalists in complex merger, acquisition, divestiture, and joint-venture transactions.

MICHAEL W. OTT

Mr. Ott is a bankruptcy and creditors' rights attorney in the law firm Ice Miller LLP. Mike regularly represents clients with counterparties in bankruptcy and insolvency situations, including in litigation over the avoidance and recovery of preferences and fraudulent transfers.

Special Concerns with Acquiring Distressed Assets

Many asset deals have hidden risks that can prove costly for buyers if not addressed prior to the closing of the transaction, particularly in a distressed transaction where the seller may be unable to satisfy retained liabilities following the closing.

The General Rule of Successor Liability

- The General Rule is that liabilities attach to entities, not assets.
- A successor is not liable for the debts of its predecessor, merely because it acquired the assets of that predecessor.

Four Principal Exceptions to General Rule

- There are four principal exceptions in the common law to the general rule:
  - Express or implied assumption of liability
  - De facto merger
  - Mere continuation
  - Fraudulent Transfer

Two Modern Exceptions to General Rule

- Other exceptions have been carved out of the general rule, including, but not limited to:
  - Product line liability for products liability; and
  - Environmental cleanup cost liability (CERCLA)

General Policy Behind Exceptions

- Basically, a buyer may be liable as a successor to the seller where:
  - The buyer has agreed to assume the liability;
  - The buyer is a separate entity from the seller in form only, but not substance;
  - The asset sale defrauded the seller’s creditors; or
  - Public policy requires the buyer to be liable as a successor.
- These exceptions are equitable in nature and highly dependent upon the specific facts of each transaction. Each successor liability "case must be determined on its own facts" including looking at the "totality of the unusual circumstances." *Rego v. ARC Water Treatment Company of Pennsylvania,* 181 F.3d 396, 403 (3d Cir. 1999).

Express or Implied Assumption – the Easy One

- Sometimes the buyer will agree to assume certain liabilities as part of the consideration that it pays to acquire the assets.
- Essentially, this exception turns on the intentions of the buyer and seller, as set forth in the asset purchase agreement.
- Successor liability under this exception is *mostly* within the control of the buyer.

Implied Assumption

- Implied assumption is analyzed using the theories of implied-in-fact and implied-in-law contracts.
  - Implied-in-fact assumption is discerned through an examination of the intentions of the parties to the contract.
  - Implied-in-law assumption is discerned where the buyer receives benefits from the seller's creditor, the buyer recognizes that it is receiving the benefits and accepts the benefits under circumstances where it would be inequitable for the buyer to retain the benefit without payment of the value thereof.

Implied Assumption (ctd.)

- A good example of implied assumption is *Alsco Inc. v. Fattys Bar LLC*, 461 P.3d 798 (Ida. 2020).
  - In that case, the bar “Tons of Fun” sold all of its assets to “Fatty’s Bar” without any express assumption of liabilities.
  - After the sale, Fatty’s Bar continued to operate a bar at the same location and used the same linen service that Tons of Fun had used, coordinating with the linen service to change the name on the account and provide new payment information.
  - Ultimately, the linen service sued Fatty’s Bar to collect amounts the service was owed by Tons of Fun before the sale. The Supreme Court of Idaho affirmed the trial court’s decision holding that by accepting the benefits of the linen service contract and performing the obligations, Fatty’s had implicitly assumed the seller’s obligations to the linen service.

Fraudulent Transactions – the other easy one

- If the creditor can establish that the buyer was the recipient of a fraudulent transfer from the seller, then the buyer may be liable to the creditor as a successor to the seller.
- There are two types of fraudulent transfer: “actual intent” fraudulent transfers and “constructive” fraudulent transfers.
  - “Actual Intent” fraudulent transfers require the creditor to establish the seller’s intention to hinder, delay, or defraud the creditor. This may be accomplished with circumstantial evidence, including by establishing the existence of certain statutory “badges of fraud.”
  - “Constructive” fraudulent transfers require the plaintiff to establish that the assets were transferred for less than reasonably equivalent value (or in some jurisdictions, “fair consideration”), while the seller was insolvent, or that the sale rendered the seller insolvent.

Badges of Fraud

- The Uniform Fraudulent Transfer Act, and its successor act, the Uniform Voidable Transactions Act identifies the following 11 “badges of fraud”:
  1. The transfer or obligation was to an insider;
  2. The debtor retained possession or control of the property transferred after the transfer;
  3. The transfer or obligation was disclosed or concealed;
  4. Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
  5. The transfer was of substantially all the debtor’s assets;
  6. The debtor absconded;

Badges of Fraud (ctd.)

7. The debtor removed or concealed assets;
8. The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
9. The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
10. The transfer occurred shortly before or shortly after a substantially debt was incurred; and
11. The debtor transferred the essential assets of the business to a lienor that transferred the assets to an insider of the debtor.

- When considering a transaction, it always helps to be mindful of any of the badges of fraud that are present.

De Facto Merger and Mere Continuation

- The "*de facto* merger" and "mere continuation" exceptions exist to prevent debtors from using a change in legal form to avoid liabilities without any significant change in substance.
- The "*de facto* merger" exception applies to "avoid the patent injustice which might befall a party simply because a merger has been called something else."*DoubleLine Capital LP v. Constructora Norberto Odebrecht SA*, 413 F. Supp. 3d 187, 214 (S.D.N.Y. 2019).
- The "mere continuation" exception applies where a the debtor essentially moves its operations to a new entity to avoid liabilities incurred at the old entity.

De Facto Merger and Mere Continuation (ctd.)

- These exceptions are often used interchangeably and overlap significantly.
  - The principal distinguishing characteristic of a typical *de facto* merger is that the consideration that the seller receives from the buyer is equity in the buyer entity (or its ultimate parent).
  - The principal distinguishing characteristic of a mere continuation is continuity of ownership and operations between the seller entity and buyer entity.

De Facto Merger and Mere Continuation (ctd.)

- These exceptions are not universally recognized. For example, Texas has effectively legislatively repealed the de facto merger doctrine. Section 5.10B of the Texas Business Corporations Act provides that

  A disposition of any, all, or substantially all, of the property and assets of a corporation…:

    (1) is not considered to be a merger or conversion pursuant to this Act or otherwise; and

    (2) except as otherwise expressly provided by another statute, does not make the acquiring corporation, foreign corporation, or other entity responsible or liable for any liability or obligation of the selling corporation that the acquiring corporation, foreign corporation, or other entity did not expressly assume.

- Among those states that recognize these doctrines, the standard—and the ease with which they can be invoke—varies significantly.

De Facto Merger

- Generally speaking, to establish a de facto merger, a creditor must show:
  1. continuity of ownership between the seller and buyer;
  2. cessation of ordinary business and dissolution of the seller corporation as soon as possible;
  3. assumption by the successor of the liabilities ordinarily necessary for the uninterrupted continuation of the business of the acquired corporation; and
  4. continuity of management, personnel, physical location, assets, and general business operation between the seller and the buyer.
- A court will “look to whether the acquiring corporation was seeking to obtain for itself intangible assets such as good will, trademarks, patents, customer lists and the right to use the acquired corporation’s name.”
- The doctrine is based on the principle that a successor who “effectively takes over a company in its entirety should carry the predecessor’s liabilities as a concomitant to the benefits it derives from the good will purchased.” Highland Crusader Offshore Partners LP v Targeted Delivery Technologies Holdings, 184 A.D.3d 116 (N.Y. App. Div. 2020).
- De facto mergers also typically involve consideration from the buyer to the seller in the form of stock in the buyer entity.

Mere Continuation

- “The underlying theory of the [mere continuation] exception is 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.” *Martin Hilti Family Trust v Knoedler Gallery LLC*, 386 F.Supp.3d 319, 352 (S.D.N.Y. 2019) (citations omitted).
- To establish mere continuation successor liability, a creditor generally must allege:
  1. Continuity of ownership, management, location, personnel, and good will with the predecessor business; and
  2. The predecessor corporation is in some way fundamentally altered by the asset transfer – for example, it no longer operates as a business or is left with few or no assets.

Continued Existence of Seller

- States differ over whether de facto merger and mere continuation exceptions can be applied if the seller entity continues to exist after the transaction.
  - The majority of states do not require legal dissolution of the seller, so long as the seller entity is effectively “shorn of its assets and has become, in essence, a shell.” *Bonanni v Horizons Investors Corp.*, 179 A.D. 3d 995, 998 (N.Y. App. Div. 2020).
  - Other states require legal dissolution before they will apply the de facto merger or mere continuation exceptions. *See Carter v City of Montgomery*, 473 F.Supp. 3d 1273 (M.D. Ala. 2020).

Continuity of Ownership

- States also differ over the extent to which equity ownership of the selling entity must continue post-sale.
  - On the one hand, New York only requires that the shareholders of the selling corporation hold an indirect interest in the buyer post-sale. *See Martin Hilti Family Trust*, 386 F.Supp.3d at 352.
  - Delaware, on the other hand, requires the shareholders of the seller to have acquired a direct ownership interest in the buyer. *See id.*

Continuity of Ownership (ctd.)

- States also differ with respect to the degree to which a plaintiff must show identity of ownership between the buyer and seller.
  - For example, Wisconsin recently reaffirmed its strict requirement of “identity of ownership” between the buyer and seller, requiring a common identity of officers, directors, and stockholders in the selling and purchasing companies before it will apply the exceptions to successor liability. *See Veritas Steel LLC v Lunda Construction Company*, 389 N.W.2d 19 (Wisc. 2020) (“Identity of ownership remains the *sine qua non* of successor liability.”).
  - Other states, such as Michigan, apply a more lenient “continuity of enterprise” rule, under which a plaintiff merely needs to establish continuity of management and personnel, but not a complete identity of stockholders. *See Foster v. Cone-Blanchard Mach. Co.*, 597 N.W.2d 506, 510 (Mich. 1999).

Public Policy Exceptions: Product Line Exception

- A minority of states, including most notably California, have adopted another exception to the general successor liability rule for product liability cases.
- In those states, the "Product Line" exception allows a plaintiff injured by a defective product to sue a successor company that acquired the product line and continues to manufacture it, without establishing continuity of either ownership or enterprise.
- To establish product line successor liability, a plaintiff must establish that:
    1. The successor produces the same product under a similar name;
    2. The successor acquired substantially all of predecessor corporation's assets, leaving only a corporate shell;
    3. The successor holds itself out as a mere continuation of the predecessor; and
    4. The successor benefits from the predecessor's good will.

  BB Buggies Inc. v Leon, 150 So.3d 90, 100 n.3 (Miss. 2014).

Public Policy Exceptions: Product Line Exception

- "Where a successor distributor acquires a predecessor's goodwill, holds itself out as akin to the predecessor by continuing to distribute similar unreasonably dangerous products, and realizes benefits from those distributions, then the product line doctrine applies." *Leren v Kaiser Gypsum Company Inc.*, 442 P.3d 273 (Wash. App. 2019).
- The product line exception is generally only applicable to products liability cases. Courts have been reluctant to expand it to other contexts. *See, e.g.*, *Oticon Inc v Sebotek Hearing Systems LLC*, 865 F. Supp. 2d 501 (D.N.J. 2011) (declining to apply product line exception to impose successor liability in a patent infringement case).

Public Policy Exceptions: Environmental Liabilities

- The Comprehensive Environmental Response Compensation and Liability Act of 1980 ("CERCLA") imposed liability for cleanup costs for certain contaminated properties on the owner of the property, regardless of whether the contamination occurred under the current owner or some previous owner.
- Accordingly, buyers cannot simply refuse to accept liability for environmental cleanup costs. Under CERCLA, those costs will be imposed upon the current owner regardless of any provisions in the purchase agreement to the contrary.
- Various states have adopted laws with provisions similar to those contained in CERCLA.

Mitigation Strategies

A. Heightened Importance of Due Diligence
   - Environmental
   - Tax
   - Employment

B. Transaction Structure
   - Asset Purchase
   - Operational Issues – Keep Separate/Keep Different

C. Purchase Agreement: Address Liability Assumption

D. Form NEWCO

E. Coordination with Seller
   - Use Care: Communications Not Privileged
   - Future of Seller (Chapter 7, Shutdown, Etc.)
   - Use of Name (Domain Name, Telephone, Numbers, Etc.)

F. Indemnity Provisions
   - Escrow
   - Guaranties or Other Security

G. Insurance

Mitigation Strategies: Bankruptcy Transactions

- Another strategy for completing distressed asset transactions with significant known liabilities, is to complete a section 363 sale in a bankruptcy case of the seller.
- Section 363(f) of the Bankruptcy Code allows a debtor to sell property “free and clear of any interest in such property of an entity other than the estate” under certain conditions. Those interest can include successor liability claims.
- A debtor may also dispose of property pursuant to a plan of reorganization with an injunction prohibiting the debtor’s creditors from pursuing their claims against third parties, including purchasers of the debtor’s assets.

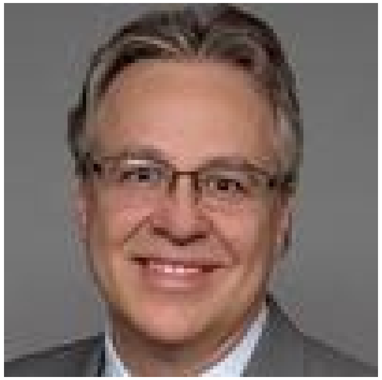
Mitigation Strategies: Bankruptcy Transactions

- The first rule of a successful bankruptcy sale is notice.
- The second rule of a successful bankruptcy sale is ***NOTICE***.
- The third and fourth rules are the same.
- As a practical matter, a bankruptcy court's power to authorize a sale of assets free and clear of interests in the property and successor liability claims is limited only by the requirements of due process. Accordingly, notice of a bankruptcy sale should be sent as broadly as possible and certainly to every known creditor.

Mitigation Strategies: Bankruptcy Transactions

- A free and clear sale or is not absolute, however, especially in the products liability context.
- Courts consistently decline to enforce free and clear sale orders against claimants that could not have known they had claims at the time the sale order was entered. *See, e.g., Kornfeind v New Werner Holding Co. Inc.*, 241 A.3d 1212 (Penn. 2020).
- The best example of this is the General Motors ignition switch litigation. GM has been litigating successor liability claims for years since it emerged from bankruptcy in 2009 following a Section 363 asset sale.

QUESTIONS



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