

**ACQUISITIONS OF FINANCIALLY
DISTRESSED COMPANIES**

**ABA BUSINESS LAW SECTION
COMMITTEE ON NEGOTIATED ACQUISITIONS**

**SPRING MEETING 2001
PHILADELPHIA**

SPEAKERS

Elizabeth A. Dellinger
Baker & Hostetler LLP
1900 East 9th Street, Suite 3200
Cleveland, Ohio 44114-3485
Telephone: 216-861-7793
Fax: 216-696-0740
e-mail: edellinger@bakerlaw.com

Scott D. Irwin
Baker & Hostetler LLP
1900 East 9th Street, Suite 3200
Cleveland, Ohio 44114-3485
Telephone: 216-861-7798
Fax: 216-696-0740
e-mail: sirwin@bakerlaw.com

David T. Sykes
Duane, Morris & Hecksher LLP
One Liberty Place, Suite 4200
Philadelphia, PA 19103
Telephone: 215-979-1000
Fax: 215-979-1020
e-mail: sykes@duanemorris.com

George M. Taylor III
Burr & Forman LLP
3100 SouthTrust Tower
420 North 20th Street
Birmingham, AL 35283
Telephone: 205-458-5254
Fax: 205-458-5100
e-mail: gtaylor@burr.com

TABLE OF CONTENTS

	<u>Page</u>
I. <u>What is “Financial Distress”?</u>	1
A. Characteristics of Financial Distress	1
B. Ancillary Crisis Resulting from Financial Distress	1
II. <u>Purchaser Issue in Asset Acquisitions of Financially Distressed Companies:</u>	
<u>Successor Liability</u>	1
A. General	1
B. The Theories of Recovery	3
C. Express and Implied Assumption of Liabilities	4
D. De Facto Merger	5
E. “Mere Continuation”	7
F. Mere Continuation Expands – The Substantial Continuation Test	8
G. Fraud	9
H. Products Liability	11
I. Duty to Warn	13
J. Liability Imposed by Statute	14
III. <u>Due Diligence in Acquisitions of Financially Distressed Companies</u>	22
IV. <u>Pricing Negotiations</u>	24
A. Purchaser’s Side	24
B. Seller’s Side	24
C. Compromise Positions	24
D. Vendor Terms	24
V. <u>Indemnification</u>	25
VI. <u>Fraudulent Conveyance Considerations, Preferences and Bulk Sales</u>	25
A. Fraudulent Conveyance	25
B. Preferences	26
C. Bulk Sales Law Compliance	26
VII. <u>Alternative Acquisition Methods</u>	27
A. Purchasing Assets out of Chapter 11 Bankruptcy	27
B. Secured Party Sale	27
C. Prepackaged Chapter 11	28
VIII. <u>Financing Acquisitions of Financially Distressed Companies</u>	29
A. Usually Leveraged Transactions	29

B.	Concept of “HLT’s” as designated by bank regulators is thing of past, although high leverage continues	29
C.	Structured Capital, ABL and Cash Flow Loans: what your Lenders are talking about	29
D.	Lenders’ Biggest Legal Worries	29
E.	Loan Documentation Provisions in Leveraged Transactions	29
F.	Leveraged acquisitions often also include third party Subordinated Debt. May include Subordinated Seller Paper	29
G.	Common Business Terms of Leveraged Financing	29
IX	<u>Director Issues in Acquisitions of Financially Distressed Companies</u>	30
A.	Traditional Approach to Director Fiduciary Duties (Solvent Corporation)	30
B.	Fiduciary Duties in Financial Distress Situations	31
C.	Challenge of Director Decision-Making in Financial Distress Situation	31
D.	Legal Definition of “Insolvent”	31
E.	The Rationale Behind the Shifting Director Duty	32

2001 welcomes back a popular topic of the early 1990's – acquisitions of financially distressed companies. This program, and these materials, present a survey of issues and special considerations unique to acquisitions involving Financially Distressed Sellers.

I. What is “Financial Distress”?

A. Characteristics of Financial Distress

1. Cash flow constrained
2. Stretched vendor payables
3. Loan defaults
4. Slow accounts receivable
5. Insolvency

B. Ancillary Crisis Resulting from Financial Distress

1. Employee turnover
2. Inability to make capital expenditures
3. Managing short-term cash flow in lieu of strategic management

II. Purchaser Issue in Asset Acquisitions of Financially Distressed Companies: Successor Liability

A. General

At the outset of every acquisition transaction, the decision must be made as to basic structure and the choice is often between purchasing the stock of the business being acquired or purchasing its assets. A prime factor favoring the selection of an asset purchase is the apparent ability of the Purchaser in an asset purchase transaction to avoid the liabilities of the predecessor business. In a stock transaction, the Purchaser automatically assumes all the liabilities of the business prior to the date of purchase. There is no way around this result, and the acquisition lawyer and his client must accept this result and do their best to protect themselves by drafting exhaustive representations and warranties, coupled with iron-clad indemnities, which are in turn backed up by extensive due diligence investigations and by whatever collateral or personal guaranties are available. The stock transaction is inherently a frightening transaction from a liability standpoint and there is no assurance that a single lawsuit or unexpected occurrence relating entirely to the period of time before the closing date will not wipe out the entire equity of the business that was acquired.

An asset purchase transaction, on the other hand, puts the Purchaser in a much better position in the area of assumed liabilities. The very nature of an asset purchase transaction is that the business is not being purchased, only specified assets. When the day is over and the transaction is closed, the Seller is left with his corporation intact, and the Purchaser has formed a new squeaky-clean entity to receive the assets and to thereafter operate the business. When litigation arises, the asset-Purchaser takes delight in informing the plaintiff that he is not the Seller and that he must go elsewhere for satisfaction.

While it has long been assumed that the Purchaser of assets is safe from claims of prior owners, the law is much less clear. Consider the following examples:

- A Purchaser purchases a manufacturing concern from a Seller with a less than sterling reputation for treating its employees fairly. The Purchaser doesn't worry. It doesn't investigate any prior labor practices because it intends to place the new business under the direction of its existing employee relations manager who can clear up any problem and who will institute the award-winning labor relations program that is in place in the rest of the company. Three weeks after closing, the Purchaser determines that not only has it inherited an unhappy and demoralized work force, but the NLRB will hold it liable for remediating some egregious unfair labor practices at the plant which occurred during the Seller's tenure. The award from the NLRB includes provision for substantial payment of back pay.
- A Purchaser of a manufacturing concern undertakes a thorough due diligence investigation into the business it is purchasing including a Phase I Site Assessment which shows the entire plant site to be clean. After closing, Purchaser learns that Seller has been shipping hazardous wastes off-site for years and dumping it illegally. When the EPA comes to visit, the Purchaser proudly points out that it purchased assets not stock. The EPA is undeterred. Purchaser eventually is assessed over \$1,000,000 in clean-up costs.
- Purchaser purchases a shipping company in an asset sale. After the sale a major customer comes forward with a claim that because of late deliveries, it has lost a major customer and has been substantially damaged as a result. Purchaser sends the customer to see the Seller because the problems arose prior to the closing. The court, however, holds that for purposes of the allegedly breached contract, the Seller and Purchaser are one and the same and the Purchaser is fully liable for the breach.
- In undertaking a transaction for a company located in the State of Alabama, you, as counsel, take great comfort in the fact that the Bulk Sales Act has been repealed and notify your client that there is no need to make any effort to comply. After closing, you learn that a creditor of the Seller in Tennessee, where apparently an insignificant amount of Seller's inventory was located, is seeking to set aside the whole transaction and/or hold your Purchaser client fully responsible because you failed to comply with the Bulk Sales Act in Tennessee.

These examples, while admittedly extreme, are not altogether unlike a number of cases that have been handed down in recent years on these various topics. The courts in many jurisdictions are quickly tearing down the boundaries between stock and asset purchases with the results that the Purchaser must exercise practically the same amount of care and caution in purchasing a business through an asset purchase as through a stock transaction. These decisions impact virtually every aspect of the acquisition transaction, from the decision of what form of transaction to follow, to the drafting of documents, to the due diligence investigation, and in many cases to whether to purchase the business at all. What follows is a summary of the developing law in the area of successor liability.

It has long been a tenet of black-letter law that the Purchaser of the assets of a business does not, without some express assumption on his part, take any of the liabilities of that business. The rule is solidly grounded on the principle that where a contract so provides, the intention of the parties will be honored. It is just and fair where one party has purchased the assets of a business entity without undertaking its liabilities that the intention of the parties will be honored with the result that the Purchaser will have no liability for the prior actions of the Seller. This rule also relates in corollary form to the bona fide Purchaser doctrine, which holds that a Purchaser purchasing in good faith without notice of a prior claim, takes the asset free and clear of that claim. See, *Polius v. Clark*, 802 F.2d 75 (3rd Cir. 1986) (citing 15 Fletcher, *Cyclopedia of the Law of Private Corporations*, Section 7122 (Permanent Edition 1983)).

That this rule sometimes worked an injustice by permitting the assets of a business to be sold off without there being made adequate provision for the payment of liabilities did not trouble the courts until recent years. In the bankruptcy courts it is not unusual for a troubled corporation to liquidate its assets, pay its secured creditors, and have little or nothing left to pay unsecured creditors. This is the basic law of bankruptcy and does not offend our sense of fairness because we encounter it every day. However, courts have developed a greater and greater reluctance to permit this same scenario in a non-bankruptcy setting. There is a sense of unfairness in permitting a Purchaser, who winds up with the assets of a business and who benefits (albeit indirectly) from the going concern value of the business and the past relationships of the Seller to walk away from obligations arising during the Seller's period of ownership.

B. The Theories of Recovery

In stretching beyond the general rule that an asset Purchaser takes no liabilities of a Seller, the courts have developed a number of theories. They may be summarized as follows:

1. The express or implied agreement to assume liabilities
2. Fraud and fraudulent transfers
3. The law of de facto mergers
4. The doctrine of "mere continuation" of the business

5. The "substantial continuation" doctrine or "continuity of enterprise"
6. Product line liability
7. The duty to warn
8. Inadequate consideration (often coupled with failure to make provision for the creditors' claims)
9. Liability imposed by statute

Many of these exceptions are grounded in traditional principles of law and are reflected in cases that apply to a broad range of substantive areas. Others, like the product line exception, relates to only one narrow area of substantive law. Yet others, such as the "substantial continuation" test, are both unprecedented and continually developing, with the result that many of the cases in this field are forging new (frightening) territory that is unknown to many of us. We will consider each of these in sequence.

C. Express and Implied Assumption of Liabilities

The most obvious case in which liabilities have been found to be assumed by the Purchaser in an asset transaction is the case where the courts have found an express assumption of liabilities. This can result from (1) the language of the contract entered into in connection with the transaction and (2) conduct of the parties. Where the contract provides that the Purchaser "assumes any and all liabilities of every description of the Seller", the Purchaser has chosen his own poison and should (rightly) be held liable by a court for every liability thereafter asserted arising out of the business.

More troublesome are cases where the courts have implied an express assumption of liabilities on the part of the Purchaser. While no precise rule sets forth the elements of implied assumption, the treatises suggest that the Purchaser's conduct or representations must indicate an intention by the Purchaser to assume the Seller's debts, and that the party asserting liability must have relied on that conduct or on those representations. 15 Fletcher, *Cyclopedia of the Law of Private Corporations*, Section 7124 (1989 Rev. Vol.) Facts to be considered include the effect upon the predecessor's creditors, and admissions by the successor's officers or other spokespersons.

Other cases on express and implied assumption depend on interpretation of contract language itself. In the case of *Mobay Corp. v. Allied-Signal, Inc.*, 761 F. Supp. 345, (D. N.J. 1991), the Purchaser agreed to indemnify the Seller from all obligations and liabilities arising out of post-closing claims or lawsuits for personal injury or property damage. After much deliberation, the court found that the language in question did not constitute indemnity for unforeseen environmental claims. Other courts have not been so anxious to limit contractual indemnities. Consider the case of *Kessinger v. Grefco, Inc.* 875 F.2d 153 (7th Cir. 1989), in which the court held that an asset purchase agreement containing similar assumption language evidenced an intention on the part of the Purchaser to assume the Seller's unforeseen product liability claims.

D. De Facto Merger

The origins of all efforts to impose liability on Purchasers for the Seller's liabilities in asset purchase transactions is the doctrine of de facto merger. The doctrine has been around in one form or another since the turn of the century and has been used for various purposes by courts intent on avoiding injustices that might result from technical compliance with existing corporate laws. A typical example is the case of *Marks v. Autocar*, 153 F. Supp. 768 (E.D. Pa. 1954), in which shareholders unable to assert dissenters' rights because of a clever transaction structuring by the corporation were able to persuade the court that the transaction, while not a technical merger, should be treated as one so that those rights could be asserted. The theory was also used where through a series of maneuvers shareholders of a corporation had successfully moved their businesses to a new corporate entity without going through a corporate merger and thereby depriving creditors and others of legitimate rights.

The traditional basis for the doctrine of de facto merger is the theory that a transaction, while nominally structured as an asset sale, amounts to no more than a consolidation of the business interests of the selling and purchasing corporations. The parties in such a transaction have achieved essentially all of the results of a merger without undertaking the corporate formalities. Typically, the selling corporation in such circumstances dissolves immediately after the transaction and the Purchaser continues the business, often with the very same or some of the former shareholders. The doctrine existed in that form for years in the common law of the various states with little attention until the Circuit Court of Appeals for the Third Circuit in 1974 in the case of *Knapp v. North American Rockwell Corporation*, 506 F.2d 361 (3rd Cir. 1974), cert. denied, 421 U.S. 965 (1975), used the theory to impose products liability on an unsuspecting Purchaser in a transaction in which the Purchaser had expressly disclaimed any assumption of liabilities of the Seller. The injury in question arose fourteen months after the closing and four months before the Seller dissolved. The court reached its conclusion by applying what it considered to be Pennsylvania law. A critical element of the courts analysis was its determination that if successor liability were not imposed, the plaintiff would be left without a remedy.

Generally, the courts now look to four basic factors in determining whether a de facto merger has occurred:

(i) whether there is a continuation of the enterprise of the Seller corporation, so that there is a continuity of management, personnel, physical location, assets and general business operations;

(ii) whether there is a continuity of shareholders which results when the purchasing corporation pays for the acquired assets with shares of its own stock, this stock ultimately coming to be held by the shareholders of the Seller corporation so that they become a constituent part of the purchasing corporation;

(iii) whether the Seller corporation ceases its ordinary business operations, liquidates and dissolves as soon as legally and practically possible; and

(iv) whether the purchasing corporation assumes those obligations of the Seller ordinarily necessary for the uninterrupted continuation of normal business operation of the Seller corporation.

See *Philadelphia Electric Co. v. Hercules, Inc.*, 762 F.2d 303 (3rd Cir. 1985). For example in the case of *In Re Acushnet River & New Bedford Harbor*, 712 F.Supp. 1010 (D.C. Mass. 1989), the court dealt with a situation in which the Purchaser purchased substantially all of the assets of the Seller pursuant to an asset purchase agreement which provided for the Seller to receive stock in Purchaser in return for the assets. The agreement required the Seller to liquidate shortly after closing. The main element of controversy before the court was whether there was continuity of ownership between the Seller and the Purchaser. The court devoted much of its discussion to the argument put forth by the Purchaser to the effect that no continuity of ownership existed between the Purchaser and the Seller in the transaction because the Seller's shareholders did not receive shares in the Purchaser itself but only shares in the newly-formed entity which had been formed by the Purchaser for the purpose of consummating the transaction. The court discarded this argument as inconsistent with the manifest purpose of the de facto merger doctrine, namely that use of the corporate shield not be used to avoid liability where the substance of the transaction was a merger of the two entities.

Most courts, even the *Acushnet* case in a sense, looking at the traditional de facto merger test have considered the transfer of stock from the shareholders of the old corporation to the shareholders of the new to be an essential element of the test. See e.g. *Travis v. Harris Corp.* 565 F.2d 443 (7th Cir. 1977), in which the court required some continuity of ownership between old shareholders and new in order for the test to be applicable. This is an integral part of the reasoning for the existence of the doctrine in the first place, namely that through a series of corporate shenanigans of some description, shareholders of one corporation have managed to move its business elsewhere, leaving the old creditors stranded. In order for this to happen, obviously the old shareholders must be involved in some manner in the new business.

While more conservative (and business-friendly) courts have continued to require all four elements to be met, and are particularly strict on the continuity of shareholder ownership, other courts have loosened that requirement to reach transactions to which traditional de facto mergers would not be applicable. Consider the case of *Lumbard v. Maglia*, 621 F. Supp. 1529 (S.D. N.Y. 1985) in which the court held that "not all [four] factors are needed to demonstrate a merger; rather those factors are only indicators that tend to show a de facto merger." 621 F. Supp. at 1535.

In the cases of *Knapp v. North American Rockwell*, 506 F.2d 361 (3rd Cir. 1974), and *Shannon v. Samuel Langston Co.*, 379 F. Supp. 797 (W.D. Mich. 1974), the courts held that the successor could be held liable even where the Seller continued in existence for a period of time after the sale, during which time the Seller could have paid off any adverse judgment. In *Knapp*, the court found the Seller's continued existence to be a mere formality and insufficient to prevent the transfer from being considered a sale, based on the brevity of the Seller's continued life after the transaction (eighteen months), the requirement in the purchase agreement that the Seller be dissolved as soon as possible, the prohibition in the same document against the Seller conducting normal business operations and the limited nature and quantity of assets retained by the Seller after

the transaction. In each of the cases, however, the assets were exchanged for shares of the Purchaser's stock, so that the continuity of interest was maintained.

A more extreme case is that of *Diaz v. South Bend Lathe, Inc.*, 707 F. Supp. 97 (E.D. N.J. 1989), in which the court used the de facto merger doctrine to find the successor liable for the actions of the Seller even though there was no continuity of interest at all. The statement of the court--"the consuming public should not be frustrated merely because the stock ownership of a corporation has not changed while all else--employees, products, supervision, and plans are transferred"--gives a very candid glimpse of the powerful public policy lurking below all these decisions. 707 F. Supp. at 101.

As the elements of the de facto merger test have been interpreted in an increasingly broad manner, one factor has been present in virtually each case. The courts are increasingly likely to use the theory to avoid injustice resulting when a Seller, having sold its assets, either doesn't exist or has insufficient assets to respond to legitimate claims of creditors.

E. "Mere Continuation"

A similar line of cases has used what is called the "mere continuation" theory to reach the same result. "The primary elements of [mere] continuation include the common identity of officers, directors or stockholders between the Seller and Purchaser, and the existence of only one corporation at the completion of the transfer." *Jacobs v. Lakewood Aircraft Service, Inc.*, 512 F. Supp. 176, 181 (E.D. Pa. 1981). The doctrine differs from the de facto merger doctrine more in form than in substance (it is not unusual for a court to discuss de facto mergers by use of "mere continuation" theory factors, and vice versa) and the factors considered by the courts are very similar. For example, a 1985 Missouri Supreme Court decision, *Jerry-Russell Bliss, Inc., v. Hazardous Waste Management*, 702 S.W. 2d 77 (Mo. 1985), confused the two doctrines by adding to the components of the mere continuation doctrine the need for the business operations, offices and trucks to become part of the successor and the requirement that the successor retain the predecessor's employees and customers. These would ordinarily be irrelevant to a determination of the corporate identity. Similar confusion was evidenced in the case of *Kelley v. Thomas Solvent Company*, 725 F. Supp. 1446 (W.D.Mich. 1988) where a successor was held liable as a mere continuation of the predecessor because, in addition to continuity of the shareholders, directors and officers, the successor "operated substantially the same business in products and services" as its predecessor. 725 F. Supp. at 1458. Basically, the rule holds that where there is a common identity of officers, directors and stockholders between selling and purchasing corporations, the Purchaser will be deemed a "mere continuation" of the Seller and will accordingly be liable for the obligations of the Seller.

Many of the early decisions considering the mere continuation doctrine in the context of asset transactions interpreted the provisions in such a manner as to not impose liability on the Purchaser. In the case of *U.S. v. Chrysler Corp.*, 31 ERC 1997 (D. Del. 1990), the court considered arguments that a Purchaser under an asset purchase agreement was a mere continuation of the Seller and that accordingly the Purchaser should be held accountable for environmental cleanup costs. The court held that commonality of shareholders and directors was an essential element of the mere

continuation theory. The Purchaser before the court had no shareholders in common with the Seller and after closing both corporations continued their separate ways in different lines of business. Under those facts, the court found that there could be no successor liability under the mere continuation theory. See, also *Louisiana-Pacific Corporation v. Asarco*, 909 F.2d 1260 (9th Cir. 1990), in which the court couched its federal common law analysis in terms of a de facto merger, but used an analysis appropriate for the mere continuation test.

F. Mere Continuation Expands – The Substantial Continuation Test

A growing number of courts have stretched the "mere continuation" test beyond all recognition into what is now known as the "substantial continuation" test. The earliest mention of this theory is in the case of *U.S. v. Distler*, 741 F. Supp. 643 (W.D. Ky. 1990), in which the court applied federal common law and suggested that successor liability could exist in CERCLA cases even where there is no common identity of officers, directors and shareholders if the business of the selling corporation is continued. Since that time, the Third, Fourth, Sixth, Eighth and Ninth Circuits have adopted the "substantial continuity" theory.

The substantial continuation test is essentially an expansion of the mere continuation doctrine, where continuity of ownership is disregarded in favor of the continuity of the business itself. In the case of *U.S. v. Carolina Transformer Company*, 978 F.2d 832, 838 (4th Cir. 1992), the court applied federal common law and referred to an eight-part standard for imposing liability on the successor entity:

- (1) Retention of the same employees;
- (2) Retention of the same supervisory personnel;
- (3) Retention of the same production facilities in the same location;
- (4) Production of the same product;
- (5) Retention of the same name;
- (6) Continuity of assets;
- (7) Continuity of general business operations; and
- (8) Whether the successor holds itself out as the continuation of the previous enterprise.

The court also noted that if the new corporation was part of an effort to continue the business of the former corporation yet avoid its existing or potential state or federal environmental liability, that factor should be considered also. On this basis, the successor corporation was found liable under CERCLA for contamination clean up costs.

The "substantial continuation" test was adopted in dicta in the case of *U.S. v. Mexico Feed and Seed Co.*, 980 F.2d 478 (3rd Cir. 1992), but the court engaged in a careful analysis and concluded that, inasmuch as the purchasing corporation was a large independent entity which had purchased the business in order to better serve its existing customers, and the selling corporation and the Purchaser were actually already in competition prior to the sale transaction, the substantial continuation test would not be applicable. On this basis, the court found that the Purchaser was not the successor to the Seller and imposed no liability.

Both of the leading circuit court cases using this theory of liability, *U.S. V. Mexico Feed and Seed Co.*, and *Carolina Transformer*, imply that an important element of the substantial continuation test is some knowledge on the part of the Purchaser of the offending conduct of the Seller. The more recent case of *Gould v. A&M Battery and Tire Service*, 1997 WL 16507 (M.D. Pa. 1995), the transaction concerned substantially all of the assets of the Seller, including a business line which went along with the deal but in which the Purchaser had no real interest. It was that business that gave rise to CERCLA liability. The court admitted that the Purchaser had no knowledge or notice of the Seller's conduct which resulted in the liability, but held that no such knowledge or notice was necessary to impose liability under the policy and purpose of CERCLA. The court distinguished *Mexico Seed and Feed* and the cases which follow it.

By eliminating the knowledge requirement, the *Gould* court would suggest that there is fundamentally no difference between an asset purchase and a stock purchase where the business of the Seller is continued after the closing. This line of cases poses the single most serious threat to our traditional notions of how an asset purchase transaction ought to work, and especially in jurisdictions where thinking of the type represented by the *Gould* court prevails, the practitioner must assume the same basic stance both for due diligence purposes and for purposes of contracting drafting as would be the case for a stock purchase.

G. Fraud

The basic "fraud" exception arises from the judicial doctrine that a transaction entered into with the specific intent to escape liability and to defraud creditors should not be permitted. In addition to the case law, the rule is codified in many states in the Uniform Fraudulent Transfer Act (the "UFTA"). Under the UFTA, a "transfer" is voidable by a creditor if the transfer is made (i) with actual intent to hinder, delay or defraud a creditor, or (ii) if the transfer leaves the debtor insolvent or undercapitalized, and it is not made in exchange for reasonably equivalent value.

The most subjective of these requirements is the finding of actual intent, which is largely in the discretion of the finder of fact. Because proof of actual intent to hinder, delay or defraud creditors may rarely be established by direct evidence, courts infer fraudulent intent from the circumstances surrounding the transfer. *Max Sugarman Funeral Home, Inc. v. A.D.B. Investors*, 926 F.2d 1248, 1254 (1st Cir. 1991). Factors to be considered in making a determination on the question of actual intent under UFTA § 4(a)(1) are whether:

- (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;
- (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 substantial debt was incurred; and
- (11) the debtor transferred the essential assets of the business to a linear who transferred the assets to an insider of the debtor." UFTA §4(b).

The foregoing factors are a codification of the common law "badges of fraud" used by the courts in determining whether to infer fraudulent intent. The presence of a single badge of fraud is not sufficient to establish actual fraudulent intent; however, "the confluence of several can constitute conclusive evidence of an actual intent to defraud, absent 'significantly clear' evidence of a legitimate supervening purpose." *Max Sugarman Funeral Home, Inc.*, 926 F.2d at 1254-55 (citation omitted).

Absent a finding of wrongful intent, the asset purchase could still be found to be a fraudulent transfer as to present and future creditors if it were effected by the Company "without receiving a reasonably equivalent value in exchange for the transfer or obligation." UFTA §4(a)(2); the corresponding provision in the Bankruptcy Code is § 548(a)(2)(A). However, the lack of equivalent value in exchange for the assets will cause the transaction to be classified as a fraudulent transfer under UFTA § 4(a)(2) only if one of the following two elements regarding the Company's financial situation is met:

- (A) The Company's remaining assets, after the transaction, were unreasonably small in relation to the business or transaction that the Company was engaged in or was about to engage in, or

(B) The Company intended to incur, or believed (or should have believed) that it would incur, debts beyond its ability to pay as they became due.

The unreasonably small assets or asset adequacy test, set forth in the first subsection above, is a separate and distinct concept from insolvency and, unlike insolvency, is not specifically defined by statute. Case law has held that, in deciding the unreasonably small assets test, a court would ask whether the Company "has the ability to generate sufficient cash flow on the date of transfer to sustain its operations." *See In re WCC Holding Corp.*, 171 B.R. 972, 986 (Bankr. N.D.Tex. 1994). To answer this question, a court would inquire into the reasonableness of the Company's cash flow projections given the circumstances on the date of transfer; the relevant question will not be whether the projections were correct, but whether they were reasonable and prudent at the time they were made, and whether the assumptions made in preparing the projections were reasonable. The Company fails this test if it is found to have retained insufficient assets to generate enough cash flow from operation and sales of assets to permit it to remain financially stable. Relevant data that a court would consider includes "historical cash growth, gross profit margins, net profits, and working capital." *Id.* at 985-86.

H. Products Liability

The leading successor liability case in the products liability area is that of *Ray v. Alad Corp.*, 19 Cal.3d 22, 560 P.2d 3 (1977). In that case the defendant successor acquired the assets of a company that manufactured ladders, after which it continued to manufacture the same product line under the same brand name and without indicating that there had been a change in ownership. The plaintiff was injured in a fall off of a defective ladder, and finding that the predecessor had dissolved, sued the successor.

The imposition of liability on a successor for products liability of its predecessor has four factors and/or justifications:

- a. The virtual desecration of the plaintiff's remedies against the original manufacturer due to the Purchaser's acquisition of the business.
- b. The Purchaser's ability to assume the original manufacturer's risk spreading role
- c. The fairness of requiring the Purchaser to assume a responsibility of defective products that was a burden which necessarily attached to the original manufacturer's goodwill now being enjoyed by the Purchaser in the continued operation of the business; and
- d. The acquisition of the manufacturing business and continuation by the Purchaser of output production of Seller's products.

Courts applying the product line exception have reasoned that a corporation that acquires the benefits of the predecessor's goodwill also acquires the built-in resources to meet its various responsibilities. On that basis, the successor should assume the concomitant responsibility of redressing any harm caused by a product it continues to manufacture. Consistent with that analysis,

these courts have taken the view that the inherent unfairness of forcing an injured consumer to bear the cost of injury justifies an exception extension of the general rule of successor liability.

In the subsequent case of *Rawlings v. D.M. Oliver, Inc.*, 97 Cal.App. 3d 890, 159 Cal. Rptr. 119, the defendant successor corporation purchased the Seller's assets and continued its general business, but it ceased the manufacture of the specialized product that caused the plaintiff's injury. The court found that the failure to manufacture the identical product did not remove the case from the *Ray* product line exception, and it therefore imposed liability on the successor. Support for the ruling came from the successor's purchase of an ongoing business which it continued at the same location under the same fictitious name, as well as a broad reading of California's policy in strict liability cases to assign responsibility of the enterprise that received the benefit and is in the best position to spread the cost of the injury among members of society.

One of the four factors articulated in *Ray* which has received significant review in subsequent cases is the requirement that the plaintiff's remedies were destroyed by the Purchaser's acquisition. Cases decided since *Ray* have noted that the application of the product line exception requires a balancing of the risks shifting principle against the fault principle which underlies all tort law. Thus, many of the courts analyzing the applicability of *Ray* have emphasized that the asset transfer must have caused the destruction of the plaintiff's remedy, including the First Circuit, *Santa Maria v. Owens-Illinois, Inc.*, 808 F.2d 848 (1st Cir. 1986), and even more importantly, the Ninth Circuit. *Klie v. Johns-Manville*, 745 F.2d 1217 (9th Cir. 1984), *Nelson V. Tiffany Industries, Inc.*, 778 F.2d 533 (9th Cir. 1985). In *Kline*, the Ninth Circuit determined that a successor would not be liable when the predecessor sold one of its product lines to the successor, but continued in business until its bankruptcy years later. In *Nelson*, the Court determined that not even California would impose successor liability where the predecessor totally dissolved following bankruptcy proceedings, and the sale of all of its assets followed. In both of these case, the essential element of causation was missing, since the successor's purchase did not cause either the predecessor's dissolution or the destruction of the plaintiff's remedy.

Not all jurisdictions agree, however. In *Pacius v. Thermtroll Corp.*, 611 A.2d 153 (N.J. Super.Ct. 1992), the defendant was a successor which purchased the assets from a company which had since gone out of business. Thus, there was no question that the defendant had not caused the destruction of plaintiff's remedy. In addition, neither the original Purchaser nor the subsequent Purchaser continued to manufacture the predecessor's equipment. The original Purchaser was a competitor of the predecessor, and merely used the predecessor's blueprints to assist in design modifications to its already-existing equipment. Neither Purchaser serviced the predecessor's product, and they did not communicate with the predecessor's customers, but the original Purchaser did use the machine's product name for two years in its marketing efforts.

Faced with these facts, the New Jersey Superior Court apparently failed to consider either *Kline* or *Nelson*, and relied instead on a prior New Jersey case, which imposed liability on a subsequent successor as a "fair and equitable burden necessarily attached to the substantial benefit enjoyed by the second Purchaser." The court, in reviewing *Ray*, viewed the emphasis there as "the fact of nonviability of the predecessor company which governed the imposition of liability, not the reason for it." 611 A.2d at 165.

The product line exception is not without its critics. For example, in *Mullen v. Alarmguard of Delmarva, Inc.*, 1993 Del. Super. LEXIS 213 (1993), a Delaware Superior Court identified the problem with both the product line and continuity of enterprise exceptions--they impose liability on entities that have no connection with the acts that caused the injury. In *Leannais v. Cincinatti, Inc.*, 565 F.2d 437 (7th Cir. 1977), the Seventh Circuit advised that "great risks arise from court adoption of policy consideration to effect a change in law so fundamental to the interdependent economic segments of a complex society," and it concluded that the issues presented are "difficult to answer by analysis of the facts of a particular case and it would appear, are more amendable to legislative investigation and determination." . 565 F.2d at 440. And in *Woody v. Combustion Engineering, Inc.*, 463 F.Supp. 817 (E.D. Tenn. 1978), the Court expressed its concern with the benefit/burden reasoning, believing that while retention of a trade name and Purchaser of goodwill gives the Purchaser an interest in the predecessor's reputation, the revelation of past production failures injures that reputation and deprives the successor of the benefit.

Fortunately for the practitioner of acquisition law, the product line exception remains a minority rule. It has been adopted in only four states and has been expressly rejected in over 20 states. However, it continues to be a growing area of the law that creates extreme difficulties in the states in which it has been adopted, and the threat of its adoption in additional states requires extreme care when manufacturing entities are acquired.

I. Duty to Warn

The "duty to warn" exception is something of an anomaly among the successor liability exceptions, in that it is an independent duty of the successor, and it is derived from the successor's own actions and/or omissions--namely, the failure to warn customers about defects in the predecessor's products. There are two elements in this exception: first, the successor must know about the defects in the predecessor's products; and second, there must be some continuing relationship between the successor and the predecessor's customers.

Knowledge of the alleged or potential defects can come either before or after the transaction is completed. In *Chadwick v. Air Reduction Co.*, 239 F.Supp. 247 (E.D. Ohio 1965), Air Reduction knew, at the time of its acquisition of assets, of other personal injury claims. The plaintiff claimed unsuccessfully that such knowledge imposed on Air Reduction a duty to notify past Purchasers of the product's danger, since the Court analogized the successor's position to the tort principle of the "good samaritan", where the law has typically not imposed a duty on an innocent bystander to rescue others. Using that principle, the court found no basis for the successor to be liable, and it held that succession alone is insufficient as a basis to impose a duty to warn of recently-discovered defects.

In subsequent cases, however, Purchasers were not so lucky. In the case of *Shane v. Hobam, Inc.*, 332 F.Supp. 526 (E.D. Pa. 1971), where the purchase agreement expressly stated that the successor assumed no product liability for sales made before the acquisition, the Court granted partial summary judgment to Hobam (the successor), finding that no liability resulted solely from the purchase of assets. The court, however, had difficulty accepting the reasoning in *Chadwick*, and was unwilling to classify Hobam as an innocent bystander free of any duty to warn. The factors cited by the Court were the transfer of the predecessor's corporate name, Hobam's continued

operation of the business under the Seller's name, Hobam's acquisition of the Seller's goodwill, and the transfer to Hobam of the responsibility for servicing equipment manufactured by the Seller before the acquisition.

The latter point mentioned in *Shane*, the obligation to service machinery manufactured by the predecessor, is also a continuing thread through the "duty to warn" cases. In *Gee v. Tenneco, Inc.*, 6245 F.2d 857 (9th Cir. 1980), the Ninth Circuit while finding no duty to warn under the facts presented in that case, held that all the elements--succession, knowledge and a continuing relationship between the successor and the predecessor's customers--must be present before the independent obligation to warn is imposed on the successor. While the list is not exhaustive, the factors noted by the Seventh Circuit in *Travis* which would justify imposing "duty to warn" successor liability on a successor in a particular case include (a) succession to, and assumption, of, the service contract (b) coverage of the particular machine under the service contract (c) service of that machine by the successor, (d) the successor's knowledge of defects in the products and (e) the successor's knowledge of the location or owner of the machine.

J. Liability Imposed by Statute

In addition to the case law theories posed above which impose liability on successor entities, there are a number of statutes which have a strong bearing on whether the Purchaser in an asset transaction will be held accountable for the acts of the Seller. In some cases, such as is true with tax liability, this is a matter which must be looked at on a state-by-state basis. Other statutes imposing such liability, such as environmental statutes, are applicable in all the states (although interpretation may differ from circuit to circuit). By way of illustration, we will consider the impact of environmental statutes on successor liability and also look at a number of miscellaneous statutory sources of liability, such as sales tax statutes and what remains of the bulk sales statutes.

1. Environmental Statutes

Liability for environmental matters in acquisition transactions is based primarily on the federal environmental laws, chief of which is The Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA"), 42 U.S.C. § § 9601-9675. That statute, which sets up the well-known Superfund, creates a comprehensive federal scheme for the regulation of environmental issues. CERCLA determines liability based on three factors:

- First, a release of hazardous substances must have occurred;
- Second, there must be expense incurred in cleaning up the release, which costs include investigating and analyzing the release and then removing it or otherwise remediating it; and
- Finally, the responsible person must be (i) a current owner or operator of a facility, (ii) a former owner or operator of a facility at the time of disposal of a hazardous substance, or (iii) a person who arranges for transport, treatment or disposal of hazardous substances or a person who actually transports such substances.

When an asset purchase involves the purchase of land, the Purchaser will become liable for any environmental contamination as the current owner of a site. The liability of the current owner is joint and several with that of all other responsible parties, and no showing of fault is required. The current owner can be required to pay the entire cleanup costs even where the prior owner was clearly responsible for it. The statute does, however, convey to the Purchaser (assuming his innocence) a cause of action against the Seller. The statute is brutal and powerful and can easily pierce the most carefully drafted of asset purchase agreements under appropriate circumstances.

To guard against liability from contaminated property, almost all Purchasers perform environmental assessments of property to be acquired. Theoretically, an environmental assessment might be used to assert "innocent landowner" defense under CERCLA. A Purchaser may avoid liability for hazardous wastes released on property which he owns by proving each of three elements:

- (a) That the property was acquired after the hazardous substance was placed there (something in and of itself often difficult to prove);
- (b) That at the time the defendant acquired the facility the defendant did not know and had no reason to know that any hazardous substance released was disposed on, in, or at the facility; and
- (c) That at the time of acquisition the defendant undertook "appropriate inquiry into the previous ownership and use of the property consistent with good commercial or customary practice in an effort to minimize liability".

42 U.S.C. § 9601 (35); see also § 9607 (b)(3). In determining whether the owner undertook "all appropriate inquiry", the statute requires that the courts "take into account any specialized knowledge or experience on the part of the defendant, the relationship of the purchase price to the value of the property if uncontaminated, commonly known or reasonably ascertainable information about the property, the obviousness of the presence or likely presence of contamination at the property, and the ability to detect such contamination by appropriate inspection." As a practical matter, the rigorous environmental assessment that is needed to satisfy due diligence standards almost always reveals any actual or suspected contamination. Thus, the innocent landowner defense is almost never successfully used.

The more interesting issue arises in the case of liabilities not directly related to the real estate being purchased, such as is the case where a Purchaser is sought to be held liable for off-site storage or transportation of wastes that occurred during the Seller's watch. The *Acushnet* case mentioned above is a good example of an early application of successor liability theories to environmental matters. Another example is the case of *Smith Land & Improvement Corp. v. Celotex Corp.*, 851 F.2d 86 (3d Cir. 1988), cert. denied, 488 U.S. 1090 (1988), where the court found the successor liability theory to be applicable under CERCLA. Although the case involved statutory merger or consolidation, the courts emphasis on public policy is indicative of rationales that might be used by other courts: "Expenses can be borne by two sources: the entities which had a specific

role in the production or continuation of the hazardous condition, or the taxpayers through federal funds. CERCLA leaves no doubt that Congress intended the burden to fall on the latter only when the responsible parties lacked the wherewithal to meet their obligations." 712 F. Supp. 1013.

In *Louisiana-Pacific Corp. v. Asarco, Inc.*, 909 F.2d 1260 (9th Cir. 1990), the plaintiff had sued for the recovery of cleanup costs from a successor which had purchased the assets of a company that marketed waste products. The Ninth Circuit concluded that if an asset Purchaser fell under one of the four traditional exceptions, it could be liable as a successor under CERCLA because Congress intended successor liability to apply to CERCLA and it expanded the analysis of *Smith Land* to apply successor liability in the context of an asset Purchaser. Two years after the *Louisiana-Pacific* case, the Fourth and Eighth Circuits decided two cases in which they ruled that the successor liability doctrine applied to CERCLA cases involving asset purchases. See also the discussion of the case of *U.S. v. Carolina Transformer Company*, 978 F.2d 832, 838 (4th Cir. 1992), set forth above which recounts the eight-part standard for imposing liability under the de facto merger doctrine.

The "substantial continuation" test was adopted in dicta in the case of *U.S. v. Mexico Feed and Seed Co.*, 980 F.2d 478 (3th Cir. 1992), see discussion, *supra*, but the court engaged in a careful analysis and concluded that, inasmuch as the purchasing corporation was a large independent entity which had purchased the business in order to better serve its existing customers, and the selling corporation and the Purchaser were actually already in competition prior to the sale transaction, the substantial continuation test would not be applicable. On this basis, the court found that the Purchaser was not the successor to the Seller and imposed no liability.

The test was narrowed further in the case of *U.S. v. Atlas Minerals and Chemicals, Inc.*, 824 F. Supp. 46 (E.D. Pa. 1993), in which the court held that the successor corporation must have substantial ties to the Seller for CERCLA liability to attach, thus eliminating the idea that the theory could be used in any arms length transaction. But in a later decision in the same case, the court noted that a different result would obtain if the Purchaser had knowledge of the contamination, or if there was willful blindness or collusion on the part of the Purchaser. *U.S. v. Atlas Minerals & Chemicals, Inc.*, 41 E.R.C. 1417 (E.D. Pa. 1995).

Both of the leading circuit court of appeals cases using this theory of liability, *Mexico Feed and Seed*, and *Carolina Transformer*, imply that an important element of the substantial continuation test is some knowledge on the part of the Purchaser of the offending conduct of the Seller. A recent case suggests that knowledge is not a prerequisite. In the case of *Gould, Inc., v. A&M Battery and Tire Service*, 1997 WL 16507 (M.D. Pa.), the court considered a traditional asset purchase transaction which contained a number of the factors used for the substantial continuation test. In *Gould*, the Purchaser purchased substantially all of the assets of the Seller, hired most of the Sellers employees, retained the Sellers name and even purchased accounts receivable. There was no interruption of the Seller's business as a result of the transaction. One interesting aspect of the transaction is that while the Seller had been engaged in the business of selling used batteries at some point in its past, the Purchaser really had no interest in that aspect of the business, but was purchasing the assets primarily to obtain the Seller's waste paper business in order to obtain a supply of recyclable paper. It was the used battery business of the Seller that gave

rise to CERCLA liability. Both the offending conduct of the Seller and the asset purchase itself occurred before the enactment of CERCLA. The *Gould* court admitted that the Purchaser had no knowledge or notice of the conduct of the Seller that gave rise to liability but held that no such knowledge or notice was necessary to impose liability under the substantial continuation test. The court went to great lengths to distinguish *U.S. v. Mexico Feed and Seed*, and the cases following that case, which hold that knowledge is a requirement for successor liability, but reasoned that the policy and purpose of CERCLA compel the conclusion that a Purchaser be held liable irrespective of knowledge of conduct on the part of Seller giving rise to liability.

Better news for purchasing entities came from the Sixth Circuit Court of Appeals in the case of *City Management Corp. v. U.S. Chemical Co.*, 43 F.3d 244 (6th Cir. 1994), in which the court held that under Michigan law the continuing enterprise exception extends only to products liability and may not be used to impose liability on purchasing entities for CERCLA violations.

2. Labor Matters

In the area of general labor law, the Supreme Court has addressed the principles of successorship liability on five separate occasions and the resulting decisions, as interpreted further by both the courts and the National Labor Relations Board, constitute the main body of law in this area. *John Wiley & Sons, Inc., v. Livingston*, 376 U.S. 543 (1964); *NLRB v. Burns International Security Services, Inc.*, 406 U.S. 272 (1972); *Golden State Bottling Co., Inc. v. NLRB*, 414 U.S. 168 (1973); *Howard Johnson Co., Inc. v. Detroit Local Joint Executive Board*, 417 U.S. 249 (1974), and *Fall River Dyeing and Finishing Corp., v. NLRB*, 482 U.S. 27 (1987).

Despite the complex nature of the successorship doctrine in the labor field and the varying interpretations it has received at the hands of the courts and the NLRB, there are actually two relatively well established principles applicable in any "Successorship Doctrine" case whether it arises under the National Labor Relations Act or under § 301 of the Labor Relations Management Act. First, if less than 50% of the Purchaser's employees in an appropriate bargaining unit were formerly employees of the Seller in an appropriate bargaining unit represented by a union, the Purchaser is not considered a "successor employer" for labor law purposes and no bargaining obligation attaches. Conversely, if 50% or more of the Purchaser's employees in an appropriate bargaining unit were formerly employed by the Seller in an appropriate bargaining unit represented by a union, then the Purchaser is considered a "successor employer" for labor law purposes" and a bargaining obligation attaches. Once this litmus test is applied, and either satisfied or not, there are various subsidiary issues which may affect the extent of the bargaining obligation, such as, for example what constitutes an appropriate bargaining unit and when the bargaining obligation matures. For example, the duty to bargain obligation attaches when the Purchaser has hired all, or a substantial compliment, of employees of the new operation and 50% or more of those employees, were formerly employed by the Seller in an appropriate bargaining unit represented by a union. However, the bargaining obligation, once it attaches, does not "mature" until the union claiming to represent a majority of the employees in an appropriate unit has made a bargaining demand. That demand may be made before the obligation attaches, in which case the demand is considered continuing, and the bargaining obligation matures at exactly the same time it attaches. The Purchaser cannot intentionally not hire the predecessor's employees to defeat the 50% rule as that

would be discriminatory unlawful discrimination based on union activity in violation of § 8(a)(3) of the NLRA. In that scenario, the former employees of the Seller who were denied employment in violation of § 8(a)(3) would be counted towards the 50% threshold and, presumably, a bargaining obligation could then be imposed.

Second, an asset Purchaser who becomes a "successor employer" does not, solely by virtue of being a "successor employer," become bound to the terms of an existing collective bargaining agreement between the predecessor and the union representing the predecessor's employees and the successor may unilaterally establish the initial terms and conditions of employment. Therefore, absent some affirmative act on the part of the successor employer, the successor neither becomes bound to the terms of the existing collective bargaining agreement between the union and the predecessor employer nor is the successor required to bargain over the initial terms and conditions of employment.

Aside from these points, there are conflicting precedents in the five supreme court cases cited above and in the following NLRB decisions which suggest that in certain other cases there may be liability on the part of a successor in an asset purchase transaction for the actions of its predecessor. A summary of the factors is as follows:

- Whether the Purchaser has notice of the pending charges or the existence of the union contract prior to completing its purchase of the assets.
- The type of remedy sought (e.g., back pay versus reinstatement of employment, or a duty to bargain with the union versus compliance with the substantive terms of the existing CBA).
- Whether the predecessor exists as a viable entity and is in a position to provide the remedy being sought after the transaction is complete.
- Whether the successor continues to provide substantially the same services or products, and whether it uses the same equipment, plants or other facilities.
- Whether the predecessor's employees make up a majority of the successor's work force.
- The time span (if any) between the termination of the employees by the predecessor/plant shutdown and their being rehired by the successor.

The last three points are usually combined to determine whether the Purchaser's operations have "substantial continuity" with those of the Seller. If so, the NLRB or the court, as appropriate, will have sufficient factual basis to find the successor liable under one or more of the conflicting precedents detailed above.

3. Employment Discrimination

Inasmuch as discrimination cases are a relatively recent development in litigation, the issue of whether a successor could be liable for its predecessor's discriminatory practices is similarly a relatively new one. Most of these cases are brought under Title VII of the Civil Rights Act of 1964, which prohibits discrimination on the basis of gender, religion, age, national origin or minority status.

The first case to decide this issued was *EEOC v. MacMillanBloedel Containers, Inc.*, 503 F.2d 1086 (6th Cir. 1974), which concerned alleged race and sex discrimination at a Cleveland facility. After completing its investigation, the EEOC sent a letter to the operator of the facility, notifying it that the EEOC had reasonable cause to believe that unlawful employment practices had occurred. MacMillan subsequently assumed operation of the facility, after which the EEOC brought this action.

The Ninth Circuit commenced its discussion by holding that the *Wiley/Burns/Golden State* analysis, justifying a successor liability doctrine, was equally applicable to unlawful employment practices under Title VII, since "Title VII was molded, to a large degree after the [National Labor Relations] Act." Like the NLRA, Title VII was designed to give the relevant agency (here, the EEOC, rather than the NLRB) and the courts broad equitable power, although in this situation, these powers are to be used to eradicate the present and future effects of past discrimination. Therefore, the application of the successor liability doctrine was implicitly mandated.

The Court's concern was that the failure to hold a successor employer liable for the discrimination acts of its predecessor could leave the victim of those actions without a remedy or with an incomplete remedy, and could also encourage evasion of responsibility through ownership transfers. The Court also noted that only the successor could provide certain types of remedies, such as reinstatement, hiring or replenishment of seniority. Thus, while "what is required is a balancing of the purposes of Title VII with the legitimate and often conflicting interests of the employer and discriminatee," the primary concern is "to provide the discriminatee with full relief."

Citing the factors developed from the NLRA cases, the Ninth Circuit reversed the District Court's grant of summary judgment in favor of the successor and against the EEOC, and remanded the case for development of a more complete factual record with respect to the successor's operations. Subsequent cases have not added greatly to the *MacMillan* Court's legal analysis. Virtually every case in the area has left standing the general rule that under certain circumstances a Purchaser of assets can be held liable for discriminatory actions of its Seller. See, e.g., *Trujillo v. Longhorn Manufacturing Co., Inc.*, 694 F.2d 221 (10th Cir. 1982); *Bates v. Pacific Maritime Association*, 744 F.2d 705 (9th Cir. 1984); *Criswell v. Delta Air Lines*, 868 F.2d 1093 (9th Cir. 1989), and *Rojas v. TK Communications, Inc.*, 87 F.3d 745 (5th Cir. 1996).

4. ERISA and Employee Benefits

ERISA was passed in 1974 as a comprehensive remedial statute designed to protect workers from widespread weaknesses and abuse in the private pension system. The statute not only established minimum vesting, funding, fiduciary, reporting and disclosure requirements which every pension plan must meet, it also delineated a uniform standard of conduct for fiduciaries and plan administrators. Although primarily designed to address pension plans, the statute applies to any "employee benefit plan," which is broadly defined to include unemployment, severance, vacation or medical insurance benefit plans. In 1980, Title IV of ERISA was amended by the passage of the multiemployer Pension Plan Amendments Act of 1980 (the "MPPAA"), which pertained to an employer's cessation of contributions to a multiemployer pension plan.

There are not many cases dealing with successor liability on an employer's obligations thereunder; however, those few cases where the issue has arisen should give the unsuspecting Purchaser cause for alarm. For example, in *Upholsterers' Int'l. Union Pension Fund v. Artistic Furniture of Pontiac*, the Seventh Circuit imposed liability on a successor in an asset sale for its predecessor's delinquent contributions to a multiemployer pension plan. In that case, the predecessor company obligated itself to make contributions to the union's pension plan under a collective bargaining agreement. When the company began to experience financial problems, those contributions were stopped. The assets were then sold to individuals with no previous ownership interest in the predecessor, who did not represent to the union or to the predecessor that they would assume liability for the contribution shortfall. The Court used the "continuity of enterprise" analysis followed by the courts in the labor cases, focusing upon the various elements discussed in those cases. Specifically, the Court found continuity of operations was established through (a) the successor's employment of all of the predecessor's work force (including supervisory personnel), (b) the successor's use of the same plant, machinery and equipment, (c) the successor continuing to manufacture the same products, (d) the successor completing work orders not finished by the predecessor, (e) the successor agreeing to honor warranty claims for goods sold by the predecessor, and (f) the successor retaining, after the asset sale, the predecessor's vice presidents of finance and manufacturing in the same positions. For those reasons, the Court determined that the Purchaser was a "successor" and that a successor could be liable for its predecessor's unpaid contribution. The case was ultimately remanded to the lower court, however, because there was an insufficient record as to whether or not the successor had prior notice of the predecessor's delinquent payments.

A slightly different issue which has arisen in other cases concerns the successor's obligation to make contributions to a benefit or pension plan under a previously - entered into collective bargaining agreement. In these cases, the courts go through a successorship analysis using the continuity of enterprise factors; however, the cases all seem to be based upon the successor continuing to make payments into the plan after sale has been consummated. As noted above, the successor can explicitly assume the predecessor's obligations, whether by words or by actions, and where it continues the predecessor's actions, whether consciously or under a mistaken belief that it is obligated to do so, the courts will impose on the successor a mandatory obligation to continue to make the contributions.

Notwithstanding the paucity of case law, it is easy to develop a listing of the liabilities that can be, either intentionally or accidentally, assumed by the unwary asset Purchaser. Those include the following:

- (a) unfunded (or under funded) health and life insurance for retirees;
- (b) express or implied commitments not to amend or terminate the plan;
- (c) undisclosed liabilities;
- (d) hidden land mines in "disclosed" liabilities;
- (e) unpublished policies, plans and procedures;
- (f) exaggerated claims in distributed plan documents; and
- (g) imprecise claims in policy and procedure handbooks.

These liabilities are potentially large and can be well-hidden in the asset acquisition transaction. The practitioner and his client should devote substantial resources to examining and analyzing these potential sources of liability.

5. Other Statutory Liability

Aside from federal environmental and labor statutes which are uniform throughout the country even if not uniformly applied, a number of states have enacted statutes which impose liability on a successor for certain types of unpaid taxes of the Seller. While the types of asset sales which are covered, the types of taxes involved, and the notice and clearance procedures that allow the Purchaser to eliminate its potential liability, differ from state to state, a few general observations can be made.

First, the Purchaser must determine which states' laws apply, keeping in mind that more than one state's laws may be applicable. State laws often apply to assets located in that state, regardless of the jurisdiction selected by the parties in their choice of law provision.

Second, the type of taxes for which the Purchaser might be liable can vary from state to state. In New Jersey, for example, the relevant statute provides that the Purchaser is liable for the Seller's unpaid sales taxes, absent notice to the Division of Taxation (N.J.R.S. Section 54:32B-22) (although the Division staff takes the position that the statute applies to all "trust fund" taxes, including employer withholding taxes.) The Alabama statute imposing liability on Purchasers for sales taxes of the Seller is illustrative:

§ 40-23-25. Person selling out or quitting business to file return; part of purchase money to be withheld. Any person subject to the provisions hereof who shall sell out his business or stock or goods, or shall quit business, shall be required

to make out the return provided under Section 40-23-7 within 30 days after the date he sold out his business or stock of goods or quit business, and his successor in business shall be required to withhold sufficient of the purchase money to cover the amount of said taxes due and unpaid until such time as the former owner shall produce a receipt from the Department of Revenue showing that the taxes have been paid, or a certificate that no taxes are due. If the Purchaser of a business or stock of goods shall fail to withhold purchase money as above provided [and] the taxes shall be due and unpaid after the 30-day period allowed, he shall be personally liable for the payment of the taxes accrued and unpaid on account of the operation of the business by the former owner. If in such case the department deems it necessary in order to collect the taxes due the state, it may make a jeopardy assessment as provided in Chapter 29 of this title. *Code of Alabama*, 1975, as amended.

The validity of such statutes has generally been upheld against attacks on a variety of grounds. In *People et rel. Salisbury Axle Co., v. Lynch*, 259 N.Y. 228, 181 N.E. 460 (1932), the court held that a statute making a successor liable for its predecessor's unpaid income tax did not violate the equal protection clause of the Constitution. Similarly, claims that such statutes violate due process have largely been unsuccessful, even where the statute was imposed retroactively. See, e.g., *Knudson Dairy Products Co. v. State Board of Equalization*, 12 Ca. App. 3d 47, 90 Cal. Rptr. 533 (1970), and *Pierce-Arrow Motor Corp. v. Measley*, 59 N.Y.S. 2d 568 (1946).

III. Due Diligence in Acquisitions of Financially Distressed Companies

Because of both successor liability concerns and often inadequate indemnification, Purchasers of financially distressed companies are forced to rely more heavily on the due diligence process. Issues to consider include:

- A. In a typical asset acquisition, the Purchaser would review only the contracts of the Seller that are specifically being assumed in the transaction. Those contracts would be subject to strict scrutiny, and that examination would be accompanied by a procedure which required the other parties to the contracts to issue estoppel letters acknowledging the existence of the contracts and confirming that no default exists thereunder. Where there is a threat of successor liability extending to contractual obligations in general, the Purchaser will need to not only review all of the contracts of the Seller of every description but carefully examine the facts of each to determine whether there is some likelihood that the Purchaser may be held responsible
- B. Subsidiary relationships become more important when the prospect of successor liability looms. Under the theories outlined above, the activities of a subsidiary can easily be attributed to the parent, and then attributed to the Purchaser.
- C. Due diligence will always take place with respect to real estate and personal property purchased in either a stock transaction or an asset purchase. While environmental risk assessments have become universally the case for real estate acquisitions, it will

be necessary to look not only at the assets being purchased but at the operations of the Seller over a period to determine if some activity, such as the shipment of hazardous wastes or past ownership of contaminated property, may give rise to liability.

- D. Where fraudulent conveyance factors are at play, it will be necessary to receive comfort from accountants and others as to solvency of the Seller and as to the fairness of the purchase price being paid.
- E. State statutes should always be examined to determine whether there is statutorily-imposed liability on the Purchaser for taxes of the selling entity.
- F. Litigation is typically a matter for careful due diligence investigation whether the transaction is structured as an asset transaction or as a stock transaction. The evaluation of pending litigation might be radically different in circumstances where some of the theories of successor liability recognized above have been adopted. For example, a customer dispute thought to be left behind in an asset transaction might become the Purchaser's problem under the "substantial continuation" theory or other theories outlined above.
- G. Where successor liability is at issue, the Purchaser might place much greater emphasis on confirming existence of Seller's liability and other insurance coverages. Where once there was a bright line between Seller's insurance prior to closing and Purchaser's insurance after closing, now the Purchaser might not only want to be sure that the Seller has adequate insurance coverage in place, but might want to be named as an additional insured under those policies. "Tail" insurance continuing the Seller's coverage to the Purchaser might be a good course of action.
- H. As to labor matters, acquisition counsel have long been wise to the need to examine carefully whether the Purchaser will assume by operation of law obligations to an existing collective bargaining unit of the Seller. Now the conservative business acquiror will undertake a thorough analysis of the labor practices of the Seller and will understand that it may well be liable for unfair labor practices existing on the date of purchase as well as for past damages arising out of those practices. The same holds true for cases of employment discrimination. To some extent existing and future insurance might have a role in resolving these issues.

The Negotiated Acquisitions Committee of the Business Law Section of the American Bar Association has published a treatise, *The Manual on Acquisition Review*, which contains a detailed listing of due diligence issues in stock purchase transactions. While not specifically directed towards the asset purchase, the manual provides a very helpful summary of issues that should be addressed in light of the successor liability concerns raised above.

IV. Pricing Negotiations

A. Purchaser's Side

1. "Fire" sale pricing.
2. "Financability" of purchase price.
3. Limited value to indemnity.
4. Use of extensive representations and warranties (see *Model Stock Purchase Agreement*); "fact-finding", and may provide fuel for discounting purchase price, particularly absent good indemnification.

B. Seller's Side

1. If proceeds cover long term debt and trade payables, what is left for the equity? Impact on negotiation dynamics.
2. Argue that Purchaser should assume portion of debt (e.g. trade debt).
3. Argue that Purchaser should assume exposure for certain operational or contingent liabilities.

C. Compromise Positions

1. Seller Paper
2. May be beneficial for Purchaser to assume trade payables (set off against purchase price).
3. Discounts on repayments of Seller's lenders.

D. Vendor Terms

1. Vendors will often have financially troubled companies on COD terms.
2. Impacts "financability" of deal for Purchaser; more cash at closing required to fund short term cash needs post-close.
3. Short term solution may be needed by Purchaser (e.g. equity puts in short term subordinated debt; negotiate permitted payment with senior lender).

V. Indemnification

In the context of sales of financially distressed businesses, Sellers often are poor sources of indemnification. The Purchaser should be sensitive to this fact in the due diligence process and pricing negotiations. The Purchaser also should seek ways to bolster the ability of the Seller to provide meaningful indemnification. Means to accomplish this objective include the following:

- A. The obligations of the selling corporation might be guaranteed unconditionally or in part by the principal shareholders. In extreme cases, personal guarantees might be secured by a pledge of collateral on the part of the guarantors.
- B. Funds may be withheld at closing and held in an escrow account in order to insure that there are funds available to satisfy any outstanding liabilities.
- C. The use of “Seller paper” (namely, the Purchaser issues a promissory note as part of the purchase price) gives the Purchaser the ability to set off indemnification obligations against payment otherwise due to the Seller. Note that a downside of this solution is that the Purchaser’s cash flow needs may not match up with the timing of set-offs and when payments would have been made to the Seller.
- D. Additional insurance coverages might be required of the Seller which would address some of the liabilities that are causes for concern.
- E. Some asset purchase agreements require ongoing business operations for a period of time after closing, impose minimum net worth standards, or prohibit the corporation from dissolving for a certain period. While providing some degree of comfort, none of these would have an impact if the Seller files for relief under bankruptcy laws.

VI. Fraudulent Conveyance Considerations, Preferences and Bulk Sales

- A. Fraudulent Conveyance
 - 1. Generally, a fraudulent intent in connection with (a) transfer (including the grant of security interests), (b) not for reasonably equivalent value, and (c) at a time that the debtor is insolvent or which causes the insolvency of the debtor. Note that there are numerous cases and statutes specifically addressing fraudulent conveyance and fraudulent transfer in each jurisdiction. Fraudulent transfer concerns are primarily concerns for buyers and lenders in leveraged acquisitions. *See Section II(G) of this outline.*
 - 2. Risk of too low purchase price – “*not for reasonably equivalent value.*” This is primarily a risk in transactions with affiliates or related entities. In third party, arms length negotiations, and particularly auctions, the risk of a

meritorious challenge on valuation is nominal. Use of counsel and financial advisors in the transaction may provide additional protection.

3. Defenses to fraudulent conveyance/transfer claims include (a) solvency, (b) adequate capital, and (c) ability to pay debts in the future.
4. Lenders are particularly nervous regarding fraudulent conveyance/transfer issues. One risk is that the financed acquisition transaction is voided on grounds that it was a fraudulent conveyance (see 2 above). The other risk is that the granting of the security interest (e.g. in a leveraged acquisition) is a fraudulent conveyance. This latter risk generally is mitigated by the fact that the lender has put up new money, although transaction structure can aggravate this situation (for example, when the funded buyer is leveraging off the assets of the target which is merging with a subsidiary of the buyer/borrower, creating effectively an upstream guaranty). Lenders also may generally be concerned that if any portion of the transaction is at risk of a fraudulent conveyance challenge, the lender's interest may be "infected" by proximity to the problem.
5. Other transaction structures that may create fraudulent conveyance/transfer concerns include redemptions, dividends, and liens on purchased assets to secure acquisition debt (traditional LBO). In each case, these transactions involve the use of the debtor/seller's assets to pay, either directly or indirectly through the granting of the assets as security, the acquisition price. The debtor/seller's assets, following the acquisition, are more highly leveraged.

B. Preferences

1. Generally, a preference is a payment made to a creditor on antecedent debt within 90 days (in cases of "insiders", up to 1 year) prior to the filing of a bankruptcy petition.
2. Preference actions present risks to creditors receiving payments out of the proceeds of the acquisition. The preference risk also attaches to creditors who get security for existing loans as part of the transaction or whose debts are assumed by the acquiring entity. A secured creditor in an "overadvance" position may be at risk for a preference action as to the amount of the payment received less the value of the collateral serving as security.

C. Bulk Sales Law Compliance

1. Bulk sales laws traditionally have required that the parties in an asset purchase transaction notify the Seller's creditors of the transaction pre-closing. As a matter of practice, Purchasers often waived this requirement

and instead rely on indemnification from the Seller. *See Article 6 of the UCC.*

2. Many states have eliminated bulk sales compliance statutes.

VII. Alternative Acquisition Methods

A. Purchasing Assets out of Chapter 11 Bankruptcy

1. Bankruptcy Court imposed notice/auction process.
2. Bankruptcy Court will favor highest current cash consideration.
3. Bankruptcy Court approval of sale required.
4. “Stalking horse” bidders.

B. Secured Party Sale

1. New UCC 9-609 – Secured party may take possession of debtor’s collateral upon default. May be pursuant to judicial process or without judicial process if no breach of peace.
2. New UCC 9-610 – Secured party has right to dispose of collateral after default. Any disposition must be in a commercially reasonable manner, although the sale may be by way of public or private proceedings, by one or more contracts, in whole or in part, at any time and place and on any terms. The secured party also may purchase the collateral at a public sale or, if the collateral is a kind customarily sold on recognized markets or subject to widely distributed standard pricing, at a private sale.
3. New UCC 9-611 – “Reasonable” notice of disposition must be sent by secured party to the debtor, any secondary obligors, other secured parties and certain claimholders. Exception for perishable collateral. Secured party should request financing statements to identify other lien holders not less than 20 nor more than 30 days before the notification date.
4. New UCC 9-612 – “Reasonable” time for notification is a factual determination. In non-consumer transactions, 10 days or more prior to disposition is deemed “reasonable.”
5. New UCC 9-613 – Contents and Form of Notification before Disposition of Collateral. Sample notices included in UCC 9-613.

6. New UCC 9-614 – Contents and Form of Notification for Consumer Goods.
7. New UCC 9-615 – Application of Proceeds of Secured Party Sale.
8. New UCC 9-616 – Calculation of Surplus or Deficiency.
9. New UCC 9-617 – Rights of Transferee of Collateral. Transferee gets all of debtor’s rights to the collateral in a secured party sale, and all liens and security interests as to such collateral are discharged (review state version of UCC 9-617 to confirm no exceptions). A good faith transferee takes collateral free of all liens and security interests even if secured party failed to comply with provisions of Article 9.
10. New UCC 9-618 – Rights and Duties of Secondary Obligors.
11. New UCC 9-619 – Transfer of Record or Legal Title.
12. New UCC 9-620 – Acceptance of Collateral in Full or Partial Satisfaction of Obligation; Compulsory Disposition.
13. New UCC 9-621 – Notice of Proposal to Accept Collateral.
14. New UCC 9-622 – Effect of Acceptance of Collateral
15. New UCC 9-623 – Right to Redeem Collateral. A debtor, secondary obligor or other lien holder may redeem collateral.
16. New UCC 9-624 – Waivers in connection with secured party sales.

C. Prepackaged Chapter 11

1. A “pre-packaged” Chapter 11 is a voluntary filing by the debtor preceded by a complete or partial agreement between the debtor and creditors as to accommodations or other negotiated settlement of such creditors’ claims. The entry into Chapter 11 is to confirm the reorganization plan, one effect of which will be to bind even those creditors and equityholders who have not previously accepted the plan.
2. Generally, need two-thirds in amount and a majority in number of claims voting in each class of claims in order to approve a reorganization plan. This approval may be secured before or after the filing of the petition. *See Bankruptcy Code §1126.*

VIII. Financing Acquisitions of Financially Distressed Companies

- A. Usually Leveraged Transactions
- B. Concept of “HLT’s” as designated by bank regulators is thing of past, although high leverage continues
- C. Structured Capital, ABL and Cash Flow Loans: what your Lenders are talking about
- D. Lenders’ Biggest Legal Worries
 - 1. Fraudulent conveyance: borrowers with balance sheet negative net worth.
 - 2. Upstream guaranties and co-borrowing arrangements.
- E. Loan Documentation Provisions in Leveraged Transactions
 - 1. Borrowing base and reserves.
 - 2. Early termination/prepayment fees.
 - 3. Anti-fraudulent conveyance language.
 - 4. Lot more “lender discretion”.
 - 5. Provisions for syndications.
 - 6. More reporting, including weekly or daily borrowing base reporting.
 - 7. More aggressive default provisions, including upon “material adverse change”.
- F. Leveraged acquisitions often also include third party Subordinated Debt. May include Subordinated Seller Paper
- G. Common Business Terms of Leveraged Financing
 - 1. Senior Debt:
 - (i) 3 to up to 5 year loan commitment
 - (ii) revolving credit facility plus amortizing term loan
 - (iii) LIBOR or Eurodollar rate may be available, although tougher credit will be prime rate based

- (iv) capital expenditures permitted subject to cap
- (v) acquisitions must be cleared with lender on a case by case basis
- (vi) secured
- (vii) financial covenants – often more limited than traditional commercial secured credits and focus on net worth or fixed charge coverage instead of earnings based covenants

2. Subordinated Debt:

- a. 5 to 7 years to maturity
- b. up to 2 years interest only and then start amortization with balloon at maturity
- c. warrants
- d. secured
- e. subordination agreement with payments permitted if no senior debt default and standstill (180 days most common)
- f. financial covenants of senior debt, albeit 10 to 25% “looser”

IX Director Issues in Acquisitions of Financially Distressed Companies

A. Traditional Approach to Director Fiduciary Duties (Solvent Corporation)

The fiduciary duties applicable to directors of solvent corporations are determined by state law. These fiduciary duties are the duties of loyalty and care. The duty of loyalty requires directors to put the best interests of the corporation and its shareholders ahead of the director’s own interests and the interests of any other persons or entities. The duty of care requires directors to act in a fully informed and deliberate manner.

Directors also enjoy the benefit of the “business judgment rule.” (Note that there is extensive case law on the business judgment rule in Delaware and that most it not all states have a similar “rule”). The business judgment rule is applied by courts in connection with a review of the directors’ discharge of their responsibilities and satisfaction of their fiduciary duties. The business judgment rule is a presumption in favor of directors that the corporation’s directors acted in good faith and satisfied their fiduciary duties of care and loyalty. Under the business judgment rule, directors are insulated from personal liability unless the director suffered from a conflict of interest,

failed adequately to inform himself or herself or made a decision so irrational that it can only be explained as an exercise in bad faith.

B. Fiduciary Duties in Financial Distress Situations

Nearly all jurisdictions recognize that the class of beneficiaries to whom fiduciary duties are owed varies with the financial health of the enterprise. Where a corporation has filed for bankruptcy protection under Chapter 11 and the debtor remains in possession, the directors of the debtor-in-possession owe fiduciary duties to all parties to the reorganization, including shareholders, creditors and the bankruptcy estate. Where a corporation is in financial distress but has not formally filed for bankruptcy protection, the class of beneficiaries is determined by state law and varies from state to state. Delaware, as well as many other states, hold that directors of insolvent corporations owe fiduciary duties of care and loyalty to creditors as well as to the corporation and its shareholders. This is known as the “insolvency exception.”

C. Challenge of Director Decision-Making in Financial Distress Situation

In financial distress situations, including insolvency, the class benefiting from a directors fiduciary duties shifts partly or entirely to the corporation’s creditors. Although understanding this, the process of decision-making with significantly disparate classes of interests may present significant challenges. There have been relatively few cases on this issue to date. In the jurisdictions that hold directors accountable only to the corporation’s creditors, directors may find decision-making fairly straightforward. In those jurisdictions where directors owe fiduciary duties to both creditors and shareholders, however, the job will be considerably more difficult.

Further complicating this situation, not all jurisdictions apply the business judgment rule in situations where the corporation is insolvent.

Counsel will need to counsel the Board as to (a) when the fiduciary duty may shift, (b) to whom it shifts, (c) how to make decisions and (d) the personal liability exposure to which directors may be subject.

D. Legal Definition of “Insolvent”

When a corporation is not seeking protection under the federal Bankruptcy Code, the definition of “insolvency” is a matter of state law. State courts have generally recognized two approaches to defining insolvency, namely the “balance sheet” approach and the “cash flow” or “equitable insolvency” approach.

The balance sheet approach, based on bankruptcy law, defines insolvency as any period during which a corporation’s liabilities exceed its assets. The cash flow approach instead considers a corporation to be insolvent if it is unable to meet its debts as they come due. Case law should be reviewed on a state by state and matter by matter basis to determine the approach most likely to be taken by a particular court.

E. The Rationale Behind the Shifting Director Duty

The most commonly-offered rationale for creating a fiduciary duty to creditors upon a corporation's insolvency is the "trust fund doctrine." This doctrine originated in 1824, in Wood v. Drummer, 30 F. Cas. 435 (C.C.D. Me. 1824). See John C. Coffee, Court Has a New Idea on Directors' Duty, Nat'l L.J. (Mar. 22, 1992); In re Reg O Co., 623 A.2d 92, 95 n.4 (Del. Ch. 1992). The courts that have applied the "trust fund" doctrine strictly have determined that, when a corporation becomes insolvent, its property is deemed the res of a trust, its directors are deemed trustees of the trust, and its creditors are deemed beneficiaries of the trust.

Two other approaches may also serve as rationales for the shifting fiduciary duty. One approach is that the fiduciary duty to creditors is justified because, during a corporation's insolvency, creditors' rights begin to resemble and converge upon the rights traditionally associated with shareholders of a solvent corporation. This approach assumes creditors of an insolvent corporation bear the risks more often associated with equity, as creditors rights under contract most likely will not be able to fully respected by the insolvent entity.

The other approach takes the view that fiduciary duties are properly extended to creditors during a corporation's insolvency because the continued focus on maximizing the corporation's value to equity holders creates a disproportionate and inequitable risk of loss to debt holders.

See Dancing with Scylla and Charybdis : Tough Job of Directors of a Troubled Company for a more complete discussion of directors duties in the context of financial distress.