Successor Liability in Asset Acquisitions: Environmental Concerns

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I. INTRODUCTION

Environmental issues in asset acquisitions have been at the forefront of concerns over successor liability in asset acquisitions for two reasons. First and foremost is the fact that liability for environmental matters typically represents the largest single (unknown) monetary risk in many business transactions. Secondly, but almost as important, is the fact that the bulk of cases imposing liability on purchasers in asset acquisitions for liabilities not expressly assumed arise out of the environmental area. For any practitioner thinking that environmental liability in an asset transaction can be safely disposed of by careful drafting, consider the following:

- Most environmental lawyers consider the "safe harbor" afforded to the careful purchaser to be largely mythical. One is hard pressed to find any case in which contamination is found to exist on a site where the landowner is absolved from liability because of this defense.

- Those of us who rely on contractual indemnification for protection should consider the numbers of purchasers who have returned to their sellers for indemnification for environmental problems only to find that the seller no longer exists and the assets have been disbursed.

- More than one draftsperson has found that what seemed to be an all encompassing indemnification covering all conduct of the seller in fact did not include indemnification for environmental matters with the result that the purchaser, having been held accountable by the government, has no contractual indemnification rights against the seller.

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- The purchaser who focuses his environmental inquiry on the assets being purchased may miss the mark altogether. There are a number of cases imposing on the purchaser liability for contamination existing on sites specifically excluded from the sale transaction.

- Even where there is no environmental liability associated with the business assets of the Seller, whether purchased or not, under certain theories of liability the purchaser may have liability for operational conduct of the seller prior to closing.

We acquisition lawyers regularly go to great lengths in drafting asset purchase agreements to limit the liability of the purchaser to a narrowly-defined set of obligations, which set rarely includes any preexisting environmental liability. On more than one occasion the courts have gone beyond the risk allocation determined by the parties at the time of the acquisition to impose unintended liability on a purchaser for environmental liability of the seller. The practitioner of acquisition law must exert his best drafting skills to minimize liability for environmental hazards but must also be acutely aware of those circumstances, outlined in detail below, in which courts have seen fit to go beyond the letter of the acquisition documents and hold a purchaser liable for environmental conditions attributable to the seller.

Before we start this review, we can at least be thankful that we are working in the context of an asset acquisition rather than a stock purchase or a merger. In a stock purchase, the liability of the surviving corporation would be automatic and unlimited. By choosing an asset purchase rather than a stock purchase, we have put substantially more distance between ourselves and a seller who may have caused an environmental problem than would be the case had we purchased shares of stock. However, there is no assurance that liability will be avoided simply because we have chosen to structure the transaction as an asset purchase. There are both statutory and case law theories of law waiting to entrap the unwary purchaser. It is to the avoidance of these traps that our efforts are directed.

II. THE STATUTORY FRAMEWORK

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, (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:

1. That the property was acquired after the hazardous substance was placed there (something in and of itself often difficult to prove);

2. 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

3. 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.

Methods and procedures of undertaking appropriate due diligence for environmental matters and thus placing the purchaser within the protection of the safe harbor are beyond the scope of this paper. The Manual on Acquisition Review, published in 1995 by the Committee on Negotiated Acquisitions of the Section of Business Law of the American Bar Association has a very comprehensive chapter (Chapter 9) analyzing the process of environmental due diligence and environmental risk assessment in an acquisition transaction.

III. SHIFTING THE RISK THROUGH CONTRACT LANGUAGE

Aside from careful environmental due diligence and possibly use of the emerging vehicle of environmental insurance, the main line of defense against environmental liability is the careful drafting of the asset purchase agreement itself. Appropriate provisions include representations as to the condition of the property being acquired, affirmative covenants, exclusion of liabilities, and (most importantly) indemnities. Drafting considerations are set forth in Section X below. For purposes of this discussion, we will assume that under the asset purchase agreement the purchaser

will assume no environmental liabilities of any description and that appropriate (and strongly worded) indemnities will be an integral part of the asset purchase agreement. Once this drafting effort is accomplished, assuming your seller is still solvent and some statute of limitations has not run on your contract rights, any environmental claim can be presented to your seller and the seller will take care of it. Other remedies may include recourse against any escrow of the purchase price being held to take care of unforseen liabilities and any set off rights under any purchase money financing or lease arrangement. This all hinges, of course, on whether provisions relating to environmental matters, specifically the indemnities, are enforceable.

CERCLA specifically addresses environmental indemnities in Section 107(e)(1) of the statute which reads in part as follows:

No indemnification, hold harmless or similar agreement or conveyance shall be effective to transfer from the owner or operator of any vessel or facility or from any person who may be liable for a release or threat of release under this section to any other person the liability imposed by this section.

Nothing in this subsection shall bar any agreement to insure, hold harmless or indemnify a party to such agreement for any liability under this section

We have put these two sentences of the same statutory section in columnar form to permit an easy comparison of the inconsistencies between them. If you read these and think the two sentences mean exactly the opposite thing, you would not be the first to do so, and the tension between these two sentences has given rise to much struggling among the courts in efforts to determine whether to enforce environmental indemnities. One interpretation of this section would permit the shifting of liability under CERCLA from one party to another (even though each is jointly and severally liable to the government). A more restrictive reading would prohibit an innocent party from assuming the liability of a clearly responsible party.

Most courts which have addressed this issue have found that contractual indemnities covering environmental matters are enforceable. A pivotal case in this line of holdings is that of *Mardan Corp. v. C.G.V. Music, Ltd.*, 804 F.2d 1454 (9th Cir. 1985), in which a purchaser, who was found to be a "responsible person" and thus required to pay cleanup costs at a waste disposal site was permitted to recover the costs incurred from the seller of the facility. In *Mardan*, the asset purchase agreement had allocated responsibility for environmental matters to the seller but subsequent to closing, the parties had entered into a settlement agreement to resolve a number of claims, including "all actions, causes of action, suits ... based upon, arising out of, or in any way relating to the Purchase Agreement." 804 F.2d at 1456. Subsequent to entering into the release, additional cleanup costs were incurred and the purchaser sought to bring a private action against the seller under Section 107 of CERCLA. As a preliminary matter, the court held that there was no developing "federal common law" as to enforceability of indemnity and settlement agreements relating to environmental matters. It then went on to examine New York law and concluded that the release was enforceable under state law, that neither CERCLA nor any other federal law invalidated the release, and that accordingly the purchaser was out of luck. In the case of *Harley-Davidson, Inc. v. Minstar, Inc*., 41 F.3d 341 (7th Cir. 1994), the court reversed a lower court ruling which had invalidated an indemnity provision, noting that the court agreed "with every other appellate court that has been called upon to interpret [CERCLA] in holding that [CERCLA] does not outlaw indemnification agreements."

In *Niecko v. Emro Marketing Co.*, 973 F.2d 1296 (6th Cir. 1992), the court took the reasoning in *Mardan* to its logical conclusion and held that indemnity agreements as well as

releases are enforceable. The *Niecko* court went on to try to reconcile the conflicting clauses of Section 107(e)(1):

> [T]he better interpretation ... is that the first sentence provides that all parties involved are to be jointly and severally liable to the claimant under the statute. Where the claimant is the government, liability may not be transferred. However, as between the parties allegedly responsible ... liability may indeed be transferred. In other words, the first sentence ensures that the clean up is performed and those responsible cannot escape their liability for cleaning the property. However, in terms of *financial* liability, the parties may allocate the costs of the clean up between them. Such an interpretation is consistent with the legislative history of CERCLA . . . . 973 F.2d at 1300-01.

The Sixth Circuit further elaborated this position in the later case of *AM International Inc., v. International Forging Equipment Corporation*, 982 F.2d. 989 (6th Cir. 1993) as follows:

> The underlying purpose of the statutory language under scrutiny is to ensure that responsible parties will pay for the cleanup and that they may not avoid liability to the government by transferring this liability to another. However, this purpose is not inconsistent with parties responsible for the cleanup transferring or allocating among themselves the cost associated with this liability, so long as they remain liable to the third party who can demand the cleanup. 982 F.2d at 994.

Accord, *City Management Corp. v. U.S. Chemical Co., Inc.*, 43 F.3d 244, 255 (6th Cir. 1994). While the courts have generally upheld the enforceability of indemnity clauses allocating responsibility for environmental cleanup costs, there remains a split as to whether federal or state law governs that determination. Most courts follow the *Mardan* case holding that state law governs the enforceability of indemnity contracts. See, e.g., *Beazer East, Inc., v. Mead Corp.,* 34 F.3d 206 (3rd Cir. 1994), *and Olin Corp. v. Consolidated Aluminum Corp.*, 807 F.Supp. 1133 (S.D. N.Y. 1992). Other courts have looked to a sort of emerging federal common law in this area. See, e.g., *Mobay Corp. v. Allied-Signal, Inc.*, 761 F.Supp. 345 (D. N.J. 1991), and *Purolater Products Corp. v. Allied-Signal, Inc.*, 772 F. Supp. 124 (W.D. N.Y. 1991).

Because of the numerous decisions referring the question to state law, practitioners should be careful to review applicable state law before placing great weight on the enforceability of such clauses. While there is no case which has actually struck down an environmental indemnity clause as contrary to state public policy, the rules of interpretation vary widely from state to state. In *Olin Corp. v. Consolidated Aluminum Corp.*, 807 F.Supp. 1133 (SD N.Y. 1992, the Second Circuit affirmed the enforceability of an agreement requiring one party to indemnify the other against "all liabilities, obligations and indebtedness" of the other, and a broad release similar to the type involved in the *Mardan* case. The holding was not nearly as favorable to the party seeking indemnity in the case of *John S. Boyd Co., Inc., v. Boston Gas Co.*, 992 F.2d 401 (1st Cir. 1993), in which the court was called upon to determine whether the purchaser who has assumed "all the duties and liabilities of [seller] related to the [business transferred]", and who had further agreed to "indemnify and save harmless [the seller] from any duty or liability with respect to the [business transferred]" had in fact undertaken responsibility for environmental matters. The court held that because the parties were not specific in mentioning environmental matters, the indemnity did not convey to the purchaser responsibility for unknown environmental liabilities existing at the time of the transfer. The lesson from all this is clear: be specific as regards environmental indemnities, and make clear that the indemnity is intended to cover all such liabilities, both known and unknown. Such drafting must also be done with a view to governing state law.

IV. NON-STATUTORY THEORIES OF LIABILITY

Aside from the statutory liability that exists in the case of asset transactions, there are older theories of law based on the common law which form a basis for imposing environmental liability on purchasers in asset transactions. Prior to the enactment of CERCLA, unless the purchaser had expressly assumed some or all of the liabilities for environmental matters, there were three basic theories for imposing successor liability on a purchaser: (1) the transaction constitutes a de facto merger; (2) the purchaser is a "mere continuation" of the seller; or (3) the transaction constitutes a conveyance intended to defraud creditors of the seller. *See* Fletcher, Cyclopedia of the Law of Private Corporations, Section 7122 (revised edition 1990); *Conn. v. Fales Division of Mathewson Corp.*, 835 F.2d 145, 146 (6th Cir. 1987); *Philadelphia Electric Company v. Hercules, Inc.*, 762 F.2d 303, 308-309 (3rd Cir. 1985); *Mozingo v. Correct Manufacturing Corporation*, 752 F.2d 168, 174 (5th Cir. 1985). Each of these theories, at one time or another, has been used as a means of imposing environmental liability on a purchasing corporation in an asset transaction. Most environmental successor liability cases are determined in federal court as federal courts have exclusive jurisdiction of CERCLA claims. In determining successor liability in a CERCLA case, courts apply either state law or federal common law.

V. DE FACTO MERGER

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 corporation. 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 that it considered to be Pennsylvania law. A critical element of the court's analysis was based on 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: (1) 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; (2) 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 Fed. 2d 303 (3rd Cir. 1985).

A good illustration of application of the de facto merger doctrine to environmental matters is found in the case of *In Re Acushnet River & New Bedford Harbor*, 712 F.Supp. 1010 (D.C. Mass 1989). In the *Acushnet* case, 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 the closing and to distribute the shares of stock it had received to its shareholders. While the purchaser assumed a number of the seller's liabilities, the agreement contained a specific disclaimer on the part of the purchaser for any liability arising out of the seller's use or disposal of polychlorinated biphenyls ("PCBs"). Subsequent to closing, the purchaser continued to manufacture electronic products at the plant site in substantially the same manner as had the seller. The claim by the government against the purchaser under CERCLA was severed and tried separately, leaving this court to consider only the issue of whether there was any basis for liability outside of CERCLA on which the purchaser should be held accountable for the contamination. The court rejected the argument that the statutory provisions of CERCLA should be the sole basis for a holding of liability with the following reasoning:

> [A] ruling that the successor liability doctrine has no viability in the CERCLA context would be an invitation to corporations, both polluters and their acquirors, to avoid liability for past pollution through formalistic corporate slight of hand. A paper transaction should not furnish a shield suitable to deflect CERCLA liability for environmental transgressions preceding the transaction. Yet, in the absence of successor liability, the government may find itself without any practical recourse against polluters where, as here, the predecessor corporation is long disbanded, its assets long disbursed, and its shareholders difficult if not impossible to locate should they be held personally liable in any way. Congress could not have intended such a result. 712 F.Supp. at 1014.

The law of successor liability applied was a "uniform federal rule" based upon "the general doctrine of successor liability in operation in most of the states." Id. at 1014. The court then went on to apply the four factors set forth above for determination of de facto mergers and held that the purchaser was in fact liable for the actions of the seller. 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 a 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.

A similar result obtained in 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 court's 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.

VI. “MERE CONTINUATION” OF THE BUSINESS

A similar line of cases has used what is called the “mere continuation” theory to reach the same result. 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. Basically, the rule holds that where there is a common identity of officers, directors and stockholders between selling and purchasing corporation, 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 de facto merger 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.

VII. “MERE CONTINUATION” GROWS -- THE “SUBSTANTIAL CONTINUATION” TEST

A growing number of courts has 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. 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:

(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 (3th 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.

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 seller's employees, retained the seller's 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.

VIII. "SUBSTANTIAL CONTINUATION" IN THE EXTREME -- TWO EXAMPLES

Two cases illustrate well the misuses of the "substantial continuation" test and the perils to acquisition counsel and their clients from its application. In one case liability was imposed for contamination pertaining to assets specifically excluded from the asset sale and in the other the purchaser was held liable for conduct of the seller that occurred four years prior to the sale. The results are astounding and the reasoning of the court in each instance, relying on what we practitioners consider standard asset acquisition language, is alarming.

In the first of these cases, *Kleen Laundry & Dry Cleaning Services, Inc. v. Total Waste Management, Inc.*, 867 F. Supp. 1136 (D.N.H. 1994), the purchaser of assets of a waste oil business was held liable for contamination on a third party's property associated with underground tanks that had been leased by the seller corporation for a period of six weeks, <u>four years</u> before the asset purchase. This was a cash transaction so that no shares were exchanged and no argument was made that any continuity of interest between seller and purchaser existed. The court used the "substantial continuation" test and use of <u>factors present in virtually every asset acquisition</u> to hold the purchaser fully liable for <u>all</u> liabilities of the selling corporation, even those occurring four years prior to the sale date. The court was influenced by factors such as the purchase of all operating assets of the seller by the purchaser, and the purchaser's admitted intention of purchasing virtually all of the business of the seller. A statement that the purchaser agreed to purchase "Seller's waste oil business", while contained in an agreement also containing a specific list of assets and a very clear disclaimer of assumption of liabilities, was used as evidence of the assumption of the environmental liabilities of the seller. Other factors influencing the court were the fact that after the sale the purchaser continued to service the old customers of the seller and the purchaser required the seller's officers to enter into noncompetition agreements. In this particular court, it is unlikely that an asset transaction would be treated differently than a stock purchase transaction for any purpose.

The second case, *U.S. v. Keystone Sanitation Company, Inc.*, 1996 U.S. Dist. LEXIS 13651, 43 ERC (BNA) 1404 (M.D.Pa. August 22, 1996), contains an equally alarming rationale. In *Keystone,* environmental liability stemmed from a landfill site that was specifically excluded from the assets conveyed to the purchaser. Unlike *Kleen Laundry*, this case at least resembled the more traditional line of cases in that the seller received some shares of stock in the purchaser in exchange for the assets. The rest of the analysis, however, is very similar to *Kleen Laundry*, and results in the conclusion that this judge would find any ordinary stock for assets transaction to impose successor liability on the purchaser, whether the purchaser purchased the offending assets or not. The court noted that management and many employees went to work for the purchaser after the closing, that all the important operational assets were purchased and that the purchaser continued to solicit the seller's customers after closing. The purchaser did assume the ordinary business obligations of the seller and held itself out to the public as the successor of the seller. The most alarming aspect of the case is the manner in which the court took very ordinary asset purchase agreement provisions and considered them as diabolical evidence of an intention that the two entities be treated as one. Included in the provisions considered by the court as supporting application of the "substantial continuation" test, were the following:

- The agreement, while containing a specific list of assets also stated that the purchaser was purchasing the "business" of the seller.

- The purchaser agreed to take over service to customers as of the date of closing.

- The seller represented that it had incurred no liabilities except in the ordinary course of business.

- The seller represented that it was a not a party to any contract which was in default.

- The seller represented that it was not a party to any litigation except as disclosed to purchaser.

- The seller warranted that there was no pending labor dispute.

- The seller represented that no material adverse changes in the business had occurred.

- The seller covenanted that prior to closing it would keep its existing business intact and keep its employees available for hiring by the purchaser and would maintain good relations with its customers.

- The agreement obligated the purchaser to assist in the collection of receivables of the seller and to forward the same to the seller.

- Seller and its shareholders entered into noncompetition agreements and consulting agreements with the purchaser.

- There was a purchase price adjustment based on revenues after closing.

As is the case with *Kleen Laundry*, it is difficult to imagine an asset purchase of a going concern business involving stock for assets that would not be found by this court to invoke successor liability, and the result in each case could easily be liability for assets not purchased or for operational activity of the seller prior to closing.

In any event, a substantial split of authority continues among the various courts that have considered the "mere continuation" theory and its more modern version, the "substantial continuation" theory, and the practitioner of acquisition law would do well to consult appropriate federal and state governing law before giving a client any comfort that he will not be subject to liability based on these theories.

IX. FRAUDULENT TRANSFERS

State fraudulent transfer laws may also impose liability on the purchaser for environmental liabilities of a seller. Under the Uniform Fraudulent Conveyance Act, "[e]very conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay or defraud either present or future creditors, is fraudulent as to both present and future creditors." The statute contains three requirements for relief:

1. There must be proof that the defendant made a conveyance;

2. The conveyance must have been made with actual intent to hinder, delay or defraud creditors; and

3. The person seeking relief must be a creditor of the defendant.

The most subjective of these requirements is the finding of actual intent, which is largely in the discretion of the finder of fact. The Michigan fraudulent conveyance law was applied to an environmental matter in the case of *Kelley v. Thomas Solvent Co.*, 725 F.Supp. 1446 (W.D. Mich. 1988). In that case, after substantial contamination problems were found on real estate owned by the Thomas Solvent Company, that company proceeded to reorganize itself into a series of corporations divided according to the various lines of its businesses. Some time after the reorganization occurred, the remaining entity, Thomas Solvent Co., filed a chapter 11 proceeding in which it sought to avoid liabilities to its creditors, including those under CERCLA for remediation of the contamination. The court had little difficulty in finding that the motivating factor behind the reorganization was the avoidance of liability for cleanup of the contaminated area.

In addition to the fraudulent theories set forth above, the uniform statute permits a transaction to be set aside as fraudulent even where there is no actual intent to defraud if the seller does not receive a reasonably equivalent value in exchange for the transfer or obligation and one of the following conditions exists: (i) the Seller's remaining assets, after the transaction, are unreasonably small in relation to the business or transaction that the Seller is engaged in or is about to engage in or (ii) the Seller intends to incur, or believes (or should believe) that it will incur debts beyond its ability to pay as they become due. This is a highly subjective standard which has been used infrequently in the area of environmental successor liability but which should be examined carefully where the circumstances suggest that less than a reasonably equivalent value is being paid for the assets. A more detailed discussion of these theories is found in the commentary following the section of the model Asset Purchase Agreement entitled "solvency".