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Selected Risk Issues in Merger and Acquisition Transactions

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Selected Risk Issues in Merger and Acquisition Transactions

HOWARD L. SHECTER*

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I. SUCCESSOR PRODUCTS LIABILITY ISSUES

A. *Introduction*

As recently as twenty years ago, a corporation purchasing the assets of another corporation could be fairly certain that, if the purchase was carefully done, it would not be liable for claims resulting from defective products manufactured by the selling corporation. That, however, is no longer the case. Any corporation considering an asset acquisition today should carefully evaluate the risks of possible successor liability for defective products manufactured by the selling corporation.

The first section of this Article will first review the development of the law of successor liability for defective products, looking at both the traditional rule of nonliability in asset acquisitions and the recently developed exceptions which impose liability on the purchasing corporation. With that historical review as background, the Article will then discuss a number of issues relating to the emerging law of successor liability that should seriously concern anyone considering an asset acquisition. Finally, the Article will offer some comments on structuring asset acquisitions to protect the purchaser.

First, then, a brief review of the traditional rule and how the law in this area has reached its present unsettled state.

B. *Development of the Law of Successor Product Liability*

1. THE TRADITIONAL RULE OF NONLIABILITY

The general rule of corporate successor liability has been—and in fact continues to be—that where one company sells or otherwise transfers all of its assets to another company, the acquiring company is not liable for the debts and liabilities of the selling company, simply by virtue of its succession to the ownership of the assets of the selling company.¹ This general rule of corporate nonliability has served, in effect, as a security blanket protecting corporate successors from unknown or contingent liabilities of their predecessors.²

As the Third Circuit Court of Appeals has noted, the general rule of corporate successor liability “was designed for the corporate contractual world where it functions well.”³ While construing the law of the Virgin

1. See *Conway v. White Trucks*, 692 F. Supp. 442 (M.D. Pa. 1988), *aff'd*, 885 F.2d 90 (3d Cir. 1989).

2. See *Luxliner P.L. Export, Co. v. RDI/Luxliner, Inc.*, 13 F.3d 69 (3d Cir. 1993); *Conway v. White Trucks*, 692 F. Supp. 442 (M.D. Pa. 1988), *aff'd*, 885 F.2d 90 (3d Cir. 1989).

3. *Polius v. Clark Equip. Co.*, 802 F.2d 75, 78 (3d Cir. 1986).

Islands, the court wrote that the traditional rule protects creditors and dissenting shareholders, facilitates a determination of responsibility for taxes, and promotes the free alienability of business assets.⁴ However, the court also noted that courts will not exalt form over substance.⁵ As a result, courts may, under appropriate circumstances, decide that "the new organization is simply the older one in another guise."⁶

Traditionally, courts have recognized only four exceptions to the general rule of nonliability.

The first exception arises in situations where the purchaser either explicitly or implicitly agrees to assume some or all of the debts and liabilities of the seller.⁷ The application of this exception usually is fairly straightforward. The purchasing corporation will normally assume certain liabilities necessary to ensure the uninterrupted conduct of the business. For example, purchasing corporations often expressly assume selling corporations' contracts. They often avoid unwanted or contingent liabilities, such as liability for defectively manufactured products, through a clause in the sales contract that expressly denies responsibility for all liabilities not expressly assumed in the contract. When disputes arise regarding the assumption of liabilities, they typically involve the question of whether an unforeseen liability has been impliedly assumed. For instance, in *Kessinger v. Grefco, Inc.*,⁸ the Seventh Circuit Court of Appeals held that, under both Pennsylvania and Illinois law, an asset-sale agreement, whereby the buyer assumed and agreed "to pay, perform and discharge all debts, obligations, contracts and liabilities" of the seller, included assumption of the seller's unforeseen liability for products liability claims.⁹ The court rejected the buyer's argument that the assumption of liability provisions were ambiguous because they did not specifically mention products liability claims.¹⁰ The problems that arise, as a rule, could have been avoided by careful drafting.

The second exception to the traditional rule of nonliability arises in cases where the court finds that the transaction is really a consolidation or merger of the seller and purchaser.¹¹ The theory of a de facto merger developed in Pennsylvania as a way of providing dissenters' rights for shareholders disgruntled by a corporate transaction that was structured

4. *See id.*

5. *See id.*

6. *Id.*

7. *See id.*

8. 875 F.2d 153 (7th Cir. 1989).

9. *Id.* at 154-55.

10. *See id.*

11. *See Polius v. Clark Equip. Co.*, 802 F.2d 75, 78 (3d Cir. 1986).

to avoid statutory dissenters' rights. In the early 1970's, a few courts began to apply the concept of a de facto merger in suits seeking to impose liability for defective products on a successor corporation. Courts have looked at a number of factors to determine whether a de facto merger has occurred so as to justify imposing products liability on a successor corporation. These include whether stock is part of the purchase price for assets, whether there is continuity of business operations between the two companies, and whether the successor assumed its predecessor's debts.¹² There are, however, two threshold characteristics—continuity of shareholders, meaning that the acquisition was made with shares of the purchasing corporation, so that the shareholders of the seller became shareholders of the purchaser, and prompt dissolution of the selling corporation.

An important development that contributed to the movement away from the traditional rule of non-liability is found in connection with the de facto mergers exception in the case of *Knapp v. North American Rockwell Corp.*¹³ In *Knapp*, the Third Circuit did two important things—first, it disregarded the requirement that the selling corporation dissolve after the asset transfer, and second, it analyzed the case in terms of the policies underlying strict products liability.¹⁴ Thus, although the selling corporation had not immediately dissolved after the transfer of assets, the court observed that the plaintiff would be left without a remedy, if the successor were not held liable.¹⁵ The court noted that, when resolving issues relating to the recognition of a cause of action in favor of an injured party, the Pennsylvania courts have emphasized the public policy considerations served by imposing liability on the defendant, rather than formal or technical requirements.¹⁶ Although it recognized that neither the predecessor nor the successor were in a position to avoid the accident, the Third Circuit concluded that the successor was the party better able to spread the burden of the loss.¹⁷ *Knapp* is important as a harbinger of recent developments in the area of successor liability. However, the expanded exception for de facto mergers developed by the Third Circuit has not been followed because it is limited to acquisitions made with stock and because a court wishing to impose liability on a successor today may do so more directly under the new theories discussed later in this Article.

It is important to note, however, that the de facto merger doctrine

12. See *Luxliner P.L. Export, Co. v. RDI/Luxliner, Inc.*, 13 F.3d 69, 73 (3d Cir. 1993).

13. 506 F.2d 361 (3d Cir. 1974).

14. See *id.* at 369.

15. See *id.* at 368.

16. See *id.* at 369.

17. See *id.* at 369-70.

has, in one case, been applied to a sale of assets where neither corporation's stock transferred.¹⁸ In *Diaz v. South Bend Lathe Inc.*, although no shares were exchanged, the court found a de facto merger had occurred based on evidence of the dissolution of the predecessor corporation; the assumption of liabilities by the successor; and the continuity of management, personnel, and physical operation.¹⁹ The conclusion that a successor corporation is a continuation of its predecessor when no stock is exchanged, however, has more frequently occurred under the "continuity of enterprise exception" which will be discussed later. Indeed, in *National Gypsum Co. v. Continental Brands Corp.*,²⁰ the district court remarked that while the *Diaz* court purported to find a de facto merger, it actually relied upon the "continuity of enterprise" reasoning to reach its result.²¹ Thus, the *Diaz* decision is of questionable precedential value.

The third exception to the traditional rule of nonliability arises in situations where the purchasing corporation is merely a continuation of the selling corporation.²² This exception has traditionally hinged on whether there is a continuity of ownership or corporate structure between the selling corporation and the buying corporation. The primary elements of continuation include the buyer's use of the seller's name, location, and employees and a common identity of stockholders and directors. It is important to emphasize that historically this exception was applied only in very limited circumstances where the successor corporation was materially identical to the predecessor. For instance, one court has noted that the "test is not the continuation of the business operation, but rather the continuation of the corporate entity."²³ However, a variation of this exception known as the "continuity of enterprise" doctrine is one aspect of the more liberal approach to successor liability that will be addressed in this Article.

The fourth, and final, exception to the traditional rule of nonliability arises where a transaction is entered into fraudulently to evade liability for debts.²⁴ This exception, the fraud exception, has been used to impose liability on a successor corporation where, for example, the consideration given for the assets was fictitious or inadequate. Thus, to impose liability on the successor corporation, the law requires a finding that the corporate transfer of assets "is for the *fraudulent purpose* of

18. See *Diaz v. South Bend Lathe Inc.*, 707 F. Supp. 97 (E.D.N.Y. 1989).

19. See *id.* at 100-02.

20. 895 F. Supp. 328 (D. Mass. 1995).

21. See *id.* at 341 n.17.

22. See *Polius v. Clark Equip. Co.*, 802 F.2d 75, 80 (3d Cir. 1986).

23. *Elmer v. Tenneco Resins, Inc.*, 698 F. Supp. 535, 542 (D. Del. 1988).

24. See *Raytech Corp. v. White*, 54 F.3d 187, 192 (3d Cir.), *cert. denied*, 116 S. Ct. 302 (1995).

escaping liability."²⁵ In essence, it is simply an application of the general rule against fraudulent conveyances. In the products liability context, the United States District Court for the District of Oregon, applying Oregon law, found that the fourth exception to the traditional rule of nonliability applied where a successor corporation had been formed for the purpose of avoiding liability for judgments entered against its predecessor in asbestos litigation.²⁶

The traditional rule of nonliability in the sale of assets, along with the four exceptions just discussed, developed within the context of corporate law and addressed the issue of liability for obligations and debts that were primarily financial in nature. As suggested by the *Knapp* case,²⁷ however, the development of the modern law of products liability, with the application of strict liability in tort, has placed the traditional rule of nonliability in asset acquisitions under some conceptual strain. The response of a number of courts to that perceived strain is a major impetus for this Article.

As a quick aside, it is interesting to note the Third Circuit's discussion of the policies underlying strict products liability in relation to successor liability. In *Polius*, the court wrote that recent developments in the area of successor liability rest in large part on the need to compensate eligible plaintiffs.²⁸ The court concluded that "the better approach" is to reject these recent developments.²⁹ According to the court, focusing exclusively on the needs of products liability plaintiffs encourages courts to overlook the business world's valid arguments.³⁰ "Unforeseen alterations in successor liability principles complicate transfers and increase transaction costs."³¹ According to the court, adhering to the traditional rule, with its familiar exceptions, fosters "a climate of relative certainty and reasonable predictability."³² The court wrote that such a climate is best for major economic decisions, which are "critical to society."³³

As this Article will discuss later, a number of courts have recently refused to extend the traditional principles of successor liability to compensate plaintiffs. Instead, these courts have favored a return to the traditional rule of nonliability with its recognized exceptions. The Arti-

25. *Id.*

26. *See Schmoll v. AC and S, Inc.*, 703 F. Supp. 868 (D. Or. 1988), *aff'd*, 977 F.2d 499 (9th Cir. 1992).

27. *See Knapp v. North Am. Rockwell Corp.*, 506 F.2d 361 (3d Cir. 1974).

28. *See Polius v. Clark Equip. Co.*, 802 F.2d 75, 80 (3d Cir. 1986).

29. *Id.*

30. *See id.* at 83.

31. *Id.*

32. *Id.*

33. *Id.*

cle will now move to a brief discussion of the cases that have departed from the traditional rule of nonliability.

2. MODERN RULES OF EXPANDED LIABILITY

a. The "Continuity of Enterprise" Exception

In *Turner v. Bituminous Casualty Co.*,³⁴ a 1976 case, the Michigan Supreme Court imposed liability on a successor corporation in a situation where the traditional rule, even with the exceptions just described, would not have imposed liability. The court's analysis essentially expanded the third exception to the traditional rule of nonliability, that is, mere continuation of the selling corporation. After observing that there clearly would have been liability under the de facto merger exception if the acquisition had been made for stock rather than cash, the court stated that it could find no reason to treat acquisitions for stock or cash differently.³⁵ In effect, the court held that the analysis in *Knapp* should also apply to cash transactions. The court thus found that it would be proper to impose liability on the purchasing corporation after evaluating factors such as the successor's corporate entity's ownership, management, personnel, physical location, assets, trade name, and general business operation.³⁶

Although the continuity of enterprise exception articulated in *Turner* has not received as much attention as the product line exception, which will be considered next, it has been adopted in Alabama,³⁷ and has been favorably treated in Pennsylvania.³⁸ However, the continuity of enterprise exception has also received criticism. As already noted, the Third Circuit criticized the exception in *Polius*.³⁹ Moreover, nine states have rejected the continuity of enterprise exception.⁴⁰ In *Niccum v. Hydra Tool Corp.*, for example, the Supreme Court of Minnesota accepted the argument that the *Turner* exception should not be adopted because the successor corporation did not create the risk by placing a

34. 244 N.W.2d 873 (Mich. 1976).

35. *See id.* at 883.

36. *See id.* at 883-84.

37. *See Turner v. Wean United, Inc.*, 531 So. 2d 827 (Ala. 1988); *Andrews v. John E. Smith's Sons Co.*, 369 So. 2d 781 (Ala. 1979).

38. *Dawejko v. Jorgensen Steel Co.*, 434 A.2d 106 (Pa. Super. 1981).

39. *See Polius v. Clark Equip. Co.*, 802 F.2d 75, 82 (3d Cir. 1986).

40. *See Johnston v. Amsted Indus., Inc.*, 830 P.2d 1141 (Colo. Ct. App. 1992); *Nissen Corp. v. Miller*, 594 A.2d 564 (Md. 1991); *Niccum v. Hydra Tool Corp.*, 438 N.W.2d 96 (Minn. 1989); *Jones v. Johnson Mach. and Press Co.*, 320 N.W.2d 481 (Neb. 1982); *Schumacher v. Richards Shear Co.*, 451 N.E.2d 195 (N.Y. 1983); *Downtowner, Inc. v. Acrometal Prods., Inc.*, 347 N.W.2d 118 (N.D. 1984); *Hamaker v. Kenwel-Jackson Mach., Inc.*, 387 N.W.2d 515 (S.D. 1986); *Ostrowski v. Hydra-Tool Corp.*, 479 A.2d 126 (Vt. 1984); *Fish v. Amsted Indus., Inc.*, 376 N.W.2d 820 (Wis. 1985).

defective product into the market, did not represent to the public the safety of its predecessor's product, and received profit on the product only in a remote way.⁴¹

b. The "Product Line" Exception

In 1977, one year after the *Turner* decision, the California Supreme Court first articulated what is referred to as the "product line exception."⁴² In *Ray v. Alad Corp.*, the buyer purchased the physical plant, manufacturing equipment, inventories of raw materials and finished goods, trade name, goodwill, and records of manufacturing designs from the seller.⁴³ The buyer also continued the employment of the factory personnel and hired the seller's general manager as a consultant.⁴⁴ Moreover, the buyer continued to manufacture the *same* product line under the same name and held itself out to potential customers as the same enterprise.⁴⁵ The California Supreme Court concluded that "a party which acquires a manufacturing business and continues the output of its line of products under the circumstances here presented assumes strict tort liability for defects in units of the same product line previously manufactured and distributed by the entity from which the business was acquired."⁴⁶ Its justification for imposing strict liability was threefold:

(1) the virtual destruction of the plaintiff's remedies against the original manufacturer caused by the successor's acquisition of the business, (2) the successor's ability to assume the original manufacturer's risk-spreading role, and (3) the fairness of requiring the successor to assume a responsibility for defective products that was a burden necessarily attached to the original manufacturer's good will being enjoyed by the successor in the continued operation of the business.⁴⁷

In the first few years following the *Ray* decision, a number of states adopted the product line exception. New Jersey, for example, adopted the product line exception in 1981 in *Ramirez v. Amsted Industries, Inc.*⁴⁸ After analyzing the differences between the continuity exception formulated by the Michigan Supreme Court in *Turner* and the product line exception in *Ray*, the New Jersey Supreme Court concluded that it would be best to adopt the rule in *Ray* which focuses on continuation of the manufacture of the product causing injury.⁴⁹

41. See *Niccum*, 438 N.W.2d at 99.

42. See *Ray v. Alad Corp.*, 560 P.2d 3 (Cal. 1977).

43. See *id.* at 5.

44. See *id.* at 5-6.

45. See *id.* at 5.

46. *Id.* at 11.

47. *Id.* at 9.

48. 431 A.2d 811 (N.J. 1981).

49. See *id.* at 819.

When the issue of successor liability was first presented to the Pennsylvania Superior Court, however, in *Dawejko v. Jorgensen Steel Co.*,⁵⁰ the court referred to *Turner*, *Ray*, and *Ramirez* in deciding to impose liability on the successor corporation.⁵¹ The court concluded that it would be best not to phrase the product line exception "too tightly" "so that in any particular case the court may consider where it is just to impose liability on the successor corporation."⁵² Thus, although the New Jersey Supreme Court's analysis in *Ramirez* focused on continued manufacture of the same product line causing the injury, the Pennsylvania Superior Court appears to have considered the manufacture of the same product line as one of several relevant factors, the presence or absence of any one of which is important but not controlling. The relevance of continuing to manufacture the same product line with respect to causing the injury in question is an important point that this Article will take up later.

The Pennsylvania Supreme Court has yet to approve the product line exception. However, the United States District Court for the Eastern District of Pennsylvania, applying Pennsylvania law, relied on the product line exception in a recent case.⁵³

c. Duty to Warn

Before reviewing a number of important issues relating to the product line exception, one other new approach to the question of successor liability should be mentioned. Concurrently with the developments just discussed, a number of jurisdictions have found a separate basis for imposing liability on a successor—failure to warn customers of defects in the predecessor's products that were discovered, or should have been discovered, by the successor.⁵⁴ Liability for failure to warn existing users of a defective product sold by a predecessor may be imposed under theories of strict liability, negligence, or failure of a successor to comply with federal regulations that impose a duty to report product problems to consumers or to warn prior purchasers of defects. Generally, courts have noted that succession alone does not impose a duty to warn the predecessor's customers of recently discovered defects. Rather, the duty arises from a continuing relationship between the successor and the predecessor's customers. Courts have required plaintiffs to prove such a relationship before imposing successor liability for failure to warn.⁵⁵

50. 434 A.2d 106 (Pa. Super. 1981).

51. See *id.* at 108-10.

52. *Id.* at 111.

53. See *Bogart v. Phase II Pasta Machs., Inc.*, 817 F. Supp. 547 (E.D. Pa. 1993).

54. See *Gee v. Tenneco, Inc.*, 615 F.2d 857 (9th Cir. 1980) (citing duty to warn cases).

55. See *LaFountain v. Webb Indus. Corp.*, 951 F.2d 544, 548 (3d Cir. 1991).

For instance, the Tenth Circuit has concluded that a "court must look at factors such as the succession to service contracts, coverage of the particular machine by a contract, service of that machine by the successor, and the successor's knowledge of the defect and of the machine owner's location."⁵⁶ In any event, because the existence of a duty to warn on the part of a successor is a question of fact, the successor should be sensitive to the possible presence of such a duty in any situation in which it may be involved.

C. Important Issues Regarding the Product Line Exception

1. CHOICE OF LAW

The first and most important issue is choice of law. With Pennsylvania and New Jersey's adoption of the product line exception in the years following the *Turner* and *Ray* decisions, it appeared that the new, more liberal approach to successor liability would sweep the country. The good news is that this has not been the case. Instead, recent cases from a variety of states, such as New York, have rejected the product line exception in favor of retaining the traditional rule on nonliability.⁵⁷

In *Schumacher v. Richards Shear Co.*,⁵⁸ the New York Court of Appeals declined to adopt *Ray's* product line exception and *Turner's* continuity of enterprise exception, but noted that both were factually distinguishable from the case before it.⁵⁹ The opinion is not entirely clear as to the court's position on the product line and continuity exceptions. One lower court interprets the *Schumacher* opinion as rejecting those exceptions in favor of adopting a rule requiring the successor to warn.⁶⁰ Another lower court reads *Schumacher* as leaving open the issue of whether the New York Court of Appeals would adopt either the

56. *Florum v. Elliott Mfg.*, 867 F.2d 570, 579 (10th Cir. 1989).

57. See *Myers v. Putzmeister, Inc.*, 596 N.E.2d 754 (Ill. App. Ct. 1992); *Hernandez v. Johnson Press Corp.*, 388 N.E.2d 778 (Ill. App. Ct. 1979); *Johnston v. Amsted Indus., Inc.*, 830 P.2d 1141 (Colo. Ct. App. 1992); *Bernard v. Kee Mfg. Co.*, 409 So. 2d 1047 (Fla. 1982); *Bullington v. Union Tool Corp.*, 328 S.E.2d 726 (Ga. 1985); *DeLapp v. Xtraman, Inc.*, 417 N.W.2d 219 (Iowa 1987); *Stratton v. Garvey Int'l, Inc.*, 676 P.2d 1290 (Kan. Ct. App. 1984); *Pelc v. Bendix Mach. Tool Corp.*, 314 N.W.2d 614 (Mich. Ct. App. 1981); *Niccum v. Hydra Tool Corp.*, 438 N.W.2d 96 (Minn. 1989); *Young v. Fulton Iron Works Co.*, 709 S.W.2d 927 (Mo. Ct. App. 1986); *Jones v. Johnson Mach. and Press Co.*, 320 N.W.2d 481 (Neb. 1982); *Simoneau v. South Bend Lathe, Inc.*, 543 A.2d 407 (N.H. 1988); *Downtowner, Inc. v. Acrometal Prods., Inc.*, 347 N.W.2d 118 (N.D. 1984); *Flaughner v. Cone Automatic Mach. Co.*, 507 N.E.2d 331 (Ohio 1987); *Goucher v. Parmac, Inc.*, 694 P.2d 953 (Okla. Ct. App. 1984); *Hamaker v. Kenwel-Jackson Mach., Inc.*, 387 N.W.2d 515 (S.D. 1986); *Griggs v. Capitol Mach. Works, Inc.*, 690 S.W.2d 287 (Tex. Ct. App. 1985); *Ostrowski v. Hydra-Tool Corp.*, 479 A.2d 126 (Vt. 1984); *Fish v. Amsted Indus., Inc.*, 376 N.W.2d 820 (Wis. 1985).

58. 451 N.E.2d 195 (N.Y. 1983).

59. See *id.* at 198.

60. See *Radziul v. Hooper, Inc.*, 479 N.Y.S.2d 324, 326 (N.Y. Sup. Ct. 1984).

product line or continuity of enterprise exceptions.⁶¹ The First Circuit Court of Appeals has speculated that the *Schumacher* court intended to reject the holdings in both *Turner* and *Ray*.⁶² Furthermore, in *Howard v. Clifton Hydraulic Press Co.*,⁶³ the court, applying New York law, declined to adopt either *Turner* or *Ray* under the facts presented.⁶⁴ In light of these cases, it is apparent that the New York Court of Appeals has yet to resolve the confusion created by its decision in *Schumacher*.

Federal courts have also expressed reservations that the product line or continuity of enterprise exceptions would be adopted by the courts of Arkansas,⁶⁵ Colorado,⁶⁶ Iowa,⁶⁷ Kentucky,⁶⁸ Louisiana,⁶⁹ Maryland,⁷⁰ Massachusetts,⁷¹ Missouri,⁷² Ohio,⁷³ and Oregon.⁷⁴

The bad news is that, notwithstanding the trend away from adopting the product line exception, the choice of law rule applied in suits against successor corporations gives the product line and continuity of enterprise exceptions wider applicability than they would otherwise have. Consider, for example, the case of *Hickman v. Thomas C. Thompson Co.*,⁷⁵ that was decided by the United States District Court for Colorado in September 1984. In *Hickman*, the plaintiff was injured by copper enameling products manufactured by a corporation that had sold all of its assets to another corporation.⁷⁶ The contract of sale was signed and executed in Illinois where both corporations based their operations.⁷⁷ The plaintiff, however, was a resident of Colorado and was injured by the products there.⁷⁸ The district court concluded that Colorado law should govern the case and that the Colorado courts would adopt the product line exception.⁷⁹ Thus, despite Illinois' rejection of

61. See *Salvati v. Blaw-Knox Food and Chem. Equip., Inc.*, 497 N.Y.S.2d 242, 245-46 (N.Y. Sup. Ct. 1985).

62. See *Santa Maria v. Owens-Illinois, Inc.*, 808 F.2d 848, 858 n.11 (1st Cir. 1986).

63. 830 F. Supp. 708 (E.D.N.Y. 1993).

64. See *id.* at 711.

65. See *Swayze v. A.O. Smith Corp.*, 694 F. Supp. 619 (E.D. Ark. 1988).

66. See *Florum v. Elliott Mfg.*, 867 F.2d 570 (10th Cir. 1989).

67. See *Weaver v. Nash Int'l, Inc.*, 730 F.2d 547 (8th Cir. 1984).

68. See *Conn v. Fales Div. of Mathewson Corp.*, 835 F.2d 145 (6th Cir. 1987).

69. See *Page v. Gulf Oil Co.*, 812 F.2d 249 (5th Cir. 1987).

70. See *Giraldi v. Sears, Roebuck & Co.*, 687 F. Supp. 987 (D. Md. 1988).

71. See *Dayton v. Peck, Stow and Wilcox Co.*, 739 F.2d 690 (1st Cir. 1984).

72. See *Tucker v. Paxson Mach. Co.*, 645 F.2d 620 (8th Cir. 1981).

73. See *Huynh v. Werke*, 90 F.R.D. 447 (S.D. Ohio 1981).

74. See *Western Helicopter Servs., Inc. v. Rogerson Aircraft Corp.*, 728 F. Supp. 1506 (D. Or. 1990).

75. 592 F. Supp. 1282 (D. Colo. 1984).

76. See *id.* at 1283.

77. See *id.*

78. See *id.*

79. See *id.* at 1286-87.

the product line exception, an Illinois business that purchased another Illinois business pursuant to a contract signed in Illinois was held liable under the product line exception because of an astute choice of forum by the plaintiff.

Ironically, in *Florum v. Elliott Mfg.*,⁸⁰ the Tenth Circuit Court of Appeals had an opportunity to predict whether Colorado would adopt the product line exception. The *Florum* court expressly disagreed with the *Hickman* court's conclusion and held that Colorado would reject the product line exception and continue to adhere to the traditional rule.⁸¹

The havoc caused by the unsettled state of the law of successor liability and a choice of law rule that ultimately looks to the law of the state where the injury occurred, is illustrated by the cases involving the power presses manufactured by the Johnson Machine and Press Company.⁸² In 1956, Johnson transferred its assets and liabilities to Bontrager Corporation in exchange for Bontrager common stock.⁸³ Bontrager continued to manufacture presses under the Johnson trade name until 1962.⁸⁴ At that time, Amsted Industries purchased all of Bontrager's assets for cash.⁸⁵ Amsted, or a subsidiary, continued to manufacture presses under the Johnson trademark until 1975.⁸⁶ Amsted then sold the press manufacturing business to LWE, Inc., which also continued to manufacture Johnson presses.⁸⁷

Since then Amsted has litigated the issue of successor liability many times. In 1975, two years before *Ray*, a California court held that Amsted was not liable as a successor for defective products manufactured by its predecessors.⁸⁸ In 1978, the United States District Court for the Eastern District of Wisconsin, applying Wisconsin law, reached a similar conclusion.⁸⁹ In the next case involving Amsted's liability for

80. 867 F.2d 570 (10th Cir. 1989).

81. *See id.* at 580.

82. *See Verhein v. South Bend Lathe, Inc.*, 448 F. Supp. 259 (E.D. Wis. 1978), *aff'd*, 598 F.2d 1061 (7th Cir. 1979); *Diaz v. South Bend Lathe, Inc.*, 707 F. Supp. 97 (E.D.N.Y. 1989); *Korzetz v. Amsted Indus., Inc.*, 472 F. Supp. 136 (E.D. Mich. 1979); *Ortiz v. South Bend Lathe*, 120 Cal. Rptr. 556 (Cal. Ct. App. 1975); *Johnston v. Amsted Indus., Inc.*, 830 P.2d 1141 (Colo. Ct. App. 1992); *Hernandez v. Johnson Press Corp.*, 388 N.E.2d 778 (Ill. App. Ct. 1979); *Jones v. Johnson Mach. and Press Co.*, 320 N.W.2d 481 (Neb. 1982); *Simoneau v. South Bend Lathe, Inc.*, 543 A.2d 407 (N.H. 1988); *Ramirez v. Amsted Indus., Inc.*, 431 A.2d 811 (N.J. 1981); *Fish v. Amsted Indus., Inc.*, 376 N.W.2d 820 (Wis. 1985).

83. *See Ortiz*, 120 Cal. Rptr. at 557-58.

84. *See id.* at 558.

85. *See id.*

86. *See Verhein v. South Bend Lathe, Inc.*, 598 F.2d 1061, 1062 (7th Cir. 1979).

87. *See id.*

88. *See Ortiz*, 120 Cal. Rptr. at 560.

89. *See Verhein v. South Bend Lathe, Inc.*, 448 F. Supp. 259 (E.D. Wis. 1978), *aff'd*, 598 F.2d 1061 (7th Cir. 1979).

Johnson presses, *Korzetz v. Amsted Industries, Inc.*,⁹⁰ the United States District Court for the Eastern District of Michigan applied *Turner's* continuity exception to Michigan law and held Amsted liable as a successor.⁹¹ The same year, an Illinois court, applying Illinois law, rejected *Ray's* product line exception and held that Amsted was not liable as a successor.⁹² Two years later, New Jersey adopted the *Ray* approach and applied it to Amsted.⁹³ The following year, in *Jones v. Johnson Machine and Press Co.*,⁹⁴ the Nebraska Supreme Court rejected the product line exception and held that Amsted was not liable as a corporate successor.⁹⁵ In 1985, in *Fish v. Amsted Industries, Inc.*,⁹⁶ the Supreme Court of Wisconsin rejected the product line exception and held that Amsted was not liable as a successor corporation.⁹⁷ In 1988, in *Simoneau v. South Bend Lathe, Inc.*,⁹⁸ the Supreme Court of New Hampshire held that New Hampshire does not recognize the product line theory of successor liability and that, therefore, liability could not be imposed on Amsted on this basis.⁹⁹ Then, in 1989, in *Diaz v. South Bend Lathe, Inc.*,¹⁰⁰ the United States District Court for the Eastern District of New York held Amsted liable under New York's de facto merger doctrine for an injury caused by a product manufactured by Johnson Machine and Press.¹⁰¹ Most recently, in *Johnston v. Amsted Industries, Inc.*,¹⁰² the Colorado Court of Appeals held that Amsted could not be held liable, because Colorado does not recognize the product line or continuity of enterprise theories of successor liability.¹⁰³

To date, therefore, Amsted has litigated the issue of successor liability ten times, once each under the laws of California, Colorado, Michigan, Illinois, New Jersey, New York, New Hampshire, and Nebraska, and twice under the law of Wisconsin. Amsted has won seven times and lost three times—losing once under the *Turner* rule, once under *Ray*, and once under a de facto merger theory. In sum, the experience of Amsted Industries serves as an important warning that in the context of the product line exception what is important in evaluating a potential

90. 472 F. Supp. 136 (E.D. Mich. 1979).

91. *See id.* at 144-45.

92. *See Hernandez v. Johnson Press Corp.*, 388 N.E.2d 778, 779-81 (Ill. App. 1979).

93. *See Ramirez v. Amsted Indus., Inc.*, 431 A.2d 811 (N.J. 1981).

94. 320 N.W.2d 481 (Neb. 1982).

95. *See id.* at 484.

96. 376 N.W.2d 820 (Wis. 1985).

97. *See id.* at 829.

98. 543 A.2d 407 (N.H. 1988).

99. *See id.* at 409.

100. 707 F. Supp. 97 (E.D.N.Y. 1989).

101. *See id.* at 100-01.

102. 830 P.2d 1141 (Colo. App. 1992).

103. *See id.* at 1147.

acquisition is *where* the selling corporation—and its predecessors—have distributed products that may be potentially dangerous.

This Article will now briefly mention several other issues, in addition to choice of law, that should further increase sensitivity to the product line exception.

2. CONTINUATION OF THE PRODUCT LINE

The next issue is whether a court would hold a purchasing corporation liable if the purchasing corporation did not continue to manufacture the product of the predecessor that caused the injury. As this Article pointed out earlier, the New Jersey Supreme Court in *Ramirez* rejected the *Turner* case in favor of California's *Ray* case, which focused on the continuation of the manufacture of the injurious product.¹⁰⁴ However, the New Jersey Superior Court has recently expanded the product line exception and allowed liability even when the company did not continue producing the product.¹⁰⁵ In *Pacius v. Thermtroll Corp.*, the court stated that if the theory behind successor liability is to afford a remedy to the plaintiff, any benefits received by purchasing the assets of the predecessor should be enough to establish the product line exception.¹⁰⁶ This is obviously an expansion of the product line exception. It will be interesting to see if the New Jersey Supreme Court accepts this interpretation.

California courts, like the *Pacius* court, have not insisted on strict continuation of the same product line as a prerequisite to finding liability.¹⁰⁷ In *Rawlings v. D.M. Oliver, Inc.*, the California Court of Appeal held that a successor corporation may be liable even where the product causing injury was not mass-produced and the successor did not continue the identical product line.¹⁰⁸ The court concluded that this result was consistent with the strict products liability rationale, which does not require the party held liable to be morally responsible for the injuries caused by the product.¹⁰⁹ Rather than require the injured party to bear the loss, the court decided that the successor should bear the loss because it was benefitting from the business and goodwill it had purchased and was in a position to spread the costs of the injury.¹¹⁰ It is interesting to note a 1988 California Court of Appeal case in which the plaintiff sought to have the product line exception applied to a negli-

104. See *Ramirez v. Amsted Indus., Inc.*, 431 A.2d 811, 818-19 (N.J. 1981).

105. See *Pacius v. Thermtroll Corp.*, 611 A.2d 153 (N.J. Super. Ct. Law Div. 1992).

106. See *id.* at 157.

107. See *Rawlings v. D.M. Oliver, Inc.*, 159 Cal. Rptr. 119 (Cal. Ct. App. 1979).

108. *Id.* at 124.

109. See *id.*

110. See *id.* at 124-25.

gence cause of action.¹¹¹ There the court held that the product line exception only applies to causes of action based on strict liability.¹¹²

3. INTERMEDIATE SUCCESSOR

Another issue to be aware of is the problem faced by an intermediate successor. Even after a corporation has divested itself of assets acquired from a previous owner, it may still be held liable for defective products manufactured by the previous owner. In *Nieves v. Bruno Sherman Corp.*,¹¹³ decided the same day as *Ramirez*, the New Jersey Supreme Court held that an intermediate successor, who at the time of injury no longer owned the assets associated with the manufacture of the defective product, could nonetheless be held liable, as a successor to the original owner, under the product line exception.¹¹⁴

In *Trimper v. Harris Corp.*,¹¹⁵ a case involving the same company that was the intermediate successor in the *Nieves* case, a federal district court has also held that an intermediate successor may be liable under the continuity of enterprise exception formulated in the *Turner* case.¹¹⁶ In *Tretter v. Rapid American Corp.*,¹¹⁷ the United States District Court for the Eastern District of Missouri adopted *Trimper*.¹¹⁸ In *Tretter*, two corporations had merged, and the court held that a successor corporation which had merged with its predecessor was liable for the tort liabilities of its predecessor, notwithstanding the fact that the successor corporation had since transferred responsibility for such liabilities to another corporation.¹¹⁹ Like the court in *Trimper*, the court in *Tretter* emphasized that its first concern was to compensate an injured plaintiff and that any agreement between the successor corporations as to the proper allocation of liability should not prevent the plaintiff's recovery.¹²⁰

It should be noted, however, to avoid any misunderstanding, that the cases imposing liability on an intermediate successor have also continued to hold the ultimate successor liable. As in *Tretter*, courts will generally honor an agreement allocating liability between successive successors, but the plaintiff, in the first instance, is not to be deprived of a potential source of recovery.¹²¹

111. See *Maloney v. American Pharmaceutical Co.*, 255 Cal. Rptr. 1 (Cal. Ct. App. 1988).

112. See *id.* at 5.

113. 431 A.2d 826 (N.J. 1981).

114. *Id.* at 828.

115. 441 F. Supp. 346 (E.D. Mich. 1977).

116. *Id.* at 347.

117. 514 F. Supp. 1344 (E.D. Mo. 1981).

118. *Id.* at 1347.

119. *Id.*

120. *Id.*

121. See *id.*

4. PUNITIVE DAMAGES

The final issue under the product line exception to be aware of is the availability of punitive damages. In 1983, a federal district court predicted that California would not grant punitive damages against successor corporations under the product line exception and, accordingly, granted summary judgment to the successor.¹²² However, in *Martin v. Johns-Manville Corp.*,¹²³ the Pennsylvania Superior Court, an intermediate appellate court, held that punitive damages could be awarded against a successor corporation.¹²⁴ The court explained its decision as follows:

We believe that when a legal change in corporate identity is not accompanied by major changes in the identity of the predecessor's shareholders, officers, directors, and management personnel, the imposition of punitive damages against the successor for the reckless conduct of the predecessor may be proper as advancing the goals of punishment and deterrence. For the actors responsible for the predecessor's reckless conduct will be punished and also deterred from similar conduct in the future. The fact that the successor does not continue the product line recklessly marketed by the predecessor, or cures the defect, will not necessarily preclude punitive damages. For in either circumstance, the fact remains that those who are in control of the successor have demonstrated a willingness to act in reckless disregard of the rights of others. That the public is now safe from being injured by product x does not mean it is safe from the next reckless business practice these actors may undertake if not deterred.¹²⁵

On appeal, the Pennsylvania Supreme Court concluded that the plaintiff had not produced evidence sufficient to warrant the submission of his punitive damages claim to the jury.¹²⁶ The court observed that it has never decided the question of whether punitive damages are available in an action grounded in strict liability for defective products and declined to do so in the case before it.¹²⁷ New Jersey has followed the Pennsylvania Superior Court's lead in holding that punitive damages can be awarded against a successor corporation.¹²⁸ The New Jersey Superior Court in *Brotherton v. Celotex Corp.* noted that the imposition of punitive damages against a successor corporation may be necessary to

122. See *In re Related Asbestos Cases*, 566 F. Supp. 818 (N.D. Cal. 1983).

123. See 469 A.2d 655 (Pa. Super. 1983), *vacated on other grounds*, 494 A.2d 1088 (Pa. 1985).

124. *Id.* at 667.

125. *Id.*

126. See *Martin v. Johns-Manville Corp.*, 494 A.2d 1088, 1100 (Pa. 1985).

127. See *id.* at 1094.

128. See *Brotherton v. Celotex Corp.*, 493 A.2d 1337 (N.J. Super. Ct. Law Div. 1985).

protect the public from egregious conduct.¹²⁹ The *Brotherton* opinion, however, emphasized that the successor corporation must be sufficiently connected to the culpable conduct to warrant punitive damages.¹³⁰

The Superior Court of Delaware, in *Sheppard v. A.C. and S Co.*,¹³¹ also suggested that punitive damages may be recovered from a successor corporation, particularly when the successor continues the manufacture and distribution of the product line which it acquired from its predecessor. The court stated that:

If, as the decisions indicate, deterrence is a policy goal supporting the allowance of punitive damages, the continuation by a successor of a product line with knowledge of its danger (as suggested by the affixing of warning labels) could be a reprehensible act properly discouraged through the imposition of punitive damages.¹³²

The court emphasized, however, that "punitive damages, in products liability cases, are assessable only for outrageous conduct and even in jurisdictions which recognize strict liability an additional showing of aggravated conduct is required."¹³³

The case law has indicated a greater willingness to impose punitive damages where the successor corporation is the product of a statutory merger, as was the case in *Brotherton*. This is because, in a statutory merger, a successor corporation expressly undertakes to become liable for all the liabilities of its predecessor, including any potential claims for punitive damages. For example, the Celotex Corporation, as the successor corporation of a merger with Panacon Corporation, which itself was the successor of a merger with the Philip Carey Corporation, has been held liable for punitive damages as a result of the actions of its predecessors.¹³⁴

5. LOSS OF REMEDY AGAINST PREDECESSOR AND CAUSATION

Some courts are looking beyond the claimant's need for compensation, to the fairness of imposing such liability on the successor corporation. In *Conway v. White Trucks*,¹³⁵ the Third Circuit Court of Appeals

129. *Id.* at 1344.

130. *Id.* at 1341.

131. 484 A.2d 521 (Del. Super. Ct. 1984).

132. *Id.*

133. *Id.* at 526.

134. See *Aguirre v. Armstrong World Indus., Inc.*, 901 F.2d 1256 (5th Cir. 1990); *Man v. Raymark Indus.*, 728 F. Supp. 1461 (D. Haw. 1989); *Hanlon v. Johns-Manville Sales Corp.*, 599 F. Supp. 376 (N.D. Iowa 1984); *Neal v. Carey Canadian Mines, Ltd.*, 548 F. Supp. 357 (E.D. Pa. 1982) *aff'd sub nom.* *Van Buskirk v. Carey Canadian Mines Ltd.*, 760 F.2d 481 (3d Cir. 1985); *Celotex Corp. v. Pickett*, 459 So. 2d 375 (Fla. 1st DCA 1984), *aff'd*, 490 So. 2d 35 (Fla. 1986); *Davis v. Celotex Corp.*, 420 S.E.2d 557 (W. Va. 1992).

135. 885 F.2d 90 (3d Cir. 1989).

examined the product line exception, as applied in Pennsylvania. The Third Circuit, noting that a number of state courts had rejected the product line exception, expressed doubts as to whether the Pennsylvania Supreme Court would adopt the exception in any form.¹³⁶ Assuming, for purposes of argument, that the Pennsylvania Supreme Court would follow the Pennsylvania Superior Court's decision in *Dawejko*,¹³⁷ the Third Circuit predicted that the supreme court "would not apply [the] exception in cases where the claimant had a potential remedy against the original manufacturer, but failed to exercise all available means to assert his or her claim."¹³⁸ The Third Circuit noted that one of the *Ray* requirements for the product line exception is the virtual destruction of the plaintiff's remedies against the original manufacturer because of the successor's acquisition of the business.¹³⁹ In *Conway*, the bankruptcy court set aside a fund to accommodate claims such as those asserted by the plaintiff.¹⁴⁰ The Third Circuit concluded that it would be inappropriate to impose liability on the successor where the plaintiff had an available remedy against the predecessor, but had failed to pursue that remedy.¹⁴¹

Two years later, the Third Circuit reaffirmed this view in *LaFountain v. Webb Industries Corp.*,¹⁴² where it declined to apply the product line exception to a case because the plaintiff had a claim against the predecessor manufacturer but failed to prove it.¹⁴³

The Third Circuit's decisions in *Conway* and *LaFountain* are instructive because they illustrate that some courts no longer impose liability on a successor corporation solely to compensate an injured plaintiff. Rather, courts have indicated a greater willingness to inquire into the fairness of imposing such liability, particularly when the successor corporation did not cause the destruction of the plaintiff's remedy against the predecessor.¹⁴⁴

D. Practical Suggestions

A successor corporation may be held liable in an unforeseen jurisdiction for both punitive and compensatory damages because of a defec-

136. See *id.* at 93-95.

137. See *supra* notes 50-53 and accompanying text.

138. *Conway*, 885 F.2d at 95.

139. See *id.*

140. See *id.* at 91.

141. See *id.* at 97.

142. 951 F.2d 544 (3d Cir. 1991).

143. *Id.* at 545.

144. See also *Tracey v. Winchester Repeating Arms Co.*, 745 F. Supp. 1099 (E.D. Pa. 1990), *aff'd*, 928 F.2d 397 (3d Cir. 1991); *Holloway v. New Jersey*, 566 A.2d 1177 (N.J. Super. Ct. Law Div. 1989), *rev'd in part on other grounds*, 593 A.2d 716 (N.J. 1991).

tive product acquired from a predecessor. Such liability seems unfair, especially if the successor corporation does not manufacture the product, cured the defect, or was only an intermediate successor. However, because it is a possibility, it is vital that the corporation structure an asset acquisition to minimize the risk of successor liability.

A correct approach to the problem requires a business evaluation of the realistic risks involved. Although the prospect of punitive damages against, for example, an intermediate successor that has remedied a defect in a product is cause for significant concern, the focus should be on whether it would be economically efficient to restructure an acquisition to minimize such a possibility. Sometimes, it is better to allow the acquisition to take another form without reference to the problem of successor liability.

In any acquisition, it is critical to evaluate business considerations that suggest a particular structure for an acquisition and the manner of operating the business following the acquisition. The potential magnitude and location of product liability claims should be weighed against those considerations. The product line acquired could be one that is not inherently dangerous and has only been distributed in states, like Illinois, that have decisively rejected the product line exception in a number of cases. On the other hand, the products may be dangerous and may have been distributed in states, like California and Pennsylvania, which have adopted the product line exception to the traditional rule of nonliability.

Assuming that the problem of successor liability is of some concern, there are a number of ways to reduce the purchaser's risks. Attention should focus on the following: factors the courts have relied on to justify the imposition of successor liability, agreements to indemnify the purchaser if the seller continues in business, and allocations of liability between various successors.

Rather than focusing on these generalized techniques here, it would be more instructive to describe two specific situations which are of some interest in this area.

The first situation involves a technique used to structure an acquisition for one of Morgan, Lewis & Bockius' English corporate clients. The English company wanted to acquire the business of an American company that had produced a product containing asbestos during the 1950's and 1960's. Although the American company was not an asbestos manufacturer and the asbestos contained in the products it had manufactured was not particularly dangerous, the American company had been named as a defendant in a number of personal injury suits. The possibility that the American company would be held liable for an

amount anywhere near the \$50-60 million sought from all the defendants was extremely remote, yet the English company was somewhat concerned.

Exploration of the situation revealed that the acquisition was going to be structured in a way that would clearly raise the issue of the product line exception—the English company was going to purchase all of the American company's assets and continue its business, and the American company was going to be dissolved.

The English company wanted to confine potential liability as much as possible. Consequently, an American subsidiary of the English company was incorporated and capitalized with a sufficient amount of cash to complete the acquisition and provide working capital for initial operations. Morgan, Lewis & Bockius provided a detailed opinion on how to operate the American subsidiary so that the corporate veil between the American subsidiary and its English parent would not be pierced. At that point, the English company could at least be confident that its maximum exposure was limited to the amount of its investment.

The next step in the acquisition is what made the transaction unique. The English company then secured a "sleep easy" insurance policy through a New York insurance broker. Lloyd's of London specially wrote the policy to cover the amount of the English company's initial investment in its American subsidiary. Assuming that the policy survives scrutiny, the English company only risks losing the American subsidiary's profits.

A second interesting situation in this area is the acquisition of a company that is in reorganization. The basic rule to remember is that acquiring the business of a company that is in reorganization—even with the benefit of a bankruptcy court order stating that the assets are transferred free and clear of liabilities—does not guarantee that the acquiring corporation will not be held liable as the successor of the corporation in reorganization.

There are a few cases to be aware of in this context. The first case is *In re Mooney Aircraft, Inc.*¹⁴⁵ The original Mooney Aircraft company filed a bankruptcy petition in 1969.¹⁴⁶ The bankruptcy court subsequently approved a sale of the assets of Mooney Aircraft free and clear of all claims and liabilities other than properly secured liens.¹⁴⁷ The assets were then sold two more times before coming to rest in a wholly-owned subsidiary of Republic Steel Corporation.¹⁴⁸ After the sales, the

145. 730 F.2d 367 (5th Cir. 1984).

146. *See id.* at 369.

147. *See id.* at 371.

148. *See id.* at 379.

families of two men who died in a crash brought a products liability suit in California against the Republic Steel subsidiary seeking to hold it liable as the successor of Mooney Aircraft for a defective plane manufactured prior to the filing of the bankruptcy petition.¹⁴⁹ Upon application by the Republic Steel subsidiary, the bankruptcy court reopened the estate of Mooney Aircraft and entered an order enjoining the prosecution of the California products liability case.¹⁵⁰ The Fifth Circuit ultimately held that the injunction was improper because the bankruptcy court did not have the power to sell the assets of Mooney Aircraft free and clear of claims by victims of an accident that had not yet occurred.¹⁵¹ Therefore, *Mooney Aircraft* stands for the proposition that a bankruptcy proceeding is not an adequate mechanism to protect against the imposition of successor liability for claims which have not accrued at the time of the bankruptcy proceeding.

The second case to be aware of is *Schweitzer v. Consolidated Rail Corp.*,¹⁵² which was decided in 1985. Unlike *Mooney*, the *Schweitzer* case did not involve a successor corporation, but rather the extent of the discharge of liability of the reorganized company itself. The Reading Railroad was one of the bankrupt northeast railroads whose rail assets were transferred to Conrail in 1976 pursuant to federal statute.¹⁵³ Following the transfer of its rail assets to Conrail, the Reading Company was reorganized essentially as a real estate holding company. After the reorganization was consummated, former Reading railroad employees who had been exposed to asbestos while working on the railroad brought a series of personal injury suits.¹⁵⁴ The Third Circuit held that the injured employees' claims arose at the point when they showed evidence of disease¹⁵⁵—which was after the consummation of the Reading reorganization—and that they thus did not have claims that could be discharged by the bankruptcy court.¹⁵⁶

Schweitzer should be read in conjunction with *In re Erie Lackawanna Railway Co.*¹⁵⁷ Although the facts of *Erie* are similar to those of *Schweitzer*, the court in *Erie* denied the plaintiffs relief because it found that the entity that survived the bankruptcy proceeding was the product of a liquidation rather than a reorganization.¹⁵⁸ Thus, the *Erie*

149. See *id.* at 371.

150. See *id.* at 372.

151. See *id.* at 375.

152. 758 F.2d 936 (3d Cir. 1985).

153. See *id.* at 940.

154. See *id.*

155. See *id.* at 942.

156. See *id.* at 944.

157. 803 F.2d 881 (6th Cir. 1986).

158. *Id.* at 883-84.

court did not address the issue in *Schweitzer* regarding the extent of discharge.

In *In re Penn Central Transportation Co.*,¹⁵⁹ the United States District Court for the Eastern District of Pennsylvania allowed plaintiffs who had been exposed to polychlorinated biphenyls ("PCB's") while employed by Penn Central Transportation Company to assert claims for that exposure against Penn Central Corporation, the corporation which came into existence upon the reorganization of the Penn Central Transportation Company.¹⁶⁰ Although the bankruptcy court issued an order exonerating the reorganized company from all tort claims, the district court, relying on *Mooney* and *Schweitzer*, concluded that the order could not discharge claims which had not accrued at the time of the reorganization proceeding.¹⁶¹

In cases where Morgan, Lewis & Bockius represented clients who acquired the assets of a company in reorganization and faced a possibility of significant contingent tort liability, the firm has requested express consent and waiver of claims from any involved unions. Note, however, that this procedure only protects clients from liability to employees and does not help in the case of injured third parties, such as in *Mooney*.

II. EMPLOYEE BENEFITS ISSUES

Whether the transaction is a stock acquisition, an asset acquisition, or a merger, the transactional lawyer must perform three distinct tasks relating to employee benefit plans. These tasks must be completed in order, because each is derived from the task immediately preceding it.

The first task that the transaction lawyer must undertake may be labeled the "identification and classification" task. It naturally subdivides into two parts. The first part of the task involves discovering and analyzing prior, current, and anticipated ownership relationships involving the target company. This discovery and analysis is critical because it defines the universe within which the transaction lawyer must look to find the benefit plans that must be examined in the second phase. Many of the provisions of ERISA and some of the key employee benefit provisions of the Internal Revenue Code pierce the traditional corporate veil, aggregating enterprises for liability or tax benefit eligibility testing purposes. An enterprise related only by a parent-subsidiary, brother-sister, common ownership (including ownership determined by applying attribution rules), or affiliated service group relationship to one or more other enterprises may form, with those related enterprises, a statutory

159. 92 B.R. 605 (E.D. Pa. 1988).

160. *See id.* at 613.

161. *See id.* at 609-10.

universe in which they share joint and several liability for certain benefit plan obligations of any number of members of that universe. If the target company was or is a member of such a common control universe, it may have substantial potential liability in respect to benefit plans that it never sponsored or maintained and that never covered any of its employees.

The target company may also have determined, or assumed, that certain of its benefit plans were eligible for tax-favored treatment on the basis of having met certain coverage or benefit testing criteria under the Internal Revenue Code. In many cases, the Code requires that such testing be based on an aggregated enterprise data base where a common control universe exists, treating all such related enterprises as a single employer. Experience indicates that such aggregate base testing requirements are often misunderstood and assumed to be inapplicable or overlooked. Thus, claimed tax benefits may be lost retroactively upon audit when the testing is redone on an aggregated universe basis.

After defining the universe of companies whose benefit plans are relevant to the transaction, it is time to turn to the second part of the first task, identifying and classifying the benefit plans which raise concern and the circumstances that brought about those plans. In making inquiries, "employee benefit plan" should be defined broadly, extending well beyond the ERISA definition,¹⁶² in order to learn as much as possible and to establish the basis for liability and risk assessment.

"Employee welfare benefit plans" and "welfare plans" are within the scope of ERISA as long as they are not limited to proprietors, partners, or shareholders, and their respective spouses.¹⁶³ Under ERISA, a "pension plan" is a plan providing for retirement income benefits or deferral of compensation to or beyond the end of covered employment.¹⁶⁴ Shorter term deferral arrangements are not within the purview of ERISA. "Welfare plans" include plans which provide for:

medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services, or . . . any benefit described in section 186(c) [of the Labor Management Relations Act of 1947] (other than pensions on retirement or death, and insurance to provide such pensions).¹⁶⁵

Therefore, inquiry as to "employee benefit plans" limited to

162. See 29 U.S.C. § 1002(3) (1994) (defining "employee benefit plan").

163. See *id.* § 1002(1).

164. See *id.* § 1002(2)(A).

165. *Id.* § 1002(1)(A)-(B).

arrangements falling within the ERISA definition of "employee benefit plan" would include any of the following types of plans of which the intelligent buyer must be cognizant: current or short-term deferred incentive bonus arrangements; most stock-based compensation arrangements, such as incentive or non-qualified stock options, restricted stock arrangements, stock appreciation rights, phantom stock plans, and employee stock purchase plans; adoption assistance plans; payroll practices; employee discounts; accumulated unused vacation and compensatory time off; pay in lieu of sick pay, such as attendance incentive programs; paid leaves of absence or sabbaticals; individual deferred compensation arrangements appearing as clauses in personal service and employment contracts; and cafeteria and flexible spending account plans.

During the discovery and classification process, financial, actuarial, and insurance information should also be examined. Such examination will enable the client to decide which plans should be terminated by the seller before closing, which plans the client is willing to take over, and which plans leave the client with little practical choice, such as those to which the target company was committed under a collective bargaining agreement by which the purchaser must agree to be bound. The plan identification and classification process will highlight the favorable planning opportunities that may be present, the perils and exposures from which the client needs protection, the corporate culture and employee expectations that may be encountered in the target company, and the potential impact, if any, of the acquisition on the client's benefit plans.

Once the discovery and classification phase is completed, the transaction lawyer can turn to the second step—the assessment of the liability the client may incur because of the purchase, and the financial risk associated with the benefit plans. This assessment ultimately results in representations and warranties, seller's covenants, indemnifications, establishment of conditions precedent to closing, pre- and post-closing undertakings, and purchase price and post-closing adjustments. The following list suggests some, but by no means all, of the issues that might need to be addressed, depending on the nature of the plans discovered in the identification and classification phase:

- (1) In the case of single-employer defined benefit pension plans, liability under Title IV of ERISA to the plans, to the Pension Benefit Guaranty Corporation, or both, regardless of whether the plans involved were sponsored by the target company or by an enterprise in its commonly controlled universe;
- (2) Withdrawal liability in connection with one or more multi-employer

pension plans, regardless of whether the plans involved were plans covering employees of the target company, or employees of an enterprise in the target company's commonly controlled universe;

(3) Excise tax liability, civil liability, or general liability for engagement in "prohibited transactions," as defined in the Code or ERISA, regardless of whether the plan involved was a plan sponsored by the target company;

(4) Disallowance of deductions taken for contributions or benefits provided under a plan intended to be tax-benefitted, such as tax-qualified retirement plans or medical expense plans, if the plan failed to meet the Code conditions for the tax benefit;

(5) Obligations to install new plans or to increase benefits, sometimes retroactively, usually under collective bargaining agreements;

(6) Penalties for failure to fully satisfy all reporting and disclosure obligations on a timely basis;

(7) Excise taxes and other penalties to commence benefit payments when required, to hold employer securities in an ESOP for the prescribed holding period, to meet minimum funding requirements on a timely basis, to withhold income tax (or wage taxes) at the source, to satisfy COBRA requirements, and for payment of excess fringe benefits, for prohibited allocation of employer securities under certain ESOPs, and for material overstatement of pension liabilities;

(8) Liability for failure to provide "employee" benefits to persons retroactively deemed to be "employees" and previously treated as "independent contractors;"

(9) Disallowance of deductions in connection with pension funding where the actuarial assumptions on the basis of which funding was done are retroactively determined by the Internal Revenue Service to have been unreasonable;

(10) Penalties for failure to make required quarterly contributions to pension plans, to report "reportable events," to pay timely or sufficient premiums to the Pension Benefit Guaranty Corporation, and to provide security for the future funding of benefit increases resulting from a plan amendment;

(11) Liabilities arising from the indemnification by the target company of others, particularly service providers and fiduciaries;

(12) Liability in connection with improperly denied claims for benefits;

(13) In the case of non-ERISA plans, liabilities and penalties for state law violations, and in the case of ERISA plans, liabilities and penalties for violation of those state laws which are not superseded by ERISA, such as state laws governing insurance, banking, and taxes;

(14) Liabilities and penalties for violations of federal laws other than ERISA that may apply to benefit plans, including the Age Discrimina-

tion in Employment Act of 1967,¹⁶⁶ the Americans with Disabilities Act of 1990,¹⁶⁷ the Uniformed Service Employees Reemployment Rights Act of 1994,¹⁶⁸ civil rights acts, gender discrimination acts, or other applicable law;

(15) Possibility of claims by the Department of Defense to recover "excess" pension costs paid in an earlier cycle, if the target is a defense contractor;

(16) The results of any possible agency compliance audit, including loss of tax-exempt status if there was a failure to obtain a timely ruling, such as might be the case with a VEBA;

(17) Economic loss for failure to make full contributions for service through the closing date, or to pay all premiums due for coverages provided through the closing date;

(18) Acceleration of vesting and benefit entitlement, expiration of restrictions on securities, or any other enhancement of benefits based on the change of control contemplated in the acquisition transaction itself;

(19) Effect of the transaction on and changes in accrued bonus pools and other incentive pay measuring devices;

(20) Proper resolution of problems associated with benefit plans that are stock-based, such as options and restricted shares, or that measure non-stock benefits by stock price performance, stock appreciation rights and phantom stock arrangements, for example.

Fully developing and quantifying all of these exposures may require the assistance of other professionals, such as appraisers and actuaries. After completion of this task, the third, and often most difficult task, must be addressed. The parties must now negotiate who will bear the certain cost of each calculable expense, who will bear the risk as to the many contingent exposures involved, and how benefit-based disputes will be resolved in the future.

Because of the several steps involved and the time that accomplishing those steps can consume, it is best for the transactional lawyer who is not a benefits expert to involve his or her benefits people in the transaction earlier rather than later. The more thoroughly tasks one and two, the identification and quantification processes, are performed, the easier it is to address the benefit issues and to prevail in negotiation.

166. See 29 U.S.C. §§ 621-34 (1994).

167. See 42 U.S.C. §§ 12101-12213 (1994).

168. See Pub. L. 103-353, 108 Stat. 3149 (codified in scattered sections of 38 U.S.C. and 5 U.S.C. § 8432(b) (1994)).

A. Sample Seller's Representations and Warranties Relating to Employee Benefit Plans

In a hypothetical transaction involving a sale by an unrelated third party of all of the stock of Country Transit, Inc. ("CTI") to Penny Rich (to purchase a seventy percent interest) and to an ESOP to be established (to purchase a thirty percent interest), the following scenarios will illustrate the use of seller's representations and warranties. Representations and warranties made by CTI are not of much value to buyers, because they will own CTI after closing. In an asset sale transaction, buyers would want CTI's representations and warranties as well. However, in an asset sale, buyers would be less concerned about certain potential liabilities with respect to which representations and warranties are suggested below.

(1) All of CTI's benefit plans, including "non-ERISA" plans, have been identified.

Sample: Schedule A is a complete list of all employee benefit plans, whether formal or informal, whether or not set forth in writing, and whether covering one person or more than one person, sponsored or maintained by CTI or to which CTI makes contributions. For the purposes hereof, the term "employee benefit plan" includes all plans, funds, programs, policies, arrangements, practices, customs and understandings providing benefits of economic value to any employee, former employee, or present or former beneficiary, dependent or assignee of any such employee or former employee other than regular salary, wages or commissions paid substantially concurrently with the performance of the services for which paid. Without limitation to the same, the term "employee benefit plan" includes all employee welfare benefit plans within the meaning of section 3(1) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and all employee pension benefit plans within the meaning of section 3(2) of ERISA. Schedule A is marked to indicate (a) each plan listed therein which is intended to meet the qualification requirements of section 401(a), 403(a) or 405(a) of the Internal Revenue Code of 1986, as amended (the "Code"); (b) each plan listed therein all of the benefits of which are funded through contracts of insurance; and (c) each plan listed therein which is intended to be exempt from income tax or to provide benefits that are tax-advantaged to the recipients.

(2) Seller has presented for examination CTI plan documents that are complete and accurate. The financial information relating to each Plan is complete and properly reflects the assets and liabilities of each plan.

Sample. CTI has delivered to Buyers a true, correct and complete copy of every plan document memorializing provisions of each plan

identified in Schedule A, including all amendments and modifications to each.¹⁶⁹ As to each funded employee benefit plan, CTI has delivered to Buyers the most recent annual financial report with respect to such plan, any subsequent interim report, and, as to each defined benefit pension plan, CTI has delivered to Buyers the most recent actuarial valuation completed with respect to such plan. Each such financial report is a substantially accurate description of the financial status of the subject employee benefit plan, and there have been no material adverse changes in the financial status of any such employee benefit plan since the date of the most recent report provided with respect thereto.

(3) CTI has not entered into any contractual commitment to continue the operation of any of the plans or to increase benefits under any of the plans.

Sample: Except as specifically set forth in its current collective bargaining agreement with the International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America, Local XYZ, a true and correct copy of which has been delivered by CTI to Buyers, and except as provided under applicable state worker's compensation laws, CTI is not obligated, contractually, or by operation of law, to either continue in operation any employee benefit plan.

(4) Plans intended to be tax-qualified under the Internal Revenue Code are tax-qualified and plans otherwise intended to satisfy Code nondiscrimination requirements do satisfy those requirements.

Sample: As to each pension, profit-sharing or other plan identified in Schedule A as being tax-qualified, all of the following are true:

(a) The plan, in form and operation, currently satisfies, and for all years subsequent to the establishment of such plan and with respect to which the Corporation's tax returns are open to audit, has satisfied, the qualification requirements of section 401(a), 403(a) or 405(a) of the Code, as applicable.

(b) The Internal Revenue Service ("IRS") has issued a favorable Letter of Determination or Opinion Letter with respect to the plan as amended to date, and all amendments required by the Code as a condition of retention of such qualified status as of the date hereof have been adopted.

(c) The IRS has not revoked any Letter of Determination or Opinion Letter to which reference is made in paragraph (b) hereof, nor has the IRS threatened any such revocation.

169. Such documents include, without limitation, plan documents, benefit schedules, insurance contracts and other funding vehicles, and published announcements, policy statements, procedures and similar instruments constituting the articulation of the provisions of any such employee benefit plan.

(d) The IRS is not presently auditing, nor has it indicated an intention to audit any such plan; and no matter relating to any such plan is presently under consideration under any voluntary compliance or closing agreements program.

(e) Each other plan subject to Code nondiscrimination requirements currently satisfies, in both form and operation, and has satisfied such nondiscrimination requirements as were applicable for all years with respect to which CTI's tax returns are open to audit.

(5) CTI has no imputed liability from any other entity under either the Code or ERISA.

Sample: CTI is not now and has not been for a period of at least six years ending on the date of this agreement (a) a part of a controlled group of corporations within the meaning of section 414(a) of the Code, (b) a trade or business constituting a part of a group of trades or businesses under common control within the meaning of section 414(b) of the Code, (c) an entity constituting part of an affiliated service group within the meaning of section 414(m) of the Code, or (d) an entity that must be aggregated for any purpose with any other entity under section 414(o) of the Code.

(6) CTI's liability under Title IV of ERISA is both limited and quantified.

Sample: Other than as to the pension to which CTI contributes on behalf of its Teamster member employees (the "Teamster Pension Fund"), CTI does not now, and has not for a period of at least six years, contributed to or maintained any pension plan subject to Title IV of ERISA and has no liability with respect to any such plan. As to the Teamster Pension Fund, CTI has no current withdrawal liability in connection therewith, and the consummation of the transaction contemplated by this agreement will not result in any such liability. If CTI were to withdraw from the Teamster Pension Fund as of the date hereof, its maximum withdrawal liability would not exceed \$ ____.

(7) CTI's obligation to fund plans is limited and satisfied.

Sample: Except as to the Teamster Pension Fund, CTI neither sponsors nor maintains any pension plan subject to the minimum funding requirements of sections 412 of the Code or 302 of ERISA. All contributions payable to any qualified employee benefit plan for any plan year or fiscal year of CTI ending prior to the date hereof have been paid in full, or are fully reflected on the financial statements of CTI which have been provided to the Buyers. All premiums payable with respect to insurance providing coverages in force up to the closing date have been or by closing date will be paid in full. All amounts withheld from

employee compensation to fund benefit plans prior to closing date will have been deposited to such plans as of closing date.

(8) CTI has no excise tax or penalty liability exposure.

Sample: Neither CTI nor any person or entity indemnified by CTI has engaged in, or entered into any binding agreement to engage in, any transaction or other conduct which may result in imposition on CTI of liability, directly or through such indemnification, for (a) any excise tax under sections 4971 through 4980(B), inclusive, of the Code, (b) any civil liability under section 502 of ERISA, (c) any criminal penalty under section 1954 of the U.S. Criminal Code, or (d) any other material economic sanction under any applicable law or regulation relating to benefit plan operation.

(9) Current status of regulatory agency matters.

Sample: Neither Seller nor CTI has any knowledge of any investigation, proceedings, administrative review or other administrative agency process which could result in imposition on CTI of any penalty or other assessment in connection with any of the employee benefit plans identified in Schedule A. Neither Seller nor CTI has any knowledge of any circumstance, condition or conduct that could result in imposition upon CTI of any tax liability, penalty, interest charge or other assessment in connection with any employee benefit plan sponsored or maintained by CTI if such plan were to be audited by any regulatory agency.

(10) CTI has complied with reporting, disclosure and tax withholding requirements.

Sample: CTI has filed or caused to be filed on a timely basis each and every return, report, statement, notice, declaration and other document required by any governmental agency, federal, state and local (including, without limitation, the Internal Revenue Service, the Department of Labor, the PBGC and the Securities and Exchange Commission) with respect to each employee benefit plan sponsored or maintained by CTI.

(11) CTI has delivered or caused to be delivered to every participant, beneficiary, alternate payee, or other party entitled to such material, all plan descriptions, returns, reports, schedules, notices, statements and similar materials, including, without limitation, summary plan descriptions, summary annual reports, individual reports of accrued benefits, and documentation required by regulation in connection with denied claims for benefits (where applicable) under Title I of ERISA, under the Code, under applicable securities laws, or under regulations with respect to any of the foregoing. CTI and its appointed plan administrators, are in compliance in all material respects, with statutory and regulatory

requirements relating to communications with, and solicitation of elections and consents from, persons covered by, or having an entitlement to benefits under, each employee benefit plan sponsored by CTI.

CTI has withheld and remitted to the proper depository all income taxes and wage taxes on benefits derived under its employee benefit plans, to the extent such withholding is required by law.

(12) CTI has no stock-based benefit programs.

Sample: CTI has no benefit plan or program and no compensation arrangement which relates to the stock of CTI.¹⁷⁰

(13) CTI has generally complied with applicable law—including securities laws, age discrimination rules, civil rights acts, and rules relating to disability and family leave.

Sample: CTI has operated, and has caused its appointees and nominees to operate, each and every employee benefit plan identified on Schedule A or improperly omitted from said Schedule in a manner which is in material compliance with all applicable law, regulations, and administrative agency rules and requirements applicable thereto. Every employee, former employee, and every dependent of the foregoing entitled to continuation of benefit coverage under any employee welfare benefit plan sponsored by CTI has been accorded all of the rights to which such person is entitled as a matter of law or regulation. Neither CTI nor any person or entity indemnified by CTI has engaged in any act which constitutes a breach of fiduciary duty under ERISA.

(14) There is no threatened litigation against CTI in connection with its benefit plans.

Sample: Except as to claims for benefits in the ordinary course, none of which are extraordinary in magnitude, neither Seller nor CTI has any knowledge of any action, claim, demand, grievance or allegation of unfair labor practice of any kind brought or threatened by any potential claimant or representative of such claimant under any employee benefit plan identified on Schedule A where CTI may be either (a) liable directly on such action, claim or demand; or (b) obligated to indemnify any person, group of persons or entity with respect to such action, claim or demand.

(15) Seller will fund bookkeeper's special annuity before closing.

Sample: Seller will secure the bookkeeper's acknowledgement that the lifetime payment promise was personal to Seller and NOT a corporate obligation of CTI, and that Seller will purchase at his own expense and deliver to the bookkeeper a fully paid single premium annuity providing for a lifetime benefit of \$15,000 per annum. The contract will be

170. There are no outstanding stock options, restricted stock shares, stock appreciation rights, or phantom stock plans.

held in trust by the Seller, with monthly installments payable to CTI during bookkeepers continued tenure, and to bookkeeper thereafter.¹⁷¹

(16) Seller's representations and warranties will survive closing.

Sample: Notwithstanding any other limitation on the duration of the warranties set forth in this Agreement, the warranties set forth in this Article shall be true as of the date hereof, and as of the closing date. Those warranties will survive the closing date by five (5) years and damages for breaches thereof shall not be subject to any deductible.

There are many other representations and warranties to be made by seller, including all standard representations and warranties concerning the corporate status of CTI, CTI's financials, any real estate that CTI owns (such as truck terminals), CTI's ownership of its assets, and all of CTI's contractual and debt obligations. Because this hypothetical transaction involves a licensed trucking operation and a warehouse in which food was stored, the seller should also be required to make representations and warranties relating to the following: (1) The validity and transferability of licenses and operating certificates; (2) environmental matters;¹⁷² (3) OSHA compliance, and (4) sanitation and product liability. Because food warehouses are notorious for inadequate refrigeration, vermin infestation, and related problems, and particularly if a state department of agriculture inspects the warehouse before renewing its license, the buyers should establish as a condition precedent to closing that the warehouse meet all applicable standards.

III. ENVIRONMENTAL ISSUES

A. *Identifying and Managing Environmental Risks in a Corporate Acquisition*

Federal and state environmental agencies have recently made efforts to transform their regulations from a "command and control" system that specifies costly technologies in all cases to one based on flexibility and case-specific risk assessment. The effect of this change on transactions is not yet clear. New opportunities to clean contaminated sites to satisfy reasonable standards and obtain relief from liability for conditions created in the past are offset by difficulties in obtaining a clear agreement with the government to set the terms of the cleanup and

171. Item 15 is probably more properly a seller's covenant and a condition precedent to closing. This problem might also be addressed by having CTI and the bookkeeper enter into a "split dollar" life insurance arrangement, a "retired life reserve" contract, or an annuitized nonqualified retirement plan, although each such device involves tax planning considerations beyond the scope of this exercise.

172. Truck terminals are often sites where oil, fuel, and other pollutants have accumulated or been dumped.

release. Although clear statutory limits on lender liability have largely resolved lenders' environmental concerns, problems with the assessment, in terms of aggregate potential cost, of existing environmental contamination problems and future operating compliance costs remain. New management tools such as the ASTM investigation standards and ISO 14000 compliance standards have not reduced the need for experienced judgment in the final assessment of the acquisition.

Since the mid-1980's, environmental risks have assumed an ever-increasing role in corporate acquisitions as potential "deal breakers." Environmental agencies at all levels of government have implemented programs aimed at preventing future contamination and cleaning up existing contamination that require expensive measures to collect and treat the contaminants. The cost of cleaning up contamination has generally dwarfed the cost of pollution controls for daily operations, largely because of the tremendous volume of material that must be managed in order to collect and treat toxic materials that dispersed into the environment over many years.

The standards for both pollution control and pollution cleanup are constantly changing. Laboratory tests are offered as proof of the potential hazards of toxic materials at very low levels. In the past, to avoid difficult decisions, legislators and regulators alike have taken the path of least resistance and required the elimination of all risks from exposure to man-made toxic materials, regardless of costs or benefits. As each successive generation of treatment becomes available and is installed, advocates have presented evidence that even tighter standards were needed to avoid all risk, causing regulators to impose tighter standards, which required costly new forms of treatment.

More recent environmental policies have modified this approach to cleanup standards in favor of protecting only against realistic exposure risks. Although technology forcing standards continue to tighten pollution controls for new or modified operating plants, agencies are willing to look at all plant operations and allow the reductions to be achieved in the most cost-effective manner. These "risk-based" and emission "bubble" policies can dramatically reduce environmental costs. Therefore, corporate transactions can be focused on more positive aspects of the deal. Questions remain, however, as to how far these changes have progressed and what the current approaches to assessing environmental risks in corporate transactions are?

B. Identifying Problems and the Nature of the Risks

The most significant legal concepts in environmental law are strict liability, joint and several liability, and overlapping federal/state juris-

diction. The first concept, strict liability, dates back to *Fletcher v. Rylands*,¹⁷³ an English case decided in 1865. In *Fletcher*, a person who engages in a use of property which is allowed, despite its known hazards, because of its social utility, should be liable for all resulting damages without regard to fault.¹⁷⁴ Sometimes this rule is read to eliminate tort law's causation requirement. Section 9607 of the Federal Comprehensive Environmental Response, Compensation, and Liability Act¹⁷⁵ ("Superfund") states that any person who owns or operates a contaminated site, transports waste there for disposal, or generates the waste that ended up at the site is liable for all cleanup costs incurred by anyone doing a cleanup in accordance with government regulations.¹⁷⁶ This broad, statutory strict liability has been used to place responsibility on current owners and operators of companies for the cleanup of contamination from past spills and disposal, in a manner that avoids judicial invalidation as retroactive legislation.¹⁷⁷

Joint and several liability has raised the notoriety of the Superfund program. Under this doctrine, although hundreds of companies may have sent waste to a landfill, the government may clean up the landfill and then recover the cost of the cleanup in an action against a single company. The company that paid for the cleanup has claims against all of the other companies for reimbursement for their fair share of the cleanup costs. This prospect, however, is hardly comforting to a company that produced one percent of the waste and is adjudged liable for the entire amount. For publicly-traded companies, major reporting and accounting problems will exist, even if the payments to the government are phased until the contribution claims can be brought to judgment.¹⁷⁸

Finally, management of environmental problems is complicated by the dual regulation in this area. Both the federal Environmental Protection Agency and each state environmental agency has the power to set standards and enforce them. Federal preemption is curbed by statute. Inconsistent requirements may hamper the management of technically

173. 159 Eng. Rep. 737 (1865), *rev'd*, L.R. 1 Ex. 265 (Ex. Ch. 1866), *aff'd*, 3 L.R.- E. & I. App. 330 (H.L. 1868).

174. *See id.*

175. 42 U.S.C. §§ 9601-9675 (1994).

176. *See id.* § 9607(1)(a). This is called the National Contingency Plan. *See id.* § 9607(d)(1).

177. For cases discussing strict liability under Superfund, see *Babbitt v. Sweet Home Chapter*, 115 S. Ct. 2407, 2420 (1995) (O'Connor, J., concurring); *Pennsylvania v. Union Gas Co.*, 491 U.S. 1 (1988); *Exxon Corp. v. Hunt*, 475 U.S. 335 (1986).

178. For a discussion of joint and several liability under Superfund, see *Redwing Carriers Inc. v. Saraland Apartments*, 94 F.3d 1489, 1500 (11th Cir. 1996); *Reichhold Chems., Inc. v. Textron Inc.*, 888 F. Supp. 1116, 1122 (N.D. Fla. 1995); *South Fla. Water Management Dist. v. Montalvo*, 1989 WL 260215 (S.D. Fla. 1989); *Bulk Distribution Ctrs., Inc. v. Monsanto Co.*, 589 F. Supp. 1437, 1443 (S.D. Fla. 1984).

simple problems, and settlements with only one level of government may not be conclusive or binding on other levels. Most environmental statutes expressly preserve the states' right to co-regulate in the subject area of the legislation.¹⁷⁹

There are two basic types of environmental problems—those arising from current operations and those resulting from prior releases of hazardous or toxic materials. In either case, the potential costs are similar—costs of treatment or remediation, costs of enforcement actions or penalties, and costs of claims made by neighbors who have suffered personal injury or loss of property value as a result of the pollution. Government actions and standards largely determine the size of the first two types of costs. Juries, however, decide the size of the third type, making the amount much more difficult to predict.

The costs of meeting environmental standards in an ongoing operation can vary. They may include administrative costs—the costs of determining the applicable requirements; applying for permits; negotiating specific terms; collecting samples; testing samples for specific constituents or general physical, chemical, and biological characteristics; filing reports; and operating and maintaining systems for treatment and disposal of wastes in compliance with the law. There are also periodic costs of changing these systems as business operations change and of upgrading systems as environmental standards and requirements change.

Another basic issue in ongoing operations is compliance, that is, the enforcement status of the facilities under consideration for acquisition. There are an enormous number of standards for air emissions; wastewater management; solid waste collection, transportation, and disposal; facility expansion; worker exposure and safety; and general protection of the environment. With so many different standards, a company can easily miss various requirements. But with penalties of \$25,000 per day for each violation, most companies cannot afford to have violations piling up unnoticed for too many days. The good news is that most violation cases are settled for much less than the statutory maximum. The bad news is that such settlements may still range from thousands of dollars to millions of dollars, depending on the quality of the company's relationships with the environmental regulators. Determining the outstanding violations and the likely cost of settlement requires careful review of records, questioning of plant and corporate personnel, and a high level of experience, skill, and knowledge of due diligence team members.

Past release of hazardous substances may result in tremendous

179. See Clean Water Act § 510, 33 U.S.C. § 1370 (1994); Resource Conservation and Recovery Act § 3006, 42 U.S.C. 6926(d) (1994); Clean Air Act § 116, 42 U.S.C. 7416 (1994).

costs for investigating the extent of the damages, determining the appropriate remedy, and implementing the remedy, as well as the administrative costs of these efforts. The best known environmental program for such remediation is the Superfund program, but similar programs abound under state law in a variety of different statutes, such as a state Superfund law, an underground storage tank law, or a traditional air water or solid waste pollution control law. Remedial costs often dominate this consideration, running into millions of dollars, but investigative costs frequently run into hundreds of thousands of dollars. When the liability for remediation is shared jointly and severally among many parties, as is often the case for the cleanup of public and commercial disposal facilities, the individual costs of participating in meetings or litigation may exceed the company's remedial cost share.

When considering liability for past releases of hazardous substances, it is important to look at the corporate history in detail. Every location at which the company ever operated becomes a potential Superfund claim. Moreover, because persons who generate waste and send it offsite for disposal may be jointly and severally liable for the cleanup of the disposal site, each waste disposal or treatment site may be a source of future liability. Even waste treatment may be a liability if the treatment is not done carefully or the wastes are mishandled in transit or at the destination.

Superfund liability arises when the cleanup occurs, regardless of the time of actual disposal. Although liability may diminish over time due to the loss of records identifying waste owners, this can cut both ways. Missing information may increase the share of the cleanup costs the unlucky companies identified at the site must pay, because joint and several liability makes those companies liable for the entire cleanup cost.

Private claims brought by the neighbors of contaminated plants are a rapidly growing area of liability.¹⁸⁰ As tort lawyers start sharing information about the bases for claims, experts begin rendering opinions that particular exposures caused identifiable damages, and the government grants access to databases recording companies' release of contaminants, individual and class action suits are targeting an increasing number of cleanup sites. Some of these cases settle for amounts which are small in comparison with the cleanup costs. However, in each case, there is a risk that one case might result in a jury verdict involving a large class of plaintiffs and an award of millions of dollars. The right to a jury trial in private damage cases makes a risk estimate a matter of

180. Worker claims, which are not discussed in this Article, fall within a special area of liability covered by state law.

guesswork requiring a high degree of experience and judgment to reduce the uncertainty.

C. *Avoiding Risk—The Form of the Transaction*

When environmental risks began to increase dramatically, the initial transactional strategy was to change the form of the deal to limit liability. Instead of assuming all liability through a merger, many transactions were done through asset acquisitions. The common law rule in most states is that a purchaser of assets does not acquire liabilities of the previous asset owner, unless one of the following four exceptions apply: (1) the transaction is a fraudulent attempt to avoid liability; (2) the transaction amounts to a *de facto* merger or consolidation; (3) the purchaser agrees to assume the liabilities, or (4) the purchaser is a mere continuation of the seller.

From the beginning, courts have responded to this approach by fashioning a federal common law rule that the legislative purpose of the Superfund law is to make those with the closest connection to the hazardous substances pay, rather than the public, for the cleanup. Some courts even read the broad liability classification in section 107(a) of Superfund to implicitly include asset purchasers.¹⁸¹ However, other courts were troubled by this abrupt disturbance of well-established law. Absent merger, consolidation, fraud, or express assumption, the “mere continuation” exception to nonliability requires identity of shareholders or ownership before and after the transaction. These competing needs have led to the active consideration of a fifth exception which has gained acceptance in some states in the area of product liability, the “substantial continuity” test. Most recently, the U.S. Court of Appeals for the Second Circuit adopted this rule for Superfund cases in *B.F. Goodrich v. Betkoski*.¹⁸² Under this test, if the company acquiring substantially all of the assets appears to intend to carry on the prior company’s business and gain any benefit from that continuation, it will be held to be the successor to the former company owning and operating the assets, and to its environmental liabilities.¹⁸³ This determination is a flexible and discretionary evaluation of several factors, including, but not limited to, any one of the following: continuity of employees, management, or stock ownership; use of the name of the prior company or its products; the selling corporation’s existence after the sale; and assumption of liabili-

181. See *Anspech Co. v. Johnson Controls, Inc.*, 922 F.2d 1240 (6th Cir. 1991).

182. 99 F.3d 505 (2d Cir. 1996).

183. See *id.* at 519.

ties by the acquirer.¹⁸⁴

The potential adoption of this exception in other circuits is forcing a rethinking of previous corporate transaction strategies. Because companies fear the exception will spread, it is likely that deals will no longer be structured as asset purchases solely to insulate the purchaser from environmental liability. Instead, other mechanisms will be used to provide a future source of payment, or the liabilities will simply be evaluated as part of the deal and accepted by the purchaser. Such negotiation and acceptance places the spotlight on quantifying the risks and arranging for payment or corrective remediation by the seller.

D. *Identification and Quantification of Environmental Risks*

There has been a great deal of effort made toward standardizing a methodology for risk identification. Terms such as a "Phase I" or "Phase II investigation," which used to be highly idiosyncratic in methodology, content, and cost are increasingly defined by standards set by organizations such as the American Society for Testing and Materials.¹⁸⁵

Typically, a Phase I review focuses on a particular property or properties and includes a "site walkthrough" by an environmental engineer, scientist, or lawyer; interviews with current personnel responsible for managing environmental compliance and liabilities; and review of government records and environmental databases for information pertaining to the company or property.¹⁸⁶ In addition to looking for visible traces of spills and the care taken in handling materials at the plants, compliance records and documentary evidence of the relationship with regulators may be reviewed. The presence of routine environmental management and compliance systems such as the International Standards Organization 14000 standards—implemented in the United States in cooperation with the American National Standards Institute—may be used to reduce the need for a detailed audit, if good records are maintained under these systems.

Where compliance problems are noted in Phase I, typically a more intense review of compliance information, including direct inquiries to regulatory officials, will be conducted. Where evidence of contamination is not matched with clear records of adequate cleanup, due diligence

184. Compare *B.F. Goodrich*, 99 F.3d at 519-20 with *United States v. Mexico Feed and Seed Co.*, 980 F.2d 478, 486-90 (8th Cir. 1992).

185. See AMERICAN SOC'Y FOR TESTING AND MATERIALS, E 1527-94, STANDARD PRACTICE FOR PHASE I: ENVIRONMENTAL SITE ASSESSMENT (National Soc'y of Envtl. Consultants No. 95170) [hereinafter E 1527-94]; AMERICAN SOC'Y FOR TESTING AND MATERIALS, E 1528-93, STANDARD PRACTICE FOR TRANSACTION SCREEN PROCESS (National Soc'y of Envtl. Consultants No. 95502).

186. See E 1527-94, *supra* note 185, §§ 6-10.

will often include sampling and testing to independently determine the scope of contamination and potential risks. As of yet, there are no routine systems for these "follow-on" investigations. In these cases, it is essential that the due diligence team have access to an experienced environmental lawyer.

The quantification of identified risks involves a balancing of views. For example, the technical or engineering review may be influenced by the prospect of a highly lucrative engagement to manage the problem after acquisition. This may result in a review which understates the potential technical cost, while qualifying the opinion to avoid professional liability.

Because a potential for serious problems exists which may call for reliance on highly qualified judgment calls, the client must be very comfortable with the quality of the expertise being relied on. The basis for this comfort level may be very individualized, changing from deal to deal. Understanding the need for client confidence is crucial. Such confidence cannot exist unless the lawyer demonstrates an ability to offer approaches for managing the identified liabilities. As crucial as the need for client confidence is the need to make the client aware that he or she, not the lawyer or technical consultant, may be assuming a significant risk.

E. Managing Risks Before and After the Acquisition

The best method for dealing with identified environmental problems is also the most difficult to manage in a transactional setting. Requiring the seller to cure all significant environmental problems seems to be the most prudent approach, and it can certainly work for many problems. Sellers will often propose to limit their responsibilities to correcting these "housekeeping-type" matters. Such matters generally relate to ongoing regulatory compliance. Of course, the more significant problems are those which have developed over time, usually because of an unwillingness to address the cost of corrective action.

The value of an indemnity—a promise to pay for the correction of any future problems or settlement of claims—from the seller relates directly to the availability of the assets backing the promise at the time the claim may be asserted. Indemnities work best for short-term problems, such as claims which have already been asserted and are in litigation or negotiation. Problems which have been identified in due diligence, but have not yet been asserted as claims or demands, are problems which may ripen into claims after the sale proceeds have been distributed and dispersed beyond any hope of reaching them to satisfy indemnity obligations. Indemnities may also lead to stalling tactics and

imperfect solutions designed to delay any serious expense until the indemnitor is gone or judgment-proof. Another option is to form an escrow. Escrows are a means of assuring funding of a corrective action program from the seller's assets. Seller usually restricts the duration and size of escrows. Unless the actions to be taken, and their likely costs, are clearly understood and expressed, an escrow will invite litigation that achieves none of the escrow's purposes, upsets the client, and enriches the new counsel engaged to handle the litigation. It is rare for a company to invite the counsel who handled the acquisition to handle litigation over the terms unless the terms are very clear and the seller is simply welching on the deal with no good defense. Long-term escrows, when they occur, invite litigation no matter how well constructed, simply because environmental standards change over time and the parties tend to forget the specific tasks of the contract in favor of a general sense of who is responsible for such matters.

Technically, insurance was not a practical option, because the application costs funded a second tier of due diligence by the proposed carrier, premiums were very high, and any contingencies were clearly and explicitly resolved against coverage. Devices such as coverage only for claims made during the policy term defeated coverage, because environmental claims often take so long to mature that insurers had plenty of time to raise premiums or terminate the policy. Recently, this trend has begun to change. As insurers have developed enough experience to assess liabilities more efficiently and to offer policies which effectively spread out the cashflow of a claim over the period of its potential assertion, with some adjustments for changes in risk over time. This is a highly specialized area, in which the unaware customer can spend a great deal of money for little or no protection.

F. *Financing Concerns*

For years, deals with outside or third-party financing were virtually impossible if there was even a trace of an environmental problem. Much of this was traceable to one case, *United States v. Fleet Factors Corp.*¹⁸⁷ In *Fleet Factors*, the Court of Appeals declared in dictum that a lender could be held liable under Superfund for the cost of cleaning up the defunct borrower's property on the theory that the lender's financial relationship gave it the capacity to control the operations of the borrower and prevent the contamination.¹⁸⁸ The Environmental Protection Agency ("EPA") later developed a Superfund regulation providing that lender's would not be liable if they exercised due care not to cause or

187. 901 F.2d 1550 (11th Cir. 1990).

188. See *id.* at 1156-59.

contribute to pollution, held no equity interest in the borrower, and offered to sell the foreclosed contaminated property to any bona fide purchaser who offered real value for the property.¹⁸⁹ This policy was overturned by the U.S. Court of Appeals in *Kelley v. EPA*,¹⁹⁰ on the grounds that the Superfund law did not authorize the EPA to redefine the classes of liable persons. However, legislative solutions continue to be pursued. For example, 1995's Balanced Budget Reconciliation Act contained an amendment to Superfund's liability provisions modeled on the EPA policy.¹⁹¹ As lender protections have grown, lender's concern about environmental problems has diminished to more proportional concerns about the availability and value of contaminated collateral property.

G. *Innovative Approaches to Environmental Risk Management*

Policies have evolved to help businesses deal with environmental laws. These policies offer the opportunity to identify sites which have been unfairly stigmatized by low to moderate contamination or high contamination but little risk of harm—for example, sites where groundwater contamination cannot be cleaned at any reasonable cost, but the groundwater is not used, or plants with contaminated soil in remote industrial areas. New programs allow changes to remediation standards to reflect the low risk. However, where cleanup costs are reasonable, such modifications remain unlikely.

Sites which are dedicated to industrial use through deed restrictions may also be eligible for reduced cleanup standards reflecting the fact that sensitive populations such as children are much less likely to be exposed. These programs can limit a purchaser's future liability in many states.

The EPA has implemented several changes to its Superfund program to aid in the redevelopment of "brownfields." The changes include policies removing cleaned sites from the list of Superfund sites, the "National Priorities List;" discouraging claims against owners of "innocent" properties affected by migration of contaminated groundwater; and promoting settlements at fair cost to de minimis parties. The EPA will also negotiate settlements with persons intending to buy contaminated Superfund sites and release the purchasers from liability for all past contamination. Some state programs will provide even broader release from environmental liability to purchasers who clean up, or arrange for the seller to clean up, truly harmful conditions. Such releases must be care-

189. See 40 C.F.R. § 300.1100(c)(2).

190. 15 F.3d 1100 (D.C. Cir. 1994).

191. The Act was vetoed by President Clinton in Dec. 1995.

fully coordinated, because each release is limited to the jurisdiction and statutory authority of the releasing agency.

Tax policies also must be carefully reviewed and considered. The Internal Revenue Service has recently allowed the expensing of certain cleanup costs, thereby changing the impact of such costs on the bottom line. However, there are eligibility requirements for this treatment, largely based on the existence of a benefit to an asset resulting from the cleanup. Opponents argue that contaminated real property is not truly improved in value or is not improved dollar for dollar by a cleanup. This issue is still being discussed and argued with in the government.

Securities and Exchange Commission ("SEC") filings also need to be a part of any due diligence review. A purchaser may well be required to incorporate the seller's public statements on its environmental liabilities unless reasons are provided for the changes. Increasing SEC review in this area makes such considerations a necessary part of due diligence.

H. Conclusion

In conclusion, new opportunities exist for the successful acquisition of corporations with environmental problems. Most of these opportunities lie with companies whose assets are only moderately contaminated and whose operating deficiencies can be addressed with the cooperation and forbearance of the regulators. Substantial legal experience and judgment are needed to assess an acquisition of this type and to determine whether the proper conditions are present for a mutually advantageous transaction. The tools for collecting the relevant information for such an assessment are increasingly available, but the knowledge and experience to use that information are not yet prevalent.

IV. LABOR AND EMPLOYMENT LAWS

Corporate mergers and acquisitions give rise to a host of challenging labor and employment issues with respect to the liability of the successor entity for actions and agreements of the predecessor entity. A fundamental conflict exists between the rights of buyers and sellers of a company to conduct business transactions without restriction and the rights of employees of the predecessor entity to enjoy stable employment conditions. This tension has resulted in the expansion of the buyer's duties to the seller's employees in certain circumstances. The purpose of this section is to highlight three areas of potential labor and employment liabilities that arise from the transfer of ownership of a company.

First, this section will address the successor corporation's notice obligations under the Worker Adjustment and Retaining Notification

Act ("WARN").¹⁹² Next, this section will address the "successorship doctrine," a federal common law creation that imputes various liabilities and responsibilities of the predecessor entity onto the successor entity. Courts have utilized the successorship doctrine to impute labor obligations under the National Labor Relations Act ("NLRA"),¹⁹³ as well as under the federal anti-discrimination statutes. This section will highlight the principal duties that have been imputed to the successor corporation under the NLRA and the federal anti-discrimination statutes. Finally, this section will address the successor entity's ability to enforce individual employment contracts entered into by the predecessor and its employees.

A. *Worker Adjustment and Retraining Notification Act—The Notice Requirement*

WARN requires business enterprises employing a minimum of 100 employees to provide sixty days written notice of a planned plant closing, mass layoff, or an actual employment termination by sale to a purchaser.¹⁹⁴ An employer who violates the Act is liable to each employee who suffers a job loss due to the violation.¹⁹⁵ Penalties may include back pay, benefits, and medical insurance premiums that would have been paid but for the plant closing, mass layoff, or employment termination.¹⁹⁶ Penalties are assessed for each day of the violation period, up to a maximum of 60 days.¹⁹⁷

192. 29 U.S.C. §§ 2101-2109 (1994).

193. 29 U.S.C. §§ 151-169 (1994).

194. See 29 U.S.C. § 2101(a) (1994). A "plant closing" is a permanent or temporary shutdown of a single employment site that causes an "employment loss" for 50 or more employees during a 30-day period. See *id.* § 2101(a)(2). A "mass layoff" is any other "employment loss" during a 30-day period for either 50 to 499 full-time employees, if the number laid off equals 33 percent of the work force or 500 full-time employees. See *id.* § 2101(a)(3). "Employment loss" is defined as "(A) an employment termination, other than a discharge for cause, voluntary departure, or retirement, (B) a layoff exceeding 6 months, or (C) a reduction in hours of work of more than 50 percent during each month of any 6 month period." *Id.* § 2101(a)(6). The Department of Labor explained in its regulations under the Act that the word "termination" was "to have [its] common sense meaning[.]," that is, that a termination is a "permanent cessation of the employment relationship." Worker Adjustment and Retraining Notification, 54 Fed. Reg. 16,042, 16,047 (1989) (to be codified at 20 C.F.R. pt. 639) (proposed Apr. 20, 1989).

The meaning of "employment loss" that triggers WARN liability has been the subject of litigation. For a discussion of what constitutes an "employment loss" under WARN, see generally *International Alliance of Theatrical and Stage Employees and Moving Picture Operators v. Compact Video Serv., Inc.*, 50 F.3d 1464, 1466 (9th Cir. 1995).

195. See 29 U.S.C. § 2104(a)(1).

196. See *id.* § 2104(a)(1).

197. See *id.* § 2104(a)(1)(B).

1. SALES EXEMPTION

Section 2101(b)(1) has two functions. First, it states that a sale of a business does not trigger the WARN's notice requirement.¹⁹⁸ Thus, section 2101(b) provides a "sales" exemption to the notice requirement. Second, section 2101(b)(1) also provides the division of liability between the buyer and seller in a sale or business transaction in the event that the sale triggers WARN obligations independent of the sale of the business.¹⁹⁹

Section 2101(b)(1) codifies the comments to WARN, which recognized that WARN does not require employers to provide notice to its employees of a sale of a business, absent any other employment modifications, such as a mass layoff, plant closing, or real employment termination.²⁰⁰ This exemption is rooted in the concept that only real, rather than technical, employment losses, should be covered under WARN.²⁰¹ Nevertheless, the statute does not explain which types of business transactions are exempted from WARN notification under this exemption.²⁰²

198. See *International Alliance*, 50 F.3d at 1467 (noting that sale of a business alone does not trigger WARN liability and that, although a technical termination of the seller's employees may be deemed to have occurred when a sale becomes effective, WARN notice is only required where the employees, in fact, experience a covered employment loss); see also *Headrick v. Rockwell Int'l. Corp.*, 24 F.3d 1272, 1280 (10th Cir. 1994) (noting that a sale is not a WARN event and that "the obligation to warn employees in the event of a closure or mass layoff skips from seller to buyer, never triggered by the sale").

Furthermore, the Tenth Circuit concluded that a reduction in pay and benefits is not an "employment loss" subject to WARN notification requirements. See *International Alliance*, 50 F.3d at 1468 (rejecting union's argument that a pay and benefits cut is a "loss" that affects one's employment, and thus, constitutes an "employment loss"). Although a sale alone may not trigger liability, an employment loss due to a sale gives rise to WARN liability, if the employment loss is one covered under the statute.

199. One case held that the provision dividing responsibility for notice obligations under WARN does not apply in merger situations. See *Carpenters Dist. Council v. Dillard Dep't Stores, Inc.*, 790 F. Supp. 663, 666-67 (E.D. La. 1992) (joint and several liability applied to buyer and seller for failure to notify employees of department store's closing because section 2101(b) only applies to sales situations), *aff'd in relevant part, rev'd in part on other grounds*, 15 F.3d 1275 (5th Cir. 1994).

200. See 29 U.S.C. § 2101(b)(1) (1994); see also Worker Adjustment and Retraining Notification, 54 Fed. Reg. 16,042, 16,052 (1989) (to be codified at 20 C.F.R. pt. 639) (proposed Apr. 20, 1989).

201. See 54 Fed. Reg. 16,042, 16,052; see also 29 U.S.C. § 2101(b) ("[A]ny person who is an employee of the seller . . . as of the effective date of the sale shall be considered an employee of the purchaser immediately after the effective date of the sale."). Section 2101(b) explicitly extends the employment relationship beyond the employee and the former employer/predecessor company. See 20 C.F.R. § 639.6 (1996) ("Although a technical termination of the seller's employees may be deemed to have occurred when a sale becomes effective, WARN notice is only required where the employees, in fact, experience a covered employment loss."). The regulations explain, however, that this only extends WARN rights. See *id.*

202. See Ethan Lipsig & Keith R. Fentonmiller, *A WARN Act Road Map*, 16 LAB. LAW. 273, 300 (1996) [hereinafter Lipsig & Fentonmiller, *Road Map*]. But see *International Alliance*, 50 F.3d at 1470 (Ferguson, J., dissenting) (drawing distinction between sale of a business and sale of

For example, there is no clear explanation whether the sales exemption covers mergers, stock sales, or asset sales. If the exemption did apply, none of those types of business acquisitions would trigger either the buyer or the seller to notify the buyer's workforce of the business transaction.

In addition to clearly explaining that a sale of a business does not trigger potential WARN liability, the sale of business exemption provides the division of notice obligations between the predecessor and successor corporations in situations covered under WARN.²⁰³ The statute draws the line of notice obligations at the date of the sale of the predecessor business.²⁰⁴ Section 2101(b) states that until and including the date of sale, the predecessor corporation is responsible for providing notice of any plant closing or mass layoff that occurs or is to occur, and is financially responsible for any penalties acquired due to its failure to provide the required notice.²⁰⁵ Section 2101(b) further explains that after the date of sale, the buyer becomes responsible for providing notice of any plant closing or layoff, and is financially responsible for any penalties assessed for its failure to give the required notice.²⁰⁶ Thus, in the case of the sale of part or all of the business, section 2101(b)(1) defines who the "employer" is for purposes of WARN notification obligations.

Despite the clear division of responsibility between buyer and

the *assets* of the business). The dissent argued that, although the former does not implicate WARN notification requirements because of the statutory exemption, the latter does because the sale of assets does not usually involve a transfer of employees. *See id.* at 1470 (noting four exceptions where sale of assets would transfer seller's liability). Under the general rule that the seller retains all liabilities in an asset sale, the dissent argued that the employment loss would be "real" and not technical. *See id.*

203. For a description of the types of events that trigger WARN notification responsibility, see *supra* note 194, which defines "mass layoff," "plant closing," and employment termination.

204. Pursuant to the authority granted by Congress, the Department of Labor provided interpretive guidance for section 2101(b)(1). The regulation states:

(c) In the case of the sale of part or all of a business, section 2(b)(1) of WARN defines who the "employer" is. The seller is responsible for providing notice of any plant closing or mass layoff which takes place up to and including the effective date (time) of the sale, and the buyer is responsible for providing notice of any plant closing or mass layoff that takes place thereafter. Affected employees are always entitled to notice; at all times the employer is responsible for providing notice.

(1) If the seller is made aware of any definite plans on the part of the buyer to carry out a plant closing or mass layoff within 60 days of purchase, the seller may give notice to affected employees as an agent of the buyer, if so empowered. If the seller does not give notice, the buyer is, nevertheless, responsible to give notice. If the seller gives notice as the buyer's agent, the responsibility for notice still remains with the buyer.

29 C.F.R. § 639.4(c) (1996).

205. *See* Jerome B. Kairr & Dennis A. Lalli, *Problems Relating to Layoffs, Plant Closure, and Sales Transactions*, in *HANDLING CORPORATION EMPLOYMENT PROBLEMS* 1991, at 465, 475-76 (PLI Litig. & Admin. Practice Course Handbook Series No. 410, 1991).

206. *See id.*

seller, the statute is ambiguous on two points. First, the division of notice responsibilities in section 2101(b)(1) does not account for business transactions other than a traditional "sale of a business." For example, at least one case held that the division of notification responsibilities in section 2101(b)(1) did not apply to the buyer in an asset sale, because the buyer was never the "employer" of the predecessor's employees under the statute.²⁰⁷ In that case, *Oil, Chemical and Atomic Workers International Union v. CIT Group/Capital Equipment Financing, Inc.*, the United States District Court for the Southern District of Texas held that the duty to notify employees of a plant closing pursuant to an asset sale never transfers to the buyer, even if the plant closing occurs after the sale.²⁰⁸

The second ambiguity found in section 2101(b)(1) relates to the fact that neither the statute nor the legislative history provides the meaning of the phrase "up to and including the effective date of sale." As noted, section 2101(b)(1) requires sellers to give notice of any impending mass layoffs or closings that occur "up to and including the effective date of sale."²⁰⁹ Commentators have provided two interpretations of the meaning of this phrase. The first interpretation is that employees working for the seller through the close of business immediately prior to the actual effective date, who are terminated as a result of the sale, will be treated as employed by the buyer.²¹⁰ This approach, the "functional" interpretation, relieves sellers of any WARN responsibilities that stem from the sale, despite the fact that it is the seller that is terminating the employee prior to the actual effective date of the sale.²¹¹ The second interpretation is that only employees who technically remain employed by the buyer after the date of the sale, and who are subsequently terminated as a result of the sale, are treated as employed by the buyer.²¹²

207. See *Oil, Chem. and Atomic Workers Int'l Union v. CIT Group/Capital Equip. Fin., Inc.*, 898 F. Supp. 451, 456 (S.D. Tex. 1995).

208. See *id.* at 455-57. The court rejected both of the plaintiffs' arguments as to why the buyers should constitute the plaintiffs' employers following the asset purchase. First, the plaintiffs argued that because the defendant created the situation which resulted in the termination of the employment, they should be the plaintiffs' employers as a matter of law. See *id.* at 455. Following other precedent, the court emphasized that the employer is not the entity that ordered the shutdown, but instead is the entity that hired, fired, supervised, and paid the employees. See *id.* Next, the plaintiffs argued that section 2101(b)(1) mandated that the sellers' employees automatically became the buyer's responsibility at the time of the sale. See *id.* at 456. Relying on the language and purpose of § 2101(b)(1), the court rejected the plaintiffs' reading of section 2101(b)(1) and held that the notice provision imputes notice obligations for a covered employment loss upon buyers only when the sale entails the transfer of a company's total business and its employees. See *id.* at 457.

209. 29 U.S.C. § 2101(b)(1) (1994).

210. See Lipsig & Fentonmiller, *Road Map*, *supra* note 202, at 301.

211. See *id.*

212. See *id.*

This approach, the "formalistic" approach, relies on the literal language of the statute and construes the phrase the "effective date of the sale" to mean "the instant the sale occurs."²¹³ In light of the serious consequences that attach to both interpretations, companies should be wary of the statute's ambiguity on this issue.

B. *Successorship Doctrine and Labor-Related Liabilities*

Through a series of decisions over the past thirty years, the Supreme Court created the successorship doctrine, which effectively transfers certain labor-related obligations from the seller of a company to the buyer if the employees are represented by a union.²¹⁴ Successorship liability can involve an assortment of obligations, including the duty to bargain with the labor union representing the predecessor's employees,²¹⁵ the duty to arbitrate under the predecessor's collective bargaining agreement,²¹⁶ the duty to remedy the predecessor's unfair labor practices,²¹⁷ and the duty to remedy the predecessor's violations of the federal anti-discrimination laws. In light of these potential liabilities, the successorship doctrine has serious implications for companies negotiating mergers or sales of businesses. This section highlights the potential areas of successorship liability that corporate attorneys should consider prior to evaluating the worth of a particular business.

1. DETERMINING SUCCESSORSHIP

The threshold inquiry in determining whether a court will saddle buyer of a company with the predecessor company's labor-related liabilities is whether the buyer falls within the definition of a "successor" under the National Labor Relations Act ("NLRA"). The Supreme Court has explained that the question of whether a buyer qualifies as a successor is a question that must be answered on a case-by-case basis.²¹⁸ The

213. See *id.*

214. If the employees are not members of the union, the successorship doctrine does not apply. Instead, the traditional rules of at-will employment are applicable.

215. See *Fall River Dyeing & Finishing Corp. v. NLRB*, 482 U.S. 27 (1987); *NLRB v. Burns Int'l Sec. Serv., Inc.*, 406 U.S. 272 (1972).

216. See *John Wiley & Sons, Inc. v. Livingston*, 376 U.S. 543 (1964).

217. See *Golden State Bottling Co. V. NLRB*, 414 U.S. 168 (1973); *M&J Supply Co.*, 300 N.L.R.B. 444 (1990).

218. See *Fall River*, 482 U.S. at 43 (noting that determination should be based on totality of circumstances of a given situation); *Howard Johnson Co. v. Detroit Local Joint Exec. Bd.*, 417 U.S. 249, 262-63, 263 n.8 (1974). *Fall River* provides an example of the application of the totality of circumstances approach. In *Fall River*, the court found that the buyer was a successor for purposes of determining whether it was required to bargain with the union that represented the predecessor's former employees. See *Fall River*, 482, U.S. at 44-46. The Court found the following factors to be persuasive evidence of successorship: (1) the buyer acquired most of the predecessor's real property, machinery, equipment, inventory, and materials; (2) the buyer did not

Supreme Court has continuously focused its determination of successorship on whether there is a "substantial continuity" between the enterprises.²¹⁹ Under the "substantial continuity" approach, the National Labor Relations Board ("NLRB") must examine a number of factors, including the following: (1) whether the business of both employers is essentially the same; (2) whether the employees of the new company are doing the same jobs in the same working conditions under the same supervisors; and (3) whether the new entity has the same production process, produces the same products, and has the same customers.²²⁰ The most important factor is the continuity of the work force.²²¹

In conducting its analysis, the Court has instructed the NLRB to determine whether "substantial continuity" exists from the employees' perspective.²²² Thus, the NLRB must ascertain whether the employees believed their jobs were altered by the business transaction.

The Court has recognized that the purchaser is under no obligation to hire the predecessor's employees.²²³ Thus, the purchaser has some degree of control over whether it becomes a successor, provided that it does not refuse to hire the predecessor's employees solely to avoid successorship status.²²⁴ Nevertheless, if the successor plans to hire a substantial part of its predecessor's workforce, it should be ready to assume the obligations that the successorship doctrine imposes.

introduce a new product line; (3) employees' jobs did not change when buyer purchased seller; and (4) the record demonstrated that the buyer acquired the seller with the express purpose of utilizing the seller's work force. *See id.* at 44. The buyer pointed to the following factors and argued that it was not a successor of the seller: (1) the buyer purchased the seller's assets on the open market, therefore there were no prior dealings between the two entities; and (2) there was a seven-month hiatus between the end of the predecessor's and the commencement of the buyer's operation. *See id.* at 44 n.10, 45. The Court rejected both of these arguments. *See id.* Specifically, the Court explained that a hiatus between operations is only one factor in the substantial continuity analysis, and that the other factors pointed toward a finding of successor status. *See id.* at 45-46.

219. *See, e.g., Fall River*, 482 U.S. at 43-46 (applying "substantial continuity" test to determine if buyer was successor); *Burns*, 406 U.S. at 280.

220. *See Fall River*, 482 U.S. at 43.

221. *See id.*; *Nazareth Reg'l High Sch. v. NLRB*, 549 F.2d 873, 879 (2d Cir. 1977) ("The key factor in determining whether an employer succeeds to an obligation to bargain with the incumbent union is the substantial continuity in the identity of the work force.").

222. *See Fall River*, 482 U.S. at 43. The emphasis on the employees' perspective furthers the policy of industrial peace, which underlies the NLRA. *See id.*

223. *See Howard Johnson*, 417 U.S. at 261.

224. *See Fall River*, 482 U.S. at 40-41 ("[T]o a substantial extent, the applicability of *Burns* rests in the hands of the successor."). If an employer refuses to hire an employee because of the employee's union membership, the employer's actions constitute a violation of section 8(a)(3) of the NLRA. *See B. Glenn George, Successorship and the Duty to Bargain*, 63 NOTRE DAME L. REV. 277, 290-91 (1988) [hereinafter *George, Successorship*]. Remedies for such discriminatory actions include reinstatement with backpay. *See id.* at 291.

2. LABOR-RELATED DUTIES

a. The Duty to Arbitrate

Assuming that a buyer qualifies as a successor, it may have a duty to arbitrate the extent of its obligations to the seller's employees under the seller's unexpired collective bargaining agreement. For example, if the predecessor corporation no longer exists and the buyer completes a "wholesale transfer" of the predecessor's employees, an arbitrator may find that the successor has a duty to arbitrate disputes arising under the predecessor's collective bargaining agreement.²²⁵ Nevertheless, the Supreme Court has limited the successor's duty to arbitrate under the predecessor's collective bargaining agreement.²²⁶ First, the duty to arbitrate the issue of whether the buyer is obligated to abide by a successors and assigns clause in the predecessor's collective bargaining agreement does not extend to the buyer if the predecessor company remains a viable corporate entity.²²⁷ Thus, the Court created the possibility that predecessors may be held liable for a breach of a successors and assigns clause in a collective bargaining agreement, and narrowed the possibility

225. These facts were presented to the Supreme Court in its first successorship case, *John Wiley & Sons, Inc. v. Livingston*, 376 U.S. 543 (1964). *Wiley* involved the merger of a small publishing company with 40 union employees, into John Wiley & Sons, a company with 300 employees. *See id.* at 545. Wiley retained all of the employees from the original publishing company. *See id.* at 545-46. The predecessor corporation had negotiated a collective bargaining agreement with the employee's union, District 65, Retail, Wholesale and Department Store Union, ("District 65"). *See id.* at 544. After the merger, District 65 claimed that it continued to represent the employees and demanded various employee rights. *See id.* at 545. Wiley refused to recognize District 65's right to arbitrate claims under the earlier collective bargaining agreement. *See id.* at 545. The Supreme Court held that District 65 had a right to arbitrate claims with the successor company under the predecessor's collective bargaining agreement. *See id.* at 550-51. The Court reasoned that the duty to arbitrate under the predecessor's collective bargaining agreement was transferred to Wiley because there was "substantial continuity of identity in the business enterprise." *Id.* at 551.

226. *See George, Successorship*, *supra* note 224 at 278-79 (noting that duty to arbitrate extent of obligations occurs only in limited and unusual circumstances).

227. *See Howard Johnson*, 417 U.S. at 257-58. In *Howard Johnson*, the union brought a cause of action under § 301 of the NLRA seeking to compel Howard Johnson to arbitrate the extent of its obligation to honor the predecessor's collective bargaining agreement. *See id.* at 252-53. *Howard Johnson* involved an asset purchase arrangement, whereby Howard Johnson purchased a motor lodge through a lease arrangement and expressly refused to assume any labor obligations of the seller. *See id.* at 251-52. The collective bargaining agreement, however, contained a successorship clause binding the predecessors' successors and assigns to the terms of the agreement. *See id.* at 251.

The Court held that Howard Johnson was not a successor employer required to arbitrate under its predecessor's collective bargaining agreement. *See id.* at 256-57. The Court distinguished its decision in *Wiley* on two points. First, less than a majority of the predecessor's employees were hired by Howard Johnson. *See id.* at 259. Second, *Wiley* involved a merger in which the original employer disappeared after the merger, while *Howard Johnson* involved a partial sale of assets in which the original employer remained a viable corporate entity. *See id.* at 257-58.

of recovery against the successor for the breach of the agreement. Second, the Court has made it clear that a buyer cannot be bound by the substantive provisions of a collective bargaining agreement previously negotiated by a seller, the buyer did not agree to its terms or expressly assume its obligations.²²⁸ Thus, the NLRB has no power to bind the successor to the provisions of the collective bargaining agreement unless the successor voluntarily assumes the contract.

b. The Duty to Bargain

In *NLRB v. Burns International Services, Inc.*, the Court held that if the buyer is deemed a successor, it has a duty to negotiate with the union representative of the former employees of the predecessor corporation.²²⁹ The factor that triggers the successor's bargaining obligations is the composition of the successor's work force. The duty to bargain with

228. See *NLRB v. Burns Int'l Sec. Serv., Inc.*, 406 U.S. 272, 284 (1972). In *Burns*, Burns replaced Wackenhut as Lockheed Aircraft's security firm. See *id.* at 274. Unlike the factual scenario presented in *Wiley*, no contractual relationship existed between Wackenhut and Burns, and no merger or sale of assets occurred. See *id.* The Court held that Burns was not bound by the substantive provisions of a collective bargaining agreement because such an imposition would chill corporate transactions. See *id.* at 287-88.

229. See *id.* at 281. The Supreme Court decided two cases with respect to the successor's duty to bargain with the predecessor's employees' union. See *Fall River*, 482 U.S. at 27; *Burns*, 406 U.S. at 272. In *Burns*, the predecessor's employees were represented by the United Plant Guard Workers of America ("UPGW") under a collective bargaining agreement. See *Burns*, 406 U.S. at 274. The change of ownership occurred during a certification period, a time in which the union's majority status is irrebuttable. See *id.* at 274-75. When Burns gained control, however, it failed to recognize UPGW as the representative union of the predecessor's workers. See *id.* at 274. The Court held that the successor's rejection of UPGW was improper and explained that "where the bargaining unit remains unchanged and a majority of the employees hired by the new employer are represented by a recently certified bargaining agent there is little basis for faulting the [NLRB's] . . . ordering the employer to bargain with the incumbent union." *Id.* at 281. In 1987, the Supreme Court returned to the question of the duty to bargain with the predecessor's union in *Fall River*. In *Fall River*, seven months after the predecessor ceased operations due to financial difficulties, Fall River purchased the equipment and inventory of the predecessor at a creditor's auction. See *Fall River*, 482 U.S. at 32. In September 1982, Fall River began operating out of its predecessor's former facilities. See *id.* at 32. Fall River's initial hiring goal was to attain one full shift of workers. See *id.* at 33. After it met this initial goal, the company planned to expand to two shifts, if expansion was feasible. See *id.* By mid-January 1983, it had hired one shift of workers and, by mid-April 1983, it had hired two full shifts. See *id.* Meanwhile, in October 1982, the union requested that Fall River recognize it as the bargaining agent for those current employees that were once the predecessor's employees. See *id.* at 33. When Fall River refused the union's demand, the union filed an unfair labor practice charge. See *id.* at 34. After hearing the case, the administrative law judge held that Fall River was a successor and that its duty to bargain arose in mid-January when it "attained a representative complement" of its predecessor's employees. See *id.* at 34. The NLRB affirmed. See *id.* at 35.

The Supreme Court agreed with the administrative law judge and the NLRB holding that: (1) the successor's duty to bargain is not limited to situations where the predecessor's union was recently certified; (2) Fall River was a successor; and (3) the duty to bargain arises when a substantial and "representative complement" of employees is attained. See *id.* at 40, 46, 52.

the predecessor's union representative arises when the majority of the employees hired by the new employer were employees of the seller.²³⁰

The Court also addressed the issue of when the buyer's work force should be measured to determine if a majority of its work force is derived from the predecessor entity. In *Fall River*, the Court approved the test utilized by the NLRB, which required that the determination be made when the successor attained "a substantial and representative complement" of employees.²³¹ Under this approach, the NLRB examines a number of factors, including the following: (1) whether the job classifications designated for the operation were filled or substantially filled; (2) whether the operation was in normal or substantially normal production; (3) the size of the staff on the date of measurement; (4) the time expected to elapse before a substantially larger complement would be at work; and (5) the relative certainty of the employer's expected expansion.²³²

The successor's duty to bargain at the "substantial and representative complement" date is triggered only when the union has made a bargaining demand.²³³ Under this rule, if a union makes a premature demand that the employer rejects, the demand remains in place until the moment when the employer reaches its "substantial and representative complement" status.²³⁴

Until the duty to bargain is triggered, the Court has made it clear that the buyer is free to alter the terms of employment of its newly acquired employees.²³⁵ Thus, in a certain sense, the duty to bargain is a

230. See *Fall River*, 482 U.S. at 46; *Burns*, 406 U.S. at 278-79. The requirement of majority status rests on the underlying principle embodied in the NLRA—the democratic principle of majority rule. See George, *supra* note 224, at 298. The rule that the successor has a duty to bargain with the union representing predecessor's employees stems from the principle that a union elected for more than one year has a rebuttable presumption of majority status that does not cease at the transfer of the ownership of a business. See *Fall River*, 482 U.S. at 37. Nevertheless, the employer can overcome this presumption if it has objective and reasonable bases for a good faith doubt about the union's continuing majority support. See *id.* at 40 n.8.

231. See *Fall River*, 482 U.S. at 49.

232. See *id.*

233. See *id.* at 52.

234. See *id.* This is referred to as the "continuing demand" rule. *Id.*; see also George, *Successorship*, *supra* note 224, at 296. Professor George explains that under the continuing demand rule, the employer can comply with its duty to bargain once it has determined that the requisite complement has been reached. To comply, the employer should determine whether the union has made a demand for bargaining. See *id.* at 296-97. If so, the duty is triggered. See *id.*; *Fall River*, 482 U.S. at 52-53.

235. See George, *Successorship*, *supra* note 224, at 295; see also Leslie Braginsky, Comment, *How Changes in Employer Identity Affect Employment Continuity: A Comparison of the United States and the United Kingdom*, 16 COMP. LAB. L.J. 231, 238 (1995) [hereinafter Braginsky, *Employer Identity*] (noting that the successor employer "has a window of opportunity within which to change the conditions of employment").

much more limited constraint on the transfer of capital than the duty to arbitrate. Because the duty to bargain depends on whether the new employer hires the requisite amount of employees, the employer can avoid the duty to bargain by not hiring the predecessor's employees. Nevertheless, the employer is required to consult with the predecessor employee's union representative if it is clear that the successor is going to retain all of the employees in the bargaining unit.²³⁶

c. Liability for Predecessor's Unfair Labor Practices

In *Golden State Bottling Co. v. NLRB*,²³⁷ the Supreme Court held that a successor corporation may be liable for its predecessor corporation's unfair labor practices.²³⁸ According to the Court's decision in *Golden State*, a purchaser could be liable as a successor for the back pay due to the employee if it acquired the predecessor with full knowledge of a prior NLRB order requiring reinstatement and back pay. It is irrelevant for purposes of this rule that the successor did not commit any unfair labor practices.²³⁹

As a result of the Court's decision in *Golden State*, the NLRB has required successor corporations to take various steps to remedy the predecessor's unfair labor practices. Examples include, but are not limited to, requiring the successor company to: (1) offer immediate reinstatement to employees without regard to any hardship such a requirement might place on the employer; (2) pay back pay from the date of the discharge by the predecessor to the date of reinstatement; (3) post cease and desist notices barring the predecessors' unlawful interrogations of pro-union employers; and (4) accord recognition to their predecessor's union to remedy the predecessor's previous unlawful withdrawals of recognition.²⁴⁰

d. Liability for Civil Rights Violations of Predecessor Entity

Several courts and the NLRB have extended the Supreme Court's reasoning in *Golden State* to impose liability upon a successor corporation for the predecessor's discriminatory practices under various federal

236. See Braginsky, *Employer Identity*, *supra* note 235, at 238.

237. 414 U.S. 168 (1973).

238. See *id.* at 186-87.

239. See *id.* at 184-85. The Court applied the successorship doctrine and concluded that it should not be narrowly construed in a situation where the successor had knowledge of the prior litigation and NLRB order. See *id.* at 182 n.5.

240. See William H. DuRoss, III, *Increasing the Labor-Related Costs of Business Transfers and Acquisitions: The Spectre of Per Se Liability for New Owners*, 67 WASH. U. L.Q. 375, 398-99 (1989).

antidiscrimination statutes.²⁴¹ Thus, successor entities are required to bear the burden of remedying the predecessor's past actions, if the successor employer had notice of the Equal Employment Opportunity Commission ("EEOC") charge filed against the predecessor company prior to the transfer of ownership.

The first case to apply the successorship doctrine to remedy past violations of the federal antidiscrimination laws was *EEOC v. MacMillan Bloedel Containers, Inc.*²⁴² The Court of Appeals for the Sixth Circuit developed a test to determine whether the new owner should be liable for the predecessor's Title VII violation.²⁴³ The factors included the following: (1) whether the successor company had notice of the charge; (2) the ability of the predecessor to provide relief; and (3) whether there had been a substantial continuity of business operations.²⁴⁴

No one factor is controlling, thus the reviewing court should look at each factor and balance the interests of the plaintiff and the national policy of abhorrence toward employment discrimination against the interest of the successor company.²⁴⁵ Nevertheless, without notice of

241. See, e.g., *EEOC v. MacMillan Bloedel Containers*, 503 F.2d 1086 (6th Cir. 1974).

242. In *MacMillan*, the Sixth Circuit applied the successorship doctrine and held that the successor corporation was required to remedy the predecessor's violation of Title VII. See *id.* at 1090.

243. See *id.* at 1089-93.

244. See *id.* at 1094 (citing *Howard Johnson Co. v. Detroit Local Joint Executive Bd.*, 417 U.S. 249, 256-58 (1974)); see also *Rojas v. TK Communications Inc.*, 87 F.3d 745, 750 (5th Cir. 1996) (finding successor not liable for predecessor's civil rights violation despite the fact that it had notice, because predecessor was a viable entity, plaintiff rejected successor's offer of reinstatement, and plaintiff did not pursue reinstatement claim); *EEOC v. G-K-G, Inc.*, 39 F.3d 740, 748 (7th Cir. 1994) (allowing plaintiff to pursue age discrimination claim against successor because successor had notice of EEOC charge prior to purchase and there was substantial continuity of enterprises); *EEOC v. Vucitech*, 842 F.2d 936, 946 (7th Cir. 1988); *Wheeler v. Snyder Buick, Inc.*, 794 F.2d 1228, 1236 (7th Cir. 1986) (finding that successorship liability is appropriate when (1) successor has notice of violation; (2) there was a substantial continuity of enterprises; (3) predecessor could not provide relief to employee); *Bates v. Pacific Maritime Ass'n.*, 744 F.2d 705, 709-10 (9th Cir. 1984) (same).

The *MacMillan* court also listed the following factors: (1) whether the buyer uses the same plant; (2) whether the buyer uses the same or substantially the same work force; (3) whether the buyer uses the same or substantially the same supervisory personnel; (4) whether the same jobs exist under the substantially same working conditions; (5) whether the buyer uses the same machinery, equipment and production methods; and (6) whether the buyer produces the same product. See *MacMillan*, 503 U.S. at 1094; see also *Brown v. Evening News Ass'n.*, 473 F. Supp. 1242, 1244-45 (E.D. Mich. 1979).

245. The primary concern in imputing liability under the successorship doctrine is to provide full relief to the plaintiff. See *MacMillan*, 503 U.S. at 1092. Courts have reached different conclusions with respect to whether the requirement of full relief compels non-monetary relief even if monetary relief may be sought from the predecessor because it remains a viable entity. Compare *Brown*, 473 F. Supp. at 1247 (not requiring successor corporation to remedy past violation with reinstatement, where predecessor could provide both monetary and non-monetary relief) with *Howard v. Penn. Central Transp. Co.* 87 F.R.D. 342, 349 (N.D. Ohio 1980) (finding

the predecessor's violation prior to the business acquisition or merger, courts have been unwilling to impute liability to the successor corporation.²⁴⁶

Several courts have followed the Sixth Circuit's decision in *MacMillan*.²⁴⁷ Since *MacMillan*, courts have applied the successorship doctrine and held successor corporations liable for their predecessor's violations of Title VII, the Equal Pay Act, the Age Discrimination in Employment Act, the Pregnancy Discrimination Act, and the Civil Rights Act of 1866.

Successor liability in the civil rights context translates into various obligations, including, but not limited to, the following: the payment of money damages and attorney's fees for the predecessor's violation of the federal antidiscrimination laws, immediate reinstatement for employees improperly terminated by the seller, compliance with injunctions and consent decrees issued against the seller, and continuance of the seller's pension and welfare contributions and medical benefits compensation. In light of the potential remedies available to plaintiffs, a predecessor should insist that the sales or merger agreement provides for its nonli-

that successor could be liable to plaintiff because absent its liability, plaintiff could not be reinstated in the position he would have had absent the discrimination, even though predecessor could provide different job and monetary relief). In addition, courts are much less willing to impute liability onto a successor corporation where the predecessor remains a viable entity. *See Rojas*, 87 F.3d at 750 (not holding successor liable for predecessor's civil rights violations, where predecessor operated other viable entities and could supply plaintiff with full relief); *Musikiwamba v. Essi, Inc.*, 760 F.2d 740, 750-51 (7th Cir. 1985) (suggesting that it is improper to hold successor liable for civil rights violation if predecessor could not provide relief prior to the transfer of ownership of the business because imposition would impede free flow of capital); *Kolosky v. Anchor Hocking Corp.*, 585 F. Supp. 746, 750 (W.D. Pa. 1983) (allowing joinder of successor corporation, but noting that successor corporation should only be liable if predecessor cannot provide full relief, reinstatement). *But see Bates*, 744 F.2d at 710-11 (allowing relief against successor despite existence of predecessor entity, holding that fact that predecessor entity was still viable was less important because plaintiffs sought class-wide relief).

246. *See Chicago Truck Drivers v. Tasemkin, Inc.*, 59 F.3d 48, 49 (7th Cir. 1995) (recognizing notice requirement); *Rabidue v. Osceola Refining Co.*, 805 F.2d 611, 616 (6th Cir. 1986) (holding that successor was not liable unless the successor knew about a filed or pending discrimination charge prior to date of purchase); *Dominguez v. Hotel, Motel, Restaurant & Miscellaneous Bartenders Union, Local 64*, 674 F.2d 732, 733 (8th Cir. 1982) (holding that insufficient evidence of the successor's knowledge about pending discrimination charge precluded imposition of liability); *Burt v. Ramada Inn*, 507 F. Supp. 336, 338 (N.D. Miss. 1980) (holding that new owner of motel was not liable to former maintenance person for Title VII race discrimination claim because new owner had no knowledge of EEOC right to sue letter); *Howard*, 87 F.R.D. at 349 (holding that successor company could be liable to plaintiff for nonmonetary relief to remedy Title VII and section 1981 discrimination, even though predecessor was in position to provide monetary relief in light of the fact that predecessor was still an ongoing entity).

247. *See, e.g., Bates*, 744 F.2d at 710; *Trujillo v. Longhorn Mfg. Co.*, 694 F.2d 221, 224-25 (10th Cir. 1982) (holding successor corporation liable for the predecessor's Title VII violation, where there was substantial continuity of the business operations, successor had notice of EEOC complaint and could have provided for nonliability in the sale agreement, and equities balanced in favor of doctrine's application).

bility or indemnification for liability incurred as a result of the predecessor's Title VII violation.²⁴⁸ While the existence of a nonliability or indemnification clause does not relieve the successor from liability against the discriminatee, it may provide for a cause of action against the predecessor.²⁴⁹

C. Assignability of Individual Employment Agreements and Covenants Not to Compete

The issue of whether a successor company may enforce an employment contract or a covenant not to compete executed by its predecessor and one of its employees is a matter of state law. Jurisdictions have resolved the matter by taking various approaches to the question. The general rule appears to be that a valid covenant not to compete made by the seller of a business is transferrable to the buyer and, thus, is enforceable by a transferee.²⁵⁰ Several cases have adhered to this view where the business transaction was a merger or stock transfer, rather than an asset sale.²⁵¹ Conversely, several jurisdictions have found that cove-

248. See *Trujillo*, 694 F.2d at 225 (noting that successor could have avoided liability by providing for nonliability or indemnification in sales agreement).

249. See *Kolosky*, 585 F. Supp. at 748 (finding that sales agreement providing for nonliability will not shield successor from liability for predecessor's Title VII violation); *Brown*, 473 F. Supp. at 1245 n.1 (rejecting defendant's argument that nonliability and indemnification clause shields defendant from successorship liability).

250. For an excellent example of the application of this rule, see *A. Fink & Sons, Inc. v. Goldberg*, 139 A. 408, 409-10 (N.J. Ch. 1927); see also *Hexacomb Corp. v. GTW Enters., Inc.*, 875 F. Supp. 457, 465 (N.D. Ill. 1993) (noting that Illinois courts have recognized the assignability of confidentiality and non-compete agreements) (citing *Hamer Holding Group, Inc. v. Elmore*, 560 N.E.2d 907, 917 (Ill.App. Ct. 1990)); *Abalene Pest Control Serv., Inc. v. Powell*, 176 N.Y.S.2d 6 (Sup. Ct. 1958), *aff'd*, 187 N.Y.S.2d 381 (App. Div. 1959); *Norman Ellis Corp. v. Lippus*, 176 N.Y.S.2d 5 (Sup. Ct. 1955).

251. In transactions where the identity of the employing entity is not regarded as having changed, courts have reasoned that there is no "assignment" of the employment contract for the employee to contest. See, e.g., *Alexander & Alexander, Inc. v. Koelz*, 722 S.W.2d 311 (Mo. Ct. App. 1986) (finding that a mere change in form of employer's business resulting from a merger did not cause assignment such that surviving corporation was precluded from enforcing employment covenants); *Nenow v. L.C. Cassidy & Son of Fla., Inc.*, 141 So. 2d 636, 638 (Fla. 3d DCA 1962) (holding that covenant not to compete was assignable where assignee was subsidiary of the assignor, because "[i]nsofar as [the employee] was concerned, this was an exchange of stock for assets, the parties remaining the same"); *Haldor, Inc. v. Beebe*, 164 P.2d 568, 572 (Cal. Dist. Ct. App. 1945) (holding that assignment does not occur where ownership, control, or management does not change, and that where a technical assignment occurs, but there was no actual substitution of parties, new entity can enforce contract); cf. *Alldredge v. Twenty-Five Thirty-Two Broadway Corp.*, 509 S.W.2d 744 (Mo. Ct. App. 1974) (holding that covenant not to compete was not binding upon successor corporation, where contract contained no provision for assignability and transaction involved sale of business).

A related problem arises when the predecessor/covenantee changes business form. Courts have allowed the new entity to enforce the covenants entered into by the earlier business entity. See, e.g., *Rogers v. Runfola & Assoc., Inc.*, 565 N.E.2d 540, 543 (Ohio 1991) (holding that covenant not to compete with sole proprietorship was transferrable to corporation transformed

nants contained in individual employment contracts were not enforceable by successor entities, relying on the principle that an employment contract is a personal service contract, which is not assignable.²⁵²

Despite support for this more restrictive approach, courts have adopted several rationales to permit a successor entity to enforce a restrictive covenant against a former employee of the predecessor company. First, even jurisdictions taking the view that personal service contracts are not assignable recognize that an express condition in an employment contract, providing for assignment by the use of terms like "assigns" or "successors," allows the successor corporation to enforce an otherwise unenforceable covenant.²⁵³ Florida is an example of a jurisdiction taking this approach. Florida courts follow the general rule that personal service contracts are not assignable.²⁵⁴ Nevertheless, in *Pino v. Spanish Broadcasting System of Florida, Inc.*,²⁵⁵ a Florida court held that a covenant not to compete was assignable, provided that the covenantor consented in writing to its assignability.²⁵⁶

Second, at least one Florida court has characterized a covenant not to compete as a non-traditional personal service contract that was assign-

from sole proprietorship, because, inter alia, change in legal structure of business did not change business itself); *Seligman & Latz of Pittsburgh, Inc. v. Vernillo*, 114 A.2d 672 (Pa. 1955) (holding that corporation that succeeded partnership could enforce employment contracts of partnership's employees because the fact of incorporation did not affect the employees' obligations to honor covenants).

252. See, e.g., *Smith, Bell & Hauck, Inc. v. Cullins*, 183 A2d 528 (Vt. 1962); *Sisco v. Empiregas, Inc.*, 237 So. 2d 463, 467 (Ala. 1970).

253. See, e.g., *Mail-Well Envelope Co. v. Saley*, 497 P.2d 364, 368 (Or. 1972) (holding that clause stating that "the provisions of this contract shall extend to the successors, and assigns of the Employer" permitted successor's enforcement of restrictive covenant).

254. See *Schweiger v. Hoch*, 223 So. 2d 557, 558 (Fla. 4th DCA 1969) ("Florida is committed to the general law that contracts for personal services, or those involving a relationship of personal confidence, are not assignable by either party unless the contract so provides, or unless the other party consents thereto or ratifies the assignment."); *Orlando Orange Groves Co. v. Hale*, 161 So. 284, 290 (Fla. 1935).

255. 564 So. 2d 186 (Fla. 3d DCA 1990).

256. See *id.* at 188. The employee entered into an employment contract that contained a covenant not to compete for a one-year period following the employee's termination of employment with the covenantor. See *id.* at 187. The contract also provided that it was "transferable or assignable by the [employer] and shall be binding upon and inure to the benefit of the [employer's] successors or assigns." *Id.* Shortly thereafter, the employer sold its assets to another company, and, as part of the sale, the employee's contract was assigned to the successor. See *id.* The court affirmed the trial court's order granting a temporary injunction to enforce the non-competition agreement. See *id.* at 189. First, it recognized that personal service contracts are assignable by consent of the parties. See *id.* at 188. Then the court rejected the plaintiff's argument that Florida's statute allowing parties to enter into restrictive covenants prevented the plaintiff assignor from enforcing the covenant. See *id.* The court found that statute did not expressly prohibit the right to assign personal service contracts containing covenants not to compete. See *id.*

able. In *In re Hearing Centers of America, Inc.*,²⁵⁷ the court noted that the employment contracts were not personal service contracts under the traditional definition, because the contracts contained covenants barring employees from performing, rather than assigning the performance of a personal service.²⁵⁸

Third, courts have recognized that a successor may be able to enforce a restrictive covenant entered into by its predecessor if the employee's conduct manifested his or her assent to, or ratification of, the prior assignment of the covenant not to compete.²⁵⁹ To permit assignment under this principle, however, courts have required proof that the predecessor assigned the employment contract to its successor and the employee knew the contract had been assigned.²⁶⁰ Florida adheres to this position. Under Florida law, however, the employee's continued employment with the successor does not, in itself, prove that the parties intended for the original contract to be assigned or that the assignment was consented to or ratified by the employee.²⁶¹ The employer must prove some additional conduct by the employee that shows his or her approval of the assignment of the employment contract.²⁶²

V. INTELLECTUAL PROPERTY ISSUES IN MERGER AND ACQUISITION

The acquisition of a business that owns or licenses patents, trademarks, copyrights, or trade secrets (the "Business") should always be preceded by an evaluation of its intellectual property rights, including a clear understanding of the nature and extent of the intellectual property rights that will be acquired. Without such an evaluation, the buyer could overestimate the value of the intellectual property. Moreover, without a clear understanding of all limitations placed upon the intellectual property rights of the Business, the buyer might inadvertently engage in conduct that exceeds the scope of the intellectual property rights obtained, thereby exposing the buyer to unexpected liability.

A buyer should take the following four major steps when acquiring the Business: (1) evaluate the intellectual property rights of the Business through a "due diligence" investigation; (2) correct any defects in

257. 106 B.R. 719 (M.D. Fla. 1989).

258. *See id.* at 721-22; *see also* A. Fink & Sons, Inc. v. Goldberg, 139 A. 408, 410 (N.J. Ch. 1927).

259. *See, e.g.,* Green's Dairy, Inc. v. Chilcoat, 89 Pa. D. & C. 351, 353 (York County 1953) (ratifying assignment of employment contract with noncompete clause); Jack Tratenberg, Inc. v. Komoroff, 87 Pa. D. & C. 1, 13 (Philadelphia County 1951) (finding that defendant's knowledge of his employer's incorporation and his failure to leave plaintiff's employ or object constituted assent to assignment of employment contract).

260. *See Schweiger*, 223 So. 2d at 558.

261. *See id.* at 559.

262. *See id.*

the intellectual property prior to closing; (3) obtain valid title; and (4) perfect that title. A party obtaining a security interest in intellectual property should take similar steps to ensure that it has an accurate estimate of the value of the collateral.²⁶³

A. *Due Diligence Investigation*

Although the due diligence investigation will vary depending on the circumstances of each proposed transaction, it will generally include reviewing the following: (1) pertinent documents provided by the Business (e.g., application files, licenses, litigation files, and nondisclosure agreements); (2) certain types of public information (e.g., the records of U.S. and foreign patent, trademark and copyright offices, and state records of Uniform Commercial Code financing statements); and (3) certain specialized information sources (e.g., trademark clearance search databases). As part of this investigation, the buyer should ask the Business to disclose the existence of actual or potential infringement suits, administrative challenges, and pending litigation concerning the intellectual property of the Business.

During the due diligence review, the buyer should be attuned to many issues, especially the following: (1) common law (i.e., unregistered) trademarks and the scope of the geographic area in which common law protection is available for those marks; (2) intellectual property rights that may have been abandoned (e.g., through non-use of a trademark), or registrations or patents that may have expired or been canceled; (3) defects in the record title to the intellectual property rights to be acquired; (4) "intent-to-use" applications for U.S. or foreign trademark registration; (5) potential threats to the validity or enforceability of the relevant patents; (6) inventions for which patent applications need to be filed to avoid losing the possibility of obtaining patent protection; (7) trade secrets of the Business and whether such are adequately protected by confidentiality agreements and covenants against competition; (8) actual or potential litigation; (9) restrictions or expanding the use of the intellectual property that will be acquired; (10) intellectual property licenses and their effect, if any, on the transaction; and (11) any encumbrances (e.g., security interests, collateral assignments and conditional assignments) on the Business' intellectual property.

B. *Correction of Intellectual Property Defects Prior to Acquisition*

If time permits, the buyer should attempt to correct any defects

263. For simplicity, this Article only refers to the buyer of the Business. There are additional issues that a creditor obtaining a security interest in intellectual property collateral should address.

found in the intellectual property of the Business before consummating the transaction. Although it may be possible to correct such defects subsequent to the closing of the transaction, it is more efficient to do so before the closing. In addition, because titles to patents, trademark registrations, and copyright registrations are frequently in an affiliate of the Business, the buyer should require that record title for all such intellectual property be transferred to the Business. Otherwise, the task of documenting valid title will be more difficult.

C. Transferring Valid Title

The buyer should ensure that the intellectual property rights of the Business are properly transferred and obtain representations and warranties concerning the nature and extent of those rights.

Several considerations are unique to intellectual property assignments and should, therefore, be taken into account to ensure that a valid assignment of those intellectual property rights will be acceptable for recording at the U.S. Patent and Trademark Office, the U.S. Copyright Office, and their foreign counterparts. These considerations include a recitation that the goodwill associated with trademarks and service marks is transferred with the marks and that the intellectual property is identified by the corresponding registration, patent, or application serial number. Finally, if it is desirable to avoid public disclosure of the acquisition agreement, a separate assignment document should be prepared for recording in government offices to cover only the intellectual property facet of the transaction.

D. Updating Record Title

Recording transfers of intellectual property is important to provide protection against subsequent purchasers of the intellectual property from the Business and to evidence ownership of the intellectual property if an infringement action becomes necessary. Depending on the nature of the intellectual property, the type of document required and the location in which it should be recorded will vary. For example, assignments of U.S. patents should be recorded at the U.S. Patent and Trademark Office ("PTO"), while trademark security interest documents should be recorded at both the PTO and state Uniform Commercial Code filing locations. Documents affecting title to patents, registered trademarks, trademark applications, or registered copyrights should be recorded promptly to ensure validity of the transfer against a subsequent bona fide purchaser. Transfers of patents, registered trademarks, and trademark applications will be valid against a subsequent bona fide purchaser only if they are recorded at the PTO within three months of the date of execu-

tion or prior to the subsequent purchase. For a document affecting title to a registered copyright to be valid against a subsequent bona fide purchaser, it ordinarily must be recorded with the U.S. Copyright Office within one month of execution or prior to the recordation of the subsequent transfer.

Moreover, if foreign intellectual property rights are involved, the buyer should anticipate what documents it will need to file with foreign patent, trademark, and copyright offices, and have them executed at the closing so that foreign counsel can update record title more efficiently.