$1.50 VOL. 34 NO. 38 www.ocbj.com SEPTEMBER 19-25, 2011

ORANGE COUNTY BUSINESS JOURNAL

Buyer Beware

Creditor claims in asset purchases

by James J. Scheinkman, Esq., Partner, Snell & Wilmer L.L.P.

The Old "New Normal"

As our slow growth – or no growth – economy continues into its fourth year, business owners and executives continue to adjust to current economic realties. To paraphrase John F. Kennedy, a stagnant tide will strand some boats, and businesses unable to grow their top line in a challenging environment and control their operating costs will founder. Of course, such a state of affairs creates opportunities for better-positioned companies to acquire weaker brethren in order to expand market share, vertically integrate their business or create other opportunities. While adjustments by businesses and business consolidation in these times of economic malaise may be the "new normal," there are still old rules governing successor liability of acquirers for the debts of their predecessors. In fact, due to a more challenging economic environment, there may be an increased risk that unpaid creditors of struggling acquired companies will seek recourse against better-heeled acquirers. The result is the need for buyers to be ever vigilant in their acquisition approach.

Exceptions Which May Swallow the Rule

The general rule is that the purchaser of a company's assets paying fair consideration is not responsible for the seller's liabilities, absent an express or implied agreement to the contrary. For this reason, purchasers frequently prefer to structure acquisitions by asset purchase as compared to a purchase of the target's capital stock or equity or a merger. However, structuring a transaction as an asset sale may not be sufficient in and of itself to resolve creditor claim concerns. There are numerous exceptions to this general rule which may result in the barrier to liability for creditor claims through an asset purchase resembling a slice of Swiss cheese.

The risk of exposure to creditor claims exists because courts and legislatures have determined that public policy requires that the interests of third party creditors who are not at the negotiating table with the buyer and seller be protected in certain instances. The easier and obvious cases are those in which it is apparent the buyer and seller have shown little regard for the interests of creditors, or the buyer has not paid fair consideration for the business being purchased. For example, under the "*de facto merger*" doctrine, buyers can be held liable for all of a seller's liabilities in situations where assets are transferred by a seller without consideration available to satisfy creditor claims or the consideration paid consists solely of the acquirer's capital stock which is distributed only to the seller's shareholders. Further, under both state fraudulent transfer statutes and the federal Bankruptcy Code, a buyer may have liability to the extent that an insolvent seller does not receive fair consideration in exchange for its assets.

On the other hand, paying a fair purchase price does not grant a buyer absolution from creditor responsibilities. For example, in a landmark 1977 decision, *Ray v. Alad Corp.*, the California Supreme Court held a successor company strictly liable for injuries caused by defective products manufactured and sold by a predecessor on account of the plaintiff's remedies against the original manufacturer having virtually disappeared by virtue of the acquisition, the buyer's ability to assume the original manufacturer's "risk-spreading" role, and the fairness of requiring the successor to assume the responsibility for defective products related to the seller's original goodwill acquired by the buyer in the continued operation of the business. Under this product line doctrine, in one case, *Rosales v. Thermex-Thermatron,* the buyer was held liable for defects in a product manufactured by its predecessor 24 years earlier!

Another example in which successor liability has been imposed is under federal employment law. In order to protect important employment-related policies, federal courts have developed a successor liability doctrine imposing liability in a manner well beyond the confines of traditional common law rules. Under this line of cases, liability has been imposed on a buyer for delinquent benefit plan contributions, as recently done by the U.S. Court of Appeals for the Third Circuit in *Einhorn v. M. L. Ruberton Construction*. The doctrine has also been used in other areas such as unfair labor practice claims, consent decrees in racial Title VII claims and gender discrimination claims. In these cases, the courts have held that liability attaches when the subsequent employer was a bona fide successor and had notice of the potential liability prior to the acquisition, and the seller is no longer able to provide adequate relief directly.

Successor liability under the product line exception and in federal employment cases are only a few examples. There are other poten-

James J. Scheinkman

James J. Scheinkman is a partner in the Orange County office of Snell & Wilmer L.L.P. and leads the firm's Business & Finance Group in California. His practice regularly involves counseling companies involved in M&A transactions and representing companies and shareholders in shareholder disputes. He can be reached at jscheinkman@swlaw.com or 714.427.7037.

$1.50 VOL. 34 NO. 38 www.ocbj.com SEPTEMBER 19-25, 2011

ORANGE COUNTY BUSINESS JOURNAL

tial areas of exposure created by a myriad of statutes. Consider the hazards of environmental liability under CERCLA (Comprehensive Environmental Response, Compensation, and Liability Act) and related environmental statutes, as well as liability to the government for such items as sales tax or unemployment insurance. Moreover, for certain acquisitions, liability may also arise to creditors under state bulk sales acts if the requisite notice has not been published or given in advance of sale.

Conclusion

"Diligence is the mother of good fortune" – Benjamin Disraeli

Certainly, structuring an acquisition as a purchase of assets is a valuable means to help limit liability. However, as with a stock purchase transaction or a merger, there is no substitute for extensive due diligence prior to sale. Identifying potential avenues of exposure in advance of the purchase affords buyers the ability to negotiate or create various protections to ensure they do not inadvertently overpay for a business due to the assertion of creditor claims. Such mechanisms may include escrow or hold-back provisions, set-off rights on deferred payments or third party insurance. In cases in which the exposure to unpaid creditor claims is more significant, the parties may want to consider alternatives such as having the seller sell the assets pursuant to a Bankruptcy Code Section 363 sale process or through an assignment for the benefit of creditors proceeding. Through diligence and analysis of creditor issues in advance of closing the deal, buyers are much more likely to attain the desired results from their acquisitions for the price they intended to pay.