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Acredula

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Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

Survey of Acredula Readership

Editor's Note

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Acredula plans to survey you, our readership, on your perception of the advantages or disadvantages of strategic alliances versus traditional mergers and acquisitions.

The lead article in the May 21, 2001 issue of *Forbes* was entitled "Partner or Perish!" The premise of not only that article, but the entire issue, is that businesses today are finding joint ventures, joint development agreements, distribution agreements, and other forms of strategic alliances "a more productive way to keep companies going than the traditional merger or acquisition."

The *Forbes* lead article cites Coca-Cola's abandonment of a traditional merger/ acquisition strategy after its failed attempt to acquire Quaker Oats. Instead, Coke "went back to the drawing board" and redirected its efforts to enter into a 50-50 joint venture with Procter & Gamble. This joint venture gives Coke access to drink and snack brands like Hi-C, Fruitopia and Pringles that will allow Coke to compete with Pepsi's snack and non-carbonated beverages.

Since that issue of *Forbes*, the failure of the proposed mergers of General Electric and Honeywell and of United Airlines and US Air have resulted in the traditional merger or acquisition being referred to as too much of "a blood sport," while strategic alliances are referred to by commentators as more of a "win-win" because they focus more on collaboration and the sharing of competencies. Thomson Financial reports that the dollar volume of strategic alliance transactions doubled in the year 2000 from 1996 to nearly the same dollar volume as mergers and acquisitions transactions in the United States.

Acredula will begin exploring strategic alliances with our September 2001 issue. As part of this exploration, *Acredula* will be surveying our readership over the next several weeks to test whether the premise of the *Forbes* article and the speculation of commentators is true. The results of the survey will be the focus of the October 4-5, 2001 "Building a Better Board Conference" at The Ohio State University Fisher College of Business. *Acredula* will report the results in our October 2001 issue. Although the results will be published, your individual responses to the survey will be treated confidentially.

This month's issue of Acredula is the penultimate issue on our series of mergers and acquisitions. John Cook examines ways to avoid succeeding to sellers' liabilities in a merger or acquisition.

Avoid Successor Liability in Asset Purchases by Preparing Careful Agreements

In structuring a business acquisition, three options are generally available to the parties:

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1. A stock purchase transaction in which the buyer purchases all of the capital stock of the selling corporation directly from the selling corporation's shareholders. (In this discussion, all references will be to corporate acquisitions. However, the same principles may apply by analogy in transactions involving other types of business entities.)
2. A statutory merger in which the buyer, either directly or through a newly created, wholly owned subsidiary, merges with the selling corporation, and pursuant to the merger the selling corporation's shareholders receive cash, stock or other consideration.
3. An asset purchase, where the buyer purchases certain business assets from, and assumes certain specified liabilities of, the selling corporation. In this scenario, the selling corporation ordinarily dissolves after the merger and distributes the purchase price to its shareholders.

There are many business reasons for choosing one structural alternative over another. One important reason to choose an asset purchase over a stock purchase or statutory merger is to prevent the buyer from being held responsible for all pre-closing liabilities of the selling corporation. In either a stock purchase (where the buyer acquires the selling corporation and, therefore, all its liabilities) or a statutory merger (where the selling corporation becomes part of the buyer or its subsidiary, and its liabilities are transferred by operation of law), the buyer cannot avoid assumption of the selling corporation's liabilities. For this reason, buyers often strongly prefer asset purchases, all other things being equal. However, buyers and their counsel should be aware that, under certain circumstances, even an asset purchase may nonetheless give rise to successor liability, causing the buyer to be held liable for the selling corporation's pre-closing liabilities. This may be true despite the fact that the buyer did not expressly assume such pre-closing liabilities in the asset purchase agreement.

Until roughly 30 years ago, successor liability was not a major concern to buyers in asset purchase transactions. The general rule was that the allocation of liabilities specified in the asset purchase agreement was honored by the courts. Since 1970, however, courts have developed several new theories of successor liability in order to hold a buyer liable for a selling corporation's liabilities. In addition, statutory laws, particularly in the environmental arena, now impose strict liability on a buyer for the pre-closing liabilities of a selling corporation after an asset purchase. In addition, federal, state and local tax laws may also impose liability on a business successor regardless of the acquisition transaction's form. However, a comprehensive treatment of environmental and tax law provisions is beyond the scope of this article.

Most court cases expanding the scope of successor liability evolved in situations involving product liability or environmental claims. In these situations, courts may be faced with relatively innocent plaintiffs who have no recourse against a selling corporation due to its cessation of business after an acquisition transaction. Rather than forcing an injured consumer to chase the selling corporation's scattered shareholders, public policy has been invoked to create theories by which recourse can be obtained against the purchaser of the business. It is particularly in these situations that buyers must carefully assess the risks of possible successor liability. The primary judicial theories imposing successor liability, include:

- ***De Facto* Mergers.** The *de facto* merger doctrine was originally developed to impose successor liability on a buyer in an asset purchase transaction where the structure of the transaction was chosen to avoid certain obligations, such as those arising under dissenters' rights statutes. The doctrine applied if these four elements were present:
    1. A continuation of the selling corporation enterprise, with continuity of management, personnel, physical location and general business operations;
    2. Some continuity of shareholders. In other words, as

originally formulated, the *de facto* merger doctrine required that the selling corporation's shareholders becomem shareholders of the buyer post-closing;

3. The selling corporation ceases its business operations and dissolves; and
4. The buyer assumes the selling corporation's normal obligations necessary for continuing operation of the business.

But, in recent decades, courts in some jurisdictions have relaxed some of these elements and applied the *de facto* merger doctrine to impose successor liability without requiring, for example, continuity of shareholder ownership interests or immediate dissolution of the selling corporation. As a result, some states like Texas, have expressly rejected the *de facto* merger doctrine by statute.

- **Continuity of Enterprise.** The *de facto* merger doctrine originally applied in transactions where there was a substantial post-closing identity between shareholders of the selling corporation and shareholders of the buyer. However, the Supreme Court in Michigan expanded the doctrine by eliminating the continuity of ownership requirement altogether. Under this analysis, sometimes called the substantial continuation test, successor liability is imposed regardless of whether the purchase price consisted of cash or stock of the buyer. This doctrine has been adopted in Alabama, but rejected in at least nine other jurisdictions, including Colorado, Maryland, Nebraska, New York, North Dakota, South Dakota, Vermont and Wisconsin. To date, Ohio courts have not been asked to rule on the applicability of the continuity of enterprise test.

- **Duty to Warn.** Some courts have created a duty imposed on the buyer of a business (after an asset purchase) to warn customers of defects in its predecessor's products. In general, this doctrine has two prongs:
  - The buyer must know about the defects in its seller's products; and
  - There must be some continuing relationship between the buyer and its predecessor's customers, such as an obligation to service the products manufactured or sold by the seller.

  The seller's goodwill, acquired by the buyer in an asset purchase, may be deemed to include an obligation to assume liability for unforeseen product liability claims that arise pre-closing.

The mere fact that an Ohio court has not adopted a specific theory of successor liability does not mean that one or more of these theories will not be utilized to impose liability in the future.

- **Implied Assumption.** This successor liability theory is primarily the result of sloppy drafting or an alleged ambiguity in the asset purchase agreement. Using this approach, a court may decide that a buyer implicitly assumed certain pre-closing liabilities of a selling corporation by agreeing to assume all its liabilities in the asset purchase agreement, even if the liabilities were unforeseen by the parties at the time of the sale.

- **Product Line Exception.** The California courts created the product line exception to impose successor liability on a buyer of a selling corporation for pre-closing product liability claims of the selling corporation in the event that:
  - The plaintiff's recourse against the selling corporation was frustrated by the buyer's acquisition of the dissolved seller's business;
  - The buyer had the ability to spread the risk of the original manufacturer and seller;
  - It was fair to require the buyer to assume responsibility due to its acquisition of the selling corporation's goodwill; and
  - The buyer continued to manufacture and sell the same products as the selling corporation.

  Thereafter, California courts further held that a failure to manufacture and sell identical products did not remove the case from the product line exception doctrine. But subsequent California cases have held that the element requiring a frustration of recourse against the selling corporation was not satisfied when the selling corporation's dissolution was not the direct result of the asset purchase, such as when the selling corporation continued in business after the asset sale and later declared bankruptcy for unrelated reasons.

- **Fraud.** Courts have long held that transactions entered into for the purpose of avoiding liability will not be permitted to insulate their legal responsibilities. Cases involving inadequate consideration, or involving a demonstrated intent to defraud creditors, have long been held by courts to permit the imposition of liability on the appropriate parties, regardless of the form of the transaction as an asset purchase.

To avoid or minimize the potential of successor liability in asset purchase transactions, counsel for a buyer (together with the client) should carefully conduct due diligence regarding the selling corporation's business operations, particularly in the product liability and environmental areas. In addition, counsel should advise the client of the possibility that a court might impose successor liability in certain circumstances, regardless of protections built into the asset purchase agreement. The mere fact that an Ohio court has not adopted a specific theory of successor liability does not mean that, in a case involving a sympathetic plaintiff, one or more of the theories outlined above will not be utilized to impose liability in the future.

In some cases, insurance coverage may be purchased to protect the buyer against responsibility for excluded liabilities. An asset purchase agreement should be carefully drafted to specify exactly which liabilities of the selling corporation are and are not being assumed by the buyer. Broadly based assumption language in an asset purchase agreement may give a court an opportunity to find in favor of a sympathetic plaintiff by using the implied assumption theory. To the extent possible, it is prudent not to include language in the asset purchase agreement that states that the buyer is purchasing the entire business of the selling corporation. Instead, it should state that the buyer is purchasing only certain specified assets of the selling corporation and assuming only certain specified liabilities, reducing the likelihood that a court will attempt to apply the continuity of enterprise doctrine.

Ordinarily, business considerations are paramount in determining the precise structure of the acquisition transaction. But, the buyer can minimize the likelihood that the *de facto* merger will be applied by a court to hold the buyer responsible for the selling corporation's pre-closing liabilities if:

- Cash is paid for the assets rather than the buyer's stock;
- The business enterprise is continued without using the selling corporation's product names; and
- Management of the business after the closing is not conducted in exactly the same way and by the same persons as before the acquisition.

By following these guidelines, buyers can diminish their chances of incurring successor liability in asset purchase transactions. Agreements incorporating these strategies can help safeguard buyers against assuming the unwanted liabilities of the seller.

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