Successor Liability

De Facto Merger

Successor Liability in Asset Acquisitions: Clarifying the De Facto Merger Exception

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People who buy and sell businesses no doubt have had the experience of turning to their lawyers and saying "let's structure this as an asset deal so that we won't get stuck with the liabilities of the target," only to be met with the lawyerly caveat "well, that's the general rule but there are exceptions." The de facto merger exception is the most problematic of these exceptions for those who crave certainty when they set out to do an acquisition. With a recent Superior Court case, Fizzano Brothers Concrete Products, Inc. v. XLN Inc., Pennsylvania joins a number of other states that have clarified and narrowed the exception.

Exceptions to the General Rule of No Successor Liability

In Fizzano the question was whether the buyer in an asset transaction was liable for a judgment that had been entered against the seller. The court cited the general rule that buyers do not succeed to liabilities of the seller but then listed five exceptions,² any of which can give rise to responsibility of the buyer for the seller's general liabilities:

1. the purchaser expressly or implicitly agreed to assume liability;
2. the transaction amounted to a consolidation or de facto merger;
3. the purchasing corporation was merely a continuation of the selling corporation;
4. the transaction was fraudulently entered into to escape liability; or
5. the transfer was without adequate consideration and no provisions were made for creditors of the selling corporation.³
Before examining these exceptions, we note that they apply only in the context of an asset transaction. Of course, the buyer will assume, directly or indirectly (depending on the structure), all liabilities of the target if the acquisition is in the form of a stock purchase or a merger. Also, the successor liability issue primarily arises where substantially all of a target corporation is being sold, as opposed to a situation where a company sells one of its divisions.

Turning back to the general exceptions listed by the Fizzano court, the first, fourth, and fifth exceptions are not particularly problematic. Typically, the asset purchase agreement will specifically set forth what liabilities, if any, are to be assumed; often these are post-closing liabilities under specifically listed contracts and ordinary course accounts payable. The "fraud" and "inadequate consideration" exceptions normally will not apply to a deal between arms'-length parties.

The "de facto merger" and "mere continuation" exceptions are problematic because their meanings are not clear and often the courts have not done a good job of explaining them in a way that is easily and clearly applied to the run-of-the-mill asset deal. To complicate matters, it is often difficult to tell these two exceptions apart.

De Facto Merger Exception

The Fizzano case focused on the de facto merger exception. The court quoted the four factors that are considered in determining whether it applies:

1. continuity of ownership;
2. cessation of ordinary business by, and dissolution of, the predecessor as soon as practicable;
3. assumption by the successor of liabilities ordinarily necessary for uninterrupted continuation of the business; and
4. continuity of the management, personnel, physical location, and the general business operation. 4

It is important to note that Pennsylvania courts have stated that these factors should be considered as opposed to saying that all—or even three of the four—factors must be present for the exception to apply. Buyers in many asset deals justifiably will be nervous that the de facto merger exception might apply, because often the selling entity will cease business fairly soon after closing, the buyer will assume ordinary course payables and contract liabilities, and there will be considerable continuity of the business. The only factor that gives the buyer any modicum of comfort is that, in an arms'-length transaction, there will not be continuity of ownership.
The trial court in *Fizzano* held that successor liability existed because the second, third, and fourth factors for a *de facto* merger existed. While the Superior Court did not agree with the trial court's view of these factors, the important part of the *Fizzano* holding is that the court found that absence of the first factor — continuity of ownership — should have been determinative. According to the Superior Court, the fact that none of the owners of the seller became owners of the buyer "should have ended the trial court's consideration of [the buyer's] potential successor liability. Continuity of ownership is a key element that must exist in order to apply the *de facto* merger doctrine." Although the *Fizzano* court cited cases from the 7th U.S. Circuit Court of Appeals and the U.S. District Court for the Eastern District of Pennsylvania, singling out the continuity of ownership factor as the determinative element had not been adopted by a Pennsylvania state court before *Fizzano*.

To the contrary, in the 2002 case of *Continental Ins. Co. v. Schneider, Inc.*, the Pennsylvania Superior Court generally held that "[a]lthough each of these factors is considered, all need not exist before a *de facto* merger will be deemed to have occurred." The court in *Fizzano* stated that *Schneider* was not intended to de-emphasize the importance of continuity of ownership. It pointed out that, in *Schneider*, three of the four factors were found to exist, but the *Schneider* court refused to grant summary judgment because the continuity of ownership factor was subject to factual dispute. The implication, according to the *Fizzano* court, was that had continuity of ownership *not* been found to exist, that fact would have overwhelmed the presence of the three other factors, the *de facto* merger exception would not have applied, and there would have been no successor liability.

**Mere Continuation Exception**

The "mere continuation" exception was not the focus of the *Fizzano* case and the court dealt with it in a footnote. The court quoted the 1981 case of *Daweikko v. Jorgensen Steel Co.*, which held that this exception requires "common identity of officers, directors and stock between the selling and purchasing corporations, and only one corporation after the transfer."

In *Fizzano*, no officer or director of the seller was made an officer or director of the buyer, and neither the seller nor its owners were given stock of the buyer; therefore, the exception did not apply. Questions could arise, however, if — as is not uncommon — the buyer involves some of the seller's management as officers and/or directors, part of the consideration in the deal is buyer equity, and/or the seller dissolves soon after closing.

Though *Fizzano* did not specifically address this exception other than in a footnote, the case nonetheless provides some comfort on the point. The court stated that the *de facto* merger doctrine emanates from the basic equitable principle that a business should not be permitted to escape its obligations through "sham corporate reorganizations." The court also quoted *Fletcher Cyclopedia of the Law of Private Corporations*, Section 7124.10, for the proposition that the exception is designed to prevent a company from escaping liability by "merely changing hats" and thereby perpetrating a fraud on its creditors. It would appear that, even if there were some common identity of the seller’s and buyer’s officers, directors, and stock, Pennsylvania courts would not invoke successor liability unless the transaction was deemed a sham rather than an...
arms'-length deal.

**Partial Continuity of Ownership**

In *Fizzano* the seller received no buyer stock so the court did not have to grapple with the issue of whether "continuity of ownership" would have existed if, for instance, the seller-owners received a 10 percent stake in the buyer. Therefore, the question is to what extent does a buyer increase its successor liability risk if, as is not uncommon, part of the consideration is paid in stock of the buyer.

At least two courts have addressed situations in which owners of the target hold some stake in the buyer and have determined that partial continuity of ownership does not in itself constitute "continuity of ownership" for purposes of the *de facto* merger doctrine.

In *North Shore Gas v. Salomon Inc.*,\(^8\) a 7th Circuit case from 1998, the selling shareholder had a 35 percent ownership interest in the buyer after the transaction, but the court found that, due to the fragmented ownership structure of the buyer, the selling shareholder's control over the business persisted and a *de facto* merger had occurred.

Conversely, a 40 percent stake in the buying company by a shareholder of the seller was found not to cause a *de facto* merger in *Commercial Nat. Bank v. Newtson.*\(^9\) In that 1976 case from the Illinois Court of Appeals, 40 percent did not constitute control because the other shareholder held 60 percent of the stock.

These cases seem to equate continuity of ownership with continued control by the seller. As in the context of securities law cases, the existence of "control" depends primarily upon stock ownership, but other factors may be taken into account as well. While this is good news for buyers who may want to structure a deal to give the sellers 10 or 20 percent of the equity in the buyer, they should note that courts in different states may have a more restrictive definition of "continuity of ownership."

Although the *Fizzano* court did not have to deal with the partial continuity issue, based on its discussion of the *de facto* merger exception, it is difficult to imagine that in Pennsylvania a deal would involve continuity of ownership even if the selling shareholder obtained equity in the buyer, as long as the equity did not constitute a controlling interest and the deal was made at arms' length.

**De Facto Merger Exception in Other States**

Nearly every U.S. jurisdiction applies the four factors stated above to determine whether a *de facto* merger has occurred. In addition, several key states require continuity of ownership for a *de facto* merger to be found, as did the *Fizzano* court.
For example, *Cargo Partner AG v. Albatrans, Inc.*, a 2003 decision from the 2nd Circuit, noted that "the doctrine of *de facto* merger in New York does not make a corporation that purchases assets liable for the seller's contract debts absent continuity of ownership."  

Illinois has also long considered continuity of ownership to be an essential factor of a *de facto* merger, as has New Jersey.

California cases have historically focused on the payment of adequate consideration in asset sales, rather than on continuity of ownership, and an arms'-length transaction with a third party likely will not trigger the *de facto* merger doctrine under California law.

Delaware law does not recognize a *de facto* merger exception as to asset sales which are not fraudulent.

### Conflicts of Laws Issues

It is not always clear which state's laws will apply to a particular transaction. The prevailing approach seems to be that the law specified in or otherwise applicable to the asset sale agreement will apply when determining successor liability. For example, the court in *White v. Cone-Blanchard Corporation*, a 2002 case from the Eastern District of Texas, used the "most significant relationship" test in a successor liability case to determine that the law of Vermont, the state in which the asset sale occurred, should apply to the question of whether the purchasing corporation faced liability for an underlying tort claim against the seller where the facts related to the claim occurred in another jurisdiction.

Buyers should certainly review the successor liability law of the state where the asset sale is centered to see if that state follows the *Fizzano* rule on the *de facto* merger exception. A third-party claim may be made in another state, and that state's conflict of law rule may not follow the prevailing approach described in *White v. Cone-Blanchard Corporation*. Therefore buyers may also want to analyze the seller's operations in their due diligence process, with a view to finding out the most likely sources of third-party claims, and research successor liability law in the states in which those third parties reside.

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There are two prominent exceptions which are analytically distinct because they are relevant to certain specific types of liabilities: (1) the product line exception, which can make the buyer liable for injuries caused by products manufactured by the seller even if the manufacture and sale occurred before the closing of the acquisition, and (2) state tax laws can make the buyer liable for taxes of the seller that are unpaid even if they relate to the pre-closing period, unless the transaction is reported in advance to the taxing authority, certain procedures are followed, and the state is protected through an escrow or otherwise. Compliance with these tax laws is not mandatory upon the buyer, but otherwise the buyer takes the risk, which can be mitigated by due diligence, an escrow, or a seller indemnity from a creditworthy source.

_Fizzano_ at 1019 (citations omitted).


_Schneider_, 810 A.2d at 135.

_See Fizzano_, 973 A.2d at 1023 n.2.


152 F.3d 642 (7th Cir. 1998).


352 F.3d 41, 46 (2d Cir. 2003).


_See, e.g., Heilbrunn v. Sun Chemical Corp._, 150 A.2d 755 (Del. 1959).


**Legal Topics:**

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