insights

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Developing Federal Common Law of Successor Liability

When a purchaser acquires substantially all the assets of a seller, the purchase agreement typically provides that the purchaser does not assume seller's liabilities except to the limited extent specifically set forth therein. Nevertheless, a disclaimer of liability is not effective in all situations. State statutes typically impose liability on successors for sales taxes and certain similar obligations, and for that reason purchasers usually protect themselves, such as by escrowing a portion of the sale proceeds until full payment of such taxes and obligations is verified. Additionally, federal courts have judicially imposed successor liability based on violations of the Labor Management Relations Act (*John Wiley & Sons, Inc. v. Livingston*, 376 543 (1964)), the National Labor Relations Act (*Golden State Bottling Co. v. NLRB*, 414 U.S. 168 (1973)), Title VII of the Civil Rights Act of 1964 (*Wheeler v. Snyder Buick, Inc.*, 794 F.2d 1228 (7th Cir. 1985)), the Employee Retirement Income Security Act of 1974 (*Upholsterers' International Union Pension Fund v. Artistic Furniture*, 920 F.2d (7th Cir. 1990), the Age Discrimination in Employment Act (*EEOC v. G-K-G, Inc.*, 39 F.3d 740 (7th Cir. 1986)), and the Family and Medical Leave Act (*Sullivan v. Dollar Tree Stores, Inc.*, 623 F.3d 7707 (9th Cir. 2010)).

By Regina M. Joseph

A disclaimer of liability is not effective in all situations.

In a recent decision, the Seventh Circuit Court of Appeals expanded what it characterized as the "federal common law" imposing successor liability to the Fair Labor Standards Act ("FLSA"), which governs minimum wage and overtime paid to workers. In *Teed et al v. Thomas & Betts Power Solutions, L.L.C.*, Nos. 12-2440, 12-3029 (7th Cir. March 26, 2013), the seller's assets had been sold by a secured lender through an auction conducted under a state court receivership. The purchaser's bid imposed the condition that the

sale had to be free and clear of all liabilities, including FLSA liabilities. An FLSA case had been filed approximately two years prior to the sale and was apparently known to the purchaser. Writing for the Seventh Circuit, Judge Posner noted that, under Wisconsin law, this disclaimer of liability would have been sufficient to dispose of the matter; however, state law was not controlling, nor was it even relevant, when a federal standard applies.

Although Judge Posner noted that the Court must, as a threshold matter, determine whether the FLSA should be included within the group of employment and labor statutes to which the federal standard had previously been found to apply, his analysis was perfunctory. He reasoned that federal labor and employment statutes are intended either to foster labor peace or to protect the rights of workers who are unable to prevent a corporate sale aimed at extinguishing employment law liabilities. The FLSA promotes this goal; ergo the federal standard is applicable.

In imposing successor liability, the district court had applied the following multi-factor test, which it derived from the cases mentioned above:

- Did the purchaser have notice of the pending lawsuit?
- Would the seller have been able to provide the relief sought in the lawsuit prior to the sale? The court noted that if an insolvent seller would have been unable to pay, it would be a windfall to the litigating plaintiffs to impose successor liability, and this weighs against imposing successor liability.
- Would the seller have provided relief after the sale? In *Tweed*, the sale proceeds went to the secured lender – the Seventh Circuit found this to be a factor in favor of successor liability.
- Is the purchaser able to provide the relief sought in the litigation?
- Is there a continuity of operations and work force? If so, successor liability is favored because "nothing really has changed."

Although reaching the same conclusion, the Seventh Circuit disavowed the multi-part test in favor of a simple federal standard – successor liability should be imposed unless "there are good reasons to withhold such liability." The Court stated that the purchaser's disclaimer of liability as an express condition of its purchase was not a good reason. Although it hinted that lack of notice might serve as a good reason, such dictum provides little comfort for structuring future transactions, since factors constituting notice are always elusive. In essence, the Seventh Circuit ruled that liabilities under federal employment and labor statutes must be assumed by a successor purchaser that buys the complete business, no matter what. Only when the business is broken up and sold piecemeal would purchasers not face successor liability.

However, the Court toyed with a "theoretical" good reason if the relative rights of competing creditors would be disrupted. In *Tweed*, the business was sold by a secured lender through a state court receivership. If the purchaser had known that it could not avoid the FLSA liability, the purchase price in its bid would have been discounted by its valuation of the liability it must assume. Viewed from the creditors' perspective, the unsecured employees' claims would be paid in full prior to the secured creditor's claims, disrupting the laws governing priority of competing claims. Since the purchaser in *Tweed* did not make this argument, instead informing the court that it did not discount its purchase bid, we do not know if the court would truly have been persuaded by this line of thought.

Tweed is a reminder of the limitations to a purchaser's reliance on a disclaimer of liability in an asset purchase agreement. There is no substitute for a thorough due diligence investigation to arrive at the appropriate purchase price.