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De Facto Merger: The Threat of Unexpected Successor Liability

By Gary S. Matsko

It is an article of faith among transactional practitioners that an entity seeking to acquire another entity without being saddled with its liabilities does so by acquiring assets. As a general proposition, that method works. "Most jurisdictions, including Massachusetts, follow the traditional corporate law principle that the liabilities of a selling predecessor corporation are not imposed upon the successor corporation which purchases its assets. . . ." Milliken & Co. v. Duro Textiles, LLC, 451 Mass. 547, 556, 887 N.E.2d 244, 254 (2008) (quoting Guzman v. MRM/Elgin, 409 Mass. 563, 566, 567 N.E.2d 929, 931 (1991)). There are however, four important exceptions to the general rule. An asset transfer may carry with it successor liability where, "(1) the successor expressly or impliedly assumes the liability of the predecessor, (2) the transaction is a de facto merger or consolidation, (3) the successor is a mere continuation of the predecessor, or (4) the transaction is a fraudulent effort to avoid liabilities of the predecessor." Id.

The possibility that exposure to successor liability will flow from an express assumption of liability is no doubt self-evident to attorneys guiding clients through an asset acquisition. Moreover, most practitioners are aware of the concerns that emerge under the Massachusetts fraudulent transfer statute. See G.L. c. 109A § 5. In addition, "mere continuations" will not be hard to recognize. A mere continuation "envisions a reorganization transforming a single company from one corporate entity into another." Milliken & Co., 451 Mass. at 556 (quoting McCarthy v. Litton Indus., Inc., 410 Mass. 15, 21–22, 570 N.E.2d 1008, 1012 (1991)). "The indices of a 'continuation' are, at a minimum: continuity of directors, officers, and stockholders; and the continued existence of only one corporation after the sale of its assets." McCarthy, 410 Mass. at 23. It will not surprise most attorneys that shuffling the deck chairs will not be enough to shake free of liabilities of an enterprise continued under a nominally new entity.

The de facto merger, however, has fuzzier boundaries. Much like the alter ego analysis, found in My Bread Baking Co. v. Cumberland Farms, 353 Mass. 614, 233 N.E.2d 748 (1968), the de facto merger doctrine calls on courts to consult multiple specified factors to determine if there has been a de facto merger; however, "[n]o single factor is necessary or sufficient to establish a de facto merger." Cargill, Inc. v. Beaver Coal & Oil Co., 424 Mass. 356, 360, 676 N.E.2d 815, 818 (1997). That is to say, the absence of any one factor will not preclude a finding of de facto merger, and, in some cases, the presence of some amount of each factor would not compel a finding of de facto merger.

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Where successor liability is found to exist by virtue of a de facto merger, the successor entity stands in the shoes of the predecessor and is fully responsible for its liabilities, which can include liability for multiple damages under G. L. c. 93A. Milliken & Co., 451 Mass. at 565. Counsel advising a client in advance of an asset acquisition must confront the alchemy of these multiple factors to assess (or, maybe guess) whether the cumulative quantum of the factors is small enough to shake free from the acquired entity's obligations, or substantial enough to expose the client to the liabilities from which it sought shelter. (Several other states have adopted some version of the de facto merger doctrine, with varying degrees of rigor applied in assessing the multiple factors. John H. Matheson, Successor Liability; 96 MINN. L. REV. 371.387-91 (2011). Delaware, for example, has a restrictive version of the doctrine that applies only where all assets of the predecessor are acquired, the purchase compensation is stock, and there is an agreement to acquire liabilities. Magnolia's at Bethany, LLC v. Artesian Consulting Engineers Inc. No. CIV.A. S11C-04013ESB, 2011 WL 4826106, at *3 (Del. Super. Ct. Sept. 19, 2011)). Several courts have noted that the analysis for successor liability is largely uniform among the states but, nonetheless, a thicket. U.S. v. General Battery, 423 F.3d 294, 301 (3d Cir. 2005). "Beneath a veneer of uniformity, the 'entire issue of successor liability . . . is dreadfully tangled, reflecting the difficulty of striking the right balance between the competing interests at stake.'" Id. (citing EEOC v. Vucitech, 842 F.2d 936, 944 (7th Cir. 1988)).

The factors considered in the analysis are whether:

(1) there is a continuation of the enterprise of the seller corporation so that there is continuity of management, personnel, physical location, assets, and general business

operations; . . . (2) there is a continuity of shareholders which results from the purchasing corporation paying for the acquired assets with shares of its own stock, . . . (3) the seller corporation ceases its ordinary business operations, liquidates, and dissolves as soon as legally and practically possible, and . . . (4) the purchasing corporation assumes those obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operations of the seller corporation.

Cargill, Inc., 424 Mass. at 359–60. Whether the transaction is used to defeat creditors' claims is also a factor. Milliken & Co., 451 Mass. at 556. The de facto merger doctrine is equitable in nature and, therefore, subject to equitable defenses. Id.

There has been some elasticity layered into these factors. For example, although the doctrine originally assumed application to transactions where shares were exchanged for assets, the shareholder component can now be met where the shareholders of the former entity paid to acquire their shares in the acquiring entity and may be satisfied with a small percentage of ownership in the acquiring entity. Cargill, Inc., 424 Mass. at 361 (12.5 percent of shares acquired satisfied the shareholder component); General Battery, 423 F.3d at 306—307 (4.5 percent held to be enough, as "[t]he continuity of shareholders element is designed to identify situations where the shareholders of a seller corporation retain some ownership interest in their assets after cleansing those assets of liability."). In one decision, the court ruled that the shares received by the owners of the predecessor entity did not have to be shares of the acquiring entity, but could instead be shares of the acquirer's parent entity, at least where the purchaser was a wholly owned subsidiary of the parent. In re Acushnet River, 712 F. Supp. 1010, 1017 (D. Mass. 1989). Formal dissolution of the predecessor is not required to establish the discontinuation of the prior business. Cargill, Inc., 424 Mass. at 361. The predecessor in Milliken continued in business for a period after the sale of its operating assets to manage and lease out substantial real estate assets. Milliken & Co., 451 Mass. at 559-60. (The operational assets had transferred and the "selling" entity continued only as a landlord. The formal dissolution, originally a component of the de facto merger doctrine was not formally met, but the selling entity did not continue in its prior business.) Factors that indicate a continuation of the predecessor's business include whether the successor entity continued the general business of the predecessor, used some of the same personnel to continue the business, and acquired assets from the predecessor (including customer lists) to continue the business. Id. at 360-61. See also Lanee Great Plastic Co., LTD v. Handmade Bow Co., No. SUCV200705245, 2010 WL 6650330, at *5 (Mass. Super. Ct. Dec. 26, 2010). Satisfaction of the fourth prong, assuming obligations necessary for business continuation, does not require taking on all obligations of the predecessor, but only those necessary to continue business uninterrupted. In Cargill, the court found it enough that the party acquiring assets assumed certain obligations such as paying creditors that agreed to continue to do business with the "successor," assuming executory contracts, assuming service contracts, and assuming delivery obligations to customers with credit balances. Cargill, Inc., 424 Mass. at 361. As the court noted, "[e]ach case must be decided on its specific facts and circumstances. Id. at 362.

Purchase of a predecessor's assets is a necessary predicate to finding a de facto merger, but how much of its assets must be acquired can be an open question. Recent decisions have held that the asset acquisition must be extensive in order for the de facto merger doctrine to apply. "Our decisions addressing successor liability have recognized consistently that successor liability depends on a transfer of all, or substantially all, assets from predecessor to successor." Premier Capital, LLC v. KMZ, Inc., 464 Mass 467, 475, 984 N.E.2d 286, 292 (2013). The Supreme Judicial Court (SJC) cited to the Milliken, Guzman, and Cargill cases referenced above, to support the contention that its decisions have included the "all or substantially all" qualification. Those cases do not actually articulate that principal, although it might be inferred from Cargill. (Guzman concerned a doctrine, accepted in some states, pursuant to which successor liability can arise from continuing to manufacture a line of product previously manufactured by a different manufacturer. The SJC in Guzman rejected the doctrine.) In Milliken, however, the predecessor retained its real estate assets, which represented nearly 25 percent of the pre-transaction value of the predecessor. Milliken & Co., 451 Mass. at 556. This factor did not preclude the court from finding a de facto merger. Id. Perhaps after Premier Capital, acquiring three-quarters of the predecessor's assets will not be enough to satisfy the "all or substantially all" requirement, or perhaps Milliken defines what "substantially all" means.

(One court concluded that two entities in combination may succeed to the business of a predecessor so as to establish a de facto merger. Lanee Great Plastic Co., LTD v. Handmade Bow Co. No. SUCV200705245, 2010 WL 6650330, at *5 (Mass. Super. Dec. 26, 2010).

Passage of time may camouflage the risk of successor liability rather than shield an acquirer from its grasp. The General Battery case makes that point. See General Battery, 423 F.3d at 294. There, General Battery merged with Exide Corporation in 2000, making Exide undisputedly a successor to General Battery's liabilities. Id. at 295. Shortly after that merger, the United States Environmental Protection Agency brought claims against Exide for liability of the long-defunct Price Battery Corp., a corporation from which General

Battery had acquired assets in 1966. Id. Applying the four-prong test described above, the Third Circuit concluded that General Battery was Price's successor and heir to its environmental liability. Id. at 309. When Exide merged with General, it became responsible for that liability. Id. The court in General Battery purported to be deciding based on federal common law, even though it used the four-pronged analysis adopted by most states. Id. at 305. Although the acceptance of the 4.5 percent share ownership as satisfaction of the second prong might be a leniency driven by the remedial statute to which the court was giving effect, there is no reason to think that the passage of time would serve as better protection in the state court. If the entity that incurred a liability were a predecessor to the entity on which a third party seeks to impose liability, there is no reason the passage of time would change that. Knowing the acquisition history of an acquisition target is an important goal of the pre-acquisition due diligence.

Assessing the likelihood that a transaction will be deemed a de facto merger can be particularly difficult where the principal assets of the predecessor are intangible, such as a service entity or a business for which the principal assets are intellectual property.

Take, for example, a financial consulting firm whose principal assets are goodwill and client relationships. Owners and principals of a struggling firm may seek to be employed by a more successful competitor. Those "acquired" owners engage in negotiations to be hired by the "acquirer," promising to bring with them "all or substantially all" of their client base. Top management and some employees (important to the newly hired executives' ability to service clients) from the acquired firm are hired by the "acquirer," which agrees to pay the employees' salaries going forward and honor accrued vacation. Those managers are offered the opportunity to buy into the "acquirer" and are given executive titles—and maybe board seats.

They close down their former business and serve their previous client base from their new offices in the acquirer's suite. If one adds to the mix the fact that the "predecessor" entity was faced with liabilities, such as client suits, that they endeavor to leave behind, the transaction hits many of the benchmarks for a de facto merger set out in the governing authority. In a fact pattern such as the above, a service provider, believing it was only engaging in hiring new executives, might find itself branded a "successor" and learn that it must answer for the liabilities that contributed to the demise of its new employees' entity.

The de facto merger doctrine presents circumstances where the flexibility of equity creates a double-edged sword. On the one hand, it gives the courts the ability to address the clever culprit who devises novel transactions to preserve its business while shaking free of liabilities for which, in fairness, it should answer. On the other, it leaves counsel advising on the structure of an asset acquisition with a measure of uncertainty as to which liabilities may piggyback onto the assets transferred. Unexpected successor liabilities can arise from an asset acquisition. Given the ad hoc nature of the de facto merger analysis, and its fact-driven character, it will at times be difficult to predict when a transaction may stand the risk of being held to be a de facto merger.

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