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Will Environmental Successor Liability Impact Your Next Asset Purchase Deal?

By Andrew S. Levine



Clients and their attorneys have several different methods of structuring deals to purchase all or parts of corporations, while minimizing the “downsides” of the target entity. Most deals take the

form of mergers, stock purchases/exchanges, or asset purchases, and each form has distinct advantages and disadvantages. The driving force of the decision of how best to structure the deal often centers on tax issues, transferability of permitted and/or government licensed activities, continuation of a known brand or a “well-oiled” company structure and financing opportunities.

However, the form of the transaction may also determine the applicability of successor liability, which could make buyers responsible for the sellers’ liabilities, despite the clear language to the contrary in an acquisition agreement. Successor liability is a given in mergers and cash-for-stock purchases, although some significant liabilities can be resolved prior to the merger. In addition, while the cost of a liability can be inserted into an indemnity obligation by the selling shareholders, a third party asserting a liability claim is not bound to follow the indemnity trail, and can assert that

claim directly upon the surviving corporate entity. Therefore, typically if the magnitude of potential liabilities exceeds the likely return on investment of the merged entity, a merger or a cash-for-stock acquisition is a questionable venture.

In contrast, asset purchases generally provide buyers with freedom from successor liability because asset purchasers merely purchase sellers’ property, equipment and/or accounts, not the companies themselves. By these means, a buyer can benefit from the synergies of the purchased assets, and with appropriate structuring be unencumbered by the liabilities that may have made the purchased entity unattractive as a merger candidate. But buyer be warned – successor liability can undercut the insulation buyers may possess in asset purchase deals, especially with respect to sellers’ environmental liabilities.

In particular, buyer’s counsel must investigate and quantify the selling corporation’s environmental liabilities to ensure that the purchase price, hold back, escrow, accrual, indemnity capitalization, and/or insurance policies in the purchase agreement sufficiently cover these risks. Federal courts typically use the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)

to transfer the seller's environmental liabilities to the buyer. Interestingly, the provisions of CERCLA do not impose successor liability directly. Rather, federal courts imposing successor liability under CERCLA use some long standing and some novel theories of common law to impose the liability.

It is important to note that federal courts disagree as to whether federal common law or state common law should supplement CERCLA, and therefore this is an evolving concept. This evolution has particularly affected the characterization and utilization of the "substantial continuity" test, one of five legal tests under which successor liability has been attached to purchasers in asset deals. Fortunately, the substantial continuity test is falling out of favor with the circuit courts.

Successor Liability in Asset Purchases: The Four Exceptions

Generally, purchasers of corporate assets are not liable for the debts and liabilities of selling entities. However, four widely accepted exceptions to this rule attach successor liability to purchasers of corporate assets.

1. The first exception occurs when purchasers expressly or implicitly agree to assume the liabilities in question. Attorneys drafting asset purchase agreements should address liability assumption by carefully defining the terms "assumed liabilities" and "non-assumed or retained liabilities." While older documents rarely mention environmental liabilities in this context, contemporary transactions must address these issues explicitly. In particular, watch for any clause that contains a phrase such as "any other liability," as that could be a clever ploy to saddle the buyer with such costs.
2. The second instance in which successor liability may attach to a purchaser of assets occurs when courts deem asset purchases to be de facto mergers, which courts will find for purported asset transfers that resemble mergers, but do not technically comply with state merger or consolidation statutes. Stock-for-assets deals can often fall within this category, even if the seller's share of total stock is absurdly low. Courts typically look for the following factors:
 - a. continuation of the seller's business, such as a continuity of management, personnel, assets and general operations;
 - b. the shareholders selling the corporation's assets own a portion of the purchasing entity;
 - c. the selling corporation ceases its ordinary business operations, liquidates and/or dissolves as soon as possible; and
 - d. the purchasing entity assumes the selling entity's liabilities that are ordinarily necessary to continue normal business operations.
3. The third exception to the general rule that purchasers of assets do not succeed to sellers' liabilities is the "mere continuity" doctrine. The "mere continuity" exception usually applies when the sole purpose of the asset purchase is to escape the selling entity's liability. "Mere continuity" requires, after the transaction, a common identity of stock, stockholders and directors between the selling entity and the purchasing entity. In short, the purchaser looks and operates much like the seller, except the purchaser emerges from the transaction without the seller's liabilities. While these are not sham transactions, courts are not likely to allow the newly emerged entity to wash its hands of the predecessors' actions; in part, that is what bankruptcy can accomplish.
4. The fourth exception to the general premise involves fraud. Courts may hold successor corporations liable for the acts of their predecessors if the transactions were fraudulently entered into to avoid liability.

The Fifth Exception: The Substantial Continuity Test

Certain courts have adopted a fifth exception to the absence of successor liability in asset acquisitions, known as the "substantial continuity" test, which is much like "mere continuity," but even more liberal in its application. While the "substantial continuity" test is falling out of favor in some federal courts, counsel should not dismiss its potential applicability at some point in the future. Many activist courts are loathed to force the government to assume costs that could be borne by a purchasing entity just because of a cleverly constructed acquisition agreement. The substantial continuity test originated in a series of U.S. Supreme Court labor relations and product liability cases, in which courts were weighing social policy against agreement language.

When applying the substantial continuity test, courts generally consider whether the following eight factors resulted from the transaction:

1. retention of the seller's employees;
2. retention of the seller's supervisory personnel;
3. retention of the seller's facilities in the same location;
4. production of the same product;
5. retention of the seller's name;
6. continuity of assets;
7. continuity of general business operations; and
8. whether the successor holds itself out as the continuation of the previous enterprise.

Courts balance these factors in analyzing the totality of the circumstances surrounding asset purchases, with no one factor being solely determinative.

It is the balancing of those factors that injects some of the randomness of the rulings under this doctrine, as courts tend to be creative.

Although the "substantial continuity" test is still good law in some jurisdictions, it appears to be falling out of favor in the Philadelphia metropolitan area, as depicted by two 2005 cases: Action Manufacturing Co., Inc. v. Simon Wrecking Co. and U.S. v. General Battery Corp., Inc.

In Action Manufacturing, the U.S. District Court for the Eastern District of Pennsylvania rejected the substantial continuity test as a source of successor liability under CERCLA. The court stated that successor liability under CERCLA should be governed by federal common law because businesses may otherwise choose jurisdictions to effectuate their acquisitions in order to avoid CERCLA liability. Federal common law, the court stated, consists of the general doctrine of successor liability in operation in most jurisdictions, and looked closely at the U.S. Supreme Court's decision in U.S. v. Bestfoods, which held that courts should not create new specific federal law in determining liability under CERCLA.

In that vein, Action Manufacturing held that the federal common law of successor liability begins with the general premise that asset purchasers generally are not liable for sellers' liabilities unless the transaction falls within one of the four traditional exceptions. The court viewed the "substantial

continuity" test as an expansion of one of the traditional rules, noting that the notion of expanding the traditional common law rules on corporate liability was rejected in Bestfoods. The court discussed the recent demise of the test in certain federal circuit courts, and stated that it was following the national trend by rejecting the substantial continuity test. In fact, four out of the six circuit courts that addressed substantial continuity in CERCLA cases rejected the test: the First, Second, Sixth and Ninth Circuits. Significantly, these four cases were decided after the Fourth and Eighth Circuits adopted the substantial continuity test.

It is also important to note that the Fourth and Eighth Circuit cases preceded the Supreme Court's determination in Bestfoods, and therefore did not have the benefit of the Court's skeptical view about expansive federal common law on successor liability issues. By the same token, if state law recognizes substantial continuity, a federal court could consider that as a critical point in imposing such a standard.

In General Battery Corp., the Third Circuit recently joined the federal trend by rejecting the substantial continuity test in CERCLA cases. The court stated that while federal common law should be utilized to determine successor liability under CERCLA, the substantial continuity test is not a fundamental common law principle of indirect corporate liability. A concurring and dissenting opinion stated that recent Supreme Court decisions call into question the concept of federal common law, and the same holding could have resulted from analyzing state de facto merger concepts.

Supreme Court Decisions

The federal circuit courts that have addressed successor liability in CERCLA cases after 1998 have relied on Bestfoods for guidance. These courts have rejected the prior decisions that expanded the scope of successor liability and declined to recognize the substantial continuity test. Where these circuit courts disagree, however, is on the question of whether federal or state common law should be applied in such cases. This lack of agreement has stemmed, in part, from three Supreme Court decisions that some courts have interpreted to stand for the premise that federal common law should not be developed in this arena: O'Melveny & Myers v. FDIC, Atherton v. FDIC and Bestfoods.

In the O'Melveny and Atherton cases, the Court quoted the venerable Erie R. Co. v. Thompkins, which long ago held that "there is no federal general common law," and state law, not

federal law, governs the imputation of knowledge to corporate victims of alleged negligence. The Court noted that cases justifying judicial creation of a special federal rule of law are few and restricted and must be called for in the originating statute, and further that there must be a “significant conflict between some federal policy or interest and the use of state law.”

Lastly, in *Bestfoods*, the Supreme Court analyzed indirect liability of parent corporations for their subsidiaries under CERCLA. Although the Court expressly declined to decide whether federal common law or state law should determine the liability of corporate parents under CERCLA, it stated that courts should not use the remedial purposes of CERCLA to reject traditional state corporate law principles. Therefore, the emphasis in analyzing liability may shift to state law successor liability concepts.

State Law Considerations

Practitioners must keep in mind that state courts have their own laws addressing successor liability in environmental matters. Therefore, even if a court does not apply federal common law, it still may impose successor liability under applicable state law. However, few state courts have had the opportunity to examine such successor liability issues, and there is a dearth of meaningful case law from which to determine how a state court would decide.

Therefore, it remains important for practitioners and clients to carefully evaluate potential environmental liabilities in asset transactions. A government agency or third party facing exorbitant clean-up costs has relatively little to lose in pressing forward in a state law claim. Success in that forum for such third parties could greatly expand the threat of substantial continuity, which at least for the moment seems to be one of the few examples of a genie being stuffed back into its bottle.

John McGrath and Linda LeFever, attorneys in Stradley Ronon’s business practice group, contributed to this article. For more information on this topic, contact Andrew Levine at alevine@stradley.com or 215.564.8073. ■

Business Practice Group Update

Awards & Accolades . . .

- Claire M. DeMatteis, director of Stradley Ronon’s Wilmington, Del., office, received the Women’s Leadership Award from the Delaware State Bar Association. She was selected for this award as a member of the Delaware Bar whose character, strength, personality, achievement and activities in matters affecting women lawyers have served as an inspiration to and a model for women lawyers in their professional careers.



DeMatteis was also recently appointed to serve on the development committee of DirectWomen – an initiative launched by the American Bar Association to increase gender equality in the boardroom.

- Stradley Ronon partner Steven A. Scolari was recently elected to the Main Line Chamber of Commerce’s Board of Directors for a three-year term. He also currently serves as co-chair of the Chamber’s Leadership Main Line Program. The Main Line Chamber is an 1,800-member organization based in suburban Philadelphia.



- Of counsel Joshua D. Shapiro was selected as one of 24 elected officials nationwide for the prestigious, invitation-only Aspen Institute-Rodel Fellowship in Public Leadership Program. Shapiro, who serves as a member of the House of Representatives from the 153rd Legislative District in Montgomery County, Pa., is the first and only Pennsylvania official to be chosen for the Rodel Fellowship.

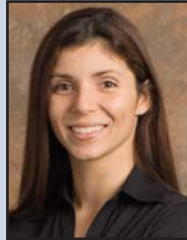


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Business Practice Group Update

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- Associate Carolina C. Spaventa was elected to the board of directors of the Hispanic Bar Association of Pennsylvania. She was also appointed secretary of the association's Legal Education Fund, a nonprofit organization that raises money for charitable and educational purposes.



- Of Counsel Catherine M. Ward was appointed to the Moorestown Township (N.J.) Environmental Advisory Committee.



At Work . . .

- We recently served as counsel on numerous business and finance transactions with an aggregate deal value of approximately \$40 million. Some of those transactions include representation of:
 - one of the largest water utility holding companies in the U.S., serving more than 18 million consumers in 29 U.S. states, Canada and Puerto Rico
 - a privately owned holding company, with several manufacturing subsidiaries in the capital goods market serving the plastics and rubber industry
 - a manufacturer of equipment for acquiring and distributing cable TV signals including satellite receivers, antennas and other signal processing devices

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