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Buyer Beware: A Cautionary Tale of the De Facto Merger Doctrine

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Special to the Legal

In its recent decision in Fizzano Brothers Concrete Products v. XLN, 42 A.3d 951 (Pa. 2012), the Pennsylvania Supreme Court addressed for the first time the question of whether, in the context of an asset purchase, it is necessary for shareholders of the selling corporation to have any ownership in the buyer in order for the de facto merger doctrine to apply. Although the court held that in a dispute based on a contract that does not implicate any public policy concerns, the de facto merger doctrine requires "some sort of" proof of continuity of ownership or stockholder interest, it expressly rejected any mechanical interpretation of this requirement. Rather, the court required that the "transactional realities and their consequences" be considered. The decision will make acquisition planning more difficult for the M&A practitioner, as there is now less certainty associated with asset purchase transactions, particularly when the seller is financially distressed.

Asset Purchases and the De Facto Merger Doctrine

Traditionally, the standard approach when buying a distressed business is to structure the transaction as an asset purchase, which allows the buyer to choose which assets it will acquire and which liabilities, if any, it will assume, leaving the remaining assets and liabilities behind in the selling entity. Under the traditional analysis, as long as the buyer pays the reasonably equivalent value for the assets and does not interject itself in any way into the seller's decision on how to satisfy the seller's unsecured creditors, the buyer takes the assets free and clear of any liabilities expressly left behind.

However, there are increasing efforts by creditors to apply the de facto merger doctrine to hold the buyer responsible for the debts of the seller. There are four principal elements to the de facto merger doctrine that courts review in light of the facts and circumstances. The factors are as follows: (1) continuity of ownership between the buyer and seller; (2) cessation of ordinary business operations and the dissolution of the selling corporation as soon as possible after the transaction; (3) the buyer's assumption of liabilities necessary for the uninterrupted continuation of the seller's business; and (4) continuity of management, personnel, physical location, assets and the general business operation. Many courts have emphasized the importance of the continuity of ownership element, and generally buyers have avoided successor liability by eliminating any common shareholders between buyer and seller.

Supreme Court Decision

Whether the seller or its shareholders must have a continuing equity ownership in the buyer in order for there to be a valid claim under the de facto merger doctrine was the principle question in Fizzano Brothers. A discussion of the basic facts of the case is relevant to illustrate the cause for concern created by the Supreme Court's decision. The facts are summarized below.

- In 1999, Fizzano purchased a software license and services from System Development Group Inc. (SDG). The software did not perform as warranted.
- In April 2000, XLN purchased the stock of SDG from its four shareholders for cash and promissory notes that were secured by the software assets of SDG. SDG and XLN had no common shareholders, but the two principal shareholders of SDG went to work for XLN in SDG's former location. Their employment ended in January 2003.
- In August 2003, XLN sold its assets, including its rights to the software, to XLNT. There were no common shareholders or officers between XLN and XLNT. XLNT assumed XLN's obligations on the promissory notes due from XLN to the former SDG shareholders, and hired two former SDG shareholders as key employees (chief operating officer and chief technology officer). XLNT operated out of the same location where XLN and SDG had formerly operated.

In 2001, Fizzano sued XLN for breach of contract and express warranty. Judgment against XLN was entered by default. In 2004, Fizzano amended its complaint to add XLNT as a defendant on the basis of de facto merger and mere continuation of the XLN business. The trial court held in 2007 that XLNT was liable under the de facto merger doctrine and as a mere continuation of XLN. In 2009, the Superior Court reversed, holding, in part, that the de facto merger doctrine did not apply because the seller did not have any continuing ownership in XLNT after the sale. The Supreme Court, in a decision that was virtually unanimous, vacated the order of the Superior Court and expressly held that:

"In cases rooted in breach of contract and express warranty, the de facto merger exception requires 'some sort of' proof of continuity of ownership or stockholder interest. However, such proof is not restricted to mere evidence of an exchange of assets from one corporation for shares in a successor corporation. Evidence of other forms of stockholder interest in the successor corporation may suffice."

The court further stated that in conducting the de facto merger analysis, courts must "look beyond the superficial formalities of a transaction in order to examine the transactional realities and their consequences." The court justified its imprecise standard because of the equitable nature of the de facto merger doctrine and the express provisions of the Pennsylvania Business Corporation Law, which allow for the payment of cash or other obligations to the shareholders of the selling corporation in a statutory merger. The court reasoned, the de facto merger doctrine should not impose a more stringent test than that applicable to a statutory merger.

Analysis and Unanswered Questions

The discussion of the statutory merger provisions of the BCL, while correct in its technical analysis, loses the forest for the trees. Of course, a statutory merger may provide cash or other obligations to the

shareholders of the selling entity such that those shareholders have no ownership interest in the surviving corporation. However, that is irrelevant, because the creditors of the selling entity remain creditors of the merged entity after the statutory merger by operation of law. The court's analysis, taken to its logical conclusion, would seem to eliminate completely from the de facto merger doctrine the requirement for any continuity of shareholder interest in the buyer. It is difficult to understand the court's statement that it is not opining or even suggesting a result as to whether there is a de facto merger in this case, because it was undisputed that the shareholders of XLN had no interest whatsoever in XLNT. The court focused only on the interests of the two former shareholders of SDG (not XLN) who sold their shares in SDG to XLN three-and-a-half years prior to the sale of assets from XLN to XLNT.

An analysis of the public policy for the de facto merger doctrine would have more clearly identified the issues. While the court refers to the brief policy discussion in the Superior Court's opinion, it does not attempt to enunciate the purposes behind the doctrine. It might have stated that the policy for this doctrine is to protect creditors from sham reorganizations that would otherwise allow a purchaser with substantially the same management and ownership as the seller to acquire assets without assuming the liabilities associated with the business (leaving them with the seller). In these situations, courts have treated the buyer and seller as having been merged together so that the buyer is liable for the debts of the seller to avoid the unfair attempt by the owners of the seller to retain the assets while escaping the liabilities. The critical point is that the same people should not be able to walk away from the corporate liabilities while keeping the corporate assets in a new entity.

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There is no discussion by the court in Fizzano of any reason why public policy dictates a result that imposes liability on the innocent buyer of corporate assets for the benefit of a creditor of a failed business. There is no fraud or bad faith alleged, no compelling consumer protection interest being protected, and no public policy argument as to why this is an equitable result. Nor is there any recognition of the fact that the court's decision could be construed to favor creditors that were less than diligent in their credit practices and prejudice buyers investing new money to continue a business and employ people who otherwise had lost or would lose their jobs.

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Also, there was no determination that the consideration paid by XLNT was not fair. In fact, a fraudulent transfer claim was dismissed by the trial court. Assuming fair consideration was paid, one must question how the creditors of SDG or XLN were harmed by the relevant transaction and, further, what public policy or guiding principle was being served by putting a good-faith purchaser for fair value at risk for all of the known and unknown liabilities of the seller.

Further confusion results because it is unclear what the court intends would constitute "some sort of continuity of ownership or stockholder interest." Does a promissory note to the seller or its shareholders satisfy this test? What about employment by the buyer of one or more shareholders of the seller? What if the employment includes an incentive based on performance of the business after the sale or stock incentives? Some of these elements would seem to relate more to the continuity of management test and not to continuity of ownership, but the court draws no such distinction.

Instead of giving legal substance to a recognized form of transaction, presumably chosen by the parties because of its predictable legal consequences, the court requires a review of the "transactional realities and their consequences" without stating why that is appropriate in this case or what is meant by "transactional realities." Why does the continuity of employment of the software developers/owners from SDG through XLN to XLNT, given their changes in shareholder status, seem so relevant? Would the transactional realities be different if the buyer folded this business into a larger software services business with many existing employees? As the Superior Court properly noted, virtually every buyer wants to continue the business it is buying or else it would not make the purchase at the outset. If that includes keeping the owners of the seller involved somehow (e.g., as employees or creditors, but not as shareholders), should that be a transactional reality that damns the buyer under the de facto merger doctrine? The court ostensibly does not answer the question, and fails to provide helpful guidance.

Finally, it is troubling that there are a number of statements in the court's opinion that are contrary to basic principles of corporate law. A basic tenet of corporate law is that shareholders are insulated from the corporation's liabilities, absent certain recognized exceptions. It is therefore of great concern to read in the court's opinion that the buyer of the shares of a corporation is liable for the debts of the acquired corporation.

It will be interesting to see what the Superior Court and trial court do to carry out the Supreme Court's decision. However, given that the 2007 judgment for Fizzano was only for $114,000, and the original claim dates from 2000, it is hard to imagine that there is much life left in this litigation. Therefore, we may well be left with no further clarification in this case.

Every business transaction creates opportunities and risks for the buyer. Careful attention not only to structuring the transaction but also to the court's opinion in Fizzano is necessary to reduce the risk of bearing unwanted liabilities in a business transaction when the seller is financially distressed. •

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