CAVEAT EMPTOR: YOU MAY BE PURCHASING MORE THAN ASSETS

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Congratulations. Your company recently completed purchasing the assets of another company and now you are looking forward to an increased bottom line from efficiencies of scale. Then, weeks, months or even years after the deal closes, your company is named as a defendant in an employment suit. The suit alleges the former company – whose assets your company purchased – discriminated or retaliated against its employee. Because that former company no longer exists, the plaintiff is now seeking to hold your company liable.

But wait, you argue. Your company simply purchased the other company's assets – not its liabilities. Moreover, you never had any notice about this claim during the due diligence process. In fact, you took specific steps to make sure your company was not liable for any debts or obligations of the prior company. How can your company be held liable for the prior company's conduct under these facts?

Unfortunately, as some companies have discovered, they can be held liable under these very facts. Here's why, and how to avoid this outcome.

PURCHASER LIABILITY: THE GENERAL RULE

The general rule in corporate law is a purchaser of a corporation's assets is not liable for the predecessor's debt or liabilities, with three exceptions: (1) where there is an express or implied agreement; (2) where the successor is a mere continuation of the predecessor; or (3) where the transaction is an attempt to escape liability.

As such, in the scenario outlined above, unless your company entered into an express or implied agreement that requires it to provide relief for the employment-related claims of the predecessor corporation, your company is simply a continuation of the predecessor corporation, or the entire transaction is a sham to avoid liability, the general rule provides that your company should have no liability for the alleged bad acts of the prior company.

THE EMPLOYMENT EXCEPTION

In at least five of the circuits, however, the general rule now potentially has a fourth exception: for claims of employment discrimination or retaliation. For such employment-related claims, courts in the Fourth, Fifth, Sixth, Seventh and Tenth Circuits have relaxed the general rule and imposed liability on a company that simply purchases the assets of the prior company. These courts have reasoned that "fairness" allows imposing liability on the purchasing entity, in order to further the goal of remedying unfair employment practices and addressing the helplessness of the victim to protect his or her rights when ownership of the business changes. For courts in these circuits, a purchasing company can be held liable for the prior company's bad acts.

In deciding whether to impose liability on the purchasing company, these courts have considered a variety of factors, including:

- Whether the successor had notice of the EEOC charge;
- The predecessor's ability to provide relief;

- Whether there has been substantial continuity of business operations;
- Whether the successor uses the same facility;
- Whether the successor uses the same or substantially the same work force;
- Whether the successor uses the same or substantially the same supervisory personnel;
- Whether the same jobs exist under substantially the same working conditions;
- Whether the successor uses the same machinery, equipment, and methods of production; and
- Whether the successor produces the same product.

Distilled to their essence, these courts focus on (1) whether the purchasing company had notice about the charge or claim; (2) the predecessor's ability to provide relief; and (3) continuity of the business.

If the purchasing entity has notice about the charge or conduct, then, the courts reason, it could have (and should have) taken steps to protect itself in the purchase agreement. As such, when there is evidence the purchasing company had notice, this fact will weigh heavily in the court's analysis.

The absence of notice, however, is not dispositive. At least one court held that, even where there was no evidence the purchaser had notice about the EEOC charge, it could still be held liable because of its lack of diligence in making an inquiry prior to purchase or in failing to provide for indemnification of any undiscovered claims.

Next, if the predecessor company remains a viable entity, or if it has resources that respond to the charge or suit (*e.g.*, an insurance policy), then the court is going to be more reluctant to impose liability on the innocent purchaser, because holding the purchaser liable would not serve the policy underlying the doctrine. On the other hand, if the prior company cannot provide relief, a court is much more likely to look to the purchaser as the only available pocket. Finally, the more indicia of continuation of operations, the more likely a court will feel comfortable in imposing liability on the purchaser.

A recent case from Maryland shows how these factors play out. In *EEOC v. Phase 2 Investments, Inc.*,[1] the EEOC began investigating a car wash (Maritime), after several employees claimed they were unlawfully terminated. While that investigation was underway, another company (Mister) agreed to purchase Maritime's assets for $15 million. In addition to investigating Maritime's potential liabilities as part of its due diligence process, Mister purchased only Maritime's assets, the asset purchase agreement made clear Mister was not liable for any liabilities beyond those listed in a schedule, and Maritime agreed to indemnify Mister. After the transaction closed, Mister transitioned away from Maritime's trademark, website, and social media presence. Mister, however, hired many of Maritime's employees, and continued operating the car washes.

More than 2½ years after the transaction closed, the EEOC sued Mister, alleging it was liable for Maritime's misconduct. Mister moved to dismiss the complaint or for summary judgment. The court denied the motion. It explained that it needed to "balance the needs of discriminatees and the national policy against discrimination evinced by Title VII against the unfairness of holding an innocent purchaser liable for another's misdeed and the possible chilling of the corporate market."

After reviewing the transaction, the *Phase 2 Investments* court held it was "equitable" to hold Mister liable for any liability that Maritime may incur in the case because: (1) Mister had some notice of the EEOC charges prior to purchasing Maritime's assets; (2) although Maritime might not have been insolvent, and there was apparently available insurance coverage, the EEOC was seeking injunctive relief, which could not be obtained from Maritime; and (3) Mister was running substantially the same business; using the same facility; using much of the same workforce, machinery, equipment and methods of production; and producing the same product (car washes).

Perversely, the court held that "the lengths to which Mister went to protect itself from liability, such as structuring the sale as an asset purchase, inquiring into Maritime's liabilities, listing the assumed liabilities in a schedule, and including an indemnification clause, actually demonstrates the fairness of holding Mister liable as a successor." As explained above, in a different case, another court held that a purchaser's lack of diligence in making an inquiry prior to purchase, or in failing to provide for indemnification of any undiscovered claims, warranted imposing liability.

HOW TO AVOID THIS PITFALL

Successor liability in the context of employment discrimination claims is determined on a case-by-case basis, so there is no bright-line rule regarding what a purchaser of corporate assets must do to avoid potential liability. As gleaned from the cases, however, it is clear a purchaser needs to take every step to protect itself before, during, and after the transaction by:

- inquiring about any pending employment-related claims, charges, or demand letters lodged or threatened against the predecessor organization;
- inquiring about employment-related internal investigations or complaints;
- making sure any actual, threatened or potential claims, charges or demands are fully addressed in the asset purchase agreement;
- adding a provision in the asset purchase agreement requiring the seller to indemnify the purchaser against any employment-related claims that arise after closing, even if not previously disclosed or even known; and
- not engaging in conduct that could be construed as a continuation of the prior business, as much as possible.

To be clear, as the *Phase 2 Investments* decision shows, even taking these steps might not protect your company against a claim. But it puts you in the best position to respond to that claim.

If your company has completed its purchase and is then sued, make every effort to show the predecessor organization remains solvent, so that it is not necessary to look to your company to make the victim whole. Although the predecessor's solvency might not be dispositive if the plaintiff is seeking injunctive relief, it is certainly critical if money damages are at issue.

At the end, as the courts repeatedly state, each case is fact-dependent and turns on issues of "fairness." As such, the prudent purchaser should do everything to make sure the fairest outcome is one where the plaintiff, and the Court, looks elsewhere.

[1] *EEOC v. Phase 2 Investments, Inc.*, No. JKB-17-2463, 2018 WL 1851480 (D. Md. Apr. 18, 2018).

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