

The Legal Intelligencer

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Corporate Successor Liability Expanded Under De Facto Merger Doctrine

Commentary

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2012-07-31 10:00:00 AM

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Can there be successor liability in an asset purchase? If so, under what circumstances? What constitutes "continuity of ownership" for purposes of corporate successor liability, and is it a required element of the de facto merger doctrine?

In *Fizzano Brothers*, the state Supreme Court breathed new life into the de facto merger doctrine and broadened the circumstances under which the buyer can be liable for the debts of the company whose assets it acquired.

The general rule of corporate successor liability is that a purchaser of corporate assets does not automatically assume the liabilities of a selling corporation simply by virtue of the asset purchase. Rather, it must expressly agree to do so.

However, courts across the country, including in Pennsylvania, have held that a purchase of corporate assets may expose the purchaser to successor liability when that purchase constitutes a de facto merger. In determining whether a de facto merger has occurred, Pennsylvania courts generally look at four factors: (1) continuity of ownership; (2) cessation of the ordinary business by, and dissolution of, the selling company as soon as practicable; (3) assumption by the purchasing company of liabilities ordinarily incurred by the selling company; and (4) uninterrupted continuation of the business; and (4) continuity of the management, personnel, location and the general business operation.

In *Fizzano Brothers*, the principal issue was whether continuity of ownership should be

showing or just a factor in the analysis of a potential de facto merger. The Supreme Court noted that the majority of case law from around the country adopted a rigid rule that a showing of continuity of ownership is always required in a contract case. The Superior Court had concluded the same, holding that continuity of ownership is an indispensable element of the de facto merger exception.

In a nuanced 40-page opinion, the Supreme Court upheld that general rule, but it nevertheless went to great lengths to explain what the Superior Court did wrong. Although the Superior Court properly held that continuity of ownership is a required element of the de facto merger doctrine in contract cases, the Supreme Court found that the Superior Court's factual assessment had been "narrow and mechanical" by limiting the analysis to whether the same shareholders were in both the predecessor and successor companies.

In *Fizzano Brothers*, the plaintiff's problem was that it could not establish the usual kind of continuity of ownership — i.e., that the same shareholders were in both the predecessor and the successor corporations. The plaintiff's suit arose out of an accounting software license that it had purchased sometime prior to 2000 from System Development Group (SDG), according to the opinion.

In 2000, SDG was acquired in a stock purchase transaction by XLN. In return for SDG stock, XLN issued promissory notes to SDG's shareholders. At or about that time, the plaintiff experienced problems with the software. In 2001, the plaintiff sued SDG's successor, XLN, for breach of contract. Two years later, and in the middle of its litigation, XLN sold its assets to XLNT Software Solutions. XLNT purchased substantially all of XLN's assets, including the right to license the software. XLNT did not expressly assume XLN's potential litigation liability to the plaintiffs, but it did assume liability for XLN's promissory notes to the former SDG shareholders. No XLN shareholders acquired any stock in XLNT as a result of the asset purchase agreement, and the two companies had no common shareholders. In short, there appeared to be no continuity of ownership between XLN and XLNT.

When the plaintiff learned that XLN had sold its assets in the midst of litigation, it added XLNT as an additional defendant and as successor to XLN. The Delaware County Court of Common Pleas entered summary judgment against XLN, and after a bench trial it also entered a verdict against XLNT.

The trial court held that XLNT was liable under a de facto merger theory because, although the plaintiffs had not shown continuity of ownership between XLN and XLNT, the three other factors of the de facto merger analysis were present, making it clear that a de facto merger had occurred between the two companies. The Superior Court reversed, holding that continuity of ownership "must exist" for corporate successor liability under a de facto merger theory.

After surveying the law of de facto merger in other jurisdictions, including federal courts, the Pennsylvania Supreme Court adopted a position different from both the trial court and the Superior Court. Unlike the trial court, it held that continuity of ownership is a required element of the de facto merger doctrine in cases arising out of contract disputes.

But, unlike the Superior Court, it refused to require that such continuity of ownership be in the form of stock holding. The court observed that "transaction realities sometimes require a scrutiny that extends beyond the confines of the immediate consequences of the proximal asset purchase agreement." In pursuing that measure, the court concluded that the "de facto merger analysis certainly may not be more restrictive than the relevant elements of a statutory merger."

Refusing to limit ownership interest to stock holdings, the court pointed to Pennsylvania's statutory corporate law for support. The court observed that the state's Business Corporation Law of 1988 does not always require an exchange of shares for a statutory merger to take place. Under that statute, "shareholders of the predecessor corporation may surrender their shares of stock for 'obligations' of the successor corporation or, in partial manner, 'cash, property or rights' in lieu of shares in the successor corporation," according to the opinion.

If Pennsylvania statutory law doesn't always require an exchange of shares in a merger, the court reasoned that a de facto merger shouldn't always require an exchange of shares.

Turning to the facts of the case, the court observed that the primary asset of value for SDG, XLN and XLNT was the software that had been licensed to the plaintiff. All three corporations held that software as their principal asset, and all three had been formed essentially to invest in the development and licensing of that software.

Moreover, XLNT did assume XLN's promissory note obligation to the former SDG shareholders. Additionally, the two principal shareholders of SDG, who had also developed the software, at various times held important positions of employment with both XLN and XLNT. Under the circumstances, the court concluded, "the record demonstrates a continuity of the business" from XLN to XLNT. According to the court, this focus on the existence of a "corporate continuum" was a more suitable analysis of a de facto merger than the Superior Court's "narrow and mechanical view."

Although it expanded the manner in which continuity of ownership could be proved, the court did not alter the traditional requirement that a de facto merger requires continuity of ownership. Drawing on language from a U.S. Court of Appeals for the Eleventh Circuit decision, the court held that the de facto merger exception to corporate successor liability requires "some sort of" proof of continuity of ownership or stock interest."

Under this standard, the court found that "some sort of proof" is not restricted to an exchange of assets for shares in a successor corporation. Evidence of "other forms of stockholder interest in the successor corporation may suffice."

The court appeared to suggest that the "other forms" of ownership interest could include (1) the successor company's assumption of debt obligations owed by the acquired business and (2) the employment of the predecessor company's most important employees by the successor corporation.

It must be noted, however, that the court did not find that continuity of ownership had been established at trial by the plaintiff. Instead, it remanded to the Superior Court for further consideration. Moreover, the court did not expressly address the quantity or quality of proof needed to establish continuity of ownership. Consequently, it will fall upon Pennsylvania's lower courts to flesh out the contours of the de facto merger doctrine and, particularly, what proof will satisfy the "continuity of ownership" element.

Finally, although the court expressly limited its holding to corporate successor liability cases involving breach of contract or warranty claims, *Fizzano Brothers* suggests that, in the future, the court may engage in a similar sort of less restrictive analysis of the de facto merger exception to corporate successor liability in tort and criminal cases as well.

As the court observed, courts in other jurisdictions have found that a more relaxed approach to the continuity of ownership requirement is warranted in such cases because of the public policy interests involved. Given the flexible approach adopted in *Fizzano Brothers* for contract and warranty actions — cases that generally don't implicate public policy concerns — the court could very possibly extend the *Fizzano Brothers* analysis in the future to claims where public policy interests are larger, such as toxic tort or environmental claims.

Thus, although *Fizzano Brothers* answers one question — the shareholders of a predecessor company don't need to acquire shares of a successor company for a court to find a de facto merger — the opinion undoubtedly presents new ones as well. How else could a plaintiff prove continuity of ownership? How much of this "some sort of proof" is enough? Should the *Fizzano Brothers* approach apply to, say, a tort claim? These questions remained to be answered by the Pennsylvania courts. •

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