

De Facto Merger Doctrine and Successor Liability under Pennsylvania Law

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Successor liability is an exception to the general rule that, when one entity sells assets to another entity, the assets are transferred free and clear of all but valid liens and security interests. When successor liability is imposed, a plaintiff with a claim against the seller may assert that claim against and collect payment from the buyer. In Pennsylvania, the general rule does not apply and liability attaches to the successor when one of the following is shown: (1) the purchaser expressly or impliedly agrees to assume such obligation; (2) the transaction amounts to a consolidation or merger ("de facto merger"); (3) the purchasing corporation is merely a continuation of the selling corporation; (4) the transaction is fraudulently entered into to escape liability; (5) the transfer was not made for adequate consideration and provisions were not made for the creditors of the transferor; or (6) the successor undertakes to conduct the same manufacturing operation of the transferor's product lines in essentially an unchanged manner. The successor is then strictly liable for injuries caused by defects in the product line, even if previously manufactured and distributed by the transferor (commonly referred to as the "Product Line exception").

Four factors are analyzed in determining whether the de facto merger exception applies: (1) continuity of ownership, (2) cessation of ordinary business by, and dissolution of, the predecessor as soon as practicable, (3) assumption by the successor of liabilities ordinarily necessary for uninterrupted continuation of the business, and (4) continuity of the management, personnel, physical location and general business operations.

In the traditional asset purchase transaction between unrelated parties, the second, third and fourth factors are often present. Accordingly, the absence of the first factor (continuity of ownership) is all that prevents a de facto merger and the purchaser being liable for the obligations of the seller. Until 2009, Pennsylvania law required courts to consider all four factors, but a de facto merger finding did not require that all four factors were present. The Pennsylvania Superior Court, in a 2009 case, established the primacy of the continuity of ownership factor by holding that if the owners or the seller do not have an ownership interest in the purchaser, the transaction is not a de facto merger and, accordingly, the purchaser is not liable for the seller's obligations. In 2012, the Pennsylvania Supreme Court vacated and remanded the Superior Court's 2009 decision in *Fizzano Brothers Concrete Products, Inc. v. XLN, Inc., et al.*, 42 A.3d 952 (2012).

In *Fizzano*, the Supreme Court held that continuity of ownership is still required for a de facto merger, but broadened the confines of what constitutes continuity of ownership to include a "stockholder interest." Unfortunately, the court did not define "stockholder interest." *Fizzano* specifically dealt with a construction company trying to collect on a \$114,000 judgment obtained against a company that sold its assets to another unrelated company. The Supreme Court did not opine on whether a de facto merger occurred but rejected the Superior Court's analysis of the continuity of ownership element, and focused on a comparison to

statutory mergers under Pennsylvania law. Because in a statutory merger the sellers can receive consideration other than stock, the Supreme Court held that the same is true for the de facto merger exception. In other words, continuity of ownership may be satisfied if the owners of the selling business have some type of interest in the purchaser (i.e. a "stockholder interest") even though the owners of the seller and the purchaser are not identical.

Due to *Fizzano*, sellers and purchasers should be cautious in structuring transactions to avoid any potential successor liability. Ideally, future decisions will help delineate what constitutes a "stockholder interest" but until then, the saga of successor liability continues.

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