Buyers' Immunity Under Employment Law Is A Myth

By **Elvira Kras**

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Asset purchases of businesses is a steadily increasing commercial practice. There were 5,185 such business transactions in 2018, according to Standard & Poor's reports, while 2019 is on pace for more with 5,254 projected based on the deals done through late June. For that many deals, it is time to start paying closer attention to the employment law liabilities that buyers may inherit.

Asset purchasers disclaim liability on claims against their sellers. While shedding those liabilities is intrinsic to the structure of every asset purchase, statutory employment laws impose an oft-overlooked limitation on that disclaimer. This is not new: It began with Golden State Bottling Co. v. National Labor Relations Board[1] recognizing successor liability under the National Labor Relations Act. That doctrine now encompasses all federal employment laws.

U.S. Equal Employment Opportunity Commission v. Phase II Investments Inc.[2] is illustrative. There, Maritime Autowash had sold its assets for $15 million, while employees had a pending charge of discrimination under Title VII of the Civil Rights Act at the EEOC. The buyer — Mister Car Wash — knew of this EEOC charge, which its due diligence identified, and explicitly provided in the asset purchase agreement that it was not assuming any liabilities of the seller.

When the EEOC later sued, it named not only Maritime but also Mister and Phase II, which had subsequently acquired Mister, as defendants. Mister moved to dismiss this lawsuit claiming that "it would be inequitable to apply successor liability in this case" because it "never employed" the individuals alleging discrimination; that "the discriminatory actions … were not performed by Mister"; and that "there is no fairly traceable connection between the … alleged injuries and Mister Car Wash."

Good points all, but unavailing. Successor liability under Title VII and other federal employment statutes is a judicially designed construct to ensure that constituents protected by those statutes are not left "without a remedy or with an incomplete remedy." Such successor liability precedents place notions of public policy interests ahead of both corporate formalities and certain rules of contract privity.

There are three focal points in every successorship case: (1) notice to the purchaser; (2) continuity of the business; and (3) the ability of the seller to provide relief. These are the contemporary counterparts of the three fates of Greek mythology: Clotho, who spun the thread of fate; Lachesis, who dispensed it; and Atropos, who cut that thread off. The ancient Greeks had a healthy regard for fate; 21st century lawyers have too little. That needs to change.

Reading the tripartite test for successor liability, it is enticing to conclude that a deal is safe. This is what the Greeks called hubris. Remember Oedipus, who also thought he could escape the prophecy of his fate? Even when it appears one of those factors ought to result in a buyer escaping successorship liability, any reading of those factors needs to be grounded in the case law because it sweeps more than a literal reading of those tripartite factors might suggest.

Even a quick look at the case law reveals the magnitude of the doctrine’s scope.

Notice

Buyers, whether strategic or private equity purchasers, will often be charged with actual or “constructive notice” of a claim or potential claim. Indeed, in a mature M&A environment, the rule of caveat emptor applies and there exists no reward for shirking due diligence, including in asset deals. Courts allow for successor liability by finding constructive notice where a buyer should have known of the risk. In one sexual harassment case, for example, the district court chastised the purchaser for failing to conduct “even the most basic of inquires” and found that this sophisticated purchaser should have known and that was enough.[3]

That holding is oft-repeated in the case law. In EEOC v. Phase II, protests of ignorance by Phase II were also rejected and constructive notice accepted. That court wrote that the notice requirement is limited “to protect innocent purchasers that were themselves blindsided, not to reward purchasers that choose to enter deals blindly.”[4] With statutory employment claims, courts believe that public policy requires protecting the employee plaintiff because the asset buyer had the best opportunity to protect itself vis-a-vis the seller in how it structured the deal (i.e., ironclad indemnification or reductions in price).

Continuity

Here, the courts apply the duck test: Does the new business look like, swim like and quack like the old business? If so, there is continuity. Buying a factory to convert to loft apartments will destroy continuity. Buying a steakhouse to convert the concept to a gastropub, but otherwise maintaining the operations of the business relatively intact, will show continuity. Continuity involves both the line of business and the transition of the workforce from the buyer to the seller.

In Medina v. Unlimited Systems LLC,[5] the buyer kept essentially the same management, the same workforce, the same customers, and virtually the same website description of the successor business as of the predecessor. Thus, the court found sufficient continuity to justify a successorship and allowed employees to enforce judgement against the successor for damages under the Fair Labor Standards Act. Medina is also interesting in its digression into common law exceptions to the immunity of buyers (e.g., de facto merger) where, as here, there was a practical overlap in ownership from the seller husband to the buyer wife but such exceptions, which are unrelated to employment statutes, offer a different set of problems beyond the scope of this analysis.

Relief

Patently, if the seller has gone belly up, it is no longer available to pay any judgment. That routinely triggers successor liability. The U.S. Court of Appeals for the Third Circuit reached that result easily in a Title VII case where the predecessor was insolvent and unable to satisfy a judgment.[6] That case also rejected any argument that it is somehow unfair to provide a plaintiff with a better chance of recovering damages from a successor rather than a “penniless predecessor.”

But, it’s not just about the money. Even a solvent seller may not be enough to fend off successor liability. EEOC v. Phase II illustrates that Catch-22.

There, the buyer’s reliance on the seller’s “$1 million employment discrimination liability insurance” got no traction with the court. That is because the remedies sought by the EEOC on behalf of the employees included injunctive relief (e.g., reinstatement to terminated employees) that only the buyer as the current operator of those car washes could provide.

Conclusion

Surveying the successorship cases collectively is myth dispelling. The tripartite test suggests a bulwark for asset purchasers that — when cases are litigated — dissipates. Asset purchasers might do better to assume that there will be successor liability and to plan their deal accordingly. That advice is routinely repeated in the case law:

- "[T]he buyer had an opportunity to protect itself by investigating the possible liability and negotiating a purchase price that would take it into account";[7]

- "[A] purchaser with notice of the predecessor's pending or potential liabilities may utilize that knowledge to negotiate a lower purchase price and/or an indemnification agreement";[8] and

- "[T]he successor is generally in the best position to remedy the violation and, because notice is required, potential liability can be reflected in the price the successor pays for the business, or the successor may secure an indemnity clause in the sales contract."[9]

But, is every asset purchaser on the hook for successor liability? Certainly, there are circumstances where purchasers are not: e.g., a buyer who purchased through a receivership was allowed to escape successor liability because the receivership did not allow for the negotiation of an indemnity clause or bargain for a price that captured the risk of potential liabilities.[10] But when push comes to shove, too few purchasers escape this fate. Plus, escaping only after litigating through the appellate court is a qualified success.

Remember Oedipus. Don’t tempt fate by underestimating successor liability.

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[1] Golden State Bottling Co. v. NLRB, 414 U.S. 168 (1973)

[2] EEOC v. Phase 2 Investments Inc., 310 F. Supp. 3d 550 (D. Md. 2018)

[3] Kratz v. Richard J. Boudreau & Assocs., LLC, No. 15-CV-232-SM, 2017 WL 3614434, at *6 (D.N.H. Aug. 22, 2017)

[4] Id. at 570

[5] Medina v. Unlimited Sys., LLC, 760 F. Supp. 2d 263, 272 (D. Conn. 2010).

[6] Brzozowski v. Corr. Physician Servs., Inc., 360 F.3d 173, 178–79 (3d Cir. 2004)

[7] Bd. of Trustees of Auto. Mechanics' Local No. 701 Union & Indus. Pension Fund v. Full Circle Grp., Inc., 826 F.3d 994, 997 (7th Cir. 2016)

[8] Xue Ming Wang v. Abumi Sushi Inc., 262 F. Supp. 3d 81, 91 (S.D.N.Y. 2017)

[9] Einhorn v. M.L. Ruberton Const. Co., 632 F.3d 89, 94 (3d Cir. 2011)

[10] Peters v. N.L.R.B., 153 F.3d 289, 301 (6th Cir. 1998)