Buyer Beware

Navigating Employment Liability Issues for Successor Employers in Asset Purchases

By Robert A. Luskin and Joshua Y. Joel

Companies should take a cautious and judicious view of employment liability matters when contemplating an asset purchase.

ABC Co. is a manufacturer of home products. To consolidate its market share and eliminate competition, it plans to buy out its biggest competitor, home products manufacturer XYZ Co. XYZ Co. employs thousands of individuals in its factories and warehouses. As with many large employers, XYZ Co. is consistently saddled with many individual employment issues, such Equal Employment Opportunity Commission (EEOC) discrimination charges under Title VII of the Civil Right Acts of 1964 (Title VII), Americans with Disabilities Act (ADA) claims, employees out on medical leave under the Family Medical Leave Act (FMLA), employees who believe that they are not being paid properly for the overtime under the Fair Labor Standards Act (FLSA), employees on military leave protected by the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA), and many more.

ABC Co. does not wish to assume responsibility for the XYZ Co.'s employment problems. On the advice of its merger and acquisitions attorney, ABC Co. therefore structures an asset purchase agreement, in which it disclaims any and all liability for employment-based claims or liability.


■ Robert A. Luskin is a partner in the Atlanta office of Goodman McGuffey Lindsey & Johnson LLP who represents clients in a wide range of insurance matters and employment litigation in federal and state courts across Georgia and the Southeast. Mr. Luskin represents various companies regarding employment-related matters, including discrimination and harassment issues. He has experience in defending corporations and individuals in various complex litigation matters as well as extensive experience in the areas of product liability, premises liability, professional negligence, and questionable insurance claims. Josh Y. Joel joined Goodman McGuffey's Atlanta office as an employment litigation associate in August 2017.

ABC Co. promises to rehire most of XYZ Co.'s employees after the closing and plans to maintain the general management structure. In fact, ABC Co. is strongly interested in the continued ceaseless operations of the manufacturing plants and warehouses of XYZ Co. While over the course of time, ABC Co. will implement its own policies, practices, and procedures—and will likely lay off employees to streamline the companies—for now most of the operations will remain the same. ABC Co. wisely approaches its employment counsel to seek advice and understand whether it will be shielded from liability from employment-based claims. This article intends to give employment counsel a general understanding of the ins and outs of employment-based liability in asset purchases.

General Liability in Asset Purchase Agreements

Under the common law "rule of non-liability," the buyer of assets of a business does not become liable for the liabilities or debts of the seller that the buyer did not expressly assume. Thus, when acquiring another company, many purchasing companies choose an asset purchase over a merger or stock acquisition because this arrangement gives the parties flexibility to agree between themselves which debts and liabilities the purchaser will assume and which debts and liabilities will remain with the seller. The parties maintain the freedom to negotiate the deal, the purchase price, and the specific assets purchased in a manner that tailors the allocated risk between the parties to the specifics of the deal.

What Happens to Employees in Asset Purchase Agreements

At the closing of an asset purchase, employees of the seller are generally terminated as employees of the seller, and after closing, those employees are rehired by the purchaser. Depending on the size, nature, and complexity of the deal, some purchasers require the employees to reapply for their positions, some guarantee positions to them and transition them over as automatic hires, and some make no promises at all. Most asset purchases, however, disclaim liability for employment claims of the seller.

However, this does not necessarily shield subsequent employers from liability for the predecessor's employment matters. The general non-liability rule has been whittled away over the last few decades, requiring those planning an asset purchase to think closely about the potential liabilities that purchasers may unwittingly take on. Thus, purchasers must be judicious in the way that the former employer's employees are handled to avoid liability pitfalls for pre-purchase employment matters.

FLSA

We will first explore liability issues regarding unpaid wage and hour claims under the FLSA. In asset purchases, a successor corporation could be held liable for the unpaid overtime or wage and hour claims of the predecessor. For example, the Third, Seventh, and Ninth Circuits have all applied the federal common law standard to determine whether a successor employer should be liable for the predecessor's FLSA violations. *Thompson v. Real Estate Mortgage Network*, 748 F.3d 142 (3d Cir. 2014); *Teed v. Thomas & Betts Power Solutions, L.L.C.*, 711 F.3d 763 (7th Cir. 2013); *Steinbach v. Hubbard*, 51 F.3d 843 (9th Cir. 1995). In *Teed v. Thomas & Betts Power Solutions*, the Seventh Circuit imposed successor liability under the FLSA despite express language in the parties' agreement disclaiming any liability over FLSA claims. Importantly, the court stated that successor liability should be presumed to apply in lawsuits involving federal employment law claims if there is not "good reason" to hold otherwise. 711 F.3d at 769.

Under the federal common law standard, successor liability applied if it can be shown that there was "(1) continuity in operations and work force of the successor and predecessor employers; (2) notice to the successor-employer of its predecessor's legal obligation; and (3) [the] ability of the predecessor to provide adequate relief directly." *Thompson v. Real Estate Mortgage Network*, 748 F.3d 142, 150–51 (3d Cir. 2014). While courts have differed whether the successor needs actual notice of the claim or whether constructive notice is sufficient, most district courts across the country have applied this test for FLSA claims.

In one interesting case, *Herzfeld v. 1416 Chancellor, Inc.,* 2017 U.S. Dist. Lexis 88732 (E.D. Pa. 2017), the judge held that a company that purchased an exotic dance nightclub could be held liable for the FLSA violations with respect to exotic dancers who had been misclassified as independent contractors. In that case, the new owner had purchased the dance club after the lawsuit had been filed and continued to operate the club while making almost no changes to the club's operations. Even though the asset

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purchase agreement specifically disclaimed liability for the dancer's FLSA suit, the court allowed the dancer to proceed against the successor corporation. While not every circuit has expressly ruled on FLSA successor liability, purchasers should be cautious about any such potential claims.

Title VII, ADA, and ADEA

Moving to discrimination claims, courts across the country have determined that liability for discrimination claims leveled against a seller company can extend to a successor company that had no role in the alleged discrimination. For example in Equal Employment Opportunity Commission v. Northern Star Hospitality, Inc., 777 F.3d. 898 (7th. Cir. 2015), a racial harassment and retaliation case, the court stated that the doctrine of successor liability was meant to allow victims of discrimination to obtain relief, even though the business organization changes, when there is substantial continuity between the predecessor and successor. The court analyzed the following factors: (1) whether the successor had notice of the pending claims, (2) whether the predecessor could have provided relief to the ex-employee before it was dissolved, (3) whether the predecessor could have provided relief after it was dissolved, (4) whether the successor could provide the relief sought, and (5) whether there was substantial continuity in the operations and workforce between the predecessor and the successor. *Id.* at 902. Applying the factors, the court determined that the successor was a successor in interest because that case involved common ownership, and the successor naturally had notice. Also, only the old restaurant could have resolved the suit before dissolution, the new restaurant was capable of providing relief, and there was a substantial continuity in operations, albeit under a different name. *Id.* at 903–04.

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While *Northern Star* did not specifically involve an asset purchase, the analysis applies equally to such a purchase. For example, in *EEOC v. Phase 2 Invs., Inc.*, 310 F. Supp. 3d 550 (D. Md. 2018), a car wash sold its assets to a successor by way of an asset purchase agreement to avoid liabilities other than those in the agreement. The agreement disclaimed Title VII liabilities. The predecessor disclosed to the successor the existence of Title VII national origin discrimination claims by Hispanic employees, and the purchase went forward. The EEOC argued that the successor company should be held liable as a successor in interest, but the successor company obviously disagreed.

The court held that successor liability under Title VII was an issue of equity, and the court should "balance the needs of discriminatees and the national policy against discrimination… against the unfairness of holding an innocent purchaser liable for another's misdeed." 310 F. Supp. 3d at 563. To do so, the court looked at nine factors:

> 1) whether the successor company had notice of the charge, 2) the ability of the predecessor to provide relief, 3) whether there has been a substantial continuity of business operations, 4) whether the new employer uses the same plant, 5) whether he uses the same or substantially the same work force, 6) whether he uses the same or substantially the same supervisory personnel, 7) whether the same jobs exist under substantially the same working conditions, 8) whether he uses the same machinery, equipment and methods of production and 9) whether he produces the same product.

Id. at 570. The court found that the successor company had constructive knowledge of the claim, that the predecessor employer could not provide any relief because it no longer operated the business, and that the successor continued to operate the same business. The court therefore held that the successor cold be equitably held responsible jointly and severally for the liability of the predecessor.

Based on this decision, a disclaimer in an asset purchase agreement is not sufficient to shield a successor employer from the pursuit of employment discrimination claims. Importantly however, a disclaimer in the asset purchase agreement could provide an avenue for the successor employer to recoup monetary losses from the predecessor for discrimination claims of the predecessor. Thus, purchasers should carefully look at any pending or potential discrimination claims before engaging in an asset purchase.

FMLA

Under the FMLA, an employee is eligible for FMLA leave only after working for a company for at least 12 months. The FMLA statutorily makes any "successor in interest of an employer" responsible for compliance with the statute. Thus, after an asset purchase, an employee who has worked for the successor employer for less than 12 months may still be statutorily eligible for FMLA protection if he or she worked for the predecessor and the successor together for 12 months or more. The statute, however, does not define "successor in interest."

The U.S. Department of Labor regulations list a number of factors to be considered when determining whether a successor business is a "successor in interest": (1) substantial continuity of the same business operations; (2) use of the same plant; (3) continuity of the work force; (4) similarity of jobs and working conditions; (5) similarity of supervisory personnel; (6) similarity in machinery, equipment, and production methods; (7) similarity of products or services; and (8) the ability of the predecessor to provide relief. 29 C.F.R. §825.107.

In 2010, the Ninth Circuit, in *Sullivan v. Dollar Tree Stores, Inc.*, 623 F.3d 770 (9th Cir. 2010), issued a decision that demonstrates how courts often treat successor in interest issues under the FMLA. In that case, Dollar Tree had purchased the lease of a store after the predecessor company filed for bankruptcy. The plaintiff had worked in the store for over a year and was rehired by Dollar Tree after the acquisition. When she request FMLA leave, Dollar Tree did not approve all of the leave requested because she was not employed for 12 months or more. In determining that Dollar Tree was not a successor employer, the Ninth Circuit analyzed the eight factors in the regulations. It reasoned that Dollar Tree purchased only the lease on the building and spent weeks renovating the store's interior. In addition, all the predecessor's employees were required to apply for new jobs at Dollar Tree, and not all of the employees carried over. Dollar Tree launched its own training methods and employed a new manager. Thus, the court held that given "the equities disclosed in the record," Dollar Tree was not a successor in interest and was not required to provide the requested FMLA benefits.

On the other hand, in a 2006 opinion, the Sixth Circuit, analyzing the same regulatory factors as the Ninth Circuit, found successor liability in *Cobb v. Contract Transport, Inc.* 452 F.3d 543 (6th Cir. 2006). That case also involved an asset purchase agreement, but the court found that Cobb's employment was not interrupted in any way for over three years. The job stayed exactly the same, but only management changed. The court therefore reasoned that Contract Transport could not avoid FMLA responsibility as a matter of policy because such an outcome would defeat the purpose of the statute. The Sixth Circuit was clear that its decision was based on balancing the equities of the employee and the employer's interest using the factors in the regulations.

As both these decisions make clear, whether a successor entity is responsible for the FMLA obligations stemming from the predecessor is a fact-intensive, equity-involving inquiry. Thus, here, too, a well-thought-out asset purchase agreement is essential.

Another important and often overlooked aspect of successor liability under the FMLA involves employees who are eligible for FMLA leave or are already out an FMLA leave. In these scenarios, if an employee notified the predecessor employer that he or she intended to take FMLA leave, a true successor in interest is required to honor the employee's request. Similarly, employees who were out on FMLA leave when an asset purchase was closed must be permitted to continue their leave by the successor employer. For instance, in *Noel v. Terrace of St. Cloud, LLC*, 212 F. Supp. 3d 1193 (M.D. Fla. 2016), a Florida district court held that a successor company was liable when its representative informed an employee that she was rejected from rehire due to excessive absences, even though she never reapplied for a job with the successor company. Importantly, even if a predecessor employer did the dirty work of informing an employee of his or her termination, the successor interest is not necessarily absolved. Finally, all FMLA requirements that would have applied to a previous employer apply to the successor in interest, including continuing benefits, saving the original or similar position, and not discriminating or retaliating against an employee for exercising FMLA rights.

USERRA

Similar to the FMLA, the successor in interest doctrine is particularly important under USERRA because of the obligation of an employer to reemploy a returning service member. The regulations provide a six-factor test, which is also predicated on whether the successor organization maintains a substantial continuity of operations. Specifically, the factors are (1) whether there is substantial continuity of operations; (2) whether the successor uses the same facilities, machinery, equipment, or methods of production; (3) whether there is substantial continuity of employees; (4) the similarity of jobs and working conditions; (5) the similarity of supervisors; and (6) the similarity of products or services. 20 C.F.R. §1002.35.

Applying these regulations, courts have reached different results based on the factual circumstances in front of them. For example, in *Murphree v. Communications Technologies, Inc.*, 460 F. Supp. 2d 702 (E.D. La. 2006), the judge concluded that the serviceman plaintiff was entitled to have his job back where the position involved a government contract, the predecessor employer lost the contract, the defendant was the new contractor, and the defendant had given the serviceman's job to someone else. On the other hand, the judge in *Reynolds v. Rehabcare Group East Inc.*, 531 F. Supp. 2d 1050 (S.D. Iowa 2008), concluded that a serviceman was not entitled to have his job back. That case involved an employer who provided contract physical therapy services to a rehabilitation center. While the plaintiff was on military leave, the employer lost the contract. The defendant was a subcontractor through a different contractor, who had no relationship to the previous contractor. The court concluded that there was no continuity between the two companies, even though the second company was providing the same services, because the new contractor was an entirely new entity, the new contractor did not purchase any of the original employer's equipment, the new contractor did not employ any of the former employer's employees, and the supervisors were different. Thus, when performing due diligence in an asset purchase, purchasers should be careful to ascertain if any employees are on USERRA-protected leave and analyze their status under the specifics of the purchase arrangement.

COBRA

Another interesting question arises when a successor employer chooses not to rehire the predecessor's employees: whether either employer has some obligation to offer continuing health coverage under "COBRA," the Consolidated Omnibus Budget Reconciliation Act. COBRA requires that covered employers provide qualified beneficiaries who lose group health benefits with continued coverage for a period of time. Under IRS regulations, 26 CFR §54.4980B-9, if a seller maintains a group health plan after the sale, that plan must provide coverage to the qualified beneficiaries affected by the sale. If a seller no longer maintains a health plan—which is often the case in asset purchase agreements—the purchaser must provide COBRA coverage if the purchaser is considered a "successor employer." For a successor employer to be required to assume the COBRA obligations of the previous employer, it must continue the business operations associated with the assets purchased from the seller "without interruption or substantial change." 26 C.F.R. §54.4980B–9, A–8(c)(1).

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Here, too, courts use a fact-based analysis under the totality of the circumstances to determine whether there was substantial continuity between the companies. Factors that courts use to analyze COBRA obligations include

> "whether the business of both employers is essentially the same; whether the employees of the new company are doing the same jobs in the same working conditions under the same supervisors; and whether the new entity has the same production process, produces the same products, and basically has the same body of customers."

Risteen v. Youth For Understanding, Inc., 245 F. Supp. 2d 1, 13 (D. D.C. 2002) (quoting *Fall River Dyeing & Finishing Corp. v. NLRB*, 482 U.S. 27 (1987)).

If these factors are met, a subsequent employer may be liable to provide continuing coverage to the predecessor's employees, even if they never formally worked for the successor employer. A failure to do so may result in substantial statutory damages and obligations to pay for medical costs accrued while the employee had no coverage.

ERISA

While the details of how successor liability fits into the complex ERISA statutory scheme is beyond the scope of this article, most courts have determined that successor employers could have successor liability for ERISA issues when there was a sufficient continuity of operations and the successor entity had notice of the liability. *Einhorn v. Ruberton Construction Co.*, 632 F.3d 89 (3d Cir. 2011); *Upholsterers' Int'l Union Pension Fund v. Artistic Furniture*, 920 F.3d 1323 (7th Cir. 1990). Thus, a purchasing company must be aware that the negotiated allocation of risk may not shield the successor from withdrawal liability or liability for delinquent multiemployer plan contributions.

Bankruptcy

Another interesting twist to successor liability law occurs when a successor corporation purchases the assets of a company that is under bankruptcy protection. In this scenario, the asset purchase must have been approved by the bankruptcy court, and therefore the policies of bankruptcy law play into a court's equity decision about whether to apply successor liability. Under the bankruptcy code, judicial enforcement of a negotiated asset sale furthers the policy of encouraging sales to maximize value for the estate and its creditors. Thus, court have recognized the importance of shielding subsequent buyers from liability from the bankrupt company's employment liabilities so as to maximize the value of the assets for the creditors, "'because without this assurance of finality, purchasers could demand a large discount for investing in a property that is laden with the risk of endless litigation as to who has rights to estate property.'" *See, e.g., Doktor v. Werner Co.*, 762 F. Supp. 2d 494 (E.D.N.Y. 2011) (quoting *In re Gucci*, 126 F.3d 380, 387 (2d Cir. 1997)); *Cargo Partner AG v. Albatrans Inc.*, 207 F. Supp. 2d 86, 112 (S.D.N.Y. 2002) (recognizing that imposing successor liability could discourage asset sales and decrease the money available to creditors). Thus, courts are reluctant to impose successor liability on companies purchasing assets that have bankruptcy protection, providing purchasers far more comfort in avoiding successor liability.

Practical Implications

As overviewed in this article, companies should take a cautious and judicious view of employment liability matters when contemplating an asset purchase. Purchasers should be aware that the negotiated terms of the asset purchased disclaiming any liability for employment issues may not be dispositive of the purchaser's position, given the equities and policies involved in employment-based claims. This is especially critical when the successor employer intends to maintain a substantial continuity of the predecessor's operations, as is often the case.

In addition, employers cannot assume that corporate changes, even changes in the way that business is performed, will protect it from successor liability, given that the inquiry is fact-intensive, equitable in nature, up to judicial discretion, and involves the totality of the circumstances. Corporations must recognize the importance of due diligence in ascertaining employment liabilities, and therefore allocating risk and determining the asset purchase price. Ignorance is not necessarily a defense. At the very least, companies must recognize that many court are determined to ensure that employees' protections under the various federal employment statutes are maintained even when companies attempt to avoid liability in asset purchase agreements.