Client Alert

pillsbury

Insolvency & Restructuring

Employment

Corporate & Securities

April 11, 2013

7th Circuit Holds Successor Liable for FLSA Claims, Despite Buyer's Disclaimer

By Paula M. Weber, Alexander Parachini, Leo T. Crowley and Thomas N. Makris

In Teed v. Thomas & Betts Power Solutions, LLC*, the 7th Circuit in an opinion written by Judge Posner held that, absent a good reason to withhold liability, a purchaser of assets was subject to successor liability for Fair Labor Standards Act ("FLSA") claims and other federal labor and employment laws, even if the successor disclaimed liability when it acquired the assets.*

Facts

Plaintiffs filed collective actions for overtime pay under the FLSA. The original defendant was JT Packard & Associates ("Packard"). Packard guaranteed a loan by its parent company. When the parent company defaulted, Packard's assets were placed in a receivership and auctioned off, with the proceeds going to the bank. Thomas & Betts Corporation bought Packard's assets and placed them in a wholly owned subsidiary, Thomas & Betts Power Solutions, LLC ("Thomas & Betts"). Over Thomas & Betts' objection, plaintiffs were allowed to substitute Thomas & Betts for the original defendants. Eventually, a judgment of $500,000 was entered against Thomas & Betts in this matter for FLSA violations that occurred when Packard owned the assets.

When Thomas & Betts purchased the assets of Packard, it knew of the pending FLSA lawsuit. One condition specified in the transfer of assets to Thomas & Betts was that the transfer be "free and clear of all Liabilities" and that Thomas & Betts would not assume any liabilities Packard might incur in the FLSA litigation. After the transfer, Thomas & Betts continued to operate Packard much as the previous owner had done and indeed offered employment to most of Packard's employees.

Application of Federal Common Law Standard of Successor Liability

When a company is sold in an asset sale as opposed to a stock sale, the buyer acquires the company's assets but not necessarily its liabilities. Most states limit successor liability, in an asset sale, to sales in which a buyer (the successor) expressly or implicitly assumes the liability. In *Teed*, Wisconsin state law applied to underlying claims based on state law, and Wisconsin follows this general rule. Thus, if Wisconsin state law governed the issue of successor liability, Thomas & Betts could not be held liable.

Judge Posner acknowledged that under state law generally applicable to the sale of assets by the receiver, the purchaser would not be liable for the debts of the seller of the assets, but he held that state law did not apply. Instead, the court applied a federal common law standard of successor liability that is more favorable to plaintiffs than the state law standard. Generally, this federal common law standard involves a multi-factor test:

1. Did the successor have notice of the pending lawsuit when it purchased the assets (here, yes);
2. Was the predecessor able to provide the relief sought in the lawsuit before the sale (here, no);
3. Could the predecessor provide relief after the sale (here, no);
4. Could the successor provide the relief after the sale (here, yes);
5. Was there continuity between the operations and workforce of the predecessor and successor (here, yes).

In *Teed*, the court concluded that this more favorable successor liability standard was “appropriate in suits to enforce federal labor or employment laws – even when the successor disclaimed liability when it acquired the assets in question – unless there are good reasons to withhold such liability.” One example the court gives as a good reason is lack of notice of potential liability – a reason clearly absent in *Teed* because there was a pending FLSA lawsuit.

The court rejected the argument that imposing successor liability in such case impedes the operation of the market by increasing the cost to the buyer of a company that may have violated the FLSA. The answer is that the successor will simply pay less for the assets it’s buying.

It also rejected arguments that to allow relief here would enable plaintiffs whose wage claims are unsecured to obtain a preference over a senior creditor, namely the bank, which had a secured claim. Thomas & Betts would have paid less at the auction had it known it would have to pay for the FLSA claims, and so the bank would have obtained less money. The court deemed that this may be a good reason not to apply successor liability after an insolvent debtor’s default, whether its assets were sold in bankruptcy or outside bankruptcy, but that concern was not applicable here: Thomas & Betts did not discount its bid from Packard because of the FLSA claims. Clearly it believed it was not assuming this liability, given that, consistent with state law, it expressly disclaimed any assumption of liability in the purchase agreement.

After rejecting a host of other arguments, including an argument that allowing successor liability provides a windfall to plaintiffs who could never recover from Packard or its parent due to its debt to the bank, the court held that there was “no good reason to reject successor liability in this case – the default rule in suits to enforce federal labor or employment.” In so holding, the court reiterated that “the successor’s disclaimer of liability is not a good reason in such a case.”

Teed thus upends what most believed was a common characteristic of an asset sale: A buyer could acquire the company’s assets without acquiring its liabilities. Careful drafting may not fix this issue, especially in those situations in which the seller will not be able to pay off the liability.

Formal Bankruptcy as an Alternative

The result would likely be different in Chapter 11. There is considerably more forceful law on the proposition that a sale under section 363(f) of the Bankruptcy Code is "free and clear of any interest in property." This section has been held to bar successor liability on employment law claims. In the course of its bankruptcy case, Trans World Airlines ("TWA") sought to sell substantially all of its assets to American Airlines. The bankruptcy court approved the sale free and clear of existing employment discrimination claims against TWA. The Third Circuit affirmed, reasoning that "interest in property" in section 363(f) must be construed more broadly than merely *in rem* interests such as liens.[1] Rather, it encompasses all interests that "arise from the property being sold."[2] Moreover, the employment discrimination claims were reducible to, and could be satisfied by, a monetary award, allowing the assets to be sold free and clear pursuant to section 363(f)(5).[3] The Third Circuit noted that, despite federal labor law and policy, in the context of a bankruptcy case employment discrimination claims are general unsecured claims and thus "are accorded low priority."[4] Addressing the same concern as the Seventh Circuit in *Teed*, it further stated that "[t]o allow the claimants to assert successor liability claims against American while limiting other creditors' recourse to the proceeds of the asset sale would be inconsistent with the Bankruptcy Code's priority scheme."[5]

The Third Circuit's decision was not without precedent, as earlier decisions under both the Bankruptcy Code and the former Bankruptcy Act had precluded successor liability on employment law claims after a sale free and clear of liens.[6] Subsequent decisions have affirmed its holding in the employment law context,[7] and even those decisions that have distinguished it have not disagreed with its core holding that a sale free and clear under section 363(f) precludes successor liability for employment claims.[8] While a 363 sale may not preclude successor liability based on claims that may arise in the future,[9] it is clear that the sale of assets in a bankruptcy case "free and clear" can extinguish successor liability for existing claims.

Open Questions

There are several open questions:

1. Would the result be different if no FLSA claim was pending at the time of the sale, but due diligence revealed possible violation of this or some other federal claim?

[1] *In re Trans World Airlines, Inc.*, 322 F.3d 283, 290 (3d Cir. 2003).

[2] *Id.*

[3] *Id.* at 291.

[4] *Id.* at 292.

[5] *Id.*

[6] *See, e.g., Rubenstein v. Alaska Pac. Consortium (In re New England Fish Co.),* 19 B.R. 323, 328 (Bankr. W.D. Wash. 1982) (holding that 363 free and clear sale precludes successor liability on Title VII claims); *see also Forde v. Kee-Lox Mfg. Co.,* 437 F.Supp. 631 (W.D.N.Y. 1977) (holding that sale under Bankruptcy Act free and clear of liens precludes successor liability on employment discrimination claims).

[7] *See, e.g., Faulkner v. Bethlehem Steel/Int'l Steel Grp.,* No. 04-CV-34 PS, 2005 WL 1172748 at *3 (N.D. Ind. Apr. 27, 2005) (citing *TWA* and holding that 363 sale precluded successor liability on racial discrimination claims).

[8] *Consol. Rail Corp. v. Ray, ex rel. Boyd*, 693 F.Supp.2d 39 (D. D.C. 2010) (declining to extend TWA to successor liability for FELA asbestos claims in case under Regional Railroad Reorganization Act, which provides only for sale "free and clear of liens and other encumbrances")*; In re Eveleth Mines, LLC*, 312 B.R. 634, 654-55 (Bankr. D. Minn. 2004) (declining to extend TWA to successor liability under state taconite production tax statute).

[9] See, e.g., *Morgan Olson L.L.C. v. Frederico* (*In re Grumman Olson Indus., Inc.),* 467 B.R. 694, 708-710 (S.D.N.Y. 2012) (permitting successor products liability for future, as opposed to existing but "unmatured" claims, despite 363 free and clear sale).

2. Would the result be different if the economics were different? In *Teed* the purchaser paid $22M for the assets, more than 40 times the amount of the FLSA judgment. If the value of the wage claim was a substantial percentage of, or even greater than the value of the assets, the result would have looked even more inequitable.

3. Would the result be the same under state wage laws in jurisdictions like California that are very protective of workers' rights? While the court relied on federal common law, state laws related to employment may have similar concepts of successor liability, and there is no doubt that plaintiffs' attorneys will be looking for avenues to extend the reasoning to state law claims.

Regardless of these open issues, it is clear that purchasers need to analyze more fully potential liability as to federal employment claims when determining the value of assets, especially in those cases in which the previous owner of the assets will be unable to pay for the liability. It also means that companies that have not been in full compliance with federal employment laws may find that buyers are going to demand a substantial discount from their asset purchase, or else a greater hold-back on amounts to be paid until the statute of limitations has passed on any such claims. Finally, both sellers and buyers will need to consider whether the protections and oversight of a formal bankruptcy proceeding offer a better mechanism for the sale of the assets of a failing business with potential employment-related claims.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

Paula M. Weber (bio)
San Francisco
+1.415.983.7488
paula.weber@pillsburylaw.com

Alexander Parachini (bio)
New York
+1.212.858.1445
alexander.parachini@pillsburylaw.com

Leo T. Crowley (bio)
New York
+1.212.858.1740
leo.crowley@pillsburylaw.com

Thomas N. Makris (bio)
Silicon Valley
+1.650.233.4509
tmakris@pillsburylaw.com

This publication is issued periodically to keep Pillsbury Winthrop Shaw Pittman LLP clients and other interested parties informed of current legal developments that may affect or otherwise be of interest to them. The comments contained herein do not constitute legal opinion and should not be regarded as a substitute for legal advice.
© 2013 Pillsbury Winthrop Shaw Pittman LLP. All Rights Reserved.