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7th Circuit Affirms Imposition of Successor Liability for FLSA on Asset Buyer Despite Buyer's Disclaimer

Overview

In *Teed v. Thomas & Betts Power Solutions*, 7th Cir., March 26, 2013, the United States Court of Appeals for the Seventh Circuit, applying federal common law, affirmed the imposition of successor liability on an asset buyer for the seller's pre-sale violations of the Fair Labor Standard Act ("FLSA"), despite contract language expressly disclaiming that liability. The Seventh Circuit concluded that in the absence of a compelling reason to rule otherwise, "successor liability is appropriate in suits to enforce federal labor or employment laws."

Background

In *Teed*, employees of JT Packard & Associates ("Packard") sued Packard and its parent S.R. Bray Corp. ("Bray") for unpaid overtime violations under FLSA. Separately, Bray defaulted on a $60 million secured bank loan several months after the FLSA lawsuit was filed. The bank received an assignment of Bray's assets, including Bray's stock in Packard. Packard ended up in receivership under Wisconsin law and its assets were sold for approximately $22 million to Thomas & Betts Power Solutions, LLC ("Thomas & Betts"). Following the sale, plaintiffs obtained a final judgment of $500,000 in the FLSA lawsuit and they attempted to substitute Thomas & Betts for Packard and Bray under a theory of successor liability. The District Court for the Western District of Wisconsin granted the substitution and Thomas & Betts appealed to the Seventh Circuit.

Extension of Federal Common Law Standard

In reviewing the District Court's decision, Seventh Circuit Judge Posner first determined whether the federal common law of successor liability should apply to FLSA violations -- a threshold question because under Wisconsin law, the contractual exclusion of FLSA liability would have precluded successor liability. Noting analogous situations in National Labor Relations Act and Title VII cases, the Seventh Circuit found that imposing successor liability in a FLSA case was essential to meeting the federal statute's goals of protecting workers' rights -- particularly in a scenario where an employer could otherwise evade liability through a well-timed corporate sale.

Application of Federal Common Law Standard

After finding that the federal common law of successor liability generally should apply to a FLSA case, the Seventh Circuit weighed its application to Thomas & Betts. The District Court had applied a traditional five-factor federal common law test in finding Thomas & Betts a successor.[1] The Seventh Circuit found the five-factor test less than satisfactory and although it reached the same result as the District Court, it did so by a different route. It found that successor liability should *always* apply in suits to enforce federal labor and employment laws, absent "good reasons" to withhold such liability. It then reviewed what some "good reasons" for not imposing liability might be. These included:

- Lack of notice to the purchaser of the potential liability (this "good reason" did not apply to Thomas & Betts, which had knowledge of the FLSA claims);
- Imposing successor liability after the sale of an insolvent company where FLSA liability was not intended to be assumed by the purchaser (and thus, the sale price did not reflect assumption of the liability), thereby effectively flipping the priority of a secured creditor and the employees' unsecured FLSA (this "good reason" did not apply because Thomas & Betts did not raise it, even though its purchase price assumed the exclusion of the FLSA liability from the acquisition);
- The notion that the FLSA claimants were receiving a windfall through imposition of successor liability because the FLSA claimants would have remained subordinated to the secured bank if Packard had not been sold or if Packard had instead been sold piecemeal, such that successor liability would be unavailable (as for this "good reason," the Circuit Court appeared more concerned with preventing a Thomas & Betts windfall by allowing it to avoid successor liability);
- Whether enterprising employees of an insolvent company strategically brought a slew of federal employment claims, either in good faith or not, to impose successor liability on a solvent purchaser; because such behavior would artificially depress the going concern price of the seller, a court could consider not imposing successor liability (this "good reason" was not a factor in the Thomas & Betts situation); and
- Related to the preceding "good reasons," perhaps successor liability should not apply in a chapter 7 or chapter 11 bankruptcy case where asset sales must achieve the highest and best price for the benefit of creditors; if FLSA successor liability was always imposed in a going concern sale, a debtor might be prevented from being sold as a going concern because the sale price would be lower than a piecemeal sale where successor liability is unavailable. Such results would be contrary to reorganization policy and would ultimately harm creditors (the Seventh Circuit treated this "good reason" as hypothetical, but in any case, the sale to Thomas & Betts took place in a receivership, not a bankruptcy case).

[1] The five factors, as applied, were: (1) whether the intended successor had notice of the liability (Yes); (2) whether the predecessor would have been able to provide the relief before the sale (No); (3) whether the predecessor could have provided the relief after the sale (No); (4) whether the successor can provide the relief in the suit (Yes), and; (5) whether there is continuity in operations between the predecessor and successor (Yes).

With none of the "good reasons" for avoiding successor liability available to Thomas & Betts, the Court of Appeals affirmed the District Court's decision. In doing so, it also observed that if Packard had not been sold out of receivership and had sufficient time been available to market the business properly, a purchaser may well have paid a good price for such a profitable company, even with its employment-related liability. It noted that the FLSA liability was only $500,000 and the purchase price was approximately $22,000,000 (the liability thus represented only about 2.2% of the purchase price).

Beyond mentioning a bankruptcy sale as part of its "good reasons" discussion, the Seventh Circuit did not elaborate on bankruptcy sales or the law under Section 363(f) of the Bankruptcy Code. Under Section 363(f), sales of estate assets are typically free and clear of liens, claims and encumbrances, including successor liability for judgments and pending or potential lawsuits. Indeed, it appears well-settled in other Circuits that Section 363 will protect a purchaser -- regardless of whether successor liability would apply outside of bankruptcy -- from employment-related successor liability. *See e.g. In re Trans World Airlines, Inc.*, 322 F.3d 283, 285 (3d Cir. Del. 2003).[2]

Conclusion

Because *Teed* exposed an asset acquirer to successor liability for FLSA claims despite an express disclaimer in the sale contract, the benefits of completing a transaction outside of bankruptcy, where the protections of Section 363(f) remain unavailable, now seem less certain, at least in the Seventh Circuit. A buyer in such a transaction may consider reducing the purchase price by the amount of the potential successor liability, or requiring a portion of the purchase price remain in escrow until such liabilities are satisfied. Alternatively (and despite the risks of competition), buyers may opt for purchasing the assets only in bankruptcy where the Section 363(f) protections should prevent the imposition of successor liability. In any event, potential buyers should proceed with caution, especially in the Seventh Circuit.

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[2] The Third Circuit in *In re TWA* found that Section 363 precluded successor liability for Equal Employment Opportunity Commission claims and also shared the Seventh Circuit's concern that successor liability in a bankruptcy context would go against both the bankruptcy priority scheme and policy. *See, Id.* at 292 ("We recognize that the claims of the EEOC ... are based on congressional enactments addressing employment discrimination and are, therefore, not to be extinguished absent a compelling justification. At the same time, in the context of a bankruptcy, these claims are, by their nature, general unsecured claims and, as such, are accorded low priority. To allow the claimants to assert successor liability claims against [purchaser] while limiting other creditors' recourse to the proceeds of the asset sale would be inconsistent with the Bankruptcy Code's priority scheme."). The *TWA* Court assumed as part of its analysis that the purchaser would be liable for the EEOC claims outside of a bankruptcy. *Id.* at 288 fn. 4. The Third Circuit subsequently held that ERISA claims could be brought against a purchaser under a federal common law theory of successor liability in a non-bankruptcy context. For more information, see our February 4, 2011 alert.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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