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Evaluating Mass Torts in a Corporate Acquisition Context

Occasionally buyers acquire more than they bargained for. A guest article from Dechert's Sean Wajert discusses best practices when it comes to dealing with the potential litigation liability of a target company.

By Sean Wajert

An important aspect of evaluating a possible acquisition is the potential litigation liability that may be acquired simultaneously. If a company is involved, or could potentially become involved, in mass tort litigation, it presents both risk and opportunity to the acquirer.



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The threat of this type of litigation may result in the opportunity to buy a target at a below-market valuation multiple, and the uncertainty caused by mass tort exposure can result in valuation discounts that make the attendant risk acceptable.

However, there are potentially significant risks associated with mass tort litigation exposure, and thus buyers would be wise to proceed carefully. In the private equity context, in particular, mass tort litigation exposure can adversely impact

the ability to secure third-party debt financing and can have an adverse impact on investment exit. Private equity buyers may also have shorter investment time frames than strategic buyers, and mass tort litigation often takes a substantial amount of time to resolve itself.

The general rule of law, and the typical structure of an asset purchase agreement, is that an acquirer of the assets, using cash, does not assume the liability for injuries caused by products sold by the target company prior to closing. But even when the parties purport to allocate such liability to the target, the buyer may still find itself responsible for the litigation through the operation of various legal doctrines that are exceptions to the general rule.

The Restatement (Third) of Product Liability Law notes that a company that acquires assets of a business can be subject to liability for a defective product sold by the predecessor business entity. This occurs when the acquisition results from a fraudulent conveyance to escape liability for the liabilities of the predecessor, or results in the successor becoming a mere continuation of the predecessor. A few states also add the so-called "product line" exception, which allows a plaintiff to recover for injuries caused by a defective product sold

by the predecessor in cases in which the successor corporation has continued the predecessor's product line.

Thus, even in the absence of an actual merger or stock acquisition, it may be that a buyer of corporate assets will still face exposure to product litigation liability risks. Attempting to structure the deal to try to minimize the possible application of such theories will often be the first line of defense.

In an asset sale, the buyer may also want to seek a provision that the seller shall not dissolve for some set period of time, so that the mass tort plaintiffs' remedies seemingly are not destroyed. Special indemnification by the seller for the underlying exposure is another alternative. This indemnification should survive for a sufficient period of time, and ideally would not be subject to a special cap higher than is typical for representations made by a "clean" company. The use of a special escrow to set aside funds for the litigation indemnification may be important.

When the target company is involved in mass tort litigation, the successor liability risks to the buyer must be examined even more carefully. Buyers must recognize that the successor liability determination may be made by a state court confronting thousands of tort suits and applying the law of the home state of the plaintiff who, absent a finding of successor liability, may be without an adequate remedy. It may not be possible for a buyer to negotiate indemnification that lasts long enough, or is backed by a large enough escrow to eliminate material risks. Thus, it may be a mistake to rely too readily on contractual safeguards without a clear understanding of the future litigation risks.

Mass tort risks

A mass tort's numerous claims pose incredible financial risks, as evidenced by the bankruptcies of large, otherwise prosperous entities because of such litigation. A simple snapshot of any current litigation may understate the potential number of claims, especially if there is a long latency period—the time between exposure to the product at issue and manifestation of the disease or harm allegedly caused by the product.

Aggregation of many claims in one procedure, such as a class action, may create an all-or-nothing risk for defendants, compelling

what some courts term “blackmail settlements.” Even if the risks of being found liable as a successor seem small, the magnitude of the possible harm generated by the mass tort dictates that the due diligence process carefully evaluate the potential liability.

Mass tort due diligence: Goals and methodology

The due diligence analysis to help answer the question “What am I buying into?” may involve actual data and dollars. But, requiring as it does judgments about the future litigation environment, it may not result in a precise numerical risk estimate. Thus, the buyer will ultimately make a business judgment about the range of risks that are acceptable in light of numerous factors, including assets available to cover the risks (such as insurance and indemnifications), and the financial benefits of the deal.

Experience has shown the optimal approach to the mass tort due diligence inquiry is to approach the risk question from numerous distinct perspectives, and then combine the learning from the approaches to help minimize the impact of gaps in knowledge. This allows extrapolations to be made with greater confidence.

Due diligence approaches: Claims history

If the target company has been involved in the litigation, the current claims status, the past claims history, and the trends that may be emerging will be analyzed. Together, the claims picture will be a useful, albeit imperfect, predictor of future litigation risks. New waves of plaintiffs, new scientific studies, and new revelations from internal documents are not unusual features that can morph mass tort litigation and impact the number of claims.

The due diligence process may include the number of claims filed and the current status of all filed cases. It may be important to know the types of cases, the injuries alleged, the occupations of plaintiffs, exposure scenarios alleged, and the dates of exposure to the product. In some instances, the legal theories involved may be important, as well as the status of any case aggregations. The jurisdictions in which the claims are filed can have a significant impact on claim value. The due diligence inquiry may also explore the identity of the plaintiff firms involved.

The process will almost certainly explore those cases resolved already, and look into the facts that have been important to settlements, motions practice and verdicts, favorable or not. The target should provide detailed information on all settlement terms. The due diligence review should not overlook other claims costs to the target, including attorney fees and disbursements for experts. Any changing patterns in the claims or dollars should be explored as well.

There are numerous sources that may be consulted for the claims information, beyond information from the seller’s deal counsel. These include SEC filings, annual reports, press releases, court dockets and published case reports. Another useful set of resources may include the in-house counsel managing the litigation, the outside defense attorney of the target and the seller’s insurance company.

A complementary approach is to gain an understanding of the product involved, its uses, marketing and warnings; the nature of the alleged defects; and the regulatory environment governing such

products. Product usage and sales can help form an estimate of the population from which actual claimants may arise. This approach might include a historical dimension if the product changed at any point in design or in its warnings. The useful life of the product can help determine whether the hazards are confined to a certain time frame or may extend beyond sales dates. An underrated factor is how easy it would be for plaintiffs to identify the target’s brand as the actual brand they used. Due diligence may want to examine the sales records that would allow plaintiffs to identify the acquisition target as the relevant manufacturer.

The chain of distribution may be traced to analyze the consumers the target sold to, and thus the potential plaintiffs. For example, the customers may be part of an older population that is diminishing actuarially. Similarly, it may be provident to assess how claimants could have been exposed to the product, with an eye to the credibility of alleged exposure scenarios. Beyond end users, other potential plaintiffs may be involved, including installers, repairers and bystanders.

While plaintiffs’ lawyers are often unencumbered by such product facts when they sue, the number of units sold, over what time period, and used by which consumers in what ways, may still be instructive of future risk.

The third recommended approach begins with the proposition that the science of plaintiffs’ claims can dramatically impact the litigation in either direction. For example, even if a company has stopped selling a product, if the latency period is 30 years, the company can theoretically see claims for three decades after stopping sales. Another science issue may be “general causation,” the ability of the product to cause the type of injury alleged. There may also be a need to assess “specific causation” in the litigation. That is, even if a product is capable of causing a disease, it does not necessarily mean that all product users with the disease got it from the product.

These medical and scientific issues associated with a product’s hazards can impact the size of the potential universe of claimants, the causation issue, and even the availability of additional, novel claims against the target company, such as medical monitoring.

The due diligence inquiry may also include an investigation of the assets available to respond to possible litigation costs, including defense costs. This may involve contractual indemnification, or possible contribution or indemnification claims available as a matter of statutory or common law against others in the product’s chain of distribution. It may include a review of insurance and the status of any coverage litigation.

The inherent uncertainty in predicting future mass tort claims calls for a multidimensional approach that will minimize the impact of information gaps and maximize the reliability of any assessment of future mass tort liability risks in the acquisition context. Such due diligence is best conducted by counsel with experience in the mass tort arena and the ability to apply an understanding of the forces driving product liability claims. **MA**

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