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Successor Liability in Bank Acquisition

by Robert W. Wood • San Francisco

In *U.S. v. First Dakota National Bank*, No. 97-1404 (8th Cir., March 6, 1998), the Eighth Circuit Court of Appeals found that an acquiring bank was liable to assume tax deficiency liabilities of the target. The case arose out of First Dakota National Bank's acquisition of American State Bank back in 1988. First Dakota assumed all of American's liabilities, except for shareholder liabilities. American's liabilities exceeded the assets, and the Federal Deposit Insurance Corp. (FDIC) ended up contributing $4.275 million to First Dakota. First Dakota also recovered $3.883 million from an insurance company for losses allegedly caused by certain American's officers.

At the time of the purchase, American was being audited by the IRS. Because of large losses in prior years, it was expected that a tax refund would be forthcoming. In order to take advantage of certain tax benefits, American made an election before being sold to First Dakota. This election resulted in additional taxes being due from American in the amount of $35,574.67 for 1981.

Not Much of a Dispute

On the surface, liability for a relatively insignificant sum of taxes in the scheme of a bank acquisition would not appear to be the stuff that jury trials are made of. John Grisham would hardly be interested. Nonetheless, First Dakota demanded a jury trial, and the jury returned a verdict in favor of First Dakota. Then, the District Court granted the government's renewed motion for judgment as a matter of law.

The District Court concluded that First Dakota failed to prove that it had no knowledge of the audit, or that knowledge of the audit would have been a material consideration in the transaction. The District Court considered that the audit was in progress, and that First Dakota assumed far

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riskier liabilities than the small tax liability that resulted from the audit. The District Court found that the testimony indicated that everyone thought that American would be entitled to a refund of taxes due to its large losses.

In the Eighth Circuit, the court found there had been no error by the trial court, and the District Court judgment was affirmed. The Appellate Court agreed with the District Court that the failure to disclose the audit, as a matter of law, was not material to First Dakota's agreement to buy American assets and assume its liabilities. In reviewing this case, several observations come to mind.

Underscores Due Diligence Process

The decision in *U.S. v. First Dakota Bank* underscores the importance of due diligence in acquisitions. The acquiring company, First Dakota National Bank, assumed virtually all liabilities of American State Bank pursuant to the acquisition. The big question was whether the lack of a specific knowledge on First Dakota's part (because of American's lack of disclosure) obviated the assumption of those liabilities.

The jury in the case determined that First Dakota did not know of the IRS audit at the time of the closing because American State failed to disclose it. The jury also determined that the failure to disclose was material to First Dakota's agreement to assume all of the liabilities. This much seems pretty obvious and straightforward.

What doesn't seem obvious is that the Eighth Circuit Court of Appeals determined that the failure to disclose was *not* material because the amount of the liability was only an additional $37,000. In the context of a $65 million deal, presumably $37,000 was just not viewed as big enough to make a difference. It didn't seem credible to argue that knowledge of this liability would have been decisive.

Relevance of State Law

First Dakota argued that it did not have liability under the contract. The court was probably sensible in concluding that a $37,000 liability in the context of a $65 million deal simply was not material enough to result in some radical shifting of burden. Anyway, the contract document itself (the purchase agreement) would describe what would happen in a circumstance like this. Generally it would provide for indemnity for the taxes, interest, penalties and any other associated costs.

Transferee Liability—How Big a Problem?

Section 6901(a) provides for transferee liability. Nonetheless, transferee liability assessments rarely seem to be made. Typically, in the context of organized acquisitions, there is full disclosure about the extent of any tax liability, and a complete set of representations and warranties by which the target company must indemnify the acquirer for any such liability. Under these circumstances, the transferee liability provision does not often need to be invoked.

Steps Acquirers Should Take

The acquiring company should typically attempt to obtain a complete and unqualified set of representations and warranties with respect to tax liabilities. These would include not only the representation and warranty that all tax returns have been filed, all appropriate elections made, etc., but would also indicate that no audit notice has been received, and that there are no grounds for any audit or any change on the tax returns as filed. Usually there is some bargaining over whether any "best

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knowledge" qualifiers will be inserted into these representations and warranties.

From the acquirer's perspective, on the other hand, the more unqualified these representations and warranties are, the better. Furthermore, a broad indemnity obligation, under which the target must indemnify the acquirer, would be essential. Virtually every contract contains this type of provision.

Broad indemnity obligations may even be coupled with an offset provision. An offset provision typically states that if any monies remain due from the acquirer to the target, the extent of any damages for breach of the representations and warranties can be offset by the acquirer against any monies otherwise due the target. Such a provision obviously increases the acquirer's bargaining power when it comes to any dispute. ■