

## Assessing Potential Risk: Due Diligence for Acquisition of Product Manufacturers

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With an increase in recent years of mass tort litigations and runaway jury verdicts, the scope and complexity of product liability and mass torts litigation continues to expand. The result: product manufacturers face ever-growing potential risk and exposure. While in the past, manufacturers may have viewed products liability litigation as an inherent risk of doing business, the current legal climate has resulted in products liability litigation being far from business as usual.

As this legal landscape continues to shift, due diligence investigations concerning products liability issues can be critically important for companies considering corporate acquisitions—especially acquirers who may not have experienced the time and expense that can be involved in U.S. litigation. Though they typically spend most of their time litigating, products liability lawyers can leverage their litigation experience to assist in evaluating potential products liability exposure when a target company is a product manufacturer.

This article addresses the areas that should be explored when evaluating a transaction from the perspective of both a products liability lawyer and a corporate transactional lawyer, and highlights the benefits of involving experienced products liability lawyers to assist with due diligence in connection with an acquisition or merger. Issues relating to products liability for consideration during corporate acquisition due diligence include: (1) basic information about the product at issue; (2) the target company's reputation regarding the product; (3) past and current litigation and/or claims involving the product; (4) litigations involving similar products; (5) applicable state law and venue of future litigations; (6) availability of insurance coverage; and (7) available steps that may mitigate risk through transaction structure and the terms of the transaction agreements.

### Basic information about the product.

Most product liability claims in the U.S. are strict liability claims. Because strict liability imposes a duty on product manufacturers to produce safe products, plaintiffs suing under strict liability need not



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prove the existence of such a duty as the law assumes the duty exists. There are three theories of liability under strict products liability: (1) manufacturing defect; (2) design defect; and (3) failure to warn. Other theories of liability include, inter alia: breach of express or implied warranty; negligence; and consumer fraud.

Basic information gathered during due diligence should relate to the theories of liability mentioned above, with a focus on manufacturing, design, and warning information. A standard diligence request list should request the following information about the target's products: (1) name and purpose; (2) a list of ingredients or component parts; (3) locations where the product is manufactured, assembled, sold or distributed; (4) the identity of vendors and manufacturers of

ingredients and component parts; (5) a list of all models, updates and variations; (6) all manufacturing designs and specifications, and the identities of the individuals involved in the designs; (7) all alternative designs; and (8) sales information going back at least 10 years. This basic product information helps assess the viability and extent of different types of potential products liability claims. An experienced products liability litigator is uniquely qualified to use this information in forming a liability assessment.

### **Target company's reputation with respect to the product.**

In the age of the internet, obtaining basic information about the public perception of the target company and its products is vital to predicting future risk. In addition to traditional news articles relating to the target company, acquirers should review social media with respect to the target and its products. Investigating the target company on social media sites may provide insight into the public perception of the target company and its products. This social media inquiry also may reveal potential litigation.

### **Past/current litigation or claims involving the product.**

Of course, past and current litigation and claims also can be a predictor of future liability. As part of its due diligence investigation, an acquirer should obtain the following: (1) all current or past litigations involving the product;

(2) information about resolution of any of the past litigations or claims; (3) the factual predicate/allegations at issue; (4) the alleged injuries at issue; and (5) defenses asserted. This information will not only help predict future litigations or claims involving the products, but also help quantify the potential liabilities. In all cases, be aware of, and attentive to, the possibility that pre-closing disclosure to an acquirer regarding pending litigation may need to be limited so as to prevent the unintentional waiver of attorney-client privilege.

### **Litigations involving similar products.**

While identifying the likelihood of potential products liability exposure is critical, quantifying that exposure is equally important. In order to quantify risk, the litigation history with respect to similar products may be useful. Acquirers should examine success rates of defenses, verdict and settlement amounts, as well as any other notable trends in similar litigation.

### **Likely applicable state law and venue of future litigations.**

In the current age of plaintiff forum-shopping, it is difficult to predict the jurisdiction and venue of a products liability suit—other than that it likely will be in a jurisdiction more favorable to the plaintiff and less favorable to the defendant. If the target company is headquartered in a jurisdiction that is not favorable to defendants in products

liability cases, that will factor into the risk calculus. In such cases, the acquirer may decide, for example, to make relocation of the target's headquarters part of the deal.

### **Available insurance to cover product liability claims.**

Acquirers must also ascertain the existence and extent of insurance available to the target company. Insurance can be a useful tool in mitigating acquired liabilities. Acquirers should consider the following insurance-related information: prior and existing primary and excess insurance coverage (and if vendors have added the target company as an additional insured), claims histories with respect to the target company's existing and historical insurance program (commonly referred to as loss runs), and documentation and loss information concerning areas that are self-insured by the target company. This information will be useful in performing a risk management evaluation, i.e., weighing existing insurance against estimates for potential exposure so as to determine if additional insurance is necessary, feasible or cost effective. This information also will be useful in ascertaining the steps that will need to be taken to preserve insurance coverage for pre-closing products liability claims—for example, by placing a products liability insurance policy written on a claims-made basis into an extended reporting period (commonly referred to as "tail" coverage). Also, if additional insurance is needed to mitigate products liability exposure, it may be

prudent to ensure that the insurance package covers unknown regulatory and products liability issues that may arise.

## Risk Mitigation Strategies

Although M&A transaction documents employ a range of risk mitigation strategies to address potentially significant, pre-closing products liability exposure, perhaps the most common and effective are: (1) structuring the transaction to avoid or minimize the risk of successor liability for pre-closing products liability claims (typically as an asset purchase); and (2) negotiating specific or stand-alone indemnity for pre-closing products liability claims in the operative transaction documents.

As to the structure of the transaction, while the specifics of the doctrine of successor liability are beyond the scope of this article, as a general matter, the liabilities of a seller will not usually be imposed on a buyer in an asset sale transaction. However, in addition to other exceptions to the general rule of successor liability, buyers in asset transactions are potentially subject, in certain jurisdictions, to successor products liability claims on a product line theory.

As to contractual indemnity, it is common for buyers in M&A transactions to negotiate for a specific or stand-alone indemnity for areas

that were identified during due diligence as being of particular concern (which might include product liability issues). A specific or stand-alone product liability indemnity would typically require the seller to indemnify the buyer for any losses suffered by the buyer as a result of product liability claims arising from the pre-closing activities of the seller. The seller's obligation would be without regard to whether such losses are attributable to any breach of a representation, warranty, or covenant of the seller in the operative transaction documents, and are typically not subject to any indemnity deductible, basket or cap (or, if subject to a cap, subject to a much higher cap, sometimes set at total purchase price). Among the complex issues that should be addressed in contractual indemnity is: which party controls the litigation or the settlement of the litigation.

While many M&A transactions are moving toward a representation and warranty insurance model of allocating certain risks between the parties, coverage for product liability exposure may not be possible under such policies for a number of reasons, including: (1) certain product liability issues may be excluded from the policy because they are known issues at closing; (2) product liability claims may be excluded from the policy

by the insurer as a matter of policy in certain industries, or as a result of diligence conducted during the underwriting process; and (3) losses arising from product liability claims may not be attributable to any breach of a representation or warranty of the seller.

## Conclusion

Mass tort and products liability due diligence investigations frequently involve estimating the number and value of claims likely to be brought in the future against a defendant, as well as valuing claims that are already pending. During the due diligence stage of the potential acquisition of a target company that manufactures products, the more information that can be gathered about the target company's product(s), the better. A products liability litigator's experience can be beneficial for the assessment and analysis of risks involved in a potential acquisition.

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