

The Privately Owned Business Practice Group at Murtha Cullina is pleased to provide clients and friends with information about topics of interest in the privately owned business law area.

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AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009

By: Marcel J. Bernier and Natale A. Messina

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The American Recovery and Reinvestment Act of 2009 (the "Recovery Act") contains a number of provisions which may be beneficial to businesses. Some of the significant provisions which apply to businesses are summarized below.

Expensing Capital Expenditures

Internal Revenue Code Section 179 permits a taxpayer who purchases depreciable tangible personal property for use in a trade or business to deduct the cost of the property for Federal income tax purposes instead of capitalizing the cost and depreciating it over a period of years. The Economic Stimulus Act of 2008 (the "Stimulus Act") increased the amount which can be expensed from \$125,000 annually before 2008 to \$250,000 annually for capital expenditures incurred in 2008. The Recovery Act continues the \$250,000 limit for capital expenditures incurred in 2009. The \$250,000 annual amount is reduced dollar for dollar to the extent the depreciable tangible personal property purchased by the taxpayer exceeds \$800,000 in the applicable year. The Section 179 deduction may not exceed the taxable income of the taxpayer for the applicable year, but any unused Section 179 deduction may be carried forward for a limited number of subsequent years.

Additional Bonus Depreciation

Code Section 168(k) currently provides a fifty percent (50%) bonus depreciation deduction for qualifying MACRS property acquired after December 31, 2007, and placed in service prior to January 1, 2009. There is no limit on the total amount of bonus depreciation that may be claimed in any given tax year. The bonus depreciation is only available for property whose

original use begins with the taxpayer that is (i) depreciable under MACRS and has a recovery period of 20 years or less; (ii) MACRS water utility property; (iii) computer software depreciable over three years pursuant to Code Section 167(f); or (iv) is qualified leasehold improvement property. The Recovery Act continues this provision for qualifying property which is placed in service in 2009.

Net Operating Loss Carryback

Internal Revenue Code Section 172 generally allows a business taxpayer which has a net operating loss for a tax year to take a net operating loss ("NOL") deduction to reduce income in another tax year. Business taxpayers can generally carry back the NOL to the two tax years preceding the loss year or to the 20 tax years following the loss year.

The Recovery Act amends section 172 to permit small business taxpayers to elect to carry back an NOL for a tax year which begins or ends in 2008 to the three, four or five preceding tax years. A small business taxpayer is generally defined as a corporation, a partnership (including an LLC) or a sole proprietorship with average annual gross receipts less than \$15 million during the three year period ending with the year of the loss which would be carried back. Affiliated entities may be combined for purposes of determining the gross receipts test. The election must be made by the

small business taxpayer by the due date for filing the tax return for the year of the loss, including extensions. Small business taxpayers who desire the earliest refund of income taxes paid in prior years should consider making this election.

It should be noted that for a partnership, LLC or a Subchapter S Corporation, an NOL is determined at the partner, member or shareholder level. Therefore, this provision may not be beneficial to owners of such small business taxpayers.

Subchapter S Corporation Built-In Gains Tax

C Corporations are corporations which pay income taxes at the entity level separately from their shareholders. Accordingly, there is the potential for taxation at both the entity level and again at the shareholder level. Consequently, many C Corporations that are closely-held elect to be taxed as an S Corporation. An S Corporation generally does not pay income taxes at the entity level because income generally is taxed only at the shareholder level. This tax treatment is especially attractive to a C Corporation which holds assets that have appreciated and which the Corporation would like to sell. Election of S Corporation status would eliminate tax on the gain at the entity level. However, to prevent such a tax motivated election, the Internal Revenue Code imposes a built-in gains tax on appreciated assets which are owned when the S Corporation election becomes effective and which are sold during the ten year period after the S Corporation election. The Act temporarily reduces the ten-year period to seven years if the seventh tax year in the ten-year period precedes 2009 or 2010.

Debt Cancellation Income

Given the current financial climate, a bank may sell some of its existing loans to increase its liquidity. Generally, if an entity (or related entity) repurchases a debt instrument like a promissory note for an amount that is less than its outstanding balance, the entity would recognize income equal to the difference between its outstanding balance and the amount paid to purchase the note. Lending institutions, in an effort to assist customers may also consider exchanging an existing debt instrument for a new debt instrument with provisions more beneficial to the customer. Alternatively, lending institutions may also agree to modifications to the existing debt. In either case, cancellation of debt income can be deemed to have occurred. The Act contains a provision aimed at integrating and deferring the adverse tax consequences of cancellation of debt income in such exchange or renegotiation transactions. If the reacquisition or renegotiation occurs in 2009, the cancellation of debt income can be recognized

over the five tax years beginning with the fifth tax year following the taxable year in which the transaction occurs and if it occurs in 2010, income can be recognized over the five tax years beginning with the fourth tax year following the tax year in which the transaction occurs.

Debt instruments covered include not only promissory notes but any contractual arrangement constituting indebtedness issued by a corporation or any person in connection with the conduct of a trade or business. In addition to purchases and modifications, reacquisition can include complete forgiveness or an exchange of debt for stock or a partnership interest. For partnerships, any cancellation of indebtedness income will be allocated to the partners in the partnership immediately before the exchange.

In the event a taxpayer dies, liquidates, sells substantially all of its assets or ceases to conduct business, any cancellation of debt income will be accelerated to the year in which the circumstance occurs. This acceleration rule applies to sales, exchanges or redemptions of interests in pass through entities such as S Corporations, limited liability companies or partnerships by the holders of such interests.

The holder of the interest in the pass through entity must irrevocably elect the deferral treatment by including a statement with its tax return for the year in which the debt reacquisition occurs.

Cancellation of a debt or obligation which would result in a deduction if it were paid by a taxpayer such as an account payable does not result in cancellation of debt income for such taxpayer.

COBRA Premium Payments

The Recovery Act requires that an employer pay 65% of the COBRA premiums (the "subsidy") for an eligible employee whose employment is involuntarily terminated by the employer between September 1, 2008 and December 31, 2009. The eligible employee is required to pay 35% of the COBRA premium.

The employer is required to pay the subsidy until the earliest to occur of: (i) nine months after the subsidy becomes available; (ii) the date the employee fails to pay 35% of the COBRA premium; (iii) the date the employee becomes eligible for another group health insurance plan or Medicare; or (iv) the end of the COBRA period.

The employer is reimbursed for the subsidy by a credit against its payroll taxes. IRS Form 941 has been revised to give the employer credit for the subsidy payments.

It is important for employers to be aware of the new COBRA provisions and take them into account in structuring

severance agreements. If an employer agrees to pay 100% of the COBRA premium for an employee, the employer will not qualify for the reimbursement of the subsidy because the employee would not pay 35% of the COBRA premium. If an employer desires to qualify for reimbursement of the subsidy, the employer should require the involuntarily terminated employee to pay 35% of the premium and may consider the amount of such premium payments by the employee in determining the amount of severance to be paid to such employee.

Please note that this summary does not cover every exception to these provisions. If you have any questions regarding how the Recovery Act will affect your business, please contact your accountant or your Murtha Cullina attorney for assistance.

GOOD NEWS FOR BUYERS: RECENT DECISION DECLINES TO APPLY PRODUCT LINE SUCCESSOR LIABILITY IN CONNECTICUT

By: [Richard S. Smith, Jr.](#)

The buyer of a business will often seek to structure an acquisition transaction as a purchase of assets rather than a purchase of stock or a merger for tax and business reasons, one of which is the ability to pick and choose the liabilities being assumed in the transaction. A recent Superior Court decision provides good news for any potential buyer in that it declined to expand the list of exceptions to the general rule that, in an asset purchase and sale transaction, the buyer only becomes responsible for those liabilities that are expressly assumed in the purchase agreement. The court in [Albini v. Osteoimplant Technology, Inc., 2008 Conn. Super. LEXIS 2751 \(Oct. 20, 2008\)](#) declined to endorse the so-called “product-line exception” that has been adopted in a minority of other jurisdictions.

Background

Osteoimplant Technology, Inc. (“OTI”) manufactured and sold artificial hip joints for medical use. In February 2004, Mr. Salvatore Albini underwent a total hip replacement and received an artificial hip that was manufactured and sold by OTI. In February 2005, OTI sold substantially all of its assets to Encore Medical Corp. (“Encore”). The Asset Purchase Agreement expressly stated that Encore was purchasing only the assets of OTI—not its liabilities. Two years after Mr. Salvatore’s surgery, his artificial hip shattered, causing substantial pain and suffering. He brought a products liability action against both OTI and Encore.

The General Rule

Encore sought to remove itself from the litigation by filing a motion for summary judgment arguing that it did

not manufacture, distribute or sell the artificial hip that had been implanted in Mr. Salvatore and that it had not assumed any liability for the hip under the Asset Purchase Agreement. Encore argued that in Connecticut, as in most jurisdictions, the buyer of all or substantially all of the assets of a business generally does not become liable for the debts and liabilities of the selling entity.

The “Product-Line” Exception

The plaintiff urged the court to adopt an exception to the general rule that the buyer of the assets of a business does not become responsible for the liabilities of the business — the so-called “product-line” exception established by the [California Supreme Court in Ray v. Alad Corp., 19 Cal. 3d 22, 136 Cal. Rptr. 574 \(1977\)](#). The product-line exception imposes liability on a successor corporation for defects in products that a predecessor manufactured if the asset purchaser continues to manufacture and sell the same product. The exception also has been adopted by the Supreme Courts of New Jersey and Washington. During the 1990s, several Connecticut Superior Courts purported to adopt the exception, but the issue has yet to be considered by the Connecticut Appellate Court or the Connecticut Supreme Court.

The Decision

In a decision that provides good news to past and potential future buyers, the Albini decision acknowledged the unsettled nature of the issue, but refused to further erode the general rule that the buyer of assets does not become liable for the debts and liabilities of the selling entity. The court stated the following:

A majority of courts have concluded that the substantial social costs of a more expansive liability rule would be incurred without actually benefiting very many tort plaintiffs. In most instances, the magnitude of future liability for products distributed pretransfer is difficult, if not impossible, to assess. As a majority of courts have recognized, the result of imposing successor liability as a general rule would be to depress the prices for transferred assets to the point that piecemeal disposition of assets, which clearly would not subject the buyers to liability, would be a preferable alternative to the sale of the assets as part of a going concern. The benefits to society of preserving the predecessor’s assets as a going concern would be sacrificed, with no commensurate benefits to tort claimants.

Restatement, Third, Torts, Sec. 12 Comment b. Rationale.

Noting that the overwhelming majority of state courts considering the issue have declined to endorse this theory of successor liability, the Court declined to adopt the product-line exception to the general rule of non-liability.

What is a Buyer to do?

The Albin decision is good news for buyers, but it underscores the unsettled nature of the law in Connecticut and the potential risk that a buyer of business assets may be deemed to have assumed an unspecified liability of the seller. The Court acknowledged that a handful of Connecticut Superior Court decisions dating back to the 1990s purported to have adopted the product-line exception. Although these cases are lower court cases that are not binding on other trial courts, so too is the Albin decision. As a consequence, the potential exists for other judges to reach a contrary result. What is a buyer to do?

First, the Albin decision highlights the importance of good drafting. It is important for the Asset Purchase Agreement to clearly state that liabilities are not being assumed.

Second, a Connecticut buyer considering an acquisition of an out-of-state business should be very cautious when responding to a request to have the purchase agreement governed by the laws of the other state—especially if the other state is California, New Jersey or Washington.

Third, a buyer should take care to avoid structuring a transaction in such a way as to risk having the transaction be recharacterized as a de facto merger or consolidation.

Fourth, a buyer should consider whether to isolate the acquired assets (and any potential liabilities) from its other business assets by acquiring them through a separate legal entity with limited liability.

Fifth, a buyer should obtain appropriate indemnification from the selling entity and its owners and secure the indemnification obligation to the greatest extent possible.

Finally, in appropriate circumstances, a buyer should consider insuring against the risk of potential liability for certain kinds of claims, including asking the seller to obtain tail insurance coverage for any occurrence on or before the date of the closing.

Murtha Cullina's business lawyers are knowledgeable about business purchase and sale transactions. If you have any questions about a possible purchase or sale of a business, please contact your attorney at Murtha Cullina for assistance.

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