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MINIMIZING PRODUCT LIABILITY IN BUILDING PRODUCTS M&A

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A revival in residential real estate sales has taken hold, and with it, an acceleration in the rate of new construction. As the new home building market picks up, interest among private equity firms and strategics in acquiring manufacturers of building and construction product companies has and should continue to increase. For instance, in September 2014, Highlander Partners, L.P. announced the acquisition of Versatex Building Products, LLC, a Pittsburgh-based provider of cellular PVC building products used in new construction and home renovations alike; other recent building products deals include Beacon Roofing Supply Inc.'s acquisition of All Weather Products Ltd., Century Communities' acquisition of Grandview Builders, and Kodiak Building Partners' purchase of Barnsco Inc.

History has shown, however, that manufacturers of those products can face, at times, significant product liability exposure that can turn a promising investment into a troubled portfolio company or division. We list below some factors to consider in acquiring building product manufacturers to minimize that exposure. Many of these factors are obvious, but they are worth setting out nonetheless as a reminder of the importance of thorough product liability due diligence when evaluating any transaction in the building and construction products space.

• Use due diligence and learn about the target's past and current products. A company's products may not be problematic now, but they might have been in the past. The paradigm for this concern is asbestos, which was widely used in construction until the 1970s. Over the last four decades, claims for asbestos-related injuries, particularly cancer claims, have engulfed increasing numbers of companies, including many in the construction industry, long after asbestos stopped being used. Due diligence should be employed to learn about both the products the potential target made previously and still makes and to determine what are the constituents in those products. It is also important to find out what the company sold--even if it did not manufacture some of the products it sold--because companies that distributed defective products can also face liability.

• Obtain a toxicological and legal assessment of the potential risks from the constituents of current and former products. More than one company with potential asbestos liability was acquired after the asbestos litigation onslaught began in the early 1970s, only for the acquisition to end up with substantial liability and defense costs or, worse yet, in Chapter 11. This history of product liability demonstrates that the acquirer should give a careful toxicological and legal assessment of the potential liability resulting from the target's former and current products prior to acquisition. One alternative may be to defer acquisition until after the company has had its liability rinsed away in Chapter 11 (as Berkshire Hathaway did with Johns Manville). Another alternative, as discussed below, may be an indemnity arrangement (assuming that the seller will have the financial resources or insurance for indemnification).

• Use due diligence to assess the risk of premature failure of products. In recent years, there have been a number of class action lawsuits over allegedly defective building products, such as water pipe, siding, or roof shakes, that have failed prematurely. Although the damage is limited to economic harm in almost all cases, the prospect of class action liability (including under state consumer protection laws) can be daunting. In addition, one can envision cases where a defective building product causes physical injury, such as when a building collapses due to wear on a defective structural element, or when piece of siding or roofing is dislodged and hits someone below.

• Assess the adequacy of product testing. In light of the potential liability concerns about premature failure, acquirers should carefully review the extent to which a target company tested its products to simulate durability in the real world. Have the products lived up to their claims in the past? Will the products live up to their claims in the future?

• Consider how to allocate liability between the acquirer and the seller. Often, product liability for products sold before an acquisition will remain with the acquired company. If that is a risk that the acquirer would prefer not take, consider how to allocate such risk to the seller. For example, when carving out product lines from a strategic seller, one could structure the acquisition so that the product lines with historic liability remain with the seller, or in the form of an asset purchase agreement under which the seller expressly retains liabilities arising out of products sold before the closing date. That, however, requires

a careful analysis of the successor liability laws of the relevant jurisdictions to ensure that doctrines such as "de facto merger" or "mere continuation" do not come into play. Another way of course is through agreed-upon contractual indemnity provisions that allocate risk to the seller.

• If the seller is going to indemnify the acquirer for pre-sale liability, consider how guaranteed indemnity obligations will be funded. If the seller is going to indemnify the acquirer, consider how to provide assurance that the seller will be able to fulfill that obligation should the need arise. One possibility is to require a long term indemnity escrow, recognizing such protections may be difficult in competitive auctions, or require that the seller maintain insurance to fulfill the obligation.

• Review older insurance policies of target. This factor involves a thorough review of the extent to which the target's historic and current insurance coverage is available to pay potential product liability claims. For instance, what were the coverage limits in older policies? Are there substantial deductibles or self-insured retentions? Are there potentially applicable exclusions? Particularly in cases of latent disease claims, old insurance policies are very relevant. Determine whether the target has retained copies of such older polices to avoid potential disputes as to their existence and provisions. Where older insurance policies of the target company are available to respond to latent disease claims, the transaction should be structured to ensure that access to such policies will continue post-closing (e.g., by maintaining its corporate existence as opposed to dissolution).

• Negotiate division of any parent-level insurance coverage. Often, a parent company and its subsidiaries will be covered on the same insurance policies. If only acquiring a subsidiary, consider negotiating with the seller on how this coverage is to be divided between them on future liability claims. Make sure that any such agreement does not run afoul of any contractual liability or anti-assignment provisions in the policies.

• Consider negotiating with insurers for "voluntary" repair efforts. In a recent case, the Texas Supreme Court held that the efforts of a siding manufacturer to repair and replace its defective product did not run afoul of the "voluntary payment without the insurer's consent" provision in its insurance policies. Presumably, this remediation effort benefited the company by allowing it to rectify mistakes and retain some customer goodwill without the expense of defending a class action that surely would have ensued. Consider whether existing insurance coverage allowing for such efforts can be negotiated into the policy.

• Consider carefully before putting your company's name and logo on acquired products. An acquirer may be tempted to place its name and logo on the packaging of a recently purchased subsidiary. While not necessarily a concern for private equity sponsors, strategic acquirers should think carefully before rebranding efforts. A telling example is Pfizer being sued for the actions of a subsidiary that manufactured asbestos-containing refractory products. After acquiring the subsidiary, Pfizer had its name, logo, and trademark placed on marketing materials for several of the subsidiary's products. Years later, Pfizer is now being sued as having "held itself out" as the products' manufacturer.

The above factors serve as a guide for diligencing and negotiating acquisitions in the home building and construction industries. Keeping these considerations in mind throughout the acquisition process will allow you to navigate an increasingly attractive market with an awareness of how to minimize one of its primary risks.

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