

RECENT DEVELOPMENTS IN SUCCESSOR LIABILITY LAW

Presented by

George M. Taylor, III
Burr & Forman LLP
Birmingham, Alabama

to the
ABA Business Law Section
Committee on Negotiated Acquisitions
Spring Meeting
March 23, 2001
Philadelphia

Researched and Written

By

David R. Yates
JD/MBA Candidate, May 2001
University of Alabama School of Law

© 2001 Burr & Forman LLP

I. INTRODUCTION

Over the past few years, identifiable trends can be spotted across jurisdictions concerning successor liability in asset acquisitions. This holds particularly true in the areas of product liability, environmental concerns, and labor and employment law. Though these trends have been mixed with regard to adopting certain exceptions to the general rule that liabilities do not follow the assets in an asset acquisition, the frequency with which courts are rendering opinions in these areas has increased steadily over recent years.

II. PRODUCT LIABILITY

In the area of products liability, many jurisdictions have addressed and decided on the more "modern" exceptions to the non-liability rule. These include the "duty to warn," the "continuity of enterprise" and the "product line" exceptions. David W. Pollak, *Successor Liability in Asset*

Acquisitions, 1126 PLI/Corp 85, 103-08 (1999). These exceptions have expanded the reach of successor liability beyond the traditionally recognized four exceptions to the rule of non-liability, which are (1) the purchaser explicitly or implicitly agrees to assume liability, (2) the asset purchase amounts to a consolidation or merger, (3) the purchasing corporation is a "mere continuation" of the selling corporation, or (4) the transfer amounts to little more than a "sham" transaction to avoid liabilities. While more conservative courts have rejected these exceptions, the prudent attorney must be cognizant of recent activity in the more liberal jurisdictions.

(A) CONTROLLING LAW

Attorneys must be aware of jurisdictional control and the applicable choice of law concerns that present themselves in most product liability cases. Specifically, one should be aware of the debate of whether tort law or corporate and contract law applies in determining the controlling law. For instance, this would be particularly important in drafting a choice-of-law provision in a purchase agreement and anticipating its validity in various jurisdictions. Very recently, the Alaska Supreme Court held that tort law, as opposed to corporate and contract law, governed the applicable law in a successor liability action involving a products liability issue. *Savage Arms, Inc. v. Western Auto Supply Co.*, 2000 WL 869342 (Alaska Mar. 2, 2001). The court held this despite the fact that all transactions relevant to the purchase of the predecessor's assets occurred in Texas, which would have clearly placed the more conservative Texas corporate law as controlling on the issue. *Id.* In looking past this apparently relative fact, the court reasoned that "successor liability is also a creature of tort law when it is claimed that the successor is liable because a product defect has caused injury or death." *Id.*

Likewise, several federal district courts have explicitly applied the law of the state with the most significant tort contacts. See *Ede v. Mueller Pump Co.*, 625 F. Supp. 656, 658, n.1 (D. Colo. 1987), *disagreed with on different grounds* *Florum v. Elliott Mfg.*, 867 F.2d 570, 579-80 (10th Cir. 1989); *Reed v. Armstrong Cork Co.*, 577 F. Supp. 246, 248 (E.D. Ark. 1983); *Korzetz v. Armsted Indus.*, 472 F. Supp. 136, 141-42 (E.D. Mich. 1979), *declined to follow on other grounds* *Johnson v. Ventra Group, Inc.*, 191 F.3d 732, 746 (6th Cir. 1999). Meanwhile, both the Fifth and Seventh Circuits have held that the law of the state with the most significant corporate contacts should apply to successor liability questions. See *Ruiz v. Blentech Corp.*, 89 F.3d 320, 326 (7th Cir. 1996); *Webb v. Rodgers Mach. Mfg. Co.*, 750 F.2d 368, 374 (5th Cir. 1985). Also, more recently, a Texas state court held that the purchase and sale agreement's choice-of-law provision controlled, which resulted in Delaware law governing whether the buyer of the assets assumed liability for the seller's contingent torts. *Lockheed Martin Corp. v. Gordon*, 16 S.W.3d 127 (Tex. App. - 1st Dist. 2000). Accordingly, the more conservative jurisdictions, such as Delaware and Texas, have exhibited a tendency to follow a more narrow interpretation of the law rather than expanding the avenues for tort plaintiffs to provide an available remedy in their actions.

(B) RECENT CASES

A most recent opinion by the Kentucky Court of Appeal explicitly declined the adoption of the product line exception. In *Pearson v. National Feeding Systems, Inc.*, 2001 WL 137599 (Ky. Ct. App. Feb. 16, 2001), the plaintiff brought an action against the corporate purchaser of a silage-

unloader brand-name for an injury, having occurred after the purchase closing, caused by a product manufactured by the predecessor company. The court held that none of the four generally recognized exceptions to successor non-liability rule applied to the successor corporation as it was properly entitled to summary judgment. The court specifically addressed the first (explicit or implicit assumption of liabilities), second (consolidation or merger), and third (mere continuation) exceptions. As to the first exception, the court strictly interpreted the language of the contract which expressly excluded liabilities for claims, actions, or suits arising out of events occurring prior to the closing. Also, the court refused to extend any express or implied assumption of liabilities for events occurring *after* the closing as the agreement language was unambiguous. The court noted that even if it found that the successor implicitly assumed liabilities occurring after the closing, no products liability could be imputed to the successor because there was no evidence that the predecessor assumed such liabilities from its predecessor. As to the second exception, the court noted that the transaction was purely a cash deal and that there was no continuity of shareholders, continuity of management, or other indicia of merger or consolidation. As to the third exception, the court quickly dismissed this assertion by relying on the lack of continuity of shareholders and lack of continuity of management. Fortunately, the court did not side step the applicability of the product line exception under Kentucky law. The court unequivocally stated: "We decline to adopt the product line exception." *Id.* at *3.

In another favorable decision for corporations, a Texas court strictly interpreted language in the Purchase Agreement denying the plaintiffs the opportunity for recovery under the first exception of explicit or implicit assumption of liabilities. In *Lockheed Martin Corp., supra*, the plaintiffs were workers who sought damages for personal injuries resulting from exposure to silica and silica-containing dust in the 1970's. In 1979, Martin-Marietta, Lockheed's predecessor (hereinafter "Lockheed"), purchased the assets of Wedron Silica Company of Delaware (the plaintiffs' former employer) and expressly enumerated the liabilities for which Lockheed assumed in the purchase. These liabilities were identified, in short, as: (1) balance sheet, (2) ordinary course of business, (3) pension plans and other employee agreements, (4) retirement plans, and (5) leases and other contractual commitments. The court, in applying Delaware law, held that Lockheed was entitled to summary judgment as the liabilities related to everyday operation of the business that Lockheed acquired, and not to contingent tort liability. The court went further in holding that Lockheed was entitled to summary judgment under Texas law as it was not contractually liable as a successor to Wedron for its contingent torts.

In another recent decision, the Indiana Court of Appeals had an opportunity to address whether it would adopt the product line exception. In *Guerrero v. Allison Engine Co.*, 725 N.E.2d 479 (Ind. Ct. App. 2000), plaintiff brought strict product liability claims against successor corporation, Allison Engine Co., which had purchased all assets of a division of a manufacturing corporation that had produced helicopter engines. In this asset purchase, Allison had paid cash for the assets of its predecessor, which was a division of General Motors Corporation. While the Indiana courts have adopted the four generally recognized exceptions to the rule of non-liability, this court specifically considered the applicability of the product line exception in this case. However, the court refused to apply the rationales underlying the product line exception to the case at hand and held that Allison could not be liable since its predecessor continued to exist. The court reasoned that the purchase of the predecessor did not destroy the plaintiffs' remedy against GM, which happens

to be one of the factors considered in the product line exception. Further, the court recognized that this rule, that the predecessor corporation no longer exists, applies to the four generally recognized exceptions to the successor non-liability rule. Notably though, the court, in conclusion, wrote that "[t]he product line exception *may* be an appropriate means by which to balance the seemingly juxtaposed concepts of strict liability under the Indiana Product Liability Act." *Id.* at 487. This language by the court leaves open the adoption of the product line exception if the right case comes along.

While explicitly declining to consider the product line exception, the Alaska Supreme Court chose to adopt the "continuity of enterprise" exception in an opinion handed down March 2, 2001. In *Savage Arms, Inc., supra*, a products liability action was brought against the manufacturer and distributor and the distributor sought indemnification from manufacturer's successor. The court supported its decision to adopt the "continuity of enterprise" exception by relying on the "substance of the underlying transaction" and looking beyond the "formal requirement" of continuity of shareholders, as required under the generally recognized "mere continuation" exception. The court acknowledged the American Law Institute's recent decision to decline the adoption of both the "continuity of enterprise" and "product line" exception for the Restatement (Third) of Torts. It went further by questioning and criticizing the Third Restatement's reliance on the theory that expanding liability harms the overall economy by making it more difficult for companies to reorganize or sell their assets without destroying the value of the ongoing business enterprise. Specifically, the court refuted the Third Restatement's arguments by making the assertion "that permitting successor liability under the 'continuity of enterprise' exception will not discourage large-scale transfers so long as anticipated successor liabilities do not exceed the value of the corporation's accumulated goodwill." 2000 WL 869342, at *5. The rationale relied upon by this court is exactly the argument a far majority of the jurisdictions have been rejecting in declining to adopt or consider any expansion of the successor liability exceptions.

While California courts created the product line exception in *Ray v. Alad Corp.*, 19 Cal.3d 22, 560 P.2d 3 (1977), the California Court of Appeals strictly construed the *Ray* opinion by limiting the application of the product line exception to strict liability actions for defective products. In *Monarch Bay II v. Professional Services Industries, Inc.*, 89 Cal. Rptr. 2d 778 (Cal Ct. App.1999), the successor corporation in an asset acquisition had also assumed the predecessor's leases, hired the predecessor's two shareholders, and its principal employees as well as all other employees. The action against the successor was for corporate negligence, as distinguished from *Ray* which was under strict tort liability. The court held that the underlying policies of strict tort liability were the basis for the product line exception and that the exception was not intended to be extended to include claims of mere negligence. Oddly, the California court went on to acknowledge the general trend against expansion of successor liability in other jurisdictions appearing to suggest that the California courts may interpret this line of cases more conservatively in the future. However, absolutely no suggestion or hint of overturning *Ray* was present in the opinion's language.

Over the past few years, the overall trend tends to be against extending successor liability. Even when a "modern" exception is adopted in a jurisdiction, the policy reasoning for adoption is based upon theories of strict liability and appears to be strictly limited to those actions. Clearly

though, most jurisdictions are explicitly rejecting adoption of the modern exceptions or at least are declining to consider them at that time.

III. ENVIRONMENTAL CONCERNS

In a surprising move by the Ninth Circuit, the court reconsidered its position of adopting federal common law as applicable in CERCLA successor liability actions and declared that state common law was more appropriate for analyzing successor liability actions under CERCLA. In *Atchison, Topeka and Sante Fe Railway Co. v. Brown & Bryant*, 159 F.3d 358 (9th Cir. 1998), amending opinion of 132 F.3d 1295 (9th Cir. 1997), the property owners, who were responsible parties under CERCLA, sought contribution from the successor corporation in an asset acquisition of property lessee by alleging that the successor was the successor-in-interest to the predecessor. In response to the property owners' request to expand successor corporate liability under CERCLA as interpreted by federal common law in the Ninth Circuit, the court in fact chose not to follow its position in *Louisiana-Pacific Corp. v. Asarco, Inc.*, 909 F.2d 1260 (9th Cir. 1990), that held that federal common law governs successor corporate liability under CERCLA. In doing, so, the court held that state common law was the appropriate law to decide such actions under CERCLA in light of recent United States Supreme Court decisions in *O'Melveny & Myers v. FDIC*, 512 U.S. 79, 114 S. Ct. 2048, 129 L. Ed. 2d 67 (1994), and *Atherton v. FDIC*, 519 U.S. 213, 117 S. Ct. 666, 136 L. Ed. 2d 656 (1997). These Supreme Court decisions called "into question the ease with which *Louisiana-Pacific* created a set of federal rules for successor liability under CERCLA." *Atchison, Topeka and Sante Fe Railway Co.*, 159 F.3d at 362. Specifically, the Supreme Court decisions raised the bar for creating federal rules when dealing with a "comprehensive and detailed" federal statutory regulation, such as CERCLA.

While *Louisiana-Pacific* relied primarily on the "need for national uniformity" as a reason for developing federal rules for successor liability, *Atherton* noted that "[t]o invoke the concept of 'uniformity' . . . is not to prove its need." *Id.* at 363 (quoting *Atherton*, 117 S. Ct. at 671). Rather, "there has been no real explanation of the need for uniformity in the particular area of successor liability - especially since state law will in many instances determine whom the EPA may or may not look to for compensation." *Id.* The Ninth Circuit proposed that the need for uniformity stems not from disarray among the states, but from the alleged need to expand successor liability beyond that currently provided by state law. Fortunately, the Supreme Court's decision spoke to this argument and stated that "[b]efore a court can recognize a federal rule of decision, there must be a 'significant conflict between some federal policy or interest and the use of state law.'" *Id.* (quoting *O'Melveny*, 114 S. Ct. at 2055 (quoting *Wallis v. Pan American Petroleum Corp.*, 384 U.S. 63, 68, 86 S. Ct. 1301, 16 L. Ed. 2d 369 (1966))). However, the court recognized the broad and explicit remediation powers in CERCLA, see *Pennsylvania v. Union Gas Co.*, 491 U.S. 1, 7, 109 S. Ct. 2273, 105 L. Ed. 2d 1 (1989), and stated that "there is no evidence that the application of state corporation law will frustrate this objective." *Id.* at 364.

Accordingly, the Ninth Circuit decided the case at hand under state common law, although it noted that the same result would be reached under federal common law. First, the court declined to extend successor liability under CERCLA to encompass the broader "substantial continuation" exception (also referred to as the "expanded" mere continuation test), as the California Court of

Appeals had already rejected the theory's adoption in *Phillips v. Cooper Labs, Inc.*, 264 Cal. Rptr. 311, 315 (Cal. Ct. App. 1989). In doing so, the court reasoned that in most cases where a successor has been held liable under this theory, they have also been accompanied by fraudulent intent and collusion. In which case, the purchaser would have likely already been liable under another traditional exception, the fraudulently-entered transaction exception. Also, the court held the asset acquisition was not a fraudulent conveyance. The court reasoned that the sale did not provide the predecessor a means for escaping liability as it already had insufficient assets to cover its liabilities before the sale and that these liabilities were in fact the catalyst for the sale. Additionally, the successor paid the appraised value for each item without any evidence provided to the contrary. Finally, the court recognized common industry practices that customers of the predecessor's type commonly follow key employees that service their accounts. Consequently, employment of these key employees, absent an agreement between the successor and predecessor to contract for their employment, did not constitute acquiring the goodwill of the predecessor without compensation. Therefore, the court upheld summary judgment in favor of the defendant successor.

In the Seventh Circuit, the court addressed the issue of successor liability under CERCLA as a matter of first impression in 1998. The court in *North Shore Gas Co. v. Salomon Inc.*, 152 F.3d 642 (7th Cir. 1998), tackled the issue of a liable corporation under CERCLA seeking contribution from a successor corporation. While the court pondered the issue of the appropriate controlling law, federal common law or state common law, it chose to follow the parties' lead and applied federal common law as neither party raised the issue of which law controlled. However, a determination as to whether state common law should be adopted or rejected on this issue was not made, though the court closely analyzed the recent Ninth Circuit case, *Atchison, Topeka and Sante Fe Railway Co.*, *supra*, interpreting recent Supreme Court cases and chose not to follow its prior holding by finding that state common law controlled in successor liability actions under CERCLA. In the case at hand, the successor corporation had acquired a corporation that had performed, in a legal sense, an asset acquisition that was actually entitled the 1941 Plan of Reorganization, which the title did not help its cause in the mind of the court. The acquisition was completed pursuant to the Holding Company Act that required utility companies to dispose of non-utility endeavors. The court held that the successor could be liable as the asset purchases would satisfy one, and perhaps two, of the four generally recognized exceptions to the successor non-liability rule. In analyzing the transaction under the de facto merger exception, the court explicitly stated that this exception would likely apply, but that the court need not develop this rationale fully as the mere continuation exception would clearly encompass the transaction, thereby, satisfying the goal of the plaintiff.

In determining that the mere continuation exception applied, the court balanced the factors where substantial control, or continuity of shareholders, remained but the continuity of directors and officers slipped. However, the court chose to look past the number-oriented analysis of continuity of directors and officers and focused on the ability of the successor to install a majority of directors. In doing so, the court admittedly relied on the rationale for the de facto merger exception and the underlying basis of the mere continuation exception. Thus, the analysis touched on the "substantial continuity" exception, but the court refused to explore or decide whether the theory would be applicable here. *Id.* at 654, n.8.

In granting summary judgment in favor of the defendant successor corporation, the Ohio District Court followed the Sixth Circuit's lead in rejecting the "expanded continuation test." In *Miami County Incinerator Qualified v. Acme Waste Management Co.*, 61 F. Supp.2d 724 (S.D. Ohio 1999), the successor corporation had purchased the assets of three "potentially responsible party" companies and merged with a fourth company. The plaintiff sought contribution for expended funds to remediate a hazardous waste site under CERCLA. The court resolved the issue of successor liability by reference to the corporation law of Ohio, as opposed to federal common law. *Id.* at 728-29 (quoting *City Management Corp. v. U.S. Chemical Co., Inc.*, 43 F.3d 244, 250 (6th Cir. 1994) (holding that "the liability of a successor corporation for CERCLA obligations is determined by reference to state corporation law, rather than federal common law")). Additionally, the court refused to consider the expanded continuation test exception as the Ohio Supreme Court declined to adopt or to reject the test in a products liability action, *see Flaughner v. Cone Automatic Machine Co.*, 30 Ohio St. 3d 60, 507 N.E.2d 331 (1987), and, subsequently, the Sixth Circuit and Ohio Court of Appeals determined that the test was inapplicable in tort actions, *see Macdermid Inc. v. Electrochemicals, Inc.*, 142 F.3d 435 (6th Cir. 1998). Moreover, the Sixth Circuit concluded that the expanded continuation test, which had been adopted by the Michigan Supreme Court for products liability cases, was inapplicable, under the law of Michigan, in CERCLA contribution action against the successor through an asset acquisition. The Ohio court reasoned that if the expanded continuation test is inapplicable in CERCLA cases in a state where that theory has been recognized in products liability cases, then a state where the expanded continuation test is inapplicable in product liability actions, such as Ohio, would be compelled to conclude that the theory could not be applied to CERCLA actions.

Accordingly, the court analyzed successor liability under the four generally recognized exceptions to the non-liability rule. The court held that none of the factors for any of the exceptions were present in the asset purchase. It relied on the facts that the successor expressly refused any of the predecessors' liabilities, as evaluated under Ohio corporate law, and all three predecessors remained in operation, albeit not in the waste hauling business. Additionally, there was no continuity of shareholders, since it was an entirely cash transaction, and no commonality of employees, officers, and directors. Finally, there were no indicia of a fraudulent effort to escape liability. Hence, the successor successfully conducted the asset acquisition without subjecting itself to successor liability in the eyes of the more conservative Ohio District Court.

IV. LABOR AND EMPLOYMENT LAW

While no major developments have occurred in recent years, the nuances of circumstances being considered as factors in determining successor liability have caught the attention of most practitioners. Although it is well settled that determining successor liability in employment and labor law actions are extremely fact specific, the specificity of which some cases turn has resulted in little guidance by the courts. Below are a few cases that are not necessarily unique, but illustrate how the smallest of factors can swing successor liability one way or the other.

In an opinion released on February 22, 2001, the Second Circuit held that the successor corporation in an asset acquisition could, potentially, assume liability stemming from plaintiff's action against the predecessor company. In *Nettis v. Levitt*, 2001 WL 170603 (2nd Cir. 2001),

plaintiff, who was the former controller of the predecessor, was allegedly dismissed for reporting financial wrongdoing and theft by other employees in violation of the New Jersey Conscientious Employee Protection Act. At some point following his dismissal, the successor purchased the assets of the predecessor, including all of its property, real and tangible, its permits, inventory, contract rights, accounts receivable, intellectual property, and business records. Notably, the purchase agreement included the predecessor's lease and contract obligations as well as its accounts payable. However, the agreement specifically excluded all other liabilities. The court held that the successor was a proper party to the action allowing plaintiff to amend his complaint. The court reasoned that the asset acquisition at hand "clearly contemplates the wholesale acquisition and continuation of [the predecessor]." *Id.* However, while the district court had based its holding on the facts that the transaction was structured as an asset purchase for cash and that the purchase expressly sought to limit the purchaser's liabilities in denying leave to add the predecessor as a defendant, the circuit court ignored the lack of continuity of ownership and focused on the continuation of the business entity, including its goodwill, customer lists, and intellectual property. Note though that this opinion simply vacated the district court's denial of leave to plaintiff and remands for further proceedings consistent with the opinion.

On the opposite end of the spectrum, a Texas District Court granted a motion for summary judgment in favor of the alleged defendant successor despite the apparent non-viability of the predecessor corporation. In *EEOC v. Clinic*, 1998 WL 386170 (N.D. Tex.), four former employees brought an action under Title VII for sexual harassment and retaliation against the medical clinic and the alleged successor corporations. The alleged successor corporations ("Successor Corporations") had merged with the corporation ("Merged Corporation"), that had acquired the assets of the company ("Asset Company") that owned all the assets of the medical clinic ("Clinic") where the four individuals worked. However, only the Clinic actually employed the four individuals and had dismissed the individuals two months prior to the asset sale by Asset Company and the future merger with Successor Corporations. Notably, the Asset Company provided all the assets for the Clinic to conduct business. The court applied the nine-factor test, recognizing the first two, (1) successor company had notice of the charge *prior* to acquiring the business or assets and (2) ability of the predecessor to provide relief, as "critical." The court held that Successor Corporations did not in fact succeed the Clinic, but rather succeeded the Asset Company, which was a separate entity from the Clinic, despite the Asset Company holding all the assets employed by the Clinic, the actual employer of the individuals, in conducting business.

The court went further in developing the lack of notice that the Successor Corporations received of the charges and eventual lawsuit. It refused to impute notice that the Clinic and Asset Company had received prior to the asset acquisition to the Successor Corporations, even though the attorneys for Clinic and Asset Company had two separate contacts with the EEOC regarding these charges. The court did this as if indicating that if this element had been present, then successor liability may have been proper against Successor Corporations. In considering the second factor, the court ignored assertions by the EEOC that Clinic is not an active corporation by reference to the facts that its doctors are now employed by Successor Corporations, as are all its employees, its patients have been transferred to Successor Corporations, and Clinic owns no property or equipment. All of this appeared to support the EEOC's assertion of the predecessor's inability to provide relief.

Evidently, the court relied exclusively on its disposition of the first critical element and granting of summary judgment.

Another Texas case demonstrates the complexities and care needed in drafting indemnification provisions in asset acquisitions when a known lawsuit has been brought and the plaintiff is seeking reinstatement. In *Shadid v. HCH Enterprises, Inc.*, 1999 WL 202581 (N.D. Tex.), a restaurant hostess initiated a lawsuit against her former employer alleging various claims based upon sexual harassment and discrimination. Subsequent to this action, the successor corporation acquired the assets of the former employer. In the Asset Purchase Agreement, the successor specifically excluded this lawsuit with the predecessor agreeing to indemnify the successor if liability were found as a result of this lawsuit. The Agreement stated that the predecessor "may enter into a settlement of [this case] without [successor]'s prior consent if such settlement is for monetary consideration only." *Id.* at *3. However, the plaintiff sought reinstatement to her position. The court denied summary judgment for the successor corporation. The court reasoned that the Agreement precluded settlement by the predecessor due to reinstatement being a necessary component and that only the successor can provide such relief. Since the predecessor did not possess the second critical element of the nine-factor test (the ability to provide relief), the court denied the successor's Motion for Summary Judgment. Due to the lack of foresight in drafting the exclusion and indemnification provisions in the Agreement, the successor remained a party to the action, subjecting itself to further litigation expenses, and continued to be vulnerable to eventual successor liability.