Successor Liability in Corporate Acquisitions - An Examination of Attempts to Limit the Use of the De Facto Merger Doctrine

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SUCCESSOR LIABILITY IN CORPORATE ACQUISITIONS—AN EXAMINATION OF ATTEMPTS TO LIMIT THE USE OF THE DE FACTO MERGER DOCTRINE

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INTRODUCTION

IN THE LAST decade there has been a marked increase in the number of corporate acquisitions and mergers. As a result of this phenomenon, the legal rights and obligations stemming from the acquisition of one corporation by another are being contested, not only by parties who have a direct interest in the acquisition but also by those whose interest in the acquisition arises years after the event. An injury caused by the use of a product manufactured by the acquired corporation often does not occur until years after the acquisition has taken place. In such a case, the injured party frequently discovers that the manufacturer is no longer in existence due to the acquisition. In addition, during the intervening years the old corporation's board of directors and shareholders will have scattered. Thus the plaintiff is left without an effective remedy against the original corporation, its former

1 Parties who have a direct interest in the acquisition include creditors and minority shareholders of the selling corporation. See Manning, The Shareholder's Appraisal Remedy: An Essay for Frank Coker, 72 YALE L.J. 223 (1962) [hereinafter cited as Manning].

2 An example of a party whose interest in the acquisition might not arise until years after the transaction is a products liability plaintiff. See Henn & Alexander, Effects of Corporate Dissolution on Products Liability Claims, 56 CORNELL L. REV. 865 (1971) [hereinafter cited as Henn & Alexander].


The plaintiff's recovery from the selling corporation may also be barred by the running of the applicable statute of limitations or by the expiration of the
directors or its former shareholders. Lacking such a remedy, the injured plaintiff must attempt to recover from the acquiring corporation. Depending upon the method in which the acquisition was made, however, the injured plaintiff may find that in addition to having no means to sue the original corporation, its former directors or its former shareholders, he also has no remedy against the acquiring corporation.⁸

To provide the injured plaintiff with a remedy, the courts of various jurisdictions have created equitable doctrines. One such doctrine is the "de facto merger" doctrine.⁸ This doctrine provides the plaintiff with a remedy against the acquiring corporation even though the acquiring corporation may have expressly denied any assumption⁷ of the target corporation's contingent liabilities at the time of acquisition.⁸ To counter this doctrine and to protect the acquiring corporation, at least one state legislature has enacted a statute which precludes the application of the de

time allowed by the postponed abatement statutes in effect in all jurisdictions. Wallach, Products Liability: A Remedy In Search of a Defendant—The Effect of a Sale of Assets and Subsequent Dissolution on Product Dissatisfaction Claims, 41 Mo. L. Rev. 321, 327-35 (1976) [hereinafter cited as Wallach].


facto merger doctrine. This comment discusses the various types of acquisitions that may occur. Its focus will then shift to the various judicial attempts to hold the acquiring corporation accountable for the liabilities of the acquired corporation when the strict procedural steps for a merger or consolidation have not been followed. Two innovative attempts, one legislative and one judicial, to resolve questions of corporate liability arising from acquisitions will be discussed. Finally, the potential impact of these two approaches and their scope and merit will be analyzed.

I. THE VARIOUS METHODS OF CORPORATE ACQUISITION

There are three basic methods to effect corporate acquisitions: (1) the statutory merger or consolidation of two corporations; (2) the use by an acquiring corporation of cash or its own stock to acquire the stock of the target corporation; or (3) the use by an acquiring corporation of cash or its own stock to acquire the assets of the target corporation.

Mergers and consolidations are creations of state laws. Both a merger and a consolidation result in the transfer of all of a corporation's assets in exchange for stock. A merger involves the absorption of one corporation by another corporation. This results in the continuance of the absorbing corporation and the dissolution of the absorbed entity. A consolidation is distinguished

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*Id.*


For a general discussion of methods of corporate acquisitions, see C. Scharf, Techniques for Buying, Selling and Merging Businesses (1964).


*See* note 13 supra.

*See* Winthrop, *supra* note 6, at 195.
from a merger in that a consolidation results in the formation of a new corporate entity and the dissolution of the two original corporations. Common characteristics of consolidations and mergers are the continuing interest of the absorbed corporation's shareholders in the newer surviving corporation and the general assumption of the liabilities of the absorbed corporation by the survivor.

The acquisition of a corporation by the exchange of the acquiring corporation's stock for the stock of the target corporation results in the continued existence of the target corporation. Since the target corporation continues its existence, it retains its liabilities, even though there has been a change in ownership. The acquiring corporation is subject to the liabilities of the target corporation to the extent of its (the acquirer's) ownership interest.

One reason for the recent increase in the number of acquisitions of this type is that world and national economic conditions in the past few years have kept the stock market stagnant. As a result, the stock of small and intermediate companies which have enjoyed a consistent series of profitable years does not reflect the strong financial condition of the companies. The book value per share of stock often exceeds the market price of the share.

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17 Id. See Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 939 (2d Cir.), cert. denied, 288 U.S. 599 (1932).
18 Due to the similarities between mergers and consolidations, they are treated in substantially the same manner for purposes of corporate law and taxation. See B. Bittker & J. Eustice, supra note 14, at ch. 14, § 12.
19 This is often referred to as a "B" type transaction. See note 15 and accompanying text supra. See B. Bittker & J. Eustice, supra note 14, at ch. 14, § 13.
22 See 15 W. Fletcher, supra note 7, at ch. 61.
23 This has been particularly true of the New York Stock Exchange. See Forbes, Feb. 18, 1980, at 40.
24 See id. at 119.
25 The determination of the book value per share is a two step process. First, the net liabilities of the company are subtracted from its net assets. Book value is then determined by dividing the figure which remains by the total number of outstanding shares.
26 See Forbes, Nov. 12, 1979, at 203.
When such a situation occurs, the company often becomes a prime prospect for a takeover. A corporation may acquire the target company by purchasing its stock at a cost substantially less than the value of the target's assets. The end result is that the acquiring corporation gains control of another corporation at a cost considerably below that necessary to acquire the same corporation through the purchase of its assets or the purchase of similar assets on the open market.

One of the major drawbacks of acquisitions carried out in this manner is that the liability of the acquired corporation generally carries over to the acquiring corporation. As a general rule, the surviving corporation in a merger or consolidation assumes the liabilities of the acquired corporation by operation of law. Thus a transaction which transfers the entire ownership interest in a corporate entity will result in the transfer of that entity’s liability. In contrast, a transaction which transfers an interest severed from the ownership interest in a corporation usually will not result in the transfer of the entity’s liabilities. The liabilities of the defunct corporation, once assumed, include both liabilities that are known at the time of the transaction, such as those of identifiable creditors, as well as unknown contingent liabilities to unidentifiable persons, such as potential products liability plaintiffs.

Even though it may cost more financially for an acquiring corporation to exchange its stock for the assets of another corporation than to exchange for the target corporation’s stock, there are advantages that often outweigh the added cost. The primary advantage is that the purchaser does not assume the seller’s lia-

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27 Id. at 224.
28 Id. at 229.
29 Id.
30 This is generally referred to as a “B” type merger. See note 14 and accompanying text supra. See Stephan, Acquisition Trouble Spots, 21 Bus. Law. 401, 410 (1966).
32 Id. See Freling, supra note 14, at 1130-31.
34 See note 14 supra, and accompanying text. This is generally referred to as a “C” type reorganization.
This is in contrast to a merger, consolidation or sale of stock where, as a matter of corporate law, liability attaches to the successor corporation. When a corporation buys the assets of another corporation it is permitted to select those liabilities it wishes to assume and to exclude from the purchase those express and unknown liabilities it does not wish to assume. This is based on the theory that the purchase of the assets of a corporation is in reality only a purchase of property. Property law provides that a bona fide purchaser who has given adequate consideration and who has no notice of prior claims against the property will not be liable for any unknown claims. As a consequence of this rule of law, the exchange of an acquiring corporation's stock for the assets of the target corporation is often more appealing than an exchange for the stock of the target corporation despite the higher cost involved.

When the target corporation receives stock of the acquiring corporation in exchange for all of its assets, the target often distributes this stock to its shareholders and then the target corporation liquidates. If the acquiring corporation has not assumed all of the liabilities of the target corporation, including its contingent liabilities, and the target has dissolved, creditors and potential products liability plaintiffs are left without a defendant.

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54 See generally H. Henn, Handbook of the Law of Corporations § 381 (2d ed. 1970); E. Kintner, Primer on the Law of Mergers (1973); N. Lattin, supra note 20, at § 184; W. Fletcher, supra note 7, at § 8224. See also B. Bittker & J. Eustice, supra note 14, at chs. 7 & 9 (tax consequences of distribution to shareholders).

59 Contingent liabilities include unknown or contingent rights of unidentifiable persons, such as potential products liability plaintiffs. See generally Freling, supra note 14, at 1130-36 (contingent liabilities in corporate acquisitions).

40 The possibility that a plaintiff will be unable to find a defendant to sue increases as the length of time after the transaction increases. See Wallach, supra note 4, at 323-35.
remedies created by the legislatures and courts do exist, however, to provide the creditor or products liability claimant with a defendant and a remedy. The early development of corporate law in this area focused on providing the plaintiff with a remedy against the dissolved corporation. However, the emphasis of modern corporate law has shifted to focus on providing a remedy against the surviving corporation. Due to the onslaught of this effort to hold the purchasing corporation responsible for the liabilities of the seller, both the Texas legislature and the California judiciary have lashed back to protect the surviving corporation from assuming, without its consent, express or contingent liabilities which it did not create.

II. CLAIMS AGAINST THE DISSOLVED CORPORATION AND ITS SHAREHOLDERS

At common law, the power of a corporation to sue and be sued ended at the time the corporation legally dissolved. To alleviate this harsh rule, the courts developed the "trust fund" doctrine to provide a remedy for plaintiffs where the corporation had dissolved.

In the typical corporate dissolution the assets of the corporation are sold to a third party and the proceeds of that sale are

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41 See Wallach, supra note 4, at 323-27 (remedies against dissolved corporations). See also Schoone, Shareholder Liability Upon Voluntary Dissolution of a Corporation, 44 Marq. L. Rev. 415 (1961) (remedies against shareholders of dissolved corporation) [hereinafter cited as Schoone]; Henn & Alexander, supra note 2 (remedies against purchasing corporation); Comment, Safeguarding the Creditors of Corporations, 36 Harv. L. Rev. 509 (1923) (remedies against purchasing corporation).

42 See Comment, Suits By and Against Dissolved Corporations, 48 Iowa L. Rev. 1006 (1963).


45 Bazan v. Kux Mach. Co., 52 Wis. 2d 325, 190 N.W.2d 521 (1971). See also W. Fletcher, supra note 7, at § 8127; Schoone, supra note 41, at 419.

used to pay any known liabilities. Any remaining consideration received from the sale is distributed to the shareholders. If plaintiff could pursue only the corporate entity, any claims arising after the dissolution and distribution would go unsatisfied.

The "trust fund" theory arose to ameliorate such a situation by providing the plaintiff with a defendant who could satisfy any of his claims. The doctrine was developed over 150 years ago in the aftermath of Wood v. Dummer. In Dummer, Justice Story set forth the notion that the capital stock of a dissolved corporation is "a pledge or trust fund" for creditors. Even though the corporate entity has vanished, its former stockholders hold the proceeds from dissolution in trust for the benefit of the creditors. Thus this doctrine provides a remedy where the corporation has dissolved and has distributed its assets to shareholders before the plaintiff's claim arises or matures.

In addition to the judicially created "trust fund" doctrine which is utilized in many jurisdictions, statutory provisions dealing with litigation by and against a dissolved corporation are now in effect in every jurisdiction. The statutes generally allow the dissolved corporation to sue and to be sued for a period of time after its dis-

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48 Wallach, supra note 4, at 328.


50 See Norton, Relationship of Shareholders to Corporate Creditors Upon Dissolution: Nature and Implications of the "Trust Fund" Doctrine of Corporate Assets, 30 Bus. Law. 1061 (1975) [hereinafter cited as Norton].

51 Id. at 1062. Although the trust fund theory was first set forth as dicta in Wood v. Dummer, it was left to subsequent courts to define and to determine the scope of the doctrine. Id. at 1064-67. See Norton, supra note 50.

52 Wood v. Dummer, 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,944).

53 Id. at 438.

54 See Norton, supra note 50, at 1061.

55 For cases directly applying the "trust fund" doctrine, see cases cited in Norton, supra note 50, at 1061 n.4.

solution. However, they vary slightly from state to state. The main variable involves the length of time after the dissolution during which a suit must be commenced by or against the dissolved corporation. The time limits vary from two to five years. These statutes are not statutes of limitation but are postponed abatement statutes. They merely modify the common law rule to postpone the time of abatement, which normally is the date the dissolution occurs. This is true regardless of whether the statute of limitations on the claim has begun to run. Thus, if a creditor or products liability claimant fails to assert his claim against the dissolved

57 About half of the states have statutes which resemble the Model Bus. Corp. Act Ann. § 105 (as amended 1976) which provides:

The dissolution of a corporation shall not take away or impair any remedy available to or against such corporation, its directors, officers, or shareholders, for any right or claim existing, or any liability incurred, prior to such dissolution if action or other proceeding thereon is commenced within two years after the date of such dissolution. Any such action or proceeding by or against the corporation may be prosecuted or defended by the corporation in its corporate name. The shareholders, directors and officers shall have power to take such corporate or other action as shall be appropriate to protect such remedy, right or claim. If such corporation was dissolved by the expiration of its period of duration, such corporation may amend its articles of incorporation at any time during such period of two years so as to extend its period of duration.

Citations to the state statutes are collected in the Model Business Corporation Act Annotated following section 105.

58 Wallach, supra note 4, at 324-25.

59 Most states have adopted a two or three year period. See 15 W. Fletcher, supra note 7, at § 8169. Another distinction among these varying statutes is their authorization to plaintiffs to assert claims that arise after dissolution of the seller. The wording of § 105 of the Model Act indicates that only claims which arose before the dissolution of the corporation may be asserted during the postponed abatement period. See Stone v. Gibson Refrigerator Sales Corp., 366 F. Supp. 733 (E.D. Pa. 1973). However, in jurisdictions which have not adopted the Model Act, the language of the statute may allow the assertion of claims which arise following dissolution, if within the period prescribed by the postponed abatement statute. See Chadwick v. Air Reduction Co., 239 F. Supp. 247 (N.D. Ohio 1965) (construing Ohio statute). Jurisdictions following the Model Act hold that where the incident which gave rise to the claim occurred after the corporation's dissolution but before the statutory abatement period's expiration, a plaintiff could not assert a claim based upon strict liability in tort. Wallach, supra note 4, at 327.

60 Wallach, supra note 4, at 325. At common law, the dissolution of the corporation abated litigation already in progress and any cause of action which existed against the corporation, even if the action had not yet been commenced. Schoone, supra note 41, at 419.

61 Wallach, supra note 4, at 324-27.
corporation within the time set by the applicable postponed abatement statute, he will be unable to sue the dissolved corporation even though the statute of limitations on his claim has not run. If the postponed abatement period has expired, the plaintiff's only alternative will be to assert his claim against the shareholders of the dissolved corporation under the "trust fund" theory. However, if the time period established by the postponed abatement statute has run, the "trust fund" theory may also be unavailable to the plaintiff. Jurisdictions vary as to whether the plaintiff may still pursue the dissolved corporation's shareholders under the "trust fund" theory. If the creditor or products liability claimant is unable to recover from the dissolved corporation due to the expiration of the postponed abatement period, or from the former shareholders due to the unavailability of the "trust fund" doctrine, the plaintiff will be forced to attempt to recover from the third party who purchased the assets of the dissolved corporation.

III. LIABILITY OF THE PURCHASER OF ASSETS OF A DISSOLVED CORPORATION

The rule that the corporation which acquires the assets of the transferring corporation is not liable for the outstanding and contingent liabilities of the transferor unless it has expressly assumed those liabilities first arose in the context of creditor-debtor relationships. The underlying rationale for this rule is that the interest of the new owners is superior to that of the creditors because the creditors enjoy a right to repayment from the previous owners under such theories as the "trust fund" theory. As long as the transferring corporation received adequate consideration for the transfer of the business, the creditors lose nothing by being denied an action against the transferee. In such a situation, the creditors

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62 Id. at 325.
63 See notes 50-55 supra, and accompanying text.
64 See generally Norton, supra note 50, at 1976-77 (availability of "trust fund" doctrine as a defense after postponed abatement period has expired).
are left with the same quantity of assets as that upon which they were willing to extend their credit. The argument to support this theory is that the creditors of the transferring corporation would be provided with a windfall if a cause of action against the acquiring corporation was to be created. A windfall would result because the acquiring corporation often has more assets from which the creditor’s claim could be satisfied.

The general rule of nonassumption of liability by the acquiring corporation has been extended to cover product liability claims. However, support for the application of the general rule to products liability claims is not as clear as it is for claims by creditors. The rationale for holding the successor corporation liable for products liability claims arising from the use of products manufactured by the transferring corporation is clear. The products liability plaintiff cannot anticipate subsequent or incidental damage claims;

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68 While the selling corporation may be able to satisfy only a part of the creditors’ claims out of the proceeds of the sale, the value of the business represents the security the creditors were initially willing to accept. Note, Cyr v. B. Offen & Co.: Liability of Business Transferees for Product Injuries, 27 ME. L. REV. 305, 309 (1975).

69 A windfall would result when the purchasing corporation has substantially more assets with which creditors’ claims could be satisfied than had the selling corporation. If, for example, the creditor obtained a judgment for $100,000 against the seller, which had only $50,000 in assets, the creditor would not be able to obtain full satisfaction of the judgment. However, if the creditor could assert his $100,000 claim against the purchaser, which had assets of $200,000, the creditor’s judgment could be fully satisfied. The windfall to the creditor derives from the fact that he was willing to risk his $100,000 knowing that the original corporation had only $50,000 in assets to satisfy claims upon default. Because the creditor lost part of his money on the risk he knowingly accepted, his attempt to come forward and assert his claim against the purchasing corporation which has substantially more assets than the predecessor would constitute a windfall. See Note, Cyr v. B. Offen & Co.: Liability of Business Transferees for Product Injuries, 27 ME. L. REV. 305, 308-10 (1975).

70 Id. at 309.


72 The requirement that privity exist between the products liability plaintiff and the defendant has been greatly relaxed. See Prosser, The Fall of the Citadel (Strict Liability to the Consumer), 50 MINN. L. REV. 791 (1966); Prosser, The Assault Upon the Citadel (Strict Liability to the Consumer), 69 YALE L. REV. 1099 (1960).

73 See Prosser, The Assault Upon the Citadel (Strict Liability to the Consumer), 69 YALE L.J. 1099, 1122 (1960); Comment, Product Liability—The
unlike a creditor, he does not base his purchase of equipment upon the financial soundness of the transferring corporation. Nor does the products liability claimant have an active role in the formation of a transaction that transfers the assets of one corporation to another, a role a creditor may assume. Since the products liability claimant neither bargains for the risk of non-payment of a judgment against the selling corporation nor profits from the assumption of that risk, he should not be limited to asserting his claim against the selling corporation.

Furthermore, unlike claims of creditors, a products liability claim may arise long after the transferring corporation has dissolved and has distributed its assets to its shareholders. If the lapse of time since the corporation’s liquidation has been sufficiently long, the products liability plaintiff will be barred from suing the dissolved corporation by the postponed abatement statutes. Even if the “trust fund” doctrine is available in the jurisdiction where the plaintiff asserts his claim, its use may be impractical if the shareholders of the dissolved corporation have scattered or have squandered away the assets they received or if they have transferred the assets to bona fide purchasers so that the assets are no longer traceable.

Initially, most courts applied the general rule, that the corporation which purchases the assets of another corporation is not liable for the selling corporation’s liabilities, equally against both products liability and creditor-debtor claims. As a result, in-

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*Expansion of Fraud, Negligence and Strict Tort Liability, 64 Mich. L. Rev. 1350, 1358 (1966).*

*Note, Cyr v. B. Offen & Co.: Liability of Business Transferees for Product Injuries, 27 Me. L. Rev. 305, 310 (1975).*

*Id.*

*Id.*


*See generally Norton, supra note 50, at 1072-73 (traceability of corporate assets upon dissolution).*

*See, e.g., Walbrun v. Babbitt, 83 U.S. (16 Wall.) 577 (1872); Racine*
equitable results arose when plaintiffs were left without a remedy or a defendant to sue. In an effort to end these inequitable results, the courts developed several exceptions to the general rule of non-liability of the purchaser.⁴⁹

Four generally recognized exceptions to the rule⁵⁰ were explicitly set forth in Kloberdanz v. Joy Manufacturing Co.,⁵¹ where the court stated:

[W]here one company sells or otherwise transfers all its assets to another company the latter is not liable for the debts and liabilities of the transferer, except where:

(1) the purchaser expressly or impliedly agrees to assume such debts; (2) the transaction amounts to a consolidation or merger of the seller and purchaser; (3) the purchasing corporation is merely a continuation of the selling corporation; or (4) the transaction is entered into fraudulently in order to escape liability for such debts.⁵²

If one of these situations occurs, the unsatisfied creditor or products liability claimant of the selling corporation will be able to recover from the purchasing corporation.⁵³

A. The Express and Implied Assumption of Liability and the Fraudulent Transactions Exceptions

The express or implied assumption of liability and the fraudulent transactions exceptions to the general rule of a purchaser's nonliability are of little practical value. Under the express assumption of liability exception, the purchasing corporation may voluntarily assume the liabilities of the selling corporation by an express agreement to do so.⁵⁴ The purchasing corporation also may

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⁵³ Id. at 820.

⁵⁴ Id.

⁵⁵ Winthrop, supra note 6, at 207.
The liabilities assumed may be contingent liabilities as well as those to identifiable creditors. However, the purchasing corporation can avoid an implied assumption of liabilities by enumerating the liabilities which are to be assumed and explicitly excluding the assumption of all liabilities not enumerated. Under the fraudulent transaction exception, both creditors and products liability claimants can have a transaction set aside if they can prove an intent to defraud on the part of the seller.

Although the courts have often cited these situations as exceptions to the general rule of purchaser nonliability, most courts have not employed them in finding successor corporations liable. In most cases, the corporation purchasing the assets of the selling corporation assumes certain liabilities and expressly denies any responsibility for those liabilities not expressly assumed. Thus there is little question as to what liabilities have been expressly or impliedly assumed by the purchaser. When there is no such assumption of liability, it is often easier for the plaintiff to prove, and for the court to find, successor liability under another exception which does not require a showing of intent to defraud.

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85 *Id.*
86 *Id.*
87 *Id.*
89 *See generally Wallach, supra note 4, at 337 n.62 (cases cited). See also *Luedcke v. Des Moines Cabinet Co.*, 140 Iowa 223, 118 N.W. 456 (1908); *Tinio, Similarity of Ownership or Control as Basis for Charging Corporation Acquiring Assets of Another with Liability for Former Owner's Debts, Annot.*, 49 A.L.R.3d 881, 884-90 (1973).
the courts have relied upon the continuation\textsuperscript{64} and de facto merger exceptions,\textsuperscript{65} as well as the newly developed exception for strict products liability cases,\textsuperscript{66} to impose liability on a successor corporation.

B. The Continuity Exception

Another of the generally recognized exceptions to the rule of successor nonliability is that the purchasing corporation may be held responsible for the liabilities of the selling corporation if it is merely a continuation of the seller.\textsuperscript{67} This exception is employed by the courts more often than are the fraud or express and implied assumptions exceptions,\textsuperscript{68} but it is used less frequently than is the exception for de facto mergers.\textsuperscript{69} One reason for the courts' reluctance to use the continuity exception is that they have been unable to agree upon the factual elements necessary to warrant application of the doctrine.\textsuperscript{70} As a result, the doctrine is ambiguous and its parameters have yet to be clearly defined.\textsuperscript{71}

Under the continuity exception, the purchasing corporation will be held liable for the seller's obligations if the purchaser is


\textsuperscript{66} See notes 195-99 and accompanying text infra.


\textsuperscript{68} See Winthrop, supra note 6, at 207; Comment, Assumption of Products Liability in Corporate Acquisitions, 55 B.U.L. REV. 86, 95 (1975).


\textsuperscript{71} See Cyr v. B. Offen & Co., 501 F.2d 1145, 1151 (1st Cir. 1974).
in most respects merely a continuation of the selling corporation.\(^{103}\)

What constitutes “most respects” varies greatly from court to court. The continuity exception generally can be divided according to its two interpretations: (1) where the exception has been construed narrowly to apply only to changes in the form of the business entity,\(^{103}\) and (2) where the exception has been construed more broadly to cover situations involving changes in ownership.\(^{104}\)

Courts which have construed the continuity exception narrowly have applied it in situations where the only change in the selling corporation has involved the form of the business entity.\(^{105}\) Examples of this are recapitalizations or alterations in the name or place of incorporation.\(^{106}\) Two cases where the courts have construed the continuity exception in this narrow fashion are McKee v. Harris-Seybold Co.,\(^{107}\) and Kloberdanz v. Joy Manufacturing Co.\(^{108}\)

In McKee, the court determined that in order for liability to attach to the purchasing corporation, it must represent no more than a “new hat” for the seller.\(^{109}\) Since the seller in McKee continued in existence after the sale of its assets and was able to satisfy its debts, the purchasing corporation was not a mere continuation of the seller.\(^{110}\) Borrowing the court’s analogy to a “new hat”, the transaction in McKee would be more appropriately characterized as a complete change in wardrobe.

\(^{103}\) It has been suggested that one concept of continuity relates to ownership of the stock of the business entities before and after the sale of the assets, while another concept is based upon the income tax consequences of the transaction. Note, Cyr v. B. Offen & Co.: Liability of Business Transferees For Product Injuries, 27 Me. L. Rev. 305, 312 (1975).


\(^{105}\) See Cyr v. B. Offen & Co., 501 F.2d 1145, 1152 (1st Cir. 1974).

\(^{106}\) Id. at 626.


\(^{109}\) 109 N.J. Super. at 570, 264 A.2d at 106.

\(^{110}\) The McKee court concluded that there was no continuation of the selling corporation, even though the vice-president, secretary and treasurer of the seller were employed by the purchaser. 109 N.J. Super. at 564, 264 A.2d at 103.
The Kloberdanz court was more specific in defining its criteria for application of the continuity exception. The court determined that the continuity exception did not apply because the seller continued to exist after the sale and because the stock and the directors, officers and shareholders of the two corporations were not identical. The decisive factor in both the McKee and Kloberdanz decisions is that there was a change in ownership and thus a substantial change in the form of the business entity. Thus the crucial factor in the determination of whether the continuity exception will apply under its narrow view exception would seem to be that a sufficient continuation of an interest from the seller to the buyer must exist. If a sufficient continuity occurs, the change in form will be disregarded and the purchaser will be responsible for the liabilities of the seller. If no continuity exists, successor nonliability will follow. Due to the lack of continuity, the defendants in McKee and Kloberdanz were absolved of liability for their predecessors' actions.

The United States District Court for the Eastern District of Pennsylvania also has adhered to a narrow interpretation of the continuity doctrine. In Lopata v. Bemis Co. the court held that in order for there to be a continuation of the selling corporation there must be both a continuation of its business operations and a continuation of the original corporate entity. Factors which would provide sufficient evidence of the continuation of the selling corporation would be the common identity of shareholders and directors of the seller and purchaser and the existence of only one corporation after the transaction. The court concluded that the exception was inapplicable in Lopata because only one director and the vice-president of the selling corporation assumed positions with the new corporation. Furthermore, the selling corporation continued to operate as a separate corporate entity

111 288 F. Supp. at 821-22. The court also stated that the adequacy of the consideration received by the selling corporation and the nonfraudulent nature of the transaction were additional factors which indicated that the purchasing corporation should not be held liable for the torts of the seller. Id. at 822.
113 Id. at 345.
114 Id.
115 Id.
after the sale of most of its assets.\footnote{116}

Not all courts have adopted this narrow view of the continuity exception. One case which clearly imposed liability based upon an expansive application of the continuation theory was \textit{Cyr v. B. Offen & Co.}\footnote{117} The plaintiff brought suit against the purchasing corporation due to injuries caused by a defect in a machine manufactured years earlier by the company which had sold the purchaser its assets.\footnote{118} There was no continuity of ownership although the purchaser claimed to have been in business for forty years and used the seller's name.\footnote{119} The court noted that the purchasing corporation had taken over an ongoing business, had assumed all of the benefits of the business from its predecessor, had continued to function as had the selling corporation, and had produced the same product and employed the same persons. Despite the complete change in ownership, the effect of these facts was sufficient to impose liability upon the purchaser under the continuation theory.\footnote{120} Thus it appears that courts which utilize a broader interpretation of the continuation theory may find the exception applicable despite a change in the selling corporation's ownership if the business activities of the seller are continued unaltered by the purchaser under the control of the persons who managed the selling corporation.\footnote{121}

\textbf{C. The De Facto Merger Exception}

The exception to the general rule of successor nonliability most frequently employed by the courts is the de facto merger doctrine.\footnote{122} Liability for claims against the predecessor automatically attaches to the successor corporation in a statutory merger or consolida-
tion. However, corporations have been able to avoid this successor liability by structuring the merger or consolidation to appear to be a sale of assets.

The de facto merger doctrine is a judicial creation to protect the rights of creditors, tort victims, and dissenting minority shareholders in transactions where substantially all of the assets of one corporation are sold to another. The doctrine provides that when a transaction had all the indices of a merger, except for failure to conform with the statutory merger requirements, the successor corporation will be subject to all the legal consequences of a merger. Thus, the successor corporation will be responsible for all debts and contingent liabilities of the predecessor corporation. In applying the doctrine, the courts look to the transaction as a whole to determine whether the transfer has sufficient characteristics of a merger to warrant a judicial finding of de facto merger, and its accompanying liability.

A survey of past decisions involving de facto mergers is helpful


124 See, e.g., Jennings Neff & Co. v. Crystal Ice Co., 128 Tenn. 231, 159 S.W. 1088 (1913).


130 See Winthrop, supra note 6, at 197-98.

in determining how closely a transaction between two or more corporations must resemble a statutory merger before a court will find a de facto merger. The different jurisdictions that have faced de facto merger claims are not in complete agreement on the relevance and importance of the various elements involved in a purchase of assets to the determination of whether a de facto merger has taken place. All courts seem to agree, however, that a continued interest by the seller's shareholders in the purchase is required.\textsuperscript{132} Therefore, if the purchaser does not utilize its own stock to pay for the assets it acquires, no de facto merger will be held to have occurred.\textsuperscript{133}

The de facto merger doctrine first arose in the context of claims by unsatisfied creditors and by minority shareholders seeking to protect their appraisal rights.\textsuperscript{134} One early case involving the de facto merger exception and the rights of minority shareholders was \textit{Farris v. Glen Alden Corp.}\textsuperscript{135} In \textit{Farris}, the minority shareholders of List Industries brought suit to enjoin a transaction which they alleged effectively constituted a merger.\textsuperscript{136} The trans-


\textsuperscript{134} The shareholders who dissent from a corporate merger or a sale of the corporation's assets have the right in most states to require the corporation to purchase their shares at a judicially determined price. See, e.g., Teschner v. Chicago Title & Trust Co., 59 Ill. 2d 452, 322 N.E.2d 54 (1974); Acree v. E.I.F.C., Inc., 502 S.W.2d 43 (Ky. 1973); Reynolds Metal Co. v. Colonial Realty Corp., 190 A.2d 752 (Del. 1963). See also Folk, \textit{De Facto Mergers in Delaware: Hariton v. Arco Electronics, Inc.}, 49 Va. L. REV. 1261, 1264 (1963) (contractual right to demand that corporation fulfill purpose for which it was created).

\textsuperscript{135} 393 Pa. 427, 143 A.2d 25 (1958).

action involved the sale of all of the assets of List Industries to the Glen Alden Corporation in exchange for Glen Alden stock.\textsuperscript{137} This stock was to be distributed to the shareholders of List and the corporation was then to dissolve.\textsuperscript{138} The Pennsylvania Supreme Court, in holding for the plaintiffs, ruled that a de facto merger had occurred.\textsuperscript{139} The court stressed that when a transaction is one in which "a corporation combines with another so as to lose its essential nature and alter the original fundamental relationships of the shareholders among themselves and to the corporation,"\textsuperscript{140} the substance and consequences of the transaction must prevail over the form of the agreement.\textsuperscript{141} In such a situation, the court would find a de facto merger in order to protect the rights of dissenting minority shareholders of the selling corporation.\textsuperscript{142}

The "substance over form" approach of \textit{Farris} was followed in \textit{Applestein v. United Board \\& Carton Corp.},\textsuperscript{143} where minority shareholders claimed that the transaction was, in effect, a merger.\textsuperscript{144} Although the court did not cite specific criteria for its finding that a de facto merger had occurred, other than the "substance over form" test, it did point out that many of the elements necessary to qualify a transaction under the New Jersey merger statutes were present.\textsuperscript{145}

\textsuperscript{137} 393 Pa. at 428, 143 A.2d at 27.
\textsuperscript{138} Id. See also Jennings Neff \\& Co. v. Crystal Ice Co., 128 Tenn. 231, 159 S.W. 1088 (1913); Rath v. Rath Packing Co., 257 Iowa 1277, 136 N.W.2d 410 (1965); Note, \textit{Knapp v. North American Rockwell Corp.}, 6 SETON HALL L. REV. 477, 482 (1975).
\textsuperscript{139} 392 Pa. at 434, 143 A.2d at 31.
\textsuperscript{140} Id. at 433, 143 A.2d at 29.
\textsuperscript{141} Id. at 432, 143 A.2d at 28.
\textsuperscript{142} Id. at 433, 143 A.2d at 29.
\textsuperscript{144} Id. at 336-37, 159 A.2d at 148.
\textsuperscript{145} The court pointed out a number of factors in \textit{Applestein} that would also have been present if the parties had merged under the New Jersey merger statute: (1) a transfer of all the shares and all the assets of Interstate to United; (2) an assumption by United of Interstate's liabilities; (3) a "pooling of interests" of the two corporations; (4) the absorption of Interstate by United, and the dissolution of Interstate; (5) a joinder of officers and directors from both corporations on an enlarged board of directors; (6) the present executive and operating personnel of Interstate will be retained in the employ of United; and (7) the shareholders of the absorbed corporation,
As the de facto merger doctrine gained judicial acceptance, its use was extended from cases involving claims by creditors and minority shareholders to those involving products liability actions against the successor corporation. By applying the doctrine of de facto mergers to strict products liability cases, general theories of corporate law have been expanded by the public policy considerations often present in those cases.

The fundamental basis for imposing strict tort liability on a manufacturer was first expressed in Greenman v. Yuba Power Products, decided by the Supreme Court of California in 1962. The court held that if a manufacturer knows that a product which it places on the market will be used without inspection for defects, the manufacturer will be held strictly liable in tort if the product later proves to have a defect that causes personal injury. Three primary policy reasons exist for imposing strict tort liability on a manufacturer: (1) the consumer is entitled to rely on the product's being what it purports to be, and not a dangerous instrumentality; (2) the imposition of such liability upon the manufacturer acts as an inducement for it to improve the safety of the product, and serves as a deterrent against the sale of other defective products; (3) the manufacturer is in a better position to bear the loss caused by a dangerous product, since it can pass the loss on to customers and thus effectively distribute the loss throughout society.

Interstate, as represented by the sole stockholder, Epstein, will surrender his 1,250 shares in Interstate for 160,000 newly issued shares in United, the amalgamated enterprise.


149 Id. at 60, 377 P.2d at 900, 27 Cal. Rptr. at 700.

Kloberdanz v. Joy Manufacturing Co. presents an example of the expansion of the de facto merger doctrine into product liability cases. The plaintiff, a workman, sought damages for a personal injury resulting from use of a "hydra-hook" on an oil drilling rig. The Joy Manufacturing Company earlier had paid cash for substantially all of the manufacturing assets of the corporation which produced the "hydra-hook," including its name and trademark. In addition, Joy had assumed certain liabilities of the seller as set forth in the sales contract, and the selling corporation had continued in existence for ten months after the sale. The Kloberdanz court found that no de facto merger had occurred and thus there had been no assumption of liability by the purchasing corporation. The court emphasized that the transaction had been conducted at arms-length, with adequate consideration paid, and that there had been no carryover of officers or shareholders' interest from the selling corporation to the purchasing corporation. In addition, the seller's retention of some assets indicated that a severance of assets from the corporate entity rather than a merger had occurred. In emphasizing the arms-length nature of the transaction and the fact that adequate consideration had been paid for the assets, the court indicated that the underlying purpose for the doctrine of successor liability was the need to protect creditors against the seller's inability to meet its obligations.

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See generally 1 Frumer and Friedman, Products Liability, § 5.06 (1979); Recent Developments, Products Liability—Liability of Transferee for Defective Products Manufactured by Transferee, 30 Vand. L. Rev. 238 (1977); Recent Developments, Products Liability—Corporations—Asset Sales and Successor Liability, 44 Tenn. L. Rev. 905 (1977).


Id. at 818-19.

Id. at 818-20.

Id. at 821-22. The court held that there was no express or implied assumption of tort liability because the parties had intended, and the sales contract had provided, that the selling corporation would retain such liabilities. Id. at 821.

Id. at 822.

Certain real and personal property of the selling corporation were not acquired by the purchasing corporation. Id. at 818-19.
if adequate consideration were not received.158

Another case involving the application of the doctrine to a products liability claim was *McKee v. Harris Seybold Corp.*159 In *McKee*, the plaintiff attempted to hold the Harris-Seybold Corporation liable under the de facto merger doctrine for injuries caused by an allegedly defective product manufactured by Seybold, the predecessor corporation. Seybold had sold its assets, business and goodwill to the purchasing corporation more than forty years before the injury occurred, receiving a mixture of cash and stock in return. Seybold had continued in existence for fourteen months after the sale, but had refrained from any active manufacturing during that time. Relying upon the analysis used in *Kloberdanz*, the *McKee* court found no de facto merger.160 The court held that a sufficient continuity of shareholder interests from the selling corporation to the purchasing corporation, as well as an absorption of the corporation identity of the seller by the purchaser, were essential elements for the existence of a de facto merger.161 The court indicated that the receipt of cash by the selling corporation for its assets did not yield the required continuity of interest by the seller's shareholders in the purchaser.162 Furthermore, there was no absorption of the selling corporation's identity into the purchasing corporation because the seller continued in existence for fourteen months after the transaction.163 Since the elements of continuity of shareholder interest and assimilation of corporate identity were absent, the selling and purchasing corporations remained "strangers after the sale"164 and no de facto merger had occurred.

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158 *Id.* at 820-21.
160 *Id.* at 567, 264 A.2d at 106.
161 *Id.* at 566, 264 A.2d at 104. Although some shares of the purchasing corporation were transferred to the selling corporation, the court felt that the continuity of the shareholders' interest was negligible due to the small percentage of the consideration which was received in the form of stock. *Id.*
162 *Id.*
The Third Circuit Court of Appeals, in Knapp v. North American Rockwell Corp., took a more liberal stance than the McKee court regarding the degree to which the selling corporation must be absorbed by the purchasing corporation at the time of sale. In Knapp, the plaintiff brought a product liability action against the North American Rockwell Corporation. He claimed that he had been injured while using a piece of machinery manufactured by a corporation that had later sold substantially all of its assets to North American in exchange for stock in that corporation. As part of the agreement, the selling corporation had agreed to dissolve and had done so eighteen months after the transaction. The court reviewed earlier decisions in other jurisdictions whose courts, under facts similar to those in Knapp, probably would have found that a sale rather than a de facto merger had occurred. In contrast to these prior decisions, however, the Knapp court found that a de facto merger had occurred. In so holding, the court expanded the de facto merger doctrine to encompass public policy considerations normally associated with the law of strict products liability.


406 F.2d 361 (3d Cir. 1974).

168 Id. at 362.

169 Id. at 363.


The Knapp court reasoned that "the philosophy of the Pennsylvania courts [is] that questions of an injured party's rights to seek recovery are to be resolved by an analysis of public policy considerations rather than by a mere prosecution application of formalities." 506 F.2d at 369.

170 Id. at 369. The underlying purpose for application of public policy considerations of strict tort liability to the question of liability of successor corporations was aptly stated in Cyr v. B. Offen & Co., 501 F.2d 1145 (1st Cir. 1974), where recovery was based on the continuity exception. The Cyr court reasoned that the purchasing corporation, like the actual manufacturer, was in a better
it did attempt to structure its analysis around the corporate law aspects of the de facto merger doctrine. The court stated that "a number of considerations indicated the insubstantiality of the continued existence of [the selling corporation], including the brevity of the corporation's continued life, the contractual requirement that [it] be dissolved as soon as possible, the prohibition on engaging in normal business transactions, and the character of the assets [it] controlled." This statement indicated the court's willingness to relax, based upon public policy considerations, the assimilation requirements of the de facto merger doctrine as set forth in McKee. If the court had applied the strict assimilation test, exemplified in McKee and Kloberdanz, it would have concluded that there had been no assimilation of the selling corporation into the purchasing corporation since the seller continued in existence for eighteen months. Instead of finding a de facto merger, the court would have concluded that the case involved a mere sale of assets.

This mixture of the de facto merger doctrine and policy considerations of products liability law has been utilized by courts in other jurisdictions. About the time Knapp was being handed down, the United States District Court for the Western District of Michigan faced a products liability action involving facts similar to those in Knapp. In Shannon v. Samuel Langston Co., the district court found that a de facto merger had occurred and that Langston, the purchasing corporation, was thus liable for the injury resulting from the plaintiff's use of a machine manufactured position than injured consumers to determine the risks of injury from products and the costs of meeting such risks because of the carryover of expertise and experience from the original manufacturer. The purchasing corporation is just as capable as was the selling corporation of spreading the costs of injuries caused by defective products throughout society by reflecting such costs in the price of the product. The court went on to state: "The successor knows the product, is as able to calculate the risk of defects of the predecessor, is in position to insure therefore and reflect such cost in sale negotiations, and is the only entity capable of improving the quality of the product." *Id.* at 1154. Accord Shannon v. Samuel Langston Co., 379 F. Supp. 797 (W.D. Mich. 1974); Ray v. Alad Corp., 19 Cal. 3d 22, 560 P.2d 3, 136 Cal. Rptr. 574 (1977).

by the selling corporation. AWARE of the public policy considerations in products liability actions, the court recited the indices of a de facto merger: (1) continuity of the selling corporation's management, personnel, physical location, assets and overall business operations; (2) continuity of ownership interest in the selling corporation's shareholders by their receipt of stock from the purchasing corporation; (3) the liquidation and dissolution of the selling corporation as promptly as possible, and; (4) the assumption by the purchaser of those obligations of the seller necessary for the uninterrupted continuation of normal operations.

Courts have felt the need to expand the de facto merger doctrine to encompass products liability claims to protect plaintiffs from inequitable results if they were unable to pursue the selling corporation or its former shareholders. In such cases, the plaintiffs would have no recovery unless one were allowed against the successor corporation. For this reason, the Third Circuit Court of Appeals in Knapp felt compelled to extend the de facto merger doctrine beyond its ordinary scope to hold the successor corporation liable. The court recognized that the ordinary consumer cannot protect himself from the risks of defective products as effectively as can the selling corporation, and that he is less capable of spreading the losses caused by such products throughout the community. Similarly, the Shannon court, holding the purchasing corporation liable under the de facto merger doctrine, reasoned that "[t]he public policy behind the evolving common law of products liability is that the enterprise, the going concern, ought to bear the liability for the damages done by its defective products."

A successor corporation, for purposes of planning and obtaining insurance, needs to know the extent of the liabilities it has assumed. Every acquisition is carefully tailored to the exact business and tax needs of the selling and purchasing corporations. Thus a cor-

176 Id. at 801.
177 Id.
180 379 F. Supp. at 802.
poration will hesitate to invest in a business unless it receives assurances that it will be responsible only for those liabilities it has voluntarily assumed. The de facto merger doctrine originally was applied only to the claims of creditors and dissenting shareholders of the original corporation. However, with the expansion of the doctrine, claims of products liability plaintiffs now may be asserted against the successor corporation based upon the alleged existence of a de facto merger. The cases discussed above indicate that various courts, attempting to incorporate into the de facto merger doctrine public policy considerations of the law of strict products liability, have formulated different criteria for finding a de facto merger. Thus, the expansion of the doctrine due to these policy considerations has led to confusion regarding the exact extent of the successor's assumption of liability. As one commentator has stated:

Given the disparate definitions applied to "de facto" merger in various jurisdictions, combined with the multijurisdictional nature of many acquisitions, the obstacles to satisfying relevant judicial criteria may seem hopelessly blocked with undecipherably intricate or even invisible barriers.\(^\text{180}\)

Other jurisdictions faced with strict products liability claims have also combined public policy considerations with the de facto merger doctrine to reach the desired result.\(^\text{181}\) The varying weight which the courts give to these policy considerations has led them to propose different criteria which must be satisfied before the transaction will be considered a de facto merger rather than a sale of assets.\(^\text{182}\) Despite the variation among the different courts, two factors consistently have been required by most jurisdictions for a de facto merger to be found. The first is a continuity of ownership by the selling corporation's shareholders in the new entity.\(^\text{183}\) The second is a liquidation of the selling corporation.

\(^{180}\) Winthrop, supra note 6, at 206.


\(^{183}\) This factor was considered particularly determinative in Shannon v. Samuel Langston Co. See also Ray v. Alad Corp., 19 Cal. 3d 22, 560 P.2d 3, 136 Cal. Rptr. 574 (1977); Western Resources Life Ins. Co. v. Gerhardt, 553
within a reasonable time\textsuperscript{184} after the transaction.\textsuperscript{185}

IV. RESPONSES TO THE EXPANSION OF THE DE FACTO MERGER DOCTRINE

Many jurisdictions have attempted to incorporate public policy considerations of strict products liability into the de facto merger doctrine. At least one jurisdiction's courts, however, have recently attempted to limit the applicability of the doctrine,\textsuperscript{186} while another jurisdiction has abolished the doctrine by legislation.\textsuperscript{187}

A. Judicial Response

The California Supreme Court, in \textit{Ray v. Alad Corp.},\textsuperscript{188} has limited the applicability of the de facto merger doctrine. In \textit{Ray}, the plaintiff was injured while using a defective ladder manufactured by a corporation which had sold its assets to the defendant Alad Corporation in exchange for stock.\textsuperscript{189} The assets purchased by Alad included the seller's plant, equipment, inventory, goodwill and trade name.\textsuperscript{190} In addition, the purchaser continued to use the same equipment, product design, personnel and sales representatives and sold to the predecessor's customers the same line of ladders which the predecessor had formerly manufactured and marketed.\textsuperscript{191} The court specifically rejected the plaintiff's contention that the sale of assets in exchange for stock had resulted in a de facto merger.\textsuperscript{192}


\textsuperscript{189} \textit{Id.} at 25, 560 P.2d at 6, 136 Cal. Rptr. at 577.

\textsuperscript{190} \textit{Id.} at 24-25, 560 P.2d at 5-6, 136 Cal. Rptr. at 576-77.

\textsuperscript{191} \textit{Id.} at 25, 560 P.2d at 6, 136 Cal. Rptr. at 577.

\textsuperscript{192} \textit{Id.} at 30, 560 P.2d at 11, 136 Cal. Rptr. at 582.}
In deciding the *Ray* case, the California Supreme Court refused to use the de facto merger doctrine to achieve a result that would satisfy the public policy underlying strict products liability law of spreading the cost of an injury throughout society. Instead, the court held that the de facto merger doctrine would apply only to transactions where: (1) the consideration paid for the selling corporation's assets was inadequate so that claims of the seller's creditors would go unsatisfied or (2) the consideration received by the selling corporation consisted entirely of the purchasing corporation's stock which was promptly distributed to the seller's shareholders, followed by the liquidation of the seller.

Although the court in *Ray* did not find a de facto merger, the plaintiff's claims were upheld on other grounds. The successor corporation was held liable under the theory of strict products liability. The court reasoned that the plaintiff would face in-

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193 See id. at 30-31, 560 P.2d at 11-12, 136 Cal. Rptr. at 582.

194 Id. at 28, 560 P.2d at 9, 136 Cal. Rptr. at 580. Rawlings v. D. M. Oliver, Inc., 97 Cal. App. 3d 890, 159 Cal. Rptr. 119 (1979), expanded the *Ray* holding by finding that a failure to continue manufacturing the identical product does not prevent it from meeting the de facto merger standard set forth in *Ray*.

195 19 Cal. 3d at 34, 560 P.2d at 15, 136 Cal. Rptr. at 586.

196 Id. at 32-34, 560 P.2d at 13-15, 136 Cal. Rptr. at 584-86. Several courts have specifically rejected the product line argument of *Ray*. In Domine v. Fulton Iron Works, 76 Ill. App. 3d 253, 395 N.E.2d 19 (1979), the court specifically rejected the strict tort liability theory as constituting an exception to the general rule of nonliability of successor corporations. The court stated:

The corporate successor to the manufacturer of a defective product cannot be said to have created the risk, and, except in a very remote way, does not reap the profit derived from the sale of the product. Moreover, the successor corporation has neither invited use of the product nor represented to the public that the product is safe and suitable for use. Finally, we do not believe that the public interest in human life and health would be served by adoption of *Ray*. The corporate successor is not in a position to exert any pressure upon the manufacturer to enhance the safety of the product.

395 N.E.2d at 23. Thus Illinois accepts only the generally recognized exceptions to successor nonliability. These exceptions encompass situations: (1) where the transaction amounts to a consolidation or merger of the purchaser and seller; (2) where the purchaser is a mere continuation of the seller, or; (3) where the transaction is for the purpose of fraudulently escaping liability. Id. at 22.

superable oostacles attempting to obtain satisfaction of a judgment from stockholders or directors of the original corporation due to its dissolution. Thus it held for the plaintiff on the ground that a party who acquires a manufacturing business and continues the output of its line of products assumes strict liability for defects in products manufactured and distributed by the acquired entity. In reaching its decision, the court used the same public policy reasoning as was advanced in Knapp and Shannon. It concluded that the justifications for imposition of strict liability on a successor were:

1) the virtual destruction of the plaintiff's remedies against the original manufacturer caused by the successor's acquisition of the business, 2) the successor's ability to assume the original manufacturer's risk, and 3) the fairness of requiring the successor to assume responsibility for defective products that was a burden necessarily attached to the original manufacturer's goodwill being enjoyed by the successor in the continued operation of the business.

Other jurisdictions have erred in their application of the de facto merger doctrine. They have ruled that the public policy considerations of strict products liability warrant imposition of liability on the surviving corporation, regardless of whether the plaintiff is a creditor, minority shareholder or consumer of the manufacturer's products. Searching for a doctrine with which to impose such liability, many courts have seized upon the de facto merger doctrine. By manipulating the theory, they have imposed liability on the successor corporation even though there have been few indices of a true corporate merger. In contrast, the Ray court kept the

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197 19 Cal. 3d at 32, 560 P.2d at 13, 136 Cal. Rptr. at 584.
199 19 Cal. 3d at 31, 560 P.2d at 12, 136 Cal. Rptr. at 583. The Ninth Circuit Court of Appeals, in Gee v. Tenneco, Inc., 615 F.2d 857 (9th Cir. 1980) (applying California law), has indicated that the fundamental requirement for the imposition of successor liability under Ray is that the successor receive the benefits of the continuation of the predecessor's business and goodwill.
de facto merger doctrine within the strict framework of corporate law originally intended by its creators. The court would find a de facto merger only when an exchange of assets for stock and a liquidation of the selling corporation, the true indices of a corporate merger, were present or when inadequate consideration was received by the seller.

The implication of the *Ray* decision is that products liability plaintiffs will have a greater chance of recovering on claims against the successor corporation than will creditors or minority shareholders. Under the facts of *Ray*, a creditor's or minority shareholder's only method of recovering from the successor corporation would be to claim that a de facto merger had occurred. However, the strict interpretation of the doctrine by the California Supreme Court would preclude recovery under this theory. In contrast, the products liability claimant would be allowed to recover from the successor corporation even though the indices of a de facto merger were not present.

This holding provides an element of uncertainty in the typical purchase of assets transaction. The successor corporation will be liable for products liability claims despite its express denial of the assumption of such contingent liabilities in the sales contract. Corporate planners thus are confronted with a dilemma since the acquiring corporation faces the prospect of liability for claims arising from the use of products manufactured by the selling corporation. An acquiring corporation would prefer to insulate itself from this liability or to place the burden of loss upon the corporation which manufactured the faulty product. The holding in *Ray* will not allow the acquiring corporation to shift this burden to the selling corporation, at least for products liability claims. The acquiring corporation may, however, shift the burden

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202 This would apparently correspond to the fraud exception to the general rule of non-successor liability. See notes 83-85 supra, and accompanying text.
of loss on to the selling corporation for creditors' or minority shareholders' claims if the transaction does not constitute a de facto merger under the criteria set forth in *Ray*.

Other alternatives for insulating the acquiring corporation against liability have been suggested, but these may not be viable. One suggested method is to deflate the purchase price for the purchasing corporation to reflect the risk of loss due to such claims or the cost of insurance to cover the risk. However, the risk of loss is often difficult to calculate and the inclusion of such a factor, in the purchase price, once it is calculated, may prove so prohibitive that the seller will be unwilling to consummate the sale. Furthermore, it is becoming increasingly difficult to obtain products liability insurance.

Despite the strong arguments in favor of avoiding the imposition of liability on the successor corporation for products liability claims, public policy considerations demand such an outcome. As the California Supreme Court stated in *Price v. Shell Oil Co.*: "The paramount policy to be promoted by the rule [of strict products liability] is the protection of otherwise defenseless victims of manufacturing defects and the spreading throughout society of the cost of compensating them." In light of this overriding public policy, the extension in *Ray* of liability for products liability claims to a successor corporation is a correct result.

**B. Legislative Response**

The de facto merger doctrine was introduced in Texas in *Western Resources Life Insurance Co. v. Gerhardt*. In *Gerhardt*, the plaintiffs alleged that fraudulent techniques had been used to induce them to purchase insurance contracts. Several years later,
the insurance company sold all of its assets to the defendant Western Resources Life in exchange for stock of that company. The seller was to dissolve and to distribute the W.R. Life stock to its shareholders. Several of the directors of the selling corporation were to assume the same position with W.R. Life. The sales contract specifically stated that the contingent liabilities of the seller were not to be assumed by the defendant.

The court began its analysis by stating the general rule that there was no assumption of liability by a successor corporation in a purchase of assets transaction. The court then listed five exceptions to that general rule, one of which would impose liability on the successor where "the transaction is tantamount to a consolidation or merger of the seller and purchaser."

The court stated that the four indices of a de facto merger set forth in Shannon v. Samuel Langston Co. were indicative of "the notion that no corporation should be permitted to commit a tort and avoid liability through corporate transformations or changes in form only." Of these four factors, "the most important in determining whether the transaction is a de facto merger seems to be whether the sale of assets was paid for in cash or shares of stock in the surviving corporation." If the sale was for

"ABC-400" insurance contracts of the American Business and Commercial Life Insurance Company. The plaintiffs pleaded that the agents for the insurance company had offered them an opportunity to invest in the insurance company by purchasing the ABC-400 contracts. They alleged that the agents represented to them that this investment would reap tremendous profits beyond the benefits afforded by the life insurance which was a part of the contract. The opportunity to purchase the ABC-400 contract supposedly was open for only a short time and was available only to a limited number of investors. The appellees allegedly were told that they were "founding" investors in the insurance company so that their investment was for the prospects of capital gain and not merely to buy life insurance.

213 Id.
214 Id.
215 Id.
216 Id.
217 Id. at 786.
218 Id.
219 See note 176 supra, and accompanying text.
221 553 S.W.2d at 786.
222 Id.
stock, a de facto merger would usually result.\textsuperscript{223}  

Shortly after the de facto merger doctrine was judicially introduced in Texas, the Texas legislature enacted a statute specifically prohibiting the courts' use of the doctrine to create an exception to the general rule of successor nonliability in a purchase of assets transaction. In 1979, Article 5.10.B was added to the Texas Business Corporation Act.\textsuperscript{224}  

A disposition of all, or substantially all, of the property and assets of a corporation requiring the special authorization of the shareholders of the corporation under Section A of this article:

(1) is not considered to be a merger or consolidation pursuant to this Act or otherwise; and

(2) except as otherwise expressly provided by another statute, does not make the acquiring corporation responsible or liable for any liability or obligation of the selling corporation that the acquiring corporation did not expressly assume.\textsuperscript{225}  

The Bar Committee comments which accompanied the statute stated that the specific purpose of the amendment was "to preclude the application of the doctrine of \textit{de facto} merger in any sale, lease, exchange or other disposition of all or substantially all the property and assets of a corporation requiring authorization under Article 5.10.A."\textsuperscript{226} The committee further declared that "[t]he new statutory provision provides that the acquiring corporation in a purchase of assets transaction does not assume or otherwise become liable for liabilities of the corporation whose assets are purchased, unless the acquiring corporation agrees contractually to assume or become liable for such liabilities."\textsuperscript{227}  

The Texas legislature intended to provide corporations with a more stable basis to determine the extent of successor liability in a purchase of assets transaction. By eliminating successor liability based upon the de facto merger theory, the legislature has attempted to absolve Texas law of the confusion over the doctrine's applicability which inherently prevails whenever it is available. The legislature was probably spurred in this effort by the incon-  

\textsuperscript{223} Id. at 787.  
\textsuperscript{224} TEX. BUS. CORP. ACT ANN. art. 5.10.B (Vernon Supp. 1979).  
\textsuperscript{225} Id.  
\textsuperscript{226} Id. at 400-01.  
\textsuperscript{227} Id. at 401.
sistencies and lack of agreement among other jurisdictions as to the criteria which must be satisfied to find a de facto merger. Indeed, even the Texas Court of Civil Appeals' attempt in *Gerhardt* to introduce the de facto merger doctrine into the state did not clearly define the circumstances under which a de facto merger would be found. Although the court listed four factors characteristic of a de facto merger and even stressed the one factor it considered most important to the determination of the issue, it gave no indication whether the presence of all four factors was necessary or whether the presence of only the most important factor (the receipt of stock instead of cash) would be sufficient to constitute a de facto merger. Furthermore, even if *Gerhardt* implicitly held that all four factors must be present for a de facto merger to exist, there was no guidance as to the degree to which they were required. Rather than submit corporations to the unanswered questions raised in *Gerhardt* and to the mass confusion which plagues holdings of other jurisdictions, the Texas legislature abolished the de factor merger doctrine completely.

Although the legislature has abolished the de facto merger exception in Texas, the creditor or minority shareholder who sues may recover under the bulk sales or fraudulent conveyances laws. The Commentary of the Bar Committee on the statute states: “[B]y expressly excepting from the operation of section B the effect of ‘any other statute of this State,’ the statutory liabilities of an acquiring corporation under the bulk sales or fraudulent conveyances laws or similar statutes are left intact.” In sharp contrast, the statute probably precludes the products liability plaintiff from asserting a claim under a strict liability theory similar to that used to impose liability on successor corporations in the *Ray* decision. However, strong public policy considerations dictate that some

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229 553 S.W.2d 783.
230 Id. at 786-87.
232 Id. at 173. A discussion of the relationship of bulk sales and fraudulent conveyance laws to the de facto merger doctrine is beyond the scope of this comment. Bulk transfers are treated in the Uniform Commercial Code. *Uniform Commercial Code* §§ 6.101-6.111 (Bulk Transfers).
233 See note 150 *supra*, and accompanying text.
method of recovery be available to these claimants. In contrast, it appears that creditors, minority shareholders and products liability claimants in Texas not only will have no basis for recovery under the de facto merger theory, they will also be unable to assert a claim in a manner similar to the one asserted in Ray with its underlying public policy considerations.

The legislature has left open additional questions concerning the applicability of other exceptions to the general rule of successor nonliability. The sweeping language of Section 5.10.B(2) that “the acquiring corporation [is not] responsible or liable for any liability or obligation of the selling corporation that the acquiring corporation did not expressly assume”354 implies that other exceptions to the general rule, such as the continuity doctrine, also will be unavailable in Texas. The bar committee comments state that the amendment applies to the de facto merger exception but do not specifically address the question of whether the use of other exceptions355 is barred by Section 5.10.B. Although preliminary indications lead to the conclusion that the recent amendment bars the use of all exceptions to the general rule of successor nonliability in purchase of assets transactions, it remains to be seen whether the Texas courts will interpret the sweeping language of Section 5.10.B(2) to preclude use of the continuity exception and these other exceptions.

V. IMPORTANCE OF SUCCESSOR LIABILITY TO THE AVIATION INDUSTRY

The importance to the aviation industry of the question of what liabilities are to be assumed by a successor corporation was demonstrated in R.J. Enstrom Corp. v. Interceptor Corp.356 The Enstrom


355 By specifically stating that the amendment precludes the use of the de facto merger doctrine in Texas, it could be argued that the Commentary of the Bar Committee implied that the use of other exceptions, such as the continuity exception, was not precluded by the amendment. Id. at 172. However, the sweeping nature of the amendment greatly weakens such an argument. See note 234 supra, and accompanying text. Later statements in the Commentary of the Bar Committee seem to further negate this argument. See note 227 supra, and accompanying text.

Corporation sued the Interceptor Corporation, the designer and manufacturer of a single-engine turboprop airplane known as the Interceptor 400, to recover for property damage sustained in the crash of Enstrom's Interceptor 400 aircraft on January 15, 1972.\textsuperscript{237} Interceptor was organized in 1966, but by early in 1972 the corporation was in serious financial trouble. In an attempt to save the corporation, six of its major stockholders formed a limited partnership in late 1972 and purchased an outstanding note of the corporation. In October of 1974 all of the assets of the corporation were purchased by the limited partnership at a public sale.\textsuperscript{238} The limited partnership continued in business as a parts distributor, but did not engage in the manufacture and sale of aircraft.

Enstrom sought to join the limited partnership as a defendant in its suit against Interceptor. Enstrom argued that the limited partnership was simply a continuation of Interceptor and that it thus would fall under an exception to the general rule of non-liability.\textsuperscript{239} However, the court refused to hold that the limited partnership was a mere continuation of the Interceptor Corporation.\textsuperscript{240} The limited partnership was not a manufacturing company; manufacturing was impossible as the partnership's warehouse was unheated and without electricity; the partnership had no employees who were certified by the FAA to build airplanes; its activities were

\textsuperscript{237} R. J. Enstrom Corp. v. Interceptor Corp., 555 F.2d 277, 279 (10th Cir. 1977).

\textsuperscript{238} A resolution was adopted at a special meeting of the shareholders of Interceptor which provided that all of the corporation's assets were to be transferred to the limited partnership in return for cancellation of the note which had been acquired by the limited partnership. One of the junior secured creditors objected and compelled a sale of the assets as provided under §§ 9-504 and 9-505 of the U.C.C. In compliance with § 9-504, notice of the proposed public sale was sent to Interceptor and Interceptor's secured creditors. The sale was conducted but no bids were placed except for that of the limited partnership. Id. at 280-81.

\textsuperscript{239} In support of the continuation theory advanced by Enstrom, the plaintiff argued that: (1) the limited partnership was a continuation of Interceptor Corporation as the limited partnership's only assets were those it received from Interceptor; (2) the active shareholders, directors and officers of Interceptor Corporation were the same individuals who owned, controlled and managed the limited partnership; (3) both the seller and purchaser employed the word "Interceptor" in their business names, and; (4) one of the limited partnership's business purposes, stated in the limited partnership agreement, was that of manufacturing Interceptor airplanes, a purpose identical to that of Interceptor Corporation. Id. at 282.

\textsuperscript{240} Id.
limited to selling spare aircraft parts, and it was not involved in the production of the Interceptor 400.

Although *R.J. Enstrom Corp. v. Interceptor Corp.* involved the continuity exception, the case demonstrates the potential importance of the de facto merger exception to plaintiffs in cases involving claims against aviation-oriented corporations. If the assets of the Interceptor Corporation had been purchased by a company in exchange for its stock, and if the acquiring corporation had continued the business and operations of Interceptor, a strong argument could have been advanced by the Enstrom Corporation that the transaction was a de facto merger. If that argument were successful, the successor corporation would have been liable to Enstrom for the loss of the aircraft.

Such a hypothetical claim could result in the imposition of successor liability under the "substance over form" theory of *Farris v. Glen Alden Corp.* and *Applestein v. United States Board & Carton Corp.* depending upon the particular facts and circumstances of each case. Successor liability under the de facto merger test set forth in *Kloberdanz v. Joy Manufacturing Co.* and *McKee v. Harris-Seybold* would primarily depend upon whether there was a sufficient continuity of interest by the selling corporation's shareholders in the purchasing corporation, as well as upon whether there had been an absorption of the corporate identity of the seller by the purchaser. The claim would clearly result in successor liability under the expansive view of the de facto merger doctrine represented by *Knapp v. North American Rockwell Corp.* and *Shannon v. Samuel Langston Co.*

If the claim arose in Texas, the new statutory provision would apparently preclude any possibility of recovery under any of the

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243 See notes 135-45 *supra*, and accompanying text.
248 See notes 152-64 *supra*, and accompanying text.
249 See notes 165-79 *supra*, and accompanying text.
250 506 F. 2d 361 (3d Cir. 1974).
four generally recognized exceptions to the rule of successor non-liability. This would be true regardless of whether the plaintiff was a creditor, minority shareholder or products liability claimant. Under the holding in Ray v. Alad Corp. the only types of claimants that would have a chance for successful recovery under the de facto merger theory would be creditors or minority shareholders. Even then liability would be imposed on the successor corporation only where the consideration paid for the seller’s assets was inadequate or where the true indices of a merger were present: the sale of assets in exchange for stock of the acquiring corporation followed by the prompt distribution of that stock to the seller’s shareholders and the subsequent liquidation of the selling corporation. Products liability plaintiffs such as the Enstrom Corporation thus would be forced to bring a claim under strict tort liability rather than under the de facto merger doctrine. Due to the public policy considerations underlying product liability claims, this type of plaintiff would have a better chance of recovery in California than would creditors and minority shareholders who are limited to the strict de facto merger test set forth in Ray.

VI. Conclusion

Due to favorable economic conditions, the number of corporate mergers and consolidations has increased in recent years. To avoid the successor liability that generally follows a merger, corporations have attempted to structure acquisitions to appear to be simple sales of assets. Initially, the courts sought to hold the selling corporation or its shareholders liable under the “trust fund” theory. However, the status of that theory’s continued applicability, due to the postponed abatement statutes now in effect in all jurisdictions, is presently unclear.

With the passage of time after a transaction, the selling corporation often dissolves, and its shareholders disperse or squander the proceeds they receive from the liquidation. When the courts became aware that plaintiffs often had been unable to recover from

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250 The creditor or minority shareholder might be protected by the bulk sales of fraudulent conveyances laws. See note 232 supra, and accompanying text.
the selling corporations, their emphasis shifted from holding the sellers or their former shareholders liable to providing the plaintiffs with an action against the purchasers. To effectuate this purpose, four exceptions to the general rule of successor nonliability were created. Most notable among these four was the de facto merger exception.

In creating these exceptions, the courts have not been able to agree upon the definitive criteria necessary for their application. This inconsistency exists whether the plaintiff is a creditor or a minority shareholder of the selling corporation. The court decisions become even more confusing when the plaintiff's claim is brought under strict products liability theory. The underlying public policy consideration of this theory, spreading the cost of injuries throughout society, has caused many jurisdictions to expand the de facto merger exception beyond the framework of corporate law which the doctrine originally occupied.

To date, there has been very little backlash to the attempts to expand the de facto merger exception. However, one jurisdiction has disregarded the lead of others which have been expanding the exception. The California Supreme Court recently refused to expand the doctrine beyond its original corporate law boundaries. However, in doing so, the court imposed strict tort liability on the successor corporation for products liability claims, creating a fifth exception in addition to those already recognized. Meanwhile, in Texas, the legislature abolished the use of the de facto merger exception after a state court adopted an expansive version of the doctrine. It is currently unclear whether that statute also forbids the use of the additional exceptions recognized by other jurisdictions to allow recovery from the purchasing corporation.

The California judicial solution appears more equitable than the Texas legislative solution. In an apparent attempt to dispel the confusion over the scope of the de facto merger doctrine's applicability, the Texas legislature has gone too far in totally abolishing the doctrine. In essence, the Texas approach limits the potential recovery of creditors and minority shareholders from the successor corporation to that prescribed by the local bulk sales or

\[259\] For a discussion of other public policy considerations in the law of strict tort products liability, see note 150 supra, and accompanying text.
fraudulent conveyances acts or the “trust fund” doctrine, and completely precludes any recovery by products liability claimants. The availability of the de facto merger doctrine has proved to be valuable to creditors and minority shareholders in other jurisdictions. As the Gerhardt case demonstrated, the doctrine could be equally valuable to such plaintiffs in Texas if its use was allowed by the legislature. However, even if the de facto merger doctrine is limited in scope as was originally intended, some method of recovery must be made available to products liability plaintiffs.

Jurisdictions contemplating abolishing the de facto merger exception in a manner similar to that undertaken by Texas should first examine the California solution. By limiting the applicability of the doctrine, California has reduced the confusion that often results when the doctrine is expanded because of public policy considerations, while it still allows recovery by creditors or dissenting minority shareholders so long as the true indices of a merger are present. To provide the products liability claimant with a means of recovering from the successor corporation, California has expanded strict tort liability concepts to impose liability on the successor regardless of the presence or absence of the indices of a merger. This approach should be followed by other jurisdictions as it provides an opportunity for recovery by creditors and dissenting minority shareholders upon their meeting the strict test of the corporate based de facto merger theory, and a more liberal opportunity for recovery by products liability plaintiffs under the theory of strict products liability with its inherent public policy considerations.

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