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REFLECTIONS ON SUCCESSOR LIABILITY

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I have a somewhat different perspective on the issues of successor liability than appears in any of the admirable Articles in this Symposium. I was first involved in business acquisitions in the late 1950s and early 1960s when I was practicing in Washington, D.C. before going into teaching. At that time, the concept of manufacturers' strict liability for product defects was virtually unknown[1] and the principles governing successor liability for obligations of the selling corporation were thought to be well understood. It was universally acknowledged that successor liability existed in whole or in part in connection with sales of stock and with statutory mergers. In sale of asset transactions, however, successor liability could be based only on express or implied consent. It was a simpler world, in short, and a useful starting point for considering the problems discussed in this Symposium.

Even without any concern about modern products liability law, it was my experience that most 1950s-era transactions were structured as a sale of assets at the insistence of the buyer, particularly in the sale of closely held businesses.[2] The basic problem in successor liability then, as it is

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1. Section 402A of the Restatement of Torts, which addresses strict liability for product defects, was adopted in 1965.

2. The prototype case I am addressing is the sale of a closely-held manufacturing business that has been in operation for many years. The selling shareholders are disposing of their business which

now, was concern about undisclosed or future-arising liabilities, particularly liabilities that were either contingent or completely unknown and unpredictable. Examples of such liabilities include tax liabilities arising from future audits of pre-acquisition years, potential government contract renegotiation liabilities, future contractual or breach of warranty claims based upon pre-acquisition transactions, and future tort claims based upon pre-acquisition incidents. Concerns about such liabilities were entirely legitimate—nothing could be quite as embarrassing as having a newly purchased business be found liable for income tax deficiencies incurred in a year prior to the purchase—and an asset transaction was the most foolproof way of handling those concerns.[3]

Because the parties structured the transaction as a sale of assets, it usually required the selling corporation to take two discrete steps. First, the selling corporation sold its assets in bulk to the purchaser (or to an entity created by the purchaser for the purpose of owning and operating the business being acquired).[4] Second, shortly thereafter the selling cor-

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they have operated and managed for many years and which the purchaser will thereafter own and operate, often through a subsidiary. Usually, the parties contemplated that the business would continue to manufacture essentially the same products under the same trade names, operate under the same or a very similar corporate name, utilize the same work force at the same plant, and continue the same distribution system for its products. Often the selling shareholders agreed to continue the management of the business for a limited period of time, and they might also retain an equity interest in the purchasing business. The purchaser likely instituted any changes in the method of operation gradually and in fact continued to follow current methods for an extended period after the transaction. This description is virtually a laundry list of what should not be done today in order to minimize the risk of successor liability. In the absence of liability, I suspect the same patterns would be very common today.

3. From an economic standpoint, parties may obtain exactly the same result by a sale of stock, a sale of assets, a statutory merger, a triangular merger, a reverse triangular merger, a statutory share exchange or by a combination of forms. Statutory mergers result in the acquiring entity becoming directly or indirectly responsible for contingent or future-arising liabilities. Generally, purchasers are unwilling to acquire businesses subject to these liabilities without some assurance of their magnitude and without some protection if the actual liabilities exceed the assured amount. Sellers might provide assurance through a formal representation or by a commitment to indemnify the purchaser against such liabilities. Enforcement of such commitments might create problems if the proceeds of the sale are dissipated. While it is possible to escrow a portion of the purchase price to assure satisfaction of those representations or commitments, it is always possible that the undisclosed or future-arising liabilities might exceed the escrow or might arise after the escrow expired. A straight purchase of stock or a triangular transaction in which the business is merged with a subsidiary of the acquiring corporation also does not provide complete protection, because the value of the acquired corporation or subsidiary may be reduced if it is compelled to discharge undisclosed or future-arising liabilities. As indicated in the text, it is uncomfortable for a purchaser of a business to discover that that business has undisclosed or future-arising liabilities relating to periods before the acquisition of the business that it must discharge.

4. The sale typically involved the sale of all business assets needed for the operation of the

poration would dissolve, distributing the proceeds of the sale—whether cash or securities of the purchaser—to its shareholders after paying or making provisions for its liabilities.[5]

In such transactions, liabilities of the selling business were apportioned between the purchaser and the seller. The purchaser usually assumed routine business liabilities. These liabilities included: (1) all liabilities reflected on the books of the corporation on a specified date (together with liabilities entered into in the ordinary course of business since that date); and (2) expressly listed significant contingent or future liabilities and obligations that were not reflected on the books. The expressly listed liabilities included major contracts, long term leases, pension plans, routine pending litigation, and the like. The contract then set forth a routine, almost boiler plate, contractual provision stating expressly that the purchaser assumed no other or additional liabilities of the selling corporation.

Because any substantial business is almost always involved in litigation of one kind or another, the purchaser in fact usually assumed responsibility for some pending litigation. Most of this litigation involved claims of a determinable maximum amount or claims covered by insurance that appeared to protect the business against the maximum potential exposure. Where the list of significant contracts and pending litigation that the seller was asking the purchaser to assume revealed substantial exposure, the typical result was further negotiation between the parties. This negotiation usually lead to a mutually acceptable compromise: (a) an appropriate reduction in the purchase price; (b) an indemnification agreement by which the seller agreed to pay the amount by which the ultimate cost of the litigation exceeded the current estimate[6] (possibly an escrow

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business, including accounts receivable, cash in banks, and inventory. In other words, the parties set a global price for the business and its assets. Unrelated businesses operated by the seller and assets that were not essential for the conduct of the business, such as funds invested in securities, unrelated businesses, and the like might be excluded, but these assets were usually spun off to the shareholders (or to a new entity created by the shareholders) in advance of the sale of the business assets to the purchaser.

In some instances the parties might defer or readjust all or part of the purchase price based on the future profitability of the business being sold—in other words, a workout.

5. The subsequent dissolution of the selling corporation was not essential. If it retained unrelated businesses, it may have continued in existence as an active business under a different name. Even if its sole asset consisted of cash (the proceeds of the sale) it might remain in existence as a personal holding company. Nevertheless, in most cases the selling corporation promptly dissolved in order for the selling shareholders to obtain the proceeds of the sale.

6. Where the pending litigation appeared to have merit and was uncertain as to amount, the

of a portion of the purchase price to ensure that funds would be available to meet these indemnification obligations); or (c) a change in the agreement specifically excluding the liability in question from those being assumed by the purchaser. In practice, the purchaser expressly did not assume a fair amount of potential or unknown liabilities and exposure to known liabilities. The selling corporation or its shareholders had to deal with these liabilities in connection with the contemplated subsequent dissolution and distribution of the sales proceeds.

Usually the decision to exclude specific miscellaneous liabilities, litigation, and unknown potential liabilities or claims from the assumption clause of the agreement did not harm present or future creditors of the selling corporation. The selling corporation remained liable on those obligations. Third persons with claims then in litigation or with accrued claims potentially the subject of litigation against the selling corporation were generally not made worse off by the sale of the business. They merely had recourse to the proceeds of the sale, rather than the operating assets of the business, in order to satisfy their claims. Further, the contemplated dissolution did not affect them adversely for two reasons: first, corporate dissolution statutes required that corporations satisfy claims or make adequate provision for their satisfaction as a condition to dissolution,[7] and second, state corporation statutes contained a provision continuing the existence of a dissolved corporation for a specified period following dissolution (usually two years), and authorizing the filing of suits against dissolved corporations within that period.[8] Even potential creditors with contingent or unaccrued, claims were, as a practical matter, probably not placed in an adverse position by the dissolution because their claims would normally surface and be brought within the survival period following dissolution. Hence, issues of transferee liability of the type discussed in this Symposium were unlikely to arise because a remedy was usually available against the selling corporation with respect to claims that the purchaser did not expressly assume.[9]

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purchaser usually declined to assume responsibility for the litigation. The seller then had the responsibility of settling the litigation or allowing it to continue with the possible consequence of delay in the contemplated dissolution and distribution of the sales proceeds to shareholders. Similarly, the seller sometimes reluctantly agreed to retain responsibility for litigation it believed to be groundless with a similar consequence.

7. *See, e.g.*, MODEL BUSINESS CORP. ACT § 80 (1960).

8. *See, e.g.*, MODEL BUSINESS CORP. ACT § 98 (1960).

9. *See generally* Friedlander & Lannie, *Post Dissolution Liabilities of Shareholders and Directors for Claims Against Dissolved Corporations*, 31 VAND. L. REV. 1363 (1978).

An obvious question that one should ask is why the problems that exist today cannot be handled in precisely the same way as analogous problems were handled thirty years ago. Clearly some new types of liabilities discussed in this Symposium—particularly strict liability in tort for defective products sold many years or decades earlier[10]—create problems for such a solution. These liabilities normally do not surface until long after the sale of assets transaction has been completed, long after the dissolution of the selling corporation, long after the distribution of the proceeds to shareholders, and long after the expiration of the post-dissolution period during which suits may be brought against the dissolved corporation.[11] Thus, present corporation statutes may bar any claim against the dissolved corporation or the shareholders who received the liquidating distributions before the plaintiff's injury even occurred. Not surprisingly, therefore, injured plaintiffs in this situation bring suit against the purchaser even in the teeth of the purchaser's contractual protection—protection based on purchase of only assets and express nonassumption of liabilities of the type asserted. Not only is the successor the deepest pocket around; it is, quite likely, the only pocket around.

When a court faces the reality that a plaintiff who has suffered injuries, possibly horribly disfiguring, painful, and permanently disabling injuries, has no defendant to sue, it is not surprising that it develops theories about "de facto merger," "continuity of enterprises," or "product lines." The arguments and justifications that courts have made in support of these doctrines are logically unpersuasive. The true explanation for them is natural solicitude for plaintiffs. That the defendant never assumed liability and was in no way involved in the manufacture or sale of the product that caused the injury becomes less significant to many courts when

10. The labor law obligations discussed by Mr. DuRoss in his Article in this Symposium appear to me to be in a somewhat different category. Even though the obligations imposed upon buyers "are incalculable at the time of ownership transfer" their existence with regard to the current work force is clearly known. In contrast, products liability and environmental clean-up claims may never arise or be asserted; they are contingent claims in the classic meaning of the word contingent. The fact that the "unpredictable and confusing criteria adopted to determine successorship renders illusory any accurate prediction of which liabilities and obligations will be imposed" of course does make the rules with respect to obligations in the labor area analogous with the rules relating to successor liability for products liability claims.

11. It is not clear that suits may be brought on post dissolution claims for liabilities that arise during this period. Hunter v. Fort Worth Capital Corp., 620 S.W.2d 547 (Tex. 1981), held that this provision allowed claimants to pursue only claims arising prior to dissolution and that a claim arising out of an accident that occurred following dissolution was not covered. *Id.* at 549-50. The Texas statute on which this decision was based was amended in 1987.

the alternative is denying all recovery to a seriously injured plaintiff.[12]

The present law of successor liability seems to me to give us the worst of all possible worlds. First, as amply demonstrated by the Articles in this Symposium, purchasers may structure transactions to avoid successor liability entirely. The advance sheets regularly contain cases in which a successor corporation avoided liability by judicious use of some of the techniques discussed in this Symposium. The doctrines therefore do not fully achieve the goal of providing some protection for injured plaintiffs. Further, however deserving the plaintiff is in light of the serious injuries he or she received, it appears unfair to impose that liability on a defendant who assumed no contractual responsibility for the transaction, was not involved in it, and did not profit from it.[13]

In addition, the present rules governing transferee liability have less obvious deficiencies that skew business transactions. Given the present uncertainties of the theories described in these Articles, a purchaser cannot know, on an *ex ante* basis, whether and when it will be subjected to transferee liability. A court decides whether to impose liability only after litigation over details of the specific transaction and the specific accident. Such open-ended and imprecise rules undoubtedly encourage litigation. This uncertainty creates two further undesirable effects: (1) it probably causes purchasers to make arbitrary and unreliable estimates of future liability and reduce the prices they are willing to pay for businesses even though claims may never arise, and (2) it encourages purchasers to make liability-minimizing changes in the acquired business methods of operations and product lines even though those changes may not be desirable from a purely economic standpoint. Thus, a purchaser may close down a plant, fire a work force, or rename or redesign a product not to improve efficiency but to break the continuity of the enterprise and the product line and thus minimize the risk of successor liability. Very sensible practices such as having an overlap of managers and having the selling share-

12. By these comments I do not mean to criticize the judges who have evolved the doctrines of successor liability. The result of no recovery in some of these situations is arguably unacceptable in a civilized society. My point is only that the arguments made by the courts in finding successor liability are make-weights or rationalizations to avoid denying all recovery to an injured plaintiff because of a sale transaction in which the injured plaintiff did not participate and of which he or she was in all probability unaware.

13. Because, by hypothesis, the injury occurred after the sale of assets the cost of the injury could not have been taken into account in the negotiation of the purchase price. It may be that as the reality of successor liability has taken hold, purchasers have reduced prices because of the risk of such liability. That, however, is an arbitrary and inaccurate way to allocate costs.

holders retain an equity interest in the purchasing enterprise significantly increase the risk of successor liability. The practice of dissolving the selling corporation promptly, which the selling shareholders usually desire so that they may obtain the benefits of the sales proceeds, may be resisted by the purchaser because it increases the likelihood of successor liability at some future time. Thus, selling corporations may remain in existence or the purchaser may require that the seller retain and continue to operate some fragment of the former business not because it is sensible to do so but because that increases the protection from successor liability of the purchasing corporation. The liability rules discussed in this Symposium are, in short, affecting conduct in a potentially undesirable way.[14]

The best solution to the current concern over successor liability is to devise better systems by which claimants may recover late-arising liabilities from the selling shareholders. An effective system of placing losses on the sellers could abolish, or a least greatly curtail successor liability. Certainly, if the parties knew of an injury caused by a product defect at the time of the sale negotiations, its cost would have been shifted back to the selling shareholders in some way and not assumed by the purchaser. Why not adopt legal rules that impose the cost of unknowable and unpredictable litigation on the parties who would have born the cost had there been negotiation based on complete knowledge about future events?

Unfortunately, the problem is more difficult than first appears. A simple rule that shareholders who receive liquidating distributions must thereafter respond to future product liability claims would mean that shareholders could never dissolve a corporation and distribute its assets on a basis that assures them that they may keep the proceeds. Such a rule creates serious unfairness for shareholders. Perhaps the most obvious example of unfairness involves the relatively small shareholder with modest means who did not participate in management of the enterprise before it was sold. When that shareholder receives a substantial distribu-

14. One possible argument for successor liability is that it compels the purchasing corporation to adopt negotiating strategies to shift the risk back to the selling corporation. In Turner v. Bituminous Casualty Co., 397 Mich. 406, 428, 244 N.W.2d 873, 883 (1976), the court suggested that *successor corporations* might protect themselves from the liability imposed in that case in the form of "products liability insurance, indemnification agreements or of escrow accounts, or even a deduction from the purchase price." While this seems theoretically plausible, it has not worked in practice, primarily because of the uncertainty of the legal principles that have evolved. Rather than seeking to develop devices to shift the risk back to sellers, purchasers appear to seek to develop devices that avoid the imposition of liability entirely. Further, given the random nature of products liability litigation in many industries, the suggestion of indemnification probably can never be very successful on a systematic basis.

tion in liquidation, a significant possibility exists that he will use this "windfall" for some personal benefit or extravagance he would not consider in the absence of the windfall. If the shareholder must return a portion of the distribution unexpectedly at some future time, he may justifiably feel that he was worse off as a result of the distribution.[15] A definite advantage exists in having a time when transactions are finally closed and recipients of funds may use them without fear that they may be snatched back at some future time.

A more serious problem is the practical difficulties that are created by a rule that shareholders must continually satisfy liabilities as they occur. It would require the difficult, if not impossible task of tracing numerous payments made many years earlier. If the funds are successfully traced, difficult questions arise. What should be done, for example, about gifts made to family members? Are the donees to be liable? One could imagine an extremely expensive and arbitrary system for determining who must return funds. Even under the simplest of rules, where the corporation makes liquidating distributions to a large number of shareholders who are scattered around the country, collection will be difficult. As a practical matter, in these scenarios the larger shareholders likely would bear all the cost of such liabilities merely because of the prohibitive cost of bringing suit against large numbers of small defendants.

One might suggest other, less fanciful, solutions. A statute might require a dissolving corporation to escrow a portion of the sales proceeds for an indefinite period for the protection of future tort claimants, but exempt shareholders who receive liquidating distributions in excess of the escrow from liability to future claimants.[16] Problems with such a proposal seem equally insurmountable. How is the amount determined? How are the rights of distant future claimants protected as against the claimant who has already brought a claim and exhausted the fund? Who is to protect and litigate on behalf of the fund? What happens ultimately to the unused portion of the fund? Does it escheat to the state?

Another suggestion proposed by some courts and academic commentators requires that corporations proposing to dissolve following a sale of assets must provide and pay for a reasonable amount of insurance against

15. I am not suggesting that the cost and unhappiness this rule would cause such a shareholder equals the cost and unhappiness of serious and permanent injury to an innocent plaintiff. I am merely pointing out that the rule suggested in the text also has costs.

16. *See* Green, *Successor Liability: The Superiority of Statutory Reform to Protect Products Liability Claimants*, 72 CORNELL L. REV. 17 (1986).

future products liability claims that may arise from products they have previously placed in commerce. While products liability insurance is available in many industries, it is usually of the type known as "claims made" insurance. This insurance provides protection only against claims made during the period the insurance is in effect. At the present time, dissolving corporations generally cannot obtain insurance covering liabilities arising from all transactions in the past that may produce claims any time in the indefinite future. Perhaps such "tail" insurance protecting against all future liabilities arising from a discrete number of past events might be economically feasible to write, and may become available in the future. If so, such insurance might provide considerable protection. This type of insurance, however, is generally unavailable at the present time.[17]

The problem of after-arising products liability claims in dissolution proceedings was considered at some length in the discussions that led to the development of the Revised Model Business Corporation Act. The drafters adopted an interim or preliminary solution.[18] Basically, the solution extends the post-dissolution period during which claiments may bring their claims to five years after the dissolution. The Act also makes it crystal clear that "a claimant whose claim is contingent or based on an event occurring after the effective date of dissolution" is entitled to take advantage of the provision.[19] Further, claims under this section may, if the assets have been distributed in dissolution, be enforced

> against a shareholder of the dissolved corporation to the extent of his pro rata share of the claim or the corporation assets distributed to him in liquidation, whichever is less, but a shareholder's total liability for all claims under this section may not exceed the total amount of assets distributed to him.[20]

The official comment states that the purpose of this clause is to ensure that claimants seeking to recover distributions from shareholders "will try to recover from the entire class of shareholders rather than concentrating only on the larger shareholder and [thus the provision] protects the limited liability of shareholders." The official comment also recog-

17. Other solutions may also suggest themselves. For example, one might imagine a "workmen's compensation" type fund to which all dissolving corporations contribute. This fund might then be available for persons injured after the dissolution by products manufactured by the dissolving corporations.

18. REV. MODEL BUSINESS CORP. ACT §§ 14.06, 14.07 (1984).

19. *Id.* § 14.07(c)(3).

20 *Id.* § 14.07(d)(2).

nizes that a five-year limitation on claims is to some extent arbitrary, but states that "it is believed that the great bulk of post dissolution claims will arise during this period."

The Revised Model Act does not attempt to limit claims against successor corporations based on the theories described in this Symposium. That was viewed as an inappropriate subject for a state corporation statute.[21] Rather, the official comment to section 14.07 merely states:

> In some circumstances a tort law concept of transferee liability, sometimes characterized as "de facto merger," has been applied to allow plaintiffs incurring post dissolution injuries to bring suit against the person that acquired the corporate assets. . . . Some courts have refused to apply this doctrine, particularly when the purchaser of the corporate assets has not continued the business of the dissolved corporation. In these cases the remedy of the plaintiff is limited to claims against the dissolved corporation and its shareholders receiving assets pursuant to the dissolution.
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> The solution adopted in section 14.07 . . . is believed to be a reasonable compromise between the competing considerations of providing a remedy to injured plaintiffs and providing a period of repose after which dissolved corporations may distribute remaining assets free of all claims and shareholders may receive them secure in the knowledge that they may not be reclaimed.[22]

The solution proposed by the Revised Model Business Corporation Act is clearly only a first attempt at rationalizing this unsatisfactory area of the law. It does, however, deserve a legitimate trial because it places the cost of litigation on the parties that should be called upon to bear that cost.

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21. The RMBCA, however, does suggest that the application of the de facto merger doctrine is inappropriate to provide appraisal rights in sale of asset transactions. *See* REV. MODEL BUSINESS CORP. ACT § 11.01 official comment 2 (1984).

22. *Id.* § 14.07 official comment 2, 3.