Successor Liability In Calif.: Where To Point The Finger

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When one product manufacturer/distributor acquires another, which party should assume the existing debt and/or ongoing liabilities — the buyer or the seller? Questions like this have plagued courtrooms for years, yet still this remains an unsettled area of successor liability law. Even more specifically, to whom should the responsibility be directed if liabilities are a function of allegedly defective products, especially if the buyer doesn't manufacture them any longer?

This short article examines California's law with respect to successor liability, strictly in the context of product liability. First, it makes sense to take a look back on where this issue has been.

Traditional Rule of Nonliability of the Successor

The general rule has been that a company that acquires all of a seller's assets is not liable for the seller's liabilities simply due to the ownership of those assets. In strict product liability cases, the traditional tort rule is similar for injuries caused by products manufactured and/or distributed by a predecessor company; that is, one of nonliability. The rule is subject to a handful of common law exceptions, which are generally limited to the following situations:

- *Defacto merger doctrine*. This refers to cases where the transaction amounts to a consolidation or merger of the buyer and seller.

- *Fraud exception*. Fraudulent intent applies where a transaction is used fraudulently to evade liability for debts.

- *Continuation*. This arises when the buyer is just a continuation of the seller. Courts typically focus on buyer's continued use of the seller's name, location, employee pool, etc.

- *Express or implicit agreement*. With this exception, the buyer agrees (expressly or implicitly) to assume some or all of the debts and liabilities of the seller.

- *Statutory scheme*. Here, successor liability is established by a statutory or regulatory scheme. There is an express or implied agreement by the purchaser to assume the seller's liabilities.

Product Line Successor Exception

The product line successor exception was created in 1977 by the California Supreme Court, in Ray v. Alad Corp. (1977) 19 Cal.3d 22. The four exceptions listed above were analyzed in Ray. The finding was that none of them applied to the case before the court. Even so, the court imposed liability on the successor corporation for an injury sustained by a plaintiff who fell off a ladder manufactured by the predecessor company. Once the plaintiff was injured, the predecessor had already liquidated and moved on. What was pertinent in this case is what was agreed to in the sale, which was that the seller would dissolve the corporation. Three months after the acquisition the dissolution was complete, which deprived the plaintiff of any legal recourse against the predecessor. This left the injured party without a remedy, hence giving birth to the product line exception:

We therefore conclude that a party which acquires a manufacturing business and continues the output of its line of products under the circumstances here presented assumes strict tort liability for defects in units of the same product line previously manufactured and distributed by the entity from which the business was acquired.

Product line, as used by the court, refers to the purchase of a company's entire manufacturing business and the continued production of some or all of its product lines. The product line exception is very similar to the continuity of enterprise exception recognized by other jurisdictions. In articulating the product line exception, the court noted three essential factors or conditions that must be met for the exception to apply:

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-spreading role.

3. The fairness of requiring the successor to assume a responsibility for defective products that was a burden necessarily attached to the original manufacturer's good will being enjoyed by the successor in the continued operation of the business.

Since Ray was decided in 1977, California courts have consistently held that the first factor of virtual destruction of the plaintiff's remedies against the predecessor is the most important condition for the exception to apply and there must be some degree of causation in that destruction by the actions of the successor business. See Kaminski v. Western MacArthur Co. (1985) 175 Cal.App.3d 445. (Successor continued the same product line, with the same employees as predecessor, but shortly after the acquisition orchestrated the dissolution of the predecessor corporation, effectively destroying any product liability remedy plaintiff Kaminski had against the predecessor.) How might one avoid invocation of the Ray exception? One way to avoid immediate dissolution would be to utilize properly designed purchase agreements that provide for the predecessor's continued existence. Or, creation of a fund from the purchase; possibly even an insurance or asset pool to avoid this prong of the Ray exception.

The second factor of the Ray product line exception, the successor's ability to spread the risk, is usually imposed on the successor, if (1) it is in the position of continuing the predecessor business or product line, or (2) is benefitting from the product line of the predecessor or (3) can obtain insurance for the risk, or (4) the assignment of prior insurance policies (Henkel Corporation v. Hartford Accident and Indemnity Co. (2003) 29 Cal.4th 934). There is quite bit of discussion in these cases about the fairness factor in the risk-spreading analysis. Bottom line: California courts have developed a test in which the rights of the party injured by the product are measured against the rights of the successor in the business. This balancing has been used to impose risk spreading to major companies with large revenues, varied product lines and sufficient resources to purchase insurance, but courts have declined to impose those same risks on a small business with minimal revenues and production capabilities.

The third factor of the Ray product line exception analysis is fairness. The Ray court concluded that it was equitable to impose liability on the successor corporation for the injuries suffered by the plaintiff because the successor had purchased the predecessor's good will, trade name and was continuing to produce the same line of products (ladders). In essence that was like presenting itself to customers/potential customers being the same company as the predecessor. Stated differently, the purchase of a company's good will and product line will likely include the assumption of liability for previously manufactured defective products that cause injury. However, some cases have used the fairness test to justify NOT imposing liability on the successor. (See Chaknova v. Wilbur Ellis Co. (1999) 69 Cal.App.4th 962)

It is important to note that although attempts have been made to extend the product line exception to nonproduct liability tort cases, California courts have refused to do so and Ray is limited to strict liability actions for injuries caused by defective products. (See Franklin v. USX Corp. (2001) 87 Cal.App.4th 615.) It is also vital to note that Ray articulated an equitable doctrine that requires a case-by-case analysis. Finally, it is a California-based doctrine and has not been accepted by the majority of U.S. jurisdictions that have considered the issue.

Avoiding Potential Successor Liability

Practically speaking, with the law as it's stated above, how does a business owner protect a company from potential liability for defective products, especially when it was the predecessor company that distributed these disreputable products? Best advice: exercise a high degree of due diligence. Think of it; a buyer must do a thorough and comprehensive investigation into the sources of all potential liabilities created by the selling entity and its products. Included in this study should be an analysis of how the products were distributed, as well as where they've been distributed. Since many states haven't recognized the product line exception, this is of particular importance. If a buyer knows the spectrum of risk in a deal, that can guide the buyer as to how best to minimize and potentially underwrite that risk.

Problems arise because most insurance policies aren't assignable by the seller without the insurer's consent (see Henkel above). As such, it may be difficult or expensive for the purchaser to insure the prior acts or previously manufactured and distributed products of the seller. A few suggestions come to mind, one being to include the costs of insuring against such risk in the purchase price. Or, to cover presale damages or injuries caused by the seller's products, require the seller to keep the existing insurance in effect past the sale date. Also, it might be appropriate to set aside a fund from a portion of the sale proceeds to cover actual or potential liabilities from injuries caused by the seller's products.

Another method of avoiding potential successor liability is carefully drafting a purchase agreement. By outlining a concise, narrow indemnification agreement that complies with the latest statutes and with case authority, it clearly places the risk of past, present or future liability for defective product claims on the seller or its insurer. Language on the agreement should unambiguously carve out the liabilities of the seller. It should state that none of the seller's known or unknown liabilities from identified products are assumed in the transaction by the buyer and are not part of the consideration paid in the sale. Another approach is a continuity clause as part of the agreement. It would require the selling entity to stay in business or maintain its partnership or corporate status for a defined period of time. This would preclude immediate dissolution of the selling business, allow for the continuance of insurance coverage for product claims and avoid the applicability of the first and second prongs of the Ray product line exception. The purchase price may be higher due to the inclusion of such exculpatory or safe harbor provisions in the purchase agreement; but, if the potential liability risks are substantial, it is probably money well spent.

The torrent of asbestos injury and wrongful death cases in California in the last 40 years is an excellent example of what happens when you apply the product line exception on successor entities, many of which did not exist at the time the original asbestos products were manufactured and put in the stream of commerce. Although such successor liability cases are extremely fact sensitive (O'Neill, Advanced Issues in Strategic Alliances (2000) 1193 PLI/CORP. 351, 391), successor product liability has been found in many of these cases. (See also Fisher v. Allis-Charmers Corp. Product Liability Trust, (2002) 95 Cal.App.4th 1182)

A successor/purchaser must be aware that limiting a transaction to an assets only purchase may not be sufficient in California, or most states, to insulate the purchaser from product liabilities created by defective products manufactured by a predecessor 30, 40 or 50 years earlier. Whereas the traditional rule of nonliability for successors has several exceptions in most states, as noted above, California has taken a step further into the area of consumer protection by its articulation of the product line successor exception in the Ray v. Alad decision .

Living With the Product Line Exception

The product line exception created by the Ray v. Alad decision in 1977 is now well-settled law in California. A case by case analysis is required and should be undertaken in any situation involving a defective product claim against an original manufacturer or distributor, or any entity in the stream of commerce or chain of distribution, that has been sold to a successor interest. If the three-pronged test of Ray is satisfied by the facts of a particular case, a successor business may be responsible for the liability created by a product designed, manufactured or distributed by a predecessor entity, long since dissolved or out of business.

As of this writing, it appears that the Ray product line exception has been adopted in California, New Jersey, New Mexico, Pennsylvania and Washington and rejected in Colorado, Florida, Georgia, Illinois, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, New Hampshire, North Dakota, Ohio, Oklahoma, South Dakota, Texas, Vermont, Virginia and Wisconsin.

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