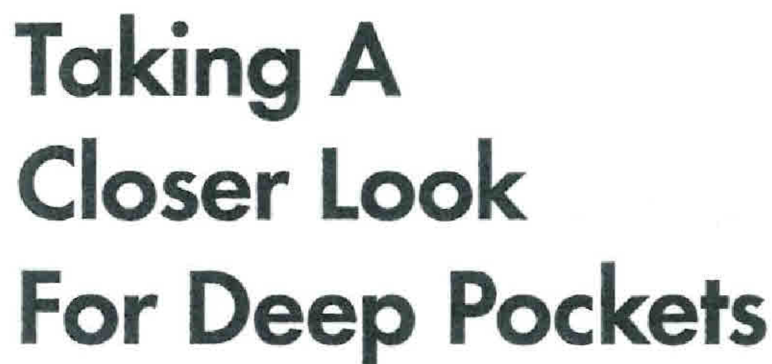

Taking A Closer Look For Deep Pockets

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The theories surrounding successor liability and piercing the corporate veil can help you find a path to recovery in some of the toughest cases.

A CORPORATION is a legal entity created by filing certain documents with the state. It offers many benefits that are found in other entities, such as limited liability, centralized management, transferability of ownership, continuity, and taxation. On the other hand, some of these benefits pose problems for securing legal liability when the corporation is used as a shield to avoid liability or to perpetuate a fraud. In these cases, a victim may be left without any avenue of relief. Fortunately, all hope is not lost!

Courts have ignored traditional rules of liability and protection, and have held successor

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companies liable for their predecessors' actions and have pierced the corporate veil to hold parent companies, shareholders, or other persons involved with the corporation liable for the actions of the corporate entity. This article is a comprehensive overview of those doctrines and provides practical strategies for pursuing the liability of a corporation that was once wholly protected.

SUCCESSOR LIABILITY • Consider a hypothetical: Manufacturing company, Damaged Property, Inc., purchases a grinding machine at Predecessor, Inc., a corporation in the business of manufacturing these machines. Two years later, a belt comes loose in the machine, generating enough friction to cause the machine to start on fire, which in turn results in extensive damage to the plant and interrupts the plant's business for over two weeks. A subsequent investigation reveals that the belt was not properly secured in the machine, a manufacturing defect. Damaged Property, Inc. wishes to recover its losses from Predecessor, Inc. However, Predecessor, Inc. is no longer in business, but a related corporation that purchased its assets, named Successor, Inc., has been formed.

The Problem

The company or enterprise whose acts or omissions caused the injury or loss is no longer in existence, and a new corporation with similar products, shareholders, assets, and members is now in place. Are you left without a remedy?

Traditional Rules And Concepts

Historically, a successor company that merely purchased assets was not liable for the debts and liabilities, incurred before the transfer, of its predecessor. This rule applied primarily in the context of product liability actions, particularly when there were claims for defective manufacturing. The purpose of the rule was to protect the rights of persons involved in the corporation who were not directly involved with, or were opposed to, the successor corporation's acquisition. The typical fact pattern was that there was some acquisition of a company by way of a merger, with shares of stock given for consideration. In those cases, the successor would assume the liability of the predecessor. It is when the assets are purchased for cash or to escape liability that the successor will become liable.

The Exceptions

Even at the outset, there were a number of recognized exceptions to this traditional rule:

- *Express or implied agreement to assume the predecessor's liabilities.* The successor agrees to assume the predecessor's liabilities, through the purchasing agreement or by its actions;
- *De facto merger or consolidation.* There is a formal merger (or de facto merger where the parties are in the same position as if a formal merger had occurred) or consolidation of the companies;
- *Mere continuation.* The successor entity is really just a continuation of the predecessor, a theory that is discussed in greater detail below;
- *Fraudulent transaction/transfer of assets done to escape liability.* The transaction is done for the sole purpose of the predecessor escaping liability and, thus, an equitable remedy is prudent; and
- *Assets are transferred without leaving adequate consideration.* A transfer does not leave enough assets to pay existing liabilities, often in insolvency situations.

In addition, sometimes a statute (CERCLA is one example) mandates that a buyer is liable for its seller's liabilities, regardless of whether there is an agreement to do so.

THE MAJOR MODERN THEORIES OF SUCCESSOR LIABILITY RECOVERY • The excep-

tions to the traditional rule have evolved somewhat, and there are now several major theories of recovery against predecessor entities.

Mere Continuation

Focus is on the continuity of the directors, officers, and shareholders from the predecessor corporation to the successor corporation. Despite a change in the name or form of an entity, the substance of the entity stays the same. Therefore, privity can be established between the new entity and the person suffering the loss. The transfer is just in the corporate form because there is no change in the relationships that would justify a change in legal liabilities.

Traditionally, this theory was limited and inflexible in strict liability. Now, some jurisdictions are expanding the use of this theory. There is no bright line test followed by the courts; however, there are several factors to consider:

- *The circumstances surrounding the asset purchase.* Consider if all or most of the assets are purchased, and determine if the seller of the assets went out of business shortly thereafter; and
- *Continuity of the directors, officers, and shareholders.* This is the main distinguishing feature of this theory because the focus is on the continuation of the entity, not necessarily the operations. No exact amount of continuity is required, and a lesser degree may be enough on its own. In some jurisdictions, this factor on its own is not enough.

Case Examples

Here are some examples of how courts have applied and interpreted the mere continuation theory:

- Plaintiff sought to enforce an injunction against a purchaser of defendant's assets. The court found no mere continuation due to the asset purchase, in part because there was no real prior connection between the companies and no evidence that the purchase was done to assist the predecessor or its officers to evade the court. *Nav-Aids Ltd. v. Nav-Aids USA, Inc.*, 2002 U.S. Dist. LEXIS 23024 (N.D. Ill. Nov. 27, 2002);
- The court overturned the imposition of successor liability against the defendant for three reasons—there was only one common officer between the companies, there was no evidence that defendant's owners were "sham" owners or "mere figureheads" who collaborated with the predecessor corporation to avoid the predecessor's debts, and there was no evidence that any officer or shareholder in the predecessor corporation had any ownership interest in the successor corporation. *Grand Labs., Inc. v. Midcon Labs of Iowa*, 32 F.3d 1277, 1286 (8th Cir. 1994);
- The court found the successor firm to be a mere continuation of a predecessor firm and considered the common ownership (i.e., shares of stock) and directorship, overlap of officers, asset transfer for inadequate consideration, similarity of business conducted by both companies and day-to-day operations and overlap of clientele. *Kaiser Found. Health Plan of the Mid-Atlantic States v. Clary & Moore, P.C.*, 123 F.3d 201, 205 (4th Cir. 1997).

Continuity Of The Enterprise

Emphasis is on the entire business operation rather than on the mere continuation of the corporate entity. The focus of the inquiry is the similarity of the business operations. The rationale of the theory's application is that a new entity should not reap the benefits from the predecessor business without bearing the burdens as well. Particularly in strict liability cases, the risk of defective products should stay with the manufacturer and not be placed on the consumer. The successor who continues the enterprise is in the best position to gauge the risks of potential product defects and is the only entity that can improve the product.