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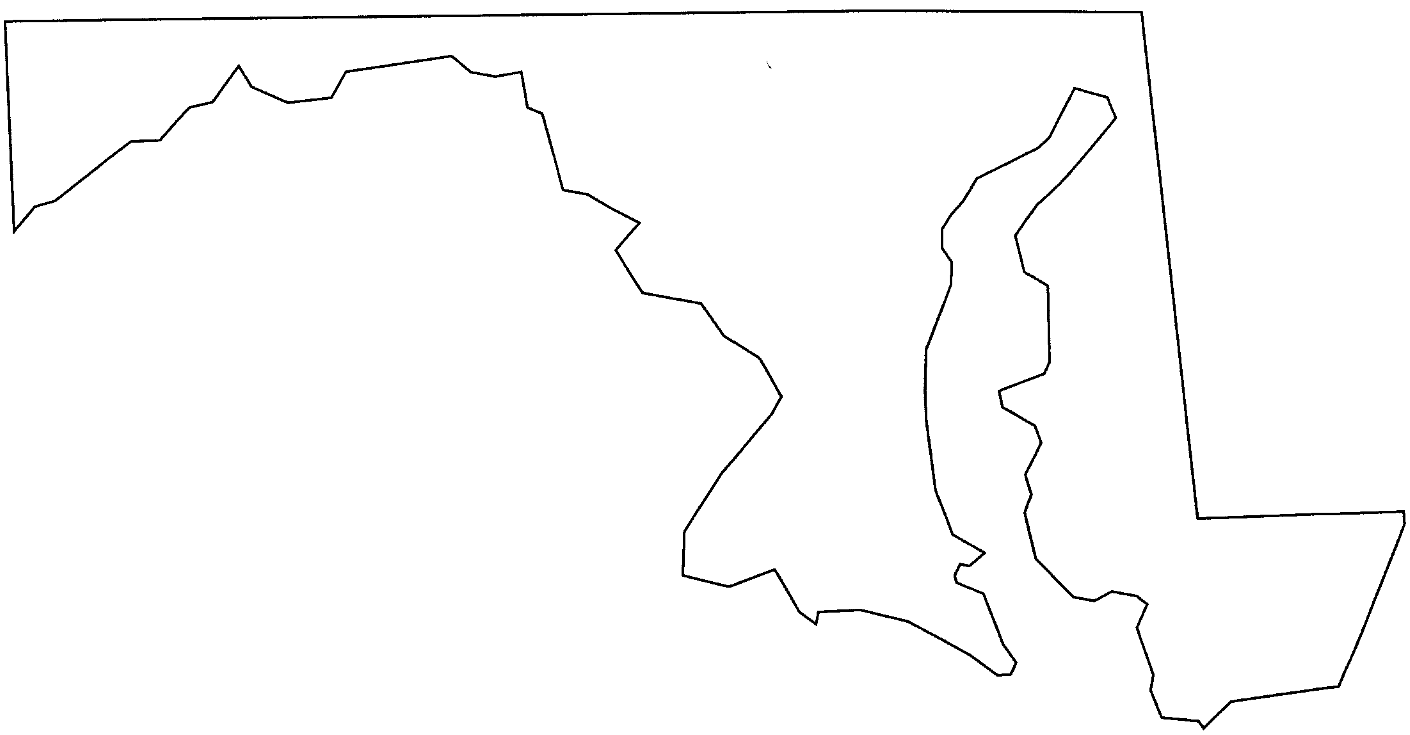

By George W. Kuney

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Successor liability is an exception to the general rule that, when one corporate entity sells assets to another entity, the assets are transferred free and clear of all but valid liens and security interests. When successor liability is imposed, a creditor or plaintiff with a claim against the *seller* may assert that claim against and collect payment from the *purchaser*.

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Historically, successor liability was a flexible doctrine, designed to eliminate the harsh results that could attend strict application of corporate law. Over time, however, as successor liability doctrines evolved in many jurisdictions they became ossified and lacking in flexibility. As this occurred, those who structure transactions learned how to avoid application of successor liability doctrines. *See* George W. Kuney, A Taxonomy and Evaluation of Successor Liability, 3 Fla. St. U. Bus. Rev. 1 (2006).

The current judge-made successor liability law is a product of and reaction to the rise of corporate law in the last half of the 19th century and early part of the 20th century. It may be better to characterize it as a part of that body of law, much like the "alter ego" or "piercing the corporate veil" doctrines, rather than as a creature of tort law, although it is used as a tool by plaintiffs who are involuntary tort claimants.

Many authorities list four, five, or six basic types of situations in which judge-made successor liability has sometimes been recognized - (1) express or implied assumption, (2) fraud, (3) de facto merger, (4) mere continuation, (5) continuity of enterprise, and (6) product line, for example. In fact, the matter is more complicated. Each of these species of successor liability has, within it, different sub-species with different standards and variations in the jurisdictions that recognize them. Some use a list of mandatory elements while others are based on a non-exclusive list of factors and considerations to be weighed and balanced in a "totality of the circumstances" fashion. Some that began as an approach consisting of a flexible list of factors have evolved into one consisting of one or more mandatory elements.

When examining successor liability, keep in mind that there is variance between formulations in particular jurisdictions. The label a court uses for its test is not necessarily one with a standardized meaning. It is dangerous to place too much reliance on a name; the underlying substance should always be examined.

The State of Successor Liability in Maryland

A. Intentional (Express or Implied) Assumption of Liabilities

Intentional assumption of liabilities, express or implied, is probably the simplest of the successor liability species. Imposing liability on a successor that, by its actions, is shown to have assumed those liabilities is essentially an exercise in contract construction and interpretation.

The Maryland courts look to the language of the asset purchase agreement to determine in the purchasing corporation expressly assumed the liabilities of the seller. Unlike most jurisdictions, Maryland has explicitly acknowledged a standard to determine if the purchaser impliedly assumed the liabilities of the seller. *In Baltimore Luggage Co. v. Holtzman*, 562 A.2d 1286, 1292 (Md. Ct. App. 1992), the court said:

> In order for a promise to be implied on the part of a corporation to pay the debts of another corporation, the conduct or representations relied upon by the party asserting liability must indicate an intention of the buyer to pay the debts of the seller. The presence of such an intention depends on the facts and circumstances of each case.

The *Baltimore Luggage* court, applying this test, held that a purchasing corporation did not impliedly assume an employment contract where the purchaser continued to pay the employee salary and report his earnings on a W-2 because the purchaser deducted these payments from the amount that the purchaser paid for the seller's assets.

B. Fraudulent Schemes to Escape Liability

Fraudulent schemes to escape liability by using corporate law limitation-of-liability principles to defeat the legitimate interests of creditors illustrate an example of the need for successor liability to prevent injustice. If a corporation's equity holders, for example, arrange for the company's assets to be sold to a new company in which they also hold an equity or other stake for less value than would be produced if the assets were deployed by the original company in the ordinary course of business, then the legitimate interests and expectations of the company's creditors have been frustrated. *Nissen Corp. v. Miller*, 323 Md. 613, 594 A.2d 564 (Md. 1990). By allowing liability to attach to the successor corporation in such instances, the creditors' interests and expectations are respected. The challenge, is defining the standard that separates the fraudulent scheme from the legitimate one.

As the *Nissen* court stated, the fraud exception is embodied in the Maryland Uniform Fraudulent Conveyance Act. There are apparently no Maryland cases that apply the fraud species of successor liability independent from a fraudulent conveyance theory.

C. *De Facto* Merger

In a *statutory* merger, the successor corporation becomes liable for the predecessor's debts. The *de facto* merger species of successor liability creates the same result in the asset sale context to avoid allowing form to overcome substance. A *de facto* merger, then, allows liability to attach when an asset sale has mimicked the results of a statutory merger except for the continuity of liability. The main difference between the sub-species of *de facto* merger in various jurisdictions is how rigid or flexible the test is. In other words, how many required elements must be shown to establish applicability of the doctrine? On one end of the spectrum is the lengthy, mandatory checklist of required elements. On the other, the non-exclusive list of factors to be weighed in a totality of the circumstances fashion.

As the *Nissen* court indicated, the *de facto* merger exception is codified in Maryland's Corporation Statute. Although the Maryland Annotated Code does not use *de facto* merger language, MD. CODE ANN., *Corporations and Associations* '3-114(e)(1) does provide that the surviving entity in a merger situation is liable for the debts of the predecessor and does not specify that such liability only extends to statutory mergers. The courts have not yet defined a test for what might constitute a *de facto* merger under Maryland law.

D. Continuation of the Business: The Continuity Exceptions

An exception with two distinct subcategories permits successor liability when the successor continues the business of the seller: mere continuation and continuity of enterprise. Each has sub-species particular to specific jurisdictions within them. The two share roughly the same indications, but continuity of enterprise does not require continuity of shareholders or directors or officers between the predecessor and the successor. That requirement said to be one of the "mere continuation" exception's dispositive elements or factors. MD. CODE ANN., *Corporations and Associations* '3-114(e)(1) (1998). Nationally, courts are not altogether careful or uniform in labeling which exception they are applying. The similarity of these doctrines to those of *de facto* merger is striking.

1. Mere Continuation

The *Baltimore Luggage* court provided a test for whether a purchasing corporation is merely a continuation of the seller:

> [A] successor corporation may be liable for the debts of its predecessor if certain indicia are met. The indicia of continuation are:
>
> "common officers, directors, and stockholders; and only one corporation in existence after the completion of the sale of assets. While the two foregoing factors are traditionally indications of a continuing corporation, neither is essential. Other factors such as continuation of the seller's business practices and policies and the sufficiency of consideration running to the seller corporation in light of the assets being sold may also be considered. To find that continuity exists merely because there was common management and ownership without considering other factors is to disregard the separate identities of the corporation without the necessary considerations that justify such an action."

Id. at 1293. In *Baltimore Luggage*, the trial court held that the purchaser was a mere continuation of the seller based on evidence that the purchaser continued to use the trade name of the seller and held itself out as the seller so that persons dealing with the purchaser would not know that the corporations changed. The Court of Special Appeals reversed because there was no continuity of ownership between the corporations, the seller remained in existence, and there was sufficient consideration for the assets.

It is important to note that neither of the mere continuation tests applied by the Maryland courts requires continuity of ownership. The *Baltimore Luggage* court, however, noted that mere continuation applies where "the purchasing corporation maintains the same or similar management and ownership but wears a 'new hat.'" 594 A.2d at 1292. In discussing the four traditional exceptions, the *Nissen* court cited this quote from *Baltimore Luggage* with approval. 594 A.2d at 566. Based on the current case law, it is hard to tell what degree of continuity is actually required before a court will impose liability based on the mere continuation doctrine.

2. Continuity of Enterprise

Unlike the more traditional and long standing "mere continuation" exception, the continuity of enterprise theory does not require strict continuity of shareholders or owners (and possibly directors and officers) between the predecessor and the successor—although the degree or extent of continuity of owners, directors and officers is a factor. *Mozingo v. Correct Mfg. Corp.*, 752 F.2d 168 174-75 (5th Cir. 1985) (noting that the traditional mere continuation exception requires identity of stockholders, directors and officers); *see also Savage Arms Inc. v. Western Auto Supply*, 18 P.2d 49, 55 (Alaska 2001) (mere continuation theory requires "the existence of identical shareholders"). Further, continuity of enterprise generally does not include the requirement of dissolution of the predecessor upon or soon after the sale, which is often a factor—and sometimes a requirement—in jurisdictions applying the mere continuation doctrine.

A detailed examination of continuity

of enterprise in the jurisdictions that have adopted it discloses three subspecies at work, all variations of the continuity of enterprise exception from *Turner v. Bituminous Cas. Co.* 244 N.W.2d 873 (Mich. 1976). The *Turner* factors are:

> (1) There is a continuation of the enterprise of the seller corporation, so that there is a continuity of management, personnel, physical location, assets, and general business operations;
>
> (2) The seller corporation ceases its ordinary business operations, liquidates, and dissolves as soon as legally and practically possible; and
>
> (3) The purchasing corporation assumes those liabilities and obligations of the seller ordinarily necessary for the interrupted continuation of normal business operations of the seller corporation.

In *Foster v. Cone Blanchard Mach. Co.*, 597 N.W. 2d 506 (Mich. 1999), the *Foster* court clarified the rule of *Turner* as one consisting of these three required elements.

Second, the *Foster* court held that the "'continuity of enterprise' doctrine applies only when the transferor is no longer viable and capable of being sued." The court's interpretation of the underlying rationale of *Turner* was "to provide a source of recovery for injured plaintiffs." The *Turner* court expanded liability based on the successor's continued enjoyment of "certain continuing benefits": "[T]he test in *Turner* is designed to determine whether the company (or enterprise) involved in the lawsuit is essentially the same company that was allegedly negligent in designing or manufacturing the offending product."

Maryland courts have not adopted the continuity of enterprise doctrine.

E. The Product Line Exception of *Ray v. Alad*

In *Ray v. Alad*, 560 P.2d 3 (Cal. 1977), the California Supreme Court recognized the product line exception to the general rule of successor non-liability. It is a very similar to continuity of enterprise. The court articulated the following "justifications" for imposing liability on a successor corporation:

> (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, and (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 goodwill being enjoyed by the successor in the continued operation of the business.

The term "justifications" is somewhat ambiguous as to whether it connotes required elements or nonexclusive factors to be balanced, much like the *Turner* guidelines.

The California Supreme Court returned to *Ray v. Alad* some years later to "clarify" things. In *Henkel Corp. v. Hartford Acc. & Indemn. Co.*, 62 P.3d 69, 73 (Cal. 2003), the California Supreme Court referred to these three justifications as conditions, thus suggesting that they were essential elements under the product line exception. Despite its name, the product line theory of successor liability appears only rarely, if at all, to have been applied in a reported decision to a successor that had acquired merely one of many product lines from the predecessor. In nearly all reported cases, it appears to have been applied to sales of substantially all of a predecessor's assets. George W. Kuney & Donna C. Looper, *Successor Liability in California*, 20 CEB Cal. Bus. L. Pract. 50 (2005). In fact, one court has emphasized that the "policy justifications for our adopting the product line rule require the transfer of substantially all of the predecessor's assets to the successor corporation." *Hall v. Armstrong Cork, Inc.*, 103 Wash. 2d 258, 260 n.1 (1984) (refusing to apply product line test to successor that purchased but one of many asbestos product lines).

The product line doctrine, where accepted, breaks into two distinct subspecies. The two differ only as to whether *Ray*'s "virtual destruction of the plaintiff's [other] remedies" condition is strictly required in order to permit recovery.

Maryland courts have not adopted the product line doctrine.

Conclusion

This article attempts to detail some of the history and the current condition of successor liability law in Maryland in light of the national state of these doctrines. The purpose of the doctrines was to provide contract and tort creditors with an avenue of recovery against a successor entity in appropriate cases when the predecessor that contracted with them or committed the tort or the action that later gave rise to the tort had sold substantially all of its assets and was no longer a viable source of recovery. The doctrine is in the nature of an "equitable" doctrine. It is invoked when strict application of corporate law would offend the conscience of the court. In large part, the doctrine remains intact and still serves that purpose.