Successor Liability in Michigan

By George W. Kuney

This article details and contrasts some of the history and the current condition of successor-liability law in Michigan against the state of the doctrine nationwide. The doctrine is in the nature of an "equitable" doctrine insofar as 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.

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Successor liability is an exception to the general rule that, when one corporate or other juridical person 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.

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, they became, in many jurisdictions, ossified and inflexible. As this occurred, corporate lawyers and those who structure transactions learned how to avoid application of successor-liability doctrines.[1]

There are two broad groups of successor-liability doctrines: those that are judge-made (the common-law exceptions) and those that are creatures of statute. This article addresses the status of the first group, judge-made successor liability in Michigan. Considering its roots as a reaction to the rise of corporate law in the last half of the nineteenth century, it may be better to think of it as part of corporate or contract law, much like the doctrines of alter ego or piercing the corporate veil,[2] rather than as a creature of tort law.

Fast Facts:

The five common law successor-liability doctrines recognized in Michigan are express or implied assumptions, fraudulent schemes to escape liability, de facto mergers, and mere continuation and continuity of enterprise.

The *Foster* Court made it clear that continuity of enterprise liability required a showing of each of the three *Turner* elements rather than a consideration of these elements as optional or variable factors.

In Michigan, the availability of a predecessor as a source of recovery for a plaintiff is fatal to actions for successor liability; the doctrine of continuity of enterprise applies only when the transferor is no longer viable and capable of being sued.

The State of Successor Liability in Michigan

This article classifies judge-made successor liability into five general species, each of which is specifically defined on a jurisdiction-by-jurisdiction basis. The five categories of successor liability discussed in this article are (1) intentional assumptions of liabilities, (2) fraudulent schemes to escape liability, (3) de facto mergers, (4) the continuity exceptions: mere continuation and continuity of enterprise, and (5) the product-line exception. The label a court uses for its test is not necessarily one with a standardized meaning applicable across jurisdictions. Accordingly, the underlying substance should always be examined.

Intentional (Express or Implied) Assumptions of Liabilities

Intentional assumption of liabilities, express or implied, is the simplest of the successor-liability species. Imposing liability on a successor that by its actions is shown to have assumed liabilities is essentially application of basic contract law doctrines of construction.[3]

Michigan recognizes express or implied assumption of liabilities as an exception to the general rule of successor nonliability.[4] On one occasion, the Michigan Court of Appeals concluded that, when the facts and circumstances surrounding a purchase agreement as well as a deposition of the successor's vice president suggested the possibility of implied assumption, summary judgment for the successor was inappropriate.[5]

Fraudulent Schemes to Escape Liability

Fraudulent schemes to escape liability by using corporate law 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 a 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. The challenge is separating the fraudulent scheme from the legitimate one.

The Michigan Court of Appeals addressed a district court's application of the fraud exception in *Gougeon Bros, Inc v Phoenix Resins, Inc*.[6] In reviewing the district court's holding of successor liability, the court stated:

> The trial court held that plaintiff demonstrated that defendant was subject to successor liability because the sale of [the predecessor's] assets was a fraudulent transfer designed to defraud…creditors and because defendant was a mere continuation of [the predecessor]. To support this holding, the court made the following findings of fact: defendant bought [the] assets for $3,000, while… sales had exceeded $115,000; the same two persons were equal shareholders of both [the predecessor] and defendant; defendant conducts business at same address as did [the predecessor]; and defendant notified [the predecessor] distributors that [an] epoxy [product] was now one of defendant's products, that defendant

would pay any currently owed invoices, and that the distributors should continue to use [the predecessor's] literature until the new literature was available…. These findings demonstrate, at least, that defendant is a mere continuation of [the predecessor].[7]

Implicit in this holding is that the threshold for mere continuation liability, discussed later in this article, may be lower than the threshold for fraud.

De Facto Mergers

In a *statutory* merger, the successor corporation becomes liable for the predecessor's debts.[8] The de facto merger species of successor liability creates the same result in the context of a sale of assets 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 subspecies of de facto merger in various jurisdictions is how many required elements must be shown to establish applicability of the doctrine.

The Michigan Supreme Court, in *Turner v Bituminous Cas Co,* while fashioning the continuity-of-enterprise exception, quoted *Shannon v Samuel Langston Co* for the "requirements" of de facto merger:

"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. There is a continuity of shareholders which results from the purchasing corporation paying for the acquired assets with shares of its own stock, this stock ultimately coming to be held by the shareholders of the seller corporation so that they become a constituent part of the purchasing corporation.

"3. The seller corporation ceases its ordinary business operations, liquidates, and dissolves as soon as legally and practically possible.

"4. The purchasing corporation assumes those liabilities and obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operations of the seller corporation."[9]

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. The subcategories are mere continuation and continuity of enterprise. Each subcategory also has subspecies particular to specific jurisdictions within them. The two subcategories 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—a requirement said to be one of the mere-continuation exception's dispositive elements or factors.[10] Courts are not altogether careful or uniform in labeling which exception they are applying. There appear to be four general subspecies of mere continuation and three of continuity of enterprise. The similarity of these doctrines to those of de facto merger is striking.[11]

Mere Continuation

As noted by the dissent in *Turner,* the mere-continuation exception is "the most confused of the four exceptions."[12] "[T]he

exception seems to encompass the situation where one corporation sells its assets to another corporation with the same people owning both corporations."[13] Since Michigan has adopted the broader continuity-of-enterprise doctrine, further discussion of mere continuation has been rendered somewhat moot.

Continuity of Enterprise

Unlike the more traditional and longstanding 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.[14]

In *Turner,* the Michigan Supreme Court developed the continuity-of-enterprise theory of successor liability, establishing three criteria that would be the threshold guidelines to establish whether there is continuity of enterprise between the transferee and the transferor corporations.[15] These three criteria consist of elements 1, 3, and 4 from *Shannon* that *Turner* adopted for de facto mergers. They 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;
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> ***
>
> "(3) The seller corporation ceases its ordinary business operations, liquidates, and dissolves as soon as legally and practically possible; and
>
> "(4) 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."[16]

The Michigan Supreme Court did not address the limits of the continuity-of-enterprise exception again until 1999 in *Foster v Cone-Blanchard Mach Co.*[17] In the interim, the Court cited *Turner* in three decisions, none of which clarified the key *Turner* holding.[18] One appellate court decision between *Turner* and *Foster* added to the criteria a fourth consideration also stated in *Turner.*[19]

The *Foster* Court made it clear that the continuity-of-enterprise test consisted of the three required elements stated in the decision and that these were not to be treated as factors or considerations.[20] 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."[21] The Court's interpretation of the underlying rationale of *Turner* was "to provide a source of recovery for injured plaintiffs."[22]

The *Foster* decision thus appears to have returned Michigan law to its state immediately after *Turner* was decided: continuity of enterprise is a recognized doctrine of successor liability, and the doctrine has three required elements. To the extent that intervening decisions had narrowed *Turner* with the addition of a fourth factor—whether the purchasing corporation holds itself out to the world as the effective continuation of the seller corporation—that reformation of the doctrine appears to have been reversed. Further, to the extent that *Turner*'s "guidelines" had been considered mere factors by other courts adopting the continuity of enterprise, the *Foster* Court made it clear that it interpreted its own rule as one composed of required elements.

The Product-Line Exception of *Ray v Alad Corp*

Although not part of Michigan law, in *Ray v Alad Corp,*[23] the California Supreme Court recognized the product-line exception to the general rule of successor nonliability. It is 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.[24]

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

The California Supreme Court returned to *Ray* some years later to "clarify" things in *Henkel Corp v Hartford Accident & Indemnity Co.*[25] There, the court referred to these three justifications as "conditions," suggesting that they were essential elements under the product-line exception.[26] 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

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of substantially all of a predecessor's assets.[27] 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."[28]

Michigan courts have not adopted the product-line doctrine. ■

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FOOTNOTES

1. See Kuney, *A taxonomy and evaluation of successor liability,* 6 Fla St U Bus R 9 (2006). A detailed jurisdiction-by-jurisdiction analysis and explanation of the state of judge-made successor liability law nationwide that is updated regularly may be found at <www.law.utk.edu/Faculty/Kuney/Kuney.htm> (accessed February 16, 2008).
2. See generally Schwarcz, *Collapsing corporate structures: Resolving the tension between form and substance,* 60 Bus Law 109 (2004).
3. Zaino, Bielagus v EMRE: *New Hampshire rejects traditional test for corporate successor liability following an asset purchase,* 45 NH B J 26 (2004).

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4. See *Foster v Cone-Blanchard Mach Co,* 460 Mich 696, 700–704; 597 NW2d 506 (1999).
5. *Safeco Ins Co v Pontiac Plastics & Supply Co,* unpublished opinion per curiam of the Court of Appeals, issued January, 21, 2000 (Docket No. 214079).
6. *Gougeon Bros, Inc v Phoenix Resins, Inc,* unpublished opinion per curiam of the Court of Appeals, issued February 8, 2000 (Docket No. 211738).
7. *Id.* at 2.
8. Joyner III, *Beyond* Budd Tire*: Examining successor liability in North Carolina,* 30 Wake Forest L R 889, 894 (1995).
9. *Turner v Bituminous Cas Co,* 397 Mich 406, 420; 244 NW2d 873 (1976), citing *Shannon v Samuel Langston Co,* 379 F Supp 797 (WD Mich, 1974); see also *Craig v Oakwood Hosp,* 471 Mich 67, 96–100; 684 NW2d 296 (2004) (holding there was no de facto merger "simply because…the purchasing corporation, paid in cash rather than stock").
10. Restatement Torts, 3d, § 12, comment g; American Law, Products Liability, 3d, § 7:20 (2004).
11. *Gladstone v Stuart Cinemas, Inc,* 178 Vt 104, 113–114; 878 A2d 214 (2005).
12. *Turner, supra* at 448 (Coleman, J., dissenting).
13. *Id.* at 449 (Coleman, J., dissenting).
14. See, e.g., *id.* at 420, 429.
15. *Id.*
16. *Id.* at 420.
17. *Foster,* n 4 *supra.*
18. *Jeffrey v Rapid American Corp,* 448 Mich 178, 201; 529 NW2d 644 (1995) (citing *Turner* for the proposition that corporate law principles should not be rigidly applied in products liability cases); *Stevens v McLouth Steel Prods Corp,* 433 Mich 365, 372; 446 NW2d 95 (1989) (citing *Turner* as a case in which the Michigan Supreme Court discussed the doctrine of successor liability in the context of a products liability suit); *Langley v Harris Corp,* 413 Mich 592, 594–598; 321 NW2d 662 (1982) (citing *Turner* for the proposition that an acquiring corporation may be held liable for products liability claims arising from activities of its predecessor corporation under a continuity-of-enterprise theory, but then holding that the *Turner* rationale will not allow a corporation to seek indemnity from the plaintiff's employer in a products liability suit).
19. *Pelc v Bendix Mach Tool Corp,* 111 Mich App 343, 352–354; 314 NW2d 614 (1982) (holding that when a successor bought only 8 percent of the assets of another corporation in a bankruptcy sale and did not meet the first three criteria of *Turner* but held itself out as a continuation of the liquidating corporation, the mere-continuation test was not satisfied). The Court noted that to impose successor liability in such circumstances would effectively be an adoption of the broader product-line exception. See also *Fenton Area Pub Schools v Sorensen-Gross Constr Co,* 124 Mich App 631, 642; 335 NW2d 225 (1983); *Lemire v Garrard Drugs,* 95 Mich App 520, 524; 291 NW2d 103 (1980); *Powers v Baker-Perkins, Inc,* 92 Mich App 645, 652; 285 NW2d 402 (1979); *Pelc, supra* at 351; *State Farm Fire & Cas Ins Co v Pitney Bowes Mgt Services, Inc,* unpublished opinion per curiam of the Court of Appeals, issued April 2, 1999 (Docket No. 205164).
20. *Foster, supra* at 703–704 and n 6.
21. *Id.* at 705.
22. *Id.*
23. *Ray v Alad Corp,* 19 Cal 3d 22; 136 Cal Rptr 574; 560 P2d 3 (1977).
24. *Id.* at 31.
25. *Henkel Corp v Hartford Accident and Indemnity Co,* 29 Cal 4th 934; 129 Cal Rptr 828; 62 P3d 69 (2003).
26. *Id.* at 942.
27. Kuney & Looper, *Successor liability in California,* 20 CEB Cal Bus L Pract 50 (2005).
28. *Hall v Armstrong Cork, Inc,* 103 Wash 2d 258, 260 n 1; 692 P2d 787 (1984) (refusing to apply product-line test to successor that purchased but one of many asbestos product lines).