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PRODUCTS LIABILITY: A REMEDY IN SEARCH OF A DEFENDANT – THE EFFECT OF A SALE OF ASSETS AND SUBSEQUENT DISSOLUTION ON PRODUCT DISSATISFACTION CLAIMS

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I. INTRODUCTION

The volume of products liability actions has increased greatly in the last ten years.¹ Some actions have involved injured parties whose claims would ordinarily permit recovery, but the likelihood of recovery is diminished because at least one of the most likely prospective defendants, usually the manufacturer of the product, is no longer in existence. This is frequently due to the fact that this prospective defendant is a corporation which has been dissolved before the unsatisfactory nature of the product has become apparent to the injured party, or before any injury has occurred, or at least before any legal action has been commenced seeking recovery for the product dissatisfaction claim. Facing such a situation, plaintiffs have urged the courts to impose liability for the defective product on some other entity which may not have been associated with the distribution, sale, or manufacture of the product.

These attempts to impose responsibility for defective products on third parties have met with mixed results. A number of different theories have been used. Other theories appear to be available, at least in some situations, which would allow for recovery against the dissolved corporation or its former shareholders. These theories, and the limitations upon the ability of those who have suffered from product dissatisfaction to utilize these theories, are the topic of this article.

Before beginning to investigate the different theories available to those seeking to find a defendant in this type of situation, a discussion of one aspect of the underlying law of products liability is necessary.

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1. Wall Street Journal, Nov. 3, 1972, at 1, col. 8. The Wall Street Journal report states that there were an estimated 500,000 product liability court cases in 1971 and that the number is expected to grow to one million by 1985.

There are three principal theories under which an entity which suffers product dissatisfaction may proceed against those who participated in the manufacture and distribution of the product: negligence, breach of warranty, and strict liability in tort.² A detailed discussion of these theories is beyond the scope of this article.³ However, the variance in the statutes of limitations for these theories is integrally involved in the following discussion and thus requires some comment.

As a general rule, the tort statute of limitations is applied to negligence and strict liability in tort claims.⁴ Tort statutes of limitations do not usually begin to run until injury, or until the defect in the product was or should have been discovered; they vary in duration from state to state and are commonly from one to five years in length.⁵

A contract statute of limitations is ordinarily applied to product dissatisfaction claims expressed under a breach of warranty theory. Most of these claims are asserted under the implied warranty of merchantability

2. Other theories of recovery are sometimes used. These include violation of a statutory duty to warn and violation of statutory standards of quality. In many cases, these standards have been established by federal legislation. See, e.g., National Traffic and Motor Vehicle Safety Act of 1966, 15 U.S.C. § 1381 *et. seq.*; Consumer Product Safety Act, 15 U.S.C. § 2051 *et. seq.* (1972), discussed in Martel, *The Consumer Product Safety Act and Its Relation to Private Products Litigation*, 10 FORUM 337 (1974); Patton & Butler, *The Consumer Product Safety Act—Its Impact on Manufacturers and on the Relationship between Seller and Consumer*, 28 BUS. LAW. 725 (1973); Federal Hazardous Substances Labeling Act, 15 U.S.C. § 1261 *et. seq.* (1970), discussed in Comment, *Federal Hazardous Substances Legislation*, 13 B.C. IND. & COM. L. REV. 504 (1972).

3. The basics of product liability, and a comparison of the various theories on which recovery can be based, are well presented in Dickerson, *The ABC's of Products Liability—With a Glose Look at Section 402A and the Code*, 36 TENN. L. REV. 439 (1969); Donovan, *Recent Developments in Products Liability Litigation in New England: The Emerging Confrontation Between the Expanding Law of Torts and the Uniform Commercial Code*, 19 MAINE L. REV. 181 (1967); Jenkins, *The Product Liability of Manufacturers: An Understanding and Exploration*, 4 AKRON L. REV. 135 (1971); Pasley, *The Protection of the Purchaser and Consumer Under the Law of the U.S.A.*, 32 MOD. L. REV. 241 (1969); Rapson, *Products Liability Under Parallel Doctrines: Contrasts Between the Uniform Commercial Code and Strict Liability in Tort*, 19 RUT. L. REV. 692 (1965); Reitz & Seabolt, *Warranties and Product Liability: Who Can Sue and Where?*, 46 TEMP. L.Q. 527 (1973); Shanker, *Pigeonholes, Privity and Strict Products Liability*, 21 CASE W. RES. L. REV. 722 (1970); Speidel, *Products Liability, Economic Loss and The UCC*, 40 TENN. L. REV. 309 (1973); Titus, *Restatement (Second) of Torts Section 402A and The Uniform Commercial Code*, 22 STAN. L. REV. 713 (1970); Wade, *On the Nature of Strict Tort Liability for Products*, 44 MISS L.J. 825 (1973).

4. Burch, *A Practitioner's Guide to the Statutes of Limitations in Products Liability Suits*, 5 U. BALT. L. REV. 23, 35 (1975); Henn & Alexander, *Effect of Corporate Dissolution on Products Liability Claims*, 56 CORNELL L. REV. 865, 875 (1971).

5. Comment, *Statutes of Limitations, Their Selection and Application in Products Liability Cases*, 23 VAND. L. REV. 775, 785 (1970). See, e.g., Morton v. Texas Welding & Mfg. Co., 408 F. Supp. 7 (S.D. Tex. 1976) (2 years from time of injury); Heavener v. Uniroyal, Inc., 63 N.J. 130, 305 A.2d 412 (1973) (2 years from time of injury). *But see*, Prokolin v. General Motors Corp., CCH PROD. LIAB. REP. ¶ 7629 (Conn. 1972) (3 years from time of sale). Victorson v. Bock Laundry Mach. Co., 37 N.Y.2d 395, 373 N.Y.S.2d 39, 335 N.E.2d 275 (1975) (3 years from time of injury).

found in article 2 of the Uniform Commercial Code.⁶ In the absence of disclaimers⁷ or attempts to shorten its duration,⁸ the implied warranty of merchantability is subject to a statute of limitations of four years from the time of sale.⁹

The applicable statute of limitations is an important consideration in the type of cases which are the subject of this article because many of these cases involve a product which was manufactured and sold a considerable number of years before the product dissatisfaction claim arose. In the typical cases, an employee or other user of a product is injured by a product which had been acquired by the employer, the user, or some other person several years before the injury occurred. The injured party has a product dissatisfaction claim under which recovery could, at least theoretically, be based on either negligence, warranty, or strict liability theories. If the corporation which manufactured the product has been dissolved during the interim, and there are no other viable prospective defendants in the chain of distribution,¹⁰ the obvious defendant is the dissolved corporation itself.

II. CLAIMS AGAINST DISSOLVED CORPORATIONS

Under the common law, a corporation's capacity to sue or be sued terminated when the corporation was legally dissolved.¹¹ This well-established

6. UNIFORM COMMERCIAL CODE § 2-314. The implied warranty of fitness found in the Uniform Commercial Code is of limited value because it only applies to goods to be used for a particular, rather than a general, purpose.

7. The warranties provided by the Uniform Commercial Code may be disclaimed by careful draftsmanship which meets the requirements of section 2-316(2).

8. Uniform Commercial Code section 2-725(1) provides that the parties may reduce the period of limitation to not less than one year, but the period may not be extended.

9. UNIFORM COMMERCIAL CODE § 2-725 (1), (2). The Code clearly commences the running of the statute of limitations at the time of sale. However, in *Morton v. Texas Welding & Mfg. Co.*, 408 F. Supp. 7 (S.D. Tex. 1975), the court held that the statute of limitations on a products liability claim based on a warranty theory did not begin to run until the time of injury. See also, *Maynard v. General Elec. Co.*, 486 F.2d 538 (4th Cir. 1973). *Maynard* is representative of the minority position that products liability actions involving personal injury claims are always subject to the tort statute of limitations, regardless of the theory of recovery which has been pleaded.

10. In any particular case, other parties associated with the manufacture and distribution of the product which causes damage or loss to an individual may not be viable defendants for any number of practical considerations. There may also be legal considerations militating against a claim against such parties. Lack of privity with those in the chain of distribution continues to prevent the successful assertion of products liability claims, at least under warranty theories, in some jurisdictions. See, *Dickerson, The ABC's of Products Liability—With a Close Look at Section 402A and the Code*, 36 TENN. L. REV. 439, 445 (1969); *Donovan, Recent Developments in Products Liability Litigation in New England: The Emerging Confrontation Between the Expanding Law of Torts and the Uniform Commercial Code*, 19 MAINE L. REV. 181, 193-95 (1967).

11. W. FLETCHER, *CYCLOPEDIA OF PRIVATE CORPORATIONS* §§ 8127, 8142-43 (1962); *Schoone, Shareholder Liability upon Voluntary Dissolution of Corporations*, 44 MARQUETTE L. REV. 415, 419 (1961); *Comment, Safeguarding the Creditors of Corporations*, 36 HARV. L. REV. 509 (1923); *Comment, Suits By and Against Dis-* Published by University of Missouri School of Law Scholarship Repository, 1976

lished rule was equated to the common law rule regarding suits by and against deceased individuals. In *Oklahoma Gas Co. v. Oklahoma*,¹² the United States Supreme Court observed:

It is well settled that at common law and in the federal jurisdiction a corporation which has been dissolved is as if it did not exist, and the result of the dissolution can not be distinguished from the death of a natural person in its effect. It follows therefore, that as the death of the natural person abates all pending litigation to which such a person is a party, dissolution of a corporation at common law abates all litigation in which the corporation is appearing either as plaintiff or defendant.¹³

The common law rule actually went beyond the rule expressed in the *Oklahoma Gas* case. The dissolution of the corporation not only abated litigation in progress, it abated all causes of action which existed by or against the corporation, even if the actions had not yet been commenced.¹⁴ The property of the dissolved corporation may, at least in part, have escheated to the Crown,¹⁵ leaving creditors without a defendant to pursue.

Modern corporations statutes pass the assets of a dissolved corporation to its shareholders.¹⁶ Every jurisdiction now has statutory provisions dealing with the matter of litigation by and against dissolved corporations.¹⁷ The effect of these statutes is to modify the harshness of the common law rule and allow the corporation to sue and be sued following dissolution. Generalizations about the effect of these statutes on the continued vitality of claims against a dissolved corporation are difficult to make. Perhaps as many as half of the states have statutes which resemble section 105 of

solved Corporations, 48 IOWA L. REV. 1006, 1006-1009 (1963); *In re Ellis*, 53 Hawaii 23, 487 P.2d 286 (1971); *Bazan v. Kux Mach. Co.*, 52 Wis. 2d 325, 190 N.W.2d 521 (1971).

12. 273 U.S. 257 (1927).

13. *Id.* at 259.

14. W. FLETCHER, *supra* note 11, at § 8172; Schoone, *supra* note 11, at 419.

15. *Addy v. Short*, 47 Del. 157, 89 A.2d 136 (1952); *State ex rel. McDowell v. Libby*, 238 Mo. App. 36, 175 S.W.2d 171 (K.C. Ct. App. 1943); *City of Klamath Falls v. Bell*, 7 Ore. App. 330, 490 P.2d 515 (1971). The historical comment to sections 78-90 of the Model Business Corporation Act states:

Until a century ago, the courts followed Lord Coke's statement of the effects of dissolution: realty reverted to the donor, personalty escheated to the sovereign, and choses in action were extinguished with the death of the corporation. *Fox v. Horah*, 36 N.C. 358, 36 Am. Dec. 48 (1841); *Coulter v. R. Robertson*, 24 Miss. 278, 57 Am. Dec. 168 (1852). This position, which resulted from dicta in *Prior of Spalding's Case*, [1467] 7 Edw. IV (but is contrary to *Johnson v. Norway*, [1622] Winch 37), no longer obtains with respect to business corporations. *Health v. Leary*, 120 N.C. 90, 26 S.E. 630, 38 L.R.A. 240 (1897).

MODEL BUS. CORP. ACT ANN. §§ 78-80 ¶ 3.01 (ABA 1960). There is some question as to whether this rule ever applied to business corporations with shareholders. N. LATTIN, *THE LAW OF CORPORATIONS* § 176 (1971); Schoone, *Shareholder Liability Upon Voluntary Dissolution of Corporation*, 44 MARQUETTE L. REV. 415, 416-17 (1961).

16. W. FLETCHER, *supra* note 11, at § 8224; N. LATTIN, *supra* note 15, at § 184; H. HENN, *LAW OF CORPORATIONS* § 381 (1970).

17. W. FLETCHER, *supra* note 11, at § 8143; Z. CAVITCH, *BUSINESS ORGANIZATIONS* § 189.02 (1975).

the Model Business Corporation Act,¹⁸ but even in these states the statutes are not uniform. The statutes in the remaining states vary considerably. These variations are of critical importance in at least two respects.

The length of time following the actual dissolution during which a suit must be commenced, either by or against the corporation, runs as long as five years, although most states have adopted either a two or three year rule.¹⁹ The period of time within which to assert a claim provided for in these statutes is not in the nature of a statute of limitations. These statutes merely postpone the abatement which occurred at the time of dissolution under the common law. This distinction is important. The effect of these statutes is to require the commencement of the suit within the allowable period,²⁰ regardless of when or even if the statute of limitations on the claim has begun to run. No distinction is drawn between claims which have already ripened before the period has run and those which are at best contingent at the time the allowable period expires.²¹

18. MODEL BUS. CORP. ACT § 105 provides:

The dissolution of a corporation either (1) by the issuance of a certificate of dissolution by the Secretary of State, or (2) by a decree of court when the court has not liquidated the assets and business of the corporation as provided in this Act, or (3) by expiration of its period of duration, shall not take away or impair any remedy available to or against such corporation, its directors, officers, or shareholders, for any right or claim existing, or any liability incurred, prior to such dissolution if action or other proceeding thereon is commenced within two years after the date of such dissolution. Any such action or proceeding by or against the corporation may be prosecuted or defended by the corporation in its corporate name. The shareholders, directors and officers shall have power to take such corporate or other action as shall be appropriate to protect such remedy, right or claim. If such corporation was dissolved by the expiration of its period of duration, such corporation may amend its articles of incorporation at any time during such period of two years so as to extend its period of duration.

19. Citations to the state statutes are collected in the Model Business Corporation Act Annotated following section 105. According to Fletcher, most states have adopted a 2 or 3 year period. W. FLETCHER, *supra* note 11, at § 8169. However, the period is extended to 5 years, at least in Tennessee and Alabama. See, Gary Furniture and Appliance Co. v. Skinner, 288 Ala. 617, 264 So. 2d 174 (1972). Until a relatively recent amendment, Washington's statute abated all claims against dissolved corporations. See, United States *ex rel.* Acme Granite & Tile Co. v. F. D. Rich Co., 437 F.2d 549 (9th Cir. 1970); Jesse A. Bland Co. v. Knox Concrete Prods., Inc., 207 Tenn. 206, 388 S.W.2d 605 (1960).

20. Johnson v. Helicopter & Airplane Serv. Corp., 404 F. Supp. 726 (D. Md. 1975); Litts v. Refrigerated Transp. Co., 375 F. Supp. 675 (M.D. Pa. 1973); Stone v. Gibson Refrigerator Sales Corp., 366 F. Supp. 733 (E.D. Pa. 1973) (construing Ill. law); Chicago & Northwestern Ry. Co. v. Hoppers Pack. Co., 363 F. Supp. 697 (N.D. Iowa 1973).

21. Christensen v. Boss, 179 Neb. 429, 138 N.W.2d 716 (1965). Phrasing the claim as an equitable one will not avoid the statutory provisions, since it has been held that the statutes apply to all types of claims, including equitable actions. Koepke v. First Nat'l Bank, 5 Ill. App. 3d 799, 284 N.E.2d 671 (1972). It is, however, possible to avoid the time requirements in some states. In Delaware, for example, § DEL. CODE § 278, the anti-abatement statute, requires the commencement of an action within 3 years of dissolution. However, a claimant may request the appointment of a receiver under § 279, and the court may do so without regard to the limitations of § 278, Smith-Johnson Steamship Corp. v. United

This distinction becomes important in jurisdictions following the Model Act rule because the effect of the postponed abatement statute is merely to provide a grace period during which pre-dissolution claims may be asserted. In those situations where the incident which gave rise to the claim occurred after dissolution but before the allowable period expired, a claimant could not assert a claim based on a strict liability in tort theory. However, the claimant could still assert a claim under a breach of warranty theory because warranty claims are deemed to arise at the time of sale.

Very few of the reported cases dealing with claims against dissolved corporations involve product dissatisfaction claims. This is perhaps some evidence that the relatively short time period during which a claim must be asserted against the corporation under the postponed abatement statutes makes these statutes of little value to such claimants. At least in situations where the incident giving rise to the claim occurs many years after sale of the product and almost as many years after dissolution, the postponed abatement statutes are hardly the source of a meaningful remedy for product dissatisfaction claimants.²⁴ The claimant might then be tempted to seek to recover from the former shareholders of the dissolved corporation.

III. CLAIMS AGAINST FORMER SHAREHOLDERS OF THE DISSOLVED CORPORATION

When a corporation is dissolved, the assets of the corporation are occasionally distributed directly to the shareholders. More often, the assets are sold to a third party or parties, the known liabilities are paid,

24. It is possible to structure an argument that, at least under postponed abatement statutes similar to the Model Act provision, a post-dissolution claim may be asserted against the corporation even after the allowable period has run because the statute only requires that pre-dissolution claims be asserted within the allowable period. Such a result would not only benefit claimants, but it would avoid the anomalous result of barring claims which may not yet have even arisen. Support for this argument comes from two decisions suggesting that shareholders could assert claims of the dissolved corporation after the allowable period because the statute only prevented the corporation from suing. *Levy v. Liebling*, 238 F.2d 505 (7th Cir. 1956); *Jesse A. Bland Co. v. Knox Concrete Prods., Inc.*, 207 Tenn. 206, 388 S.W.2d 605 (1960). There is, however, persuasive authority to the contrary. *See U.S. Plywood-Champion Papers v. Pan-Amer. Gyro-Tex. Co.*, 345 F. Supp. 1 (N.D. Ill. 1972); *Gordon v. Loew's, Inc.*, 147 F. Supp. 298 (D.N.J. 1956). The argument seems contrary to the often expressed concept that the postponed abatement statutes are in derogation of the common law. Unless the statutes specifically provide relief from the traditional abatement rule, the action must be deemed abated. The argument also runs afoul of the policy behind abating causes of action after what appears to be a reasonable time during which to allow claims:

There should be a definite point in time at which the existence of a corporation and the transaction of its business are terminated. To allow, as the plaintiff contends, the continued prosecution of lawsuits perverts the definiteness and orderly process of dissolution so as to produce a continuous dribble of business activity contrary to the intent of the winding up provisions of the statute.

Bishop v. Schield Bantam Co., 293 F. Supp. 94, 96 (N.D. Iowa 1968). *See also*,
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and the remaining consideration received on the sale of the assets is distributed to the shareholders. Even if a suit can still be brought against the dissolved corporation under a postponed abatement statute, in many instances the corporation will no longer have any assets from which to satisfy the claim. In other cases, the expiration of the grace period under the postponed abatement statute will prevent a suit against the dissolved corporation. In either case, the holder of the product dissatisfaction claim must find a way to pursue his claim against the former shareholders.

Prior to the adoption of postponed abatement statutes, an equitable theory evolved to alleviate the harshness of situations which resulted when a corporation was dissolved. Under this theory, creditors of all kinds could pursue the shareholders of a dissolved corporation in order to satisfy their claims against the corporation itself. This equitable doctrine has been referred to as the "trust fund" theory.²⁵

This equitable doctrine has been applied consistently for the past 150 years, and there are numerous examples of its use in recent cases.²⁶ The theory has been described in the following language:

Where the assets of a dissolved corporation have been distributed among the stockholders, a creditor of the dissolved corporation may follow such assets as in the nature of a trust fund into the hands of stockholders. The creditors have the right to subject such assets to their debts and for that purpose the stockholders hold them as though they were trustees.²⁷

The cases which apply the doctrine appear to make no distinction between claims which were asserted against the corporation before dissolution and those which were first asserted following dissolution.²⁸ The

Johnson v. Rac. Corp., 491 F.2d 510, 512-13 (4th Cir. 1974); Litts v. Refrigerated Transp. Co., 375 F. Supp. 675 (M.D. Pa. 1973); Gary Furniture and Appliance Co. v. Skinner, 288 Ala. 617, 624, 264 So. 2d 174, 181 (1972).

25. Norton, *Relationship of Shareholders to Corporate Creditors upon Dissolution: Nature and Implications of the "Trust Fund" Doctrine of Corporate Assets*, 30 BUS. LAW. 1061, 1062 (1975); Schoone, *Shareholder Liability Upon Voluntary Dissolution of Corporation*, 44 MARQUETTE L. REV. 415, 418-19 (1961); Comment, *Suits By and Against Dissolved Corporations*, 48 IOWA L. REV. 1006, 1006-09 (1963); Comment, *Safeguarding the Creditors of Corporations*, 36 HARV. L. REV. 509, 543-45 (1923); Cowden Mfg. Co. v. United States, 340 F. Supp. 1204 (E.D. Ky. 1972).

26. See, e.g., Stewart v. United States, 326 F.2d 201 (10th Cir. 1964); Cowden Mfg. Co. v. United States, 340 F. Supp. 1204 (E.D. Ky. 1972); Drew v. United States, 367 F.2d 828 (Ct. Cl. 1966); King v. Coosa Valley Mineral Prods. Co., 283 Ala. 197, 215 So. 2d 275 (1968); Thomas v. Harper, 14 Ariz. App. 140, 481 P.2d 510 (1971); Zinn v. Bright, 9 Cal. App. 3d 188, 87 Cal. Rptr. 736 (1970); John Julian Const. Co. v. Monarch Builders, Inc., 306 A.2d 29 (Del. Super. 1973); Godshall v. Hessen, 227 So. 2d 506 (Fla. App. 1969); Menconi v. Davison, 80 Ill. App. 2d 1, 225 N.E.2d 139 (1967); Collins v. Richland Aviation Serv., Inc., 225 So. 2d 241 (La. App. 1969); Town of Hampton v. Hampton Beach Improvement Co., 107 N.H. 89, 218 A.2d 442 (1966).

27. Koch v. United States, 138 F.2d 850, 852 (10th Cir. 1943).

28. The following cases involve claims which had been asserted before dissolution: Gaskins v. Bonfils, 79 F.2d 352 (10th Cir. 1935); King v. Coosa Valley Mineral Prods. Co., 283 Ala. 197, 215 So. 2d 275 (1968); John Julian Const. Co.

doctrine seems to apply whenever a creditor has an unsatisfied claim against a corporation which has been dissolved.

Many of the postponed abatement statutes apply to actions against former shareholders, officers, and directors, in addition to actions against the corporation itself.²⁹ Thus, these statutes now provide a legal remedy which can be used when the assets of a dissolved corporation have been distributed to the former shareholders.

There is an interrelationship between the postponed abatement statutes and the "trust fund" theory which has not been carefully considered by the courts thus far.³⁰ The "trust fund" theory arose to alleviate the harshness of the rule that dissolution abates all actions and claims against a corporation. The postponed abatement statutes also serve the same general function. This raises the question of whether the enactment of the abatement statutes bars further resort to the "trust fund" theory.³¹

At first glance, there appears to be no reason why the "trust fund" theory and the postponed abatement statutes could not co-exist. A claimant would then have alternative remedies at his disposal. The availability of the "trust fund" theory can be critical to the success of product dissatisfaction claims against dissolved corporations and their former shareholders. Where the cause of action has arisen before dissolution, it should make little if any difference to the claimant if the action is treated as one covered by the postponed abatement statute or by the "trust fund" theory.³² However, if the statutory approach is exclusive and the cause

v. Monarch Builders, Inc., 306 A.2d 29 (Del. Super. 1973); Collins v. Richland Aviation Serv., Inc., 225 So. 2d 241 (La. App. 1969).

The following cases involve claims which may have existed prior to dissolution, but were not asserted by the creditor until after dissolution: Hutton v. Commissioner, 59 F.2d 66 (9th Cir. 1932); Drew v. United States, 367 F.2d 828 (Ct. Cl. 1966); Zinn v. Bright, 9 Cal. App. 3d 188, 87 Cal. Rptr. 736 (1970); Godshall v. Hessen, 227 So. 2d 506 (Fla. App. 1969).

29. The Model Business Corporation Act provision is of this type. See text of section 105 at note 18 *supra*. Approximately half of the statutes expressly cover directors, officers and shareholders. Z. CAVITCH, BUSINESS ORGANIZATIONS § 189.02 (1) (c) (1975).

30. Z. CAVITCH, BUSINESS ORGANIZATIONS § 189.02 (1) (c), (1) (d) (1975).

31. One of the few cases dealing with the problem is Reconstruction Finance Corp. v. Teter, 117 F.2d 716 (7th Cir. 1941), *cert. denied*, 314 U.S. 620 (1941). The court clearly refused to allow the plaintiff to proceed under a "trust fund" theory but the reason for the result is not clear. It appears that the complaint was dismissed because the plaintiff failed to comply with the procedural prerequisites associated with an equitable action. The plaintiff had failed to show that he had exhausted his remedies against the corporation, a requirement that is ordinarily satisfied by obtaining a judgment and a writ of execution followed by a return of the writ *nulla bona* by the sheriff. Thus, it appears that the complaint was dismissed for procedural errors. The decision is read differently by several authorities, who suggest that the court concluded that the "trust fund" cause of action was unavailable once a postponed abatement statute had been adopted. See Norton, *supra* note 26, at 424-26. Schoone, *supra* note 26, at 726-27, admits the basis for the decision is not entirely clear. See also cases cited note 35 *infra*.

32. One important difference is the exhaustion of legal remedies requirement normally associated with equitable actions. Ordinarily, the plaintiff must show that he has been unable to collect his claim from the corporation. See, e.g.,

of action does not arise until after dissolution, the claimant may find himself without a defendant to pursue, at least in those states where the statutes do not allow assertion of post-dissolution claims against a corporation or its shareholders.³³ Even where post-dissolution claims may be asserted under the statute, the period within which these claims must be asserted will be considerably shorter under most of the statutes than it would be under the equitable statute of limitations associated with the "trust fund" theory.³⁴

Ordinarily the strongest indication of whether the two approaches should remain equally available would be legislative intent. Unfortunately, the intent of the draftsmen who wrote these statutes and of the legislatures which adopted them is far from clear. The intent of the draftsmen of the Model Business Corporation Act, which has served as a model for many of these statutes, is nowhere clearly stated. The comments to section 105 of the Model Act, which contains the postponed abatement statute, seem to suggest that the equitable action no longer has a purpose to fulfill now that the states have adopted legislation which remedies the harshness of the common law abatement rule.³⁵ This could be construed as an intent to eliminate the use of the "trust fund" theory. Only in Wisconsin is the intent, at least of the draftsmen of the statute, clearly known.

A number of early Wisconsin decisions addressed themselves to this co-existence question, and concluded that Wisconsin's postponed abatement statute did not displace the "trust fund" theory, so creditors could pursue the former shareholders of a dissolved corporation even after the statutory grace period for pursuing the corporation had expired.³⁶ It was the intention of the draftsmen of the 1951 Wisconsin Business Corporation Law to statutorily overrule these decisions³⁷ by making the statutory remedy exclusive. This would necessarily require that an action against the former shareholders be commenced within the statutory grace period. The only decision in Wisconsin which has raised the issue since the

Reconstruction Finance Corp. v. Teter, 116 F.2d 716 (7th Cir. 1941); Zinn v. Bright, 9 Cal. App. 3d 188, 87 Cal. Rptr. 736 (1970). However, several decisions have recognized that this requirement can be excused where the corporation clearly has no assets and an attempted execution on corporate property would be a "useless thing" or an "idle formality." Stewart v. United States, 327 F.2d. 201 (10th Cir. 1964); Drew v. United States, 367 F.2d 828 (Ct. Cl. 1966).

33. See text accompanying notes 22-23 *supra*.

34. Z. CAVITCH, BUSINESS ORGANIZATIONS § 189.02 (1) (d) (1975). Cavitch suggests that the most common statute of limitations on equitable claims is 10 years. See also Schoone, *supra* note 26, at 428. In many states, however, equitable actions are subject to the statute of limitations applicable to the underlying legal cause of action. J. POMEROY, EQUITY JURISPRUDENCE § 419 (1941).

35. MODEL BUS. CORP. ACT. ANN. § 105 ¶ 2 Comment (A.B.A. 1971).

36. State *ex rel.* Pabst v. Circuit Court, 184 Wis. 301, 199 N.W. 213 (1924); Lindemann v. Rusk, 125 Wis. 210, 104 N.W. 119 (1905). See also West Milwaukee v. Bergstrom Mfg. Co., 242 Wis. 137, 7 N.W.2d 587 (1943).

37. Young, *Some Comments on the New Wisconsin Business Corporation Law*, 1952 Wis. L. Rev. 6, 14-15.

adoption of the new statute found it unnecessary to determine the legislature's intent in passing the statute because the statute was found to be inapplicable to the case before the court.³⁸

Recent cases from other jurisdictions have allowed recovery under the "trust fund" theory.³⁹ However, legislative intent to bar recovery under that theory by the adoption of postponed abatement statutes apparently was not argued.

Aside from an actual intent by the legislatures to statutorily overrule the "trust fund" theory, the postponed abatement statutes logically would serve no real function if the "trust fund" theory survived the adoption of such statutes.⁴⁰ The "trust fund" theory allows for the assertion of all creditor claims under a relatively long statute of limitations. What could be the purpose of a statute which, at best, allows for the assertion of the same claims, and in some instances a smaller class of claims, during a shorter period of time?

There are a number of possible answers to this argument. The postponed abatement statutes were designed to alleviate the harshness of the common law abatement rule. These statutes may well have been proposed without considering the extent to which the "trust fund" doctrine already had alleviated the problem. Thus there may well have been no intention to affect the viability of the "trust fund" theory. Logic may not produce the correct answer to this question. The answer should be, but has not been, found in history. The motives of the legislatures may have been to provide an alternative approach because the "trust fund" theory may not have been as satisfactory a remedy as it would at first appear to be.

All of the recent cases utilizing the "trust fund" approach have involved claims which existed against the corporation at the time it was dissolved, even if the claim had not been asserted actively at the time of dissolution. In contrast, claims based on post-dissolution injuries are at best contingent liabilities where the future plaintiff has not yet suffered any product dissatisfaction. There appears to be no clear authority for the use of the "trust fund" theory in such circumstances, although there is nothing in the underlying nature of the theory to suggest its inapplicability in such cases. However, the "trust fund" theory, because of its equitable nature, is subject to the usual prerequisites of an equitable action, and the statutes may have been proposed so that creditors could assert their claims without first satisfying these prerequisites, which require that the claimant show that his legal remedies are non-existent or have been exhausted without success. In most cases, this means that the claimant must first get a judgment against the dissolved corporation and then execute against the corporation's property without recovering his judg-

38. *Security Nat'l Bank v. Cohen*, 31 Wis. 2d 656, 143 N.W.2d 454 (1966).

39. See cases cited note 28 *supra*.

40. Miller, *The Status of Choses in Action of Dissolved But Unadministered Corporations After Expiration of the Statutory Period for Winding Up*, 9 Miss. L.J. 455, 462-64 (1937).

ment in full.⁴¹ Thus, it may be that the postponed abatement statutes were intended only to provide a remedy which avoided these prerequisites, and that there was no intent to eliminate the availability of the "trust fund" theory.

Even if the adoption of the statutes was not intended to eliminate the "trust fund" theory, the equitable nature of the theory may suggest this result. Equitable remedies exist to supply relief where no legal remedy exists, or where the existing legal remedy is inadequate under the circumstances of a particular case.⁴² The "trust fund" theory evolved to fill a void in creditor's remedies created by the common law abatement rule. Now that a statutory remedy exists, it may be argued that an adequate legal remedy is available which deprives the court of equitable jurisdiction.

This conclusion has been reached in a number of analogous situations. The most important such situation involves the continued availability of equitable creditor's remedies when previously unavailable legal means of reaching the debtor's assets have been enacted.⁴³ For example, where execution was not available against the interest of a debtor in a trust, a remedy was available in equity. But once a legislature allowed creditors to reach such interests by legal execution, the courts ruled that the equitable procedure was no longer available to creditors.⁴⁴

It should be noted, however, that equity principles are by no means absolute. The equity principle examined above was used to explain the availability of equitable relief in the absence of a legal remedy. It was thus used to create equity jurisdiction, not to eliminate it. Its use to eliminate the availability of the "trust fund" theory as a means of relief is an improper application of the principle. Furthermore, the situations involving the expansion of the types of interests subject to the reach of creditors by legal execution are not apposite here because they involve a clear legislative intent to provide one remedy in lieu of another. Such an intention is not readily apparent in the postponed abatement statutes.

A number of courts, when faced with the argument that exceptions should be created to allow actions against corporations which had not been commenced or carried forward properly within the requirements of

41. J. POMEROY, EQUITY JURISPRUDENCE § 1415 (1941).

42. D. DOBBS, LAW OF REMEDIES § 2.5 (1973); H. McCLINTOCK, PRINCIPLES OF EQUITY §§ 43-47 (1948).

43. J. POMEROY, EQUITY JURISPRUDENCE § 1415 (1941). The coexistence problem has been raised in other contexts. Compare, e.g., Scheibner v. Scheibner, 199 Mich. 630, 165 N.W. 660 (1971) (equity retains jurisdiction to construe wills after statute gives power to construe wills to probate courts) with Brooks v. Hargrave, 179 Mich. 136, 146 N.W. 325 (1914) (equity does not retain jurisdiction to order accounting by executor once statute gives such power to probate court). See also Leone v. Bear, 241 S.W.2d 1008 (Mo. 1951) (statute requiring redemption bond from mortgagor as a condition precedent to exercising statutory right of redemption is not exclusive, and mortgagor may bring action in equity seeking relief from sale).

44. J. POMEROY, EQUITY JURISPRUDENCE § 1415 (1941).

a postponed abatement statute, have refused to do so on the theory that time is critical in the assertion of claims against dissolved corporations. This appears to be based on a policy argument in favor of the dissolved corporation that there should be a definite time after which claims could not be asserted.⁴⁵ Under this approach final distribution of assets can be accomplished without fear of late claims by creditors. If creditors could pursue claims against the shareholders long after the assets or the consideration received on their sale had been distributed, the shareholders would be exposed to a long period of uncertainty regarding potential claims. That would seem to conflict with the statutes, which create a limited and definite grace period for asserting claims against the corporation, and in most cases, its directors, officers, and shareholders.

However, the need for promptness in regard to claims against the corporation does not necessarily exist for the shareholders. The relatively short grace period of the postponed abatement statutes has been created so that at the expiration of the grace period the corporation's existence, and its records, could be finally closed. The short period is a response to fears of the later appearance of a creditor who might resurrect the corporation for the sole purpose of defending a dissatisfaction claim long after its officers and directors have turned to other endeavors. The shareholders, however, continue to function as individuals, and to enjoy the assets of the former corporation or the fruits of those assets. Allowing creditors to assert claims against them under the "trust fund" theory, while creating uncertainty, does not prevent the final termination of an entity, as does the possibility of delayed claims against the dissolved corporation.

Perhaps the strongest argument in favor of the equal availability of the "trust fund" theory and the abatement statutes is the general public policy favoring products liability claims. This policy has been justified on several grounds—it encourages manufacturers to produce safer products, spreads the cost of the consequences of unsatisfactory products among all users and consumers, and prevents a single individual from having to bear the sometimes astronomical and unaffordable losses caused by a product which injured him without fault on the consumer's part.⁴⁶ This policy supports co-existence of the two theories because of the claimants' increased opportunities for recovery.

45. See, e.g., *Litts v. Refrigerated Transp. Co.*, 375 F. Supp. 675 (M.D. Pa. 1973); *Bishop v. Schield Bantam Co.*, 293 F. Supp. 94, 96 (N.D. Iowa 1968); *Gary Furniture & Appliance Co. v. Skinner*, 288 Ala. 617, 624, 264 So. 2d 174, 181 (1972).

46. McKean, *Products Liability: Trends and Implications*, 38 U. CHI. L. REV. 3, 39 (1970); Pasley, *The Protection of the Purchaser and Consumer Under the Law of the U.S.A.*, 32 Mod. L. REV. 241, 255-59 (1969); Prosser, *The Assault Upon The Citadel (Strict Liability To The Consumer)*, 69 YALE L.J. 1099, 1119-24 (1960); Traynor, *The Ways and Meanings of Defective Products And Strict Liability*, 32 TENN. L. REV. 363, 366 (1965); Comment, *Reforming the Law of Consumer Recovery and Enterprise Liability Through the Uniform Commercial Code*, 60 VA. L. REV. 1013, 1023 (1974).

Another argument in support of the continued vitality of the "trust fund" theory can be drawn from *United States v. Palakow*.⁴⁷ This case involved the application of the Wisconsin postponed abatement statute. The Wisconsin statute contained a two year grace period, but the Small Business Administration, as plaintiff, had failed to commence its action within the allowable period. The defendants were former directors of the corporation who claimed to be protected from liability by the statute, which covered claims against directors as well as the corporation.

The Small Business Administration attempted to avoid the application of the statute by claiming that, because it had become a shareholder of the corporation prior to its dissolution, its action against the defendants was in its capacity as a shareholder against the defendants in their capacity as directors for failing to distribute to the SBA its pro-rata share of the assets. The SBA argued that this type of action was not subject to the two year limitation. In reversing the district court's judgment for the defendants, the United States Court of Appeals for the Seventh Circuit agreed with the SBA and declared that even if the nature of the liability asserted against one of the defendants was in his capacity as a director, it would not be barred by the postponed abatement statute.

The court said that because the "main purpose" of the postponed abatement statute was:

. . . to extend the life of the corporation for a two year period after dissolution so as to allow suits to be brought by and against the corporation which would ordinarily abate upon dissolution, [t]hose suits which would not have abated upon dissolution are not covered by . . . [the statute].⁴⁸

A director's personal liability for improperly distributing assets to the shareholders upon dissolution is a cause of action which did not abate before the statutes were adopted.⁴⁹ Thus, the statute had no application to the cause of action. Similarly, it could be argued that because the "trust fund" cause of action also is one which did not abate upon dissolution, but in fact first arose on dissolution, the statutes have no effect on the "trust fund" type of action.

Viewing the situation from the position of the holder of a product dissatisfaction claim who is attempting to pursue a claim barred under the postponed abatement statute by utilizing the "trust fund" theory, the best that can be said is that the law is unclear and uncertain. Although it may well have been the intent of the draftsmen to overrule the "trust fund" theory, legislative intent to the same effect has not been clearly enunciated. An attempt to pursue the trust fund remedy might still succeed. Courts may be unwilling to find that equitable jurisdiction has been

47. 438 F.2d 1177 (7th Cir. 1971), *rev'g* 298 F. Supp. 1378 (E.D. Wis. 1969).

48. *Id.* at 1179.

49. *Id.*

precluded on such faint evidence.⁵⁰ The strong public policy of encouraging enforcement of product dissatisfaction claims in an attempt to foster safer practices is currently enjoying great influence in the courts. There is insufficient case law in this area to date to discount the continued vitality of the "trust fund" theory.

IV. CLAIMS AGAINST THE PURCHASER OF THE ASSETS OF A DISSOLVED CORPORATION

The discussion thus far has assumed that the shareholders or directors of a corporation have had some business reason for dissolving the corporation, and, as part of this dissolution process, the assets have been sold to a third party. While this may occur occasionally, most of the time an acquisition-minded corporation has approached the directors and shareholders seeking to acquire the business. The shareholders and directors may find the offer appealing for any number of reasons and agree to a sale of their business.

The corporation which is making the purchase can do so by any one of several well-established acquisition techniques. The acquiring corporation ordinarily makes the decision of which technique to use. The two corporations may merge, with the corporation which is acquiring the other business ordinarily being the surviving corporation. Or, the two corporations may consolidate into a new corporation. In either of these situations, the corporation entity which remains after the acquisition is completed is responsible for all of the liabilities of the acquired corporation, including product dissatisfaction claims.⁵¹

As an alternative, the acquiring corporation may acquire the seller by buying its outstanding shares from the shareholders. In this case the original seller of the product is still in existence and product dissatisfaction claims may be asserted directly against it. Finally, the acquiring corporation may purchase the assets of the selling corporation.

Where the acquiring corporation has chosen to purchase the assets, the injured party faces a problem not present if one of the other three common approaches has been utilized. A corporation or other entity which purchases the assets of another business traditionally has not been liable for claims against the selling business. The general rule in such cases was expressed in *Kloberdanz v. Joy Manufacturing Company*⁵² in the following language:

[W]here one company sells or otherwise transfers all its assets to another company the latter is not liable for the debts and liabilities of the transferor, except where: (1) the purchaser expressly

50. See H. McCLINTOCK, PRINCIPLES OF EQUITY § 49 (1948). According to McClintock, equity jurisdiction is generally held not to be diminished, once clearly established, merely because the remedy at law has since become adequate by the adoption of a statute. However, McClintock recognizes that the principle is not uniformly adhered to.

51. This rule is now imposed by statute in all jurisdictions. See MODEL BUS. CORP. ACT. ANN. § 76 (e); Z. CAVITCH, BUSINESS ORGANIZATIONS § 167.04 (1975).

52. 288 F. Supp. 817 (D. Colo. 1968).

or impliedly agrees to assume such debts; (2) the transaction amounts to a consolidation or merger of the seller and purchaser; (3) the purchasing corporation is merely a continuation of the selling corporation; or (4) the transaction is entered into fraudulently in order to escape liability for such debts.⁵³

This concept is a basic part of the corporate law of the United States and language expressing the concept is found in essentially the same form as that quoted above in cases decided as early as the turn of the century.⁵⁴ The existence of this rule of law has led businesses interested in acquisition of another business to utilize a purchase of assets approach instead of a merger, consolidation, or purchase of stock because any of these latter approaches will lead to the assumption of liabilities of the selling corporation.⁵⁵

The insulation from liability enjoyed by corporations which acquire a business through a purchase of assets rather than through alternative acquisition techniques is as much a "citadel"⁵⁶ against the chances of recovery as privity once was to warranty claims by remote parties against those in the chain of manufacture and distribution of a product. Like the citadel of privity, assaults upon the insulation enjoyed by such purchasers of assets have continued, and have begun to meet with some success. The development of the law in this area is really just beginning, but the successful cases have thus far involved one or both of the following theories: the acquiring corporation is a continuation of the predecessor corporation, or there has been a defacto merger or consolidation of the two enterprises.

A. *The Continuation or Successor Theory*

Historically, the liability of a purchaser of assets for claims against the business which sold those assets originated from contract claims by

53. *Id.* at 820.

54. Virtually identical expressions of the test are found in *Chase v. Michigan Tel. Co.*, 121 Mich. 631, 80 N.W. 717 (1899), and *Swing v. Empire Lumber Co.*, 105 Minn. 356, 117 N.W. 467 (1908). See also *Spring Creek Oil Corp. v. Dillman*, 90 Okla. 129, 215 P. 1053 (1923); *Burkholder v. Okmulgee Coal Co.*, 82 Okla. 80, 196 P. 679 (1921).

55. Z. CAVITCH, *BUSINESS ORGANIZATIONS* § 161.01-02 (1975); Juenger & Schulman, *Assets Sales & Product Liability*, 22 WAYNE L. REV. 39, 40 (1975). The avoidance of liabilities is actually one of the principal reasons for using a purchase of assets approach to an acquisition, at least where an entire business operation is being acquired.

Tax reasons are sometimes cited as a motivation, because the asset purchase results in a stepped-up basis while the other methods of acquisition do not. However, the acquiring corporation can obtain a stepped-up basis, at least in a stock acquisition, by complying with the requirements of I.R.C. § 334 (b). See Z. CAVITCH, *id.* at § 175.08-12; Hasday, *The Bouncing Basis Rule: A Proposed Revision of Section 334(b)*, 53 TAXES 668 (1975).

56. Prosser, *The Assault Upon the Citadel (Strict Liability to the Consumer)*, 69 YALE L.J. 1099 (1960); Prosser, *The Fall of the Citadel (Strict Liability to the Consumer)*, 50 CALIF. L. REV. 791 (1962).

general creditors of the seller.⁵⁷ Courts were reluctant to impose liability on the purchaser of assets unless there was a substantial identity of ownership of the two corporations or the circumstances indicated that the transfer was motivated by a desire to avoid meeting the seller's obligations. Thus, in *Ozan Lumber Co. v. Davis Sewing Machine Co.*,⁵⁸ the court stated:

... in order to recover from a corporation of one name the obligations of a corporation of another name, upon the theory that the former is a mere continuation of the latter, it must appear that the former is the same legal entity as that whose obligation is sought to be charged upon it as one of its own; that is to say, it must be the same legal person, having a continued existence under a new name.⁵⁹

This reluctance to impose liability on a purchaser of assets who acquired even all of the assets and then operated the acquired business in the same form, as a continuation of or successor to the seller of the assets, has carried over into other areas. Thus, on at least two related questions, the liability of the acquiring corporation for tax liabilities of the former owner of the assets⁶⁰ and the liability of the acquiring corporation under collective bargaining agreements,⁶¹ the same general results have been reached.

The third exception to the rule found in the *Kloberdanz* decision, continuity of ownership, is rarely of value.⁶² The acquiring corporation

57. See, e.g., *Pringle v. Hunsicker*, 154 Cal. App. 2d 789, 316 P.2d 742 (1957); *J. F. Anderson Lumber Co. v. Myers*, 296 Minn. 33, 206 N.W.2d 365 (1973); *Lamb v. Leroy Corp.*, 85 Nev. 289, 454 P.2d 24 (1969); *McAlister v. American Ry. Express Co.*, 179 N.C. 556, 103 S.E. 129 (1920).

58. 284 F. 161 (D. Del. 1922).

59. *Id.* at 165.

60. Comment, *Transferee Liability and The Reorganization*, 40 U. COLO. L. REV. 380 (1968); *Commissioner v. Stern*, 357 U.S. 39 (1958).

61. *Howard Johnson Co. v. Hotel Employees*, 417 U.S. 247 (1974); *NLRB v. Burns Int'l Security Serv., Inc.*, 406 U.S. 272 (1972); *John Wiley & Sons, Inc. v. Livingston*, 376 U.S. 543 (1964). See *Gates, Successor Management's Obligations Under Existing Collective Bargaining Agreements*, 40 Mo. L. REV. 304 (1975).

62. This article concentrates on the effects of legitimate business transactions on the ability of one who suffers product dissatisfaction to find a defendant against whom the claim can be pressed. Where fraudulent transfers of assets or inadequate consideration are involved, or the assets have not really been transferred to new and different owners, a plaintiff should have little trouble in asserting his claim against the entity acquiring the assets. See, e.g., *Bishop v. Dura-Lite Mfg. Co.*, 489 F.2d 710 (6th Cir. 1973) (continuity of ownership and business); *Okmulgee Window Glass Co. v. Frink*, 260 F. 159 (8th Cir. 1919), *cert. denied*, 251 U.S. 563 (1920) (continuity of ownership and business); *Alexander & Baldwin, Inc. v. Peat, Marwick, Mitchell & Co.*, 385 F. Supp. 240 (S.D.N.Y. 1974) (continuity of ownership and operations); *Economy Refining & Serv. Co. v. Royal Nat'l Bank*, 20 Cal. App. 3d 434, 97 Cal. Rptr. 706 (1971) (no consideration); *Bergman & Lefkow Ins. Agency v. Flash Cab Co.*, 110 Ill. App. 2d 415, 249 N.E.2d 729 (1969) (continuity of ownership and business); *Wolff v. Shreveport Gas, Elec., Light & Power Co.*, 138 La. 743, 70 So. 789 (1916) (continuity of ownership and business); *Fena v. Peppers Fruit Co.*, 185 Minn. 137, 239 N.W. 898 (1931) (incorporation of sole proprietorship—identity of ownership and business); *Jackson v. Diamond T. Trucking Co.*, 100 N.J. Super. 186, 241 A.2d 471 (L. Div. 1968) (inadequate consideration); *Ruedy v. Toledo Factories Co.*, 61 Ohio App. 21, 22 N.E.2d 293 (1939) (continuity of ownership and business).

is frequently a large corporation, and, even if the selling corporation's shareholders receive stock of the acquiring corporation in payment for the assets, there is no continuity of ownership because most of the shareholders of the acquiring corporation will have had no relationship to the seller of the assets. This has been sufficient to lead to a denial of recovery against the acquiring corporation even though it continues to run the acquired business as a subsidiary or division of a larger enterprise, use the same name and tradenames, and employ the benefits of the former owner's goodwill, customer lists, and records.⁶³

However, in a recent case a plaintiff persuaded the court to impose liability even without continuity of ownership. In *Cyr v. B. Offen & Co.*,⁶⁴ an individual was injured by an explosion in the oven of a press sold to his employer in 1959. The individual who manufactured the oven died in 1962 and his estate sold the business to an employee group in 1963. The employees formed the corporate defendant in the personal injury suit, continued to use the former owner's name, and claimed to be a 40-year-old business. Although the ownership of the business had changed completely, the court noted that the defendant had taken over an ongoing business, assumed all the benefits of its predecessor, continued to function in the same manner, and produced the same products with the same employees. Even though the court did appear to rely heavily on the fact that the same employees whose negligence led to the creation of the defective product continued to be associated with the new owner of the assets,⁶⁵ this case clearly imposes liability on a continuation theory.

B. *The De Facto Merger Theory*

The facts in *Shannon v. Samuel Langston Company*,⁶⁶ were more typical than the facts in the *Cyr* case. In *Shannon*, the plaintiff was injured in 1967 while operating a piece of machinery owned by his employer. The machine had been manufactured about 1952 by a corporation called the Samuel M. Langston Company. This corporation had sold its assets to a subsidiary of the Harris Intertype Corporation, an unrelated corpora-

63. *Cintron v. Amsted Indus., Inc.*, 395 F. Supp. 1147 (E.D. Pa. 1975). See also *Denolf v. Frank L. Jursik Co.*, 54 Mich. App. 584, 221 N.W.2d 458 (1974), modified, 395 Mich. 661, 238 N.W.2d 1 (1976); *National Dairy Prods. Corp. v. Borden Co.*, 363 F. Supp. 978 (E.D. Wis. 1973); *Bazan v. Kux Mach. Co.*, 358 F. Supp. 1250 (E.D. Wis. 1973); *Copease Mfg. Co. v. Cormac Photocopy Corp.*, 242 F. Supp. 993 (S.D.N.Y. 1965); *Ortiz v. South Bend Lathe*, 46 Cal. App. 3d 842, 120 Cal. Rptr. 556 (1975); *Schwartz v. McGraw-Edison Co.*, 14 Cal. App. 3d 767, 92 Cal. Rptr. 776 (1971); *Pringle v. Hunsicker*, 154 Cal. App. 2d 789, 316 P.2d 742 (1957); *Buis v. Peabody Coal Co.*, 41 Ill. App. 2d 317, 190 N.E.2d 507 (1963); *J. F. Anderson Lumber Co. v. Myers*, 296 Minn. 33, 206 N.W.2d 365 (1973); *Lamb v. Leroy Corp.*, 85 Nev. 289, 454 P.2d 24 (1969); *McKee v. Harris-Seybold Co.*, 109 N.J. Super. 555, 264 A.2d 98 (L. Div. 1970), *aff'd per curiam*, 118 N.J. Super. 480, 288 A.2d 585 (App. Div. 1972); *McAlister v. American Ry. Express Co.*, 179 N.C. 556, 103 S.E. 129 (1920); *Southwestern Gas, Light & Power Co. v. Jay*, 275 S.W. 735 (Tex. Civ. App. 1925).

64. 501 F.2d 1145 (1st Cir. 1974).

65. *Id.* at 1154.

66. 379 F. Supp. 797 (W.D. Mich. 1974).

tion, in 1966, approximately a year before the injury. The subsidiary had been formed specifically for the purpose of acquiring the selling corporation's assets and had a name very similar to that of the seller of the assets. Later, the subsidiary was merged into the parent corporation and the assets of the selling corporation were used in a division of the parent called the Langston Division of Harris Intertype Corporation. The selling corporation had dissolved after distributing the shares received in exchange for its assets to its shareholders. The court noted that all of the tangible and intangible assets of the seller had been acquired and that the business was operated in substantially the same way it had been operated before the sale. This continuity in operations, combined with a partial continuation of ownership (the shareholders of the selling corporation had become shareholders of the buying corporation), led the court to find that a de facto merger had occurred.⁶⁷

In *Knapp v. North American Rockwell Corp.*,⁶⁸ the plaintiff was an individual who was injured while using a piece of machinery owned by his employer. The equipment had been manufactured by a corporation in 1966 or 1967. The corporation manufacturer later sold its assets to the defendant for shares of the acquiring corporation. As is typical in such acquisitions, the selling corporation agreed to change its name and dissolve, which it did some 18 months after the sale and about 6 months after the injury to the plaintiff.

The court purported to distinguish, but in fact rejected, decisions from other jurisdictions which refused to impose liability on the purchaser of assets.⁶⁹ The court relied heavily on a line of cases recognizing the right of dissenting shareholders to an appraisal of their shares on a sale of assets just as if a merger had occurred.⁷⁰ The court also observed that:

Denying Knapp the right to sue Rockwell because of the barren continuation of TMW after the exchange with Rockwell would allow a formality to defeat Knapp's recovery.

If we are to follow the philosophy of the Pennsylvania courts that questions of an injured party's right to seek recovery are to be resolved by an analysis of public policy considerations rather than by a mere procrustean application of formalities, we must, in con-

67. *Id.* at 801. The court distinguished *McKee v. Harris-Seybold Co.*, 109 N.J. Super. 555, 264 A.2d 98 (L. Div. 1970), *aff'd per curiam*, 118 N.J. Super. 480, 288 A.2d 585 (App. Div. 1972), a leading case in which recovery was denied, because in that case the selling corporation had received cash, rather than stock, so that not even a partial continuation in ownership was present. If the test to be applied is purely one of continuity of business operations rather than continuity of ownership, the form of consideration received for the sale of an ongoing business should be irrelevant. Juenger & Schulman, *Asset Sales and Products Liability*, 22 WAYNE L. REV. 39, 53-54 (1975).

68. 506 F.2d 361 (3rd Cir. 1974), *cert. denied*, 421 U.S. 965 (1975).

69. *Id.* at 364-67.

70. *Id.* at 370-71. The leading case in this area is *Farris v. Glenn Alden Corp.*, 393 Pa. 427, 143 A.2d 25 (1958). See also *Applestein v. United Bd. & Carton Corp.*, 60 N.J. Super. 333, 159 A.2d 146 (Ch. Div.), *aff'd per curiam*, 33 N.J. 72, 161 A.2d 474 (1960).

sidering whether the TMW-Rockwell exchange was a merger, evaluate the public policy implications of that determination.⁷¹

In his concurring opinion, Judge Rosenn suggested a test for determining liability, under a de facto merger theory, of a corporation which acquires assets of another business enterprise. Judge Rosenn stated:

I believe that, where a corporation purchases substantially all the assets of a second corporation, the legislature intended to impose the second corporation's tort liabilities on the acquiring corporation at least if the following attributes of merger are present:

- (1) an ongoing business, including its name and goodwill, is transferred to the acquiring corporation; and
- (2) the corporation whose assets are acquired is dissolved after distribution to its shareholders of the consideration received from the acquiring corporation.⁷²

Although some refinement may be necessary in less typical fact situations, the test proposed is both workable, and, from a policy standpoint, a desirable one. When applied to the facts of the *Knapp* case, the test allows the injured party to pursue his claim against a defendant. The *Knapp* decision has been criticized because it refused to adhere to the traditional distinction between acquisition based on a purchase of assets⁷³ and acquisition by purchases of shares, merger, or consolidation. Instead, the decision should be applauded for refusing to exalt form over substance.

Both the "continuation or successor," and the de facto merger theories provide the plaintiff with a defendant where the acquiring corporation, in a case like *Knapp*, intends and will profit from the exploitation of the selling corporation's goodwill, established customers, personnel, and internal procedures of manufacture and distribution. Under either theory, a "pooling of interests and continuity of operation"⁷⁴ leads to liability for the seller's obligations. These two approaches are really alternative ways of expressing the same concept. With the benefits of a business continuation should go the responsibility the selling corporation had for product dissatisfaction claims which would have been asserted against it if it had still been in existence.

In other situations, as where the purchaser of tangible assets does not acquire and use intangible assets such as the seller's name, goodwill, and customer lists, so that it does not clearly appear that the acquiring

71. *Id.* at 369.

72. *Id.* at 371.

73. Comment, *Assumption of Products Liability in Corporate Acquisitions*, 55 B.U.L. REV. 86, 105-06 (1975). But see Note, *Products Liability—Corporate Transaction Structured as a Sale of Assets Treated as De Facto Merger so as to Hold Transferee Corporation Accountable for Products Liability Claim Against Dissolved Transferor*, 6 SETON HALL L. REV. 477 (1975). For similar criticism of the *Cyr* decision see Note, *Corporations—Successor's Tort Liability for Acts or Omissions of Predecessor*, 16 B.C. IND. & COM. L. REV. 676 (1975).

74. *Shannon v. Samuel Langston Co.*, 379 F. Supp. 797, 801 n.1 (W.D. Mich.

corporation has acquired a continuing business enterprise, courts will undoubtedly continue to resist demands to impose responsibility.⁷⁵ In such situations, the acquiring corporation has not enjoyed the benefits discussed as fully as where it trades directly on the established nature of the acquired business. However, it would be overly simplistic to suggest that liability should not be imposed unless this business continuation test is satisfied as clearly as it was in *Knapp*.

At the opposite extreme from the acquisition of an ongoing business operation is the purchase of less than all, or perhaps even all of the tangible assets, where the acquiring corporation merely integrates this machinery and equipment into its own operations. In such cases, there is no continuity of operation.

There are many cases which fall between the extremes. In these cases, the transaction must be carefully scrutinized to determine the extent to which the acquiring corporation has benefited from the acquisition of more than the mere physical assets of the seller. If the facts indicate that the acquiring corporation has acquired and used some of the benefits of the prior business as a going concern, then the courts will have to face the difficult question of deciding whether the extent of the benefits received and utilized justifies the imposition of liability for product dissatisfaction claims. In cases of doubt, it appears that the policy justifications discussed in the *Knapp*, *Cyr*, and *Shannon* decisions would justify an imposition of liability.⁷⁶

Kloberdanz v. Joy Manufacturing Co.,⁷⁷ a leading case in which recovery was denied, is illustrative of a fact situation between the two extremes which would be difficult to decide under the business continuation test adopted in these new cases. The acquisition agreement between the buying and selling corporations provided that the buyer would acquire all the property and assets of the seller, including the corporate name. The buyer had the right to use the name for a division or subsidiary of the buyer, or as a trade name. The only significant assets not acquired were the land and buildings, and employment contracts.

Some liabilities were expressly assumed. These included certain "liabilities" which are more likely to be treated as something of value to an ongoing operation—outstanding purchase orders, outstanding obligations for supplies and components of the seller's product, and a sublease on some warehouse space. These facts support a finding of a business continuation.

75. In *Cyr v. B. Offen & Co.*, 501 F.2d 1145, 1152, n.13 (1st Cir. 1974), the court cited with approval cases in which courts had refused to find a de facto merger because of an insufficient degree of business continuity. *Accord*, *Comstock v. Great Lakes Distrib. Co.*, 209 Kan. 306, 496 P.2d 1308 (1972).

76. *Knapp v. North American Rockwell Corp.*, 506 F.2d 361, 369 (3d Cir. 1974), *cert. denied*, 421 U.S. 965 (1975); *Cyr v. B. Offen & Co.*, 501 F.2d 1145, 1153-54 (1st Cir. 1974); *Shannon v. Samuel Langston Co.*, 379 F. Supp. 797, 802 (W.D. Mich. 1974).

77. 288 F. Supp. 817 (D. Colo. 1968).

Other facts, however, support a contrary conclusion. None of the shareholders or principal officers of the seller became employees of the buyer, nor apparently, did any of the other former employees of the seller. The buyer never used the seller's name, except as a trademark on thirteen out of an undisclosed number of tools sold by the buyer. Other facts relevant to the determination, especially the extent to which the buyer dealt with the seller's former customers, are not reported. Nevertheless, on the basis of the reported facts, it is likely that a court following the business continuation test would impose liability on the buyer of the assets in this case.

Another theory has been advanced for imposing liability on the entity which acquires assets of a business which is no longer in existence. This theory could be used as an alternative to the business continuation test.

C. *Subsequent Duty to Warn*

A duty to warn of possible dangers to users of products is now well established in the products liability area.⁷⁸ Where the dangers were not contemplated by those involved in the chain of manufacture and distribution at the time the product was placed on the marketplace, it has been suggested that a subsequent duty to warn arises upon discovery of the existence of a dangerous propensity after the product has been sold.⁷⁹ The subsequent duty to warn is not nearly as well established as the duty to warn; at the time of the initial marketing, of dangers associated with the use of a product. This subsequent duty to warn, which is itself an emerging concept in the products liability area, has been combined with the successor theory to successfully avoid a motion for summary judgment by a purchaser of assets who was a defendant in a products liability action.

In *Shane v. Hobam, Inc.*,⁸⁰ the only reported decision utilizing this approach, an individual who was injured while using a piece of manufacturing equipment brought an action against the corporation which had acquired the assets of the manufacturer of the equipment 14 years after the machine had been sold to the injured individual's employer. The court rejected the reasoning of a prior case⁸¹ which had refused to accept this subsequent duty to warn theory as a possible basis for imposing liability on the purchaser of the assets of a corporation which had manu-

78. Dillard & Hart, *Product Liability: Directions for Use and the Duty to Warn*, 41 VA. L. REV. 145 (1955); Kidwell, *The Duty to Warn: A Description of the Model of Decision*, 53 TEX. L. REV. 1375 (1975); Noel, *Products Defective Because of Inadequate Directions or Warnings*, 23 SW. L.J. 256 (1969); Comment, *Foreseeability In Product Design And Duty To Warn Cases—Distinctions And Misconceptions*, 1968 WIS. L. REV. 228; Jackson v. Coast Paint & Lacquer Co., 499 F.2d 809 (9th Cir. 1974); Reyes v. Wyeth Laboratories, 498 F.2d 1264, cert. denied, 419 U.S. 1096 (1974).

79. Gillham v. Admiral Corp., 523 F.2d 102 (6th Cir. 1975), cert. denied, 96 S. Ct. 1113 (1976). Cf. Borel v. Fibreboard Paper Prods. Corp., 493 F.2d 1076, 1106 (5th Cir. 1973), cert. denied, 419 U.S. 869 (1974).

80. 332 F. Supp. 526 (E.D. Pa. 1971).

81. *Id.* at 530. In Chadwick v. Air Reduction Co., 239 F. Supp. 247 (N.D. Ohio 1965), the court had refused to impose liability on a purchaser of assets under

factured and marketed a defective product. The court did not necessarily accept the theory, in part because of a number of unanswered factual questions. The court said:

If Hobam actually knew that the previously manufactured machine was significantly defective, was Hobam obligated to advise all of Smith's previous customers of the nature of the defect? Was Hobam obligated to notify all original purchasers of the nature of the defect even when the original purchasers were no longer serviced by Hobam and had no other business relationship with Hobam? Plaintiff is treading on uncharted precedential seas and while there may be a serious question as to whether he has tipped the balance of precedent in his favor, I am reluctant to, and therefore will not, grant a summary judgment before pertinent factual gaps in the present case are filled in, thereby permitting the above questions to be answered with greater precision.⁸²

Shane leaves at least one very important question unanswered. Is the degree of "pooling of interests and continuity of operation"⁸³ which must be present to justify the imposition of liability under a subsequent duty to warn theory greater than, less than, or identical to the degree necessary to impose liability under the "continuation or successor" or de facto merger theories? It is possible that the courts will not require as significant a degree of continuity of operations under the subsequent duty to warn theory. If they do not, this theory may ultimately become more important in cases which are close under the other theories. The reason courts may not require the same degree of continuity is that the cost associated with the responsibility, at least where the responsibility is met, should not be nearly as great.

Chadwick v. Air Reduction Co.,⁸⁴ the earlier decision which rejected the subsequent duty to warn theory, contains a fact situation which illustrates the policy considerations present in these cases. The defendant had purchased all of the assets of a corporation which manufactured incubators used by hospitals in the care of premature babies. A baby had been burned when his foot became lodged in the heating element of the incubator. The defendant was alleged to have had actual knowledge of defects in this model of incubators. Assuming that the incubator was defective because of an insufficient shield on the heating element, and that the purchaser of the assets had knowledge of this defect, should it have been required at least to warn known buyers of the product of the dangers associated with its continued use? The court thought not, yet the decision seems erroneous. The cost of warning hospitals known to have purchased these incubators would have been relatively small. The risks to users of the product was large. Under these circumstances, a warning should be required and liability imposed for failure to warn, even if the degree of business

82. *Id.* at 530.

83. *Shannon v. Samuel Langston Co.*, 379 F. Supp. 797, 801 n.1 (W.D. Mich. 1974).

84. 239 F. Supp. 247 (N.D. Ohio 1965).

continuity is insufficient to support a finding of liability under one of the other theories.

These evolving theories of de facto merger, liability as a continuation or successor to the dissolved corporation, or violation of a subsequent duty to warn may produce a defendant against whom an injured claimant may successfully assert product dissatisfaction claims. There is, however, at least one important question which has yet to be resolved, even if liability is to be imposed under one of these theories.

V. THE EXTENT OF POTENTIAL RECOVERIES

If a product liability claim is asserted against a dissolved corporation under a postponed abatement statute, the corporation's potential liability is, of course, unlimited, other than by the total value of all assets owned by the corporation. It is very unlikely that the shareholders would have any potential personal liability under a "piercing" theory.⁸⁵ If the grace period of the postponed abatement statute has expired by the time the product liability claim is asserted, the shareholder's potential liability under the "trust fund" theory, assuming that theory is available to the claimant, should be limited to the value of the assets received by that shareholder.⁸⁶ However, unresolved problems are raised by a consideration of the extent of the potential liability of the corporation which acquired the assets of the dissolved corporation.

A stock purchase would limit the extent of liability to the value of the assets acquired, unless the injured party could convince a court to hold the acquiring corporation liable to the extent the acquired corporation was unable to satisfy the claim.⁸⁷ If the acquiring corporation merges or consolidates with the acquired corporation, its potential liability under a products liability claim could exceed the value of the assets acquired. There is no authority which suggests the liability could be limited in any way under statutory mergers and consolidation.⁸⁸

Corporations which acquire a business by means of a purchase of

85. Imposing liability on shareholders for corporate obligations is often called "piercing the corporate veil." Shareholder liability only results when fraud or illegality are involved, or less often, if the corporation was inadequately capitalized upon formation. H. HENN, LAW OF CORPORATIONS §§ 146-48 (1970); N. LATTIN, LAW OF CORPORATIONS §§ 14-15 (1971).

86. *Gaskins v. Bonfils*, 79 F.2d 352 (10th Cir. 1935); *Hutton v. Commissioner*, 59 F.2d 66 (9th Cir. 1932); *Collins v. Aviation Serv., Inc.*, 225 So. 2d 241 (La. App. 1969). *But see King v. Coosa Valley Mineral Prods. Co.*, 283 Ala. 197, 215 So. 2d 275 (1968) (shareholder liability can exceed value of assets received). New Jersey has a statutory provision allowing creditors to trace the assets of a dissolved corporation into the hands of the shareholders. The statute apparently limits the shareholder's liability to his rateable part of the claim. Juenger & Schulman, *Assets Sales and Products Liability*, 22 WAYNE L. REV. 39, 42 (1975).

87. "Piercing the corporate veil" is even more unlikely in this context than it would be if the initial shareholders retained the ownership of the shares. See note 85 *supra*.

88. Z. CAVITCH, BUSINESS ORGANIZATIONS § 161.02[2] (1975); W. FLETCHER, Cyclopedia of PRIVATE CORPORATIONS §§ 7112, 7118, 7123 (1973).

assets could, until the recent decisions discussed in this article, anticipate escaping liability completely so long as the transaction was legitimate. However, under the new theories, the corporation which uses an asset purchase as its method of acquisition may now be exposed to liability for product dissatisfaction claims. If traditional approaches are followed in determining the scope of liability, the theory used in determining to impose liability may well make a difference. If a court adopts a successor in interest or continuation theory, the potential liability would probably not exceed the value of the assets purchased.⁸⁹ However, if the de facto merger theory is used by the court, the acquiring corporation would be exposed to unlimited liability, similar to that imposed upon a statutory merger.⁹⁰

In cases where the amount of the claim exceeds the value of the assets acquired, the theory chosen for imposing liability could obviously be important to both the claimant and the acquiring corporation. Yet, it is difficult to suggest a preferable approach. It could be argued that the claimant should not get a recovery greater than the recovery he would have gotten if the sale of the assets had not occurred. If the sale had not taken place, the actual recovery against the corporation would not exceed the value of its own assets, unless the corporation had had products liability insurance, even if the claimant's judgment was for a greater amount. However, plaintiffs of all types benefit from apparent windfalls in all types of situations.

If a person inherits a large sum of money, all those with claims against him get a perhaps unexpected but improved opportunity for realizing on their claims. If this person cannot expect to successfully argue that his creditors are not entitled to a windfall, perhaps the acquiring corporation will also be unsuccessful in urging a court to accept the theory which will limit its own liability. Until this problem is resolved, acquisition-minded corporations, fearing products liability exposure under a de facto merger theory, may demand that the acquisition occur under a purchase of stock approach. Their hope would be that this approach would at least continue in the future to limit potential liability to the value of the assets of the acquired corporation which has now become a subsidiary of the acquiring corporation.

VI. CONCLUSION

A products liability claimant who discovers that a corporation which might have been liable to him for the consequences of his product dissatisfaction has been acquired by another corporation, and has since been dissolved, is in an unenviable situation. At a minimum, he faces the likelihood of a more complicated lawsuit involving factual and legal issues

89. W. FLETCHER, *supra* note 88, at § 7129; Okmulgee Window Glass Co. v. Frink, 260 F. 159 (8th Cir. 1919), *cert. denied*, 251 U.S. 563 (1920); McKee v. Standard Minerals Corp., 18 Del. Ch. 97, 156 A. 193 (1931).

90. See note 88 *supra*.

which would not be present if the corporation were still in existence. The claimant also faces the possibility that he may have a remedy without a defendant against whom the remedy can be asserted successfully.

If the corporation was dissolved recently enough so that the grace period of the applicable postponed abatement statute has not expired, the claimant will be able to assert his claim against the dissolved corporation. However, if the grace period has expired, or the cause of action is one which does not fall within the types of claims permitted by the statute, the claimant will be unable to assert his claim against the corporation. It is fairly clear that the statutes, because they are in derogation of the common law abatement rule, are to be strictly construed. The claim must be one permitted by both the scope and time limitations of the statute or it will be held to have abated.

The claim may be asserted against the former shareholders of the corporation, either under a postponed abatement statute or under the "trust fund" theory. To the extent the claim is asserted under a statute, the claimant faces the same problems present under a claim against the dissolved corporation. The "trust fund" theory should continue to be available to claimants in the absence of a clear legislative intent to abolish its use. The theory will provide defendants if the claimant can avoid a laches or statute of limitations defense.

There are two elements affecting the claimant's chances of holding the acquiring corporation responsible for his product dissatisfaction claim where a purchase of assets has been used. First, the courts must begin to apply the theories discussed in these recent cases consistently.⁹¹ Second, the claimant must be able to show a sufficient degree of business continuation to justify the imposition of liability under one or more of these theories. The degree of business continuity required before liability will be imposed has not yet been determined, and perhaps cannot be. However, it is clear that the acquisition of intangible assets, such as the corporate name, trademarks and customer lists, is considered more significant by the courts than the amount of physical assets acquired.

91. The only recent decision clearly adopting these cases as precedent is *Ray v. Alad Corp.*, ___ Cal. App. 3d ___, 127 Cal. Rptr. 817 (1976). In *Lopata v. Bemis Co.*, 406 F. Supp. 521 (E.D. Pa. 1975), the court, in applying New Jersey law, refused to follow *Knapp*, distinguished *Shannon* on the facts, and granted summary judgment for the purchaser of the assets. The court relied on *McKee v. Harris-Seybold Co.*, 109 N.J. Super. 555, 264 A.2d 98 (L. Div. 1970), *aff'd per curiam*, 118 N.J. Super. 480, 288 A.2d 585 (App. Div. 1972), a leading New Jersey case in which recovery against a purchaser of assets was denied. See also *Cinocca v. Baxter Laboratories, Inc.*, 400 F. Supp. 527 (E.D. Okla. 1975) (recognizing purchaser's potential liability under de facto merger theory, without citation to cases); *Cintron v. Amstead Indus., Inc.*, 395 F. Supp. 1147 (E.D. Pa. 1975) (refusing to apply these theories, without citation to cases); *Husak v. Berkel, Inc.*, 234 Pa. Super. 452, 341 A.2d 174 (1975) (recognizing purchaser's potential liability, without citation to cases); *Granthum v. Textile Mach. Works*, 230 Pa. Super. 199, 326 A.2d 449 (1974) (recognizing purchaser's potential liability, citing *Shannon*).

The courts might not require as significant a degree of continuity in operations under the subsequent duty to warn theory as they would under the continuation, successor or de facto merger theories. The limited authority in this area to date indicates, however, that even a claimant relying on the subsequent duty to warn theory must show a significant degree of business continuity in order to be successful.