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# Ohio Upholds Traditional Exception to General Rule of Corporate Successor Nonliability

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## OHIO UPHOLDS TRADITIONAL EXCEPTION TO GENERAL RULE OF CORPORATE SUCCESSOR NONLIABILITY

### INTRODUCTION

In *Welco Industries v. Applied Companies*,<sup>1</sup> the Ohio Supreme Court was again faced with the controversy of corporate successor liability.<sup>2</sup> The issue was whether a successor corporation that purchases the assets of another corporation may be held liable for the unassumed contractual obligations of the predecessor under the mere continuation exception to corporate successor nonliability.<sup>3</sup>

In a decision with far-reaching implications for corporate acquisitions, the *Welco* court declined to expand the “mere continuation” exception to successor liability.<sup>4</sup> The decision upholds the basic freedom of purchasers of “going concern businesses”<sup>5</sup> to acquire assets for fair value without assuming liabilities.<sup>6</sup>

The purpose of this Note is to carefully analyze the Ohio Supreme Court’s reasoning in *Welco* and its implications. Part II discusses corporate

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1. 617 N.E.2d 1129 (Ohio 1993)

2. In 1987, the court decided *Flaughner v. Cone Automatic Machine Co.*, 507 N.E.2d 331 (Ohio 1987). Although a products liability case, the court laid down the basic foundation for corporate successor liability in Ohio. See *infra* notes 36-38 and accompanying text for further discussion of the Flaughner decision.

See 15 WILLIAM M. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 7123-7123.07 (perm. ed. rev. vol. 1990 & Supp. 1994) (for a general discussion of the doctrine of corporate successor liability).

3. *Welco*, 617 N.E. 2d at 1132. The doctrine of corporate successor liability in a cash-for-assets purchase holds that a successor corporation is not responsible for the liabilities of the predecessor corporation, subject to certain exceptions.

One such exception, the mere continuation exception, allows for successor liability where the successor corporation is a “mere continuation” of the predecessor. Generally speaking, this exception applies if there is a continuation of the corporate entity.

4. *Id.* at 1133.

5. A “going concern business” is defined as:

An enterprise which is being carried on as a whole, and with some particular object in view. The term refers to an existing solvent business, which is being conducted in the usual and ordinary way for which it was organized. When applied to a corporation, it means that it continues to transact its ordinary business. A firm or corporation which, though financially embarrassed, continues to transact its ordinary business.

*City and County of Denver v. Denver Union Water Co.*, 246 U.S. 178 38 S. Ct. 278, 62 L.Ed. 649 (1918). BLACK’S LAW DICTIONARY 691 (6th ed. 1990).

6. Brief for Appellant at 4, *Welco Industries, Inc. v. Applied Companies*, 617 N.E.2d 1129 (Ohio 1993)(No. 92-471). Hereinafter referred to as “Brief for Appellant”.

successor liability<sup>7</sup> in general, and then focuses narrowly on the mere continuation exception to successor nonliability. Part III breaks down the case itself, presenting the facts, procedure, and reasoning of the majority and dissent. Finally, Part IV analyzes the court's refusal to expand the mere continuation exception, suggesting that had the court chosen to expand the the exception, the advantages of a cash-for-assets acquisition in Ohio would have been lost.<sup>8</sup>

## BACKGROUND

Under traditional rules of corporate liability, the successor corporation is not liable for the unassumed debts and obligations of the predecessor corporation.<sup>9</sup> However, successor liability may vary depending upon the type of acquisition involved.<sup>10</sup>

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7. The doctrine is commonly referred to as "corporate successor liability", but because the general rule in a cash for assets purchase is that the successor corporation is *not* liable, this Note will refer to the doctrine as "corporate successor nonliability."

8. For discussion of the advantages of a cash-for-asset acquisition, *see infra* notes 83-92 and accompanying text.

9. Howard L. Shecter, *Acquiring Corporate Assets Without Successor Liability: Is It A Myth?*, 1986 COLUM. BUS. L. REV. 137, 138-39.

The general rule of corporate successor liability has been—and in fact continues to be—that where one company sells or otherwise transfers all of its assets to another company, the acquiring company is not liable for the debts and liabilities of the selling company . . . simply by virtue of its succession to the ownership of the assets of the selling company.

*Id.*

The traditional rule developed within the context of corporate, contract, and property law. It provided a balanced means of facilitating corporate acquisitions and promoting the transferability of capital while protecting the interests of commercial creditors. By protecting both the creditors of the predecessor and protecting the successor from unknown or contingent liability, the rule offered fair and equitable treatment to parties involved in corporate acquisitions. George L. Lenard, *Products Liability of Successor Corporations: A Policy Analysis*, 58 IND. L. J. 677, 683 (1983).

See Timothy J. Murphy, *A Policy Analysis of A Successor Corporation's Liability for its Predecessor's Defective Products When the Successor Has Acquired the Predecessor's Assets for Cash*, 71 MARQ. L. REV. 815, 821 (1988) (for additional background on the rationale for the traditional rule of corporate successor liability); *see also* John C. Dupee, Jr., Comment, *Acquisition of Goodwill: The Acid Test of Successor Liability*, 53 ALB. L. REV. 475, 475 (1989); David M. Henry, Comment, *Choice-of-Law in Minnesota Corporate Successor Products Liability: Which Rule Is the "Better Rule"?*, 8 HAMLINE L. REV. 373, 376 (1985).

10. *See* BA FOX & FOX, CORPORATE ACQUISITIONS AND MERGERS §§ 23.01-.04 (1984). There are three major types of corporate acquisition: (1) statutory merger or consolidation; (2) purchase of the acquired corporation's stock; and (3) cash purchase of the acquired corporation's assets. *Id.* If the corporate acquisition is the result of a statutory merger or consolidation, the surviving corporation will usually be held to have assumed the liabilities of its predecessor, which ceases to exist. 15 FLETCHER, *supra* note 2, § 7121.

If the corporate acquisition is through a cash purchase of the acquired corporation's

Most jurisdictions recognize four exceptions to the general rule of successor nonliability.<sup>11</sup> The exceptions include: (1) the buyer expressly or impliedly<sup>12</sup> agrees to assume such liability;<sup>13</sup> (2) the transaction amounts to a de facto consolidation or merger;<sup>14</sup> (3) the buyer corporation is merely a continuation of the seller corporation;<sup>15</sup> or (4) the transaction is entered into

stock, the acquiring corporation does not directly assume the liabilities of the acquired corporation. See Robert J. Yamin, *The Achilles Heel of the Takeover: Nature and Scope of Successor Corporation Products Liability in Asset Acquisition*, 7 HARVARD J. L. & PUB. POL'Y 185, 213-214 (1984). However, as Yamin indicates, there is still an indirect assumption of liabilities because the acquired corporation is still in existence and subject to liability. *Id.*

If the corporate acquisition is through a cash purchase of the acquired corporation's assets, the general rule is that the successor corporation does not assume the present or contingent liabilities of the predecessor. 15 FLETCHER, *supra* note 2, § 7122. As will be seen, it is this general rule which the expanded mere continuation exception seeks to modify.

11. See, e.g., *Flaughner v. Cone Automatic Machine Co.*, 507 N.E.2d 331, 334 (Ohio 1987). Some jurisdictions recognize an additional exception allowing liability to be imposed if inadequate consideration is paid by the successor corporation. 15 FLETCHER, *supra* note 2, § 7122. However, most jurisdictions include this as a factor in analyzing the de facto merger exception or the mere-continuation exception. *Id.*

12. An implied assumption of liability means that "[a]bsent agreement by the successor corporation, [the successor corporation's] conduct must manifest an intent to assume the tort liability of its predecessor, or the equities must be sufficiently strong to impose that liability on the successor corporation." *Smith v. Navistar Int'l Transp. Corp.*, 737 F. Supp. 1446, 1449 (D. Md. 1988).

13. 15 FLETCHER, *supra* note 2, § 7122 & n.9. This exception can only be invoked when a successor corporation makes an express or implied agreement to assume the predecessor corporation's liabilities. See James W. Maxson, Case Comment, *Nissen Corp. v. Miller: Maryland Courts Reject the "Continuity of Enterprise" Doctrine*, 54 OHIO ST. L. J. 261, 262 & n.8 (1993). The exception is applied in a fairly straight forward manner: if a successor corporation agrees, either expressly or impliedly, to assume the liabilities of the predecessor corporation, then it will be held responsible for any liability that arises after the dissolution of the predecessor corporation. *Id.*

Whether a court finds an express or implied assumption of liabilities often depends upon the interpretation of the purchase agreement between the predecessor and successor corporations. See 15 FLETCHER, *supra* note 2, at §§ 7112, 7114-15, 7124. If the language in the purchase agreement concerning the debts or liabilities assumed by the successor corporation is vague, unclear, or too broad, courts have found an implied assumption of liability. See, e.g., *Bouton v. Litton Industries*, 423 F.2d 643, 652 (3d Cir. 1970)(successor corporation held liable where assumption of liabilities in transfer agreement was so broad as to constitute an implied assumption of predecessor's tort liability for defective products).

14. 15 FLETCHER, *supra* note 2, § 7122 & n.11. Generally, the requirements of a de facto merger have been stated as follows: (1) a continuity of enterprise, i.e., continuity of predecessor's management personnel, location, and assets; (2) continuity of ownership, i.e., shareholders of predecessor corporation become shareholders of successor corporation; (3) dissolution of predecessor corporation as soon as practically possible; and (4) an assumption by the successor corporation of those liabilities ordinarily necessary for the uninterrupted continuation of the predecessor's business operations. *Shannon v. Samuel Langston Co.*, 379 F. Supp. 797, 801 (W.D. Mich. 1974).

15. 15 FLETCHER, *supra* note 2, § 7122 & n.13. The common law elements of the mere continuation exception include: (1) a continuation of the officers, directors and shareholders

fraudulently for the purpose of escaping liability.<sup>16</sup> This note will focus on the mere continuation exception.<sup>17</sup>

### *Traditional Mere Continuation Exception*<sup>18</sup>

The traditional test focuses on the "continuation of the corporate entity"<sup>19</sup> rather than continuation of the business operation.<sup>20</sup> The primary elements of continuation of the corporate entity include: (1) the use by the successor corporation of the same name, location, and employees as the seller used; and (2) a common identity of ownership and management.<sup>21</sup> The exception has been narrowly construed to protect purchasers from unassumed liabilities.<sup>22</sup>

of the predecessor corporation in the successor corporation; (2) inadequacy of the consideration given for the assets acquired; and (3) dissolution of the predecessor corporation in either fact or law. *Jackson v. Diamond Trucking Co.*, 241 A.2d 471, 477 (N.J. Super. 1968). See *infra* notes 18-39 and accompanying text for a detailed discussion of the mere continuation exception.

16. 15 FLETCHER, *supra* note 2, § 7122 & n.12 for discussion of cases applying the fraud exception.

17. There generally has been little controversy concerning the application of the other three exceptions. The mere continuation exception, however, has presented courts (as in *Welco*) with the decision of whether to strictly apply or to expand the exception.

18. Throughout this note, the terms "theory," "test," "doctrine" and "exception" will be used interchangeably when referring to mere continuation, as the terms vary among their use by different jurisdictions and commentators.

19. "Entity" is defined as "[a]n organization or being that possesses separate existence for tax purposes." BLACK'S LAW DICTIONARY 532 (6th ed. 1990).

20. *Flaughner v. Cone Automatic Machine Co.*, 507 N.E.2d 331, 336 (Ohio 1987); see also 15 FLETCHER, *supra* note 2, § 7122 & n.13.

The mere continuation exception is an equitable doctrine developed mainly to protect creditor's claims against the predecessor corporation. See *Murphy*, *supra* note 9. In the cases where this exception applies, in essence it is in the nature of a corporate reorganization, rather than just a sale. See generally *Groover v. West Coast Shipping Co.*, 479 F. Supp. 950 (S.D.N.Y. 1979); *State ex rel. Donahue v. Perkins & Will Architects, Inc.*, 413 N.E.2d 29 (Ill. App. Ct. 1980); *J.F. Anderson Lumber Co. v. Myers*, 206 N.W.2d 365 (Minn. 1973). For further discussion of the difference between continuation of the corporate entity and continuation of the business operation, see *infra* notes 21, 26-29 and accompanying text.

21. See *Shecter*, *supra* note 9, at 141. The mere continuation exception is "problematic of application . . . because it has never been quite clear just in what sense a corporation must continue in order to trigger the exception." *Yamin*, *supra* note 10, at 226. However, certain essential elements of the exception can be ascertained from case law: (1) continuity of common management, directors and officers; (2) continuity of common shareholders; and (3) only one corporation in existence after the sale of the assets. See *Murphy*, *supra* note 9, at 820-21.

The policy behind the mere continuation exception is the same as that behind the de facto merger exception in that a corporation should not be able to avoid liability simply due to a change in its form and name. Both exceptions concern a situation where two corporations combine as one final corporation. See *Arthur Elevator Co. v. Grove*, 236 N.W.2d 383, 391-93 (Iowa 1975).

22. *Flaughner*, 507 N.E.2d at 33.

The traditional rule was developed prior to the advent of modern products liability law and thus does not take into account the policies behind strict tort liability.<sup>23</sup> To overcome this obstacle, products liability plaintiffs have sought to expand the mere continuation exception, as well as add an additional “product line” exception to the traditional exceptions discussed above.<sup>24</sup>

### *Expanded Mere-Continuation Theory*<sup>25</sup>

Rather than focus solely on the continuation of management and ownership, the expanded mere continuation theory would impose liability on a successor corporation if: (1) there has been a basic continuity of the predecessor’s business and enterprise;<sup>26</sup> and (2) if the predecessor effectively ceased its business operations.<sup>27</sup> Although the Michigan Supreme Court adopted this approach in *Turner v. Bituminous Casualty Company*,<sup>28</sup> it

23. *Turner v. Bituminous Casualty Co.*, 244 N.W.2d 873, 878 (Mich. 1976). The traditional mere continuation exception was developed historically in response to problems “in the areas of creditors’ protection, . . . tax assessments, or, in the case of the de facto merger, in the context of shareholder rights.” *Id.*; see also Hill, *Products Liability of a Successor Corporation—Acquisition of “Bad Will” with Good Will*, 23 IDEA J. L. & TECH. 9, 10 (1982).

24. See Murphy, *supra* note 9.

25. This theory has also been referred to as the “continuity of enterprise” doctrine. See Nathan E. Assor, *Corporate Successor Liability Issues*, C817 A.L.I.-A.B.A. 131, 136 (1993).

26. Assor, *supra* note 25, at 136. The focus of the expanded theory is on whether there is substantial continuity of pretransaction and posttransaction business activities resulting from the use of acquired assets. *Id.* at 136. Factors to consider include: retention of the same employees, retention of the same supervisory personnel, retention of the same production facilities in the same physical location, production of the same product, retention of the same name, continuity of the general business operations, and whether the successor holds itself out as the continuation of the previous enterprise. *Id.*

This approach differs from the traditional exception which focuses on the existence and continuation of the corporate entity rather than on the continuation of its business operations. See W. Edward Sell, *Successor Corporation’s Liability for Defective Products of Its Transferor – The Product Line Exception*, 4 J. L. & COM. 65, 68 (1984). Proponents of expanding the mere continuation exception argue that the traditional approach within a products liability context places unwarranted emphasis on the form of a particular corporate transaction which, to the consumer, is largely irrelevant. See *id.* at 76-78.

27. Assor, *supra* note 25, at 136. Courts have also stressed: (1) the importance of finding that the seller has effectively ceased ordinary business operations or has been dissolved; and (2) that the buyer has assumed the seller’s ordinary business liabilities and obligations. See *Brown v. Economy Baler Co.*, 599 So. 2d 1, 1 (Ala. 1992); *McCarthy v. Litton Industries, Inc.*, 570 N.E.2d 1008, 1012-12 (Mass. 1991)(but indicating that Massachusetts has not been forced with the issue of whether to adopt the doctrine).

28. 244 N.W.2d 873 (Mich. 1976). *Turner* expanded the mere continuation exception. See *id.* at 883-84. The *Turner* court held that successor liability will follow “where the totality of the transaction demonstrates a basic continuity of the enterprise.” *Id.* at 875. Under the continuity of enterprise rule adopted in *Turner*, the following four factors make out a prima facie case of successor liability:

remains the only state to have done so.<sup>29</sup>

### *Product Line Exception*

The California Supreme Court adopted the product line exception in *Ray v. Alad Corporation*,<sup>30</sup> Under this theory, a successor corporation which continues to manufacture a predecessor's product line "assumes strict tort liability for defects in units of the same product line . . ." <sup>31</sup> While New Jersey, Pennsylvania and Washington have also adopted the product line excep-

1) There was basic continuity of the enterprise of the seller corporation, including, apparently, a retention of key personnel, assets, general business operations, and even the [predecessor's] name.

2) The seller corporation ceased ordinary business operations, liquidated, and dissolved soon after distribution of consideration received from the buying corporation.

3) The purchasing corporation assumed those liabilities and obligations of the seller ordinarily necessary for the continuation of the normal business operations of the seller corporation.

4) The purchasing corporation held itself out to the world as the effective continuation of the seller corporation.

*Id.* at 883-84. See also *Cyr v. B. Offen & Co.*, 501 F.2d 1145, 1154 (1st Cir. 1974). In *Cyr*, the court, applying New Hampshire law, held that a successor corporation could be held liable even where it had paid adequate consideration for its predecessor's assets, and where there was no continuity of ownership interest. See *id.* at 1151-54. This decision expanded the mere continuation exception by doing away with the traditional requirement of continuity of ownership interest. See *id.*

29. "Eight states-Kentucky, Missouri, Nebraska, New York, North Dakota, South Dakota, Vermont and Wisconsin-have all declined to expand the mere continuation exception". David B. Hunt, Note, *Tort Law - Towards a Legislative Solution to the Successor Products Liability Dilemma - Niccum v. Hydra Tool Corp.*, 438 N.W.2d 96 (Minn. 1989), 16 WM. MITCHELL L. REV. 581, 585 n.14 (1990) (listing cases and their holdings in states that have declined to adopt the expanded theory).

30. 560 P.2d 3 (Cal. 1977). In *Ray*, the buyer had purchased the physical plant, inventories of raw materials and finished goods, manufacturing equipment, trade name, goodwill, and records of manufacturing designs from the seller and had continued the employment of the factory personnel. The buyer also hired the seller's general manager as a consultant. In addition, the buyer continued to manufacture the same line of products under the same name, and held itself out to potential customers as the same enterprise. *Id.* at 5-6.

The California Supreme Court held that "a party which acquires a manufacturing business and continues the output of its line of products under the circumstances here presented assumes strict tort liability for defects in units of the same product line previously manufactured and distributed by the entity from which the business was acquired." *Id.* at 11. The court gave three reasons for its ruling: (1) the plaintiff's lack of remedy against the original manufacturer; (2) the successor's ability to assume the predecessor's risk spreading role by means of insurance and increasing product costs; and (3) essential fairness in requiring a successor who benefits from a predecessor's goodwill to bear the predecessor's products liability costs. *Id.* at 8-9.

31. *Id.* at 11.

tion,<sup>32</sup> most other states have not.<sup>33</sup>

### *Ohio Law*

Ohio follows the traditional mere continuation exception to successor liability.<sup>34</sup> In *Flaughner v. Cone Automatic Machine Company*,<sup>35</sup> a products liability case,<sup>36</sup> the Ohio Supreme Court<sup>37</sup> rejected the plaintiff's arguments that either the expanded mere continuation exception or the product line exception were applicable to the case.<sup>38</sup> The court concluded that if corporate liability were to be expanded in Ohio, it would require legislative, not judicial, action.<sup>39</sup>

## STATEMENT OF THE CASE

### *Facts*

On February 16, 1988, Welco Industries,<sup>40</sup> filed a breach of contract suit against Applied Companies.<sup>41</sup> On March 30, 1988, Vickers, Incorpo-

32. See *Ramirez v. Amsted Indus. Inc.*, 431 A.2d 811, 819 (N.J. 1981); *Dawejko v. Jorgensen Steel Co.*, 434 A.2d 106, 110 (Pa. 1981); *Martin v. Abbott Laboratories*, 689 P.2d 368, 388 (Wash. 1984).

33. See *Hunt*, *supra* note 29, at 586 n.18 for listing of cases and their holdings in states that have declined to adopt the product line exception.

34. *Welco*, 617 N.E.2d 1129, 1132 (Ohio 1993).

35. 507 N.E.2d 331 (Ohio 1987).

36. The facts of *Flaughner* creating a successor corporate liability issue were as follows: the plaintiff, Carla Flaughner, was injured on April 24, 1979, by a Conomatic screw machine manufactured by Cone Automatic Machine Company in 1953. *Id.* at 333. In 1963, Cone Automatic's assets were purchased by Pneumo Corporation. *Id.* Subsequently, Cone Automatic was dissolved and a new Cone Automatic was formed by Pneumo as a dormant holding company for the "Cone" name. *Id.*

37. The opinion was written by Justice Douglas, and was joined by Justices Moyer, C.J., Locher, Holmes, Wright and Brown, JJ. Justice Sweeney was the lone dissenter. *Id.* at 333, 338.

38. *Id.* at 336 ("It is obvious that even the expanded view of continuity has no application under these facts."). See also *id.* at 337 ("We hold . . . that the 'product line' exception to corporate successor non-liability is a far-reaching and radical departure from traditional principles, such that its adoption is a matter for the legislature rather than the courts.").

39. *Id.* As of the date *Welco* was heard, the Ohio General Assembly had taken no such action. See *Welco*, 617 N.E.2d at 1133.

40. Hereinafter "Welco".

41. *Welco*, 617 N.E.2d at 1131. Hereinafter "Applied Companies" will be "Applied".

Applied Companies was a supplier under contract with the United States Department of Defense to produce a number of mobile air-conditioning units, and was directed by that department to use Welco Industries as a source of air compressors to be installed in those units. In compliance with a purchase agreement, Welco . . . began supplying compressors to Applied Companies. . . . At some point, Applied Companies became convinced that quantities of the compressors were defective.



rated<sup>42</sup> entered into a purchase agreement with Welco and its parent corporation, E.A.C. Industries, Inc.<sup>43</sup> Vickers agreed to purchase certain Welco assets, including the Welco name, physical plant, machinery, inventory, patents, and goodwill.<sup>44</sup> Vickers also assumed certain Welco liabilities, but specifically *did not* assume any rights or liabilities regarding the contractual arrangements between Welco and Applied.<sup>45</sup> This new corporate entity continued in

Welco Industries, Inc. v. Applied Companies, No. C-900801, 1992 WL 2566, at \*1 (Ohio App. 1<sup>st</sup> Dist.). Ultimately, Applied refused to accept shipments from Welco, which prompted the suit for breach of contract in which Welco sought approximately \$1.4 million in damages. *Id.*

On July 20, 1989, Applied counterclaimed against Welco and E.A.C. Industries, its parent corporation, for compensation for its losses stemming, allegedly, from the breaches of the agreement by Welco, in addition to compensatory damages for its losses as a result of Welco's fraud, and punitive damages, costs and attorneys fees. Record at 14, 35, *Welco* (No. 92-471) [hereinafter "Record"].

42. Hereinafter "Vickers".

43. *Welco*, 617 N.E.2d at 1131. Hereinafter "E.A.C. Industries, Inc." will be "EAC". It is undisputed that Vickers acquired Welco by an agreement dated March 30, 1988, with EAC, a New York corporation. *Welco*, 1992 WL 2566, at \*1.

"The base purchase price, \$8,324,542, was paid in cash by Vickers entirely to EAC." *Id.* at \*2. Vickers contends: (1) that the contract by which it acquired Welco was the result of arms-length negotiations; and (2) that fair consideration was paid for the assets of Welco. Brief for Appellant, *supra* note 6, at 2. To support these contentions, Vickers referred to uncontested statements contained in an affidavit in support of the Motion for Summary Judgment. Record at 124-26.

There were no shares of Vickers stock issued as part of the transaction. Vickers did not purchase any shares of the sellers. Record at 125-26. These facts generally eliminate the possible application of the de facto merger exception. See *supra* note 14 and accompanying text for further discussion of the de facto merger exception.

Furthermore, the transaction was not a merger and did not in any way call for or provide for the discontinuation or dissolution of the seller's corporation. Record at 125-26.

44. *Welco*, 617 N.E.2d at 1131. Welco retained certain assets such as cash on hand other than petty cash, stock records, and the right to collect under any insurance policies owned by Welco or EAC. *Id.*

45. *Id.* The purchase agreement provided in part that Welco would retain:

all rights, if any, existing under the Applied Companies, Inc. Purchase Order Number 10001 dated March 3, 1986 with Welco, the Applied Companies, Inc. Purchase Order Number 10030 dated August 19, 1986 with Welco, and the Applied Companies, Inc. Purchase Order Number 10078 dated November 20, 1986 with Welco (collectively, the 'Applied Contracts') and, to the extent related thereto, all inventories, accounts receivable, claims, causes of action, rights of recovery and rights of setoff of any kind.

*Id.*

The agreement provided also that Welco would retain:

any liability or obligation relating to, based in whole or in part on events or conditions occurring or existing in connection with, or arising out of, the Retained Assets, including, without limitation, any claim, liability or obligation incurred in connection with, or relating to, or arising out of, the Applied Contracts.

*Id.*

the same line of business previously conducted by Welco under the new name Vickers-Welco.<sup>46</sup> Welco continued to exist as a shell corporation,<sup>47</sup> changing its name to Wesche Electric.<sup>48</sup>

On July 20, 1989, Applied counterclaimed against Welco, alleging Welco had breached their contractual agreement.<sup>49</sup> Applied added Vickers as a counterclaim defendant, alleging Vickers was liable under a theory of successor liability.<sup>50</sup>

### *Procedural History*

“Vickers moved to dismiss Applied’s claims, asserting that it had specifically not assumed any obligations to Applied”.<sup>51</sup> The court treated the motion as a motion for summary judgment.<sup>52</sup> Applied argued that there were issues of material fact regarding Vickers’ liability as a successor corporation.<sup>53</sup>

The Hamilton County Court of Common Pleas granted Vickers’ Motion for Summary Judgment.<sup>54</sup> The First District Court of Appeals reversed the Common Pleas Court, holding that there were issues of material fact regard-

46. *Id.* See also Brief for Appellee at 4, *Welco Industries, Inc. v. Applied Companies*, 617 N.E.2d 1129 (Ohio 1993) (No. 92-471) [hereinafter “Brief for Appellee”]. Applied contended:

After purchasing Welco, Vickers operated the business in all respects as a continuation of Welco. The goal in purchasing Welco was to buy an ongoing business which fit into its strategic expansion plans. . . . Vickers-Welco [] continued in an identical line of business, with the same employees, same supervisors and management performing the exact same tasks and producing the exact same products as Welco.

*Id.*; but also see Brief for Appellant *supra* note 6, at 3. “Although some of the former officers of Welco remained officers of the Welco Division of Vickers and continued to manage its business, none of the former officers or directors of Sellers became officers or directors of Vickers, itself.” *Id.*

47. A “shell corporation” is “[a] corporate frame, containing few, if any, assets, kept alive by required filings, generally for future use.” BLACK’S LAW DICTIONARY 343 (6th ed. 1990).

48. *Welco*, 617 N.E.2d at 1131. For the sake of clarity, in this casenote, “Vickers” refers both to Vickers before the transaction and to Vickers-Welco, and “Welco” refers only to the predecessor corporation, later renamed Wesche Electric. *Id.* at 1131 n.1.

49. *Id.* at 1131. Applied alleged Welco had breached the purchase agreement by supplying them with products that were both defective and composed of parts not approved by the government. *Id.*

50. *Id.*

51. *Id.* See also *supra* note 45 and accompanying text.

52. *Welco*, 617 N.E.2d at 1131. Because Vickers’ motion was supported by an affidavit of Lawrence J. Lyng, it was treated as a Motion for Summary Judgment. Brief for Appellant, *supra* note 6, at 1.

53. *Welco*, 617 N.E.2d at 1131. See also Brief for Appellee, *supra* note 46, at 8.

54. *Welco*, 617 N.E.2d at 1131.

ing Vickers' liability as a successor corporation.<sup>55</sup> The case was then appealed to the Ohio Supreme Court.<sup>56</sup>

### *Reasoning of the Majority*

The issue before the Ohio Supreme Court was "whether a stranger corporation that purchases the assets of another corporation may be held liable for the unassumed contractual obligations of the predecessor under a theory of successor liability."<sup>57</sup> The facts of the case specifically required the court to "define the contours of the 'mere-continuation' exception to the general rule of successor nonliability as it applies to claims sounding in contract."<sup>58</sup>

In a five to two decision, the Ohio Supreme Court reversed the decision of the First District Court of Appeals.<sup>59</sup> The Majority held: (1) that the expanded mere continuation theory was not applicable to this case; and (2) that, under the traditional mere continuation exception, there was no genuine issue of material fact as to whether Vickers was liable for the contractual liabilities of Welco.<sup>60</sup>

The Majority began its analysis discussing the recent expansion of the mere continuation exception in products liability cases.<sup>61</sup> The Majority examined both the "product line"<sup>62</sup> and "continuity of enterprise"<sup>63</sup> theories of successor liability, but ultimately determined that, however valid the justifications for expanding liability in products cases, those justifications are not

55. *Id.* See also *Welco*, 1992 WL 2566, at \*3. ("It is clear to us from this record that the case does not lend itself to disposition under Civ.R. 56 but demands a plenary trial.")

56. *Welco*, 617 N.E.2d at 1131.

57. *Id.* at 1132.

58. *Id.* Applied urged the court to apply an expanded version of the mere continuation exception, thus calling on the court to re-examine the *Flaughner* decision, only this time in a non-products liability context. See Brief for Appellee, *supra* note 46, at 11.

59. *Welco*, 617 N.E.2d at 1135. Chief Justice Moyer wrote the majority opinion, joined by Justices Wright, Brogan, Francis E. Sweeney, and Pfeifer. *Id.* Justice A. William Sweeney wrote a dissenting opinion, joined by Justice Douglas. (James A. Brogan, Jr. of the Second Appellate District sat for Justice Resnick). *Id.*

60. *Id.* at 1134-35. The Majority's refusal to expand the mere continuation exception will be the focus of the analysis section of this Note. The court's ultimate decision to uphold the trial court's grant of summary judgment was simply a factual analysis under the chosen conclusion of law.

61. *Id.* at 1132-33. See *supra* notes 25-39 and accompanying text for discussion of the recent expansion of the traditional exceptions to corporate successor liability. Note that the Ohio Supreme Court in *Flaughner* expressly declined to expand the mere continuation exception, even in the products liability arena.

62. *Welco*, 617 N.E.2d at 1132. See *supra* notes 30-33 and accompanying text for discussion of the "product line" theory of successor liability.

63. *Welco*, 617 N.E.2d at 1133. See *supra* notes 26-29 and accompanying text for discussion

applicable in non-products liability disputes.<sup>64</sup>

The Majority compared tort law, which is guided primarily by public policy considerations, to contract law, which looks primarily to the intentions of the parties.<sup>65</sup> The Majority concluded that to expand the mere continuation exception in a *contractual* dispute “would virtually negate the difference between an asset purchase and a stock purchase,”<sup>66</sup> and result in an “unnecessar[.]y chill [to] the marketplace of corporate acquisitions.”<sup>67</sup>

of the expanded mere continuation exception, also called the “continuity of enterprise” doctrine. Note that the *Welco* court refers to this theory as an “approach . . . [which] relax[es] the requirements of the ‘mere continuation’ exception.” *Welco*, 617 N.E.2d at 1133. Regardless of the description used, all refer to the same theory.

64. *Id.* As the court discussed in *Flaughner*, the public policy grounds used to justify expanding the mere continuation exception in products liability cases are similar to those used to justify strict liability in tort. For example, manufacturers are in a better position than consumers to bear the costs of the injuries their products cause, and they are in a unique position to improve their products. *Flaughner v. Cone Automatic Machine Co.*, 507 N.E.2d 331, 337 (Ohio 1987); *see also* *Cyr v. B. Offen & Co.*, 501 F.2d 1145, 1153-54 (1st Cir. 1974). Another factor is the benefit the acquiring corporation derives from the accumulated goodwill of the seller corporation. *Id.* at 1154.

These policy considerations have convinced at least one court to conclude that in some cases the consequences of a sale of assets should be no different from a de facto merger for the purposes of liability. *See Turner v. Bituminous Casualty Co.*, 244 N.W.2d 873, 880 (Mich. 1976).

65. *Welco*, 617 N.E.2d at 1133 (citing *Victorson v. Bock Laundry Machine Co.*, 335 N.E.2d 275, 277 (N.Y. 1975)). The *Welco* court explained: “[t]he concerns for predictability and free transferability in corporate acquisitions that led this court to decline to expand the test for tort successor liability in *Flaughner* are even more compelling where the claim is in contract.” *Welco*, 617 N.E.2d at 1133.

66. *Id.* The court further opined:

Courts would be forced to look beyond the surface of any asset purchase to determine the extent of shared features between predecessor and successor in order to decide whether liability should attach to contractual obligations that were explicitly excluded from the transaction. The sale of a corporation’s assets is an important tool in raising liquid capital to pay off corporate debts.

*Id.*

67. *Id.* The court concluded:

For these reasons, we decline to expand the traditional exceptions to the general rule of nonliability of successor corporations, and hold that a corporation that purchases the assets of another corporation is not liable for the contractual liabilities of its predecessor corporation unless . . . [one of the four traditional exceptions to successor nonliability applies].

*Id.*; *See supra* notes 11-16 and accompanying text for discussion of four traditional exceptions.

At this point, the Majority analyzed the facts under each of the four exceptions: (1) “Vickers did not expressly or impliedly assume any contractual liability to Applied. The purchase agreement expressly disclaimed both *Welco*’s rights in its claim against Applied and its potential liability in the counterclaim”. *Welco*, 617 N.E.2d at 1134. (2) There was no

*Reasoning of the Dissent*

Justice A. William Sweeney dissented,<sup>68</sup> criticizing the Majority's refusal to embrace the "expanded continuity of enterprise doctrine."<sup>69</sup> Relying on the reasons stated in *Flaughner*, Justice Sweeney agreed with the rationale that a purchase of assets, where significant features are shared between buyer and seller, should be treated the same as a de facto merger.<sup>70</sup> Justice Sweeney did not agree, however, with those cases requiring the dissolution of the predecessor as a condition precedent to the application of the expanded mere continuation exception.<sup>71</sup> The basis for Justice Sweeney's disagreement was that to require dissolution as a condition precedent allows a successor corporation to avoid liability simply by keeping a shell corporation in the place of the predecessor.<sup>72</sup>

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evidence of a de facto merger. A de facto merger is a transaction that results in the dissolution of the predecessor corporation and is in the nature of a total absorption of the previous business into the successor. *Id.* citing *Flaughner v. Cone Automatic Machine Co.*, 507 N.E.2d 331, 338 (Ohio 1987)(A.W. Sweeney, J., dissenting). (3) The asserted indicia of mere continuation include Vickers-Welco having the same physical plant, employees, officers, and product line as Welco had. The *Welco* court held these facts only relevant to the expanded mere continuation and product line theories of successor liability, which they refused to adopt. *Welco* at 1134. (4) There is no indication that either of the parties entered into the transactions with fraudulent intent to escape liability. *Id.* "Indicia of fraud include inadequate consideration and lack of good faith". *Id.* Applied never contended they were entitled to relief under this exception, and the record failed to show that the \$8.3 million purchase price was inadequate or the result of unfair or fraudulent negotiations. *Id.*

68. Justice Sweeney was joined by Justice Douglas in his dissent. *Id.* at 1135 (Sweeney, J., dissenting).

69. *Id.* Justice A. William Sweeney did, however, concur with the Majority in that the traditional exceptions of successor corporate liability are applicable to actions for breach of contract. *Id.*

70. *Id.* This would most likely result in an implied assumption of liability. *See supra* notes 12 & 13 and accompanying text.

71. *Welco*, 617 N.E.2d at 1135 (Sweeney, J., dissenting). *See supra* note 28 and accompanying text for discussion of cases requiring dissolution of predecessor.

72. *Welco*, 617 N.E.2d at 1335 (Sweeney, J., dissenting). Justice Sweeney concluded that:

[I]liability should not be dependent upon such a facile maneuver. Instead, I would measure whether the successor corporation was a continuation of its predecessor based upon the following factors:

1. Continuity of management, personnel, physical location and assets;
2. Assumption of the ordinary business obligations and liabilities by the successor;  
and
3. The successor's presentation of itself as the continuation of the predecessor.

*Id.*

## ANALYSIS

In *Flaughner v. Cone Automatic Machine Company*,<sup>73</sup> the Ohio Supreme Court was presented with its first opportunity to confront the issue of corporate successor liability in a products liability case.<sup>74</sup> Subsequent to the *Flaughner* decision, Ohio appellate courts had been divided on whether the *Flaughner* court adopted the traditional or the expanded mere continuation exception.<sup>75</sup> *Welco Industries v. Applied Companies*,<sup>76</sup> gave the court the opportunity to clarify the *Flaughner* decision in a non-products liability case.<sup>77</sup>

*Rejection of the Expanded Mere Continuation Theory*

In *Welco*, the Ohio Supreme Court clearly embraced the traditional mere continuation exception to corporate successor nonliability: “[h]aving declined to adopt the expanded mere-continuation theory, we must decide whether Applied may recover under the traditional mere-continuation theory.”<sup>78</sup>

73. 507 N.E.2d 331 (Ohio 1987).

74. The *Flaughner* court, analyzing the facts of the case under the traditional rule of corporate successor non-liability, expressly declined to adopt the product line theory as an additional exception: “[w]e hold, therefore, that the ‘product line’ exception to corporate successor non-liability is a far-reaching and radical departure from traditional principles, such that its adoption is a matter for the legislature rather than the courts.” *Id.* at 337. However, the position of the *Flaughner* court is not quite so clear concerning whether or not they adopted the traditional or expanded mere continuation exception: “[i]t is obvious that even the expanded view has no application under these facts.” *Id.* at 336. This indicates the court’s *analysis* under the expanded mere continuation exception, but does not indicate whether the court also *adopted* the expanded mere continuation exception.

75. *Davis v. Loopco Industries*, No. 59594, 1992 WL 2590, at \*3 (Ohio App. 8 Dist.). See *McGaw v. South Bend Lathe, Inc.*, 598 N.E.2d 18, 21 (Ohio Ct. App. 1991) (“The Ohio Supreme Court in *Flaughner v. Cone Automatic Machine Co.* . . . declined to abandon the traditional rule for the *Ray* product-line approach, but, by implication, adopted the ‘expanded view of continuity’ that has emerged from the *Cyr* and *Turner* cases.”); but see *Erdy v. Columbus Paraprofessional Inst.*, 599 N.E.2d 338, 341 (Ohio Ct. App. 1991) (“[i]n *Flaughner* the Supreme Court commented that the basis-of-continuity theory lies in the continuation of the corporate entity not merely the continuation of the business operation.”). Other courts have merged the two tests. See, e.g., *Bagin v. IRC Fibers Co.*, 593 N.E.2d 405, 407 (Ohio Ct. App. 1991) (“[i]ndicia of the continuation of the corporate entity would include the same employees, a common name, the same product, [and] the same plant.”).

76. 617 N.E.2d 1129 (Ohio 1993).

77. The *Welco* court expressly declined to adopt the expanded mere continuation exception to corporate successor nonliability. The ruling was, however, narrow, as the court held: “we decline to expand the traditional exceptions to the general rule of nonliability of successor corporations, and hold that a corporation . . . is not liable for the *contractual liabilities* of its predecessor corporation unless . . . [one of the four traditional exceptions applies].” *Id.* at 1133 (emphasis added).

78. *Id.* at 1134.

The court's refusal to adopt the expanded mere continuation exception was in line with the majority of holdings in corporate successor liability cases.<sup>79</sup> Those courts that have adopted the expanded theory have done so only in products liability cases.<sup>80</sup> The reason given for expanding the mere continuation exception in product liability disputes, as opposed to contract or other types of disputes, is the influence of strong public policy considerations present in strict liability tort law decisions.<sup>81</sup> However, the policy considerations which justify liability upon subsequent manufacturers of defective products do not apply in *Welco*, a non-products liability case.<sup>82</sup>

### *Practical Implications of Expanding the Traditional Exception*

If the court had adopted the expanded mere continuation theory of successor liability, it would be nearly impossible for any person in Ohio to purchase substantially all<sup>83</sup> of the assets of a going concern business without assuming all of the liabilities of that business.<sup>84</sup> "If the courts were to hold that

79. See *supra* note 29 and accompanying text.

80. See, e.g., *Turner v. Bituminous Casualty Co.*, 244 N.W.2d 873 (Mich. 1976); *Cyr v. B. Offen & Co.*, 501 F.2d 1145 (1st Cir. 1974).

81. *Welco*, 617 N.E.2d at 1133. One basis for the expansion of the mere continuation doctrine in the products liability context is the policy that the economic burden of an injury should be shifted away from the person upon whom it falls and onto someone else even though that person was not at fault and did not cause the injury. See WILLIAM L. PROSSER, HANDBOOK OF THE LAW OF TORTS 1, at 6 (4th ed. 1971). In the products liability arena, several policy considerations have been advanced to justify holding innocent successors and others strictly liable for injuries of plaintiffs: (1) to shift the costs of injuries away from innocent plaintiffs; (2) to place the costs of injuries on manufacturers who are continuing to place the same products into the stream of commerce; and (3) to provide incentive for improvements of defective products. See Brief for Appellant *supra* note 6, at 15.

82. *Welco*, 617 N.E.2d at 1133. In *Turner*, the Supreme Court of Michigan, in introducing the case, said: "[t]his is a product liability case first and foremost." 244 N.W.2d 873, 877. The same could be said about *Welco*, only instead of product liability, *Welco* is a contract case "first and foremost".

The majority of commentary on the subject of corporate successor liability concerns the products liability arena. *Welco* was not a products liability case, and therefore, whether the expanded mere continuation exception should be adopted in products liability cases is not the focus of this analysis and will be discussed only in comparison.

83. A sale of "all or substantially all" of the corporation's property has been held to mean virtually all of its assets. Thus, it has been held that a sale of the property of the corporation which excluded cash, notes, accounts, bills receivable and real estate totalling more than \$200,000 was not a sale of all or substantially all the property and assets of the corporations within the meaning of the statute. This result followed notwithstanding that the sale might, for all practicable purposes, have terminated the corporation's customary operations as a manufacturing concern. FRED A. SUMMER & DAVID A. ZAGORE, OHIO CORPORATION LAW & PRACTICE § 10.2 (1991 Supp.); see also MODEL BUSINESS CORP. ACT ANNOTATED § 12.02, at 1336 (3d. ed. 1993).

84. Brief for Appellant, *supra* note 6, at 6. See *infra* note 83 for reasons why.

good faith purchasers who have paid fair consideration, in addition to paying for the assets, must be responsible for all liabilities of the former owners, including liabilities the parties have specifically excluded from the transaction, then the advantages of the asset purchase transaction for a going business would be destroyed in Ohio".<sup>85</sup>

In addition, purchasers of going concern businesses may structure the transaction as a purchase of assets, a purchase of shares or one of a variety of tax-free reorganizations including mergers and consolidations.<sup>86</sup> In a purchase of assets, the buyer may pay cash<sup>87</sup> for all or specified assets of the selling entity and may assume some, all, or none of the liabilities of the business.<sup>88</sup>

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85. Brief for Appellant, *supra* note 6, at 6. The common law rule in Ohio concerning a sale of assets was that neither the directors nor a majority of the shareholders had the power to sell or otherwise transfer all the property of a corporation if a single shareholder dissented. However, statutes have since been enacted in every jurisdiction containing provisions that govern the sale of assets by a corporation, thereby eliminating the common law veto power of minority shareholders. SUMMER & ZAGORE, *supra* note 83, § 10.1. As far as director and shareholder voting power is concerned, this change effectively makes a sale of assets similar to a merger or consolidation. See OHIO REV. CODE ANN. § 1701.78 (Baldwin 1993). The benefit derived is that the corporation seeking to enter into a sale of assets transaction is only required under statute to have the affirmative vote of the shareholders who have enough shares entitling them to exercise two-thirds of the voting power of the corporation; but, in order to achieve this luxury, the corporation need not enter into a statutory merger or consolidation as in the past, thus subjecting the purchasing corporation to statutory liability. OHIO REV. CODE ANN. § 1701.76 (Baldwin 1993); SUMMER & ZAGORE, *supra* note 83, § 10.1.

In addition,

[a]side from tax considerations, an asset purchase may be more attractive to the [purchasing corporation] than other methods of structuring a transaction because the buyer can pick and choose the specific assets desired and may avoid assuming some or all of the debts and liabilities of the selling entity. An asset acquisition may be the only practical method of purchasing the assets of a failing company or a company with uncertain liabilities. If the buyer is forced to assume *all* liabilities, [however], the purchase price may become . . . uncertain.

Brief for Appellant, *supra* note 6, at 7.

An additional advantage to an asset purchase transaction is that the buyer can pay cash, thus the purchase price is more reasonable and therefore more manageable and certain. If the purchaser were to be held generally liable for the debts and liabilities of the predecessor corporation, then one of the principal advantages of the asset purchase transaction would, in most cases, be lost. *Id.*

The *Welco* Majority also discussed a further advantage of the asset purchase: "[t]he sale of a corporation's assets is an important tool in raising liquid capital to pay off corporate debts." *Welco*, 617 N.E.2d at 1133.

86. See *supra* note 10 for discussion of mergers and consolidations, stock purchases, and cash-for-assets purchases and the effect as to liability of each type of acquisition.

87. The consideration for the sale of assets may consist, in whole or in part, of *money* or other property of any description. SUMMER & ZAGORE, *supra* note 83, § 10.1.

88. Brief for Appellant, *supra* note 6, at 7. See also SUMMER & ZAGORE, *supra* note 83, §



Finally, one who purchases the assets of a going concern business intends to preserve the good will of the business by continuing the business as before.<sup>89</sup> If the successor corporation could be held liable for all unassumed liabilities of the sellers merely because it continued in the same business, then the asset purchase format for the acquisition of a going concern business will not be chosen by “prudent Ohio purchasers.”<sup>90</sup>

### CONCLUSION

In *Welco Industries v. Applied Companies*, the Ohio Supreme Court was presented with the issue of whether to expand the mere continuation exception of corporate successor nonliability. The facts involved a contractual claim, not a products liability dispute. The parties were both corporations negotiating at arm’s-length, not an innocent consumer against a powerful corporation. The purchase agreement excluding liability was clear and concise, not vague and subject to interpretation.

As a matter of both legal conclusion and factual analysis, the *Welco* court reached the proper decision in refusing to expand the mere continuation exception. The Ohio Supreme Court’s decision to uphold the traditional corporate successor liability doctrine has preserved the cash-for-assets transaction as an effective means of corporate acquisition in Ohio.

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10.4. Where a corporation sells or otherwise disposes of all or substantially all of its assets to a bona fide purchaser, for value, and without notice of claims, the purchasing corporation takes the property free of all liabilities. *Id.* However, the purchaser is liable to the extent that the purchaser assumes the obligations of the selling corporation. *Id.*

89. Assor, *supra* note 25, at 136-37. For example, the successor corporation will often operate the predecessor’s business with the same facilities, the same employees, the same management, and production of the same products. However, if the court were to expand successor liability to depend on these factors, as Applied urged it to do, this would effectively eliminate any preservation of good will in future corporate cash-for-asset acquisitions. See Brief for Appellant, *supra* note 6, at 7.

90. *Id.* In addition, “[s]ellers who are burdened with uncertain or large debts would not be able to realize fair value for their assets, which would increase the need for sellers to resort to bankruptcy proceedings” instead of selling their assets to raise liquid capital to help pay for the debts. *Id.* *Welco*, 617 N.E.2d at 1133.