Arkansas Association of Defense Counsel

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Successor Liability

The sale of a business is a commonplace occurrence. Transactions take place on a weekly basis where one entity purchases the assets of another. But what if an accident occurred under the previous owner's watch? Is the new owner liable? Typically, the answer is no. But in certain circumstances, a new owner can be liable for acts that occurred while the business was under the operation of the previous owner. This idea is successor liability.

Generally, a corporation which purchases assets from another entity does not purchase the selling entity's liabilities. *Swayze v. A.O. Smith Corp.*, 694 F. Supp. 619, 622 (E.D. Ark. 1988); *Ford Motor Co. v. Nuckolls*, 320 Ark. 15, 26, 894 S.W.2d 897, 903 (1995). There are four exceptions to this rule:

> (1) where the transferee assumes the debts and obligations of the transferor by express or implied agreement; (2) where there is a consolidation or merger of the two corporations; (3) where the transaction is fraudulent or lacking in good faith; and (4) where the purchasing corporation is a mere continuation of the selling corporation.

Swayze, 694 F. Supp. at 622; *see also Nuckolls*, 320 Ark. at 26, 894 S.W.2d at 903.

The first exception is basic contract law. If the predecessor and successor business entities include a provision in a contract, such as the Asset Purchase Agreement or Sale Agreement, that the successor entity assumes the debts and obligations of the predecessor entity, the successor entity will be liable for acts that occurred during the time the business was under the control of the predecessor entity. The parties would take into account the risk of accepting the liability of the predecessor in negotiating the purchase.

With respect to a successor corporation, "the general rule is that, after a merger, the resulting corporation is liable for the debts of the other corporation." *Nuckolls*, 320 Ark. at 27-28. The Arkansas Supreme Court in *Nuckolls* noted "public policy requires that the obligations of the extinguished corporation in a merger survive as obligations of the surviving corporation." *Id.* at 27

(quoting 19 Am. Jur. 2d *Corporations* § 2715 (1986)). Thus, under the second exception, a court looks beyond the form of an asset sale to determine whether there has in substance been a merger or consolidation. If so, the purchaser is responsible for the seller's liabilities. A court will consider the following factors in determining whether there has been a de facto merger: (1) a continuation of management and personnel and general business operations; (2) a continuity of shareholders resulting from the purchasing corporation paying for the assets with shares of its own stock so the selling corporation stockholders become a constituent part of the purchasing corporation; (3) the seller corporation ceasing ordinary business operations and dissolving as soon as possible; and (4) the purchasing corporation assuming those obligations necessary to continue normal, ordinary business operations" in determining whether there is a de facto merger. *ARE Sikeston Ltd. P'ship v. Weslock Nat., Inc.*, 120 F.3d 820, 829 (8th Cir. 1997).

Third, a transaction that is fraudulent or lacking in good faith will subject a successor entity to liability. Rule 8 of the Arkansas Rules of Civil Procedure provides that when a party pleads a claim of fraud, they must do so with "particularity." Absent particular facts that a transaction was fraudulent, a complaint should not survive a motion to dismiss based on successor liability. In situations where the sale of the business was the result of an arm's length transaction, this exception should not apply.

Fourth, the majority of Arkansas courts considering the "mere continuation" exception emphasize a common identity of officers, directors, and stock between the selling and purchasing corporations. *Campbell v. Davol, Inc.*, 620 F.3d 887, 892 (8th Cir. 2010) (applying Arkansas law and quoting *Swayze*, 694 F. Supp. at 622-23). If the purchasing and selling entities carefully craft the sale so there is no overlap with stock, officers and directors, this exception should not apply. Judge Dawson in the Western District of Arkansas determined that although the Chief Executive Officer of the predecessor entity continued to serve as a consultant, and the successor entity continued to sell the same product and used the same website and trademark it was not enough to establish the successor was a mere continuation of the predecessor. *See Hughes v. Bentley Indus., LLC*, No. 11-6025, 2013 WL 5405677, at *4 (W.D. Ark. Sept. 25, 2013). Judge Howard similarly ruled that the use of the same logo and sale of the same product were insufficient to create an issue of fact

with respect to whether the successor was a mere continuation of the predecessor. *See Swayze*, 694 F. Supp. at 623-24 (E.D.Ark.1988).

Other states have found that two additional exceptions can serve as the basis for imposing successor liability: continuity of enterprise and product line. The continuity of enterprise exception states a successor corporation can be liable where: (1) there is a continuation of the enterprise of the seller corporation, so that there is a continuity of management, personnel, physical location, assets, and general business operations; (2) the seller corporation ceases its ordinary business operations, liquidates, and dissolves as soon as legally and practically possible; and (3) the purchasing corporation assumes those liabilities and obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operations of the seller corporation. *Turner v. Bituminous Cas. Co.,* 244 N.W.2d 873 (Mich. 1976).

The product line exception applies when "a party that acquires a manufacturing business and continues the output of its line of products…assumes strict tort liability for defects in units of the same product line previously manufactured [by the seller.]" *Ray v. Alad Corp*, 560 P.2d 3, 11 (Cal. 1977). No Arkansas court has applied these exceptions, and in all likelihood, the Arkansas Supreme Court would reject the addition of these exceptions to the general rule. *See Campbell v. Davol, Inc.*, 620 F.3d 887, 894 (8th Cir. 2010) (noting that given the general rule and its exceptions have been part of Arkansas law for almost one hundred years, and because no state case has called "into question or … otherwise showed dissatisfaction with the status quo," the Arkansas Supreme Court would likely reject the non-traditional continuity of enterprise and product line exceptions) (citing *Tucker v. Paxson Mach. Co.*, 645 F.2d 620, 626 n.15 (8th Cir. 1981); *Swayze*, 694 F. Supp. at 623-24; *Reed v. Armstrong Cork Co.*, 577 F. Supp. 246, 248 (E.D. Ark. 1983)).

Because of the varying laws on successor liability among the states, additional consideration should be given to the choice of law where the successor liability question will be determined. It is also important to note that an entity may be considered a "purchaser" even if it did not purchase the assets through a typical sale. If an entity acquires all or substantially all of the predecessor's assets and property, it is considered a purchaser. *See Granjas Aquanova S.A. de C.V. v. House Mfg. Co.*, No. 3:07CV00168 BSM, 2010 WL 2243673, at *3 (E.D. Ark. June 4, 2010) (buyer considered

purchaser where assets acquired at action and purchaser used seller's manufacturing facility, vehicles, and confidential and proprietary information by way of lease agreements); *Patin v. Thoroughbred Power Boats Inc.,* 294 F.3d 640, 651–652 (5th Cir.2002) (noting that transfer of assets does not necessarily require a sale); *Peters Jewelry Co. V. C & J Jewelry Co.*, 124 F.3d 252 (1st Cir.1997) (intervening foreclosure sale does not exempt an asset purchaser from successor liability); *United States v. Vertac Chemical Corp.*, 671 F. Supp. 595 (E.D. Ark. 1987), *vacated on appeal, U.S. v. Vertac Chemical*, 855 F.2d 856 (8th Cir. 1988) (transfer occurred where purchasing corporation leased predecessors property).

While it is easy for a plaintiff to name a successor corporation as a defendant in a lawsuit, a motion to dismiss should be filed when there are no facts pled to support an exception to the general rule of no successor liability. A complaint which only rephrases the elements of a cause of action is insufficient. *See Perrodin v. Rooker,* 322 Ark. 117, 120-121, 908 S.W.2d 85 (1995) (complaint which "touches" on the elements of a cause of action but fails to set forth any facts which gave rise to the elements insufficient to survive motion to dismiss).

The AADC thanks Amber Prince of Conner & Winters for writing this article.

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