

# Products Liability and Successor Corporations: Protecting the Product User and the Small Manufacturer Through Increased Availability of Products Liability Insurance.

*The recent expansion of successor products liabilities threatens both the product user and the small manufacturer. Modification of both tort and insurance law is necessary to make appropriate insurance coverage available. This article discusses legislative reforms which will increase the availability of products liability insurance and thus enable small businesses to safely acquire manufacturing enterprises without attempting to dodge successor liability.*

## INTRODUCTION

Small corporations planning to acquire the assets of another corporation face the prospect of being held liable for injuries caused by products manufactured and sold by the purchased corporation.<sup>1</sup> In the past, this was not the case since successor liability was governed solely by corporate law which dictates that asset acquisitions do not automatically transfer the seller's liabilities.<sup>2</sup> Although there are several exceptions to the corpo-

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<sup>1</sup> See, e.g., *Ray v. Alad*, 19 Cal. 3d 22, 560 P.2d 3, 136 Cal. Rptr. 574 (1977).

This comment deals solely with the liability of product manufacturers for injuries caused by their predecessor's products. The liability of a product seller for injuries caused by a product sold, but not manufactured, by the seller is not discussed. For a discussion of the liability of product sellers see 50 CAL. JUR. 3d, *Products Liability* § 27 (1970).

<sup>2</sup> For a complete collection of cases involving this general rule, see 15 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 7122 n.1 (rev. perm. ed. 1973). Recent cases which have applied the general rule include *Klobdanz v. Joy Mfg. Co.*, 288 F. Supp. 817 (D. Colo. 1968) (applying California law); *Ortiz v. South Bend Lathe*, 46 Cal. App. 3d 842, 120 Cal. Rptr. 556 (2d

rate rule, acquisition planners<sup>3</sup> were able to avoid these exceptions with relative ease.<sup>4</sup> In recent years, however, several courts have developed an additional theory for the transfer of products liabilities in asset acquisitions.<sup>5</sup> These courts hold that as a matter of tort law, a corporation which purchases the assets of a manufacturing corporation might automatically assume the products liabilities of the predecessor corporation.<sup>6</sup>

The California Supreme Court recently adopted the new tort theory, thereby forcing prospective purchasers of California corporations to plan acquisitions in light of the new law.<sup>7</sup> The conflict of laws rule of the forum will determine which state's substantive law is to be applied.<sup>8</sup> Frequently, the jurisdiction where the injury occurred is held to have the most substantive contact with the issues and the court will therefore apply the law of that state.<sup>9</sup> Since products manufactured by small corporations lo-

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Dist. 1975); *Schwartz v. McGraw Edison Co.*, 14 Cal. App. 3d 767, 92 Cal. Rptr. 776 (2d Dist. 1971).

<sup>3</sup> Acquisition planners may be members of the acquiring corporation or persons outside the corporation selected for their expertise in corporate acquisitions. Planners help corporate management to best achieve its goals. The role of the acquisition planner depends largely on the particular corporation and the kind of planning assistance it has requested. For example, acquisition planners help determine the goals of management, discuss the alternatives available in obtaining those goals, help management to select a plan, and, finally, help implement that plan. For an extensive discussion of the role of the corporate planning director see J. BROWN, *PLANNING AND THE CORPORATE PLANNING DIRECTOR* (1974).

<sup>4</sup> Liabilities will transfer in an asset acquisition when (1) the purchaser expressly or impliedly agrees to assume the seller's obligations, (2) the transaction amounts to a consolidation or merger of the two corporations, (3) the purchasing corporation is a mere continuation of the old corporation, or (4) the parties enter the transaction fraudulently in order to escape liability. For a discussion of these exceptions and related planning tips see notes 20-48 and accompanying text *infra*.

<sup>5</sup> See, e.g., *Ray v. Alad*, 19 Cal. 3d 22, 560 P.2d 3, 136 Cal. Rptr. 574 (1977); *Turner v. Bituminous Gas Co.*, 397 Mich. 406, 244 N.W.2d 873 (1976).

<sup>6</sup> The first state to adopt the new tort exception was Michigan in the case of *Turner v. Bituminous Gas Co.*, 397 Mich. 406, 244 N.W.2d 873 (1976).

<sup>7</sup> *Ray v. Alad*, 19 Cal. 3d 22, 560 P.2d 3, 136 Cal. Rptr. 574 (1977).

<sup>8</sup> See Heitland, *Survival of Product Liability Claims in Assets Acquisitions*, 34 Bus. Law. 490 (1979). For a discussion of the conflict of laws rule as applied by California courts, see *Hurtado v. Superior Court*, 11 Cal. 3d 574, 522 P.2d 666, 114 Cal. Rptr. 106 (1974).

<sup>9</sup> See Heitland, *supra* note 8. The California Supreme Court has held that California law is to be applied in cases based upon injuries arising within the

cated in California will most likely be used within the state, the majority of product-related injuries will occur in California. As a result, products liability suits will be governed by California law and the new tort theory will be applicable. It is essential that corporations planning acquisitions of California corporations be aware of this law if they are to protect themselves against successor liability.

Small corporations are more threatened than larger corporations by potential liability for injuries caused by a predecessor's product. Small corporations have limited assets<sup>10</sup> and thus face possible financial destruction should the predecessor's products give rise to multiple personal injury suits.<sup>11</sup> The economy as a whole suffers when small successor corporations lose such cases since corporate acquisitions are discouraged due to business

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state. *Hurtado v. Superior Court*, 11 Cal. 3d 574, 522 P.2d 666, 114 Cal. Rptr. 106 (1974). In *Hurtado*, a resident of Mexico was killed in an automobile collision in California. The decedent's widow and children, all residents of Mexico, brought a wrongful death action in a California court. Applying the conflict of laws rules of California, the court held that California substantive law should control. The Court based its finding on the state's interest in applying its own law to California defendants who allegedly caused personal injuries within its borders. *Id.*

<sup>10</sup> Definitions of the small business vary. The United States Small Business Act defines the small business as "one which is independently owned and operated and which is not dominant in its field of operation." 15 U.S.C. § 632 (1976). In addition to the foregoing criteria, the Act states that number of employees and dollar volume may be considered. *Id.* In 1959, the Senate Small Business Committee defined the small business as one with fewer than 250 employees, \$500,000 in total assets, and \$1,000,000 in business volume. J. BUNZEL, *THE AMERICAN SMALL BUSINESSMAN* 31 (1962). The Department of Commerce defines the small business as any manufacturing plant that employs 100 persons or fewer, a wholesale establishment with annual sales less than \$200,000, or other business with sales or receipts less than \$400,000 a year. 25 *ENCYCLOPEDIA AMERICANA* 48 (1976).

<sup>11</sup> Personal injuries frequently give rise to hundreds of thousands of dollars in damages. See, e.g., *Johnson v. Pacific Southwest Company*, *JURY VERDICTS WEEKLY*, Dec. 28, 1979, at 15 (plaintiff awarded \$3,000,000 in wrongful death action arising from airplane crash in which defendant's liability was uncontested); *Taylor v. Volkswagon of America*, *JURY VERDICTS WEEKLY*, May 11, 1979, at 16 (plaintiff awarded \$3,125,000 for quadriplegic condition incurred when a defectively designed door latch allowed plaintiff to eject from his van and strike his head); *Anderson v. Sperry Rand*, *JURY VERDICTS WEEKLY*, March 30, 1979, at 13 (plaintiff awarded \$2,605,836 for paraplegic condition incurred when defective steering link caused vehicle to leave the road and eject plaintiff).

planners' fears of being held so liable. Furthermore, the marketability of on-going corporations is diminished, perhaps forcing the sellers into the undesirable process of liquidation proceedings.<sup>12</sup> Currently, small manufacturing corporations comprise ninety percent of the nation's manufacturing enterprises.<sup>13</sup> If small manufacturing corporations liquidate rather than transfer ownership, the chances that the corporations will be replaced by other successful small corporations are decreased. As a result, there will be fewer small manufacturers and the larger more centralized manufacturers will increase their production to meet the demands of the marketplace. Greater centralization of business is adverse to the long held American notion that the small business represents independence, freedom and perseverance.<sup>14</sup> To ensure the survival of small business manufacturing, planners must plan acquisitions taking the new law into account rather than avoid acquisitions altogether.

The insurance market has caused the small corporation to dodge successor liability in the corporate acquisition process.<sup>15</sup> Most small corporations are unable to secure policies covering liability for injuries caused by the predecessor's products. When such insurance is available, the cost is often prohibitive. Corporations unable to secure insurance policies are greatly disadvantaged since they cannot pass the costs of transferred liabilities onto customers without faltering in a market dominated by non-

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<sup>12</sup> Selling the assets of an on-going corporation is preferable to a sale of the assets in liquidation proceedings. A sale of assets by a successful on-going business ensures the successor a degree of security in establishing the business and keeps waste to a minimum. A sale of liquidated assets, on the other hand, prevents the new owner of the assets from benefitting from the business relations and procedures previously established by the seller. The stability built by the predecessor is lost and the new owner must start from the beginning with increased risks of business failure. In addition, a sale of assets in liquidation proceedings is often cumbersome for the shareholders since buyers must be found for each asset and sales made in a piecemeal manner.

<sup>13</sup> 25 *ENCYCLOPEDIA AMERICANA* 48 (1976). For information on the growing strength of the small business in American economy see Singer, *The Small Business Lobby Is Reaching For The Big Time*, 11 *NAT'L J.* 311 (1979).

<sup>14</sup> For a discussion of the importance of small business in the American heritage see J. BUNZEL, *supra* note 10. See generally Comment: *A Matter of Survival: How to Defend Small Business Cooperative Activity Against Antitrust Challenge*, this issue at 755.

<sup>15</sup> For a discussion of the inability of small corporations to obtain products liability insurance see notes 91-94 and accompanying text *infra*.

successor corporations whose prices do not reflect the costs of transferred liabilities. When unable to insure against successor liability, the purchaser must attempt to acquire the manufacturing enterprise so as to totally avoid a transfer of liability. The result of such planning is that injured parties are often left without a viable defendant. The inability of small manufacturers to insure themselves against successor liability makes it impossible to accommodate both the product user's right to adequate compensation for product-related injuries and the small corporation's need to protect its business from unmanageable liabilities. Modification of products liability and insurance law is necessary to increase the availability and affordability of products liability insurance for the small manufacturer. Until the legislature enacts appropriate legislation, the small manufacturer must, in an effort to protect its own investment, plan carefully to avoid a transfer of liabilities.

Successor liability under California law can be based on traditional corporate rules or on the newly-recognized tort theory. Therefore, this comment discusses planning acquisitions with respect to both corporate law and tort law. The comment closes with several proposals for tort law and insurance reform that will protect product users as well as small corporations planning to purchase manufacturing enterprises.

## I. PLANNING ACQUISITIONS OF SMALL MANUFACTURING CORPORATIONS

### A. *Avoiding a transfer of liability through the corporate rules*

Corporate acquisitions can be accomplished in one of three ways. The acquisition can be made in conformance with statutory requirements for merger or consolidation.<sup>16</sup> There can be a

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<sup>16</sup> A statutory merger is a transfer of all the assets of the acquired corporation pursuant to the requirements of the relevant local statute. See CAL. CORP. CODE § 1107 (West 1979); W. FLETCHER, *supra* note 2, § 7041. In the merger, the acquired corporation ceases to exist and the assets of the acquired corporation transfer to the purchasing corporation. See BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS § 8020 (4th ed. 1979). The merger differs from a mere purchase of corporate assets. A merger is the absorption of one corporation by another, with the buying corporation retaining its name and corporate identity but adding the capital and powers of the merged corporation. W. FLETCHER, *supra* note 2, § 7041, at 7. The merger, therefore, is essentially a

sale of all stock of the acquired corporation in exchange for stock, cash or other property.<sup>17</sup> Finally, there can be a sale of substantially all of the assets of the acquired corporation in exchange for stock, cash or other consideration. The only method of acquisition which does not transfer liability for injuries caused by the predecessor's product is the purchase of assets. Statutory mergers, consolidations and stock purchases transfer the liabilities of the predecessor to the successor corporation.<sup>18</sup>

The traditional corporate rule that liabilities do not transfer in a purchase of assets is related to the rules of property law. That is, a corporation purchasing another corporation's assets is basically a purchaser of property, and the purchaser who gives

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readjustment of existing interests. In comparison, a sale of corporate assets is a vehicle through which the vendor parts with its entire interest in the corporation in exchange for cash and nothing more. *Id.* § 7044, at 19 n.3.

A consolidation is similar to the merger, except that both corporations cease to exist and a whole new corporation is formed. *Id.* § 7041, at 6-8; 15 CAL. JUR. 3D, *Corporations* § 411 (1979). In a consolidation, the shareholders of both the acquired and the acquiring corporations are issued shares of the new corporation. The California legislature eliminated the consolidation because it is an outmoded procedure. The Code now treats transactions resembling the old consolidation as mergers. REPORT OF THE ASSEMBLY SELECT COMMITTEE ON THE REVISION OF THE CORPORATIONS CODE 91 (1975). In both the statutory merger and the consolidation, the corporate entity which remains after the acquisition is completed is responsible for all of the liabilities of the purchased corporation, including products liability claims. Statutes in all jurisdictions now impose this rule. 15 CAL. JUR. 3D, *Corporations* § 424 (1979).

<sup>17</sup> When a corporate acquisition is made through a sale of stock, the acquired corporation becomes a subsidiary of the acquiring corporation. See CAL. CORP. CODE § 189 (West 1979). In this instance, the original seller of the product remains in existence as a subsidiary and product dissatisfaction claims can be brought directly against it. Except in instances where the parent-subsidiary relationship is improperly maintained, the parent of the subsidiary, the acquiring corporation, is immune from direct liability. The parent is, however, vulnerable to the extent of its investment in the subsidiary since the subsidiary, itself, remains liable for injuries caused by products manufactured before the acquisition. For a discussion of rules regarding liability of the parent corporation for the products liabilities of its subsidiary see notes 80-81 and accompanying text *infra*.

<sup>18</sup> See notes 16-17 *supra*. Although products liabilities transfer in these acquisitions, there are substantial tax advantages that accompany the transactions. The Internal Revenue Code categorizes these types of acquisitions as reorganizations and gives special treatment to the gains or losses realized. I.R.C. § 368. For a detailed discussion of special tax treatment afforded in corporate reorganizations see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* §§ 14.01-14.57 (3d ed. 1971).

adequate consideration and is without notice of prior claims against the property acquires no liability for those claims.<sup>19</sup> Courts developed this doctrine to facilitate the transfer of property and its application to corporate acquisitions serves the same function.

There are, however, exceptions to the general rule which necessitate careful planning even where the acquisition involves a purchase of assets. In an asset purchase, the liabilities of the predecessor will transfer to the successor if the purchaser expressly or impliedly agrees to assume the seller's obligations.<sup>20</sup> Liability will also transfer if the transaction amounts to a consolidation or merger of the two corporations<sup>21</sup> or if the purchasing corporation is a mere continuation of the old corporation.<sup>22</sup> Finally, liability will pass to the successor if the parties enter the transaction fraudulently in order to escape liability.<sup>23</sup> In planning a corporate acquisition it is essential that the planner carefully examine the acquisition in order to guarantee that the purchase falls outside the scope of all four exceptions.

The planner must word the acquisition agreement to preclude the finding of an express or implied agreement by the successor to assume the predecessor's products liabilities. To ensure that courts do not interpret the purchase contract to include such an agreement, the contract should specifically state that the liabilities do not transfer. This statement is particularly important in contracts in which there is a broadly worded assumption clause for other liabilities.<sup>24</sup> Courts do not always interpret contracts

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<sup>19</sup> For a discussion of the bona fide purchaser doctrine regarding real property sales see J. CRIBETT, *PRINCIPLES OF THE LAW OF PROPERTY* 178-79, 221-24 (1962).

<sup>20</sup> *E.g.*, *Bouton v. Litton Indus., Inc.*, 423 F.2d 643, 652 (3d Cir. 1970).

<sup>21</sup> *E.g.*, *Knapp v. North Am. Rockwell Corp.*, 506 F.2d 361 (3d Cir. 1974), *cert. denied*, 421 U.S. 965 (1975); *Shannon v. Samuel Langston Co.*, 379 F. Supp. 797, 801 (W.D. Mich. 1974). For a general discussion of the characteristics of a merger see note 16 *supra*.

<sup>22</sup> *E.g.*, *Bishop v. Dura Lite Mfg. Co.*, 489 F.2d 710 (6th Cir. 1973); *McKee v. Harris-Seybold Co.*, 109 N.J. Super. 480, 288 A.2d 585 (App. Div. 1972).

<sup>23</sup> *Pierce v. Riverside Mortgage Sec. Co.*, 25 Cal. App. 2d 248, 257-58, 77 P.2d 226, 230-31 (4th Dist. 1938); See W. FLETCHER, *supra* note 2, § 7122, at 188; *id.* § 7125, at 201. See also Annot., 49 A.L.R. 3d 881, 883-90 (1973).

<sup>24</sup> Courts may treat a transfer of several general liabilities as an indication that the parties were impliedly including a transfer of products liabilities. For example, in *Bouton v. Litton Indus., Inc.*, 423 F.2d 643 (3d Cir. 1970), the purchasing corporation expressly agreed to assume the transferor's liquidated

which expressly transfer certain specific liabilities and obligations as impliedly transferring products liabilities.<sup>26</sup> The purchasing corporation is most secure, however, when the contract expressly denies a transfer of the predecessor's products liabilities.

Courts sometimes rely on the de-facto merger doctrine to find a transfer of the seller's liabilities where the buyer has acquired the seller through a purchase of its assets.<sup>26</sup> Under this doctrine, courts treat a sale of assets as a merger when the transfer does not meet the formal requirements for a statutory merger but has the basic characteristics of a merger.<sup>27</sup> In applying the doctrine, courts stress a number of factors. These include the fact that the

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but known liabilities arising in the normal and ordinary course of business, undetermined liabilities arising out of certain specific contracts and commitments, and liabilities and obligations in respect of all other contracts and commitments entered into in the regular and ordinary course of the transferor's business. *Id.* at 648-49. The court based its finding of an implicit assumption of products liabilities on the contract's broad language concerning the transfer of liabilities. It concluded that the parties had clearly envisioned that the risk of insuring against the claims arising from future accidents was one assumed by the party carrying on the transferred business. In addition, the court relied on the fact that the purchase agreement included a transfer of all insurance policies of which one was a products liability policy.

<sup>25</sup> In *Kloberdanz v. Joy Mfg. Co.*, 288 F. Supp. 817 (D. Colo. 1968) (applying California law), a corporation acquiring certain assets of a manufacturer of oil drilling equipment expressly agreed to assume the seller's liabilities for accounts payable, payroll taxes, accrued wages and compensation, outstanding purchase orders, and outstanding obligations for supplies and components to be used in the manufacture of the seller's products. The court found no implied assumption of products liabilities since the transfer of tort liabilities was not expressly included in the contract.

In *Ortiz v. South Bend Lathe*, 46 Cal. App. 3d 842, 120 Cal. Rptr. 556 (2d Dist. 1975), an asset purchase agreement provided that the purchaser would assume certain liabilities of the seller, other than liability on its products, but expressly stated that the purchaser would not assume any liability, debt or obligation except those expressly assumed under the agreement. The agreement also stated that the seller would remain solely responsible for all of its other known or unknown liabilities, debts or obligations arising prior to or subsequent to the closing. Here again, the court found no express or implied assumption by the purchaser for the products liabilities of the predecessor.

<sup>26</sup> See *Shannon v. Samuel Langston Co.*, 379 F. Supp. 797, 800-01 (W.D. Mich. 1974); *Schwartz v. McGraw Edison Co.*, 14 Cal. App. 3d 767, 780-81, 92 Cal. Rptr. 776, 783-84 (2d Dist. 1971).

<sup>27</sup> For an extensive discussion of the de-facto merger doctrine as it relates to products liability see note, *Assumption of Products Liability in Corporate Acquisitions*, 55 B.U.L. Rev. 86, 96-100 (1975).



acquiring corporation used its own stock as consideration, rather than cash or promissory notes;<sup>28</sup> the fact that the purchasing contract required the acquired corporation to dissolve;<sup>29</sup> and evidence of continuity of management.<sup>30</sup> When these factors are present the acquisition closely resembles a statutory merger and courts classify the transaction as a de facto merger. This result causes the successor corporation to be liable for all debts of the predecessor and ensures that merging corporations do not escape liability by failing to comply with the statutory merger formalities.

To avoid categorization as a de-facto merger the purchaser must acquire the assets with cash rather than shares. Moreover, the purchaser must not retain a substantial number of the seller's officers or employees. In addition, the purchasing contract should not require the seller to dissolve. Rather, the purchasing corporation should encourage the continued existence of the seller.<sup>31</sup> When the plaintiff has a cause of action directly against the manufacturer of the injury-causing product, courts are less willing to extend a cause of action against the successor corporation.<sup>32</sup> Thus, the purchaser should stop short of

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<sup>28</sup> See Note, *Postdissolution Product Claims and the Emerging Rule of Successor Liability*, 64 V.L. REV. 861, 867 n.33 (1978).

<sup>29</sup> See *Kloberdanz v. Joy Mfg. Co.*, 288 F. Supp. 817, 821 (D. Colo. 1968). In *Kloberdanz* the critical test was whether the two companies involved in the transfer were "strangers" before and after the sale. The fact that the new company retained the officers of the old corporation, coupled with the immediate dissolution of the seller would be strong evidence of a de facto merger. The requirements were not met under the circumstances and the court ruled for the defendant. *Id.*

<sup>30</sup> See Note, *supra* note 28, at 867.

<sup>31</sup> However, the selling corporation may prefer to liquidate in order to take advantage of favorable tax treatment afforded corporations upon liquidation. The Internal Revenue Code provides that corporations recognize neither gain nor loss on the distribution of their assets in partial or complete liquidations. I.R.C. §§ 336, 337. If the shareholders desire to continue some type of business, they might decide to liquidate the old corporation and form a new corporate entity with the proceeds from the asset sale. However, if the Internal Revenue Service recognizes the series of transactions as a reincorporation of the selling corporation, rather than an actual liquidation, the shareholders may lose the tax protections afforded upon liquidation. See B. BITTKER & J. EUSTICE, *supra* note 18 § 11.05. For a complete discussion of the effects of corporate liquidation upon federal income taxation of corporations and shareholders see *id.* §§ 11.01-11.71.

<sup>32</sup> See note 71 *infra*.

buying all of one seller's assets in order to allow the seller to continue business in some substantial manner.<sup>33</sup> This complicates an acquisition since the buyer may have to shop elsewhere for the remaining necessities of production and the seller might refuse to sell only part of its assets. It is worth the planner's time, however, to compare the costs involved in making an incomplete purchase with the costs of potential products liabilities should a court later find the transaction to be a de-facto merger.

To prevent a transfer of liabilities, acquisition planners must also avoid characterization of the asset transfer as a continuation of the acquired corporation's business. Though theoretically distinct, continuations and de-facto mergers are based on similar factors.<sup>34</sup> A court is most likely to find a continuation where there is continuity of management, business operations, and a majority of stockholders from the selling corporation.<sup>35</sup> However, some courts will not label the acquisition a continuation unless the purchaser gave insufficient consideration.<sup>36</sup>

Avoiding characterization of an acquisition as a continuation requires precautions similar to those necessary to avoid characterization as a de-facto merger. For example, the purchase should be made with cash rather than stock.<sup>37</sup> In addition, the

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<sup>33</sup> The seller's continued existence must be substantial. In *Knapp v. North Am. Rockwell Corp.*, 506 F.2d 361 (3d Cir. 1974), *cert. denied*, 421 U.S. 965 (1975), assets were purchased with stock in the acquiring corporation. The seller retained its articles of incorporation, various corporate records and real estate and did not dissolve for 18 months. Nonetheless, the court found that the acquisition met the seller dissolution requirement for a de facto merger. The court concluded that the continued existence was insubstantial and brief and stressed that the purchase contract had required that the seller dissolve as quickly as possible. The conclusion that the acquisition was a de-facto merger was largely prompted by the court's belief that a successor corporation should not be permitted to escape liability by delaying formal dissolution of the predecessor. Though decided under Pennsylvania law, *Knapp* is frequently cited by California courts. See, e.g., *Ortiz v. South Bend Lathe*, 46 Cal. App. 3d 842, 120 Cal. Rptr. 556 (2d Dist. 1975); *Schwartz v. McGraw Edison Co.*, 14 Cal. App. 3d 767, 92 Cal. Rptr. 776 (2d Dist. 1971).

<sup>34</sup> See Note, *Expanding the Products Liability of Successor Corporations*, 27 HASTINGS L.J. 1305, 1313-14 (1976).

<sup>35</sup> See, e.g., *Ray v. Alad*, 19 Cal. 3d 22, 29, 560 P.2d 3, 7-8, 136 Cal. Rptr. 574, 578 (1977); *Ortiz v. South Bend Lathe*, 46 Cal. App. 3d 842, 120 Cal. Rptr. 556 (2d Dist. 1975).

<sup>36</sup> See, e.g., *Ortiz v. South Bend Lathe*, 46 Cal. App. 3d 842, 847, 120 Cal. Rptr. 556, 558-59 (2d Dist. 1975).

<sup>37</sup> A cash purchase will prevent a continuity of a majority of shareholders

management of the successor corporation should not be the same as that of the predecessor. To some degree, continuity of business operations is inevitable if the successor corporation desires to manufacture the same type of product as did the predecessor. However, if the planner avoids the other three prerequisites: continuity of management, continuity of shareholders, and inadequate consideration, the acquisition should be safe.

For public policy reasons, a federal court recently expanded the continuation theory of successor liability. In *Cyr v. B. Offen & Co.*,<sup>38</sup> the First Circuit found successor liability in spite of the payment of adequate consideration and a lack of continuity in management and shareholders. In *Cyr*, key employees formed a new corporation to purchase the assets of the B. Offen Company manufacturing business<sup>39</sup> following the death of the business' sole proprietor.<sup>40</sup> The purchasers did not notify customers of the original company that a new or different company was beginning. The new company advertised that it was an on-going, forty year old business, and produced the same product previously manufactured by the old company. Subsequently, two employees of a printing company were injured by a printing press purchased from the original B. Offen Company, and brought suit against the successor. Though the two corporations had no stockholders, directors or managers in common, the court held

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which results when the owners of the selling corporation receive stock in the successor.

<sup>38</sup> 501 F.2d 1145 (1st Cir. 1974).

<sup>39</sup> The B. Offen Company manufactured printing presses and dryers. The *Cyr* opinion states that the B. Offen Company was a sole proprietorship at the time it manufactured the product in question. The court, however, applies all of the corporate rules regarding the transfer of liabilities in asset acquisitions and consistently refers to the predecessor as a corporation. It is unclear whether the predecessor was in fact a corporation or whether the court is indicating that the corporate rules apply regardless of whether the predecessor manufacturing business was incorporated. Only one of the cases citing *Cyr* raises this issue. In *Rawlings v. D.M. Oliver, Inc.*, 97 Cal. App. 3d 890, 159 Cal. Rptr. 119 (4th Dist. 1979), the defendant successor corporation had purchased assets from a sole proprietor. The *Oliver* court cited *Cyr* in support of its finding that the rules for successor liability apply to nonincorporated businesses. *Id.* at 900, 159 Cal. Rptr. at 124.

<sup>40</sup> The name of the new corporation, B. Offen & Co., Inc., was almost identical to that of its predecessor, the B. Offen Company. *Cyr v. B. Offen & Co.*, 501 F.2d 1145, 1151 (1st Cir. 1974).

the corporation liable.<sup>41</sup> The court found a sufficient basis for determination of continuity because the successor corporation manufactured the same product with the same employees and failed to notify customers of the change in ownership.<sup>42</sup>

Products liability policy prompted the decision that liability should transfer. According to the *Cyr* court, manufacturers rather than consumers should bear the risks inherent in production.<sup>43</sup> The court also stressed that successor corporations can calculate and insure against risks which accompany the acquisition of the predecessor's manufacturing enterprise.<sup>44</sup> Having concluded that public policy dictated the finding of transferred liability, the court fit the corporate acquisition into the continuation mold by stressing continuity of product line, employees and location. The California Supreme Court, however, has rejected the *Cyr* court's expansion of the continuation theory, thereby retaining the requirements previously established for the characterization of a successor corporation as a mere continuation of its predecessor.<sup>45</sup>

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<sup>41</sup> *Id.* at 1156.

<sup>42</sup> *Id.* at 1153-54.

<sup>43</sup> See note 44 *infra*.

<sup>44</sup> The court stated:

The very existence of strict liability for manufacturers implies a basic judgment that the hazards of predicting and insuring for risk from defective products are better borne by the manufacturer than by the consumer. The manufacturer's successor, carrying over the experience and expertise of the manufacturer, is likewise in a better position than the consumer to gauge the risks and the costs of meeting them. The successor knows the product, is as able to calculate the risk of defects as the predecessor, is in position to insure therefore and reflect such cost in sale negotiations, and is the only entity capable of improving the quality of the product. . . . In the most real sense [the successor] is profiting from and exploiting all of the accumulated good will which the products have earned, both in its outward representations of continuity and in its internal adherence to the same line of equipment.

*Cyr v. B. Offen & Co.*, 501 F.2d 1145, 1154 (1st Cir. 1974).

<sup>45</sup> In *Ray v. Alad*, 19 Cal. 3d 22, 29-30, 560 P.2d 3, 7-8, 136 Cal. Rptr. 574, 578-79 (1977), the court rejected the plaintiff's reliance on *Cyr* stating that one or both of the following elements were necessary for the successor corporation to be considered a continuation: (1) no adequate consideration was given for the predecessor corporation's assets and made available for meeting the claims of its unsecured creditors; (2) one or more persons were officers, directors, or stockholders of both corporations. The *Alad* court "[disagreed]. . .with any implication in *Cyr*. . .that the settled rule governing a corporation's succession

The purchaser who wishes to avoid a transfer of liabilities in an asset acquisition must also ensure that a court cannot characterize the purchase as a fraudulent transfer of assets. The fraud exception to the corporate rule that liability will not transfer in a sale of assets is invoked when there is an obvious attempt by the seller to escape liability to its creditors.<sup>46</sup> The exception is necessary to protect creditors' rights by discouraging fraudulent conveyances.<sup>47</sup> Acquisitions made with inadequate consideration are suspect as fraudulent conveyances and prompt courts to look further into the characteristics of the transaction.<sup>48</sup> Buyers questioning the appropriateness of the purchase price should investigate more fully the circumstances prompting the sale, the predecessor's debts and liabilities, and the real value of the assets involved.

*B. Avoiding a transfer of liability resulting from expanded tort theories*

Courts are increasingly relying on tort theory to find successor liability in instances where liability would not otherwise transfer.<sup>49</sup> As a result, planners must familiarize themselves with the tort rationale as well as the corporate rules imposing successor liability. A lack of instructional case law and a continued trend toward expanding products liabilities, however, make it difficult to plan with regard to tort law.<sup>50</sup>

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to its predecessor's liabilities *generally* should be modified so as to require such succession merely because of the factors of continuity present in *Cyr. . . .*" *Id.*

<sup>46</sup> See W. FLETCHER, *supra* note 2, § 7125, at 201.

<sup>47</sup> See Note, *Extension of Products Liability to Corporate Asset Transferees—An Assault On Another Citadel*, 10 LOY. L.A.L. REV. 584, 597-98 (1977).

<sup>48</sup> Most California cases involving successor liability make reference to the fraudulent conveyance exception, but no California case involves a transfer found to be fraudulent. See, e.g., *Ortiz v. South Bend Lathe*, 46 Cal. App. 3d 842, 120 Cal. Rptr. 556 (2d Dist. 1975); *Schwartz v. McGraw Edison Co.*, 14 Cal. App. 3d 767, 92 Cal. Rptr. 776 (2d Dist. 1971). For an example of a fraudulent conveyance leading to successor liability in another state see *Wolff v. Schreveport Gas, Elec. & Power Co.*, 138 La. 743, 70 So. 789 (1916).

<sup>49</sup> *Cyr v. B. Offen & Co.*, 501 F.2d 1145 (1st Cir. 1974); *Ray v. Alad*, 19 Cal. 3d 22, 560 P.2d 3, 136 Cal. Rptr. 574 (1977); *Rawlings v. D.M. Oliver, Inc.*, 97 Cal. App. 3d 890, 159 Cal. Rptr. 119 (4th Dist. 1979); *Turner v. Bituminous Gas Co.*, 397 Mich. 406, 244 N.W.2d 873 (1976).

<sup>50</sup> One tort law exception to the rule that liabilities do not transfer in an asset acquisition is not so difficult to avoid. Some courts analogizing from the

The most difficult problems in this area of acquisition planning stem from the development of successor corporation tort liability in the California Supreme Court decision of *Ray v. Alad*.<sup>51</sup> In *Alad*, the court faced a factual situation similar to that in *Cyr*.<sup>52</sup> Alad II purchased the manufacturing assets, including real estate, plant, offices, equipment, trade name, inventory and good will of Alad I, a small corporation which manufactured ladders.<sup>53</sup> The purchase was made with a total cash consideration in excess of \$207,000.<sup>54</sup> The sales agreement required that Alad I dissolve its corporate existence as soon as practical and assist in the organization of the new corporation.<sup>55</sup> The agreement did not specifically mention Alad II's liability for injuries caused by Alad I's defectively manufactured products.<sup>56</sup>

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Good Samaritan Rule will transfer liability to the successor corporation. The Good Samaritan Rule is a rule of social conduct which impels a person to render assistance to another though the impending peril does not result from any wrongful act on the first person's part. Failure to render assistance to the person in need may lead to actionable negligence. *See, e.g., L.S. Ayres & Co. v. Hicks*, 220 Ind. 86, 40 N.E.2d 334 (1942) (defendant store held not negligent with respect to construction and operation of elevator causing plaintiff's injuries, yet was liable for aggravations to injuries since store personnel did not exercise reasonable care to assist injured plaintiff). In certain instances, a successor corporation that becomes aware that its predecessor placed a dangerously defective product on the market may be held liable for failing to warn third persons of the defect. *See, Shane v. Hobam, Inc.*, 332 F. Supp. 526 (E.D. Pa. 1971); *Chadwick v. Air Reduction Co.*, 239 F. Supp. 247 (N. D. Ohio, 1965). *See generally* Annot., 66 A.L.R. 3d 824, 829-31, 853-54 (1975). Although California courts have never recognized this exception, it may be that they have never been confronted with a case which raises the issue. In light of California's current trend toward expansion of successor corporation liability, there is strong reason to believe the courts might recognize such an exception if the opportunity arose. Prevention of transferred liability under this doctrine requires that the successor take reasonable steps to warn past purchasers of the discovered defect. At the planning stage purchasers should consider how likely it is that the need to warn past purchasers will arise and whether they are willing to incur the time and expense of making the contacts should they become necessary.

<sup>51</sup> 19 Cal. 3d 22, 560 P.2d 3, 136 Cal. Rptr. 574 (1977).

<sup>52</sup> For a review of the facts before the *Cyr* court see notes 38-41 and accompanying text *supra*.

<sup>53</sup> *Ray v. Alad*, 19 Cal. 3d 22, 24-25, 560 P.2d 3, 4-5, 136 Cal. Rptr. 574, 576-77 (1977).

<sup>54</sup> *Id.* at 26, 560 P.2d at 6, 136 Cal. Rptr. at 577.

<sup>55</sup> *Id.*

<sup>56</sup> The only contract provisions relating to assumption of liabilities referred to the purchaser's responsibility to pay for orders previously made by Alad I

Following the acquisition, Alad II manufactured the same line of ladders as had Alad I, and used the same name, equipment, designs, and personnel.<sup>57</sup> In addition, Alad II solicited Alad I's customers through the same sales representatives and without any outward acknowledgment of the change in ownership.<sup>58</sup> Alad I began dissolution proceedings within two months of the sale as required by the contract.<sup>59</sup> The plaintiff, injured six months after the dissolution when he fell from a defective ladder manufactured by Alad I, sued Alad II.

The trial court found that Alad II was not liable under the traditional corporate rules governing successor liability and therefore granted the defendant's motion for summary judgment.<sup>60</sup> On appeal, the California Supreme Court considered whether the policies underlying strict liability for defective products called for a departure from the corporate rules.<sup>61</sup> After reviewing three seminal California products liability cases,<sup>62</sup> the court stated that the paramount policy of strict products liability is the protection of defenseless victims of manufacturing defects by spreading throughout society the costs of compensating

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and to the purchaser's duty to fill Alad I's uncompleted orders and to hold Alad I harmless from the successor's failure to do so. *Id.*

<sup>57</sup> *Id.* at 24-25, 560 P.2d at 5, 136 Cal. Rptr. at 576.

<sup>58</sup> *Id.*

<sup>59</sup> A dissolution certificate was filed declaring that Alad I had paid its known debts and liabilities and that the corporation's known assets had been distributed to its shareholders. *Id.* at 31, 560 P.2d at 9, 136 Cal. Rptr. at 580.

<sup>60</sup> *Id.* at 25, 560 P.2d at 5, 136 Cal. Rptr. at 576.

<sup>61</sup> *Id.* at 30, 560 P.2d at 8, 136 Cal. Rptr. at 579. The court analogized the situation at bar to a situation that had faced the United States Supreme Court in which the Court had refused to be bound by established rules when their application would unduly thwart the public policies underlying labor law. *Id.* See *Howard Johnson Co. v. Hotel Employees*, 417 U.S. 249, 257 (1974).

<sup>62</sup> The court reviewed, in order, *Greenman v. Yuba Power Prod., Inc.*, 59 Cal. 2d 57, 377 P.2d 897, 27 Cal. Rptr. 697 (1963) (purpose of strict liability is to ensure that the costs of injuries resulting from defective products are borne by manufacturers who put such products on the market rather than injured persons powerless to protect themselves); *Seeley v. White Motor Co.*, 63 Cal. 2d 9, 403 P.2d 145, 45 Cal. Rptr. 17 (1965) (risks of injuries caused by defective products can be insured against by the manufacturer and distributed among the public as a cost of doing business); and *Price v. Shell Oil Co.*, 2 Cal. 3d 245, 466 P.2d 722, 85 Cal. Rptr. 178 (1970) (paramount policy to be promoted by strict tort liability is the protection of otherwise defenseless victims of manufacturing defects and the spreading throughout society of the costs of compensating them).

those victims.<sup>63</sup> The court concluded that traditional corporate rules would not serve this protective policy and justified the imposition of tort liability on Alad II on three distinct grounds. Those grounds were the virtual inability of the plaintiff to recover from the original manufacturer,<sup>64</sup> the fairness of requiring a successor to assume liability when it enjoys the good will established by the predecessor,<sup>65</sup> and the successor corporation's ability to assume the original manufacturer's risk spreading role.<sup>66</sup>

The *Alad* court left unanswered the question of how closely circumstances must resemble those in *Alad* for the new tort theory to apply.<sup>67</sup> The only subsequent California appellate court to apply the new theory did so liberally.<sup>68</sup> In *Rawlings v. D.M. Oliver, Inc.*,<sup>69</sup> the fourth district court of appeal cited the policy of the *Alad* court to support its finding of liability even though the successor manufacturer had discontinued the product design responsible for the plaintiff's injury.<sup>70</sup> It remains to be seen

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<sup>63</sup> Ray v. Alad, 19 Cal. 3d 22, 31, 560 P.2d 3, 8, 136 Cal. Rptr. 574, 579 (1977).

<sup>64</sup> See notes 71-73 and accompanying text *infra*.

<sup>65</sup> See note 76 and accompanying text *infra*.

<sup>66</sup> See note 87 and accompanying text *infra*.

<sup>67</sup> For a discussion of questions left unanswered by the *Alad* Court see Note, *supra* note 47, at 611.

<sup>68</sup> See *Rawlings v. D.M. Oliver, Inc.*, 97 Cal. App. 3d 890, 159 Cal. Rptr. 119 (4th Dist. 1979).

<sup>69</sup> *Id.*

<sup>70</sup> *Id.* In *Oliver*, Warren Stubbendieck, a sole proprietor doing business as Warren Industrial Sheet Metal (Warren Industrial) manufactured kelp dryers according to plans and specifications furnished by Kelco Company. A dryer manufactured by Warren Industrial was installed at the Kelco plant in October of 1969. Seven years later the plaintiff, an employee of Kelco, was injured while cleaning the dryer. Three months after the accident, David Oliver purchased certain assets of Warren Industrial. The seller retained only the land and building where the business was located, cash on hand and accounts receivable. The seller did not continue the business. Oliver's business was subsequently incorporated as D.M. Oliver, Inc., doing business as Warren Industrial Sheet Metal. *Id.* at 894-95, 159 Cal. Rptr. at 120. Plaintiff filed suit against the successor corporation on the basis of strict liability and negligence. The trial court granted defendant a summary judgment. The appellate court reversed stating that the *Alad* decision should not be construed so narrowly as to preclude a finding of liability except in cases with circumstances identical to those in *Alad*. *Id.* at 900, 159 Cal. Rptr. at 124. The court asserted that the focus must be upon the policy considerations underlying strict products liability rather than upon a blind application of the factors enumerated in *Alad*. *Id.* The Oli-



whether the other appellate courts will follow the *Oliver* court in construing *Alad* liberally or whether they will hold more closely to the set of factors present in *Alad*.

Though the ramifications of the *Alad* decision are uncertain, small corporations unable to bear the risks of successor liability must plan to avoid categorization within the *Alad* criteria. Acquisitions should be arranged so that the public policy criteria established in *Alad* lack foundation in the circumstances of the small corporation's acquisition and continued production. In addition, the purchasing corporation should insulate itself as well as possible to ensure minimum financial damage should products liabilities transfer.

The plaintiff's inability to collect a judgment from the predecessor was basic to the *Alad* court's decision to extend liability to the successor.<sup>71</sup> The acquiring corporation should, therefore,

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*ver* court concluded that liability should transfer since *Oliver* was better able than the plaintiff to bear the economic burden proximately caused by the defective product. *Id.* at 901, 159 Cal. Rptr. at 194. In support of its conclusion the court noted that *Oliver* had benefitted from the good will of the predecessor and from the ability to continue business at the same location and with the name of the predecessor. *Id.* These benefits, according to the court, put *Oliver* in a position to spread the costs of injuries among its current customers. *Id.* The court specifically stated that the elimination of the product line responsible for the plaintiff's injury would not affect the application of the new tort theory for successor liability. *Id.*

The defendant's petition for review before the California Supreme Court was rejected. Thus, this liberal application of the *Alad* decision is restricted to the fourth district.

<sup>71</sup> The *Alad* court noted that, for all practical purposes, the plaintiff's right of recovery from *Alad I* was worthless. *Ray v. Alad*, 19 Cal. 3d 22, 31-32, 560 P.2d 3, 8-10, 136 Cal. Rptr. 574, 580-81 (1977). In order to understand the reasons why collection from *Alad I* would be extremely difficult, a review of California law regarding dissolution and shareholder liability is essential. When a corporation elects to dissolve it must comply with relevant sections of the California Corporations Code. The corporation must file a verified certificate of dissolution stating that all known debts and liabilities have been provided for. CAL. CORP. CODE § 1905 (West 1979). An assumption of liability or guarantee of payment by a responsible party satisfies this requirement. *Id.* § 2005. After these provisions have been made, the board of directors distributes all the remaining assets to the shareholders. *Id.* § 2004. Though dissolved, section 2010 of the Code states that the corporation continues in existence for the purpose, *inter alia*, of being sued. *Id.* §§ 2001, 2010. Whether or not the plaintiff can successfully sue the dissolved corporation largely depends upon whether the action arose before or after the dissolution. See Henn & Alexander, *Effect of Corporate Dissolution on Product Liability Claims*, 56 CORNELL

take all possible steps to see that the remedies against the selling corporation survive the acquisition. To ensure the plaintiff's ability to sue the predecessor, the buyer must not require the predecessor to dissolve.<sup>72</sup> Rather, when possible, the buyer should purchase less than all of the seller's assets so that the predecessor can continue some type of viable business leaving its corporate structure intact.<sup>73</sup>

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L. REV. 865 (1971). As do most state statutes, California's Corporations Code deals with pre-dissolution claims. Section 2011 states that, where the corporation has dissolved, the shareholders may be sued in the corporate name upon any cause of action against the corporation arising prior to dissolution for an amount not to exceed the value of the assets received by the shareholder. CAL. CORP. CODE § 2011(a) (West 1979). The liquidation distributions held by stockholders are often referred to as a "trust fund" which is held for the benefit of corporate creditors. See Henn & Alexander, *supra*, at 894 n.161.

Plaintiffs are unable to sue shareholders for post-dissolution claims. See Note, *supra* note 34, at 1310 n.9. Though one might argue that section 2010 would allow post dissolution claims to be brought against shareholders since the corporation exists indefinitely for the purpose of being sued, and, as a practical matter, recovery could only be made against shareholders who received the assets upon dissolution, courts have interpreted section 2011 to bar post-dissolution claims. *Id.* The *Alad* court noted that because of these harsh rules the plaintiff would, as a practical matter, be without a cause of action against Alad II's predecessor.

For a more complete discussion of the effects of dissolution on products liability claims see Henn & Alexander, *supra*.

<sup>72</sup> However, the seller must not continue as a mere shell of a corporation. Its continued existence must be substantial or courts are likely to transfer liabilities of the seller to the purchaser. See note 33 *supra*.

Refraining from requiring the seller to dissolve also defeats an essential requirement for the de-facto merger exception to the corporate rule that liabilities do not transfer in asset acquisitions. See notes 26-32 and accompanying text *supra*.

For a discussion of the effects of favorable federal income tax treatment afforded liquidating corporations on the seller's decision whether to continue its corporate existence see note 31 *supra*.

<sup>73</sup> It is unclear to what degree the predecessor must remain intact for courts following the *Oliver* decision to preclude a transfer of liability. In *Oliver*, the court admitted that the predecessor was available for an indemnity cause of action brought by the successor. Nevertheless, the court concluded that the circumstances of the predecessor's continued existence did not guarantee an adequate remedy for the plaintiff and justified granting to the plaintiff a cause of action against the successor. *Rawlings v. D.M. Oliver, Inc.*, 97 Cal. App. 3d 890, 900-01, 159 Cal. Rptr. 119, 124 (4th Dist. 1979). The court's unwillingness to restrict the plaintiff to a cause of action against the predecessor may have stemmed from the fact that the predecessor was a sole proprietorship whose owner died prior to the filing of the plaintiff's suit. Though the proprietor's

Several options for ensuring the survival of the seller's corporate structure are available to the purchaser. The acquisition planner might consider purchasing only one of the seller's product lines rather than all. This would allow the successor to purchase the necessary assets for production of some product while leaving the predecessor with a financially responsible enterprise. Thus, even though the successor has taken over production of the product line related to the plaintiff's injuries, it would not be a proper defendant in an action based on the predecessor's product since it was not connected with the manufacture of the product and the plaintiff has a remedy against the actual manufacturer.<sup>74</sup> The purchaser might also consider buying equipment from a corporation that is selling its equipment in order to modernize or expand its manufacturing process. The seller would not dissolve but would continue production with the new equipment. In considering this alternative, the purchaser should adequately inspect the equipment to ensure that the sale was not prompted by a discovery that the machinery produced unsafe products.

The *Alad* court emphasized that successor liability is equitable where a successor corporation has benefitted from the good will of the predecessor.<sup>75</sup> *Alad II* inherited the good will of *Alad I* when it purchased the trade name, customer lists and product line of the predecessor, continued operation with the predecessor's employees, and otherwise benefitted from the predecessor's

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estate would have been a source of recovery for the plaintiff, a satisfactory judgment would be less certain than if the predecessor had been incorporated and intact at the time of the suit.

For a brief discussion of whether the *Alad* doctrine should apply when the selling corporation did not dissolve see Note, *Products Liability for Successor Corporations: A Break from Tradition*, 49 U. COLO. L. REV. 357, 374 (1978).

<sup>74</sup> The assumption that courts will not transfer liabilities when the injury-causing product line is continued by the successor and the actual manufacturer of the product retains its corporate structure is not inconsistent with the *Oliver* decision. In *Oliver*, liability transferred to the successor in part because the court believed that recovery against the predecessor would be difficult. *Rawlings v. D.M. Oliver, Inc.*, 97 Cal. App. 3d 890, 900, 159 Cal. Rptr. 119, 124 (4th Dist. 1979); see note 73 *supra*. *Oliver's* liability as successor was not affected by whether the corporation continued the production of the injury-causing product. Instead, liability was based upon the substantial difficulty the plaintiff would have in recovering from the predecessor.

<sup>75</sup> *Ray v. Alad*, 19 Cal. 3d 22, 34, 560 P.2d 3, 10-11, 136 Cal. Rptr. 574, 581-82 (1977).

established business operations.<sup>76</sup> In planning an acquisition, the purchaser should analyze which assets can be transferred without automatically transferring the seller's good will. Unfortunately, the *Alad* court did not suggest any guidelines as to how much successors can benefit from their predecessor's reputation and method of production before they will be considered to enjoy its good will. It is also unclear whether all of the benefits reaped by *Alad II* were essential to the finding of liability or whether fewer benefits would have been adequate.<sup>77</sup>

The purchaser faces some difficult problems in determining which assets not to purchase. In many purchases, the predecessor's reputation is a primary asset. In addition, some products pose so little danger of injury to the consumer that the benefits of transferred good will far outweigh the risks. A planner must determine the value to the enterprise of each asset and weigh accordingly the following suggestions as to which assets should not be purchased.

For greatest protection against a finding of transferred good will, the successor should purchase only machinery. Trademarks or tradenames should not be purchased so that a court can not characterize the buyer as benefitting from the business reputation established by its predecessor. Similarly, the buyer should

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<sup>76</sup> The court stated that the purchase of these assets enabled *Alad II* to exploit to its benefit the established reputation of its predecessor. *Id.* Believing that "one who takes the benefit [should] bear the burden," the court reasoned that *Alad II* should incur the burden of defending suits which arose from the prior production and sales from which *Alad II* gained so many benefits. *Id.* In addition, the court noted that imposing liability on successor manufacturers would preclude any windfall to the predecessor that might otherwise result from the absence of successor liability in an enhanced price paid by the successor for the business assets. *Id.* What the court failed to note was that even a lower purchase price, in light of a transfer of products liabilities, might not make the acquisition cost-efficient for the buyer since potential liabilities could far outweigh the total value of assets. The small corporation, with a limited amount of assets, *see note 10 supra*, is more likely to have potential liabilities outweighing the value of the business than is the larger corporation.

<sup>77</sup> The *Oliver* court stressed the importance of the successor having reaped the benefits of the predecessor's good will, but did not require all of the benefits found in *Alad* to be present for a finding of successor liability. The court noted that *Oliver* bought an on-going business, continued business at the same location, and used the same fictitious name as its predecessor. *Rawlings v. D.M. Oliver, Inc.*, 97 Cal. App. 3d 890, 901, 159 Cal. Rptr. 119, 124 (4th Dist. 1979). There is no mention in the opinion of whether *Oliver* used the predecessor's customer lists or retained the predecessor's employees.

use an original name for the corporation rather than the name, or even part of the name, of its predecessor. The new corporation should also actively indicate to all concerned that there has been a change in ownership. This might include advertisements in newspapers or pamphlets affirmatively stating that a new business, with new management and personnel, has opened. Advertisements should not refer to the reliability and quality of the predecessor corporation. The successor corporation must also refrain from using the predecessor's customer lists.

When possible, the successor should also change the product design. A change in design is beneficial for two reasons. Development and marketing of a new design indicates that there has been a complete change in business rather than a mere change in name and personnel. Secondly, courts, in an attempt to encourage corporations to improve old designs and produce a safer product, might, as a matter of policy, refuse to apply the *Alad* doctrine when a corporation makes design changes.<sup>78</sup> A refusal to transfer liability when the successor modifies a design which caused a plaintiff's injury would be in accord with the policy of encouraging product safety which underlies products liability law.<sup>79</sup>

To ensure minimum financial losses should products liabilities

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<sup>78</sup> In *Oliver*, discontinuation of the injury-causing product line did not preclude a finding that the successor had benefitted from the predecessor's good will. *Id.* at 901-02, 159 Cal. Rptr. at 124-25. The court stated that "the manner in which the successor company elects to use the good will of its predecessor is irrelevant to the issue of whether the costs of injuries sustained as a result of defective products previously manufactured may be spread over society." *Id.* at 901, 159 Cal. Rptr. at 125. The court concluded that it must consider whether the predecessor's "general business" was continued and not merely whether a specific line of products was discontinued. *Id.* Thus, to protect oneself under the *Oliver* decision, the purchaser must do more than merely change product design. The purchaser must ensure that its business is not a continuation of the seller's general business. In many asset acquisitions this will be impossible since the purchaser usually intends to continue the general business with the newly acquired assets. Under *Oliver*, successor liability in an asset purchase where the purchaser plans to do business in a manner identical to that of the seller seems almost inevitable. The court in *Oliver* thus seems to have gone beyond the scope of liability intended by the *Alad* court.

<sup>79</sup> Optimally, the planner should follow all of the aforementioned suggestions in order to avoid a transfer of the predecessor's good will. In many instances, compliance with all will be inconsistent with business reality. However, acquisition planners should thoughtfully consider each suggestion, weigh the costs and benefits and make their decisions accordingly.

transfer, acquisitions should be made through a wholly-owned subsidiary.<sup>80</sup> A parent corporation is not liable for the legal obligations of its subsidiary except in circumstances where the parent-subsidiary relationship is not properly maintained.<sup>81</sup> The parent corporation, therefore, is not directly liable if the products liabilities of the predecessor corporation transfer to the parent's properly formed purchasing subsidiary. Thus, if the subsidiary is found liable, the liability of the parent is limited to the extent of its investment in the subsidiary.

While large manufacturers have assets and cash reserves making it possible to own distinctly separate corporations as subsidiaries, smaller corporations often do not have the financial capacity to run one business while owning another. In order for both the subsidiary and the parent to function, they would probably need to integrate business operations. A lack of resources might compel the corporations to share officers or directors, property and other assets. As a result, a court would probably find an unacceptable degree of control by the parent and hold it liable

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<sup>80</sup> A subsidiary corporation is "one in which another corporation owns a majority of shares and thus has control." BLACK'S LAW DICTIONARY 1280 (5th ed. 1979). The California Legislature has defined a subsidiary of a specified corporation as "a corporation shares of which possessing more than 50 percent of the voting power are owned directly or indirectly through one or more subsidiaries by the specified corporation." CAL. CORP. CODE § 189a (West 1979).

<sup>81</sup> When a subsidiary, though wholly owned by the parent, is independently managed and controlled, courts treat the corporations as separate entities. See *McLoughlin v. Bloom Sons Co., Inc.*, 206 Cal. App. 2d 848, 851-52, 24 Cal. Rptr. 311, 313 (1st Dist. 1962); *Marr v. Postal Union Life Ins. Co.*, 40 Cal. App. 2d 673, 681, 105 P.2d 649, 654 (2d Dist. 1940). See generally 6 B. WITKIN, *Corporations* § 11 (8th ed. 1974). However, when, in addition to ownership, the parent controls the subsidiary and treats it as a mere instrumentality, courts will treat the entities as one and hold the parent liable for the obligations of the subsidiary. *Id.* A basic factor in establishing that the subsidiary is merely an instrumentality of the parent is abuse of the separate corporate entity by the parent. See, e.g., *David v. Alexander*, 269 U.S. 114 (1925); *Elmer v. Pfeifer & Schults, Inc.*, 360 F. Supp. 731 (E.D. Wis. 1973); *Handlos v. Litton Indus. Inc.*, 326 F. Supp. 965 (E.D. Wis. 1971). Abuse occurs when the parent exercises a degree of control over the subsidiary beyond that normally necessary to maintain the relationship of stockholder. Evidence of control over the subsidiary is not, however, in and of itself sufficient proof that the subsidiary lacks the separate existence necessary to protect the parent from liability. See, e.g., *Noto v. Cia Secula di Armanento*, 310 F. Supp. 639 (S.D.N.Y. 1970); *American Trading & Prod. Corp. v. Fishbach & Moore, Inc.*, 311 F. Supp. 412 (N.D. Ill. 1970). See generally Annot., 7 A.L.R.3d 1343 (1966).

for the torts of the subsidiary. For the smallest corporations, the inability to form a subsidiary is not important. If the corporation only has capital sufficient to support one corporation, there are no assets apart from those committed to the newly purchased manufacturing business to protect by limiting liability to a purchasing subsidiary. The larger small corporation, however, may have substantial assets separate from those involved in the manufacturing process of the newly acquired corporation. Such a corporation should investigate the possibility of making the acquisition through a wholly-owned subsidiary.

The successor corporation can use indemnity or escrow agreements to provide for payments of judgments should products liabilities transfer. An indemnity provision would require the seller to reimburse the purchaser for money judgments paid by the purchaser as a result of suits based on the predecessor's faulty products.<sup>82</sup> Predecessor corporations whose insurance policies cover only pre-acquisition occurrences will probably refuse to agree to such a provision, as will those corporations whose policies are on a "claims made" basis.<sup>83</sup> If the seller refuses to insert an open indemnification clause, the purchaser might suggest indemnification with a fixed ceiling. While a fixed ceiling indemnification provision does not protect the purchaser against all possible judgments, it will help insulate the company in the first years of production while it establishes its new manufacturing procedures and becomes more financially stable.

To ensure payment under an indemnity agreement, or as an alternative to indemnity, the purchaser might require that a portion of the purchase price be delivered to a third party stakeholder.<sup>84</sup> The funds would remain in escrow for a stipulated period of time during which the funds could be used to pay judgments rendered against the successor in cases based on the predecessor's faulty products. When the stipulated period lapsed, the remaining funds would go automatically to the seller

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<sup>82</sup> For a general discussion of indemnity agreements in purchase contracts see J. FREUND, *ANATOMY OF A MERGER* 365-70 (1975). For a discussion of the role of indemnity in the *Oliver* court's decision to transfer liability to the successor corporation, see note 73 *supra*.

<sup>83</sup> Insurance policies written on a "claims made" basis provide no coverage for occurrences prior to the acquisition unless the claim against the manufacturer is also made prior to the acquisition. Heitland, *supra* note 8, at 497.

<sup>84</sup> For a general discussion of escrow arrangements in purchase contracts see J. FREUND, *supra* note 82, at 382-88.

who could then distribute them among the shareholders of the dissolved corporation. The fixed ceiling of an escrow fund may make an escrow agreement easier to obtain than an indemnity agreement. The selling corporation can place a fixed portion of the sales price in escrow knowing that it won't be liable beyond that amount after the stipulated period of time. An escrow agreement also benefits the purchaser because placing the funds with a neutral party makes collection more certain.<sup>85</sup>

Ideally, the purchasing corporation should acquire insurance covering products liability suits based on injuries caused by the predecessor's products after dissolution.<sup>86</sup> In fact, the *Alad* court assumed that successor corporations could readily obtain such insurance.<sup>87</sup> As a practical matter, however, acquiring such a policy is difficult.<sup>88</sup> The buyer's best chance to purchase the necessary insurance is through a transfer of the seller's products liability insurance.<sup>89</sup> Whether such a transfer is possible depends upon the policy and the insurance company's willingness to accept the new manufacturer as an insurance risk. If the buyer is a responsible manufacturer, there is little reason for the insurer not to transfer the policy since it will continue to receive the

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<sup>85</sup> Under an indemnification agreement the purchaser must collect from the seller and risks being refused payment and forced into taking legal action to enforce the provision.

<sup>86</sup> Corporations interested in procuring products liability insurance may obtain one of three types of policies: the comprehensive general liability policy, the completed operations products liability policy, and the products liability only policy. For a discussion of the protection that each policy offers see Kadens, *Practitioner's Guide to Treatment of Seller's Product Liabilities in Asset Acquisitions*, 10 U. Tol. L. Rev. 1, 25-32 (1978).

<sup>87</sup> An important factor in the *Alad* court's development of successor tort liability was the presumption that successor corporations are able to estimate and insure against the risks involved in successor liability. *Ray v. Alad*, 19 Cal. 3d 22, 33, 560 P.2d 3, 10, 136 Cal. Rptr. 574, 581 (1977). According to the court, the asset transfer had concurrently transferred to Alad II the resources to meet the responsibilities which previously belonged to its predecessor. *Id.* In support of its contention the court cited the *Cyr* decision which held that the successor was in a position to estimate the risks and obtain appropriate insurance. *Id.* The court concluded that Alad II, through the use of insurance, could spread throughout society the costs of compensating the victims of the predecessor's defective products. *Id.*

<sup>88</sup> For a discussion of the difficulties in the acquisition of adequate products liability insurance see notes 90-95 and accompanying text *infra*.

<sup>89</sup> For a discussion of options available to the buyer seeking protection under the seller's policy see Kadens, *supra* note 86, at 36.



same premiums for similar risks. Nevertheless, the current market does not make this option readily available since it is unlikely that the selling corporation has an adequate policy to transfer.

## II. PROTECTING PRODUCT USERS AND SUCCESSOR CORPORATIONS THROUGH INCREASED AVAILABILITY OF PRODUCTS LIABILITY INSURANCE

The inability of small corporations to obtain insurance for successor liability undermines the rationale and purpose of the *Alad* decision. The *Alad* court transferred liability to the successor on the assumption that the corporation could insure itself against the risk of successor liability.<sup>90</sup> When the purchasing corporation is unable to procure the necessary insurance, however, it must either plan the acquisition to avoid a transfer of liabilities or refrain from making the purchase altogether. If the purchasing corporation is able to prevent a transfer of products liabilities in an asset acquisition, the plaintiff may be unjustly left without compensation. On the other hand, if the purchasing corporation is unable to plan an acquisition without the probable transfer of unmanageable liabilities, the would-be seller may be unable to sell the manufacturing business intact and therefore may be forced to liquidate. Both the acquisition planned with the specific intent to avoid successor liability and the liquidation of the would-be seller are side effects of the *Alad* decision that the court did not intend. The solution to the problem is to make products liability insurance more available and affordable for the small corporation.

There has been substantial legislative investigation into the existence and possible causes of the insurance problem. In 1977, the House Small Business Subcommittee heard evidence on the high cost and lack of availability of products liability insurance.<sup>91</sup> Statistical surveys revealed that products liability insurance was unavailable to many businesses.<sup>92</sup> In addition, the subcommittee discovered that products liability premium costs had

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<sup>90</sup> *Ray v. Alad*, 19 Cal. 3d 22, 560 P.2d 3, 136 Cal. Rptr. 574 (1977).

<sup>91</sup> *Products Liability Insurance: Hearings Before the Subcomm. on Capital, Investment and Business Opportunities, of the House Comm. on Small Business*, 95th Cong., 1st Sess., (Part 1) (1977).

<sup>92</sup> 21.6% of those who sought products liability insurance could not obtain it. *Id.* at 4 (testimony of Charles W. Whalen, Jr.).

increased dramatically in the 1970's and at a much faster rate than that of premium costs in other areas of insurance coverage.<sup>93</sup> In a study released later that same year, the Commerce Department Interagency Task Force on Products Liability concluded that the problems of affordability and availability were mainly concentrated among small manufacturers.<sup>94</sup>

One reason for the high price and lack of availability of insurance is that underwriters are unable to measure products liability risks. This makes it difficult to distribute premiums equitably among products and producers.<sup>95</sup> It is even more difficult to measure products liability risks for small manufacturers since they often have no measureable loss frequency record.<sup>96</sup> To remedy the problem the insurance industry has begun to improve the rate-making system. In 1978 the National Association of Insurance Commissioners adopted a proposal calling for improved state reporting of products liability data on the part of the insurer.<sup>97</sup> If this plan is successful, it would be in the interests of other insurance companies to follow suit.

Creating readily available and affordable products liability insurance for the small manufacturer also requires modification of both tort and insurance law.<sup>98</sup> Modification of tort law is neces-

<sup>93</sup> The average increase in premium costs from 1970 to mid-1977 was 944.6%. The growth rate for premiums was 5.8 times greater than that for annual sales of the insurance companies surveyed. *Id.*

<sup>94</sup> Lenz, *'Products' Study Backs Federal Ins. Mechanism*, National Underwriter, April 15, 1977, at 1, col. 3. In 1976 the Ford Administration established the Federal Interagency Task Force on Products Liability for the purpose of studying and analyzing the unavailability and unaffordability of products liability insurance. The Task Force released several comprehensive reports, all of which are available to the public. For information on obtaining copies of the reports see Schwartz, *The Federal Government and the Products Liability Problem: From Task-Force Investigation to Decisions by the Administration*, 47 U. CIN. L. REV. 573, 574 nn.1-3 (1978).

<sup>95</sup> Clements, *Scarcity of Product Cover Eyed*, Journal of Commerce, May 5, 1977, at 2A, col. 5; Schwartz, *supra* note 94, at 578.

<sup>96</sup> Ghiardi, *Products Liability-Where is the Borderline Now?* 13 F. 206, 210 (1977).

<sup>97</sup> Schwartz, *supra* note 94, at 582. As a result, products liability is reported as a separate item on the annual statement. *Id.*

<sup>98</sup> California Assemblyman McAllister has stated that the tort law system and the insurance mechanisms created to insure against tort damages are so intertwined and interdependent as to constitute a "single individual system" for compensating injured persons. Assem. Bill No. 50 (1979-1980 Reg. Sess.). He has proposed that the legislature establish insurance and tort law policies

sary to reduce the number and costs of products liability actions. Various interested parties have prepared numerous proposals.<sup>99</sup> Realizing that a uniform products liability law is necessary for tort reform to have a sizeable impact on insurance availability, the Commerce Department drafted a uniform products liability law to encourage uniform laws at the state level.<sup>100</sup>

The Draft Uniform Law begins with a legislative finding that rising products liability insurance premiums have created serious problems such as increased prices of consumer and industrial products; businesses going without products liability coverage, thus jeopardizing the availability of compensation to injured persons; and panic reform efforts that would unreasonably curtail the rights of product users.<sup>101</sup> The legislative finding

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which together provide a successful system for compensating plaintiffs. *See id.*

<sup>99</sup> In 1977, 11 companies involved in products liability litigation drafted comprehensive proposals. All proposals would shorten the current statute of limitations. Other proposed modifications included allowing a state of the art defense, eliminating or restricting punitive damages, regulating attorney's fees, prohibiting manufacturer liability when there has been a subsequent alteration or modification in the product which has contributed to the injury, reducing awards by any amounts received through workers' compensation, allowing introduction of evidence on other collateral sources, and requiring the losing party to pay all costs of suit. *The Product Liability Problem: Proposals for Solutions Through Tort Reform*, center insert, J. INS., May/June 1977.

<sup>100</sup> DRAFT UNIFORM LIABILITY LAW, 44 Fed. Reg. 2996, 2779 (1979) [hereinafter cited as DRAFT UNIFORM LAW]. The California legislature recently considered adoption of the UNIFORM PRODUCTS LIABILITY ACT which closely paralleled the DRAFT UNIFORM LAW. Assem. Bill No. 600 (1979-1980 Reg. Sess.). The bill died at desk in early 1980.

In the 1979-1980 California legislative session some 20 bills aimed at reducing the number and costs of products liability suits were proposed within the first seven months of session. Sen. Bill No. 50 (1979-1980 Reg. Sess.); Assem. Bill No. 149 (1979-1980 Reg. Sess.); Assem. Bill No. 150 (1979-1980 Reg. Sess.); Assem. Bill No. 151 (1979-1980 Reg. Sess.); Assem. Bill No. 152 (1979-1980 Reg. Sess.); Assem. Bill No. 153 (1979-1980 Reg. Sess.); Assem. Bill No. 236 (1979-1980 Reg. Sess.); Sen. Bill No. 222 (1979-1980 Reg. Sess.); Sen. Bill No. 223 (1979-1980 Reg. Sess.); Sen. Bill No. 224 (1979-1980 Reg. Sess.); Sen. Bill No. 225 (1979-1980 Reg. Sess.); Sen. Bill No. 226 (1979-1980 Reg. Sess.); Assem. Bill No. 382 (1979-1980 Reg. Sess.); Assem. Bill No. 383 (1979-1980 Reg. Sess.); Assem. Bill No. 600 (1979-1980 Reg. Sess.); Assem. Bill No. 1221 (1979-1980 Reg. Sess.); Sen. Bill No. 1013 (1979-1980 Reg. Sess.); Assem. Bill No. 1602 (1979-1980 Reg. Sess.); Assem. Bill No. 1668 (1979-1980 Reg. Sess.); Assem. Bill No. 50 (1979-1980 Reg. Sess.). Most of the bills have gone through various amendments. To date, however, none of the bills have been passed.

<sup>101</sup>. DRAFT UNIFORM LAW, *supra* note 100.

states that the insurance problem results in part from the uncertainties in products liability law that stem from the fact that laws vary among jurisdictions. The finding further states that insurers set premiums that might not reflect actual product risk because of uncertainty over the outcome of products liability litigation. It concludes with the assertion that no individual state can solve the problems and that a uniform law is essential.

The Draft Uniform Law calls for numerous changes in current products liability tort law. The Law precludes admission of evidence of changes in the "state of the art" occurring after the manufacture of the product.<sup>102</sup> Evidence of compliance with the "state of the art" at the time of manufacture would raise a rebuttable presumption that the product was not defective.<sup>103</sup> Product sellers<sup>104</sup> complying with governmental safety standards would, in certain circumstances, be presumed to have manufactured a non-defective product.<sup>105</sup> The Law establishes a rebuttable presumption in favor of the product seller where the manufacturer complied with administrative or legislative standards.

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<sup>102</sup> The "state of the art" refers to the safety, technical, mechanical, and scientific knowledge in existence and reasonably feasible for use at the time of manufacture. *Id.* Evidence of subsequent changes in design and manufacturing is of very limited value, while the prejudicial effect of showing the changes - particularly one undertaken by the manufacturer itself - is quite substantial. See *LaMonica v. Outboard Marine Corp.*, 48 Ohio App. 2d 43, 355 N.E.2d 533 (1976); *Haysome v. Coleman Lantern Co.*, 89 Wash. 2d 474, 573 P.2d 785 (1978). For a further discussion see DRAFT UNIFORM LAW, *supra* note 100, at 3006-07.

<sup>103</sup> For a definition of "state of the art" see note 102 *supra*. For a detailed discussion of the relevancy and application of the "state of the art" defense as compared to the defense of compliance with custom in the manufacturing industry, see DRAFT UNIFORM LAW, *supra* note 100, at 3007.

<sup>104</sup> The DRAFT UNIFORM LAW refers to the liability of the "product seller." Product seller is defined as "any person or entity, including a manufacturer, wholesaler, distributor, or retailer, who is engaged in the business of selling such products, whether the sale is resale, or for use or consumption." DRAFT UNIFORM LAW, *supra* note 100, at 2997-98.

<sup>105</sup> A governmental safety standard is one which meets the following criteria: it must have been developed through careful, thorough product testing and a formal product safety evaluation; consumer as well as manufacturer interests must have been considered in formulating the standard; it must have been more than a minimum safety standard at the time of its development; and, the standard must have been up-to-date in light of the technological and scientific knowledge reasonably available at the time the product was manufactured. See DRAFT UNIFORM LAW, *supra* note 100, at 3007-08.

Moreover, product sellers would be liable only for harm caused by the product during the useful safe-life of the product.<sup>106</sup> Except in certain enumerated circumstances, the product seller would not be liable for injuries caused by a product altered or modified by a person other than the product seller or the claimant.<sup>107</sup>

In addition, the Draft Uniform Law would allow either party to institute arbitration proceedings for claims involving less than

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<sup>106</sup> Currently, there is no statute of limitations protecting the product seller whose product causes an injury long after the intended life span of the product has passed. Since most products liability policies include coverage of claims based on products sold in the past the absence of a statute of limitations on the seller's liability results in a sizeable increase in policy premiums. A number of states have enacted statutes limiting the time period during which a seller can be liable for injuries caused by a defective product. See DRAFT UNIFORM LAW, *supra* note 100, at 3008. The common law in most states includes a useful safe-life limitation on the duration of the seller's liability. *Id.* The useful safe-life limitation forces the trier of fact to consider the expected useful life of the product and the stress to which it has been put when determining whether the product was sold in a defective condition. See *Kusis v. Baldwin-Lima-Hamilton Corp.*, 457 Pa. 321, 319 A.2d 914, 923 (1974). California courts have also established a useful safe-life limitation. See, e.g., *Darling v. Caterpillar Tractor Co.*, 171 Cal. App. 2d 713, 722, 341 P.2d 23, 29 (2d Dist. 1959) (In considering whether the manufacturer of a tractor which injured the plaintiff should be liable, the court stated that a manufacturer is not responsible for mechanical failure due to ordinary wear and tear on the product. The court reasoned that parts which have served their expected life cannot be regarded as defective because they eventually gave out.). Codification of the limitation, which would necessarily include clarification and specification of the relevant criteria, would aid both judge and jury in applying the limitation. A more consistent application of the useful safe-life limitation will ensure greater accuracy in determining whether the seller's product was defective and, in turn, make insurance costs more predictable and less costly. For a further discussion of the length of time product sellers are liable for product-related injuries see DRAFT UNIFORM LAW, *supra* note 100, at 3008.

<sup>107</sup> Barring liability of the product seller where a third party has modified the product is justified when the seller complied with its duty to provide a safe product. The product seller must, however, anticipate certain modifications or alterations of the product and courts would hold the seller to a reasonable person standard in assessing whether the injury-causing modification was foreseeable. In addition, the product seller could avoid liability for a defective product only where the harm would not have occurred "but for" the alteration or modification. This proposed reform is essentially an expansion and codification of the rule set out in the Restatement (Second) of Torts which states that a seller shall not be liable if he has delivered a safe product which was subsequently mishandled or due to some other cause was made harmful by the time it was consumed. RESTATEMENT (SECOND) OF TORTS § 204A, Comment g, (1977).

\$30,000.<sup>108</sup> The Law would abolish the collateral source rule and thereby allow the introduction of evidence of other forms of compensation received by the plaintiff.<sup>109</sup> Furthermore, the Law would limit the amount of non-pecuniary damages, such as damages for pain and suffering.<sup>110</sup> Either party to the action could

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<sup>108</sup> Arbitration proceedings in products liability cases would be more efficient than courtroom litigation since cases would go before a small panel, composed of at least one expert in the field, better able to comprehend the esoteric details of products liability cases. As a result, awards would be more accurate. For a further analysis of the use of arbitration proceedings in products liability cases see DRAFT UNIFORM LAW, *supra* note 100, at 3014-16.

<sup>109</sup> Present law precludes the product seller from introducing evidence of payments to the plaintiff from another (collateral) source. This results in monetary awards to the plaintiff that exceed the plaintiff's actual losses. The rationale behind the collateral source rule was articulated in the California Supreme Court's decision of *Helfend v. Southern Rapid Transit Dist.*, 2 Cal. 3d 1, 465 P.2d 61, 84 Cal. Rptr. 173 (1970). In *Helfend*, the Court supported the rule as a means for encouraging citizens to procure and maintain insurance. *Id.* at 10, 465 P.2d at 66-67, 84 Cal. Rptr. at 178-179. In addition, the court stated that the rule is necessary to prevent defendant wrongdoers from obtaining credit for the compensation the plaintiff has received from other sources. *Id.* Eliminating the collateral source rule would reduce the awards in products liability suits by the amount of money the plaintiff has already received and thus reduce the costs to products liability insurers representing defendant product sellers. Reduced costs to insurers would enable them to lower premiums. The elimination of the collateral source rule from products liability cases would not result in an unjustified credit to the defendant. When sellers are strictly liable, they have not necessarily engaged in intentionally wrongful or negligent conduct which would warrant forbidding credit for the amount of compensation that the plaintiff has received from other sources. See DRAFT UNIFORM LAW, *supra* note 100, at 3018. In addition, it is not at all clear that abolishment of the collateral source rule would discourage persons from procuring insurance for personal injuries. Policies such as health insurance are most likely procured for protection against expenses of non-tortious injuries since the policy holders probably assume that a tort-feasor will pay the expenses of their tortious injuries. *The Supreme Court of California 1969-1970*, 59 CALIF. L. REV. 30, 272 (1971). Since policy holders desire to protect themselves from all losses, it is unlikely that denying them double recovery in the case of tortious injuries will lessen their motivation to procure insurance. *Id.* For a more thorough critique of the collateral source rule see Fleming, *The Collateral Source Rule and Loss Allocation in Tort Law*, 54 CALIF. L. REV. 1478 (1966); Comment, *Unreason in the Law of Damages: the Collateral Source Rule*, 77 HARV. L. REV. 741 (1964).

<sup>110</sup> Currently, damages for pain and suffering are unlimited and thus, unpredictable. Limiting non-pecuniary damages would enable insurers to better predict the size of judgments in products liability cases. Limiting non-pecuniary damages, as opposed to eliminating them altogether, is preferable since they serve plaintiffs with a substitute for vengeful retaliation and also serve an im-

seek reimbursement for reasonable attorneys fees and other costs if such expenses were attributable to the pursuit of a frivolous claim or defense by the opposing party.<sup>111</sup>

In sum, these reforms could substantially lower the number and costs of products liability suits. Adoption of such proposals would make the overall costs of products liability litigation more predictable. This, in turn, would make insurers more able to set accurate rates and more willing to extend policies to both small and large corporations.

Legislative reform of the insurance industry is also necessary.<sup>112</sup> One efficient way to increase the availability of products liability insurance is through the imposition of mandatory pool-

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portant deterrent function to manufacturers. For a further discussion see DRAFT UNIFORM LAW, *supra* note 100, at 3017-18.

<sup>111</sup> The ability of product sellers to collect costs of defense in frivolous suits would decrease the number of suits filed. Most products liability cases are filed on a contingent fee basis causing the plaintiff little financial loss when a cause of action fails. Forcing the plaintiff or plaintiff's attorney to pay the costs in a groundless suit will increase the cost of, and thereby discourage the filing of, such suits. The proposal defines a frivolous claim as one which the court determines is without any reasonable legal or factual basis. DRAFT UNIFORM LAW, *supra* note 100, at 3001.

<sup>112</sup> Two insurance reform options, though inappropriate for adoption at this time, deserve mention. The first is the option of creating a federal reinsurance program. Contracts for reinsurance are ones by which insurers procure a third person to insure them against the loss of liability they will suffer if they are forced to pay out under an original insurance policy issued to their insured. See J. APPLEMAN, *INSURANCE LAW AND PRACTICE* § 7681, at 480 (rev. ed. 1976). A federal reinsurance program would set up federal funds to provide the reinsurance. *Department of Commerce Options Paper on Products Liability and Accident Compensation Issues*, 43 Fed. Reg. 14,612, 14,619 (1978) [hereinafter cited as *Options Paper*]. The Department of Commerce has conceded that such a program would lower insurance costs for businesses suffering serious insurance problems, but claims that the potential costs and complications warrant reserving the option for a time when the insurance problem reaches "emergency proportions." *Id.* at 14,623. California law allows contracts for reinsurance. CAL. INS. CODE § 620 (West 1979). The state does not, however, provide any monetary assistance for funding such contracts.

A second option is the establishment of a no-fault compensation system for product-related injuries. Several experts have studied the possibility of enacting such a system. Various problems, such a difficulty in maintaining proper incentives for risk prevention by manufacturers and administrative difficulties, have prompted the experts to conclude that introduction of such a system in the near future is not possible. See Ghiardi, *supra* note 96, at 586-88; *Options Paper*, *supra*, at 14,617-18, 14,624.

ing requirements.<sup>113</sup> Mandatory insurance pools compel insurers to underwrite certain risks.<sup>114</sup> Each member of the pool is required to participate in the operation of the association by bearing a portion of the operating expenses and losses sustained by the pool.<sup>115</sup> Any insurance company writing products liability policies would be required to participate, ensuring that even the most hazardous products were covered. Individual insurers would be less vulnerable to the full impact of large damage awards levied against high-risk policy holders since the loss would be spread among many insurers. As a result, insurers would be more readily available for manufacturers who might otherwise be unable to secure coverage at an affordable price.

Another direct approach to the availability dilemma is legislative encouragement of captive insurers.<sup>116</sup> A captive insurance company is one that is organized by a firm or group of firms to insure their own risks. A "pure captive" is a wholly-owned subsidiary which insures only the risks of its parent and the parent's affiliates.<sup>117</sup> Small corporations could form "hybrid captives." A hybrid captive is a trade association or industry captive owned by a number of firms in the same industry which operates somewhat like a cooperative.<sup>118</sup> The benefits of captives for the small corporation are twofold. The captives allow each member to pay a smaller premium than the regular market would require.<sup>119</sup> In addition, the use of captives also provides many of the benefits of self-insurance programs, such as experience rating, incentive for loss prevention and control over litigation.<sup>120</sup>

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<sup>113</sup> The imposition of mandatory pooling requirements as an attempt to increase the availability of products liability insurance was discussed by the Department of Commerce. *Options Paper*, *supra* note 112, at 14,620. The Department concluded that mandatory insurance pools in the area of products liability would only be effective at the federal level. *Id.* For a discussion of the conceptual and administrative difficulties requiring pooling to be administered at the federal level see UNITED STATES DEP'T OF COMMERCE, INTERAGENCY TASK FORCE ON PRODUCT LIABILITY: FINAL REPORT, VII-115-17 (1977) [hereinafter cited as TASK FORCE REPORT].

<sup>114</sup> *Options Paper*, *supra* note 112, at 14,620.

<sup>115</sup> *Id.*

<sup>116</sup> The Department of Commerce has discussed the efficacy of legislative encouragement of captive insurers. See *id.* at 14,620-21.

<sup>117</sup> *Id.* at 14,620.

<sup>118</sup> *Id.* at 14,620-21.

<sup>119</sup> TASK FORCE REPORT, *supra* note 113, at VII-155.

<sup>120</sup> *Options Paper*, *supra* note 112, at 14,621.



Modification of insurance regulatory law to impose less stringent requirements on captives than on standard insurance companies would encourage the formation of captives.<sup>121</sup> Legislative reform could encourage the formation of captive insurance companies at the state level because national insurance companies are not involved.

Legislatures should also enact laws requiring product manufacturers to obtain minimum amounts of insurance coverage. The laws should not impose the requirements, however, until the insurance market provides reasonably priced policies for both small and large manufacturers. Legislators could formulate mandatory products liability insurance requirements based upon state experience with mandatory automobile liability policies. If well enforced, the requirement would guarantee plaintiffs a source of recovery while protecting manufacturers from potential bankruptcy. In addition, mandatory products liability insurance coverage would guarantee purchasing corporations the opportunity to transfer the manufacturer-seller's insurance policy in the acquisition process. This eliminates the successor's need to obtain a whole new policy with coverage of liability based on injuries caused by the predecessor's products. It is only through a combination of insurance and tort law reform that the *Alad* court's goal of spreading the risks of successor liability throughout society can be realized.

### CONCLUSION

Not all manufacturing acquisitions pose grave products liability problems. Those manufacturers whose products present little risk of serious injury can plan acquisitions without focusing on avoiding successor liability. Corporations which manufacture potentially injurious products, however, must be concerned with successor liability. If they cannot insure against the risks of successor liability they must plan their acquisitions so as to avoid liability altogether.

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<sup>121</sup> See *id.* Congress is currently considering adoption of the "Product Liability Risk Retention Act." S. 1789, 96th Cong. 1st Sess. (1979); H.R. 6152, 96th Cong., 1st Sess. (1979). The Act would allow manufacturers and product sellers to form captives. The Act would also pre-empt state laws that regulate captives or make them unlawful. The Commerce Department would oversee the formation and conduct of captives. The House has overwhelmingly passed the bill, 126 CONG. REC. 1671-84 (1980).

Products liability insurance must be made available for the small corporation if the *Alad* court's attempt to protect plaintiffs without unduly burdening the successor corporation is to succeed.<sup>122</sup> Readily available and affordable insurance provides the small corporation with a means of compensating plaintiffs injured by the predecessor's products. When adequately insured, small corporations are less likely to dodge liability and are not forced to liquidate due to would-be purchasers' fears of uninsurable successor liability. Reform of tort and insurance law at the state and federal level is necessary in order to make available affordable insurance. California, having set the pace with the *Alad* decision, must now take the legislative initiative and make the rationale a reality.

*Debra Ann Schiff*

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<sup>122</sup> If the other California appellate courts adopt the liberal application of the *Alad* decision developed by the fourth district court in *Oliver* (for a review of the *Oliver* decision see notes 70, 73, 74 & 77 *supra*) insurance for successor corporations will become even more essential since, under the *Oliver* decision, products liabilities are bound to transfer when the successor continues the general business of the predecessor.

