ARTICLES

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INTRODUCTION

Corporate common law generally provides that a corporation that purchases the assets of another does not thereby become liable for the tort and other liabilities of the seller. However, a few states, including California, New Jersey, Washington and Pennsylvania, have adopted a "product line" exception to this principle. Under this doctrine, by purchasing substantially all of a manufacturer's assets and continuing to market goods in the same product line, a corporation exposes itself to strict liability for defects in the predecessor's products.

This article finds the policies behind the "product line" exception inapplicable to the purchase of assets at a bankruptcy sale. Not only does this extension of strict liability violate basic principles of tort law, but it also contradicts the fundamental goals of the Bankruptcy Code (the "Code").

THE "PRODUCT LINE" EXCEPTION

Though generally insulated from successor liability, a corporation acquiring the assets of another may nonetheless be found to have assumed the predecessor's liability where:

1. the acquiring corporation expressly or impliedly agrees to assume the selling corporation's liability;
2. the transaction is entered into fraudulently to allow the predecessor to escape liability for such obligations;

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3. the transaction amounts to a merger or a consolidation of the purchaser and seller corporations (a "de facto" merger); or
4. the purchaser corporation is merely a continuation of the seller corporation.¹

In each of these four exceptions to nonliability, the acquiring corporation either agrees to accept liability or is in some way responsible for the destruction of a products plaintiff’s remedy against the selling corporation. Moreover, the affiliation of the successor and the predecessor could be said to provide such plaintiffs with the reasonable expectation of successor liability.

However, although none of these four circumstances applied to the factual situation before it, in Ray v. Alad² the California Supreme Court developed a fifth, or “product line,” exception to impose successor liability on a corporation that, after purchasing the predecessor’s plant, equipment and inventory, had continued to produce the same line of ladders. Pursuant to the purchase agreement, the predecessor had dissolved after the sale. The plaintiff had subsequently been injured while using a ladder manufactured by the predecessor.

Ray held that “[a] party which acquires a manufacturing business and continues the output of its line of products under the circumstances here presented assumes strict tort liability for defects in units of the same product previously manufactured and distributed by the entity from which the business was acquired.”³ This exception differs from the continuation of business exception in predicating liability on the continued production of a type of goods, rather than on the two corporations’ similarities in ownership, management, personnel and location.⁴

Ray established three grounds for imposing this form of successor liability. First, by acquiring substantially all the assets of the former business, the successor had caused “the virtual destruction of the plaintiffs’ remedies against the original manufacturer.”⁵ Second, the successor could assume the original manufacturer’s role of spreading the risk of product liability claims, by adjusting the price of its goods.⁶ Finally, the court considered it only fair for the successor to shoulder the burdens of products liability along with the benefit of the original manufacturer’s good will.⁷ Although the successor

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² 560 P.2d 3 (Cal. 1977).
³ Id. at 11.
⁴ Id. at 7.
⁵ Id. at 9.
⁶ Id.
⁷ Id.
corporation had not manufactured the products that had caused the injury, this requirement was not a part of the four other successor liability situations.

As invoked in ordinary acquisition situations, the product line exception has met with resistance in many jurisdictions, and is clearly a minority position. However, the application of this exception to the successor’s purchase of assets at a bankruptcy sale is even more tenuous, as it offends the guiding principles both of tort law and of bankruptcy law.

**TORT LAW OBJECTIONS**

In non-bankruptcy acquisitions, some courts have rejected the product line exception as inconsistent with the traditional tort policy of requiring some type of fault on the part of the defendant in causing the injury. Instead of such fault on the successor’s part, Ray’s product line exception has been satisfied by the successor’s having caused the destruction of the plaintiff’s remedies.

Yet even this degree of ersatz “fault” is usually not present in a bankruptcy sale, in which the bankruptcy process itself terminates plaintiffs’ remedies. Unless the successor has filed an involuntary bankruptcy petition against the debtor or otherwise triggered the bankruptcy, its purchase does not cause the destruction of plaintiffs’ remedies. Accordingly, there would be no justification for imposing liability on the purchaser for a plaintiff’s lack of remedies.

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10. See e.g., Kline v. Johns-Manville, 745 F.2d 1217 (9th Cir. 1984) (under Alad, “the asset sale [must] contribute to the destruction of plaintiff’s remedies”); Hall v. Armstrong Cork, Inc.; 692 P.2d 787 (Wash. 1984) (key premise of product line exception is that successor liability is only appropriate when successor corporation, by its acquisition of predecessor, actually played some role in curtailing or destroying claimant’s remedies against predecessor.


12. Presumably, courts would not deem an acquirer whose “price wars” or other market strategies had resulted in the seller’s bankruptcy to be at “fault” for the destruction of a products plaintiff’s remedies against the seller.

13. In fact, although pending suits against a defendant are automatically stayed by institution of bankruptcy proceedings, it constitutes claims against the bankrupt estate. However, in bankruptcy, debtors often do not pay these claims in full.
For this reason, in California, the very state that generated the product line exception, both the state and federal courts have declined to find such liability in bankruptcy sale situations. Acknowledging that the situation demanded a choice between tort law and corporate law, the state Court of Appeals explained that corporate nonliability is only counterbalanced by a policy of strict liability when "the acquisition by the successor, and not some other event or act," destroys the plaintiff's remedies. 14 In the absence of any showing that the successor corporation induced the predecessor to enter bankruptcy, there were no grounds for applying the product line theory. 15

The Ninth Circuit agreed that the product line exception should not be applied in this context:

It is our view that the California Supreme Court's decision in Ray does not apply where there is a good faith dissolution in bankruptcy which is not intended to avoid future tort claims against the predecessor. Under such circumstances, the successor corporation has not contributed to or caused the destruction of the plaintiff's remedies. 16

However, several decisions in New Jersey state courts have rejected this analysis, focusing instead on the argument that the plaintiff has no remedy except against the successor. Wilkerson v. C.O. Porter, 17 Goncalves v. Wire Technology 18 and Pacius v. Thermtroll Corp. 19 imposed strict liability on a successor by broadly construing the criterion of "causing" the destruction of plaintiff's remedies. The courts held that if the successor corporation, or the transaction of purchase, causes the destruction of plaintiff's remedies against the predecessor corporation, then the product line exception is applicable. 20 "It [is] the fact of the nonviability of the predecessor company which govern[s] the imposition of liability, not the reason for it." 21 Bussell v. DeWalt Products Corp. 22 went even farther, holding that "[c]ausation . . . has no relationship to the theory of successor corporate liability. Rather, fairness is based on the benefit received by the successor corporation in acquiring the assets and product line of the predecessor." 23

15. Id. at 676.
The holding of the New Jersey state courts that successor liability principles will apply to the purchase of assets at a bankruptcy sale in effect converts the purchaser into an insurer. Specifically, as noted above, a company which purchases assets at a bankruptcy sale is generally not responsible for the destruction of a remedy that the plaintiff might have against the corporation that manufactured the product. In addition, the purchaser of assets at a bankruptcy sale might not acquire good will, but solely hard assets, such as punch presses, dies, and other tangible items. In that case, the major policy justification for imposing successor liability on a company that purchases assets in a bankruptcy sale would be that the company purchasing the assets is in a position to "spread the risk" of injuries (i.e., pay claims) by increasing the price (i.e., charging a premium). Yet the successor may not have access to all of the relevant information that the debtor had in order to assess these risks accurately: 24 for instance, although it can review the products liability claims that have been filed in the bankruptcy, the successor might not have any indication of past or future products claims against the debtor.

**Bankruptcy Law Objections**

Focusing on the "benefit received by the successor" at a bankruptcy sale reveals other shortcomings of the Ray analysis. Imposing successor liability here violates the fundamental purposes of bankruptcy law, as it not only passes through bankruptcy what amounts to a lien on the assets by future products liability claimants, but also decreases the sale price, effectively defeating the standard order of priority of claims in bankruptcy.

The Code seeks to maximize the orderliness and amount of distributions to creditors, according to a specific hierarchy of claims. Claims against the assets of a corporation in bankruptcy are sorted into five categories, in order of decreasing priority: (1) secured claims, which are secured by liens on the debtor's assets; (2) "administrative expenses" for the necessary costs and expenses of preserving the bankruptcy estate; (3) specified types of "priority claims," such as the wage claims of employees; (4) unsecured claims, which are all other legal obligations of the debtor requiring the payment of money (including products liability claims); and (5) the equity interests held by the corporation's shareholders. 25

Under the "absolute priority rule," each of these classes must be paid in full before the next is paid; in addition, the distribution to every claim in the


last class for which there are funds must be made pro rata. Since prospective buyers anticipating the application of the product line exception will lower their bids for the debtor’s manufacturing equipment accordingly, this doctrine diminishes the funds available to be distributed to the debtor’s current creditors. Future products liability claimants, who will have recourse against the successor, have thus “jumped the line” to come out ahead of the debtor’s current creditors, who are deprived of compensation for their claims.

In the most extreme case, a potential acquirer that estimates that the value of products liability claims will exceed the value to it of the debtor’s salable assets will decline to bid for those assets. The debtor’s creditors will be denied the purchase price of the assets, which themselves will be wasted; the would-be acquirer (and its industry) will pass up what, but for products liability considerations, would have been a good opportunity to enhance its plant; and future products liability claimants will end up no better off than if the products liability exception had not been in force.

CONCLUSION

For the reasons above, the product line exception is untenable with regard to bankruptcy sales. Prospective purchasers should:

1. review the applicability of the exception in their jurisdictions;
2. investigate the products liability claims brought, and likely to be brought, against the debtor and others manufacturing similar products;
3. minimize their causal connection with the debtor’s bankruptcy, so as to avoid, as much as possible, being found to have deprived products plaintiffs of their remedies against the debtor; and
4. distinguish the names and appearances of their products from those of the debtor, to reduce the argument that the successor received “good will” along with the debtor’s assets.

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