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Saving Your Assets: Understanding Successor Liability In Illinois

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Imagine this scenario: One day you receive a new complaint. The plaintiff is claiming your client is liable based on decades-old conduct. But you know that the company did not even own the business at that time. What now? The answer could be directly tied to how the purchase was structured. And when it was structured to purchase assets only, a defense attorney should turn to the successor liability defense (the "defense").

In Illinois, like most jurisdictions, liabilities of the selling predecessor will not be imposed on the asset buyer. *Vernon v. Schuster*, 179 Ill. 2d 338, 344-45, 688 N.E.2d 1172, 1175 (1997); *Nguyen v. Johnson Mach. & Press Corp.*, 104 Ill. App. 3d 1141, 1151, 433 N.E.2d 1104, 1112 (1st Dist. 1982). This traditional rule of non-liability for buyers "developed as a response to the need to protect bonafide purchasers from unassumed liability and was designed to maximize the fluidity of corporate assets." *Vernon*, 179 Ill. 2d at 345. The import of the defense is that it acts as a complete defense to claims arising out of a seller's acts, including the seller manufacturing a defective product or acting negligently.

While this defense traditionally is used in product liability actions, defendants have utilized it in actions involving ERISA, breaches of real estate contracts, opposition to the EEOC's subpoena power, and security trading violations, to name a few.

Certain exceptions exist, however, and, in some ways, the defense is better known for its exceptions than the general rule. The exceptions fall under two categories: traditional and non-traditional. Illinois only recognizes the traditional exceptions. The traditional exceptions are: (1) an express or implied assumption of the seller's liabilities; (2) a merger occurring between the buyer and seller; (3) the buyer acting as a mere continuation of the seller; or (4) the transaction being completed for fraudulent purposes. *Id.* at 345. The non-traditional exceptions consist of the "product line" and "continuity of enterprise" exceptions and have been rejected in Illinois.

For the assumption of liability exception to apply, the buyer must assume the seller's liabilities. A plaintiff generally cannot establish an assumption if the agreement is silent, and, if an agreement disclaims liability, no assumption occurs. The question of when a company impliedly assumes liabilities is an open one in Illinois; however, Illinois courts have found no assumption where the buyer agrees to purchase insurance for the seller. *Green v. Firestone Tire & Rubber Co.*, 122 Ill. App. 3d 204, 210, 460 N.E.2d 895, 899 (2d Dist. 1984); *Ruiz v. Weiler & Co., Inc.*, 860 F. Supp. 602, 605 (N.D. Ill. 1994).

Where a plaintiff claims the merger exception applies, the plaintiff must establish: (a) continuity of management, personnel, physical location, assets, and

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business operations; (b) continuity of shareholders; (c) the seller ceases its business operations, liquidates, and dissolves as soon as legally and practically possible; and (d) the buyer assumes those liabilities and obligations of the seller ordinarily necessary for the uninterrupted continuation of the seller's business operations. *Nguyen*, 104 Ill. App. 3d at 1143,; *Myers v. Putzmeister, Inc.*, 232 Ill. App. 3d 419, 425, 596 N.E.2d 754, 756 (1st Dist. 1992); (exception does not apply where proof of any element absent); *Nilsson v. Cont'l Mach. Mfg. Co.*, 251 Ill. App. 3d 415, 418, 621 N.E.2d 1032, 1034 (2d Dist. 1993) (continuity of ownership a prerequisite to establish exception).

When a company uses fraudulent means to escape liability, it can later be liable for the debt or liabilities of the predecessor. While Illinois has not established a test for when a fraudulent transaction takes place, *per se*, in the context of the successor liability defense, the Uniform Fraudulent Transfer Act presents a list of factors that a court may consider when analyzing the applicability of this exception.

Where a plaintiff claims the mere continuation exception applies, a plaintiff must show that no corporation existed before the asset purchase and also must establish that there was: (a) similar identity of officers and directors; and (b) stock being transferred between the selling and purchasing corporations. Generally, Illinois courts look no further than whether a continuity of ownership exists. *Nguyen*, 104 Ill. App. 3d at 1149,; *Putzmeister, Inc.*, 232 Ill. App. 3d at 423, ("a purchaser of assets will not be liable under the theory of *de facto* merger or mere continuation in the absence of continuity of ownership").

A fraudulent transfer also defeats the defense. When a company uses fraudulent means to escape liability, it can later be liable for the debt or liabilities of the predecessor. While Illinois has not established a test for when a fraudulent transaction takes place, *per se*, in the context of the successor liability defense, the Uniform Fraudulent Transfer Act (740 ILCS 160/5 (2011)) presents a list of factors that a court may consider when analyzing the applicability of this exception. *See*, *e.g.*, *Steel Co. v. Morgan Marshall Indus., Inc.*, 278 Ill. App. 3d 241, 251-52, 662 N.E.2d 595, 601-2 (1st Dist. 1996). One example of potential fraud occurs when a company sells its assets far below market value to another company in which the seller's shareholders hold a stake. *Morgan Marshall*, 278 Ill. App. 3d at 245, 662 N.E.2d at 598; *cf. Putzmeister, Inc.*, 232 Ill. App. 3d. at 425, 596 N.E.2d at 756 (no fraud despite a "disparity between the value of the predecessor's debts and assets").

Two additional exceptions exist, but Illinois does not recognize either. The "product line" exception defeats the defense when a buyer continues to manufacture the same product line as the seller. The justification for this exception is that, despite the buyer not manufacturing the defective product, the buyer benefitted from the seller's goodwill and should make the plaintiff whole. This exception was first adopted by the California Supreme Court in *Ray v. Alad Corp.*, 19 Cal. 3d 22, 560 P.2d 3 (Cal. 1977). This exception has been rejected in over 20 states, including Illinois. *Diguilio v. Goss Int'l Corp.*, 389 Ill. App. 3d 1052, 1063-64, 906 N.E.2d 1268, 1278 (1st Dist. 2009) (identifying cases rejecting product line exception).

The "continuity of enterprise" exception was popularized following the Michigan Supreme Court decision of *Turner v. Bituminous Cas. Co.*, 397 Mich. 406, 244 N.W.2d 873 (Mich. 1976). This exception effectively creates

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liability for a buyer for the seller's debt if the buyer merely continues the business of the seller. Only Michigan, Alaska, Alabama, Ohio, Pennsylvania, and New Jersey have adopted or written favorably about this exception, and 16 states, including Illinois, have rejected it. *Nguyen*, 104 Ill. App. 3d at 1144-48.

Applying this defense requires an attorney to know the client's corporate history. To determine whether the defense applies, litigators must seek out information on a company's corporate history, should request copies of all prior purchase agreements, and pay particular attention to whether those deals were structured as an asset purchase or a stock deal. If it is structured to purchase assets of the seller, then the defense applies and a litigator should then consider the exceptions discussed above. ■