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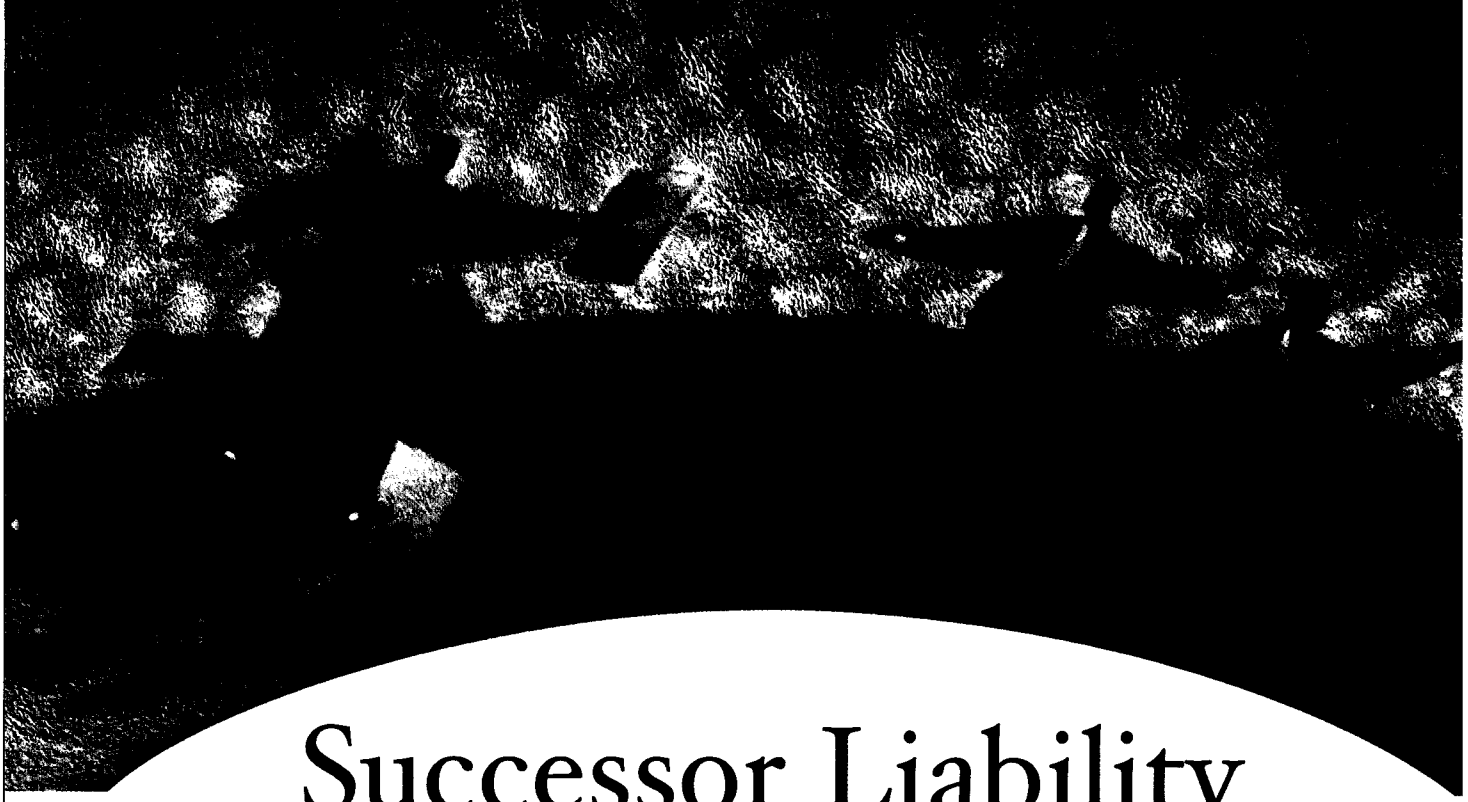

Successor Liability in Illinois

When can creditors and tort victims sue the buyer of a business for the debts and torts of the seller? This article discusses Illinois case law on the doctrine of successor liability.

By George W. Kuney

Successor liability is an exception to the general rule that, when one corporate or other juridical person sells assets to another entity, those assets are transferred free and clear of all but valid liens and security interests. When successor liability is imposed, a creditor or plaintiff with a claim against the seller may assert that claim against and collect payment from the purchaser.

Historically, successor liability was a flexible doctrine, designed to eliminate harsh results from strict application of corporate law. Over time, however, as successor liability doctrines evolved, they became ossified in many jurisdictions. Corporate lawyers and those who structure transactions learned how to avoid successor liability doctrines.[1]

This article summarizes what has become of various species of non-statutory successor liability in Illinois.[2]

Background

Successor liability doctrines are both judge-made (the "common law" ex-

1. See George W. Kuney, *A Taxonomy and Evaluation of Successor Liability*, 6 Fla St U Bus L Rev 9 (2006), also available at http://www.law.utk.edu/FACULTY/Kuney/TaxandEvalOfSuddLia.pdf.

2. A detailed jurisdiction-by-jurisdiction analysis and explanation of the state of judge-made successor liability law can be found at http://www.law.utk.edu/FACULTY/Kuney/AppendixTaxonomy10-15-07.pdf. The author updates this analysis regularly so that it remains current.

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ceptions) and statutory. Both represent a public policy that, in certain instances and for certain liabilities, the general rule of non-liability of a successor for a predecessor's debts following an asset sale should not apply. This article addresses the status of the first group, judge-made successor liability in Illinois.

Judge-made successor liability is a product of the rise of corporate law in the last half of the 19th century and early part of the 20th century. It appears to have developed because of and in reaction to the rise of corporate law. It is probably better classified as a corporate-law doctrine, like "alter ego" or "piercing the corporate veil,"[3] rather than as a creature of tort law, although it is used by involuntary tort claimants.

Authorities list four to six situations in which judge-made successor liability has been recognized: (1) express or implied assumption, (2) fraud, (3) de facto merger, (4) mere continuation, (5) continuity of enterprise, and (6) product line.[4] In fact, the matter is more complicated than that. Each species of successor liability comprises different sub-species with different standards in the jurisdictions that recognize them.

Some use a list of mandatory elements while others are based on a non-exclusive list of factors to be weighed in a "totality of the circumstances" fashion. Some that began as a flexible list of factors have evolved into mandatory elements. In any event, to state that there are only four, five, or six categories is to oversimplify the matter.[5]

When examined in detail, the types of successor liability can be classified into five general species, each of which is specifically defined on a jurisdiction-by-jurisdiction basis. The four categories of successor liability recognized in Illinois[6] and addressed in this article are: (1) intentional assumptions of liabilities, (2) fraudulent schemes to escape liability, (3) de facto mergers, and (4) the "mere continuation" continuity exception. The fifth category, the product-line exception, has consistently been rejected by Illinois courts.[7]

Intentional (express or implied) assumption of liabilities

Intentional assumption of liabilities, express or implied, is probably the simplest of the successor liability species. Imposing liability on a successor that by its actions is shown to have assumed liabilities is essentially in the realm of contract law, drawing on doctrines of construction and the objective theory of contract.[8] In the absence of any such terms the default rule that the purchaser does not assume any liability applies.

In determining whether the successor corporation assumed the liabilities of the predecessor, the Illinois courts "are nevertheless governed by the express provisions of the written document which dictates the agreement between the parties."[9]

Fraudulent schemes to escape liability

The next species of successor liability is based on fraud. Perpetrators of fraudulent schemes to escape liability by using corporate law limitation-of-liability principles to defeat the legitimate interests of creditors are typically subject to successor liability.[10]

If a corporation's equity holders, for example, arrange for the company's assets to be sold for less than market value to a new company in which they also hold a stake, the legitimate interests of the company's creditors have been frustrated.[11] By making the successor corporation liable in such instances, the creditors' interests are respected. The challenge, of course, is defining the standard that separates the fraudulent scheme from the legitimate one.

Illinois courts have not developed a test for the fraud exception. However, in *Myers v Putzmeister,* the first district held that there was no evidence of fraud in the transaction sub judice "notwithstanding the disparity between the value of the predecessor's debts and assets."[12] Under Illinois law, it is not necessary to show the existence of a majority of the 11 badges of fraud listed in the fraudulent conveyance statute.[13]

De facto merger

In a *statutory* merger, the successor corporation becomes liable for the predecessor's debts.[14] The de facto merger theory of successor liability imposes the same result for an asset sale that is like a statutory merger except for the continuity of liability, so that form doesn't triumph over substance.

The main difference between the sub-

3. See generally Steven L. Schwarcz, *Collapsing Corporate Structures: Resolving the Tension Between Form and Substance*, 60 Bus Law 109 (2004).

4. See *Savage Arms, Inc v Western Auto Supply Co*, 18 P3d 49 (SC Alaska 2001) (discussing varied approaches to determination of whether successor liability was a creature of contract and corporate law or tort law as part of its choice of law analysis and concluding that successor liability is a tort doctrine designed to expand products liability law; collecting cases and other authorities on both sides of the issue).

5. The variance in states' approaches to successor liability and to the related doctrines of alter ego or piercing the corporate veil are one of the reasons that the federal courts have adopted a uniform federal common law of these subjects under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA). See *United States v General Battery Corp, Inc*, 423 F3d 294, 298-301 (3d Cir 2005) (collecting authorities).

Successor liability is an exception to the rule that when one entity sells assets to another entity the transfer is free and clear of everything but valid liens and security interests.

6. *Vernon v Schuster*, 179 Ill 2d 338, 345-46, 688 NE2d 1172, 1175-76 (1997); *Community Ins Servs v United Life Ins Co*, 2007 WL 2710495 *3 (SD Ill 2007). *Judson Atkinson Candies, Inc v Latini-Hohberger Dhimantec*, 476 F Supp 2d 913 (ND Ill 2007); *Joseph Hubber Brewing Co, Inc v Pamado, Inc*, 2007 WL 2583719 *8-9 (ND Ill 2006); *Muniz v Rexnord*, 2006 WL 3210463 at *3 (ND Ill 2006); *Consol Servs and Const, Inc v S. R. McGuire Builder and Gen Contractor, Inc*, 367 Ill App 3d 324, 329, 854 NE2d 715, 720 (1st D 2006); *MacDonald v Hinton*, 361 Ill App 3d 378, 836 NE2d 893 (1st D 2005); *Flanders v California Coastal Communities, Inc*, 356 Ill App 3d 1113, 1118, 828 NE2d 793, 798 (5th D 2005); *Chatham Surgicore, Ltd v Health Care Serv Corp*, 356 Ill App 3d 795, 826 NE2d 970 (1st D 2005); *Brandon v Anesthesia & Pain Mgmt Asso Ltd*, 419 F3d 594 (7th Cir 2005).

7. *Nilsson v Continental Mach Mfg Co*, 251 Ill App 3d 415, 418, 621 NE2d 1032, 1035 (2d D 1993); see also *Green v Firestone Tire & Rubber Co, Inc*, 122 Ill App 3d 204, 212, 460 NE2d 895, 901 (2d D 1984) (refusing to adopt the rationale of the *Turner* (note 24) line of cases but confusing the *Turner* continuity of enterprise exception with the product line exception).

8. Michael J. Zaino, Bielagus v EMRE: *New Hampshire Rejects Expansion of Traditional Test for Corporate Successor Liability Following an Asset Purchase*, 45 NH Bar J 26 (2004).

9. *Myers v Putzmeister*, 232 Ill App 3d 419, 424, 596 NE2d 754, 756 (1st D 1992); *Kehrer Bros Const, Inc v Custom Body Co*, 2008 WL 182503 *4 (SD Ill 2008); *Pamado*, 2006 WL 2583719 *9.

10. *Pamado*, 2006 WL 2583719 *9, citing *Vernon v Schuster*, 179 Ill 2d 338, 688 NE2d 1172 (1997).

11. Causation is a required element of all species of the fraud exception. See, for example, *Milliken & Co v Duro Textiles, LLC*, 19 Mass L Rep 509 (2005) (discussing need for causation, but also that judgment creditors could look to company's long term prospects, not just immediate insolvency).

12. *Myers* at 424, 596 NE2d at 756.

13. *Brandon v Anesthesia & Pain Mgmt Assocs Ltd*, 419 F3d 594 (2005).

14. G. William Joyner, III, *Beyond* Budd Tire: *Examining Successor Liability in North Carolina*, 30 Wake Forest L Rev 889, 894 (1995).

species of de facto merger in various jurisdictions is how rigid or flexible the test is. In other words, how many of the elements that indicate a de facto merger must be present before the doctrine applies and the successor business is liable? On one end of the spectrum is the lengthy, mandatory checklist of required elements; on the other is a non-exclusive list of factors to be weighed in a totality-of-the-circumstances fashion.

The purpose of the doctrine was to provide creditors with recourse against a successor entity when the predecessor was judgment-proof.

In *Nilsson v Continental Machine Mfg Co*, the second district noted that, as under the mere continuation exception, continuity of ownership is a prerequisite for imposing liability under the de facto merger exception.[15] The court noted that the mere-continuation and de facto merger exceptions are similar but apply in different circumstances: the former when no corporation existed before the asset purchase, the latter when two existing corporations are combined in the sale.[16] Besides stating this obvious difference, the *Nilsson* court provided no guidance on the contours of the de facto merger exception.

In another decision by the first district, the court stated the following "elements" of a de facto merger:

> (1) There is a continuation of the enterprise of the seller corporation, so that there is a continuity of management, personnel, physical location, assets and general business operations.
>
> (2) There is continuity of shareholders which results from the purchasing corporation paying for the acquired assets with shares of its own stock, this stock ultimately coming to be held by the shareholders of the seller corporation so that they become a constituent part of the purchasing corporation.
>
> (3) The seller corporation ceases its ordinary business operations, liquidates and dissolves as soon as legally and practically possible.
>
> (4) The purchasing corporation assumes those liabilities and obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operations of the seller corporation.[17]

Continuation of the business: "mere continuation"

An exception with two distinct subcategories permits successor liability when the successor continues the business of the seller. The subcategories are "mere continuation" and "continuity of enterprise."

The two share roughly the same indications. The difference: continuity of enterprise does not require continuity of shareholders or directors or officers between the predecessor and the successor. That requirement is one of the mere-continuation exception's dispositive elements or factors.[18] The continuity-of-enterprise doctrine, however, has not been adopted in Illinois.

Under Illinois law, continuity of ownership is a threshold requirement of the mere-continuation exception but it is unclear from state court opinions what other factors are relevant.[19] Federal district courts in Illinois have applied factors based on other federal opinions such as continued existence of transferring entity, adequate consideration, continuity of personnel and employees, the successor operating under a similar name to that of predecessor, and the successor holding itself out as a continuation of the predecessor.[20]

In *Vernon v Schuster*, the Illinois Supreme Court held that a corporation or partnership that purchases the assets of a sole proprietorship where the proprietor is deceased cannot possibly be a continuation of the former business because the sole proprietor's death means that there is no continuity of ownership.[21]

The dissent in *Vernon* argued that continuity of ownership should be only one of several factors that the court considers under the mere continuity exception.[22] The seventh circuit has held, citing *Vernon,* that successor liability may lie under the mere-continuation exception even if the predecessor has not dissolved.[23]

Despite the strict requirement of continuity of ownership required by the Vernon majority, some courts have found such continuity in surprising situations such as with transfers between family members and in cases where the owners of the predecessor have a significantly reduced ownership in the successor.[24]

Illinois courts have noted the similarity between the mere continuation and de facto merger doctrines, but it was determined that the two are distinguishable: "[t]he mere continuation exception applies where a corporate reorganization has taken place, so that the corporation has simply 'put on a new coat.' A merger, on the other hand, involves the combining of two existing corporations into a single successor corporation."[25]

Conclusion

This article and its more detailed companion on the author's website (http://www.law.utk.edu/FACULTY/Kuney/kuney.htm) attempt to detail some of the history and the current condition of successor liability law in Illinois.

The purpose of the doctrine was to provide contract and tort creditors with recourse against a successor entity when the predecessor that contracted with them or committed the tort had sold the assets and was no longer a source of recovery. Its various species acted as a relief valve on the strict limitation of liability created by corporate law.

The doctrine is "equitable" in nature to the extent that it comes into play when strict application of corporate law would offend the conscience of the court. In large part, the doctrine remains intact and still serves that purpose. ■

15. *Nilsson* at 418, 621 NE2d at 1035.
16. Id at 417, 621 NE2d at 1034.
17. *Myers* at 423, 596 NE2d at 756 (internal citations omitted).
18. Rest 3d Torts-PL §12, Comment g; Am L Prod Liab 3d § 7:20 (2004).
19. *Vernon* at 346, 688 NE2d at 1176; *Kehrer,* 2008 WL 182503 *11.
20. *United States Commodity Future's Trading Commission v Lake Shore Asset Mgmt*, 2007 WL 2659990 *21 (ND Ill 2007); *Pamado*, 2006 WL 2583719 *8.
21. *Vernon* at 346, 688 NE2d at 1176.
22. Id at 351, 668 NE2d at 1178 (Bilandic dissenting).
23. *Brandon v Anesthesia & Pain Mgmt Assocs Ltd*, 419 F3d 594, 598-99 (7th Cir 2005) (finding that the predecessor was being preserved in a "ghostly existence" by the successor precisely to defeat a finding of continuity for successor liability purposes).
24. *Pamado*, 2006 WL 2583719 *12.
25. *Nilsson* at 418, 621 NE2d at 1034 (citations omitted); *Dileo v Vi-Jon Laboratories, Inc*, 2007 WL 2317247 *2 (ND Ill 2007).