CUSTOMER FOCUS ON **LOSS CONTROL**

NUMBER 5

Hidden Exposures: Mergers, Acquisitions, and Product Liability

Since the 1970's, mergers and acquisitions have become fairly common place. As corporations "downsize", divisions, departments, or product lines are sold to others, discontinued, or reorganized into to new entities. Organizations that are experiencing financial difficulties are seeking protection through liquidation and bankruptcy. From a product liability perspective, these actions can represent "hidden exposures." "The form of an acquisition and the subsequent conduct of the parties govern the liability of the purchasing corporation for injuries arising out of products manufactured, sold, or distributed by the acquired business prior to the transfer." (1) An acquisition can take place in any of these basic ways:

- ***A stock purchase*** leaves the original company intact as if there had been no change in ownership.
- A ***merger*** or ***consolidation*** allows the "selling" organization to continue its operation as part of the "purchasing" company. The purchaser retains all the obligations and liabilities of the "seller."
- The ***sale of assets for stock in the purchasing company*** is considered a "de facto" or unofficial merger or consolidation. As such, the purchaser retains the seller's liabilities.
- In ***sale of assets for cash,*** the purchaser "normally" does not retain the liabilities. This is known as *"successor non-liability."*

As with many laws or codes, there are exceptions to the rule. In the case of "successor non-liability," there are *four recognized exceptions*:

- An express agreement to assume obligations of the seller
- A *de facto* merger or consolidation
- Fraudulent attempts to avoid the seller's obligations
- When the buyer is a mere continuation of the seller

Two other exceptions are advocated by a few courts: Continuity of enterprise, and the product line theory.

(continued on next page)

THE HARTFORD

Continuity of enterprise considers the 'big picture;" liability is imposed when:

- The seller transfers substantially all assets
- The purchaser keeps key personnel, facilities, and operations
- The seller discontinues operations following the takeover
- The purchaser assumes the seller's liability for general operations and is considered a continuation of the seller's previous operations.

This exception requires the purchaser to manufacture the seller's product using the seller's personnel and production facilities. When only the patents, plans or production rights are purchased, with no acquisition of facilities or use of the seller's personnel, liability is normally *not transferred* to the purchaser.

The product line theory makes it almost impossible for a person to file suit against the original manufacturer. Under this theory, liability passes from the seller to the purchaser when:

- Virtually all assets are purchased
- The seller discontinues and dissolves operations after the purchase is completed
- The purchaser continues the same product line
- There is no easily detected indication that a change of ownership/management took place

If the seller continues to operate following the sale, the purchaser incurs no liability. This is also the case should the seller later dissolve for reasons unrelated to the sale (e.g., bankruptcy).

Even with these rules in place, the effect of an acquisition or merger on the product liability of the purchaser for defective products made and/or sold *prior to the sale* is significantly influenced by the laws of the state where the injury occurs. The terms of the sale agreement would not be the determining factor.

Regardless of the type or form of the agreement, the purchaser may find itself liable because inadequate warnings for products that were made and distributed by the seller prior to the sale. This duty is dependent on the purchaser's knowledge, actual or constructive, of the defect and the location and owner of the defective product.

Reference

1. "Mergers, Acquisitions and Product Liability : Buying More Than You Bargained For." *Best's Underwriting Newsletter*, Volume 22, Number 3, March 1993. (entire issue)