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Flaugher v. Cone Automatic Machine Co.: The Ending of a Trend in Successor Liability or a Minor Setback for Product Liability Claimants?

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FLAUGHER v. CONE AUTOMATIC MACHINE CO. THE ENDING OF A TREND IN SUCCESSOR LIABILITY OR A MINOR SETBACK FOR PRODUCT LIABILITY CLAIMANTS?

The struggle to define the outer boundaries of "successor corporation" product liability has consumed more than a decade of judicial resources.[1] Traditionally, a corporation purchasing the assets of another corporation assumes the seller's liabilities if any of the following four conditions are met: (1) the purchasing corporation expressly or impliedly agrees to assume the liabilities; (2) the purchase constitutes a de facto merger or consolidation; (3) the purchasing corporation is a mere continuation of the seller; or, (4) the transfer of assets constitutes a fraudulent attempt to avoid liabilities.[2] Many courts[3] and commentators,[4] deeming the traditional rule unfair to product liability claimants,[5] responded by either expanding the application of one or more of the four traditional exceptions to successor non-liability,[6] or by embracing a fifth exception, popularly known as the "product-line" exception.[7]

Primary judicial expansion of the traditional exceptions has taken place under the de facto merger and continuation areas.[8] Historically, the de facto merger exception required that the consideration received by the seller for its corporate assets consist exclusively of successor corporation stock.[9] Modern courts insist only that there be a continuity of shareholders and that the con-

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[1] *See* Turner v. Bituminous Cas. Co., 397 Mich. 406, 244 N.W.2d 873 (1976); Ray v. Alad Corp., 19 Cal. 3d 22, 560 P.2d 3, 136 Cal. Rptr. 574 (1977); Ramirez v. Amsted Industries, Inc., 86 N.J. 332, 431 A.2d 811 (1981); Martin v. Abbott Laboratories, 102 Wash. 2d 581, 689 P.2d 368 (1984); George v. Parke-Davis, 107 Wash. 2d 584, 733 P.2d 507 (1987).

[2] *Ramirez*, 86 N.J. at 340-41, 431 A.2d at 815.

[3] *See, e.g., Ramirez*, 86 N.J. at 341, 431 A.2d at 815-16; *Turner*, 397 Mich. at 418-24, 244 N.W.2d at 886-93.

[4] *See, e.g.*, Phillips, *Product Line Continuity And Successor Corporation Liability*, 58 N.Y.U. L. REV. 906 (1983); Green, *Successor Liability: The Superiority Of Statutory Reform To Protect Product Liability Claimants*, 72 CORNELL L. REV. 17 (1986) [hereinafter cited as *Green*]; Aylward & Aylward, *Successor Liability for Defective Products — Misplaced Responsibility*, 13 STETSON L. REV. 555 (1984); Hyman, *The Liability of Successor Corporations For Defective Products Of A Predecessor Corporation — A Switch From Corporate To Tort Law*, 10 S.U. L. REV. 165 (1984).

[5] When a products liability claimant is injured by a defective product, often the product's manufacturer has already sold all its assets and gone out of existence. The claimant's sole recourse is suing the successor corporation under one of the four traditional exceptions, essentially designed to protect the rights of commercial creditors and dissenting shareholders. Flaugher v. Cone Automatic Machine Co., 30 Ohio St. 3d 60, 68, 507 N.E.2d 331, 339 (1987) (Sweeney, J., dissenting, quoting *Ramirez*, 86 N.J. at 341, 431 A.2d at 815-16).

[6] *E.g.*, Knapp v. North Am. Rockwell Corp., 506 F.2d 361 (3d Cir. 1974), *cert. denied*, 421 U.S. 965 (1975). *Turner*, 397 Mich. at 429-30, 244 N.W.2d at 895-96; Cyr v. B. Offen & Co., 501 F.2d 1145 (1st Cir. 1974).

[7] *E.g., Ramirez*, 86 N.J. at 358, 431 A.2d at 825; *George*, 107 Wash. 2d at 588, 733 P.2d at 510.

[8] Green, *supra* note 4, at 24; Note, *Expanding The Products Liability Of Successor Corporations*, 27 Hastings L.J. 1305 (1976).

[9] *See, Turner*, 397 Mich. at 422-23, 244 N.W.2d at 880. *See, e.g.*, Shannon v. Samuel Langston Co., 379 F. Supp. 797, 801-02 (W.D. Mich. 1974); *Green, supra* note 4, at 25 n. 37.

sideration paid include shares of stock.[10]

The traditional continuation exception requires proof that the successor corporation is a continuation of the corporate entity in all functional aspects.[11] Under the expanded view, the courts insist only that the seller and buyer share significant features, including common officers, directors, employees or shareholders.[12] Some courts have chosen to eliminate the requirement that the seller corporation dissolve immediately after the sale of assets.[13]

The "product-line" exception originated in *Ray v. Alad Corp.*[14] The California Supreme Court held that a transferee of a company's operating assets assumes strict tort liability for defective units within the same product line as previously manufactured and distributed by the transferor manufacturer.[15] *Ray* has been interpreted as requiring three additional factors: (1) that there be a virtual destruction of plaintiff's remedies against the original manufacturer caused by the successor's purchase of the business; (2) that the successor be capable of assuming the original manufacturer's risk-spreading role; and, (3) that the successor benefit from the goodwill of the original manufacturer.[16]

This Casenote analyzes the recent Ohio Supreme Court decision in *Flaugher v. Cone Automatic Machine Co.*[17] to evaluate both its impact on the field of successor corporate liability and the opinion's fundamental soundness. The *Flaugher* court identified three issues: (1) whether the facts demanded application of one of the traditional exceptions to the rule of successor non-liability, (2) whether the court should adopt the "product line" theory of liability, and (3) whether the defendant corporations had a duty to warn plaintiff of the alleged defect in the machine which injured her.[18] The court affirmed the lower court's decision by answering each issue in the negative.

THE FACTS

On April 24, 1979, plaintiff-appellant Carla Flaugher was injured by an eight-spindle Conomatic bar and screw machine.[19] Defendant Cone Automatic Machine Company, Inc. (Cone I) manufactured the Nu Conomatic machine

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[10] In Re Asbestos Litigation (Bell), 517 A.2d 697, 699 (Del. Super. Ct. 1986); Savini v. Kent Machine Works, Inc., 525 F. Supp. 711, 716 (E.D. Pa. 1981).

[11] *Green, supra* note 4, at 25; *Ramirez*, 86 N.J. at 342, 431 A.2d at 823.

[12] *Flaugher*, 30 Ohio St. 3d at 64-65, 507 N.E.2d at 336.

[13] *See Knapp*, 506 F.2d at 361.

[14] 19 Cal. 3d 22, 560 P.2d 3, 136 Cal. Rptr. 574 (1977).

[15] *Id.* at 34, 560 P.2d at 11, 136 Cal. Rptr. at 582.

[16] *See* Lundell v. Sidney Mach. Tool Co., 190 Cal. App. 3d 1546, 1550-55, 236 Cal. Rptr. 70, 74-78 (1987); *George*, 107 Wash. 2d at 588, 733 P.2d at 510.

[17] 30 Ohio St. 3d at 60, 507 N.E.2d at 331.

[18] *Id.* at 61-62, 507 N.E.2d at 333-34.

[19] *Id.* at 60, 507 N.E.2d at 333.

in 1953.[20] Cone I no longer exists and is not a party to this appeal.[21] On July 19, 1963, Pneumo Corporation purchased Cone I's stock and assets.[22] Pneumo Corporation then dissolved Cone I and immediately created a new corporation, Cone Automatic Machine Co., Inc. (Cone II).[23] Cone II held the "Cone" name and associated rights as a non-functional holding company.[24]

After purchasing Cone I, Pneumo Corporation combined its manufacturing capabilities with those of Blanchard Machine Company and Springfield Grinding Machine Company, creating a new enterprise: Pneumo Dynamics Machine Tool Group (PDMTG).[25] In December, 1972, Cone-Blanchard Machine Company (Cone-Blanchard) purchased PDMTG's assets and Cone II's stock for approximately eleven million dollars.[26]

The plaintiff's complaint named Cone I, Cone II, Pneumo Corporation and Cone-Blanchard as defendants.[27] Carla Flaugher alleged that she sustained injuries as a direct and proximate result of the defendants' negligent design and manufacture of the Conomatic, and their negligent failure to warn of its dangerous condition.[28] The trial court sustained Cone I's motion to dismiss for plaintiff's failure to state a sufficient claim.[29] The trial court also granted the Pneumo Corporation and Cone II motions for summary judgment, reasoning that neither corporation fell within the traditional exceptions to the general rule of successor non-liability.[30] The trial court refused to apply the "product-line" theory of liability,[31] reasoning that even if the theory were adopted in Ohio, the facts rendered it inapplicable because the predecessor entity, Pneumo Corporation, remained a viable business concern.[32] Because appellees had no notice of the purported defect, no liability could arise through any failure in their alleged

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[20] *Id.*

[21] *Id.*

[22] Pneumo Corporation was then known as Pneumo Dynamics Corporation. *Id.* The trial court dismissed the action against Pneumo Dynamics because the applicable statute of limitations had run. Flaugher v. Automatic Machine Co., No. CA84-05-040, slip op. at 10 (Ohio App. 1986). The dismissal went unchallenged, and Pneumo Dynamics was not a party to this appeal.

[23] *Flaugher*, 30 Ohio St. 3d at 60, 507 N.E.2d 333.

[24] *Id.*

[25] *Id.* at 60-61, 507 N.E.2d at 333.

[26] *Id.* at 61, 507 N.E.2d at 333.

[27] Appellant Carla Flaugher's husband, Bradley Flaugher, was also a party to this action. *Id.*

[28] *Id.*

[29] Cone I was a Vermont corporation. Applicable Vermont law bars claims against dissolved corporations where the claim did not exist prior to dissolution. *Id.*

[30] *Id.*

[31] *See supra* note 4.

[32] This argument apparently relies on the later interpretation given *Ray v. Alad Corp.* For example, in *Lundell*, the California Court of Appeals followed *Ray* by requiring a "virtual destruction of plaintiff's remedies against the original manufacturer caused by the successor's acquisition of the business" before the law may impose strict liability. Lundell v. Sidney Mach. Tool Co., 190 Cal. App. 3d at 1550, 236 Cal. Rptr. at 74 (quoting *Ray*, 19 Cal. 3d at 31, 560 P.2d at 9, 136 Cal. Rptr. at 580).

duty to warn appellant of the defect in the Conomatic.[33]

The court of appeals substantially adopted the reasoning of the trial court in affirming the decision.[34] The cause was brought before the Ohio Supreme Court following appellant's motion to certify the record.[35]

ANALYSIS

The court first determined whether either Cone II or Cone-Blanchard fell within a recognized exception to the traditional rule of successor non-liability.[36] Stating that "[t]he general rule in products liability is that a successor corporation's amenability to suit will depend on the nature of the transaction which gave rise to the change in ownership,"[37] the court continued by reciting the traditional exceptions to the rule of successor non-liability.[38] The court reasoned that because the purchase of PDMTG and Cone II by Cone-Blanchard was a "sale of assets" transaction, Cone-Blanchard could not be held liable unless one of the four exceptions applied.[39] The appellants conceded that the second and fourth exceptions were inapplicable. Therefore, the court examined Cone II and Cone-Blanchard's potential liability under the first and third exceptions.[40]

Under the first exception, appellants argued that the purchase agreement between Pneumo Corporation and Cone-Blanchard was ambiguous as to whether Cone-Blanchard intended to assume Cone I's tort liability.[41] The court found that the purchase agreement unambiguously stated that Cone-Blanchard assumed only those liabilities incurred by Pneumo Corporation.[42] Further, the court determined that section 5.2 of the purchase agreement clearly indemnified Cone-Blanchard against any liabilities predating the purchase agreement and not ex-

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[33] *Flaugher*, 30 Ohio St. 3d at 61, 507 N.E.2d at 333.

[34] *Id.*

[35] *Id.*

[36] *Id.*

[37] *Id.* at 62, 507 N.E.2d at 334.

[38] *Id.*

[39] *Id.* The traditional rule has been greatly criticized as being "inconsistent with the rapidly developing principles of strict liability in tort and unresponsive to the legitimate interests of the products liability plaintiff." *Ramirez*, 86 N.J. at 341, 431 A.2d at 815.

[40] *Flaugher*, 30 Ohio St. 3d at 62, 507 N.E.2d at 334. Appellants did not argue the "de facto merger" exception because even under the liberal view, courts have insisted that the consideration include shares of stock. In Re Asbestos Litigation (Bell), 517 A.2d 697, 699 (Del. Super. Ct. 1986). The consideration paid by Cone-Blanchard was approximately eleven million dollars, which apparently included no Cone-Blanchard corporate stock. *See Flaugher*, 30 Ohio St. 3d at 61, 507 N.E.2d at 333.

[41] *Flaugher*, 30 Ohio St. 3d at 62, 507 N.E.2d at 334.

[42] Section 6.2 of the purchase agreement provided in pertinent part that ". . . Buyer shall assume any liability *of Seller* for any damages . . . arising or alleged to arise . . . out of the negligence or willful misconduct *of Seller* in the manufacture of such machines or parts therefor . . . ." (Emphasis added.) *Id.* at 62-63, 507 N.E.2d at 334 n.2.

pressly assumed by Cone-Blanchard.[43]

The court continued by discussing the third exception to successor nonliability, the so-called "mere continuation" exception.[44] After stating that the traditional "mere continuation" exception required both continuation of the business operation and the corporate entity, the court noted that even under the expanded view Cone-Blanchard could not be considered a continuation of either Cone I or Pneumo Corporation.[45] The court substantially based its conclusion on two key facts: (1) Cone-Blanchard had no directors or officers in common with either Cone I or Pneumo Corporation, and (2) Pneumo Corporation continued to be a viable business concern long after the 1972 transfer.[46]

The court then looked to appellee Cone II, concluding that neither the "assumption of liability" nor the "mere continuation" exceptions applied.[47] First, no document had been disclosed which could be considered an assumption of liability by Cone II of Cone I's defectively-manufactured equipment.[48] Second, Cone II was a holding corporation, an entirely inactive corporate shell possessing only the Cone name and associated rights.[49] Consequently, Cone II could not be considered a "mere continuation" of Cone I, which had employees, a place of business and a product line.[50]

The court went on to address whether the "product-line" theory should be adopted by Ohio and applied to the facts presented.[51] The court determined that the "product-line" exception's "far reaching and radical departure from traditional principles" and its "potentially devastating burden on business transfers" dictated that its adoption would require legislative action rather than judicial activism.[52]

The third and final issue addressed by the court was whether Cone-Blanchard had a duty to warn appellant of the alleged defect in the Conomatic.[53] The court held that "a successor corporation has no duty to warn of defects

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[43] Section 5.2 of the purchase agreement provided in pertinent part that "Seller shall indemnify and hold Buyer harmless and shall assume the defense of any claim being asserted after the Effective Date against . . . the Machine Tool Group . . . arising out of any transaction entered into, or any state of existing, prior to the Effective Date . . . ." *Id.* at 63, 507 N.E.2d at 335, n.3.

[44] *Id.* at 64, 507 N.E.2d at 336.

[45] *Id.* at 64-65, 507 N.E.2d at 335-36. *See supra* note 12.

[46] *Id.* at 65, 507 N.E.2d at 336. As the majority points out, many courts applying the "mere continuation" exception have required that the predecessor be dissolved or liquidated after the transfer of assets. *E.g.*, *Turner*, 397 Mich. at 419-20, 244 N.W.2d at 887-88. *Contra Knapp*, 506 F.2d at 361; Trimper v. Bruno-Sherman Corp., 436 F. Supp. 349 (E.D. Mich. 1977).

[47] *Flaugher*, at 65, 507 N.E.2d at 336.

[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] *Id.* at 65-66, 507 N.E.2d at 336.

[52] *Id.* at 66-67, 507 N.E.2d at 337. The majority felt that legislative action was more appropriate due to the legislature's "comprehensive machinery for public input and debate." *Id.* at 66, 507 N.E.2d at 337.

[53] *Id.* at 67, 507 N.E.2d at 337.

in products manufactured by its predecessor unless the successor is shown to have had pre-existing knowledge, actual or constructive, of the particular defect alleged to exist."[54] Although Cone-Blanchard knew that an alleged defect in a different machine had previously caused a similar injury, the court found this finding insufficient to justify imposing liability.[55]

In his dissent, Justice Sweeney asserted that the majority's adherence to the traditional rule ignored both the rule's business law foundations and total irrelevance to the policy considerations underlying products liability law.[56] Justice Sweeney also opined that adoption of the "product-line" rule would "advance the protections afforded innocent third parties for injuries resulting from encounters with defective products."[57]

Justice Sweeney attacked the majority's conclusion that adoption of the "product line" theory required legislative action.[58] He pointed out that this case was one of first impression in Ohio and that both the "traditional" and the "product-line" theories were common-law concepts requiring equal treatment.[59] Therefore, the majority could not reject one concept as necessitating legislative action while in the same breath judicially adopt the other.[60]

Justice Sweeney also challenged the majority's other justification for refusing to adopt the "product-line" theory: that its adoption "would cast a potentially devastating burden on business transfers and would convert sales of corporate assets into traps for the unwary."[61] He emphasized that the rule embraced by the *Flaugher* majority placed the burden of loss on Ohio citizens suffering injuries inflicted by defective products, rather than on business enterprises benefiting from access to Ohio commerce.[62] Justice Sweeney further stressed that "such an inequitable allocation of burdens and benefits is both unjust and inexcusable."[63] Justice Sweeney advocated the adoption of the "product-line" theory, concluding that it satisfied all the policy considerations[64] for imposing liability on the entity responsible for the quality of a particular product.[65]

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[54] *Id.* at 67, 507 N.E.2d at 338.

[55] *Id.*

[56] *Id.* at 68, 507 N.E.2d at 338-39. These policy considerations include: (1) the manufacturer's superior ability to protect itself and bear the costs; (2) the manufacturer's launching the product into the channels of trade; (3) the manufacturer's violating the representation of safety implicit in putting the product into the stream of commerce; (4) the manufacturer's sole ability to improve the product's quality; and, (5) the negligence of the manufacturer's employees. *Id.* (citing Cyr v. B. Offen & Co., 501 F.2d 1145, 1154 (1st Cir. 1974)).

[57] *Flaugher*, 30 Ohio St. 3d at 68, 507 N.E.2d at 338.

[58] *Id.* at 72, 507 N.E.2d at 341.

[59] *Id.*

[60] *Id.*

[61] *Id.*; *see also supra* note 52.

[62] *Id.* at 72, 507 N.E.2d at 341.

[63] *Id.*

[64] *See supra* note 39.

[65] *Flaugher*, 30 Ohio St. 3d at 70, 507 N.E.2d at 340.

In dissent, Justice Sweeney contended that the extent to which Cone-Blanchard was aware or should have been aware of the defects in the machine involved factual questions which were best resolved by a jury.[66] Therefore, he opined, the trial court erred in granting Cone II's and Cone-Blanchard's motions for summary judgment.[67]

THE EFFECT OF FLAUGHER

Flaugher v. Cone Automatic Machine Co. is the first Ohio Supreme Court case dealing primarily with the liability of a successor corporation.[68] As such, *Flaugher* represents the Court's initial attempt to formulate an Ohio rule potentially impacting significantly on the field of successor corporate liability. However, the Ohio Supreme Court's decision, due to its lack of exactness and direction, will have little jurisprudential influence in the area of successor liability.

Unlike other courts,[69] the Ohio Supreme Court failed to enunciate clearly the prerequisites for applying any of the four traditional exceptions to the general rule of successor non-liability. While discussing the "mere continuation" exception, the court analyzed both the traditional and expanded versions. Without expressly adopting either interpretation, the court reviewed the material facts in light of the expanded view.[70] Although of little consequence in the present case, the court's failure to officially sanction either view may be critical in some future case involving different facts.[71] In such a case, *Flaugher* will be of little assistance.

Most importantly, the *Flaugher* majority declined to take a firm position on the "product-line" theory.[72] Most courts have either embraced or rejected the rule.[73] In deferring that decision to the state legislature, the court only perpetuates the confusion among both successor corporations and product liability claimants. Unless and until the Ohio Supreme Court issues clear rules governing successor corporate liability or the Ohio legislature takes a similar initiative, the *Flaugher* decision will probably encourage continued litigation of the issue. Meanwhile, *Flaugher* will give transferee corporations the advantage in the game of successor corporate liability.

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[66] *Id.* at 72, 507 N.E.2d at 341. Appellants contended that the requisite prior notice of the defect causing the injury was received by Cone-Blanchard on March 16, 1979, in a summons to defend a Texas lawsuit by a plaintiff who alleged an injury similar to that suffered by appellant. *Id.* at 67, 507 N.E. 2d at 337-38.

[67] *Id.* at 72, 507 N.E.2d at 342.

[68] In fact, this author could locate only four Ohio cases which referred to the subject of successor liability. Two of the four cases were unpublished, appellate-level decisions.

[69] *See* In Re Asbestos Litigation (Bell), 517 A.2d 697, 699-700 (Del. Super. Ct. 1986); *Ray,* 19 Cal. 3d at 31, 560 P.2d at 9, 136 Cal. Rptr. at 580.

[70] *Flaugher,* 30 Ohio St. 3d at 64-65, 507 N.E.2d at 336.

[71] The applicability of the "mere continuation" exception may well turn on which view the Court finally chooses to adopt.

[72] *Flaugher,* 30 Ohio St. 3d at 66-67, 507 N.E.2d at 336-37.

[73] *See, e.g., Ray,* 19 Cal. 3d at 34, 560 P.2d at 11, 136 Cal. Rptr. at 582; Young v. Fulton Iron Works Co., 709 S.W.2d 927 (Mo. App. 1986).

CONCLUSION

Flaugher v. Cone Automatic Machine Co. illustrates that the court's refusal to confront directly the issue of successor corporate liability can effectively deny product liability claimants compensation for injuries caused by a predecessor manufacturer's allegedly defective products.[74] By holding that the "product-line" exception to corporate successor non-liability is a matter for the legislature rather than the courts, the *Flaugher* decision encourages criticism.

If the "product-line" theory is indeed "far-reaching" and "radical" when compared to the traditional exceptions, then its adoption should require legislative action. However, considering how far some courts have expanded the traditional exceptions to successor corporate non-liability,[75] the "product-line" exception is not as "far-reaching" and "radical" as the *Flaugher* majority asserts. This comparison, especially when viewed in the context of a clear trend toward more liberal exceptions to the general rule of successor corporate non-liability,[76] puts the *Flaugher* court's holding on questionable ground. In addition, such an exercise of judicial restraint is specious at best. Deferral to the legislature ignores political reality,[77] does little to assist product liability claimants and, in practical terms, favors Ohio corporations.

Public policy considerations supporting the extension of strict product liability to claimants such as Carla Flaugher[78] and the clear trend toward more liberal exceptions to the traditional rule of successor corporation non-liability[79] indicate that *Flaugher* was incorrectly decided.[80] It may represent the beginning of a long, perilous journey for the product liability claimant confronted with a successor corporation defendant.

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[74] By failing to endorse the "product-line" theory in Ohio, the Court has forestalled plaintiffs' only recourse where a transferor corporation has dissolved prior to plaintiffs' injuries.

[75] This observation is true especially in the areas of the "de facto merger" and "mere continuation" exceptions. *See Green, supra* note 4, at 23.

[76] *See Ramirez*, 86 N.J. at 336, 431 A.2d at 817-19; *Green, supra* note 4, at 24.

[77] One commentator who advocates legislative action admits: "Realistically the proposed statute would confront significant political hurdles. The lobby for long-tail products liability claimants is exceedingly weak." *Green, supra* note 4, at 24.

[78] *Flaugher*, 30 Ohio St. 3d at 68, 507 N.E.2d at 338-39.

[79] *See supra* note 59.

[80] The author disagrees primarily with the Court's holding on the "product-line" issue rather than the duty to wash question of the application of the traditional successor non-liability exceptions.