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The Liability of the Unsuccessful Successor

By: Keller & Almassian, PLC
A. Todd Almassian

Client: Hi, I don't think I need an attorney, but I just want to run something by you real quick about a Complaint I just received.

Attorney: Okay, I don't do free consultations, but give me an overview of what you are dealing with.

Client: I owned a concrete company, AAA Concrete, LLC. Things got bad with Covid. AAA Concrete, LLC owes a lot of people and the bank a lot of money.

Attorney: Do you want to explore bankruptcy?

Client: No, I don't own AAA Concrete, LLC. I closed it down. My brother-in-law's uncle's friend, who knows a lot, told me to form a new company and transfer all the assets to the new company. We left our old location, my wife owns the new company, we changed the name to AA Concrete, LLC, and it has all of the former assets of AAA Concrete, LLC. The problem is AA Concrete, LLC just got sued from one of the vendors of AAA Concrete, LLC. They can't sue AA Concrete, LLC, right?

Attorney: Well, there is a body of case law known as Successor Liability.

Client: But, we have not been very Successful at AA, does that matter?

It is not uncommon to receive those calls, either in contemplation of a sale or transfer of assets or after such sale or transfer has occurred. Successor liability analysis is very fact intensive. The purpose of this article is to share the development of successor liability in Michigan as well as the applicable case law that may guide you in advising the owner of AAA Concrete, LLC and AA Concrete, LLC.

Michigan courts apply the traditional rule of successor liability which provides that a successor in a merger assumes all of its predecessor's liabilities, but a purchaser of assets for cash does not. *Foster v. Cone-Blanchard Mach Co.,* 597 N.W.2d 506 (Mich. 1999). In the case of asset purchase, the Michigan Supreme Court has identified five exceptions in which a purchaser can be held liable as a successor. *Id.* at 510. These exceptions include (1) where there is an express or implied assumption of liability, (2) where the transaction amounts to a consolidation or merger, (3) where the transaction was fraudulent, (4) where some elements of a purchase in good faith were lacking, and (5) where the transferee corporation was a mere continuation or reincarnation of the old corporation. *Id.* at 509-10.

The final exception, mere continuation, is one exception insolvency professionals often receive inquiries about.

Mere continuation has been subject to much confusion in Michigan courts. Ever since the Michigan Supreme Court's introduction of the separate but similar continuity of enterprise doctrine, the

two have often been conflated and misapplied. It is helpful to understand these two doctrines so that they may be distinguished when examining the facts of a case.

a. Continuity of Enterprise in the Michigan Supreme Court.

In 1976, the Michigan Supreme Court in *Turner v. Bituminous Casualty Co.* established the continuity of enterprise doctrine which expanded the scope of successor liability. 244 N.W.2d 873 (Mich. 1976). *Turner* featured a case where a worker injured by a faulty product could not recover because a successor corporation purchased the manufacturing corporation. *Id.* at 880. The successor corporation used the name of the predecessor, manufactured identical products, and held themselves out to the public as manufacturers of those same products. *Id.* at 876. Nevertheless, because the sale was cash-for-assets the successor corporation was protected from successor liability. *Id.*

Examining the roots of successor liability as an equitable doctrine, the court found that leaving the injured products liability plaintiff unable to recover in a cash-for-assets scenario was inequitable because the same plaintiff would have been entitled to recovery under a merger scenario. *Id.* The continuity of enterprise exception was thus created to provide for injured plaintiffs to recover in products liability actions. *Id.* Importantly, the court repeatedly couched its new exception in the consumer protection policy considerations of the products liability context. *Id.* at 880-81.

Thirty years later, the Michigan Supreme Court reiterated the unique nature the continuity of enterprise doctrine as a products liability consideration. In *Starks v. Michigan Welding Specialists, Inc.* the court reaffirmed the *Turner* doctrine as a successor liability exception designed to protect injured victims of defective products and declined to extend its use to judgement creditors. 722 N.W.2d 888, 889 (Mich. 2006). In reaffirming that the continuity of enterprise doctrine was linked to policy considerations behind products liability cases, the court clearly limited its use to those suits. *Id.* Despite this marriage of continuity of enterprise to products liability suits, the doctrine has crept away from the products liability arena in the decades following *Turner*. *Id.*

b. The Conflation of Continuity of Enterprise and Mere Continuation in the Michigan Court of Appeals.

On more than one occasion, the continuity of enterprise and mere continuation doctrines have been confused and conflated by the Michigan Court of Appeals. In *RDM Holdings, LTD v. Continental Plastics Co.,* the plaintiff sought holdover rent and insurance payments from its lessee. 762 N.W.2d 529, 533 (Mich. Ct. App. 2008). When the lessee filed Chapter 7 Bankruptcy the plaintiff sued a subsequently formed corporation, claiming they were liable as a successor. *Id*. After discussing the five traditional exceptions to the general rule of successor non-liability, the court took up *Turner* and applied the continuity of enterprise doctrine without considering the language regarding product liability.

In *Lakeview Commons Ltd. Partnership v. Empower Yourself, LLC,* the court again misapplied the continuity of enterprise doctrine outside the products liability arena. 802 N.W.2d. 712, 714 (Mich. Ct. App. 2010). Like *RDM Holdings*, *Lakeview Commons* involved a plaintiff-lessor claiming a successor corporation is liable for outstanding lessee obligations of its predecessor. *Id.* at 716. Again, like *RDM Holdings,* the *Lakeview Commons* court took up *Turner* an applied the continuity of enterprise doctrine without any mention of products liability. *Id.* at 715-16.

In an unpublished opinion from 2015, the Michigan Court of Appeals furthered its confusion regarding the continuity of enterprise doctrine. In *Taizhou Golden Sun Arts & Crafts, Co., Ltd., v. Colorbök, LLC*, Colorbök Inc. sold and transferred all its assets to Colorbök LLC, which was owned and operated by the same executives. 2015 WL 4932243 at *1 (Mich. Ct. App. 2015). Taizhou sued the successor corporation for outstanding debts not satisfied by proceeds from the foreclosure sale of the predecessor. *Id.* The Michigan Court of Appeals recognized that there was a dispute as to whether a mere continuation argument existed. *Id.* at *3. However, the *Taizhou* court again conflated mere continuation with continuity of enterprise, this time in reverse. *Id.* Looking at the *Starks* court's holding, the Michigan Court of Appeals held that the mere continuation analysis was not available because the case did not present a products liability suit. *Id.*

c. Distinguishing the Doctrines.

There has been recognition of the ongoing conflation of the two doctrines by the Michigan Court of Appeals. In 2016, the court in *Commonwealth Land Title Insurance Co. v. Metro Title Corp.* was asked to rule that the mere continuation exception was no longer a component of successor liability, having been eclipsed by the continuity of enterprise doctrine. 890 N.W.2d 395, 397 (Mich. Ct. App. 2016). The court rejected this argument, ruling that continuity of enterprise is applicable only in the products liability arena whereas the mere continuation exception applies generally. *Id.* at 397-99. The *Commonwealth* court forced the mere continuation and continuity of enterprise doctrines apart with the help of several unreported cases that arose in the Sixth Circuit. *See Stramaglia v. United States*, 377 Fed.Appx. 472, 475 (6th Cir. 2010); and *C.T. Charlton & Associates, Inc. v. Thule, Inc.*, 541 Fed.Appx. 549, 521-22 (6th Cir. 2013).

Despite this attempt to draw these two doctrines apart, in an unpublished 2021 opinion, the court stated its intent to undergo the mere continuation analysis, but instead went on to apply the continuity of enterprise test. *Hiatt v. Prairie Creek Golf Course, Inc.*, 2021 WL 1043992 at *4 (Mich. Ct. App. 2021). The court relied on the Michigan Supreme Court's ruling in *Foster*, a 1999 products liability suit that discussed the continuity of enterprise doctrine. *Id.* The *Hiatt* court appears to have been completely blind to the *Commonwealth* decision just five years prior.

The mere continuation exception has long been conflated with the continuity of enterprise doctrine at the hands of the Michigan Court of Appeals. The most apparent explanation for this conflation is that the continuity of the enterprise analysis is a simpler, three factor analysis while mere continuation is an ill-defined test requiring courts to engage in a totality of the circumstances analysis.

Perhaps one of the reasons that the continuity of enterprise doctrine came so close to eclipsing the mere continuation doctrine is that continuity of enterprise comes equipped with clear three-part analysis. Mere continuation on the other hand has never been so clearly enunciated by a Michigan court. The most recent review of mere continuation comes from the Sixth Circuit in *Stramaglia v. U.S.*, 377 Fed.Appx. at 475.

d. Mere Continuation.

The *Stramaglia* court determined that a proper mere continuation analysis involves a totality of the circumstances examination. *Id.* Looking deeper, the Sixth Circuit identified six factors that have been relevant to Michigan courts over the years. *Id.* These factors include but are not limited to:

> (1) whether there is common ownership between the successor and predecessor corporation, (2) whether substantially all of the predecessor corporation's assets were transferred to the successor corporation, (3) whether the successor corporation's main corporate purpose was the same as the predecessor corporation, (4) whether the successor corporation retains the predecessor corporation's officers and employees, (5) whether the successor corporation occupies the old corporation's place of business, and (6) whether the new corporation selectively repaid the old corporation's debts.

Alex M. Petrik, The Current State of Successor Liability in Michigan and Why the Michigan Supreme Court's Clarification is Necessary, 93 DET. MERCY L. REV. 437, 440 (2016) (laying out the six factors from *Stramaglia*, 377 Fex.Appx at 475).

In its review of mere continuation under Michigan law, the Sixth Circuit commented that the factors themselves were not equally weighted in their importance. *Id.* It provided that "the only indispensable prerequisites to application of the [mere continuation] exception appear to be common ownership and a transfer of substantially all assets." *Id.* The next most important factor identified was the continuation of corporate purpose as shown by how drastically the nature of the business changed from predecessor to successor. *Id.* The Sixth Circuit did not comment on the weight of the remaining three factors, implying an equal weight below the first three.

In *Stramaglia*, OldCo formed NewCo to insulate itself from the liability risks of operating one of its assets, a waterpark. *Id.* at 473. When NewCo failed to honor its tax obligations it became subject to IRS tax liens. *Id.* OldCo subsequently cancelled its lease agreements with NewCo and reclaimed several assets, including the waterpark. *Id.* The IRS shifted its focus to OldCo, claiming it was liable for the tax liabilities of NewCo. *Id.* In determining that OldCo was liable as a mere continuation, the Sixth Circuit noted that OldCo transferred substantially all of NewCo's physical and intangible assets, one shareholder had sole control over both OldCo and NewCo's performance obligations to each other, OldCo conducted the exact same business NewCo had, the same managers of that business were retained, and there was substantial retention of the higher trained members of the workforce.

In *Pearce v. Schneider*, the Michigan Supreme Court applied the mere continuation exception, finding a later corporation was a reincarnation of the old corporation. 217 N.W. 761, 762 (Mich. 1928). In the case, three stockholders of the OldCo, a coal mine, organized NewCo with the purpose of taking over all the assets and operations of OldCo. *Id.* The Michigan Supreme Court found mere continuation because the stockholders were the same, the main corporate purpose was to conduct the same business, and all the assets of the former corporation were turned over to the new. *Id.*

In *Shue & Voeks, Inc. v. Amenity Design & Manufacturing., Inc.*, a lessee sued both an OldCo and NewCo for breach of lease and reletting expenses. 511 N.W.2d 700, 702 (Mich. App. 1993). The Michigan Court of Appeals reviewed the totality of the circumstances and determined there was no mere

continuation. *Id.* The court noted that NewCo retained only four of the previous thirty employees and changed the focus of its business from primarily manufacturing to primarily sales and marketing. *Id.*

In *Ferguson v. Glaze*, the creditor of a dissolved OldCo sued a NewCo, attempting to make good on a promissory note. 2008 WL 314544 at *1 (Mich. Ct. App. 2008). The Michigan Court of Appeals reached the conclusion that there was no mere continuation despite NewCo retaining some core clients, two employees, and several corporate officers. *Id.* at *5. The court noted that sale of "some, if not most" of OldCo's assets, sale of drilling equipment and truck which were key to OldCo's corporate purpose, and a change of corporate purpose from "contracting work, environmental services, and remedial action" to "consulting business that performed site assessments and helped its customers obtain permits" all cut against a finding of mere continuation. *Id.* Additionally, it was of no significance that both entities worked in the environmental field. *Id.*

In *Gougeon Bros. v. Phoenix Resins, Inc*., OldCo was found liable for violating Michigan's Consumer Protection Act. No. 211738, 2000 WL 33534582, at *2 (Mich.App. Feb. 8, 2000). Prior to the judgement and filing bankruptcy, OldCo sold all of its assets to NewCo. *Id.* The Michigan Court of Appeals determined NewCo was a mere continuation of OldCo. *Id.* Relevant facts included that NewCo bought OldCo's assets for $3,000 while OldCo's sales had exceeded $115,000, the same two persons were equal shareholders of both entities, NewCo conducted business at same address as did OldCo, and a notice to OldCo's customers that NewCo now sold OldCo's products; would pay any currently owed invoices; and those customers should continue to use OldCo's product literature. *Id.*

The Michigan Court of Appeals has firmly distinguished the mere continuation and continuity of enterprise doctrines after years of conflation. *Commonwealth,* 890 N.W.2d at 397. The former of the two applying generally, and the latter applied only to products liability cases. *Id.*

Regarding the application of the mere continuation exception, few Michigan cases have engaged in its analysis. The Sixth Circuit has curated a set of relevant factors that have been used by Michigan courts in the past. *Stramaglia*, 377 Fex.Appx at 475. The two most important of these factors appear to be common ownership and transfer of substantially all assets. *Id.* Third is the similarity of corporate purpose. *Id.* The last three, retention of officers and employees; same place of business; and selective repayment of debts, appear to share equal weight. *Id.*

Successor liability cases are challenging. Certainly, when assets are transferred and all of the badges of fraud are present the creditor will likely prevail, and for good reason. But what about the cases where a business owner desires to continue doing the one job s/he knows how to do. Is a painter, construction worker, or dentist never allowed to continue pursuing self-employment opportunities through a new small business? If a carpenter owns a single member LLC and a large judgment is entered against the entity for a breach of contract, must that carpenter cease being self-employed?

Facts matter and when advising a client about the risks of successor liability it is important to have a working knowledge of the case law. If the opportunity exists, reaching out to creditors in advance can clear a path to a feasible out of court resolution in advance of suspect asset transfers. Insolvency professionals are well suited to examining these factors and working with clients to address a feasible resolution rather than transferring assets and hoping for the best.