Plaintiff
That just doesn't add up.

Products liability: Litigating the product-line-exception case

The product line exception theory of liability may prove useful when a manufacturer has gone out of business

By Matthew Kracht
The Veen Firm, P.C.

Your client was injured by a product designed and manufactured by Company X. However, Company X is no longer in business, and we'll assume that you cannot seek recovery from Company X. Is your otherwise deserving client out of luck? Maybe not.

If the product that injured your client is still being manufactured, but by another entity, Company Y, your client may be able to maintain a cause of action against Company Y pursuant to the Product Line Exception theory of liability. However, before you embark upon what could be a long and arduous journey, filled with fact-intensive inquiries and endless nights of sifting through paper-work, be aware of what you may be getting yourself into.

In a general sense, you will need to learn everything you can about the original manufacturer, Company X, including information dating back to the initial design, testing and manufacturing process. You will need to learn the details regarding how and why the new manufacturer, Company Y, began production of this product. You will need to learn about Company Y's testing, design and manufacturing process, even though they were not involved until well after the subject product was manufactured. And, if that doesn't already sound like enough, please also keep in mind that (1) you will likely face a summary judgment motion, and (2) you still have to prove the product was defective.

Nevertheless, if you can leap over all these hurdles and obtain a just recovery for your client, it will be well worth the effort.

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Ray v. Alad: Birth of the product line exception

• ***General rule Re: Successor Liability***

In *Ray v. Alad,* (hereinafter "*Ray*") the California Supreme Court carved out an exception to the general rule that when a corporation purchases the assets of another corporation, it does not assume the liabilities unless: (1) there is an express or applied assumption to do so; (2) the transaction is tantamount to a consolidation or merger; (3) the purchasing corporation is a mere continuation of the seller; or (4) fraud is involved. (*Id*. at p. 28.)

In *Ray*, plaintiff was injured after he fell from a defective ladder that was designed and manufactured by Alad Corporation ("Alad I"). (*Id.* at p. 24-25.) However, prior to plaintiff's injuries, Alad I sold its assets, inventory, goodwill, etc., to another company which subsequently named itself Alad Corporation ("Alad II") (*Ibid*.) After the sale, Alad II continued to design and sell ladders, just as Alad I had done. (*Ibid*.) Thereafter, Alad I dissolved. Plaintiff filed suit against Alad II, alleging strict products liability and related causes of action. (*Id*. at p. 24.)

It was undisputed that Alad II did not manufacture or sell the defective ladder that caused plaintiff's injuries. (*Ibid*.) Summary judgment was entered in Alad II's favor. (*Id*. at p. 26.) The ruling was appealed to the California Supreme Court who developed a new rule for imposing successor liability called the product line exception (*Id*. at p. 29-30.)

• ***Three-pronged product line exception test***

The *Ray* court developed a three-prong test, holding that, "[j]ustification for imposing strict liability upon a *successor* to a manufacturer under the circumstances presented here rests upon (1) the virtual destruction of the plaintiff's remedies against the original manufacturer caused by the successor's acquisition of the business, (2) the successor's ability to assume the original manufacturer's risk-spreading role, and (3) the fairness of requiring the successor to assume responsibility for defective products that was a burden necessarily attached to the original manufacturer's good will being enjoyed by the successor in the continued operation of the business. (*Id*. at p. 31.)

After applying this new rule, the Supreme Court reversed summary judgment. (*Id*. at p. 34.)

Step 1: How Company Y came to manufacture the product

There will likely be a controlling document, such as an asset purchase or business sale agreement, between Company X and Company Y, permitting Company Y to manufacture the product. This document will significantly shape how you proceed with the litigation. Typically, the issue of a seller's liabilities will be addressed, though not always. If Lady Luck is on your side (doubtful), this document will provide that Company Y assumes all of Company X's liabilities. Should this be the case, bypass the remaining steps and proceed to proving a defect.

It is more likely that the agreement will address the assumptions of liability by indicating that Company Y is only purchasing assets, but not the debts which are expressly retained by Company X. This is one area where defense counsel may premise their argument in an attempt to contrast *Ray*. "Your Honor, *Ray v. Alad* does not apply because their document did not address the assumption of liabilities, but mine does." This argument should not deter you. It is true that in *Ray*, the controlling document was silent regarding which company assumed liabilities. However, the Supreme Court did not condition application of the three-prong test upon the central agreement not addressing which entity assumed the liabilities. Similarly, I have not seen any case law that does.

Step 2: Gather evidence regarding the three-prongs

To obtain the evidence necessary to establish, or at least create a triable issue of material fact, regarding the three-prongs of *Ray*, you should have a complete understanding of every asset that was purchased by Company Y. Did the purchase include design specifications, equipment, stock, customer lists, real property, contracts, etc.? Did Company X's employees become Company Y's employees? Be aware that while the controlling document *should* comprehensively list the items purchased, it may not. A Person Most Qualified (PMQ) deposition of the individual with most knowledge regarding the negotiation/terms and conditions of the purchase may be necessary. In the case of a very small manufacturing business, this may be the attorney, business broker or even the escrow company officer who closed the transaction.

You should look at the design, manufacturing, inspection, testing, etc., processes of *both* Company X and Company Y. This will also potentially help you in proving a defect down the road.

(1.) The virtual destruction of the plaintiff's remedies against the original manufacturer caused by the successor's acquisition of the business.

The first *Ray* prong will require that you establish Company Y"s acquisition destroyed plaintiff's remedies against Company X. Although this purports to be one prong, it really requires a showing of two things. First, there must be no remedy against Company X. Second, Company Y's acquisition caused there to be no remedy.

At the beginning of this article I asked you to assume you cannot seek recovery against Company X. In practice, determining whether a remedy is available will turn upon many variables, including whether Company X had an insurance policy that may provide coverage. However, in *Ray*, the issue of potential insurance coverage was directly addressed. "[T]he products liability insurance of a company that has gone out of business is not a likely source of compensation for injury from a product the company previously manufactured." (*Ray* at p. 32.) Though this may not be the best explanation for why this prong is

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satisfied even though a policy exists, it nevertheless is something to reference in your opposition to summary judgment.

Determination of whether Company Y's acquisition caused the destruction of the remedy will be fact specific to your circumstances. If Company X dissolved immediately or shortly after the asset sale closed, you should be fine. However, if Company X continued on for a significant period of time, manufacturing different products, you may need to think outside of the box. Remember, the standard is "virtual destruction" not actual destruction. This is your opening to be creative.

(2.) The successor's ability to assume the original manufacturer's risk-spreading role.

To satisfy the ability to assume risk-spreading prong, you will apply all of the information you learned regarding the assets that Company Y purchased from Company X. In *Ray*, the court focused on Alad II's purchase of Alad I's resources, such as the plant, equipment, inventory, goods, design records and continued employment of factory personnel. "With these facilities and sources of information, Alad II had virtually the same capacity as Alad I to estimate the risks of claims for injuries from defects in previously manufactured ladders…" (*Ray* at p. 33.)

Where your successor company essentially stepped into the original company's shoes and continued production without much disruption or change in the process they will be deemed to have the ability to assume the risk-spreading role. Having a comprehensive understanding of the design, testing, manufacturing and inspection process of both companies may give you additional evidence to establish this prong.

(3.) The fairness of requiring the successor to assume responsibility.

The *Ray* court determined it was fair to require Alad II to assume responsibility for the defective ladder based upon, "Alad II's acquisition of Alad I's trade name, good will, and customer lists, its continuing to produce the same line of ladders…[and] legitimate exploitation of Alad I's established reputation…" (*Ray* at p. 34.) Here again, to the extent Company Y is simply continuing the business and manufacturing the same product, you will be able to meet this threshold.

It is also fair to impose successor liability where the successor manufactures the same product under the same name as its predecessor. (*Ibid*.) The summary judgment you face will no doubt have a declaration from the successor company executive indicating that Company Y does not manufacture the product under Company X's trade name. Don't take this at face value. We opposed a summary judgment regarding a piece of heavy construction machinery, and premised our "fairness" argument, in part, upon the new company manufacturing the product under both the old and new companies' names, contrary to their executive's declaration that they did not. Support for this argument came by happenstance.

I was chauffeuring one of my children to a sporting event when we drove past an open parking lot with the same model machine at issue in our litigation parked in a corner. Though it annoyed my child, I, of course, stopped to take a closer look and noticed the machine had labeling from both the old and new companies. I took photos, and after laying the appropriate foundation used them in my summary judgment opposition. "Your Honor, it is fair to require Company Y to assume the responsibility for Company X's product because Company Y is manufacturing the same product and is even still using Company X's name on it."

Also consider offering a public policy argument, which the court in *Ray* discussed at length. The court wrote:

> The purpose of the rule of strict tort liability "is to insure that the costs of injuries resulting from defective products are borne by the manufacturers that put such products on the market rather than by the injured persons who are powerless to protect themselves." However, the rule "does not rest on the analysis of the financial strength or bargaining power of the parties to the particular action. It rests, rather, on the proposition that '*The cost of an injury and the loss of time or health may be an overwhelming misfortune to the person injured, and a needless one, for the risk of injury can be insured by the manufacturer and distributed among the public as a cost of doing business*.' Thus, "the paramount policy to be promoted by the rule is the protection of otherwise defenseless victims of manufacturing defects and the spreading throughout society of the cost of compensating them.

(*Ray* at p. 34.)

Step 3: Be aware of authority that hurts your case

In *Lundell v. Sidney Machine Tool Co*. (1987) 190 Cal.App.3d 1546, the court declined to apply the product line exception because the company was sold no less than four times before the alleged successor's purchase. Where there were multiple sales of the company, the product line exception is harder to maintain.

Defense counsel may point to a string of cases relating to sales through bankruptcy proceedings where the product line exception was not allowed. In *Kline v. Johns-Manville* (1984) 745 F.2d 1217, the predecessor company filed bankruptcy and a successor purchased assets from a court-approved sale. This is not an arm's length transaction. Moreover, the court wrote "[t]he rule announced in Ray is not directly applicable to this case because Unarco did not liquidate." (*Id*. at p. 1219.)

Summary

These are potentially very interesting – and expensive – products liability cases that are hard-fought by each side. If you end up with a recovery that adequately compensates your deserving client, pat yourself on the back and get ready for your next adventure.

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Kracht

Matthew J. Kracht is an attorney with The Veen Firm *on the Leary Trial Team, which handles complex cases involving life-altering injuries or death. His practice area includes products liability, workplace injuries, dangerous conditions of property and vehicle negligence. Prior to joining The Veen Firm, Mr. Kracht worked for civil litigation defense firms in San Francisco and Oakland.*

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