CLIENT UPDATE

HOLDING THE DEFENSIVE LINE: DELAWARE COURT REJECTS EXTENSION OF WARN ACT LIABILITY TO PRIVATE EQUITY SPONSOR

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On May 10, 2013, Judge Brendan Linehan Shannon of the United States Bankruptcy Court for the District of Delaware rejected an attempt to hold a private equity sponsor liable for its portfolio company's alleged violations of the federal Worker Adjustment and Retraining Notification Act (the "WARN Act") under the "single employer" theory of liability. Although investors would be wise to avoid becoming directly involved in the personnel decisions of distressed companies, the Bankruptcy Court's decision provides some comfort that many of the common hallmarks of the sponsor/portfolio company relationship will not necessarily trigger WARN Act liability at the sponsor level.

Since significant layoffs and plant closings often occur in the context of bankruptcy or other financial distress, WARN claimants may be unable to collect amounts owed from a primary employer. In that situation, they often look for deep-pocketed related parties – such as key investors and/or lenders – against whom they can assert claims. In 2011, one court did hold a private equity sponsor liable for WARN Act obligations. (See our earlier client update, "*Single Employer Liability for Investors and Lenders: A WARN-ing from the Delaware Bankruptcy Court*," dated September 6, 2011, and available at www.debevoise.com.) Similar attempts have been made to attach sponsors with the unpaid pension obligations of bankrupt portfolio companies. While any failure of a portfolio company presents a risk that employee-related claims will be lodged against the sponsor,

following best practices relative to corporate governance, corporate separateness and documentation of management agreements will dramatically improve the sponsor's ability to defend itself from liability. The recent Delaware ruling in *Jervic Holding Corp et al. (Case No. 08-110066 (BLS) (Bankr. D. Del. May 10, 2013))* presents an instructive example.

BACKGROUND

In 2006, a subsidiary of Sun Capital Partners, Inc. ("SunCap") acquired Jevic Transportation, Inc. ("Jevic"), a carrier and delivery service operating in the U.S. and Canada. At that time, Jevic and Sun Cap entered into a management services agreement under which Sun Cap provided specified consulting services in exchange for compensation. In May 2008, Jevic and certain of its affiliates (the "Jevic Debtors") filed for chapter 11 protection. Jevic's employees had received WARN Act termination notices just the day before the filing. Three days later, a class of terminated Jevic employees sued the Debtors *and Sun Cap* under both federal and state law for having terminated employees without the required notice. In naming SunCap as a defendant, the plaintiffs argued it was a "single employer" with the Jevic Debtors and was therefore liable along with them for any WARN Act or similar violations.

THE WARN ACT AND "SINGLE EMPLOYER" LIABILITY

The WARN Act requires companies with 100 or more employees to provide sixty days advance notice of mass layoffs or plant closings. Covered employers that fail to provide sufficient notice of termination to eligible employees can be held liable for lost wages, benefits and other damages.

In deciding whether to hold a related party liable as a "single employer" with the primary employer, the Third Circuit uses a five-factor balancing test, originally laid out by the Department of Labor, that focuses on the "nature and degree of control possessed" by an entity over the employer. The five factors include: (1) common ownership, (2) common directors and/or officers, (3) *de facto* exercise of control, (4) unity of personnel policies emanating from a common source and (5) dependency of operations.

THE BANKRUPTCY COURT'S DECISION

Applying the five-factor test to SunCap and Jevic, Judge Shannon observed that the first two factors, common ownership and common directors/officers, were undisputed and favored the claimants.

Moving to the third factor, the Court rejected plaintiffs' arguments that SunCap exercised *de facto* control over Jevic, explaining that the relevant question for WARN Act purposes was whether SunCap was specifically involved in the decision to terminate employees or to close facilities, not whether SunCap had control as a practical matter because of "the ordinary incidents of stock ownership." Pointing to the fact that the Jevic Debtors had hired independent professionals, including turnaround consultants, to advise them on their deteriorating financial condition, and because there was no evidence that SunCap had played any role in Jevic's decision to terminate its employees, Judge Shannon held that the plaintiffs had not established *de facto* control for WARN Act purposes. Notably, the Court refused to accept plaintiffs' argument that Sun Cap's decision to stop funding Jevic – which admittedly was a key factual event leading to Jevic's decision to terminate employees – was an exercise of *de facto* control. Judge Shannon concluded that it was Jevic, and not its sponsor SunCap, that "retained the ultimate responsibility for keeping the company alive." In addition, the Court dismissed plaintiffs' attempts to hold SunCap, in its capacity as corporate parent, to a higher standard than a third-party lender in deciding whether SunCap used *de facto* control.

Finally, the Bankruptcy Court held that factors four and five, unity of personnel policies and dependency of operations, also weighed in favor of SunCap. Judge Shannon again noted that a parent company's "ordinary powers of ownership" are not the same as control over day-to-day operations. In that context, Judge Shannon found that SunCap and Jevic operated as two distinct and separate businesses and were not operationally dependent on one another. The management services agreement, which provided for Jevic to pay Sun Cap for specified consulting services, did not by its own terms create any special relationship or establish operational dependency. Judge Shannon held that SunCap's attempts to assist or "rescue" Jevic pre-bankruptcy, including a $1 million initial investment at the time of the acquisition and a $2 million guarantee provided after the business declined, were also insufficient to establish financial dependency because there was no evidence these arms'-length investments were outside of the ordinary course of business or on unusual terms.

Judge Shannon therefore granted SunCap's motion for summary judgment, ruling that only the first two factors favored the plaintiffs and that those factors alone could not establish single employer status for WARN Act purposes.

GOOD NEWS FOR PRIVATE EQUITY SPONSORS?

Judge Shannon's decision is good news for investors in troubled companies. But, private equity sponsors likely will continue to be targets for claimants seeking to recover on

employee-related liabilities if a portfolio company fails. Sponsors can minimize their exposure to these kinds of liabilities by being careful not to become directly involved in employee-related decisions, by hiring independent financial advisors to work with and advise portfolio companies that become distressed, and by following best practices with respect to corporate separateness, fiduciary duties, documentation of management agreements and similar formalities.

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Please do not hesitate to contact us with any questions.

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