SINGLE EMPLOYER LIABILITY FOR INVESTORS AND LENDERS: A WARN-ING FROM THE DELAWARE BANKRUPTCY COURT

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To Our Clients and Friends:

In a recent opinion, Judge Mary F. Walrath of the United States Bankruptcy Court for the District of Delaware held that a debtor's indirect owner and lender could be held liable with the debtor as a "single employer" for violations of the federal Worker Adjustment and Retraining Notification Act (the "WARN Act").[1] In finding that the owner and lender exercised *de facto* control over the debtor warranting liability under the WARN Act, the Bankruptcy Court's decision serves as an important reminder to both investors and lenders of the potential risks they face when becoming involved in the personnel decisions of distressed companies.

BACKGROUND

The debtor, Tweeter Opco, LLC (the "Debtor"), filed for Chapter 11 protection on November 5, 2008. On the same day, a class consisting of former employees terminated by the Debtor filed an adversary proceeding against both the Debtor and Schultze Asset Management, LLC ("SAM"), the Debtor's indirect equity holder and lender, alleging violations under the WARN Act. After the Debtor's Chapter 11 case was converted to a Chapter 7 liquidation, the Bankruptcy Court stayed the proceeding against the Debtor but allowed the case against SAM to proceed.

The WARN Act requires certain employers to provide eligible employees with sixty days advance notice of plant closings or mass layoffs. Covered employers that fail to provide the requisite notice of termination may be liable for lost wages, benefits and other penalties. However, because many plant closings and mass layoffs are the result of an employer's financial distress, WARN Act claimants sometimes also assert claims against related entities who actually controlled the employer and therefore are treated as a "single employer" for purposes of WARN Act liability.

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[1] *D'Amico v. Tweeter Opco, LLC (In re Tweeter Opco, LLC), Adv. Pro. No. 08-51800 (MWF) (Bankr. D. Del. July 8, 2011).*

In the Debtor's case, affected employees were terminated and received notice of their termination on the same day, instead of having received the sixty days advance notice required under the WARN Act. The Bankruptcy Court found that the plaintiffs had established each of the elements necessary for a WARN Act violation.

"SINGLE EMPLOYER" STATUS

Having determined that a WARN Act violation had occurred, the Bankruptcy Court then considered whether SAM and the Debtor constituted a "single employer" for purposes of WARN Act liability. Citing the Third Circuit's adoption of a five-factor test originally promulgated by the Department of Labor, the Bankruptcy Court applied the following factors to determine whether SAM was liable as a single employer: (1) common ownership, (2) common directors and officers, (3) *de facto* exercise of control, (4) unity of personnel policies emanating from a common source, and (5) dependence of operations between the entities.

In applying the common ownership factor, the Bankruptcy Court rejected the application of a *per se* rule that a "grandparent" company can never share common ownership with its indirect subsidiary. Together with SAM's significant indirect ownership interests in the Debtor, the Bankruptcy Court found that SAM's financial control of the Debtor in its capacity as lender was sufficient to satisfy the common ownership factor. Similarly, Judge Walrath found that the Debtor and SAM shared common directors and officers, because four of the Debtor's five directors were connected to or controlled by SAM and the Chairman of the Debtor's board was also the managing member and 100% owner of SAM.

The Bankruptcy Court then addressed the third prong of the five-factor test, the *de facto* exercise of control, which, according to the Court, carries "special weight." Control in this context, the Court stated, is specific to the employment practice at issue and turns on whether the parent or lender "specifically directed the allegedly illegal employment practice that forms the basis for the litigation." After reviewing the plaintiff's evidence, including emails from SAM employees describing SAM's desire to exercise "tighter control" over the Debtor and testimony that SAM's general counsel and other SAM employees provided advice to and assisted the Debtor with the firing of many of its employees, the Bankruptcy Court concluded that SAM's exercise of *de facto* control over the Debtor's employment practices was "particularly egregious."

Finally, the Bankruptcy Court found that the plaintiffs had not presented sufficient evidence to establish either the unity of personnel policy factor or the dependency of operations factor of the five-factor test. However, after giving SAM's *de facto* exercise of control substantial weight, and rejecting both of SAM's arguments regarding the applicability of various exceptions and

defenses under the WARN Act, Judge Walrath granted the plaintiffs' motion for summary judgment on the issue of single employer liability.

IMPLICATIONS

Because terminated employees with WARN Act claims against a bankrupt company are more likely to look to related entities for compensation, investors in and lenders to distressed companies should take special care when getting involved in decisions which could trigger WARN Act liability. In most circumstances, an investor will share common ownership with its subsidiary, or, in the case of a lender, exercise financial control through covenants and other restrictions on a borrower. Similarly, there is likely to be significant overlap in the directors and officers of these entities. As a result, a financial sponsor's risk of exposure to WARN Act liability will often hinge on whether the sponsor exercised *de facto* control over the employer. Judge Walrath's opinion makes clear that this determination is fact-intensive and depends on a claimant's ability to point to facts demonstrating the investor's or lender's extensive involvement in the personnel decision at issue.

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