Silberglied

Finocchiaro

"Don't Say They Didn't WARN You": Bankruptcy Court's High Threshold for Corporate Affiliates' WARN Act Liability

Russell C. Silberglied and Julie Finocchiaro

Special to the Delaware Business Court Insider | June 01, 2011

In two recent decisions, the Delaware Bankruptcy Court rejected the imposition of WARN Act liability on corporations affiliated with debtors. The court determined that, notwithstanding common ownership and (in one case) common directors or officers, the plaintiff-employees failed to introduce sufficient facts to support a finding of de facto control. Absent such evidence, the Delaware Bankruptcy Court held that the affiliate corporations cannot be held liable for alleged WARN Act violations of the debtor-employer.

These decisions interpret the 3rd U.S. Circuit Court of Appeals' *Pearson* test as establishing a high threshold for imposition of liability on either lenders with voting power (through a pledge) or parent corporations. The 3rd Circuit's 2001 opinion in *Pearson v. Component Technology Corp.* had established a nonexhaustive five-factor balancing test for determining "indicia of corporate 'sameness'" for purposes of assessing liability against corporate affiliates under the WARN Act.

Last year, in *In re Consolidated Bedding Inc.*, Judge Brendan L. Shannon held that establishing only one *Pearson* factor — common ownership — was insufficient to create a plausible claim for relief against a lender under the WARN Act.

Now, in April 2011, in *In re DHP Holdings II Corp.*, Judge Mary F. Walrath held that satisfying two out of the five factors — common ownership and common directors or officers — was also insufficient to establish liability of the debtors' parent corporation.

In both cases, there were facts indicating that the affiliated corporation had some involvement in the management of the company generally, and even specifically with regard to the facility-closing decisions. Nevertheless, in both cases, the Delaware Bankruptcy Court held that the plaintiffs failed to establish the key concept of de facto control. This interpretation of the five-factor *Pearson* test creates a high threshold for imposing WARN Act liability on affiliated corporations, which will be viewed as a welcome development by lenders and private equity funds with insolvent portfolio companies.

WARN Act and the 'Pearson' Five-Factor Test

The Worker Adjustment and Retraining Notification Act of 1988 (the WARN Act) requires certain employers with over 100 employees to provide them with 60 days' notice prior to closing a plant or initiating mass layoffs. If a qualified employer fails to give such notice, the WARN Act provides affected employees with various remedies, including back pay and benefits. In order to prevail on a WARN Act claim, employees must identify an "employer" that meets certain criteria and has sufficient resources to satisfy a judgment. However, because plant closings and mass layoffs typically occur at troubled and often insolvent employers, many WARN Act claims are asserted against deeper pockets, such as lenders or parent companies.

In *Pearson*, the 3rd Circuit addressed whether a lender with certain control rights was liable for a borrower's alleged WARN Act violations. General Electric Capital Corp. (GECC) was the major secured lender of Component Technology (CompTech), which had defaulted on the loan. Thus, pursuant to its rights under a pledge, GECC voted the pledged stock in favor of installing a new board of directors, which in turn appointed new officers. GECC also selected the new joint CEO, who was under contract as a consultant with and indemnified by GECC.

GECC then restructured the loan agreements, writing off significant portions of the loans and providing CompTech with a revolving line of credit. In return, GECC received nonvoting preferred stock and warrants for 75 percent of the stock, and retained veto power over decisions regarding highly paid employees. Despite GECC's continued support, CompTech was unable to recover, and ultimately GECC refused to provide any additional funds to keep the company afloat. CompTech began its liquidation and notified the employees that its plant was closing effective immediately. CompTech's employees filed an action against GECC alleging WARN Act liability.

In determining whether CompTech and GECC constituted a "single employer" for the purposes of WARN Act liability, the 3rd Circuit rejected traditional affiliate liability (such as veil piercing or alter ego) tests in favor of the five factors promulgated by the Department of Labor (DOL): common ownership; common directors and/or officers; de facto exercise of control; unity of personnel policies emanating from a common source; and the dependency of operations.

The court explained that unlike "traditional veil-piercing and some of the other theories," the DOL factors focus on the particular circumstances relevant to labor relations. The 3rd Circuit explained that no single factor is dispositive, nor is the list exhaustive. The factors are to be used as a balancing test, and courts should consider the totality of the circumstances in deciding whether an affiliate corporation is liable under the WARN Act. The five factors make "room for the exercise of the flexibility that this area of law requires." A factfinder "may consider not only the aspects of corporate organization specifically listed in the (DOL) regulations, but also may consider other indicia of corporate 'sameness' that have characterized this area of law, such as nonfunctioning of officers and directors, gross undercapitalization, and other circumstances that demonstrate a lack of an arm's-length relationship between the companies."

Applying the factors, the 3rd Circuit found that the plaintiffs established only the first factor, common ownership, by demonstrating majority stock ownership through control of the CEO and top officers. With the second factor, the plaintiffs argued that CompTech's officers and directors were GECC's "agents." The court disagreed, holding that without showing that some of the same individuals constituted the management team of both companies, the plaintiffs failed to establish sufficient evidence of the second factor.

With regard to unity of personnel policies, the plaintiffs presented evidence that GECC controlled the hiring and firing of the president and CEO. However, the court found that the plaintiffs failed to satisfy this prong because they did not establish that the companies functioned as a single entity with regard to their relationship with employees. The plaintiffs also did not establish that the companies shared or coordinated labor policies.

Next, despite GECC's control over the hiring and firing of CompTech's high-level management, the court found that the plaintiffs did not establish the kind of day-to-day control necessary to satisfy the dependency of operations factor. The court said there was no evidence of the existence of arrangements such as the sharing of administrative or purchasing services, interchanging of employees or equipment, and the commingling of finances. In addition, exercising "ordinary powers of ownership, i.e., to vote in directors and set general policies," was insufficient to demonstrate CompTech's dependency.

Finally, with respect to the de facto control factor, the 3rd Circuit explained that this factor endorses a hybrid of the direct liability and integrated enterprise liability common law tests. The 3rd Circuit considered de facto control a "catch-all factor ... that has the potential to tip the balance in an otherwise close case." It allows consideration of evidence that is not contemplated by the other factors but suggests liability should be imposed. Overall, the court explained that this factor is not meant to apply to ordinary control pursuant to a parent's stock ownership or a lender's general oversight, but properly applies where the parent or lender ultimately made the employment decisions giving rise to the litigation.

The plaintiffs in *Pearson* argued that GECC's monitoring and control of CompTech's finances and its relationship with CompTech's high-level officers were sufficient to establish de facto control. However, the court stated that the decision to stop loaning funds to CompTech was not sufficient to satisfy this part of the test because CompTech had contemplated closure prior to the withdrawal of funds and it had attempted to secure additional outside financing. Therefore, the plaintiffs could not establish the final factor or any additional facts outside the five factors. The court thus held that the plaintiffs did not prove the high degree of integration of ownership and operations necessary to establish that CompTech and GECC constituted a single employer for WARN Act purposes.

In 2008, in *In re APA Transport Corp. Consolidated Litigation*, the 3rd Circuit reaffirmed the use of the five DOL factors. However, the court noted that the factors are not equally weighted: Common ownership and common directors and/or officers are relevant, but insufficient by themselves to establish "single employer" liability. The 3rd Circuit in *APA* stated that the goal of the five-factor *Pearson* test is "to determine whether [an affiliated company] had become so entangled with [the direct employer's] affairs so as to engender WARN Act liability, or whether the two continued to function at arm's length as separate entities."

Consolidated Bedding

In *Consolidated Bedding*, an investment company, American Capital (AmCap), was both the lead financier and equity holder of the debtors. As part of its general practice, AmCap employed "Operations Teams" to assist its portfolio companies, including the debtors, with reducing costs and improving performance. In addition, AmCap's employees held the majority of seats on several of the debtors' boards of directors. The debtors' boards of directors authorized the closing of certain facilities and terminated the plaintiff-employees without the requisite 60-day notice under the WARN Act. The plaintiff-employees brought suit against AmCap, alleging that it and the debtors constituted a single employer for purposes of WARN Act liability.

The court analyzed the plaintiffs' claim of affiliated corporation liability under the *Pearson* test. The first factor of common ownership was met and not contested. However, the court found that the plaintiffs failed to establish the remaining factors.

It held that the second factor was not met because although the AmCap employees held the majority of the board seats, those AmCap employees were not directors or officers of AmCap, so there were no "common directors." Next, with respect to de facto control, the plaintiffs argued that AmCap employees controlled the debtors' boards of directors, and, because the boards made the decision to close the facilities, AmCap ultimately made the key decision. The court disagreed and held that the presence of AmCap employees on the debtors' boards of directors was insufficient to establish that AmCap was ultimately responsible for the plant closings. The court noted that the plaintiffs failed to allege that when they made the decision to close the facilities, the AmCap employees on the debtors' boards were acting "with their American Capital 'hats' on."

Finally, the court held that the plaintiffs failed to adequately plead facts to satisfy the remaining factors of the *Pearson* test, unity of personnel policies and operational dependency.

In an interesting footnote, the *Consolidated Bedding* court noted that "the *Pearson* test [is] awkward and difficult to apply" in analyzing whether a lender constitutes a single employer with the debtor where the lender and debtor "operate in separate and drastically different spheres." Citing *Coppola v. Bear Stearns & Co.*, the court noted that the 2nd Circuit considered the de facto control factor as the primary, and perhaps only, relevant factor in determining a lender's WARN Act liability. Because under *APA Transport* each *Pearson* factor need not be given equal weight, this footnote is an indication that the Delaware Bankruptcy Court might give the most weight to the de facto control factor.

'DHP'

In April 2011, Walrath's *DHP* opinion applied *Pearson* to a parent/controlling stockholder of the debtors and continued the high threshold for corporate affiliate liability under the WARN Act. As in *Consolidated Bedding*, the Delaware Bankruptcy Court found that, notwithstanding that "associates" of the controlling stockholder occupied nearly all of the debtors' board positions and the boards discussed and authorized the layoffs and facility closings, the decisions were not attributable to the controlling stockholder.

H.I.G. Capital LLC (HIG) was the controlling stockholder of the debtors, owning a 70 percent stake in the debtors' ultimate parent company. After the debtors defaulted on their credit agreement with third-party lenders, the lenders swept the debtors' cash and froze their bank accounts. The lenders then insisted that the debtors hire Craig Dean of AEG Partners LLC as chief restructuring officer. Layoffs, the bankruptcy filing and a WARN Act suit followed.

In analyzing the *Pearson* factors, the court held that the plaintiffs satisfied the first and second prongs. HIG's indirect 70 percent stake constituted a controlling ownership interest for purposes of the first factor. Its associates also held almost all of the director and officer positions of the debtors. Interestingly, the opinion does not state whether the HIG appointees to the debtors' board were or were not officers or directors of HIG, notwithstanding Shannon's decision in *Consolidated Bedding* that "common" directors or officers means they must be directors or officers, not just employees, of both entities. Likely because the second prong was uncontested, Walrath found that it was met.

With regard to the crucial de facto control factor, the *DHP* court held that the plaintiffs failed to establish that HIG "was the decision maker responsible for the employment practice giving rise to the litigation." The court found that although the debtors' boards of directors were controlled by HIG, the decisions directly related to termination of the employees generally were made by the debtors' chief restructuring officer.

While the plaintiffs argued that the debtors' boards (controlled by HIG) had made the decision to close the facilities in an effort to cut costs, the court found that the chief restructuring officer came to the same decision independently. It concluded that a board's approval of closings "is insufficient to establish that HIG ordered the terminations."

The court found no evidence supporting the remaining two factors, unity of personnel policies and dependency of operations. To the contrary, the court noted that when the debtors ceased operations, HIG continued in business, indicating that there was no dependency of operations.

Perhaps as important as Walrath's analysis of each factor was her citation — like Shannon's — to the 2nd Circuit's *Coppola* opinion for the proposition that de facto control was the most important factor and holding that "the Department of Labor factors other than the de facto control factor are not really compelling."

De Facto Control as the Critical Factor

The five factors promulgated by the DOL for determining affiliated corporate liability were considered by the 3rd Circuit in *Pearson* to be a lower hurdle than existing common law tests, such as the alter ego test. That proposition caused concern for deep pockets like controlling stockholders (particularly private equity firms whose portfolio companies become debtors) and lenders. Fortunately for those entities, *Consolidated Bedding* and *DHP* demonstrate that the Delaware Bankruptcy Court will strictly construe that lower hurdle and apply a high threshold for liability of controlling stockholders and lenders.

In doing so, the Delaware Bankruptcy Court has indicated that the most critical factor is whether the affiliated corporation exercised de facto control — not just generally, but specifically — over making the decision to terminate the employees. The satisfaction of other factors without exercise of de facto control likely is insufficient to establish liability. Indeed, the court has described the other DOL (and *Pearson*) factors as "not compelling" as well as "awkward and difficult to apply" where the debtor and the parent or lender are in separate industries.

Thus, in future cases, while certainly litigants must be cognizant of all five *Pearson* factors, it appears that they should place the most heavy emphasis on "whether a creditor is exercising control over the debtor beyond what is necessary to recoup some or all of what is owed, and is operating the debtor as the de facto owner of an on-going business," in the words of *Consolidated Bedding*. And in applying this factor, the court requires significant evidence that the parent or lender directly made the decision to close the plant or terminate the employees, rather than simply approving a CRO's decision. The high hurdle this creates is a welcome development for lenders and controlling stockholders in Delaware.

Russell C. Silberglied *is a director of Richards Layton & Finger. His practice includes Chapter 11 bankruptcy cases, bankruptcy litigation and advice to directors of financially troubled companies. He can be contacted at silberglied@rlf.com.*

Julie Finocchiaro*, an associate at the firm, focuses on Chapter 11 bankruptcy cases and bankruptcy litigation. The views expressed in this article are those of the authors and not necessarily those of their firm or clients. She can be contacted at finocchiaro@rlf.com.*