YOU'VE BEEN WARNED: DELAWARE BANKRUPTCY COURT AFFIRMS AFFILIATED COMPANY LIABILITY FOR WARN ACT VIOLATIONS

By: Jonathan M. Horne

A recent Delaware Bankruptcy Court decision in favor of WARN Act class action claimants was a victory for laid off employees, and should be heeded as a warning to any related entity or lender that exerts managerial control over the hiring and firing decisions of a struggling company. In In re Tweeter Opco, LLC,[1] Judge Mary Walrath held that the affiliated indirect owner of and lender to the debtor was liable for WARN Act violations committed in connection with the debtor's attempted restructuring and subsequent liquidation because, in significant part, the affiliated company's exertion of de facto control over the debtor's hiring and firing decisions was "particularly egregious."[2] The ruling should be particularly encouraging to aggrieved employees and their lawyers given the uncertainty of WARN Act claim recoveries in bankruptcy. If affiliated liability can be established as it was in Tweeter Opco, WARN Act plaintiffs potentially have a deeper (or at least non-bankrupt) pocket from which to seek recovery.

BACKGROUND

Specialty consumer electronics retailer Tweeter Home Entertainment originally filed for Chapter 11 reorganization in June 2007. After a failed reorganization attempt, Schultze Asset Management ("SAM"), an entity wholly owned by George Schultze and his immediate family members, purchased substantially all of Tweeter's remaining assets in a bankruptcy sale held on July 13, 2007. SAM operated a scaled-down version of the original Tweeter business as Tweeter Opco LLC ("Tweeter Opco"), and also loaned funds to Tweeter Opco on a subordinated basis. Tweeter Opco, however, fared no better than its predecessor and sought to restructure through a Chapter 11 reorganization commenced on November 5, 2008.[3] As part of its restructuring plan, on October 31, 2008, Tweeter Opco began laying off employees from its many retail locations, as well as its corporate headquarters located in Canton, Massachusetts, and at another large corporate facility located in King of Prussia, Pennsylvania. During the bankruptcy, Tweeter Opco was refused the continued use of cash collateral by its secured lenders and was forced to immediately close all stores and lay off all remaining employees after SAM also refused to provide debtor-in-possession financing.[4] The case was subsequently converted to a Chapter 7 liquidation proceeding. On the date of its bankruptcy filing,

[1] In re Tweeter Opco, LLC, 2011 WL 2680838 (Bankr. D. Del. July 8, 2011).
[2] Id. at *7.
[3] Id. at *1.
[4] Chris Reidy, *Bankruptcy trustee: Tweeter stores won't reopen,* THE BOSTON GLOBE, Dec. 18, 2008, *available at* http://www.boston.com/business/ticker/2008/12/bankruptcy_trus.html).

employees filed a class action complaint against Tweeter Opco and SAM alleging violations of the WARN Act based on the pre-petition layoffs. The complaint was subsequently amended to include employees laid off during the bankruptcy proceeding.

THE WARN ACT

The Worker Adjustment and Retraining Notification Act (the "WARN Act")[5] requires employers to give employees 60 days' notice, subject to certain exceptions, prior to a plant closing or mass layoff, and provides affected employees with various remedies if their employment is terminated without the requisite notice.[6] The WARN Act is intended to soften the blow to workers affected by plant closings or mass layoffs by providing time to secure a new job while still being paid through their current, albeit terminating employment. When workers are discharged without the required notice, they may generally recover "back pay" consisting of up to 60 days of wages and benefits, essentially putting them in the position of having both notice of the termination and a paycheck for a 60-day period.[7] Although this remedy for employees is nice in theory, plant closings and mass layoffs often signify an employer's precarious financial condition, and in some instances presage, or are made in conjunction with, a bankruptcy filing. In such cases, the intersection of the WARN Act with bankruptcy law introduces additional issues that may severely limit the recovery of WARN Act claimants.

WARN ACT ISSUES IN BANKRUPTCY

WARN Act issues primarily arise in bankruptcy cases in one of two contexts, which are distinguishable by the timing of an alleged violation. In one context, a debtor conducts layoffs prior to filing for bankruptcy, while in the other, the debtor files bankruptcy and then commits WARN Act violations while attempting to reorganize. Assuming that valid WARN Act claims exist in each instance, the ultimate issue becomes how those claims should be classified in bankruptcy. With respect to post-petition violations, employees generally hold administrative priority claims, pursuant to 11 U.S.C. § 503(b)(1)(A) to the extent of their WARN Act claims.[8] On the other hand, claims

[5] 29 U.S.C. §§ 2101-2109.
[6] Id. at § 2102.
[7] Id. at § 2104.
[8] In re Beverage Enterprises, Inc., 225 B.R. 111, 117 (Bankr. E.D.Pa. 1998) (WARN claim for postpetition actions of the debtor is entitled to administrative priority whether it is properly classified either as postpetition wages or in the nature of damages paid in compensation for postpetition injuries); In re Hanlin Group, Inc., 176 B.R. 329, 334 (Bankr. D.N.J. 1995) ("[b]ecause the date of termination occurred postpetition, any back pay due for WARN violation will be deemed as earned postpetition, and therefore in the nature of wages for services rendered after the commencement of the case entitled to administrative expense status."). But see In re Jamesway Corp., 235 B.R. 329, 347-48 (Bankr. S.D.N.Y. 1999) (WARN claims arising out of postpetition termination not entitled to administrative priority claim where company made prepetition decision to liquidate through Chapter 11 filing and thus firings were not made by the debtor in its continuing operation of the business).

resulting from prepetition violations have been limited to prepetition claims entitled to priority under 11 U.S.C. § 507(a)(4) up to the statutory cap, with the balance becoming a general unsecured claim.[9] Due to this dichotomy, an employee's WARN Act claim recovery may hinge solely on the timing of the violation in relation to the debtor's bankruptcy filing, with mere days being the difference between a potentially full or partial recovery. Not surprisingly then, downsized employees and their counsel seek ways to work around the issues created by a WARN Act violator's bankruptcy filing. One such way is to attempt to hold the debtor's affiliates, including lenders, liable for its WARN Act violations.

AFFILIATED LIABILITY UNDER THE WARN ACT

The law is clear that affiliated companies, such as SAM, can be held liable for WARN Act violations if the employing company and the affiliate are adjudged to be a single "employer"[10] for purposes of the WARN act and the requisite notice is not made. What is not clear, however, is what test should be applied to establish single "employer" status.[11] The Tweeter Opco Court, following previous Third Circuit precedent,[12] applied a five-factor test promulgated by the U.S. Department of Labor's ("DOL") regulations interpreting the WARN Act.[13] Specifically, the five factors to be considered are: (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) the dependency of operations.[14] The foregoing factors, none of which are controlling, provide a non-exhaustive list and the fact-finder may consider other evidence in its analysis.

COURT'S OPINION

In Tweeter Opco, Judge Walrath applied the DOL's five-factor test and held that SAM was an "employer" for WARN Act purposes and was therefore liable for violations stemming from the termination of employees at the Canton and King of Prussia

[9] At least one commentator believed that revisions to § 503(b)(1)(A) enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) would eliminate the "timing is everything" distinction. See Robert J. Keach, *BAPCPA and WARN Act "Back Pay:" Now, Timing Isn't Everything*, 24 JAN. AM. BANKR. INST. J. 26 (2006). However, recent decisions do not bear out this prediction. See In re Powermate Holding Corp., 394 B.R. 765 (Bankr. D. Del. 2008) (WARN claims arising out of terminations conducted on same day as, but prior to, Chapter 11 filing, were prepetition claims not entitled to administrative priority); In re First Magnus Financial Corp., 390 B.R. 667 (Bankr. D. Ariz. 2008), *aff'd* 403 B.R. 659 (D.Ariz. 2009).

[10] 29 U.S.C. § 2101(a)(1).

[11] See Marisa Anne Pagnattaro, *The Perils of Control: Affiliated Liability Under the WARN Act*, 41 AM. BUS. L.J. 313, 314 (2004) (noting that some circuits apply a "business enterprise test" while others apply the five factor test promulgated in the Department of Labor regulations interpreting the WARN Act).

[12] See Pearson v. Component Tech. Corp., 247 F.3d 471 (3d Cir. 2001).

[13] See Worker Adjustment and Retraining Notification, 20 C.F.R. § 639.3(a)(2)(2002).

[14] Id.

facilities.[15] First, the Court found that common ownership was satisfied because SAM had financial control over the debtor, while rejecting SAM's argument that common ownership could not be found as a matter of law because of SAM's far removed and indirect ownership interest.[16] The Court then determined that the second factor favored affiliate liability because four of the debtor's five directors were connected to SAM in some way, either as employees of SAM or members of its advisory board.[17] Most critical, though, was SAM's "particularly egregious" de facto exercise of control over the debtor, whereby George Shultze repeatedly called for reductions in payroll to increase profits and ordered the termination of certain employees, while SAM's employees were members of the debtor's board of managers and were directly involved in terminating the debtor's employees as well.[18] In light of this conduct, the Court concluded that affiliate liability was appropriate even though the fourth and fifth factors did not militate in favor of it, because the third factor, de facto exercise of control, carries special weight within the five-factor test.[19]

CONCLUSION

In some respects, the facts in Tweeter Opco are unique in that WARN Act violations themselves, given the myriad corporate defenses, can be difficult to establish even without the added hurdle of proving affiliate liability. Nonetheless, this decision is a vivid reminder that affiliates and lenders of struggling companies that chose to involve themselves in the turnaround and restructuring process, including hiring and firing decisions, need to be aware of and take measures to avoid the potential affiliated company liability that comes with having such de facto control.

[15] Tweeter Opco, 2011 WL 2680838 at *10.
[16] In the corporate hierarchy SAM was Tweeter Opco's great, great, great grandparent. Id. at *4-5.
[17] Id. at *5-6.
[18] Id. at *6-7.
[19] Id. at *9.