

## DELAWARE BANKRUPTCY COURT HOLDS INDIRECT OWNER AND LENDER LIABLE FOR DEBTOR'S WARN ACT VIOLATIONS

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

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On July 8, 2011, the United States Bankruptcy Court for the District of Delaware, per the Honorable Mary F. Walrath, issued an opinion applying the Worker Adjustment and Retraining Notification Act (the "WARN Act"), which may have important ramifications to owners of and lenders to distressed businesses that may be considering plant closings or mass layoffs of employees. The case provides guidance for investors and lenders regarding the degree to which they should involve themselves in the employment decisions of their portfolio companies.

### Background

Schultze Asset Management, LLC ("SAM"), was an indirect owner of, and lender to, Tweeter Opco, LLC, and its affiliates (the "Debtor," and together with its affiliates, the "Debtors"). The Debtors filed petitions for relief under chapter 11 of the Bankruptcy Code on November 5, 2008. On the same day, a group of former employees of the Debtor (the "Plaintiffs") filed a class action lawsuit against the Debtor and SAM alleging WARN Act violations. After the Debtor's bankruptcy case was converted to a chapter 7 liquidation, the Court permitted the Plaintiffs to continue the case against SAM only.

### The Debtor's WARN Act Violations

The WARN Act requires covered employers to provide 60 days' written notice of an upcoming plant closing or mass layoff of employees at a single site of employment. The

Debtor, who all parties agreed was a "covered employer" under the WARN Act, terminated at least 50 employees at its two Massachusetts-based and one Pennsylvania-based facilities on one day's notice. SAM initially challenged whether the two Massachusetts facilities constituted a single site of employment. Relying on the undisputed facts that the facilities were on adjacent parcels of land and shared a parking lot, IT equipment, and departmental offices, the Court rejected this position. SAM also unsuccessfully disputed whether the requisite number of employees had been terminated. Accordingly, the Court held that the Plaintiffs had made out a *prima facie* case of the Debtor's WARN Act violation.

### The Owner-Lender's Liability as a Single Employer with the Debtor

Plaintiffs contended that SAM and the Debtor were a single employer under the WARN Act. Following instruction from the Third Circuit, the Court examined the following factors to determine whether SAM was liable with the Debtor as a single employer: (1) common ownership; (2) common directors and/or officers; (3) the *de facto* exercise of control; (4) unity of personnel policies emanating from a common source; and (5) the dependence of operations between the entities. Based on its finding that factors one, two, and three were present, the Court held that SAM and the Debtor were a single employer for the purpose of WARN Act liability.

In discussing the common ownership factor, the Court rejected case law from outside the Third Circuit which holds that entities with an indirect ownership interest in another company can never share common ownership with their indirect subsidiary. Rather, Judge Walrath ruled that "[f]inancial control itself is sufficient to satisfy the common ownership factor," and that SAM had "financial control over the Debtor through its lender relationship." Accordingly, the Court found that the combination of SAM's indirect ownership of the Debtor with its position as a lender satisfied the common ownership element.

Judge Walrath also found that SAM shared common directors and officers with the Debtor. The only overlapping member of the Debtor's and SAM's formal management team was SAM's managing member, George Schultze. Nonetheless, the Court concluded that this prong had been met because

the evidence established that Schultze was chairman of the Debtor's board, was CEO and managing member of the Debtor's parent company, and controlled the other three directors of the Debtor, who were also employees, or on the advisory board, of SAM.

The third factor, the *de facto* exercise of control, examines "whether the parent [or lender] has specifically directed the allegedly illegal employment practice that forms the basis for the [WARN Act] litigation." This factor carries "special weight" among the five factors, and liability is warranted if the *de facto* exercise of control is "particularly egregious."

The record contained evidence of several statements and actions by Schultze, or attributed to him, upon which the Court relied in finding *de facto* control. At one point, Schultze gave instructions to terminate half of the employees at the Debtor's Massachusetts corporate center. Schultze was also reported to have directed the termination of the Debtor's CEO and to have stated that he was "now on board with the idea that mass terminations should be done." Furthermore, one of the Debtor's directors communicated frequently with SAM's inside counsel concerning the Debtor's employment practices. The Court also noted that, at Schultze's direction, SAM personnel had assisted the Debtor's management in firing employees.

#### The Owner-Lender's Additional Defenses Are Unavailing

SAM also attempted, without success, to invoke the "faltering company" and "good faith" defenses to liability under the WARN Act. The Court rejected the "faltering company" defense because the Debtor's notice had failed to provide workers with specific facts explaining why the Debtor had not complied with the 60-day notice period. Finally, the Court ruled that SAM could not invoke the Debtor's good faith as a defense because it had failed to raise the defense until after discovery had closed.

#### Practical Impact

The *Tweeter* decision adds to a growing body of case law from the Delaware Bankruptcy Court on the WARN Act and is the first recent decision from the Court to extend WARN Act liability to a non-debtor. See *Manning v. DHP Holdings II Corp.* (*In re DHP Holdings II Corp.*), Adv. Pro. No. 09-50023, 2010 WL 6561052 (Bankr. D. Del. Apr. 26, 2011) (Walrath, J.); *Azzata v. Am. Bedding Indus., Inc.* (*In re Consol. Bedding, Inc.*), 432 B.R. 115 (Bankr. D. Del. 2010) (Shannon, J.).

Although determinations of single-employer status remain highly fact-specific, Judge Walrath's opinion in the *Tweeter* case – especially if read together with the Court's earlier opinions in *DHP* and *Consolidated Bedding* – provides helpful guidelines on the boundaries that investors and lenders must maintain between itself and the company. Because *de facto* control over a company's employment practices appears to be the most important consideration in determining single-employer status, investors and lenders are wise to refrain from involving themselves too deeply in a company's decisions to close facilities or terminate personnel.

Furthermore, in times of distress, investors and lenders would do well to encourage the company to hire a third-party chief restructuring officer ("CRO") not directly affiliated with its owner or lender (something that apparently was done in *DHP* but not in *Tweeter*) and give that CRO a prominent role in decisions whether to close facilities and terminate personnel. The involvement of a CRO – especially one given broad discretion and, if possible, reporting to a special committee of independent board members – may go a long way toward confining liability to the debtor entity.

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