VC EXPERTS

Delaware District Court Affirms Bankruptcy Court Ruling that Private Equity Fund Is Not Liable for WARN Act Liability of Its Portfolio Company

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On September 29, 2014, in *Czyzewski v. Sun Capital Partners, Inc. (In re Jevic Holding Corp.)*, [1] the United States District Court for the District of Delaware issued a decision holding that a private equity fund, Sun Capital Partners, Inc. ("**Sun Capital**"), could not be held liable for its portfolio company's alleged violation of the WARN Act. Applying the Third Circuit's test for "single employer" liability, the District Court concluded that Sun Capital and its wholly owned subsidiary, Jevic Transportation, Inc. ("**Jevic**"), did not function as a "single employer" for WARN Act purposes. The decision, affirming Delaware Bankruptcy Judge Brendan L. Shannon's 2013 ruling, [2] provides valuable guidance to private equity funds seeking to ensure that they are not held liable for their portfolio companies' WARN Act liabilities. It is important to note, however, that *Jevic* does not change the landscape for private equity funds in the separate but somewhat analogous context of portfolio companies' underfunded pension liabilities, which was addressed by the First Circuit in its important and controversial 2013 decision in the Scott Brass, Inc. bankruptcy case, [3] also involving Sun Capital funds.

Background

Sun Transportation, LLC, a wholly owned subsidiary of Sun Capital, acquired Jevic, a trucking company, in a leveraged buyout in 2006. In connection with the acquisition, Sun Capital and Jevic entered into a management services agreement providing for Sun Capital's consulting services to Jevic and compensation therefor. In 2007, Jevic began experiencing financial difficulty. After providing Jevic's senior lender with a $2 million guarantee in 2008 and negotiating multiple forbearance agreements to avoid a loan default by Jevic, Sun Capital ultimately decided not to invest any additional funds into Jevic. Jevic then embarked on a sale process, which was not successful.

On May 16, 2008, Jevic's board of directors authorized a chapter 11 filing, and Jevic sent termination notices to its employees. The notices were received by Jevic's employees on May 19, 2008, and Jevic filed its chapter 11 petition on May 20, 2008.

On May 21, 2008, five former Jevic employees filed an adversary proceeding (later certified as a class action) in the United States Bankruptcy Court for the District of Delaware against Sun Capital and Jevic alleging that the defendants, as a "single employer," violated the federal WARN Act and the New Jersey WARN Act by failing to provide employees with the requisite 60-day notice before a plant closing or mass layoff. After lengthy discovery and a hearing, the Bankruptcy Court granted Sun Capital's motion for summary judgment and held that Sun Capital was not a "single employer" with Jevic for WARN Act purposes. [4] The former employees subsequently appealed the Bankruptcy Court's decision to the District Court.

The District Court Decision

In determining whether Sun Capital could be held liable as a "single employer" for Jevic's failure to provide its employees with 60 days' notice of a plant closing, District Court Judge Sue L. Robinson relied on a five-factor test promulgated by the Department of Labor and adopted by the Third Circuit. [5] Those five factors are: (1) common ownership; (2) common directors and/or officers; (3) *de facto* exercise of control; (4) unity of personnel policies; and (5) dependency of operations. [6]

On appeal, Sun Capital did not contest the Bankruptcy Court's findings that the first two factors were satisfied: Sun Capital was the direct parent of Jevic, and two common individuals served on the formal management teams of both Jevic and Sun Capital. [7] However, under applicable case law, these two factors alone are insufficient to impose "single employer" WARN Act liability on a parent company. Thus, the District Court focused on the three remaining factors.

As to the *de facto* exercise of control factor, which the District Court noted is not satisfied merely by a parent's exercise of control attendant to stock ownership, Judge Robinson analyzed whether Sun Capital "specifically directed the allegedly illegal employment practice." The former employees argued that, although Sun Capital did not direct the plant closure, it was Sun Capital's decision to stop investing in Jevic that ultimately led to the shutdown. The District Court rejected this "natural and probable consequences" argument, finding that Jevic was ultimately responsible for shutting down the company, signing the WARN notices and terminating the employees. The District Court also rejected the argument that, because two of Sun Capital's representatives were on Jevic's three-member board of directors, Sun Capital maintained control of Jevic.

The District Court also found that the fourth factor, unity of personnel policies, which focuses on whether two companies function as a single entity

with respect to employees such that they have "centralized hiring and firing, payment of wages, and personnel and benefits recordkeeping," weighed in favor of Sun Capital. Despite allegations of certain instances of interaction, such as a shared incentive plan and Jevic's CFO's attendance at a Sun Capital-run training conference, the District Court did not find sufficient evidence of any such unity since Sun Capital did not directly hire or fire Jevic employees, pay Jevic employee salaries or share personnel records with Jevic.

Finally, with respect to the fifth factor, dependency of operations, the District Court considered whether Sun Capital and Jevic shared administrative or purchasing services, interchanged employees and equipment and/or commingled finances. Similar to the *de facto* control factor, courts have held that this factor is not satisfied by a parent exercising its "ordinary powers of ownership," and it also cannot be satisfied by the provision of loans from a parent to its subsidiary. In support of their position that Jevic and Sun Capital were dependent on each other, the former employees pointed to the management services agreement between the two parties and the fact that a Sun Capital representative worked on a restructuring plan for Jevic. The District Court held that this did not provide evidence of sufficient day-to- day involvement by Sun Capital in Jevic's operations to create a dependency of operations. More telling was the fact that Jevic maintained separate books and records, bank accounts and financial statements and did not share any administrative services, facilities or equipment with Sun Capital. Further, pursuant to the express terms of the management services agreement, Sun Capital was acting as an "independent contractor" that was compensated by Jevic for its work, including advice on restructuring.

The First Circuit Sun Capital Case [8]

In July 2013, in a controversial ruling, the United States Court of Appeals for the First Circuit endorsed the view of the Pension Benefit Guaranty Corporation that a private equity fund can be held jointly and severally liable for the unfunded pension obligations of its portfolio companies. In that case, which centered on Scott Brass, Inc., a portfolio company held by multiple Sun Capital funds, the First Circuit focused on the active role of the management company affiliated with a Sun Capital fund, and held that certain Sun Capital funds were engaged in a "trade or business," a critical test for control group liability for unfunded pension obligations.

In determining whether the "trade or business" standard was satisfied, the First Circuit utilized the "investment plus" test, which examines (1) whether the private equity fund was engaged in an activity with the primary purpose of income or profit and (2) whether it conducted that activity with continuity

and regularity. Among other factors, the First Circuit pointed to the following in finding that certain Sun Capital funds met this test:

- Sun Capital funds exercised oversight of and participated in management and operation of their portfolio companies. In particular, the general partners, through their partnership agreements, had the authority to make decisions and determinations on behalf of the funds regarding hiring, terminating and compensating agents of the funds and the portfolio companies;
- Sun Capital affiliates participated in developing restructuring and operating plans for the portfolio companies with the intent of implementing "significant operating improvements" in order to sell the companies for a profit;
- Sun Capital affiliates served on the boards of the portfolio companies and held two of the three seats on the Scott Brass board, allowing the funds to effectively control the board; and
- Most importantly, one of the Sun Capital funds received an offset of the management fees that it otherwise would have paid to the Sun Capital management company in an amount equal to 50% of the fees that the management company received from Scott Brass for the services it provided to Scott Brass.

After finding that certain Sun Capital funds were "trades or businesses," the First Circuit remanded the case to the United States District Court for the District of Massachusetts to determine whether the Sun Capital funds and Scott Brass were under "common control," the second prong of the ERISA control group test, which generally requires common ownership of at least 80%. The Sun Capital funds appealed to the Supreme Court, but the Supreme Court denied certiorari. The Massachusetts District Court has yet to rule on the "common control" issue.

Lessons of *Jevic* and *Sun Capital*

Jevic provides clear guidance on a private equity fund's potential liability under the WARN Act, at least in the Third Circuit. Although each case is highly fact-specific, the "single employer" test used in *Jevic* to determine WARN Act liability certainly appears to require much more specific involvement in the day-to- day operations of the portfolio company than the "investment plus" analysis used in *Sun Capital* to determine the first prong of the ERISA control group test.

Under *Jevic*, a private equity fund can escape WARN Act liability of its portfolio company so long as it does not make the decision to shut down operations or hire, fire or directly pay the employees, even if the private equity fund places its own personnel on the portfolio company's board of directors, refuses to provide additional funding, exercises some oversight

and shares certain benefit plans and employee monitoring functions. Nonetheless, private equity funds should be mindful, to the extent practicable, to maintain corporate separateness and observe corporate formalities, avoid sharing employees with the portfolio company, make clear that all decisions regarding hiring and firing are left exclusively to the portfolio company and require that their portfolio companies hire independent professionals to advise on personnel issues.

In contrast, under the "investment plus" standard used in *Sun Capital* to determine a private equity fund's potential control group liability for unfunded pension obligations, anything more than a passive investment could expose the private equity fund to liability.

Given that WARN Act liability was not at issue in *Sun Capital*, it cannot be determined whether the Sun Capital funds' conduct in that case, which the First Circuit characterized as "substantial operation and managerial control," would have been sufficient to satisfy the "single employer" test used in *Jevic*. For example, in finding that the Sun Capital funds were "intimately involved in the management and operation of the company," the First Circuit pointed to the fact that Sun Capital employees received weekly financial and business reports from Scott Brass; Sun Capital representatives were present at a meeting where three Scott Brass salesmen were hired and possible acquisitions and capital expenditures were discussed; Sun Capital appointed two of its officers to Scott Brass' three-member board of directors; [9] and Sun Capital provided personnel to Scott Brass for management and consulting services. The court in *Jevic* found similar facts insufficient to establish that Sun Capital yielded the requisite control and day-to- day involvement to incur WARN Act liability.

It is also not clear whether the outcome in *Jevic* would have been different had the District Court considered certain facts adduced in *Sun Capital* with respect to Sun Capital's general business practices. In *Sun Capital*, the First Circuit relied on the Sun Capital funds' private placement memoranda to find that the funds were actively involved in the management and operation of their portfolio companies, such as signing checks for the portfolio companies and holding "frequent meetings with senior staff to discuss operations, competition, new products and personnel." [10] The First Circuit also pointed to the Sun Capital funds' partnership agreements, which expressly authorize the Sun Capital funds' general partners to make decisions about hiring, terminating and compensating employees of their portfolio companies. These facts were not in the record in Jevic, and, despite numerous references to the First Circuit's findings in the *Jevic* plaintiffs' pleadings on appeal, [11] the District Court declined to take judicial notice of such facts in *Jevic*.

Jevic and *Sun Capital* were decided under different statutes, legal standards and factual scenarios, but they both provide useful guidance to private equity funds regarding the risks involved in actively participating in the management or operations of distressed portfolio companies. While *Jevic*'s guidance on avoiding WARN Act liability is helpful, private equity funds must continue to be careful when structuring and determining the level of involvement in their investments in portfolio companies that are obligated to contribute to multiemployer plans or sponsor or contribute to single employer pension plans, and should consider structuring their investments in such a way as to keep their ownership of each portfolio company under 80% [12] and/or using alternative investment vehicles.

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[1] No. 08-11006, 2014 U.S. Dist. LEXIS 137071 (D. Del. Sept. 29, 2014).

[2] *Czyzewski v. Jevic Transp. Inc. (In re Jevic Holding Corp.)*, 492 B.R. 416 (Bankr. D. Del. 2013).

[3] *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013), *cert. denied*, 134 S. Ct. 1492 (2014).

[4] Judge Shannon separately ruled that Jevic was not liable for federal WARN Act violations because of an exemption for unforeseen business circumstances, but allowed claims under the New Jersey WARN Act (which does not include such an exemption) to go forward. *Czyzewski v. Jevic Transp. Inc. (In re Jevic Holding Corp.)*, 496 B.R. 151 (Bankr. D. Del. 2013).

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

[6] The analysis of "single employer" liability under the federal WARN Act and the New Jersey WARN Act is substantially similar, and, therefore, the Bankruptcy Court and the District Court applied the same analysis.

[7] Sun Capital had argued to the Bankruptcy Court that these two individuals were not members of Jevic's "senior management team," which controlled Jevic's day-to-day operations, and thus, this factor was not satisfied. However, Judge Shannon rejected this argument on the basis that the test refers to formal director or officer titles and not control.

[8] A more detailed analysis of the First Circuit's *Sun Capital* decision is set forth in our August 6, 2013 client memorandum (available here).

[9] Unlike in *Jevic*, the First Circuit in *Sun Capital* found that the funds' appointment of two Sun Capital officers to the three-member board of directors was evidence of Sun Capital's control over the board.

[10] For example, the private placement memoranda provided that individuals who work for the general partner of a Sun Capital fund "typically work to reduce costs, improve margins, accelerate sales growth through new products and market opportunities, implement or modify management information systems and improve reporting and control functions."

[11] The First Circuit's *Sun Capital* decision was not yet issued when *Jevic* was briefed and decided in the Bankruptcy Court.

[12] While still appearing to be a viable alternative, the issue of whether investments by two affiliated funds could be aggregated to meet the 80% requirement was not ruled on in Sun Capital, and is currently before the Massachusetts District Court.

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