

Understanding and Estimating the Impact of Potential WARN Act Claims on Unsecured Creditors

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Editor's Note: Please see the feature "In re First Magnus Financial Corp. Revisited: The Powermate Decision" on page 18 for a more detailed analysis of these two cases, which are briefly discussed herein.

Professionals representing creditors' committees are generally focused on one outcome: What will be left for the unsecured creditors? Few things cast this process into such disarray as the filing of a complaint for damages under the Worker Adjustment and Retraining Notification Act (WARN Act, or Act). There is little precedent as to what the outcome of any given suit might be, resulting in debtors pushing such litigation to the back burner while attending to more pressing matters of the restructuring or liquidation. This leaves the committee uncertain as to the potential outcome. While much has been written about landmark WARN Act cases and decisions, in this article we attempt to use the outcomes of these cases as a mechanism for potential claim analysis and decision-making.

Muddy Waters: Defenses Available to the Employer

Early in the process, advisors should ascertain the likelihood and strength of the debtor's various defenses. A "faltering company" is one that may provide less than 60 days' notice to affected employees because, before the time at which notice was actually given, the company was actively seeking capital or business that, if received, would have allowed the employer to delay or avoid having to give notice. In this effect, the employer, in good faith, believed that had notice been provided earlier, such notice would have precluded the company from obtaining said capital or business.¹ In addition, a company may provide less

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than 60 days' notice if the closing is the result of an unforeseeable business circumstance.² Although there are other exemptions, such as that for a natural disaster,³ these are the most-often used, although there are traps in assuming the validity of either of these exemptions.

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Importantly, the debtor must actually give notice. Courts have found that a failure to give explicit notice can render invalid any claim of an exemption under the "faltering company" or "unforeseen circumstances" tests that provide for "shortened notice," and not an exemption to notice. In addition, the qualitative aspect of the defenses must also be met. For a distressed company, showing that it was actively seeking capital (either debt or equity) that would have prolonged survival should not be a difficult endeavor. Meeting the requirements of the good-faith presumption, however, is a difficult hurdle to clear. As for the exemptions granted by §2102(b)(2), a company with a sustained history of losses and deteriorating performance is unlikely to claim that its collapse was unforeseen, especially given general acceptance that only about 8 percent of business failures stem from

external factors beyond management's control.⁴

One often-overlooked exemption stems from the Act's requirement that the number of employees used in calculating liability be at a single site. Companies in the transportation or logistics industries, for example, may operate using widely-dispersed employees or facilities (drivers' terminals, pilots' bases, etc.) getting their directions from a single location. In *Teamsters Local Union 413 v. Drivers Inc.*, 101 F.3d 1107 (6th Cir. 1996), the court held that a trucking company operating from 11 separate terminals had 11 different sites of employment, despite the fact that all routes were discharged from a single terminal.

Another exemption is that of the "liquidating fiduciary." In *United Healthcare*,⁵ the court ruled that the debtor was not a "business enterprise" as defined by the Act and was therefore

exempt from liability because it functioned as a "liquidating fiduciary" at the time of notice and termination. The facts that ultimately allowed the debtor to meet the definition of liquidating fiduciary were as follow:

- The company had a sustained period (more than three years) of consistent operating losses;
- The company's board accepted an offer of purchase from a competitor that required the debtor to close its hospital and cease operations;
- The company made notice of its intent to cease operations and liquidate, so advised the state regulatory authorities and turned in its operating certificates; and on the same day;
- The company filed a voluntary petition under chapter 11;
- At the time of the petition, the company had *ceased all operations* and transferred all patients to other facilities; and
- After the committee in the debtor's case filed a motion to compel termination of all employees, the debtor terminated 1,200 of its 1,300 employees, with the

⁴ Bibeault, D.B. 1982. *Corporate Turnaround: How Managers Turn Losers into Winners*. New York: McGraw-Hill. Reprint, Top of the Hill Books, 1996, p. 25-26.

⁵ In re *United Healthcare System Inc.*, 200 F.3d 170 (3rd Cir. 1999).

¹ 29 U.S.C. §2102(b)(1).

² 29 U.S.C. §2102(b)(2)(A).

³ 29 U.S.C. §2102(b)(2)(B).

remaining employees engaged only in tasks related to the liquidation of the company.

The bankruptcy court rejected the faltering company and unforeseen business-circumstances defenses and ruled that the company was an employer under the Act. On appeal, the Third Circuit determined that the debtor was not operating as a going concern but was instead solely engaged in the liquidation of its enterprise. The appeals court found support in the fact that the hospital had turned in its operating certificates to the state regulatory authorities, thus preventing the debtor from operating under state law.

Ensuring that bankruptcy professionals would forever find little guidance in the court's decision, the appeals court left open the possibility that an employer engaged in a postpetition liquidation of its business may still incur liability under the Act. The key to this liability, said the court, is a review of the debtor's activities both pre- and postpetition to determine if the debtor continued to meet the Act's definition of an employer by continuing to operate its business as a going concern.

In *Jamesway*,⁶ the debtor claimed exemption on the basis of the faltering-company, unforeseeable business circumstances and liquidating fiduciary defenses. The court found that because the debtor had provided no notice before terminating employees, the defenses made available under §2102(b)(2) of the Act were unavailable, in that:

- the company's board of directors had voted to liquidate the company and file the chapter 11 case six days before the petition date;
- the company had undertaken explicit plans for the termination of employees, including identification of employees to be terminated and a schedule for the terminations and had started the terminations six days prior to the filing of the case.

This supported the employees' claims that the company had the opportunity to provide shortened notice before the petition date. The court determined that the company had the obligation to notify the terminated employees as required under the Act. The dichotomy presented by *United Healthcare* and *Jamesway* is stark: The debtor that terminated employees postpetition while engaging only in liquidation of the business had no liability,

whereas the company that terminated employees before the petition date while liquidating its business had liability. The comparison among liquidating companies that have ceased their going-concern operations would appear to indicate a preference toward notice and termination of employees only postpetition. It is never that simple and an erroneous choice of timing carries a large price.

The Easy Part: Calculating Worst-case Potential Damages

In calculating potential damages, little creativity is required. Estimating 60 days of wages and benefits (damage-period wages) for the terminated employees is a straightforward task, and likely the last trivial task in this process. In determining what the actual damages might be, we first determine when notice was given. If none was given, courts have generally deemed notice to have occurred on the date of termination. If notice was given before termination and the employees were paid for time worked between notice and termination, then the amount of those wages and benefits should be deducted from the damage-period wages. Now, at least, we have a number (the "adjusted worst-case damages)." Where that number falls in the scheme of priorities is the subject of great concern and varied opinions.

The Hard Part: Interplay of Recent Cases and the Code's Priority Scheme

Assuming that one reaches comfort as to the adjusted worst-case damages and leaving for future consideration the validity of any defenses, one key issue for consideration is the ultimate priority of any damages. To address this analysis, one must determine when the termination event occurred relative to the petition date.

If termination occurred on or before the petition date, then in the determination of the priority of WARN Act claims, 2008 was a banner year. The first case to address this issue after the enactment of BAPCPA was *First Magnus*,⁷ in which the debtor, without providing notice, laid off a number of employees five days before the filing of its chapter 11 petition. A group of employees sued for damages, asserting administrative-expense priority (under the new Bankruptcy

Code §503(b)(1)(A)(i) and (ii))⁸ for that portion of the 60-day notice period that extended into the postpetition period. The court determined that, as the claim did not arise from the act of providing necessary and beneficial postpetition services to the estate, and as Bankruptcy Code §503(b)(1)(A) considers the timing as to when services were rendered to determine priority, not when the "wages, salaries or commissions" are due to be paid, any WARN Act claim that employees eventually prevailed upon would not rise to the level of an administrative claim. Thus, by fixing the date of notice and/or termination prepetition, the potential claim would be subject to the \$10,950 per employee cap on priority unsecured claims. Any overage would be considered a general unsecured claim.

Recognizing *First Magnus*, the Delaware Bankruptcy Court's decision in *In re Powermate*⁹ further developed this guidance. In that case, employees terminated on the petition date sued under the WARN Act and alleged administrative status for the portion of the 60 days wages and benefits due that occurred postpetition (essentially all of the damages due). The debtor sought to have the damages, if awarded, categorized as priority unsecured claims under §507(a)(4) and (5). Hon. **Kevin Gross** cited *First Magnus* extensively and continued the previous court's analysis, ruling that because:

- BAPCPA awards administrative status only to those wages and benefits that are *attributable* to the postpetition period;
- in the case of a WARN Act claim, *attributable* equates to the date on which the rights vest to the employees; and
- in the case of WARN Act damages, those rights vest *as of the termination date*;

then, as the termination date was prepetition, the potential WARN Act claims are prepetition claims, in the first instance as fourth or fifth priority wage

⁸ "After notice and a hearing, there shall be allowed administrative expenses...including...(i) wages, salaries and commissions for services rendered after the commencement of the case; and (ii) wages and benefits awarded pursuant to a judicial proceeding or a proceeding of the National Labor Relations Board as back pay attributable to any period of time occurring after commencement of the case under this title, as a result of a violation of Federal or State law by the debtor, without regard to the time of the occurrence of unlawful conduct on which such award is based."

⁹ *In re Powermate Holding Corp.*, case No. 1:08-50559-KG (Bankr. D. Del., Oct. 10, 2008).

⁶ *In re Jamesway Corp.*, 235 B.R. 329 (Bankr. S.D.N.Y. 1999).

⁷ *In re First Magnus Fin. Corp.*, case No. 4:07-bk-01578-JMM (Bankr. D. Ariz. June 20, 2008).

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claims, then as general unsecured claims. The matter is currently on appeal.

If termination occurred on or before the petition date, calculation of the potential amount of the worst-case claim after *Powermate* and *First Magnus* is a matter of calculating the adjusted worst-case damages on a per-employee basis and determining how each employee is impacted by the statutory cap in §507(a)(4) and (5). If, for example, an employee asserts a WARN Act claim of \$25,000 and received compensation for post-notice prepetition work in the amount of \$1,500, then the remaining priority claim would be calculated as follows:

Statutory Cap: \$10,950

Less amount already paid: (\$ 1,500)

Priority cap remaining: \$ 9,450

The employee would receive priority treatment for the first \$9,450 of the claim, with the remaining \$15,550 being an unsecured-nonpriority claim. The crucial issue for unsecured creditors in this context is the ultimate amount of potential priority claims, because in a case where unsecured creditors are all but “out of the money,” the committee may soon find itself with nothing left for which to fight.

What of those cases where termination (or notice and subsequent termination) occurs postpetition? If the debtor can show clear and convincing evidence that it was not engaged in operation as a going-concern business before or after the termination date, then the “liquidating fiduciary” defense may be available. Be aware, however, of the inherent gamble in that presumption; with the contrast between *United Healthcare* and *Jamesway*, and taking the language in *First Magnus* and *Powermate*, it is conceivable that the mere act of providing notice (either actual or *de facto*) postpetition may give rise to an administrative claim. Giving explicit notices appears to preserve the viability of the

faltering company and unforeseen-circumstance defenses, however, and if the company can prove the remaining facts necessary for its any of its defenses, then so be it—but rarely is the committee in a position to have comfort in that outcome.

A case where potential recoveries are so thin that a multi-million dollar administrative claim would “kill the case” is not unrealistic. Advisors to committees should account for this potential risk and determine their stance accordingly. If the adjusted worst-case damages are of such amount that they could be awarded administrative status to the detriment of all other classes of creditors, the committee is left in the same position as where we left the issue of priority claims: With nothing left to fight for, why continue to fight?

Even now, the committee still has leverage: the risk inherent in litigation. While recent cases have discussed treatment of potential claims, many, if not most, settle without a determination by the court as to the validity or amount of the actual claim. This relative uncertainty does provide some assistance to the committee in determining a solution that provides for a recovery to all unsecured creditors. Assuming that a liquidation analysis has been prepared that estimates recoveries by unsecured creditors, the comparison of this estimated recovery to the amount of WARN Act claims may be insightful for both sides. If payment of priority WARN Act claims drains the estate of all available assets and therefore eliminates any hope for subsequent recoveries by both the employees (on the nonpriority portions of their claims) and other unsecured creditors, a committee might seek to ensure a recovery for its constituents by negotiating a recovery for other classes of creditors.

For example, a carve-out for the class of WARN Act creditors wherein some percentage of total recoveries

available for the unsecured creditor class are allocated for payment to the WARN Act claimants provides for a viable post-confirmation estate while still recovering value for all classes of unsecured creditors. In calculating the amounts of such an arrangement, of course, attention should be paid to the relative size of the priority claim asserted by the WARN Act claimants as well as the likelihood of success in litigation. While the notion of settling a suit which may have been brought for no other reason than to force a quick settlement because of the fear of a case-killing administrative or priority claim may be distasteful, litigating the case into administrative insolvency doesn't provide any better outcome. With the thoroughly convoluted landscape of cases in this area, there are few opportunities for certainty. But it appears that all parties can at least agree on the math. Maybe. ■