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Mission Impossible? Addressing
<u>WARN Act Liability in Liquidating Mid-Market Liquidating Cases</u>[1]

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You have been approached on short notice by a panicked company, PoorCo. PoorCo's lender is owed $3 million and has cut off its line, leaving the company with a few days of cash. The company has stretched its vendors and owes them north of $10 million. PoorCo has talked to potential suitors – one or two are interested, but none has yet presented an engagement ring. The company has one facility and employs 400 employees. PoorCo turns $75 million in revenue annually, but if forced to close and liquidate, you estimate that the best the company could do is net $3 million once secured debt is satisfied.

Sound familiar? PoorCo is just another mid-market company on the ropes – perhaps a sale candidate, but restructuring is not a realistic option.

With a couple of potential suitors, you assume chapter 11 is a viable path, as long as you can fund the case long enough to get through a sale, followed by a liquidating plan. You prepare a cash flow model and waterfall for the case, and identify a potential issue - a likely claim by each employee for a claim arising under the Worker Adjustment and Retraining Notification (WARN) Act (29 U.S.C. §§ 2101 et seq.), which claim could total up to 60 days of wages and benefits for each employee terminated in connection with the bankruptcy filing.

Assuming PoorCo's employees are terminated in connection with the bankruptcy filing, either upon filing or shortly thereafter, other than a skeleton crew to see it through the case, PoorCo may face significant WARN Act claims on behalf of each employee that may be entitled to administrative claim status. *See* 11 U.S.C. § 503(b)(1)(A)(ii); *Matthews v. Truland Group, Inc. (In re Truland Group, Inc.)*, 520 B.R. 197, 200-05 (Bankr. E.D. Va. 2014) ("wages and benefits that may be awarded pursuant to the WARN Act constitute administrative expenses under subsection (ii) of Section 503(b)(1)(A) of the Code"); *In re Philadelphia Newspapers, LLC*, 433 B.R. 164, 173- 174 (Bankr. E.D. Pa. 2010) (same). Furthermore, even if the WARN Act claims are not entitled to administrative claim status under Section 503(b)(1)(A)(ii), at least a substantial portion of such claims may be entitled to priority claim status under 11 U.S.C §§ 507(a)(4) and (5).

High personnel costs as a percentage of revenue (and value) is a hallmark of mid-market entities. PoorCo pays $400,000 per week, or over $20 million per year, in wages and benefits. 60 days (approximately 8 weeks) of WARN Act liability is $3.2 million in additional cash that you may need to get from point A (petition date) to B (confirmed liquidating plan).

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Chapter 11 practitioners want to take their clients into bankruptcy with a plan – to eliminate or reduce liabilities, restructure long term debt, remake the capital structure, and exit; or alternatively, to sell substantially all assets in a liquidation, and exit. In either case, the exit contemplates a confirmed chapter 11 plan, which requires, among other things, some assurance that the estate can pay administrative and priority claims in full. *See* 11 U.S.C. §§ 1129 (a)(4) (administrative claims) and (a)(9) (priority claims).

Adding a potential $3.2 million administrative or priority claim for work that is never performed (because the employees were terminated with the filing of the case), on top of the necessary administrative expenses incurred in conducting the case, may prove to be an insurmountable obstacle to confirmation of your liquidating plan.

Of course, this issue of WARN Act liability giving rise to significant administrative or priority claim risk is unique to bankruptcy. Outside of bankruptcy, these claims are treated *pari passu* with other general unsecured claims, and do not lead to direct personal liability on the part of company principals or owners. However, assuming that, for other reasons, a bankruptcy case is the best path for your client, what can you do to mitigate the risk?

Possible Solutions: Liquidating Fiduciary Defense, or Structured Dismissal

Liquidating Fiduciary Defense

The WARN Act provides for three statutory areas of defense to liability under the statute, faltering company, unforeseeable business circumstances, and natural disasters exceptions. These defenses entail fact intensive inquiry that, at best, may result in reduced liability. There is also an exception that lies outside the four corners of the WARN Act, known as the "liquidating fiduciary" defense. This defense raises fewer fact issues and, if successful, eliminates WARN liability. For PoorCo, we will limit the discussion to this defense.

The liquidating fiduciary defense arises out of the Department of Labor's preamble to its regulations implementing the WARN Act:

> [A] fiduciary whose sole function in the bankruptcy process is to liquidate a failed business for the benefit of creditors does not succeed to the notice obligations of the former employer because the fiduciary is not operating a "business enterprise" in the normal commercial sense. In other situations, where the fiduciary may continue to operate the business for the benefit of creditors, the fiduciary would succeed to the WARN obligations of the employer precisely because the fiduciary continues the business in operation. 54 Fed.Reg. 16,042, 16,065 (1989).

The handful of cases that have addressed the issue have accepted and relied upon this DOL commentary in considering whether the entity before it is a "liquidating fiduciary" under the WARN Act. *See e.g.*, *In re MF Global Holdings LTD.*, 481 B.R. 268, 280 (Bankr. S.D.N.Y. 2012) (holding that the DOL preamble is persuasive and should be applied, rejecting plaintiffs' argument that the preamble does not have the force of law under *Chevron, U.S.A., Inc. v. Natural Res. Def Counsel, Inc*., 467 U.S. 837 (1984), further noting that no cases adopted the contrary view).

The determination of liquidating fiduciary status turns on whether the company is an “employer” under the WARN Act at or following the time of the layoffs giving rise to WARN liability. A leading case on the liquidating fiduciary principle is the Third Circuit's decision, *In re United Healthcare Sys., Inc.*, 200 F.3d 170 (3d Cir. 1999). In *United Healthcare,* the debtor provided its employees with 60 days' notice of termination of employment pursuant to the WARN Act, and filed for chapter 11. Two weeks into the case, the creditors' committee filed a motion asking the bankruptcy court to order the immediate termination of all employees. Two days later, and before the bankruptcy court could rule on the motion, the debtor informed 1,200 of its 1,300 employees that they were no longer to report to work.

The bankruptcy court held that the debtor remained an "employer" after it filed its bankruptcy petition because it continued to employ its workforce for sixteen days after the petition was filed. Id. However, on appeal, the Third Circuit reversed. While acknowledging that the debtor filed under chapter 11 rather than 7, the court noted that the debtor's actions from the petition date throughout the proceedings clearly demonstrated an intent to liquidate. The panel concluded that although the debtor continued to operate at some level for two weeks post-petition, the debtor was nevertheless acting as a liquidating fiduciary because its activities focused on transfer of patients and liquidation activities. The panel contrasted this to a case where a company continues to act “in an 'employer' capacity, operating the business as an ongoing concern." *United Healthcare, 200 F.3d* at 179. A similar conclusion was reached in
In re Century City Doctors Hospital, LLC, 417 B.R. 801, 805 (Bankr. C.D. Cal. 2009) ("The trustee's intentions have consistently been to close the hospital business at the earliest reasonable time and to liquidate its assets for the benefit of its creditors . . . . Thus, the trustee acted solely as a 'liquidating fiduciary," rather than an employer "operating a business enterprise in the normal commercial sense.'"), affirmed 2010 WL 645903 (B.A.P. 9th Cir. 2010).

The principle established in these cases is that a debtor that files bankruptcy and can establish that it is acting to liquidate assets and wind down operations for the benefit of creditors is a liquidating fiduciary, and therefore not subject to the notice obligations of the WARN Act or liability under the WARN Act.

Another Path: Structured dismissal – but is that door closing?

The other path to mitigating this risk is the structured dismissal, an increasingly popular approach to terminating chapter 11 cases following a 363 sale of substantially all assets. Under a structured dismissal, the case can be resolved through a settlement that is effectuated outside of bankruptcy, following dismissal, and may include a waterfall structure that does not comply with bankruptcy priority rules. This path remains viable, although that door may be closing, depending on the outcome of a case that is currently before the United States Supreme Court.

On December 7, 2016, the Supreme Court heard oral argument in *Czyzewski v. Jevic Holding Corporation* (Sup Ct. No. 15-649). In *Jevic*, the debtor, the secured creditors, and the Official Committee of Unsecured Creditors entered into a structured dismissal that placed general unsecured creditors ahead of a WARN Act class that would have been entitled to priority status under the Bankruptcy Code's distribution scheme. In the settlement, the debtor and the Committee agreed to release fraudulent-transfer claims against the parties that purchased Jevic's assets in a leveraged buyout in exchange for $3.7 million from the fraudulent-transfer defendants, with the case being dismissed. The $3.7 million was distributed fund distributions to priority tax creditors and general unsecured creditors and to pay case professionals. The settlement excluded the WARN Act class, who asserted priority claims totaling $8.3 million.

The bankruptcy court approved the structured dismissal, considering it preferable to the alternative. 2014 WL 268613 (Jan. 24, 2014). No Chapter 11 plan could be confirmed given Jevic's inability to satisfy its administrative liabilities, and only the secured creditors would receive anything in a Chapter 7 liquidation because a bankruptcy trustee would lack the means to pursue the fraudulent-transfer litigation that was the sole source of recovery. The 3rd Circuit Court of Appeals affirmed, holding that a chapter 11 case may, "in a rare case," be resolved through a dismissal that deviates from the Bankruptcy Code's priority scheme. 787 F3d 173 (2015).

The Supreme Court could rule narrowly, affirming *Jevic* on narrow legal and factual grounds, leaving this a viable path to managing the risk that a WARN Act claim destroys the ability to confirm a chapter 11 plan or make distributions to other unsecured creditors. If *Jevic* is decided broadly, however, then companies like PoorCo will find their options limited, and in some cases, may find that bankruptcy itself is foreclosed to them.