UPSTREAM LIABILITY FOR PRIVATE EQUITY FUNDS

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In times of economic distress, creditors start to look for non-traditional sources of payment. Private equity owners represent a rich target for creditors of portfolio companies.

While liability under traditional common-law alter-ego or veil-piercing theories is not commonly assessed against funds, there are numerous other sources of potential liability, principally the plethora of federal and state statutes regulating broad aspects of any portfolio company operations.

This is a multi-part article examining this type of risk in the context of three major federal statutes and their accompanying regulations: the WARN Act, the False Claims Act, and ERISA.

These statutes generally approach upstream liability from the perspective of corporate conglomerates. The animating principle is to ensure corporate parents can't hide behind thinly-capitalized subsidiaries and so, in an effort to elevate substance over form, the statutes provide a means to conflate a "controlling" corporate parent with a "controlled" subsidiary.

This approach doesn't square neatly with the alternative "fund—portfolio company" ownership structure. Private equity funds are generally organized as limited partnerships, and their governance is itself nuanced, with a general partner which outsources its investment management function to an affiliated investment advisor. And certain elements of the private equity business model that blur the distinction between investor and business, or put pressure on the distinction, exacerbate the problem. These elements include:

- Holdco-Opco structures, where Holdco lacks assets other than the stock of Opco;
- Substantial financial leverage;
- Management advisory agreements with management companies affiliated with the sponsor (the same entity that also serves as investment advisor to the fund);
- Intensive balance sheet management, often outsourced in part to the sponsor;
- Aggressive, owner-driven business strategies oriented to maximize value for a three to five year exit; and
- A hands-on governance approach.

Private equity funds are at bottom investment vehicles, not corporate parents in a General Electric-type conglomerate. But at the same time private equity investors are actively involved in managing their businesses. The level of involvement has, if anything, grown since the 2008 financial crisis, as sponsors have learned that superior returns can no longer be achieved through the use of financial leverage alone; rather the underlying businesses must be made to perform better. Though the specifics of "how this looks" can vary from sponsor to sponsor and company to company, the look is very different from that of a passive financial investor in publicly-traded equity securities. And the level of involvement usually becomes even more intensive where a portfolio company is financially troubled.

Liability Under the WARN Act

The federal Worker Adjustment and Retraining Notification Act the (the "WARN Act") often comes into play in times of economic distress. The WARN Act requires advance notice of large layoffs and awards damages where the required notice is not given. Not surprisingly, plaintiffs often aggressively seek an entity with assets more liquid than what the failed company has to offer.

The question of when and where to upstream WARN Act liability is confused, both in terms of the underlying legal theory and the way legal theory is applied to facts in cases. To start with the legal analysis, the National Labor Relations Board has long used one approach, an "integrated enterprise" analysis, in the context of labor relations for determining when two entities constitute a "single employer." This analysis is used in cases under the Labor Management Relations Act, the Age Discrimination Act and the Fair Labor Standards Act, among other things, and the Department of Labor has adopted the analysis for the Family Medical Leave Act. The DOL has, however, issued an alternative set of regulations under the WARN Act with a different test for assessing what the DOL terms "single enterprise liability" under the WARN Act.

Pearson v. Component Technology Corp.[1] is a Third Circuit decision that rationalizes the various legal theories and provides a comprehensive approach to single employer liability. While the case involved the liability of a third party lender, it has been followed by a number of subsequent decisions looking at private equity owner[2] liability. *Pearson* determined that the proper test for upstream liability was, as laid out in the DOL's WARN Act regulations, based on the presence of five factors in the relationship between two entities:

- Common ownership;
- Common directors and/or officers;
- De facto exercise of control;
- Unity of personnel policies emanating from a common source; and
- Dependency of operations.

The first two factors are often present in the private equity setting, whereas the last two are not—a private equity owner does not typically expect uniformity of personnel policies across its portfolio companies, nor is there a dependency of operations between the owner fund and the company (or other portfolio companies). So in many WARN Act decisions the analysis focuses on the "de facto exercise of control" as the critical factor.

Generally speaking, these cases expose the tension between, on the one hand, an investor's "monitoring" its portfolio company's activities and, on the other hand, "taking control" of activity, particularly where the investor makes the decision that gives rise to the WARN liability, *i.e.*, ordering the shutdown. A leading and often-cited decision addressing this topic is *In re Jevic Holding Corp.*[3] The *Jevic* case involved Sun Capital. Referring to the "exercise of control," the court stated:

> The case law with respect to this factor is clear. The Court must consider "whether the parent has specifically directed the allegedly illegal employment practice that forms the basis for the litigation." *Pearson*, 247 F.3d at 491; *see also In re APA Transp. Corp. Consol. Litig.*, 541 F.3d 233, 245 (3d Cir. 2008) ("The core of this factor is whether one company 'was the decision-maker responsible for the employment practice giving rise to the litigation.' ") (citation omitted). This factor is "not intended to support liability based on a parent's exercise of control pursuant to the ordinary incidents of stock ownership." *Pearson*, 247 F.3d at 503.

The court concluded that there was no evidence that Sun Capital directed Jevic to shut down, and it rejected the plaintiffs' argument that Sun Capital should be liable for WARN damages because its decision to withhold further funding caused the shutdown.

> The Debtors retained the ultimate responsibility for keeping the company alive and therefore, Sun Cap did not incur WARN Act liability by refusing to make an additional investment. *Pearson,* 247 F.3d at 505. It is undisputed that the Debtors made the decision to shut down the company. The WARN notice was signed by the Debtors, not Sun Cap, and it is not alleged that Sun Cap played a direct role in the employees' termination. . . . Sun Cap's decision to cut off funding was not a "de facto exercise of control" over the Debtors' decision to close its doors.

The approach of *Pearson* and its progeny—limiting the question of control to whether the specific employment practice was directed by the parent, rather than examining control from a broader perspective—is in a sense reassuring to business owners. That being said, the way the underlying legal principles are applied to specific facts in *Jevic* and in many of these cases is curious. That is, *Jevic* is similar to many of the WARN Act decisions in taking a somewhat un-nuanced approach to the question of fund-owner liability. *Pearson* states that the "exercise of control" element is not intended to impose liability based upon the "ordinary incidents of stock ownership," but there is a lot of white space around what is "ordinary" and what it means to "direct" a decision to shut down a company.

In *Richards v. Advanced Accessory Systems, LLC*,[4] sponsor Castle Harlan avoided WARN liability in a case decided with reasoning similar to *Jevic*:

> Pursuant to a Management Agreement with [the portfolio company, AAS], Castle Harlan provided "business and organizational strategy, financial and investment management, advisory and merchant and investment banking services." Castle Harlan received management fees from AAS for these services. Castle Harlan was not, however, involved with the day-to-day operation of AAS. Specifically, Castle Harlan (1) played no role in meeting with customers or in seeking new or additional business, and (2) provided no administrative, human resources, or purchasing services, and did not have a role in the preparation of AAS personnel policies.

Concluding that "Castle Harlan's management of AAS was limited to ensuring its financial success and played no part in the day-today operations" of the portfolio company, the court found no WARN liability on the part of the private equity sponsor. (There was no discussion of how to square the presence of a management agreement with Castle Harlan with the court's statement that Castle Harlan provided no administrative services.)

Similarly, in *Cleary v. American Capital, Ltd.*,[5] American Capital was not faulted for the aggressive acts of its appointed directors attempting to save its portfolio company:

> [T]he actions undertaken by American Capital, however aggressive, were consistent with those of (an ultimately unsuccessful) attempt to protect its investment. These include proposing and assisting the recruitment of "new management," and the ferreting out of an accurate and complete understanding of the company books . . . While a WARN Act plaintiff should not be held to the nearly impossible burden of demonstrating a complete merger of identities between the defunct employer and its former equity owner, at a minimum a plaintiff must establish control by the latter over the "the allegedly illegal employment practice that forms the basis for the litigation." *Pearson,* 247 F.3d at 491. Plaintiffs offer no material evidence that the decision of [portfolio companies] NewStarcom and Constar to terminate all employees and file for bankruptcy was made by American Capital, nor any plausible reason why American Capital, as an unsecured creditor, would have thought it in the interest of its shareholders to do so.

Contrasting the lack of direct activity in the cases described above, a New Jersey appellate court (applying the *Pearson*-approved five factor DOL test to the New Jersey version of the WARN law) assessed the alleged activities of a fund sponsored by Lone Star Funds in *DeRosa v. Accredited Home Lenders, Inc.,*[6] an appeal taken from a lower court's grant of summary judgment in favor of the Lone Star fund.

Before the court was Accredited Home Lenders, Inc., a failed sub-prime mortgage lender that was in 2007 purchased by a string of holding companies to become a portfolio company of Lone Star Fund V ("LSFV"), whose investments were managed by a related company called Hudson Advisors. LSFV, Hudson, and the holding company of Accredited were party to an asset advisory agreement. There was some testimony indicating that after Lone Star's purchase of Accredited, the portfolio's "senior managers were no longer 'calling the shots.' " The shutdown was sudden and it was announced in person, not by any executive of Accredited, but by Hudson's director of portfolio management, who at the time of announcing the shutdown held himself out as an employee of Lone Star. Reversing a lower court's summary judgment decision in favor of both Lone Star and Hudson, the court held with respect to the question of de facto control:

> As to this factor, the record reflects that after LSFV Accredited purchased Accredited Holding, Hudson, LSFV and Accredited Holding entered into an asset advisory agreement pursuant to which Hudson provided oversight and support services to Accredited. According to [Accredited division manager] Mohan, during this time period, Accredited's senior management lost day-to-day control of the business. Prushan, who was employed by Hudson, was involved in evaluating Accredited's business and in planning and implementing the shutdown of the office.

> Giving plaintiff all favorable inferences, the record reflects that LSFV, through Hudson, exercised control over Accredited and ordered the closure of the office. The trial court also recognized that this presented a factual dispute that was unresolvable on summary judgment.

In *In re Tweeter OPCO, LLC*,[7] things were worse for Schultze Asset Management, a family investment fund run by its patriarch, George Schultze. In a rare outcome, summary judgment was granted *against* the fund because of its involvement with its portfolio company, Tweeter.

> The Court finds that the Plaintiff has established *de facto* control by [Schultze Asset Management ("SAM")] of the Debtor's employment practice. The [Tweeter CEO] Granoff termination letter evidences SAM's control over the Debtor, especially the portion that states, "we felt we needed tighter control of Tweeter within our own organization." George Schultze repeatedly called for reductions in payroll to increase profits. Further, George Schultze ordered Kelerchian to terminate employees of the Debtor in 2007, demonstrating his control over the Debtor's employment practice. With SAM employees on the Debtor's board, SAM's inside counsel supervising their actions, and SAM employees directly involved with terminating employees of the Debtor, the Court finds that SAM's exercise of *de facto* control over the Debtor on the WARN Act issue was particularly egregious. *See Pearson,* 247 F.3d at 504 (concluding that if the *de facto* exercise of control is "particularly egregious," then liability is warranted).

If the legal analysis in the WARN Act cases is somewhat confused, there are some practical lessons for private equity sponsors. For one, try not to step into the day-to-day affairs of the portfolio company and especially do not direct from above that the portfolio fund is to lay off workers and/or shut down. These decisions are properly in the domain of the directors of the troubled company, even if they are appointed by the private equity sponsor. It is not uncommon for sponsors to appoint a third party consultant (sometimes recommended by lenders) as a "Chief Restructuring Officer" for a troubled company. This is a practice that is likely helpful to mitigate WARN Act risk to the fund and sponsor. On the other hand, occasionally fund sponsors appoint sponsor employees as officers of portfolio companies. Clearly this is not a good idea from a WARN Act liability perspective or from the perspective of upstream liability more generally. The cases counsel that to the greatest extent practicable, the governance structure should maintain a distinction between the sponsor and the management team operating the business day-to-day, with the fund acting appropriately in its role as owner and company management making ordinary course business decisions. The board of directors should serve as the sole interface between owner and management. Management arrangements or agreements are an obvious exception to this, and while this is not a particularly favorable element to the upstream liability risk equation, the cases do not seem to single out these arrangements as a foundation for liability.

ENDNOTES:

[1]*Pearson v. Component Technology Corp.*, 247 F.3d 471, 17 I.E.R. Cas. (BNA) 769, 143 Lab. Cas. (CCH) P 11005 (3d Cir. 2001).

[2]References to "private equity owners" in this article refer generally to the limited partnership investment funds that invest in portfolio companies and "sponsors" to the investment advisor and/or general partner affiliated with the limited partnership. Some of the upstream liability cases are not rigorous in the approach to the different entities in a fund/advisor structure and conflate sponsors, their personnel and the actual funds.

[3]*In re Jevic Holding Corp.*, 492 B.R. 416, 424, 57 Bankr. Ct. Dec. (CRR) 272, 38 I.E.R. Cas. (BNA) 1155 (Bankr. D. Del. 2013), aff'd, 526 B.R. 547, 39 I.E.R. Cas. (BNA) 304, 164 Lab. Cas. (CCH) P 10719 (D. Del. 2014), aff'd, 656 Fed. Appx. 617, 2016 I.E.R. Cas. (BNA) 241827 (3d Cir. 2016).

[4]*Richards v. Advanced Accessory Systems, LLC*, 31 I.E.R. Cas. (BNA) 1387, 2010 WL 3906958 (E.D. Mich. 2010).

[5]*Cleary v. American Capital, Ltd.*, 59 F. Supp. 3d 249, 258-59, 165 Lab. Cas. (CCH) P 10729 (D. Mass. 2014).

[6]*DeRosa v. Accredited Home Lenders, Inc.*, 420 N.J. Super. 438, 22 A.3d 27, 32 I.E.R. Cas. (BNA) 927 (App. Div. 2011).

[7]*In re Tweeter OPCO, LLC.*, 453 B.R. 534, 545, 55 Bankr. Ct. Dec. (CRR) 41 (Bankr. D. Del. 2011).

