Second Circuit Holds Lender Is Not Employer of Borrower's Employees for WARN Act Liability

October 5, 2007

A recent decision by the United States Court of Appeals for the Second Circuit should give comfort to lenders exerting control over a borrower in an effort to stabilize a faltering business or facilitate its sale. In *Coppola v. Bear Stearns & Co., Inc.*, the Second Circuit held that a creditor who exercised "substantial" control over its borrower's business as part of a workout strategy was not an "employer" under the Worker Adjustment and Retraining Notification Act ("WARN Act" or "WARN") and therefore was not liable to the borrower's employees for failure to give advance notice of termination. No. 05-6440-CV, 2007 WL 2439787, at *6 (2d Cir. Aug. 30, 2007). In affirming summary judgment for the creditor, the Second Circuit held that the dispositive question in determining whether a creditor qualifies as an "employer" is "whether a creditor is exercising control over the debtor beyond that necessary to recoup some or all of what is owed and is operating the debtor as the *de facto* owner of an ongoing business." *Id.* at *5.

BACKGROUND

National Finance Corporation ("NFC") originated and resold mortgages and home equity loans to residential customers. *Id.* at *1. To fund these loans, NFC relied in part on a credit line from Bear Stearns & Co., Inc. ("Bear Stearns"). *Id.* In early 1999, unable to fund its continued operations, NFC falsified documents and retained money that should have been paid to Bear Stearns. *Id.* When Bear Stearns learned of the approximately $5.6 million in misappropriated funds, it pursued a workout strategy that allowed NFC to remain in business with a view toward selling the company and repaying Bear Stearns out of the proceeds of the sale. *Id.* Pursuant to the workout plan, Bear Stearns demanded the resignation of NFC personnel involved in the fraud. *Id.* at *2. Bear Stearns also refused to continue its initial credit line arrangement with NFC but agreed that its subsidiary, EMC Mortgage Corp. ("EMC"), would purchase certain loans originated by NFC. *Id.* Bear Stearns hired its own underwriter to perform on-site evaluations of the loans NFC proposed for purchase by EMC. *Id.*

With a soiled reputation and no way to fund loans rejected by EMC, NFC struggled financially and was unable to meet its payroll. *Id.* Although it was unwilling to loan NFC money for this purpose, Bear Stearns advanced funds to NFC for loans that were "in the pipeline" but had not yet closed. *Id.* The next time NFC faced the same problem, however, there were not enough loans in the pipeline to cover the payroll, and Bear Stearns refused to advance funds that could not be secured. *Id.* Shortly thereafter, NFC's president and general counsel decided to close the business. *Id.* at *3.

NFC employees subsequently filed a class-action lawsuit against Bear Stearns, alleging that Bear Stearns effectively controlled NFC and terminated the employees without providing the advance notice required by the WARN Act. *Id.* at *1. Both parties moved for summary judgment, but the District Court for the Northern District of New York sided with Bear Stearns, granting its motion and holding that Bear Stearns was not plaintiffs' "employer" under the WARN Act. *Id.* Plaintiffs appealed to the Second Circuit.

THE *COPPOLA* DECISION

The Court of Appeals began its analysis by noting that WARN requires "employers" to give sixty days advance written notice before a plant closing or mass layoff, and thus "[t]he dispositive question on this appeal is whether Bear [Stearns] was an 'employer' within the meaning of WARN."[1] *Id.* at *3.

In determining the appropriate test for evaluating whether a creditor qualifies as an employer under WARN, the court considered the tests used by the three circuit courts that previously had addressed the issue. "The test employed by the Eighth and Ninth Circuits is whether, at the time of the plant closing, the creditor was in fact 'responsible for operating the business as a going concern' rather than acting only to 'protect [its] security interest' and 'preserve the business asset for liquidation or sale.'" *Coppola*, 2007 WL 2439787, at *3 (citing Chauffeurs, Sales Drivers, Warehousemen & Helpers Union Local 572 v. Weslock Corp., 66 F.3d 241, 244 (9th Cir. 1995); Adams v. Erwin Weller Co., 87 F.3d 269, 272 (8th Cir. 1996)). The test used by the Third Circuit, on the other hand, analogizes lender liability to parent liability and looks to the factors used by the Department of Labor to determine whether subsidiaries and independent contractors are treated as separate employers or as part of the parent company under WARN. *Coppola*, 2007 WL 2439787, at *4 (citing Pearson v. Component Tech. Corp., 247 F.3d 471, 493 (3d Cir. 2001)). These factors are: "(i) common ownership, (ii) common directors and/or officers, (iii) de facto exercise of control, (iv) unity of personnel policies emanating from a common source, and (v) the dependency of operations." 20 C.F.R. § 639.3(a)(2).

Noting its accordance with traditional principles of lender liability, the *Coppola* Court concluded that the proper test was the one employed by the Eighth and Ninth Circuits. *Coppola*, 2007 WL 2439787, at *5. The court rejected the Third Circuit's approach, reasoning that, with the exception of "de facto control," the factors considered by the Third Circuit had "little direct bearing on paradigmatic relationships between lenders and borrowers." *Id.*

In selecting the appropriate test, the court considered the WARN Act's text as well as the practical policy implications. "Employer," wrote the court, "is not a word that commonly refers to creditors – even large creditors." *Id.* In addition, the court noted that WARN is intended to "cushion the blow" to workers who are terminated due to mass layoffs or plant closures. *Id.* If creditors are not able to undertake short-term workouts and assume the necessary degree of control without risking WARN

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1 The statute simply defines "employer" as "any business enterprise that employs (A) 100 or more employees, excluding part-time employees; or (B) 100 or more employees who in the aggregate work at least 4,000 hours per week." 29 U.S.C. § 2101(a)(1).

liability, then "there will be fewer workouts and more business closures, many without WARN notice." *Id.*

Under the Second Circuit's newly-adopted standard, "the dispositive question is whether a creditor is exercising control over the debtor beyond that necessary to recoup some or all of what is owed and is operating the debtor as the *de facto* owner of an ongoing business." *Id.* Significantly, the court stated that a creditor may exercise "very substantial" control "in an effort to stabilize a debtor and/or seek a buyer so as to recover some or all of its loan or security without incurring WARN liability." *Id.* The line is crossed, however, and a creditor risks incurring WARN liability, "[w]hen the exercise of control goes beyond that reasonably related to such a purpose and amounts to the operation of the debtor as an ongoing business – such as when there is no specific debt-protection scenario in mind." *Id.*

Viewing the facts in the light most favorable to appellants as required on summary judgment, the court applied its new test to appellants' claim that Bear Stearns effectively controlled NFC by firing NFC officers, choosing their replacements, and regulating the loans that NFC could make. *Id.* at *6. The court concluded that though the control exerted by Bear Stearns was "indeed substantial," it was "no more than was needed for a lender who had been defrauded . . . and who was attempting to salvage a company bereft of cash." *Id.* Citing in part to a Bear Stearns memo noting that the workout plan was intended to allow NFC to operate for the "3-4 weeks . . . it would take a prospective buyer to evaluate whether to buy the company," the court held that Bear Stearns's exertion of control "was prompted solely by a short-term interest in facilitating the sale of NFC as a means of salvaging some of the debt it had extended" and "[t]his is not sufficient to trigger WARN liability." *Id.* at *7.

PRACTICAL IMPLICATIONS

With this decision, creditors can be confident that short-term workout strategies intended to protect their security interests will not render them "employers" for WARN Act purposes. This is true even where creditors exercise "very substantial" control over the debtor's operations. The *Coppola* decision thus affords creditors considerable flexibility in their efforts to stabilize a debtor or seek a buyer. However, this flexibility is not without limits. To avoid potential WARN liability, creditors should document a specific debt-protection plan and steer clear of actions that amount to operating the debtor as an ongoing business.

Private equity firms, which also may hold some of their portfolio companies' debt and therefore have some similarity to lenders, are not likely to benefit substantially from the ruling in *Coppola*. The private equity sponsors normally participate in the management of the companies' business at the board of directors level on an ongoing basis, and they have the right to participate in day to day management issues, although they may choose not to exercise that right frequently, if at all. This level of participation in the business as a going concern, albeit on a strategic management level, would seem to come within the Second Circuit's reference to Eighth Circuit authority, to the effect that "[o]nly when a lender becomes so entangled with its borrower that it has assumed responsibility for the overall management of the borrower's business will the degree of control necessary to support employer responsibility under WARN be achieved." *Id.* at 3 (quoting *Adams*, 87 F.3d at 272). A sponsor might have an improved chance of invoking *Coppola* if the sponsor were not involved in management of the company at any level other than that of a passive equity owner – an unusual private equity firm relationship with a portfolio company – and took actions akin to those taken by Bear Stearns with the short-term purpose of protecting collateral that may secure debt instruments.

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