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Investment Funds Alert

Control of Portfolio Investment Creates Potential Liability for Fund Under Labor Law

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How much control can a private equity firm exercise over the affairs of a portfolio company without being liable for the portfolio company's labor and employment actions? Not very much, according to a recent decision from the Court of Appeals for the 5th Circuit.

In *Oaktree Capital Management, L.P. et al. v. N.L.R.B.*,[1] the 5th Circuit upheld a National Labor Relations Board order finding asset and investment manager Oaktree Capital Management, L.P. liable for the labor law violations at Turtle Bay Hotel and Resort, a resort property owned indirectly by several Oaktree investment funds and leased by indirect Oaktree subsidiary Turtle Bay Resorts. As a result of the court's decision, Oaktree–like its portfolio company–was required to bargain with the union, and was ordered to take a host of other steps to comply with the National Labor Relations Board's order.

Oaktree is the latest in a series of decisions that substantially increase the exposure private equity firms face for employment actions of their portfolio companies. In recent years, private equity firms have been found liable for millions of dollars in withdrawal liability to underfunded pension plans of portfolio companies,[2] have been held responsible for portfolio companies' violations of the Worker Adjustment Retraining and Notification Act ("WARN Act"),[3] and have been unable to extricate themselves from other suits, such as actions alleging employment discrimination.[4] These developments can be expected to embolden an already aggressive plaintiffs' bar, and lead to a significant increase in the number of actions naming private equity firms as defendants.

Given the heightened risks private equity firms now face–including the risk of potential liability and the collateral risks of litigation, such as adverse publicity and the potential for increased investor scrutiny–now is the time for firms to review their relationships with their portfolio companies to ensure they are optimally structured in light of the firms' business goals and risk profile.

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[1] No. 10-60749 (5th Cir., Sept. 26, 2011).

[2] *See* September 26, 2007 decision by the Appeals Board of the Pension Benefit Guaranty Corporation, issued by letter, available at http://www.pbgc.gov/Documents/apbletter/Decision--(Liability%20within%20a%20group%20of%20companies)%202007-09-26.pdf (finding private equity fund joint and severally liable for $4 million in withdrawal liability and interest to the pension plan of a portfolio company). *See also Board of Trustees, Sheet Metal Workers' National Pension Fund v. Palladium Equity Partners, LLC*, 722 F.Supp.2d 845 (E.D. Mich. 2010) (denying summary judgment and finding that three private equity funds, and their common financial advisor, may be liable to portfolio company's pension plan for millions of dollars in withdrawal liability).

[3] *See*, *e.g*., *D'Amico v. Tweeter Opco, LLC* (*In re Tweeter Opco, LLC*), 453 B.R. 534 (Bankr. D. Del. 2011) (holding asset management company liable for WARN Act violations of portfolio company); *See*, *e.g*., *Vogt v. Greenmarine Holding, LLC*, 318 F. Supp. 2d 136 (S.D.N.Y. 2004) (seeking, from private equity firms, 60 days' back pay and back benefits for 6,500 terminated employees, plus costs and attorneys' fees).

[4] *See*, *e.g*., *Tyghter v. Beachside Capital Partners, Inc*., No. 3:09-CV-610 (RNC), 2010 WL 3909341 (D. Conn. Sept. 30, 2010) (denying private equity firm's motion to dismiss claims against it for portfolio company's alleged employment discrimination).

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Oaktree and Its Holdings

At issue in *Oaktree* was whether the private equity firm exercised sufficient control over the operations and labor relations of the Resort for Oaktree and Turtle Bay to be considered a "single employer." Under federal labor law, two ostensibly separate companies are treated as one for liability purposes where there is (i) common ownership or financial control, (ii) common management, (iii) centralized control over labor relations and (iv) interrelation of operations.

The court in *Oaktree* found all four of these criteria met. In reaching its conclusion, the 5th Circuit focused on factors that are common in typical relationships between private equity firms and their portfolio companies:

- *Indirect Ownership*. Oaktree purchased the Resort through several funds, structured the ownership chain between the Resort and the funds and invested $50 million to renovate the Resort. The court found this involvement sufficient to establish common ownership or financial control, even in the absence of evidence that Oaktree directly owned the Resort.

- *Asset Management*. Oaktree described itself as investment manager, a financial advisor and an asset manager. The court focused on the last of these roles, finding the Resort to be one of Oaktree's "assets." A single-employer finding was supported by the fact that Oaktree was responsible for managing the Resort and had to be consulted before any significant decisions were made.

- *Supervisory Control*. Several Oaktree employees also held management roles or titles at the Resort. Though the evidence showed that dual Oaktree/Turtle Bay employees participated directly in the failed labor negotiations leading to the violations at issue, the court did not require proof that Oaktree was involved in the Resort's day-to-day labor relations or that it was the final decision maker on the disputed issues (a requirement typically found in single-employer decisions). Here, Oaktree's involvement in high level labor decisions was sufficient to impute liability.

- *Hazy Paper Trail*. Several key documents were signed by dual Oaktree/Turtle Bay employees in their capacity as representatives of Oaktree rather than Turtle Bay. These documents included the Resort's lease agreement and the management agreement between Turtle Bay and a third party company hired to operate the Resort. Oaktree was also listed as the Resort's owner in the employee handbook used by the third party manager.

Practical Implications for Private Equity Firms

The "corporate veil"–the line of legal separation between two corporate entities–has long been relied upon by private equity firms to keep the assets and liabilities of one entity distinct from those of affiliated entities. The *Oaktree* decision and other recent cases blur the line of demarcation and create a risk that private equity firms may be directly exposed to liabilities of their portfolio companies. These potential liabilities could include money damages for claims of workplace discrimination or wage and hour violations; back pay, back benefits and statutory penalties for failure to provide adequate notice of mass layoffs or plant closings; regulatory penalties for workplace safety violations; contributions or withdrawal liability to underfunded pension plans; obligations to collectively bargain with a portfolio company's unions; and a host of other potential remedies.

To help insulate themselves from unexpected liabilities, private equity firms should consider a number of factors when structuring their relationships with their portfolio companies. The key focus should be on ensuring the separateness of entities at the operational level, both from the perspective of how decisions are actually made and implemented, and with respect to how they are memorialized.

- *Extent of Overlapping Management*. Private equity firms should be cognizant of the extent to which employees of the firm are installed as officers and directors of the portfolio company. The greater the level of overlap, the greater the likelihood that the subsidiary will be seen as merely an arm of the private equity firm instead of as a

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distinct and independent company. Further, when management of different entities overlaps, it becomes unclear which "hat" the employee was wearing when making the decisions at issue, increasing the likelihood that a court could find the private equity firm to have been involved in those decisions.

- *Authority over Employment-Related Decisions*. Traditionally, a hallmark of single-employer findings under the WARN Act and in employment discrimination cases has been the involvement of the parent company in the actual employment decisions at issue. In *Oaktree*, the court suggested that such involvement was unnecessary, and that even "involvement in high-level decisions affecting labor relations" may be sufficient to impose liability in certain cases. Where a private equity firm can be alleged to dictate the human resources or labor relations policies of a portfolio company, a court is more likely to hold the private equity firm liable for portfolio company decisions.

- *Ultimate Policy Control*. Where circumstances allow, a private equity firm may be able to install a trusted independent management team, rather than directly overseeing a portfolio company's day to day operations. Where the private equity firm must be involved in high-level decisions or day to day affairs to ensure the portfolio company's viability, the firm should consult legal counsel to devise an operational structure that achieves operational objectives while minimizing risk.

- *Arbitration Agreements*. Portfolio companies also should consider implementing arbitration agreements under which their employees must arbitrate any disputes that arise in connection with the employment relationship. While such agreements raise a host of issues, they ideally could help ensure that disputes that arise vis-à-vis the portfolio company or any of its affiliates would be heard in a private forum, rather than in court and under recent authority, such a agreements may be effective to preclude class claims.

Conclusion

The *Oaktree* decision and the line of cases leading up to it place private equity firms at increased risk for the alleged labor and employment violations of their portfolio companies. The plaintiffs' bar is likely to be emboldened by these recent decisions, and can be expected to drag private equity firms into litigation whenever they perceive the opportunity to do so, either to seek a deeper pocket to fulfill a potential judgment or to increase leverage for settlement discussions. Private equity firms should take this opportunity to reconsider the degree of control they assert over their investments, and consider whether prudent changes can be made to minimize future risk.

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