Employee-Related Litigation

The New Cause of Bankruptcy

By Mark S. Horoupian

Business bankruptcy filings are down significantly from their high point during the Great Recession. Some reports have corporate bankruptcies down nearly 70% from 2010. There is no shortage of speculation as to why this is the case, but all seem to agree that the ready availability of cash from institutional and non-institutional lenders, coupled with interest rates that have remained at all-time lows for years, are allowing even under-performing businesses to stay out of Chapter 11. The days of the main catalyst for business bankruptcies being a lender tightening a credit line or calling a loan due appear to be over, at least for now. Even if a company's existing lender wants out, often there is a new lender anxious to provide replacement financing. What appears to have replaced foreclosures and institutional debt issues as the straw that breaks the camel's back is litigation. In many cases seen locally (in the Central District of California), the nature of litigation that pushes a company over the line comes in the form of employee-related causes of action.

EEOC Charges

While overall bankruptcy filings are down, employee-related charges to the Equal Employment Opportunity Commission (EEOC) for various types of discrimination have been constant at around 90,000 charges per year. When these charges turn into civil litigation, the fate and future of the defendant company may be on the line. This is particularly true if the defendant does not have Employment Practices Liabilities Insurance (EPLI). Companies that carry EPLI can rest somewhat easier knowing that they are covered for most liability for which they may be found culpable, and that the insurance company will typically attempt to negotiate a resolution of these actions on their behalf (EPLI does not typically cover any punitive damages awards — so if there is any chance of punitive damages, it is important to try and negotiate a settlement prior to trial. EPLI also does not typically cover WARN Act or wage and hour disputes). Many small- to mid-sized companies elect to forgo EPLI because of its cost. When companies are working hard to make ends meet, it may be difficult to sell them on an expensive policy when it is something they perceive they do not need in order to stay in business. A company with more robust earnings is more likely to be willing to take on that cost to protect itself. Ironically, though, it is the business that is barely scraping by that is the most vulnerable to these types of lawsuits.

A Hypothetical

Consider a retail company (the "Company") that has sales of $10 million a year, and operates at a 2% net profit margin. Were the Company to be sued by one of its former or current employees for employee-related claims such as wrongful termination or discrimination, without EPLI to look to, the Company would need to retain and pay for its own counsel. Depending on the complexity and length of that litigation, those costs could easily consume all of its available net profit. Taking it further, if a large judgment is entered against the Company, the Company will have no way to satisfy the judgment. The plaintiff, typically represented by an attorney on a contingency fee basis, is likely to pursue aggressive collection remedies, such as levying against bank accounts and/or putting in a keeper or receiver to collect on the judgment. Receivers can be placed at the place of business with the authority to take all cash payments received at the cash registers until enough money has been collected to satisfy the judgment. Obviously, the Company could not afford to have all of its cash swept, leaving it unable to pay employees, vendors and any existing lenders. Absent finding a source of money to satisfy the judgment, the Company would have little choice but to either shut down the business or resort to a bankruptcy filing.

Under this scenario, the Company needs to consider the costs and benefits of a Chapter 11 case. The immediate relief that would be provided to the Company is that any collection efforts by the plaintiff would halt by operation of the "automatic stay." During that "breathing spell," the Company would need to decide its exit strategy. For example, the Company could be sold pursuant to a "Section 363 Sale," with the proceeds distributed in order of priorities established by the Bankruptcy Code. Generally speaking, sales proceeds would go first to satisfy any secured debt, then to payment of certain administrative costs including taxes, attorneys' fees and certain priority wage claims, among others, then to pay unsecured creditors, and finally, presuming all creditors are paid in full, the balance would be distributed to the owners. Presuming that a bankruptcy is filed before the plaintiff records a lien against the Company's assets, the plaintiff's judgment would be unsecured and would get treated the same as any other unsecured creditor.

It is quite common in bankruptcy sales that there is very little to distribute to unsecured creditors after the satisfaction of claims with senior priority, so the plaintiff's win at trial could be a pyrrhic victory. A sale under this scenario may have little allure for the owners of the Company, as they too are unlikely to see any cash distributions from the sale. A sale does present some benefits, however, in that it could result in the satisfaction of certain debts for which the owners may have personal liability, as in the case where the owners may have personally guaranteed bank loans

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and/or leases. The Company could also try to confirm a plan of reorganization, whereby the owners would retain the business and would pay claims, including the Plaintiff's claim, over time. The requirements for confirmation of a plan are complex, and beyond the scope of this article. Generally speaking, however, the Company must be able to demonstrate that a payment plan is feasible based on the past operating history of the Company and may require an additional capital infusion from those wishing to retain the business operations.

Chapter 11

Chapter 11 bankruptcy cases are expensive, particularly if they are handled appropriately by competent bankruptcy counsel. Typical retainers for business bankruptcies start at $50,000 and fees well in excess of that should be expected. Some business owners are surprised to hear this, and think that if their business is not large or complex, reorganization fees and costs should not be as high as larger companies. While there is some logic to that, even a small business requires a great degree of attorney involvement, and in the example of a highly contested case, the Company can expect to need the involvement experts on issues such as business valuation, feasibility of the plan, and interest rate. All of this translates to a large bill at the end of the case regardless of the size of the business.

Conclusion

In the current plaintiff-driven environment, it is important for all businesses to protect themselves to the extent possible from liability to current and former employees. In this regard, businesses should carefully monitor their managers and their employee practices, make sure those managers are trained appropriately, and that employee handbooks and employee records are meticulously maintained and updated. Laws change frequently, and businesses would be well served to have their policies reviewed frequently by qualified employment lawyers or human resources consultants. Businesses should strongly consider obtaining EPLI coverage. While it may not seem to be an expense that is required to do business today, it may be far less expensive than the alternatives.

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Sterling Jewelers

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investigations. To their consternation, in September 2015, the U.S. Court of Appeals for the Second Circuit held in *EEOC v. Sterling Jewelers, Inc.* that courts do not have authority to review the extent or sufficiency of the EEOC's investigation of charges. Indeed, the Second Circuit ruled that, to satisfy its statutory obligation, the EEOC need only demonstrate that it conducted an investigation pertinent to the allegations ultimately included in the complaint prior to moving forward with an enforcement action under Title VII.

Background

Sterling Jewelers involved 19 individual charges of discrimination brought over a two-year period by women employed in stores operated by Sterling Jewelers and its affiliates ("Sterling") in nine states. Five EEOC investigators initially worked on the case, but all of the claims were later transferred to a single investigator. The EEOC requested copies of company-wide protocols and policies, as well as personnel information including hire dates, roles and responsibilities, and pay and promotion data. Sterling and the charging parties, with EEOC participation, also engaged in unsuccessful mediation efforts. Thereafter, Sterling agreed to provide the EEOC with reports that were generated in connection with the mediation process, including statistical analysis of Sterling's pay and promotion practices, which concluded that Sterling paid its female employees less than their similarly situated male colleagues and promoted male employees at higher rates than female employees.

The EEOC's Letter of Determination, which found that Sterling engaged in a pattern or practice of discrimination at its stores nationwide, referenced this statistical analysis as well as witness testimony. The EEOC subsequently relied on the same information in its complaint against Sterling. Following discovery, seven years after the conclusion of the EEOC investigation, Sterling alleged that the EEOC had not conducted a nationwide investigation. Sterling noted that the two EEOC investigators who were deposed could not recall details of the investigation and declined to answer some questions. The district court granted Sterling's motion for summary judgment on the basis that the EEOC failed to conduct a nationwide investigation before commencing suit on alleged claims of nationwide discrimination, and therefore did not satisfy its obligations to conduct a pre-suit investigation. The district court dismissed the case in March, 2014, and the EEOC appealed.

The Second Circuit's Ruling

In concluding that the courts cannot inquire into the sufficiency of the EEOC's investigation and that, accordingly, the summary judgment granted by the lower court was improper, the Second Circuit relied on *Mach Mining LLC v. EEOC*, an April, 2015 decision of the U.S. Supreme Court. In *Mach Mining*, the Supreme Court held (in reviewing the EEOC's obligation to engage in a pre-suit conciliation process) that judicial review of the EEOC's administrative actions should be narrow and generally limited to considering whether an attempt at conciliation had been made. The court's role does not extend to reviewing the adequacy of the

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