Employment & Labor Relations Law

AMERICAN BAR ASSOCIATION

Section of Litigation Spring 2009 Vol. 7 No. 3

The Credit Crisis and WARN's Unforeseeable Business Circumstances Exception

By Timothy H. Savage and Ross H. Friedman

As the economy has deteriorated over the last year or so, the financial services industry has garnered considerable national attention. The rapid decline in credit market conditions has forced one-time Wall Street powerhouses Bear Stearns, Merrill Lynch, and Lehman Brothers into bankruptcy or fire sales to bank-holding companies. As a result, thousands of employees from these firms have lost their jobs, as have thousands more from other financial services firms and companies associated with residential mortgage lending and construction.

Given the magnitude of these layoffs and reductions in force, the potential for lawsuits under the federal Worker Adjustment and Retraining Notification Act (WARN), 29 U.S.C. §§ 2101 et seq., is high. Lehman Brothers currently faces a class action suit under both the federal WARN Act and the New Jersey WARN Act, and scores of other companies in a wide range of industries face similar suits. While any analysis would be dependent on actual fact patterns, we believe that, in general, it would have been difficult for senior management to reasonably have foreseen the current crisis given the rarity with which such events occur. That said, the challenges of defending this position should not be underestimated.

WARN Act Requirements

WARN generally requires employers with more than 100 employees to provide unions, nonunion affected employees, and certain government entities 60 days' written notice before any mass layoff or plant closing. Similar laws in some states lower the employee threshold for an employer

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Fair Credit Reporting Act: What Employers Need to Know about Conducting Background Checks

By Eva Shih Herrera

As employers have become increasingly concerned about the risks of hiring employees and independent contractors without performing sufficient background checks, the scope of the Fair Credit Reporting Act (FCRA) has expanded to provide greater privacy protection to consumers. Background checks are an invaluable tool for employers. When performed properly, they help promote a safe workplace and protect employers from losses associated with theft, embezzlement, harassment, negligent hiring, and more. On the other hand, job candidates rejected because of a background check are entitled to statutory protections. Failing to extend those protections can expose an employer to civil and criminal penalties under the FCRA. As a result, employers must exercise caution when hiring employees or engaging independent contractors.

Congress enacted the FCRA in 1970 to require that "consumer reporting agencies adopt reasonable procedures for meeting the needs of commerce for consumer credit, personnel, insurance, and other information in a manner which is fair and equitable to the consumer, with regard to the confidentiality, accuracy, relevancy, and proper utilization of such information."[1] The FCRA imposes restrictions and disclosure requirements on an employer's use of background information in making employment decisions, and it applies

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Employment & Labor Relations Law (ISSN: 1937-3406) is published by the ABA Section of Litigation, 321 N. Clark Street, Chicago, IL 60654. The views expressed within do not reflect the views of the American Bar Association, the Section of Litigation or the Employment and Labor Relations Committee.

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Unforeseeable Business Circumstances Exception

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to be covered, and increase the number of days of notice required. WARN defines a mass layoff as an employment loss over a 30-day period of 33 percent of a facility's employees (as long as at least 50 employees are included), or an employment loss of 500 or more employees over a 30-day period, regardless of whether the employees constituted 33 percent of the facility's workforce. A "plant closing" under WARN is a temporary or permanent shutdown of a single site of employment or one or more operating units within a single site of employment.[1]

Employers that violate WARN are liable for back pay and the cost of related benefits for every day that required notice is not provided (up to a maximum of 60 days). Additionally, employers that fail to provide adequate notice to local government officials incur an additional fine of up to $500 for each day of the violation ($30,000 over the 60-day period). An employer's liability will be reduced by "any voluntary and unconditional payment by the employer to the employee that is not required by any legal obligation."[2] Thus, any severance required under state or federal law (e.g., a private severance plan enforceable under the Employee Retirement Income Security Act), or pursuant to any contract or collective bargaining agreement, will not reduce an employer's liability, nor may a severance conditioned on the signing of a waiver and release.

The Unforeseeable Business Circumstances Exception

WARN contains several exceptions and exemptions that may eliminate or (more often) reduce an employer's obligation to provide 60 days' advance notice. One of those exceptions is WARN's "unforeseeable business circumstances" exception.

The unforeseeable business circumstances exception states that the 60-day notice period may be reduced "if the closing or mass layoff is caused by business circumstances that were not reasonably foreseeable as of the time that notice would have been required."[3] The employer must still provide as much notice as possible and explain why reduced notice is being given.[4]

The regulations implementing WARN state that an important indicator of a business circumstance that was not reasonably foreseeable is where the circumstance is "caused by some sudden, dramatic, and unexpected action or condition outside the employer's control."[5] The regulation provides examples of such conditions, including "an unanticipated and dramatic major economic downturn." The test for determining whether business circumstances are reasonably foreseeable is focused on the employer's business judgment, but an employer is "not required . . . to accurately predict general economic conditions that also may affect demand for its products or services."[6]

Courts have interpreted the unforeseeable business circumstances exception to require the employer to prove both causation (i.e., that the "sudden, dramatic and unexpected action" caused the layoffs) and foreseeability (i.e., that the employer reacted the same way that other reasonable employers within its market would have reacted). The Sixth Circuit, in explaining foreseeability, has stated that

> WARN was not intended to force financially fragile, yet economically viable, employers to provide WARN notice and close its doors where there is a *possibility* that the business may fail at some undetermined time in the future. Such a reading of the Act would force many employers to lay off their employees prematurely, harming precisely those individuals WARN attempts to protect. A company that is struggling to survive financially may be able to continue on for years and it was not Congress's intent to force such a company to close its doors to comply with WARN's notice requirement.[7]

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Following the Sixth Circuit, the Seventh Circuit has stated that "the WARN Act deals in reasonable probabilities, not possibilities. Moreover, an employer does not have to be caught completely off guard by a dire business circumstance for it to be 'sudden, dramatic or unexpected.'"[8]

While numerous cases have interpreted the unforeseeable business circumstances exception, very few are instructive as to what type of "an unanticipated and dramatic major economic downturn" would satisfy the exception. For example, one employer argued that the September 11, 2001, terrorist attacks prompted a significant enough decrease in business to warrant coverage under the exception. However, the court ruled that while the attacks were unforeseeable, the employer had not presented enough evidence to show that they caused the layoffs in question.[9] Last year, a court ruled that United Airlines presented enough evidence to move the case to trial regarding whether the termination of a number of its mechanics was the result of an instant drop in business commencing with the start of the 2003 Iraq War. That case is still pending.[10] The current economic crisis, particularly the rapid decline in credit market conditions, will very likely increase the number of employers attempting to invoke the unforeseeable business circumstances exception, based on the regulatory language regarding "an unanticipated and dramatic major economic downturn."

Simply put, while this financial crisis may have been, at some point, a possibility, it is sufficiently rare not to have had reasonable probability.

Recent Financial History

The initial reductions in force resulting from the current financial crisis were concentrated in construction firms, residential mortgage lenders, and financial institutions with substantial portfolios of residential mortgage-backed securities (MBS).[11] More recently, however, as the result of frozen lines of credit and declining consumer spending, the crisis has affected firms outside finance and mortgage lending. It is generally understood that the initial cause of current credit market conditions, which began to deteriorate in early 2007, was the commencement of a deflation in the asset bubble associated with residential real estate and the methods used to finance it. To understand the development of this asset bubble, it is helpful to review briefly some recent macroeconomic and financial history.

In response to the 2001 economic recession associated with the "dot-com" bust and exacerbated by the September 11, 2001, attacks, the U.S. Federal Reserve adopted a markedly expansive monetary policy. Standard measures of the U.S. money supply grew rapidly throughout the second half of 2001, all of 2002, and much of 2003. In addition, the federal funds rate, a key short-term interest rate set by the U.S. Federal Reserve, was lowered dramatically from 6 percent in January 2001 to 1.75 percent in December 2001 and ultimately to 1 percent in June 2003. In turn, market-determined interest rates, which represent the cost to borrow money, followed closely behind. Between 2001 and 2003, rates on longer-term U.S. Treasury bills fell by over 40 percent. Average rates for 30-year fixed-rate mortgages, which stood at 7 percent in 2001, fell to approximately 5.8 percent in 2003, where they remained through the end of 2005.[12]

For borrowers with existing home mortgages and would-be homeowners, low mortgage rates born of an expansive monetary policy created a golden opportunity. Would-be owners could finance larger principals on the same income, and those who refinanced could lower their monthly payments, use cash-out refinances to capitalize on higher house values, or both. As a result, between 2001 and 2003, the total value of mortgages associated with purchase loans increased 60 percent—from approximately $1 trillion to $1.6 trillion, while the value associated with refinance loans nearly doubled from approximately $1.3 trillion to $2.5 trillion. Spurred on in part by this additional demand, growth rates in house prices accelerated. Through 2003, the vast majority of this incremental mortgage lending was so-called conventional and conforming prime lending.[13] When these residential mortgages were pooled together and sold as MBS on secondary mortgage markets, the vast majority were purchased by Freddie Mac and Fannie Mae, the government-sponsored entities (GSEs) created in part to provide liquidity to residential mortgage markets.

Starting in 2004, however, residential mortgage lending began to change markedly as lending standards were relaxed. As a result of risk diversification, the profitability of residential MBS induced private investors to enter the market in large numbers.[14] Before 2004, so-called subprime residential mortgages represented less than 8 percent of the total dollar volume of lending, and Alt-A mortgages were de minimis.[15] By 2006, however, they had risen to 20 percent and 13 percent of total dollar value, respectively. Between 2004 and 2006, the total dollar volume of subprime and Alt-A loans was nearly $2.5 trillion. Moreover, the residential MBS based on these mortgages were being predominately purchased by private, non-GSE investors, including Wall Street investment banks, some of which, as noted, no longer exist.

By the end of 2006, the Federal Reserve reversed its expansionary monetary policy, and interest rates, including residential mortgage rates, began to rise. As a result, the volume of mortgage lending fell, and the share of loans constituted by subprime and Alt-A fell back to low single digits. In addition, private investors dramatically scaled back their participation in securitization markets.

Was the Crisis Reasonably Foreseeable?

Given this background, our discussion turns to whether the current financial crisis was reasonably foreseeable within the context of WARN. First, the most salient observation in this regard is that the current financial crisis is historically a rare event. While asset bubbles have been around at least since the Dutch tulip bubble of the 1630s, the most recent example of similar financial events is 1929. Prior to that, episodic "bank panics" occurred in the 1800s. While crises of the current magnitude are fortunately rare, it is their rarity that makes forecasting extraordinarily difficult, in particular for senior management more focused on daily operations. Simply put, while this financial crisis may have been, at some point, a possibility, it is sufficiently rare not to have had reasonable probability.

In addition, there were no clear trends in key factors that determine the value of residential MBS: house prices and mortgage default rates. A government-sponsored house price index showed nationwide house prices rising through the second half of 2007 and flat for the next three quarters. Only by the end of 2008 did this index show quarter-on-quarter nationwide declines. In contrast, a privately sponsored house price index showed house prices already in steady decline nationwide by the second half of 2007. Default rates in prime loans were steady through the end of 2007, while those for subprime loans, although rising slightly starting in late 2006, were still lower than their peaks in late 2002. This lack of clarity in trends, particularly when juxtaposed against the conventional wisdom of the day that house prices only go up, compounded the difficulties of foreseeing a rare event.

There was also little consistent guidance in residential real estate in the national financial and business press regarding the asset bubble. Perhaps following a herd mentality, much of the financial press, in particular the 24-hour financial networks on cable television, focused almost exclusively on the profitability of Wall Street investment banks and hedge funds in 2006 and 2007 without entertaining the possibility that house prices had risen well above their long-term trends. For example, Bear Stearns was on the forefront of investing in MBS, but much of the financial news on cable reported that there were no substantial problems at Bear Stearns right up to its March 2008 fire sale to JP Morgan, which was necessitated by Bear's near insolvency from its MBS losses. A recent media review of press coverage at the time found that it focused excessively on intrigue and the personalities of executives. Individuals who raised concerns about the effects of MBS on the stability of the larger financial system were "swept aside as part of a greater conversation about how to keep investing."[16]

The guidance from public officials was no clearer. For example, former chairman of the U.S. Federal Reserve Board Alan Greenspan, one of the most influential officials at the time, affirmatively encouraged Americans to rely on rising home values to manage their debt loads.[17] Another senior regulatory official argued at the time that it was not the job of authorities to anticipate asset bubbles.[18] In light of this, it is unclear who has the responsibility to forecast potential asset bubbles. Indeed, while Greenspan would later admit to flaws in his thinking regarding residential real estate prices, he himself called the current financial crisis "a once-in-a-century credit tsunami."[19]

Conclusion

WARN's unforeseeable business circumstances exception focuses on whether an employer could have reasonably foreseen a "sudden, dramatic, and unexpected" event that ultimately caused it to reduce a sufficient number of employees to fall under WARN's provisions. WARN's regulations specifically countenance that "an unanticipated and dramatic major economic downturn" would be a sufficient basis for an employer's invocation of the unforeseeable-business-circumstances exception, and courts have held that an employer need not give WARN notice where there is a possibility of layoffs; rather, there must be a reasonable probability of layoffs.

Recently, financial services companies, prompted by the current financial crisis, have engaged in large-scale reductions in force, prompting at least one class action lawsuit alleging a violation of WARN. The current crisis is, however, a historically rare event for which there were few obvious trends until the summer of 2008 and little consistent guidance from media pundits or public officials. While the financial crisis may have been a possibility at some point in the recent past, it is sufficiently rare—and sufficiently "sudden"—not to have been a reasonable probability.

Endnotes

1. 29 U.S.C. §§ 2101-02; 29 C.F.R. §§ 693.2–693.3.
2. 29 U.S.C. § 2104(a)(2)(B).
3. 29 U.S.C. § 2102(b)(2)(A).
4. 29 U.S.C. § 2102(b)(3).
5. 20 C.F.R. § 639.9(b)(1).
6. 20 C.F.R. § 639.9(b)(2).
7. Watson v. Mich. Indus. Holdings, Inc., 311 F.3d 760, 765 (6th Cir. 2002).
8. Roquet v. Arthur Andersen LLP, 398 F.3d 585, 589 (7th Cir. 2005).
9. Allen et al v. Sybase Inc., 468 F.3d 642 (10th Cir. 2006).
10. Williamson v. United Airlines, Inc., 2008 U.S. Dist. Lexis 70216, 2008 WL 4298090 (S.D. Ind. Sept. 15, 2008).
11. In simplest terms, a residential MBS is a financial instrument, purchased by investors, backed by the pool of properties for which the mortgage loans were issued, which yields a stream of payments to investors based on borrowers' monthly mortgage payments. As a result, the valuation of a residential MBS depends on the value of the properties that back the mortgages and the likelihood that borrowers default on their monthly mortgage payments or prepay the mortgage. For a detailed discussion of securitization and residential MBS, *see* Richard J. Rosen, *The Role of Securitization in Mortgage Lending,* Chicago Fed Letter No. 244, (Fed. Reserve Bank of Chi., Chicago, Ill.), Nov. 2007.
12. All figures and statistics cited rely on the following sources: money supply and federal reserve rate, the U.S. Federal Reserve (www.federalreserve.gov/releases/h6/hist/h6hist1.txt and www.federalreserve.gov/fomc/fundsrate.htm); Treasury bill rates, the U.S. Department of the Treasury (www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/yield_historical_huge.shtml); average mortgage interest rates, Freddie Mac (www.freddiemac.com/pmms/docs/30yr_pmmsmnth.xls); mortgage origination and refinance volume, *Mortgage Origination Estimates* of the Mortgage Bankers Association; house price indices, House Price Index of the Office of Federal Housing Enterprise Oversight and the S&P/Case-Shiller U.S. National Home Price Index of Standard & Poor's; volume of lending by type, *Inside Mortgage Finance;* volume of ABS by investor, *Inside MBS & ABS;* delinquency and default rates by type, *National Delinquency Survey* of the Mortgage Bankers Association.
13. A conventional conforming loan is one that is not federally insured and falls within loan limits established by government-sponsored entities Freddie Mac and Fannie Mae.

14. Residential MBS can be profitable because pooling mortgage loans can reduce risk through diversification. For example, ignoring insurance and taxes, annual payments on a 30-year fixed-rate mortgage of 5.8 percent on a principal of $200,000 are about $17,500. Some portion of the 5.8 percent, however, is a risk premium associated with loan default or prepayment. If the pooling of diversified loans can sufficiently lower the average risk premium, the discounted value of the streams of annual payments will exceed the outstanding principals of the mortgages that back the MBS. Therefore, as long as default rates are relatively low and house prices are flat or rising, MBS have positive returns.

15. The term "subprime" has no single definition. One generally accepted characteristic of a subprime borrower is a low credit score, reflecting impaired credit history, such as 640 or lower on a scale of 300 to 900. Generally, "Alt-A" loans are loans made to borrowers whose income or assets were not fully verified.

16. *Morning Edition: Where Were the Media as Wall Street Imploded?* (National Public Radio broadcast Mar 9, 2009). We note, however, that *The Economist*, a weekly news magazine that covers both politics and economics, recognized as early as 2003 that residential real estate prices were increasing at unprecedented rates. A limited number of academic economists, such as Nouriel Roubini at New York University and Robert Shiller at Yale University, were also warning of such dangers.

17. *Greenspan Says Arms Might Be a Better Deal*, USA Today, Feb. 24, 2004.

18. *Miskin: Finding Asset Bubbles Not Fed Role*, Reuters, Sept. 1, 2007.

19. *Greenspan Admits 'Mistake' That Helped Crisis*, Associated Press, October 23, 2008.

Message from the Editors

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Herrera's article provides a thorough discussion of the most broadly applicable statute governing background checks in the employment arena, the Fair Credit Reporting Act (FCRA). In addition to providing a thorough analysis of the FCRA's provisions, Herrera also discusses the impact of the Fair and Accurate Credit Transactions Act of 2003, which imposes affirmative obligations upon employers in an effort to prevent the growing problem of identity theft.

Andru H. Volinsky and Ron Schneider's article articulates why even the most experienced labor and employment lawyer would benefit from taking an experienced criminal lawyer to lunch. After discussing examples of significant overlap between criminal law and employment law, Volinsky and Schneider draw from their considerable personal experience to illustrate how the early assistance of a criminal lawyer greatly improves the odds of a favorable result for the client.

In the next article, Gary L. Simpler and Teresa D. Teare analyze how extensively employers may control the use of company email systems, in light of the National Labor Relations Board's recent *Register Guard* decision. As discussed by Simpler and Teare, the board's *Register Guard* decision marks a change in the way that the board has traditionally viewed issues such as union email access and related union solicitation issues. With the change of administration since *Register Guard* was decided, it remains to be seen whether the current board will revisit the standards articulated in the decision.

Daniel E. Harrell's article discusses last year's Supreme Court decision in *Meacham v. Knolls Atomic Power Laboratory*. In *Meacham*, the Court held that the "reasonable factor other than age" defense constituted an affirmative defense, which therefore required the employer to carry both the burden of production as well as persuasion as to the defense. Harrell posits that the impact of the decision will lessen the likelihood of cases being disposed of on summary judgment and will no doubt provide additional leverage to employee advocates for pretrial settlement discussions.

In addition to the substantive articles set forth in this edition of the newsletter, the area of employment and labor relations law continues to be fertile ground for new developments. In particular, on April 1, 2009, the Supreme Court decided what may turn out to be a far-reaching decision in *Penn Plaza LLC v. Pyett*, 2009 WL 838159. In *Penn Plaza*, the Court, in a 5–4 decision, held that a collective bargaining agreement that clearly and unmistakably requires bargaining-unit employees to arbitrate statutory Age Discrimination in Employment Act claims is enforceable. In so holding, the Court construed its prior decision in *Alexander v. Gardner-Denver*, 415 U.S. 36 (1974), more narrowly than most courts had previously interpreted it. Specifically, the Court construed *Gardner-Denver* as only holding that an employee cannot be compelled to arbitrate a statutory discrimination claim where the collective bargaining agreement in question does not require that such statutory claims be arbitrated. In *Penn Plaza*, the Court majority clearly reemphasized the trend in the Court's more recent decisions that favor arbitration as a means of dispute resolution. The Court receded from dicta in *Gardner-Denver* that suggested otherwise. Justices Souter and Stevens authored spirited dissents, contending that *Gardner-Denver* should be construed as precluding a union from binding individual bargaining unit members from arbitrating statutory claims.

Our website, www.abanet.org/litigation/committees/employment, as well as upcoming editions of the newsletter, will continue to keep committee members apprised of new developments in employment and labor relations.

Bill Martucci
and Brian Koji