

## Message from Our Managing Partner

We're pleased to announce these new enhancements to Pepper services:

- our Virginia Financial and Securities Fraud Response Team, to assist financial institutions and companies respond to investigations and prosecutions by prosecutors and regulators
- our Independent Contractor Compliance Practice Group, to advise and assist clients as Congress moves to make employee misclassification a federal labor law violation
- our Italian Desk, as a bridge between Italian and U.S. businesses.

In the world of assets and securities, Julia Corelli, Ivan Knauer and Gregory Nowak show how asset managers can avoid the "Ponzi scheme presumption" and survive potential scrutiny by a new SEC unit investigating asset managers.

Reporting on innovations at HUD, Shel Schreiber and Scott Fireison explain PPC processing, FHA modernization, PETRA and more.

We welcome comments, questions and suggestions.

David A. Wormser, Partner

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## Pepper Hamilton Announces Virginia Financial and Securities Fraud Response Team

The Virginia Financial and Securities Fraud Response Team will assist financial institutions and public companies, along with their officers, directors and employees, in responding to investigations emanating from the Virginia Financial and Securities Fraud Task Force, which was announced on May 21.

The task force will combine the efforts of the United States attorney of Virginia, the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission, FBI, Postal Service, Internal Revenue Service and state law enforcement agencies. The stated goal of this task force is to prosecute actions in the U.S. District Court for the Eastern District of Virginia — known as the "Rocket Docket" because of the speed with which cases are moved through the system.

Neil MacBride, U.S. attorney for the Eastern District of Virginia, claims that this court has jurisdiction over all public companies that make periodic filings with the SEC because the SEC facility that processes those filings is based in a Virginia suburb of Washington, D.C.

Pepper Hamilton's Washington-based attorneys, located within close proximity to the "rocket docket" federal court in Alexandria, Virginia, are ideally suited to assist financial institutions and public companies in responding to investigations and prosecutions by federal prosecutors, securities and banking regulators. The core of Pepper Hamilton's response team includes partners with a wealth of relevant experience, notably:

This publication may contain attorney advertising.

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**Ivan B. Knauer**, formerly vice president and managing trial counsel at the Financial Industry Regulatory Authority (FINRA) and a member of FINRA's senior enforcement staff. He also formerly served as senior counsel in the Enforcement Division in the SEC's home office in Washington. Mr. Knauer has handled many SEC investigations and has successfully litigated and tried cases against the SEC and FINRA. He can be reached at 202.220.1219 or [knaueri@pepperlaw.com](mailto:knaueri@pepperlaw.com).

**Timothy R. McTaggart**, previously the Delaware state bank commissioner and counsel to the U.S. Senate Banking Committee. He has represented clients before the federal bank regulatory agencies, including the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation,

Office of Thrift Supervision and the Board of Governors of the Federal Reserve System, as well as various state banking departments across the country. Mr. McTaggart can be reached at 202.220.1210 or [mctaggartt@pepperlaw.com](mailto:mctaggartt@pepperlaw.com).

**Frank C. Razzano**, formerly an assistant United States attorney and SEC trial attorney. He has represented defendants in criminal securities fraud actions in the Virginia federal court based on a similar claim of jurisdiction (i.e., that Virginia's courts have jurisdiction over anyone who sends an e-mail through AOL's server in Virginia). He has handled many SEC investigations and has successfully litigated and tried cases against federal criminal prosecutors, the SEC and FINRA. Mr. Razzano can be reached at 202.220.1286 or [razzanof@pepperlaw.com](mailto:razzanof@pepperlaw.com).

Pepper Hamilton's Virginia Financial and Securities Fraud Response Team is supported by more than 85 lawyers in the White Collar and Corporate Investigations Practice Group, the Securities Enforcement and Litigation Practice Group, and the Financial Services Practice Group across eight of Pepper Hamilton's 11 office locations.



## The Deal and Pepper Hamilton's Legal Roadmap to Success - Distressed M&A Dealmaking

There are a number of hot-button legal topics interesting to dealmakers at the moment. What key legal issues should you be thinking about in the coming months? Hear thoughtful perspectives in this series of incisive podcasts from The Deal and Pepper Hamilton LLP.

# The Deal

### EPISODE 4: PEPPER HAMILTON ON DISTRESSED M&A DEALMAKING

In this 2010 Legal Roadmap to Success podcast sponsored by Pepper Hamilton LLP, partners Todd A. Feinsmith and James D. Rosener discuss distressed M&A dealmaking with The Deal's Maria Woehr.

Listen today by visiting

[www.thedeal.com/knowledge/knowledge-center/pepper-hamiltons-feinsmith-and-rosener-on-distressed-ma.php](http://www.thedeal.com/knowledge/knowledge-center/pepper-hamiltons-feinsmith-and-rosener-on-distressed-ma.php)

## Congress Moves to Make Employee Misclassification a Federal Labor Law Violation

*In Response, Pepper Creates Independent Contractor Compliance Practice Group*

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On April 22, 2010, a long-awaited bill addressing the issue of misclassification of employees as independent contractors was introduced by the House (Rep. Lynn Woolsey, D-CA) and Senate (Sen. Sherrod Brown, D-OH). The bills, H.R. 5107 and S. 3254, are called the Employee Misclassification Prevention Act (EMPA). They would amend the federal Fair Labor Standards Act to impose strict recordkeeping and notice requirements on businesses with respect to workers treated as independent contractors, and expose such businesses to fines from \$1,100 up to \$5,000 per employee for each violation of the law.

The purpose of EMPA is to curtail and penalize the practice of many businesses in the United States of misclassifying employees as independent contractors. This practice has reportedly contributed to the “tax gap” at both the federal and state level, as well as a loss of federal and state labor protections for those workers that, by law, should be classified as employees instead of as independent contractors.

EMPA does not prohibit businesses from continuing to use properly classified independent contractors; it only prohibits companies from misclassifying workers as independent contractors when such workers are really employees.

Nonetheless, all businesses would be affected by EMPA, because it imposes upon every company that uses either employees or independent contractors a recordkeeping and a notice requirement. Any business that fails to provide the required notice would be subject to fines, even if its independent contractors are properly classified.

Briefly, if enacted into law as drafted, EMPA would:

- require every company covered by the law to provide a written notice to all workers who perform labor or services informing them that they have been classified as either an employee or “non-employee,” directing them to a Department of Labor Web site for further information about the rights of employees under the law, and informing them to contact the Department of Labor if they have any questions about whether they have been misclassified

### PEPPER HAMILTON ATTORNEYS’ NEW BLOG ADDRESSES INDEPENDENT CONTRACTOR COMPLIANCE

Pepper Hamilton’s Independent Contractor Compliance Practice Group leaders have launched a blog at [www.independentcontractorcompliance.com](http://www.independentcontractorcompliance.com), which includes a comprehensive set of legal resources for companies and lawyers seeking information about independent contractor misclassification, and which will track and comment on developments in the law. Richard Reibstein, Lisa Petkun and Andrew Rudolph have been handling worker classification matters for more than 20 years. As part of Pepper’s interdisciplinary practice in this field of law, they address this issue from the labor, tax and employee benefits law perspectives.

- require companies which are now required to keep records of the hours of work and wages of employees to keep comparable records for “non-employees” providing labor or services to the business
- add a new provision making it a “prohibited act” under federal law to fail to accurately classify a worker as an employee (i.e., to misclassify a worker as a non-employee)
- impose upon businesses a penalty from \$1,100 to \$5,000 per worker for a violation of the notice or recordkeeping requirements or for misclassifying an employee as a non-employee, and
- impose triple damages for willful violations of the minimum wage or overtime laws where the employer has misclassified the affected employee.

In addition, EMPA would direct the Secretary of Labor to:

- establish a misclassification Web site that would enable workers to file complaints online and notify them that employees may have greater rights under state or local laws than under federal law
- amend the Social Security Act to establish penalties for misclassifying employees or for paying unreported wages to employees for unemployment compensation purposes
- authorize the Department of Labor to report misclassification information to the IRS, and
- direct the Department of Labor to conduct “targeted audits” of certain industries “with frequent incidence of misclassifying employees as non-employees.”

The proposed legislation also seeks to pierce the corporate veil of corporations, partnerships, and LLCs owned in whole or part by the worker and used to avoid the issuance of Form 1099s.

EMPA is one of two bills introduced in this legislative term that deal with misclassification of employees. In 2009, the House and Senate introduced the Taxpayer Responsibility, Accountability, and Consistency (TRAC) Act of 2009 (S. 2882 and H.R. 3408). If enacted, the TRAC Act would limit the availability of the so-called “safe harbor” provisions in Section 530 of the Revenue Act of 1978, which has been relied on by many businesses to designate workers as independent contractors for federal employment tax purposes. The TRAC Act also would afford workers the right to petition the IRS for a determination of the worker’s status, and increase penalties of up to \$1 million to \$3 million for intentional disregard by taxpayers filing incorrect Form 1099s.

Both houses of Congress are expected to reintroduce TRAC Act bills in 2010 that are similar or identical to those bills introduced in 2009.

The introduction of EMPA is consistent with the national labor policy of the Obama administration. The recently released Budget for Fiscal Year 2011 authorized \$25 million to the Department of Labor to target employee misclassification through the hiring of 90 additional investigators and 10 additional lawyers to pursue “a joint proposal that eliminates incentives in law for employers to misclassify their employees” and “enhances the ability of both agencies to penalize employers who misclassify.”

In anticipation of this proposed legislation on employee misclassification, Pepper has created its Independent Contractor Compliance Practice Group (<http://www.pepperlaw.com/Prac->

[ticeArea\\_preview.aspx?PracticeAreaKey=72](http://www.pepperlaw.com/Prac-ticeArea_preview.aspx?PracticeAreaKey=72)). This practice team focuses on the interrelated legal issues involving independent contractors by using an interdisciplinary approach along with unique proprietary tools and techniques to diagnose and enhance compliance with independent contractor laws.

We also have prepared an article (available online at [http://www.pepperlaw.com/publications\\_article.aspx?ArticleKey=1769](http://www.pepperlaw.com/publications_article.aspx?ArticleKey=1769)) that explains steps employers should take now to minimize the risks posed by the use of independent contractors.

Pepper’s Independent Contractor Compliance Practice Group includes more than 25 employment, tax, and employee benefits attorneys working collectively. We have a dual approach: first, to assist organizations that currently use independent contractors to do so in a permissible manner under applicable employment, tax and employee benefits laws and to minimize exposure to liability from such laws; and second, to defend organizations that are subject to misclassification challenges brought in judicial and administrative proceedings and audits by governmental agencies and private lawyers.

Our team members understand that an audit by an unemployment or workers’ compensation agency of a company’s use of independent contractors may also lead to legal challenges in the tax and employee benefits areas, and vice versa. When asked by clients to enhance their legal compliance with independent contractor laws, we examine the issues and propose compliance measures from all three related legal disciplines – tax, employee benefits, and labor/employment law – using our proprietary tools, including “IC diagnostics” based on continually updated legal research.

More information about Pepper’s Independent Contractor Compliance Practice Group may be obtained by contacting any of the group’s co-chairs: Richard J. Reibstein (employment/labor matters) at 212.808.2722 or [reibsteinr@pepperlaw.com](mailto:reibsteinr@pepperlaw.com); Lisa B. Petkun (tax matters) at 215.981.4385 or [petkunl@pepperlaw.com](mailto:petkunl@pepperlaw.com); or Andrew J. Rudolph (employee benefits matters) at 215.981.4749 or [rudolpha@pepperlaw.com](mailto:rudolpha@pepperlaw.com).

## Beware the 'Ponzi Scheme Presumption' – New SEC Unit to Investigate Asset Managers

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We all read the papers, so we are aware that the SEC has organized a new unit in its Enforcement Division specifically designed to investigate potential wrongdoing by people who manage money for others. But what does this mean for entities – such as private equity and hedge fund managers – who are not (yet) directly regulated by the SEC? It means that the SEC may come knocking sooner rather than later, and when they do, it pays to be prepared.

### THE PONZI SCHEME PRESUMPTION

In the wake of the Madoff scandal – among others – the SEC Enforcement staff is being very diligent in making sure that anybody managing money for others is taking good care of that money. As the nation's top securities regulator, this is what they're supposed to do. As has been widely reported in the press, one of the reasons that Bernie Madoff was able to escape detection for so long is that he figured out a way to “dance between the raindrops” of the various regulatory regimes that controlled broker-dealers, on the one hand, and investment advisers on the other. The SEC never wants this to happen again. And its Enforcement staff is very motivated to make sure this never happens again. In light of all of this, in the event the SEC gets wind of any potential problems at an asset management firm, the staff will keep digging until they satisfy themselves, not only that the complaint is without merit, but also that the company manages money properly. The practical implication for the “unregulated” entity is that now the asset management firm has to shoulder the burden of proving the negative. They have to rebut the “Ponzi scheme presumption.” This becomes very difficult, time-consuming and expensive.

### WHAT'S THE SEC'S JURISDICTION IN ALL THIS?

As the SEC staff will remind anybody who asks, the SEC always has jurisdiction to investigate alleged or suspected fraud in connection with the purchase or sale of securities. Units of investment (to use a generic term) in an investment fund are securities. Portions of the Investment Advisers Act of 1940 also

ONCE THEY START ASKING QUESTIONS, YOU HAVE TWO CHOICES: (A) ANSWER OR (B) NOT. IN THE REAL WORLD, OPTION B IS RARELY THE RIGHT CHOICE, AS OPTION B IS VERY LIKELY TO RESULT IN THE SEC STAFF ISSUING A FORMAL ORDER OF INVESTIGATION AND SERVING A SUBPOENA SEEKING THE SAME INFORMATION AND DOCUMENTS.

apply to advisers even if they are not registered with the SEC (such as the anti-fraud rule and the prohibitions against principal trading without client consent). For these purposes, both the general partner of a fund and the entity actually making the investment decisions are deemed to be investment advisers. In the SEC staff's view, the fact that a security is involved or that an action is alleged to have violated or skirted a statutory or regulatory prohibition is enough authority for them to start asking questions. Once they start asking questions, you have two choices: (A) answer or (B) not. In the real world, option B is rarely the right choice, as option B is very likely to result in the SEC staff issuing a formal order of investigation and serving a subpoena seeking the same information and documents.

Keep in mind that state regulators and attorneys general also have independent authority to investigate claims of fraud or breaches of the applicable state securities laws. So the scenario can play out the same way with a state regulator, who may even send the local sheriff to enforce the subpoena. Common sense will tell you this is not a good place to be.

In the real world, firms are more likely going to go with option A. This is a rational choice because if the firm is responsive and successful in its position, the SEC staff will be satisfied and go away. Asset management firms that are not regulated by the SEC (yet) don't have any recordkeeping obligations mandated by law, and because they don't have any such affirmative recordkeeping obligations, they may not have kept the requested records accessible and organized. If that is the case, then what could be a simple exercise, of providing the SEC staff with information to rebut the staff's Ponzi scheme presumption, becomes a more involved exercise of locating documents and information that may no longer be in the firm's possession. Delays in responding can foster the SEC's or state's negative view of your firm, making it even harder to extricate from the investigation.

### SO WHAT'S THE ANSWER?

Keep good records. If you don't, then start doing so immediately. If you have them, keep them up to date. If they're disorganized, organize them promptly. Although this may seem like a daunting task, organizing one topic or product at a time can take the sting out of the effort. A work plan of that sort also shows that management is committed to fostering a "compliance culture:" something the regulators are looking for whenever they walk into a shop. As of now, private equity and hedge fund advisers can't get in trouble with the SEC (and most states) simply for failing to have such records. But if the SEC comes knocking, or if your firm becomes required to be registered, having a comprehensive set of organized records may keep a simple question from turning into a long, drawn-out, expensive process. Many believe that registration is inevitable for all asset management firms. Those that are required, today or ultimately, to register, will be in a far better position if they have started now to organize and systematize their recordkeeping.

### PEPPER CAN HELP

Pepper lawyers have helped private equity and hedge fund managers navigate regulatory inquiries to a successful resolution and provide guidance on best practices in record keeping. We can help you, too. If you have any questions, please contact one of the authors or your regular Pepper contact.

## Recent Events

### GREEN INCENTIVES FOR BUSINESS: TAX INCENTIVES THAT HELP ALLEVIATE THE COST OF INVESTING IN ENERGY-EFFICIENT ASSETS AND ALTERNATIVE ENERGY

June 8, 2010 | Webcast

Pepper partner **Todd B. Reinstein** spoke at The Knowledge Congress's Live Webcast on "Green Incentives for Business: Tax Incentives That Help Alleviate the Cost of Investing in Energy-Efficient Assets and Alternative Energy." For more information on this webcast, visit [www.knowledgecongress.org](http://www.knowledgecongress.org).

### GOING TO PROTEST? THE EVOLVING PROCESS AT GAO

June 10, 2010 | Teleconference and Live Audio Webcast

Pepper partner **Michael R. Golden** moderated this panel by the American Bar Association Section of Public Contract Law and the ABA Center for Continuing Legal Education on June 10. For more information, visit [www.abanet.org](http://www.abanet.org).

### SOLAR POWER FOR END USERS WEBINAR SERIES

Recently, Pepper Hamilton hosted a three-part webinar series on "Solar Power for End Users." The topics included *Here Comes the Sun: Getting Started with Solar Power*; *Negotiating Solar Agreements, Leases and Related Agreements*; and *Tax Credits and Other Government Incentives for Solar Power*.

The recordings and PPT slides from these webinars can be found online at [www.pepperlaw.com/webinars.aspx](http://www.pepperlaw.com/webinars.aspx).

## Pepper Hamilton Announces Formation of Italian Desk as Bridge Between Italian and U.S. Businesses

Continuing its long history of assisting Italian companies and individuals in their business endeavors in the United States, and American companies and individuals investing and conducting business in Italy, Pepper Hamilton LLP has formed its Italian Desk, part of the firm's continued development of its International Practice Group.

The Italian Desk, a multi-disciplinary team of attorneys and professionals, has strong credentials and experience in a variety of practice areas and in many industries, including fashion and retail, manufacturing, food and beverage, pharmaceuticals and life sciences, financial services, technology and energy.

Pepper Hamilton partners Joseph V. Del Raso and Frank J. Cerza, co-chairs of Pepper Hamilton's Italian Practice Group, co-announced the creation of the Italian Desk. "We are very excited about the Italian Desk as a way to provide value to companies in both countries by bringing to bear our legal and business skills, client experience and relationships, and deep understanding of the similarities and differences between the Italian and American cultures," Del Raso said. "This effort is part of Pepper Hamilton's commitment to providing a bridge between Italian business and U.S. opportunities, and vice versa."

Cerza said the members of Pepper Hamilton's Italian Desk are uniquely positioned to serve not only as business lawyers, but also as business advisors. "We certainly have the depth of knowledge of real estate; corporate and securities matters; commercial litigation, arbitration and other forms of dispute resolution; tax; mergers and acquisitions; trade; intellectual property; and regulatory, labor and other matters that Italian companies will encounter as they establish or expand their business in the United States," he added. "In addition, Joe and I also had experience in business, before we were lawyers. So, with the help of a deep Pepper Hamilton bench, the Italian Desk also offers strategic and business planning advice on corporate formation, site selection, distribution, licensing and franchising approaches, tax planning and other areas."

The Italian Desk also advises clients about:

- entry and growth in the U.S. market
- venture capital and private equity
- cross border transactions, such as investments, joint ventures and dispositions of assets or businesses
- facilitating access to private investment funding
- sales of goods and services
- establishment of business operations in Italy
- Foreign Corrupt Practices Act and related compliance and enforcement issues.

Both Del Raso and Cerza pointed out that the benefits the Italian Desk offers to clients are enhanced by the firm's strong relationships with Italian law firms and key commercial and financial institutions as well as federal, state and regional governmental and regulating bodies in the United States and Italy.

Del Raso, a Pepper Hamilton commercial partner, also is president of the National Italian American Foundation and chairman of the board of trustees of The American University of Rome. Cerza, a member of the Board of the Italy-America Chamber of Commerce, Inc. and Honorary Representative of the American Chamber of Commerce in Italy for the State of New York, has lived in Italy and is fluent in Italian.

For more information about Pepper Hamilton's Italian Desk, contact Frank Cerza at 212.808.2741 or [cerzaf@pepperlaw.com](mailto:cerzaf@pepperlaw.com), or Joseph Del Raso at 215.981.4506 or [delrasoj@pepperlaw.com](mailto:delrasoj@pepperlaw.com).

## PPC Processing, FHA Modernization and PETRA — Signs of Innovation at HUD

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As we have noted repeatedly, the Obama administration's Department of Housing and Urban Development (HUD), headed by Shaun Donovan and staffed with experienced veterans from the multifamily industry, has been remarkably active in program development, while managing and administering an enormous increase in FHA activity, the maturing of several existing HUD-subsidized portfolios, and entry into the HUD multifamily arena by many newcomers, drawn by available and predictable subsidies, funding and financing.

HUD has worked to lead in industry recovery and stabilization, early on, by quick and strong administration of American Recovery and Reinvestment Act (ARRA) TCAP funds and additional public housing capital funds, followed by appropriate modification of FHA programs and institution of revised policies for partial payment of insurance claims, and most recently, development and submission to Congress of the Preservation, Enhancement, and Transformation of Rental Assistance Act of 2010 (PETRA). HUD has been and looks to be a source of much innovation moving forward. This article briefly discusses some of these matters.

### PETRA

PETRA, initially called TRA or Transforming Rental Assistance, represents an initiative HUD has been working on for months, and provides the outline for serious changes to public housing and other rental subsidy platforms. While still subject to much criticism from the multifamily community, PETRA's goals are noteworthy, and its provisions will likely be pivotal in policy discussions over the next 18 months. At its core, PETRA seeks to coordinate rental subsidy programs that currently fall outside of common Section 8 project-based boundaries, including public housing operating subsidies. HUD now provides rental assistance to more than 4.5 million households through roughly 13 different rental and often overlapping subsidy programs. PETRA presents a multi-year plan to consolidate these programs into fewer tiers of long-term project-based and tenant-based assistance, including flexibility to address public housing capital

WHILE STILL SUBJECT TO MUCH CRITICISM FROM THE MULTIFAMILY COMMUNITY, PETRA'S GOALS ARE NOTEWORTHY, AND ITS PROVISIONS WILL LIKELY BE PIVOTAL IN POLICY DISCUSSIONS OVER THE NEXT 18 MONTHS.

requirements, increased resident mobility and, hopefully, simplified program administration.

If PETRA were passed in its current form, all rental subsidy programs (outside of Section 202/811 PRAC, unless this program is also designated by the HUD Secretary) would be reconfigured to fit within one of three program umbrellas: project-based Section 8; project-based vouchers; and tenant-based vouchers.

Existing project-based Section 8 contracts (commonly, HAP Contracts) would remain largely unchanged, as the current program, largely governed under the Multifamily Assisted Housing Reform and Affordability Act of 1997 (MAHRAA), is not directly addressed in PETRA. Other outlier subsidy programs, however, including Section 8 Mod Rehab, Rental Supplement (Rent Supp) and Rental Assistance Payments (RAP), along with some portion of public housing units will be consolidated, under a new Section 8(n), with project-based Section 8 HAP Contracts substantively similar to those falling under MAHRAA, but including long-term use obligations for the owner and some modified annual rent adjustment mechanisms. PETRA does represent one potential solution to the approximately 40,000

units of RAP and Rent Supp “orphan projects” with assistance contracts that are now expiring or have already expired, and for which no replacement funding or program is generally available.

With respect to public housing units, as drafted, PETRA would establish additional requirements specifically addressing conversion from traditional public housing (PHA-owned Section 9 units) to new Section 8(n) project-based HAP Contracts. While common “disposition” processes will not be required for “conversion,” tenant participation, residency limits for “extremely low income,” Section 3 contracting and other public housing administrative requirements would remain in place for converted Section 9 properties.

Project-based vouchers (PBVs) will be generally extended to owners of partially assisted or “small” projects. Section 8(o), under which PBVs are currently governed, will be modified by PETRA to increase the number of units that may be covered, increase contract terms, and provide some discretion to the HUD Secretary in establishing maximum rent limits, among other changes. In some cases, PHAs may have as much as 40 percent of their Section 8 voucher authority administered as PBVs.

HUD hopes that PETRA will also permit leveraging of additional resources to meet the capital and operating needs of the projects, as it has been done in public housing mixed financed projects. PBVs and conversion of public housing units to project-based Section 8 can be readily foreseen as providing a more predictable source of operating income than current PHA funding mechanisms, allowing for greater access to private financing and equity sources. HUD’s 2011 budget asks for \$350 million for PETRA’s first phase, but its cost, uncertain at this time, may rise in out years as specific tenant mobility provisions kick in – including the need for funding of additional vouchers to tenants of converted projects, where project-based subsidy remains and tenants who leave after some lengthy period of residence are entitled to receive tenant-based subsidy for use elsewhere.

As one might expect, PETRA, as presented by the Obama administration, grants a great deal of discretion to the Secretary in development and application of many finer points such as rent setting, eligibility, transferability of this new subsidy, physical standards and other substantive matters. Congressional members and staff currently view PETRA respectfully, but its costs skeptically, and that is certain to result in some revision. We will keep you informed of progress as this important and comprehensive initiative moves forward.

## MULTIFAMILY FINANCE

In developing and implementing changes to its multifamily insurance programs (MAPs), HUD has stressed three primary goals: (1) to be a reliable source of liquidity, particularly as a counter-cyclical tool, (2) to support production, particularly with respect to affordable housing, and (3) to manage its insurance risk.

In figures released in April, HUD indicated it had 736 projects totaling more than \$12 billion in its firm commitment pipeline. Its multifamily insurance commitments are averaging nearly \$900 million a month and volume is up between 250 and 400 percent in the last year, depending on the index used. The key factor in this rising activity, of course, is the availability of HUD credit for health care and multifamily projects at a time when most other capital providers have limited their activity. With this increased demand and associated pressure on the FHA system, HUD reasonably wants to assure that production goals and needs are met responsibly. In that vein, HUD has announced in several forums plans to tighten its underwriting standards, to increase required lender experience and capitalization, and lender and project monitoring.

With respect to supporting production, HUD recently instituted an important change in project financing limits, now permitting deletion of land value from the maximum mortgage calculation. This modification can make FHA programs available in higher-cost areas, where they have otherwise realized minimal activity.

At a different level, HUD has strong concerns that FHA programs may not be doing as much as they might be in support of affordable multifamily development and preservation. In one example, in fiscal year 2009, out of 661 initial endorsements, only 22 project loans closed with housing tax credits. To improve this record, HUD is defining “affordable housing” which, going forward, would qualify for somewhat more generous underwriting standards than market-rate properties. HUD also understands that it is currently an available and advantageous credit enhancer and can use this time and circumstance to strengthen its programs with respect to market-rate properties.

While always subject to change, under currently foreseen plans not yet finally resolved, but soon to be addressed in a Mortgage Letter, projects meeting the affordability criteria would be processed at 1.15 debt service coverage, and 87.5 percent loan ratios. Additionally, if a project receives Section 8 for at least 90 percent of its units or if all the units are rented to tenants at LIHTC

income levels with rents at least 20 percent below market, the project could be underwritten using 95 percent occupancy. For Section 221(d)(4) affordable properties, lenders would be able to underwrite projects with 90 percent project-based Section 8 at a debt service coverage of 1.11 percent and a maximum loan ratio of 90 percent. Without project-based Section 8, debt service coverage for affordable 221(d)4 properties would be 1.15 and loan ratios maximized at 87.5 percent. 223(f) affordable properties with 90 percent project-based assistance would be at the 1.15/87.5 percent standard and without Section 8 they would appear to be at a slightly higher standard, even if affordable, of 1.176/85 percent. Market-rate refinancings would require debt service coverage of 1.20 and loan ratios of approximately 83.3 percent. Also included in prospective changes will be modestly higher escrow requirements for operating deficits, working capital, and substantial rehab construction contingencies.

HUD is also planning to distinguish between market-rate and “affordable” project underwriting by instituting a change in application processing. Market-rate construction and sub-rehab projects will undergo a two-stage process that will eliminate direct-to-firm applications. Sponsors/lenders would also be required to attend a concept or predevelopment meeting with appropriate field-office staff to better develop estimates of the probability of success for the given application. Affordable projects would also require a “concept meeting,” but would retain direct-to-firm options. The pre-application meeting for market-rate projects will require a 15-basis-point non-refundable fee that will be credited against a 30-basis-point firm commitment fee. Affordable projects skipping the pre-application would not have to pay this fee.

While there are many more multifamily lenders, the MAP program is limited to about 90 lenders with demonstrated experience underwriting multifamily and healthcare loans. In the long run, HUD expects to further segment multifamily lenders so that not all would be able to process all types of multifamily loans. Greater experience and depth will enable lenders to process more complicated transactions and provide the basis for which each might be qualified under specific programs. New and existing lenders will generally be required to demonstrate a level of competence based on experience in four types of projects: market-rate refinances, affordable housing refinances, new construction/substantial rehabilitation market-rate, and new construction/substantial rehabilitation affordable. Lenders might also be restricted geographically, with mortgagees qualifying for

various types of lending in specific regions, rather than under the current system, under which an approved lender is free to operate nationwide.

Much of the above is general, and has yet to be set in stone. We will keep you informed of further progress as plans solidify and are implemented.

#### PARTIAL PAYMENT OF CLAIMS

HUD's use of partial payment claims (PPCs) for multifamily properties continues to be refined. As discussed above, HUD-FHA's insured multifamily and health care loan programs are experiencing an extraordinary increase in demand as other sources of finance have slowed, and in some cases, dried up – with some exception for those sold to Fannie Mae and Freddie Mac. The quality of HUD-FHA borrowers has improved, particularly with maturing loans, as strong entrepreneurs have sought alternatives to conduits and banks. While HUD's programmatic changes discussed elsewhere in this article are intended to ensure higher-quality loans, we believe that the quality of both new and refinanced HUD loans is already improving, together with that of their sponsors. At the same time, we are involved with more partial payments of claim involving troubled multifamily and health care projects, almost exclusively involving market conditions rather than owner or manager failings.

Over the past 18 months we have worked through a good number of HUD PPCs in multiple contexts and project financing configurations. During that time, the PPC program has undergone a good bit of tweaking in response to new scenarios and novel circumstances. We have seen it mature rapidly into a much more effective tool for preservation and providing significant savings to FHA insurance funds. Many of these tweaks have occurred as we and others have worked with HUD to improve the screening of projects. Today, while HUD's rules remain stringent, we believe them to be fair and to represent a good balance between holding owners responsible for misdeeds and missteps, while recognizing that market conditions have caused great difficulty that can be responsibly relieved at lower cost than would be incurred by simply awaiting project failure. PPC restructurings can be and are being completed with benefit to all stakeholders.

An abridged explanation: PPCs have been used for more than 15 years to avoid HUD payment of full mortgage insurance claims for financially troubled projects. Rather than full claim payment, (i) an insured loan is re-sized to a sustainable level, (ii) the insured mortgagee receives payment on a partial claim and

retains the balance as an insured loan, and (iii) HUD, in recognition of its partial insurance payment, receives a second mortgage in the amount of the claim payment. HUD second loans are due and payable upon the earlier of a stated maturity, or the sale or refinancing of the property. Given the interplay of resulting extended use restrictions, housing tax credit LURAs, and concern over out-year viability, we have recently seen the maturity date of the resulting HUD-held second mortgage extended from the once-common ten years, to as long as 20 years, providing some predictable and viable outlook for recapitalization and full repayment.

In seeking a PPC, HUD will require owners and lenders to coordinate their efforts and application for review by both field office and HUD headquarters. The process and variables are complex, but HUD headquarters staff charged with administration of this program can now be counted on to perform a justifiably thorough but thoughtful review, without overly strict and rote application of outdated rules. In the past, we have seen review of the same material by headquarters and field offices result in opposite conclusions, i.e., the field offices more often in support with headquarters in denial, with concern over proposal viability and long-term outlook for the project. With headquarters continuing to upgrade functional and comprehensive evaluation tools, projects are, in our experience, now presented with an underwriting conclusion that reduces FHA claim amounts while supporting new Ginnie Mae issues for resulting restructured first liens.

We, HUD, and some lenders have now worked through multiple PPCs, under varied complexities in ownership and financing. While early issues arising from existing tax-exempt and taxable bonds, multiple layers of soft financing and interplay of state agency and tax credit equity requirements did cause delay and even halts to PPC processing, they are not now first-impression matters. HUD headquarters and some HUD field offices have even coordinated their efforts and administration well, to accomplish TPAs with change of general partners, simultaneously with PPC processing.

New issues do continue to arise, as projects move forward with differing variables. HUD can now be expected to undertake a closer review of a project's long-term physical viability. In addition, mechanisms to set interest rates for resulting first lien and HUD-held second lien debt have been recently modified to more accurately take into account market conditions. Nevertheless, with each change to the PPC process we have seen "lessons learned" applied by HUD well. With thoughtful and appropriate

PPC application and, of course, actual project need, HUD can be expected to exhibit knowledgeable understanding and appropriate flexibility – rather than presenting a “guess what color I am thinking when your square peg does not fit into this circle” machination.

We will keep you abreast as further refinements are made in this important tool.

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