

## Message from Our Managing Partner

As this issue of our *Update* focuses on 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. We also highlight an episode of The Deal and Pepper Hamilton’s Legal Roadmap to Success podcast series: “Distressed Debt,” and note several other of our attorneys’ recent and upcoming events and webinars.

We’re also pleased to announce these new enhancements to Pepper services:

- our Independent Contractor Compliance Practice Group, led by Richard Reibstein (in labor matters), Lisa Petkun (in tax issues) and Andrew Rudolph (for employee benefits issues). This new Pepper group can advise and assist clients on an interdisciplinary basis, as Congress moves to make employee misclassification a federal labor law violation
- our Italian Desk, led by Joe Del Raso and Frank Cerza and part of Pepper’s International Practice Group. The Desk is designed to serve as a bridge between Italian and U.S. businesses.

We always welcome comments, questions and suggestions.

James D. Rosener, Managing Partner

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## 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.

This publication may contain attorney advertising.

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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
- 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 Deal and Pepper Hamilton’s Legal Roadmap to Success - Distressed Debt

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 5: PEPPER HAMILTON ON DISTRESSED DEBT

In this 2010 Legal Roadmap to Success podcast sponsored by Pepper Hamilton, partners William R. Wagner and John P. Duke discuss distressed debt with The Deal’s Maria Woehr.

Listen today by visiting <http://www.thedeal.com/knowledge/legal-roadmap-to-success/pepper-hamiltons-wagner-and-duke-on-distressed-debt.php>.

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/PracticeArea\\_preview.aspx?PracticeAreaKey=72](http://www.pepperlaw.com/PracticeArea_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,

### INDEPENDENT CONTRACTOR COMPLIANCE (ICC) BREAKFAST BRIEFING SERIES

July 20, 2010 | Pepper Hamilton’s New York Office

8:00 a.m. Registration and Breakfast

8:30-11:30 a.m. Panel Presentation and  
Question & Answer Session

Pepper Hamilton’s ICC Practice and Marcum LLP are pleased to present a series of Breakfast Briefings highlighting the legal and legislative challenges facing employers that use independent contractors, and focusing on ways businesses can continue to use independent contractors in compliance with applicable labor, tax, and employee benefit laws.

To register for this event, visit

[www.regonline.com/ICC\\_NewYork](http://www.regonline.com/ICC_NewYork).

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).

## 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).

## 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 apply to advisers even if they are not registered with the SEC

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.

(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.

## Upcoming Events

### PEI PRIVATE FUND COMPLIANCE FORUM

June 22-23, 2010 | New York

Pepper partners **John Ford**, **Julia Corelli** and **Joan C. Arnold** are speaking at the Forum being presented by *Private Equity International* magazine and the online magazine *Private Equity Manager*. Mr. Ford will present at Workshop A: "What to Expect During the First 6-12 Months as a Registered Investment Advisor." Ms. Corelli will present on a panel, "Effective and Appropriate Marketing Materials." Ms. Arnold will present on a panel, "Changes in the Taxation of Carried Interests."

Register: <http://www.peimedia.com/Product.aspx?cID=7441&cpID=206941&contType=1>

### TRADE SECRET PROTECTION IN THE UNITED STATES AND CANADA - SIMILARITIES AND DIFFERENCES

#### *Canadian Webinar Series*

Thursday, June 24, 2010 | 12:00-1:00 p.m. EASTERN

Pepper partner **Susan J. Krembs** will moderate a discussion on the similarities and differences of trade secret protection in the United States and Canada.

#### Speakers

*M. Kelly Tillery*, partner, Pepper Hamilton LLP  
*Christopher C. Van Barr*, partner,  
Gowling Lafleur Henderson LLP

Register: <https://www.regonline.com/tradesecretprotection>

### 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).