

## Message from Attorneys in Charge

This issue reports on financial and regulatory issues affecting foreign investment in India and India's investments abroad—including U.S. regulations that can “unwind” even closed transactions, enhanced anti-corruption enforcement worldwide and India's corresponding moves to increase investor confidence, and strengthening of U.S. regulations dealing with employee misclassification and financial services reform—which could further change the landscape for U.S.-India business.

We're also happy to report here that Pepper's India practice is keeping busy with the acquisition by a listed business process outsourcing company of an IT company, the acquisition by an Indian listed technology company of an IT division, both in the United States; an international equity securities placement related to an Indian IPO; the closing of a third India-focused fund; the establishment of a technology platform in India; the establishment of an education institution in India; and an arbitration in New Delhi.

We always welcome your comments, questions and suggestions.

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## Exon-Florio: Indian Buyers Are Increasingly Susceptible to U.S. Government Scrutiny of their Acquisitions in the United States

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If you think only a totalitarian government could undo your closed merger, takeover or acquisition transaction, it is time to think again. The President of the United States has the authority to unwind your merger, acquisition or takeover deal even after the transaction is closed. The Committee on Foreign Investment in the United States (CFIUS) caught the attention of very few for almost two decades, but has been of significant interest to many in the past two years. The scope of CFIUS reviews was significantly expanded by the Foreign Investment and National Security Act (FINSA) at the end of 2007 and as a result more transactions than ever are being submitted for voluntary review by CFIUS.

CFIUS was created in 1975 by an executive order, in reaction to Middle East investments, to monitor the impact of foreign investments in the United States. The Exon-Florio Amendment of 1988 to the Defense Production Act of 1950 provided the President the authority to suspend, prohibit or take other action with respect to foreign acquisitions, mergers, and takeovers of U.S. businesses that threaten to impair U.S. national security. The passage of FINSA in late 2007 further broadened the scope of this authority to include transactions that would result in foreign control of U.S. critical infrastructure including but not limited to “critical technology” and “major energy assets.”

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The review process under Exon-Florio is delegated to CFIUS, currently a committee of nine prominent U.S. government agencies. It is chaired by the secretary of the Treasury, and the U.S. departments of Defense, Homeland Security, Commerce and Justice generally take the most active roles in the process. As a result of FINSA, the Office of the Director of National Intelligence must now evaluate a transaction's national security implications. The review authority of CFIUS covers any inbound M&A transaction involving any foreign person that could result in foreign control of a U.S. business. CFIUS primarily reviews transactions that (i) threaten to impair U.S. national security, (ii) would involve control by a foreign government, or (iii) would result in foreign control of U.S. critical infrastructure, if such control threatens to impair national security.

Most transactions are voluntarily submitted to CFIUS for review by filing a notice to CFIUS. The benefit of submitting a transaction for voluntary review is that once CFIUS has concluded its review or investigation and determined that there are no unresolved national security concerns the transaction qualifies for a "safe harbor" and, subject to the terms of any safe harbor, mitigation agreement or other conditions imposed by CFIUS, the transaction can proceed without the possibility of suspension or prohibition. A transaction that has not successfully completed CFIUS review and qualified for the safe harbor can unilaterally be reviewed by CFIUS even after the transaction has been concluded, which can result in the transaction being unwound if national security considerations cannot be resolved.

Today more than ever, Exon-Florio has become particularly relevant to Indian companies investing in the United States for the following reasons:

Although Exon-Florio and CFIUS have been around for more than three decades, this regulatory landscape has evolved considerably in the past two years as a result of FINSA's expansion of the scope of CFIUS reviews beyond areas traditionally viewed as "national security" (e.g., defense, and nuclear matters, etc.) to the area of "critical infrastructure," which in some cases could include technology and telecommunications. Almost half of the transactions subject to CFIUS review from 2006 to 2008 involved the manufacturing sector and approximately one-third involved the information sector. This is important to Indian buyers because information technology (IT) and IT-enabled services companies have been and will continue to be of significant interest to Indian buyers, as the growth of the Indian economy to a large extent is dependent on the growth of its IT industry.

**CFIUS WILL KEEP ITS EYES WIDE OPEN FOR INVESTMENTS BY INDIAN BUSINESSES TO ENSURE THAT THE INDIAN GOVERNMENT DOES NOT INDIRECTLY HAVE ANY CONTROL OVER U.S. BUSINESS THAT COULD HAMPER U.S. INTERESTS.**

Close to 50 percent of the acquisitions by Indian companies in the United States between 2006 and 2009 and 65 percent in the first half of 2010 were in the information technology sector. The manufacturing and the energy sectors are also a significant and growing part of Indian acquisitions in the United States.

We have seen a dramatic increase in the number of cases subject to CFIUS review (a 250 percent increase in transaction reviews by CFIUS over the last five years) and investigation (transactions subject to CFIUS investigation in 2008 and 2009 were more than three times the number of investigation in 2006 and 2007). During this four-year period more than 10 percent of the transactions were withdrawn by the parties during the 30-day review period and 25 percent were withdrawn during the follow-on 45-day investigation period. In the vast majority of these transaction the parties were able to make necessary changes to the transactions to mitigate and address CFIUS concerns and successfully resubmitted the transactions for CFIUS review and approval. For example, of 23 notices withdrawn in 2008, 20 were resubmitted and only three were abandoned.

Acquisitions by Indian companies in the United States have grown considerably over the past few years (aggregating approximately \$3.8 billion in the first half of 2010 alone), and are expected to continue to grow. Transaction sizes have also been growing, with the first half of 2010 witnessing mega-deals like Reliance's acquisition of Atlas Energy and Pioneer Natural Resources valued at \$2.8 billion and Essar Group's acquisition of Trinity Coal for \$600 million. The stories of big Indian corporate houses taking over major international companies in the past few

years has put India Inc. in the headlines of leading U.S. newspapers and certainly on the minds of CFIUS members.

As Indian companies continue to aggressively expand their operations outside India and their acquisitions in the United States, they further diversify their investments in the United States beyond the traditional technology sector to the telecommunication, transportation, coal, oil and gas and other energy sectors of the U.S. economy, which are more traditionally the subject of CFIUS scrutiny. Recent transactions such as Reliance's deal with Atlas to pick up a 40 percent stake in Marcellus Shale, a gas project, or Coal India's proposal to buy equity in Peabody Energy Corp., and Mphasis's acquisition of Fortify Infrastructure Services are only indicative of the future trends. It is expected therefore that as the diversification continues, more transactions will be subject to CFIUS scrutiny.

Finally, although India's disinvestment program in the last two decades has significantly reduced the Indian government's control of many Indian businesses, several Indian businesses are still owned in part by the government of India. CFIUS will keep its eyes wide open for investments by Indian businesses to ensure that the Indian government does not indirectly have any control over U.S. business that could hamper U.S. interests.

This is not to say that all acquisitions by Indian companies are expected to be subject to Exon-Florio and CFIUS review. However, becoming knowledgeable about the statute and its scope and learning to navigate the CFIUS review process effectively should become a mainstay for Indian companies looking at doing acquisitions in the United States, especially in light of the following:

The statute is intentionally broad to provide latitude to the President in the protection of U.S. national security interests. The term "national security" has a flexible and evolving meaning under the statute and the regulation, which allows the U.S. authorities to interpret the term broadly. In practice, CFIUS reviews each covered transaction on a case-by-case basis to evaluate whether any national security concern may be presented by a transaction, based on factors such as whether the transaction involves "critical infrastructure" or activities affecting national defense or homeland security. It is expected that CFIUS will continue to interpret this term in a broad manner. It is therefore not easy for foreign buyers without the assistance of regulatory experts to determine if the acquisition of a U.S. business could be subject to CFIUS scrutiny.

## Indian Webinar Series: Bankruptcy Proceedings in the United States and Strategies for Buyers of Assets in Bankruptcy

Wednesday, August 4, 2010

10:00 a.m. - 11:00 a.m. Eastern

7:30 p.m. - 8:30 p.m. India Standard Time

Partners from Pepper Hamilton LLP will discuss basic bankruptcy proceedings in the United States (including Chapter 11 concepts). The webinar will cover all aspects of bankruptcy, from commencement of a case through confirmation of bankruptcy plans and emergence from bankruptcy in the United States. The speakers also will focus on M&A acquisition strategies for foreign investors desiring to invest in bankruptcy assets in the United States. The speakers also will discuss selected issues and strategies affecting the rights of holders of equity securities of U.S. companies in bankruptcy.

Topics will include:

- bankruptcy restructurings and distressed asset sales in the United States
- the chapter 11 process
- creditor constituents and the priority scheme
- strategies for buying distressed companies/assets in bankruptcy.

### Moderator

*Valérie Demont*, corporate and securities partner, head of Pepper Hamilton's U.S.-India Practice

### Speakers

*Todd A. Feinsmith*, corporate restructuring and bankruptcy partner, Pepper Hamilton LLP

*William R. Wagner*, financial services partner, Pepper Hamilton LLP

To register visit <http://www.regonline.com/bankruptcy>.

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The addition of “critical infrastructure” in the CFIUS review is of practical importance because of the reach of this concept and its applications. The statute requires additional investigation in cases in which the transaction results in foreign control over critical infrastructure that, in the determination of CFIUS, could impair national security. “Critical infrastructure” is defined as “a system or asset, whether physical or virtual, so vital to the United States that the incapacity or destruction of the particular system or asset of the entity over which control is acquired pursuant to that covered transaction would have a debilitating impact on national security.” This definition allows CFIUS to consider many inbound transactions to be within the scope of their investigation. Critical infrastructure would include industries such as telecommunications, energy, electrical power systems, oil and gas, transportation, banking and finance, water supplies and emergency services. Technology, however, is a grey area, as certain technologies could be instrumental in national defense. Acquisitions of U.S. technology by a foreign buyer is therefore becoming of growing interest to CFIUS.

CFIUS is required to advise Congress if it finds a coordinated effort by a foreign government or foreign companies to acquire U.S. companies producing “critical technologies.” “Critical technologies” are critical technology, critical components, or critical technology items essential to national defense, identified under the statute, subject to regulations issued at the direction of the President. The meaning of “essential to national defense” is again an evolving concept based on several factors, including government policies. India ranked fourth among the countries acquiring “critical technologies” in the United States in 2008, with 11 acquisitions.

Despite the ambiguity, there are some indicators that may help a foreign buyer understand the landscape. For example, in certain technology transactions, it is common for CFIUS to require information “regarding whether the U.S. business provides cyber systems, products or services (including business systems used to support common business processes and operations, such as enterprise resource planning, e-commerce, e-mail, and database systems; telecommunications or Internet systems; control systems used to monitor, assess, and control sensitive processes and physical functions, such as supervisory control, data acquisition, and process and distributed control systems; or safety, security, support, and other specialty systems, such as fire, intrusion detection, access control, people mover, and heating, ventilation, and air conditioning systems).”

Notification of a transaction to CFIUS is voluntary, and parties who are comfortable that their transaction does not implicate national security issues can elect not to notify CFIUS of their plans. However, failure to notify is no guarantee that the transaction is in compliance with Exon-Florio and leaves the transaction subject to unilateral CFIUS review and Presidential action indefinitely.

Following notification, CFIUS has a 30-day period to conduct a review of the transaction. Following this initial review period, CFIUS has an additional 45-day period to conduct an investigation of the transaction if it chooses to do so. This 45-day period can be extended as required by the investigation. At the end of the process, if national security considerations have not been resolved, the President can decide to suspend, prohibit or take other actions, including unwinding the transaction. Out of 469 transactions that were subject to CFIUS review between 2006 and 2009, 61 were subject to investigations and only two were subject to presidential determination. In both of these cases, the President decided not to suspend in light of agreements that mitigated U.S. government concerns.

Conducting a preliminary CFIUS analysis in connection with the review of potential acquisition targets in the United States should become a mainstay for all Indian companies doing business in the United States. And in certain cases, filing a voluntary notification under Exon-Florio may be advisable because of the potentially severe consequences, as well as the uncertainties caused by not filing.

## From Canada to India, Officials Step Up Anti-Corruption Enforcement

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In Toronto last week, the Group of Twenty (G-20) leaders declared that corruption threatens the integrity of markets, undermines fair competition, destroys public trust and undermines the rule of law. The G-20 leaders also agreed to take further steps to combat international corruption. A week earlier, the Organization for Economic Co-Operation and Development (OECD) had issued a report urging more nations to step up their anti-corruption efforts.

A sign that this international pressure can work appeared in Canada, which the OECD had criticized for insufficient anti-corruption enforcement. For the first time in several years, Canadian officials last month brought charges under Canada's anti-corruption law against an Ottawa man accused of bribing Indian government officials to win a multi-million dollar airport security system contract. "The allegations were that company officials made a payment to an Indian government official in order to facilitate the execution of a multimillion-dollar contract for the supply of a security system," a Royal Canadian Mounted Police (RCMP) statement on the case said.

While the Mounties have released few details, the accused man, Nazir Karigar, worked at Cryptometrics, a U.S. firm specializing in facial recognition software for airports and governments around the world. The Mounties had interviewed employees last year at Cryptometrics, which has not been charged with any crime.

This prosecution is the first to result from the creation three years ago of two RCMP teams focusing exclusively on international anti-corruption. The teams' existence resulted in large part from pressure from the OECD and from U.S. enforcement officials who sought a strong partner.

The people who are alleged to have taken bribes from Karigar also have reason to be concerned. India last month announced that it had brought charges against a member of India's Central Insecticides Board and Registration Committee and others for allegedly accepting \$32,000 in cash, jewels and hospitality to expedite approvals for pesticides. While a laudable voluntary inspection by Dow revealed these payments, which Dow promptly reported, the company nonetheless reached a 2007 agreement

with the U.S. Securities and Exchange Commission requiring payment of a \$325,000 fine.

The investigation of the board official appears to have picked up momentum last year when the Indian ambassador to the U.S. drew the Indian government's attention to several recent U.S. Foreign Corrupt Practices Act (FCPA) cases involving "illegal payments having been made to officials in India," including the Dow subsidiary case. The main investigative body in India, the Central Bureau of Investigations (CBI), soon opened investigations on the matters. The U.S. authorities also shared information with the Indian counterparts in the CBI to help the investigations. The CBI also has brought recent cases against excise tax assessors and a government official who steered contracts to a friend, all in an effort to enhance India's credentials in fighting corruption.

Anti-corruption enforcement by officials around the world will only continue to expand in coming months. To address the risks of conducting business in the global market, Pepper Hamilton provides experienced guidance to ensure that our clients' compliance and risk management programs are deterring and detecting potential anti-corruption issues. Our practice group includes experienced professionals seasoned by years of running law enforcement agencies and counseling international businesses on sophisticated compliance issues. We often conduct our work in close coordination with former FBI Director Louis Freeh and his consulting company, Freeh Group International. Engaging Pepper and the Freeh Group sends a strong signal that a company is committed to conducting its business ethically and properly.

## Investments in U.S. Financial Institutions by Business Enterprises Domiciled in India

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Financial institutions in the United States have been hit hard by the global financial crisis and its related fallout. For many institutions, this has resulted in a need to raise capital that cannot be met through traditional capital markets channels. Simultaneously, foreign investors in India have shown interest in investing in the U.S. financial sector, sensing an opportunity to realize substantial returns when the markets stabilize. However, the U.S. regulatory framework applicable to investments in various types of financial institutions can be complex, particularly for investments in financial groups that include a bank. Therefore, non-traditional investors and foreign business enterprises, as well as financial institutions that might seek to raise capital from such investors, need to understand the regulatory framework in order to plan for a viable transaction.

This article discusses the governing law, application process, and relevant considerations that U.S. regulators consider in approving an acquisition proposal by a foreign person or group, and provides a brief summary of the requirements for investing in a domestic financial institution in the United States.

In the United States, supervisory and regulatory responsibilities for domestic banking institutions is divided among several different federal and possibly state regulatory agencies, depending on the type of charter (e.g., federal or state). These regulators include the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) at the federal level, as well as the banking departments of the various states (e.g., the New York State Banking Department (NYSBD)). The primary supervisor of a domestic banking institution is generally determined by the type of institution it is and the governmental authority that granted it permission to commence business (commonly referred to as a charter). Banks that are chartered by a state government are referred to as state banks; banks that are chartered by the OCC, which is a bureau of the Department of the Treasury, are referred to as national banks.

The FRB has primary supervisory authority for state banks that elect to become members of the Federal Reserve System (state

THROUGH CAREFUL PLANNING WITH EXPERIENCED ADVISORS AND CLOSE COOPERATION WITH THE REGULATORS, INVESTORS IN FINANCIAL INSTITUTIONS SHOULD BE ABLE TO REALIZE THE GOALS OF THEIR INVESTMENTS WITHOUT UNWANTED REGULATORY BURDENS.

member banks). State banks that are not members of the Federal Reserve System (state nonmember banks) are supervised by the FDIC. In addition to being supervised by the FRB or FDIC, all state banks are supervised by their chartering state. The OCC supervises national banks (a type of federally chartered bank). All national banks must become members of the Federal Reserve System. This dual federal-state banking system has evolved partly out of the complexity of the U.S. financial system, with its many kinds of depository institutions and numerous chartering authorities. It has also resulted from a wide variety of federal and state laws and regulations designed to remedy issues that the U.S. commercial banking system has faced over its history.

Banks are often owned or controlled by another company. These companies are referred to as bank holding companies. The FRB has supervisory authority for all bank holding companies, regardless of whether the subsidiary bank of the holding company is a national bank, state member bank, or state nonmember bank.

The FDIC insures the deposits of banks and savings associations up to certain limits established by law. As the insurer, the FDIC has special examination authority to determine the condition of an insured bank or savings association for insurance purposes.

We note that legislation currently pending in the U.S. Congress may significantly change many aspects of the regulation of financial services activities in the United States, including consolidation of the OTS into the OCC. However, we do not expect that the application and approval process for foreign banking organizations to acquire U.S. banks would be affected.

Section 3(a)(1) of the Bank Holding Company Act (BHCA) requires prior FRB approval for any action that causes a company to become a bank holding company. A company becomes a bank holding company by acquiring control of a bank. "Any action" that causes a company to become a bank holding company may include the merger or acquisition of a domestic bank.

The BHCA requires the FRB to consider various factors when acting on bank holding company acquisition proposals. These factors are: the competitive effects of the proposal in the relevant geographic markets; the financial and managerial resources and future prospects of the companies and banks involved in the proposal; the convenience and needs of the community to be served, including the records of performance under the Community Reinvestment Act (CRA) of the insured depository institutions involved in the transaction; the availability of information needed to determine and enforce compliance with the BHCA and other applicable federal banking laws; and, in the case of applications involving foreign banks, whether the foreign bank at issue is subject to comprehensive supervision and regulation on a consolidated basis by its home country supervisor. In considering these factors, the FRB will formulate a record that includes information provided by the applicant, confidential supervisory and examination information relative to the target bank, publicly reported financial and other information, and information col-

lected from the applicant's home country supervisor. Investments made directly in banks that are not owned by a bank holding company require a similar process as required by the FRB.

The review by the various regulators of proposed investments by foreign investors tends to take six months, on average, from filing to approval. However, in cases in which a given application raises novel supervisory issues, or when the investors have a history of compliance difficulties in their home country, the process may take longer. In order to mitigate the effect of any supervisory concerns, the regulators encourage pre-filing meetings at which the applicants can introduce themselves to the regulators, review the proposed investment, and identify any threshold issues.

In the current economic environment, financial institutions are eager to attract new investment capital, and U.S. regulators have shown that they are looking for ways to accommodate. The dilemma for some investors will be to consider and determine what level of control and scope of activity they seek for their investment. Through careful planning with experienced advisors and close cooperation with the regulators, investors in financial institutions should be able to realize the goals of their investments without unwanted regulatory burdens.

*A more detailed version of this article is available online at [www.pepperlaw.com/publications\\_update.aspx?ArticleKey=1753](http://www.pepperlaw.com/publications_update.aspx?ArticleKey=1753).*

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## India Moves to Enhance Transparency, Investor Confidence

The Government of India released a Consolidated Foreign Direct Investment Policy on March 31, 2010 in an effort to make it easier for more foreign investments to enter the country. This document consolidates all existing regulations on Foreign Direct Investment contained in the Foreign Exchange Management Act, press notes issued so far and the RBI circulars. This policy document came into effect on April 1, 2010 and will be replaced every six months after incorporating the changes that have been effected during the said period. All earlier Press Notes/Press Releases/Clarifications on FDI issued by DIPP in force and effect as of March 31, 2010 stand rescinded as of March 31, 2010 and are accordingly consolidated and subsumed in the present Circular. This policy also is expected to improve transparency and investor confidence.

## Bill Addresses Independent Contractor Misclassification

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On April 22, a bill was introduced in Congress to make misclassification of employees as independent contractors a federal labor law violation. The Employee Misclassification Prevention Act (EMPA) would also impose record-keeping and notice obligations upon companies and subject them to hefty penalties for noncompliance with the proposed new law. Upon the likely enactment of EMPA sometime this year, businesses will be confronted with an anticipated onslaught of private actions by workers claiming they are misclassified “employees” who have been improperly paid on an Internal Revenue Service (IRS) Form 1099 basis.

Prior to the enactment of EMPA — and, to a lesser extent, prior to the date when businesses will be required under EMPA to provide a mandatory notice to their workers stating whether they have been classified as “employees” or “non-employees” (six months following enactment of the law) — there is a window of opportunity for companies to enhance their compliance with existing and proposed laws governing independent contractors. Three options for companies to minimize their exposure to misclassification liability are bona fide restructuring of their relationships with their independent contractors, reclassifying workers and choosing employee leasing or other staffing options.

Under current law, companies are permitted to use independent contractors, as long as such workers are not “employees” under existing tax, employee benefit, and labor and employment laws. If independent contractors are correctly classified, they may be paid on a Form 1099 basis without the withholding or payment of any employee taxes, Federal Insurance Contributions Act (FICA) allocations or unemployment or workers’ compensation premiums. They may also be excluded from participation in a company’s employee benefit plans.

In contrast, employees misclassified as independent contractors under current laws can lead to costly liabilities, even if the employees have been mistakenly misclassified. For those companies whose business models rely on the use of independent contractors, the potential costs of misclassification can be extremely high. Risks include liability for years of unpaid federal, state and local income tax withholdings; Social Security and Medicare contributions; unpaid workers’ compensation and unemployment insurance premiums; and unpaid work-related expenses and overtime compensation. Another costly liability risk arises when misclassified employees, who may be entitled to coverage under employee benefit plans, have not been provided with health, pension and other employee benefits.

### RECENT ENFORCEMENT ACTIONS

The enactment of many state laws during the past two years regulating the use of independent contractors has made misclassification an even greater liability risk. Some new state laws severely limit the type of workers who may qualify as independent contractors and impose extraordinarily high penalties for misclassification of employees, including disbarment from state contracts and loss of licenses to do business in the state.

The long-awaited EMPA bill recently introduced in Congress by both the House and Senate would amend the federal Fair Labor Standards Act (FLSA) to make misclassification a federal labor offense. Under current law, failure to withhold or failure to file a W-2 is a federal offense, but not the misclassification itself. The EMPA bill would also impose strict record-keeping and notice requirements upon businesses with respect to workers treated as independent contractors, expose such businesses to fines of \$1,100 to \$5,000 per employee for each violation of the law and double the liquidated damages provisions under the FLSA.

The EMPA is one of two bills introduced in this legislative term that deals with misclassification of employees. In 2009, both the House and Senate introduced the Taxpayer Responsibility, Accountability, and Consistency (TRAC) Act. If enacted, the TRAC Act would limit the availability of the so-called “safe harbor” provisions relied upon by many businesses to designate workers as independent contractors for federal employment tax

purposes, afford workers the right to petition the IRS for a determination of their status and increase penalties upon companies for filing incorrect Form 1099s.

Businesses that use independent contractors have also been targeted by plaintiffs' class action lawyers, focusing on companies that make use of independent contractors as part of their business model. The lawsuits seek damages for unpaid employee benefits such as medical and pension benefits, as well as unpaid overtime and unreimbursed employee expenses.

### THREE OPTIONS FOR EMPLOYERS

No states have outlawed the use of independent contractors, and the proposed federal legislation continues to permit businesses to use independent contractors — provided they are properly classified. Nonetheless, most lawyers routinely advise businesses to reclassify their independent contractors as employees to avoid the potential for misclassification liability. There are, however, no fewer than three measures that businesses can take to minimize or avoid the risk of future liability — and one of these allows companies to maintain their business models that rely upon the use of independent contractors. The three options are bona fide restructuring of the relationship between a company and its independent contractors, employee leasing and voluntary reclassification.

Most companies concerned about the potential for misclassification liability recognize that their independent contractors probably fall within the proverbial “gray area,” presenting businesses with a real dilemma. But rather than changing a successful business model, a company may wish to consider undertaking a bona fide restructuring of its independent-contractor relationships, using independent-contractor diagnostics to determine the extent to which restructuring of the independent-contractors position will minimize or avoid future misclassification liability. As described below, independent-contractor diagnostics refers to a process beginning with an examination of whether the position would pass the applicable independent-contractor tests under governing state and federal laws, using each of the applicable 48 factors used by different decision-making bodies in determining independent-contractor status.

A 2006 Government Accountability Office report addressing employee misclassification stated that the tests used to determine whether a worker is an independent contractor or an employee are “complex, subjective, and differ from law to law.” With the exception of a few state laws, most tests used by the courts

and administrative bodies are based in whole or large part on whether the hiring party has the “right to control the manner and means” by which the worker accomplishes the end product of his or her work. For companies interested in maintaining their use of independent contractors but eager to minimize or avoid future misclassification liability, the first step in restructuring their independent-contractor relationships is to consider what adjustments they are prepared to make to their present level of control over the manner and means by which their independent contractors accomplish their work.

At the end of the independent-contractor diagnostics process, the company's degree of compliance with each of the applicable laws can be measured on an “IC Compliance Scale.” This process can provide a company with an informed means by which to determine the extent that the restructuring alternative may minimize or eliminate future misclassification liability.

If independent-contractor diagnostics indicate that the bona fide restructuring option is a sound choice, the business can proceed with this alternative and memorialize the bona fide restructuring in a modified independent contractor agreement. Companies must ensure that the words used in the independent-contractor agreement will be actually implemented in the field and are not empty recitals, which the law disregards. Other steps may include reviewing and revising company operating manuals and procedures, documenting the implementation of certain of the provisions in the independent-contractor agreement and putting safeguards in place to ensure that actual business practices conform to the terms of the modified independent-contractor agreement. If, however, independent-contractor diagnostics suggest that, even with restructuring, the workers will not likely pass the governing tests for determining independent-contractor status when measured on the IC Compliance Scale, the business has at least two other alternatives to avoid or minimize future risks of misclassification liability.

Although employee leasing or other staffing alternatives cannot completely eliminate all potential liability for misclassification, the use of a responsible and sophisticated staffing organization can dramatically reduce the risk of such liability, as well as the likelihood of a lawsuit challenging the classification of a group of workers paid on a 1099 basis. When an employee-leasing organization hires some or all of a company's independent contractors as their employees, the leasing company withholds income taxes, makes Medicare and Social Security contributions, pays workers' compensation and unemployment insurance premiums,

provides an array of benefits to the former independent contractors, including health insurance under a plan maintained by the leasing company, and handles the employee relations of the leased employees.

Although use of an employee-leasing or -staffing company can substantially lessen the risk of future misclassification liability if all legal documentation and procedures are carefully observed, it is not a panacea. For example, a business that contracts with an employee-leasing organization may still need to account for the leased employees in the employer's benefit-plans language and perform "nondiscrimination" testing required under the Employee Retirement Income Security Act (ERISA).

If legislation at the federal level is enacted as expected, companies will be obligated to notify all independent contractors that they have the right to a governmental determination as to whether they have been properly classified as an independent contractor. Voluntary reclassification is likely to be far less painful and costly than being forced by a government agency or court to reclassify in connection with an order to make payment of back taxes, unpaid Social Security and Medicare contributions, and unpaid unemployment insurance and workers' compensation premiums.

Reclassification, whether voluntary or compelled by a state or federal agency or court, requires businesses to consider relevant federal and state tax, employee-benefits and employment laws, and is labor intensive. Reclassification, however, does not require that all workers previously excluded from an employee-benefit plan must be included in the future. Exclusions are permissible if the governing documentation for the company's plans is drafted properly and the exclusion does not violate applicable tax or ERISA rules.

There are a number of alternatives from which businesses can choose to reduce or eliminate the risk of future misclassification liability. In view of the current legislative, regulatory and judicial landscape, the only unacceptable alternative is inaction.

## Senate Passes Financial Services Reform Bill

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On May 20, 2010, the U.S. Senate in a 59-39 vote passed the controversial Restoring American Financial Stability Act of 2010 (S. 3217), capping a chaotic and partisan battle over re-vamping the regulation of the financial services industry.

On March 15, 2010, Sen. Christopher Dodd (D-Conn.), Chairman of the Senate Committee on Banking, Housing & Urban Affairs, released a draft of the legislation (the Dodd Bill or Bill), after months of trying to come up with a compromise bill that would earn bipartisan support. On April 19, the Dodd Bill was voted out of committee on a party-line vote, with no debate and no amendments offered. During weeks of procedural wrangling and bitter partisan debate in the full Senate, some 400 amendments were prepared before cloture was invoked and the bill was passed.

The Dodd Bill now moves to conference committee, where House and Senate conferees will attempt to reconcile the provisions of the Bill with the House version, H.R. 4173 (the House Bill), which passed the House on December 11, 2009. The outlines of the bills are similar, but significant differences remain that will need to be hammered out in conference. On May 25, 2010, Senate Democrats named the Senate conferees who will negotiate the final version of the Bill. The conferees include seven Democrats and five Republicans. The House conferees will likely be named in early June. A final bill is expected to be voted on in late June or early July.

Unless otherwise noted below, the Dodd Bill would be effective one day after enactment.

## HIGHLIGHTS OF THE DODD BILL

## ESTABLISHING THE CONSUMER FINANCIAL PROTECTION BUREAU

*Powers of the CFPB*

The Dodd Bill would establish the Consumer Financial Protection Bureau (the CFPB), a division of the Federal Reserve Board (FRB).<sup>1</sup> It would have rulemaking authority to protect consumers with respect to consumer financial products or services, defined as any financial product or service to be used by a consumer primarily for personal, family or household purposes.<sup>2</sup> The CFPB's director would be appointed by the President and confirmed by the Senate. The CFPB would have authority to pass rules applicable to all banks and non-banks with respect to consumer financial law. However, it would only have examination and enforcement powers over banks and credit unions with greater than \$10 billion in assets, all mortgage-related businesses, and certain nonbank financial companies such as payday lenders, debt collectors and consumer reporting agencies. Banks and credit unions with assets under \$10 billion will continue to be examined by their current regulators. In addition, any service provider to a depository institution would be subject to the enforcement power of the CFPB. A service provider is defined as any person that provides a material service to a covered person in connection with the offering or provision of a consumer financial product or service, including the design, operation, maintenance or processing of a consumer financial product. A service provider to a "substantial" number of such entities would be subject to the authority of the CFPB.

The Dodd Bill exempts certain businesses and activities, except in limited circumstances, from the CFPB's authority. Those businesses and activities include, among other things, merchants, retailers or other sellers of nonfinancial goods or services who extend credit directly to a consumer "exclusively" for the purpose of enabling consumers to purchase the product. In addition, subject to certain exceptions, the CFPB would not have rule making, supervisory or enforcement authority over real estate brokers and agents, manufactured and modular home retailers, accountants and tax preparers. The Bill also bars the CFPB from setting usury limits for the extension of credit to consumers unless otherwise explicitly authorized by law.

The CFPB notably may take any authorized action to prevent a covered person or service provider from committing or engaging in an unfair, deceptive or abusive act or practice in connection with any transaction with a consumer for a consumer financial

THE BILL DOES NOT EXPAND THE CURRENT STATE OF PREEMPTION, IN THAT STATE LAW IS STILL PREEMPTED, AND VALID PREEMPTION DETERMINATIONS MADE BY THE OCC EITHER BY REGULATION OR ORDER ARE STILL BINDING.

product or service. The Bill defines an "abusive" practice as an act or practice that: (1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or (2) takes unreasonable advantage of – (a) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service; (b) the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or (c) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.

The CFPB may prescribe rules identifying such acts or practices and include requirements for the purposes of preventing such acts or practices. However, Amendment 3758 preserves the authority of the Federal Trade Commission (FTC) under the Federal Trade Commission Act to enforce any such rule as to a person subject to the FTC's jurisdiction.

*Pepper Points* – *The very existence of the CFPB would substantially inhibit any meaningful coordination of safety and soundness with the consumer protection missions of depository institutions. Indeed, this schism between the dual goals of regulation would result in the CFPB having the authority to trump the applicable safety and soundness regulator, raising the likelihood of increased instability in the financial system. In fact, this approach follows that taken in regulating Fannie Mae and Freddie Mac. In that instance, the Department of Housing and Urban Development (HUD) set consumer standards while the Office of Federal Housing Enterprise Oversight supervised the safety and soundness of the two housing enterprises. Ultimately, as many have argued, the consumer standards set by HUD undermined the solvency of Fannie and Freddie, which have become the largest recipients of federal bailout funds.*

*In avoiding abusive practices, the dilemma that institutions will encounter – and regulators may exploit – is the practical application of the statutory definition. Similar to the concepts of an “unfair” or “deceptive” practice under the Federal Trade Commission Act, the notion of an “abusive” practice is inherently subjective and leaves institutions with significant uncertainty in avoiding committing such practices. As in the case of unfair or deceptive practices enforcement, we are likely to see regulators attempting to cite certain purportedly “abusive” practices, where such practices may have been occurring with examiners’ full knowledge for extended periods. Institutions also are likely to see what might appear to be inconsistent enforcement, where the regulators find the conducting of a certain practice at one institution to be acceptable, and a similar practice at another institution to be abusive. In short, as with unfairness and deceptiveness, the concept of abusive practices offers too much discretion for regulators and too little clarity for institutions.*

#### *Preemption*

The Bill contains important clarifications of preemption of state law, and the authority of state attorneys general. The Bill permits state attorneys general to bring a civil action in the name of the state against a national bank or federal savings association to enforce a regulation prescribed by the CFPB and to secure remedies under the Bill or other federal law. Before initiating any such action, the state authority must provide the FRB with a copy of the complete complaint to be filed. The CFPB may then intervene and remove the action to federal court.

The Bill also clarifies the scope of federal preemption of state consumer financial laws. The Bill provides that state consumer financial laws are only preempted if: (1) the state law is discriminatory against national banks in comparison to banks chartered by that state; (2) the state law is preempted in accordance with the Supreme Court’s decision in *Barnett Bank v. Nelson*, 517 U.S. 25 (1996), as applied by any court, by regulation of the OCC, or by determination of the Comptroller of the Currency on a case-by-case basis; or (3) the state law is preempted by some other provision of federal law.

The Bill codifies the Supreme Court’s decision in *Cuomo v. Clearing House Ass’n*, 129 S. Ct. 2710 (2009), in providing that state attorneys general may bring a civil action against a national bank or federal savings association to enforce applicable law.

*Pepper Points – The Bill does not expand the current state of preemption, in that state law is still preempted, and valid preemption determinations made by the OCC either by regulation or order are still binding.*

*The Bill does, however, add a range of new laws that can be enforced through civil litigation by state attorneys general – specifically, the regulations promulgated by the CFPB. Even then, it remains to be seen as to whether and how frequently the CFPB intervenes in state enforcement attempts. One notable deficiency in the Bill is that while it requires state authorities to consult with the CFPB, and gives the CFPB the opportunity to intervene, it does not provide that such intervention would curtail the state action. Regardless of whether the CFPB deemed the action worth pursuing, the state authority may continue to prosecute the case.*

Other highlights of this bill, including the Snowe-Pryor Amendment, the reorganization of banking regulations in the United States, the new powers of the U.S. Federal Reserve Bank and the FDIC, the establishment of the Financial Stability Oversight Council, the new Volcker Rule, and the new provisions on the registration of hedge fund and other private fund advisors are discussed in a full version of this article online at

[www.pepperlaw.com/publications\\_update.aspx?ArticleKey=1793](http://www.pepperlaw.com/publications_update.aspx?ArticleKey=1793).

#### ENDNOTES

- 1 Unlike the Senate Bill, the House Bill envisions the new consumer financial protection authority as a stand-alone independent agency.
- 2 The Consumer Financial Protection Bureau would be established effective as of the date of the Dodd Bill’s enactment. The CFPB’s rulemaking authority would be effective as of the date that the Treasury Secretary transfers consumer financial protection authority from existing regulators to it, which must occur within six months of the date that the Dodd Bill is enacted.

Join us for a free webinar, “What the Financial Reform Legislation Means for You,” on Thursday, July 15, 2010 from noon to 1:30 p.m. Eastern / 9:30 - 11:00 p.m. India Standard Time to learn how this bill is likely to affect you. The panel will be moderated by Richard P. Eckman, chairman of Pepper’s Financial Services Practice Group, and will include seasoned regulatory, litigation and corporate lawyers: Timothy R. McTaggart, Audrey D. Wisotsky, Stephen G. Harvey, Frank A. Mayer, III, Daniel G. Murray, Travis P. Nelson, Gregory J. Nowak, and Robert A. Friedel.

For more information, please visit

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