

Counsellors at Law

Summer 2009

inside



Serving Our Clients in Difficult Economic Times

by James J. Marcellino, Esq.

In times of financial stress, our business clients are often presented with a Hobson's choice—the stakes in business disputes are concomitantly higher when profit margins are lean, yet funds for litigation and dispute resolution are equally precious. One of the questions for lawyers, then, is how to most effectively aid clients in these tough times. Good lawyering, as always, requires gearing counseling toward maximizing efficiency and effectiveness and ensuring communication is clear and frequent, with heightened sensitivity to a client's business status in this down economy. What follows is a short list of attitudes and actions to consider.

In the first place, mind-set counts. When business judgment dictates an aggressive pursuit of a would-be defendant, choosing the right lawyer is key. Many know Jim Collins, the author of *Good to Great* and other business strategy books.

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what's new

Our Washington, DC office has moved to new office space as business continues to grow. The DC office, opened in 2008 and specializing in intellectual property law, has expanded to include 9 legal professionals. The DC office's new address is:

**1055 Thomas Jefferson Street,
N.W., Washington, DC 20007.**

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Good Money After Bad? Deepening Insolvency—An Update

by Natalie Sawyer, Esq.

The legal concept of “deepening insolvency” has long been a volatile one.

As defined by the Third Circuit Court of Appeals, deepening insolvency is “an injury to the Debtors’ corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.” Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3rd Cir. 2001). For example, a faltering company (and its lender) may be faced with a choice of shutting the company’s doors or borrowing more in an effort to turn the company around. When that turnaround effort fails, and less is ultimately available for unsecured creditors, blame may be cast on the basis that “value [could have been] salvaged, if the corporation [was] dissolved in a timely manner, rather than kept afloat with spurious debt.” *Id.*

“...potential defendants should remain aware that deepening insolvency has yet to be expressly denounced in all jurisdictions, and that, even if it were, potential liability remains in the form of other, established causes of action.”

The scope of defendants who have found themselves defending against a deepening insolvency claim is wide, including officers, directors, lenders, parent corporations, professionals, and customers. For creditors seeking alternate sources of recovery, a claim based on deepening insolvency seems a just result. For those involved in the company’s transactions, however, the concept of deepening insolvency seems like a no-win position—giving creditors the opportunity to be “Monday morning quarterbacks” and fix blame for innocent efforts to rejuvenate.

In the years since Lafferty, however, the popularity of the deepening insolvency theory has waned, and a review of the most recent cases indicates that no resurgence is on the horizon. Critics have questioned not only the scope of circumstances to which deepening insolvency should be applied, but the basic rationale of the theory. See, e.g., *In re SI Restructuring, Inc.*, 532 F.3d 355

(5th Cir. 2008). For example, why, such critics ask, should lenders be held accountable for making a loan, when the real problem is the unwise spending of the loan’s proceeds? See, e.g., *In re Propex Inc.*, 2009 WL 562595 (Bankr. E.D. Tenn.). The Delaware Supreme Court, reprimanding a prior bankruptcy court which dared to predict that Delaware

would recognize deepening insolvency, surmised that deepening insolvency’s prior success was only “because the term has the kind of stenorious academic ring that tends to dull the mind to the concept’s ultimate emptiness.” *Trenwick America Litigation Trust v. Billet*, 931 A.2d 438 (Del. 2007).

Some critics have rejected the notion of deepening insolvency not because they quibble with the rationale, but because they find deepening insolvency redundant to existing causes of action. See, e.g., *In re VarTec Telecom, Inc.*, 335 B.R. 631 (Bankr. N.D. Tex. 2005). This distinction is instructive. It is a reminder that, even in jurisdictions that reject the notion of deepening



Harold B. Murphy Joins American College of Bankruptcy

Harold B. Murphy, founder and Director of Hanify & King's Bankruptcy and Financial Restructuring Group, has become a Fellow of the American College of Bankruptcy. The College, an invitation-only organization, is dedicated to the advancement of the highest standards for the Bankruptcy and Restructuring profession and to the pursuit of educational and pro bono bankruptcy endeavors.

Murphy has been recognized by the Board of Regents of the College and by peer Fellows as having demonstrated the highest standard of professionalism, ethics, character, integrity, professional expertise and leadership contributing to the enhancement of bankruptcy and insolvency law and practice; sustained evidence of scholarship, teaching, lecturing or writing on bankruptcy or insolvency; and a commitment to elevate knowledge and understanding of the profession and public respect for the practice.

The ceremony took place at the U.S. Supreme Court in the Great Hall on March 27, 2009, and was presided over by David G. Heiman, Chair of the College. The keynote speaker was Dennis W. Archer, Esq., a former Justice of the Michigan Supreme Court and past president of the American Bar Association.

Recently, Chambers USA noted that Murphy "is probably the best debtor's lawyer in the jurisdiction," and that he is "known for being extremely resourceful and creative" and one who is "not afraid to wade into the battle." Chambers has also noted that Murphy is "an outstanding lawyer who is really bright and imaginative when dealing with restructuring and debtor work. Chambers publishes an annual guide to the legal profession in the U.S.

Specializing in bankruptcy and commercial law, Murphy has represented debtors, creditors' committees, trustees, and creditors in Chapter 11 reorganizations and Chapter 7 liquidations. Murphy was also cited in Best Lawyers in America for Bankruptcy and Insolvency expertise. ●



insolvency, the underlying basis for the claim may simply be repackaged and prosecuted under more traditional legal theories. For example, a lender who lends to an insolvent borrower may still face claims of equitable subordination, fraudulent transfer and fraud.

Yet other critics are willing to accept the notion of deepening insolvency, but only as a theory of damages, not as an independent cause of action. Such critics say that, while deepening insolvency may be raised as a means of demonstrating the harm suffered by a company, a separate tort is required to establish liability. See, e.g., *In re Felt Mfg. Co., Inc.*, 371 B.R. 589 (Bankr. D. N.H. 2007); *In re Adelpia Communication Corp.*, 2006 WL 687153 (Bankr. S.D. N.Y.).

While the trend continues toward rejection of the deepening insolvency concept—potential defendants should remain aware that deepening insolvency has yet to be expressly denounced in all jurisdictions, and that, even if it were, potential liability remains in the form of other, established causes of action. ●

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Don't Let One Bad Apple Spoil the Whole Bunch

Simple Steps for Avoiding Liability in Veil Piercing Litigation Against Close Corporations

by Michael Marcucci, Esq.

Even in good times, creditors habitually cast a wide net in search of cash to satisfy their claims. In today's economic climate, cash-starved creditors are sure to "follow the money," pursuing a well-heeled corporate relative of the debtor, whether they have viable claims against that entity or not. For instance, where it has a direct claim against a subsidiary that is insolvent or nearly so, a savvy creditor and its attorney may also bring claims against a solvent parent company, affiliates or even individual officers or stockholders. There are numerous legal theories on which such claims are based, including the commonly alleged (and less commonly proven) action to "pierce the corporate veil." Set forth below is a discussion of the legal basis for piercing the corporate veil, as well as practical steps that corporations can take to avoid these collateral attacks.

These claims, even if they have little merit, are particularly vexing for corporations (or individual entrepreneurs) who have a stake in multiple entities, each with distinct-but perhaps complementary-lines of business. Consider a real estate investment firm ("parent") with five properties. Each property is held in a separate LLC or corporation ("subsidiary"), wholly or substantially owned by the parent. The parent also has an agreement with a management company that operates each property.

Each subsidiary may have a similar name, the same board of directors, the same investors or shareholders, and may share office space with each other and/or their parent; but the entire business structure was established to segregate the liabilities of each through the separate legal identities. However, where such a set up can be undermined is in the day-to-day operation of the companies. The law, straightforward on its face, may be thorny to apply in the context of litigation.

As a basic premise, in order to promote capital investment, corporations are generally regarded as legally separate, distinct from each other and from their respective stockholders. My Bread Baking Co. v. Cumberland Farms, Inc., 353 Mass. 614, 618 (1968). The corporate form promotes innovation by protecting its shareholders from personal liability for the corporation's debts. Even corporations in a similar business, with the same shareholders and with related governance structures, will be regarded as separate entities so long as the corporate principals treat them as such. Therefore, the creditors of Corporation A cannot sue Corporation B when A becomes insolvent, unless the interrelation of A and B merit so-called "veil-piercing." Veil piercing allows a court, as a matter of equity, to permit creditors to reach the assets of share-

Given the fact-intensive nature of the veil-piercing analysis, it is difficult to dismiss such a claim early in the case, or even by a later dispositive motion. The result is expensive discovery for the solvent defendant, even though fighting with the creditor of another, although related, entity.

holders, or related corporations, on the ground that "justice" requires the legally separate companies and, at times their shareholders, be treated as one.

Courts are clear that the corporate veil should be pierced only in "rare particular situations to prevent gross inequity" and only when "an agency or similar relationship exists between the entities." My Bread Baking Co. v. Cumberland Farms, Inc., 353 Mass. 614, 619-620 (1968). See also, Scott v. NG U.S. 1, Inc., 450 Mass. 760, 767 (2008). "[C]ommon ownership of the stock of two or more corporations together with common management, standing alone, will not give rise to liability on the part of one corporation for the acts of

another corporation or its employees[.]” My Bread Baking Co., 353 Mass. at 619.

More specifically, a corporate veil may only be pierced where “there is active and direct participation by the representatives of one corporation, apparently exercising some form of pervasive control, in the activities of another and there is some fraudulent or injurious consequence of the intercorporate relationship.” My Bread Baking Co., 353 Mass. at 619; Scott, 450 Mass. at 767. The ultimate decision to disregard the settled expectations accompanying the corporate form requires a determination that the parent corporation directed and controlled the subsidiary, and used it for an improper purpose, based on evaluative consideration of twelve factors:

(1) common ownership; (2) pervasive control; (3) confused intermingling of business activity assets, or management; (4) thin capitalization; (5) nonobservance of corporate formalities; (6) absence of corporate records; (7) no payment of dividends; (8) insolvency at the time of the litigated transaction; (9) siphoning away of corporate assets by the dominant shareholders; (10) non-functioning of officers and directors; (11) use of the corporation for transactions of the dominant shareholders; and (12) use of the corporation in promoting fraud. *Evan v. Multicon Constr. Corp.*, 30 Mass. App.Ct. 728, 733, rev. denied, 410 Mass. 1104 (1991), citing *Pepsi Bottling Co. v. Checkers, Inc.*, 754 F.2d 10, 16 (1985). Massachusetts courts will refer to these twelve factors in order to determine whether “justice requires that the separate existence of the corporation be ignored.” *Pepsi Bottling Co.*, 754 F.2d at 16. Notably, a litigant seeking to pierce the corporate veil need not satisfy each factor. Instead, enough facts must be proved to show that the debtor corporation is being directed and controlled by another, and used by it for an improper purpose. Scott, 450 Mass. at 768.

Given the fact-intensive nature of the veil-piercing analysis, it is difficult to dismiss such a claim early in the case, or even by a later dispositive motion. The result is expensive discovery for the solvent defendant, even though fighting with the creditor of another, although related, entity. For many businesses, having to venture deep into the discovery process constitutes a loss in

itself, even if they would be ultimately vindicated at trial. The cost in attorneys fees and lost employee and management time may not be worth the battle, often leading to settlement despite viable defenses, thus providing creditors with incentive to bring these claims, even if the merits are dubious.

What is more, while a business’s structure may have been established with the advice of counsel to segregate liabilities among the different entities, the veil-piercing analysis focuses on the actual operation of the businesses, and this is where companies can run into trouble. Where closely-related businesses operate from the same location and use the same employees, the distinct nature of each business may be unclear or unknown to lower-level employees, vendors, or creditors, who view the whole operation as one and the same. Fortunately, there are relatively inexpensive steps companies can take to guard against a successful veil-piercing claim.

➔ **Educate your employees:** if having separate corporate entities was important enough to warrant the effort in the first place, it is important enough to spend time once a year explaining to your employees what each company does and why it is important that expenses be properly allocated, that the public be aware of the differences between the companies, et cetera. Unwitting and uninformed employees can be

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One Bad Apple

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a gold mine for aggressive attorneys looking to show a vague relationship between a parent and a subsidiary.

- **Be clear with the public.** You may have three business-Blue Industries, Blue Enterprises and Blue Development LLC and think of them as the “Blue Group of Companies.” There is nothing wrong with using a brand name to cross-sell. When it comes to making contracts with third parties, however, your documents should be crystal clear about the contracting entity. Beware of boilerplate in contracts that purport to define the contracting company along the lines of “Blue Industries, together with its parents, subsidiaries, affiliates (collectively “Buyer”).” Unless the parents, subsidiaries and “affiliates” (a common term with no fixed meaning) want to be on the hook for the contract, defined terms should be strictly limited to the company entering into the contract.
- **Keep expenses separate.** Careful accounting can solve many problems. If four companies work out of the same space, and the office spends \$800 a month on bottled water, those expenses should be allocated among the four in some reasonable manner.

- **Document any resource sharing.** Similar to the point about segregating expenses, if your employees get a W-2 from Blue Enterprises, but also do work for Blue Industries and Blue Development, there should be a written agreement (a one-page term sheet should be sufficient) spelling out how Blue Enterprises is to be compensated for providing its employees’ time to its sister corporations. Accounting entries reflecting this arrangement should be clear as well.

- **Keep good corporate records.** The absence of such records is one of the veil-piercing factors; keeping them is easy and inexpensive and can make a world of difference when it comes to litigating a veil piercing claim.

- **Observe corporate formalities.** For each entity, have annual meetings, take minutes, make sure employees who hold corporate office know they are officers and have at least a minimal understanding of their role.

Corporations that establish and maintain corporate formalities and that confirm their separate existence despite common control or ownership are less likely to be responsible for their sister

corporation’s debt. As noted above, “there is present in the cases which have looked through the corporate form an element of dubious manipulation and contrivance [and] finagling.” Scott, 450 Mass. at 768 (quoting, Evans, 30 Mass. App. Ct. at 736). Nothing makes a corporation look like it is being manipulated more than the failure to comply with simple corporate formalities and lack of attention to detail in making accounting entries. The court in My Bread Baking Co., noted that “failure (a) to make clear which corporation is taking action in a particular situation and the nature and extent of that action, or (b) to observe with care the formal barriers between the corporations with a proper segregation of their separate businesses...

In these difficult times, when creditors are more aggressive than ever, a small investment of time and money in keeping the corporate books and records tidy can save a load of litigation trouble down the road.

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records, and finances” may result in veil piercing to prevent gross inequity. 353 Mass. at 619. The purpose of the veil piercing doctrine is to protect third parties who, through no fault of their own, believe that several related entities are, in fact, a single enterprise. When companies take care internally and externally to note their separate roles, it is much less likely that an outsider will be able to claim that he or she was misled.

In short, companies that operate in a manner consistent with their legal form are better able to avoid or defend against claims of veil-piercing. In these difficult times, when creditors are more aggressive than ever, a small investment of time and money in keeping the corporate books and records tidy can save a load of litigation trouble down the road. ●

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His most recent book, *How the Mighty Fall*, on the back cover, contains the following summary of his philosophy:

Whether you prevail or fail, endure or die, depends more on what you do to yourself than on what the world does to you.

Lawyers can, and should be tough-minded and game for the fight, without crossing any ethical boundaries. In difficult economic times, we must find ways to fight on, which generally means we must carry the fight.

The words and attitude of Theodore Roosevelt in his “The Man in the Arena” speech are also worthy of note:

...who, at the best, knows in the end, the triumph of high achievement, and who, at worst, if he fails, at least fails while daringly greatly, so his place shall never be with those cold and timid souls who neither know victory nor defeat.

Let us dare greatly, but always with the desired business resolution in sight.

Use the resources at hand.

Stonewall Jackson, at the First Battle of Bull Run in July 1861, when his colonel complained about the rain and the threat that the troops’ gun powder might not fire, responded “Then, Sir, we will

give them the bayonet!” To survive, and thrive, businesses must adopt the Coast Guard’s motto, “semper paratus,” always prepared. And their lawyers play a vital role in making this happen through thoughtful interaction with clients as they think through economic and financial exposures and strategies that protect against revenue shortfalls. On the positive side, lawyers, working with their business clients, can think or re-think through market opportunities that are available or may become available in the short run, and any legal considerations attendant to newly conceived business strategies. Is this a good time to review growth opportunities? Might there be an enhanced market for the development of additional business in existing or new markets? Are there legal barriers to entering a market that should be explored to determine the right strategy?

While our list is short, the task of growth or indeed survival can be daunting—but is doable. Constructing the right team that understands the business’s playbook will add value and ensure success as this downturn inevitably reverses direction. ●

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First, Pay All Wages

by Karen A. Whitley, Esq.

In these challenging economic times, employers are making tough financial choices. Companies may find themselves prioritizing payments owed to third parties, paying the “squeaky wheel” first. However, thinking that payments owed to employees are less pressing is a mistake. The number of lawsuits arising under the Massachusetts Wage Act has spiked in the last 18 months, resulting in substantial verdicts and settlements in favor of employees for unpaid compensation, multiple damages, and attorneys’ fees against their present and former employees.

Most employers understand that the weekly employee payroll is sacrosanct. However, other forms of compensation owed to employees may also be considered “wages” under the Massachusetts Wage Act. Indeed, as employees continue to feel the crunch of the recession, they can be expected to offer creative arguments about why various types of financial arrangements should be considered compensation under the Wage Act.

Generally, the Wage Act dictates the timing of payments of wages to hourly and salaried employees, both during their employment and when employment ends. The purpose of the Act is to prevent an employer from unreasonably

withholding earned wages. The term “wage” is not defined in the statute, however, other than to confirm that it includes vacation pay, holiday pay, and commissions which are “due and payable” and the amount of which has been “definitely determined.” Not only has the definition of “commission” proved somewhat difficult to apply, but there are many other forms of compensation that do not fit neatly into the traditional notion of a “wage.” For example, incentive commissions, bonuses, stock options, and other monetary arrangements must be carefully examined to see if, by their nature, they were intended to be covered by the Wage Act. The following summarizes the applicability of the Wage Act to various types of compensatory arrangements, though it must be recognized that each inquiry is fact-specific and that the law continues to evolve.

Regular Pay

As noted above, hourly wages earned by workers and regular salary paid to exempt employees must be at the top of the list when an employer is deciding what to pay. Only a very few limited deductions from these wages (such as tax withholdings and pre-approved 401(k), stock, or cafeteria plan contributions) are allowed. That said, employers are increasingly implementing salary freezes,

and even salary deductions. These methods of cost-saving are permissible only if they meet all employment law requirements. For example, if the salary of an exempt employee falls below \$455 per week as a result of a salary reduction, the employee will no longer be “exempt” and must receive overtime pay for any hours worked over 40 hours per week. Additionally, salary cuts should be implemented in a non-discriminatory manner, preferably across a whole class of jobs, and ideally starting at the top.

Deferred Wages

If an employer institutes a wage freeze, it must be clear that the employer is not merely postponing the payment of wages until the company can afford to pay. Such an arrangement is prohibited by the Wage Act—even if the employee agrees to delayed payments. For example, in a 2003 case, *Dobin v. CIOView Corp.*, decided in the Massachusetts Superior Court, the employee was hired to a management position as the company’s third employee. 2003 WL 22454602 (Mass. Super., October 29, 2003). Her salary was initially \$75,000 per year, plus monthly commissions. Her annual salary was later increased to \$95,000. Within a short period of time, the company’s financial condition deteriorated, with enough money to pay rent

“...the employee’s ‘voluntary’ agreement to allow the company to defer her salary until business improved was void, even if the employee benefited from the delayed payments because the company stayed in business long enough to pay her everything she was owed.”



and utilities for several months, but not enough to pay its three employees. The plaintiff agreed to defer her salary for a while, as long as salaries were paid next after rent and utilities when money came into the company. The employee did not receive any salary for six months. She complained that the practice of deferring wages violated the Wage Act, even though she had agreed to the delay. She was promptly fired.

The Court agreed with the employee that her monthly salary was a “wage” which was required to be paid no more than six days after the termination of the monthly pay period. It did not matter that the employee had agreed to the deferred payments. The Wage Act does not contain any exception allowing an employee to waive the right to receive wages in a timely fashion. In fact, the Wage Act specifically says that an employer and employee cannot enter a contract that exempts the employer from these requirements. Therefore, the employee’s “voluntary” agreement to allow the company to defer her salary until business improved was void, even if the employee benefited from the delayed payments because the company stayed in business long enough to pay her everything she was owed.

In March 2009, a federal judge agreed that a contract allowing for the deferral of the company president’s wages violated the Wage Act. The president, a co-founder and investor in the startup company, signed an agreement stating that his salary for the first year could be deferred at the discretion of the Board but would be paid before any profits were distributed. *Stanton v. Lighthouse Fin. Servs., Inc.*, 2009 WL 931659 (D. Mass. March 25, 2009). The company did not have any money, and the president received no salary. After fifteen months, the president complained to the Attorney General and then filed suit in federal court. The court found that the payments owed to the president were

“wages” and the deferral provision was unlawful, even though the employer was a startup company, and the president agreed to the deferral of wages.

Vacation

Employers who provide paid vacation to employees are required to treat vacation pay like other wages, paying it when due and paying all earned vacation time at the end of employment. Employees may not forfeit vacation time that has already been earned. For example, the Supreme Judicial Court recently invalidated a vacation policy which granted employees vacation time, but which also included a provision that any vacation time remaining at the time of termination of employment would not be paid to the employee. *Electronic Data Systems Corp. v. Attorney General* (SJC-10260, June 11, 2009). In EDS, the plaintiff sought nearly five weeks of paid vacation time when he was terminated. The employer argued that vacation pay wages were not “due” under its policy, which stated that “vacation time is not earned and does not accrue. If you leave EDS, whether voluntarily or involuntarily, you will not be paid for unused vacation time (unless otherwise required by state law).” The Attorney General (“AG”) contended that once the employee accumulated vacation time, it became “due” under the definition of “wages,” and therefore had to be paid in full on the day of the employee’s discharge. The SJC recognized that on the one hand, the policy

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said that “vacation time is not earned”; on the other hand, the policy stated that employees were entitled to vacation pay based on the number of years they had worked. Citing the AG’s Advisory 99/1 regarding vacation pay, the Court agreed with the AG that vacation time granted to the employee on a yearly basis was “earned” and was therefore “wages,” and that the employer could not require employees to forfeit unused vacation time upon discharge.

Because employers are not required to provide vacation time at all, they may change vacation accrual policies prospectively. In order to reduce past vacation balances, which could result in large deficits if the business ultimately fails, employers may, with adequate notice, institute “use it or lose it” policies and may even accommodate a workplace shutdown for a short period of time through the use of paid vacations. However, if an employer interferes with an employee’s ability to take earned vacation time, the employer must pay the value of that time.

Sick/Personal Time

Absent an express agreement, an employee is not entitled to recover compensation for unpaid personal or sick time under the Wage Act. However, if an employer institutes a Paid Time Off system,

allowing employees to take time off for any permissible reason from one bank of time, they should clearly state how much time will be allocated to vacation time to be paid out upon termination of employment. Ambiguities in a personnel policy regarding unused vacation time will be construed against an employer.

Commissions

As stated above, for commissions to qualify under the Wage Act, they must be “due and payable” and “definitely determined.” In 2007, the Massachusetts Appeals Court disagreed with earlier decisions which had engrafted other conditions on the payment of commissions under the Wage Act. As a result, it is now clear that commissions must be paid even if the employee also receives a “healthy” or substantial base salary. Commissions must be paid even if they were contingent on the happening of an event, as long as that event occurred and the amount owed is “arithmetically determinable.” And, commissions must be paid even if the employee does not fit the notion of a traditional commissioned employee who relies on commissions as a significant portion of weekly income.

On the other hand, commissions relating to “deals in the pipeline” are generally not considered “definitely determined” or “due and payable” and are

“Where bonuses are explicitly discretionary or based on subjective criteria regarding profitability, performance, or individual contributions, however, they are not ‘wages’ and fall outside the scope of the Wage Act.”



not subject to the Wage Act. Moreover, where an employer, in a written compensation plan, retains the sole and absolute discretion to make final and binding adjustments to booking values on sales by its commissioned employees, the employer does not violate the Wage Act

for making such adjustments or capping commissions owed, even if the adjustments result in a substantial decrease to an employee's compensation.

Bonuses

In this era of belt-tightening, bonuses are likely to be first on the chopping block. "Bonus" payments are not specifically mentioned in the Wage Act. However, if the bonus is actually a temporary increase in salary, it would be covered by the Wage Act. And, if the bonus has the earmarks of a commission (such as being paid on a periodic basis based on certain records and according to a certain formula), then it would likely be covered by the Wage Act. Where bonuses are explicitly discretionary or based on subjective criteria regarding profitability, performance, or individual contributions, however, they are not "wages" and fall outside the scope of the Wage Act.

Incentive Payments

Some forms of incentive compensation or performance rewards are more like a commission, due and payable when earned. Others are more like a discretionary bonus. To minimize the possibility of such payments being considered "wages," employers should have clear written policies that give them absolute discretion to set conditions and deadlines for eligibility, to cap or adjust amounts, and to pay at intervals convenient to the employer.

Contingent Salary Arrangements

When it is clear between the employer and employee that compensation for services will be irregular and subject to contingencies (for example, the receipt of grants or other funding), the Wage Act may not apply. A recent case involved a Term Sheet signed by an employer and employee fourteen months into an employment relationship. The Term Sheet was backdated to the beginning of employment, and set the employee's compensation at "\$240,000 per year, payable semi-monthly in arrears at the same time other payroll is paid [which] may be deferred indefinitely if cash is not available; however, deferred compensation must be paid before any profit distributions are made." A Superior Court judge decided that the compensation structure was conditional and contingent and also included equity participation and profit-sharing components; thus, the Wage Act did not apply. The court refused to extend the Wage Act's "protections and [] special remedies" to the employee. More recently, however, the Stanton case noted above has called into question whether the deferral of any wage pending profitability of the company is valid under the Wage Act, and any such arrangement deserves close attention.

Stock Option Plans

Employee stock purchase plans generally are not covered by the Wage Act. This point was confirmed in January 2009, when the Massachusetts Supreme

Judicial Court ("SJC") responded to a question posed by the United States District Court about whether the Wage Act governed an employee stock plan which required workers who quit or were fired to surrender all unvested company stock. *Weems v. Citigroup, Inc.*, 453 Mass. 147 (2009). Under the employer's program, a portion of the employees' cash compensation was deducted and used to purchase stock. Before some of their stock vested, the employees voluntarily terminated their employment. They argued that the plan violated the Wage Act because when they forfeited their unvested stock, they also were required to forfeit the underlying portion of their earned wages which had been used to purchase the stock. The SJC decided that the Wage Act did not apply because the payroll program was voluntary, its benefits were not illusory, and the participants had effectively requested in writing that a designated percentage of their earned wages be used to purchase company stocks.

Severance Pay

Despite the staggering number of layoffs being reported in the media, many employers are still able to offer at least modest severance pay to their former employees. In some cases, severance pay is required by employment agreements signed at the beginning of employment. In the leading case on the issue of severance, *Prozinski v. Northeast Real Estate Servs. LLC*, the

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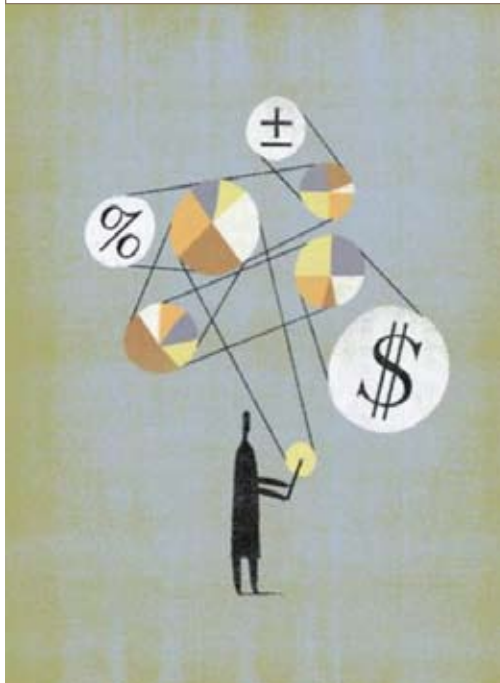
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employee argued that his employment offer letter required the employer to pay him severance pay as part of his wage package. 50 Mass. App. Ct. 599 (2003). The Appeals Court disagreed on the grounds that severance pay was not “earned,” but was contingent upon the employee being terminated. In a different case, where an employment agreement required three months’ notice of an employee’s termination, during which time she would be paid her regular salary and benefits, the compensation due under the three-month notice period was found not to constitute “earned wages” under the Wage Act because the employee did not perform any work during those months. It is now generally recognized that severance pay is not a “wage” under the Act because it is a contractual obligation which does not depend upon any work being performed.

Payments to High Wage Earners

The Wage Act governs wages owed to all employees, regardless of where they fall on the pay scale. Thus, even highly-paid executive and professional employees may seek damages under the Wage Act for nonpayment of their ordinary base wages or wage equivalents. In an interesting twist, some of those same highly-paid executives (the president, treasurer, or other officer or agent with

responsibility for management of the corporation) could also be personally liable under the Wage Act for failing to pay wages because they are deemed to be the “employer” under the statute. Their designation as employer calls into question their standing to bring a claim under the Wage Act in their own right for compensation.



At least one Superior Court judge has commented, however, that “it does not necessarily follow that a person cannot be both an employer and an employee” for purposes of the Wage Act. The Court reasoned that the Wage

Act purports to protect all employees from the unreasonable detention of their salary and should not bar an employee from recovering unpaid wages, even if, under some circumstances, that employee could also incur personal liability for failing to timely pay other employees. *Kohli v. RES Eng’g., Inc.*, 2000 WL -1876605 (Mass. Super., Memorandum of Decision on Motion to Dismiss, December 19, 2000). Moreover, the *Stanton* case recently confirmed that the co-founder of a startup company was an “employee” under the Wage Act, noting that “an individual may be an employer vis-à-vis subordinates and an employee vis-à-vis superiors.” Although the Massachusetts appellate courts have not yet decided this issue, a careful employer will treat all salary attributable to an officer or manager’s work as an employee as wages, to be paid timely and in full.

Payments to Independent Contractors

In situations where payments are owed to bona fide independent contractors, those payments fall outside the scope of the Wage Act, which governs only payments to employees. However, there is a heavy presumption in Massachusetts that workers who provide services to employers are employees, not independent contractors. All arrangements with independent contractors should be reviewed

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Stephanie Scruggs Named Hanify & King Shareholder

periodically to ensure compliance with the Independent Contractor Law.

Consequences of Failure to Pay

Under current law, failure to pay amounts due to employees under the Wage Act can lead to civil and criminal penalties, injunctive relief, and attorneys' fees, as well as personal liability for the president, treasurer, and any officers or agents who manage the company. Moreover, as of July 2008, failure to pay wages to an employee when due (whether or not as the result of an honest mistake) now carries the automatic penalty of triple damages. The lesson is clear: when money is already tight, it is critical for employers to pay "wages" to employees and former employees in a timely manner, even where more vocal creditors are clamoring for attention. ●

Karen Whitley is a shareholder in the firm, where she leads the firm's Employment Law group. Ms. Whitley defends employers in court and arbitration settings and counsels them on compliance with federal and state employment laws. Ms. Whitley can be reached at kaw@hanify.com.

We are pleased to announce that attorney Stephanie Scruggs has been named a firm shareholder. Scruggs is an accomplished intellectual property attorney practicing in the firm's Washington, D.C. office. She joined the firm as an associate in April 2008 when the firm's Washington D.C. practice was founded.

"Stephanie is a rising star at Hanify & King and we are pleased to announce her promotion to shareholder," said Jim King, founder and shareholder of Hanify & King. "Stephanie's hard work, dedication and undeniable smarts have been an asset to the firm since she joined us more than a year ago. We know all that she has to offer and are confident that she will continue to provide Hanify & King clients with superior service and unmatched expertise."

Scruggs represents clients in a variety of intellectual property matters. She is primarily focused on patent litigation, patent prosecution, and product clearance and patent validity opinions, but also has extensive experience in trademark prosecution and counseling, patent licensing, and due diligence associated with IP transfers. She represents both U.S. and foreign-based clients in a variety of industries including the chemical, biochemical, pharmaceutical, medical devices and mechanical arenas.

Scruggs regularly appears before the U.S. Patent and Trademark Office Board of Patent Appeals and Interferences. In addition, she has been involved with intellectual property cases in the Federal Courts in Virginia, Massachusetts and Delaware, and the International Trade Commission.

Prior to law, Scruggs consulted for major global process industry clients in project system capital effectiveness and project feasibility evaluations for projects ranging from \$500,000 to \$2 billion. Clients included Fortune 500 companies in the pharmaceutical, chemical, consumer products, petroleum and heavy industrial arenas. Scruggs also conducted research on biological warfare agents and biosensors with the Naval Research Laboratories in Washington, D.C. She has co-authored numerous articles on biosensors, silane stability and array photopatterning.

Scruggs holds a Bachelor of Science and Master of Science in Chemical Engineering from the University of Mississippi and Virginia Polytechnic Institute and State University, respectively. She received her Juris Doctor from George Mason University School of Law. She resides in Vienna, Virginia with her husband and three daughters. ●

Partner's Letter



“In anticipation of this projected increase in litigation activity, companies should take steps to ensure that they have sufficient risk management strategies in place to avoid being caught flat-footed when the litigation tidal wave hits.”

Michael R. Perry is a Shareholder in the firm's litigation department. His practice focuses on the trial of business disputes involving professional liability, healthcare, class action and environmental issues. Mr. Perry can be reached at mrp@hanify.com.

Although the full extent of the damage from the recent economic downturn has not yet been measured, one thing appears certain—the prolonged recession will lead to a significant increase in litigation over the course of next several years. The Fifth Annual Litigation Trends Survey issued by Fulbright & Jaworski indicates that, although new case filings and enforcement actions were down in the past two years—17 percent of U.S. companies surveyed stayed litigation free in 2006-2007 and 21 percent stayed litigation free in 2007-2008—this trend is not expected to continue in the coming year. Indeed, between, 2007 and 2008, 29 percent of firms with annual revenue in excess of a billion dollars were served with more than fifty new lawsuits. Forty-three percent of those in the same bracket anticipate that, in the coming year, there will be a significant increase in litigation. Moreover, in-house counsel anticipating a decrease in legal disputes involving their companies next year, are outnumbered by their counterparts believing the opposite, four-to-one.

In anticipation of this projected increase in litigation activity, companies should take steps to ensure that they have sufficient risk management strategies in place to avoid being caught flat-footed when the litigation tidal wave hits. Nowhere is this prevention strategy more important than in the employer/employee context. Increased economic pressure often results in increased tension between employees and their employers. As a result, companies need to make sure that they are complying with all applicable state and federal employment laws and regulations when engaging in any employee layoffs or terminations. Companies also need to be intimately familiar with laws governing issues such as unemployment benefits, continuing healthcare benefits, the negotiation of severance agreements and unpaid vacation time. Hanify & King recently issued an Employment Law Alert to its clients notifying them of changes to the Family Medical Leave Act (FMLA) as well as changes to COBRA regulations resulting from the enactment of the American Recovery and Reinvestment Act of 2009. (See the Firm News tab at www.hanify.com). In addition, members of our employment law group are available to conduct internal audits to ensure that companies are in full compliance with all applicable employment laws, and are always on-call in the event that clients have any questions regarding this important, and sometimes confusing, area of the law. In these trying economic times, an ounce of prevention can lead to a significant decrease in expensive and avoidable lawsuits. ●

Personal Information Protection

by Karen A. Whitley, Esq.

Our Employment Law group continues to monitor developments under the Massachusetts Standards for the Protection of Personal Information of Residents of the Commonwealth, 201 CMR 17.00, commonly known as the new “privacy regulations.” The privacy regulations, which supplement the identity theft laws passed in 2007 (Mass. G.L.c. 93H and 93I), are slated to take effect on January 1, 2010. The regulations require individuals, businesses, and governmental agencies to use certain safeguards when collecting, maintaining, transmitting, disposing of, or destroying records (electronic or paper or otherwise) that contain personal information of Massachusetts residents. Personal information is a combination of a person’s name and a Social Security number, bank account number, or credit card number. The regulations apply to all entities conducting business in Massachusetts, regardless of their size.

“In situations where personal information might have been compromised, Hanify & King’s lawyers are available to help employers determine the appropriate course of action, and will guide employers through the required steps of notifying affected individuals and various governmental agencies.”



Even though the regulations were initially publicized more than one year ago, and chapter 93H and 93I were passed into law two years ago, many clients have not yet begun the work necessary to ensure that they are compliant. For example, many companies have not yet surveyed the information they have to determine where and how they hold “personal information,” whether they adequately protect that information (particularly when stored on portable devices or transmitted wirelessly or on public networks), and what they do with the information once they no longer need it.

Under the regulations, every person who stores personal information must have a Written Information Secu-

urity Program (WISP). The WISP should include certain administrative, technical, and physical safeguards that will be used to keep personal information safe, secure, and confidential. Although a WISP will be different for each company, it should include the following:

- designation of an employee to maintain the WISP;
- guidelines for evaluating and addressing reasonably foreseeable internal and external risks to security;
- security policies applicable to current and former employees;
- appropriate disciplinary measures for violations;

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Personal Information Protection

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- method for verifying that third-party service providers also protect personal information;
- limits on the amount of personal information that is collected and maintained;
- other reasonable procedures or restrictions, depending upon the needs and size of the business; and
- documenting any security breaches and responsive actions.

It is also a good time to draft or update other related policies, such as document or email retention policies, confidentiality policies, and policies governing employees' use of company

property, including laptops and Blackberries. In situations where personal information might have been compromised, Hanify & King's lawyers are available to help employers determine the appropriate course of action, and will guide employers through the required steps of notifying affected individuals and various governmental agencies. ●

For more information about the new privacy regulations or for assisting in drafting a WISP or implementing other compliance measures, please contact Karen A. Whitley, Esq., kaw@hanify.com.

“Personal information is a combination of a person's name and a Social Security number, bank account number, or credit card number. The regulations apply to all entities conducting business in Massachusetts, regardless of their size.”



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