2015 Insights

Skadden

A collection of commentaries on the critical legal issues in the year ahead.

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2014 represented a record year for the equity and high-yield markets, and, with tempered expectations, the outlook remains positive. Innovative financing structures continue to evolve and are expected to receive significant attention in 2015. New rules, trading platforms and approaches to research reports all are impacting the markets in the United Kingdom, China and Germany, respectively.

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US IPO Market Review and Outlook: Can the Pace Continue?

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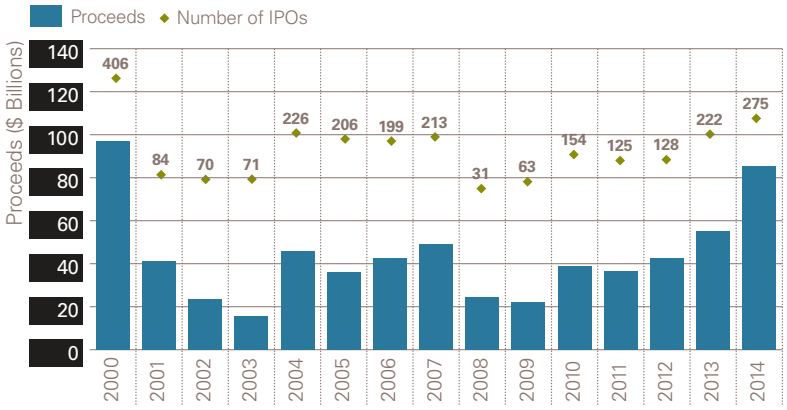
The 2014 U.S. initial public offering market was the most active for new issues since 2000. The market began to recover from the recession in 2010 and took off in 2013 with 222 offerings raising an aggregate of $55 billion,[1] and the pace accelerated in 2014 with 275 offerings raising $85 billion. U.S. listings in 2014 led the global IPO market, with initial listings of companies on U.S. stock exchanges generating approximately 37 percent of IPO proceeds raised globally and accounting for approximately 73 percent of all offerings.

U.S. IPO activity was fueled by pent-up supply, a strong M&A market and favorable valuations on stock exchanges. The outlook for 2015 appears positive as fundamental U.S. economic indicators remain strong, the M&A market continues to be robust, returns from IPOs in 2014 have been attractive and market valuations remain healthy. Given the strength of the M&A market and solid market valuations, we expect to continue to see the trend of companies pursuing dual-track processes, in which a private company simultaneously pursues an IPO and a sale of the company to a strategic or financial buyer, as a strategy to maximize valuations. However, the pace of IPOs may slow due to rising interest rates expected in 2015, low energy prices and large inflows into venture capital funds that are investing in later-stage private companies.

US IPO Activity



Adapted from data reported in Renaissance Capital's *US IPO Market 2014 Annual Review*

Health Care and Technology Lead Activity by Industry

The health care and technology industries led the U.S. IPO market in 2014, as low interest rates drove investors to seek returns in new issues in sectors with opportunities for significant growth. Health care companies were the most active issuers, with 102 health care companies representing 37 percent of all U.S. IPOs and raising an aggregate of approximately $9.2 billion of proceeds. This was driven in part by a boom in biotech company IPOs. However, average proceeds raised per offering in the second half of the year versus the first declined significantly, signaling that investors' appetite for health care new issues may be waning.

With the $25 billion Alibaba IPO, technology companies raised the most proceeds, an aggregate of $32.3 billion through 55 offerings. Venture capital investments in nascent technology companies continued in 2014 and may lead to further IPO exits in 2015.

Excluding the Alibaba IPO, financial companies led the field by proceeds, raising an aggregate of $18.6 billion through 36 offerings, including the financial information provider Markit, which raised almost $1.3 billion in its June IPO.

Foreign-Issuer Listings on US Exchanges Continue to Grow

The ability to access global investment capital and stronger equity markets appears to have made U.S. listings more attractive to foreign companies in recent years, reversing a trend where foreign securities exchanges were considered more attractive. U.S. exchanges led the global IPO market — NASDAQ by number of IPOs and the NYSE by capital raised — in 2014. According to a study by E&Y, U.S. exchanges attracted 52 percent of the cross-border listings in 2014 (including 26 from Europe, 16 from China and 12 from Israel), and 80 percent by capital raised.

Representing this trend, Alibaba, China's largest e-commerce company, went public in September 2014 through a listing on the New York Stock Exchange. Alibaba also set a new global record for the largest IPO by raising approximately $25 billion of proceeds through its initial listing on the NYSE. Alibaba's stock has performed well since its IPO; at year-end, it was up 53 percent from its IPO price.

The flexibility offered to "emerging growth companies" under the JOBS Act, including the deferral of the auditor attestation report required by Section 404(b) of the Sarbanes-Oxley Act, may make a U.S. listing more attractive to foreign private companies. Interestingly, Alibaba chose to list on the NYSE rather than in Hong Kong in order to preserve its founders' ability to hold super-voting stock and maintain control after offering a majority of the company's equity to the public.

Financial Sponsor-Backed IPOs Drive Increase in Volume

In 2013, private equity and venture capital firms began to take advantage of stronger equity markets and attractive valuations in order to exit their pre-recession investments through IPOs. This trend continued in 2014 and drove a significant portion of the increase in the volume and number of offerings as compared to 2013. Private equity-backed IPOs accounted for 26 percent of offerings and 29 percent of proceeds in 2014. IPOs backed by venture capital firms accounted for 46 percent of offerings and 41 percent of proceeds in 2014. We expect this trend to continue. *The Wall Street Journal* reported that venture capital firms raised $33 billion in 2014, a 62 percent increase over 2013 and the highest total since 2007.

While IPOs remain an attractive option, the volume of VC-backed IPOs in 2015 may not match the last three years, as the robust private placement market may allow private companies to delay their IPOs. In 2014, Uber, Xiaomi and many other companies were able to raise significant amounts of capital in the private institutional markets. The recent trend of company insiders able to cash out a portion of their investments through these private placements also is reducing the pressure on private companies to go public sooner. As a result, private companies may grow without the scrutiny and expense of being a public company, and this may make them a more attractive merger or IPO candidate in the future.

Energy IPOs Utilize MLP Structure

Energy companies represented approximately $12.7 billion (15 percent) of the proceeds raised and 30 of the IPOs (11 percent) in the U.S. market this year. Use of the master limited partnership (MLP) structure, in which an entity that generates income from qualifying natural resource activities can be publicly traded and not be subject to federal income taxes at the entity level, has become a prevalent strategy for a number of energy companies. In 2014, energy companies employing the MLP strategy raised almost $6 billion of gross proceeds in IPOs. Among alternative energy companies, an emerging IPO strategy is the yieldco structure, in which an entity owns and may acquire contracted generation and thermal infrastructure assets that do not qualify for pass-through tax treatment applicable to the MLP structure. (See "'Yieldcos' Present a New Growth Model for Renewable Energy Companies.")

Although energy IPOs attracted investor interest in 2014, the steep drop in oil prices that began in late 2014 may make new issues in the energy sector less attractive in 2015. In addition, dividend payments at certain MLPs are dropping so companies can preserve cash, which may hurt companies' ability to access capital in a rising interest rate environment.

REIT IPO Outlook Uncertain for 2015

Although the number and proceeds raised by REIT IPOs in 2014 did not match 2013 levels, the $2.3 billion IPO of Paramount Group, an office building landlord, in November 2014 set a new record for the largest U.S. REIT IPO. With over $1.7 trillion in commercial real estate debt maturing between 2014 through 2018, according to Trepp, and traditional banks reducing their lending to the real estate market, nonbank financial institutions such as mortgage REITs have been filling the void. However, whether mortgage REITs will be able to access the capital markets in order to meet this demand remains to be seen. As investors expect interest rates to rise later in 2015, new-issue REITs may confront challenging markets in the second half of the year.

Although U.S. economic fundamentals remain strong, it will be difficult for 2015 to match the record U.S. IPO volumes of 2014.

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[1] Unless otherwise noted, the source of all quantitative data is from the US IPO Market 2014 Annual Review of \Renaissance Capital (a manager of IPO-focused ETFs). All offering statistics include IPOs with a market cap of at least $50 million and exclude closed-end funds and SPACs.

The US High-Yield Market: Balancing Risk and Return in 2015

Contributing Partner

Michelle Gasaway / Los Angeles

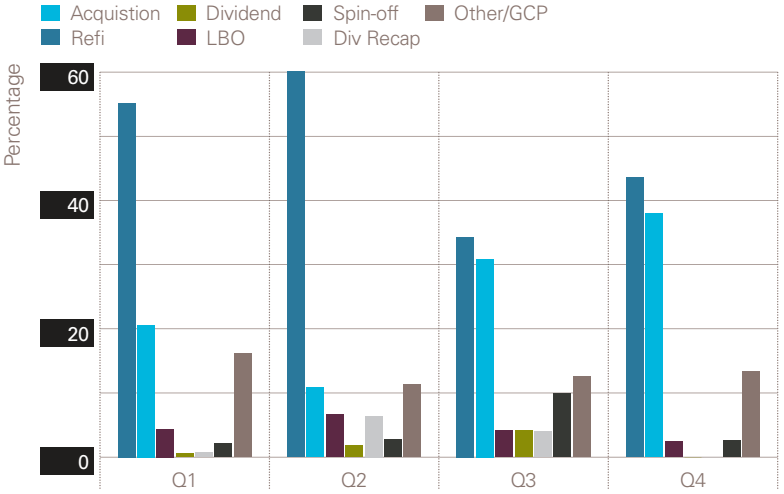
The U.S. high-yield market delivered the third strongest year by volume in 2014, with more than $310 billion of primary issuances,[1] thanks in large part to the most active year in the M&A market since before the financial crisis. (See "M&A Activity Jumps to Levels Unseen Since Before Global Financial Crisis.") With promising predictions for M&A in 2015 and several other key drivers of volume in place (including higher yields relative to other asset classes, a strengthening U.S. economy and low default rates generally), the overall outlook for the 2015 high-yield market is positive.

However, investor expectations are tempered because of increased risk and volatility at a time when returns are near record lows. Declines in high-yield bond prices in the second half of 2014 as a result of concerns about higher risk — from both issuer-favorable bond terms and the market impact of geopolitical and macroeconomic factors, in particular the effect of falling oil prices on energy companies — were a reminder that the high-yield market, which has remained robust for several years, is not immune to volatility. Although the market in general rebounded relatively quickly, underscoring the desire for higher-yielding investments, the continued strength of the high-yield market depends on investors' ability to maintain the right balance between risk and return to find opportunities in the face of increased volatility.

Key Trends and Outlook for 2015

Acquisition Financings. A reflection of the strong M&A market, acquisition financings represented an increased portion of high-yield offerings in 2014, a trend likely to continue in 2015. Of 2014 deal volume, close to 30 percent funded acquisitions (including LBOs), with a greater portion of this activity in the second half of the year. Refinancings made up only around 40 percent of 2014 deal volume, in comparison to more than 50 percent in 2013.

Use of Proceeds



Source: Debtwire Analytics

Energy Companies. Energy companies comprised the largest proportion of high-yield issuances by sector in 2014 and represent the second-highest share of the market overall behind media and telecom, at more than 15 percent.

Factors that negatively affected this industry, such as falling oil prices and operational cash concerns, also negatively affected the high-yield market. In particular, hard-hit exploration and production and oilfield services companies were some of the principal contributors to the decline in high-yield prices at the end of 2014 and represented a significant portion of the pulled deals for that period. Although the high-yield market as a whole has largely stabilized from the declines (and some sectors, such as consumer retail, may benefit from the decrease in oil prices), the overall outlook for energy-sector high-yield remains recessionary if oil prices remain low. However, increased M&A activity and solid asset coverage may create some opportunities in the sector in 2015, particularly for issuers with strong corporate fundamentals and more diverse energy exposure, including integrated energy companies, and for issuers seeking additional liquidity, including through second-lien deals.

High-Yield Lite. Bond issuers continued to enjoy low coupons and issuer-friendly terms in 2014, with "high-yield lite" bonds accounting for an increasingly greater portion of issuances. A covenant package typically is considered to be "high-yield lite" if it lacks either a debt incurrence covenant or a restricted payments covenant, or both (although high-yield lite deals often also lack other traditional high-yield covenants and have investment-grade style redemption provisions). According to Moody's, credit quality reached a record-low level at the end of 2014 as a result of lower-rated credits going to market with weaker covenant packages, including high-yield lite structures which accounted for almost half of the issuances in September and October. Historically issued by "fallen angels" — high-yield issuers that were previously investment grade — or by issuers on the cusp of being investment grade, high-yield lite bonds are now frequently issued by first-time high-yield issuers with ratings well below investment grade. High-yield lite is unlikely to disappear in 2015; however, it may become more difficult for companies that do not have strong credits, or historic high-yield lite or investment grade bonds, to depart from traditional high-yield covenant packages to the extent seen in 2014.

Shortened Tenor and Noncall Periods. The weighted average maturity of high-yield issuances has steadily declined over the past two years, reaching a low of around seven years in the first quarter before ending 2014 at slightly above eight years. Increased issuances of five-year and eight-year bonds helped drive the decline in the average. The issuer-favorable trend of the shortened "noncall" period also continued in 2014. Although issuers in the past often paid for this flexibility with a higher first-call premium of 75 percent of the coupon, many issuers in 2014 were able to get the best of both worlds — a shorter noncall period with the traditional 50 percent of the coupon first-call premium.

Heightened Risk and Volatility. In July, Federal Reserve Chair Janet Yellen cautioned investors regarding heightened risks in lower-rated corporate debt. The returns on high-yield bonds (and the spread to U.S. treasuries) are near record lows, with little cushion to protect investors from increased volatility and risk. Meanwhile, the historic demand for high-yield bonds has led to more risk in the market, with more issuer-friendly provisions, including high-yield lite terms and shortened noncall periods, and more speculative issuances, in both use of proceeds and issuer credit quality. As issuers continued to push for increased covenant flexibility, traditionally European high-yield terms — such as a "portable" change-of-control feature and market capitalization-based dividend baskets — began to appear in a few, more aggressive deals; and prior trends of leverage or asset-based restricted payments and debt incurrence baskets continued. In addition, geopolitical risks, broader global economic factors and macroeconomic factors in the U.S. — including a potential rise in interest rates and the impact of sustained low oil prices on the energy sector — could negatively impact bond prices and increase issuer borrowing costs, which may lower demand in 2015.

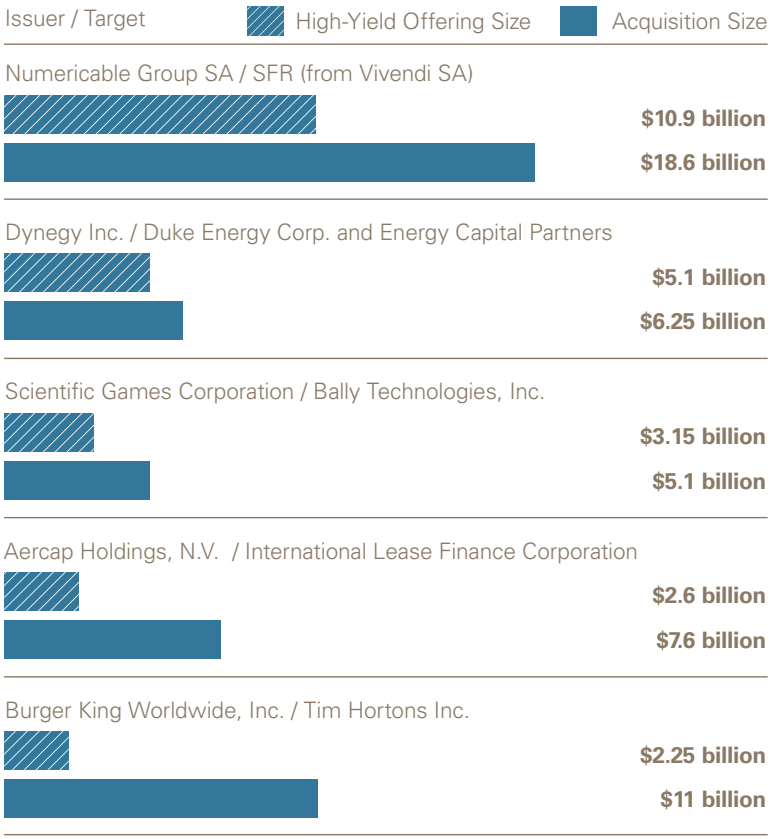
Leveraged Lending Guidelines. What impact the leveraged lending guidelines will have on the high-yield market, including whether there will be an increase in bond-for-loan refinancings in 2015, also remains to be seen. Although the guidelines apply to loans rather than bonds,

with the increased Federal Reserve attention on lower-rated corporate debt generally and difficulties in placing some very highly leveraged bond deals, it is not clear that high-yield bonds will fill the gap for deals with leverage in excess of the amount permitted by the guidelines.

Focus on Credit Quality and Liquidity. As a result of increased risk and volatility, investors may be more selective in 2015. Higher-rated issuers, strong sponsor-owned companies and healthy strategic acquirers should fare best as investors focus on key credit fundamentals, such as leverage, cash flows and credit-enhancing uses of proceeds. Repeat issuers that are able to place larger deals also likely will be in demand as investors seek increased liquidity and flexibility to reduce exposure to macroeconomic factors. The demand by investors for credit quality and liquidity also may contribute to increased M&A activity financed by investment-grade bonds. In contrast, smaller issuers and those with weak corporate or industry-sector fundamentals, aggressive structures or more speculative uses of proceeds may face greater difficulty issuing new debt than in prior years.

[1] Volume and other statistical data discussed in this article are based on information provided by HighYieldBond.com, Thomson Reuters and the Debtwire High Yield Database.

Notable High-Yield Acquisition Financings of 2014



For more on this topic see skadden.com/insights

European High-Yield Market Looks Strong Coming Off Record Year

Investor enthusiasm in Europe for high-yield bonds reached a peak in July 2014, followed by a quiet August and September before the market returned, driven by M&A activity. Despite an inconsistent year, European high-yield bonds set a new annual value record, topping the €70 billion record set in 2013 with €72 billion of issuances in 2014.

The market for 2015 appears promising. The anticipated continuation of M&A activity has generated a strong pipeline, and we expect issuers with outstanding debt to continue to take advantage of low yields to refinance their debt so long as market conditions remain strong.

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New Listing Rules for Premium-Listed UK Companies: The Fine Line Between Upholding Majority Rule and Protecting Minority Rights

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The protection of minority shareholders in companies with a premium listing on the London Stock Exchange came to the fore in the United Kingdom following the 2012 and 2013 publication of consultation papers on the effectiveness of theU.K. listing regime, largely in response to market pressure to improve protections for minority shareholders. The Financial Conduct Authority (FCA) introduced a number of Listing Rule changes in PS14/8, which became effective May 16, 2014. The requirements aim to ensure that premium-listed companies with a controlling shareholder are capable of, and are seen to be, acting independently of their controlling shareholders and their affiliates.

The new rules add an additional layer of scrutiny to the relationship between controlling shareholders and premium-listed issuers without opening the door to the risk of minority rule. Noteworthy changes include enhanced eligibility and relationship agreement requirements, the dual-voting mechanism for the election of independent directors and more rigorous oversight measures.

A Company With a "Controlling Shareholder" Should Be Distinguished From a "Controlled Company"

The definition of "controlling shareholder" now includes the interests of any persons with whom the individual is "acting in concert" (a concept borrowed from the U.K. Takeover Code) when determining whether the shareholder in question owns or controls 30 percent or more of the voting rights in the issuer. This is a lower threshold than that provided in the definition of "controlled company" for NYSE- or NASDAQ-listed companies, which sets the bar at over 50 percent of the voting power for the election of directors.

Applicants Must Comply With Enhanced Eligibility Requirements Regarding Carrying on an Independent Business

The new rules enhance the existing requirement that an applicant for a premium listing is carrying on an independent business as its main activity. The FCA has provided a non-exhaustive list of factors that indicate when this requirement may not be satisfied, many of which reference the company's relationship with its controlling shareholder(s). For example, if a new applicant cannot demonstrate that it has access to financing other than from a controlling shareholder (or the controlling shareholder's affiliates), it is unlikely that the FCA would be satisfied that the new applicant has met the "independent business" eligibility requirement.

Controlling Shareholders Must Enter Into a Relationship Agreement With the Company

Premium-listed companies with a controlling shareholder must enter into a legally binding "relationship agreement" that includes the following three undertakings:

1. Transactions and arrangements between the issuer and the controlling shareholder will be conducted at arm's length and on normal commercial terms;
2. The controlling shareholder will not take any action that would prevent the issuer from complying with its obligations under the Listing Rules; and
3. The controlling shareholder will not propose or procure the proposal of a shareholder's resolution that is intended or appears to be intended to circumvent the proper application of the Listing Rules.

The FCA has indicated that the aim of such agreements is to prevent "inappropriate relationships" from developing. Issuers with a controlling shareholder must include a statement in their annual reports confirming that they have entered into the required agreements, the extent of each party's compliance and explanations for any noncompliance. This echoes the "comply or explain" obligations imposed on premium-listed companies with regard to the U.K. Corporate Governance Code.

Election Procedure for Independent Directors

Under the new rules, where a premium-listed company has a controlling shareholder, resolutions to elect or re-elect independent directors will require the approval of (1) the majority of shareholders as a whole, and (2) the majority of independent shareholders. This requirement can be fulfilled with a single vote per shareholder on a single resolution, provided the votes of the independent shareholders can be identified. Issuers must ensure that their constitutions permit dual approval, but the FCA has helpfully confirmed that constitutions need not positively provide for it; rather, it is enough that they do not prohibit it.

Additional information about independent directors (including information regarding their existing or previous relationships and transactions or arrangements with controlling shareholders) must be provided in a circular accompanying any notice for their election or re-election.

Noncompliance Triggers Enhanced Oversight Measures

In the event an issuer with a controlling shareholder fails to adhere to the above rules, independent shareholders will be given the power to vote on (and veto) all transactions between the issuer and the controlling shareholder, regardless of size and whether they are in the ordinary course of business. These "enhanced minority protections" will remain in place until the issuer's board is able to make a unanimous statement of compliance in its annual report.

Overall Impact on Premium-Listed Issuers With a Controlling Shareholder

Given that the new rules are binding rather than principles-based, at first blush they appear to bring the U.K. one step closer to a "regulator-led" approach — a tagline more often used to describe the U.S. approach to securities regulation. Yet, in substance, the U.K.'s additional requirements on companies with controlling shareholders are in stark contrast to the corporate governance exemptions available to "controlled companies" listed in the United States. While issuers and applicants with controlling shareholders will need to bear in mind the above procedural requirements (which should not be too onerous for issuers to implement), ultimately, the new rules protect minority interests without substantively curtailing voting and other rights of controlling shareholders; hence, the principle of majority rule remains intact.

Insider Trading Laws Complicate the Distribution of Research Reports in German IPOs

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Under German law, the preparation and distribution of predeal research reports — a common practice for German initial public offerings — raises certain insider trading law issues that recently have changed the manner in which analyst presentations are prepared and published. These reports typically are distributed to institutional investors following a press release by the issuer announcing its IPO (a so-called intention to float or ITF).

German Securities Trading Act

Pursuant to Section 12 of the German Securities Trading Act (GSTA), so-called "insider securities" are securities that, among other features, are admitted to trading on a German stock exchange. Under Section 12, securities will be deemed admitted to trading on a German stock exchange if the application for such admission or inclusion has been made or publicly announced.

Whether or not an ITF triggers a public announcement within the meaning of Section 12, which goes beyond European law requirements in this area, may depend on the wording of the specific ITF. In most cases, however, the ITF will be interpreted as the "announcement" of the contemplated IPO and stock exchange listing, which means that the German insider trading laws may apply as of the date of its publication.

Additionally, Section 13 of the GSTA provides that "inside information" is any specific information relating to one or more issuers of insider securities that is not publicly available, or to the insider securities themselves, which, if publicly known, would likely have a significant effect on the stock exchange or market price of the insider security.

Application to Analyst Presentations and Research Reports

Under these definitions, an analyst presentation, if not made publicly available, could constitute inside information within the meaning of the GSTA. This would prevent the recipient of such information — and the recipient of research reports prepared on the basis of this information — from (1) making use of the information to acquire or dispose of insider securities for its own account or for the account or on behalf of a third party, (2) disclosing or making the information available to a third party without the authority to do so, or (3) recommending on the basis of such information that a third party acquire or dispose of insider securities, or otherwise inducing a third party to do so (Section 14 of the GSTA).

Consequently, if the ITF were to constitute a public announcement within the meaning of Section 12, the distribution of the research reports, which generally occurs immediately after the publication of the ITF, would happen when the shares in the IPO already qualify as insider securities. In this case, information contained in the research reports, including the valuation developed by the research analyst, could constitute inside information with the consequences set forth in Section 14 of the GSTA. The same issue presents itself, irrespective of the ITF and the analysis of Section 12, in re-IPO transactions in which the shares to be offered or other securities of the issuer (or potentially of its parent or another affiliate), such as high-yield debt, already are trading on a regulated or unregulated market.

Publishing Analyst Presentations to Avoid Insider Trading Violations

As a result of the foregoing, and depending on the structure of the transaction and capital markets history of the issuer involved, it has become market practice in Germany — especially in re-IPO transactions or other transactions in which securities of an issuer or its parent trade on an exchange prior to the IPO — to make the information in the analyst presentation publicly available before research reports are distributed by the syndicate banks. Such publication avoids potential concerns about selective disclosure and provides syndicate banks involved in German IPOs with the ability to rely on the safe harbor set forth in Section 13, which provides that a valuation prepared exclusively on the basis of publicly available information is, in and of itself, not inside information, even if it could significantly influence the price of insider securities.

In practice, the contents of an analyst presentation can be made publicly available in two ways. First, the issuer can post the presentation in its entirety on the issuer's website. This approach may be particularly advisable in re-IPOs or other transactions for which an increased concern exists regarding selective disclosure of the valuation, forecasts or other material information contained in the related research report. Alternatively, the issuer may decide to structure its website so that all substantive information about the issuer contained in the analyst presentation (but not the analyst presentation as such) is made available and easily accessible. Regardless of which approach the issuer follows, to avoid insider trading concerns, the issuer should ensure that the public is informed of the fact that new substantive information about the issuer is available and where the information may be found, *e.g.*, by specific reference to its webpage in an official announcement or in the ITF.

In order to avoid potential securities laws liability, an analyst presentation for a German IPO should contain information that is substantially consistent with the information that will be contained in the subsequently published IPO prospectus. That concept is not new. However, the fact that analyst presentations (or their material content) need to be made publicly available at the time the issuer announces the intention to go public to avoid insider trading violations subjects analyst presentations to significant additional scrutiny, adding complexity and liability concerns to the overall IPO process.

Outlook

The new EU Regulation on Market Abuse (which will apply beginning in mid-2016) should clarify the applicable legal framework — specifically, by requiring that the respective insider trading laws only apply to issuers of previously nonlisted securities if and when a formal request for admission to trade securities on a regulated market has been made, and not upon a mere informal announcement of a future listing in an ITF. When that happens, it will be an important step toward further harmonizing European capital markets laws and practice.

The fact that analyst presentations need to be made publicly available at the time the issuer announces the intention to go public adds complexity and liability concerns to the IPO process.

Shanghai-HK Connect Opens Possibilities for Companies Looking to Tap Chinese Investor Demand

Contributing Partner

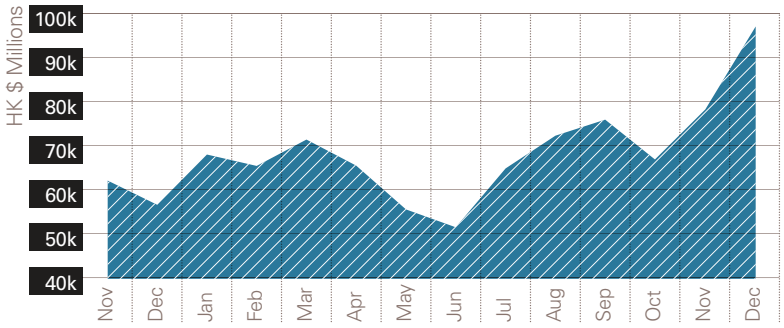
Christopher W. Betts / Hong Kong

November 17, 2014, marked the first day of trading under the Shanghai-Hong Kong Stock Connect, a mutual market access platform that effectively opens the Hong Kong market to mainland Chinese investors. The Shanghai-HK Connect enables mainland Chinese investors to trade in securities listed on the Hong Kong Stock Exchange (HKEx) in renminbi (RMB) through broker members of the Shanghai Stock Exchange (SSE), and Hong Kong investors to trade in securities listed on the SSE through their HKEx brokers. Although it is in its infancy, the Shanghai-HK Connect is an important step in the liberalization of China's capital markets and adds to the appeal of Hong Kong as a listing venue for companies looking to tap Chinese investor demand.

A modest rise in trading volumes on the Hong Kong exchange from mid-2014 lows had been broadly attributed to the impending commencement of the platform, with valuations of Shanghai-listed companies generally much higher than those of Hong Kong-listed companies and the platform potentially leading to a narrowing of that gap. Even more pronounced has been the rise in the average daily turnover on the SSE, from a low of US$9.7 billion in May 2014 to US$40 billion in November 2014.

Average Daily Turnover on the HKEx

(November 2013 through December 2014)



Source: HKEx

At least initially, the scope of the Shanghai-HK Connect has limitations. Mainland Chinese, or "southbound," investors are only able to invest in constituent stocks of the Hang Seng Composite LargeCap Index, the Hang Seng Composite MidCap Index, and the H shares of any other PRC-incorporated companies that have corresponding listed A shares in Shanghai — a sum total of approximately 270 companies that together represent approximately 82 percent of the HKEx's total market capitalization and 78 percent of average daily turnover. Companies that only have a secondary listing on the HKEx, namely companies with a primary listing on an exchange outside China and Hong Kong, are one notable group excluded from the platform. Hong Kong, or "northbound," investors are able to trade in the shares of 568 SSE-listed companies that represent approximately 90 percent of the SSE's total market capitalization and 80 percent of average daily turnover.

The platform does not extend to subscribing for shares in initial public offerings, which are often perceived as higher-risk, so companies listing on the HKEx will need to wait until they qualify for one of the applicable Hang Seng indices to benefit from the platform. Chinese investors also are unable to short sell or engage in margin financing or stock borrowing or lending. In line with China's

tight foreign currency controls, an initial cap of RMB250 billion exists on the net amount of HKEx-listed securities that may be purchased under the program by mainland Chinese investors (together with a daily net purchase cap of RMB10.5 billion), as well as a corresponding RMB300 billion aggregate quota on the purchase of Shanghai-listed securities by Hong Kong investors. The RMB250 billion aggregate cap, just over US$40 billion, is equivalent to roughly one week's turnover on the HKEx — although as sales are netted off against purchases the cap is not necessarily indicative of the overall level of turnover generated by the platform.

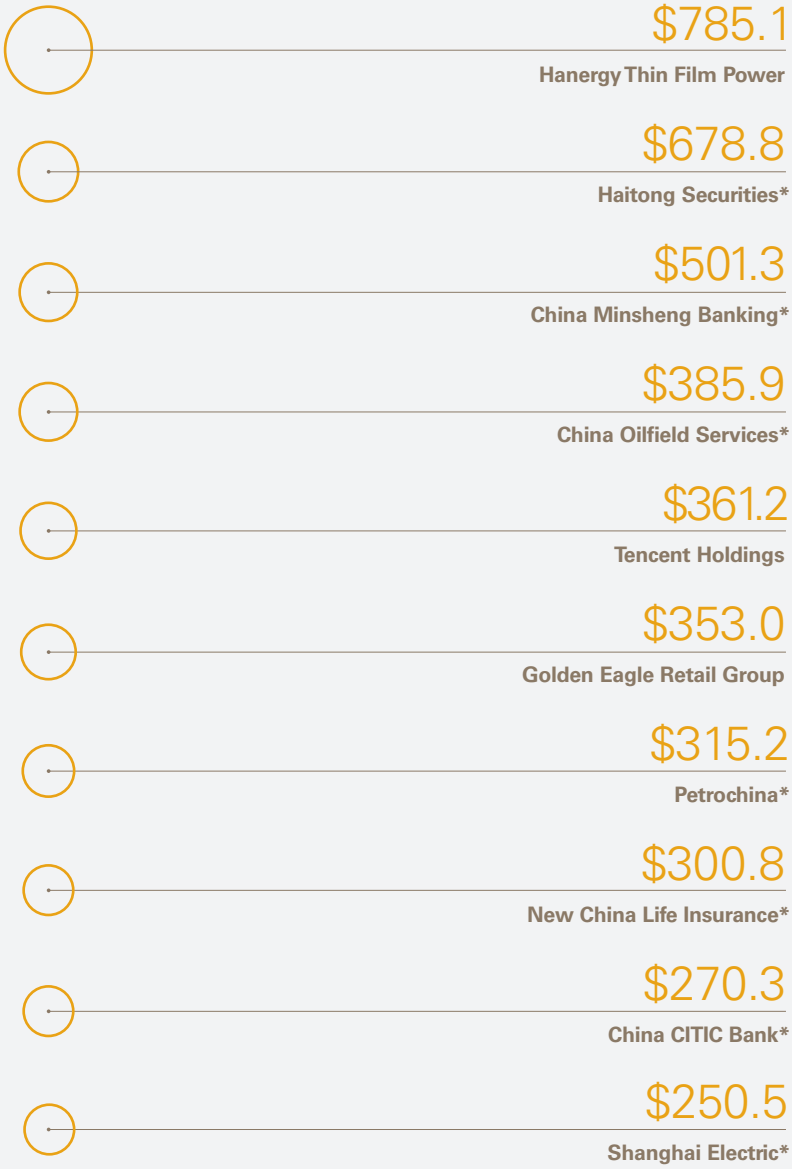
Additionally, both northbound and southbound investors need to comply with the securities laws governing the markets in which they are trading, including the applicable disclosure requirements of those markets. The Securities and Futures Commission of Hong Kong and the China Securities Regulatory Commission have entered into a memorandum of understanding to strengthen cooperation on enforcement matters that provides, among other things, for the sharing of information and data about potential or suspected wrongdoing. Non-Chinese investors seeking to use the program to trade in SSE-listed securities must, therefore, ensure that they familiarize themselves with applicable requirements.

By the beginning of 2015, shares in 268 HKEx-listed entities had been traded by southbound investors, with the most heavily traded shares a mix of the HKEx's largest constituent stocks and state-owned companies with H shares trading at significant discounts to their SSE-listed A shares. Counter to the expectations of many who anticipated the HKEx's lower valuations to be of primary appeal, net northbound purchases of SSE-listed shares by Hong Kong investors have significantly exceeded net southbound purchases. As of December 26, 2014, roughly one-quarter of the RMB300 billion net purchase quota for northbound trades had been used, compared to only RMB10.5 billion of the net purchase quota for southbound trades.

If the Shanghai-HK Connect is successful in its initial pilot phase, both sides have publicly indicated that the platform may be broadened in terms of the quotas, markets and securities covered. However, no timetable has yet been set for any broadening of the platform.

Top 10 HKEx-listed Companies Acquired by "Southbound" Investors

(As of January 2, 2015, by Net Purchase Value and in HK$ millions)



*represents dual-listed company that also had SSE-listed A shares

Source: HKEx

'Yieldcos' Present a New Growth Model for Renewable Energy Companies

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In the past few years, many energy companies with investments in renewable energy projects have considered forming "yieldcos," with five formations in 2013 and 2014. A yieldco is a growth-focused public company, typically formed by a public sponsor to hold long-term operating assets that generate low-risk cash flows in the form of dividends for stakeholders, and a cost-effective financing option for the owners of the renewable energy assets. Yieldcos also provide an investment opportunity similar to master limited partnerships (MLPs), combining predictable and growth-oriented cash flows with favorable tax treatment for investors.

A Pure-Play Public Investment Vehicle

Assets are typically only put into the yieldco at a point in their lifecycle when their development presents limited risk. This allows investors to make a pure-play investment in operating energy assets through a highly liquid security. In addition, yieldcos generally are designed to provide an ongoing inflow of additional assets from the sponsor via a right of first offer or call rights on projects in the sponsor's development pipeline, which can result in further dividend growth potential over time.

Adopting a Hybrid Approach That Parallels MLPs

As the popularity of yieldcos has grown, the transaction structures have become more complex. The first yieldcos utilized relatively simple two-tier corporate structures that passed to investors distributable cash received by a yieldco from its operating subsidiaries. Over time, companies began to seek an incentive compensation structure that would provide upside potential to the sponsor, similar to the incentive distribution rights that historically were specific to MLPs.

Incentive rights are one of the more prominent features of MLPs, providing for an increasing percentage of distributions to be paid to the sponsor as the total distributions achieve specified thresholds. As the total distributions increase, the percentage paid to the sponsor increases, up to a ceiling of a 50-50 split between public holders and the sponsor. In exchange for this benefit, MLPs typically have a subordination mechanism, which provides that, for a specified period of time, public holders receive distributions on the public units before the sponsor receives payment on its units. As a result, to the extent quarterly distributions do not meet minimum quarterly distribution thresholds, the subordinated units held by the sponsor will not receive distributions.

Incorporating these structures into the yieldco model creates complexities because of both the differing tax treatment afforded to yieldcos, in that yieldcos do not benefit from the specific tax exemption afforded to MLPs, and the unique attributes of the projects in renewable energy portfolios, which often can make it difficult to fully adopt the MLP construct. These attributes differ from company to company and can include, among other things, consent requirements under power purchase agreements or from regulatory authorities, change-of-control provisions in certain agreements at the projects, and limitations on distributions and other restrictions in project financing arrangements, all of which can restrict a yieldco's ability to replicate the capital structure of traditional MLPs as well as the securitization of incentive distribution rights. In addition, introducing

public holders into a historically sponsor-driven structure presents several other challenges, particularly with respect to the grandfathering of historical management and operational services provided by the sponsor, and credit support provided by the sponsor to project entities, which requires a balance between maintaining efficiency and functionality while accommodating the interests of a broad group of public investors.

The First Yieldco to Successfully Incorporate the MLP Incentive Structure

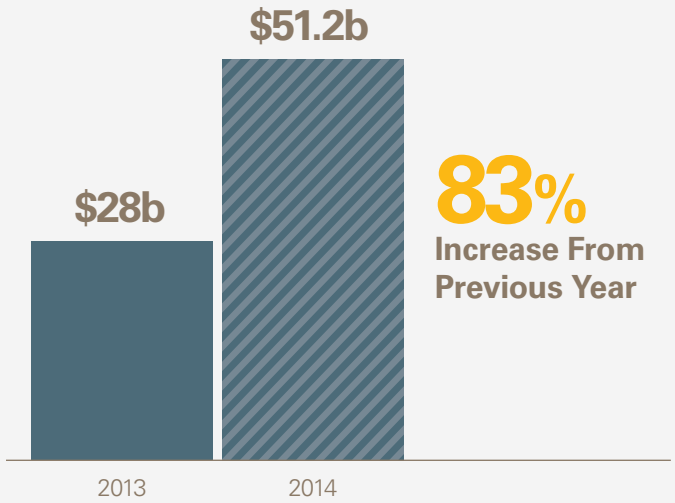
The first public offering to successfully incorporate the MLP incentive structure within the existing yieldco model was the initial public offering of NextEra Energy Partners in July 2014. This transaction was an example of the need for a customized approach to balance commercial aspirations against the reality of an existing and sometimes inflexible operational structure. Using a two-tier limited partnership framework, NextEra formed a structure that achieved the incentive and subordination economics of MLPs via intricate and interdependent contractual arrangements among various sponsor entities. Importantly, the structure also followed the operational construct of other yieldco vehicles, including a right of first offer for the sponsor's developmental pipeline with ongoing management, as well as operational and credit support provided by the sponsor. Several subsequent transactions have followed a similar hybrid approach, and we expect that yieldcos will continue to be a point of interest for established players within the energy space. Ultimately, yieldcos may make a substantial contribution to the development of the U.S. renewable energy infrastructure.

For more on this topic see skadden.com/insights

Acquisition Financings: European Certain Funds vs. US Limited Conditionality

There has been a steadily increasing trend of European borrowers with little or no specific business in the U.S. raising financing under so-called "Yankee loans" — where the credit facility is syndicated to U.S. investors, is governed by New York law, and has typical U.S.-style incurrence covenants and few, or no, financial covenants. In terms of volume, European borrowers raised in excess of $28 billion in 2013 under such loans, which was an increase of over 30 percent from 2012; that figure nearly doubled in 2014, totaling $51.2 billion.

Annual Volume of Yankee Loans



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Corporate Restructuring

Corporate Chapter 11 filings were relatively low in 2014, but the environment in which financially distressed companies operate continues to change. In the coming year, rulings on everything from cramdowns and credit bidding to fiduciary duties in insolvency situations will impact parties to corporate restructurings. Meanwhile Chapter 11 itself could be due for an overhaul following an American Bankruptcy Institute report on proposed reforms.

Only 17 large public companies filed Chapter 11 cases in 2014

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A Chancery court decision reinforces business judgment rule protections for business strategy decisions — even risky ones — that are designed to maximize value

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The burden debtors need to meet to cram down their secured creditors has lessened in the wake of *MPM Silicones*

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A recent ruling provides comfort to foreign investors that the proceeds of their indirect investments in U.S. companies may be outside the reach of bankruptcy trustees

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Significant Ruling Gives Chapter 11 Debtors New Leverage Over Secured Creditors

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The Bankruptcy Code's so-called "cramdown" statute provides debtors with a significant tool that can be used to impose a reorganization plan upon recalcitrant secured lenders, subject to fulfillment of certain requirements. In particular, Section 1129(b) of the Bankruptcy Code allows a bankruptcy court to approve a debtor's reorganization plan over the objections of a secured creditor so long as the plan is "fair and equitable" to the creditor. A debtor can meet the "fair and equitable" requirement if the plan allows a secured creditor to retain its lien on the assets securing its allowed claim and affords the creditor deferred cash payments with a present value totaling at least the value of those assets. The relevant inquiry is what present value interest rate should be applied to the deferred stream of payments in order to ensure that the creditor's claim will be satisfied in full.

A hotly contested Chapter 11 case in the Bankruptcy Court for the Southern District of New York, *In re MPM Silicones LLC, et al.*, Case No. 14-22503-rdd (Bankr. S.D.N.Y. Aug. 26, 2014), has the potential to change the dynamics between debtors and secured creditors in cramdown situations, with the court's decision on the relevant interest rate lessening the burden debtors must meet to restructure secured obligations.

Calculating Cramdown Rate of Interest Under *Till*

Prior to the Supreme Court decision in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), courts varied in their approaches to determining the appropriate rate of interest for a cramdown loan. Some applied the market rate of interest that would provide the secured lender with the interest rate that it could have obtained had it foreclosed on the collateral and reinvested the proceeds. Others considered either the contract rate in existence between the parties, the cost the lender would incur to obtain the cash equivalent of the collateral or the prevailing rate of interest if an efficient market existed.

The Supreme Court rejected these varied approaches in *Till* and held that a "formula" approach was the appropriate metric. Under this approach, the interest rate is calculated using a riskless base rate plus a percentage risk adjustment to reflect the risk of the debtor's nonpayment of its obligation. According to the *Till* court, this risk adjustment will usually be 1-3 percent, depending on the debtor's circumstances, the nature of the security and the length of the payment. However, because *Till* was decided under Chapter 13 of the Bankruptcy Code, which applies only to individuals and not corporations, the Supreme Court noted in a footnote that "when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce." By distinguishing a Chapter 13 cramdown situation from one in Chapter 11, the Supreme Court seemingly left the door open for courts to adopt other approaches in the Chapter 11 context, if they found that an efficient market existed.

Following the *Till* decision, many courts have adopted a two-step approach to determining whether proposed cramdown treatments meet the fair and equitable test in the Chapter 11 context. The first step considers whether an efficient market for the loan exists, and if so, what interest rate would apply. If no efficient market exists, most courts apply the *Till* formula. As a practical matter, however, regardless of whether one or two steps are required in any given case, and with few exceptions, most post-*Till* courts approve Chapter 11 cramdown rates that do not stray far from the *Till* model of the prime rate plus a risk adjustment of 1-3 percent.

MPM Silicones: A Variation of *Till's* Formula Approach in Chapter 11

In the *MPM Silicones* case, the Bankruptcy Court for the Southern District of New York ruled that the *Till* formula approach applies in Chapter 11 cases, without the need to first answer whether an efficient market exists. Judge Robert D. Drain allowed the debtors to use the Treasury rate, rather than prime, as the base rate for the reorganized notes issued under the plan, noting that the Treasury rate is often used as the base rate for longer-term corporate debt instruments such as the reorganized notes. In recognition of the lack of risk and profit found in the Treasury rate given that the United States government is the obligor, he required the debtors to factor in a modest incremental increase to the risk premium. Judge Drain found that the risk premiums on the replacement notes under the debtors' plan, which fell within the 1-3 percent range, were adequate, based in significant part on the likely prospect of repayment given the significant deleveraging, equity infusion and equity cushion.

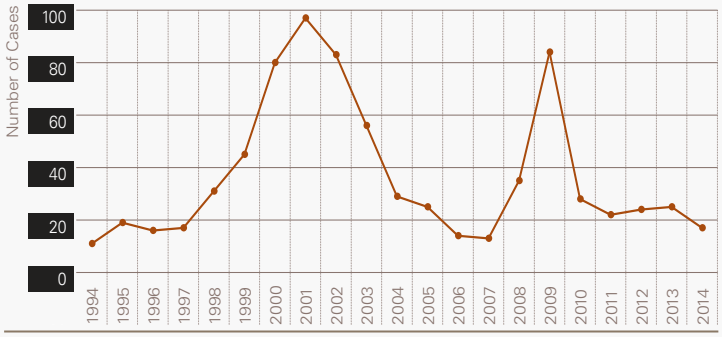
Depending on the jurisdiction, the applicability of the *Till* formula in Chapter 11 cases may still be unsettled. As noted, however, regardless of the method employed for calculating cramdown interest rates, courts typically approve cramdown payments that fall within the same range as prime plus 1-3 percent. At least in Judge Drain's courtroom, and likely in the Second Circuit generally, the formula approach seems to be the standard. In the wake of *MPM Silicones*, it appears that debtors can comply with the *Till* formula by using not only the prime rate but the Treasury rate as well. The net result is a lessening of the burden Chapter 11 debtors need to meet to cram down their secured objecting creditors.

For more on this topic see skadden.com/insights

Trends in Chapter 11 Filings, Venue and Proposed Reforms

Corporate Chapter 11 filings remained relatively low in 2014, down slightly from 2013, due to a robust capital market environment, low interest rates and easy access to financing. These and other factors allowed highly leveraged borrowers that might otherwise have been Chapter 11 restructuring candidates to refinance or pursue other nonjudicial restructuring alternatives. Among those companies that filed corporate bankruptcies, the District of Delaware and the Southern District of New York continued to capture the lion's share of cases. An examination of available statistics for Chapter 11 filings reveals that these dynamics are consistent with trends which span several years.

Large Public Company Chapter 11 Filing Volume Over Time*



*Data is derived from the UCLA-LoPucki Bankruptcy Research Database, a database of large public company bankruptcies compiled by professor Lynn LoPucki of UCLA. While public companies account for a fraction of all large Chapter 11 cases, we believe that this data is a reasonable proxy for large Chapter 11 filings as a whole.

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Recent Cases Highlight Potential Pitfalls for Distressed Investors

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Despite lower-than-average Chapter 11 activity in 2014, the legal landscape for distressed investors has continued to evolve, with significant legal developments in credit bidding, make-whole premiums and intercreditor agreements. By staying apprised of the evolving jurisprudence in these areas, distressed investors can mitigate risks that have foiled lenders in recent cases.

Credit Bidding

The credit bid is a key safeguard of secured lenders' rights in a Chapter 11 sale: It allows a lender to bid the debt it is owed in a sale of the debtor's assets, thereby ensuring that the collateral is not sold for an unreasonably low price. However, two 2014 decisions have unsettled the law on credit bidding, suggesting that courts have broad discretion to limit it based on a loose, "for cause" standard.

In *In re Fisker Automotive Holdings, Inc.*, a Delaware bankruptcy court held that a secured lender's credit bid could be limited to the (heavily discounted) price it paid for the secured loan. The court reasoned that unlimited credit bidding would preclude competitive cash bidding, as no one was likely to bid more than the amount of the secured lender's credit bid. The court also noted that the validity of the lender's liens on certain of the debtor's assets was disputed by the unsecured creditors' committee, leaving the amount of the lender's secured claim uncertain (even though the value of the assets underlying the dispute was fairly insignificant relative to the face amount of the secured debt).[1] A few months later, in *In re Free Lance-Star Publishing of Vicksburg, VA*, a bankruptcy judge in the Eastern District of Virginia also found cause to cap the credit bid of a secured lender who engaged in an "overly zealous loan-to-own strategy." The court noted that the secured lender engaged in affirmative "misconduct" intended to suppress interest in the debtor's assets.[2] The implications of *Fisker* and *Free Lance-Star* remain unclear, but the two cases suggest that the pendulum may be shifting toward greater scrutiny of credit bidding, potentially impairing secured lenders' ability to minimize losses in a sale context. At the same time, however, neither case suggests that bankruptcy courts have boundless discretion to limit credit bidding.

Make-Whole Premiums

The enforceability of "make wholes" (*i.e.*, contractual obligations to pay a specified premium if a loan is repaid prior to its stated maturity, which are designed to compensate lenders for the loss of future interest income) has been among the most hotly contested issues in recent bankruptcy cases. In *In re MPM Silicones, LLC (Momentive)*, also in 2014, a bankruptcy court in the Southern District of New York rejected senior lenders' request for allowance of a make-whole premium. Because bankruptcy accelerates a loan, "payment" of a loan in bankruptcy is not a *prepayment* and, presumptively, does not trigger a prepayment premium. If the parties intend a contrary result, they must unambiguously contract for the premium. The *Momentive* court parsed the applicable indentures and concluded that they did not clearly require payment of the make whole upon acceleration.

Although the *Momentive* court rejected the lenders' make-whole claim, the court provided a roadmap to drafting make-whole provisions that are likely to withstand judicial scrutiny in bankruptcy. In brief, the credit documents must clearly

require payment of the make whole upon (1) acceleration or (2) any payment prior to the stated maturity.[3] In other words, the debt document must clearly provide that the prepayment fee is payable if the loan's original maturity date has not yet passed.

Separately, most courts will (at least in the case of a fully secured creditor) enforce unambiguous make-whole provisions on the theory that such premiums are liquidated damages provisions that represent "charges" or "fees," which are allowable to fully secured creditors under Section 506(b) of the Bankruptcy Code. However, if the make whole grossly exceeds the lenders' possible losses, it may be vulnerable to attack as a penalty.[4] Anecdotal evidence suggests that lenders are responding to *Momentive* and similar decisions by drafting make-whole provisions that unambiguously require payment of a premium upon acceleration in bankruptcy. Accordingly, we expect that make-whole litigation increasingly will focus not on contract interpretation, but on the legal enforceability of the make-whole provisions at issue — *e.g.*, whether the premium is so large that it constitutes a penalty.

Intercreditor Agreements

The *Momentive* bankruptcy also highlighted another issue relevant to lenders: the enforceability of intercreditor agreements in bankruptcy. Intercreditor agreements typically contain a plethora of provisions governing the relative rights of senior and junior lenders in bankruptcy and are frequently structured to limit junior creditors' participation in bankruptcy proceedings.

These provisions can generate litigation, as junior lenders often seek to participate actively in bankruptcy despite the provisions. While outcomes are heavily fact-dependent, intercreditor provisions generally are enforced if the language of the agreement clearly proscribes the junior lenders' conduct.[5] Moreover, a trend in the case law has been to interpret agreements unfavorably against a party characterized as engaging in obstructionist behavior.[6]

When the agreement is ambiguous, bankruptcy courts often are reluctant to bar junior lenders' participation. In *Momentive*, for instance, the senior lenders challenged the junior lenders' (1) objection to the senior lenders' make-whole claims and (2) support for a cram-up plan. The court construed the agreement strictly and, because the intercreditor agreement provided for lien subordination and not claim subordination, ruled the agreement did not specifically bar the junior lenders from challenging the senior lien claims. Rather, the court said the agreement merely barred the junior lenders from challenging the senior liens. Accordingly, the court concluded that the junior lenders' actions, which did not put the senior liens in dispute, did not violate the intercreditor agreement. We expect that decisions like Momentive will spur senior lenders to insist on greater precision in drafting intercreditor agreements and to negotiate for claim, rather than lien, subordination.

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[1] *In re Fisker Auto. Holdings, Inc.*, 510 B.R. 55, 59-61 (Bankr. D. Del. 2014).

[2] *In re Free Lance-Star Publ'g Co. of Vicksburg, VA*, 512 B.R. 798, 807 (Bankr. E.D. Va. 2014).

[3] *See* Hearing Transcript at 35:12-35:22, 36:8-36:11, 44:18-44:21, 40:11-40:18, *In re MPM Silicones, LLC*, No. 14-22503 (RDD) (Bankr. S.D.N.Y. Aug. 26, 2014).

[4] *See, e.g.*, *In re Sch. Specialty, Inc.*, No. 13-10125 (KJC), 2013 WL 1838513, at *2-3, 5 (Bankr. D. Del. Apr. 22, 2013); *see also MPM Silicones, supra* note 7, at 46:4-46:8.

[5] *See, e.g.*, *In re Ion Media Networks, Inc.*, 419 B.R. 585, 590, 593-595 (Bankr. S.D.N.Y. 2009).

[6] *See id.* at 587 (noting junior lenders' use of "aggressive bankruptcy litigation tactics" to "earn outsize returns"); *see also In re Erickson Retirement Cmtys., LLC*, 425 B.R. 309, 315-20 (Bankr. N.D. Tex. 2010). *But cf. Boston Generating, LLC*, 440 B.R. 302, 316-20 (Bankr. S.D.N.Y. 2010) (narrowly construing intercreditor to permit participation by junior lenders not "engaging in … obstructionist behavior").

[7] Bench Ruling at 18:21-19:7, *In re MPM Silicones, LLC*, No. 14-08247 (RDD) (Bankr. S.D.N.Y. Oct. 14, 2014).

Delaware Court of Chancery Decision Clarifies Fiduciary Issues in Insolvent Company Context

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The Court of Chancery of Delaware recently issued a noteworthy decision clarifying fiduciary duties and confirming business judgment rule protection for board-level business strategy decisions by directors of insolvent corporations.[1] *Quadrant Structured Products Company v. Vertin*, 102 A.3d 155 (Del. Ch. 2014).

The court's ruling reinforces continued business judgment rule protections for business strategy decisions — even decisions to pursue risky strategies — that are rationally designed to maximize the economic value of an insolvent firm as a whole. The Court of Chancery also ruled the business judgment rule does not protect directors who cause or permit the transfer of insolvent company value preferentially to a controlling stockholder or its affiliate without ratably benefiting all residual claimants (*i.e.*, creditors).

Background

Athilon Capital Corp., a Delaware-incorporated credit derivative product company, sold credit protection to financial institutions. Athilon's operating guidelines restricted its investments to short-term, low-risk securities.

The 2008 financial crisis left Athilon insolvent, and it lost its AAA/Aaa rating. Under Athilon's operating guidelines, its credit rating downgrade forced it into runoff mode.

Subsequently, EBF & Associates purchased all of Athilon's equity and its junior subordinated notes. EBF placed four directors — three of whom were current or former EBF employees — on Athilon's five-director board.

In May 2011, Athilon's board sought and obtained permission from credit rating agencies to amend Athilon's operating guidelines to permit riskier investments. The board thereafter adopted a high-risk investment strategy.

After EBF had gained equity control over Athilon and its board, Quadrant Structured Products Company became a primary creditor of Athilon by acquiring its senior subordinated notes and subordinate notes. In October 2011, Quadrant commenced an action in the Court of Chancery asserting derivative breach of fiduciary duty claims against Athilon's board of directors and EBF.[2]

Quadrant alleged that Athilon's directors breached their fiduciary duties when they (1) failed to defer interest payments made to EBF on "underwater" junior subordinated notes held by EBF, (2) caused Athilon to pay excessive services agreement and software license fees to an EBF affiliate and (3) adopted a high-risk investment strategy for Athilon that benefited EBF rather than winding up and liquidating Athilon's business for the benefit of its creditors including Quadrant.[3] The defendants moved to dismiss Quadrant's complaint for failure to state a claim.

The Court's Decisions

With in-depth discussion of relevant case law on fiduciary duties and corporate insolvency, including the Delaware Supreme Court's *Gheewalla*[4] decision, the Court of Chancery decided that Quadrant's challenges to Athilon's transfers of value to its controlling shareholder EBF and an EBF affiliate stated derivative fiduciary breach claims. However, the court dismissed Quadrant's challenge of

the Athilon board's strategic decision to take on greater business risk (instead of winding up and liquidating Athilon's insolvent business), holding that the business judgment rule applied to strategic decision-making.

High-Risk Investment Strategy Protected by Business Judgment Rule

The Court of Chancery applied the business judgment rule presumption to dismiss Quadrant's asserted claim that the defendants breached their fiduciary duties by amending Athilon's operating guidelines to permit Athilon to make riskier investments when it was insolvent.[5]

Quadrant had argued that, given Athilon's insolvency, its directors should have pursued a wind-down and liquidation for the benefit of its creditors rather than a high-risk investment strategy. Quadrant's rationale was that Athilon's creditors allegedly bore all the risk of failure of the high-risk strategy, while EBF as controlling shareholder and holder of underwater junior subordinated notes would enjoy any upside of the strategy's success.

The Court of Chancery disagreed, explaining that Delaware law "does not require the Board to shut down Athilon's business and manage towards a near-term dissolution for the benefit of creditors. Notwithstanding a company's insolvency, '[t]he directors continue to have the task of attempting to maximize the economic value of the firm.'" The court held that the business judgment rule presumption protected the board's decision to adopt Athilon's high-risk strategy because "when directors make decisions that appear rationally designed to increase the value of the firm as a whole, Delaware courts do not speculate about whether those decisions might benefit some residual claimants more than others."

While Quadrant alleged that the Athilon directors were "acting for the benefit of EBF and contrary to the interests of other stakeholders," that did not sufficiently "call into question the rationality of a riskier investment approach" or support a bad faith inference. Quadrant failed to rebut the business judgment rule presumption because it did not demonstrate Athilon's directors received any "direct and specific benefits" by adopting the risky business strategy.

Accordingly, the Court of Chancery dismissed the claim challenging the board's business strategy decision: "to hold otherwise and treat directors as interested in pursuing a riskier business decision that allegedly benefitted the equity holder such that the standard of review would escalate to entire fairness would be inconsistent with … *Gheewalla* [which] declin[ed] to recognize the existence of fiduciary duties owed directly to creditors."

Nondeferral of Interest Payments and Excessive Fees Paid to Affiliate of Controlling Shareholder

The Court of Chancery held that Quadrant's allegations challenging Athilon's failure to defer interest payments made to EBF, and Athilon's payment of excessive service and license fees to an EBF affiliate, stated derivative breach of fiduciary duty claims against the directors and EBF. The court decided that the challenged payments were actionable because they diverted funds from Athilon to EBF (Athilon's sole shareholder) when Athilon was insolvent and its creditors had become the residual beneficiaries of any increase in Athilon's value.

Citing *Gheewalla*, the court reasoned that when a corporation like Athilon is insolvent, its creditors take the place of its shareholders as the residual beneficiaries of any increase in corporate value. When a corporation is insolvent, "a transfer of value to the sole stockholder does not inure to the ratable benefit of all of the residual claimants … . [but rather] transfers value … owned beneficially and indirectly by all of the residual claimants to the party in control of the corporation."

Accordingly, the court concluded that the business judgment rule presumption did not apply to protect the director defendants, and they therefore had the burden of proving the entire fairness of the challenged payments.

Implications

Quadrant highlights Delaware's business judgment rule protection of rational board-level business strategy decisions that attempt to maximize the economic value of a corporation — even decisions adopting a high-risk business strategy that might benefit controlling shareholders when a corporation is insolvent and creditors have become its residual beneficiaries. The *Quadrant* decision also illustrates litigation risks directors of insolvent corporations face if they permit transactions that transfer value to or for the benefit of a controlling shareholder or its affiliate.

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[1] Delaware has three tiers of review for evaluating director decision-making: the business judgment rule, enhanced scrutiny and entire fairness. Delaware's default standard of review is the "business judgment rule," a principle of nonreview that reflects and promotes the role of the board of directors as the proper body to manage the business and affairs of the corporation. The rule presumes that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Only when a decision lacks any rationally conceivable basis will a court infer bad faith and a breach of duty.

"Entire fairness" is Delaware's most onerous standard of review of director decisions. The entire fairness standard applies when a plaintiff rebuts one or more of the presumptions of the business judgment rule and applies when there is a challenge to a transaction involving self-dealing by a controlling shareholder.

[2] Delaware law imposes fiduciary duties on those who effectively control a corporation.

[3] Quadrant's complaint also asserted fraudulent transfer, waste, constructive dividend and conspiracy claims. The fraudulent transfer and waste claims survived the defendants' motion to dismiss to the extent such claims challenged the nondeferral of interest on EBF's junior subordinated notes and payment to EBF's affiliate of excessive service agreement and license fees.

[4] *North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla,* 930 A.2d 92, 103 (Del. 2007) (holding that creditors may sue directors of insolvent corporations derivatively but not directly).

[5] On October 28, 2014, the court denied Quadrant's motion to reconsider this ruling. *Quadrant Structured Prods. Co. v. Vertin*, No. 6990-VCL (Del. Ch. Oct. 28, 2014).

For more on this topic see skadden.com/insights

Health Care Sector Creates Challenges for Distressed Providers, Opportunities for Others

In the United States, consolidation continues to occur in the hospital and health care services subsector, often involving distressed health care providers. For many distressed providers — often small and midsized hospitals and hospital systems — acquisition by a financially strong counterparty is the only way to survive.

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Ruling on Extraterritoriality May Protect Foreign Investors in US Bankruptcies

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The Bankruptcy Code authorizes a bankruptcy trustee to avoid (*i.e.*, obtain the return of) certain types of prepetition property transfers so that the bankrupt estate can be divided among creditors fairly. For example, a trustee may bring actions to set aside transfers made within a specified period before the bankruptcy (preferences) and transfers made deliberately to defraud creditors (fraudulent transfers). Section 550(a) of the Bankruptcy Code also permits a trustee to "follow the money" to recover the property (or its value) either from the initial transferee who first received the property from the bankrupt party, or from subsequent transferees, so long as there is no double recovery. But how far — and where — can the money be followed? While the Bankruptcy Code's reach with respect to initial transfers remains unsettled,[1] a Southern District of New York opinion rendered in the Madoff bankruptcy provides comfort to foreign investors that the proceeds of their indirect investments in U.S. companies may be outside the reach of bankruptcy or Securities Investor Protection Act (SIPA) trustees.

After Bernard Madoff's multibillion-dollar Ponzi scheme collapsed in December 2008, Irving Picard was appointed trustee pursuant to the SIPA statute to administer the Madoff estate — that is, to recover money and redistribute it to creditors of the estate, namely, Madoff's direct investors. Since December 2008, Picard has filed numerous "clawback" suits seeking to recover initial and subsequent transfers that originated with the Madoff estate. Included in these actions are clawback claims against alleged subsequent transferees located in some 27 countries. A number of these foreign subsequent transferees challenged the trustee's authority to recover allegedly Madoff-originated funds from them, arguing before Judge Jed Rakoff that Section 550(a)(2) of the Bankruptcy Code, which empowers a trustee to recover funds from subsequent transferees, did not apply extraterritorially.

In a July 7, 2014, opinion, Judge Rakoff held that Bankruptcy Code Section 550(a) does not apply extraterritorially to allow for the recovery of subsequent transfers received abroad by a foreign transferee from a foreign transferor (except in cases of actual fraud).[2] In a subsequent transfer case — where debtor funds flow from (1) debtor to initial transferee, then (2) from the initial transferee to a subsequent transferee — the focus is *not* the domestic or foreign character of the initial transfer transaction, Judge Rakoff explained. Rather, the focus is the subsequent transfer itself, with the key inquiry being whether "the relevant transfers and transferees are predominantly foreign." Importantly, the court determined that a "predominantly foreign" transaction may have some U.S. connection, yet remain outside the Bankruptcy Code's reach: "Mere connection to a U.S. debtor, be it tangential or remote, is insufficient" to render an otherwise foreign transaction domestic. According to Judge Rakoff, the fact that a chain of transactions originated with a U.S. debtor, or even that a subsequent transfer was processed through a U.S. correspondent bank, would not, standing alone, be enough to render a transaction domestic and thus within the ambit of the Bankruptcy Code.

Although rendered in the SIPA trustee context, Judge Rakoff's broad-based reasoning and holding that Section 550(a) does not "apply extraterritorially to allow for the recovery of subsequent transfers received abroad by a foreign transferee from a foreign transferor" may have wide application, unless reversed on appeal.[3] The opinion holds, in effect, that a trustee's ability to follow the money only extends to subsequent transfers with a substantial U.S. nexus. Foreign financial market participants can thus take comfort that payments they received abroad from another foreign transferor or financial intermediary will not be upended by a U.S. trustee on allegations that these payments originated in a U.S. bankrupt estate with which the innocent foreign party may not have had any contact. This conclusion applies only to cases not involving fraud and, therefore, does not invite malefactors to make foreign subsequent transfers expecting geography to take tainted transfers beyond the reach of U.S. trustees.

[1] Compare *In re French*, 440 F.3d 145 (4th Cir. 2006) (finding that Bankruptcy Code Section 548 applied extraterritorially to transfer of foreign property) with *In re Midland Euro Corp.*, 347 B.R. 708 (Bankr. C.D. Cal. 2006) (finding precisely to the contrary).

[2] *Sec. Inv. Protection Corp. v. Bernard L. Madoff Inv. Sec., LLC*, 513 B.R. 222 (S.D.N.Y. 2014).

[3] Judge Rakoff's decision is not currently appealable and will not be ripe for appeal until applied by the Bankruptcy Court in pending motions to dismiss.

For more on this topic see skadden.com/insights

A Question of Behavior: Foreign Sovereign Debt Restructuring Before US Courts

The impact of Argentina's prolonged dispute with the holdouts of its defaulted debt continues to reverberate in the context of foreign sovereign debt restructuring.

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M&A/ Governance

Deal volume and total transactions reached their highest levels since before the global financial crisis last year, and, although the pace of the economic recovery varies significantly from region to region, key drivers of M&A activity remain in place heading into 2015. Meanwhile, public company boards continue to face pressure from a variety of areas, including activist shareholders, whose scrutiny shows no signs of slowing. Boards must be prepared to tackle issues ranging from proxy access to risk oversight to board composition to executive compensation.

$17.4 trillion

approximate value of China's state-owned enterprises

page 48

40,000 tracked transactions in 2014 totaling $3.5 trillion

page 32

In 2015, we expect to see more Latin American and international companies looking to build businesses across the region rather than in just a single country.

– **Paul T. Schnell**, Partner, M&A

page 44

>90%

Approval rate from shareholders on a majority of say-on-pay proposals

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M&A Activity Jumps to Levels Unseen Since Before Global Financial Crisis

Contributing Partner

Thomas H. Kennedy / New York

Global M&A activity jumped in 2014, with over 40,000 tracked transactions totaling approximately $3.5 trillion in value.[1] This represents the biggest year for M&A since 2007, the last year before the impact of the global financial crisis was fully felt.

Favorable conditions, such as higher stock price levels, abundant cash resources and availability of acquisition financing at favorable rates, as well as the desire by corporations to find growth opportunities by means other than organic growth, have existed for several years. In 2014, an improved economic environment, combined with financial market support for well-constructed mergers, relatively low market volatility, the absence of significant political or economic shocks, and the momentum effect of an increasingly active M&A cycle, led increasingly confident boards and management teams to move forward with transactions, some of which were long-contemplated. The number of large transactions increased significantly last year, with 95 announced deals over $5 billion, driving $1.25 trillion (36 percent) of global deal value. That compares to 46 deals worth over $5 billion in 2013, comprising $546 billion (23 percent) of total deal value in 2013.

U.S. activity in 2014 — approximately $1.6 trillion — was up over 50 percent from 2013 levels, comprising approximately $1.3 trillion in domestic transactions and approximately $275 billion in U.S.-targeted cross-border activity. Despite a strong dollar, many European companies (especially German) looked to the United States for favorable acquisition opportunities, and inbound investment into the U.S. increased dramatically. In addition to consolidation activities, many large companies, as part of a continuous emphasis on core strategies, executed large divestitures.

Although many European economies remain sluggish, Europe M&A activity grew to approximately $840 billion-$875 billion, up 50 percent from 2013 and representing almost a quarter of the global transaction volume. (See "The Newfound Attractiveness of European M&A.") Cross-border activity involving Europe was an important driver of the 2014 activity, especially earlier in the year when the so-called "inversion" phenomenon (which involves the merger of a U.S. entity with a foreign entity, with domiciliation of the surviving entity in a lower tax jurisdiction) helped drive transactions, especially in the pharmaceutical industry. Fundamental changes in the approach of various industry participants to research and development and global marketing and distribution were significant factors in the drive to consolidate and were aided by the possibility of effecting more favorable fiscal positioning for these companies. (See "Insights Conversations: Life Sciences.")

Activity in Asia amounted to approximately $780 billion and was in large part due to activity involving Chinese state-owned enterprises, which are engaging in internal restructuring activity and are increasingly driven to pursue strategy (including acquisitions) on a global basis. (See "China M&A: Reform Plan Promotes Mixed Ownership of State-Owned Enterprises.") Asian transactions were focused on the consumer and resource sectors.

Other than health care, sectors that experienced significant activity included energy ($579 billion), in part driven by the ramifications of both fundamental industry transformation and the collapse of oil prices; and telecom/media/entertainment (TME) ($472 billion), where consumer demand for mobile and broadband, the resulting need of carriers for additional capacity, and the challenges of rapid market and technological changes in the converging industry drove transactions, albeit oftentimes subject to the restraining influence of regulatory pressures. (See "Antitrust and Competition: Surveying Global M&A Enforcement Trends.")

While M&A activity in the TME sector developed earlier in the U.S. (*e.g.*, Comcast/Time Warner, AT&T/DIRECTV), European activity surged in late 2014 (*e.g.*, BT bid for EE). In addition to transactions classified as TME, other technology M&A soared in 2014. Rapid changes across multiple verticals of the tech sector (*e.g.*, mobile, big data, cloud computing or the "Internet of things") are driving the strategic imperative for companies to align themselves for perceived future trends. Large companies such as Google, Apple, Yahoo, Facebook and Microsoft continue to be active acquirers, in search of user base, intellectual property and talent; and activity in the smaller end of the market also is robust. Certain industries, such as financial companies, lagged significantly, in large part due to the continued pressures brought by regulators.

Private equity transactions amounted to $562 billion, constituting 21.9 percent of global M&A activity. Much of this volume was driven by exit activity in maturing funds. Private equity transactions involving large public companies were somewhat quiet earlier in 2014, in large part due to the ability of corporate acquirers to outbid for desired strategic assets, although the Petsmart, Tibco, Gates Global and Acosta deals showed the ability to accomplish transactions in appropriate circumstances. Overall, levels of private equity M&A transactions for public companies remain below the levels that prevailed in 2006 and 2007.

Strategic Decisionmaking and Impact of Activism. The impact of activism on M&A is profound — the presence of activism is now viewed as an integral part of the corporate landscape and not a passing fad or cyclical phenomenon — with implications for all aspects of the M&A ecosystem. While the philosophical debate on the value of activism continues in the academic arena, corporate boards and senior management teams recognize the tremendously increased clout of activists — who have somewhere between $100 billion and $200 billion under management and participated in over 350 targeted campaigns in 2014 — and are increasingly willing to listen to their ideas. As importantly, boards are attuned to the desire of institutional shareholders and other investors for corporate focus on shareholder value in the near- to medium-term and are in many instances taking proactive steps to achieve increased value even before or without the public appearance of an activist. Activist activity is increasingly targeted at companies that are not actually lagging in financial results or market performance. In addition to capital allocation decisions, including share buybacks, this has led to a continuing number of spin-offs (over 60 announced in 2014) and divestitures, as well as determinations to sell a company when circumstances warrant. In addition, companies with meaningful portfolios of qualifying property are increasingly looking to use REIT strategies to help unlock value. (See "Unlocking Value Through REIT Spin-Offs.")

Hostile Activity; Deal Jumping and Withdrawn Deals. Six unsolicited bids exceeded $20 billion in 2014, all in the pharma or telecom space. While the original hostile bidder was not ultimately successful in many transactions, the use of aggressive techniques continues to be acceptable in the corporate world. Companies have not hesitated to move aggressively on strategic targets — which may have led to a surge in announced but later withdrawn transactions. The dismantling of corporate defenses as a result of institutional shareholder pressure and the positive attitudes of these investors to favorable bids helped propel such activity. In addition, corporate players will intervene in an announced transaction when a desirable acquisition target is engaging in a transaction (*e.g.*, Hillshire Brands, Chiquita). Finally, 2014 saw the withdrawal or termination of almost $800 billion of transactions — roughly one-fifth of announced transactions. Europe experienced an even higher percentage of withdrawn deals, many involving potential inversions. This is indicative of the challenges to successful execution of a transaction, and, as discussed more below, the need for careful planning and execution.

Sales Processes. Two significant themes were reiterated by Delaware courts in 2014 — the need for careful board involvement in M&A decisionmaking and judicial deference to the business judgment of a fully involved and independent board as to how to maximize value. (See "Fee-Shifting, Financial Advisor Liability Among Likely Delaware Law Issues for 2015.") The first theme was prevalent in the Court of Chancery's decision in *In re Rural Metro Corp. Stockholders Litigation*, where, after trial, the court found a financial advisor liable on an aiding and abetting theory for money damages after ruling that various

conflicts of interest existed among the company's management, board and advisers. The case is a stark reminder that attention to conflicts in any transaction is crucial. Both themes were clear in the Delaware Supreme Court's opinion in *C&J Energy Services, Inc. v. City of Miami General Employees' and Sanitation Employees' Retirement Trust*, which confirmed that a disinterested and fully informed board need not shop the company to fulfill its duty to seek to maximize value in a change-of-control transaction. Also, in *In re Family Dollar Stores, Inc. Shareholder Litigation*, the Delaware Court of Chancery reconfirmed that in seeking to obtain the highest value reasonably attainable, boards are not limited to reviewing "headline" price, but can look at factors such as likelihood of consummation. These decisions reaffirm the Delaware courts' deference to well-informed, unconflicted boards that seek to maximize stockholder value.

Regulatory/Compliance. Corporate acquirers remain cognizant that regulatory factors in the U.S., the EU and in other major economies (*e.g.*, China, India, Brazil and Canada) remain a significant obstacle to successful execution of transactions. In addition, social and political factors, including employment and labor relations, industrial policy and national security concerns, must be carefully considered in significant transactions, especially cross-border.

Deal Complexity. With the interplay of activist involvement, aggressive strategic competition in the M&A process and global regulatory issues, completing a significant transaction requires extensive planning, clear articulation of strategy at announcement, broad dialogue with affected constituencies, and constant and vigorous attention to execution.

Prospects

Most of the factors that drove M&A activity in 2014, including board confidence and the fundamental need to find growth opportunities in a world where the pace of economic recovery varies significantly from region to region, continue to exist (the surge in inversion transactions being a notable exception). In the absence of a significant change in the geopolitical or economic landscape, we likely will continue to see a favorable environment for M&A transactions, perhaps in a broader range of industry sectors. That said, acquisition multiples are high, and changes in the economic or financial markets, including a cooling of current investor receptivity to transactions, could change the mood.

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[1] The statistical data used in this discussion is derived from a variety of sources, including reports from Thomson Reuters, Bloomberg and Dealogic, as well as various major news publications. Definitions and computations may vary across these sources, and the data may not be gathered from definitive year-end reports. In many instances, we have rounded or approximated the data.

M&A by the Numbers

Global M&A activity jumped in 2014, with over **40,000 tracked transactions** totaling approximately **$3.5 trillion** in value.

Private equity transactions amounted to **$562 billion**, constituting 21.9 percent of global M&A activity.

Activists participated in **over 350** targeted campaigns.

Six unsolicited bids exceeded **$20 billion**.

Insights Focus: Key Observations for Directors and Senior Executives

Contributing Partners

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Although *Insights* is intended to cover a wide range of issues, there are a number of topics we believe will be of particular interest to directors and senior corporate executives. Below is an introduction to these topics and a link to the *Insights* articles that address them in greater detail.

The Return of M&A

In 2014, an improved economic environment, combined with financial market support for well-constructed mergers, relatively low market volatility, the absence of significant political or economic shocks and the momentum effect of an increasingly active M&A environment, led more confident boards and management teams to move forward with transactions, some long-contemplated.

The use of aggressive techniques, including hostile or unsolicited bids, continues to be acceptable in the corporate world. Companies have not hesitated to move on strategic targets — which may have led to a surge in announced but later withdrawn transactions. The dismantling of corporate defenses as a result of institutional shareholder pressure and the positive attitudes of investors to favorable bids helped propel this activity. In addition, corporate players have shown continued willingness to intervene in an announced transaction when a desirable acquisition target is engaging in a transaction with another party. (See "M&A Activity Jumps to Levels Unseen Since Before Global Financial Crisis.")

Corporate Governance

Activism. For a number of years, the message for directors of U.S. public companies has been that their decisions face greater and greater scrutiny. One of the principal sources of this scrutiny has been investors, including activist investors, governance activists such as state and labor pension funds, mutual funds and other long investors. This trend is part of the paradigm shift from a more deferential, board-centric model of corporate governance for public companies to a more skeptical, shareholder-centric model. (See "US Corporate Governance: Boards of Directors Remain Under the Microscope–Shareholder Activism.")

Impact on M&A. The impact of activism on M&A is profound — its presence is now viewed as an integral part of the corporate landscape. As importantly, boards are attuned to the desire of institutional shareholders and other investors for corporate focus on shareholder value in the near- to medium-term and are in many instances taking proactive steps to achieve increased value even before or without the public appearance of an activist. (See "M&A Activity Jumps to Levels Unseen Since Before Global Financial Crisis–Strategic Decisionmaking and Impact of Activism.")

Shareholder Engagement. The relationship of the board with the shareholder base is changing. With the topic of "shareholder liaison committees" on some institutional investors' agendas, the topic of shareholder engagement is of key importance. (See "US Corporate Governance: Boards of Directors Remain Under the Microscope–Where Do We Go From Here.")

Proxy Access. With the advent of "proxy access," governance activists are on the verge of causing another major change to the framework of director elections.

(See "US Corporate Governance: Boards of Directors Remain Under the Microscope–Governance Activism and Proxy Access.")

Other Governance Issues. Boards will continue to face scrutiny on a number of other governance issues, including compensation policy, diversity and tenure ("board refreshment"). (See "US Corporate Governance: Boards of Directors Remain Under the Microscope–Board Composition" and "Overwhelming Majority of Say-on-Pay Proposals Continue to Garner Support.")

The Role of the Board in the M&A Process. Delaware courts have made it clear that they expect active board involvement and oversight in the M&A process. (See "M&A Activity Jumps to Levels Unseen Since Before Global Financial Crisis–Sales Processes.") A number of other developments, including multiforum litigation in M&A transactions and the possible advent of fee-shifting bylaws requiring unsuccessful stockholder plaintiffs to pay the adversaries' legal fees, may be of interest. (See "Fee-Shifting, Financial Advisor Liability Among Likely Delaware Law Issues for 2015.")

Risk Management

Duty of Oversight. The duty of a board to oversee risk management arises primarily from its fiduciary duty of oversight established under state law. A board should continually assess, monitor and oversee the corporation's risk profile. In addition to cybersecurity (discussed below), areas of focus could include risks in financial markets, including commodities, derivatives or currencies, climate change and privacy issues (including consumer and employee). Fundamentally, risk analysis should focus on risks inherent in the enterprise as well as new external trends or events that could create new risks. (See "US Corporate Governance: Boards of Directors Remain Under the Microscope–Risk Oversight.")

Cybersecurity. One of the key risk issues corporations face is cybersecurity. Five of our partners explore this issue in "Insights Conversations: Cybersecurity."

The Global Government Enforcement Landscape. In the global criminal and regulatory enforcement arena, robust enforcement actions against multinational companies are likely to continue worldwide in 2015. U.S. authorities continue to aggressively pursue cross-border investigations and to scrutinize closely the compliance programs of multinational corporations. Investigative activity by U.S. authorities in 2014 was particularly intense in the areas of market abuse, corrupt practices and bribery, and tax fraud, and that activity is anticipated to extend into 2015, perhaps with an even broader geographical reach. In Europe, Asia and South America, with criminal investigations and prosecutions across multiple areas, regulators are working together to comprehensively target alleged misconduct of global corporations and financial institutions. (See "Robust Action Dominates Global Government Enforcement Landscape.")

US Corporate Governance: Boards of Directors Remain Under the Microscope

Contributing Partner

Marc S. Gerber / Washington, D.C.

For a number of years, the message for directors of U.S. public companies has been that their decisions face greater and greater scrutiny. While some of this enhanced scrutiny has come from federal and state governments, regulators, the press and the courts, one of the principal sources has been investors, including activist investors, governance activists such as state and labor pension funds, mutual funds and other long investors. This trend is part of the paradigm shift from a more deferential, board-centric model of corporate governance for public companies to a more skeptical, shareholder-centric model. Looking to 2015 and beyond, there is every reason to believe that the scrutiny and attendant second-guessing of board action or perceived inaction will continue and intensify.

This scrutiny, second-guessing and the associated campaigns for certain corporate actions by activist investors has engendered debate on the role of the corporation in society, short-termism and whether shareholder activism is a good or bad thing. Laurence D. Fink, CEO of BlackRock, the world's largest asset manager, has expressed the view that strategies pursued by activist investors often destroy jobs and that companies must be free to invest today in order to generate long-term future growth.

Shareholder Activism. Perhaps the largest, most powerful microscope brought to bear on directors is that of activist investors. These investors come armed with financial acumen and detailed data and analyses in their quest to find so-called undervalued companies. Perhaps more important, they bring significant amounts of capital and the ability to invest it in a concentrated fashion. As a result of the returns generated by some activist investors over the years, activist investing is now recognized as its own asset class. The number of activist funds has continued to increase as the protégés of well-known activists set up their own funds, and the level of assets under management by activist funds continues to increase rapidly. As a result, the days of large market-cap companies having some level of immunity from activists are long gone. Over the last few years, activists have launched campaigns at large-cap companies such as Apple, Microsoft, Dow Chemical, P&G and PepsiCo.

The areas in which activist investors are willing to scrutinize and second-guess directors' decisions are wide-ranging. They have criticized companies and agitated for change on matters such as companies' portfolios of businesses, capital allocation policy, operating performance, stock price performance, corporate governance and executive compensation. Moreover, activists will not hesitate to question incumbent management's ability to implement necessary changes in business strategy, both as part of a campaign for board seats and once they are on the board. Nor will they hesitate to question the abilities of boards of directors to oversee management and a company's business strategy.

It is critical to keep in mind that activist investors do not exist in a vacuum. Rather, they have a critical ally in traditional long investors, including many state and local pension funds. This alliance takes many forms, including voting support, direct investments in the activist funds, the sharing of ideas as to underperforming portfolio companies, and sometimes direct and public teaming up. In 2013 the California State Teachers' Retirement System (CalSTRS) paired with Relational Investors to push the Timken Company to separate its steel and ball bearing businesses, and in 2014 CalSTRS publicly supported efforts by Trian Partners to achieve breakups of PepsiCo and DuPont. Finally, a new type of alliance occurred when Pershing Square Capital and Valeant Pharmaceuticals joined forces in connection with Valeant's pursuit of Allergan. Although it is unclear whether we will see additional instances of public companies teaming with

activist funds in connection with the pursuit of acquisition targets, it is a reminder of the myriad alliances that are possible.

Governance Activism and Proxy Access. The hand of activist investors has been strengthened meaningfully by the efforts of some state and local pension funds and other investors to change the framework of director elections and otherwise eliminate so-called anti-takeover protections. For most large-cap companies and a segment of mid-cap companies, governance activists have succeeded in eliminating classified boards and plurality voting, so that directors at these companies are elected to one-year terms and must submit their resignations if not supported by holders of a majority of the shares voting at a stockholders' meeting. In addition, a growing percentage of these companies permit stockholders to call special meetings or to act by written consent in lieu of a meeting, abilities that traditionally have been utilized to attempt to remove directors between annual meetings in order to advance hostile takeovers or activist agendas that boards believed were not in the best interests of stockholders.

Governance activists are on the verge of causing another major change to the framework of director elections, one that has the potential to increase significantly the number of contested elections and provide an easier path to further scrutinize and second-guess directors. "Proxy access" would provide a means for certain stockholders or groups of stockholders to nominate candidates for election to the board and — rather than requiring the stockholders to prepare, file with the SEC and disseminate their own proxy materials — have the stockholder nominees appear in the company's proxy materials, thereby making it easier (and significantly less costly) for a stockholder to contest an election.

There is a developing consensus among investors to support proxy access shareholder proposals — modeled on the SEC rule that was successfully challenged and invalidated on procedural grounds — that provide the access right to holders or groups of holders owning at least 3 percent of a company's shares for at least three years, allowing for the nomination of candidates for 20-25 percent of board seats. In 2014, three-year, 3 percent of shares, one-quarter of the board proxy access shareholder proposals received majority support at Abercrombie & Fitch, Big Lots, Boston Properties, International Game Technology, Nabors Industries and SLM Corp. Also, Nabors and Kilroy Realty adopted three-year, 5 percent proxy access bylaws, and McKesson Corp. agreed to propose a proxy access bylaw at its 2015 annual meeting. In addition, shareholders approved company sponsored proxy access proposals at CenturyLink, Chesapeake Energy, Darden Restaurants and Verizon (implementing shareholder proposals that received majority support in 2012 or 2013).

Seeking to capitalize on this development, the New York City comptroller, on behalf of various New York City pension funds, has submitted three-year, 3 percent, one-quarter of the board proxy access shareholder proposals to 75 companies for consideration at 2015 annual meetings. This campaign, under the banner "The Boardroom Accountability Project," targets companies with perceived issues relating to CEO compensation, board diversity or climate change. CalPERS has indicated that it also may launch a proxy access initiative, and other institutional investors may follow suit. While many of the companies receiving proxy access proposals will include the proposals in their proxy statements and recommend that shareholders vote against proxy access, more than 20 companies had sought to exclude the proposals on the basis that they will be submitting their own proxy access proposals (with different parameters) for stockholder approval. This approach was upended by the recent announcement that the SEC staff has been directed to review the application of the rule on conflicting proposals and would no longer express no-action views under that rule. In any event, over time this campaign is likely to result in a significant increase in the number of companies with some form of proxy access. And, inevitably, stockholders who disagree with a board's judgments will utilize the proxy access mechanism to attempt to translate that disagreement into a change in board composition.

Risk Oversight. Not surprisingly, in a post-financial crisis environment, investors continue to emphasize boards' capabilities to oversee risk management. Further, as governments, companies, universities, individuals and other organizations grapple with the challenges

and vulnerabilities laid bare by cybersecurity breaches, there is continued second-guessing over the role and activities of boards of directors in overseeing these risks. In 2014, certain directors of Duke Energy were the subject of a "vote no" campaign by CalPERS and the New York City comptroller concerning board oversight of risks presented by a coal ash spill earlier that year, and a majority of directors of Target Corporation faced negative Institutional Shareholder Services recommendations as part of the aftermath of a major cybersecurity breach at the company. Although these campaigns and negative recommendations failed to impact the ultimate outcome of the elections, these instances serve as warnings that the perceived failure of a board of directors to properly oversee a company's risk profile and risk management has the potential to impact director elections. In fact, if the New York City comptroller targets companies for proxy access shareholder proposals based on issues such as climate change, there is no reason to believe that companies with perceived gaps in risk oversight might not find themselves with proxy access shareholder proposals sooner rather than later.

Board Composition. Investors continue to question whether boards have the right people on them in order to effectively oversee management. These questions go to expertise, independence and diversity. Activist investors have grown more sophisticated in their selection of nominees, often finding very credible candidates with extensive industry knowledge and experience. The lack of gender and racial diversity on boards was one of the criteria used by the New York City comptroller in selecting companies at which to submit proxy access proposals.

The question of director tenure, and the purported impact of tenure on director independence, is a particularly vexing issue. In some instances, long-tenured directors, especially those who have outlasted multiple CEOs, may be the directors most likely to ask the challenging and insightful questions and bring tremendous industry knowledge to the board discussion. Nevertheless, some investors question whether long-tenured directors may become "too close" to management or the company such that they lose their independent perspective. State Street Global Advisors (SSgA) engaged in a letter writing campaign in 2014 to highlight its focus on this topic. Specifically, SSgA sought greater engagement at companies with average board tenure in excess of 13 years (its calculation of one standard deviation from average tenure) and where one-third or more of the nonmanagement directors had tenures in excess of 16 years (two standard deviations from average tenure). SSgA policy states that it may vote against the nominating/governance committee chair for failure to address board refreshment, long-tenured directors serving on key committees, or members of the nominating/governance committee and long-tenured directors on classified boards. In practice, SSgA reports that many companies engaged with it on the topic of board refreshment such that SSgA voted against few directors under this policy. More recently, governance activist John Chevedden, on behalf of James McRitchie and Myra Young, submitted a stockholder proposal to Costco Wholesale, for consideration at an annual meeting in early 2015, that requests the Costco board adopt a bylaw requiring that at least two-thirds of the board have less than 15 years tenure on the company's board. Although some investors are wary of arbitrary limits that risk the loss of well-qualified directors, the voting results on this proposal will be watched with great interest from all sides of the debate.

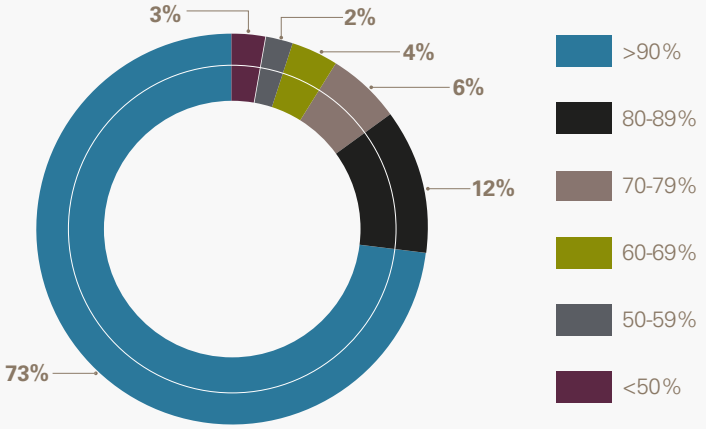
Where Do We Go From Here. In the current environment, it is unlikely that there will be any diminishment in activists and institutional investors second-guessing the decisions and qualifications of public company boards of directors, particularly when a company's stock price fails to keep up with peer companies. Nevertheless, directors can be proactive, asking themselves the same hard questions that investors may ask. Recently, Vanguard, one of the largest fund managers and one of the largest stockholders in many public companies, raised the prospect of board "shareholder liaison committees." Putting aside the question of whether yet another board committee is necessary versus having chairmen and lead independent directors form the principal board point of contact for engagement with major stockholders, the underlying premise is valid: Directors ought to understand the questions and views of stockholders. One goal of a robust shareholder engagement effort, spearheaded by management under the direction of the board and incorporating board members when and if appropriate, is to listen to investors and hear their concerns.

Getting that feedback and addressing it before small concerns grow into broader investor dissatisfaction with a board can be critical to establishing board credibility with institutional investors. Moreover, viewing their companies through the eyes of investors, including activist investors, is one way to best prepare for — and perhaps even pre-empt — some of the second-guessing directors face. Doing so may put the company and management in a better position to respond to suggestions by activists and other shareholders. Companies will be well-served by indicating that the board has already considered the idea raised and rejected it in favor of the company's strategy for credible, articulable reasons or, alternatively, that the company is in the process of implementing changes to address the concerns raised. Scrutiny and second-guessing of boards cannot be eliminated, but robust and vigorous governance processes and shareholder engagement efforts should enable companies to manage those issues as part of the broader governance landscape.

Overwhelming Majority of Say-on-Pay Proposals Continue to Garner Support

2014 Say-on-Pay Proposal Support Levels

(Percentage of Say-on-Pay Proposals Suported by Shareholders)



The overall say-on-pay proportions for 2014 are not substantially different from those in prior years, with the overwhelming majority of companies easily getting majority support on say-on-pay proposals. Despite this seeming status quo, some companies have seen shifts in support of up to 30 percent or more, typically driven by year-over-year changes in proxy advisory firm recommendations.

In November 2014, Skadden's Executive Compensation and Benefits Group published the first edition of its *Compensation Committee Handbook*. The *Handbook* is intended to help compensation committee members understand and comply with the duties imposed upon them and to serve as a useful resource for compensation committee advisers. Although not intended to be an exhaustive compliance resource, the *Handbook* provides helpful insights and brings clarity to an area that has become increasingly complex.

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The Newfound Attractiveness of European M&A

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In 2014, Europe registered its highest levels of M&A deal activity since the financial crisis. Compared to 2013, overall European M&A activity climbed 40.5 percent to $901.4 billion (the highest value since 2008).[1] Inbound M&A, at $320.6 billion, reached a record high by both deal value and deal count since 2001, mostly driven by U.S.-based acquirers (which represented 60.7 percent of the total) and Asian acquirers (with Chinese buyers alone representing 76.2 percent of all of emerging Asia's investment into Europe). Underlining the strength of European companies, outbound M&A surged to its highest level since 2007 (at $365.8 billion, it shot up 190 percent from the previous year), most of it directed toward the U.S. (71 percent of the total, the highest value since 2001). Intra-European cross-border M&A was also extremely strong at $264.5 billion (*i.e.*, more than double the 2013 figure of $131.3 billion). On average, M&A transactions were larger (deal volume was up only 4.8 percent year-on-year) and 10 deals exceeded the $10 billion mark compared to only six in 2013.

The general trend was observed in most of Europe's main markets, including France, the most active European country for M&A ($204.7 billion, the highest value since 2007 and up 327.5 percent over 2013), the United Kingdom ($154.5 billion, up 28.7 percent) and Germany ($73.9 billion). These three countries together represented 45 percent of total European activity in 2014.

Macroeconomic Trends

On a macroeconomic level, the gradual (albeit selective) recovery of European economies and financial markets, after five years of financial, credit, sovereign-debt and monetary crises, spurred increased confidence in the continent's prospects. Stronger M&A activity resumed in Europe under the combined effect of improved financing conditions, high levels of cash reserves on corporate balance sheets and, in private equity and investment funds, rising levels of investment returns, and strong equity market performance that allowed listed corporate buyers to pay all or part of their public takeovers in stock. In addition, the volume of capital available to U.S. corporations, one of the most significant groups of investors in Europe, increased substantially, and their willingness to deploy such capital grew in large part as a result of an improved U.S. economy.

The study of some of the major announced or completed transactions, and the motives underlying them, reveals a mix of opportunistic and deeper-seated reasons for the renewed vitality of European M&A in 2014.

Key Differentiating Factors Driving European M&A

High-Quality Assets. During the financial crisis, European companies were forced to reorganize their structures, clean up their balance sheets, streamline their activities and focus on their core businesses. As a result, many companies emerged with better asset quality, which made them more attractive to potential buyers, or with increased cash and/or share performance, which facilitated their acquisition strategy. Buyers were prepared to pay the price for such assets: At $365.4 million, the average price paid for European targets was the highest in seven years. Combined with other factors, this helps explain the robust health of European M&As in 2014, as well as a wave of industry consolidations. For example, the pharmaceutical, medical and biotech industry reached an aggregate deal value of $114.9 billion in 2014, including (1) inbound transactions, such as Eli Lilly's purchase of Novartis' animal health business through an asset swap worth $5.4 billion, (2) outbound transactions, such as Merck's $17 billion acquisition of Sigma-Aldrich Corporation, and (3) intra-European transactions,

such as Novartis' announced acquisition of GlaxoSmithKline's vaccines and oncology drug developing division for $14.5 billion.

Fiscal Attractiveness and General Political Stability. One of the main drivers of cross-border M&A activity into Europe in 2014 was the increase of so-called "tax inversions," *i.e.*, in a European context, a combination transaction between a U.S. and a non-U.S. company resulting in the surviving company relocating its corporate headquarters in a European jurisdiction (where it generally enjoys a lower effective tax rate). Twelve inversion transactions were announced globally in the first nine months of 2014 alone, eight of which involved a European target, for a total value of $309 billion (over four times the value for the same period of 2013), including Medtronics' $45.9 billion acquisition of Ireland-based Covidien. Other advantages of most European jurisdictions include their general political stability, the existence of an independent judicial system and general openness to foreign investment. Even the newly introduced French regime on foreign investments, which drew much criticism in connection with General Electric's announced $12.3 billion purchase of Alstom's Thermal & Renewable Power and Grid assets, remains relatively mild compared to the protectionist measures adopted in numerous other markets.

Access to Talent and Technology. Beyond the classic motives underlying strategic growth transactions, such as the desire to expand into new markets, increase revenue, increase market share and/or achieve economies of scale (*e.g.*, the planned merger of French Lafarge with former Swiss rival Holcim worth $39.6 billion, creating a European behemoth in the cement industry), European M&A in 2014 also has been characterized by a search for talent and new technologies. This has been particularly evident in the technology, media and telecommunications industry (TMT), which underwent important global consolidation and took the top spot in Europe with $120.2 billion of M&A deal value in 2014. Relevant examples include Luxembourg-based Altice's $23 billion acquisition of SFR (and $9.2 billion proposed acquisition of Portugal Telecom assets) and Vodafone's $10.1 billion acquisition of Kabel Deutschland, all of which aim to combine a mobile company with a cable or fiber assets operator, allowing the combined entity to compete with operators that are taking a competitive edge by offering quadruple-play (*i.e.*, fixed phone, wireless phone, TV and Internet) solutions to their clients.

European M&A in 2015

Will economic operators be able to build on this momentum to continue the trend into 2015? Inversion transactions from the United States may slow down as a result of recent measures adopted by the U.S. government. Economic recovery remains fragile in a number of European countries, and national governments may continue to protect their sensitive (and, in certain cases, less sensitive) industries from foreign buyers. Geopolitical tensions in certain regions may take their toll on economic and M&A activity if they continue or worsen. This being said, the overall attractiveness of European companies should remain strong in 2015. Global factors, such as the strength and search for external growth of U.S. and Asian players, a prolonged weakness of the euro, or the recent pressure on oil prices, will provide M&A opportunities. Industry consolidations, fueled in part by regulatory efforts to increase convergence, are likely to continue, in particular in the TMT, pharmaceutical, medical and biotech, and industrials sectors. Unsolicited transactions may again become more frequent, and certain shelved transactions (including pan-European relocations) may resume if political conditions evolve favorably. All in all, 2015 is shaping up to be a promising year for European M&A.

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[1] Sources regarding statistical deal activity presented in this article are mostly based on data published by mergermarket (*M&A Monthly Insider*, December 2014; and *Global and Regional M&A*: 2014) and Dealogic (Global M&A Review, Full Year 2014) as well as a variety of major news publications. Such sources may adopt different criteria or assumptions to collect or present their data, and some of them may not derive the underlying data from definitive year-end reports.

Insights Conversations: Latin America M&A

Contributing Partners

Paola Lozano / New York

Paul T. Schnell / New York

Political stability, investor-friendly (or unfriendly) policies, commodity pricing, corruption scandals, and new legal regimes in areas such as tax and antitrust all factor into the M&A market in Latin America. Skadden partners Paola Lozano and Paul T. Schnell discuss the current state and 2015 outlook for activity in the region.[1]

How do you view the general outlook for corporate/M&A legal business in Latin America for 2015?

Paul: We are expecting a moderate level of M&A activity in the coming year. Although conditions are variable, they are much less volatile than in the past, as the markets have continued to stabilize. The exuberance of several years ago is gone — when there was talk about Latin America having decoupled from the rest of the world, rising above the global financial crisis in 2009 — and the region faces plenty of political, economic and social challenges, but there seems to be more confidence in the ability to weather these challenges without slipping into a crisis. This increase in confidence, even if tempered, will embolden companies and private equity firms to continue to do deals.

Economic conditions and M&A activity in the region also will continue to be impacted by developments in other parts of the world. In the first several years after the financial crisis, Latin America was considered more attractive for investment than other regions, offering a combination of economic growth and increasing stability that could not be found elsewhere. It was only a few years ago that investors in global private equity firms saw Brazil as the single most attractive market for PE deals. More recently, however, as growth has slowed in Latin America and economic conditions and investment opportunities have become more appealing in other regions, including the U.S., Asia and even Europe, it's no longer clear that Latin America retains an edge as a place in which corporate, private equity and institutional investors will want to participate.

For a region where natural resources and commodities are such a major part of the economy, global pricing and demand for oil and other basics will have a significant local impact. Additionally, an increase in interest rates rise in the U.S. and elsewhere could negatively impact economic conditions in Latin America, which would in turn adversely impact the level of investment and M&A activity.

In 2015, we expect to see more Latin American and international companies looking to build businesses across the region rather than in just a single country. We think inbound investment will continue from all major sources — the U.S., Europe and Asia, and strategic and private equity buyers. While there may be several high-profile outbound deals — Latin American companies making acquisitions outside the region — we think there may be fewer of these deals in 2015.

When it comes to Latin America, you can't just talk about the region as a whole. What are some of the differences that exist when you examine the M&A market on a country-by-country basis?

Paul: Colombia and Peru remain the strongest M&A markets in the region, with acquirers attracted by high economic growth, decent political stability and reasonable pricing for assets. By contrast, activity has cooled in Chile, which is a striking change, as Chile was long the strongest, most developed market in the region. Brazil continues to be buffeted by uncertainty; other countries that continue to be pockets of volatility, such as Argentina and Venezuela, still do not show signs of becoming meaningful markets for M&A in the near term. Mexico has not met expectations for increased M&A activity due to macroeconomic worries, although it remains a major market for sophisticated transactions.

Mexico

Large, sophisticated cross-border players, as well as private equity funds, appear ready to increase their investment in Mexico.

Let's talk about Mexico. What are the issues and what can we expect in 2015?

Paola: Mexico saw a healthy volume of M&A deals throughout 2014, but the volume of inbound deals did not reach the levels some had hoped for. Investors' perception on difficult macro questions, including gross domestic product growth, increased violence in certain regions, high-profile corruption scandals, and the uncertainty that comes with evolving legal and enforcement regimes in important areas — Foreign Corrupt Practices Act, antitrust, and oil and energy, among others — will need to be overcome for the volume of cross-border M&A activity to dramatically increase during 2015. However, large sophisticated cross-border players, as well as private equity funds, appear ready to increase their investment in Mexico. We also continue to see new entrants into the Mexican markets either because they are close to outgrowing the possibilities in their home jurisdiction and are looking for sizeable new markets with growth potential, or because of the promise that with some increased stability in the U.S., Mexico can deliver on its unrealized potential. It is important to note the growing reach of large and mid-market Mexican companies actively pursuing outbound transactions into a wider variety of regions — not only into other Latin American countries, but also into the U.S. and Europe. We expect those trends to continue through the first half of 2015, providing enough transactional opportunities to make for a healthy year in Mexican M&A. Also, improvements in the market driven by the structural reforms recently undertaken will likely start having a more tangible impact, enhancing the opportunities for transformational transactions. Finally, domestic M&A activity, with increased levels of sophistication, should remain at a steady pace.

Will Brazil fare any better in 2015 than it did last year?

Paul: We expect Brazil to remain a challenging market in 2015, very similar to 2014. There are too many question marks affecting the country: low growth, lower prices for commodities, increasing inflation, concerns about the government's anti-business sentiment and interference with the economy, excessive regulation, and pressure on its currency and its credit rating. The corruption investigations affecting Petrobras and other entities have been cited as an additional factor negatively impacting the market, and that is likely to continue to be the case in the near term. In the longer term, if Brazil can show that it can deal with corruption in a transparent and effective way — a big "if," perhaps — confidence in the country could increase. Even with the corruption headlines, Brazil compares very favorably, in terms of rule of law, with other emerging markets.

Brazil

We expect Brazil to remain a challenging market in 2015.

Despite its troubles, Brazil is such a large market that a steady flow of transactions will continue. Lower prices for assets, reflected in a significant drop in the stock market, and a weaker currency may make investment more attractive for international acquirers. There should be interest across many industries, including infrastructure and commodities, health care, consumer products and financial services. With the continuing increase in purchasing power among more and more of its population, Brazil will remain one of the more attractive markets for consumer product companies.

What should we expect from the rest of Latin America in 2015?

Paola: Colombia continues to attract growth-focused investors, resulting in significant inbound M&A activity. Experts expect GDP growth to be robust in 2015-19 (at an average of 4.4 percent), citing a positive business environment, a track record of investor-friendly policies and a perception of sound macroeconomic management as additional drivers of the sustained interest of foreign investors. We believe this will hold true through 2015. However, negative pressure on global oil and mineral prices, the uncertainty of the peace process and the concerns arising from the evolving tax regime could have a negative impact on overall activity.

Colombia

Colombia continues to attract growth-focused investors.

Our outlook on outbound M&A activity by Colombian conglomerates is very positive; we have started to see middle-market players expanding into other Latin American countries, increasing our confidence that the volume of outbound M&A from Colombia will grow in 2015.

Peru's growth has slowed down significantly, mainly due to downward pressure on prices of commodities. The mining sector also had been a driver of M&A activity. Therefore, the overall inbound M&A volume and aggregate dollar value will depend largely on the evolution of

Peru

Downward pressure on commodity prices has slowed Peru's growth significantly.

the trends of the global commodities market and the growth and policies of Peru's large trading partners in Asia. However, we believe infrastructure and consumer-based opportunities will help maintain the interest of foreign investors in Peru.

Chile suffered a significant slowdown in 2014, and with an economy largely dependent on copper and a perception of uncertainty based on the implementation of tax reforms, we expect a slow start for cross-border inbound M&A activity in Chile as compared to previous years. However, energy and infrastructure needs and policy priorities likely will help reduce the gap and create significant opportunities for cross-border activity, as will some seasoned investors with a continued willingness to expand their investments in Chile in strategic areas of their businesses.

Bolivia and Ecuador are expected to pick up additional interest from foreign investors, mostly from other Latin American countries, seeking growth markets.

We expect some inbound action focusing on Central America in the near future. Strategic investors capable of managing the region as one — despite the varying levels of sophistication and market development among the countries that comprise it — will likely maintain a healthy appetite for inbound M&A, as the potential for growth is very significant, even in sectors in which the larger economies in Latin America seem to have matured already.

Central America

Potential for growth is significant, especially for strategic investors.

While some significant transactions are likely to occur in Argentina, and Venezuela may be motivated to promote some high-profile transactions as it seeks much-needed liquidity, we expect activity in those jurisdictions to be measured by only a handful of significant matters rather than any consistent growth in the cross-border M&A market. This is likely to be the norm unless and until there is a significant shift toward sustainable foreign investment policies and legal certainty.

[1] Portions of this commentary were published by *Latinvex* on January 14, 2015.

China M&A: Reform Plan Promotes Mixed Ownership of State-Owned Enterprises

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Chinese state-owned enterprises (SOEs) have played a significant role in the world's second-largest economy, with over 155,000 SOEs valued at approximately $17.4 trillion at the end of 2013 spanning almost every industry sector. Despite the tremendous success some of the SOEs have enjoyed, largely thanks to their monopolistic market positions and entry barriers for private sector competitors, criticism of the overall inefficiency in the management of these assets has increased.

SOE Reform Plans and Implementation

In November 2013, China's new government administration under President Xi Jinping announced, among other economic overhauls, a bold SOE reformation plan, which called for ownership diversification and the withdrawal of SOEs from sectors with healthy, competitive environments. At the same time, the reforms require SOEs to maintain a controlling and influential role in the overall economy.

The language of the reform plan is vague, thus leaving ample room for interpretation and more detailed implementation plans. In addition, Beijing has not yet officially promulgated the list of industry sectors that it considers competitive, giving no indication where the withdrawal of state ownership will likely take place. However, given the large number of SOEs in China and the breadth of sectors in which they operate, the plan has understandably attracted significant interest within the business community. While many observers continue to question the government's will and ability to implement the changes in the face of various incumbent interests, including politically connected elites, several recent developments indicate that the current leadership may actually be serious about implementing this reform.

In April 2014, China's State Council listed 80 projects in state-dominated sectors to private investors, including transportation infrastructure, information infrastructure, clean energy and traditional energy projects. In the same month, the Ministry of Finance announced plans to open China's munitions industry for private investments. Three months later, the State-Owned Assets Supervision and Administration Commission (SASAC) followed suit by announcing pilot implementation programs to reform six central government-level SOEs, two of which — Sinopharm and China National Building Materials Group — will be open to ownership diversification.

At the provincial level, many local governments have responded to the call of the central government. By September 2014, over 20 provinces, spanning most of the major municipalities (including Beijing, Shanghai, Guangdong and Chongqing), had announced concrete implementation programs involving the potential listing or selling off of assets in up to 70 percent of the provincial SOEs by 2017. Chongqing and Guangdong are among those that have laid out the most aggressive targets and timelines. Chongqing pledged to increase the percentage of state-owned assets with mixed ownership from 47.4 percent to two-thirds by 2017 and has designated over 110 projects for reform. These projects involve 25 SOEs and total assets of over $44.2 billion, and more than half of them involve dilution of state ownership. Guangdong committed to reform all of its SOEs and to achieve mixed ownership in at least 70 percent of them by 2017.

Mega-Size Central SOEs Pioneering the Reform Process

In March 2014, CITIC Group, China's largest conglomerate, announced a massive restructuring plan in which it will inject nearly all of its assets, valued at $37.5 billion, into CITIC Limited, a company listed on the Hong Kong Stock Exchange.

In September 2014, SINOPEC successfully sold 29.99 percent of its downstream oil marketing and distribution business, valued at $17.4 billion, to 25 private and social institutions. SINOPEC's new shareholders include a wide variety of institutions, such as private equity funds, industry players, social welfare funds and private enterprises. Based on market intelligence, SINOPEC's share sale process largely targeted Chinese investors, and the private placements were significantly oversubscribed. The other dominant Chinese oil company, PetroChina, has identified specific business segments, such as undeveloped oil and gas reserves, for mixed ownership reform.

Two other leading SOEs, CNOOC and COFCO, also are expected to initiate their reform programs in the near future.

The Role of Foreign Investors in SOE Reform

Due to its potentially broad impact on the Chinese economy, the SOE reform will be implemented gradually, with a trial-and-error period. The central government has yet to publish a list of sectors in which state control will persist, and it is clear that the Foreign Investment Catalogue still will dictate the industries in which foreign investors are either allowed or forbidden to participate. It is still too soon to determine what role foreign investors might play or what appetite Chinese SOEs may have for foreign investment in the ownership diversification process. However, many commentators speculate that, given the large number of SOE players, the successful implementation of the SOE reform would require the participation of foreign capital in one form or another.

155,000
state-owned enterprises valued at approximately
$17.4 trillion

In SINOPEC's share sale, many foreign investors, like their domestic counterparts, were invited to submit bids. Although it is clear that priority was given to strategic, domestic and social welfare investors — all of the top subscribers receiving equity allocations in the sale process were state-backed domestic enterprises and funds — some foreign investors' names did appear on the list of the final winning bidders. The largest foreign investor in the transaction, RRJ Capital (a foreign private equity firm run by a former Goldman Sachs partner), was permitted to subscribe for approximately 1 percent of SINOPEC's marketing arm.

The business community is hopeful that SINOPEC is only the first step toward a more market-driven reform process and that, moving forward, local governments may take a more liberal stance toward foreign investments. For example, Chongqing's reform plan expressly invited foreign strategic investors to increase their stakes in projects they have jointly initiated with SOEs.

Conclusion

China's SOE reform and foreign investors' participation in it could take time to unfold. However, given the aggressive plans already outlined by some of the central administrative agencies and provincial governments, and the magnitude of potential state assets to be sold, interested foreign investors should closely follow the reform trend and the opportunities they find attractive.

Election Results Bring Hope for Significant Changes in India and Indonesia

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This past year brought important political changes for the two largest economies in South/Southeast Asia. Although significant challenges remain, the election of a new government in India and a new president in Indonesia have been met with optimism by many participants in those countries' markets.

India

In May, financial markets and the Indian business community reacted positively to Narendra Modi's landslide victory in the Indian elections. Foreign investors, who have experienced years of uncertain governmental regulation, grindingly slow bureaucratic processes and underdeveloped infrastructure, have shown cautious optimism. The hope of Indian and foreign investors alike is that Modi's decisive style, together with his party's outright majority in the lower house, can finally allow real, significant change to occur. Modi's government already has raised the foreign investment cap in the defense and railways sectors from 26 percent to 49 percent and shaken up the governmental bureaucracy — which reportedly has resulted in dramatically reduced turnaround times for many governmental approvals and licenses. Modi's government plans to implement additional proposals, including:

- raising the foreign investment cap in the insurance sector from 26 percent to 49 percent;
- easing regulations on the purchase and development of land for infrastructure projects;
- reforming the labor market (though substantial resistance is expected from India's trade unions);
- implementing a nationwide goods and services tax; and
- implementing government asset sales, including in the coal and energy sectors.

Modi faces significant challenges in carrying out these proposals, including that his Bharatiya Janata Party does not control the upper house of Parliament and is likely to encounter difficulties pushing through the entirety of his proposed agenda.

Growth in M&A

In terms of deal activity, the aggregate value of cross-border mergers and acquisitions involving Indian companies in 2014 remained subdued, at around half the 2007 levels. Unlike many Asian markets, which quickly recovered in the second half of 2009 on the back of the massive monetary stimulus in China, Indian inbound and outbound deal activity has not yet recovered to precrisis levels — in part because of a number of very large outbound acquisitions by major Indian corporations in 2006 and 2007 that resulted in massive write-downs. However, domestic M&A activity, particularly among midmarket companies, recovered strongly in 2014 and now exceeds precrisis levels. Some signs indicate that the change in government, including several of the initiatives mentioned above, are spurring greater interest in Indian targets from foreign strategic and financial investors, particularly in the health care/pharma, technology, manufacturing and consumer products sectors, all of which augur well for an increase in inbound M&A activity in 2015.

Increase in Equity Offerings

Following a significant recovery in equity markets in 2014 — largely on the back of Modi's election victory — an increase in equity offerings, including initial public offerings, by Indian companies is expected in the coming year. Recent regulatory changes by the Securities and Exchange Board of India (SEBI), including allowing Indian companies to list depositary receipts on overseas stock exchanges without first listing their shares on an Indian stock exchange, should open up capital raising opportunities for Indian companies.

The market for offerings of foreign currency-denominated debt securities by Indian companies has previously faced significant hurdles, including a very active local bank-lending market, high withholding tax rates on offshore interest payments and restrictions imposed by the Reserve Bank of India's (RBI) External Commercial Borrowing (ECB) guidelines. The guidelines are designed to manage the Indian economy's exposure to short-term or high-cost foreign currency-denominated debt by imposing restrictions on the use of proceeds of foreign currency-denominated borrowings in noncapital-related activities and certain sectors, as well as an all-in cost ceiling (known as the "interest rate cap") on such borrowings of between 350 bps and 500 bps above six-month LIBOR, depending on tenor.

In 2014, the government announced a temporary reduction in withholding tax on interest payable to foreign institutional investors, from 20 percent to 5 percent until May 2015, which spurred significant debt issuance by well-known, higher-rated Indian corporations and banks. However, the strict enforcement of the ECB guidelines by the RBI, including with respect to recent offerings that used an offshore issuer structure to fund Indian operating affiliates, have prevented the development of a more robust foreign currency debt market for lower-rated Indian corporates.

Indonesia

Indonesia's July 2014 presidential election was in many ways a watershed moment for the country, the fourth most populous in the world. Joko Widodo's (Jokowi) win is considered a victory for the common man over the establishment — all prior presidents since Indonesia's democratization following the downfall of the Suharto regime in 1997 have been from the military or political elite.

That said, the break from the old guard has not been complete. Jokowi was handpicked to lead his party by former President Megawati Sukarnoputri, the daughter of Indonesia's first President Sukarno. The new president's coalition is a minority in the Indonesian parliament (known as the People's Representative Council); the majority coalition consists of parties that supported Jakowi's competitor in the presidential election runoff, former Gen. Prabowo Subianto.

The new government faces several challenges. While Indonesia's economy, the largest in Southeast Asia, continued to grow in 2014, the pace of growth was slower than in previous years. The decreasing rate of expansion largely was driven by a significant slowdown in commodity exports, which in turn was due to falling Chinese demand and the related decrease in global commodity prices. Nevertheless, consumer demand continues to grow, which benefits the manufacturing, retail, real estate and leisure sectors, among others. Indonesia has long been attractive to investors due to its appealing demographics — *i.e.*, its young population — its natural resources and, compared to the past, its relatively stable political environment.

As for deal activity, the Indonesian M&A and equity markets were relatively subdued in 2014 compared to prior years. The slowdown was driven in part by the prospect of a presidential election, which historically has placed a damper on strategic corporate action, but also by the emerging markets sell-off in the early part of the year and the refocus by global investors on developed markets.

For inbound investment into Indonesia, regulatory concerns remain. For example, in January 2014 the government implemented a law prohibiting the export of unprocessed mineral ores in an effort to boost investment in smelters and ore processing plants. While the law has the potential to move Indonesia up the commodities value chain, it also risks a pullback in production by some miners and the scrapping of new projects by investors.

In 2014, U.S. dollar debt issuance by Indonesian corporations was robust, particularly in the real estate sector. However, late in the year, the central bank expressed significant concern about Indonesian corporations' exposure to foreign currency-denominated debt. These concerns date back to the Asian financial crisis, when the substantial exchange rate devaluation was the driver for massive foreign-currency debt defaults. What has followed is a new Bank Indonesia regulation that requires nonbank entities incurring offshore borrowings to hedge a portion of the foreign currency exposure, maintain minimum liquidity levels as they approach payment dates and, beginning on January 1, 2016, have a minimum "BB" credit rating from an Indonesian or international rating agency. A significant amount of foreign currency debt of Indonesian corporations comes due in the next couple of years, and it remains to be seen how this new regulation will affect the refinancing of this indebtedness.

Antitrust and Competition: Surveying Global M&A Enforcement Trends

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US: Continuation of Aggressive Review and Enforcement

In 2014, the U.S. Department of Justice's Antitrust Division (DOJ) and the Federal Trade Commission (FTC) further embraced their aggressive approach to merger enforcement. U.S. regulators continued their pursuit to enjoin, and in some cases unwind, transactions they believed likely to substantially lessen competition, a trend that is expected to continue for the remainder of the Obama administration.

Merger Challenges: Hart-Scott-Rodino (HSR) Reportable Transactions

Transactions in highly concentrated industries remain at the forefront of the agencies' enforcement agenda. For example, the DOJ recently sued to block National Cinemedia's $375 million acquisition of Screenvision. The DOJ noted that the two companies, which account for approximately 88 percent of all movie theater "preshows" in the U.S., compete aggressively and directly, leading to significant price reductions for advertisers. Assistant Attorney General Bill Baer described this transaction as a "merger to monopoly" and "exactly the type of transaction the antitrust laws were designed to protect." In order to prevail in federal court, the DOJ will have the burden of proving that preshow advertising constitutes an economically relevant market that is separate from other forms of advertising.

Guiding a transaction through the DOJ or FTC can be complicated when other federal agencies also have jurisdiction to review the deal. Two of the most high-profile transactions of the year face ongoing scrutiny from the Federal Communications Commission (FCC). Working hand-in-hand with the DOJ, the FCC continues to investigate the Comcast/Time Warner Cable merger. Key to the agencies' analysis will be the combined company's position at the upstream level — specifically, its ability to control the flow of content to consumers and exert leverage over content providers. And while the DOJ approved AT&T's acquisition of DIRECTV in August, the merger remains under FCC investigation. The acquisition has faced less criticism than some other situations, largely due to anticipated synergies that would result from the combination of a major telecommunications company and one of the largest satellite TV providers.

Divestitures continue to play a significant role as parties consider preemptive measures to enhance the likelihood of agency approval. In anticipation of intense antitrust scrutiny, Reynolds American agreed to divest four of its cigarette brands, in addition to the sale of an e-cigarette line, as a condition of its acquisition of Lorillard, announcing the proposed "fix" at the same time as the larger deal. The Reynolds/Lorillard merger would combine two of the three largest tobacco companies in the U.S. Similarly, Sysco and US Foods, the only two U.S. national food distributors, agreed in their deal documents to divest up to $2 billion in annual sales to secure antitrust approval. Whether these parties' proposed fixes will be sufficient to address competitive concerns remains to be seen, and both the FTC and the DOJ have recently demonstrated they will litigate to challenge a deal rather than accept an inadequate remedy.

Merger Challenges: Nonreportable Transactions

Following a full trial on the merits, Bazaarvoice was required to divest PowerReviews, effectively unwinding the nonreportable acquisition successfully challenged by the DOJ beginning in 2013. Bazaarvoice and PowerReviews were the only two significant competitors in the market for online ratings-and-review platforms. In achieving this result, the DOJ relied heavily on the parties' internal documents to bolster the allegation that the transaction would eliminate competition in the

industry and lead to price inflation. The court found this evidence credible and persuasive. The FTC also recorded a significant victory when the U.S. Court of Appeals for the Sixth Circuit upheld an FTC order unwinding a 2010 nonreportable hospital merger between ProMedica and St. Luke's, two Ohio-based hospitals. These rulings highlight the agencies' commitment to pursuing transactions that present anti-competitive risk, even if those transactions do not meet HSR filing thresholds and have closed. Notably, between 2009 and 2013, 20 percent of all merger investigations conducted by the DOJ involved nonreportable transactions, a trend that is expected to continue.

Gun-Jumping

In November, the DOJ announced a $5 million settlement of charges that Flakeboard and SierraPine had engaged in unlawful premerger coordination, despite the fact that the parties ultimately abandoned the merger in light of DOJ concerns. At the request of Flakeboard, SierraPine closed a mill and transitioned customers to Flakeboard prior to the expiration of the HSR mandatory waiting period. The DOJ alleged that the parties' conduct constituted both a *per se* unlawful agreement between competitors to reduce output and allocate customers in violation of Section 1 of the Sherman Act and a premature transfer of beneficial ownership (commonly known as "gun-jumping") in violation of the HSR Act. The DOJ's action underscores the requirement that merging parties must remain separate and independent competitors during the HSR review period.

HSR Fines

Berkshire Hathaway Inc. agreed to pay a civil penalty of $896,000 resulting from its failure to make an HSR filing in conjunction with its December 2013 conversion of notes into voting securities of USG Corporation. Notwithstanding the fact that the failure to file was inadvertent, Berkshire Hathaway did not qualify for the "one free pass" for inadvertently failing to file, because it had committed a similar infraction previously that resulted in a corrective filing in connection with a different issuer.

All signs point to continued aggressive enforcement by the FTC and DOJ in 2015.

European Union Merger Regulation

A number of important changes in EU merger control policy took place in 2014, including the adoption of several legislative measures that are expected to shape merger control enforcement in 2015. Additionally, recent merger decisions confirm the aggressive enforcement by the European Commission of the procedural requirements under the EU Merger Regulation (EUMR).

EU Merger Simplification Package

The commission has adopted important revisions to its merger control procedures with the Merger Simplification Package, which entered into force on January 1, 2014. The purpose of these revisions is to streamline the EU merger review process for unproblematic transactions, which are now eligible for review under a less burdensome and faster, simplified procedure. The revisions expand the scope of the simplified filing procedure to apply to a broader set of transactions and shorten (and in certain cases eliminate) the need for a prenotification consultation process.

White Paper on Acquisitions of Minority Shareholdings

On July 9, 2014, the EU Commission published a white paper setting out proposed changes to the EUMR. The most relevant proposal is the extension of the EUMR to cover acquisitions of minority shareholdings, which it currently does not do. The white paper proposes to introduce a "targeted transparency system" pursuant to which acquisitions of noncontrolling minority interests with an EU dimension would be subject to a notice requirement. The stated goal of the proposal is to limit the commission's jurisdiction to review the acquisition of minority interests to potentially problematic transactions, identified as transactions that create a competitively significant link between two companies. Transactions meeting both of the two following criteria would be deemed to create such a link: (1) the target company is a competitor of the acquirer or active in a vertically related market; and (2) the equity or voting interest acquired is (a) around 20 percent, or (b) above 5 percent and accompanied by additional elements, such as de facto blocking minority rights, a seat on the

board of directors or access to commercially sensitive information of the target company.

The EU Commission also is considering the introduction of a waiting period of 15 working days following the submission of the information notice, during which the parties would be prevented from completing the transaction. Within this period the commission would decide whether further investigation is warranted on the basis of a full FORM CO notification in the context of a normal EUMR review procedure. The proposals reflect some of the aspects of the merger control review systems applicable in EU member states such as Germany and Austria, without going as far as extending the standard review procedure to minority investments.

The commission anticipates that the new system will capture a limited number of transactions (around 20 to 30 annually) and that the burden on businesses will be relatively limited. The proposals in the white paper are expected to be formalized in a legislative proposal in 2015, which will be subject to the vote of the EU Council and the consent of the European Parliament.

Recent Trends in EU Merger Control Review

Two key trends emerge in reviewing the EU Commission's 2014 merger control decisions.

First, they reveal a stricter application of the EU procedural requirements. During 2014, the commission took enforcement action against merging companies for gun-jumping violations, for the supply of misleading information during the EU merger review and for failure to comply with information requests within the EUMR deadlines. In particular, in July 2014, the commission fined the company Marine Harvest €20 million for breaching the standstill obligation and for failure to comply with the mandatory preclosing notification requirements under the EUMR. This is the first time the EU Commission pursued a gun-jumping violation in a case involving serious competition issues. The nature and extent of these issues had an impact on the amount of the fine imposed by the commission.

Second, the commission also adopted a tougher stand on merger remedies in a number of cases. Recent trends include, in particular, a greater reliance on upfront-buyer commitments, stricter purchaser approval requirements and a broader scope of remedy packages, all of which are likely to continue in 2015.

Insights Conversations: Cybersecurity

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This past year has been called the "year of the massive data breach," with many high-profile attacks on well-known companies. Skadden partners Cyrus Amir-Mokri, Patrick Fitzgerald, Marc S. Gerber, Stuart D. Levi and Timothy A. Miller discuss the issues businesses must consider, the litigation risks involved and the evolving role of governments in cybersecurity.

Cybersecurity attracts a lot of attention as one of the critical issues for businesses today. Is the problem overblown?

Pat: In a word: no. About four years ago, when I was a U.S. attorney, I was surprised when the FBI agent in charge of the Chicago office told me cybersecurity, not terrorism, was the issue that most kept him awake at night. As he briefed me on the issue, I understood why. The government has opened up more and more about its concerns in this area over the last few years, but I think many people wondered whether the threat was overstated. As things have played out, it is becoming more and more clear that the concerns were not overstated and that this is a real issue. What is less clear is how we will adapt. Companies need to address the nuts and bolts of cybersecurity, but they also need to consider how they wish to interact with the government in handling this common issue. Companies are concerned both about the risks of cooperating too closely with the government and the risks of not doing so. Fashioning policies that protect a company's intellectual property and the privacy of customers or employees, while not compromising national security and public safety, is not easy but it is important to do. The recalibration of how the public and private sectors interact in the cyber area is as important as any other legal and policy issue we face today.

Cyberattacks seem certain to increase in the near future. What steps should corporations and their boards take before a cyberattack occurs?

Stuart: The high-profile cyberattacks of 2014 serve as an important reminder that every company is vulnerable. At the end of 2013, too many companies decided that the Target attack did not apply to them because they were not retailers holding credit card information. Companies must not make the same mistake with the Sony attack and decide that this is not their issue because they do not engage in activity with geopolitical ramifications. The unfortunate reality is that every company is a potential target. For example, we have seen politically based hackers launch "ransomware" attacks on companies that are apolitical.

Companies therefore need to make cybersecurity a critical component of their risk assessment and business planning. The National Institute of Standards and Technology framework provides the best guidance for implementing such an assessment. In addition, companies must have a documented rapid response plan so they are prepared to address a cyberattack. In our experience, companies with such plans respond faster and are better able to contain their risk. Finally, the legal department should audit the company's privacy policies and procedures. It is a failure in these areas, more than failings on the technology front, that makes companies most susceptible to legal and regulatory challenges after a cyberattack.

Marc: With that in mind, there are certain steps a board should take. As part of its oversight of a company's risk management, the board should understand how cyber incidents can impact the company's business, the company's experience with cyber incidents to date and the company's ongoing preparations for future cyber incidents. This includes asking questions to reach an informed view of whether management is considering the risks in a way that is consistent with the company's risk profile and whether it has employed appropriate resources to prevent and mitigate them. These are ultimately business judgments and, as with any business judgment, the board needs to be informed.

Cyrus: A key first step in that effort is to clarify accountability within senior management for cybersecurity issues, which should include a way for employees to escalate material cybersecurity issues promptly to senior management and, ultimately, the board. Senior managers responsible for cybersecurity should have direct access to the board. For example, boards should

consider asking the chief information security officer to prepare regular reports to the board and present them in person at least annually so the board has the opportunity to ask follow-up questions.

More generally, companies should have a comprehensive cybersecurity policy, which should include performing a cybersecurity risk assessment, developing and continually updating a cyberattack crisis management protocol, maintaining robust lines of communication with relevant agencies of the U.S. government, adopting cyber hygiene best practices, participating in information-sharing platforms, evaluating all outside connections and discussing cyber readiness with business partners and vendors, and having a disaster recovery and business continuity plan.

What should companies think about in developing their rapid response teams? Are there considerations that are specific to particular industries?

Tim: Retail is an industry that faces a specific and significant set of security issues, with the cybersecurity of payment systems maintained by retailers being a focal point of plaintiffs and regulators. Retailers who suffer a security breach of credit card data can expect a fight on two fronts — from consumers impacted by the breach and from issuer banks — and rapid response teams can help minimize potential liability by allowing for a response at the first sign of a data breach.

Target is a good example. Computer hackers installed malware on Target's computer servers that read the data from 110 million customers' credit and debit cards when they were swiped in Target's stores over several weeks during the 2013 holiday season. In the ensuing multidistrict federal litigation in Minnesota (*In re Target Corporation Customer Data Security Breach Litigation*, MDL No. 14-2522 (D. Minn., Dec. 2, 2014)), the court recently allowed several claims to proceed against Target brought by the financial institutions that issued cards impacted by the breach and a separate putative class of Target consumers. The ruling on the claims by financial institutions hinged primarily on the allegation that Target turned off one of its security measures, thereby allegedly increasing the risk of a data security breach, and the claim that Target failed to respond swiftly enough to purported warning signs of an impending cyberattack. In upholding general negligence claims under Minnesota law, the court held that no special relationship was required between Target and the financial institutions to establish a duty, because the financial institutions were foreseeable victims of Target's allegedly negligent act of disabling a data security feature. In its separate ruling in the consumer class action, the court found Article III standing based on allegations of actual economic harm — for example, unauthorized credit card charges. The court found claims brought under dozens of state consumer protection and other statutes to be "plausible," allowing them to proceed absent compelling state law authority precluding the claims or supporting Target's interpretation of the various statutes at issue.

Cyrus: Another factor to consider with rapid response teams is how to address differences based on the unique characteristics of specific companies and industries. For example, because different government agencies act as principal cybersecurity contacts for particular industry sectors (*i.e.*, "sector-specific agencies"), rapid response teams will need to tailor crisis communications and information-sharing protocols to the relevant government agency for their sector. A similar tailoring of communications protocols would hold for relationships with ISACs (information sharing and analysis centers), which also are organized along industry sector lines.

The Target example also highlights the litigation risks involved with cyberattacks. How has the landscape for class actions evolved in this area, and what might we expect in the near future?

Tim: Actions seeking remedies for breaches in data security have followed practically every significant breach at retailers, banks and other businesses. Cases involving Target, Adobe and Sony (the PlayStation, not the movie studio) moved through the legal system in 2014. Standing continues to be the threshold battleground issue. Article III standing requires plaintiffs to allege injury in fact that is concrete and particularized and actual or imminent. The harm cannot be merely conjectural or hypothetical.

Plaintiffs continue to allege damages for risk of future harm, such as the increased risk of identity theft. So far courts have disagreed as to whether an increased risk of personal data being misused in the future is sufficient to constitute "concrete" and "imminent" injury necessary for Article III standing. Some courts have held that an increased risk of personal data being misused in the future is not sufficient, though the Ninth and Seventh Circuits have held the opposite. There was hope that the U.S. Supreme Court's decision in *Clapper v. Amnesty International*, 568 U.S. ___ (2013), would strengthen defendants' standing argument, because it seemed to suggest that a plaintiff must show that threatened future injury is "certainly impending." But federal courts in California have held that *Clapper* did not change the law. Meanwhile, plaintiffs' attempts to manufacture standing by making out-of-pocket expenditures on credit monitoring services have been rejected by most courts.

We anticipate that cases involving Article III standing will continue to favor class action plaintiffs. If so, look for plaintiffs to focus on state consumer protection statutes as a basis for liability. However, those statutes typically require a showing of "actual damages" that is higher than the Article III standing requirement of "concrete" injury. In 2014, courts continued to dismiss damage claims under such statutes.

Where does board oversight fit into the picture, and what are some of the key considerations for boards in this area?

Marc: The Target breach is an instructive example. Following the breach, shareholder lawsuits alleged that directors failed to take reasonable steps to oversee the company's efforts to protect data and prevent breaches, in violation of their fiduciary duties. As I mentioned earlier, boards and those who advise boards need to build a record of being informed — understanding the company's susceptibility to cyber incidents, the potential threats the company faces, the potential consequences of an incident, and the company's rapid and longer-range response plans. To the extent industry standards or other external benchmarks are available, the board should understand why the company may or may not meet those standards and the business case for any decisions being made.

In December, the Senate Banking Committee held a hearing on ways to protect the financial sector from cyberattacks, with a particular focus on interagency cooperation. What did the public learn from the hearing? What can we expect from the government on cyber issues?

Cyrus: We know from the testimony of the government witnesses and from their agencies' other efforts that they are hard at work within government and in collaboration with the private sector to help prevent attacks and to mitigate them when they occur. One important area in which they have made significant progress is information sharing. It is critical for the private sector to participate and make maximum use of government information-sharing and incident-management resources. Such information can enhance security efforts, for example, by providing insight into the signatures, penetration techniques and other exploits used by cyberattackers, or by identifying what IP addresses might be originating cyberattacks.

Government agencies also are more focused on cybersecurity now than they were a few years ago. In the financial services sector, for example, the banking regulators, market regulators and state regulators have taken significant steps to develop examination protocols and rules as part of their financial stability and safety and soundness missions.

Stuart: Another area to consider going forward is legislation. A couple of years ago, the Senate passed and the Obama administration supported comprehensive cybersecurity legislation, which the House rejected. Very little has been accomplished in the meantime. But this month, perhaps emboldened by Sony and the other recent high-profile breaches, President Obama proposed legislation to enhance online privacy and cybersecurity, including additional public-private information-sharing authorities, revisions to criminal laws related to computer crimes and a federal data breach notification law. The proposed legislation replicates many of the features of the 2011 initiative, though not some of its more controversial components, such as the establishment of a new cybersecurity regulatory authority permitting the Department of Homeland Security to review and approve critical infrastructure cybersecurity frameworks.

These changes, along with a continuing stream of breaches, may be enough to convince Congress of the case for a federal role in private sector cybersecurity.

Recent reports have linked the governments of China, Iran and North Korea to major cyberattacks on public corporations. Do attacks launched by sovereign nations have different implications for corporations than those by "private" hackers?

Stuart: State-sponsored cyberattacks are particularly concerning because of the unprecedented resources a nation-state can bring to an attack. It's also far easier for hackers to conceal an attack if they enjoy the protection of the host state. It will be interesting to see whether, like in the case of Sony, state-sponsored attacks generate greater attention from the U.S. government and therefore stronger retaliatory measures. That said, law enforcement officials will tell you that the line between state-sponsored terrorism and criminal activity is beginning to blur, with countries relying on rogue actors to enhance their hacking capabilities.

Cyrus: Attacks by sovereign nations have at least three important implications. First, as Stuart noted, certain sovereign nations are very sophisticated and, therefore, may be able to inflict greater damage than other attackers. Second, the motives of sovereign nations vary, which means that the consequence of their intrusions will be different. Some sovereign nations may be interested only in exfiltrating sensitive information. Such actions do not cause destruction or embarrassment — as other sovereigns may wish to do — but they may enable competitors in other countries to use business and other secrets to better compete. Third, in the case of an attack by a sovereign, the response may be constrained by geopolitical, diplomatic or national security factors. In other words, law enforcement or private legal action may no longer be the focus.

In light of the cyber events of 2014, are all the old approaches to cybersecurity obsolete?

Pat: Not at all. The technical capabilities that have been deployed by rogue states, hackers and criminal enterprises are daunting and have rightly caught the attention of government agencies, companies and their boards, and now the plaintiffs' bar. But we should not forget the lower-tech threat from the insider that can do great damage as well. Many enterprises lose valuable intellectual property when employees — especially soon-to-be-former employees — walk out the door with trade secrets in low-cost thumb drives or log in from home to the company's secure network and download away. Companies need to do the basic blocking and tackling of limiting access to the most sensitive materials to those with a need to know, creating levels of security appropriate to the information, and changing levels of access as employees' positions change or as they leave the company. Paying attention to employees whose downloading activity is aberrational — either because of unusual volume or because the materials accessed are not related to the employee's responsibilities — is important, especially when the company learns an employee will be leaving the company.

Not all traditional insurance policies cover cyber losses. How has the "year of the massive breach" impacted the insurance industry? Do you expect to see a continued rise in specialty cyber policies or the emergence of other cyber-related coverage?

Cyrus: There is clearly greater interest in cyber insurance. Some insurers are beginning to underwrite cyber risk, although this is still a nascent market. Firms should evaluate whether their business-interruption policies cover cyberattacks. Some insurers have exclusions for cyber insurance in their business-interruption policies, making it a separate product. The development of cyber insurance is a subject to watch. Unlike other hazards, including severe weather and even terrorism, experience with cyberattacks is relatively new — accordingly, the market will continue to develop.

If 2014 was the year of the massive data breach, what are the big cybersecurity issues you expect to unfold in the near future?

Stuart: In many ways, 2014 laid the foundation for what are likely to be the key developments in 2015. There is no doubt that cybersecurity attacks will increase and spread, as companies and hackers engage in an "arms race" of cyber protection and cyberattack. We also are likely to see many more enforcement actions brought by the Federal Trade Commission as it looks to effectively impose minimum cybersecurity requirements on companies through Section 5 claims. 2015 also is likely to be the year that regulators in a variety of industries come down hard on their regulated companies to ensure that they are adhering to evolving industry standards in cyber protection. Finally, we expect to see greater cooperation between the government and the private sector as they combat this growing threat.

Cyrus: I agree — I think everyone agrees — that we should view the cyberattacks and breaches of 2014 as a harbinger of what's to come. Breaches and attacks occurred prior to 2014, including some very significant ones, so in a sense 2014 was simply a continuation of what was going on before. However, what we are seeing is increasing sophistication of attackers, together with the realization of the incredible capacity for disruption and destruction. Companies should become smarter in redesigning or reconfiguring their systems. It is no longer sufficient to design systems with a view of keeping attackers out. Companies should assume that penetration will occur. Their focus must shift from absolute prevention of penetration to making navigation and destruction by attackers more difficult to mitigating and managing damage once it occurs.

Overall, in addition to expecting more and more destructive cyberattacks, we should watch for the following trends: First, we should expect that non-sovereign nation actors will become more and more sophisticated. Second, as our connectivity through wireless media expands, we should watch for attacks on and through mobile technology. Third, although thus far we have not had instances of catastrophic data destruction, it is important for companies to continue to develop resilience in that respect.

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Litigation/ Controversy

Emerging tactics from enforcement agencies and plaintiffs. Multiple (and increasingly international) jurisdictions. Court interpretations of recent significant Supreme Court rulings. Businesses continue to face an incredibly complex litigation landscape with aggressive counterparties. Numerous cases — either recently decided or working their way through the courts now — will further impact strategies in key areas of litigation.

The Law 42

cases demonstrate that BITs can provide some protection to an investment in the event of a windfall tax or other measure

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Enforcers are realizing the benefits of coordination, and mechanisms to facilitate cooperation continue to rise.

– **Ingrid Vandenborre**, Partner, European Union and International Competition Law

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The success of the Affordable Care Act's implementation could be at stake before the Supreme Court

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$30M

amount the SEC whistleblower program paid to a single whistleblower in September 2014

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2014-15 Supreme Court Highlights

Contributing Partner

Boris Bershteyn / New York

Approaching the midpoint of its 2014-15 term, the Supreme Court has added to its docket several cases with potentially wide-reaching implications for a range of important policy and business issues. The Court accepted for review a dispute about the interpretation of the Affordable Care Act (ACA), the outcome of which may significantly affect the statute's implementation. It will also decide whether states must license same-sex marriages and recognize same-sex marriages lawfully performed in other states. Other notable cases before the Court address separation of powers, administrative law, federal litigation procedure, antitrust law and securities law. Summarized below are some of the cases of interest to our clients.

Affordable Care Act

The Supreme Court is once again at the center of a politically charged dispute over the ACA — and the success of the statute's implementation could be at stake. Critical to the ACA's design are subsidies, in the form of tax credits, that help millions of individuals purchase health insurance. The statute makes these tax credits available in connection with insurance purchased through an exchange — which is a type of health coverage marketplace — "established by the State." In a majority of states, however, the exchange is facilitated by the federal government rather than state-run. The Internal Revenue Service has promulgated rules making the tax credits available in connection with purchases on either type of exchange. Challenges to that regulation — based principally on the argument that the plain language of the ACA limits tax credits to purchases on state-run exchanges — were rebuffed by a panel of the Fourth Circuit but succeeded before a panel of the District of Columbia Circuit. The D.C. Circuit appeared to redress this circuit split — and thus make Supreme Court review unnecessary — when it decided on September 4, 2014, to take up the issue *en banc* and vacate its panel decision. But the Supreme Court nonetheless granted *certiorari* in the Fourth Circuit case, *King v. Burwell*, on November 7, 2014. The plaintiffs in *King* are residents of Virginia (a state served by a federally facilitated exchange, HealthCare.gov), who argue that, without tax credits, they would be unable to afford health coverage and therefore would be exempt from the ACA's individual mandate to purchase health insurance. The argument in the case will be heard on March 4, 2015.

Separation of Powers

During its last term, the Supreme Court significantly limited the president's authority to circumvent the congressional confirmation process through recess appointments. It will hear notable separation of powers cases again this term, albeit from more obscure corners of the federal government.

In *Department of Transportation v. Association of American Railroads* (argued on December 8, 2014), the Court may dust off the nondelegation doctrine — a constitutional limitation on Congress' authority to delegate its powers — which the Court has not used to invalidate any statute since the New Deal. The case concerns a 2008 law requiring the Federal Railroad Administration (FRA) and Amtrak "jointly" to "develop" standards that would help enforce a dispatching preference that Amtrak's passenger trains enjoy over other rail services. (Under the statute, disagreements between Amtrak and the FRA about these standards would be resolved through binding arbitration.) The District of Columbia Circuit held that this statutory scheme unconstitutionally delegated legislative power to a private entity — namely, Amtrak. The Supreme Court's decision could turn on narrow grounds, such as whether Amtrak's unusual governance structure renders it a public or private entity for purposes of the nondelegation doctrine. But the Court also could charter a broader course by addressing, for example, the limits of public-private collaboration in federal regulation and governance.

Another case this term will explore the respective roles of legislative and executive branches in foreign affairs — an issue of frequent dispute between Congress and the White House, but one rarely touched by courts. The State Department has maintained a practice of listing "Jerusalem" — rather than "Israel" — as the place of birth in passports and certain other documents of United States citizens born in Jerusalem, in recognition of contested sovereignty over that city. But in 2002, Congress enacted a statute directing the State Department to honor those citizens' (or their legal guardians') requests to record Israel as their place of birth. President George W. Bush objected to the statute in a signing statement, asserting that the statute impermissibly interfered with the president's constitutional authority to conduct foreign affairs, and declined to enforce it. The District of Columbia Circuit recently agreed with the executive branch and held the statute unconstitutional. The Supreme Court will review that decision in *Zivotofsky v. Kerry* (argued on November 3, 2014). A broad ruling could expand or curtail the ability of Congress to influence through legislation a wide range of foreign diplomacy, including negotiations over trade and other economic affairs.

Administrative Law

The Supreme Court continues to scrutinize recent regulatory activity by the Environmental Protection Agency (EPA). Last term, it considered the EPA's authority to control greenhouse gases and its approach to controlling air pollution that crossed borders between states. Now, the Court has taken up a challenge to the EPA's rules controlling emissions of hazardous air pollutants — in large part, mercury — from power plants. As with many controversial regulatory policy issues, this dispute focuses on compliance costs. In particular, the Court will examine whether the EPA permissibly construed the Clean Air Act by considering costs in setting the level of emission controls on power plants, but not in deciding whether to regulate power plants in the first place. The District of Columbia Circuit upheld the EPA's approach, and the Supreme Court will review that decision in *Michigan v. EPA*, *Utility Air Regulatory Group v. EPA* and *National Mining Association v. EPA*. The economic significance of the EPA's rule can hardly be overstated: According to the agency's projections, the rule's requirements (when implemented fully in 2016) would impose annual costs of $9.6 billion and produce annual monetized benefits between $37 billion and $90 billion.

The Court's review of regulations and other administrative actions frequently yields decisions that narrowly address a particular agency's jurisdiction or statutory scheme. But even when those decisions have great policy significance — as in the mercury cases described above — they rarely affect every sphere of rulemaking. This term, however, the Court will address in *Perez v. Mortgage Bankers Association* and *Nickols v. Mortgage Bankers Association* (argued on December 1, 2014) a procedural question with potential implications across all areas of regulatory activity.

When an agency promulgates a new regulation or amends an old one, the Administrative Procedure Act requires it to provide notice to the public and solicit the public's comments — an undertaking that can require substantial time and resources. The same notice-and-comment procedure generally is not required when an agency interprets its own existing regulation. Courts of Appeals disagree, however, about the process an agency must follow before it can significantly revise its interpretation of its regulation. The Supreme Court will review the District of Columbia Circuit's ruling that a revision of this kind requires notice and comment.

While *Perez* and *Nickols* arise from interpretations of particular overtime rules by the Department of Labor, their outcome could have much broader reach. After all, the Administrative Procedure Act governs a wide spectrum of rules, from pollution controls to securities to telecommunications. The notice-and-comment process serves as the principal formal colloquy between administrative agencies and members of the public, including the regulated community. It also contributes to the record upon which a regulatory agency must base its final rules and defend those rules in the courts. A decision in the government's favor in *Perez* and *Nickols* could therefore encourage agencies to avoid the time and expense of notice-and-comment rulemaking by making policy through interpretation of existing regulations.

Procedural Aspects of Federal Litigation

The Supreme Court frequently resolves disputes about procedures of federal litigation, and this term is no exception. In one of the term's first decisions, *Dart Cherokee Basin Operating Company*, *LLC v. Owens*, the Court placed a low pleading burden on a defendant seeking to remove a case from state to federal court. It held that the defendant's notice of removal needs to include only a plausible allegation that the amount in controversy exceeds the jurisdictional threshold — and need not contain evidentiary submissions on that issue. In the underlying case, the Tenth Circuit let stand a district court order remanding a class action back to state court because the defendant's notice of removal did not include evidence that the amount in controversy exceeded $5 million — a prerequisite for removal under the Class Action Fairness Act (CAFA), a 2005 statute that expanded federal jurisdiction over class actions in an effort to curb forum shopping by plaintiffs. The Supreme Court vacated the Tenth Circuit's judgment, disagreeing with the district court's reasoning and siding with defendants that seek to take advantage of CAFA removal jurisdiction.

Although decisions announced at the beginning of a term typically reflect unanimous or lopsided votes, the justices in *Dart Cherokee* split five to four. The dispute among them, however, had less to do with whether the district court properly remanded the case than whether the Supreme Court should have addressed that question at all. After the Supreme Court accepted *Dart Cherokee* for review, an *amicus* brief drew its attention to a procedural twist: The Tenth Circuit never expressly ruled on the legal reasoning of the district court — it only made a discretionary decision not to review the district court's remand order. For the four dissenting justices, this procedural complication became dispositive; they would have dismissed the defendant's *certiorari* petition in *Dart Cherokee* without deciding its merits. But the majority disagreed and held that the Tenth Circuit's refusal to review the district court's remand decision "was infected by legal error" that the district court committed.

The disagreement among the justices highlights two important lessons for Supreme Court practice: First, a party opposing a *certiorari* petition must meticulously identify any procedural oddities that might make the petition a poor vehicle for addressing the legal question the petition asks the Court to resolve. The *Dart Cherokee* plaintiff might have benefited from highlighting at an early juncture the discretionary nature of the Tenth Circuit's ruling. That might have deterred the Supreme Court (including members of the majority who ultimately sided with the defendant) from granting *certiorari* in the first place. Second, a well-targeted *amicus* brief can continue to assist and influence the Court's deliberations.

The Court also has ruled that a plaintiff can immediately appeal the dismissal of a single action within a group of federal cases consolidated for pretrial proceedings. The dispute before the Court arose from private lawsuits alleging manipulation of the London InterBank Offered Rate (LIBOR), an important reference point for determining interest rates for financial instruments. The Judicial Panel on Multidistrict Litigation consolidated a number of these actions — including an antitrust case brought by the petitioners — for pretrial proceedings in the District Court for the Southern District of New York. The district court dismissed many of the LIBOR-related claims, including all of the petitioners' antitrust claims, but allowed certain claims in other consolidated cases to proceed. The petitioners appealed to the Second Circuit, which dismissed their appeal on its own initiative for lack of appellate jurisdiction, because the district court had not disposed of all claims in the consolidated actions. On January 21, 2015, the Supreme Court unanimously reversed the Second Circuit's judgment, holding that the district court's dismissal of the petitioners' claims effectively removed the petitioners from the consolidated proceedings and triggered their right to appeal. This outcome may have the effect of expediting appellate review in complex business disputes, such as antitrust or products liability actions, which often involve multiple cases consolidated for pretrial purposes. And the Supreme Court's decision clears the way for the Second Circuit's consideration of the

LIBOR dispute's merits, with possible implications for a number of other pending cases alleging manipulation of various financial benchmarks.

Other Business Cases

The Supreme Court will address the scope of the state-action doctrine — an exception from the antitrust laws that allows states to substitute certain regulatory schemes for free-market competition. The question before the Court concerns the circumstances in which that doctrine protects a state regulatory agency composed primarily of market participants. Asserting that such agencies (like other private parties performing acts authorized by a state) become immune from antitrust laws only when actively supervised by the state, the Federal Trade Commission enjoined certain actions by the board that regulates North Carolina's dental practices, which is composed mostly of practicing dentists. The board argued that it need not be subject to the state's active supervision to qualify for the state-action exception to antitrust laws. The Fourth Circuit disagreed, and the Supreme Court will review its decision in *North Carolina Board of Dental Examiners v. Federal Trade Commission* (argued on October 14, 2014). Should the Court broadly extend antitrust immunity, it would raise the specter of self-interested market participants using state powers to foreclose competition. Yet a limited immunity could make it more difficult for states to draw on practitioners for service on regulatory bodies. The policy questions implicated by *Board of Dental Examiners* echo those of the *Association of American Railroads* (discussed above), albeit in distinct areas of law.

Finally, in the area of securities law, the Court will address the scope of Section 11 of the Securities Act of 1933, in a case that addresses statements of opinion in a registration statement. (See "Securities Litigation Developments Largely Expected to Shift From Supreme Court to District and Circuit Courts in 2015.") If the Supreme Court upholds the Sixth Circuit's decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund* (argued November 3, 2014), the ruling could suggest that Section 11 imposes strict liability for objectively untrue statements of opinion and therefore open the door to more private Section 11 lawsuits.

Portions of this article were published in the Skadden memorandum "Cases to Watch in the 2014-15 Supreme Court Term," October 2014. For previously covered cases, this article includes updates and supplemental material.

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Securities Litigation Developments Largely Expected to Shift From Supreme Court to District and Circuit Courts in 2015

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As observed in the 2014 edition of *Insights*, the Supreme Court stood poised last term to resolve a number of noteworthy issues with the potential to affect the securities litigation landscape. In *Chadbourne & Parke*, *LLP v. Troice*, 134 S. Ct. 1058 (2014), the Supreme Court clarified that the Securities Litigation Uniform Standards Act applies only "where the misrepresentation makes a significant difference to someone's decision to purchase or to sell a covered security," and in *Lawson v. FMR, LLC*, 134 S. Ct. 1158 (2014), it held that the whistleblower protections under Sarbanes-Oxley apply to employees of a public company's private contractors and subcontractors. In its much-anticipated opinion in *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014), and as explored further below, the Supreme Court reaffirmed the applicability of the fraud-on-the-market presumption of reliance, but also definitively confirmed a defendant's right to rebut the presumption at the class certification stage by presenting evidence that the alleged misrepresentations did not affect the stock's price.

Although the number of settlements remained at a nearly 20-year low, the number of new federal securities class action filings remained essentially unchanged last year as compared to the average over the previous five years. Despite such apparent stability, the landscape and potential strategic responses to federal class action securities litigation continue to evolve, and important ever-present considerations remain for all publicly traded companies. Recent developments notwithstanding, many uncertainties in the law remain, and we anticipate further evolution in several areas in 2015.

Does Section 11 Require Statements of Opinion or Belief to Be Reasonable?

The U.S. Supreme Court likely will decide in the next few months whether opinion statements that later prove false, regardless of whether the speaker believed them to be true when made, are actionable under Section 11 of the 1933 Securities Act, 15 U.S.C. § 77k.

The Second, Third and Ninth Circuits have held that an opinion statement is actionable under Section 11 only if (1) the statement later turned out to be incorrect (the "objective falsity" requirement) and (2) the speaker did not actually believe the statement to be true at the time it was made (the "subjective falsity" requirement). Conversely, the Sixth Circuit recently held in *Indiana State District Council of Laborers Pension & Welfare Fund v. Omnicare, Inc.*, 719 F.3d 498 (6th Cir. 2013), that Section 11 claims are predicated upon strict liability and thus can proceed solely on the basis of allegations of objective falsity (*i.e.*, rejecting any subjective falsity requirement).

The Supreme Court heard oral argument on November 3, 2014. The petitioner, Omnicare, argued that Section 11 imposes liability only if both the objective and subjective falsity predicates are met, contending that an opinion statement cannot be false if the speaker genuinely believed in the truth of the statement at the time it was made. The respondents — investors who purchased Omnicare securities in a 2005 public offering — argued that Section 11 is a strict liability statute and thus consideration of a speaker's state of mind concerning a challenged opinion statement is not relevant and issuers should be held liable for opinions that turn out to be incorrect.

Neither view appeared to move the Supreme Court as much as the government's proffered "reasonable basis" approach to assessing Section 11 opinion liability. This "middle ground" test is essentially an attempt to harmonize the circuit court split and focuses the inquiry on whether (1) the speaker genuinely believed the

opinion at the time it was made and (2) there was a reasonable basis for believing that opinion to be true. Speculation abounds, but a consensus is growing that the Court will move toward this type of composite formulation rather than picking among the current poles.

To be sure, the seeming ambiguity of what might constitute a "reasonable basis" underlying the belief required to satisfy the government's proposed standard is a legitimate concern (as noted in questions posed by Justice Samuel Alito at oral argument). Additionally, adopting a "reasonable basis" standard could unfairly disadvantage issuers seeking resolution at the pleading stage, because what constitutes a "reasonable basis" likely would be argued by the plaintiffs' bar to involve a fact-intensive inquiry that only should be resolved at the summary judgment stage after discovery.

However, adoption of a "reasonable basis" inquiry would repudiate in an important way the Sixth Circuit's approach to opinion statements — which untethered opinions from their judgmental basis despite the fact that such statements of belief are by definition uncertain and, in some instances, may later turn out to be incorrect. Indeed, opinions that often are at issue in Section 11 cases — loan loss and other similar reserve determinations, litigation outcome estimates, goodwill and other judgmental assessments — could become more problematic to defend if plaintiffs are only required to plead objective falsity. Rather, by requiring plaintiffs to plead nonconclusory facts from which to infer that the speaker lacked an appropriate basis for the opinion or belief, the Court would preserve an important minimum pleading baseline that plaintiffs must meet to survive dismissal.

After *Halliburton*: Assessing the Preliminary Effects as Courts (Re)Consider Evidence of 'Price Impact' at Class Certification

In June 2014, the U.S. Supreme Court issued perhaps its most anticipated securities law opinion in recent years if not decades, *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014) (*Halliburton II*), which revisited the fraud-on-the-market theory first integrated into federal securities law by *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). Essentially, the fraud-on-the-market theory provides class action plaintiffs with a presumption of reliance on the market price of a stock so long as the stock was traded in an efficient market, the alleged misrepresentation was material and known to the public, and the investor purchased stock after the alleged misrepresentation was made. This presumption is a rebuttable one, and the Court long ago articulated in *Basic* that "any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance." *Basic*, 485 U.S. at 248.

In *Halliburton II*, the Court reaffirmed the viability of the fraud-on-the-market theory, but reiterated that the "burden of proving th[e] prerequisites still rests with plaintiffs and (with the exception of materiality) must be satisfied before class certification." The Court likewise reaffirmed a defendant's right to rebut the presumption of reliance by "appropriate evidence," and clarified that one way of doing so is by offering "evidence that the asserted misrepresentation (or its correction) did not affect the market price of the defendant's stock."

The Supreme Court's unambiguous approval of a defendant's right to contest "price impact" at class certification is important, even if it only affirmed the standards already prevailing in some circuits. The Second Circuit, for example, previously endorsed consideration of event studies and other evidentiary tools in order to demonstrate "no impact" on price.

However, the Court did not address several important practical uncertainties.

For example, what evidentiary burden must a defendant satisfy to demonstrate a lack of price impact? Thus far, no answers have emerged from the district court after the Supreme Court remanded the case in *Halliburton II*. However, the Halliburton defendants have renewed their argument in the district court that the plaintiffs were not entitled to a presumption of reliance because the alleged misrepresentations had no price impact, asserting that "[n]either the Supreme Court nor Justice Ginsburg's concurrence … ever stated a defendant must 'prove' a lack of price impact by the preponderance of the evidence," and therefore that the burden to demonstrate a lack of price impact "is one of evidentiary production, not ultimate persuasion."

Some of the first post-*Halliburton II* district court decisions, however, have drawn that assertion into question. In *McIntire v. China MediaExpress Holdings, Inc.*, No. 11-cv-0804 (VM), 2014 WL 4049896, at *13 (S.D.N.Y. Aug. 15, 2014), the court determined that the "defendant bears the burden to prove a lack of price impact" — which the court noted could be shown through an increase or the absence of a decrease in price. The auditor defendant in that case could not forestall certification because it had not "met its burden to prove that its alleged misstatements did not improperly maintain [the] already-inflated stock price."

In that same vein, the court in *Aranaz v. Catalyst Pharmaceutical Partners, Inc.*, 302 F.R.D 657 (S.D. Fla. 2014), determined that "defendants have the burden of rebutting the presumption of price impact," which was characterized as an "onerous" and "daunting" task. Indeed, the court further observed that "proving an absence of price impact seems exceedingly difficult, especially at the class certification stage in which it must be assumed that the alleged misrepresentation was material." Similarly, a recent decision in *Local 703, I.B. of T. Grocery & Food Employees Welfare Fund v. Regions Financial Corp.*, No. CV-10-J-2847-S, 2014 WL 6661918 (N.D. Ala. Nov. 19, 2014), relying in part on *Catalyst* and expressly remanded by the Eleventh Circuit to consider evidence of lack of price impact, concluded that "nothing in Halliburton II requires the plaintiffs to produce an event study in opposition to defendants' event study on a class certification motion."

To be sure, *Halliburton II* confirmed that evidence of any price impact must be considered at class certification. While that much is certain, other more practical questions — including whether there is a quantitative as well as a qualitative evidentiary burden a defendant must overcome to demonstrate lack of price impact; if and how dueling expert reports will be resolved; and whether Rule 23's own mandates ever cause the burden to shift back to plaintiffs — must await guidance from the lower courts and, ultimately, more definitive resolution by the circuit courts. It may be that another trip to the Supreme Court will be necessary to fully answer those and other remaining questions. Until that time, issuers and their advisers likely will continue to weigh how robustly to challenge class certification in order to preserve the above issues for leverage during any settlement negotiations and to ensure that they remain a part of the arsenal available for summary judgment and trial.

Omnicare Also May Shape the Contours of Corporate Scienter

In another recent decision involving *Omnicare — Ansfield v. Omnicare, Inc. (In re Omnicare, Inc. Securities Litigation*, 769 F.3d 455 (6th Cir. 2014) — the Sixth Circuit articulated its standard for imputing scienter under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. The Sixth Circuit explained that the knowledge of only three categories of individuals may be imputed to a corporation: "(a) the individual agent who uttered or issued the misrepresentation; (b) any individual agent who authorized, requested, commanded, furnished information for, prepared … reviewed, or approved the statement in which the misrepresentation was made before its utterance or issuance; (c) any high managerial agent or member of the board of directors who ratified, recklessly disregarded, or tolerated the misrepresentation after its utterance of issuance." Applying this clarified approach to the assessment of corporate scienter allegations, the Sixth Circuit affirmed the dismissal of Section 10(b) claims against Omnicare and several of its current and former officers, noting that the complaint failed to allege specific facts showing that the individual defendants had actual knowledge of any material misrepresentation or omission. It remains to be seen whether the Sixth Circuit's new approach to corporate scienter will expand to, and be similarly applied in, the other circuit courts and/or whether it will contribute to any eventual trip to the Supreme Court to harmonize the various circuit approaches to imputation. Pending further percolation, the more immediate question is whether yet another standard for pleading corporate scienter will have any meaningful effect more broadly on whom plaintiffs choose to name as defendants in Section 10(b) litigation.

Federal Extender Statutes and Statutes of Repose: The Implications of *Waldburger* Remain Unsettled

Earlier this month, the Supreme Court declined to grant *certiorari* a second time in Nomura Home Equity Loan, Inc.'s ongoing battle in the Tenth Circuit with the National Credit Union Administration (NCUA). Once again, the Supreme Court deferred an opportunity to clarify whether a federal extender statute (in this case, a provision included in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA)) applicable to claims brought by the NCUA against lenders like Nomura was intended to displace the Securities Exchange Act's three-year statute of repose. The Tenth Circuit held in 2013 that the extender provision in FIRREA "established a universal time frame for the [NCUA] to bring any actions on behalf of credit unions placed into conservatorship or receivership," notwithstanding other potentially applicable statutes of limitations or statutes of repose, and the Supreme Court granted *certiorari* to review that decision, *National Credit Union Administration Board v. Nomura Home Equity Loan, Inc.*, 764 F.3d 1199 (2014). Before oral argument, however, the Supreme Court reversed and remanded for reconsideration in light of *CTS Corp. v. Waldburger*, 134 S. Ct. 2175 (2014). In *Waldburger*, the Supreme Court addressed similar questions raised by a different federal law (in that case, one applicable to environmental claims) and held that a state's statute of repose was not pre-empted. Upon reconsideration, the Tenth Circuit reinstated its decision, holding that the federal statute addressed in *Waldburger* concerned a claim's accrual date and was substantially different from the FIRREA extender statute, which "plainly establishes its own exclusive time limits for NCUA enforcement actions and displaces all others." *Nat'l Credit Union Admin. Bd.*, 764 F.3d at 1209.

The Supreme Court's decision to deny *certiorari* was surprising in light of the stakes involved in the expansive catalog of similar cases brought around the nation by the NCUA, the Federal Housing Finance Agency and the Federal Deposit Insurance Corporation (FDIC). For example, the two failed credit unions at issue in *Nomura* purchased a total of $1.74 billion in mortgage-backed securities and allegedly incurred "staggering" losses when foreclosure rates increased. Indeed, as a result of the mixed extender statute rulings from courts nationwide, much uncertainty in this area remains and likely will continue to prevail until the Supreme Court chooses to step into the fray again. For instance, in *F.D.I.C. v. Chase Mortgage Financial Corp.*, No. 12 Civ. 6166(LLS), 2014 WL 4354671 (S.D.N.Y. Sept. 2, 2014), a district court for the Southern District of New York determined that the FIRREA extender statute applicable to claims brought by the FDIC was not intended to alter (*i.e.*, pre-empt) the applicable statute of repose, and held that the FDIC's claims were barred. *Id.* at *5. But in *National Credit Union Admin. Board v. Morgan Stanley & Co.*, No. 13 Civ. 6705 (DLC), 2014 WL 5017822 (S.D.N.Y. Sept. 30, 2014), the court adopted the Tenth Circuit's pre-emption reasoning from *Nomura*, holding that the NCUA's claims could move forward. *Id.* at *3.

These decisions and others evince the need for further clarification in this area, and several forthcoming appellate court decisions can be expected to be monitored closely by stakeholders and their advisers. In the Second Circuit, the Court of Appeals will hear the FDIC's appeal in *Chase*, and the Ninth and Fifth Circuits are also poised to decide similar cases later in 2015 or early 2016. *National Credit Union Administration v. Goldman Sachs & Co.*, No. 14-55309 (9th Cir.) (NCUA extender provision); and *FDIC v. Merrill Lynch Pierce Fenner & Smith, Inc.*, No. 14-51055 (5th Cir.) (FDIC extender provision). Although many observers felt that conditions were ripe for the Supreme Court to address more promptly the issue most recently raised in *Nomura*, another opportunity may present itself quickly if one or more of the forthcoming appellate decisions conflicts with the Tenth Circuit's analysis in *Nomura*.

Robust Action Dominates Global Government Enforcement Landscape

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In the global criminal and regulatory enforcement arena, robust enforcement actions against multinational companies are likely to continue worldwide in 2015. In North and South America, Europe and Asia, with criminal investigations and prosecutions across multiple areas, regulators are working together to comprehensively target alleged misconduct of global corporations and financial institutions.

In addition to U.S. enforcement activity, authorities outside the United States have increasingly pursued significant, complex international investigations of their own, a trend we expect to continue in 2015. Corruption investigations and enforcement have been particularly active areas in 2014 in the United Kingdom, Germany, France, China and Brazil, as have antitrust and fraud actions. This same active enforcement environment has pushed important governance and criminal law issues to litigation in Europe, testing the boundaries of board of director duties in Germany and double-jeopardy protections in France. These legal questions are expected to be addressed further in 2015.

United States: International Cooperation, Anti-Corruption and Tax Remain Key Issues for Enforcement Authorities

U.S. authorities continue to aggressively pursue cross-border investigations and to scrutinize closely the compliance programs of multinational corporations. Investigative activity by U.S. authorities in 2014 was particularly intense in the areas of market abuse, corrupt practices and bribery, and tax fraud, and that activity is anticipated to extend into 2015, perhaps with an even broader geographical reach. However, aggressive enforcement by U.S. and international regulators also led to tensions regarding employee rights, regulatory competition and double-jeopardy concerns, and conflicts between U.S. expectations and non-U.S. privacy and data protection rights. These concerns will continue in 2015.

Market Abuse Investigations Illustrate Challenges of International Cooperation

In November 2014, the U.S. Commodities Futures Trading Commission (CFTC), U.S. Office of the Comptroller of the Currency (OCC), U.K. Financial Conduct Authority (FCA) and Swiss Financial Market Supervisory Authority (FINMA) announced coordinated settlements with five international financial institutions in relation to alleged efforts by foreign exchange traders to manipulate the benchmark currency exchange rates. Like the LIBOR investigations before it, which resulted in nearly $6.5 billion in fines, the foreign exchange (FOREX) market settlements have resulted in $3.3 billion in fines. Notably, neither the U.S. Department of Justice (DOJ) nor the New York Department of Financial Services (DFS) was part of this round of settlements, reflecting the difficulties that entities face in achieving global peace in a multijurisdictional investigation. Indeed, according to public reports, one financial institution withdrew from the November 2014 settlement in an effort to achieve a global and more coordinated settlement at a later time.

The LIBOR and FOREX investigations also have illustrated the tensions that arise when multiple regulators pursue the same individuals. In the LIBOR investigations, for example, the DOJ has charged four U.K. bankers with violations of U.S. law (one of whom has pleaded guilty) while these same individuals are subject to investigation by the U.K. Serious Fraud Office (SFO). In the FOREX

investigations, numerous individuals reportedly have been targeted by multiple regulators, complicating the efforts of any one regulator to secure cooperation or testimony from individual bankers.

US Authorities Continue to Focus on Anti-Corruption Investigations

U.S. authorities are actively enforcing the U.S. Foreign Corrupt Practices Act (FCPA) — often resulting in significant settlements with the entity being investigated. In 2014, the DOJ and Securities and Exchange Commission (SEC) resolved several long-running FCPA investigations with significant settlements, including with Alstom S.A. ($772 million), Alcoa Inc. ($384 million), Avon Corporation ($135 million), Hewlett-Packard Co. ($108 million) and Marubeni Corp. ($88 million). The Alstom settlement is the largest criminal penalty to date in an FCPA matter.

The SEC and DOJ have used the 2014 investigations and settlements to emphasize the importance of corporate voluntary disclosures and unfettered cooperation in investigations. In speeches last year concerning FCPA investigations, Marshall Miller and Leslie Caldwell, principal deputy attorney general and assistant attorney general and chief of the DOJ's Criminal Division, respectively, warned that as a result of the DOJ's deepening international relationships and increasing sophistication in analyzing non-U.S. law, the DOJ will more rigorously evaluate claims that international data privacy laws preclude the production of materials requested by the DOJ and may consider such claims "obstructionist" if deemed unsupported by relevant law. In resolving the Marubeni investigation, the DOJ noted "Marubeni's decision not to cooperate with the department's investigation when given the opportunity to do so, its lack of an effective compliance and ethics program at the time of the offense, its failure to properly remediate and the lack of its voluntary disclosure of the conduct." In the Alstom settlement, the DOJ noted (among other factors related to the resolution and fine), "Alstom's failure to voluntarily disclose the misconduct even though it was aware of related misconduct at a U.S. subsidiary that previously resolved corruption charges with the department in connection with a power

United States

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project in Italy [and] Alstom's refusal to fully cooperate with the department's investigation for several years."

Nevertheless, voluntary disclosures and full cooperation and disclosures do not guarantee minimal penalties. In settling FCPA investigations with the DOJ and SEC, Bio-Rad Laboratories agreed to disgorgement and penalties totaling $55 million despite having voluntarily disclosed compliance concerns to the government and cooperating fully with their investigations. Similarly, the DOJ and SEC credited Avon's cooperation in their investigations but still obtained $135 million in disgorgement and penalties.

Cross-Border Tax Resolutions Gain Additional Momentum

Non-U.S. banks and financial advisors suspected of aiding U.S. taxpayers in evading their tax obligations by opening and maintaining undeclared accounts overseas continue to face investigation and prosecution from U.S. authorities. (See also the Skadden memorandum "Latest Swiss Cross-Border Tax Investigation Reflects Wider US Enforcement Agenda" (June 26, 2014).)

In May 2014, Credit Suisse AG pleaded guilty to conspiracy to aid and assist U.S. taxpayers in filing false income tax returns and other documents with the Internal Revenue Service (IRS). Credit Suisse AG also agreed to pay $2.6 billion in fines in connection with the plea. The prosecution of Credit Suisse arose from a long-running investigation resulting in indictments of eight of its executives since 2011, two of whom have pleaded guilty.

In December 2014, Bank Leumi Group entered into a two-year deferred prosecution agreement with the DOJ in relation to allegations

that the bank conspired with U.S. taxpayers to prepare and present false tax returns to the IRS by assisting taxpayers in shielding income and assets in offshore bank accounts. Bank Leumi Group entities agreed to pay a total of $270 million to the DOJ. In a simultaneous and related settlement, Bank Leumi agreed to fines of $130 million imposed by DFS in relation to conduct by Bank Leumi USA and regarding Bank Leumi clients in New York state. In addition to the DFS fine, Bank Leumi agreed to an independent monitor, selected by DFS, to review the bank's compliance programs, policies and procedures.

Additionally, approximately 80-100 Swiss banks reportedly are still participating in the voluntary disclosure program, which began in 2013, that allows Swiss banks that may have committed a tax- or monetary-related offense under U.S. law to obtain a nonprosecution agreement (NPA). Banks participating in the program must pay a substantial fine and disclose a significant amount of information about U.S. accountholders, which has included details that will help in drafting requests to Swiss authorities for information related to undisclosed accounts.

The DOJ's investigation and resolution of tax matters will continue to be significant in 2015. Several financial institutions remain targets of DOJ investigation, and settlements are likely to be reached that are consistent with the Credit Suisse and Bank Leumi matters. In addition, the U.S.-Swiss Amnesty Program can be expected to result in numerous nonprosecution agreements with banks that are participating in the program. Finally, the DOJ has used its investigations and the program to gather information on U.S. taxpayers as well as individuals and entities that have assisted taxpayers in maintaining funds abroad, and the DOJ and IRS are likely to use such information to pursue additional investigations in 2015.

United Kingdom: The SFO Focuses on Corporate Fraud and Corruption

Once the subject of speculation regarding its possible consolidation with other agencies, the Serious Fraud Office (SFO) had an exceedingly busy 2014, with all signs suggesting that it will continue its aggressive enforcement in 2015. U.K. criminal enforcement investigations and enforcement actions in 2014 were typified by significant corporate fraud and corruption cases across numerous sectors, including financial services, transport, mining, energy, pharma, retail, aerospace and defense.

Financial Crisis-Related Actions

Post-financial crisis enforcement proceedings continue to dominate the investigations landscape. The SFO and the Financial Conduct Authority (FCA) brought several new criminal and regulatory enforcement proceedings against global banks and financial services firms in 2014, including the FCA's involvement in the November 2014 FOREX settlements with six international banks. To date, the SFO has brought criminal charges in the LIBOR investigation against 13 individuals. One defendant reportedly has pleaded guilty but has not been named. The first trial has been scheduled for May 2015 and will undoubtedly be followed by more trials regarding rate-setting.

New Fraud and Corruption Actions

The SFO also has opened a number of new and significant fraud and corruption matters. U.K. government procurement remained in the spotlight over public services contracts involving Serco Group plc and G4S plc, which fraudulently overcharged for providing prisoner electronic tagging services to the Home Office. Suspected revenue recognition and accounting irregularities investigated by the SFO at Autonomy and Gyrus (a subsidiary of Olympus plc) have been followed by similar allegations against Tesco Plc, including charges of overstating its profits.

In addition to opening significant corruption investigations against Eurasian Natural Resources Corp. plc (ENRC) and Rolls Royce, this past summer the SFO concluded the long-running prosecution of Innospec Ltd, with corruption convictions of two former CEOs and two other directors for bribing Indonesian public officials to maintain or increase sales of a lead-based petroleum product. The conviction and jailing of three of the four Innospec executives followed a $40 million settlement of the case brought by SFO in partnership with the DOJ, SEC and OFAC. Finally, the SFO opened an investigation of GlaxoSmithKline (GSK), following investigations by Chinese authorities,

United Kingdom

The internationalization of U.S. investigation and settlement techniques included the introduction of DPAs in the U.K. in 2014, but at least one case suggests that the SFO will only offer DPAs to companies in selective circumstances.

further reflecting the multijurisdictional trends in corporate corruption investigations.

Changes to the UK Criminal Justice System

The trend of internationalization of U.S. investigation and settlement techniques was confirmed with the introduction of deferred prosecution agreements (DPAs) in the U.K. in February 2014. Under a U.K. DPA, a company that admits certain economic and financial offenses, cooperates with the authorities and commits to significant remediation will be able to avoid prosecution if it complies with set conditions that include the payment of financial penalties. Notably, this disposition was available but rejected by the SFO in the long-running and heavily contested Alstom matter — in July 2014, the SFO charged the U.K. subsidiary of Alstom with corruption in the transport sector in India, Poland and Tunisia that allegedly occurred between 2000 and 2006. The lack of a DPA is an aggressive approach adopted against Alstom and suggests that the SFO will only offer DPAs to companies in selective circumstances.

In another potentially significant 2014 development, the U.K. Sentencing Council announced significant reforms of sentencing principles to be applied in serious economic crime cases. The Sentencing Council clarified the central factors for criminal sentencing for fraud, money laundering and corruption offenses. Focusing on harm and culpability, the reform brings U.K. sentencing principles recognizably closer to the structured approach set forth in the U.S. Federal Sentencing Guidelines. As a result, companies facing enforcement proceedings in the U.K. in 2015 and beyond can expect a more certain enforcement terrain for contested trials and settlements.

Reforms of the U.K. justice system also have been consolidated by the introduction of new criminal offenses. In the wake of the banking crisis, the U.K. has criminalized negligent banking and the manipulation of benchmarks such as LIBOR. In addition, the SFO and other interested parties have advocated for the criminalization of inadequate or negligent supervision of companies committing fraud.

Outlook for 2015

Over the past year, enforcement proceedings have become easier to bring in the United Kingdom. On December 5, 2014, the SFO announced the convictions of two individuals in an investment fraud case in which Bribery Act offenses were brought. Undoubtedly, it will not be long before the agency brings its first significant Bribery Act enforcement proceeding against a company.

Despite reported comments by the U.K. home secretary that she may restructure the SFO or merge it with other U.K. enforcement agencies, the SFO remains active in several significant, complex and internationalized cases of national and international importance. With the U.K. chancellor's recent pronouncement following the FOREX bank settlements that he would write a "blank cheque" to finance the SFO's FOREX enforcement proceedings against bank traders and executives, it seems that the agency's short-term future is assured and that it will continue to investigate and bring significant enforcement proceedings in the foreseeable future.

Germany: High-Profile Enforcement Actions and Increased Cartel Prosecution Dominate Enforcement Landscape

Several high-profile corporate criminal investigations and prosecutions in Germany have led to the scrutiny of directors and officers for failure of controls and supervision. Several recent notable German enforcement actions against directors and officers under both private and criminal law demonstrate the challenges members of boards of directors face under German corporate law and highlight the potential need to change director's liability rules.

In addition, the German Federal Cartel Office (Bundeskartellamt) has significantly stepped up its efforts in cartel prosecution, culminating in the imposition of cartel fines exceeding €1 billion in 2014, an all-time high in Germany, putting companies, boards, and their directors and officers on high alert for increased scrutiny in these areas in 2015.

Actions Against Directors and Officers: Civil Law

Unlike U.S. corporate law, German corporate law provides for a two-tier board system, comprising a management board (Vorstand) and a supervisory board (Aufsichtsrat). The management board is directly responsible for day-to-day management and represents the company in and out of court. The supervisory board oversees the management board and represents the company in claims against members of the management board.

In December 2013, the Regional Court (Landgericht) Munich ordered Heinz-Joachim Neubürger, former CFO of Siemens AG, to pay €15 million in damages for failing to implement and monitor an appropriate compliance system for identifying and stopping corruption within Siemens. Even though the decision was appealed and the parties have settled, the judgment has been scrutinized closely by the legal community, as it addressed the important question of which requirements a compliance system must fulfill. The court stated that each member of the managing board had the duty to set up an effective compliance system that prevented and uncovered compliance violations and enabled the company to address them. The court ruled that the managing board also must monitor the effectiveness of the compliance system and, if need be, make necessary adjustments.

The Neubürger decision has fueled a discussion regarding the need to change the (rather strict) German director's liability rules. For example, German company law provides for joint and several liability of board members for full damages, even in cases of mere negligence, including some circumstances in which the alleged failure does not fall within the area of responsibility of the sued board member. Another much-debated rule is the burden of proof for diligent behavior, which lies with the board member, not the company.

Germany

Recent enforcement actions highlight the potential need to change director's liability rules.

Actions Against Directors and Officers: Criminal Law

In criminal law, three ongoing cases are likely to have a significant impact in the coming year:

Three current and former CEOs of Deutsche Bank AG (Rolf Breuer, Joseph Ackermann and Jürgen Fitschen) and other bank officers have been indicted for allegedly attempting to defraud the court in the civil litigation proceedings between the late Leo Kirch and Deutsche Bank. Kirch, a Munich-based film mogul, raised claims for damages against Deutsche Bank following a 2002 Bloomberg interview by Breuer that allegedly led to the collapse of Kirch's film empire. Although the parties settled the civil litigation in early 2014, the dispute continues to command attention because Deutsche Bank and the law firms of Hengeler Mueller and Gleiss Lutz were raided by the prosecution, which is investigating whether the firms' partners illicitly exerted influence on witnesses (as opposed to legally preparing them for trial). If the investigation leads to legal action against the law firms, it would likely have a substantial impact on how attorneys prepare witnesses. The Regional Court Munich's decision on whether to try the current and former Deutsche Bank CEOs is expected in early 2015. Five years after the near-collapse and nationalization of Hypo Real Estate (HRE), which led to the largest bank rescue in German history, former management board Chairman Georg Funke and other HRE officers face criminal charges. Funke is accused of falsely representing HRE's financial position in financial statements in 2007 and 2008. The decision as to whether to proceed with a trial currently rests with the Regional Court Munich. In November 2014, Thomas Middelhoff, the former CEO of Arcandor AG, was sentenced to three years in prison for embezzlement and tax evasion in connection with the company's insolvency. The judgment has not become final yet. Both the HRE and Arcandor situations demonstrate the increased risk of criminal prosecution that board members now face.

Antitrust Enforcement

This past year marked the first time that the German Federal Cartel Office (FCO) imposed cartel fines exceeding €1 billion. (See "Insights Conversations: Cartels.") The key reasons for the record year include an expansion of the FCO's staff, newly effective key witness programs and so-called "leniency" programs. Dating back to 2000, the FCO has utilized leniency programs, granting immunity from or a reduction of fines to cartel participants whose cooperation contributes to uncovering a cartel. Almost 50 percent of cartels that have been found in that time were uncovered because of such leniency programs.

In addition, private "follow-on" claims for damages suffered from cartel law violations complement the increasing public antitrust enforcement activity. The effectiveness of private damages actions has been strengthened through legislative action in recent years, which has established Germany as a "claimant-friendly" country for such claims. Most notably, where damages are claimed for an infringement of competition law, German courts are bound by a finding that an infringement has occurred if such a finding was made in a final decision by the cartel authority. Furthermore, the individual damage does not have to be calculated precisely but rather can be estimated by the relevant court. Given the current state of antitrust enforcement in Germany, most of the requirements of the new Directive on Antitrust Damages by the European Union, which was signed on November 26, 2014, and has been a hotly discussed topic, already are fulfilled under German law. (See "EU Nonmerger Antitrust Enforcement Gets Stricter.")

France: The *ne bis in idem* Principle and Settlements With US Authorities

Successive investigations in France following U.S. prosecutions and settlements have led to court challenges on the grounds of double jeopardy, a trend that will only increase as more countries scrutinize the same conduct in multijurisdictional investigations. Under Article 113-9 of the French Criminal Code (and Article 692 of the Code of Criminal Procedure), a French citizen cannot be prosecuted for crimes and misdemeanors (délits) committed outside France, nor can a foreigner if the offense involved a French victim, if the perpetrator has been tried abroad for the same facts and, if convicted, a sentence was served or is time-barred.

However, for offenses committed at least in part on French republic territory, French courts consistently have held that decisions rendered by foreign tribunals in connection with the same facts do not have *res judicata* effect in France. In 2013, the French Supreme Court (Cour de cassation) slightly tempered that principle by holding that any period of imprisonment spent abroad should be taken into consideration by the French criminal court at the sentencing stage.

In recent years, the broad interpretation of the scope of certain laws and regulations, especially in corruption, economic sanctions and money laundering cases, has increased the number of cases in which an individual or legal entity is prosecuted and possibly sanctioned twice for the same set of facts — especially in situations in which U.S. authorities have secured an NPA, DPA or guilty plea. This has led the Paris criminal court of first instance (Tribunal correctionnel) to revisit the above jurisprudence and decide that the *ne bis in idem* principle should in fact be enforced by French courts. (See "France's Double-Trial System for Market Abuses May Be Headed for Reform.")

France

In recent years, the broad interpretation of the scope of certain laws and regulations has increased the number of cases in which an individual or legal entity is prosecuted and possibly sanctioned twice for the same set of facts.

One significant matter involves prosecutions in France following the U.N. Oil-for-Food investigations. In this matter (*TGI Paris, 11ème ch. Correctionnelle*, July 8, 2013), the oil company Vitol, among many others, was prosecuted in France for bribing foreign public officials in connection with the allocation of contracts in Iraq. The Paris criminal court held that the plea deal between Vitol and U.S. authorities prevented prosecution in France. The court ruled that the French Code of Criminal

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France's Double-Trial System for Market Abuses May Be Headed for Reform

In 2015, the French double-trial system for market abuses will be referred to the Constitutional Council for an assessment of the system's constitutionality under the double jeopardy rule. Should the current system be held unconstitutional, this would mark the end of concurrent criminal and administrative sanctions against violators of financial market regulations.

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Procedure section governing *res judicata* and the International Covenant on Civil and Political Rights of 1966 section guaranteeing *ne bis in idem* protections were not limited to "domestic" sentencing decisions.

A second important matter relates to the investigations and prosecutions of Jeffrey Tesler for corruption in connection with a liquidated natural gas (LNG) facility construction project in Nigeria. Tesler, a British lawyer, concluded an FCPA plea agreement with the U.S. in 2011; Tesler admitted guilt, waived his rights to challenge the facts and served 21 months in prison. French authorities subsequently sought to bring charges against him, and the French court held that such a follow-on prosecution was precluded (*TGI Paris, 11ème ch. Correctionnelle*, June 24, 2014). In light of Tesler's covenants under the plea agreement, the court held that he was no longer in a position to receive a fair trial in France pursuant to Article 6, Section 1, of the European Convention on Human Rights (ECHR). The court also ruled that the *ne bis in idem* principle should be applied under these circumstances.

Finally, the exact same issue also will arise in 2015 in the upcoming Total S.A. trial, in which the French oil company will be prosecuted for alleged bribery in Iran in the context of the attribution of oil and gas fields. In May 2013, Total entered into a DPA with the U.S. for the same facts and agreed to pay a $398 million settlement.

Whether these decisions will be confirmed on appeal will constitute one of the major criminal law developments in the coming months in France.

China: Multinationals Continue to Adapt to Active Enforcement Environment

Over the past few years, the U.S. authorities have continued their aggressive stance toward corrupt activity in China; 2014 saw significantly increased enforcement efforts by Chinese authorities, both of local companies and multinationals doing business in China.

Two of the highest-profile FCPA settlements in recent years involved alleged conduct in China. Avon paid $135 million in 2014 in its settlement with U.S. authorities and reportedly spent nearly $400 million on its five-year FCPA investigation. Diebold Inc. paid $48 million in 2013 in its settlement with U.S. authorities and reportedly spent nearly $23 million on its own FCPA investigation.

Chinese enforcement actions against prominent multinationals have ramped up considerably in connection with both China's well-publicized anti-corruption campaign and the increasingly expansive application of its Anti-Monopoly Law. Those actions have involved multiple government agencies, including the State Administration for Industry and Commerce (SAIC), the Ministry of Public Security (MPS) and the National Development and Reform Commission (NDRC). Chinese authorities have emphasized that they are not targeting multinationals per se, yet investigations of businesses based overseas appear to be increasing in number, reflecting at least a heightened interest in the conduct of foreign entities operating in China.

The Anti-Corruption Campaign and Heightened Anti-Monopoly Enforcement

As has been well-reported, the Chinese authorities are in the midst of a wide-ranging anti-corruption campaign, which has resulted in the detention or arrest of a large number of current and former Chinese government officials. In December, authorities arrested Zhou Yongkang, former member of the Chinese Communist Party Politburo Standing Committee and the most prominent official to be arrested thus far. But the anti-corruption campaign has targeted multinational companies operating in China as well. The investigation into GSK,

China

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a multinational pharmaceutical company headquartered in the U.K., was perhaps the largest and best-publicized enforcement action against a non-Chinese company. It was alleged that GSK sales representatives made improper payments or offered other incentives to doctors to prescribe GSK pharmaceuticals, including via third parties such as travel agencies and consultancies. In July 2013, the Chinese police detained large numbers of China-based GSK personnel, and on September 19, 2014, GSK's Chinese subsidiary was found guilty in the Changsha Intermediate People's Court in Hunan Province of bribing nongovernment personnel to obtain improper commercial gain and fined almost $500 million.

The GSK enforcement actions were not limited to the company itself. GSK's former top executive in China, Mark Reilly, also was convicted of bribery charges, received a suspended three-year prison sentence and will be expelled from China. Four other senior GSK executives received suspended sentences as well. Chinese authorities also prosecuted Peter Humphrey and Yu Yingzeng, a husband-and-wife team of investigators hired by GSK to examine the whistleblower allegations, on charges that they illegally purchased personal data in connection with their investigation. Humphrey and Yingzeng were sentenced to two and a half years and two years in prison, respectively.

While the investigation of GSK is perhaps the clearest example of the increased regulatory scrutiny of multinationals, Chinese authorities reportedly also have initiated investigations or made inquiries of other multinational pharmaceutical companies doing business in China, including AstraZeneca, Roche, Bayer, Eli Lilly and Novartis. Nor have these inquiries been confined to the pharmaceutical industry. Multinational automobile and chipmakers also have come under scrutiny by the NDRC and SAIC, often for alleged violations of China's

anti-monopoly laws. The NDRC has pursued Qualcomm Inc. for alleged monopolistic behavior, claiming that Qualcomm charged excessive licensing fees. The SAIC also announced an anti-monopoly probe of Microsoft after reportedly visiting company offices in Beijing and several other cities. In July, foreign car companies including Mercedes-Benz, Audi and Jaguar Land Rover reportedly agreed to cut prices for cars, parts or service following pressure from the NDRC probes, and both Chrysler and General Motors' Shanghai joint venture reportedly have been subject to regulatory inquiries. Some of these regulatory inquiries can have ripple effects outside China, prompting investigations in other jurisdictions. For example, the Qualcomm investigation reportedly has triggered inquiries by the U.S. Federal Trade Commission (FTC) and the EU, and GSK is reportedly now facing additional corruption probes in the U.S., the U.K., Iraq, Jordan, Lebanon, Poland and Syria.

Adjusting to the New Enforcement Environment

The recent wave of enforcement activity in China requires continued vigilance for multinational companies and underscores the importance of an integrated global compliance infrastructure responsive to the different enforcement environments in various jurisdictions. Rigorous and regular evaluation and refinement of corporate compliance programs, enhanced monitoring of operations and careful attention to the regulatory and enforcement landscape will assist multinationals in limiting their risks worldwide. However, it seems clear that companies increasingly must have the capability to manage an ever larger number of regulators and respond to multiple simultaneous, parallel enforcement actions in different countries, including China.

Brazil

The Petrobras scandal will be a test of the strength and independence of the Brazilian judicative, as well as the first chance to enforce the 2013 Brazilian Anti-Corruption Act.

Brazil: Recent Corruption Scandals Offer First Test of Brazilian Anti-Corruption Act

As in China, in 2014, authorities in Brazil significantly increased investigations and enforcement actions. Brazilian headlines recently have been dominated by the corruption scandal involving Petrobras (Brazil's state-run, U.S.-listed energy company) and numerous Brazilian politicians and companies. The Petrobras case centers on the alleged granting of large contracts by certain senior Petrobras managers to Brazilian companies at inflated costs in exchange for "commissions" later transferred to political parties, politicians and others. The Brazilian federal police are investigating the allegations, and the scandal will be a test of the strength and independence of the Brazilian judicative, as well as the first chance to enforce the 2013 Brazilian Anti-Corruption Act. Highlighting the risks of multijurisdictional matters, the U.S. Department of Justice also is investigating the allegations, demonstrating the challenges companies face as various regulators exert increasingly broad jurisdiction to conduct anti-corruption and related investigations.

The Petrobras situation highlights the fact that Brazilian entities increasingly are subject to scrutiny by external regulators, including U.S. authorities, even when alleged corruption involves mostly local Brazilian entities. To avoid serious disruptions and significant

penalties in 2015 and beyond, Brazilian companies must adapt their business, risk-management and compliance practices to satisfy the heightened local and international anti-corruption standards and investigations associated with the increasingly globalized world. The Marubeni settlement highlights the broad jurisdictional reach of the FCPA.

DOJ and Other US Investigations

In March 2014, Marubeni pleaded guilty to one count of conspiring to violate the FCPA's anti-bribery provisions and seven counts of violating the FCPA's anti-bribery provisions by using third-party consultants to funnel bribes to high-ranking Indonesian government officials. While the company's stock did not trade on a U.S. stock exchange, the evidence turned on the fact that it made payments through its employees to a consultant's U.S. bank account knowing that a portion would be used for bribes. Knowingly making payments for illicit purposes, such as bribery, through third parties in the United States was sufficient to sustain a FCPA violation, even for an unregistered, foreign corporate entity.

Implications for 2015

The Petrobras situation demonstrates that Brazilian companies must adapt their business, risk-management and compliance practices to the new reality of global enforcement in order to avoid potentially serious consequences. With this in mind, companies, regardless of their ties to the United States, should have an effective internal compliance program to govern their activities and be prepared for any investigation, including by U.S. or other non-Brazilian regulators. Compliance programs should address local and international concerns and take into consideration, at a minimum:

- enhanced codes of conduct and related anti-corruption/government procurement policies and procedures;
- targeted education of employees regarding relevant anti-corruption laws and how to respond to high-risk situations;
- effective recordkeeping procedures and regular compliance audits of high-risk subsidiaries;
- effective internal reporting and investigative procedures to follow up on any indication of improper conduct;
- effective controls over monetary transfers, cash accounts and other disbursements; and
- thorough and meaningful due diligence on third-party business partners, including consultants, intermediaries and agents.

Aggressive SEC Enforcement Approach Creates New Challenges for Resolving Investigations

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The U.S. Securities and Exchange Commission (SEC) pursued aggressive enforcement of the securities laws in the past year. Several trends related to the SEC's vigorous approach are likely to continue in 2015.

SEC Whistleblower Program Begins to Pay Significant Awards

The Dodd-Frank Act gave the SEC authority to pay cash awards to whistleblowers to encourage the submission of enforcement tips. The program was seen by practitioners as having the potential to dramatically alter the SEC's traditionally reactive enforcement efforts by providing the agency with real-time evidence of ongoing misconduct. Although senior enforcement officials have lauded the quality of information obtained through the program since its launch, the long gestation period for awards — in many cases, several years — initially made it difficult to assess how effective the program actually had been.

Evidence supporting enforcement officials' claims has begun to come in, as both the number and size of whistleblower awards increased in fiscal year 2014. For example, the SEC issued nine awards, more than all previous years combined,[1] and in September 2014, the SEC authorized an award of more than $30 million, the largest to date, to a single whistleblower, who provided key information that led to a successful enforcement action.[2] Notably, this marked the fourth award to a whistleblower living in a foreign country, demonstrating the program's international reach. Both the size and number of awards are bound to incentivize others to utilize the program.

The Office of the Whistleblower also is coordinating with the Enforcement Division to identify cases of retaliation against whistleblowers. In the first case filed under the agency's new authority to bring anti-retaliation actions, the SEC charged an advisory firm with engaging in prohibited transactions and then retaliating against the employee who reported the activity by removing him from his position and stripping him of his responsibilities.[3]

Settlement Challenges for Financial Firms and Other Corporations

Policy changes adopted in response to the fallout from cases associated with the financial crisis have altered the calculus of settlement of SEC enforcement actions in various ways. Certain SEC commissioners have begun to scrutinize the decision of whether to grant issuers, in particular financial services firms, waivers from certain disqualification provisions otherwise triggered by SEC enforcement actions. Those waivers historically were handled at the staff level and, although not universally issued, were granted under generally predictable standards — a large financial institution that became subject to an enforcement action relating to a segment of its business could obtain an exemption that would permit it to continue to take advantage of certain streamlined offering processes and safe harbors. Criticism by SEC commissioners of this result and the decision to depart from past practice in certain instances has created uncertainties as to the collateral consequences of a settlement with the SEC. Recently, Commissioner Kara M. Stein indicated that the SEC may be moving toward limited and conditional waivers, as was done in a recent case involving Bank of America, but this remains an area of great uncertainty.[4] Accordingly, defendant companies may have a difficult time assessing whether proposed settlement terms are acceptable, given the potential business harm resulting from being denied relevant waivers.

Additionally, the SEC has continued its new policy of requiring admissions to settle certain cases. Although "neither admit nor deny" settlements remain the norm, the SEC now requires defendants to admit wrongdoing "in certain cases where heightened accountability or acceptance of responsibility through the defendant's admission of misconduct may be appropriate," even if that means the SEC will have to litigate rather than achieve a "prompt" resolution.[5] Since initiating the policy, the SEC has entered into several "admit" settlements, including a $920 million settlement with JPMorgan concerning its so-called "London Whale" trading.[6] It remains challenging to predict which cases may require admissions. However, such cases can have substantially greater collateral consequences, including the use of admissions in a criminal or civil proceeding, professional repercussions or additional fines from other regulatory organizations.

Increased Reliance on Administrative Proceedings

Coincident with its stiffening posture with regard to settlement demands, the SEC has determined to resort more regularly to its in-house administrative tribunal to adjudicate cases that it cannot settle, rather than to federal district court. In fiscal year 2014, the SEC filed 235 administrative proceedings, up 10 percent from the prior year.[7] The SEC likes the administrative forum because the process and procedure generally, but not always, tilt in the SEC's favor.

This increased reliance on administrative proceedings has come under scrutiny. U.S. District Court Judge Jed S. Rakoff recently criticized the proceedings, questioning the fairness of a forum presided over by a judge appointed and paid by the SEC.[8] Insider trading defendants also have filed suit to enjoin the agency from bringing actions as administrative proceedings.[9]

Despite the criticism, Andrew Ceresney, director of the Enforcement Division, has confirmed that the SEC plans to increase the use of administrative proceedings.[10] Ceresney defended the increase, noting that the proceedings offer a more streamlined process, which leads to a quicker hearing and result, and citing the impartiality and expertise of the administrative law judges. It appears the increased reliance on the administrative forum may be here to stay. In June 2014, the SEC nearly doubled the size of its Office of Administrative Law Judges.[10]

Focus on Holding Individuals Accountable

Under the leadership of Chairwoman Mary Jo White, the SEC has reiterated its focus on taking enforcement action against individuals who are responsible for securities law violations, rather than solely proceeding against the companies where they work. Ceresney recently affirmed the Enforcement Division's focus on individuals, stressing the heightened deterrent impact of actions against individuals as compared to those solely against entities.[11] One new approach adopted by the SEC is the use of Section 20(b) of the Securities Exchange Act of 1934 (Exchange Act), which imposes primary liability on a person who, directly or indirectly, does anything "by means of any other person" that would be unlawful for that person to do on his or her own. The use of Section 20(b) allows the SEC to avoid restrictions imposed by the Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), which held that only the maker of a statement may be liable for a fraudulent statement under Section 10(b) of the Exchange Act and that a maker is the person or entity with "ultimate authority" over that statement, including its contents and whether and how to communicate it. For example, in a recent administrative proceeding, the SEC alleged that an oil and gas company and its CEO violated Section 20(b) by providing a stock promoter with false information that "[t]hey knew or were reckless in not knowing" the stock promoter would use in promoting the company's stock to investors.[12] The focus on individuals is apparent in the SEC's aggressive pursuit of individuals' assets to satisfy financial remedies. In one recent matter, for example, the SEC has sought $455 million, potentially one of the largest judgments ever issued against an individual defendant, from Texas businessman Sam Wyly for his involvement in an offshore fraud scheme.[13] In order to secure the judgment, the SEC asked the court to freeze his and 12 relatives' assets.

The continuing evolution of the SEC's enforcement approach toward more aggressive demands, particularly with regard to settlements, alters the calculus for dealing with the agency. Where it was once a plausible strategy to consent to a disposition in which the SEC asserted factual and legal positions that it might not be able to sustain in litigation, the rising cost of such settlements justifies a deeper consideration of the case merits. In some situations, it will be appropriate to consider forgoing a settlement and putting the SEC to its proof in litigation.

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[1] U.S. Sec. & Exch. Comm'n, *2014 Annual Report on the Dodd-Frank Whistleblower Program* (2014).

[2] *Claim for Award in Connection with Redacted*, Exchange Act Release No. 73,174, Whistleblower Award Proc. No. 2014-10 (Sept. 22, 2014). The SEC noted that the award in this matter could have been larger, but the SEC reduced the sum because the whistleblower delayed reporting the misconduct after first learning of it.

[3] *Paradigm Capital Management, Inc.*, Exchange Act Release No. 72,393, Investment Advisers Act Release No. 3857, Admin Proc. No. 3-15930 (June 16, 2014).

[4] *See* Kara M. Stein, Commissioner, U.S. Sec. & Exch. Comm'n, Remarks Before the Consumer Federation of America's 27th Annual Financial Services Conference (Dec. 4, 2014).

[5] *See* Mary Jo White, Chairman, U.S. Sec. & Exch. Comm'n, Speech at the *Wall Street Journal* CFO Network Conference (June 18, 2013).

[6] *In the Matter of JPMorgan Chase & Co.*, Exchange Act Release No. 70,458, Accounting and Auditing Enforcement Act Release No. 3490, Admin. Proc. File No. 3-15507 (Sept. 19, 2013).

[7] Report on Administrative Proceedings for the Period April 1, 2014 through September 30, 2014, Exchange Act Release No. 73,458 (Oct. 29, 2014), *available at* http://www.sec.gov/reportspubs/special-studies/34-73458.pdf.

[8] Stephen Joyce, *SEC to Use Administrative Cases More, Despite Defense Bar Complaints, Officials Say*, Bloomberg BNA (Nov. 17, 2014), http://www.bna.com/sec-administrative-cases-n17179911882/.

[9] *See, e.g., Peixoto v. SEC*, No. 14-cv-8364 (S.D.N.Y. filed Oct. 20, 2014).

[10] Joyce, *supra* note 55.Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces New Hires in the Office of Administrative Law Judges (June 30, 2014).

[11] *See* Andrew Ceresney, Director, Division of Enforcement, U.S. Sec. & Exch. Comm'n, Remarks at the 31st International Conference on the Foreign Corrupt Practices Act (Nov. 19, 2014).

[12] *Houston American Energy Corp.*, Exchange Act Release No. 72,749, Admin. Proc. No. 3-16000 (Aug. 4, 2014).

[13] *SEC v. Wyly*, No. 10-5760 (S.D.N.Y. filed 2014).

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Recent Regulatory and FASB Actions Impacting Auditors

In one of several recent actions impacting auditors, the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) have devoted heightened attention to related-party transactions, adopting a new auditing standard that requires an enhanced level of reporting detail for such transactions, significant transactions outside the normal course of business and transactions with executives. The PCAOB found the new standard necessary because of "continuing weaknesses in auditors' scrutiny in these areas."

Another development impacting auditors is that the Financial Accounting Standards Board (FASB) recently announced new revenue recognition rules for contracts with customers that become effective at the end of 2016. The FASB described the new rules as "converged guidance" with the International Accounting Standards Board, and the new guidance represents "a major achievement in the Boards' joint efforts to improve this important area of financial reporting," according to the FASB.

In addition, as part of its statutory mandate under the Jumpstart Our Business Startups (JOBS) Act, the SEC is in the process of comprehensively reviewing its longstanding disclosure rules under Regulation S-K to determine, in part, whether these older rules remain pertinent and what information issuers should be required to disclose.

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Glazer: A Big Defense Victory, but Everyone Lost

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The most watched class action of the past year was the *Glazer* case — a rare occurrence of a consumer class action trial — which resulted in a defense victory. *See In re Whirlpool Corp. Front-Loading Washer Prods. Liab. Litig. (Glazer v. Whirlpool Corp.)*, No. 1:08-wp-65001-CAB (N.D. Ohio Oct. 31, 2014), ECF No. 491. In some ways, the jury's decision was unsurprising: Only a very small percentage of users reported mold problems with the energy-efficient front-load washing machines. But the fact that the case even reached a class trial raises critical concerns about overly broad classes, overcompensation of class members and the propriety of so-called "issues" trials — questions that are likely to dominate the class action landscape in the coming year.

Consumer class action trials are exceedingly uncommon because of the significant settlement pressure that comes with class certification, regardless of whether the plaintiffs' claims have any merit. Once a class is certified, the defendant faces a scenario in which a single jury can declare it liable to hundreds, thousands or even millions of plaintiffs, and potentially grant an astronomical damages award that could be ruinous to the company. As a result, class trials are often bet-the-company propositions. Class action defendants' general unwillingness to take that bet stems largely from the fact that, in a class trial, the deck is stacked in favor of the plaintiffs. As some courts have recognized, any trial in which the claims of many different plaintiffs are tried jointly against a defendant poses the risk of serious due process concerns. For one thing, there is a real risk that the jury will assume that "where there's smoke, there's fire"— *i.e.*, the fact that multiple plaintiffs have made the same allegations against a defendant means that those allegations are true. In addition, a jury may find in favor of all plaintiffs — even those who cannot prove the required elements of a legal claim individually — based on the facts of a single plaintiff's case.

Whirlpool may have been emboldened to go to trial because *Glazer* was certified as an issues class solely to determine whether the machines had a defect that made them more prone to mold; the court explicitly reserved damages for a second phase in the event of a plaintiff verdict. Issues trials are one of the most controversial open questions in class action practice today. The Sixth Circuit has embraced the concept, both in *Glazer* and other recent cases, as a means to facilitate class certification even where certain elements of the plaintiffs' claims — such as causation and/or injury — are inherently individualized. By contrast, other circuits have expressed skepticism regarding the use of issues classes. As these courts have noted, there is a serious risk that issues classes will result in multiple juries examining the same questions in violation of the Seventh Amendment. In addition, resolving a single issue on a classwide basis has little, if any, efficiency benefit in most cases.

Going forward, some consumer class action plaintiffs' lawyers may point to the *Glazer* verdict as evidence that class actions are not as one-sided as defendants paint them to be, and argue that courts therefore should liberally grant class certification, even where the proposed classes include uninjured claimants, because juries will reject bogus class action claims. There are many problems with such an argument. The fact that one class action defendant was able to overcome the significant prejudice inherent in a class trial is far from proof that such prejudice does not exist. In addition, as discussed above, even a small risk that a jury could award tens of millions of dollars in classwide damages can sometimes be enough to scare defendants into settling even the most spurious

class claims. This is particularly true for class action defendants that are much smaller than Whirlpool and for which a class trial carries a risk of bankruptcy. Perhaps most importantly, liberal certification of class claims imposes a significant and completely unnecessary cost on both the parties and the judicial system. A class trial is an expensive and time-consuming proposition. The parties can potentially spend millions of dollars litigating a case to verdict, an investment that is often far disproportionate to the limited number of class members who had any complaint with the product or service. This is all the more true with respect to issues classes like *Glazer* because, even if plaintiffs had prevailed at trial, the proceedings would not have been over. Instead, a new phase would have begun to determine damages.

While *Glazer* ended well for Whirlpool, plaintiffs' lawyers will continue to use the *Glazer* model to seek certification of overbroad classes, including bids for issues classes, in the hopes that the next major class action trial will go their way. Class action defendants should be prepared to fight back against such attempts to carve out allegedly "common" issues for class treatment and convince other courts that the Sixth Circuit simply got it wrong. An important part of that fight will be explaining to federal and appellate court judges that the outcome of the *Glazer* trial demonstrates that when overly broad classes are certified, no one wins.

For more on this topic see skadden.com/insights

California Consumer Class Actions: What *CashCall* Means for Businesses in Privacy Cases

The California Invasion of Privacy Act (CIPA) contains a private right of action, which has led to several recent class actions against companies with call monitoring procedures designed solely to improve customer service. But a recent California appeals court ruling sets the bar higher for class certification in these cases, bringing good news for defendants facing CIPA claims.

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The 'Law 42' Arbitrations Against Ecuador and the Importance of BIT Language

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Bilateral Investment Treaties (BITs) afford investors a series of guarantees against expropriation or unfair treatment of investments in foreign jurisdictions. They also typically allow investors to enforce those rights before a neutral international arbitral tribunal under the rules of the International Centre for Settlement of Investment Disputes (ICSID) (affiliated with the World Bank) or the United Nations Commission on International Trade Law (UNCITRAL).

Three recent ICSID decisions, *Perenco Ecuador Ltd. v. Ecuador*, *Burlington Resources, Inc. v. Ecuador* and *Occidental Petroleum v. Ecuador*, all involving a controversial Ecuadorean "windfall tax" measure known as "Law 42," provide useful illustrations of BIT protections and illustrate the varying features of different BITs, including possible limitations on at least one United States BIT.[1] The contrast between the 2014 *Perenco* decision and prior BIT decisions highlights the importance of the particular language addressing the status of taxes in investment treaties.

Ecuador's Law 42

More than a decade ago, a number of oil companies, including Burlington, Occidental (Oxy) and Perenco, entered into long-term production-sharing contracts (PSCs) with the government of Ecuador to develop oil fields in the Ecuadorian Amazon.[2] Under those contracts, private investors assumed the risks and costs associated with the exploration of oil reserves in a designated area in return for a share of any oil eventually discovered.

In 2002, an increase in oil prices prompted some local constituencies to accuse foreign investors of reaping excessive profits. Over the next several years, the Ecuadorian government sought to renegotiate the terms of the PSCs with foreign companies, including Burlington, Oxy and Perenco. In 2006, with no agreement having been reached, the Ecuadorian Congress enacted Law 42, which allocated to the government in the form of a 50 percent tax of the so-called windfall profits of hydrocarbon producers and defined windfall as any "non agreed or unforeseen surpluses from oil selling prices."[3] In 2007, Law 42 was amended to increase the windfall tax rate from 50 to 99 percent.[4]

These measures sharply reduced the profitability of foreign-owned oil operations within Ecuador. Many claimed the taxes violated their rights under the PSCs and international law, while seeking (unsuccessfully) to negotiate an adjustment of the levies. Others, like Perenco, ceased production. Both Perenco and Burlington then commenced separate BIT arbitrations before ICSID, claiming that Ecuador's actions violated the PSCs as well as its obligations under the French-Ecuador BIT and U.S.-Ecuador BIT, respectively. In 2009, Ecuador physically took over the operations of Perenco and Burlington and canceled their PSCs.[5]

US-Ecuador BIT and the Limits of Jurisdiction Over 'Taxation' Measures

As is typical in most BITs, the treaties in the *Burlington*, *Oxy* and *Perenco* disputes provided protection against "expropriation" and guaranteed "fair and equitable treatment" (the FET clause). But those treaties (in the case of *Perenco*, the France-Ecuador BIT, and, in *Burlington* and *Oxy*, the U.S.-Ecuador BIT) contained different wording on the critical issue of tax. In the *Burlington* case, this difference has had potentially significant consequences.

The Law 42

cases demonstrate that BITs can provide some protection to an investment in the event of a windfall tax or other measure.

Specifically, although Articles II and III of the U.S.-Ecuador BIT contained protection against expropriation and also an FET clause and other guarantees (such as "full protection and security"), Article X of the U.S.-Ecuador BIT provided a carve-out for "matters of taxation." Thus, the FET and other guarantees did not apply to a measure that was a tax.[6] As a result, if the challenged measure was characterized as a tax, it could only be deemed to breach the treaty if the tax itself was tantamount to expropriation or nationalization.

Seizing on this provision, Ecuador moved to dismiss Burlington's FET and other non-expropriation claims, arguing that Law 42 constituted a tax and was thus subject to the Article X carve-out.[7] In a 2010 decision, a 2-1 majority of the *Burlington* tribunal upheld this argument.[8]

In contrast with the above two cases, the *Perenco* claim was subject to the France-Ecuador BIT, which contains a more limited carve-out for taxation measures. Because of this difference in wording, Perenco was able to pursue and ultimately prevail on a claim that Law 42 violated Ecuador's FET obligations under that treaty — essentially the same argument that was barred in the Burlington arbitration.[9] Consequently, the tax-exemption language in the France-Ecuador BIT provided greater investor protection than the U.S.-Ecuador BIT, a difference that may well affect the amount of compensation that can be awarded in the forthcoming quantum phase of the *Perenco* arbitration.[10]

Whether Law 42's Windfall Tax Is an 'Expropriation'

Neither the *Burlington* nor the *Perenco* tribunal found that Law 42 constituted an expropriation. Both tribunals acknowledged that a tax would constitute an expropriation if it was confiscatory in nature and its effects caused a "substantial deprivation" or "diminution" of an investment.[11] They held, however, that to demonstrate a "substantial deprivation," an investor must prove that its "investment's continuing capacity to generate a return has been virtually extinguished."[12]

This threshold was not met in either arbitration; both tribunals held that at 50 percent, Law 42 did not constitute a "substantial deprivation" of either Burlington's or Perenco's investment.[13] A majority of the *Burlington* tribunal noted that, by definition, it would be unlikely that a windfall tax would qualify as an expropriation:

> The Law 42 tax is a so-called windfall profits tax, *i.e.*, a tax applying to oil revenues exceeding the ones prevailing at the time the PSCs were executed. By definition, such a tax would appear not to have an impact upon the investment as a whole, but only a portion of the profits. On the assumption that its effects are in line with its name, a windfall profits tax is thus unlikely to result in the expropriation of an investment.[14]

Arbitrator Francisco Orrego Vicuna dissented and argued that the windfall taxes, particularly at 99 percent, constituted an expropriation when viewed in the overall context.[15] Critical to the *Burlington* majority's holding was evidence that the investment continued to have a potentially positive cash flow following enactment of the measure, albeit radically reduced; thus, although "Law 42 at 99% diminished Burlington's profits considerably," Burlington's investment still "preserved its capacity to generate a commercial return."[16]

The *Perenco* tribunal's analysis was similar. It held that at 50 percent, "Law 42 reduced Perenco's profitability [but] it did not deprive

the Claimant of its rights of management and control over the investment in Ecuador, nor did it reach the requisite level of a substantial diminution in the value of that investment."[17] Next, it held that although the tax at 99 percent made "operating conditions highly sub-optimal," it did not amount to an expropriation because Perenco's business was not "effectively taken away from it."[18]

The third case, *Occidental v. Ecuador*, like *Burlington*, was decided two years prior to *Perenco*. *Oxy* addressed Law 42 in a somewhat different context. In *Oxy*, the Ecuadorian government issued a 2006 administrative decree, purporting to rescind Oxy's rights under its PSC. In a 2012 award, this action was found to have been an unlawful expropriation. Although Law 42 was enacted only a month before the administrative decree was issued, it nevertheless became relevant to damages — specifically, whether, absent the cancellation, Oxy could reasonably have expected to have earned significant revenue after 2006 or whether its revenues would have been curtailed by Law 42.[19] By a 2-1 majority, the *Oxy* tribunal held that Law 42 was not properly characterized as a tax, among other things because "it was not 'created' in accordance with the Ecuadorian Constitution,"[20] with the result that: (1) Article X's tax carve-out did not apply; (2) it was thus open to the tribunal to view Law 42 as a measure that violated the FET obligations because it unilaterally modified the contractual and legal framework that existed when the PSCs were executed;[21] and (3) in assessing Oxy's damages (based on a discounted cash flow analysis) the tribunal rejected Ecuador's argument that cash flows should be discounted for the effect of the windfall taxes in Law 42 on potential profits, because this would allow Ecuador "to profit from its own wrongdoing."[22] The result was a $1.7 billion award of damages, which Ecuador is now challenging before a three-member "annulment" committee convened under Article 52 of the ICSID Convention.

Physical Seizure and Declaration of *Caducidad* Amount to Expropriation

Both the *Burlington* and *Perenco* tribunals held that Ecuador's subsequent actions following the implementation of Law 42 constituted an expropriation. However, their reasoning differed. The *Burlington* tribunal found that Ecuador's physical seizure of the oil fields was an expropriation. By contrast, the *Perenco* tribunal noted that Perenco had abandoned its operations prior to the physical takeover, meaning Ecuador was justified in seizing the oil fields in order to ensure their continuity and productivity. The tribunal held that an expropriation did not occur until Ecuador issued an administrative decree (*caducidad*) cancelling the PSC.[23] The impact of these findings, from a damages perspective (and the timing of the valuation date), is yet to be determined but could vary depending on when the tribunal finds that the expropriation began.

Implications

All of the above cases are still pending and subject to further quantum phases and/or annulment appeals. At least one other challenge to Law 42 (by Murphy Oil) also is under way. Nevertheless, some preliminary observations are warranted. The *Burlington*, *Oxy* and *Perenco* decisions demonstrate that BIT protection can provide some (but by no means comprehensive) protection to an investment in the event of a windfall tax or other measure. Moreover, not all confiscatory taxes will violate BITs, particularly if the relevant BIT has a broad tax carve-out clause that excludes taxation from review under the FET standard, as is the case under some U.S. BITs.

As a result, investors should consider adding taxation safeguards to their PSCs or other investment contracts with host state governments (through stabilization or similar clauses), and explore any features of the relevant BIT that would cover their investment. Such an assessment should be made in the overall context of evaluating how best to maximize investment protection and safeguard against expropriation or related risks in the foreign market in question.

For more on this topic see skadden.com/insights

Recent Cases Are Likely to Reduce the Use of New York Courts for 'Turnover' Actions

New York's position as a global financial center means litigants often have sought to use New York courts as a forum to enforce judgments or arbitration awards against foreign entities. In reality, the burden of enforcement proceedings often falls on third parties, such as financial institutions that hold (or are alleged to hold) the judgment debtor's assets. Typically, enforcement proceedings involve the issuance of subpoenas and/or freezing orders against banks with branches in New York, with the judgment creditor attempting to identify, freeze and ultimately obtain assets or accounts held by these banks. The proceedings (known as "turnover" actions) have raised the issue of whether a New York court can attach, or order banks to turn over, assets or bank accounts located outside the United States. However, decisions in 2014 by both the New York Court of Appeals and the U.S. Supreme Court are likely to affect a judgment creditor's ability to use the New York courts for turnover proceedings in the future.

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[1] *Perenco Ecuador Ltd. v. Ecuador*, No. ARB/08/6, Decision on Liability (ICSID 2014) (*Perenco* (Liability)); *Burlington Resources Inc. v. Ecuador*, No. ARB/08/5, Decision on Liability (ICSID 2012) (*Burlington* (Liability)); *Occidental Petroleum Corp. v. Ecuador*, No. ARB/06/11, Award (ICSID 2012) (*Oxy* (Award)).

[2] *Perenco Ecuador Ltd. v. Ecuador*, No. ARB/08/6, Decision on Jurisdiction ¶ 4 (ICSID 2011) (*Perenco* (Jurisdiction)); *Burlington Resources Inc. v. Ecuador*, No. ARB/08/5, Decision on Jurisdiction ¶ 14 (ICSID 2010) (*Burlington* (Jurisdiction)); *Occidental Petroleum Corp. v. Ecuador*, No. ARB/06/11, Decision on Jurisdiction ¶¶ 10-12 (ICSID 2008) (*Oxy* (Jurisdiction)).

[3] *Burlington* (Jurisdiction) ¶ 39.

[4] *Id.* ¶ 45.

[5] *Perenco* (Jurisdiction) ¶¶ 31, 32.

[6] *Burlington* (Jurisdiction) ¶ 123.

[7] *Id.* ¶ 167.

[8] *Id.* ¶ 249.

[9] *Perenco* (Liability) ¶ 627. The *Perenco* decision also illustrated a noteworthy feature of the France-Ecuador BIT: The definition of "national" in Article 1(3)(ii) notes that BIT permits non-French companies to claim French nationality on the basis that they are subject to "control" by a French national. *See Perenco* (Liability) ¶ 216. As a result, Perenco (a Bahamian company) successfully established French nationality on the basis that it was owned and controlled by a French family. *Id.* ¶ 514, 527-30.

[10] *Id.* ¶ 713.

[11] *Id.* ¶ 672; *Burlington* (Liability) ¶¶ 390-402.

[12] *Burlington* (Liability) ¶ 399.

[13] *Id.* ¶ 430; *Perenco* (Liability) ¶ 672.

[14] *Burlington* (Liability) ¶ 404.

[15] *Burlington Resources Inc. v. Ecuador*, No. ARB/08/5, Vicuña Dissent to Decision on Jurisdiction ¶ 27 (ICSID 2012).

[16] *Burlington* (Liability) ¶ 456.

[17] *Perenco* (Liability) ¶ 672.

[18] *Id.* ¶ 687.

[19] *Oxy* (Award) ¶ 467.

[20] *Id.* ¶ 495.

[21] *Id.* ¶¶ 525-27.

[22] *Id.* ¶¶ 546-47.

[23] *Burlington* (Liability) ¶ 536; *Perenco* (Liability) ¶ 705, 710.

Fee-Shifting, Financial Advisor Liability Among Likely Delaware Law Issues for 2015

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The Delaware courts weighed in on familiar issues of importance last year, including multiforum deal litigation and the emphasis on an independent board process, while also delving into relatively new territory such as fee-shifting bylaws. Meanwhile, significant changes to the benches of both the Delaware Court of Chancery and the Delaware Supreme Court in 2014 will undoubtedly shape the way Delaware jurisprudence develops in the coming years.

The Courts. Last January, former Chancellor Leo E. Strine Jr. was confirmed as the new Chief Justice of the Supreme Court, and a few months later Chancellor Andre Bouchard was appointed as the new head of the Court of Chancery. Additionally, Justice Karen L. Valihura and Justice James T. Vaughn Jr. filled the vacancies created on the Supreme Court with the retirements of Justices Jack B. Jacobs and Carolyn Berger. Justice Henry DuPont Ridgely also is set to retire in January 2015, meaning that four of the five justices will have changed within the last 12 months.

Multiforum Litigation. Stockholder plaintiffs filed claims after the announcement of nearly every significant public company transaction in 2014 and often attempted to litigate claims in multiple jurisdictions. The cost and inefficiency of this multiforum jurisdiction phenomenon has received widespread attention in recent years. One reaction by Delaware corporations has been to adopt forum selection bylaws choosing an exclusive forum for disputes — generally Delaware — as a way to reduce the risk of costly multijurisdictional stockholder litigation. Courts have largely upheld those bylaws, and stayed or dismissed lawsuits filed outside the selected jurisdiction. In *City of Providence v. First Citizens BancShares, Inc.*, 99 A.3d 229 (Del. Ch. 2014), Chancellor Bouchard followed the line of reasoning set forth by then-Chancellor Strine in *Boilermakers*, holding that a Delaware corporation may validly adopt a bylaw designating an exclusive forum, including a forum other than Delaware, for litigating intra-corporate disputes. Notably, the court also rejected a challenge to the timing of the adoption of the bylaw — which happened the same day the board of directors announced a merger transaction — reasoning that the timing is immaterial in the absence of any well-pleaded allegations demonstrating impropriety.

Fee-shifting Bylaws. A new development in 2014 related to fee-shifting bylaws, which require unsuccessful stockholder plaintiffs to pay their adversaries' legal fees. In *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014), the Delaware Supreme Court found that such a provision in the bylaws of a Delaware nonstock corporation could be enforceable, setting off a flurry of reactions from Delaware corporations, practitioners and legislators that ranged from strong support, and even the adoption, of fee-shifting bylaws to fervent disapproval. Legislation that would effectively overrule *ATP Tour* was quickly proposed after the opinion was issued but then tabled for further consideration. The continuing development of this legislation, and the reaction of Delaware courts as more corporations adopt these types of bylaws, will surely be a critical topic in 2015 as additional bylaws emerge.

The Role of the Board in Transactions. Delaware courts also continued to focus on how board independence should be considered in deciding whether deferential business judgment review or the exacting entire fairness standard should be applied. In *KKR Financial Holdings LLC Shareholder Litigation*, Consol. C.A. No. 9210-CB (Del. Ch. Oct. 14, 2014), Chancellor Bouchard dismissed breach of fiduciary duty claims regarding the acquisition of KKR

Financial Holdings LLC (KFN) by KKR & Co. L.P., which stockholders alleged was the controlling stockholder of KFN. The court held that KKR was not a controlling stockholder by virtue of a management agreement, and applied the business judgment rule after finding that a majority of KFN's board was disinterested and independent, and a majority of fully informed stockholders approved the merger.

In *Cornerstone Therapeutics Inc. Stockholder Litigation*, C.A. No. 8922-VCG (Del. Ch. Sept. 10, 2014), the court applied entire fairness at the pleadings stage to a controlling stockholder freeze-out merger, holding that disinterested directors entitled to exculpation under the company's charter could not prevail on a motion to dismiss. Applying the Supreme Court's decision in *Emerald Partners*, the court determined that the directors "must await a developed record, post-trial, before their liability is determined," despite the fact that no particularized allegations were brought against the directors. The Court of Chancery's decision in *In re Novell, Inc. Shareholder Litigation*, Consol. C.A. No. 6032-VCN (Del. Ch. Nov. 25, 2014), also is notable, because the court granted former directors' motion for summary judgment on a bad-faith claim alleging favorable treatment to one bidder over another. Despite the fact that the board was independent and disinterested, the court had initially denied a motion to dismiss the claim. In granting summary judgment in favor of the former directors, the court held that the plaintiffs failed to present evidence "that the board members were motivated by some improper purpose that makes their conduct culpable."

More recently, in *In re Rural/Metro Corp. Stockholders Litigation*, Consol. C.A. No. 6350-VCL (Del. Ch. Oct. 10, 2014), Vice Chancellor J. Travis Laster held post-trial that a financial advisor was liable for $75.8 million for aiding and abetting breach of fiduciary duty claims for, among other things, failing to oversee the board's special committee. The court also found that the directors of Rural/Metro Corporation breached their fiduciary duties in connection with the purchase of Rural/Metro at a premium, citing various conflicts of interest among management, the board and financial advisors. Before trial, the director defendants and another financial advisor had reached a settlement with the plaintiff on the same claims, leaving the financial advisor as the sole defendant in the lawsuit and subject to joint and several liability for damages. *Rural/Metro* highlights the caution that both directors and their financial advisors must take in ensuring that a board fulfills its obligations to remain fully informed and cautious of potential conflicts during a sale process. This matter may be the subject of an appeal, and one that all practitioners will be watching closely in 2015.

Finally, in *C&J Energy Services, Inc. v. City of Miami General Employees' & Sanitation Employees' Retirement Trust*, — A.3d —, No. 655/657, 2014 (Del. Dec. 19, 2014), the Delaware Supreme Court unanimously reversed a preliminary injunction issued by the Court of Chancery, holding that an active sale process is not automatically required for a target board to satisfy its fiduciary duties in a change of control transaction. The Delaware Supreme Court confirmed that a company selling itself in such a transaction is not per se required under *Revlon* and its progeny to shop itself to seek the highest immediate value, so long as the target board acts in good faith, tests the deal through a viable passive market check, and gives stockholders a fully informed opportunity to vote on the deal. The Court of Chancery subsequently relied on *C&J Energy in In re Family Dollar Stores, Inc. Shareholder Litigation*, Consol. C.A. No. 9985-CB (Del. Ch. Dec. 19, 2014), which addressed allegations that a target board had failed to satisfy its *Revlon* duties by turning down a higher-priced bid with potential antitrust issues in favor of a lower-priced bid with greater certainty of closing. The court held that *Revlon* requires a board to pursue the highest price reasonably attainable — not just the highest price offered, and that Delaware law is deferential to well-informed, disinterested boards that pursue a transaction in good faith.

Insights Conversations: Cartels

Contributing Partners

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With improved coordination among agencies and across borders and the threat of dual criminal and civil enforcement, companies facing cartel investigations must navigate an increasingly complex environment. Skadden partners Warren Feldman, Steven C. Sunshine and Ingrid Vandenborre examine the current trends and issues in this area.

In the last several years, the Antitrust Division of the U.S. Department of Justice has been developing criminal cases in conjunction with the Fraud Section. Do you see this trend continuing?

Warren: Absolutely. The LIBOR and foreign exchange investigations and resolutions as well as Foreign Corrupt Practices Act matters illustrate that they are working collaboratively to investigate and prosecute cases in ways not seen in the past. The investigations relating to financial benchmarks have included allegations relating to collusion across banks as well as manipulation and fraud within banks. This has caused both arms of the DOJ to have to work together and in conjunction with various bank regulators, the Commodity Futures Trading Commission and the Securities and Exchange Commission, not to mention agencies around the world. One investigation seems to be bleeding into the next. There is also great potential for crossover between Antitrust and Fraud in FCPA cases.

Dual criminal and civil enforcement also seems to be a topic of much discussion in this area. If a company chooses to cooperate in a criminal investigation, what effect does cooperation have on civil enforcement, including private litigation?

Steve: In the U.S., a criminal conviction, including as the result of a guilty plea, is generally admissible in subsequent civil litigation. In the U.S. antitrust context, criminal convictions are *prima facie* evidence of a violation for all matters covered by the judgment. As a result, civil litigation almost always follows a criminal antitrust conviction. During the civil suit, the convicted entity can still contest damages or conduct outside the plea agreement, but not liability inside the plea agreement.

Criminal and civil liability are limited, however, for companies that are first in the door to report antitrust violations. First-in leniency recipients receive complete amnesty from criminal fines. In the civil context, leniency recipients also limit their liability to single — as opposed to treble — damages and receive relief from joint and several liability.

Ingrid: Outside the U.S., the risk of criminal liability varies, resulting in complex interactions between criminal and administrative enforcement proceedings. For instance, the European Commission does not prosecute antitrust violations criminally, but cartel behavior may qualify as a criminal offense in certain jurisdictions within the EU, like the United Kingdom. This can result in important procedural distinctions in relation to, for example, the extent to which information can be exchanged between the agencies. While evidence typically can be exchanged between different EU member states in the context of an administrative procedure, this is not permitted in the context of potential criminal enforcement where different protection rights apply. Moreover, employees with criminal or civil exposure may require separate counsel and warrant judicious treatment by their

employer and its counsel. These complications may affect a company's ability to effectively cooperate with an investigation and require particular vigilance on the part of counsel.

Additionally, the recently adopted EU Directive on Antitrust Damages Actions is anticipated to increase the scope of potential civil liability for cartel conduct, which may affect immunity applicants first and foremost, further complicating a company's assessment of the best course of action. In the EU, amnesty does not affect the scope of potential civil liability for damages. The EU directive provides that a final and definitive finding of an infringement by cartel participants, including the amnesty recipients, serves as *prima facie* evidence in subsequent damages actions. Unless an amnesty recipient appeals, the finding of infringement will typically become definitive years before those of other defendants, which are likely to appeal a cartel finding.

While the directive seeks to improve the position of amnesty recipients by providing that they carry joint and several liability only for damages suffered by their own direct and indirect purchasers, it also creates uncertainty by allowing claimants other than direct or indirect purchasers to seek compensation from the amnesty recipient if they otherwise risk not getting compensated. All of these factors indicate that companies need to carefully weigh all implications of cooperation. Even if a decision to cooperate is made, the increased likelihood of private litigation in the EU, with corresponding discovery, should be taken into account in the company's approach to the agency. This includes the ways in which information is submitted that will ultimately appear in the agency's records and potentially be made accessible to civil plaintiffs.

How do you foresee the evolution of the increasing levels of cooperation between U.S. and foreign regulators in cases such as the foreign exchange investigation?

Steve: Cooperation in international cartel investigations is on the rise largely because the number of antitrust enforcers across the globe, and their enforcement activity, continues to grow. Many of the active enforcers offer leniency or amnesty programs. As a result, the first company to recognize a violation has an incentive to approach all relevant jurisdictions. Companies also may benefit from a coordinated approach to the various regulators, which can ensure consistency in approaches and requirements for leniency.

As background, the modern era of international cooperation in cartel investigations is a relatively recent phenomenon. It can be traced to February 2003, when authorities from the United States, European Union, Canada and Japan first conducted a coordinated raid. The trend toward coordination has continued recently in the auto parts investigation — the largest criminal investigation in the antitrust division's history — which involved coordination with the Japan Fair Trade Commission, Korean Fair Trade Commission and the European Commission, among others.

Warren: The market manipulation cases are a good illustration of how this cooperation has evolved. In LIBOR, the cases have been investigated for a lengthy period around the world, and resolutions are still being rolled out years after Barclays was the first to settle. By contrast, in the foreign exchange matter, the Financial Conduct Authority worked out a resolution with a series of banks after less than an 18-month investigation and apparently worked in a coordinated way with the CFTC and the Office of the Comptroller of the Currency to roll out simultaneous resolutions. It is worth noting, however, that there have been no resolutions of publicly reported DOJ and EC investigations as of yet, so the coordination appears to have some limits.

Ingrid: I agree, and I think this uptick in coordination is the new normal. Enforcers are realizing the benefits of coordination, and mechanisms to facilitate cooperation continue to rise. In fact, key regulators have lauded the benefits of international coordination in recent remarks, suggesting there is more to come. The U.S. is party to countless mutual legal assistance agreements and soft antitrust cooperation agreements with nations with growing enforcement such as Brazil, Israel and Japan. Additionally, the International Competition Network now has members from over 100 national and multinational competition agencies and maintains an active working group dedicated to cartel offenses.

Given the expansion of global enforcement, how can companies control the scope and cost of a worldwide investigation?

Warren: The sweeping scope of global cartel investigations places enormous burdens on the companies under investigation. The witnesses and documents are typically spread around the world and are costly to collect and review. In my experience, the key to preventing the costs of investigation from spiraling out of control is to maintain a seamless team of lawyers capable of advising on the investigative tactics and issues globally. It is typically helpful to engage in a robust dialog with the prosecutors and regulators to try to get an agreement on appropriate limits on investigative scope.

Steve: It's also worth noting the importance of compliance programs that detect and potentially resolve issues before they result in liability — helping reduce the potential for significant expenses and loss of time that occur with global investigations. Authorities expect modern multinationals to have rigorous compliance programs in place. Policies alone won't excuse the company of a violation, but their absence may be a factor against the company.

Ingrid: There is an ongoing debate as to whether the existence of a compliance program should be a factor in assessing the company's liability when an infringement has occurred in violation of the program. While the EU Commission has been unwilling to acknowledge the existence of a compliance program in the determination of the fine level, certain EU member states like the U.K. and France have taken into account compliance programs when assessing liability and remedies and issuing guidance on what an effective compliance program should cover. The debate underscores the importance of an effective compliance program.

With coordination among regulators and the proliferation of civil litigation, when can a company expect to have a global investigation wholly resolved?

Steve: Resolution of cross-border investigations takes time, whether referring to the close of a grand jury or commission investigation. For example, we're aware of investigations that proceed for two years and then close. It depends on myriad factors, such as the products and customers at issue, the number of jurisdictions involved, and even the tendencies of the individual case handlers within the various regulators. Of course, once a company enters a plea, there is another cycle for the civil litigation.

When an investigation begins, companies should employ a lean and experienced cross-border team to control the scope of the investigation and push for efficient resolution. The availability of an interdisciplinary team is also important since, as Warren noted, FCPA and antitrust investigations have and will continue to overlap. Companies benefit from access to experts in both fields to help identify and resolve issues as they arise.

Ingrid: Agreed. A robust assessment of potential exposure across jurisdictions is key to a swift resolution. Also, companies should bear in mind that an investigation, by its very nature, is iterative. It requires flexibility on the part of companies and their counsel to continuously reassess the best course of action throughout the investigation, taking into account the need for a coordinated approach to numerous interested and potentially interested regulators, and implications for the scope of administrative, criminal and civil exposure in each jurisdiction.

For more on these topics see skadden.com/insights

EU Nonmerger Antitrust Enforcement Gets Stricter

Developments in the past year are likely to affect nonmerger antitrust enforcement in the European Union in 2015 and beyond. A new Directive on antitrust damages and the headline-grabbing Intel appeal judgment indicate the potential for greater enforcement risks for companies operating in the EU.

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Post-*Actavis* Rulings Focus on What Constitutes a Payment in Reverse-Payment Settlements

Nearly a year and a half after the Supreme Court's landmark decision in *Federal Trade Commission v. Actavis, Inc.*, the hotly contested issue of the legality of reverse-payment settlements remains as fraught as ever. While observers expected that the lower courts would grapple with the question of what constitutes a "large" and "unjustified" payment, they have instead struggled with an altogether more basic question: What is a payment?

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Courts Parse First Amendment Protections for Anonymous Critics Online

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The Supreme Court has long recognized that the freedom of speech enshrined in the First Amendment extends to anonymous speech, noting that "persecuted groups and sects … throughout history have been able to criticize oppressive practices and laws either anonymously or not at all."[1] Today, the right to speak anonymously is most frequently exercised via the Internet, including through email, message boards and social media websites. But even though the Internet "provides relatively unlimited, low-cost capacity for communication of all kinds,"[2] it also creates unprecedented tools with which to unmask an anonymous speaker's identity.

Internet providers such as Comcast and Verizon, email and search companies such as Google and Yahoo, and social media platforms such as Facebook and Twitter all regularly track and monitor users' activities online. No matter the steps an Internet "speaker" may take to remain anonymous, the target of Internet criticism frequently needs only to file a defamation lawsuit against a "John Doe" defendant and issue a subpoena to one of these entities to learn the speaker's identity. Many Internet providers do notify users of requests for such information. Nevertheless, First Amendment groups have criticized these "John Doe subpoenas," asserting that "plaintiffs file John Doe lawsuits against anonymous Internet users only to expose their identities, not because they want to pursue a legally valid claim against them."[3]

Due to the increased use and potential abuse of such John Doe subpoenas, the job of sorting out claims involving the right to speak anonymously increasingly has fallen to the judiciary. State courts, in particular, have been quick to react to developments in this area. Recognizing the need to balance an Internet speaker's "right to anonymous free speech" with the government's "justifiable interests in preventing certain evils" such as defamation,[4] state courts have responded to the proliferation of John Doe subpoenas by crafting balancing tests that require the plaintiff to make some showing on the merits before ordering compliance with a subpoena requesting the disclosure of the John Doe defendant's identity.

Dendrite International, Inc. v. Doe No. 3 has been particularly influential in this regard.[5] In *Dendrite*, an anonymous individual posted a series of comments critical of changes in Dendrite's revenue recognition accounting on a Yahoo bulletin board. Dendrite, a New Jersey company, sued the anonymous commenter for defamation and misappropriation of trade secrets and sought discovery regarding the commenter's identity. On appeal, the New Jersey Superior Court held that a court may not compel disclosure of an anonymous speaker's identity until the plaintiff makes a three-part threshold showing. The plaintiff must:

1. Attempt to notify the speaker of the request to discover his or her identity,

2. Specifically identify the allegedly actionable speech at issue, and

3. Produce evidence supporting each element of the defamation claim.[6]

If the plaintiff can meet these three requirements, the court must then balance the defendant's First Amendment rights against the strength of the plaintiff's evidentiary showing before ordering disclosure.[7]

In addition to New Jersey, jurisdictions that have adopted or applied judicially crafted balancing tests include, but are not limited to, Arizona, California, Delaware, the District of Columbia, Indiana, Kentucky, Maryland, Michigan, New Hampshire, Pennsylvania and Texas.[8] Similar requirements have been prescribed by statutes or court rulings in other jurisdictions, including Illinois, New York, Virginia and Wisconsin.[9] The facts underlying those cases are

as diverse as the types of Internet speech themselves at issue, and include anonymous comments regarding the financial fitness of a mortgage lender,[10] anonymous criticism of corporate officers in an online financial message board,[11] anonymous claims of copyright infringement made to a trade association,[12] and anonymous emails alerting government officials to a business competitor's improper conduct.[13]

Companies or individuals that anticipate taking legal action against anonymous Internet critics would do well to familiarize themselves with the standards applicable in their jurisdiction. Even if there is no precedent directly on point, potential plaintiffs may need to be prepared to meet a summary judgment or similar standard, given the strong trend toward balancing tests such as the one imposed in *Dendrite*. Moreover, to the extent they have not already done so, Internet providers and other companies that maintain identifying information about their customers should consider adopting notification policies that will allow *Dendrite*-type objections to be raised by anonymous Internet speakers. Finally, where the anonymous defendant has received notice of the action, defense counsel should be prepared to hold the plaintiffs to their burden.

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[1] *Talley v. California*, 362 U.S. 60, 64 (1960).

[2] *Reno v. ACLU*, 521 U.S. 844, 851 (1997).

[3] Digital Media Law Project, *Potential Legal Challenges to Anonymity, available at* http://www.dmlp.org/legal-guide/potential-legal-challenges-anonymity.

[4] *Melvin v. Doe*, 836 A.2d 42, 47 (Pa. 2003).

[5] 775 A.2d 756 (N.J. Super. Ct. App. Div. 2001).

[6] *Id.* at 760.

[7] *Id.* at 760–61.

[8] *See Mobilisa, Inc. v. Doe No. 1*, 170 P.3d 712 (Ariz. Ct. App. 2007); *Krinsky v. Doe No. 6*, 72 Cal. Rptr. 3d 231 (Cal. Ct. App. 2008); *Doe No. 1 v. Cahill*, 884 A.2d 451 (Del. 2005); *Solers, Inc. v. Doe*, 977 A.2d 941 (D.C. 2009); *In re Ind. Newspapers, Inc.*, 963 N.E.2d 534 (Ind. Ct. App. 2012); *Doe v. Coleman*, 436 S.W.3d 207 (Ky. Ct. App. 2014); *Indep. Newspapers, Inc. v. Brodie*, 966 A.2d 432 (Md. 2009); *Ghanam v. Does*, 845 N.W.2d 128 (Mich. Ct. App. 2014); *Mortg. Specialists, Inc. v. Implode-Explode Heavy Indus., Inc.*, 999 A.2d 184 (N.H. 2010); *Pilchesky v. Gatelli*, 12 A.3d 430 (Pa. Super. Ct. 2011); *In re Does 1-10*, 242 S.W.3d 805 (Tex. Ct. App. 2007). A few federal courts have also applied First Amendment balancing tests when faced with John Doe subpoenas. *See, e.g., McVicker v. King*, 266 F.R.D. 92 (W.D. Pa. 2010); *Doe v. Individuals*, 561 F. Supp. 2d 249 (D. Conn. 2008); *Doe v. 2TheMart.com, Inc.*, 140 F. Supp. 2d 1088 (W.D. Wash. 2001).

[9] *See Maxon v. Ottawa Publ'g Co.*, 929 N.E.2d 666 (Ill. Ct. App. 2010) (declining to adopt a judicial balancing test in light of 134 Ill. 2d R. 224); *Varrenti v Gannett Co., Inc.*, 929 N.Y.S.2d 671 (N.Y. Sup. Ct. 2011) (holding that the court did not need to decide whether to apply balancing test or convert request into proceeding for pre-action disclosure pursuant to CPLR 3102 (c) because common factor in all tests was needed to state a *prima facie* cause of action for defamation, which plaintiffs failed to do); *Yelp, Inc. v. Hadeed Carpet Cleaning, Inc.*, 752 S.E.2d 554 (Va. Cir. Ct. 2014) (declining to adopt a judicial balancing test in light of § 8.01–407.1 of the Code of Virginia); *Lassa v. Rongstad*, 718 NW 2d 673 (Wis. 2006) (interpreting § 802.03 of the Wisconsin Statutes, which requires defamation to be pleaded with particularity, to require a court to address a pending motion to dismiss a defamation action against an anonymous defendant before compelling discovery).

[10] *See Doe No. 1 v. Cahill*, 884 A.2d 451 (Del. 2005).

[11] *Krinsky v. Doe No. 6*, 72 Cal. Rptr. 3d 231 (Cal. Ct. App. 2008).

[12] *See Solers, Inc. v. Doe*, 977 A.2d 941 (D.C. 2009).

[13] *See Kuwait & Gulf Link Transp. Co. v. Doe*, 92 A.3d 41 (Pa. Super. Ct. 2014).

Federal Circuit Wrestles With Patent Eligibility of Internet-Based Business Methods

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When are Internet-based business methods eligible for patent protection under 35 U.S.C. § 101? In 2014, the Supreme Court laid the groundwork for the Federal Circuit to grapple with this question, when it decided *Alice Corp. Pty. Ltd. v. CLS Bank, International* 134 S.Ct. 2347 (June 19, 2014). As two recent decisions show, the Federal Circuit has yet to provide a clear answer to that crucial question, thereby leaving the door open to continued refinement of its position in the coming year.

In *Ultramercial Inc. v. Hulu, LLC*, No. 2010-1544, 2014 U.S. App. LEXIS 21633 (Fed. Cir. Nov. 14, 2014), the Federal Circuit invalidated a patent covering methods for distributing media over the Internet to consumers who view advertisements; under the business model in question, advertisers paid for the media consumers viewed. The court reasoned that the patent involved the abstract idea of "a method of using advertising as an exchange or currency," and the claims were ineligible because they simply implemented that idea using routine, conventional activity on the Internet.

Subsequently, in *DDR Holdings, LLC v. Hotels.com, L.P.*, No. 2013-1505, 2014 U.S. App. LEXIS 22902 (Fed. Cir. Dec. 5, 2014), the Federal Circuit held eligible a patent covering the generation of webpages that displayed a merchant's content using the "look and feel" of a host website. The court explained that the patent was not directed to an abstract idea because it did not claim an algorithm or longstanding commercial practice. And, "[A]lthough the claims address a business challenge (retaining website visitors), it is a challenge particular to the Internet." Moreover, unlike the claims in *Ultramercial*, the claims in *DDR Holdings* specified "how interactions with the Internet are manipulated to yield a desired result — a result that overrides the routine and conventional sequence of events ordinarily triggered by the click of a hyperlink."

These two cases may prove difficult to reconcile in practice. Both actions involved computer-implemented business practices for interacting with consumers on the Internet, yet the interactions specified in *Ultramercial* (requiring consumers to view ads) constituted routine Internet activity, while the interactions in *DDR Holdings* (generating styled webpages) overrode routine Internet activity. At first glance, the cases might be harmonized by assuming a patent is more likely to be eligible if it addresses a new problem that uniquely arises in the context of the Internet, rather than simply provides a new solution to an old problem. But, such a principle risks merging Section 101 eligibility with Section 102 novelty — a conflation unlikely to be approved by the Federal Circuit.

Additional decisions from the Federal Circuit will no doubt follow in 2015, though it remains to be seen whether more objective standards will emerge to elucidate which Internet-based methods are patentable and why. In the meantime, it is evident from the reasoning in *Ultramercial* and *DDR Holdings* that the manner in which litigants articulate the abstract idea or problem addressed by a challenged patent will be instrumental to the patentable subject matter analysis.

Insights Conversations: Life Sciences

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A healthy market for M&A activity, particularly cross-border deals, and a strict regulatory environment are the big factors influencing the health and activities of life sciences companies. Skadden partners John T. Bentivoglio, Jennifer L. Bragg, Marie L. Gibson and Graham Robinson discuss the outlook for businesses in this sector.

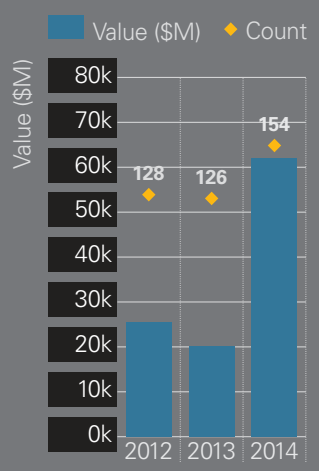
M&A activity in the life sciences sector has surged in the past year. What has contributed to this trend, and do you see it continuing throughout 2015?

Graham: One trend that received significant attention last year that may have helped kick off a resurgence in life sciences M&A was deals in which the tax structure produced part of the value thesis. However, this portion of the deal market diminished toward the end of 2014, in large part because of the U.S. Treasury's efforts to discourage these transactions, and I think it has been over-credited. Other factors are at play as well. For starters, we are now several years into a resurgence of the life sciences IPO market and venture capital investment in new life sciences companies. Many of these companies are maturing to the point where they are very attractive investments for larger acquirers. Second, confidence in business conditions has improved in the U.S., which drives the biopharma market in particular. And third, the increase in shareholder activism and hostile M&A activity has created transaction momentum in a number of cases. I believe these factors played a larger role in creating the overall volume of life sciences M&A transactions than tax structuring alone; the life sciences M&A boom has continued even as tax-structured deals have faded. Based on what we hear, we are very optimistic about the life sciences M&A market for 2015.

Marie: I agree, 2015 should be another busy year. It's too early to tell whether inversion transactions are completely off the table; we continue to be in a "wait and see" mode until the new Congress begins work and the U.S. Treasury provides further interpretations. In addition, I believe activist scrutiny and shareholder demands for finding and developing more sources of growth will continue to lead to traditional mergers inside (and outside) the life sciences sector. There is a general perception that potential acquirers are still holding onto significant cash balances and need to deploy their capital to achieve desired growth rates.

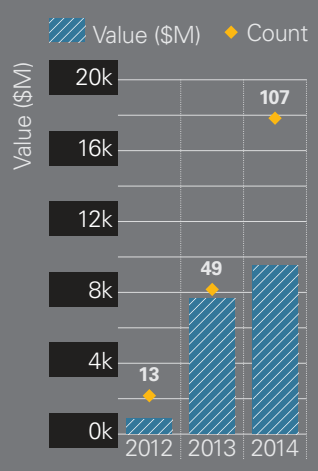
In the life sciences sector, I also expect to continue to see many small- and medium-sized transactions — especially product acquisitions — in-licensing of products and intellectual

Total Cross-Border Into the US
(Health Care Sector)



Source: Thomson Reuters

Total IPOs by Health Care Companies Listing in the US



Source: Thomson Reuters

Activism Campaigns Against Health Care Companies

Source: Capital IQ

property, and collaborations. We have seen not only some large deals involving collaborations between small-cap or private companies and big pharma, but also deals among the big pharma players. More collaborations are likely as companies continue to struggle with ever-increasing costs to bring products to market.

To what extent do you see cross-border transactions being an important part of the M&A market in 2015?

Marie: Our international and U.S. clients think about medicine globally and are looking for ways to expand, deepen vertical integration and enhance their supply chain capabilities — all of which indicate that the cross-border transaction market is likely to remain robust. Local pricing and reimbursement policies will continue to impact how attractive opportunities will be, but the interest is there.

Graham: I see three specific factors driving cross-border activity. First, lower tax rates outside of the U.S. in many cases result in cash-producing pharmaceuticals and medical devices being worth more if owned by a non-U.S. company. In some cases, that leads predictably to their paying a premium relative to how the U.S. market values those companies independently or the price that a U.S. acquirer would pay. Second, in the biopharma sector in particular, the large acquirers are global, but the most valuable market for new drugs is by far the U.S. As a result, many of the most attractive targets are based in the U.S. (or are foreign companies pursuing U.S. approval for their drug candidates). This leads to many non-U.S. buyers pursuing U.S. targets, a trend that should accelerate in 2015. Third, and perhaps more interestingly, we are hearing from a number of larger U.S. companies that they plan to invest significantly in ex-U.S. targets, particularly in Asia. Some of these companies have comprehensive M&A strategies mapped out, with large budgets allocated to the effort. Absent a market setback, I expect these plans will be carried out, leading in 2015 (and beyond) to a significant increase in U.S. companies buying these targets.

How will the regulatory environment play a role in these trends?

Jennifer: The global uptick in M&A that Graham and Marie describe can present regulatory challenges. Companies must evaluate the quality of the manufacturing operations in the organizations they acquire in order to ensure they meet FDA regulations. When the operations are located in geographies distant from the parent — like when a U.S. company purchases a target in Asia — this becomes more challenging. Overall, the globalization of the supply chain that has taken place over the last decade has resulted in increased efforts by the FDA to ensure that manufacturing operations outside the United States are commensurate with the standards applied to domestic operations. This appears to be part of a broader effort by the FDA to focus its enforcement resources on core public health issues, such as ensuring product quality. The FDA has a variety of regulatory enforcement tools that it can employ when it believes a company has systemic shortcomings in its manufacturing operations, and some are quite potent. This means that what may initially have seemed like a simple regulatory issue can become much more significant, sometimes having a material effect on a company's bottom line.

John: In addition to those issues, life sciences companies continue to face a challenging regulatory environment in getting their products to market — and getting reasonable reimbursement for their products once they are approved. The FDA approved 35 new molecular entities (NMEs) and biological license applications (BLAs) through December 15, 2014. That figure is up from the 27 NME and BLA approvals in 2013 but is essentially flat when compared to the 39 approvals in 2012. Also, criticism of the FDA's device approval and clearance process, including front-page investigative stories in leading national publications, poses a risk of stricter approval and clearance requirements in 2015. On the reimbursement side, the Obamacare medical device tax continues to be a focus of policy and legislative lobbying as manufacturers contend the tax is curbing profits and stifling innovation. Drug and device companies also face other pressures as public- and private-sector health care reform efforts focus on reimbursement rates tied to cost effectiveness and cost savings. This will require companies to gather data — above and beyond what's necessary to support approval or clearance — to ensure adequate coverage and reimbursement.

Kickback and off-label promotion issues are another area where drug and device companies have endured a very tough enforcement environment. Do you see enforcement continuing at its current pace in 2015? What other areas of enforcement should companies be considering?

John: The good news is that industrywide compliance efforts are having a positive impact — we didn't see a settlement above $1 billion in 2013 or 2014. Such "blockbuster" settlements will continue to be rare in the next several years — and possibly beyond. But the amount of enforcement activity reflected in the total number of investigations and settlements is likely to continue at a high tempo as *qui tam* relators continue to file hundreds of cases each year — many targeting life sciences companies — and the U.S. Department of Justice is obligated by law to investigate these complaints. We have seen an increased willingness of *qui tam* relators to pursue active litigation even when the DOJ declines to intervene, and we predict this trend will continue. We also believe the DOJ will bring criminal charges against individuals in cases where it believes the conduct has been egregious, as we've seen in the *Otis Medical* and *Vascular Solutions* cases this year.

Jennifer: I agree. Unfortunately, government enforcement efforts directed at life sciences companies are not likely to stop in the near term. There are simply too many financial incentives for relators to bring cases and for the DOJ to pursue them. Nevertheless, we have seen the nature of these cases change and expect some of these changes to continue. In addition to fewer ultra-large settlements, as John mentioned, our sense is that the DOJ has begun to focus more on the financial relationships between physicians and life sciences companies, particularly on the reimbursement process and the role that life sciences companies play in it. Additionally, look for the FDA to recommend cases to the DOJ when it believes it has uncovered serious manufacturing lapses that may impact public health.

The Second Circuit's decision in *United States v. Caronia* was heralded by some lawyers as a big loss for the DOJ's prosecution of truthful, off-label promotional activities. What impact, if any, has the decision had in the current cases you're handling?

Jennifer: To understand the impact of *Caronia*, it's important to start with some background. Historically, the DOJ and FDA have been the two important players policing life sciences companies' promotional efforts. The FDA developed policy and referred cases to the DOJ in instances where it believed its policies had been flouted in an aggravated fashion. For much of the last decade, however, a third player — relators — began to impact policy. The civil False Claims Act, with bounty provisions that provide tremendous incentives for relators to bring claims to the government rather than the life sciences company, required the DOJ to investigate these cases. Ultimately, the DOJ had to construct legal theories to support enforcement decisions in an area where neither the case law nor the regulations were well-developed.

Over time, the DOJ's theories of wrongdoing, as articulated through settlement materials, grew further afield from the text of the statute or the regulations. The company under investigation could ill afford to risk the consequences of conviction — which can include exclusion from federal health care programs — by seeking review of the legal issues before a judge at trial. Thus, company after company reluctantly settled cases premised on legal theories that were

sometimes untested and poorly supported without having a meaningful opportunity to challenge those theories. Too often, the FDA did not appear to have a meaningful voice in determining whether the legal theories were consistent with its policy.

Today, the FDA appears to have reclaimed its voice in setting policy as it pertains to how companies can lawfully promote their products. The FDA has spent considerable time and effort developing guidance documents that articulate how it views various practices and how it believes its policy can be achieved in a compliant manner. While many are unsure that FDA policy aligns with the First Amendment, these guidance documents have been a welcome development and have been extremely useful in fostering a dialog regarding promotional practices that for many years resided in the "gray area." At the same time, the DOJ seems to be less focused on cases involving solely promotional speech. While we don't know why this shift has occurred, it is possible that the decision in *Caronia* played a role. The reality of *Caronia*, two years later, is that it has almost certainly been more impactful than the government publicly acknowledged.

John: I agree. Many DOJ prosecutors have said publicly that *Caronia* has had no effect on their enforcement efforts, but this is not what we're seeing in the current cases we're handling. The DOJ is now — appropriately, in our view — focused on promotional activity that involves false or misleading information and is steering away from purely truthful, nonmisleading promotional activities. We think this new, more narrow approach will continue until other federal circuits or the Supreme Court squarely address the issue.

Looking more broadly at the industry and the year ahead, all of these factors — a strong pace in M&A and corporate activity and the accompanying regulatory challenges of that activity, as well as the current enforcement environment — indicate that companies should continue to bolster their compliance programs, incorporate robust pre- and post-closing regulatory diligence in their acquisition efforts, and heed developments on the enforcement front.

Regulatory

Financial Regulation

The global growth of post-crisis financial regulation has continued to impose new, complex (and oftentimes costly) requirements on institutions. The implementation challenge is complicated by significant differences in regulatory requirements among jurisdictions for cross-border businesses, and by the growing tendency of criminal and civil authorities to extract significant financial and criminal penalties for regulatory compliance failures.

Approximately 100 FBOs — some with global assets of as little as $10 billion — would be subject to at least one requirement under Regulation YY

page 110

The FDIC determined that plans submitted in 2013 for resolving troubled banks were not credible

page 118

> $1.7B

in restitution to consumers under Unfair, Deceptive, or Abusive Acts and Practices actions brought by the CFPB

page 132

21,500

Number of institutions the NPRM estimates that the proposed rule covers in the United States, over half of which are considered to be small institutions

page 128

New Provisions Require Structural Change for Foreign Banking Organizations

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The Enhanced Prudential Standards (Regulation YY) of the Board of Governors of the Federal Reserve System represent a significant shift in the U.S. regulation of foreign banking organizations (FBOs). In general, Regulation YY, which implements certain provisions of Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, establishes enhanced prudential standards for large U.S. bank holding companies (BHCs) and FBOs. Most of the compliance obligations for an FBO become applicable on July 1, 2016. However, important exceptions include the intermediate holding company (IHC) implementation plan, which was due January 1, 2015.

Regulation YY increases the breadth and depth of the U.S. regulatory regime governing FBOs. While it does not formally depart from the historical framework of deference to the home country supervisor, it represents more expansive Federal Reserve supervision of FBOs with respect not only to their U.S. banking offices but also to their nonbanking activities and global risk profile.

Regulation YY imposes a tiered structure of requirements based on an FBO's global and U.S. assets. The Federal Reserve estimated that approximately 100 FBOs — some with global assets of as little as $10 billion — would be subject to at least one requirement under Regulation YY. While a relatively small subset of FBOs will be subject to the most extensive requirements, other FBOs could nevertheless feel the impact of the broader set of requirements through heightened supervisory expectations. FBOs have been re-evaluating the nature, structure and size of their U.S. operations in light of the regulation.

An FBO with significant (at least $50 billion) U.S. non-branch assets is required to organize its U.S. operations through a U.S. IHC, which itself is subject to Regulation YY on a consolidated basis, including risk management requirements. The U.S. IHC will need to manage relationships with both its U.S. prudential regulator, the Federal Reserve, and the prudential regulatory authority of its parent. Such managing of relationships with multiple safety and soundness regulators who exercise authority at various levels of the banking organization is akin to how many U.S. financial institutions must manage their regulatory relationships.

Regulation YY also has important governance requirements. For example, it requires an IHC to have a risk committee that approves and periodically reviews the risk management policies and oversees the risk-management framework of the IHC. In addition, the FBO must have a U.S. risk committee that oversees the U.S. operations. The IHC risk committee may serve as the FBO's U.S. risk committee, or the FBO could have a separate U.S. risk committee as either a committee of the FBO's global board of directors or as part of its enterprisewide risk committee. If the IHC risk committee serves as the U.S. risk committee, its oversight responsibilities would include the FBO's U.S. branch operations in addition to the IHC's operations. The FBO parent would still be required, however, to take appropriate measures to ensure that its combined U.S. operations implement the risk management policies overseen by the U.S. risk committee. In addition, the U.S. risk committee must closely coordinate with the FBO parent with respect to fundamental capital and liquidity planning matters (*e.g.*, the U.S. risk committee must approve the FBO's contingency funding plan for its combined U.S. operations and must set the FBO's liquidity risk for its combined U.S. operations with the FBO's board or the FBO's enterprisewide risk committee).

As noted above, FBO IHC implementation plans were due on January 1, 2015. However, an FBO is not required to form an IHC until July 1, 2016. In preparing to comply with the IHC formation requirement, an FBO should consider whether any restrictions exist that could impede or delay the transfer of certain entities under the IHC structure. These restrictions may be more likely to present issues in situations where the FBO parent technically controls the entity for purposes of the IHC requirement but does not have the ability to exercise practical control over it for corporate purposes.

In addition, an FBO that has organized and operates a business division as a unitary entity, such as a global investment banking organization, should assess the optimal allocation and separation of business between the U.S. and other countries (*e.g.*, where personnel should be located, where positions should be booked, how it will coordinate compliance efforts including on matters such as the Volcker Rule, and how to arrange for shared services and recordkeeping/reporting requirements) or whether for business reasons it makes sense to move traditional banking activities, such as primary dealing activities, under the U.S. branch where they were historically located. When forming the IHC, in addition to tax considerations and capital allocation issues, the FBO will want to review the implications of the Federal Reserve's Regulation W and restrictions on affiliate transactions.

For more on these topics see skadden.com/insights

Regulators Adopt Final Risk Retention Rules for Asset-Backed Securities

In October 2014, several regulatory agencies adopted a final set of rules implementing the credit risk retention requirements of the Dodd-Frank Act. The objective of the rules is to align the interests of securitizers with those of other transaction participants by requiring them to retain a specified percentage of the credit risk of the assets they securitize.

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Risk Retention Rules Impact Registered Fund Tender Option Bond Financings

The credit risk retention requirements adopted by regulatory agencies in October 2014 apply to tender option bond (TOB) programs. As a result of the final rules, registered investment companies that use TOB trusts to leverage their portfolios will be required to change their practices, which likely will make TOB trusts a more expensive form of leverage.

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FATCA Finally Takes Effect, Subject to Transition Rules

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After several years of delays, the Foreign Account Tax Compliance Act (FATCA) finally took effect on July 1, 2014. Congress enacted FATCA as part of the Hiring Incentives to Restore Employment Act in 2010 to stop U.S. taxpayers from evading U.S. taxes through undisclosed offshore accounts and investments. FATCA requires foreign financial institutions — defined broadly to include not just foreign depositary or custodial institutions but also some foreign insurance companies, investment funds and other entities — to report to the Internal Revenue Service (IRS) information about the holdings of U.S. taxpayers or face 30 percent withholding on certain payments they receive. FATCA also imposes new withholding and reporting obligations on U.S. financial institutions as well as nonfinancial U.S. companies with respect to payments they make to foreign entities.

The U.S. Treasury Department and IRS delayed FATCA's effective date several times in order to give institutions more time to prepare to comply with FATCA's sweeping requirements, as well as to allow the Treasury and IRS to finalize detailed regulations and forms necessary for FATCA's implementation. The extra time also allowed the IRS to put into place its Internet portal — which each foreign financial institution must use to register and receive the global intermediary identification number (GIIN) it needs to evidence FATCA compliance to payors — and update frequently asked questions and answers about FATCA on its website.

Shortly before July 1, 2014, the Treasury and IRS released transition rules, further delaying implementation of the rules with respect to foreign entities. Thus, although FATCA took effect July 1, under the transition rules certain due diligence, reporting and withholding requirements do not take effect until 2015 or 2016. In addition, the IRS said that, for purposes of FATCA enforcement, it will consider 2014 and 2015 transition years and will take into account the extent to which institutions have made good faith efforts to comply.

Also, in the time leading up to July 1, the Treasury negotiated intergovernmental agreements (IGAs) with dozens of different countries implementing FATCA for institutions in those jurisdictions. The IGAs address local law impediments, such as bank secrecy and data protection laws, that would prevent institutions in those countries from fully complying with FATCA, and in some cases provide that institutions report to the local government rather than to the IRS. The Treasury and IRS will treat countries that have agreed in substance to an IGA but have not yet entered into one as having an IGA in effect and therefore will consider financial institutions in those jurisdictions to be FATCA-compliant for a period of time. Meanwhile, the Treasury has continued to conclude additional IGAs. Institutions in IGA jurisdictions ultimately will be governed by laws enacted by their local jurisdictions to implement FATCA. A handful of countries (including the United Kingdom, Ireland and the Cayman Islands, among others) have enacted FATCA laws or at least published guidance in draft form, while many countries have not yet done so.

Notably, the Organisation for Economic Co-operation and Development has released a common reporting standard (CRS) for Automatic Exchange of Financial Account Information based on FATCA and a model Competent Authority Agreement. Under the CRS, countries that choose to participate will collect information from financial institutions in their jurisdictions and will automatically share that information with their exchange partner countries in exchange for reciprocal information, thereby allowing participating countries to obtain the same type of data about their own taxpayers that the U.S. will obtain under FATCA.

Despite the considerable time and resources devoted to FATCA's implementation, unresolved issues remain. Institutions are finding that many people have difficulty understanding how to complete the complex new IRS forms that FATCA requires. In addition, aspects of the interaction between the Treasury regulations and the IGAs are still unclear. Moreover, because the IGAs contemplate that each country ultimately must enact its own specific rules implementing FATCA, institutions face the uncertainty of having to comply with requirements and interpretations in different jurisdictions that have not yet been put into place but may ultimately differ from the Treasury regulations.

In sum, FATCA — initially met with widespread resistance and disbelief by financial institutions in the U.S. and abroad — has become a reality and, indeed, the model for some other countries as they move toward greater tax transparency. In the meantime, institutions must grapple with FATCA's continuing challenges as best they can.

For more on this topic see skadden.com/insights

Regulation AB: New Rules for Publicly Issued Asset-Backed Securities

In August 2014, the Securities and Exchange Commission revised the existing regulations that govern the offering process and the disclosure and periodic reporting requirements for publicly offered asset-backed securities under Regulation AB. For publicly issued ABS, the new rules will put speed bumps in the offering process, introduce new parties to ABS transactions and require certain asset classes to provide significantly more information with respect to the underlying asset pool.

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Reconciling Regulatory Requirements in Cross-Border Derivatives Takes Center Stage

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As the Commodity Futures Trading Commission (CFTC) completes the derivatives regulations mandated by the Dodd-Frank Act, the European Union continues to develop its own derivatives rules. Both sets of regulations seek to fulfill the Group of 20 (G-20) derivatives reform agenda, announced at the 2009 Pittsburgh Summit, which includes regulating dealers, clearing and trading (including trade reporting), mitigating systemic risk and protecting against market abuse. Over the past few years, one of the major efforts for global financial regulators in the areas of both safety and soundness of the financial system and market regulation has been to coordinate on timing and substance of the regulations. In the area of derivatives, in fact, the G-20 have tasked the Over-the-Counter (OTC) Derivatives Regulatory Group (the principals of regulatory authorities with responsibility for regulation of over-the-counter derivatives markets across the globe) with reporting to it on "conflicts, inconsistencies, gaps, and duplicative requirements."

Despite these coordination efforts, differences in approaches remain. Multinational entities have many questions concerning issues of cross-border regulation, particularly where the U.S. and EU regulatory approaches, though similar in intent, appear to diverge in content. In particular, these entities are concerned about how best to reconcile the sometimes disparate equivalence and substituted compliance approaches in the U.S. and EU. At the same time, U.S. and EU enforcement efforts focused on market conduct in the listed and OTC derivatives markets have increased, further highlighting the need for clarity on when and how cross-border regulations will apply so that businesses can set up appropriate compliance arrangements. In addition to clarity on the substance of regulations, coordination between enforcement authorities is important, particularly in circumstances where the enforcement efforts are multijurisdictional. With implementation of two EU legislative measures — the Markets in Financial Instruments Directive and the Markets in Financial Instruments Regulation (MiFID 2[1]) — expected by January 2017, along with more final U.S. regulations on issues such as noncleared margin, further cross-border derivatives harmonization should materialize in 2015. (See "MiFID 2: Reforming the Regulation of EU Securities and Derivatives Markets.")

The recent U.S. noncleared margin requirements illustrate the challenge of achieving consistent global regulation. In 2014, U.S. banking regulators and the CFTC revised their 2011 proposals for imposing margin on OTC noncleared derivatives to be more reflective of margin requirement standards that were recommended a year earlier by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO). The U.S. proposals would require dealers to post and collect initial margin for noncleared derivatives from financial end-user counterparties with a material swap exposure of $3 billion even though the Basel/IOSCO standards would only require dealers to post and collect initial margin for noncleared derivatives when financial end-user counterparties have a material swap exposure of $11 billion. The U.S. proposals also would allow only cash collateral for variation margin for noncleared derivatives while the Basel/IOSCO framework would allow posting of noncash collateral.

Clearing is another area where, notwithstanding the similar focus, there is tension between U.S. and EU regulations. EU regulation is following in the footsteps of the U.S. "mandatory clearing" requirement for interest rate swaps and credit default swaps. However, where the U.S. regulations recognize an exception from mandatory swap clearing for commercial end users that are not financial entities

and use swaps for hedging, the EU determines its exception from mandatory clearing by using notional thresholds specific to a swap asset class entered into for nonhedging purposes. Thus, the EU approach subjects nonfinancial counterparties whose "speculative positions" exceed the thresholds (NFC+s) to mandatory clearing while exempting subthreshold nonfinancial counterparties (NFC-s). This tension is further exacerbated by the U.S. and EU's potentially different interpretations of the term "hedging."

The EU secondary legislation for implementing MiFID 2, which is scheduled to be developed by the European Securities and Markets Authority (ESMA) and the European Commission in the coming year, may give rise to other inconsistencies with U.S. derivatives regulation. For example, MiFID 2 recognizes categories for derivatives execution venues that can be used to transact "trading-eligible" derivatives[2] (*i.e.*, regulated markets, multilateral trading facilities, organized trading facilities, systematic internalizers) that do not correspond precisely to the U.S. categorization of designated contract markets (futures exchanges) and swap execution facilities. Even where there are substantial similarities, such as MiFID 2's recognition of exceptions to the trading requirement similar to the U.S. inter-affiliate exceptions, significant differences exist. For example, under MiFID 2 an affiliate would have to apply before it could rely on the "trading obligation" exception. In addition, MiFID 2's new position limits requirements will contain a much broader hedging exemption that includes anticipatory hedging, which the current U.S. proposal has mostly eschewed, and MiFID 2 will not require single spot month limits, which the U.S. regime does.

Added to this is ongoing uncertainty over what falls within the definition of foreign exchange (FX) and commodity derivatives, with the United Kingdom, other EU member states and the U.S. all taking a variety of views. The U.K., where the bulk of EU swaps trading occurs, currently does not classify certain categories of deliverable and nondeliverable foreign currency forwards as derivatives. The U.K.'s views, however, have not been shared by all EU member states. Differences in approach also exist in the treatment of physically settled commodity derivatives. These differences matter because the derivatives definition triggers EU reporting, margin, clearing and (in some cases) licensing obligations. ESMA is attempting to harmonize EU member state approaches. In September 2014, ESMA issued for comment draft guidelines to count physically settled commodities trades as derivatives with limited exceptions for spot trades (though there is a debate over whether spot trades must be settled in two or seven days) and certain energy transactions. ESMA supervisory board minutes indicated that EU trade reporting requirements for FX derivatives will wait for clarification of the relevant definition during MiFID 2 implementation, which may take two years, even though ESMA is separately pressing on with a consultation on phasing in the EU clearing obligation for nondeliverable FX forwards. Meanwhile, more than two years ago, the U.S. Treasury exempted physically settled foreign currency forwards and physically settled foreign currency swaps from mandatory clearing and trading and most other CFTC requirements, and the CFTC has provided various exceptions for physically settled energy and agricultural forwards. However ESMA and the U.K. resolve their differences, it seems likely that EU derivative definitions will differ from those used in the U.S.

No issue has perhaps presented a greater challenge to harmonization efforts in recent months than recognizing foreign clearinghouses and determining the authorities of each regulator with respect to such entities. In November, CFTC Chairman Timothy Massad laid out his views that this particular cross-border challenge cannot be solved by "a simple notion of deference," thereby rejecting the idea that, if the clearinghouse is based in a foreign jurisdiction, the CFTC would defer completely to foreign regulation and regulators for supervising those entities. Chairman Massad instead embraced the concept of "dual registration and cooperative oversight" among regulators, which is different from the traditional EU approach of deferring completely to home state supervision when: (1) the home state's supervision is equivalent to EU requirements, and (2) the non-EU home state provides reciprocal access to EU clearinghouses. It remains to be seen how European authorities will respond to Chairman Massad's suggestion. If the EU maintains its traditional approach, the difference between the U.S. and EU also may complicate the separate

equivalence decisions needed under MiFID 2 to allow EU derivatives counterparties to transact "trading-eligible" derivatives on non-EU exchanges.

Another example of the continuing need for reconciliation of cross-border regulatory approaches is the EU's proposed regulation of administrators and users of indices used as benchmarks in financial instruments and financial contracts (EU Benchmark Regulation). If implemented as proposed, the EU Benchmark Regulation may prohibit European supervised entities from using benchmarks created by administrators located in third countries, such as the U.S., unless certain equivalence standards are met. The EU Benchmark Regulation is proposed at this time, making it another area that bears watching in the new year.

Thus, much important work lies ahead in 2015 toward continuing to resolve different approaches to cross-border regulatory issues.

[1] The Markets in Financial Instruments Directive (2014/65/EC) and the Markets in Financial Instruments Regulation ((EU) 600/2014) will be supplemented over the next two years by a variety of EU secondary legislation and EU member state laws and regulations

[2] A "trading-eligible" derivative will be a derivative that is traded on at least one EU trading venue, subject to EU clearing obligations and deemed to be sufficiently liquid so as to require that it be traded on a regulated execution venue and not OTC. This will be called the "trading obligation."

For more on this topic see skadden.com/insights

MiFID 2: Reforming the Regulation of EU Securities and Derivatives Markets

The European Union has begun a wide-ranging and radical reform of its securities and derivatives markets through MiFID 2, which is scheduled to be implemented across the EU by January 3, 2017.

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MiFID 2 will:

- Enhance investor protection
- Tighten regulation of algorithmic and high-frequency trading
- Reduce OTC trading in shares and derivatives, increase on regulated venues
- Increase trading transparency across a broader range of securities and derivatives
- Bring more commodity derivatives trading within EU regulatory scope
- Tackle vertical silos in trading, clearing and settlement
- Begin harmonizing rules for non-EU investment firms
- Give ESMA an expanded supervisory role

For more on this topic see skadden.com/insights

SEC Focus Results in Investment Adviser Fee and Expense Changes

Recent efforts by the Securities and Exchange Commission to bring concentrated regulatory attention to investment managers sharpened over the past year to include a particular focus on the private equity and hedge fund industry and on a variety of monetary arrangements between advisers and the funds they manage.

Noteworthy SEC Compliance Inspection and Examination Updates From 2014

Jan 30

SEC holds the Compliance Outreach Program National Seminar, and Chairwoman Mary Jo White, in her opening remarks, identifies (1) expense shifting out of the management company and into funds, and (2) ancillary revenue such as transaction fees, which reduce cash to funds, in each case without proper disclosure or investor consent, among four major regulatory concerns in the private fund industry.

Feb 25

SEC institutes proceedings against Clean Energy Capital LLC (CEC) and its founder and CEO, Scott Brittenham, alleging in part that Brittenham inappropriately allocated expenses including rent, salaries and personal expenses, such as for estate planning and his daughter's school transportation, to investors. CEC and Brittenham later agreed to an approximately $2 million settlement.[1]

Apr 15

SEC files charges alleging that Total Wealth Management, Inc., its owner and its CEO failed to disclose revenue-sharing fees through which they paid themselves from investments they recommended to their clients.[2]

May 6

Director of the SEC's Office of Compliance Inspections and Examinations, Andrew Bowden, indicates in a speech that, after conducting more than 150 examinations of private equity firms, examiners identified what they believe are "violations of law or material weakness in controls" regarding collection of fees and allocation of expenses in over half of the firms examined.[3]

Q2

Investors and potential investors in private funds enhance their due diligence regarding fee and expense issues, according to *The Wall Street Journal*.

PitchBook reports that fewer than one-third of the transactions for this period included transaction or monitoring fees, in contrast to 90 percent of such transactions for the first quarter of 2012.

Jul - Oct

According to *The Wall Street Journal*, more than 15 private fund advisers revise their Form ADV filings midyear to provide additional disclosure regarding fee and expense practices, including accelerated monitoring fees, group-purchasing rebates not passed on to investors and allocation of costs associated with operating partners.

Sep 22

Lincolnshire Management Inc. (LMI) agrees to pay $2.3 million to settle charges by the SEC that it inappropriately allocated expenses relating to two portfolio companies between its private funds that owned these companies. The SEC alleged that LMI failed to follow its expense allocation policy in certain instances, resulting in a misallocation of funds.[4]

Oct 7

Blackstone indicates that it will curb its practice of charging accelerated monitoring fees in correspondence with a fund investor. *The Wall Street Journal* reports that the firm will no longer collect these fees when divesting companies and will distribute fees received in connection with companies already in its portfolio to investors or reduce other fees.

Dec 28

The Wall Street Journal reports that some of the largest private equity firms (including Blackstone, Apollo, KKR and Carlyle) will now pass transaction and monitoring fees to investors in full.

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[1] *Clean Energy Capital, LLC*, Securities Act Release No. 9667, Exchange Act Release No. 73,386, Investment Advisers Act Release No. 3955, Admin. Proc. No. 3-15776 (Oct. 17, 2014).

[2] *Total Wealth Management, Inc.*, Securities Act Release 9575, Exchange Act Release No. 71,948, Investment Advisers Act Release No. 3818, Investment Company Act Release No. 31,107, Admin. Proc. No. 3-15842 (April 15, 2014).

[3] Speech, Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, at the Private Equity International Private Fund Compliance Forum (May 6, 2014), *available at* www.sec.gov/News/Speech/Detail/Speech/1370541735361.

[4] *Lincolnshire Management, Inc.*, Investment Advisers Act Release No. 3927, Admin Proc. No. 3-16139 (Sept. 22, 2014).

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Lawmakers and Regulators Continue Focus on Strategies for Resolving SIFIs

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The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 contains two sets of provisions for managing the insolvency of financial institutions. First, the legislation creates an Orderly Liquidation Authority (OLA), a comprehensive regime for resolving a financial institution whose failure is determined to potentially endanger the U.S. financial system. Second, certain financial institutions, including so-called "systemically important financial institutions" (SIFIs), are required to develop "living wills," which are plans for restructuring or winding down in accordance with the U.S. Bankruptcy Code. The plans are submitted annually and are subject to review by the FDIC and the Federal Reserve, which make credibility assessments. The preferred approach for dealing with an insolvent financial institution is through the bankruptcy process; the FDIC-administered OLA is to serve only as a fallback.

Over 100 financial institutions have prepared and submitted living wills to the FDIC and the Federal Reserve. The largest financial institutions submitted their first ones in 2012 and have submitted two additional versions since. Smaller financial institutions first began submitting their living wills in 2013. Some of the smaller financial institutions required to submit living wills have been allowed to submit more streamlined, "tailored" plans.

On August 5, 2014, the FDIC and the Federal Reserve concluded that the living wills submitted by 11 of the largest financial institutions (so-called "First Wave Filers") had shortcomings. These included problematic assumptions regarding the likely behavior of market participants in reaction to the firms' distress and the failure to make or identify necessary changes in structure and practice to improve prospects for orderly resolution. The agencies required actions in the following areas on or before July 1, 2015, so the firms would show progress on the identified shortcomings: (1) establishing less complex legal structures that would better align legal entities and business lines, (2) developing holding company structures to improve resolvability, (3) amending financial contracts to avoid early termination triggered by insolvency, (4) ensuring the continuity of shared services, and (5) demonstrating operational readiness for resolution, including the ability for timely production of reliable information.

However, the FDIC also stated its directors had determined that the 2013 plans submitted were not credible, implying that the plans would not facilitate an orderly resolution under the Bankruptcy Code. FDIC Vice Chairman Thomas Hoenig issued a separate statement in which he identified three categories of shortcomings: continued reliance on wholesale funding and an inadequate showing that liquidity would be available for restructuring, insufficient capital in view of leverage levels, and lack of clarity with respect to the ability to effectuate a cross-border flow of funds during a crisis, given uncertainties around actions regulators may take in different jurisdictions.

The regulators' statements underscore the significance and breadth of the task of planning an orderly wind-down or resolution of a large, global financial institution. The scale and depth of the required analysis may be inferred even from the high-level guidance that the agencies issued in April 2013. There, the agencies identified the following "obstacles" to rapid and orderly resolution: (1) multiple competing insolvencies under different bankruptcy regimes for various affiliates within a financial holding company (*e.g.*, simultaneous proceedings under the Securities Investor Protection Corporation (SIPC) for broker-dealers, the Federal Deposit Insurance Act (FDIA) for an insured depository institution, and foreign law for non-U.S. affiliates); (2) the potential that foreign supervisors and governments would take actions such as ring-fencing (protecting assets in one jurisdiction from transfer to another) that could exacerbate the financial

institution's funding position; (3) the impact of operations and interconnectedness, raising the risk that third parties ranging from financial market utilities to IT vendors and other service providers may take adverse actions that significantly exacerbate the situation; (4) the risk that trading counterparties would seize collateral or take other actions to complicate, if not impede, resolution; and (5) the inability to obtain funding (including debtor-in-possession or "DIP" financing) to maintain critical operations. To make the exercise even more challenging, financial institutions must present their plans against baseline and stressed market scenarios, considering possibly idiosyncratic failure or failure under stressed market conditions. Finally, financial institutions may not assume any kind or level of extraordinary government assistance.

Accordingly, to develop a plan that regulators will find acceptable, financial institutions need to focus not just on planning for the nuts and bolts of bankruptcy filings; they also must develop detailed accounts of the impact of markets and the behavior of their counterparties and vendors on their balance sheet and operations. The nature of the assumptions made in connection with each aspect of operations, counterparty behavior (including financial market utilities), asset valuation and funding sources will be critical to the integrity of the proposed living will and subject to rigorous scrutiny by the regulators. Although the challenges are many, five sets of issues merit further comment: providing for liquidity and securing funding sources, managing self-help measures taken by counterparties, anticipating actions and proceedings in foreign jurisdictions, aligning legal entity structure with line of business, and operational ability to handle resolution.

Having enough liquidity to allow a financial institution to operate in an orderly fashion as it winds down is critical to managing distress and avoiding a spillover to the financial system. A significant focus in the living wills process is how financial firms will obtain and maintain liquidity, whether in the form of sufficient unencumbered assets or otherwise, to serve as the functional equivalent of DIP financing. In a typical situation, DIP financing is an operating loan made — usually by financial institutions — to an entity in bankruptcy. The OLA resolution scheme under Title II addresses liquidity provision through the creation of an orderly liquidation fund (OLF), with the expectation that any amounts disbursed will be recouped without taxpayer exposure. However, in the living wills process, financial institutions must design their liquidity provisions with no expectation of extraordinary government support.

One challenge is that financial counterparties typically are reluctant to provide funding to financial institutions approaching insolvency. As a result, financial holding companies must think carefully about the liquidity needs associated with each of the scenarios they present, and whether they adopt liquidation or restructuring strategies with respect to various affiliates as a result of the underlying analysis. A related, though antecedent, issue is outlining how the company will use liquidity in the 30-day "runway" period, and how it will determine whether resolution, as opposed to recovery, is required. Sometimes, because companies in crisis utilize their unencumbered assets to avoid formal insolvency proceedings, they may have few such remaining assets to support DIP financing if and when they file for bankruptcy. The living wills process requires firms to prepare for such contingencies. Accordingly, providing for sufficient DIP financing to fund resolution will require living wills to contemplate entry into formal insolvency proceedings long before reserves and other unencumbered assets are depleted, which in turn may require far greater vigilance in the early phases of troubled market dynamics.

Second, closely related to the issue of funding is managing counterparties during a period of distress. Various legal contracts with counterparties can complicate the winding-down process by affording them the right to seize collateral or to terminate contracts. Moreover, cross-default provisions and parent guarantees can magnify the impact of the failure of a particular affiliate across the entire holding company structure, including potential impact on efforts to transfer assets and liabilities during a restructuring to a bridge bank. Living wills are expected to focus on issues surrounding counterparty rights and collateral management (including netting and valuation). Regulators and industry associations have been pressing for progress on these issues, more generally, to assist resolution planning. On October 11, 2014, for example, the International Swaps and Derivatives Association (ISDA) announced in a press release a Resolution Stay Protocol that

imposes short-term stays on counterparties exercising remedies in the event of a counterparty insolvency that, in theory, would avoid termination of certain short-term financing instruments. Such stays would preserve a financial institution's liquidity position and avoid a short-term run as it resolved its affairs.

Third, since the "First Wave Filers" are global financial institutions, they also must account for how the resolution efforts will affect, or be affected by, the circumstances of their foreign affiliates. The challenge here is that the bankruptcy laws of different countries are not the same and regulators may not all react to distressed financial firms with a consistent policy. Thus, firms will need to not only consider the impact of different laws on their efforts to resolve, but also anticipate the impact of potential actions such as ring-fencing. Such actions may result in constraints on deployment of liquidity by the financial firm and disruption of basic operating services, such as data management and trade execution. Firms must plan for contingencies with respect to the operational interdependencies of their global affiliates. Again, the regulators have sought to address structural issues in this area. Certain foreign banking organizations (FBOs), for example, are obligated to create an intermediate holding company structure based in the United States, which will be designed to facilitate resolution. 12 C.F.R. pt. 252, subpt. O (2015).

Fourth, continuing on the issue of structure, firms will have to further demonstrate alignment of legal entity with business lines. Frequently, financial firms conduct similar activity across multiple legal entities, such that a single transaction might involve several affiliates (for example, in the case of derivatives and risk-hedging transactions). Managing a bankruptcy where positions on individual transactions, for example, implicate multiple entities can become very complicated. Thus, firms and regulators will need to balance the business and efficiency rationale of housing activity in multiple entities against the incremental complexity it might create for orderly resolution.

Finally, operational continuity is critical to orderly resolution. Complex financial firms benefit from operational synergies through shared services, for example. In resolution, should some affiliates be disposed in bankruptcy, to maintain essential operational continuity, it is important that the shared services contracts contemplate continued service to the various entities. Moreover, rapid and efficient bankruptcy proceedings require that systems be configured to provide up-to-date information regarding the financial positions, exposures and general condition of the firm and all its affiliates. Accurate and timely internal reporting of data thus becomes critical to resolution planning. This requires attention to controls, so as to optimize timely input of data and information, and system integration, which consists of timely and accurate reporting and recordkeeping of the consolidated entity and its subsidiaries.

The foregoing measures, whether by regulators or financial institutions in their living wills, may assist in resolving financial institutions under the Bankruptcy Code. However, one challenge is that the Bankruptcy Code's focus on protection of creditor rights and process, designed to afford all interested parties with advance notice and an opportunity to be heard, can impede the ability of a troubled financial institution to effectuate a resolution with the speed necessary to preserve value and protect private interests while simultaneously minimizing systemic risk and protecting the public. Accordingly, a bill has been introduced in Congress that, if adopted, would amend the Bankruptcy Code through creation of a new subchapter for large financial institutions (Subchapter 5). Like the OLA and the FDIA, Subchapter 5 provides for the prompt transfer of a large financial institution's assets to a newly created "bridge company." Again, under this approach, a single holding company would file bankruptcy — a "single-point-of-entry" — with the assets of such company, *i.e.*, the stock in its operating subsidiaries, transferred to the bridge company. The bridge company must assume protected accounts and secured debt related to any transferred collateral, but unsecured claims and equity would be left behind in the bankruptcy estate. The equity in the new bridge company

would be placed into a trust to be disposed at the discretion of a plan trustee with the proceeds distributed to unpaid, unassumed creditors in the order of their priority.

Unlike the OLA, however, a Subchapter 5 proceeding would not be effectuated with the FDIC as receiver, nor would there be an OLF. Rather, the process would be overseen, on a highly expedited basis, by an experienced bankruptcy judge selected from among a predetermined group designated to serve in this role. And consistent with the OLA, the FDIA and the ISDA's Resolution Stay Protocol, parties to short-term funding sources like repurchase agreements and securities contracts could not immediately terminate their obligations if they are assumed by a bridge company — which, under Subchapter 5, must occur within 24 hours of the commencement of a formal insolvency proceeding for the SIFI.

The proposed legislation may modify the Bankruptcy Code to further mitigate the risks to the financial system of financial institution insolvency and enhance the resolvability of financial institutions that do become insolvent. However, it does not address some important issues, such as funding and the complexities attendant to differing requirements that may be imposed on cross-border enterprises subject to multiple legal regimes. Moreover, Subchapter 5 does not provide for the resolution of a U.S. branch of an FBO. This is significant given most FBOs' very prevalent use of the U.S. branch structure. Accordingly, holding company structures may not necessarily result in a more streamlined "single-point-of-entry" insolvency process for FBOs. Until lawmakers and regulators across the globe coordinate on such matters, the risk of disjointed insolvency proceedings, which itself could contribute to financial system instability, will remain.

For more on this topic see skadden.com/insights

Europe's New Toolbox Aims to Minimize Impact of Troubled Banks

Europe's latest legislative response to the recent financial crisis — the Bank Recovery and Resolution Directive — is intended to establish a minimum common toolbox for regulators in each member state to address bank solvency issues sooner, maintain key financial functions and minimize the impact of any failure.

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Managing Regulatory Risk in Bank M&A

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We expect the slowly developing but increasingly perceptible trend toward community and regional bank consolidation in the United States to continue in 2015. In connection with growing bank M&A activity, closing risk in the current bank regulatory environment has become a top-of-mind issue for senior executives and boards of directors of banks mulling potential M&A transactions. For those institutions looking to enter the bank M&A fray, a proactive strategy for managing regulatory risk will be key to successfully executing bank M&A transactions in 2015.

However, significant delays in transaction closings due to regulatory concerns or issues in well-publicized situations such as M&T/Hudson City, Cullen/Frost/WNB Bancshares and BancorpSouth's pending acquisition of two community banks in Louisiana and Texas, among others, have made an impression in the minds of many bank executives. Indeed, perceptions of the regulatory climate for bank M&A remain a significant chilling factor for a resurgence in deal activity in the banking industry. Both buyers and sellers are concerned about "hanging out there in the market" for prolonged periods of time due to difficulties in obtaining regulatory approvals, which create potential franchise disruption and instability as well as openings for market/shareholder criticism. As a result, boards of directors of potential sellers are requiring a more comprehensive understanding of the buyer's regulatory standing in earlier stages of transaction discussions, while buyer executives considering an acquisition are seeking greater comfort from regulators prior to any deal announcement regarding the prospects for timely transaction approval.

We believe understanding and managing regulatory risk will remain a dominant theme for bank M&A in 2015. In particular, bank executives and boards will need to focus on the following three areas of managing regulatory risk to successfully navigate bank M&A discussions in 2015:

Regulatory Reverse Due Diligence. Reverse due diligence on a buyer's regulatory standing must be among the top priorities of seller boards from the outset of transaction discussions. Navigating regulatory reverse due diligence frequently involves thorny issues, including the limitations involved in communications around confidential supervisory information, but now has become a critical step for potential sellers in identifying regulatory concerns in connection with a transaction. Likewise, potential buyers increasingly are called upon to proactively provide sellers with comfort regarding their regulatory standing and "approvability" and will face many of these same issues in seeking to meet these seller requests, particularly at the early stages of a deal when a buyer is not yet in a position to obtain from the target bank the confidential financial and operating information necessary for the buyer to adequately assess the facts relevant for regulatory approval of the deal.

Pre-Announcement Regulatory Strategy. Virtually no bank M&A transaction in today's environment is getting signed without significant pre-announcement discussions with the regulators. A considered pre-announcement regulatory strategy is essential to putting the proposed transaction in the best position to close without significant delays. A successful pre-announcement regulatory strategy requires balancing the risks of meeting with the regulators too early in the process when the parties do not yet have the requisite facts in place to properly respond to regulators' questions about the transaction with the potential costs and delays in transaction timing if regulatory conversations begin too late in the process. In addition, appropriate sensitivity to the regulatory dynamics in pre-announcement discussions is critical to accurately gauging regulatory receptivity to the transaction while remaining realistic about the degree of comfort that can be gained from such discussions.

Regulatory Risk Allocation. Deal parties increasingly are focusing on the regulatory provisions in transaction agreements, including the covenant to seek regulatory approvals, the definition of a "burdensome regulatory condition" exception to the buyer's obligation to obtain regulatory approvals and complete the deal, and termination rights that affect risk allocation relating to the regulatory process (including the "drop-dead" date). These provisions form the backdrop for post-announcement deal dynamics in the event regulatory concerns or issues arise while the deal is pending. In addition, deal parties have considered other contractual provisions to further address regulatory risk allocation, including regulatory reverse termination fees, ticking fees in the event of regulatory delay, covenants restricting preclosing activities of a buyer that would impede or delay regulatory approval, and provisions that permit a seller to explore alternative third-party proposals if the transaction closing is delayed due to buyer regulatory issues. On the whole, these other risk-allocation provisions have not become a part of the final transaction documentation with any regularity or frequency, but they increasingly form part of the toolkit of deal makers during transaction negotiations.

For more on this topic see skadden.com/insights

Specialty Finance M&A: Market Update

Transactions involving nonbank specialty finance companies attracted strong interest from the private equity community and strategic buyers alike in 2014. Market activity involving nonbank consumer finance companies in particular remained robust. The underlying drivers for this activity have been the increasingly complex and active regulatory and enforcement environment and the availability of more attractive financing alternatives for these businesses.

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Broker-Dealer M&A Transactions: Toward a More Accommodating Regulatory Process

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M&A transactions involving regulated broker-dealers often require Financial Industry Regulatory Authority (FINRA) approval under NASD Rule 1017. Such approval is required for any direct or indirect acquisition by a broker-dealer of another broker-dealer,[1] change in control of a broker-dealer or "material change in business operations" of a broker-dealer.

Rule 1017 has gained prominence in light of recent consolidation within the independent broker-dealer industry, which experienced a decrease in broker-dealers registered as members of FINRA from 4,905 in 2008 to 4,105 as of October 2014.[2] The consolidation has been driven by low interest rates (which have harmed independent broker-dealers by decreasing revenues from lending on margin) and difficult business conditions following the credit crisis. At the same time, the requirements of Dodd-Frank and other new regulations have imposed additional compliance costs on independent broker-dealers.

The timing and ultimate outcome of the Rule 1017 process are often critical factors in broker-dealer M&A transactions. Participants in broker-dealer M&A transactions may be unable, without FINRA assistance, to determine whether a transaction requires approval under Rule 1017. If Rule 1017 approval is required, uncertainties as to the likely timing for approval may further complicate the transaction.

Scope of Rule 1017 in the Context of M&A Transactions

A FINRA member broker-dealer that undergoes any of the changes described in Rule 1017 is required to file an application for FINRA's approval under the rule. Some common examples of transactions requiring Rule 1017 approval include:

- acquisition or disposition of a controlling block of the equity securities of a broker-dealer, or of an equity interest that represents less than a controlling interest but 25 percent or more of the outstanding equity securities of the broker-dealer;
- acquisition or disposition of an asset management firm that includes a broker-dealer subsidiary or affiliate (such as a hedge fund management firm that uses a broker-dealer subsidiary to trade securities and/or raise capital for its funds and other products); and
- acquisition or disposition of assets that will materially change the business operations of the acquiring and/or disposing broker-dealer, such as may be encountered in the acquisition of a material amount of revenues attributable to sales of securities (*e.g.*, mutual funds).

FINRA approval is required as a condition to closing each of the foregoing types of transactions and, in many cases, requires a longer period of time than any other closing condition — thus becoming the "critical path" to completing the deal.

Uncertainties in the Rule 1017 Process

Participants in M&A transactions involving FINRA members face uncertainty regarding the timing of the Rule 1017 process, from initial consultations, through the formal application process, to the effective date of FINRA approval. Moreover, the facts and structure of many transactions present no clear answer to the threshold question of whether FINRA approval is necessary.

Rule 1017 Timeline

Filing of Application

At least 30 days prior to the change in ownership or control under Rule 1017, FINRA member must submit an application to the Department of Member Regulation (DMR), including a Change of Membership Application (Form CMA).[1]

30 Days

DMR may serve initial request for additional information or choose to interview the applicant within 30 days after the filing date.[2]

45 Days

If DMR does not request additional information or an interview, it must issue a decision within 45 days after the filing date.

60-90 Days

FINRA generally approves transactions within 60 to 90 days after the filing date.

180 Days

The entire process would be expected to take no more than 180 days from the filing date.

[1] *NASD Notice to Members 12-33* (2012), *available at* https://www.finra.org/Industry/Regulation/Notices/2012/P131267.

[2] DMR also may interview applicant within 30 days after the date of any request for more information. If DMR requests additional information or membership interview, it must issue a decision within 30 days after the later of the filing of the requested information or the conclusion of the interview.

Recent developments indicate that the FINRA staff is taking steps to expedite its responses to requests for materiality consultations in connection with a potential "material change in the business operations" of a broker-dealer under Rule 1017.

For example, deal participants may be unable, without FINRA assistance, to determine whether a transaction will result in a "material change in business operations" of a broker-dealer for the purposes of Rule 1017. FINRA defines a material change in business operations as removing or modifying a membership agreement restriction; market making, underwriting or acting as a dealer for the first time; or adding business activities that require a higher minimum net capital. However, this definition is not all-inclusive. FINRA has further provided that whether any particular business expansion is material will depend on the following factors:[3]

- the nature of the proposed expansion;
- the relationship, if any, between the proposed new business line and the firm's existing business;
- the effect the proposed expansion is likely to have on the firm's capital;
- the qualifications and experience of the firm's personnel; and
- the degree to which the firm's existing financial, operational, supervisory and compliance systems can accommodate the proposed expansion or addition.

A limited safe harbor exists for firms that do not have a membership agreement, firms with restrictions in their membership agreements that would conflict with the expansions allowed under the safe harbor, and firms that do not have a disciplinary history. Firms that can invoke the safe harbor can expand — up to prescribed numbers — the number of Associated Persons involved in sales, the number of offices or the number of markets made without triggering a material change in business operations. Exceeding the prescribed numbers may or may not constitute a material change in business operations.

Toward a More Efficient Process

Efficient execution of mergers and acquisitions involving registered broker-dealers may be compromised by lengthy processes to obtain the consent (or advice as to the requirement for such consent) of regulators, such as FINRA. FINRA staff members have been willing to conduct "materiality consultations" regarding whether a transaction will result in a material change in business operations of a broker-dealer.[4] In practice, however, at least prior to the developments of this past year, the response by FINRA to a materiality consultation could be lengthy enough to discourage transacting parties from using the process and instead opt to simply submit the Rule 1017 application.

Recent developments indicate that the FINRA staff is taking steps to expedite its responses to requests for materiality consultations in connection with a potential "material change in the business operations" of a broker-dealer under Rule 1017, including adding staff dedicated to materiality consultations. Participants in broker-dealer M&A transactions can be expected to welcome any endeavors by FINRA to expedite the materiality consultation process and to increase the transparency and formality of that process. To that end, written procedures — including prescribed time periods for FINRA responses — could be particularly helpful.

The authors wish to acknowledge the contributions to this article of Brynn M. Rail, an associate in the New York office of Skadden.

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[1] NASD Rule 1017(a)(2), (a)(4), (a)(5) (2014).

[2] Fin. Indus. Regulatory Auth., *FINRA Statistics & Data*, FINRA, http://www.finra.org/Newsroom/Statistics/ (last visited Nov. 25, 2014).

[3] NASD Rule 1011(k) (2014); NASD IM-1011-1 (2006); National Ass'n of Sec. Dealers, NASD *Notice to Members 00-73* (2000), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003977.pdf. A FINRA Hearing Panel applied some of these factors to find that a firm in the general retail securities business had made a material change in business operations by selling four types of financial products that were not contemplated by its membership agreement and the nature of which was found by the Hearing Panel to be materially different from ordinary equities that the firm was allowed to sell, both "in terms of the sale of the products and the supervision of the sales." Dep't of Enforcement v. Merrimac Corporate Sec., Inc., Complaint No. 2007007151101, 2010 FINRA Discip. LEXIS 41 (Dec. 8, 2010), *aff'd*, 2012 FINRA Discip. LEXIS 43 (May 2, 2012).

[4] Nat'l Ass'n of Sec. Dealers, *NASD Notice to Members 13-11* (2013), *available at* https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p217586.pdf; *Continuing Membership Guide: CMA Requirements*, http://www.finra.org/Industry/Compliance/Registration/MemberApplicationProgram/CMGuide/P009723 (last visited Jan. 16, 2015).

FinCEN Proposes Tighter Customer Due Diligence Requirements for Financial Institutions

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For financial institutions, customer due diligence may become tougher and costlier in 2015 if the Financial Crimes Enforcement Network's (FinCEN) latest proposed rule is finalized in its current form. On July 30, 2014, FinCEN issued a Notice of Proposed Rulemaking (NPRM) intended to expand customer due diligence (CDD) requirements for banks, securities brokers or dealers, mutual funds, and futures commission merchants and introducing brokers in commodities. Of particular importance, the NPRM proposes amendments to FinCEN's anti-money laundering (AML) program rules that would require these financial institutions to know and verify the identity of the ultimate beneficial owners of their entity customers. The ultimate beneficial owners would include the natural persons who own, directly or indirectly, 25 percent or more of the entity and the natural persons who have significant responsibility to control, manage or direct the entity. The NPRM represents just one element of the U.S. government's broader strategy to enhance financial transparency.

The NPRM also will bring the United States more in line with existing international standards. Since 2005, the European Union has required financial institutions to identify and verify beneficial owners. Other international financial centers such as Switzerland, Singapore and Hong Kong also require the same. Since 2003, the Financial Action Task Force, an intergovernmental body that sets AML standards, has recommended that financial institutions identify and verify the identity of the beneficial owners of customers, including taking reasonable measures to understand the ownership and control structure.

Financial institutions should consider the following takeaways:

Institutions Should Not Delay Preparations. Since the beneficial ownership proposal has been the subject of an Advanced Notice of Proposed Rulemaking, public hearings and significant regulatory guidance, FinCEN and the financial regulators do not view this rule as a surprise. We anticipate that FinCEN will move quickly to finalize the NPRM in order to meet commitments in the Action Plan for Transparency of Company Ownership and Control made following the June 2013 G-8 summit. Although the final rule may change in response to industry suggestions to limit the scope of certain definitions or expand on certain exemptions, we nonetheless expect examiners will begin to focus on this issue immediately in AML target examinations. Institutions should anticipate questions from examiners prior to finalization and plan accordingly.

As Drafted, the NPRM Impacts Small and Large Institutions Alike. The NPRM estimates that the proposed rule covers approximately 21,500 institutions in the United States, over half of which are considered to be small institutions. Commenters representing these institutions have expressed concern over the associated compliance costs. Nonetheless, small institutions historically have not been immune to regulatory requirements in this area and have been the subject of civil and criminal enforcement actions. Furthermore, regulators — and prosecutors for that matter — have specifically expressed concern that as larger institutions reduce compliance risk, smaller institutions will assume these activities.

The NPRM Permits "Reasonable" Reliance on Representations of Customers. While the NPRM as drafted requires financial institutions to identify and verify beneficial owners, it explicitly does not require financial institutions to verify that the natural persons identified are, in fact, the beneficial owners. FinCEN acknowledged that some customers may have complex legal ownership structures making it difficult to identify indirect beneficial owners. FinCEN expects financial institutions to be able to rely "generally" on the representations of customers, and commenters have even suggested a safe harbor for

financial institutions that identify beneficial owners using FinCEN's proposed form. We anticipate, however, that any reliance must be reasonable. As numerous enforcement actions illustrate, regulators are unlikely to be sympathetic to institutions that turn a blind eye to apparent red flags.

Heightened Expectations in Economic Sanctions Compliance are Likely. Identifying beneficial owners is important in a financial institution's economic sanctions compliance program. Sanctions apply where the ultimate benefit of a transaction is received in a sanctioned country, including by beneficial owners located in that country. Additionally, on August 13, 2014, the Office of Foreign Assets Control changed its longstanding guidance and stated that it would begin aggregating beneficial interests of sanctions targets; now, if two or more sanctions targets together own 50 percent or more of an entity, the sanctions will apply equally to that entity. We expect that a formal beneficial ownership rule and more generally the heightened focus on beneficial ownership in the United States and abroad will make mitigation arguments more difficult.

Voluntary Compliers Should Consider Reevaluating Their Programs. The NPRM only applies to covered financial institutions. However, companies that voluntarily subject themselves to AML program requirements may consider adopting the finalized beneficial ownership requirements or at least enhancing their CDD procedures, particularly if other financial intuitions rely on their CDD. For example, broker-dealers who rely on investment advisers pursuant to the Securities and Exchange Commission no-action letter may expect the investment adviser to identify and verify ultimate beneficial owners to the same extent as if it were subject to the rule.

Institutions Must Manage Differences in Applicable Legal Regimes. In February 2013, the European Commission proposed a fourth EU money laundering directive, which would require all companies, legal entities and trustees to hold adequate and up-to-date information on their beneficial owners and to make this information available to persons performing AML due diligence and to law enforcement agencies. Last March, the European Parliament released a separate proposal, which included a requirement for a central registrar of beneficial owners. In December 2014, the European Council and Parliament reached a deal that would require ultimate beneficial owners to be listed in central registers available to the government, "obliged entities" such as banks, and persons who demonstrate a "legitimate interest." The fourth directive must still be finalized, but the message is clear: While the rules concerning beneficial ownership vary across jurisdictions, they are tightening globally.

For more on this topic see skadden.com/insights

Dusting Off FIRREA: Old Statute Poses Challenges for Financial Institutions

Enacted in response to the savings and loan crisis but scarcely used over the following two decades, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) has become a favored tool for prosecutors in the aftermath of the recent financial crisis. FIRREA offers prosecutors unusual and powerful advantages, which have only been amplified by the Department of Justice's aggressive interpretations of the statute — interpretations that have, so far, enjoyed a friendly reception from the courts.

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Sectoral Sanctions Add New Layer of Complexity to OFAC Sanctions

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In response to the protracted crisis in Ukraine, the Obama administration authorized traditional and innovative economic sanctions against Russian and Ukrainian persons through Executive Orders 13660, 13661, 13662 and 13685. In keeping with other traditional sanctions programs, the U.S. government has added dozens of Russian and Ukrainian entities and individuals to the Specially Designated Nationals and Blocked Persons List (SDN List) since March 2014. The SDN List details the specific targets of U.S. sanctions, and these traditional U.S. sanctions prohibit any transactions involving designated persons and U.S. persons or the territory of the United States. In December 2014, the president also prohibited U.S. investment in or trade with the Crimean region. The recent sanctions against Crimea are comparable to other comprehensive sanctions programs the U.S. maintains against Sudan, Iran, Syria and Cuba. In July 2014, however, the U.S. government created an entirely new type of sanctions regime, the "sectoral sanctions," that aims to limit certain sectors of the Russian economy from gaining access to U.S. capital and debt markets, as well as U.S. technology and expertise in the energy sector.

For various reasons, the Ukraine-related sanctions have posed significant compliance challenges. Unlike the targets of other U.S. sanctions programs, many targets of the Ukraine-related sanctions are highly integrated into the global economy due to their participation in international trade and their vast global holdings. Businesses must ensure that they are not engaging in prohibited transactions with this large and active network of companies. Additionally, companies operating in multiple jurisdictions often must comply with sanctions imposed by several governments: The United States, G-7 and EU countries have imposed overlapping, and sometimes differing, sanctions. Additionally, an active U.S. Congress may encourage even more aggressive and unilateral sanctions on the part of the United States. All of these factors — against the backdrop of a strict-liability regime — complicate compliance with U.S. sanctions, particularly for companies engaging in highly complex transactions, managing business matters across multiple jurisdictions or operating in the sectors targeted by these sanctions.

The Novelty of Sectoral Sanctions. Sectoral sanctions are an entirely new breed of sanctions for which the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) has issued several directives. To date, however, OFAC has provided limited guidance or interpretation on its directives, and it remains unclear how OFAC will enforce them. On July 16, 2014, OFAC created a new Sectoral Sanctions Identifications (SSI) List pursuant to Executive Order 13662, which had authorized sanctions against certain sectors of the Russian economy, including the financial services, energy, mining, and defense and related materiel sectors. Pursuant to OFAC's first three SSI directives, transactions involving U.S. persons or the United States are prohibited to the extent that the transactions involve the issuance by SSI entities of new debt (and in some cases new equity) that exceeds 30 or 90 days' maturity. The concepts of debt and equity can appear relatively simple in the abstract, but their application to highly complex international financial transactions is more difficult. Businesses have been struggling to determine whether certain agreements, financial instruments or components of complex transactions would fall under OFAC's simplified definition of debt and equity. Businesses may wish to consider all aspects of a transaction that could give rise to an SSI List entity owing an obligation that exceeds 30 or 90 days' maturity and that involves a U.S. nexus.

Due Diligence of the Ownership Structure of Targeted Entities. As with all U.S. sanctions, the Ukraine-related sanctions apply to any entity owned 50 percent or more by a sanctioned person. Based on recent guidance from OFAC, this rule now applies to aggregate ownership by sanctioned persons. The individuals and companies designated under the Ukraine-related sanctions often have vast and sometimes nontransparent holdings throughout the world, meaning that businesses cannot simply screen counterparties' names against the OFAC lists. They also must determine whether sanctioned persons directly or indirectly own — in the aggregate — 50 percent or more of their counterparties. As a result, due diligence of counterparties should go beyond only screening counterparty names against watchlists to include analyzing ownership structures.

SDN Involvement in Management and Board Representation of Nonsanctioned Entities. Several of the individuals that have been designated as SDNs hold leadership positions in large enterprises throughout Russia. In many cases, the companies for which they are directors or officers are not sanctioned. OFAC has explained that when a blocked person controls, but does not own, 50 percent or more of an entity, the entity is not automatically blocked. OFAC, however, has advised U.S. persons to act with caution when transacting business with an SDN in his or her capacity as an official representative of a nonsanctioned entity. OFAC indicated that in certain circumstances, U.S. persons may not execute a contract with a nonsanctioned entity when the contract is countersigned by an SDN, even when the SDN does not own 50 percent or more of the counterparty. The positions advanced by OFAC are novel, and the enforcement landscape is evolving.

Different Sanctions Across Jurisdictions. The U.S. has imposed sanctions against Russian persons in conjunction with the European Union, Canada, Australia and other jurisdictions. However, the lists of sanctioned parties are not identical, and the scope of the sanctions varies. Moreover, businesses have had to navigate Russian countermeasures imposed in response to Western sanctions. To date, the Russian countermeasures are limited to an import ban on certain food products originating from the United States, EU and other states and an import ban on certain consumer goods, if the goods will be used by the Russian state. As a result, companies operating in multiple jurisdictions not only must understand and comply with the U.S. sanctions but should heed the sanctions in these other jurisdictions as well.

U.S. Legislative Outlook for 2015. From the onset of the crisis, the Obama administration has opted to coordinate with the G-7 and European Union on each of its sanctions announcements pertaining to events in Ukraine. On December 18, President Obama signed legislation authorizing new sanctions on the Russian energy and defense sectors. His action was based on the "flexibility" provided in the legislation, including waiver authority. The new Congress that convened this month, led by Republican majorities in the House and Senate, could push the administration to be more aggressive and unilateral, depending on developments in the region. Such legislation, which would be intended to have a more significant deterrent effect than the sanctions imposed by the administration to date, may be extraterritorial in scope to include foreign persons that engage in significant transactions with certain Russian entities. Persons making business and investment decisions involving the region should be mindful that the new Congress may create a more dynamic sanctions environment in the United States than existed previously.

CFPB Defines 'Unfair,' 'Deceptive' and 'Abusive' Practices Through Enforcement Activity

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Since the Consumer Financial Protection Bureau (CFPB) opened its doors in July 2011, it has aggressively pursued enforcement actions against a wide range of consumer financial services providers. Although the Dodd-Frank Act gives the bureau the authority to enforce numerous financial services statutes, the CFPB has relied upon its authority to prosecute Unfair, Deceptive, or Abusive Acts and Practices (UDAAP) more than any other authority. Of the more than 40 enforcement matters that the CFPB has made public to date, half have alleged violations of the UDAAP provision of the Dodd-Frank Act. These actions have resulted in restitution to consumers totaling more than $1.7 billion, as well as civil money penalties totaling more than $142 million.

The bureau has relied upon UDAAP as its primary enforcement tool for a number of reasons. First, penalties for violating the UDAAP provision can be drastic — up to $1 million per day for a knowing violation of the law. In 2014, six of the bureau's 14 UDAAP enforcement actions resulted in penalties greater than $5 million, including two actions with penalties greater than $10 million.

Perhaps more importantly, the language of the UDAAP provision is broad and vague, allowing the CFPB to rely on its UDAAP authority to challenge conduct it finds troubling, even if not in violation of any express legal requirement. Although some precedent exists regarding the interpretation of "unfair" or "deceptive," those terms remain elastic; as to "abusive," there is no prior precedent, and the statute provides little guidance as to what constitutes an abusive act or practice. While both Congress and industry groups have called upon the bureau to clarify the scope and meaning of UDAAP through its rulemaking authority, the CFPB has declined to do so, choosing instead to rely upon its enforcement authority and develop its UDAAP doctrine on a case-by-case basis.

Recent enforcement cases illustrate the CFPB's broad application of its UDAAP authority. The bureau alleged that:

- mortgage loan servicers engaged in unfair and deceptive practices by impeding borrowers' access to loss mitigation options and misrepresenting the right to appeal loan modification denials.
- a number of financial institutions engaged in unfair and deceptive practices by failing to disclose all relevant terms of identity fraud protection and credit monitoring memberships or by billing the full price of the memberships regardless of whether the member was utilizing all of the membership benefits.
- an online loan servicer engaged in unfair, deceptive and abusive practices by collecting on debts that were allegedly void under state law without informing the consumers that the debts might be void.
- a payday lender engaged in unfair and deceptive practices by "robo-signing" inaccurate affidavits and pleadings in debt collection lawsuits.

Institutions also can infer the bureau's views on what constitutes evidence of a potential UDAAP violation from various informal CFPB guidance documents addressing issues such as debt collection practices, credit card marketing and student lending. Taken together, the CFPB's enforcement actions and guidance documents highlight the types of practices that are likely to be subject to scrutiny, as well as steps that institutions can take to identify and mitigate UDAAP risks.

The CFPB likely will continue to rely upon its UDAAP authority as its primary enforcement tool in 2015. In particular, the CFPB may pursue a number of cases alleging abusive acts or practices, and these actions could clarify two elements of the abusive standard: (1) whether a practice "materially interferes" with a consumer's ability to understand a product or service, and (2) whether the practice takes "unreasonable advantage" of consumers. In addition, the CFPB is expected to promulgate rules in 2015 addressing a number of products, such as bank account overdraft coverage and prepaid cards. Practitioners will look to these rules not only to understand the bureau's approach for specific products, but also to draw broader conclusions about how the bureau is likely to utilize UDAAP as it continues to enforce the nation's consumer financial services laws.

For more on this topic see skadden.com/insights

Supreme Court May Nix Disparate Impact in Fair Lending Enforcement

In recent years, the Consumer Financial Protection Bureau and Department of Justice have increased fair lending enforcement under the disparate impact theory of liability. This term, however, the U.S. Supreme Court is set to rule in a case that could curtail or eliminate the use of disparate impact in the fair lending context.

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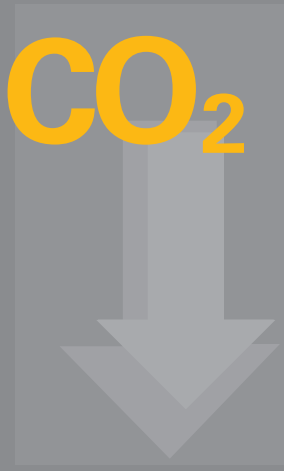
Regulatory Developments

Whether facing an environment of tightened enforcement activity or assessing the regulatory implications of transactions and other business opportunities, companies must continue to weigh the impact of changes in the regulatory environment. With promises from a Republican-led Congress to rein in agencies and litigation challenging enforcement efforts, companies will need to vigilantly monitor updates of relevance to their areas of business.



The EPA's "Clean Power Plan" is a controversial proposed regulation impacting existing fossil fuel-fired electric generating units

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The Supreme Court's *McCutcheon* decision could mean aggregate political contribution limits are on the way out

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CFIUS statistics for 2012 — the most recent year available — for the first time listed China as the top originator of transactions reviewed

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A REIT must invest at least 75 percent of its assets in real estate and cash, derive at least 75 percent of its gross income from rents from real property or mortgage interest, and pay out at least 90 percent of its taxable income to shareholders

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Ambitious EPA Plan Would Require States to Reduce CO_2 Emissions at Existing Power Plants

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In 2015, the U.S. Environmental Protection Agency (EPA) intends to issue in final form three proposed regulations for limiting carbon dioxide (CO_2) emissions pursuant to Section 111 of the Clean Air Act. The proposed regulations would impact new, modified and reconstructed, and existing fossil fuel-fired electric generating units.

While all of these proposed rules have drawn considerable attention,[1] the proposed regulation relating to existing sources, also referred to as the "Clean Power Plan," is the most controversial.[2] Because there currently are no cost-effective pollution controls that can be installed at existing power plants to reduce CO_2 emissions, a proposed emission guideline limited to what could be achieved on a source-by-source basis would result in minimal real-world emission reductions. EPA therefore has developed a much more ambitious and complex plan to require states to reduce CO_2 emissions based on what can be achieved by each state's electric generating sector.

For both new and existing sources subject to regulation under Section 111, EPA is required to issue regulations to achieve a "standard of performance," which means "the degree of emission limitation achievable through the application of the best system of emission reduction which (taking into account the cost of achieving such reduction and any nonair quality health and environmental impact and energy requirements) the Administrator determines has been adequately demonstrated" (BSER). 42 U.S.C. §7411(a)(1). With respect to existing sources, EPA's challenge is developing guidelines that would actually result in significant reductions. For coal-fired electric generating units, EPA considered and rejected (1) retrofitting such units for carbon capture and sequestration (CCS)[3] and (2) substitution of natural gas for some or all of the coal-fired generation (although EPA did solicit comments on whether natural gas cofiring or conversion should be considered part of the BSER). The only part of EPA's final proposal that directly relates to specific affected sources is the reduction of the carbon intensity of generation through heat-rate improvements at individual affected coal-fired steam generating units. Energy efficiency improvements at existing power plants would result in only modest CO_2 reductions; as EPA has noted, without other incentives to reduce generation and CO_2 emissions from coal-fired power plants, energy efficiency improvements would cause such units to become more competitive compared to other electric generating units, further limiting the benefit of such regulation.

EPA's final proposal to reduce CO_2 emissions from existing electric generating units is based on the idea that the U.S. electricity system "is a highly interconnected, integrated system" with large numbers of electric generating units operating "diverse fuels and generating technologies … in a coordinated manner to produce fungible electricity services for customers." EPA concluded that it could propose a standard of performance for existing electric generating units based on what could be achieved by this broader system, not just at specific units, so long as the term "system" in the definition of "standard of performance" could be interpreted in this manner. EPA's position is that "system" is not defined in the Clean Air Act and that the dictionary definition of "system" refers to an "interconnected set of things working together." As a result, EPA asserts that it can include all of the "interconnected" elements as part of the "system," so long as these elements result in a system that is the "best" at reducing emissions and is adequately demonstrated, taking into account costs and other nonair quality impacts. EPA further argues that it is entitled to deference with respect to its

interpretation of "standard of performance" pursuant to *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).[4]

Relying on this broad construction of the term "system," EPA identified the following "building blocks" as BSER with respect to existing electric generating units:

- Heat rate improvements at affected sources. EPA based its proposal on improving the average heat rate of coal-fired steam electric generating units by 6 percent;
- Displacing coal-fired steam and oil/gas-fired steam generation in each state by increasing generation from existing natural gas-fired combined-cycle combustion turbines toward a 70 percent utilization rate;
- Including the projected amounts of generation achievable by completing all nuclear units under construction, avoiding retirement of about 6 percent of existing nuclear capacity and increasing renewable electric generating capacity over time through the use of state-level renewable generation targets consistent with renewable generation portfolio standards that have been established by states in the same region; and
- Increasing state demand-side energy efficiency efforts to reach 1.5 percent annual efficiency savings in the 2020-29 period.

Based on these elements, EPA proposed state rate-based CO_2 emission performance goals (in terms of lbs. CO_2/net MWh) as an average for each state. EPA proposed "interim" goals for the states to meet beginning in 2020, based on what it believed the states would be able to achieve in that timeframe, and final performance goals by 2030.[5] The proposed emission performance goals for each state are not identical, as EPA took into account the generation mix in each state, the performance of affected electric generating units and the opportunities for achieving emission reductions in each state using the various building blocks. EPA claims that the Clean Power Plan will result in a 30 percent reduction in CO_2 emissions from the electric power sector compared to 2005 emissions.

States have flexibility to develop plans to achieve compliance with the proposed emission performance goals. In particular, the proposal allows states to develop intra- or interstate market-based trading programs, such as the Regional Greenhouse Gas Initiative that has been in effect since 2009 in nine Northeastern states or the emissions trading program adopted by California pursuant to the Global Warming Solutions Act of 2006. (See "California Climate Change Initiatives Create Framework for Others.")

On January 7, 2015, Acting Assistant Administrator Janet McCabe announced that EPA plans to finalize the Clean Power Plan for existing power plants and the performance standards for new, modified and reconstructed power plants by midsummer 2015. States would have until June 30, 2016, to submit their own plans for approval by EPA, unless the delay in issuing the final rule causes EPA to extend the deadline for submission of state implementation plans. The proposed rule allows for more time if states indicate their interest in developing regional approaches to achieve compliance with the guidelines. If states do not submit satisfactory plans, EPA would then issue federal implementation plans that would apply directly in any such states. In the January 7, 2015, announcement, McCabe stated that EPA is developing a model rule for existing power plants that could serve as the basis for federal implementation plans if necessary.

Considerable uncertainties associated with EPA's approach to regulating CO_2 emissions from power plants remain. There will be serious legal challenges to these proposed rules, including whether: (1) EPA's proposed standard for new coal-fired electric generating units, which is based on the partial implementation of carbon capture and sequestration technology, has been adequately demonstrated; (2) Section 111(d) of the Clean Air Act bars EPA from regulating electric generating units at all because hazardous air pollutions from such units are regulated under Section 112 of the Clean Air Act; and (3) EPA has authority to require states to achieve CO_2 reductions from their electric generating sectors as a whole, rather than limiting this requirement to what can be achieved by

individual electric generating units. There will be legislative efforts to block this rulemaking. Finally, assuming that EPA finalizes these regulations in a form substantially similar to what has been proposed, an extremely complicated process will be initiated on a state, regional and federal level to develop the specifics of regulatory programs that will have profound impacts on how electricity is generated in the United States.

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[1] For a more complete discussion of these issues, including background on the judicial and regulatory developments that form the context for the rulemaking discussed herein, the proposals regarding new, modified and reconstructed, and existing fossil fuel-fired electric generating units, and the most significant legal issues that will be raised with respect to EPA's efforts to regulate CO2 emissions from new and existing power plants, see the Skadden memorandum "EPA's Proposals to Regulate CO2 Emissions From Power Plants: Reasonable (Perhaps) by Legislation, but Challenging via Clean Air Act."

[2] The proposed rule with respect to existing electric generating units was published on June 18, 2014. Carbon Pollution Emission Guidelines for Existing Stationary Sources: Electrical Generating Unites, 79 Fed. Reg. 34,830 (June 18, 2014) (to be codified at 40 C.F.R. pt. 60).

[3] By contrast, EPA's proposed performance standard for new coal-fired electric generating units is based on partial implementation of CCS.

[4] *Id.* at 34,879-89.

[5] EPA issued a "Notice of Data Availability" on October 30, 2014, seeking comments on the interim 2020-29 goals. 79 Fed. Reg. 64,543. Stakeholders have expressed concerns that the interim goals would limit state flexibility in developing plans based on all of the building blocks set out by EPA. There have been trade press reports that EPA is considering pushing back the initial interim compliance date to 2025.

For more on this topic see skadden.com/insights

California Climate Change Initiatives Create Framework for Others

With climate change mandates stalled at the federal level and ongoing international political struggles complicating global climate change efforts, several U.S. states and Canadian provinces have been at the forefront of efforts to mitigate climate change. Not surprisingly, California has been a leader in these efforts, most notably with its passage of the California Global Warming Solutions Act of 2006, known colloquially as "AB 32."

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Emerging Issues in the Federal Regulation of Electricity Markets

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In 2015, the Federal Energy Regulatory Commission (FERC) will address many of the most serious challenges the electric industry faces in multiple proceedings that will be closely followed by industry participants. Those challenges include the retirement of substantial portions of the nation's generation fleet and the changing composition of that fleet due to the increased use of natural gas and renewable resources.

Fuel Assurance. In late 2014, FERC required all regional market operators to determine whether the generators in their regions have sufficient fuel supplies to handle severe weather events such as the "polar vortex" of 2014. PJM Interconnection, LLC, the largest organized market in the nation, has submitted a proposal to overhaul its generating capacity product to enhance fuel assurance. FERC will approve, modify or reject this "capacity performance" proposal in early 2015.

EPA Regulation. The Environmental Protection Agency (EPA) has adopted or proposed several rules with significant impacts on the electric power sector, including adopting the Mercury Air and Toxics Standard (which regulates plant emissions of certain hazardous air pollutants) and proposing the Clean Power Plan (which regulates greenhouse gas emissions. (See "Ambitious EPA Plan Would Require States to Reduce CO_2 Emissions at Existing Power Plants.") Although FERC's role in connection with EPA initiatives is limited, several Midwest utilities already have asked FERC for exemptions from capacity market rules, due to EPA compliance obligations. More requests may follow in 2015. Hearings before the energy committees in both the U.S. House of Representatives and Senate on FERC's role in addressing the impact of the EPA regulations also are probable, with many Republicans likely urging for greater FERC involvement determining reliability impacts. For example, one major issue will be whether transmission system reinforcements necessary to address coal plant retirements can be constructed quickly enough to maintain reliability.

Reliability Standards. The North American Electric Reliability Corp. (NERC), which is responsible for grid reliability and is subject to FERC oversight, will implement multiple new standards on key reliability issues in 2015, including physical and cybersecurity standards to protect against terrorism. Given increasing concerns over cyberattacks on U.S. businesses and infrastructure, the industry's success in implementing these standards will have a significant impact on whether Congress is asked to adopt legislation to enhance FERC's powers in this area.

Gas-Electric Coordination. Electric and natural gas markets do not use the same daily scheduling protocols, which means electric generators often have to make gas supply decisions before they know whether they will be obligated to produce electricity the next day. FERC has proposed changes that will reduce these inefficiencies and will continue to press both the electric and natural gas industries on this issue in 2015.

Efficient Price Formation. FERC will take multiple actions in 2015 designed to increase the efficiency of bid-based ("organized") markets that are administered by a neutral grid operator. FERC has issued a series of white papers on flaws in these markets that can result in inefficient price formation during times of scarcity. In November 2014, FERC required grid operators to address fuel assurance, and FERC is likely to take action to address this issue in 2015.

Demand Response. A steadily growing portion of the capacity resources in organized electric markets in recent years has been supplied by retail customers willing to reduce their consumption during times of shortage. However, the D.C. Circuit in 2014 struck down FERC's landmark rule regulating demand response payments in the energy markets, holding that only the states, not FERC, have authority to regulate these payments. In mid-January 2015, the U.S. solicitor general asked the Supreme Court to review and reverse that ruling. Several complaints also have been filed pressing FERC to remove demand response from the capacity market auctions scheduled in early 2015. FERC action on these complaints, as well as the Supreme Court's decision on whether to review the D.C. Circuit ruling, are expected in March-April 2015.

Transmission Infrastructure. FERC has long supported policies that facilitate the construction of new transmission infrastructure but is now grappling with several tensions in this area. One such tension involves FERC's policy, enunciated in Order 1000, to open bidding on new transmission projects to any qualified entity, which state governments contend intrudes on their traditional siting jurisdiction. The first competitive solicitations are being held in many regions, and it appears likely that FERC will be asked to resolve disputes over results in some cases. Another continuing tension involves the effort to provide financial incentives that are high enough to attract investment in transmission but not so high that they become unfair to consumers by allowing excess returns. FERC revamped its return-on-equity policy in 2014 by modifying its formula for computing those returns and now faces a slate of litigation across the country over how to implement the new policy.

Transmission Cost Allocation. FERC also will address a remand from the 7th Circuit that, for a second time, found that FERC had not supported its decision to allocate transmission costs broadly across the multistate PJM footprint, rather than only to customers benefiting from the transmission. How FERC handles this remand will affect other regions as well, particularly those with substantial opposition to spreading the costs of transmission across all customers.

Enforcement. FERC continues to aggressively implement its enforcement authority. However, its processes for enforcing its regulations and the substantive standards for doing so are the subjects of substantial debate in the industry, academia and Congress. Two pending federal district court actions are expected to decide key challenges to FERC's enforcement policies, including its market manipulation standard and the scope of district court review of penalty assessments. It is also possible that congressional oversight hearings will be held on whether FERC should reform some of its processes for prosecuting enforcement investigations.

Dudenhoeffer: An Effective Tool to 'Weed Out Meritless' Employer Stock-Drop Claims?

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In *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. __, 134 S. Ct. 2459 (2014), a unanimous U.S. Supreme Court held that fiduciaries of an employee stock ownership plan (ESOP) are not entitled to a special presumption that their decisions to hold or buy employer stock satisfy the duty of prudence imposed on fiduciaries under the Employee Retirement Income Security Act of 1974 (ERISA). Previously, several courts of appeals had recognized that such decisions were entitled to a presumption of prudence and applied this presumption at the pleading stage. This frequently resulted in the dismissal of claims by plan participants — commonly referred to as stock-drop claims — alleging that ESOP fiduciaries had acted imprudently by retaining investments in employer stock despite a precipitous decline in the stock's value. While rejecting the presumption of prudence, the Court articulated pleading standards that, according to many commentators, could be an equally effective barrier to stock-drop claims. However, a recent decision by the Court of Appeals for the Ninth Circuit applying these standards suggests that this assessment may have been premature.

The plaintiffs in *Dudenhoeffer* were former employees of Fifth Third Bancorp who participated in a profit-sharing plan sponsored by Fifth Third. Under the plan, participants were allowed to invest their contributions in different funds, including an ESOP that invested exclusively in Fifth Third common stock. Although matching contributions made by Fifth Third were automatically invested in the ESOP, participants also had the right to move these contributions to the other funds. The price of Fifth Third common stock declined 74 percent between July 2007 and September 2009, when the plaintiffs filed suit against Fifth Third, its CEO, and members of Fifth Third's Pension, Profit Sharing and Medical Plan Committee. The plaintiffs alleged that by July 2007, the defendants knew or should have known, based on inside information as well as public reporting on the subprime mortgage industry, that Fifth Third common stock was overvalued. They also alleged that the defendants breached their fiduciary duty of prudence by failing to sell the stock held by the ESOP and failing to prevent further investments in the stock.

The District Court for the Southern District of Ohio granted the defendants' motion to dismiss the prudence claim. The district court determined that, because the stock fund was an ESOP, the plan fiduciaries were entitled to a presumption that their decision to allow the ESOP to remain invested in the Fifth Third common stock was prudent. The district court further determined that this presumption applied at the pleading stage, and that the facts alleged in the plaintiffs' complaint — which indicated that, despite incurring substantial losses with respect to its portfolio of subprime mortgage loans, Fifth Third remained a viable business — were insufficient to overcome the presumption. The Court of Appeals for the Sixth Circuit reversed, holding that the presumption of prudence did not apply at the pleading stage, the plaintiffs had met their burden by alleging facts sufficient to establish that a fiduciary breach had occurred, and there was a causal connection between the breach and the losses suffered by the plan.

On appeal, the Supreme Court held that ERISA did not create a special presumption of prudence for ESOP fiduciaries but rather, "the same standard of prudence applies to all ERISA fiduciaries, including ESOP fiduciaries, except that an ESOP fiduciary is under no duty to diversify the ESOP's holdings." Although

some circuit courts had justified the presumption as a way of balancing an ESOP fiduciary's duty to act prudently with its duty to act in accordance with the terms of a plan's governing documents, the Court observed that, under the statute, the latter duty applied only insofar as the plan documents were consistent with ERISA. Accordingly, the Court noted, "the duty of prudence trumps the instructions of a plan document, such as an instruction to invest exclusively in employer stock … ."

While the Court held that ESOP fiduciaries are not entitled to a presumption of prudence with respect to investments in employer stock, it did recognize the need for meaningful protections "to weed out meritless lawsuits." To address that need, the Court established the following standards to be applied by courts when considering motions to dismiss stock-drop claims:

First, where the employer stock is publicly traded, allegations that an ESOP fiduciary should have recognized from publicly available information alone that stock was overvalued "are implausible as a general rule, at least in the absence of special circumstances." In the Court's view, ESOP fiduciaries could not reasonably be expected to outperform the market based solely on their analysis of publicly available information, and thus it would be prudent for such fiduciaries to rely on the market price of publicly traded employer stock.

Second, to state a claim based on an ESOP fiduciary's failure to act on nonpublic information, plaintiffs must plausibly allege both that the ESOP fiduciary should have taken an alternative action that would not violate securities laws and that such alternative action would not do more harm than good to the ESOP.

Third, when evaluating claims predicated on nonpublic information, courts should apply the following additional principles:

- Allegations that an ESOP fiduciary acted imprudently by failing to sell employer stock based on nonpublic information do not state a claim, because such selling would violate insider trading laws; and
- In evaluating claims that an ESOP fiduciary possessing nonpublic information acted imprudently by failing to refrain from making additional investments in employer stock or failing to publicly disclose that information, courts should consider the extent to which imposing an ERISA-based duty to take such actions would conflict with insider trading and corporate disclosure requirements under federal securities laws (or the objectives of those laws) and whether the plaintiffs have plausibly alleged that a prudent fiduciary in the defendant's position could not have concluded that such actions would do more harm than good by driving down the value of the stock already held by the ESOP.

As noted by many Court observers, these standards, if applied strictly, would establish a formidable barrier to stock-drop claims. Nevertheless, variations in how rigorously such standards are applied by the lower courts are inevitable. For example, in *Harris v. Amgen*, Inc., 770 F.3d 865 (9th Cir. 2014), a case that was remanded to the Court of Appeals for the Ninth Circuit for reconsideration in light of the *Dudenhoeffer* decision, the circuit court reaffirmed an earlier ruling that the plaintiffs had sufficiently alleged that the defendants acted imprudently. The plaintiffs argued that [the] defendants should not have continued to allow participants in plans sponsored by Amgen, Inc. to invest in Amgen stock knowing that the company had engaged in illegal marketing and sales of off-label drugs.

While disagreeing with the defendants' claim on remand that *Dudenhoeffer* had established higher pleading standards for stock-drop claims, the circuit court concluded that even if this were the case, its prior ruling was consistent with those standards. But the circuit court's analysis in *Amgen* bears little resemblance to the close scrutiny of prudence claims envisioned by the Supreme Court in *Dudenhoeffer*. For example, the circuit court readily concluded that the plaintiffs had alleged plausible alternative actions the defendants could have taken that would not violate federal securities laws but did not separately consider whether imposing

a duty under ERISA to take such actions would further the objectives of such laws. The circuit court also determined that it was at least plausible that the defendants could have taken these actions without causing undue harm to plan participants. But the pleading standards described in *Dudenhoeffer* clearly require that a court go further and determine whether the plaintiffs have plausibly alleged that a prudent fiduciary in the defendants' position could not have concluded that the alternative actions would do more harm than good.

Although *Dudenhoeffer*'s rejection of a presumption of prudence might be viewed as a setback to ESOP fiduciaries, the Court established a potentially effective tool for ESOP fiduciaries to challenge stock-drop allegations with respect to publicly traded stock. As demonstrated in *Amgen*, however, how rigorously that framework is applied and the extent to which courts conduct the "careful, context-sensitive scrutiny of a complaint's allegations" contemplated by *Dudenhoeffer* remain to be seen and will be closely watched issues in 2015. In the meantime, plan sponsors should re-evaluate the practice of appointing investment committee members who are in possession of nonpublic information, and consider whether they should engage an independent fiduciary to manage employer stock funds.

For more on this topic see skadden.com/insights

Global Workforces Create Compensation Challenges for Employers

In-house legal and human resources professionals at companies of all sizes are expected to navigate the legal and cultural ramifications of employing a global workforce. Compensation programs designed for employees at a company's primary location often must be adapted to comply with local customs while still maintaining the "one culture — one company" mentality. To successfully adapt these programs, legal and HR professionals must have a working familiarity of tax, securities and employment laws around the globe; be able to spot common areas of noncompliance; and know when to seek out the local experts.

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For more on these topics see skadden.com/insights

New Rules Change Requirements for Federal Contractors

A string of Executive Orders signed by President Barack Obama and new rules published by the Department of Labor in 2014 have imposed additional obligations on federal government contractors and subcontractors. New rules set requirements for the hiring of veterans and those with disabilities, mandate disclosure of labor and employment law violations, increase minimum wage, expand protected classes and more. While the full impact of these new requirements remains to be seen, employers who contract with, or are considering contracting with, the federal government must stay current on these rules in order to ensure compliance and assess costs.

Possible Expansion of Joint Employer Status Would Impact Businesses With Contracted Workers

As businesses are increasingly using labor contractors and staffing agencies to supply workers, the National Labor Relations Board and the Equal Employment Opportunity Commission are seeking to expand the definition of a "joint employer," to ensure companies are held responsible for the labor and employment practices applied to such contracted workers. If successful, this effort will have significant implications for businesses that subcontract or outsource any function.

'Ban the Box' Initiatives: Removing Conviction Histories From Employment Applications

The use of criminal records in the hiring process has received a great deal of attention in recent years. The Equal Employment Opportunity Commission issued guidance in 2012 requiring employers to demonstrate that conviction records upon which they rely in making hiring decisions are directly job-related and applicants are individually assessed for each position. In addition, the federal Fair Credit Reporting Act and similar state laws impose a number of procedural requirements on employers that use third parties to conduct background checks on applicants.

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Balancing Protection of Information With Employee Rights in Confidentiality Policies

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The developing law on employer confidentiality policies underscores the tension between an employer's ever-increasing need to protect confidential information and an employee's established right to discuss terms and conditions of employment. With the exponential growth of social media, instant communication and theft of confidential information, employers are erecting stronger firewalls and more restrictive employment policies to protect their and their clients' information. These are worthy goals from a business perspective, but they potentially conflict with the legal right of employees to discuss information relating to their wages, hours and working conditions.

The National Labor Relations Board (NLRB) is scrutinizing employers' workplace rules and policies, including those pertaining to confidentiality. In doing so, the NLRB has turned to its well-established principle that an employer violates the National Labor Relations Act (NLRA) by maintaining a rule that "reasonably tends to chill employees in the exercise of their Section 7 rights" under the NLRA to discuss terms and conditions of employment. In this regard, the NLRB first determines whether the rule at issue explicitly restricts employees' rights; if it does, the rule is unlawful and the analysis ends. If the rule survives the first part of the test, the NLRB goes on to determine whether employees would reasonably construe the rule to restrict employee rights, whether the rule was promulgated in response to union activity, or if the rule was applied to restrict employee rights. The rule is unlawful if any of these factors are satisfied. *See Martin Luther Mem'l Home, Inc.*, 343 N.L.R.B. 646 (Case 7-CA-44877 2004).

Lawful vs. Unlawful

A number of NLRB cases following the reasoning above have found confidentiality policies did not violate the NLRA. For example, the NLRB in *K-Mart*, 330 N.L.R.B. 263 (Case 32-CA-15575 et al. 1999), ruled K-Mart's policy prohibiting discussion of "company business and documents" was lawful because employees would reasonably read the rule as protecting private business information rather than prohibiting discussion of terms and conditions of employment. Similarly, in *Burndy, LLC*, 34-CA-65746 (N.L.R.B. July 31, 2013), the NLRB found a rule prohibiting employees from disclosing "employee information" was not unlawful because it was included in a broader section of a policy restricting disclosure of intellectual property. The NLRB found a reasonable employee would construe such a rule as prohibiting disclosure of classified company information, not terms and conditions of employment.

In contrast, several cases over the last year have shown that confidentiality policies involving explicit prohibitions on discussing terms or conditions of employment or overly broad prohibitions on discussing personnel and company information may be found to be unlawful. For example, in *Flex Frac Logistics, LLC v. N.L.R.B.*, 746 F.3d 205 (5th Cir. 2014), the Fifth Circuit held a confidentiality policy prohibiting employees from disclosing "company financial information" and "personnel information" violated the NLRA because such information implicitly included wages. Further, in *Fresh & Easy Neighborhood Market,* 361 N.L.R.B. No. 8 (31-CA-077074, 31-CA-080734 July 31, 2014), the NLRB held

an employer's confidentiality policy was unlawful where it prohibited disclosure of "customer and employee information" and the provision was not adequately limited by context.

Media Statements and Company Investigations

With respect to media policies, in *DirecTV U.S. DirecTV Holdings, LLC*, 359 N.L.R.B. No. 54 (21-CA-039546 2013), a policy expressly instructing employees not to contact the media was unlawful because such policy could encompass protected communications regarding a labor dispute. To withstand scrutiny, media policies must be tailored to protect the employer's legitimate interest in not having employees hold themselves out as speaking for the company.

Policies forbidding employees from communicating about company investigations also must be carefully drafted and applied. In *Hyundai America Shipping Agency, Inc.* 357 N.L.R.B. No. 80 (28-CA-22892 Aug. 26, 2011), the NLRB held a company's policy broadly barring employees from discussing employee investigations was unlawful because the company failed to engage in individualized reviews of each situation to determine whether there was a substantial justification for prohibiting employees' discussion of investigatory matters, such as the protection of witnesses or evidence. And in *Banner Health System*, 358 N.L.R.B. No. 93 (28-CA-023438 2012), the NLRB held it was unlawful for a company to routinely ask employees making a complaint not to discuss the matter with their coworkers. Both cases demonstrate the employer's need to analyze each situation; proper consideration of factors such as safety, harassment or spoliation of evidence could and should result in a reasonable restriction on communications about the investigation.

'Savings Clauses'

Employers should be aware that a "savings clause" may not cure a defective policy. According to an administrative law judge (ALJ) decision in *American Red Cross Blood Services*, No. 08-CA-090132 (N.L.R.B. June 4, 2013), a clause providing an agreement "does not deny any rights provided under the [NLRA] to engage in concerted activity, including but not limited to collective bargaining" will not make an overly broad confidentiality policy lawful. The ALJ held such a clause would cancel unlawfully broad language only if employees are savvy enough to know the NLRA permits employees to discuss terms and conditions of employment. On the other hand, *Tiffany Co.,* (01-CA-111287 N.L.R.B. Aug. 5, 2014), upheld a savings clause that appeared immediately following an unlawful prohibition on disclosure of compensation information and explicitly provided the policy "does not apply to employees who speak, write or communicate with fellow employees or others about their wages, benefits or other terms of employment."

* * *

As demonstrated by these cases, the application of the law in the area of confidentiality policies is unsettled, and employees and employers face uncertainty as a result. Perhaps some of the uncertainty will be eliminated through the promulgation of model confidentiality policies, as NLRB General Counsel Richard F. Griffin Jr. contemplated in a memorandum analyzing the legality of various policies in employee handbooks. See "NLRB Sets Sights on Work Rules Banning Wage Discussions," *Law360* (June 6, 2014). In addition, due to procedural issues relating to President Obama's recess appointments to the NLRB in January 2012, there is a chance certain of these decisions may be changed in the near term. It remains important, however, for employers to take a reasoned approach to confidentiality and protect important business information without overreaching.

Implications of National Security Reviews on Foreign Acquisitions of US Businesses

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The Committee on Foreign Investment in the United States (CFIUS) can have a significant impact on transactions involving foreign acquirers. Parties considering cross-border merger and acquisition transactions should be aware of the following recent developments in this area and consider their potential implications.

Impact of the *Ralls* Decision

In September 2012, on the recommendation of CFIUS, President Obama ordered Ralls Corporation, a Chinese-controlled U.S. company, to divest itself of all interests in four Oregon wind farms that it had acquired in March 2012. *Ralls* challenged this decision in court, and in July 2014, a panel of the U.S. Court of Appeals for the District of Columbia Circuit ruled that *Ralls* had not been afforded due process before it was deprived of its property interests. The court decided that Ralls was entitled to review and rebut unclassified information used during the CFIUS process, noting that the president's decision relied on the record developed during that process.

In November 2014, the government provided Ralls with unclassified evidence and factual findings developed during CFIUS' review of the transaction. This unprecedented step may have no effect on the ultimate resolution of the *Ralls* matter, but the appellate court decision and subsequent CFIUS action could affect future transactions and CFIUS reviews in a number of ways:

- Because the court ruled that only the president has the authority to block transactions, CFIUS may decline to seek mitigation terms that have the substantive effect of a block, resulting in either more complex mitigation structures or more referrals of cases for presidential action.
- CFIUS may be more willing to disclose the unclassified information on which it relies in reaching its decisions, giving parties an opportunity to review and possibly rebut that evidence. The production and review of such information, however, may prolong many CFIUS cases.
- CFIUS may collect more information during the review process to bolster the factual record. These supplemental requests also could prolong the CFIUS process.
- The due process rights within CFIUS of parties to transactions are dependent on the existence of property rights. Parties seeking to establish property and due process rights may consider closing transactions before filing with CFIUS. Doing so, however, entails substantive risks; the *Ralls* case and many others have demonstrated that CFIUS' concerns are heightened when parties complete transactions before filing with CFIUS.

China's Role at CFIUS

CFIUS statistics for 2012 for the first time listed China as the top originator of transactions reviewed by CFIUS. China overtook the United Kingdom, which had been the leading source of CFIUS filings for many years. CFIUS has not yet released statistics for 2013 or 2014, but we believe, based on announced M&A activity and increased Chinese awareness and understanding of the CFIUS process, that China remains the leading source of CFIUS-reviewed transactions. We expect this trend to continue in 2015 as China's economic growth slows, leading Chinese investors to seek to diversify their holdings in other countries.

Additionally, more high-profile Chinese acquisitions of U.S. businesses are being approved by CFIUS, giving investors from China greater confidence that prospective U.S. investments will be successful. CFIUS approved several

high-profile Chinese acquisitions during 2014, including China Huaxin's acquisition of the enterprise business of Alcatel Lucent and Lenovo's acquisitions of IBM's server business and Google's Motorola Mobility business. Notably, all three of these transactions involved information and communications technology, a sector in which Chinese acquirers have had previous difficulties obtaining CFIUS approval.

Sanctions Programs

In most cases, CFIUS is concerned that a prospective foreign acquirer has had dealings with a sanctioned country or entity, and that products, technology or funds from an acquired U.S. business might be transferred to the sanctioned country as a result of the acquisition. If the acquirer does not have an effective sanctions compliance program in place, CFIUS may require tighter mitigation terms or seek to prevent the transaction from being completed. It's prudent for prospective acquirers to establish and implement such a plan.

In addition, because the filing requirements listed in the CFIUS regulations do not account for ties between acquirers and sanctioned countries, CFIUS increasingly requests supplemental information from acquirers. This includes details on their dealings, if any, with sanctioned countries and entities, and the trend highlights the need for robust sanctions compliance plans, which can assist in documenting an acquirer's dealings with countries subject to U.S. sanctions, Specially Designated Nationals and Blocked Persons, or other sanctioned entities. (See "Sectoral Sanctions Add New Layer of Complexity to OFAC Sanctions.")

Transaction Structure Elements Prospective Acquirers Must Consider

CFIUS has increasingly been presented with foreign acquisitions of businesses with technology and operations relating to U.S. national security and critical infrastructure, including acquisitions originating in China and other traditionally "sensitive" countries. These transactions often present a high risk of CFIUS mitigation, and structuring around such risk has become increasingly critical. Prospective buyers and sellers of sensitive businesses should be aware of the many options available to allocate risk, including standard mitigation covenants or more esoteric options, like reverse termination fees.

Fees paid by acquirers for failure to complete a transaction and/or conditioned on failure to obtain corporate approvals or necessary financing have been part of the deal environment for many years. Recently, failure to obtain U.S. or foreign regulatory approvals — particularly those relating to antitrust laws, but occasionally CFIUS as well — also has been the trigger for payment of breakup fees by acquirers. In September 2014, for example, Germany's Siemens agreed to pay US$400 million — just over 5 percent of the target's enterprise value — if CFIUS failed to approve the acquisition of oil and gas equipment producer Dresser-Rand. Acquirers considering proposals from sellers that include such fees should carefully assess the mitigation risks associated with a CFIUS review.

Pre-emptive divestitures also may be appropriate in select cases where a U.S. target has defense contracts or other contracts relating to national security, develops or uses sensitive technologies, or has access to sensitive government facilities. A preemptive divestiture of operations connected with national security can be undertaken in an orderly, value-preserving manner, reducing concerns associated with conditions imposed in CFIUS mitigation. This approach first received public attention in late 2012 when A123 Systems, a bankrupt U.S. battery maker, sold its government and defense businesses to a U.S. company before selling the remaining automotive and commercial battery businesses at auction. When China's Wanxiang Group won the auction for those less sensitive businesses, the companies were able to gain CFIUS approval in early 2013.

These emerging issues are among the many that could have implications for cross-border investment transactions. To enable careful advance planning, it is critical that parties pursuing such transactions during 2015 be prepared to engage in the CFIUS process.

For more on this topic see skadden.com/insights

Communications: Significant Actions on the Horizon

The Federal Communications Commission (FCC) addressed a number of longstanding issues in 2014. Much of the FCC's time and effort, however, was dedicated to laying the groundwork for several significant regulatory actions it intends to undertake in the next year. These actions, including the broadcast television incentive auction and the issuance of net neutrality regulations, dominated the commission's debates in 2014 and led to significant disagreements between its Democratic and Republican commissioners.

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Changes Likely in Campaign Finance, Pay-to-Play

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In recent months, aggregate political contribution limits have been the subject of dramatic change due to the *McCutcheon* decision as well as significant legislative modifications in the federal budget bill. Meanwhile, pay-to-play restrictions continue to expand at the federal level, with proposed rules covering municipal advisors as well as third-party and affiliated placement agents. Additionally, at least a half-dozen significant cases are pending that have the potential to further impact campaign finance and pay-to-play rules. Corporations should continue to monitor these changes and refine their compliance programs accordingly.

Aggregate Limits on the Way Out?

The U.S. Supreme Court's April 2014 decision in *McCutcheon v. Federal Election Commission*, 134 S.Ct. 41 (2013), struck down the aggregate limits imposed on individual political contributions under federal law. Many state and local jurisdictions also impose aggregate limits on individual, political action committee (PAC) and/or corporate contributions. In the aftermath of the *McCutcheon* decision, several states and localities have taken steps to eliminate aggregate limits.

Two legal challenges to state aggregate limits already are moving forward in court. In Minnesota, a judge temporarily blocked enforcement of the state's unique system of aggregate limits; and in Wisconsin, after a federal district court judge permanently enjoined the state from enforcing its aggregate contribution limit imposed on individuals, the state's Government Accountability Board released a statement explaining that, pursuant to the court's order, it will no longer enforce the aggregate annual limit. Maryland voluntarily decided to not implement its aggregate limits while these cases play out. The attorney general for the District of Columbia asked the city council to repeal the district's aggregate contribution limit. Connecticut, Kentucky, Los Angeles, Maine and New York state announced they will no longer enforce their aggregate limits on individual contributors. Massachusetts passed a bill that repealed the state's aggregate contribution limit for individuals on August 1, 2014. The state's annual aggregate limit on political party contributions remains in effect. These developments are only a portion of the activity that has taken place at the state and local levels since *McCutcheon*, and further developments are expected in 2015.

Higher Limits on National Party Committee Contributions

On December 16, 2014, President Obama signed into law — as part of the $1.1 trillion budget package — amendments to the Federal Election Campaign Act, increasing the amount an individual or PAC may contribute to a national party committee (*e.g.*, Republican National Committee, Democratic National Committee, National Republican Senatorial Committee, Democratic Senatorial Campaign Committee, National Republican Congressional Committee and Democratic Congressional Campaign Committee). In particular, the amendments allow increased contributions to certain designated accounts established by such national parties. In early 2015, the FEC is expected to announce increased contribution limits for individual contributions for the 2015-16 election cycle. As a result, the amount that individuals may contribute to these accounts will further increase. Without the aggregate limits that had been in place prior to *McCutcheon*, individuals are now able to contribute $777,600 per national party committee per year.

Continued Expansion of Pay-to-Play Rules

Interestingly, pay-to-play rules continue to expand at a time when campaign finance limits in general are becoming more generous. Pay-to-play rules, which marked their 20th anniversary in 2014, restrict or prohibit political contributions made by covered employees of companies that have, or attempt to obtain, government contracts. These laws cover activity at the federal, state and local levels. The latest wave of federal pay-to-play rules includes Securities and Exchange Commission Rule 206(4)-5 covering investment advisers, Commodity Futures Trading Commission Rule 23.451 covering swap dealers, and, most recently, proposed amendments to Municipal Securities Rulemaking Board Rule G-37 that would expand coverage from broker-dealers to municipal advisors as well as a proposed Financial Industry Regulatory Authority pay-to-play rule for third-party and affiliated placement agents.

Significant cases are pending with the potential to impact the pay-to-play arena. *Wagner v. FEC*, for example, could throw out a statute prohibiting federal contractors from making contributions to individual candidates and parties. A case on appeal, the *New York Republican State Committee v. SEC*, challenges aspects of SEC Rule 206(4)-5 that imposes pay-to-play restrictions on investment advisers.

Continued Refinement of Compliance Programs a Must for Corporations

Because of the ever-increasing risk of enforcement actions, broadening shareholder scrutiny, and negative publicity that may cause adverse economic and reputational consequences, corporations in virtually every industry continue to develop and refine compliance programs to address laws regulating government affairs and government procurement activities. Common elements among these programs include implementing tailored policies, preclearing certain activities, providing protocols to ensure registration and ongoing reporting requirements are met, training programs for certain officers and employees, and procedures for keeping abreast of the latest developments in this area of law.

National Party Contribution Limits

(Per year unless otherwise noted)

	Individual	Multicandidate PAC
Candidates (per election)	$2,600	$5,000
National Party Committee (*e.g.*, RNC, DNC)	$32,400	$15,000
Senatorial National Party Committee (*e.g.*, NRSC, DSCC)	$32,400	$15,000
Congressional National Party Committee (*e.g.*, NRCC, DCCC)	$32,400	$15,000
National Party Committee for conventions	$97,200	$45,000
National Party Committee for buildings	$97,200	$45,000
National Party Committee for recounts and legal fees	$97,200	$45,000
Senatorial National Party Committee for buildings	$97,200	$45,000
Senatorial National Party Committee for recounts and legal fees	$97,200	$45,000
Congressional National Party Committee for buildings	$97,200	$45,000
Congressional National Party Committee for recounts and legal fees	$97,200	$45,000
Aggregate contribution limit for all of the national party committees of a given party (Democratic or Republican)	$777,600	$360,000
State or Local Party Committee federal account	$10,000	$5,000
PAC (*e.g.*, a corporate or leadership PAC)	$5,000	$5,000

Corporate contributions are prohibited to all committees except Independent Expenditure Committees (Super PACs). Contribution limits are adjusted for inflation. The next adjustment will be made in early 2015 for the next cycle.

Challenging the IRS Anti-Inversion Notice: A Hollow Threat

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On September 22, 2014, Treasury and the IRS issued Notice 2014-52, 2014-42 I.R.B. 712 (the Notice), announcing their intention to issue regulations aimed at blunting certain of the benefits from so-called inversion transactions. The Notice adopts a two-pronged approach: It expands the scope of transactions that are subject to the existing anti-inversion regime by announcing new rules under Sections 7874 and 367 of the Internal Revenue Code, and it limits certain U.S. tax benefits that can be achieved by companies that undertake inversion transactions on or after September 22, 2014. The latter changes fundamentally alter several generally applicable Internal Revenue Code provisions in a manner that adversely impacts a narrow class of taxpayers. Moreover, unlike some other recent Treasury and IRS notices, the Notice lacks a "binding commitment exception" for transactions that were the subject of binding contractual commitments, but had not yet closed, before September 22, 2014. Parties to these transactions and other taxpayers affected by the Notice have raised serious concerns about the legal authority for the rules contained in the Notice, but those considering a timely challenge to the Notice face a number of procedural hurdles.

The normal procedures for challenging IRS rules and regulations are of little practical use to taxpayers seeking to challenge the Notice now. Taxpayers generally cannot challenge an IRS rule or regulation until the IRS disputes the taxpayer's position taken on a filed tax return or denies a taxpayer's request for a refund of taxes paid. Specifically, the Anti-Injunction Act (AIA), 26 U.S.C. § 7421(a), prohibits a "suit for the purpose of restraining the assessment or collection of any tax [from being] maintained in any court by any person." Further, the Declaratory Judgment Act (DJA), 28 U.S.C. § 2201(a), prohibits any suit for declaratory judgment "with respect to Federal taxes" other than certain circumscribed topics not relevant to the Notice. Accordingly, a taxpayer generally must pay its taxes and file a claim for refund before commencing any suit against the IRS, or, alternatively, wait for the IRS to examine its return and assert a deficiency, after which the taxpayer may bring suit in the Tax Court. Either way, a taxpayer generally has to wait (usually for years) until an IRS rule or regulation is enforced against it before bringing its challenge in court.

A taxpayer could file a separate action claiming that Notice 2014-52 violates the procedural or substantive requirements of the Administrative Procedure Act (APA), 5 U.S.C. § 551 et seq. But the government likely would challenge the suit on two grounds: (1) Section 704 of the APA requires that the Notice represent a "final agency action" and that there exists "no other adequate remedy in a court," and (2) Section 702 of the APA precludes an action for review under its provisions if "any other statute … expressly or impliedly forbids the relief sought." Notice 2014-52 describes possible regulations that the IRS and Treasury "intend to issue" and requests comments on these proposals and thus arguably does not represent a "final agency action." The government also would likely contend that taxpayers can obtain an "adequate remedy" by bringing suit (eventually) in Tax Court or federal district court once the rules of Notice 2014-52 have been enforced against the taxpayer.

Taxpayers have cleared these procedural hurdles in certain unusual circumstances. For example, courts have permitted claims for declaratory and other prospective relief to proceed if they pertain to agency action "unrelated to tax assessment and collection." *Cohen v. United States*, 650 F.3d 717, 733 (D.C. Cir. 2011) (*en banc*). Courts also have concluded that similar claims for prospective

relief are not adequately addressed via the refund mechanism, thus opening the door to suit under Section 702 of the APA. *See, e.g.*, *King v. Burwell*, 759 F.3d 358, 367 (4th Cir. 2014), *cert. granted on other issues*, 135 S. Ct. 475 (2014) (No. 14-114); *Halbig v. Burwell*, 758 F.3d 390, 397-98 (D.C. Cir. 2014), *rehearing en banc granted*, No. 14-5018, 2014 WL 4627181 (D.C. Cir. Sept. 4, 2014).[1] Further, the APA's "final agency action" requirement is not a jurisdictional bar but rather a prudential exhaustion requirement that the courts have concluded can yield to other compelling interests. *See Cohen*, 650 F.3d at 732-33 (describing cases). But it is not clear that the unusual circumstances present in those cases are sufficiently analogous to warrant application of this case law to the Notice.

Given the intense political focus on halting inversion transactions by any means, and the government's position that informal administrative pronouncements like the Notice are immune to immediate legal challenge, one might wonder whether Treasury and the IRS strategically targeted inversion transactions in this manner to exploit the historic procedural rules promulgated in response to very different concerns in a different era. At the very least, the procedural limitations on timely challenges to Treasury and IRS action taken via notice suggest a need for greater temperance on the part of Treasury and the IRS when regulating via notice.

[1] The plaintiffs' suits in both *King* and *Halbig*, while effectively challenging the tax credits granted on the federal health care exchange, did not in fact involve claims for tax refunds. Instead, they challenged the imposition of the "penalty" under the Affordable Care Act, which, per the Supreme Court, is not considered a tax for purposes of the AIA and thus is not subject to the AIA's bar on pre-enforcement challenges.

For more on this topic see skadden.com/insights

Congressional Investigations Highlight Risks for Companies Across Industries

For businesses that find themselves involved in a congressional investigation, understanding the rules (or lack thereof) and minimizing reputational harm and the collateral impact of the investigation should be the highest priorities. Employing transparency strategically, maintaining a high level of credibility and working cooperatively with committee staff during the course of a congressional investigation help mitigate the reputational harm caused and better position a company for collateral issues such as derivative investigations or litigation.

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Unlocking Value Through REIT Spin-Offs

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Real estate investment trust (REIT) spin-offs provide a means for companies to unlock the value of their real estate. Due to current economic conditions, more companies in more business sectors are considering separating their real estate from their operating businesses to take advantage of the favorable economic climate that allows REITs to raise capital at a relatively low cost.

Spun-off REITs engage in ongoing lease and contractual relationships with the legacy operating companies. While one tax reform proposal contemplated barring REITs from the tax-free spin-off rules, companies continue to recognize the strategic nontax business advantages of separating their real estate and operations into autonomous enterprises that appeal to different and broader investor bases and lower the cost of their capital.

Strategic Benefits of REIT Spin-Offs

REIT spin-offs fundamentally provide a means for companies to unlock the value of their real estate, which the market often significantly undervalues when it is held within an operating company. The general business rationales for spin-offs hold true in the REIT context. Both the existing company and the newly formed independent REIT can focus on their core businesses after a spin-off. The newly formed REIT, for example, can pursue investments in real estate, infrastructure and networks. The operating company can focus on running its operating business and providing services to customers. Real estate investments often have a different optimal capital structure than more active operating businesses. Thus, a company can spin off its qualifying assets into a REIT and, as a result, shed debt that the REIT, with its steady rental income, can better absorb. Additionally, the REIT becomes a new and distinct opportunity for investors, including those more interested in a "pure play" real estate company, rather than a company comprised of both operations and real estate assets. While some commentators have focused exclusively on the enhanced tax efficiencies inherent in the aforementioned structure, many corporations have strong nontax reasons to pursue the REIT spin-off option, such as appealing to a different and broader investor base and lowering their cost of capital.

Windstream Receives Favorable IRS Private Letter Ruling

Windstream Holdings, a telecommunications corporation, recently announced it intends to spin off its copper and fiber network into a REIT. Many other corporations that previously held significant real estate assets also have chosen tax-free REIT spin-offs. In July 2014, Windstream reported that it had received a favorable private letter ruling in which the Internal Revenue Service confirmed that (1) Windstream's fiber and copper networks are qualifying REIT assets under the Internal Revenue Code, and (2) the spin-off of those assets in a newly formed REIT (independent of Windstream) would qualify as tax-free. The REIT could then lease the fiber and copper networks back to Windstream, the income from which would largely pass through to the REIT's investors without corporate-level tax.

The Complexity of the REIT Regime

Companies also must weigh the complexity of the REIT rules, which require sophisticated planning, against the anticipated benefits. A REIT must invest at least 75 percent of its assets in real estate and cash, derive at least 75 percent of its gross income from rents from real property or mortgage interest, and pay out at least 90 percent of its taxable income to shareholders, among many other requirements. Additionally, both the distributing corporation and the spun-off REIT must have been engaged in the active conduct of a trade or business for five years. In other words, the REIT rules must dovetail with the requirements for spin-offs, including having a valid corporate business purpose for the transaction,

e.g., enabling a corporation in an active business to spin off its real estate assets and focus on its core operating business, while providing a real estate-only opportunity subject to a sophisticated tax regime to investors.

REIT Spin-Offs and Tax Revenue

REITs generally are not subject to corporate-level tax, and thus provide a tax-efficient method of real estate investment. Ignored by some critics, however, are the ways in which the elimination of corporate-level tax is, in part, offset by increases in revenue at the Treasury level. First, because a REIT must distribute at least 90 percent of its taxable income (and most REITs distribute 100 percent), REIT conversions permanently increase individual ordinary tax revenues. This requirement precludes investors from deferring taxation while earnings remain at the corporate level. Furthermore, distributions made out of a REIT's earnings and profits are taxed at the maximum 39.6 percent ordinary income rate, not at the lower maximum 20 percent capital gains rate to which corporate dividends are normally subject for individual/noncorporate shareholders. REIT conversions also increase tax revenues because a converting REIT must distribute all of its accumulated earnings and profits in a taxable dividend. Without a REIT election, such earnings might never be distributed. Finally, and most importantly, REIT spin-offs can create real value for shareholders for the reasons discussed above. That increased value is the ultimate goal of REIT spin-offs and will generate long-term revenue for the Treasury.

Conclusion

In certain cases, a REIT spin-off is an attractive option for corporations with significant real estate assets. It has significant potential to improve a company's financial position, enable management to focus on its company's key operations, and provide real estate-oriented investors with new opportunities.

REIT spin-offs fundamentally provide a means for companies to unlock the value of their real estate, which the market often significantly undervalues when it is held within an operating company.

The Multifaceted General Counsel

Contributing Partner

Lawrence S. Spiegel / New York

From legal adviser to business strategist to compliance officer, an in-house counsel typically finds herself playing multiple roles in her organization. Each role requires knowing the organization's business, understanding its goals, and at all times demonstrating a commitment to its success. Yet these functions risk creating a tension with an in-house counsel's ultimate risk management responsibility. Protecting the organization's interests requires an in-house counsel to be clear about who the client is and what role the in-house counsel is undertaking, all while fostering a culture of compliance.

Identifying the Client

To provide timely, relevant, effective advice, an in-house counsel must have an in-depth understanding of the organization's business, needs, goals and risk tolerance profile. Equally important is clarity about who is the client. Rule 1.13 of the ABA Model Rules of Professional Conduct (Organization as Client) states that the organization is the client of an in-house lawyer; the in-house lawyer does not represent the organization's constituents, *e.g.*, its directors, officers, employees, members, shareholders or others.

As compared to outside counsel, a lawyer working in-house spends every day as a colleague of the organization's business people. This informality of relationships is useful as it furthers information flow, allowing an in-house counsel to stay up-to-date on business as well as legal issues. In such discussions, she must remain mindful of Model Rule 1.13(f), which provides that, when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the individual, the lawyer must explain to the individual that the organization is the lawyer's client. That is, an in-house lawyer must ensure employees understand that she does not represent them individually, and any discussion with her may not be kept confidential or privileged. (Model Rule 13(g) provides that the in-house lawyer may represent an individual jointly with the organization when doing so does not present a current client conflict under Model Rule 1.7.)

The duty of confidentiality runs to the organization, and the organization owns the privilege. Any lack of clarity on this point may create an impermissible conflict of interest and compromise an in-house counsel's ability to continue to represent the organization effectively, including due to the organization potentially forfeiting control of its otherwise privileged information to personnel claiming to be her clients. Consequences may include disqualification from the matter and possible malpractice claims. An in-house counsel also may find herself named as a witness in a matter.

The Potential for Conflicts of Interest and Inadvertent Employee-Clients Necessitates the Use of So-Called *Upjohn* Warnings

Interviews and, where appropriate, other formal or informal conversations with employees about matters in which they may have distinct, personal interests should begin with a discussion of confidentiality and privilege, including reminders that an in-house does not represent the individual personally and that, while the communications are confidential and privileged, she may share anything said by the individual with others in or outside the organization because the privilege belongs to the organization.

Wearing Multiple Hats

Similarly, an in-house counsel must be clear as to whether she is advising on a legal or business matter. In-house counsel may be consulted on a wide variety of issues, including regulatory, compliance, personnel, public relations and

business negotiations. Whether such communications constitute legal or business advice or some combination thereof can implicate privilege and ethics issues. Because an in-house lawyer's role often blurs these distinctions (or can later be claimed as such by an adversary), courts tend to scrutinize claims of privilege by an in-house lawyer more rigorously than those of an outside counsel. To preserve a later argument that the attorney-client privilege applies, an in-house counsel must indicate unambiguously where the advice sought or given is predominantly legal, or risk it being discovered by third parties.

To strengthen a later assertion of privilege, documents seeking or providing legal advice from in-house counsel should identify in-house counsel as such and contain an explicit reference to a request for legal advice. Consider using a header such as "Request for Legal Advice" in addition to "Privileged and Confidential." If nonlegal personnel are communicating among themselves regarding legal advice or to collect information at the request of counsel, they should reference the request for legal advice or the request from counsel, *e.g.*, "for the purpose of seeking legal advice" or "at the request of counsel."

In addition, an in-house counsel should consider that offering business advice may dilute the effectiveness of her legal function. Because business assessments are often subjective and generally open to discussion and judgment among non-lawyers, a lawyer providing business advice or advice that combines legal and business judgments may create the perception that her legal counsel is also founded on subjectivity and ultimately beholden to the bottom line. This risks undermining her authority, which can be particularly problematic when handling objective legal requirements that could impose a cost on the business. Maintaining the trust of the organization's business people is crucial to an in-house counsel's success, and delving into a business role may undermine her credibility when it is most needed.

Promoting a Culture of Compliance

Ultimately, an in-house counsel's function is that of risk manager. Success requires establishing clear standards that are appropriate and practical. She must ensure — through training and formal and informal discussions — that employees are aware of and can identify the relevant risk issues, including when to turn to the legal department for guidance. Not every risk issue requires legal counsel involvement, so an effective in-house counsel will provide colleagues with the knowledge and tools to address foreseeable issues before they rise to the level of requiring the legal department's assistance or intervention.

An in-house counsel should not be afraid to be a deal-breaker when necessary. Sometimes colleagues need a reminder that an in-house counsel's role is to manage risks to the business and to enable the business to operate with the utmost integrity. This becomes easier as she builds credibility by offering thoughtful, practical legal guidance and develops her colleagues' confidence in her judgment. The time spent cultivating the perception of an in-house counsel as a principled partner dedicated to the organization's best interests will contribute significantly to her effectiveness and her client's ongoing success.

Larry Spiegel is Skadden's general counsel and a partner in the firm's government enforcement and white collar crime practice.

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