

Insights

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14

A COLLECTION OF COMMENTARIES ON THE CRITICAL LEGAL ISSUES IN THE YEAR AHEAD

2014 Insights / Editorial Board

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Capital Markets

Throughout 2013, issuers of all sizes and across multiple industries and jurisdictions were able to access the U.S. IPO, high-yield and syndicated loan markets, making it a robust year for U.S. capital markets. The high-yield market fell just shy of the record set in 2012, with issuer-favorable covenant packages and more speculative uses of proceeds continuing throughout the year, while PIK toggle issuances reached near-record volume. IPOs were dominated by emerging growth companies that continue to take advantage of many of the benefits afforded to them by the JOBS Act, which has changed the IPO “playbook.” Meanwhile, the U.S. securities exchanges continued to be increasingly popular venues for listings by non-U.S. companies. Despite the recent decision by the U.S. Federal Reserve to begin tapering its asset purchase program and the potential for increased interest rates, many of the fundamentals and drivers of U.S. capital markets activity remain positive for the year ahead.

Though not as strong as the U.S. markets, optimistic signs exist elsewhere around the globe. In Europe, the equity capital markets are recovering; however, remaining volatility in countries such as Germany has resulted in market participants utilizing alternative transaction models to maximize flexibility and shorten the time to market. Eager to continue increasing its flow of new listings, the Stock Exchange of Hong Kong Limited implemented several recent changes to its listing rules that will be of interest to certain overseas companies considering listing their equity in Hong Kong.

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The US High-Yield Market: A More Cautious 2014

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Investor enthusiasm for U.S. high-yield bonds continued in 2013.¹ The market delivered the second-strongest year by volume, despite the summer's increased interest rates and volatility resulting from speculation about the Federal Reserve's tapering of asset purchases and the October government shutdown. As in 2012, lower returns on other investments made high-yield bonds an attractive alternative for investors, while issuers continued to enjoy low coupons and issuer-friendly terms.

With primary issuances totaling approximately \$320 billion, the 2013 U.S. high-yield market volume fell just short of the approximately \$340 billion record set in 2012. The near-record volume in 2013 also occurred alongside a strong market for initial public offerings.

Key trends from 2012 continued into 2013, with issuer-favorable covenant packages and more speculative uses of proceeds, including for dividend payments and leveraged buyouts (LBOs). The U.S. high-yield market in 2013 also included a large number of issuances of \$1 billion or more and a near-record volume of "payment-in-kind" (PIK) toggle issuances, which allow the issuer, at its option, to pay interest with additional notes.

Many of the fundamental drivers of volume in 2012 and 2013 remain in place. However, market-specific factors, together with macroeconomic factors, may temper the volume of high-yield issuances in 2014.

Key Trends of 2013

Large Issue Size. More than 50 issues of \$1 billion or more came to market in 2013. Almost a quarter of these issuances were in September, including Sprint's two-tranche issuance of \$6.5 billion of bonds, setting the record for the third-largest high-yield offering — after issuances by TXU (\$7.5 billion) and First Data (\$7.065 billion) in 2007 — and the second-largest single tranche issue (after the \$6.34 billion Harrah's LBO issuance in 2007).

Other significant high-yield issuances in 2013 included those to fund acquisitions of MetroPCS (\$3.5 billion), H.J. Heinz (\$3.1 billion), BMC Software (\$1.625 billion) and Dell (\$1.5 billion). Further illustrating the market's demand for multiple large offerings from a single issuer, T-Mobile USA completed \$7.6 billion of offerings in 2013, and Sprint issued another \$2.5 billion of bonds in December 2013.

September's \$48 billion of primary issuances, following the Federal Reserve's announcement that it would delay tapering of asset purchases, was the highest for any month since October 2007, exceeding the prior monthly high of \$46.7 billion from September 2012. This trend was paralleled during the same month in the investment-grade market with Verizon Communication's record-setting \$49 billion offering.

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

PIK Toggle Notes. A near-record volume of PIK toggle notes was issued in 2013 — more than 20 issuances totaling more than \$10 billion — the greatest volume since 2008's \$13.4 billion. Most of the PIK toggle notes issued in 2013 were holding company issuances to fund shareholder dividends or share repurchases, primarily in the third and fourth quarters.

Neiman Marcus also issued \$600 million of PIK toggle notes, together with \$960 million of cash-pay notes, in October to partially fund its re-LBO. The Neiman Marcus offering was the first time that a PIK toggle bond had been issued at an operating company level to fund an LBO since before the financial crisis. Coming full circle, Neiman Marcus was one of the first companies to issue PIK toggle notes when it did so to partially fund its first LBO in 2005. Before the Neiman Marcus issuance in October 2013, the last PIK toggle issue to fund an LBO was BWAY Corporation's \$335 million issuance in October 2012.

As with other issuances, many of the PIK toggle notes reflected more issuer-favorable terms, including a more issuer-friendly equity clawback feature and more flexibility to pay PIK interest for the life of the notes.

Covenant Quality and Use of Proceeds. The U.S. high-yield market in 2013 also included a continuation of key trends from 2012 in issuer-favorable covenant packages and more speculative uses of proceeds. According to Moody's, credit quality reached a record-low level in September as a result of lower-rated credits going to market with more aggressive structures, including PIK toggle notes.

Among the more controversial issuer-favorable covenants in 2013 was an early redemption feature that would permit an issuer to redeem notes during the first two years at a premium lower than the traditional make-whole premium. Investors typically view such a provision as an indication that the company may be positioning itself for a change of control during that period. Over the past several years, few issuers have been able to negotiate this provision into their notes, often expressly tied to the occurrence of a change of control, with redemption prices generally well in excess of the typical 101 percent required to be paid in a standard change of control offer. However, the feature received particular attention in June 2013 when Yankee Candle pulled its notes offering, the proceeds of which were to be used to pay a dividend to its private equity sponsor. Among other issuer-favorable features included in the proposed offering was a provision that would have permitted Yankee Candle to redeem the notes at its option during the first two years at only 101.5 percent, with the redemption price stepping up thereafter to the more traditional declining premium schedule. Yankee Candle cited market conditions in pulling the deal, leading some to question whether the terms of the notes were too aggressive — even for the robust 2013 high-yield market.

The issuer-favorable climate continued to allow the use of proceeds of high-yield offerings for more speculative purposes. Of total 2013 deal volume, 6 percent funded dividends and share repurchases for principal shareholders and 24 percent funded acquisitions (including LBOs), with a greater portion of this activity in the second half of the year. Refinancings made up 56 percent of 2013 deal volume. In comparison, for 2012, 61 percent of total deal volume was used for refinancings, 23 percent to fund acquisitions (including LBOs) and 6 percent to fund dividends.

The issuer-favorable climate continued to allow the use of proceeds of high-yield offerings for more speculative purposes.

Continued Positive Fundamentals and More Macroeconomic Certainty but Cautious Expectations

The outlook for the U.S. high-yield market in 2014 is one of caution. Many of the fundamental drivers of volume remain, and the Federal Reserve's forward guidance, together with the new federal budget deal, eliminate the related uncertainty and volatility that negatively impacted the market in the summer and fall of last year. However, some uncertainty still remains, including as to the impact of future economic data, the transition in leadership at the Federal Reserve and the need for Congress to negotiate the federal debt ceiling in early 2014. Further, given the large number of refinancings over the past two years, the 2014 U.S. high-yield market may be more dependent on speculative uses of proceeds, such as acquisitions and dividend payments, to drive volume. In addition, some issuers may abandon the U.S. high-yield market altogether, preferring instead to tap the European high-yield market or to issue equity and take advantage of a record U.S. stock market for their capital raising needs.

Positive Fundamental Drivers. Many fundamental drivers of U.S. high-yield market volume in 2012 and 2013 are continuing into 2014. Yields of other fixed-return investments remain low, corporate default rates also remain low, and issuers continue to enjoy low coupons and issuer-friendly terms on their high-yield bonds.

More Macroeconomic Certainty. The economy is continuing to expand at a moderate pace, and the Federal Reserve provided the much-awaited forward guidance with respect to its asset purchases and its views on inflation and short-term interest rates.

In December 2013, the Federal Reserve put an end to the speculation about tapering of quantitative easing when it announced that it would begin reducing asset purchases in January 2014, by \$10 billion per month. The Federal Reserve also provided additional guidance on future short-term interest rates, stating that it expects to maintain the federal funds target in its current near-zero range well past the time that the unemployment rate falls below 6½ percent, especially if inflation continues to remain below 2 percent. Some have interpreted this to mean that the Federal Reserve will not increase short-term interest rates until 2015 or possibly as late as 2016.

The forward guidance provided by the Federal Reserve with respect to the tapering of its asset purchases and its views on inflation and short-term interest rates mitigates much of the related uncertainty and volatility that negatively impacted the high-yield market in the summer months and again in the fall of 2013. In addition, the fact that the Federal Reserve is still infusing money into the economy, just at a slower pace, and the expectation of continued low short-term interest rates until at least 2015, could have a positive impact on high-yield issuances in 2014.

However, some uncertainty still remains. Federal Reserve Chairman Ben Bernanke acknowledged that asset purchases are not on a predetermined course and are dependent on economic data — the Federal Reserve could end the reduction in asset purchases if the economy is not performing as well as expected or could accelerate them if the economy is performing better than expected. In addition, on February 1, 2014, Janet Yellen will succeed Bernanke as Federal Reserve Chairman. Bernanke stated in his December press conference that he consulted closely with Yellen on the decisions with respect to asset tapering and that she supports the decisions. However, it remains to be seen whether there may be policy changes under Yellen's leadership.

New Federal Budget Deal. Also in December 2013, President Obama signed a budget deal to fund federal agencies through the fall of 2015. The deal eased the automatic sequestration spending cuts, provided a greater level of certainty on government spending and reduced the risk of another government shutdown, subject to Congress passing a detailed spending bill in early 2014, which appears likely. However, the agreement did not raise the federal debt ceiling, which Congress must address in 2014.

More Speculative Drivers of Volume. Most of the issuance volume in 2013 was to refinance existing debt, leading to a lower potential for refinancings in 2014, particularly when viewed together with the large number of refinancings in prior years. As a result, volume in the U.S. high-yield market in 2014 may depend more on speculative uses of proceeds, including acquisitions and dividend payments (see [Global M&A/“US M&A: Looking Back at 2013 and Forward to a Brighter 2014”](#)). In addition, based on a number of large pending acquisitions currently backed with bridge loans, several large high-yield acquisition financings, particularly in the health care and telecommunications industries, may be in the pipeline for 2014.

“Dividend deals also may continue to have a place in 2014 as investors continue to search for higher-yielding investments.”

Dividend deals also may continue to have a place in 2014 as investors continue to search for higher-yielding investments. Typically, the resurgence of PIK toggle issuances at a level not seen since 2007 would be interpreted by the market as a warning sign that debt structures are becoming too aggressive. However, many of the PIK toggle issuances in 2013 were by better-performing credits with lower leverage than was seen at the peak of the credit crisis and included features such as shorter maturities and special call options or equity clawback provisions designed to facilitate a near-term initial public offering.

The “Great Rotation” from Bonds to Stocks. The U.S. stock market set record highs in 2013. Both the Dow and the S&P 500 ended the year up nearly 30 percent from 2012, and the Nasdaq Composite Index was up almost 40 percent. In contrast, the average year-to-date clearing yield on U.S. high-yield bonds was only 6.59 percent for 2013, a decline of 65 bps from 2012. As a result, issuers and investors may favor stocks over bonds in 2014. The IPO market also is expected to remain strong in 2014.

European High-Yield Market. The European high-yield market enjoyed a record year in 2013, with volume more than doubling over 2012. Continued strength in the euro market in 2014 could provide U.S. issuers with an alternative to the U.S. high-yield market.

* * *

The U.S. high-yield market in 2014 likely will be less robust than in 2012 and 2013, with a greater portion of the volume driven by acquisition financings and dividend payments. Continued low interest rates, forward guidance from the Federal Reserve and a new deal on government spending should have a positive effect on the market. However, some continued uncertainty as to potential changes in the Federal Reserve’s levels of asset purchases as a result of new economic data and the need for Congress to address the debt ceiling in early 2014 could unfavorably impact the market. In addition, a strong U.S. stock market and strong European high-yield market may attract issuers and investors away from the U.S. high-yield market in 2014.

The JOBS Act: The Resurgent IPO Market and What We Learned in Year Two

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Almost two years have passed since the Jumpstart Our Business Startups Act (the JOBS Act) was signed into law to ease regulatory burdens on smaller companies and facilitate public and private capital formation.¹ The provisions related to IPOs, which have been effective since enactment, seek to encourage companies with less than \$1 billion in annual revenues, or emerging growth companies (EGCs),² to pursue an IPO by codifying a number of changes to the IPO process and establishing a transitional “on-ramp” that provides for scaled-down public disclosures for EGCs. Although the U.S. IPO market was stronger in 2013 than any year since 2000, both in terms of the number of IPOs and capital raised,³ most commenters agree that the JOBS Act itself has had little impact on the increased volume of IPO activity. Its impact on the execution of IPOs, however, has been significant, resulting in new market practices that issuers and their advisors should be aware of when planning an IPO.

A Stronger IPO Market

In 2013, a total of 222 IPOs generated \$54.9 billion in gross proceeds, a significant increase compared to 2012, when 128 IPOs generated \$42.7 billion (\$26.9 billion, excluding Facebook), and 2011, when 125 IPOs generated \$36.3 billion. The IPO market continues to be dominated by EGCs, which accounted for approximately 80 percent of all IPOs in 2013, representing an increase from 75 percent of all post-JOBS Act IPOs in 2012. Measured by total proceeds raised, the energy, financial and health care segments were the most active in 2013; however, the resurgence of the IPO market generally was broad-based. Financial sponsors also continue to play an important role in the IPO market. In 2013, a total of 70 private equity-backed IPOs generated \$24.8 billion and 81 venture capital-backed IPOs generated \$9.6 billion, which, measured by the number of deals, represented a multi-year high. In 2013, the average IPO generated an average total return of 35 percent, which outpaced the 2013 performance of benchmark indices and represented a significant increase from the 21 percent average total return in 2012. Returns were driven by average first-day gains of 17 percent and average after-market gains of 15 percent, up from 14 percent and 6 percent, respectively, in 2012.

Given the cautious optimism in the markets (even in the face of the recent decision by the U.S. Federal Reserve to begin tapering its asset purchase program) and the general willingness of investors to pursue higher yielding assets in the current low interest rate and low volatility environment, we believe the IPO market will remain strong in 2014.

¹ See *Skadden Corporate Finance Alert: ‘Jumpstart Our Business Startup Act’ Signed Into Law* (Apr. 5, 2012), available at <http://www.skadden.com/insights/corporate-finance-alert-jumpstart-our-business-startups-act-signed-law>.

² An EGC is defined as an issuer (including a foreign private issuer) with total annual gross revenues of less than \$1 billion during its most recently completed fiscal year.

³ Renaissance Capital, *US IPO Market, 2013 Annual Review*, December 18, 2013 (2013 Annual Review). All historical IPO performance data herein is derived from the 2013 Annual Review, which includes IPOs with a market capitalization of at least \$50 million and excludes closed-end funds and SPACs, as of December 18, 2013.

Reforms to the IPO Process

In an effort to remove some of the traditional obstacles in the IPO process, the JOBS Act codified a number of substantive and procedural reforms, which have become an established part of the EGC “playbook.” Using data from the final prospectuses of approximately 175 EGCs that successfully completed underwritten IPOs between April 5, 2012, and December 18, 2013, with gross proceeds of at least \$75 million, below is a summary of a number of current market practices for EGC IPOs and related practical commentary, including certain interpretative guidance issued by the staff of the U.S. Securities and Exchange Commission (Staff and SEC, respectively).

Confidential Submission of Draft Registration Statements

An EGC may submit its IPO registration statement confidentially in draft form for Staff review, provided that the initial confidential submission and all amendments are publicly filed with the SEC not later than 21 days prior to the EGC’s commencement of its roadshow. The confidential submission process permits an EGC to commence the SEC review process without publicly disclosing sensitive strategic, proprietary and financial information. Further, in the case of adverse market conditions, weak investor demand in response to testing-the-waters communications or regulatory concerns, an EGC may withdraw its draft registration statement and terminate the IPO process without ever making a public filing, thus removing a potential disincentive to commencing an IPO, and permitting the immediate pursuit of a private placement.

Continued Strong Acceptance of Confidential Submission Process. Approximately 87 percent of EGC IPOs consummated in 2013 availed themselves of the confidential submission process, compared to approximately 70 percent of post-JOBS Act EGC IPOs consummated in 2012. In both years, a majority chose to submit two draft registration statements before making their first public filing.

While the decision to take advantage of the confidential submission process always should be made based on the particular facts and circumstances an EGC faces, we believe that market practice will continue to trend strongly in favor of confidential submissions. Some EGCs, however, may determine not to avail themselves of the confidential submission process. For example, we continue to see a number of EGCs that forego the confidential submission process based on the belief that a public filing would help attract bidders in the case of a “dual-track” IPO/M&A process.

Practice Points

- **Substantially Complete.** The registration statement and prospectus must be substantially complete when submitted to the SEC, including a signed audit report. However, because it is not deemed “filed” under the Securities Act, a draft registration statement need not be signed by the company or by any of its executive officers and directors, nor must it include an auditor’s consent.
- **Mechanics of Making a Confidential Submission to the SEC.** All draft registration statements and amendments to draft registration statements must be submitted via Edgar using the new submission form types DRS and DRS/A. An EGC need not pay any registration fee at the time of the confidential submission.

An EGC will not be subject to Sarbanes-Oxley until the registration statement is publicly filed.

- **FINRA Filing Requirements and Fees.** The FINRA filing requirements and related fees are triggered when the EGC names any of its underwriters. The FINRA filing will not be available to the general public.
- **Sarbanes-Oxley.** An EGC will not be subject to Sarbanes-Oxley, including the prohibition on personal loans to directors and executive officers, until the registration statement is publicly filed.
- **Press Releases.** An EGC may issue a press release that publicly announces the confidential submission of the registration statement provided the press release complies with limitations imposed by Rule 135 to avoid gun-jumping issues.⁴ The recent IPO by Twitter included a much discussed Rule 135-compliant “tweet” that announced the confidential submission of the draft registration statement; however, to date, most EGCs have not issued press releases announcing a confidential submission.
- **Inadvertently Commencing the Roadshow in Connection With Internal Sales Force Presentations.** Confidentially submitted registration statements have to be filed publicly at least 21 days before an EGC conducts its roadshow. The Staff has provided informal guidance that it does not view internal sales force presentations as commencing the roadshow so long as the sales force does not make outbound calls on that date and the net roadshow has not been activated.

Reduced Financial Statements and Selected Financial Data

An EGC may present two years of audited financial statements in its IPO registration statement, compared to the three years required for a non-EGC. An EGC also may limit the number of years of selected financial data to two years.⁵

Increasing But Still Mixed Acceptance. Approximately 56 percent of EGC IPOs that were consummated in 2013 elected not to take advantage of the ability to include reduced financial disclosures and, instead, included three years of audited financial statements in their prospectus. Of the EGCs that elected to include three years of audited financial statements, slightly more than half included three years of selected financial data. EGCs that elected to provide only two years of audited financial statements typically included only two years of selected financial data. This contrasts with 2012, where approximately 75 percent of EGC IPOs included three years of audited financial statements, and most included five years of selected financial data.

Where three years of audited financial statements are included in the prospectus, EGCs and their advisors continue to cite the extra year of audited financial statements as necessary to show investors the longer-term trends and historical growth trajectory of the company, which may have a positive impact on marketing the offering as well as satisfy liability concerns. Where an EGC includes only two years of audited financial statements in the prospectus, the decision most often is tied to a determination that the extra year of financial statements is not necessary to understand the EGC’s “story,” e.g., the EGC is a life sciences company that will not be valued based on historical

⁴Rule 135 permits an issuer to discuss the “anticipated timing of the offering.” Thus, so long as the confidential submission is noted narrowly in the context of the timing of the offering, the press release will comply with Rule 135 (assuming the conditions of the rule are otherwise satisfied).

⁵Title I FAQs, at Question 11.

financial performance or is a development stage company with little operating history during the third year. We believe that each of these trends likely will continue, although the ultimate decision to include reduced financial disclosures will be company- and transaction-specific.

Practice Points

- **Abbreviated Financial Statements of Acquired Businesses and Equity Method Investees.** An EGC registration statement that is required to present only two years of audited financial statements also may limit the audited financial statements of acquired businesses and equity method investees under Regulation S-X to two years.⁶

Testing-the-Waters Communications

The JOBS Act significantly eases the Section 5 restrictions on gun-jumping by permitting an EGC, or a person authorized to act on the EGC's behalf, to make oral and written offers to qualified institutional buyers (QIBs) and institutional accredited investors before or after the filing of a registration statement to gauge their interest in the offering.

Increasing But Still Mixed Acceptance. The frequency and degree to which EGCs or their authorized representatives have conducted testing-the-waters communications is not readily apparent from SEC filings, because these communications do not need to be publicly filed with the SEC. Although overall use of these communications remains largely deal-specific, in our experience, they are increasing.

Market practices related to testing-the-waters communications are best understood if the communications are separated into general "meet the management" presentations and presentations exploring valuation. "Meet the management" presentations between EGCs and underwriter-selected QIBs, which in certain cases precede any confidential submission, are an increasingly accepted practice. The substance of these meetings generally focuses on explaining the EGC's "story," with a view toward assisting the EGC in determining whether to proceed with an IPO. Financial statements and performance-related information generally are not part of the presentation unless the deal team is comfortable that the presentation materials will conform to the prospectus, and there is no discussion of valuation or solicitation of nonbinding indications of interest.

Presentations exploring valuation, on the other hand, have been used, albeit not frequently and typically on a post-filing basis, to explore valuation for EGCs that had a "story" or were a part of an industry that was the subject of heightened interest from investors. Not surprisingly, the timing of these more substantive discussions continues to be heavily influenced by buy-side interest. Companies should note that many underwriters prefer to schedule these testing-the-waters meetings, if at all, only after the draft registration statement has been through at least one (and preferably two) rounds of Staff review in an effort to ensure that the content of the communications will conform to the prospectus.

⁶*Id.* at Question 16. Question 45 expands this guidance to an EGC business combination registration statement, and provides that an EGC that is not a shell company and includes only two years of audited financials in its business combination registration statement needs to present only two years of audited financial statements of a (non-smaller reporting) target company notwithstanding its significance. *Id.* at Question 45.

In the case of either “meet the management” presentations or presentations exploring valuation, consideration must be given to the launch date of the offering, as some investors continue to balk at entertaining a testing-the-waters meeting close in time to the actual roadshow. However, as a general matter, the robust IPO market appears to have reduced buy-side complaints of investor fatigue resulting from the devotion of limited resources to testing-the-waters presentations.

We expect practices will continue to evolve in this area — though cautiously and incrementally — and likely will be influenced materially by the strength of the IPO markets.

Practice Points

- **Liability.** Given that the JOBS Act does not exempt issuers and underwriters from potential anti-fraud liability for any oral or written testing-the-waters communications, EGCs and their authorized personnel generally should follow the same procedures and protocols in these communications as for a roadshow (*e.g.*, conforming the communications to the statutory prospectus disclosure and generally avoiding the use of projections). EGCs should not treat a testing-the-waters presentation as a “mock” roadshow; rather, management should be prepared to deliver a final and refined pitch.
- **SEC Comments.** Although a testing-the-waters communication does not need to be filed with the SEC, EGCs should continue to expect to receive a standard comment from the Staff requesting that any “written materials” used in connection with testing-the-waters communications (even if taken back after a presentation) be provided supplementally to the Staff in connection with its review of the registration statement. The Staff will analyze these materials primarily with a view to ensuring consistency between any testing-the-waters communications and the prospectus. Because of the prospect of having to include these materials in the prospectus, EGCs and underwriters sometimes prefer oral presentations. If written materials are used, consider providing the materials to the Staff on a supplemental basis and requesting that the materials be returned or destroyed as contemplated by Securities Act Rule 418(b). Issuers also should consider including a separate back-up request for confidential treatment under Rule 83 of the SEC’s Rules on Information and Requests, in case the Staff does not agree that the return or destruction of the documents is appropriate under the circumstances.
- **Use of a “Pink Herring” Prospectus.** In connection with certain testing-the-waters meetings, some EGCs have posted a password-protected version of the confidential registration statement on the Internet roadshow and disabled the print option. These precautions are intended to ensure that the EGC is not deemed to be using a non-compliant prospectus in violation of Section 5, which requires that a valid preliminary prospectus be publicly filed and include a bona fide price range.
- **Representations/Indemnification.** As with free writing prospectuses, EGCs continue to be asked to make representations to the underwriters with respect to the information contained in testing-the-waters materials and to indemnify the underwriters for any damages arising from material misstatements in or omissions from the materials.
- **Gauging Investor Interest Versus Soliciting Orders.** In August 2012, the Staff addressed the impact on testing-the-waters communications of the limitations under Exchange Act Rule 15c2-8(e), which requires a broker-dealer to provide a

customer a preliminary prospectus prior to any solicitation of orders. The Staff guidance confirmed that Rule 15c2-8(e) applies only after the filing of a registration statement, and clarified that underwriters may discuss price, volume and market demand and solicit nonbinding indications of interest without being considered to be improperly soliciting a customer's order.

Publication and Distribution of Research Reports

Broker-dealers may publish or distribute at any time a research report about an EGC that proposes to register an equity offering or has a registration statement covering an equity offering pending, and the research report will not be deemed an "offer" under the Securities Act, even if the broker-dealer is participating or will participate in the offering. Together with 2012 NYSE and FINRA rulemaking,⁷ the JOBS Act also eliminates, for EGC IPOs, the existing FINRA-based 40-day (for managing underwriters and co-managers) and 25-day (for other syndicate members) quiet periods imposed immediately after IPOs and the 15-day (for managers and co-managers) quiet period extension imposed prior to and after the expiration, waiver or termination of a lock-up agreement. Anti-fraud liability under Exchange Act Section 10(b) and Rule 10b-5 thereunder and state law is not impacted by the JOBS Act provisions addressing the publication and distribution of research reports.

Underwriters continue to maintain a cautious approach to the publication and distribution of pre- and post-deal research.

Continued Mixed Acceptance. Underwriters continue to maintain a cautious approach to the publication and distribution of pre- and post-deal research, based largely on regulatory, practical and liability concerns. First, we are not aware of any participating underwriters publishing research before or during an IPO by an EGC. Second, as it relates to post-deal research, underwriters continue to abide by a "best practices" consensus that research should be published no earlier than 25 days after the date of the EGC IPO, so as not to compete with the IPO prospectus during the prospectus delivery period. In the near-term, we expect little change in market practices related to current pre- and post-deal research reports.

Practice Points

- **Elimination of Research Quiet Periods Not Related to an IPO.** Underwriters are taking advantage of the elimination of the research quiet periods to publish research following an EGC secondary or follow-on offering and/or during the 15 days prior to or following the expiration, waiver or termination of a lock-up agreement.

Streamlined or Exempt Disclosures

EGCs continue to move aggressively to take advantage of many accommodations under the JOBS Act, including the eligibility to make scaled disclosures or rely on exemptive relief from certain disclosure and other requirements for up to five years following their IPOs. The EGC may elect to forego reliance on any disclosure accommodation or exemption available to it.

⁷ See Skadden Corporate Finance Alert: "FINRA Amendments Adopted to Implement JOBS Act Changes," (Oct. 2012), available at <http://www.skadden.com/insights/corporate-finance-alert-finra-amendments-adopted-implement-jobs-act-changes>. The liberalization of analyst participation in pitch meetings for IPOs by EGCs is beyond the scope of this article.

Limited Executive Compensation Disclosures

EGCs are permitted to provide scaled executive compensation disclosure under the requirements generally available to smaller reporting companies. Accordingly, and counter to the disclosures otherwise required by Item 402 of Regulation S-K, an EGC may (i) omit the detailed Compensation Discussion and Analysis (CD&A), (ii) provide compensation disclosure covering the top three (including the CEO), rather than the top five, executive officers for a period of two years as compared to three years, and (iii) omit four of the six executive compensation tables required for larger companies.

Continued Strong Acceptance. Approximately 80 percent of EGC IPOs consummated in 2013 that otherwise would be required to include traditional executive compensation disclosures (*i.e.*, excluding offerings by foreign private issuers, externally managed REITs, commodity pools, etc.) elected to take advantage of the reduced disclosure. The majority of these EGCs took full advantage of the accommodation and omitted the CD&A section and included only a Summary Compensation Table and Outstanding Equity Awards Table covering three rather than five named executive officers and limited the tabular disclosures to two years. This largely aligns with 2012, where approximately 75 percent of the qualifying EGC IPOs commenced after mid-April 2012 elected to take advantage of the reduced executive compensation disclosure, and a majority took full advantage of the accommodation.

Practice Points

- **Abbreviated CD&A.** In our experience, most investors continue to be primarily interested in the historical executive compensation data. To the extent they desire an analysis and discussion of a company's executive compensation disclosures, these investors typically are more interested in a forward-looking discussion of the company's executive compensation philosophy and practices as a newly public company rather than the executive compensation decisions made while a private company. Absent special circumstances, however, the inclusion of an abbreviated CD&A generally is not necessary to successfully market an EGC IPO.

Auditor Attestation Report Under Section 404(b) of Sarbanes-Oxley

EGCs are exempt from the requirements under Section 404(b) of Sarbanes-Oxley to have an auditor attest to the quality and reliability of the company's internal control over financial reporting. The exemption remains valid for so long as the company retains its EGC status. The practical effect of this exemption is to extend relief already available to almost all newly public companies. That is, under SEC rules, all newly public companies, regardless of size, generally have until their second annual report to provide the auditor attestation report, and smaller public companies (generally those with a public float of less than \$75 million) are permanently exempted.

Continued Strong Acceptance. Virtually all EGCs dating to the enactment of the JOBS Act have included disclosure that they intend to, or may, take advantage of the exemption from providing the auditor attestation report under Section 404(b). The decision almost universally is tied to potential significant savings in terms of time and money. However, the debate persists over whether the perceived savings are overestimated given the costs companies already incur in connection with IPO due diligence

Most investors continue to be primarily interested in a company's historical executive compensation data.

related to internal controls and that they will incur related to management's opinion on internal control over financial reporting. Further, for any EGC that quickly graduates to large accelerated filer status (e.g., Facebook), the exemption offers no relief that would not otherwise be available based on the newly public company exemption set forth in the instructions to Item 308 of Regulation S-K.

The effect of the newly public company exemption means that we will have to wait until the 2012 EGC class files its second annual report on Form 10-K in early 2014 to determine whether these companies, in fact, have taken advantage of the exemption from the requirements of Section 404(b).

Practice Points

- **Management's Report Under Section 404(a) of Sarbanes-Oxley.** An EGC is not exempt from having to provide management's opinion on internal control over financial reporting. As is the case with virtually all newly public companies, however, an EGC generally would not provide management's opinion until it files its second annual report with the SEC.
- **CEO and CFO Certifications.** The Section 404(b) exemption does not change the requirement for an EGC's CEO and CFO to provide compliance certifications under Sections 302 and 906 of Sarbanes-Oxley in 10-Ks and 10-Qs.

Extended Transition for New GAAP

EGCs are not required to comply with new or revised financial accounting standards until those standards apply to private companies, giving EGCs a longer transition than public companies in situations where a different effective date exists for an accounting standard specified for private companies.

Continued Weak Acceptance. Approximately 76 percent of EGC IPOs that were consummated in 2013 elected not to take advantage of the extended transition period for compliance with new or revised financial reporting standards, as compared to 80 percent of EGC IPOs consummated in 2012. The reasons that EGCs consistently have elected to forego the extended transition period in large numbers are twofold. First, EGCs and their advisors are concerned that taking advantage of the extended transition period will create an unfavorable comparison in the market-place to their competitors. Second, an EGC IPO registration statement still must satisfy the line-item requirements of the relevant Securities Act form, including as it relates to then-current accounting disclosures required by Regulation S-X. Thus, the transition provides only a prospective benefit and is of limited utility, especially when the comparability issues are considered.

Practice Points

- **Opt Out/Opt In.** A determination by an EGC to opt out of or reject the transition period for complying with new or revised financial accounting standards is irrevocable. An EGC should disclose its choice at the time of the initial confidential submission or, if it chooses not to make a confidential submission, at the time it first publicly files its registration statement.⁸ An EGC that initially decides to opt in

⁸Title I FAQs, at Question 13.

or take advantage of the extended transition period may determine at any time to opt out (*i.e.*, abandon the extended transition period and comply with the accounting standard effective dates applicable to non-EGCs). This decision, which will be irrevocable, must be disclosed prominently in the EGC's next periodic report or registration statement.⁹

- **Prospectus Disclosure.** If an EGC elects to avail itself of the extended transition period relief, the SEC staff will require the EGC to include disclosure in each of the risk factor and critical accounting policies sections that explains that its financial statements may not be comparable to those companies that comply with public company effective dates.
- **Extended Phase-In for Foreign Private Issuers.** A foreign private issuer that qualifies as an EGC and reconciles its home country GAAP financial statements to U.S. GAAP can take advantage of the extended transition period for complying with new or revised financial accounting standards in its U.S. GAAP reconciliation.¹⁰

* * *

The JOBS Act has changed significantly the manner in which IPOs are executed. We expect EGCs to continue to take advantage of the confidential submission process and, as circumstances dictate, scaled disclosures and exemptive relief from certain disclosure and other requirements. Other market practices, especially testing-the-waters communications and, potentially, the publication and distribution of research reports, will continue to develop and their impact will become more apparent with the passage of time.

⁹Title I FAQs, at Question 37.

¹⁰Title I FAQs, at Question 34.

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Will 2014 Be the 'Year of the Foreign Private Issuer'?

Experience in 2013 has shown that U.S. securities exchanges are once again becoming increasingly popular venues for listings by non-U.S. companies. The number of non-U.S. companies that conducted initial listings in the U.S. in 2013 nearly tripled the number of such listings in 2012, and was 18 percent higher than 2007, the previous high in recent history. The surge has been driven by both traditional initial public offerings by foreign private issuers (FPIs) and initial U.S. offerings and listings by companies already trading in other markets, as well as by M&A transactions.

We expect this trend to continue in 2014 as a result of substantial available investor capital in the U.S., the potential for higher valuations for companies in some industry sectors than may be available on other exchanges, the more permissive U.S. regulations applicable to certain issuers available under the JOBS Act, and increased investor confidence due to the number of successful deals. Less stringent governance and disclosure obligations (as compared to the requirements applicable to domestic U.S. SEC registrants) will also continue to be attractive to FPIs.

Liquidity. The NYSE and NASDAQ remain the two most liquid exchanges in the world, with market capitalization (as of November 30, 2013) of \$17.4 trillion and \$6.0 trillion, respectively, compared to \$4.5 trillion for the Tokyo Stock Exchange and \$4.2 trillion for the London Stock Exchange, the world's third- and fourth-largest exchanges, respectively. In addition to making it easier to access the U.S. capital markets, U.S. exchanges provide access to a broader shareholder and investor base and wider research and analyst coverage in many industries, which may enhance an issuer's corporate reputation and potentially result in a higher valuation of its shares.

Acquisition Currency. There is a continuing interest in consolidation across several sectors (such as telecommunications and pharmaceuticals) with increased strategic opportunities for companies to use their shares as acquisition consideration. With the Dow Jones Industrial Average continuing to rise to all-time highs at the end of 2013, U.S.-listed equity securities of FPIs may be a more attractive acquisition currency than non-U.S. listed shares or alternative sources of financing.

In order to consummate an acquisition of a U.S. public company using shares of the acquirer, the offer of the share consideration needs to be registered with the SEC. However, deregistration rule changes that came into effect in 2007 allow FPIs to consummate such an acquisition through an SEC registered offering and then deregister with relative ease 12 months following the completion of a transaction, provided that U.S. trading levels remain low (less than 5 percent of worldwide volume). Following the initial registration, the acquirer only needs to file one annual report with the SEC and then may deregister upon meeting certain conditions and be free from SEC reporting requirements. Since the rules' inception, however, only a handful of acquirers have taken advantage of the opportunity to do an SEC registered acquisition and then subsequently deregister. It is interesting to note that while there was a surge in deregistrations immediately following effectiveness of the rules on deregistration (58 companies deregistered in 2007 and 32 in 2008), the number of FPIs seeking to exit U.S. markets decreased significantly, with only five deregistrations in 2012 and 11 in 2013.

The JOBS Act. The JOBS Act simplified the SEC registration process for emerging growth companies (EGCs). Companies, including FPIs, seeking to conduct an initial public offering that have annual revenue for the most recent fiscal year of less than \$1 billion qualify as EGCs. EGCs enjoy reduced regulatory burdens in connection with SEC registrations for an initial public offering and may submit their initial registration statement for confidential, nonpublic SEC review. However, such confidential review is not available in secondary listings that are not offerings. EGCs also are entitled to delay auditor attestation of internal controls (see below). While EGCs can conduct the SEC review process confidentially, the initial confidential submission and all amendments are required to be publicly filed at least 21 days prior to the start of the roadshow. In addition, the JOBS Act allows EGCs to “test the waters” in the U.S. markets prior to committing to a U.S. listing, akin to the “pilot fishing” practice in Europe (see “[The JOBS Act: The Resurgent IPO Market and What We Learned in Year Two](#)”).

FPIs that do not qualify as EGCs but are listed or are concurrently listing outside the U.S. may still have their registration statement confidentiality reviewed by the SEC, provided they file the initial confidential submission and all amendments when they publicly file the registration statement (which may be later than 21 days prior to the roadshow).

The Dodd-Frank Act. Dodd-Frank has limited application to FPIs that are not financial institutions. Provisions from which they are exempt include mandatory say-on-pay shareholder votes and independent compensation committee requirements. Other provisions of the act, including disclosure of the issuer’s use of conflict minerals, are mandatory for FPIs and the application of other Dodd-Frank provisions, including executive compensation clawbacks and disclosure of hedging activities of directors and officers, remains unclear and is subject to SEC rulemaking. Overall, Dodd-Frank provisions that have come into force to date do not seem to have been a deterrent for FPI listings in the U.S. as FPIs are exempt from provisions that are viewed to be most burdensome by issuers (*i.e.*, the say-on-pay shareholder votes).

Disclosure Requirements and Governance Provisions. As a general matter, U.S. public companies must file annual and quarterly reports with the SEC, and must file 8-K reports upon the occurrence of specified material events. However, SEC rules permit FPIs to file only an annual report (within longer a timeframe than U.S. companies) — and to furnish to the SEC certain information that they make or are required to make public in another jurisdiction on Form 6-K.¹ In addition, FPIs are not subject to other rules including the U.S. proxy solicitation, “short-swing” profit, executive compensation disclosure or “fair disclosure” of material information rules that apply to U.S. domestic SEC registrants.

FPIs also may follow their home-country practices instead of numerous corporate governance requirements of NYSE and NASDAQ. In effect, many FPIs are exempt from all NYSE and NASDAQ corporate governance requirements other than the requirement to have an independent audit committee.

Non-U.S. companies registered with the SEC that maintain primary market share outside the U.S. may benefit from the cross-border U.S. tender offer regulations, which simplify the disclosure and procedural requirements for acquiring such companies.

¹ NASDAQ requires an FPI to submit on a Form 6-K an interim balance sheet and income statement as of the end of its second quarter.

“Many FPIs are exempt from all NYSE and NASDAQ corporate governance requirements.”

Lingering Deterrents. Despite the many advantages FPIs receive from listing on a U.S. exchange, the Sarbanes-Oxley Act and litigation exposure may continue to give certain issuers pause.

Sarbanes-Oxley Act. Non-U.S. companies considering registration in the U.S. continue to regard the Sarbanes-Oxley Act with some scepticism and hesitation, expressing concern about the costs and liability it imposes on directors and officers. In practice, however, many Sarbanes-Oxley disclosure provisions that apply to FPIs are similar to regulations already applicable under foreign national law or stock exchange rules and are a part of the existing governance practices of sophisticated multinational corporations. In addition, FPIs that qualify as EGCs may delay for up to five years one of Sarbanes-Oxley's most burdensome and costly provisions, the requirement to obtain an audit opinion on internal controls.

Litigation. The U.S. remains a litigious environment with an active plaintiffs' bar. The 2010 U.S. Supreme Court decision in *Morrison vs. National Australia Bank* drew a bright line around the U.S. borders for securities fraud litigation, making it harder to sue foreign companies that are not listed in the U.S., but stopped short of applying such limitation to U.S.-listed FPIs. However, recent studies suggest that FPIs experience class action lawsuits at about half the rate of U.S. companies with similar levels of litigation risk. This statistic, coupled with the recent increase in listings on U.S. exchanges, may be enough to encourage other FPIs to take advantage of the U.S. securities market.

Non-U.S. companies nonetheless continue to view the benefits of pursuing a U.S. listing and the allowances given to FPIs as outweighing the lingering deterrents. We expect the trend of tapping into the U.S. equity markets for capital raises and M&A transactions to continue in 2014.

Alternative Transaction Structures: The 'New Normal' in Volatile German Capital Markets

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During the past two years the European equity capital markets have shown clear signs of recovery. However, these markets continue to experience more volatility than before the global financial crisis. Virtually every market participant — corporations, private equity firms, institutional investors, as well as investment bankers and lawyers — has been searching for a competitive advantage by using alternative transaction models to raise capital without excessive delays.

In Germany last year, market participants relied on several transaction structures to shorten the time to market, maximize flexibility and generally reduce risk in the capital-raising process. We expect these models to increase in popularity and usage in 2014.

Shelf Registrations

Although the shelf registration process, which permits the approval of a disclosure (registration) document for a securities transaction well in advance of an actual offering, has been available since the EU Prospectus Directive was implemented in 2005, German companies previously made little use of it.

Under the EU shelf registration regime, a company prepares a registration document, a securities note and a summary note — together, the three documents comprise the prospectus for a securities offering. The preparation of a registration document in advance of an actual transaction may significantly shorten the period between preparation and launch of an IPO or a large capital increase. Companies can front-load the most time-consuming preparatory tasks (e.g., due diligence, prospectus drafting, etc.) and the process of obtaining the registration document approval by the German regulator (BaFin). (The registration document is valid for 12 months following BaFin approval. Upon approval and publication of the securities note and the summary note, the prospectus also is valid for 12 months.)

Because the registration document is made public by BaFin upon approval, the company has an up-to-date and thoroughly prepared disclosure document available to support early investor meetings and other premarketing efforts in anticipation of a subsequent equity offering. The downside of this process is that the company needs to spend time and incur legal, accounting and other costs prior to knowing if and when an IPO or capital increase transaction actually can take place. In prior years, the shelf registration process has been used mainly by large German financial institutions such as Deutsche Bank, Commerzbank and Allianz. To increase financing flexibility, we believe that a broader spectrum of German companies will consider this approach, as documentary preparedness should enable them to take advantage of capital markets windows which have been much narrower and more difficult to predict in the wake of the global financial crisis.

Pre-IPO Placements

In an attempt to reduce risk, German companies continue to seek contractual commitments from cornerstone (i.e., large institutional) investors in advance of an actual IPO. This requires the availability of certain public company information, which investors

can use in making investment decisions and conducting comprehensive due diligence reviews. Pre-IPO cornerstone investors typically will ask for some discount off the subsequent IPO price, and their involvement needs to be disclosed in the IPO prospectus. Cornerstone investors normally do not accept lock-up periods, and their shareholding typically will count toward the minimum free-float requirement for stock exchange listing purposes.

In 2013, Evonik AG completed the largest-ever pre-IPO placement in Germany. Several dozen institutional investors purchased Evonik shares in an aggregate amount of €1.7 billion on the basis of two rounds of global private placements. Because the pre-IPO private placements ended up accounting for more than 10 percent of Evonik's share capital, the company met the free-float and other listing requirements of the Frankfurt Stock Exchange without the need to implement a public offering of its shares. The pre-IPO investors bought their Evonik shares on the basis of publicly available information (without a prospectus), at a discount to the subsequent IPO price and with a lock-up period lasting until the shares were listed on the exchange.

Although a 2013 landmark equity capital markets transaction in Germany, the circumstances of the Evonik pre-IPO placement were quite unique: After three failed IPO attempts and because of public information made available by Evonik to its then-existing bondholders, institutional investors already had sufficient information about the company, enabling them to make an informed cornerstone investment decision without significant further due diligence. The transaction was implemented within a very short time frame (less than two months) with investors from the United States, Europe, the Middle East and Asia.

Because of the special circumstances surrounding the Evonik pre-IPO (including those related to disclosure), meeting the entire free-float requirement for a stock exchange listing on the basis of cornerstone investments will remain the exception. However, privately and bilaterally negotiated investments by institutional investors prior to an IPO undoubtedly will increase, including in connection with spin-offs of well-documented divisions of public companies or for IPOs of frequent bond issuers, particularly those in the high-yield market.

Block Trades and Accelerated Book-Buildings

Undocumented block trades remain an appealing method for German public companies to secure quick access to equity capital markets while avoiding a comprehensive due diligence investigation and preparation, review and approval of a lengthy disclosure document. The block trades involve an accelerated book-building, which means that the time between launch of the transaction and pricing typically is 24 hours or less.

From a German corporation law perspective, companies accessing the capital markets to raise funds on a block-trade basis rely on Section 186 (3) of the German Stock Corporation Act (*Aktiengesetz*), which permits the exclusion of the subscription rights of existing shareholders if (i) the capital increase in question does not exceed 10 percent of the company's issued share capital and (ii) the placement price is not less than 3 to 5 percent below the then-current market price at the time of the placement.

Block trades frequently are implemented overnight, with the German issuer or shareholder contacting a number of investment banks on the evening prior to the intended placement, soliciting bids in an auction-type process (on the basis of prepared documentation) and awarding the trade to the bank committing to the highest backstop

price. The decision to launch the block trade typically is made following the stock exchange's close because of BaFin's ad hoc publication obligation, and the placement with institutional investors happens overnight with a pricing occurring most often within 12 to 24 hours after launch.

Dual-Track Structures

As a result of recent capital markets volatility, selling shareholders, in particular private equity firms, have decided to run parallel IPO and M&A processes to increase transaction certainty for a contemplated exit at the highest possible price. While there are certain synergies between the capital markets and M&A processes (e.g., with respect to due diligence and certain documents, such as the IPO prospectus and the information memorandum provided to the bidders in the M&A process), there also exist significant challenges to align the timetables for the two processes.

During the past two years almost all German dual-track situations ended up in an M&A trade sale, because selling shareholders often prefer transaction certainty with a full exit at a defined valuation. A partial exit in an IPO, possibly with a higher valuation and valuation upside, is subject to share price and capital markets volatility for many months — and possibly years — to come.

* * *

We believe that German capital markets volatility and unpredictability will need to be taken into account for the foreseeable future. As a result, alternative and, at times, innovative new transaction structures will continue to be developed. Increasing the documentary preparedness for an equity capital markets transaction early, shortening the time-to-market period through block trades and reducing risk in transactions through pre-IPO and dual-track structures are the new normal. So is the institutional investors' willingness to transact with companies directly without investment banks as intermediaries. These developments will continue to change how transactions are structured, marketed and documented.

We believe that German capital markets volatility and unpredictability will need to be taken into account for the foreseeable future.

Hong Kong Exchange Looks to Attract Overseas Companies

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Bolstered by a solid fourth quarter, 2013 was a stronger year than 2012 for Hong Kong in terms of new listings. In 2013, the Stock Exchange of Hong Kong Limited (the HKEx) reported 110 new listings raising \$21.5 billion, compared to 64 new listings raising \$11.6 billion in 2012.

Despite the significant improvement, the flow of new listings remains sluggish compared to just a few years ago. This includes fewer listings by “overseas” companies (*i.e.*, companies incorporated outside one of the four “recognized” jurisdictions of Hong Kong, China, the Cayman Islands and Bermuda), which the HKEx is eager to attract, particularly mature companies from developed markets such as Europe and North America.

Key Rule and Policy Changes Affecting Overseas Companies

A new set of rules altering the listing process came into effect on October 31, 2013 (the 2013 Rule Changes), which are likely to be of interest to overseas companies that are considering listing their equity in Hong Kong. While the principal focus of these rules was on the role of sponsors (*i.e.*, investment banks that sponsor a company’s listing application), the rule changes significantly impact the listing process, including listings by overseas companies.¹ In adopting these rules, the HKEx included two exceptions that seem intended to ensure that the rule changes do not drive away overseas companies that otherwise might list in Hong Kong. Moreover, on September 27, 2013, the HKEx and the Securities and Futures Commission of Hong Kong (the SFC) issued a joint policy statement on the listing of overseas companies (the 2013 Joint Policy Statement), which sets forth a number of changes to key rules affecting overseas companies that are intended to increase the appeal of listing in Hong Kong.² These changes also appear to have been designed with a view to simplifying the process of obtaining a secondary listing in Hong Kong (*i.e.*, a listing of the equity of a company that is listed on another acceptable stock exchange and where a majority of the trading continues to take place on the other stock exchange).

Relief From Publication of Application Proof. One of the major 2013 Rule Changes is that a draft of the listing document (with certain information about the offering omitted) will need to be published on the HKEx’s website when the listing application is filed. Unlike the other 2013 Rule Changes, this requirement will apply only to listing applications submitted on or after April 1, 2014. The application is required to be substantially complete, which the HKEx believes will result in more care being put into initial filings, and, coupled with reforms intended to streamline the vetting process, is expected to result in a quicker and less cumbersome HKEx application and vetting process.

¹For a detailed discussion, see the Skadden publication “Outline of the Hong Kong Stock Exchange Rule Changes to Complement New Sponsor Regulations” (July 25, 2013), available at <https://www.skadden.com/insights/outline-hong-kong-stock-exchange-rule-changes-complement-new-sponsor-regulations>.

²For a detailed discussion, see the Skadden publication “HKEx and SFC Release New Joint Policy Statement on Listing of Overseas Companies in Hong Kong” (Oct. 17, 2013), available at <https://www.skadden.com/insights/hong-kong-stock-exchange-and-sfc-release-new-joint-policy-statement>.

The HKEx included two key exceptions to the requirement that an application be published at the time it is filed. First, applicants that have been listed on a recognized overseas stock exchange for at least five years and which meet a market capitalization test specified by the HKEx (currently \$400 million) at the time of the application need not publish their application proof and may instead elect to file confidentially. Second, if requested, the HKEx or the SFC has the authority to waive or modify the publication requirements where the listed company is being spun off from a parent company listed on an overseas exchange.

Simplification of Shareholder Protection Requirements. Hong Kong's listing rules require that, as a condition to listing, an applicant incorporated outside one of the four recognized jurisdictions must satisfy the HKEx and the SFC that the jurisdiction in which it is established has shareholder protections that are at least equivalent to those afforded to shareholders of a company incorporated in Hong Kong. Prior to the publication of the 2013 Joint Policy Statement, listing of such companies was governed by a 2007 joint policy statement.

Under the 2007 joint policy statement, companies not incorporated in one of the four recognized jurisdictions were required to prepare a detailed table of shareholder protection items, with submissions often running to 50 pages or more. Under the 2013 Joint Policy Statement, this table has been replaced with a much shorter list of 11 items.

The HKEx also has begun to publish "country guides" for approved jurisdictions to help companies incorporated in an acceptable jurisdiction satisfy shareholder protection requirements. The publication of country guides replaces the prior practice of publishing listing decisions relating to the approval of companies in particular jurisdictions.

Financial Statements. The 2013 Joint Policy Statement provides clarity to the use of financial statements prepared in accordance with standards other than International Financial Reporting Standards (IFRS) and Hong Kong Financial Reporting Standards (HKFRS). It lists the other financial reporting and auditing standards that previously have been accepted by the HKEx, as well as the additional disclosure that will be required where the financial reporting standards differ materially from HKFRS/IFRS. Generally, an accounting firm not qualified in Hong Kong may only be used if it (i) has an international name and reputation, (ii) is a member of a recognized body of accountants and (iii) is subject to independent oversight by a regulatory body of a jurisdiction that is a signatory to the International Organisation of Securities Commissions' Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information.

Waivers. It is customary for companies seeking a secondary listing on the HKEx to obtain from the HKEx waivers of listing rules needed to harmonize the company's existing practices with the HKEx requirements. The negotiation of these waivers often has been a time-consuming and burdensome process. Following the 2013 Joint Policy Statement, a number of these waivers will be granted automatically to companies that meet specified criteria. These include waivers of certain corporate governance requirements, as well as waivers of Hong Kong's requirements with respect to disclosure and disinterested shareholder approval of related-party transactions, listing of subsidiaries and share option schemes. To be eligible for these automatic waivers, a company must, among other things, have a market capitalization in excess of \$400 million, be listed on one of certain recognized stock exchanges, and have an acceptable track record of legal and regulatory compliance. Companies listed on other exchanges may still obtain a secondary listing, but must first demonstrate that their primary exchange meets Hong

The HKEx also has begun to publish 'country guides' for approved jurisdictions to help companies satisfy shareholder protection requirements.

Kong's shareholder protection standards. The HKEx also has formally reiterated its long-standing policy that companies with a "center of gravity" in Greater China are not eligible for secondary listings.

* * *

It is too soon to tell whether the various rule and policy changes adopted in 2013 will have an appreciable impact on overseas and secondary listings on the HKEx. However, it is clear that Hong Kong's regulators recognize the importance of attracting these types of companies and are prepared to take meaningful steps to ensure that Hong Kong remains a competitive listing venue for companies whose businesses lie outside Greater China.

Corporate Restructuring

The globalization of capital and the multinational nature of many larger businesses are leading to an increasing utilization of financial restructuring techniques and strategies. In the past, a particular nation's legal regimes and laws governing insolvency matters and creditor rights generally were viewed as having limited utility, applying only to businesses operating or based primarily in the particular nation.

Today, non-U.S. businesses and their stakeholders are beginning to use Chapter 11 and Chapter 15 of the U.S. Bankruptcy Code to reorganize non-U.S. businesses with the assistance of U.S. bankruptcy courts — and, likewise, English corporate law “schemes of arrangement” are being used by European companies incorporated outside the U.K. to address their financial problems. This globalization trend is likely to grow in 2014 and beyond, even as the number of traditional commercial Chapter 11 cases in the United States may decline.

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Using Chapter 11 to Restructure Non-US and Multinational Companies

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Chapter 11 of the U.S. Bankruptcy Code is the most well-developed law of any insolvency regime in the world for helping troubled companies restructure their affairs. Some nations, like Canada and the United Kingdom, also have insolvency regimes that are very helpful for restructuring businesses, but few others do, and none of these systems is as commercially oriented as Chapter 11.

Advantages

Arguably the most appealing feature of Chapter 11 is the ability to confirm a reorganization plan with less than unanimous stakeholder support, even if applicable credit agreements or indentures require unanimity to change fundamental economic terms like tenor and pricing. For example, a business in Chapter 11 can sell substantially all its assets without shareholder approval. The assets also can be sold free and clear of secured and unsecured claims, without the need to obtain creditor approval, subject only to secured creditor rights to bid their debt for their collateral.

Alternatively, a business in Chapter 11 can reorganize its capital structure pursuant to a reorganization plan that converts debt to equity, provides for new capital or new financing and/or provides for the disposition of one or more business lines. Confirmation of a Chapter 11 plan requires creditor consents, but the voting thresholds are low. Creditors vote by class, with holders of similar claims placed in the same class (*e.g.*, bank debt in one class, senior bond debt in another, subordinated bond debt in yet another, etc.). Only one class of creditors whose rights are impaired by the plan must vote to “accept” the plan and its terms for the reorganization plan to be confirmed, so long as the plan follows the “fair and equitable rule,” *i.e.*, senior creditors are provided for in full before more junior creditors are.

Significantly, for an impaired class to be deemed to have accepted a plan, only one-half of the creditors in that class, holding two-thirds of the debt in that class, must vote in favor of the plan — counting only those who actually vote. A company in Chapter 11 therefore need not obtain a minimum level of participation (*e.g.*, 50 percent of all holders) to confirm and consummate a Chapter 11 reorganization plan. As long as one impaired creditor class accepts, all other dissenters and abstainers will be bound by the plan.

These highly advantageous features of Chapter 11 make it an attractive tool not only for companies domiciled in the U.S., but also non-U.S. and other multinational companies. Many such companies have successfully utilized Chapter 11, including businesses with few assets, operations or employees in the United States. Examples include several global shipping companies and, recently, Central European Distribution Corporation (CEDC), one of Russia’s largest vodka distributors with operations in Hungary, Poland, Russia and Ukraine, which obtained court approval for its prepackaged Chapter 11 reorganization plan in May 2013.¹

¹Skadden was counsel to CEDC in its successful Chapter 11 restructuring.

Important Considerations

Non-U.S. or multinational corporations contemplating Chapter 11 must assess several legal and practical considerations.

Location. While an enterprise need not have its headquarters, significant assets or employees in the U.S., each entity seeking Chapter 11 protection must have property in the United States — although a bank account with only \$100 suffices. That said, the more U.S. contacts, the better: The practical reach of United States jurisdiction may be limited if none of the major stakeholders has a presence in the U.S. and may not be inclined to heed the directives of a U.S. court.

However, in many transactions, it is rare that a stakeholder has no U.S. presence. Even with an Eastern European enterprise like CEDC, the overwhelming majority of the bank and bond debt holders had some type of operations in the U.S., which subjected them to the jurisdiction of U.S. courts. For this same reason, Chapter 11 likely is a more useful tool for implementing a balance-sheet restructuring of a non-U.S. or multinational company rather than a sale of non-U.S. assets. Indeed, it is not clear that U.S. bankruptcy courts would or could enter orders that would be respected in other jurisdictions governing the sale or other disposition of assets located only in foreign nations because, as a practical and legal matter (including U.S. court deference to foreign courts), the power and jurisdiction of a U.S. bankruptcy court over purely foreign assets may not be vindicated in foreign jurisdictions.

“With a prepackaged Chapter 11, the business has its restructuring solution and bankruptcy exit plan fully documented and ‘in hand’ from day one of the U.S. bankruptcy case.”

Shorter Stays. Prepackaged Chapter 11s also are very useful for non-U.S. and multinational companies. In a “prepack,” the plan is negotiated and voted upon before the enterprise actually files bankruptcy, thereby minimizing its stay in bankruptcy. This is especially important for non-U.S. entities, because their non-U.S. vendors, suppliers and employees typically associate bankruptcy with liquidation, failure and, in some cases, jail. Accordingly, the less time that the enterprise can be subject to formal court proceedings, the better. With a prepackaged Chapter 11, the business has its restructuring solution and bankruptcy exit plan fully documented and “in hand” from day one of the U.S. bankruptcy case, which is critical to maintaining the franchise during its short stay in Chapter 11.

Non-U.S. Governing Documents. A helpful feature of some non-U.S. bank loans and indentures is that debt and related liens and guarantees may be compromised and released if only 90 percent of the holders agree (the threshold is unanimity under most U.S. loans and indentures). An out-of-court exchange or tender offer therefore may have a higher chance of success with an enterprise governed by such documents, because the 90 percent threshold is easier to reach. In the case of CEDC, only its U.S. parent companies filed Chapter 11, which was utilized to significantly restructure its bond debt. CEDC’s Polish and Russian subsidiary-operating companies had guaranteed that debt and pledged their assets to secure their guarantee obligations. However, CEDC obtained more than 90 percent participation in its exchange offer/back-up reorganization plan, allowing it to obtain the consensual release of these Polish and Russian subsidiaries.

Jurisdictional and Cultural Nuances. Chapter 11 cannot always solve all problems. Advisers to a multinational enterprise may need to work in advance with restructuring professionals in local non-U.S. jurisdictions to address unique problems and, most importantly, to educate stakeholders and decision makers there. For example, the notion that public shares can be cancelled in a U.S. bankruptcy is antithetical to the cultures and sensibilities of many nations. This was the case in Poland, where CEDC’s

shares had been publicly listed. Another notable example is South Africa, which has very creditor-friendly maritime laws that present challenges for shipping companies attempting to reorganize in the United States.

Perhaps most critically, board members, officers and employees of non-U.S. operating companies often have very different benefits and burdens compared to U.S. board members, officers and employees. In some nations, board members and officers are legally obligated to suspend business operations when their business becomes insolvent — there is no notion of debtor-in-possession financing, and officers and board members can be held personally (and sometimes criminally) responsible if the business continues to trade while insolvent. One of the paramount rules in any cross-border restructuring, therefore, is to ensure that non-U.S. operating subsidiaries are adequately funded while parent entities restructure their troubled balance sheets.

Conversely, non-U.S. nationals who are board members, officers or others who will be involved in a Chapter 11 restructuring may need to be carefully educated about U.S. notions of fiduciary duty law. Regardless of the jurisdiction of organization of a particular entity, if it seeks the protection of a U.S. bankruptcy court, its officers and directors must follow U.S. bankruptcy law duties and disclosure requirements to the letter. The level of disclosure required by U.S. law often times is much higher than that required under the laws of non-U.S. jurisdictions. For example, solicitation materials accompanying prepackaged Chapter 11 plans can be very detailed, and the disclosure and disinterested obligations imposed upon professionals may seem very alien to non-U.S. advisers who have never encountered them before.

* * *

Chapter 11 affords a number of helpful tools for restructuring non-U.S. companies and is available to a larger number of non-U.S. enterprises than ever before. The barriers to taking advantage of Chapter 11 may be more cultural than legal. However, with sufficient planning and sensitivity to the legitimate concerns of those unfamiliar with Chapter 11, non-U.S. enterprises can use it as effectively as U.S. businesses.

Chapter 11 Strategies Increasingly Appeal to Banks in Need of Recapitalization

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Historically, the Chapter 11 bankruptcy process was not used as a technique to recapitalize struggling banks. An aversion to using Chapter 11 was attributable in part to concerns that regulators and depositors might perceive a bankruptcy filing as synonymous with financial meltdown and trigger a “run on the bank.” One of the key developments — and lessons — from the recent financial crisis and recovery is that the federal bankruptcy laws, when employed as part of a carefully planned and executed recapitalization strategy, can be an effective tool to restructure and recapitalize troubled banking organizations in the United States.

In the wake of the financial crisis, the banking industry has used two basic transaction structures involving Chapter 11. The first structure is a “Section 363” sale, which was first employed in the recapitalization of AmericanWest Bank in 2010. Since then, more than a dozen community banking organizations have turned to the Section 363 sale to facilitate their recapitalization. The second structure is a recent development involving a “prepackaged” plan of reorganization. Anchor Bancorp Wisconsin, Inc. successfully utilized a prepackaged plan in September 2013 to comprehensively resolve more than \$300 million of legacy debt and TARP obligations and to raise \$175 million of new common equity capital.

These Chapter 11 transactions overcame the historical concerns of regulators and other constituencies. The transactions also demonstrated that Chapter 11 restructuring techniques are flexible and can be tailored to the needs of the banking industry and specific institutions. In 2014, we expect an increase in Chapter 11 bank recapitalizations.

Background

Most commercial and retail banking organizations in the United States are structured with a parent holding company and a subsidiary bank. The parent company typically serves as the issuer of various equity securities (*e.g.*, common stock, preferred stock, trust-preferred securities) and debt instruments (*e.g.*, subordinated debt, senior borrowings). For example, banking organization parent companies issue virtually all of the preferred securities to the U.S. Treasury Department under the TARP program. The parent company then downstreams the proceeds of these various issuances to the subsidiary bank as common equity.

If the organization runs into trouble, regulators generally will prohibit the subsidiary bank from paying dividends to its parent company to conserve capital at the subsidiary bank. Without dividends from its subsidiary bank, the parent company does not have a ready source of funds to service the various securities it has issued to investors and lenders. As a result, the parent company cannot make principal and interest payments on its borrowings or pay dividends to its trust-preferred security holders. This is the risk of “double leverage”: the subsidiary bank alone might have a viable and valuable franchise, but its parent company is insolvent.

When these organizations seek to raise additional capital, prospective investors often are unwilling to invest unless the parent company’s legacy obligations are resolved. This may be impossible without a Chapter 11 strategy. First, many banking organizations

have issued securities that are held by collateralized debt obligations and other pooled structures that make it very difficult to identify ultimate holders that are empowered to negotiate or make decisions. Second, even if the legacy holders can be identified, fashioning a deal that will command unanimous approval from those holders is difficult.

Threat of FDIC Receivership

Without a resolution of the parent company's legacy obligations, the organization is hindered significantly in its efforts to raise additional capital. This puts the subsidiary bank at risk of failure and FDIC receivership. FDIC receivership is a bad outcome for just about all constituencies. In a receivership, the FDIC seizes the subsidiary bank and simultaneously sells its assets and liabilities to a third-party bank preselected by the FDIC through an auction process. Only qualifying bank charters are allowed to participate in these FDIC auctions, which are conducted on a nonpublic basis, with limited opportunity for diligence and little flexibility in terms and structure. In virtually every case, the parent company receives zero consideration. Its creditors and security holders receive little, if anything at all. In addition, the FDIC typically will suffer a meaningful loss in connection with the receivership. The FDIC will seek to recover that loss by bringing lawsuits and other enforcement actions against the former directors, officers and other institution-affiliated parties that it may regard as responsible for the bank's troubles.

Chapter 11 Strategies

For many struggling banking organizations, Chapter 11 bankruptcy techniques offer strategic options to avoid FDIC receivership and to preserve the bank's underlying value. Restructuring through Chapter 11 can:

- resolve legacy obligations of the parent holding company and maximize the value recovered by its legacy debt and security holders;
- enable the investment of new capital;
- preserve the underlying bank's franchise value, including to its employees, customers and community;
- achieve compliance with regulatory directives to raise capital;
- avoid FDIC receivership and loss to the Deposit Insurance Fund; and
- avoid reputational, legal and financial risk to directors and officers associated with FDIC receivership.

Section 363. A Section 363 sale involves the parent company filing for Chapter 11 bankruptcy. The bankruptcy involves only the parent company — not the subsidiary bank. The bankruptcy process enables the parent company to sell its subsidiary bank to the highest bidder in a court-supervised, open and public auction process. In most cases, the parent company will have signed an asset purchase agreement with a "stalking horse bidder" before filing for bankruptcy, as AmericanWest did with SKBHC Holdings. The stalking horse bidder thereby sets a floor on the price and terms of the auction. The Section 363 process allows the buyer to leave behind the parent company's legacy obligations. The buyer then can invest new capital in the bank and move forward without the overhang of the legacy parent company. The parent company continues in the regular bankruptcy process and satisfies its legacy obligations, to the extent possible, using the proceeds from the Section 363 sale of the subsidiary bank.

Chapter 11 bankruptcy techniques offer strategic options to avoid FDIC receivership.

Prepackaged Chapter 11. Unlike a Section 363 sale, a prepackaged plan of reorganization does not involve a sale of the subsidiary bank, a stalking horse bidder or a public auction process. Rather, a prepackaged plan of reorganization is a formal written plan to resolve the parent company's legacy obligations, typically through partial payment or by otherwise compromising their terms. The plan also can contemplate the receipt of new capital. The plan must be approved by the bankruptcy court and receive the consent of some — but not all — of the parent company's legacy creditors. The plan is "prepackaged" because the necessary creditor consents have been solicited before bankruptcy is even filed — which means the parent company is better able to manage the risks associated with the negative publicity of a bankruptcy. A prepackaged Chapter 11 can be extremely effective — in the case of Anchor BanCorp, the total time from bankruptcy filing to court confirmation was just 18 days — but it does require certain conditions to be present, including having a segment of the creditor base that is identifiable, large enough to control the vote of its class and willing to negotiate the restructuring.

Implications

In light of the benefits of these restructuring strategies, well-advised boards of directors of troubled banking institutions are routinely considering their bankruptcy alternatives among other options. Banking regulators have been supportive of transparent and well-planned Chapter 11 restructurings and have acted reasonably promptly to review and approve live transactions. In both the AmericanWest Bank and Anchor BanCorp transactions, bank regulatory clearances were received and the transactions were completed less than 60 days after the bankruptcy filing.

More than 500 institutions remain on the FDIC's troubled bank list, more than 100 institutions have failed to repay their TARP obligations, the coupon rate on TARP obligations is set to increase from 5 to 9 percent, and the coupon deferral period on many trust-preferred securities is set to expire. Considering these pressures, we anticipate that more banking institutions will pursue bankruptcy recapitalization strategies in 2014.

Enforcement of Make-Whole Provisions in Bankruptcy: The Importance of Careful Drafting

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Indentures typically contain provisions that offer protection to bondholders and borrowers in the event of early repayment of or, in some instances, default on the loan. This includes make-whole provisions, which traditionally have compensated bondholders for the loss of future interest payments in situations where, because of declining market interest rates, the borrower voluntarily prepays its debt obligations. Make-whole provisions therefore can be best understood as lender-side protections that allow for prepayment in exchange for a sum to compensate the lender for the loss of its bargained-for investment yield. Without such protections, bondholders would suffer damages to their investment yield if forced to reinvest the prepaid funds.

While bondholders have relied on make-whole provisions in voluntary redemption contexts for years, their right to recover their investment in default situations has been the cause of frequent litigation. As borrowers seek Chapter 11 protection to refinance their debt at lower interest rates, bondholders have faced serious obstacles to recovering their make-whole payments. Similarly, borrowers have found themselves on the losing end in litigation, as courts have ordered them to execute the make-whole provisions in their loan agreements. Three 2013 decisions have reinforced the importance of clear contractual language that protects bondholders and borrowers should Chapter 11 cast a shadow over the trust indenture.

Voluntary Redemption Versus Acceleration of Debt

Indentures often draw a distinction between a borrower's voluntary early redemption and acceleration of principal because of a borrower's default, either by a missed payment or automatically upon the borrower's filing of a bankruptcy petition. In the latter case, a make-whole premium may not be due if the default operates to accelerate the maturity date for the entire amount of the debt because the bondholders are forcing early repayment (as opposed to the borrower electing early repayment prior to the maturity date).

However, the issue becomes less clear where, after acceleration caused by a bankruptcy default, the borrower elects to repay the loan early to refinance its debt at lower interest rates. In these circumstances, bondholders and borrowers have fought intensely over the scope of the make-whole protection. In earlier litigation involving the US Airways, Solutia and Calpine reorganizations, the courts held that automatic acceleration of debt under a bankruptcy provision, also known as an *ipso facto* clause, negates any right to a make-whole premium because, absent clear contractual language to the contrary, automatic acceleration would result in the acceleration of the maturity date, and any repayment that follows would necessarily occur after the maturity date.

The 2013 cases — *School Specialty*, *GMX Resources* and *AMR Corp.* (in connection with American Airlines) — have taken the issue a step further, stressing that the key to whether bondholders may recover their bargained-for make-whole premium is whether the contractual language in the governing agreements clearly provides for payment of the make-whole premiums upon acceleration — even an automatic acceleration under Chapter 11 — or only in the event of a voluntary early redemption.

Clear Contractual Language

Specific Provisions. In *School Specialty* and *GMX Resources*, the bankruptcy courts found that the governing agreements specifically provided for payment of the make-whole premium, even in the event of a bankruptcy default and acceleration. In both cases, the governing agreements provided for a make-whole premium if the loan was prepaid or accelerated before the stated maturity dates.¹ In contrast, in *AMR*, the U.S. Court of Appeals for the Second Circuit affirmed the bankruptcy court's finding that the clear contractual language of the relevant indentures provided that the voluntary bankruptcy filing acted to automatically accelerate the debt to maturity.² The relevant indentures expressly stated that no make-whole payment was due upon automatic acceleration.³

Rejected Arguments. In each of these cases, the courts also rejected attempts by the challenging parties to overcome the clear and unambiguous terms of the governing agreements.

In both *School Specialty* and *GMX Resources*, the courts found that the make-whole provisions provided for liquidated damages that were enforceable as a matter of state law, and rejected the arguments that the make-whole payments were "unmatured interest,"⁴ for which claims are not allowed under the U.S. Bankruptcy Code. In both *School Specialty* and *GMX Resources*, the objecting parties also argued that the make-whole amount was a penalty or plainly disproportionate to the claimants' loss and, accordingly, the make-whole provisions were not enforceable under state law and therefore not allowed under the Bankruptcy Code. The courts in both cases rejected the arguments that the make-whole amounts were penalties.⁵ Additionally, in both cases the courts dismissed the argument that the make-whole payment was not reasonable under Section 506(b) of the Bankruptcy Code, which only allows a secured creditor to recover, in addition to the amount of its secured claim, "reasonable" fees, costs and charges provided for under the governing agreement or applicable state law.⁶ Indeed, the *School Specialty* court found that because the make-whole payment was not a penalty, it did not need to pass muster under the "reasonableness" test.⁷

In *AMR*, the Second Circuit dismissed the indenture trustee's various policy and statutory arguments. First, the Second Circuit rejected the trustee's arguments that only the indenture trustee could trigger acceleration and affirmed the bankruptcy court's conclusion that any attempt by the indenture trustee to waive the event of default and decelerate the debt, if indeed the contract provided for such a remedy, would be a violation of the automatic stay (from which they were not entitled to relief).⁸ (In bankruptcy, the automatic stay protects the debtor from the collection efforts and potential "race to the courthouse" of its creditors, which could result in the loss of going

¹ See Transcript of Proceedings at 26, 31, *In re GMX Resources Inc.*, No. 13-11456 (Bankr. W.D. Okla. Aug. 27, 2013); *In re Sch. Specialty Inc.*, No. 13-10125 (KJC) 2013 WL 1838513, at *1 and *6 (Bankr. D. Del. April 22, 2013).

² *In re AMR Corp.*, 730 F.3d 88, 99 (2d Cir. 2013).

³ *Id.*

⁴ See Transcript of Proceedings at 26, *In re GMX Resources Inc.*; *In re Sch. Specialty Inc.*, 2013 WL 1838513, at *1 and *6.

⁵ See Transcript of Proceedings at 18-21, *In re GMX Resources Inc.*; *In re Sch. Specialty Inc.*, 2013 WL 1838513, at *3-5.

⁶ See Transcript of Proceedings at 29, *In re GMX Resources Inc.*; *In re Sch. Specialty Inc.*, 2013 WL 1838513, at *4.

⁷ *In re Sch. Specialty Inc.*, 2013 WL 1838513, at *4.

⁸ *In re AMR Corp.*, 730 F.3d 88 at 100-01, 102.

concern value of the debtor's estate.) Second, the Second Circuit rejected the trustees' attempt to characterize repayment as "voluntary" under the governing agreement; under the provisions of the agreement, a "voluntary" prepayment would require the payment of the make-whole amount.⁹ Although American Airlines sought to refinance its obligations at more favorable rates, it only did so after its obligations had been automatically accelerated to maturity. Finally, the Second Circuit held that *ipso facto* clauses are not invalid *per se*, as the prohibition of *ipso facto* clauses under the Bankruptcy Code applies to executory contracts — contracts under which performance by both sides remains outstanding — and the contract at issue in this case was not executory.¹⁰

Implications

These decisions serve as an important reminder regarding the drafting of clear and unambiguous terms. Moreover, these decisions highlight the contractual language parties may want to use in future indentures to either avoid or ensure imposition of a make-whole payment.

Borrowers that expect to avoid make-whole payments upon the voluntary filing of a bankruptcy petition may seek clear contractual language providing that no make-whole premium is due if the obligations are repaid following a voluntary bankruptcy filing irrespective of an acceleration under an *ipso facto* clause.

On the other hand, bondholders that seek to protect themselves against voluntary debt refinancings in Chapter 11, particularly in a declining interest rate environment, may seek clear contractual language requiring payment of a make-whole premium, even after an event of default that operates to automatically accelerate the debt.

Regardless of the path bondholders and borrowers choose, the *School Specialty*, *GMX Resources* and *AMR* cases have sent a message: All indenture parties no longer can rely solely on statutory and policy arguments to determine whether a make-whole payment is due, but should carefully draft these provisions to specify the situations in which lenders are entitled to their bargained-for investment yield in the form of a make-whole payment.

“Indenture parties no longer can rely solely on statutory and policy arguments to determine whether a make-whole payment is due.”

⁹ *Id.* at 103.

¹⁰ *Id.* at 106. In *AMR*, the indenture trustee also argued that Section 1110 of the Bankruptcy Code mandated payment of the make-whole amount. Section 1110 maintains the automatic stay as against a party with a security interest in aircraft equipment, if the aircraft lessee agrees to perform "all obligations" under the governing agreement. American elected to perform under the governing agreement in order to continue using and operating the aircraft that secured the bondholders' debt. The Second Circuit rejected the indenture trustee's argument, finding that Section 1110 only required American to cure nonbankruptcy defaults. *Id.* at 110-111.

The Unsafe Harbor: The *Tribune* Decision and the Erosion of Bankruptcy Code Section 546(e)

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A 2013 court decision has cast doubts over the future scope of the U.S. Bankruptcy Code's safe harbor protections against the reversal of settled securities transactions. If the ruling stemming from the Tribune Company bankruptcy is applied to future cases, the Chapter 11 process may no longer be viewed as the method to address prebankruptcy claims conclusively.

Fraudulent Transfers and Bankruptcy Code Section 546(e) Safe Harbor

Fraudulent transfer causes of action allow creditors to unwind transactions that unfairly or improperly deplete a debtor's assets. Every state has enacted a fraudulent transfer statute that gives creditors a right to assert claims to recover fraudulent transfers. In addition, the Bankruptcy Code permits the bankruptcy trustee to undo fraudulent transfers. After a bankruptcy filing, a bankruptcy trustee (generally, a debtor-in-possession in Chapter 11 cases) has the exclusive right to assert fraudulent transfer claims (including those authorized by the Bankruptcy Code).¹ These claims can be based either on actual fraud (where the transferor had intent to hinder, defraud or delay recovery to its creditors) or constructive fraud (where the unfairness stems not from intent but from the debtor not receiving reasonably equivalent value in exchange for what it transferred).

The Bankruptcy Code, however, also places some limits on the debtor-in-possession's ability to bring avoidance actions. For example, Section 546(e) prevents a bankruptcy trustee from avoiding settlement payments made by a debtor in a securities transaction. Section 546(e) does not, however, provide a safe harbor for such settlement payments if they are shown to be an intentionally fraudulent transfer, which can be challenging, as it requires proof of the transferor's intent to harm its creditors (thus, generally requiring wrongdoing).

Prior to the September 2013 decision in *In re Tribune*,² courts generally had expanded the scope of the Section 546(e) safe harbor by interpreting it broadly to cover a wide range of transactions

The Tribune Company Bankruptcy

The *Tribune* debtors are a media company that publishes newspapers and operates radio, television stations and Internet businesses. In the mid-2000s, Tribune's financial conditions were deteriorating, and the company agreed to go private through a leveraged buyout (LBO) that paid more than \$8.2 billion to thousands of public shareholders in exchange for their Tribune shares. After the payouts were made and, as the publishing industry began to decline, Tribune was forced to file for bankruptcy in 2008;³ the company emerged from Chapter 11 in late 2012.

¹ At least some courts have held that this exclusive right to assert fraudulent transfer claims does not last forever, and that state law claims revert back to creditors when the bankruptcy trustee relinquishes the claim or no longer has a viable cause of action. See, e.g., *In re Integrated Agri Inc.*, 313 B.R. 419, 427-28 (Bankr. C.D. Ill. 2004).

² *In re Tribune Company Fraudulent Conveyance Litigation*, 11 MD 2296 (RJS) (S.D.N.Y. Sept. 23, 2013).

³ Skadden currently represents, among others, certain of the selling shareholders and the members of the special committee for the board of directors.

Under Tribune's Chapter 11 plan of reorganization, intentional fraudulent transfer claims, which are not barred by Section 546 (e), were transferred to a litigation trustee for a litigation trust created under the plan.⁴ Because the estate representative was limited to bringing actual fraudulent transfer claims against shareholders in this context, under Tribune's Chapter 11 plan, the debtors' estates disclaimed the right to assert constructive fraudulent conveyance claims against Tribune shareholders who received LBO payments for their shares. As a result, those claims would allegedly revert back to individual creditors, who subsequently filed numerous state law constructive fraudulent conveyance claims against former Tribune shareholders nationwide. In theory, thousands of creditors could sue thousands of shareholders all over the country to seek to recover more than \$8 billion in payouts from the LBO. The state law constructive fraudulent conveyance suits that were filed were consolidated into a multidistrict litigation in the U.S. District Court for the Southern District of New York.

The Court's Decision

In the multidistrict litigation, the shareholder defendants argued that Section 546(e) preempted the creditors' state law constructive fraudulent conveyance claims. However, the district court held that, by its plain language, the Section 546(e) safe harbor for securities transaction settlement payments applies only to protect such payments against fraudulent transfer avoidance actions brought by a bankruptcy trustee and does not preclude state law constructive fraudulent conveyance claims asserted by individual creditors.

The court held that individual creditors' state law constructive fraudulent conveyance claims against former Tribune shareholders were automatically stayed by Bankruptcy Code Section 362, which, among other things, provides for a broad stay of litigation upon the filing of a bankruptcy case. According to the court, the state law claims were stayed because an estate representative (in this case, the litigation trustee) already was asserting actual fraudulent conveyance claims targeting the same LBO shareholder payment transactions. The court reasoned that unless and until the estate representative actually and completely abandoned its claims, the individual creditors lacked standing to bring their own fraudulent conveyance claims targeting the same transactions. The litigation trustee has stated that it intends to proceed with its intentional fraudulent conveyance claim, but reserves its right to amend its complaint to abandon those claims.

Implications

Prior to *Tribune*, courts had expanded the Bankruptcy Code Section 546(e) safe harbor giving shareholders who received payouts in an LBO (and others participating in settled secured transactions) more comfort that their recoveries could not be avoided. The *Tribune* decision leaves open the possibility that that safe harbor provision will now be routinely circumvented.

It follows that in the wake of *Tribune*, settlement of fraudulent transfer actions by an estate representative will become more complicated. While Chapter 11 bankruptcy plans are meant to address all prebankruptcy claims conclusively, the *Tribune* ruling may impede that goal if certain claims may now be asserted outside the bankruptcy process.

In the wake of *Tribune*, settlement of fraudulent transfer actions by an estate representative will become more complicated.

⁴In this case, the official committee of unsecured creditors obtained derivative standing to stand in the shoes of the debtor-in-possession to file certain claims, including intentional fraudulent conveyance claims against the selling shareholders.

English Schemes of Arrangement Expand to Continental Europe and Beyond

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A scheme of arrangement is a tool of English corporate law that has been used in M&A and restructurings for decades. A company implementing a scheme has complete freedom to choose with which groups of shareholders and creditors to engage to achieve the desired commercial end. The longevity of schemes in English law also has allowed a broad and detailed body of case law to develop, which has engendered predictability without endangering the tool's flexibility.

In restructurings, schemes have been used to effect complex financial reorganizations tailored to the specific needs of the stakeholders. The amount of debt can be reduced with the pain shared generally in accordance with the participants' relative legal rights and other points of leverage. In the U.K., schemes often are used instead of a formal insolvency process, and they can be employed to provide more innovative solutions in administrations and liquidations than insolvency legislation can accommodate.

The appeal of English schemes of arrangement, coupled with recent case law supporting their use, has contributed to a significant increase in European companies outside of the U.K. relying on this tool to address their financial difficulties. We believe the following factors will result in this trend continuing into 2014.

Jurisdictional Flexibility. In Europe, the opening of insolvency proceedings is governed by the European Insolvency Regulation, which restricts this action to the country where a company has its center of main interests (or COMI). The COMI concept also is found in Chapter 15 of the U.S. Bankruptcy Code concerning the recognition of non-U.S. bankruptcy proceedings. However, because schemes are creatures of corporate rather than insolvency law, they are not governed by the European Insolvency Regulation — and their use is not limited to companies that have their COMI in the United Kingdom.

Governing Law Clauses. Recent case law has established that a scheme of a non-U.K. company can be implemented where the debts in question are governed by English law, and there is ample evidence to show that, if approved, the effect of the scheme would be recognized in the company's home jurisdiction. To date, schemes have been successfully implemented for companies incorporated in Spain, Germany, Italy, the Netherlands, Denmark, Bulgaria and even Kuwait. Given the prevalent use of English law clauses in international financings, the scheme has the potential to be used even more broadly in the future.

Amend-and-Extend Transactions. Traditionally, schemes have been used to effect substantial balance sheet restructurings. Schemes involve two court hearings and bespoke drafting of the scheme documents following detailed negotiations; consequently, they have tended to be deployed in more complex situations. Recently, however, schemes have been used under straightforward circumstances. A defining feature of the distressed European landscape since the global financial crisis began has been a reluctance on the part of lenders to realize losses that otherwise can be avoided. This has led to what are sometimes called "amend-and-extend" transactions under which maturities are pushed out and other terms adjusted. This permits the company to postpone addressing what may be fundamental structural issues for the period of the extension with the hope that the economic environment will improve. Several European

companies, including Spanish retailer Cortefiel and German roofing supplier Monier, successfully used schemes in 2012 and 2013 to obtain amend-and-extend agreements on their debt facilities.

No Creditor Consensus, No Problem. There appears to be an increasing appetite to use schemes in a broader set of financial circumstances to address the problem posed by holdout creditors. Finance agreements often require unanimity — an often impossible threshold to achieve — to amend key terms such as the amount of principal and maturity dates. When this happens the results can include deadlock, having to pay holdouts in accordance with the original terms or even the failure of the business. A scheme provides a method of binding a minority to a new deal.

Stay on Legal Proceedings. Since it is not a creature of insolvency law, the proposal of a scheme does not give rise to a moratorium to prevent creditors from taking action against the company to maximize their own recovery or to derail the scheme itself. In *Bluecrest Mercantile BV v. Vietnam Shipbuilding Industry Group* [2013] EWHC 1146 (Comm), a recent English High Court case on this issue, monies had come due under a facility, and two of the lenders sought summary judgment. The company had no defense to the claim, but negotiations on a scheme were reasonably well-advanced. The court used its inherent case management powers to grant a temporary stay to give the chance for a scheme to be developed and approved. It will be interesting to monitor whether the grant of a stay becomes a relatively common feature of the scheme process.

* * *

As the eurozone crisis continues to linger and companies and investors seek to remedy financial distress, the use of schemes is expected to grow in European restructurings where there is significant English law-governed debt. Notwithstanding some recent changes to the formal insolvency processes in countries such as Spain and Germany, European borrowers should view the British legal system's unique tool as an additional aid in navigating the restructuring process.

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The New Challenge With Defining Insolvency in the UK

The statutory gateway to an insolvency process under U.K. law hinges on the definition of insolvency in the Insolvency Act 1986 (IA 1986). However, a 2013 decision by the Supreme Court of the United Kingdom has created ambiguity over the definition and has cast significant doubt on whether creditors can continue using a long-standing test to determine whether a company is insolvent.

Traditional UK Insolvency Definitions

In the U.K., a company may be wound up if one of two statutory provisions are proved to the satisfaction of a court:

- The company is unable to pay its debts as they fall due (the cash-flow test); or
- The value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities (the balance-sheet test).

In *BNY Corporate Trustee Services Ltd v. Eurosail* [2013] 1 WLR 1408, the Supreme Court analyzed the balance-sheet test for the first time. Its decision suggests that, except for the clearest cases, this test will be very difficult for a creditor to use to establish an insolvency event of default.

Background

Eurosail is a special purpose vehicle that was formed by Lehman Brothers in 2007. It acquired sterling-denominated mortgage-backed loans using the proceeds of long-term notes denominated in sterling, U.S. dollars and euros. The rights of the various noteholder classes, including their relative priority, were set out in the finance documents. Such provisions sometimes are known as the payment or priority "waterfall": As cash becomes available, it flows down to meet payment obligations, starting with the most senior noteholders and ending with the most junior class.

Lehman's collapse in 2008 caused adverse movements in foreign exchange rates after currency hedging arrangements were terminated between Eurosail and Lehman. This resulted in a slowdown in the rate at which Eurosail was repaying the non-sterling notes. One class of noteholders wanted to trigger a contractual change to the payment waterfall to improve the speed at which they would have been repaid (albeit at the expense of other noteholders). The finance documents provided that either cash-flow or balance-sheet insolvency was an event of default. The dissatisfied noteholder group alleged that Eurosail was insolvent on a balance-sheet basis only as it was patently able to pay its obligations as they fell due. The latest financial statements of Eurosail showed net liabilities of about £75 million and assets exceeding £600 million, and the applicant noteholders relied on this as clear evidence that the balance-sheet test had been triggered.

The Court's Decision

Last year, the Supreme Court unanimously held that the noteholders had failed to establish that Eurosail was insolvent on a balance-sheet basis. A petitioner has to establish to the satisfaction of the court that, on the balance of probabilities, a company has insufficient assets to be able to meet all its liabilities, including prospective and contingent liabilities. Eurosail was a structured finance vehicle with income and payment obligations stretching out for 30 years. In such a case, a court should be very cautious in finding balance-sheet insolvency when the company was meeting current liabilities as they fell due. The noteholders faced an even greater hurdle in making their case, as there are inherent uncertainties to determining the levels of future interest and foreign exchange rates over an extremely long period of time.

The Court also held that the assessment of whether a company is balance-sheet insolvent may differ from a company's balance sheet prepared in accordance with U.K. companies legislation. In particular, the assessment of future and contingent liabilities may be different from the standard company accounting approach. Significantly and unfortunately, the Court offered no guidance on how this assessment should be conducted.

Implications

A hostile creditor rarely has access to anything other than a company's publicly available financial information. On the back of this judgment and absent extreme facts, it will be extremely challenging for a creditor to establish balance-sheet insolvency, and it remains for future cases to cast meaningful light on what valuation approach or approaches are appropriate. In the meantime, a prudent lender may wish to negotiate a balance-sheet event of default measurable by reference to the accounting standards ordinarily applicable to the borrower rather than the test set out in the Insolvency Act 1986.

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Restructuring ELA Liabilities: Lessons From Ireland

The Irish banking crisis has provided some insights into the use by EU member states of emergency liquidity assistance (ELA), which supports financial institutions or markets that are experiencing an exceptional and temporary crisis of liquidity. As other EU member states' banking systems continue to struggle with their debt in 2014, the approach used to restructure the ELA liabilities of the Irish Bank Resolution Corporation (IBRC) merits consideration.

How ELA Works

In many states, the discretionary use of ELA is one of the core functions of the national central bank, which acts as a "lender of last resort." Typically, the national central bank will create money and lend it to a troubled financial institution with the intention that, upon repayment, the money will be destroyed; the aim is to provide support to meet the demands of a crisis without making a long-term impact on a country's monetary policy.

In EU member states that use the euro as their currency, the national central banks have remained in existence, retaining their former powers and functions subject to the restrictions on monetary sovereignty imposed by several legislative instruments.¹ The banks are entitled to engage in ELA programs unless expressly prevented by a two-thirds majority vote of the European Central Bank's (ECB) Governing Council. However, any proposed use of ELA still must be communicated to the ECB in advance in accordance with published procedures,² giving the ECB a central role in governing the use of ELA within the eurozone. Despite the ECB's role, the national central banks remain responsible for providing the emergency liquidity, and their member states assume the costs and risks,³ which makes ELA an exception to the eurozone's single monetary policy. The ECB's involvement in the process has led to some erroneous commentary suggesting that the ECB has lent money to eurozone banks through ELA.

Study of ELA activity is complicated by the veil of secrecy (deployed in the interests of systemic stability) that shrouds not only the negotiation of ELA proposals between the ECB and national central banks, but also the provision of ELA to particular institutions. In many cases, the existence of an ELA program is discernible only through a close reading of national central banks' published balance sheets, while the identities of ELA recipients will not be publicized. However, during the global financial crisis, this veil was lifted to some extent, as the ELA liabilities of certain eurozone banks to their respective national central banks became public knowledge in the context of the "bail-outs" of troubled eurozone states. Very significant and potentially destabilizing ELA liabilities in certain states were important factors in the negotiation of assistance programs. IBRC was one of the more remarkable known instances of a financial institution with very

Very significant and potentially destabilizing ELA liabilities in certain states were important factors in the negotiation of assistance programs.

¹ These include the Treaty on the Functioning of the European Union (TFEU) and the Statute of the European System of Central Banks and of the European Central Bank (ESCB Statute), which set out the powers and functions of the European Central Bank. Note that the ESCB Statute is drafted to apply to all national central banks within the EU, but that its application to national central banks outside the eurozone is limited by Article 139 of the TFEU and Article 42 of the ESCB Statute.

² European Central Bank Eurosystem, *ELA Procedures*, (Oct. 17, 2013), available at <http://www.ecb.europa.eu/pub/pdf/other/elaprocedures.en.pdf>.

³ "Responsibility for the provision of ELA lies with the NCB(s) concerned. This means that any costs of, and the risks arising from, the provision of ELA are incurred by the relevant NCB." *Id.*

The restructuring of IBRC's liabilities may be an instructive example going forward for other member states with troubled financial sectors.

significant ELA liabilities, and the restructuring of these liabilities may be an instructive example going forward for other member states with troubled financial sectors.

The IBRC Restructuring

The July 2011 court-mandated merger of Anglo Irish Bank and Irish Nationwide Building Society, which had been taken into public ownership by the Irish government during the crisis, created IBRC.

Both banks had suffered heavy losses largely as a result of over-exposure to the Irish property lending market. Anglo Irish, the larger of the two, experienced a dramatic loss of access to funds in the years before the merger; between 2007 and 2010, its funding from deposits and debt securities declined from €82 billion to €19 billion. The Central Bank of Ireland (CBI) started providing ELA⁴ financing to Anglo Irish in 2009. The scale of support given to the bank was vast: At the end of June 2011, Anglo Irish had ELA liabilities of around €40 billion. Irish Nationwide experienced similar problems and also was supported with much smaller amounts in ELA. As a result of the merger, the publicly held IBRC owed approximately €42 billion in ELA debt to the CBI, guaranteed by the Irish government.⁵

To support IBRC's ELA liabilities repayment, the Irish government first issued promissory notes to IBRC, which provided for payments to IBRC of €3.1 billion per year for the period of about 10 years that it would take IBRC to repay the CBI. However, many commentators on the deal expressed concerns that this approach was not satisfactory, as it allowed a large, long-term burden to remain on the Irish public finances (the annual payments of €3.1 billion would represent about 2 percent of Irish GDP), which would prevent a return to fiscal health. The arrangement also may have contravened the EU's prohibition on monetary financing,⁶ although no legal action was taken.

As a result, a more radical restructuring was enacted. An agreement was reached whereby the promissory notes held by IBRC were retired, in return for which the government provided long-dated bonds worth €25 billion. The new bonds have a maturity range from 27 to 40 years and an interest rate of six-month Euribor plus 263 basis points. Next, in a February 2013 parliamentary session, emergency legislation was passed to wind up IBRC, with the result that the bonds ended up in the hands of the CBI.

The key element of the restructuring is that the CBI undertook to sell the bonds to the private sector in accordance with a schedule that imposes a gradually increasing minimum annual sales level until all the bonds are sold in the early 2030s (although, financial stability permitting, the government has stated it may dispose of the bonds as early as possible). Because the CBI's profits are returned to government funds, the plan

⁴ Known in Ireland as "Exceptional Liquidity Assistance."

⁵ Karl Whelan, *ELA, Promissory Notes and All That: The Fiscal Costs of Anglo Irish Bank* (September 2012), available at <http://www.karlwhelan.com/IrishEconomy/Whelan-PNotes-September2012.pdf>.

⁶ Article 123 TFEU: "Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States ... in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments."

means that initially the coupon on the bonds will mostly return to the government, but gradually over time, the amount paid out to private investors will increase as the bonds are sold on.

The result is that IBRC has been liquidated, and its huge and destabilizing ELA liabilities have been replaced by a program of gradually increased borrowing by the government from investors over a 40-year period, with the primary burden falling at a time when inflation, economic growth and a return to fiscal health may be expected to have reduced its impact. There may be some dispute as to the compliance of the plan with the EU's legislative guidelines — although the bonds were not directly provided to the CBI under the restructuring, the mechanism by which IBRC was forced into liquidation was part of a prearranged scheme. The ECB has indicated that it will not seek to challenge the restructuring, illustrating further the pragmatic approach to interpretation of EU law that it has routinely employed during the crisis when financial stability is otherwise endangered.

Despite the restructuring's success, the *Financial Times* reported in September 2013 that Elliott Management, once of IBRC's creditors, was seeking to investigate the circumstances surrounding the liquidation. What, if anything, might come of aggressive investor action in this case remains unclear. Regardless, the IBRC approach to restructuring ELA liabilities may provide a useful example in 2014, as other EU member states, such as Cyprus and Malta, attempt to come to terms with similar problems in their own banking systems.

Financial Regulation

The past year marked important turning points in the global regulation of financial institutions. In the United States, federal financial policymakers declared their work implementing the 2010 Dodd-Frank Act to be largely finished. Although completion of a number of important rules remains, U.S. regulators wrapped up 2013 with the promulgation of the Volcker Rule, the largest and longest pending of all of the Dodd-Frank rules. Combined with the departure of the last regulatory heads who worked on the passage of Dodd-Frank, this signals a shift from the creation of new rules to a period in which the primary focus will be on implementing new powers through supervision and enforcement efforts.

In the EU, steady progress continues to be made on a number of regulatory fronts, including investment management, derivatives and capital adequacy rules. However, a credible implementation of a framework of financial institution supervision covering the eurozone and most of the EU, together with expected political agreement on how to resolve troubled financial institutions, would give the EU a seminal opportunity to create a more robust and integrated financial services system that can more readily support the EU's monetary union and capital markets.

The new year brings important questions about how these new powers will be used and whether the hopes for more robust global economic growth can be reconciled with regulators' efforts to ensure the safety and soundness of individual institutions and the financial system. Changes in the regulatory environment, coupled with changes in the markets, are likely to encourage global financial organizations to explore opportunities to shed certain businesses and assets, while acquiring others to build upon their strengths. The effect will be a reshaping of global finance and the institutions that inhabit that landscape over the balance of this decade.

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Entering a New Regulatory Era Under the Final Volcker Rule

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In December 2013, five U.S. financial regulatory agencies adopted final regulations to implement the Volcker Rule.¹ As expressed in the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Volcker Rule generally prohibits banking entities from engaging in proprietary trading, but permits certain types of proprietary trading activities — including underwriting, market making and risk-mitigating hedging. The Volcker Rule also prohibits banking entities from making substantial investments in, and conducting certain other activities with respect to, private equity funds and hedge funds. The Volcker Rule represents an effort to separate the “social safety net” afforded by the Federal Reserve’s discount window (which provides short-term, low-interest loans to banking institutions to cover shortages of liquidity) from risks incurred by financial institutions through their own short-term investments.

Overview

The Volcker Rule is intended to prevent the type of proprietary trading that poses significant risks to a banking entity and the financial system while allowing the banking entity to continue to provide services, including underwriting and market making, that are considered essential commercial banking functions. The actions that banking entities and their regulators will take in 2014 as they adapt to life under the final rule will begin to reveal answers to the following key questions:

- In a dynamic and rapidly evolving trading environment, will the final rule provide market participants and regulators with the interpretive tools necessary to distinguish permitted underwriting, market making and hedging from prohibited proprietary trading?
- Will the final rule impose costs on banking entities that will impair the efficiency of the market for financial services?
- Will the final rule create distortions and imbalances in the supply of and demand for financial instruments? Will the final rule increase the cost and decrease the availability of credit?

In 2014, each financial institution subject to the Volcker Rule must begin the interpretive and administrative work necessary to bring its trading practices into conformity with the rule and to implement the internal compliance systems the rule requires. Foreign financial institutions also must assess their global operations, in light of the extraterritorial reach of the final rule, to ensure they either comply with the prohibition on proprietary trading or with the specific standards set forth in the final rule with respect to the locus of the decision makers in a purchase or sale of financial instruments and the other extraterritorial requirements of the final rule. Additionally, institutions will face uncertainty as to the range of potential interpretations that each agency may adopt as it applies and enforces the final rule. This uncertainty is magnified by the complexity, ambiguity and subjectivity of the rule’s provisions and the discretion that the final rule provides regulators. During the coming year, observers will attempt to ascertain whether the rule will chill the market-making activities and other essential services and functions it intends to permit and, thus, drive up the cost of capital in the U.S. financial markets.

¹ <http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm>.

Aspects of the final rule may be challenged in 2014; moreover, legislative and regulatory initiatives may affect its application. Since the release of the final rule in December, the following potential sources of change have emerged:

- The American Bankers Association filed a lawsuit to block portions of the final rule that treat debt interests in collateralized debt obligations of trust-preferred securities as ownership interests in a covered fund. In response to the lawsuit, the regulators have issued an amendment to the final rule, which permits banking entities to retain interests in certain collateralized debt obligations backed primarily by trust preferred securities.
- The chairman of the House Financial Services Committee and the chairwoman of the Financial Institutions Subcommittee introduced legislation to allow ownership of covered funds “predominantly” backed by trust-preferred securities held prior to the release of the final rule. Senate Republicans have introduced broader legislation that would allow ownership of debt securities issued by collateralized loan obligations prior to the adoption of the final rule. Senators Manchin and Wicker have introduced legislation that would allow institutions with total consolidated assets below \$50 billion to retain ownership of collateralized loan obligations where the “primary purpose” was to be a vehicle for trust preferred securities and the investment was made prior to the adoption of the final rule. All of the legislative proposals are broader than the amendment to the final rule. Other similar proposals may be introduced in the coming weeks.
- A recent letter from the chairman of the House Financial Services Committee to the chairwoman of the SEC asserted that the absence of cost-benefit analysis from the rulemaking process violates federal law. As noted in the letter, the courts have supported challenges to other regulations issued under Dodd-Frank on the grounds that the rulemaking process was “arbitrary and capricious” due to insufficient analysis of the economic consequences.
- Reports in the media indicate that the European Union plans to implement its own ban on proprietary trading, bringing the EU’s approach to regulation of its largest financial institutions more into congruence with the Volcker Rule. This represents a departure from previous expectations that the EU would, rather than imposing any such ban, follow some EU national governments in requiring financial institutions to “ring-fence” their proprietary trading and other investment banking activities into a separate business unit or subsidiary.²

Institutions will face uncertainty as to the range of potential interpretations that each agency may adopt as it applies and enforces the final rule.

Applicability

Subject to certain exclusions, the final rule applies to the following types of entities and their affiliates or subsidiaries:

- any FDIC-insured depository institution;
- any company that controls an FDIC-insured depository institution; and
- any company that is treated as a bank holding company under the International Banking Act of 1978.

² See The Vickers Report: The UK Proposal to ‘Ring-Fence’ Banking Operations, available at http://www.skadden.com/sites/default/files/publications/Skadden_2012_Insights_Financial_Regulation_0.pdf.

Although the compliance and reporting obligations mandated by the final rule are scaled to the size of the regulated entity, the fundamental prohibitions apply to banking entities of any size. The final rule does not address how the restrictions might apply to nonbank entities designated as systemically important financial institutions (SIFIs). The preamble to the final rule notes that two of the three companies currently designated as nonbank SIFIs are affiliated with insured depository institutions and are, therefore, covered by the final rule as banking entities. The regulatory agencies are continuing to consider whether the remaining nonbank SIFI engages in activity subject to the final rule and what requirements may apply.

Prohibited Proprietary Trading

The final rule prohibits banking entities from engaging in proprietary trading, subject to certain exceptions. For these purposes, proprietary trading means “engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments.” A trading account is generally an account used for short-term trading activities. The final rule includes a rebuttable presumption that purchases or sales of a financial instrument are for the trading account of the institution if held for fewer than 60 days or if the banking entity substantially transfers the risk of a financial instrument within 60 days of the purchase or sale.

The final rule permits banking entities to pursue the following permitted activities:

- underwriting and market making-related activities,
- certain risk-mitigating hedging activities,
- trading on behalf of customers,
- trading by a regulated insurance company and its affiliates for the general account of the insurance company,
- trading in certain domestic and foreign government obligations (in order to support markets in those obligations), and
- trading activities of foreign banking entities.

None of the foregoing activities is permitted if it involves a material conflict of interest, results in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy, or poses a threat to the safety and soundness of the banking entity or to the financial stability of the United States. Under the final rule, banking entities engaged in permitted activities, including underwriting, market making and risk-mitigating hedging, must establish internal compliance programs that contain reasonably designed written policies and procedures, internal controls, analysis and independent testing. These heightened compliance program requirements will force significant and expensive changes in the structure and operations of the regulated entities. The cost of these changes may be mitigated, however, to the extent that the final rule allows internal policies and procedures to be tailored to different markets and asset classes based on characteristics such as liquidity.

A detailed discussion of the final rule’s prohibition on proprietary trading is available at <http://www.skadden.com/insights/proprietary-trading-restrictions-under-final-volcker-rule-0>.

Private Equity Funds and Hedge Funds

The Volcker Rule generally prohibits banking entities from making investments in “covered funds.” The final rule defines a covered fund to include:

- an issuer that would be an investment company as defined in the Investment Company Act of 1940 but for Section 3(c)(1) or Section 3(c)(7) thereof;
- any commodity pool for which the commodity pool operator has claimed an exemption under CFTC Rule 4.7 or a commodity pool that is substantively similar; and
- foreign funds sponsored or owned, directly or indirectly, by a U.S. banking entity (except foreign public funds).

Although the final rule expands the statutory definition of a covered fund by including commodity pools, it (unlike the original proposal) covers only those commodity pools that are offered privately to investors who meet a heightened sophistication standard — much like traditional hedge funds or private equity funds.

The final rule excludes certain categories of entities from the definition of covered fund. Entities that are specifically excluded include wholly owned subsidiaries, joint ventures, acquisition vehicles, foreign pension funds, insurance company separate accounts, bank-owned life insurance funds, certain loan securitization entities, qualifying asset-backed commercial paper conduits, qualifying covered bonds, small business investment companies and public welfare investment funds, registered investment companies and business development companies, and funds exempt or excluded from the Investment Company Act of 1940 that rely on an exemption or exclusion other than Section 3(c)(1) or Section 3(c)(7).

Despite the ban on investments in covered funds, however, the final rule allows banking entities to continue to sponsor and invest in covered funds, subject to certain exemptions. These “permitted funds exemptions” allow banking entities to provide covered funds with seed capital. They also allow for *de minimis* investments generally of no greater than 3 percent of the value of the fund and, across the institution’s investments in all covered funds, of no greater than 3 percent of the institution’s tier 1 capital.

Impact on Securitizations

The Dodd-Frank Act provides that the Volcker Rule should not be construed to limit or restrict the ability of a banking entity to securitize loans, but the definition of covered fund in the final rule is broad enough to encompass many securitization transactions. The final rule excludes certain types of securitizations, but it will nonetheless have a significant impact on certain active segments of the securitization market, particularly collateralized loan obligations (CLOs) and asset-backed commercial paper (ABCP) conduits. Sponsors may be able to structure new CLOs and ABCP conduits and other securitizations of financial assets to take advantage of the exclusions provided under the Volcker Rule for loan securitizations, qualifying ABCP conduits and wholly owned subsidiaries of banking entities. Certain existing securitization entities, however, will be considered covered funds under the final rule. Banking entities will generally not be permitted to hold ownership interests in covered funds after the extended conformance period ends in July 2015 (subject to any further extension).

The broad reach of the covered fund definition forces banking entities to consider whether any securitization entity that they organize or in which they invest will be

viewed as a covered fund. If so, they must examine whether they have an ownership interest in the covered fund, act as a sponsor with respect to the covered fund or have other relationships with the covered fund, including market-making activities, that may now be limited or prohibited. Ownership interest is broadly defined to include not only equity interests but also traditional debt securities that have rights to participate in the removal or replacement of an investment manager for a covered fund, which includes debt securities issued by most CLOs.

A detailed discussion of the final rule's impact on securitizations is available at <http://www.skadden.com/insights/structured-finance-alert-final-volcker-rule-impact-securitizations>.

Compliance and Reporting Requirements

The final rule imposes a number of compliance and procedural requirements on banking entities. It applies increasingly stringent and comprehensive compliance requirements to banking entities that are larger and more heavily involved in covered activities.

The most rigorous compliance requirements apply to banking entities with at least \$50 billion in total consolidated assets (or \$50 billion in U.S. assets in the case of non-U.S. banking entities), as well as banking entities with significant trading assets. These institutions must implement a "six pillar" compliance program and meet "enhanced" standards for compliance, which include a requirement that the chief executive officer provide an annual attestation, in writing, to the appropriate regulator that the banking entity employs a compliance program reasonably designed to achieve compliance with the final rule.

Beginning on June 30, 2014, banking entities with \$50 billion or more in worldwide trading assets and liabilities (excluding certain U.S. government obligations) will be required to report specified quantitative metrics regarding their trading activities to the applicable agency. That threshold is reduced to \$25 billion on April 30, 2016, and to \$10 billion on December 31, 2016.

Expected Developments

In 2014, participants in the financial services industry will begin to bear the burden of interpreting and operating within the new regulatory environment created by the Volcker Rule. The agencies charged with administering the rule will similarly be forced to confront the interpretive and practical challenges it presents. The courts also may be called upon to interpret various aspects of the rule. The interactions to come among the financial industry, the regulators and the courts, as each develops its understanding of and approach to the final rule, will begin to reveal the full extent of its impact.

Bank Regulators Eye Leveraged Lending

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Historically low interest rates in the United States have helped to fuel tremendous growth in leveraged loans. Leveraged loan volume in 2013 surpassed record levels set just prior to the global financial crisis, as banks and other institutional investors sought opportunities with potentially higher returns from more highly leveraged borrowers. In response to the substantial growth and significant participation of unregulated non-bank entities, U.S. bank regulators appear to be paying closer attention to the leveraged lending activities of their regulated banks. We expect this attention to continue in 2014, and banks will need to consider how new guidelines will affect their leveraged lending activities.

The Interagency Guidance on Leveraged Lending

On March 21, 2013, the Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation issued updated guidance outlining principles related to safe and sound leveraged lending activities for banks operating in the United States. The Interagency Guidance on Leveraged Lending (the Guidance) replaces interagency guidance on this topic from 2001 and takes a more detailed and prescriptive approach than its pre-economic crisis predecessor. Nevertheless, the Guidance remains vague, and many institutions have expressed concern, if not confusion, about how they should implement it. Of note, the Guidance includes the following:

- **Call for clear underwriting and risk rating standards.** Emphasizing the importance of sound lending practices following the financial crisis, the Guidance stressed the need for clear, written and measurable underwriting standards regardless of whether the loan is underwritten to hold or distribute. Banks must closely analyze the ability of the borrower to de-lever to a sustainable level over a reasonable period of time; the Guidance generally suggests that institutions look at whether base case cash-flow projections show the ability to fully amortize senior secured debt or repay a significant portion of total debt over the medium term. Similarly, with regard to a bank's internal risk rating of loans, the Guidance notes that supervisors assume that the ability to fully amortize senior secured debt or the ability to repay at least 50 percent of total debt over a five- to seven-year period provides evidence of adequate repayment capacity.

Institutions also must scrutinize covenant protections in credit agreements, including the lack of meaningful financial maintenance covenants that require a borrower to maintain certain financial metrics. The Guidance notes that a leverage level after asset sales in excess of 6X Total Debt/EBITDA raises concerns for most industries, and thus the loan may be criticized.

- **Standards that differ from certain market practices.** The Guidance articulates certain standards that conflict with those of many market participants, particularly unregulated nonbank entities, that accept (i) projected levels of amortization significantly lower than that referenced in the Guidance and rely on refinancing capacity in the market for repayment, (ii) "covenant-lite" term loans or (iii) in certain cases, higher leverage levels.

- **Detailed board and senior management reporting.** The Guidance includes detailed requirements for the level and type of reporting and monitoring, as well as board and senior management involvement, and suggests at least 14 metrics for leveraged lending reports. Banks likely will need to invest substantial organizational and financial resources to update management information systems to generate accurate and timely reports.
- **Stress testing the portfolio.** The Guidance directs a bank to develop and implement periodic portfolio stress tests of leveraged loans originated to hold and loans originated to distribute. The stress tests are meant to assess how economic changes will impact asset quality, earnings, liquidity and capital.

The *SNC Review*

The Guidance became effective in May 2013. In September, the bank regulators issued the *Shared National Credit (SNC) Review*, an annual interagency review of large, complex credits shared by multiple banks. The *SNC Review* highlighted the significant volume of leveraged loans both as a whole and as a percentage of total criticized SNC assets (although the volume of criticized assets generally has decreased since 2009). Leveraged loans in the SNC portfolio totaled \$545 billion. Forty-two percent of the leveraged loans in the SNC portfolio were criticized by examiners. By contrast, 10 percent of the loans in the total SNC portfolio were criticized. Criticized assets include all assets rated by examiners as either “special mention,” “substandard,” “doubtful” and “loss,” as defined by the agencies’ uniform loan classification standards and examination manuals.

The *SNC Review* also cited material weaknesses in underwriting practices, a high volume of leveraged loans to borrowers without a capacity to de-lever over a reasonable period of time and a lack of meaningful financial covenants. The *SNC Review* specifically cited in this regard the reduced number of financial maintenance covenants, the use of net debt in many leverage covenants and various provisions that allow increased debt above starting leverage and the dilution of senior secured positions. According to the report, 34 percent of recently originated transaction structures were cited as weak due to a combination of high leverage and absence of financial covenants.

Additional Observations

The regulators have made clear they intend to scrutinize leveraged lending practices closely. Following the *SNC Review*’s release, several news reports indicated that the regulators sent individual letters to several banks. The regulators reportedly told the banks they had 30 days to come up with a plan for tighter procedures. Additionally, at least one high-ranking OCC official has said publicly that the regulators are looking to deter the origination of criticized or below-standard loans and alluded to the supervisory tools regulators have available, including enforcement orders and lower supervisory ratings. Both tools can have a significant impact on a bank’s ability to receive required approvals from regulators or otherwise operate consistent with their intended business plans.

The annual stress-test scenarios are another indication that the bank regulators are focusing increased attention on leveraged lending. On November 1, 2013, the Federal Reserve released the scenarios for the 2014 capital planning and stress tests. The adverse and severely adverse scenarios include factors that will test a bank’s response to changes in economic conditions that may affect the performance of leveraged and

Regulators have made clear they intend to scrutinize leveraged lending practices closely.

other high-risk loans, such as the widening of U.S. corporate borrowing spreads. A bank's negative performance in the annual stress test could impact its ability to make capital distributions, such as dividend payments or stock repurchases.

Other recent final rules suggest banks will need to pay more as they increase the volume of the leveraged loans they hold. For example, in 2011 and 2012, the FDIC revised its deposit insurance assessment scheme so that banks will pay higher deposit insurance premiums if they have higher-risk assets, including leveraged loans. The FDIC's scorecard for highly complex banks considers the ratio of a bank's higher-risk assets to its tier 1 capital and reserves.

The traditional bank regulators' focus on credit and its impact on the health and performance of individual banks may explain the attention on leveraged lending only in part. Since the economic crisis, regulators also have focused on macroprudential risk. The regulators' view that banks should treat equally loans they intend to hold and distribute may be specific evidence of this concern. A large number of the loans subject to the Guidance are originated by the banks to be held by unregulated nonbank entities that are the primary buyers of riskier loans. The Guidance articulates a concern that the risks associated with poorly underwritten transactions can impact a wide array of investments and exacerbate systemic risks within the general economy.

* * *

It remains to be seen to what degree the Guidance will restrain terms for leveraged loans in a robust credit market or increase the cost of credit for borrowers of leveraged loans. In the meantime — and regardless of a regulator's motive — banks will need to pay close attention to leveraged lending or face unwelcome consequences. Although the Guidance technically is nonbinding, banks that do not implement strong risk management processes consistent with the Guidance may be criticized by examiners and found to be engaging in unsafe and unsound banking practices warranting enforcement actions.

Financial Institutions Wrestle With FATCA Implementation

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Over the past year, financial institutions have wrestled with the challenges presented by the U.S. Foreign Account Tax Compliance Act (FATCA). Originally scheduled to take effect in 2013, the U.S. Treasury Department and IRS have delayed FATCA several times to give financial institutions more time to comply with the legislation's substantial burdens. As the current implementation date of July 1, 2014, approaches, financial institutions must continue to prepare despite the significant hurdles that remain.

Background

Congress enacted FATCA as part of the Hiring Incentives to Restore Employment (HIRE) Act in 2010 in a legislative effort to stop U.S. taxpayers from evading U.S. taxes through undisclosed offshore accounts. FATCA places significant requirements on foreign financial institutions, a term defined broadly to include not only foreign banks and custodial institutions, but also certain foreign insurance companies and investment entities such as hedge funds and private equity funds. FATCA requires foreign financial institutions to agree to report information about the holdings of U.S. taxpayers to the IRS. Failure to comply will result in an institution suffering 30 percent withholding tax on certain payments it receives from U.S. sources. FATCA also places new withholding and reporting obligations on U.S. financial institutions with respect to payments they make to foreign financial institutions and other foreign entities.

Industry Response and Intergovernmental Agreements

Many financial institutions have devoted considerable time and resources getting ready for FATCA. The effort involves putting into place new data collection systems and account opening procedures, performing due diligence with respect to existing accounts, and preparing for the extensive new withholding and information reporting that FATCA will require, among other things. Yet despite the progress of financial institutions to prepare for FATCA — and the Treasury Department and IRS having published detailed regulations, notices and other guidance — questions remain. Perhaps the most notable centers on the specific requirements that different foreign jurisdictions may impose pursuant to intergovernmental agreements (IGAs) with the United States.

For almost two years, the Treasury Department has worked to address local law impediments, such as bank secrecy laws that prevent the disclosure of information FATCA requires. The Treasury has been negotiating IGAs with different countries to facilitate the enforcement of FATCA in those jurisdictions by, for example, allowing foreign financial institutions in certain countries to report the required information to their local tax authorities (who will then provide the information to the IRS).

Although the Treasury has signed IGAs with a number of countries, many more remain in various stages of negotiation. Moreover, the IGAs contemplate that authorities in the relevant country will issue guidance implementing FATCA for institutions in that country. Yet only the United Kingdom has done so to date. As a result, financial institutions must prepare for FATCA based on the existing U.S. Treasury regulations and published IGAs. This raises a significant concern: The institutions may be preparing for specific

Financial institutions must prepare for FATCA based on the existing U.S. Treasury regulations and published IGAs.

compliance requirements that ultimately differ from the implementing guidance countries issue once the Treasury Department concludes the relevant IGAs with authorities in those countries.

Additional compliance issues include the fact that, although the Treasury has published drafts of new tax reporting forms to collect the extensive information that FATCA will require, it has yet to publish instructions and finalize the forms. Although we expect the Treasury to do so soon, this leaves a short amount of time for institutions to familiarize themselves with the detailed new forms and incorporate the reporting requirements into their systems. Financial institutions also need further guidance coordinating the existing withholding and reporting regime with the new FATCA requirements.

More Time?

In November 2013, several banking associations, including the American Bankers Association, the Clearing House Association, the Institute of International Bankers, and the Securities Industry and Financial Markets Association, asked the Treasury Department and the IRS to further delay the timeline for FATCA in light of the administrative challenges and the uncertainties still existing. Treasury and IRS officials have said, as recently as January 14, that the government will not extend the dates.

In the meantime, as FATCA's start date approaches, financial institutions undoubtedly will continue to prepare and, absent further extension, voice concerns over this far-reaching legislation.

Consumer Financial Protection Bureau Focuses on Fair Lending

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Having enacted a number of mortgage-related rules on the eve of statutory deadlines, the Consumer Financial Protection Bureau (CFPB), which now has a confirmed director, has shifted its focus to fair lending enforcement, announcing two major actions in December 2013. In 2014, we expect the CFPB to rely heavily on the disparate impact theory and continue its fair lending enforcement in a manner that may have transformative effects for auto and mortgage lending.

Since its inception with the passage of the Dodd-Frank Act, the CFPB's authority had been limited because the act required a permanent director for the bureau to exercise many of its authorities. After a court decision had called into question President Obama's recess appointment of Richard Cordray as the bureau's director, the Senate confirmed Cordray's appointment as director in August 2013. And despite a pending lawsuit challenging the CFPB's constitutionality, the bureau now is vested with authority to exercise all of the broad powers granted to it by Dodd-Frank.

Auto Lending

The bureau has closely scrutinized dealer "markup" — a common industry practice whereby dealers are compensated based on the difference between the auto finance company's "buy rate" and the interest rate negotiated between the dealer and the consumer. In March 2013, the CFPB released a bulletin stating that markup creates a risk of pricing disparities on the basis of race, national origin and potentially other prohibited bases. The bureau advised lenders to mitigate these risks by implementing a robust fair lending compliance management system that includes statistical monitoring to determine whether dealer markup compensation is higher on finance contracts with, for example, minority consumers as compared to nonminority consumers, and to provide remediation to adversely affected consumers. Alternatively, the bureau stated that dealers could mitigate fair lending risk by eliminating dealer markup compensation.

On December 20, 2013, the bureau announced a consent order with Ally Financial Inc. and Ally Bank (Ally) settling allegations that Ally's dealer compensation policies resulted in higher dealer markup on loans to African-American, Hispanic and Asian/Pacific Islander consumers. Under the terms of the settlement, Ally agreed to pay \$80 million to consumers and an \$18 million civil penalty. Additionally, Ally agreed to conduct ongoing monitoring of dealer markup disparities and provide payments to affected consumers based on the results of those analyses throughout the term of the agreement or until Ally adopts a nondiscretionary dealer compensation plan. The Ally enforcement action, which is the CFPB's first major fair lending enforcement action, was coordinated with the U.S. Department of Justice (DOJ).

A number of unresolved issues remain, many of which were discussed in a CFPB indirect auto lending public forum in November 2013. One open issue is how to conduct statistical analyses to determine whether minorities and other protected class consumers have paid more than similarly situated nonprotected class consumers, given that lenders are prohibited under federal law from collecting information on the consumer's race, ethnicity and sex. While there are a number of different "proxy" methodologies

using names and geography to estimate the race, ethnicity or sex of the consumer, there is no single prescribed approach. In addition, some commentators have questioned whether monitoring programs are feasible or effective. Other issues include whether dealer markup policies have a positive or negative impact on consumers, as well as potential alternative dealer compensation structures such as paying dealers a flat fee or fixed percentage on each finance contract.

Mortgage Lending

We also expect that the CFPB will continue fair lending scrutiny of mortgage lending. On December 23, 2013, the CFPB announced its first mortgage fair lending enforcement action, with National City Bank. Under the terms of a consent order, National City Bank agreed to pay \$35 million to consumers to settle allegations that it charged higher prices to African-American and Hispanic consumers on mortgage loans as compared to similarly situated non-Hispanic white borrowers. The consent order, which the CFPB filed jointly with the DOJ, alleged that higher pricing to minorities resulted from discretionary pricing practices in the bank's retail channel and through mortgage brokers.

Although the National City Bank enforcement action and other recent DOJ mortgage cases have addressed pricing, the CFPB has indicated that redlining and underwriting issues will be its top mortgage fair lending priorities, with continued attention on pricing and steering as well. Also, beginning in January 2014, mortgage lenders will be required to comply with a new ability-to-repay rule, loan officer compensation rules and other requirements. In response to significant industry concerns, the CFPB and other federal regulators issued guidance in October 2013 regarding fair lending implications of the new ability-to-repay and qualified mortgage rules. Consistent with the CFPB's guidance, lenders who are considering curtailing lending that falls outside of the qualified mortgage criteria in response to the new ability-to-repay rule should consider the potential fair lending implications of these changes. Finally, in 2014, we anticipate that the CFPB will propose and possibly finalize rules for enhanced reporting and disclosure requirements for mortgage and small business lending, which likely will lead to increased CFPB scrutiny. In anticipation of enhanced regulatory scrutiny in these areas, mortgage and small business lenders may wish to analyze their mortgage and small business pricing, underwriting, and compliance policies and procedures.

The CFPB has indicated that redlining and underwriting issues will be its top mortgage fair lending priorities.

US Swap Regulation: Cross-Border Debate Among Issues to Watch in 2014

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Since the enactment of Dodd-Frank in 2010, the CFTC and the SEC have proceeded at different speeds to address previously unregulated markets for swaps and security-based swaps, respectively. The CFTC moved quickly to develop and adopt a panoply of swap rules.¹ The SEC proceeded more cautiously and, to date, has adopted a fraction of the regulations for security-based swaps that Dodd-Frank contemplates.

As the CFTC's first swap rules took effect in 2013, market participants dedicated considerable resources to comply with a host of new regulations, primarily rules that require every swap to be reported to a swap data repository and many interest rate and credit derivative swaps to be cleared by a derivatives clearing organization. Swap dealer registration also became a reality in 2013, with at least 90 swap dealers (SDs) registering with and now regulated by the CFTC. Finally, CFTC rules took effect in October 2013 requiring those operating "many-to-many" electronic and voice-trading platforms to register as swap execution facilities (SEFs).² In 2014, some swaps offered on these platforms could become subject to a CFTC mandate that trading of those swaps must occur on a registered SEF or a traditional futures exchange (otherwise known as a designated contract market).

The path to compliance with these and other CFTC rules has been rather bumpy because of operational hurdles and confusion in the industry regarding the new regulations. The uncertainty also was exacerbated by the CFTC's limited resources and, on the eve of launching SEFs, the federal government shutdown. CFTC staff issued more than five dozen no-action letters and other forms of guidance last year, many of which were published on the eve of compliance dates and aimed at providing interim relief until market participants could implement changes needed to comply with new regulations. However, it was the CFTC's final guidance on the cross-border application of certain of its swap regulations that may have been one of the commission's most significant regulatory efforts in 2013.

The Cross-Border Debate

In July 2013 on the eve of the expiration date of CFTC temporary guidance in this area, then CFTC Chairman Gary Gensler and European Commissioner Michel Barnier announced a "path-forward" agreement regarding their joint understandings of cross-border derivatives regulation.

Recognizing the international nature of the derivatives market, the path forward stated that the U.S. and EU agreed that jurisdictions and their regulators should be able to defer to each other when justified by the quality of their respective regulation and enforcement regimes rather than risk conflicts of law, inconsistencies and legal uncertainty by applying U.S. and EU law simultaneously. The agreement paved the way for

¹ For detailed discussions about the wide range of issues the CFTC addressed in 2013, please view our publications at <http://www.skadden.com/practice/industry-related/derivatives>.

² A many-to-many trading platform is a trading platform on which more than one person has the ability to execute or trade swaps with more than one other person.

substituted compliance determinations in the U.S. and equivalence determinations in the EU. These determinations would enable a market participant to comply with the regulatory requirements of one jurisdiction rather than both jurisdictions.

The CFTC's resulting final guidance issued soon after the path forward agreement provided a definition of a "U.S. person" and adopted exclusions of certain non-U.S. transactions from the SD and major swap participant registration threshold calculations. The CFTC guidance also sets forth a framework under which the commission could entertain "substituted compliance" applications, which would allow a non-U.S. entity to comply with the laws of its home jurisdiction instead of the relevant CFTC "entity-level" and "transaction-level" requirements when the requirements in the entity's home jurisdiction are comparable.

However, a November 2013 CFTC advisory limited the availability of substituted compliance and took a more territorial approach to regulating swap dealing activity that occurs within the United States. According to the advisory, a non-U.S. SD regularly using personnel or agents located in the U.S. to arrange, negotiate or execute a swap with a non-U.S. person cannot avail itself of substituted compliance, even if the transaction is booked in a non-U.S. branch of the non-U.S. swap dealer. Instead, such a transaction is, or soon will be, subject to the CFTC's transaction-level requirements, which include the clearing requirement, the trade execution mandate and real-time public reporting obligations.

Echoing the reaction of much of the international swap community, a spokesman for European Commissioner Barnier was "surprised" by the CFTC advisory, which "seem[s] to us to go against both the letter and spirit of the path forward agreement. ... [The advisory is] another step away from the kind of inter-operable global system that we want to build."

At the end of 2013, the CFTC issued the first comparability determinations — for Australia, Canada, the EU, Hong Kong, Japan and Switzerland. These comparability determinations permit substituted compliance with non-US requirements in lieu of some but not all CFTC regulations. In an apparent effort to deflect criticism regarding its approach to cross-border issues — and in the wake of a lawsuit challenging its cross-border guidance — the CFTC began 2014 by taking the unusual step of requesting public comments on all aspects of its November 2013 advisory.

The practical implementation of this substituted compliance framework may prove to be one of the CFTC's more challenging issues in 2014. Although it is too early to tell whether U.S. or EU regulations will be less onerous for market participants, the CFTC's early substituted compliance determinations indicate that substituted compliance and equivalence determinations may not fully eliminate duplicative regulatory compliance. Some market commentators worry that the November 2013 advisory invites retaliation by the European Commission, which is considering whether CFTC regulations are comparable to Europe's regulatory framework. The ability of the CFTC to successfully engage foreign governments on international derivatives concerns will be critical to the success of the its cross-border regulatory approach.

Additional Issues to Watch

SEC Developments. The SEC proposed its own rules and interpretive guidance in 2013 to address the cross-border application of security-based swap rules, which differ from the CFTC's final guidance in some respects. During the coming year, it will be important to monitor whether disparities develop between the two U.S. regulatory agencies.

Additionally, the SEC has yet to adopt the critical mass of regulations needed to launch the Dodd-Frank framework for SEC-regulated security-based swaps. Accordingly, we can expect more activity from the SEC in establishing trade execution and clearing mandates, recordkeeping and reporting requirements, business conduct standards and rules to govern security-based swap data repositories and security-based swap execution facilities.

Changes in Leadership. CFTC Chairman Gensler ended his tenure on January 3, 2014, along with other commissioner departures. President Obama has nominated as the new chairman Timothy Massad, the Treasury Department official who oversaw the Troubled Asset Relief Program following the 2008 financial crisis, and brokerage firm executive Christopher Giancarlo and securities lawyer Sharon Bowen as new commissioners. It is unclear when the Senate will act on these nominations.

It remains to be seen how new leadership will impact the CFTC agenda. The CFTC still has significant proposed rules to address in 2014, including outstanding proposals for conflicts of interest for registered entities and a recent re-proposal of position limits for exempt and agricultural futures, options and economically equivalent swaps. Although for the past several years the CFTC has worked with the SEC, Federal Reserve, FDIC and other regulators, the finalization and implementation of uncleared margin rules has yet to occur.

It is possible that the CFTC may operate with just two existing commissioners — one Republican and one Democrat — for the foreseeable future. It will be interesting to see how the agency functions in this structure, which inevitably will require consensus and cooperation.

We expect more activity from the SEC in establishing trade execution and clearing mandates.

The CFTC's Fraud-Based Manipulation Authority Raises Questions

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In October 2013, the Commodity Futures Trading Commission used enforcement powers it gained under the Dodd-Frank Act in an order finding that a major financial institution recklessly employed manipulative devices in trading credit default swaps.¹ In doing so, the CFTC wielded its fraud-based manipulation rule in a manner that has raised additional questions about CFTC powers that market observers already found troubling — and potentially unconstitutional — since the CFTC implemented its authority two years earlier.

The CFTC and Dodd-Frank

Over the years, the CFTC has used its powers to fight price manipulation, false reporting and fraud in the commodity markets aggressively and capably. In 2010, Congress added to the agency's already robust arsenal through Dodd-Frank when it enacted a fraud-based manipulation standard for the CFTC that largely mimicked the SEC's authority under Section 10(b) of the Securities Exchange Act.

Under this standard, the CFTC was authorized to adopt regulations prohibiting "manipulative or deceptive devices or contrivances." Market observers and participants wondered what conduct would be prohibited that was not already unlawful prior to the enforcement of Dodd-Frank. Observers also questioned how the CFTC would provide adequate notice to market participants of these forms of misconduct that carried significant civil and possibly criminal penalties, or if these powers would allow the CFTC to label as manipulation trading behavior it decided years after the fact was inappropriate or irresponsible.

Rule Adoption and Reaction. In 2011, the CFTC adopted its fraud-based manipulation prohibition, CFTC Rule 180.1, modeled after SEC Rule 10b-5.² The CFTC seemed to recognize that market participants needed notice of what new kind of misconduct was prohibited but was no more helpful than stating "Rule 180.1 *augments* the Commission's existing authority to prohibit fraud and manipulation."³ The CFTC did clarify, however, that unlike its existing authority to prohibit manipulation, it only would have to prove that the forms of misconduct were committed recklessly rather than intentionally, a point which offered little comfort to market participants.

Commenters on the proposed rules warned the CFTC that, without further clarification, Rule 180.1 could be unconstitutionally vague because it failed to provide sufficient notice regarding whether a practice ran afoul of the rule and exposed market "participants to the threat of arbitrary and unfair enforcement."⁴ The CFTC, however, adopted the rule as proposed.

¹In re *J.P. Morgan Chase*, Docket No. 14-01 (CFTC Oct. 16, 2013).

²Section 6(c) of the Commodity Exchange Act makes it unlawful to employ any manipulative or deceptive device or contrivance in connection with a swap, future or contract of sale of any commodity in contravention of CFTC rules. CFTC Rule 180.1 implements Section 6(c) and makes it unlawful to intentionally or recklessly employ any manipulative device, scheme or artifice to defraud in connection with a swap, future or contract of sale of any commodity.

³Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398, 41401 (July 14, 2011).

⁴76 Fed. Reg. at 41400.

The 2013 CFTC Order

In 2013, the CFTC found certain credit default swap (CDS) trading in violation of Rule 180.1. The CFTC alleged that a bank's CDS traders established positions during a price settlement period with the intent to create an artificial settlement price. The traders allegedly did this because the settlement price was used for marking-to-market the bank's CDS position, and an artificial price would mask significant losses the bank suffered on its CDS positions. If true, these facts could reasonably fit the CFTC's often relied-upon "banging the close" theory (entering trades at the end of a trading period in a manner designed to exert artificial pressure on the settlement prices) in violation of the CFTC's pre-Dodd-Frank market manipulation prohibitions.

However, the CFTC did not allege such a violation; instead, the order found that the traders employed a manipulative device "because they sold enormous volumes of [CDS] in a very short period of time at month-end." Their actions were reckless because they were "operating out of desperation to avoid further losses," the size of the position had the potential to affect the market, and the traders sold during a concentrated time period of the market. Thus, the traders "interfered with free and open markets" and traded with a "reckless disregard to obvious dangers to legitimate market forces"

The CFTC's order raises a host of unanswered questions regarding a Rule 180.1 violation:

- At what point did the volume of trading become "enormous" such that it embodied reckless behavior?
- How short is a "very short period of time"?
- What constitutes "interference"?
- What are "legitimate market forces" or "free and open markets"?⁵

The most troublesome questions, however, are raised by the CFTC statement in the order that a trader can be held liable even if motivated by a "desire to obtain compensation rather than by a desire to affect a market price." Is the CFTC suggesting that trading to avoid losses or trading to obtain compensation in the absence of any intent to affect the market price is not a legitimate market force? Does such trading truly interfere with free and open markets? Can trading to minimize losses and maximize profits by itself be illegitimate or deemed to interfere with free and open markets?

Implications

As market participants consider how the CFTC's order may affect their 2014 trading activity, the CFTC's statement adds another layer of complexity and uncertainty. Ironically, under the CFTC's rationale, trading large amounts of derivatives in a market exclusively with a motive to profit from that trading can be a manipulative or deceptive device and can violate Rule 180.1, even though the same trading activity, but in smaller volumes or in the same volume stretched out over a longer period of time, apparently would not be a violation. Market participants may find themselves asking how the CFTC will distinguish acceptable trading volumes from "enormous" quantities, as regulatory direction remains far from clear.

⁵Another unanswered question is how the CFTC views the temporal reach of its jurisdiction over swaps. The conduct at issue in the order occurred in January and February 2012, and the order cites CFTC Rule 1.3(zzz) as its jurisdictional basis. Rule 1.3(zzz) defines which security-based swaps are subject to CFTC as opposed to SEC oversight; however, Rule 1.3(zzz) was not adopted until August 2012 and was not effective until October 2012 — more than seven months after the alleged conduct.

Regulators Renew Their Focus on Anti-Money Laundering Compliance

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A resurgence in anti-money laundering (AML) enforcement over the last few years reflects a renewed post-crisis focus on compliance with the regulatory requirements of the Bank Secrecy Act (BSA) imposed on banks (AML Compliance). With financial institutions generally on the mend in the wake of the global financial crisis, state and federal prosecutors, as well as the federal banking agencies, have redirected their attention toward AML Compliance lapses. This trend has resulted in a number of notable enforcement actions against major financial institutions leading to deferred prosecution agreements, regulatory sanctions and large fines. Fines have grown substantially during this period; internationally active banks, in particular, have incurred staggering fines up to nearly \$2 billion. In addition, for such banks, AML Compliance deficiencies have been associated, from a supervisory perspective, with problems in related areas such as compliance with economic and trade sanctions administered by the Office of Foreign Assets Control (OFAC).

In recent statements, regulators have signaled a greater focus on pursuing enforcement efforts. For example, in a speech to the Global Economic Policy Forum in November 2013, New York Federal Reserve President William Dudley highlighted “the apparent lack of respect for law, regulation and the public trust” evident by some large financial institutions, adding that “[t]ough enforcement and high penalties will certainly help focus management’s attention on this issue.” This tough enforcement posture, coupled with mounting pressure on Capitol Hill to criminally indict financial institutions for BSA/AML violations, sets the stage for a very active enforcement landscape in 2014.

At the same time, there has been an increase in enforcement actions and penalties directed at the AML Compliance shortcomings of regional and smaller banks. The growth in such actions also has emerged as an obstacle for institutions contemplating or engaging in mergers and acquisitions.

Recent Supervisory and Enforcement Actions

Internationally Active Banks. Authorities have scrutinized large banks with global footprints for AML Compliance in connection with alleged oversight and monitoring deficiencies of their international activities. When entering into deferred prosecution agreements or cease-and-desist orders, authorities have identified a number of AML Compliance issues:

- Not maintaining an effective AML program and system of internal controls to adequately oversee the institution’s activities.
- Failure to conduct appropriate due diligence on foreign correspondent account holders.
- Inadequate monitoring involving remote deposit capture/international cash letter activity in the institution’s foreign correspondent banking business.
- Deficiencies in ensuring that suspicious activity at a foreign branch is communicated effectively to other affected branches within the institution’s network.
- Failure to ensure that, on a risk basis, customer transactions at foreign branch locations can be effectively assessed, aggregated and monitored.

- Conducting inadequate customer due diligence on retail and international banking customers.

In addition to AML Compliance shortcomings, some institutions were cited for OFAC violations, reflecting a growing interconnection between OFAC and BSA/AML issues as matters of supervisory concern. To address these deficiencies, institutions have been required to take various remedial actions, including:

- Retaining independent compliance monitors.
- Improving information sharing systems and increasing AML staffing.
- Linking executive bonuses to compliance performance.
- “Clawing back” deferred compensation bonuses given to senior AML and compliance officers.
- Ensuring compliance officer independence from the business lines.
- Establishing board-level compliance committees.

Of note, the United Kingdom’s Financial Conduct Authority (FCA), and its predecessor, the Financial Services Authority, coordinated closely with U.S. authorities, including federal and local prosecutors as well as federal regulators, in a recent multiparty investigation of an internationally active bank. The FCA also independently required the institution to bolster its AML compliance systems and employ an independent monitor.

Suspicious Activity Report (SARs) Filings. Regulators have taken a closer look at the adequacy and promptness of SARs filings. Last fall, the Office of the Comptroller of the Currency (OCC) and the Financial Crimes Enforcement Network (FinCEN) announced a civil money penalty against a national bank. The penalty was for the bank’s failure to file a series of SARs relating to suspicious account activity involving a fraudulent investment scheme undertaken by one of the bank’s customers. The SEC also fined the bank and filed charges against one of its former executives who was accused of enabling the scheme. In connection with this matter, Andrew J. Ceresney, co-director of the SEC’s Division of Enforcement, stated that “[f]inancial institutions are key gatekeepers in the transactions and investments they facilitate and will be held to a high standard of accountability when their officers enable fraud.” Earlier in 2013, the OCC similarly assessed a civil money penalty against another national bank for, among other alleged misconduct, the bank’s late filing of SARs involving cash transactions in which there were indications of illegal “structuring.”

Smaller Institutions Subject to Scrutiny. Regional and smaller institutions also face greater AML Compliance scrutiny. Regulators and prosecutors have expressed concern that as larger institutions move to reduce risk in their foreign correspondent banking and bulk cash businesses, smaller banks will assume these activities despite having less developed systems of controls and infrastructure to manage the associated risks. For example, FinCEN and the OCC levied a fine on a community bank in September 2013 in conjunction with a civil forfeiture action brought by the DOJ. Regulators identified AML Compliance deficiencies in connection with the bank’s failure to conduct adequate due diligence on foreign correspondent accounts, and to detect and adequately report in a timely manner suspicious activities in the accounts of foreign money exchange houses.

Impact on an Institution's Growth. Federal banking agencies' response to AML Compliance deficiencies includes enforcement actions and assessing money penalties, but also places limits on institutions' growth via mergers and acquisitions. The Federal Reserve recently exercised such powers by suspending a bank acquisition pending the implementation of a comprehensive plan to fix deficiencies in the acquiror's internal BSA/AML controls. As an institution expands, whether organically or through acquisitions, regulators expect compliance resources, staffing and expertise to keep pace with growth. Changes in regulatory compliance and bank examination priorities have created greater uncertainty for buyers and sellers alike for transactions that may require at least six months to complete.

Key Takeaways From Recent Supervisory and Enforcement Actions

A review of the publicly available actions reveals the following important takeaways:

High-Risk Areas. Institutions should ensure adequate and effective AML Compliance programs, systems and procedures. Specifically, BSA/AML programs need to be updated to take into account higher risk areas, such as foreign correspondent banking practices and bulk cash transactions. AML information technology and transaction monitoring systems should be updated to reflect these risks.

Compliance Infrastructure. Institutions should commit more resources to ensure strong compliance programs. Moreover, compliance staff must have the authority to fully implement a BSA compliance program consistent with the risks and the institution's profile, and, as needed, to question account relationships and business plans.

Independent Compliance Function. Compliance staff also should be independent from the business line and not subject to evaluation or performance determinations from the business.

Independent Reviews. In scrutinizing the adequacy and promptness of SARs filings, enforcement actions increasingly are requiring institutions to conduct independent reviews of transaction and account activity.

BSA/AML programs need to be updated to take into account higher risk areas.

'Know Your Customer': OFAC Raises Due Diligence Expectations of Non-US Banks

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Since 2005, a series of very large non-U.S. banks — including ABN AMRO, Credit Suisse and ING — have paid significant penalties to U.S. authorities for processing funds transfers through the United States related to business with Iranian, Cuban and other clients that are subject to U.S. economic sanctions. Some of these payments were directly on behalf of sanctioned entities (such as an Iranian or Cuban bank), while others were more generally related to business with sanctioned countries (such as trade finance transactions involving European exports to Burma). All of these funds transfers violated regulations of the Office of Foreign Assets Control (OFAC).

In September and October 2013, OFAC tried something new: It announced the imposition of civil penalties not against non-U.S. banks, but rather directly against their non-U.S. customers for originating payments related to business with Iran. While penalizing customers is a notable departure from the U.S. government's established model, the practice likely serves as a new warning to non-U.S. banks that they will be required to improve due diligence programs significantly to avoid harsher penalties in 2014 and beyond.

The Customer Penalties

OFAC first penalized an obscure Turkish trading company \$750,000 for making payments through the United States for the benefit of persons in Iran, and then it penalized a company in the United Arab Emirates \$1.5 million for doing substantially the same. The Emirati company, Alma Investments LLC, appears to have been the subject of a previous "scam alert" by the Dubai Financial Services Authority. Neither the Turkish nor the Emirati company appears to have participated in OFAC's enforcement proceedings, and OFAC seems unlikely to collect the money penalties. It is possible that the banks were penalized separately; OFAC did not name the financial institutions involved.

These penalties are consistent with OFAC's recent focus on third parties that transact on behalf of Iranian companies, which apparently have turned to trading companies and exchange houses because the recent escalation of U.S. sanctions effectively has shut them out of the international financial system. In January 2013, OFAC issued a rare advisory to U.S. financial institutions to be on the lookout for third-country (*i.e.*, non-U.S., non-Iranian) exchange houses and trading companies that act as money transmitters for Iranian businesses. OFAC also is responsible for implementing Executive Order 13608, which, since 2012, has authorized economic sanctions against "foreign sanctions evaders." OFAC has explained that it may use the order to sanction third-country entities that conduct deceptive financial transactions on behalf of Iranian companies, "where the foreign person had no physical, financial, or other presence in the United States and did not submit to U.S. administrative proceedings Such a listing under Executive Order 13608 also provides Treasury with the capability to put the world on notice as to such foreign persons' activity and the risk of similar future activity." The Turkish and Emirati trading companies would appear to have met the criteria for sanctions under Executive Order 13608, but OFAC instead elected to penalize them under its traditional administrative proceedings, even though they did not appear to submit to those proceedings. This illustrates how the same transaction involving Iran now can trigger multiple, overlapping laws from which OFAC or other U.S. authorities may choose.

The purpose of these newer penalties against trading companies seems to reinforce OFAC's prior warnings to non-U.S. banks.

OFAC's Real Audience

Superficially, this new approach seems fairer than penalizing the banks, which despite robust know-your-customer programs cannot reasonably be expected always to know their customers' reasons for making particular payments. It is unlikely that fake, disposable front companies for Iranians would be undeterred by these types of penalties, which they may never have to pay.

However, the real audience for these trading-company penalties seems once again to be non-U.S. banks, which OFAC explicitly encouraged to exercise greater due diligence for these types of customers. In this sense, the purpose of these newer penalties against trading companies seems to reinforce OFAC's prior warnings to non-U.S. banks and possibly to lay a foundation for future penalties against such banks that, in the eyes of U.S. authorities, should have done a better job ferreting out these types of customers.

It is not clear how exactly OFAC or other U.S. authorities expect a bank to detect sanctions evasion by trading companies or exchange houses, but two developments earlier last year indicate that resubmitted payments may be the clearest sign of a problem:

- In its January 2013 advisory, OFAC explained that the third-country exchange houses and trading companies commonly omitted references to Iranian names or addresses. So what is a bank to look for, if the Iranian funds transfers purposely do not mention Iran? OFAC identified three red flags, of which two were essentially resubmitted payments, *i.e.*, payments initiated by a customer that the bank rejects for compliance reasons, and which the customer then alters and resubmits in an effort to avoid detection. (The third red flag was unusual patterns in the volume or frequency of payments.)
- In February 2013, OFAC concluded a civil penalty settlement with the Bank of Guam because a bank employee resubmitted a single payment that another bank rejected due to a reference to Iran. The Bank of Guam settlement likely reflects a regulatory expectation that once a payment is rejected for OFAC-related reasons by one bank, any bank that processes it is on notice of a serious problem that requires attention. A trading company or exchange house that attempts to send a funds transfer referencing Iran through the United States probably should not be given a second chance.

* * *

Despite the November 2013 nuclear deal between Iran and six other nations that calls for temporary relief from economic sanctions, OFAC is unlikely to ease its scrutiny and will continue to levy civil penalties aggressively when it identifies transactions in violation of U.S. law. Even though OFAC has begun a practice of penalizing non-U.S. companies for their banking transactions, that does not reduce the exposure of the banks themselves. Risk-averse non-U.S. financial institutions will need to consider re-evaluating and, where possible, strengthening their due diligence programs or potentially face negative publicity, significant fines or both.

OFAC and German Foreign Trade Regulations: Underwriters Attempt to Square the Circle

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When negotiating underwriting and purchase agreements for securities offerings by German issuers, legal advisers face conflicting requirements under U.S. economic sanctions laws administered by the Office of Foreign Assets Control (OFAC) and the anti-boycott statutes under German and EU law. It can be quite challenging to bridge these seemingly incompatible legal regimes, and underwriters and their counsel need to consider the nuances of each jurisdiction to better navigate and comply with the laws impacting international securities offerings.

OFAC Obligations

U.S. and non-U.S. banks offering securities of a German foreign private issuer (FPI) are seeking higher levels of comfort that the issuer is complying with OFAC regulations, whether the transaction takes place in the U.S. through a private placement or registered offering, or is executed in another country outside the U.S. under the Regulation S safe harbor of the Securities Act of 1933. Because of the heightened expectations that banks comply with OFAC, this comfort level applies even if the FPI is not directly subject to U.S. sanctions laws.

Banks have to consider two types of OFAC obligations:

- **Direct.** Underwriting banks may not conduct business with a person who is a target of OFAC sanctions or controlled by a person who is subject to OFAC-sanctions. Banks also cannot support an FPI's business with persons who are sanctioned by OFAC (e.g., providing services or advice regarding such business or allowing proceeds from an offering to be used to fund such business). For U.S. banks, this is a matter of complying with U.S. law; non-U.S. banks often view this as a necessary compliance policy choice (see ["Know Your Customer": OFAC Raises Due Diligence Expectations of Non-US Banks](#)”).
- **Indirect.** Underwriting banks should avoid situations that are subject to OFAC regulations. This includes (i) engaging in offering-related activity involving a U.S. jurisdiction (which may be as little as settling U.S. dollars or using a U.S.-based server to clear the transaction), (ii) causing violations of, conspiring to violate, or aiding and abetting violations of OFAC regulations, (iii) engaging in transactions involving the extraterritorial exercise of a U.S. jurisdiction (such as the re-export of controlled goods, where jurisdiction is deemed to attach to the goods themselves) and (iv) engaging in activity to which jurisdiction applies *per se* (such as nuclear proliferation or terrorist financing).

German Anti-Boycott Laws

Section 4a of the German Foreign Trade Ordinance prohibits a German FPI from declaring its intention to comply with a foreign sanction regime that is not recognized by German, EU or international law. A Section 4a violation may result in a voided contract, civil monetary penalties of up to €500,000, and, in some cases, imprisonment and criminal fines.

U.S. and non-U.S. banks offering securities of a German foreign private issuer are seeking higher levels of comfort that the issuer is complying with OFAC regulations.

While the language of Section 4a is broad in scope, it has been interpreted in various circular orders (*Runderlasse*) and letters (*Rundschreiben*) issued by the German Federal Ministry of Economics and Technology. As a result, the following actions generally are considered to be prohibited under German anti-boycott provisions:

- A statement of compliance with the boycott laws of a third country.
- “Blacklist” clauses, which include a statement that:
 - the FPI or its affiliates or directors are not listed as a person on the OFAC list of special designated nationals; and
 - the FPI is neither directly nor indirectly associated with nor does business with states, regions, persons or organizations listed on the OFAC list, nor those that have been sanctioned in connection with OFAC programs.
- Even though a declaration with regard to the compliance with all laws of a foreign country generally is permissible, it is prohibited if given in close connection with other statements that point to the participation in a foreign boycott against a third country. For example, a declaration is prohibited if (i) the boycott laws of third countries name the specific target countries of applicable boycotts, (ii) it provides declarations that all laws regarding the boycott of a specific third country will be complied with or (iii) it generally provides that all boycott laws will be complied with.

Permissible actions include (i) factual statements about the past and (ii) declarations regarding boycotts that are recognized by Germany, the EU or the UN.

Reconciling the Two Regimes: Representation and Covenant Language

As a result, a German law-compliant OFAC representation and covenant in an underwriting or purchase agreement for an international securities offering by a German FPI typically will state that (with respect to the past) neither the company nor any of its subsidiaries has taken any action resulting in a violation of any laws or regulations administered by OFAC and the Office of Export Enforcement of the U.S. Department of Commerce, or any equivalent sanctions or measures imposed by the U.S., Germany, the EU, the UN or any other relevant sanctions authority.

With respect to the use of the proceeds from an offering, the company typically will confirm that it will only use such proceeds, or lend, contribute or otherwise make available such proceeds for the purposes as disclosed in the applicable disclosure document (*e.g.*, prospectus).

If there is no disclosure document available or if no specific use of an offering’s proceeds has been defined, the company typically will be asked not to use the proceeds from an offering in a manner that would cause a breach by the underwriters of any law applicable to them.

Since statements with respect to future behavior are particularly problematic under applicable German law, a company typically will only represent that it (and its subsidiary) will comply with the sanctions and measures imposed by Germany, the EU, the UN and the applicable federal laws of the U.S. to the extent such compliance is not prohibited by applicable law.

OFAC-Related Business Due Diligence

Banks customarily conduct specific OFAC-related due diligence to address the OFAC representation in an underwriting or purchase agreement for an international securities offering by a German FPI. OFAC-related questions in a business due diligence questionnaire may be posed with respect to the past and also extend to the present, as any answer to such a question will be deemed a mere statement as to facts or information. However, as discussed above, under German law, statements in response to due diligence questions with respect to future compliance with the boycott laws of a third country generally are prohibited.

* * *

We expect that capital markets (and bank financing) transactions involving German companies will continue to be affected by some conflict between OFAC (and the underlying U.S. foreign policy) and German foreign trade laws and practice. Underwriters in German transactions will need to draw a fine line between the respective U.S., European and German practices, and focus on clear contractual language and enhanced due diligence.

The Future of Marketing Non-EU Alternative Investment Funds in Europe

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Adopted by the European Parliament in 2010 and implemented by EU member states in July 2013, the Alternative Investment Fund Managers Directive (the Directive) seeks to protect investors and mitigate market instability by regulating alternative investment fund (AIF) managers¹ in the EU.

Marketing Passport Restrictions

Under the Directive, EU managers can market EU AIFs to EU investors² through the use of a pan-European marketing passport. However, this marketing passport will not be available to non-EU managers of AIFs, or EU managers of non-EU AIFs, until at least 2015. If they wish to market actively to EU investors, such managers will need to rely on individual member states' national private placement regimes (NPPRs), which the Directive allows to be maintained.

In addition to NPPR compliance, marketing a non-EU AIF to EU investors also will trigger a requirement to comply with applicable parts of the Directive, which defines marketing as a direct or indirect offering or placement solicited at the initiative or on behalf of the manager. Raising capital from EU investors by way of reverse solicitation, where the investor takes the initiative, will not trigger a requirement to comply with the Directive because there is no marketing "at the initiative of" the manager. However, the Directive does not specify what this means. Member states may have different interpretations as to the precise activities that constitute marketing (and therefore when a requirement to comply with the Directive arises) and reverse solicitation.

NPPR Compliance — Additional Directive Conditions

Minimum Conditions. The Directive requires that managers satisfy additional conditions to market to professional investors in the EU,³ including:

- **The manager must disclose certain information to investors before they invest.** Much of this information typically would be contained in a private placement memorandum (PPM) (e.g., fees and leverage disclosures). However, some specific disclosures typically are not contained in PPMs (e.g., information "on the existence

¹ AIFs are alternative investment funds that include private equity, hedge, real estate and infrastructure funds. AIFs can be open-ended or closed-ended, listed or unlisted. The following are not AIFs (and therefore fall outside the scope of the Directive): UCITS funds, single-investor funds, holding companies and SPVs (although advice should be sought on a case-by-case basis to ensure that any relevant criteria are met). The manager, or AIFM, is the legal person (i.e., not an individual) that is responsible for performing portfolio management and risk management functions with respect to an AIF.

² The Directive regulates marketing to "professional investors" (which includes investment firms, credit institutions, pension funds and institutional investors whose main activity is to invest in financial instruments). Individual member states may permit marketing to nonprofessional investors at their discretion, subject to compliance by the manager with the Directive rules relating to marketing to professional investors and any additional rules imposed by those member states.

³ The Directive allows member states to impose stricter requirements on marketing AIFs to retail investors in their territories.

or not of any legal investments providing for the recognition and enforcement of judgments in the territory where the AIF is established”) and either can be added to the PPM or inserted in a supplement.

- **The manager provides an annual report in respect of the AIF to the regulators of each member state in which the AIF is marketed and to investors on request.** In addition to the usual information found in an annual report, the document must disclose the total amount of remuneration paid by the manager to its staff, including any carried interest paid by the AIF. Remuneration must be divided into fixed and variable. Certain other disclosures also are required.
- **The manager provides regular reports to the regulators of each member state in which the AIF is marketed.** These reports are broadly similar to Form PF, although differences exist. Frequency of reporting ranges from quarterly to annual depending on quantum of assets under management and other criteria.
- **The regulator of the non-EU AIF and the regulator of each member state in which the AIF is being marketed must enter into cooperation agreements.**⁴ Most EU member states have entered into cooperation agreements with regulators from the most common fund jurisdictions. The SEC and CFTC, for example, have entered into agreements with all but a handful of member states. However, some member states have not entered into cooperation agreements with certain offshore Caribbean jurisdictions (for example, at the time of writing, Spain and Italy have not concluded agreements with the Cayman Islands).
- **The non-EU AIF is not established in a country that is listed as a Non-Cooperative Country and Territory by the Financial Action Task Force.** In addition, if the manager is not in the EU and registered in a jurisdiction different from that of the non-EU AIF, the manager must not be established in a country that is listed as a Non-Cooperative Country and Territory by FATF.

Additional Member State Conditions. The Directive allows member states to impose additional conditions for AIFs to be marketed under the NPPRs (if any) of their territories.

- The U.K. requires a manager to notify the U.K. Financial Conduct Authority (FCA) of its intention to market in the U.K. This is effected by submitting the applicable electronic notification form that appears on the FCA’s website.⁵ The FCA’s consent is not required before marketing can commence. Once the FCA has processed the notification form, it will issue the manager a notification number and request that a modest fee is paid. The manager is entitled to start marketing the AIF once it has submitted the notification form; however, the FCA states that managers may wish to wait until they have received confirmation from the FCA that the notification has been successfully processed.
- Other member states, such as Ireland, have imposed similar notification requirements. Germany and France impose more stringent obligations, which involve compliance with certain additional Directive requirements and, in Germany, a manager must obtain approval from the BaFin, the country’s financial regulator.

⁴In addition, if the manager is not EU-based and registered in a jurisdiction different from that of the non-EU AIF, cooperation agreements must be in place between the manager’s home regulator and the home regulator of each member state in which the AIF is being marketed.

⁵The FCA’s notification forms are available at <http://www.fca.org.uk/firms/markets/international-markets/aifmd/nppr>.

Transitional Relief

Some member states have implemented transitional provisions, which allow marketing to continue under the applicable NPPR without having to comply with the Directive's minimum conditions for a period of 12 months (subject to certain conditions being met). A non-EU manager can market its AIFs to investors in the U.K. if it managed an AIF immediately before July 22, 2013, and marketed that same AIF in any member state prior to that date. However, starting July 22, 2014, all transitional provisions implemented by member states will expire and the Directive's minimum conditions will need to be satisfied to market to EU investors under the NPPRs.

* * *

At a time when the JOBS Act has lifted the ban on general solicitation in the U.S., the marketing restrictions in the Directive can have a significant impact on marketing strategies that managers might otherwise pursue. For example, where managers are opening up their websites to potential investors, they should consider whether this could be construed as marketing under the Directive, triggering a requirement to comply or, if not, whether it could impact an investor's ability to reverse-solicit investments.

The EU Banking Union: Will the New Regulatory Framework Restore Confidence in European Banking?

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“Banking Union also will need a single resolution regime to make sure that failing banks with cross-border operations can be ‘resolved’ efficiently without significant adverse market impact.”

The European Union is implementing a single bank regulatory framework (Banking Union)¹ that will formally cover banks headquartered either in a eurozone country or in a participating non-eurozone EU country. The U.K., Sweden and the Czech Republic, all non-eurozone countries, have indicated that they will not participate. Nevertheless, Banking Union will affect banks headquartered in these countries that maintain branch offices in any participating EU country.

During the recent financial crisis, the EU experienced significant problems in trying to break the “vicious link” between member state sovereigns and an ailing bank sector. As EU countries struggled to recapitalize their banks, financial markets repriced EU sovereign debt to address the additional strain placed on EU countries’ public finances. Financial markets also took account of the additional risk that problems in one eurozone country could contaminate others.

EU lawmakers believe that, when implemented in November 2014, Banking Union will help restore confidence in the EU banking sector through a single EU prudential supervisory framework. However, to break the link between national governments and national banking sectors, Banking Union also will need a single resolution regime to make sure that failing banks with cross-border operations can be “resolved” efficiently without significant adverse market impact. The EU resolution regime has proven more politically contentious and is not expected to be in place before January 1, 2015, at the earliest.

Banking Union will make the European Central Bank (ECB) the primary prudential regulator for banks² with head offices in a participating EU country. The ECB also will prudentially regulate branches of banks established in participating EU countries, but whose head office is located in a nonparticipating country.³ The ECB will have formal supervisory and enforcement powers, which will enable it to remove board directors from banks and fine those institutions and, in some cases, their EU parent companies. The ECB will have no formal role in regulating securities and insurance markets but will enter into memoranda of understanding with relevant regulatory bodies, which may increase the ECB’s informal persuasive power in a number of areas outside prudential regulation.

Significant Institutions

Banking regulators in EU participating countries will retain a major role in the prudential regulation of banks operating in their jurisdictions, although the ECB will have overall responsibility. Operational responsibility will be split between the ECB and national

¹The legal framework is set out in the Banking Union Regulation (Regulation 1024/2013), which is the main law relating to the single supervisory framework, and in Regulation 1022/2013, which amends laws governing the functions of the European Banking Authority (EBA).

²The relevant laws use the term “credit institution” and exclude some deposit-taking entities from ECB regulatory scope. However, for present purposes, nearly all retail and investment banks are subject to ECB regulation.

³In theory, most prudential regulation will be the responsibility of the “home state” regulator, with the ECB having responsibility for a limited number of items including branch liquidity. However, time will tell to what extent the ECB will seek a more prominent role in the prudential regulation of nonparticipating country banks.

regulators, with the latter having more responsibility for less “significant” institutions. The precise criteria that will be used to determine significance is expected to be finalized in the second quarter of 2014. However, in broad terms, a bank will be significant if:

- its assets exceed €30 billion;
- the total value of its assets is at least €5 billion, and the ratio of those assets exceeds 20 percent of the participating member state’s GDP;
- the local national regulator believes that it is significant and, after assessment, the ECB agrees;
- the ECB assesses it as significant when taking its cross-border activities into account;
- it receives, or applies for, bailout funds from the European Financial Stability Facility or the European Stability Mechanism; or
- it is one of the three most significant institutions in a participating EU country, unless the ECB decides otherwise.

The ECB will be responsible for licensing (and removing the licenses of) banks headquartered in participating countries. In addition, the ECB will be responsible for deciding whether to approve in advance the acquisition or disposal of a qualifying holding in a bank, which in the normal course is a 10 percent direct or indirect stake in share capital or voting power. However, national regulators will retain a major role in assessing applications and making recommendations to the ECB.

For significant institutions, the ECB will:

- be responsible for compliance with requirements covering “own funds,” “passporting” applications, securitization, large exposures, liquidity, leverage, regulatory reporting and public disclosure;
- supervise overall governance arrangements, including board composition and remuneration policies;
- carry out supervisory reviews and stress tests and decide whether banks need to add more capital, make further liquidity arrangements or publicize their prudential arrangements;
- take a leading role where an institution needs to be resolved;
- supervise banks on both a consolidated (*i.e.*, as part of a group) and solo basis; and
- participate in financial conglomerate supervision relevant to in-scope banks.

In carrying out these functions, the ECB will receive assistance from relevant national regulators. For nonsignificant banks, national regulators will take the lead on all of these matters except for financial conglomerate supervision, where they will coordinate with the ECB under its direction.

Next Steps

The development of the overall supervisory framework is expected to be finalized by May 4, 2014. In the meantime, the ECB and national regulators need to agree which institutions are significant and precisely how coordination will work.

The ECB also will assess the capital adequacy and prudential arrangements of the eurozone's most significant banks before Banking Union is formally implemented in November 2014. The process, called a "comprehensive assessment," also will involve a number of stress tests. National regulators in the relevant countries are preparing intensively for this assessment. The exercise may lead to the recapitalization of some EU banks, which a number of commentators have said has lagged the similar action taken by U.S. regulators a number of years ago. The exercise also may lead to more bank M&A if affected banks believe they must sell assets, business units or subsidiaries to comply with regulatory capital ratios. The comprehensive assessment promises to be the ECB's first significant supervisory exercise in the new prudential framework and a significant indicator of what EU banks can expect of the new regime.

EMIR Regulations Continue to Impact Derivatives Markets in 2014

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The financial crisis highlighted a number of problems in global OTC derivatives markets, including transparency, counterparty credit risk and a consequent removal of market liquidity. International concerns about these problems led to the 2009 G20 Pittsburgh agreement, which included provisions that all standardized OTC derivative contracts should be cleared through a central counterparty (CCP) and reported to trade repositories (TRs), and counterparties to nonstandardized derivatives should take steps to mitigate the risks of their positions.¹

The EU Regulation on OTC derivatives, central counterparties and trade repositories (EMIR)² implements part of the EU's G20 commitments, and although enacted in 2012, its provisions have only recently started to become operative. In addition to setting out a regulatory framework for CCPs and TRs, EMIR imposes a number of obligations on EU counterparties, as well as on non-EU counterparties that enter into derivatives deemed to have a "direct, substantial and foreseeable effect" within the EU or to have been designed to evade EMIR requirements. With additional EMIR requirements being implemented in 2014, OTC derivative market participants need to consider the implications of the legislation.

EMIR's Scope

EMIR applies to a wide variety of derivatives: credit default swaps, options, futures/forwards, swaps and contracts for differences, over a broad range of underlying financial instruments, assets, commodities and indices. Spot contracts are excluded. However, different EU jurisdictions and markets take different views on the maximum time allowed to settle spots, with settlement cycles varying between two and five business days. These differences can create confusion when a trade that is considered a spot in one jurisdiction is classified as a derivative in another.

The majority of EMIR requirements apply to OTC derivatives, although the trade reporting obligations notably apply to all derivatives. The OTC derivative concept is narrowly defined to include contracts that are not traded on a "Markets in Financial Instruments Directive (MIFID) regulated market" or "equivalent third-country (*i.e.*, non-EU) market." This means that derivatives traded on EU multilateral trading facilities or U.S. swap execution facilities that are not EU-recognized technically will be regarded as OTC.

Counterparty Obligations

If OTC derivatives are not centrally cleared by an authorized EU, or recognized non-EU CP, EMIR requires the counterparties to enter into an agreement that sets out how they will mitigate risks. This requirement went into effect in 2013. Depending on their classification, counterparties must:

¹The G20 also agreed to move the trading of certain OTC derivatives on to trading venues. The EU will implement this commitment separately through the "MIFID 2" process.

²Regulation (EU) No 648/2012, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF>.

- confirm OTC trades within specified timeframes;
- have formal procedures to reconcile derivative portfolios;
- where applicable, perform portfolio compression exercises that involve trade netting to maintain the same risk profile while reducing the number of outstanding contracts and gross notional value;
- have dispute resolution procedures;
- utilize mark-to-market or, where applicable, mark-to-model accounting principles;
- exchange and segregate collateral; and
- hold capital against positions.

The risk mitigation obligations are being implemented through a mixture of International Swaps and Derivatives Association protocols and bilateral agreements between the sell-side and buy-side. The process has been far from smooth: with limited exceptions, non-EU counterparties are not subject to EMIR risk mitigation obligations. However, EU counterparties are required to enter into an agreement with non-EU counterparties, which enables them to secure compliance with their own EU obligations.

Starting February 12, 2014, all EU counterparties will need to comply with the trade reporting obligation.

Starting February 12, 2014, all EU counterparties will need to comply with the trade reporting obligation. This will involve reporting to a TR all derivative transactions entered into from February 12, 2014, or which are outstanding on that date. There also will be a requirement to back report derivatives transactions that are not outstanding on February 12, 2014, and either were outstanding on August 16, 2012, or entered into after that date. It is possible for one counterparty to delegate the performance of, but not the legal responsibility for, trade reporting to the other. It remains to be seen, however, whether the sell side will agree to trade report on behalf of the buy side given liability concerns. In any event, such a service will not assist nonfinancial counterparties that enter into intragroup hedging transactions. Either they will have to report those trades themselves or find a third-party provider solution.³

Finally, EMIR will require specific types of counterparties to clear specified classes of OTC derivatives through authorized or recognized CCPs. The EU has fallen behind the U.S. in implementing the clearing obligation, and the requirement is not expected to come into force until late 2014 at the earliest because EU regulators still need to authorize and recognize CCPs and identify classes of clearing-eligible derivatives.

Counterparty Classification

EMIR requirements are applied differently, depending on counterparty classification. EMIR divides counterparties into:

- **Financial counterparties (FCs):** EU banks, investment firms, insurers and pension providers, UCITS funds (and their managers) and alternative fund managers authorized or registered under the Alternative Investment Fund Managers Directive. Generally, FCs are (or will be) subject to all EMIR risk mitigation, trade reporting and applicable clearing obligations;

³For a detailed discussion on the trade reporting obligations, see the Skadden publication "EU Derivatives Trade Reporting Obligations to Begin on February 12, 2014" (Nov. 15, 2013), available at <https://www.skadden.com/insights/eu-derivatives-trade-reporting-obligations-begin-february-12-2014>.

- **Nonfinancial counterparties (NFCs):** EU-established entities that are not FCs. There are two types of NFCs: NFC+s, with 30-day rolling average OTC derivative positions entered into for nonhedging purposes above specified thresholds, and NFC-s, with contracts that do not exceed such thresholds. Generally NFC+s will be subject to most of the EMIR risk mitigation, trade reporting and applicable clearing obligations, while NFC-s will be subject only to trade reporting and some of the EMIR risk migration requirements;⁴ and
- **Third-country entities:** those that enter into derivative contracts that have a “direct, substantial and foreseeable effect” within the EU or have been designed to evade EMIR requirements. They will be subject to the clearing obligation and relevant risk mitigation obligations.

Cross-Border Implications

EMIR allows the European Commission to declare that a non-EU country’s risk mitigation, trade reporting and clearing obligations are equivalent to EU requirements, which would allow an EU and non-EU counterparty to agree that they will comply with non-EU requirements. ESMA, the pan-EU securities regulator, has been advising the European Commission on whether the OTC derivative regimes of the U.S. and a number of other countries are equivalent. While these discussions are at an initial stage, early indications are that the equivalence declarations will not be straightforward. Nevertheless, OTC derivatives market participants hope that some international agreement among regulators and lawmakers eventually will ease the burden in one of the most globally active markets.

* * *

As EMIR provisions become effective in 2014, OTC derivatives market participants should reinforce their compliance efforts across the spectrum. They must prepare for clearing obligation compliance, deal with data required to perform portfolio reconciliations and have processes to prepare for the variety of trade reporting requirements under the new regime. In addition, internationally active market participants will need to identify how to comply with overlapping requirements arising from the Dodd-Frank Act in the United States.⁵

⁴NFC-s need only comply with trade confirmation, portfolio reconciliation and compression, and dispute resolution requirements.

⁵For a more detailed discussion, see the Skadden publication “EU Derivatives Trade Reporting Obligations to Begin on February 12, 2014” (Nov. 15, 2013), available at <http://www.skadden.com/insights/eu-derivatives-trade-reporting-obligations-begin-february-12-2014>.

Global Litigation

The litigation landscape could experience seismic changes in 2014, as courts question seemingly settled legal principles. Private securities class actions could undergo significant reform, as the Supreme Court revisits the “fraud on the market” doctrine that has governed securities fraud cases for a quarter of a century. Additionally, the U.S. president’s long-standing authority to make recess appointments is one of many constitutional issues the justices will decide in its current term, along with a slate of important business-related cases. Other changes will be more gradual, such as the continued evolution of consumer class actions following recent Supreme Court decisions, and the redefining of food and beverage labeling and marketing practices in light of increasing litigation in this area.

Companies in the pharmaceutical and technology industries will remain at the forefront of intellectual property litigation, as well as in the cross-hairs of competition authorities on both sides of the Atlantic. As cross-border relationships multiply, so do related legal challenges. Aggressive enforcement activity continues to impact businesses globally, and the use of international arbitration to protect legal rights in foreign countries will further develop.

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US Supreme Court Cases to Watch in 2014

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The U.S. Supreme Court will rule on numerous significant cases in 2014, involving such issues as presidential power, affirmative action, campaign contributions, environmental regulations, intellectual property, commercial arbitration, *parens patriae* suits and implementation of the Affordable Care Act. The Court also will reconsider the so-called “fraud-on-the-market” theory in a potentially landmark securities law case.

Presidential Recess Appointment Power and Other Constitutional Issues

The Supreme Court will consider a rare dispute at the heart of the separation of powers between the executive and legislative branches of the federal government. *National Labor Relations Board v. Noel Canning* poses several questions about the scope of the president’s so-called recess appointment power — that is, the power to temporarily fill vacancies in senior executive branch positions without Senate approval when the Senate is in recess. The Court will examine whether the president may exercise this power only during a recess that occurs between sessions of the Senate, or also during a recess that occurs within a session of the Senate. The justices also will consider whether the recess appointment power may be exercised while the Senate is convened for brief *pro forma* sessions in which no business is conducted. Finally, it will examine whether the president may use this power to fill any vacancies that exist during a recess (whenever the vacancy first arose) or, alternatively, only vacancies that first arose during that recess. Should the Court substantially diminish the president’s recess appointment power, it may enable the Senate, by failing to act on presidential nominees, to stymie the activity of certain regulatory agencies — for example, the National Labor Relations Board, which requires a quorum of three members. Regardless of how the Court rules, the case will be another important development regarding the president’s power to appoint federal officials — on the heels of the Senate’s November 2013 decision to restrict filibusters against executive branch nominees.

The Court will address a range of other important constitutional questions during its current term.

Affirmative Action. In *Schuette v. Coalition to Defend Affirmative Action*, the justices will consider whether a state violates the U.S. Constitution’s equal protection clause when it bans affirmative action in public university admissions. The case involves an amendment to Michigan’s constitution, approved by the state’s voters in 2006, prohibiting race-conscious admission policies in public universities. In the past, the business community has actively participated in the Court’s affirmative action cases. Only a year ago, when the Court considered a challenge to race-conscious admissions at the University of Texas, a group of 57 leading American companies filed an *amicus curiae* brief supporting the university. Past cases, however, typically focused on the circumstances in which a state violates the equal protection clause by adopting an affirmative action program; by contrast, *Schuette* asks whether a state’s ban on those programs may be unconstitutional.

Federal Government Powers. The Court will return to a question it has addressed several times in the past decade — the constitutionality of efforts to control the influence of money in elections. This time, in *McCutcheon v. Federal Election Commission*, it will

scrutinize statutory limits on the aggregate amounts that an individual may contribute to all federal candidates, political parties and other political committees in a two-year election cycle. The Court also will consider whether a federal statute implementing a treaty may exceed Congress' other enumerated powers. The case raising this question, *Bond v. United States*, involves the federal government's use of legislation implementing the Chemical Weapons Convention to prosecute what arguably amounts to ordinary poisoning — a Pennsylvania woman's attempt to place in contact with toxic chemicals an individual who had an affair with her husband.

Health Care. Finally, the Court will examine yet another controversy arising from the implementation of the Affordable Care Act. In 2014, it will consider legal challenges to regulations that require mandatory coverage of contraceptives in employer-provided health insurance plans. Some for-profit corporations have alleged that these regulations violate their constitutional right to free exercise of religion, as well as the Religious Freedom Restoration Act. The Court will hear two cases raising these issues: *Sebelius v. Hobby Lobby Stores, Inc.* and *Conestoga Wood Specialties Corp. v. Sebelius*.

Environmental Policy

The Court's regulatory docket includes two sets of important cases challenging rules promulgated by the Environmental Protection Agency. These cases do not appear to raise canonical, or even generally applicable, questions of administrative law. Rather, they are notable because both of the rules in question have significant environmental policy implications.

First, the Court will examine in *Utility Air Regulatory Group v. EPA* (and related cases) whether the EPA permissibly extended its oversight of greenhouse gases under the Clean Air Act to include stationary sources, such as power-generating plants or industrial facilities. The EPA's regulatory activity in this sphere has flowed, in part, from an earlier Supreme Court decision, *Massachusetts v. EPA* (2007). There, the Court held that greenhouse gases are "air pollutants" under the Clean Air Act and that the EPA must regulate greenhouse gas emissions from new motor vehicles if it determines they may endanger public health or welfare. The EPA made such an endangerment finding in 2009, and in coordination with the National Highway Traffic Safety Administration, it subsequently promulgated rules regulating greenhouse gas emissions from new light-duty vehicles. The EPA then took the position that these rules (which addressed only mobile sources) automatically triggered permitting requirements for any stationary source that emitted greenhouse gases above a certain threshold. Whether the Court endorses this leap from mobile to stationary sources could substantially affect the course of the federal government's climate change policy.

The second set of cases — *EPA v. EME Homer City Generation* and *American Lung Association v. EME Homer City Generation* — concerns the Clean Air Act's "good neighbor" provisions, which require the EPA and states to address interstate movement of air pollution that affects downwind states' ability to meet air quality standards. In 2011, the EPA promulgated regulations for determining how much an upwind state contributes to air pollution in its downwind counterparts. The U.S. Court of Appeals for the District of Columbia Circuit rejected EPA's methodology, and the Supreme Court will consider procedural and substantive challenges to that decision.

The Court's regulatory docket includes two sets of important cases challenging rules promulgated by the Environmental Protection Agency.

Intellectual Property

The Court also will rule on a number of cases that raise important issues in the field of intellectual property (see “Intellectual Property and Technology: Patent Issues to Watch in 2014”).

Two patent cases have drawn substantial attention from the technology industry. The first is a sequel to the Court’s 2007 decision in *MedImmune, Inc. v. Genentech, Inc.*, in which a patent licensee was permitted to bring a declaratory judgment action against the patent holder, claiming that no royalties were due because the licensed product did not infringe the patent. In *Medtronic, Inc. v. Boston Scientific Corp.*, the Court will consider who bears the burden of proof in such a suit: whether the patentee must prove infringement, or the licensee must show that its products do not infringe the patent.

The second patent case, *Alice Corporation Pty. Ltd. v. CLS Bank International*, will ask the Court to address whether certain “computer-implemented” inventions are eligible for patent protection. The patent at issue involves a computer-based system for exchanging financial instruments. A highly fractured *en banc* U.S. Court of Appeals for the Federal Circuit ruled that the patent was invalid, but no single rationale commanded a majority. The case raises difficult questions about the circumstances, if any, under which computer software may be patented. The Supreme Court’s answer could have wide-ranging implications both for producers and consumers of technology.

The Court also will examine whether, and under what circumstances, the equitable defense of laches may bar a copyright infringement claim. The case, *Petrella v. Metro-Goldwyn-Mayer, Inc.*, involves a 2009 lawsuit concerning rights to the book and two screenplays that allegedly formed the basis for the film “Raging Bull.” Although the lawsuit only sought recovery for infringement during the three preceding years (consistent with the three-year statute of limitations under the copyright laws), the plaintiff delayed bringing infringement claims for nearly two decades. The Supreme Court will consider whether lower courts appropriately determined, on summary judgment, that the copyright infringement claim was barred by laches.

Arbitration

In *BG Group PLC v. Republic of Argentina*, the Court will consider whether the Federal Arbitration Act requires courts or arbitrators to determine whether a precondition to arbitration has been satisfied. Under the statute, parties to an arbitration agreement are generally free to structure the dispute resolution process as they choose, designating certain issues to be resolved through litigation and others through arbitration. But who should decide a disputed issue when the arbitration agreement is silent? The Supreme Court has distinguished between two types of disputes: (i) “questions of arbitrability,” which are potentially dispositive gateway questions about whether a dispute is suitable for arbitration, and which are presumptively for a court to decide; and (ii) “procedural questions,” which grow out of a dispute and bear on its final disposition, and which are presumptively for the arbitrator to decide. The distinction between questions of arbitrability and procedural questions has proven elusive in practice, however.

The dispute in *BG Group* arose under a treaty between Argentina and the United Kingdom providing that conflicts between an investor and the host state would be resolved in the host state’s courts. If the conflict remained unresolved after 18 months,

The Court also will examine whether, and under what circumstances, the equitable defense of laches may bar a copyright infringement claim.

however, the treaty permitted a resort to arbitration. BG Group, a British corporation that had invested in Argentine gas companies, invoked the treaty's arbitration clause without first filing a claim in Argentine court. An arbitration panel determined that this failure did not preclude arbitration and awarded BG Group more than \$180 million in damages. The question now before the Supreme Court is whether the dispute over the litigate-and-wait precondition was a question of arbitrability that should have been resolved by a court rather than by the arbitrators.

Class Actions and Securities Law

The Class Action Fairness Act (CAFA) permits removal to federal court of "mass actions" that involve the claims of "100 or more persons." The question in *Mississippi ex rel. Hood v. AU Optronics Corp.* is whether this definition permits removal of a so-called *parens patriae* suit — a suit in which a state litigates as a representative of its citizens. State attorneys general increasingly have turned to such suits as a tool for enforcing a range of state laws, including consumer protection, environmental, civil rights and antitrust laws. In *AU Optronics*, the U.S. Court of Appeals for the Fifth Circuit had ruled that *parens patriae* suits are mass actions that are properly removable to federal court. It reasoned that, even though the state is the sole named plaintiff, the citizens on whose behalf the state sues also are "real parties in interest" and, therefore, count toward CAFA's 100-person threshold. In a unanimous opinion by Justice Sonia Sotomayor, the Supreme Court has now reversed, concluding as a matter of statutory interpretation that the phrase "100 or more persons" does not encompass unnamed persons, even if they are real parties in interest. The Court accordingly ordered that the case be remanded to state court. The Court's ruling means that *parens patriae* suits typically will not be removable to federal court, which is commonly viewed as a less favorable environment than state court for plaintiffs in such suits.

Halliburton Co. v. Erica P. John Fund, Inc. is a potential blockbuster in the field of securities law. There, the Court will reconsider the fraud-on-the-market theory: a presumption that securities investors rely on an efficient market that reflects all public information. The Supreme Court's embrace of the theory in 1988 — which allowed suits for fraud without a showing of individual reliance on the allegedly fraudulent misrepresentation — made the modern securities class action possible. In *Halliburton*, the Court will decide whether to change course; if it does so, it could significantly transform private actions under the securities laws (see "[Securities Litigation Landscape Continues to Evolve in 2014](#)").

Other Business Cases

Two other business cases from this term, one of which the Court decided on December 3, 2013, concern the proper forum for resolving disputes.

Walden v. Fiore asks whether the requirements of personal jurisdiction and statutory venue are satisfied if the defendant's only contact with the forum state is his knowledge that the plaintiff has connections to that state. In *Walden*, the plaintiffs were stopped by federal law enforcement officials in Georgia while traveling home to Nevada. Alleging that the officials improperly seized \$97,000 from their luggage, the plaintiffs filed suit in the U.S. District Court for the District of Nevada. The district court dismissed the suit for lack of personal jurisdiction, but the U.S. Court of Appeals for the Ninth Circuit

reversed, finding that the officers had “expressly aimed” their conduct toward Nevada by targeting persons known to have substantial connections there. The Ninth Circuit also held that Nevada was a proper venue under the federal venue statute because the plaintiffs had suffered harm there, even though the allegedly unlawful conduct occurred in Georgia. The Supreme Court will consider both the personal jurisdiction and venue rulings, and its decision could have important implications for cases involving parties from multiple jurisdictions, such as those arising from communications and commerce conducted over the Internet.

Finally, in *Atlantic Marine Construction Co. v. U.S. District Court for the Western District of Texas*, the Court recently ruled in favor of forum selection clauses — contractual provisions in which the parties designate in advance the jurisdiction where a dispute should be litigated. The question in *Atlantic Marine Construction* was what a court should do with a breach-of-contract suit when the contract at issue contained a clause specifying that litigation should occur in a different forum. In a unanimous opinion written by Justice Samuel Alito, the Supreme Court ruled that, absent exceptional circumstances, such a court should normally grant a motion to transfer on the ground of *forum non conveniens*, sending the dispute to the contractually agreed-upon jurisdiction. The ruling is consistent with the Court’s recent emphasis on giving effect to contractual language and closing avenues for parties to circumvent the terms of their agreements.

Antitrust and Competition: Nonmerger Enforcement Activity Heats Up on Both Sides of the Atlantic

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U.S. and European antitrust agencies had similar enforcement priorities last year, a trend we expect to continue in 2014. Nonmerger enforcement will continue to focus on intellectual property, financial services and pharmaceuticals, which also will be in the crosshairs of private plaintiffs. In the U.S., a recent Supreme Court decision may have a significant impact on the certification of antitrust class actions. In Europe, officials will push to pass new legislation designed to increase the availability of private antitrust damages actions throughout the EU, and the pharmaceutical, financial services and high-technology sectors will remain the subject of intense scrutiny by competition authorities. Global companies must be aware of the differences, similarities and trends on both sides of the Atlantic that are critical to developing global litigation strategies. This is particularly important given the continuing strong coordination between U.S. and European antitrust agencies, and increasing coordination with other antitrust agencies around the world.

United States

Under new Assistant Attorney General Bill Baer, the DOJ has continued to promote an active enforcement agenda, ranging from merger challenges to criminal cartel prosecutions. Similarly, the FTC, now led by Chairwoman Edith Ramirez, a former intellectual property litigator, has been active in both merger and nonmerger enforcement activity and has maintained its focus on pharmaceutical “reverse payment” settlements and the intersection of antitrust and intellectual property. Additional changes at the FTC include a new commissioner, Joshua Wright, a Republican who joined in 2013, and another awaiting confirmation, Terrell McSweeney, a Democrat who was nominated as the FTC’s fifth commissioner in June 2013.

We expect the DOJ and FTC to continue their merger-related activity (see [Global M&A/“Antitrust and Competition: Surveying Global M&A Enforcement Trends”](#)). Additionally, private litigation likely will shadow the agencies’ enforcement activity; for example, reverse payment cases are multiplying. However, private actions also will face tougher standards for class certification in antitrust cases in the wake of recent Supreme Court decisions (see [“Mass Tort and Consumer Class Action Outlook: A Mixed Landscape for Defendants in 2014”](#)).

Intellectual Property

- Reverse payment patent settlements will remain in the spotlight following the U.S. Supreme Court’s June 2013 decision in *Federal Trade Commission v. Actavis, Inc.*, 133 S.Ct. 2223 (2013). The ruling addressed the antitrust analysis applicable to settlements of patent litigation between brand-name and generic pharmaceutical manufacturers, where the brand-name manufacturer allegedly has paid the generic manufacturer to delay entry of a competing generic product. In a 5-3 decision, the Court rejected both the “scope of the patent” approach and the FTC’s proposed presumption of illegality for such settlements, instead adopting a rule of reason approach under which the antitrust plaintiff bears the burden of proving “significant unjustified

On the standard essential patents front, developments in 2013 brought greater clarity to the boundaries of enforcement.

anti-competitive consequences” flowing from the agreement¹ (see “[Intellectual Property and Technology: Patent Issues to Watch in 2014](#)”). In the wake of *Actavis*, private plaintiffs are challenging settlements involving at least 14 brand-name drugs.² The FTC also plans to “re-examine settlements previously filed with the Commission to determine whether they merit further investigation,”³ and Commissioner Wright recently stated that he is “quite certain” that the FTC plans “to bring a couple more” reverse payment cases in addition to the two it has pending.⁴

- The FTC will commence a study of patent assertion entities (PAEs),⁵ with the goal of examining the “costs and benefits” to “competition and innovation” of the PAE business model and PAE activities. The FTC will seek detailed information from a number of PAEs and from a select number of manufacturers and licensing entities in the wireless communications sector. Patent assertions in the wireless sector will be used as a case study and compared to patent assertions by PAEs in other industries. The FTC will issue a report in a year or two, but in the interim we would not be surprised to see private parties challenge PAEs, particularly those alleged to be engaged in “privateering,” under the antitrust laws.
- On the standard essential patents (SEP) front, developments in 2013 brought greater clarity to the boundaries of enforcement. The FTC (in *Google/Motorola Mobility*), the DOJ (in speeches at industry forums, including by Deputy Assistant Attorney General Renata B. Hesse) and even the White House (which vetoed an ITC exclusion order against Apple) established limits on patent holders’ ability to seek injunctive relief in patent infringement suits involving SEPs that are subject to a “fair, reasonable and non-discriminatory” (FRAND) licensing commitment. Moreover, two federal courts issued the first rulings determining FRAND royalties for particular SEPs.⁶ Additionally, the DOJ has engaged in advocacy to help clarify patent policies adopted by standards setting organizations (SSOs) so as to avoid later disputes regarding SEPs and FRAND terms. We expect the DOJ’s work with SSOs will continue, that more courts will issue FRAND rulings and that enforcement activity in the SEP space may increase.⁷

¹ *Actavis*, 133 S.Ct. at 2227, 2237-38.

² The drugs are Aggrenox, AndroGel, Cipro, Effexor XR, K-Dur 20, Lamictal, Lidoderm, Lipitor, Loestrin 24, Nexium, Niaspan, Provigil, Solodyn and Wellbutrin XL. Because a single patent settlement can spawn multiple follow-on private suits, the number of brand-name drugs at issue vastly understates the number of actual reverse payment cases pending.

³ Prepared Statement of the FTC Before the U.S. Senate Committee on the Judiciary on “Pay-for-Delay Deals: Limiting Competition and Costing Consumers,” July 23, 2013, available at http://www.ftc.gov/sites/default/files/documents/public_statements/statement-chairwoman-edith-ramirez-pay-delay-settlements/130923pfdo_peningstatement_0.pdf.

⁴ Jeff Bliss, “FTC plans to sue more drugmakers over pay-for-delay deals, Wright says,” Mlex, November 14, 2013.

⁵ Agency Information Collection Activities; Proposed Collection; Comment Request, 78 Fed. Reg. 61,352 (Oct. 3, 2013); see “FTC Seeks Comment on Collection of Information Relating to Patent Assertion Entities” (Sept. 30, 2013) available at <http://www.skadden.com/insights/ftc-seeks-comment-collection-information-relating-patent-assertion-entities>.

⁶ *Microsoft Corp. v. Motorola, Inc.*, No. 10-1823, 2013 WL 2111217 (W.D. Wash. Apr. 25, 2013); *In re Innovatio IP Ventures, LLC Patent Litig.*, No. 11-9308, 2013 WL 5593609 (N.D. Ill. Oct. 3, 2013); see also “US District Court Issues First Decision Calculating a FRAND Royalty for Standard-Essential Patents” (Apr. 29, 2013), available at <http://www.skadden.com/insights/us-district-court-issues-first-decision-calculating-frand-royalty-standard-essential-patent>.

⁷ Regarding future enforcement actions, the DOJ has repeatedly stated that it will “continue to explore where there is room for liability under Section 2 of the Sherman Act in cases where holders of FRAND-encumbered SEPs seek injunctive relief after a standard is in place.” Remarks of Deputy Asst. Attorney General, Renata Hesse, *The Art of Persuasion: Competition Advocacy at the Intersection of Antitrust and Intellectual Property* (Nov. 8, 2013), available at <http://www.justice.gov/atr/public/speeches/301596.pdf>.

Class Certification

- In 2014, courts will grapple with the significance of the Supreme Court's *Comcast Corp. v. Behrend* ruling, which reversed certification of a class of Comcast subscribers because plaintiffs' class expert's damages model failed to isolate damages resulting from the remaining theory of antitrust liability and impact.⁸ The Court held that "a model purporting to serve as evidence of damages ... must measure only those damages attributable to that theory" of liability. Rule 23(b)(3) predominance could not otherwise be shown because "[q]uestions of individual damage calculations" — *i.e.*, was the class member damaged by the accepted liability theory or some other conduct — "will inevitably overwhelm questions common to the class." *Comcast* mandates that the certification analysis must include careful scrutiny of the expert's models to prevent the acceptance of "any method" that purports to be applied class-wide. Open questions in the wake of *Comcast* include whether *Comcast* has changed the rule that individual damages calculations do not preclude class certification under Rule 23(b)(3); whether it is permissible to certify a class that potentially contains some number of uninjured class members; whether *Comcast* is limited to situations in which the expert's model is not "linked" to the liability case; and whether courts will seek to avoid injury- and damages-related complications by certifying classes on liability only under Rule 23(c)(4).

European Union

In 2013, the EU's competition law enforcement activity continued to focus on the pharmaceuticals, financial services and high-technology sectors. In the area of private enforcement, the European Commission (EC) published its long-awaited proposal for a harmonizing directive that would, once adopted, establish certain minimum standards for private damages actions in EU member states. These developments will set the stage for 2014. The term of office of the EC runs until October 31, 2014, and new commissioners, including those for competition, will be appointed or reappointed for another five-year term. In any event, the EU's nonmerger enforcement activity is unlikely to slow down in the interim.

Proposed Legislation on Private Antitrust Damages

- On June 11, 2013, the EC issued a package of measures relating to private damages actions consisting of (i) a proposal for a directive on rules governing private antitrust damages actions (the Proposed Directive), (ii) a nonbinding practical guide for national courts on the quantification of harm in private antitrust damages actions and (iii) a nonbinding recommendation on collective redress mechanisms (the Recommendation), which applies to antitrust damages claims and civil claims in other areas, including data protection, the environment and financial services.
- The centerpiece of the legislative package is the long-awaited Proposed Directive, which is the product of almost 10 years of internal considerations and a long-running public debate. The Proposed Directive seeks to establish certain minimum standards for private damages actions throughout the EU. Key elements of this proposal concern (i) the disclosure and protection of evidence, (ii) the effect of decisions issued by national competition authorities, (iii) limitation periods, (iv) joint and several liability,

⁸133 S. Ct. 1426 (2013).

(v) the “passing-on” defense and (vi) proof of harm. The Proposed Directive does not address collective redress, which is dealt with separately in the Recommendation. The Proposed Directive is subject to adoption by the EU Parliament and the EU Council and may be modified in the course of the legislative process. The Proposed Directive is anticipated to be adopted before summer of 2014, but timing will depend largely on when the relevant institutions and stakeholders can agree on the final scope of the Proposed Directive’s provisions. However, it is very likely that 2014 will bring further clarity to the terms and the scope of private damages claims in Europe. Once adopted, EU member states will have two years to implement the directive.

Pharmaceuticals

- After its pharmaceutical sector inquiry in 2008 and 2009 and subsequent monitoring of patent settlements in the EU, the European Commission issued its first decision in relation to reverse payment settlements on June 19, 2013, imposing a fine of €93.8 million on the brand-name originator firm Lundbeck and fines totaling €52.2 million on a number of generic producers that concluded patent settlement agreements with Lundbeck in the period 2002 and 2003. The EC’s decision supports a standard of review for the reverse payment patent settlements at issue based on a presumption of anti-competitive effects, which appears to contrast with the U.S. Supreme Court’s findings in *FTC v. Actavis* endorsing an effects-based rule of reason analysis as discussed above. The EC’s decision has been appealed to the EU’s General Court, which is expected to clarify the applicable legal standard.
- On December 10, 2013, the EC issued a decision imposing fines of €10.8 million on Johnson & Johnson and €5.5 million on Novartis in relation to a co-promotion agreement involving a reverse payment which, according to the decision, delayed the market entry of Novartis’ generic drug in the Netherlands.
- Two additional EC investigations are pending in relation to patent settlement agreements involving reverse payments from brand-name originators to generic firms. The EC has publicly indicated that it may open additional investigations in the future, so we expect this issue to remain on the forefront of the EU’s agenda in 2014.

Financial Services

- On December 4, 2013, the EC issued its first decisions concerning cartels in the financial sector since the start of the financial crisis in 2008. In two parallel decisions concerning the alleged manipulation of interest rate derivatives covering the European Economic Area relating to the EURIBOR, JPY TIBOR and Euroyen TIBOR rates, the EC imposed fines on eight financial institutions totaling more than €1.7 billion, which constitutes the highest-ever fine issued in Europe. The decisions were issued under the EU settlement procedure which allows for a simplified process. A number of banks and financial brokers involved in the investigations decided not to settle, and the EC opened formal proceedings against those companies under the standard (non-settlement) cartel procedure. The timing of decisions in the cases that did not settle is unclear.
- In July 2013, the EC also issued a Statement of Objections in the *Markit* case involving credit default swaps. A second EU probe relating to credit default swaps officially was put on hold.

Significant legal uncertainty remains in the EU over whether a patent owner can seek injunctive relief based on its patent.

- The EC in 2013 also extended its benchmark-rate investigations to the potential manipulation of such rates denominated in Swiss francs and launched new preliminary investigations into the possible manipulation of foreign exchange rates at several banks.
- The EC has indicated publicly that cartel enforcement in the financial sector remains a “top priority.”

High-Technology

The EC issued a Statement of Objections against Motorola Mobility in May 2013 for an alleged misuse of its standard essential patents when it sought to enforce those patents against Apple through an injunction in an alleged breach of FRAND commitments. In a similar case, the EC had issued a Statement of Objections against Samsung in December 2012, for the alleged misuse of patents by seeking injunctions against Apple under a possible violation of FRAND commitments. In October 2013, Samsung offered commitments to the EC that are being market-tested. Under the proposal, Samsung commits for a period of five years not to seek injunctions on the basis of any of its standard essential patents, present and future, that relate to technologies implemented in smartphones and tablets against any company that agrees to a particular licensing framework. Once the commitments are accepted, the EC will issue a commitment decision making the commitments binding.

Significant legal uncertainty remains in the EU over whether a patent owner can seek injunctive relief based on its patent, despite having entered into FRAND commitments, and more generally whether any obligation exists for a patent holder to license a patent under FRAND terms. Hopefully, 2014 will bring some clarity as the *Samsung* and *Motorola Mobility* cases move to a final decision.

* * *

U.S. and EU antitrust agencies show no signs of slowing down in 2014, and their coordination will continue to strengthen. Global businesses will need to be attuned to the trends on both sides of the Atlantic when mapping their global litigation and risk management strategies.

Mass Tort and Consumer Class Action Outlook: A Mixed Landscape for Defendants in 2014

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Recent decisions by the U.S. Supreme Court have improved the landscape for defendants seeking to fend off mass tort and consumer class actions. In *Comcast Corp. v. Behrend*, 133 S. Ct. 1426 (2013), the Supreme Court tightened the requirements for predominance; in *Standard Fire Insurance Co. v. Knowles*, 133 S. Ct. 1345 (2013), it derailed one of the most common tactics used by plaintiffs' attorneys to evade federal jurisdiction under the Class Action Fairness Act (CAFA); and in *Mutual Pharmaceutical Co. v. Bartlett*, 133 S. Ct. 2466 (2013), the Court breathed new life into preemption. These rulings have equipped defendants with additional tools to fight large-scale, aggregate litigation, but early signs suggest that certain lower courts may take a narrow view of some of these rulings.

- **Comcast and the future of product-based class actions.** The future of product-based consumer class actions will turn in large part on the resolution of two washing-machine class actions that are now before the Supreme Court for the second time. In *Glazer v. Whirlpool Corp.*, 722 F.3d 838 (6th Cir. 2013) and *Butler v. Sears, Roebuck & Co.*, 727 F.3d 796 (7th Cir. 2013), the plaintiffs have alleged that the defendants manufactured front-load washing machines with a design defect that makes them prone to accumulate mold. The U.S. Courts of Appeal for the Sixth and Seventh Circuits previously held that these cases could proceed on a classwide basis with their washers. Both cases were appealed to the Supreme Court, which vacated and remanded the decisions in light of its *Comcast* ruling. The Sixth and Seventh Circuits have since issued new rulings, finding that the cases were properly certified notwithstanding *Comcast*. The two courts of appeal essentially read *Comcast* as a very narrow decision that does not affect cases where the damages are small. The defendants thought the Supreme Court meant something more and petitioned for *certiorari* a second time. If the Court grants review and confirms that *Comcast* forecloses class proposals seeking to compensate class members whose products have not malfunctioned, the result could be a major blow for overbroad product-based class actions. If the Supreme Court allows the Sixth and Seventh Circuit rulings to stand, however, product manufacturers should expect more class actions in 2014.
- **Preemption making a comeback.** Recent preemption rulings in favor of pharmaceutical manufacturers likely will lead to more aggressive defense strategies at the outset of litigation. In *Mutual Pharmaceutical Co. v. Bartlett*, 133 S. Ct. 2466 (2013), the Supreme Court held that design-defect claims against generic drug companies are preempted by federal law, marking a decisive victory for generic pharmaceutical defendants. Another recent favorable preemption ruling was *In re Fosamax (Alendronate Sodium) Products Liability Litigation (Glynn v. Merck)*, 2013 U.S. Dist. LEXIS 90425 (D.N.J. June 27, 2013). There, the district court found failure-to-warn claims preempted where Merck presented evidence that the FDA would have rejected a stronger warning of the sort proposed by the plaintiff. Expect defendants to try extending these rulings in 2014; in fact, some pharmaceutical companies already have begun to argue that *Bartlett* should not be limited to generic manufacturers.
- **Ascertainability has its day.** In 2013, federal courts continued to take the requirement of ascertainability more seriously, requiring plaintiffs to prove at the class certification stage that class membership can be determined practicably and definitively.

Most notably, in *Carrera v. Bayer Corp.*, 727 F.3d 300 (3d Cir. 2013), the U.S. Court of Appeals for the Third Circuit held that a class of purchasers of Bayer's One-A-Day WeightSmart multivitamin was not ascertainable because "extensive and individualized fact-finding or mini-trials" would be required to determine who purchased the specific multivitamins at issue. *Carrera*, 727 F.3d at 305 (internal quotation marks omitted). The case, and several others that preceded it, are significant wins for manufacturers of low-value consumer products, particularly disposable items for which consumers do not tend to keep receipts. The plaintiff in *Carrera* filed a petition for rehearing before the Third Circuit, supported by several amici, effectively arguing that the decision was the death knell of small-value consumer class actions in the Third Circuit. It remains to be seen whether the Third Circuit will narrow its *Carrera* ruling, but either way, expect defendants to push harder on ascertainability in 2014, regardless of the circuit.

Recent judicial decisions interpreting CAFA generally have made it easier for defendants to remove interstate class actions from state to federal court.

- **Presumption of reliance not gone ... yet.** Some courts in 2013 continued to apply a "presumption" or "inference of reliance" in fraud and consumer fraud cases where the plaintiff alleges an omission or misrepresentation that would be deemed "material" by a reasonable consumer. *See, e.g., In re Motor Fuel Temperature Sales Practices Litigation*, 292 F.R.D. 652, at *670 (D. Kan. 2013). In practice, this concept has established reliance on behalf of all class members despite the inherently individualized nature of such an inquiry, with no real opportunity for rebuttal by defendants. In fact, defendants almost always are denied access to the individual class member discovery they would need to make such a defense. This is an area that may be ripe for scrutiny and reform in light of recent Supreme Court decisions in the class action arena, which have emphasized that defendants have a right to pursue individualized defenses in putative class litigation (*see Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2561 (2011)), and have questioned the logical underpinnings of presumptions of reliance (*see Amgen Inc. v. Connecticut Retirement Plans And Trust Funds*, 133 S. Ct. 1184, 1204 (2013) (Alito, J., concurring)). Thus far, at least one court has concluded that a defendant's right under *Wal-Mart* to present individualized defenses makes a presumption of reliance improper. *See O'Brien v. Hasbro*, No. BC438958, 2012 WL 6638112 (Cal. Super. Ct., L.A. Cty. Dec. 12, 2012). The Supreme Court is likely to provide further guidance on this issue in 2014 when it decides *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (U.S. cert. granted Nov. 15, 2013), which squarely presents the question whether defendants are entitled to present evidence to rebut a presumption of reliance in securities-fraud cases (*see "US Supreme Court Cases to Watch in 2014"*).
- **CAFA jurisprudence matures.** Recent judicial decisions interpreting CAFA generally have made it easier for defendants to remove interstate class actions from state to federal court. For example, in *Standard Fire*, the Supreme Court held that a named plaintiff may not avoid removal under CAFA by stipulating in his complaint that he is not seeking to recover more than \$5 million on behalf of absent class members. In barring this tactic, the Court reiterated Congress' central intent behind passing CAFA, which was to expand federal jurisdiction over interstate class actions. The importance of *Standard Fire* recently was highlighted by the U.S. Court of Appeals for the Ninth Circuit in *Rodriguez v. AT&T Mobility Services LLC*, 728 F.3d 975 (9th Cir. 2013), which read *Standard Fire* as abrogating the stringent "legal certainty standard" for proving the amount-in-controversy requirement under CAFA. The *Standard Fire* and *Rodriguez* decisions likely will lead other federal courts to reject efforts by plaintiffs' lawyers to evade federal jurisdiction under CAFA. At the same time, however, there are pockets of federal judges in various circuits, who remain hostile to CAFA removals, and continue to remand cases that belong in federal court.

- **Cy pres.** In 2013, plaintiffs continued to test the limits of *cy pres*, the practice of distributing class funds to third-party charities instead of delivering the money to aggrieved class members. Two courts of appeal rejected *cy pres* settlements on the ground that the attorneys' fees vastly outweighed any meaningful relief to the class members. See *In re Baby Prods. Antitrust Litig.*, 708 F.3d 163 (3d Cir. 2013); *In re Dry Max Pampers Litig.*, 724 F.3d 713 (6th Cir. 2013). However, all eyes were on *Marek v. Lane*, the \$9.5 million settlement of a privacy lawsuit approved by the U.S. Court of Appeals for the Ninth Circuit, \$6.5 million of which was a *cy pres* award dedicated to establishing a new charity organization called the Digital Trust Foundation. The Supreme Court denied *certiorari* in the case, but Chief Justice John Roberts issued an unusual statement along with the denial, stating that the Court may "in a suitable case ... need to clarify the limits on the use of" the *cy pres* practice. See *Marek v. Lane*, 571 U.S. – 134 S. Ct. 8 (2013) (statement by Roberts, C.J.) For the time being, however, *cy pres* is alive and well, and 2014 likely will include more settlements using this practice.

Government Enforcement: Aggressive Efforts Continue Around the Globe

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Government enforcement efforts in 2013 produced major settlements of matters relating to the global financial crisis, high-profile insider trading convictions, near-record amounts of FCPA settlements, and new pledges of robust and aggressive SEC enforcement activity. We expect these trends to continue in 2014.

US Enforcement Trends

Major Monetary Penalties and a Push to Prosecute

Since the financial crisis began to subside, politicians and commentators repeatedly have criticized federal and state prosecutors for failing to bring charges against banks and executives that they contend bear responsibility for the crisis. In the past year, prosecutors reached a significant number of settlements, with multimillion- and, occasionally, billion-dollar price tags. Yet, the critics persist in their calls for more enforcement activity in the new year, and we believe federal and state authorities will continue to take increasingly harsh positions when investigating perceived wrongdoing by financial institutions and their executives. This includes seeking substantial penalties, acknowledgments of wrongdoing and the imposition of criminal sanctions where extraordinary facts exist.

Aggressive Use of FIRREA

Last year the DOJ began aggressive use of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) to investigate and prosecute cases arising from the recent financial crisis. FIRREA was enacted in 1989 in response to the savings and loan crisis, but the DOJ has rarely used it in the ensuing two decades. The law's structure explains why the DOJ has turned to it: FIRREA provides the government with a very broad scope without the limitations of other statutory schemes (most especially, the federal securities laws), a reduced burden of proof (preponderance of evidence rather than beyond a reasonable doubt), tough civil penalty provisions, broad investigative authority, incentivizing whistleblower provisions and a generous 10-year statute of limitations.

We expect the DOJ to continue leaning heavily upon FIRREA as part of its final push to bring even more headline-grabbing cases related to the financial crisis. Defining sensible outer limits on FIRREA's reach in terms of liability and penalties will be a challenge. We expect many answers will develop this year, including in public FIRREA litigation rather than behind the closed doors, where financial institutions and other organizations often feel pressure to negotiate resolutions of criminal investigations to avoid the damaging consequences that often accompany a criminal indictment.

Cross-Border Tax Investigations in Switzerland and Beyond

Approximately five years ago, a major global investment bank entered into a deferred prosecution agreement (DPA) with the DOJ and agreed to pay \$780 million in fines to the DOJ and SEC to resolve allegations that the bank had conspired with U.S. taxpayers to evade their tax obligations and for having engaged in unregistered broker-dealer

and investment advisor activities in the United States. Since that time, the DOJ and IRS have continued their aggressive pursuit of financial institutions and tax professionals for purportedly conspiring with U.S. taxpayers to defraud the IRS by maintaining undeclared accounts in Switzerland and elsewhere. For example, Wegelin & Co., a Swiss private bank, pled guilty to felony tax charges in 2013 and paid nearly \$74 million in fines, after which it announced it would be closing permanently, and public reports have identified more than a dozen other Swiss banks currently under criminal investigation for facilitating tax evasion by U.S. taxpayers. The government's efforts in this area have been significant: Since 2009, the DOJ has brought criminal charges against more than 30 banking professionals and nearly 70 U.S. account holders for violations concerning their offshore banking activities. In addition, more than 50 U.S. taxpayers and four bankers and financial advisors have pled guilty, and five taxpayers have been convicted at trial. Recognizing the risk of prosecution, approximately 40,000 U.S. taxpayers have participated in the IRS's offshore voluntary disclosure program. Most, if not all, of these individuals have likely provided potentially damaging evidence against their former banks, bankers and service providers.

Despite these successes, DOJ officials appear frustrated with the pace of their investigation of the offshore banking industry and inability to obtain client and other information from non-U.S. financial institutions, particularly in Switzerland. To address these issues — and to further its long-standing investigation of the Swiss banking industry — the DOJ announced a voluntary disclosure program for Swiss banks in August 2013.

Generally speaking, the program provides Swiss banks that have reason to believe they may have committed a tax- or monetary-related offense under U.S. law with an opportunity to obtain a nonprosecution agreement (NPA) in exchange for (i) paying a substantial fine based on the value of undeclared accounts that it maintained or opened after August 2008 and (ii) disclosing a significant amount of information about its historical activities and relationships with undeclared U.S. account holders. With respect to the latter obligation, banks must disclose how their cross-border business was structured, the names and functions of employees, and service providers involved in the cross-border business, how undeclared account holders were serviced, and the number and value of undeclared accounts that existed at various points in time after the investigation that led to the DPA became public in August 2008. Banks also must provide nonpersonalized data concerning "leavers" — *i.e.*, undeclared account holders who moved their account(s) to other banks after August 2008 — including the names of the institutions where any such funds were sent.

Swiss banks are not legally required to participate in the program, but estimates suggest that a significant percentage of the Swiss banking industry will seek an NPA. Many others likely will request a nontarget letter under the program by providing the DOJ with an internal investigation report and other information purportedly establishing that they did not commit a tax or monetary offense. Banks that don't pursue either option and later become targets of DOJ investigations should expect to be aggressively pursued. The DOJ may treat these banks more harshly if it determines they violated U.S. law. While it is impossible to predict outcomes in the abstract, the DOJ may be more likely to indict such banks (as well as culpable employees and managers) and seek financial penalties greater than what the voluntary disclosure program suggests.

While the program is aimed at the Swiss banking industry, it also presents substantial risks to financial institutions in other jurisdictions that maintained or serviced undeclared accounts for U.S. taxpayers. The DOJ and IRS have stated that their enforcement efforts extend beyond Switzerland, and they plan to follow the trail of undeclared money around the world. These threats must be taken seriously since the authorities have and will continue to obtain substantial amounts of potentially incriminating evidence against financial institutions through the Swiss program, the IRS's offshore voluntary disclosure program, cooperating witnesses, whistleblowers and investigations of other banks. Financial institutions with U.S. cross-border private banking operations, particularly those in known private banking centers, should move quickly to evaluate their situations and take appropriate steps.

While prosecutors will closely scrutinize the securities industry in 2014, the current flood of traditional insider trading prosecutions may be cresting.

US: Insider Trading and Securities Regulation

Federal prosecutors have pursued insider trading relentlessly in recent years. The U.S. Attorney for the Southern District of New York, Preet Bharara, has been particularly active in this arena, with an unbroken string of nearly 80 convictions since 2009. These include the high-profile corporate guilty plea and payment of a \$1.2 billion fine by SAC Capital Advisors in November 2013. While prosecutors will still closely scrutinize the securities industry in 2014, the current flood of traditional insider trading prosecutions may be cresting. In its place, we expect the SEC and other regulators to focus more attention on other hot-button issues, such as high-frequency trading. In addition, New York Attorney General Eric Schneiderman and other state prosecutors may use broadly worded blue sky laws, such as New York's Martin Act, to push beyond the traditional bounds of insider trading law into what Schneiderman has coined "Insider Trading 2.0." While he has yet to define this catchphrase, early indications suggest Schneiderman's office will focus on perceived "unfairness" in the marketplace, including potential informational and timing disparities within the securities industry.

We also expect robust SEC enforcement activity throughout 2014. In Chairwoman Mary Jo White's first year, she minced few words on this point, stating that the SEC "will be in more places than ever before" on the enforcement front. The commission's aim, Ms. White underscored, is "to create an environment where you think we are everywhere — using collaborative efforts, whistleblowers and computer technology to expand our reach; focusing on gatekeepers to make them think twice about shirking responsibilities; and ensuring that even the small violations face consequences."¹ Ms. White's reference to gatekeepers is in connection with the SEC's newly minted focus on auditors as part of an initiative dubbed Operation Broken Gate, which "probes the quality of audits and determines whether the auditors missed or ignored red flags; whether they have proper documentation; and whether they followed their professional standards."

Global Anti-Corruption Enforcement

Multijurisdictional enforcement and international cooperation continue as rising trends in anti-corruption matters. While the sheer number of announced settlements by U.S. authorities under the Foreign Corrupt Practices Act may have slowed in 2013, the dollar

¹ Securities Enforcement Forum, (speech, Washington, D.C., Oct. 9, 2013), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370539872100#.UqB6cmTk9eE>.

All indications are that DOJ and SEC investigation pipelines remain full, with both agencies continuing to devote significant resources to robust FCPA enforcement.

amounts of those settlements are not waning. Early reports show that at least a dozen companies paid a total of \$731 million to resolve FCPA cases, up from the \$259 million paid by 12 companies in 2012. All indications are that DOJ and SEC investigation pipelines remain full, with both agencies continuing to devote significant resources to robust FCPA enforcement.

Outside the United States, China has made the most headlines, with a series of investigations in the pharmaceutical sector; several high-profile prosecutions of public officials; and a very public campaign to reduce hospitality, entertainment and gift-giving involving public officials and state-owned enterprises. China's State Administration for Industry and Commerce (SAIC) announced that it would look for "bribery, fraud and anti-competitive practices" in a wide range of industries and initiated numerous regulatory visits and investigations in 2013. China's National Development and Reform Commission also announced it would review pricing practices in a range of sectors, including automotive, energy and telecommunications.

Although China's efforts have dominated public attention, significant legal and enforcement developments have occurred in other countries. For example:

- In 2013, Brazil enacted a new anti-corruption law (effective January 28, 2014), called the "Clean Company Act" (CCA), which specifically prohibits bribery of foreign government officials and prohibits fraud, manipulation and bribery in connection with public tenders. The act applies to corporate entities that operate in Brazil, including an entity's directors, officers, employees and agents. If an entity is determined to be a Brazilian company, the CCA applies to that entity's business operations around the world. The act does not appear to require proof of intent or knowledge on the part of an entity and provides for civil money penalties rather than criminal liability.
- Canadian authorities levied the largest-ever corporate fine (CDN 10.35 million) in an anti-corruption investigation, reaching a plea agreement with Griffiths Energy International in 2013 in relation to payments to intermediary consultants to secure oil production exploration rights in Chad. In addition, Canadian authorities achieved their first conviction of an individual under the Corruption of Foreign Public Officials Act (CFPOA), against an individual who conspired to bribe officials of Air India to secure business for a Canadian security company. In 2013, Canada reported to the OECD Convention Against Corruption that it had more than 30 ongoing foreign bribery investigations, and the OECD Convention views Canada as having continued enforcement momentum. Canada has amended its CFPOA to add a books and records provision, expand nationality-based jurisdiction, increase penalties and provide for an eventual prohibition of facilitating payments.
- French authorities worked closely with U.S. prosecutors in an investigation of Total S.A., and the DOJ announced in May 2013 that Total had agreed to pay a \$398 million monetary penalty to resolve charges related to violations of the FCPA in connection with illegal payments made through third parties to a government official in Iran to obtain valuable oil and gas concessions. On the same day, French authorities initiated criminal proceedings against Total's chairman and CEO and two other individuals for alleged violations of France's anti-bribery law and other statutes.
- German state prosecutors also continue to actively pursue anti-corruption matters. In August 2013, Volvo's CEO struck a deal with German prosecutors and his former employer, truck maker MAN SE, to settle an investigation into corruption during his time with the German company. In connection with an ongoing investigation of Atlas

Elektronic (a joint venture of EADS and ThyssenKrupp), German police raided the offices of Atlas Elektronic and the Rheinmetall in August 2013 on suspicion that the companies were paying bribes of €18 million related to an order of submarine equipment from Greece. (EADS and ThyssenKrupp confirmed the raid on Atlas Elektronic; Rheinmetall has denied any involvement in the alleged bribery scheme.)

UK Enforcement Trends

Administrative and Legislative Changes

U.K. regulators showed an increased appetite for criminal investigations and enforcement proceedings in 2013, even while in the midst of agency reorganization and renewal. On April 1, 2013, the enforcement functions of the financial regulator, the Financial Services Authority (FSA), were transferred to the Financial Conduct Authority (FCA). Additionally, the Serious Organised Crime Agency was replaced by the National Crime Agency (NCA), which became operational in October 2013 and is tasked with investigating economic crime, among other forms of organized crime. How the NCA will work with enforcement authorities, including the FCA, Serious Fraud Office (SFO) and other prosecution authorities with a remit for economic crimes, remains to be seen. What is clear from the NCA's and FCA's creation alongside the retention of the SFO as a standalone prosecutor is the U.K. government's continued political commitment to fight financial crime. The FCA and SFO have brought an increased number of prosecutions and investigations in 2013, and the two agencies increasingly have worked together on cross-border investigations with U.S. regulators and other international enforcement entities.

In April 2013, the Crime and Courts Act 2013 established a mechanism for the use of DPAs in U.K. enforcement actions. DPAs likely will be brought into force in the course of 2014, and once effective, the U.K. will have a sentencing option that will enable prosecutors to set aside criminal charges in exchange for a company's admission of wrongdoing and an agreement to comply with other requirements set out in the DPA (e.g., a financial penalty, disgorgement of profits, reparations to victims, individual or organizational remediation and monitoring of compliance obligations). The U.K. model for DPAs has many similarities to U.S. law and practice but — crucially — it involves earlier and greater judicial oversight. The DPA approval process begins with a nonpublic first appearance before the "sentencing" judge for an assessment as to whether a potential DPA would be "in the interests of justice" and "fair, reasonable and proportionate." The government hopes that DPAs will incentivize discretionary self-reporting and encourage cooperation with government investigations in fraud, corruption and other economic crimes.

Serious Fraud Office — Notable Enforcement Proceedings

The SFO conducted a number of important investigations and prosecutions in 2013, enjoying relative success at trial. For example:

- The SFO is partnering with the FSA in criminal and regulatory investigations into the rigging of LIBOR benchmarks. These investigations, brought in tandem with U.S. regulators, have resulted in fines and other enforcement outcomes against a number of financial institutions, as well as criminal charges against a number of individuals.

- In January 2013, Achilleas Michaelis Kallakis and Alexander Williams were found guilty of conspiracy to defraud banks. The two individuals had obtained a £100 million bridging loan facility from the Allied Irish Bank and the Bank of Scotland through deception and forgery to obtain financing for a property portfolio and a super-yacht conversion. After a prosecution appeal following imprisonment sentences for both individuals, the Court of Appeal increased the Kallakis and Williams sentences to 11 and eight years' imprisonment, respectively.
- In August 2013, the SFO charged three individuals associated with Sustainable AgroEnergy plc with "making and accepting a financial advantage" as part of a wider investigation into an alleged £23 million "bio fuel" investment fraud, for which four individuals have been charged with false representation and conspiracy to furnish false information in promoting and selling bio fuel investment products to U.K. investors.
- Following a government audit into contracts for electronic tagging of criminals between the U.K. Ministry of Justice and security companies Serco and G4S, the government referred allegations pertaining to overcharging to the SFO in September 2013. The inquiry revealed that the Ministry of Justice had been charged for tagging people who were found to be dead, in prison or overseas. In December 2013, the government referred to the SFO further allegations regarding overcharging on separate public sector contracts worth £3.9 billion. On December 20, Serco agreed to refund the U.K. government £68.5 million for its tagging contracts.
- In April 2013, the SFO launched an investigation into Eurasian Natural Resources Corporation over fraud, bribery and corruption claims relating to certain of its mining operations, including in Kazakhstan. The SFO announced its own investigation despite the company having previously conducted its own internal investigation and cooperated with the SFO. The investigation is ongoing.
- In October 2013, the SFO charged Smith & Ouzman Limited, a specialty papers and printing company, as well as two of its directors, an employee and one agent, with corruptly agreeing to make payments totalling £400,000 to influence the award of contracts in Mauritania, Ghana, Somaliland and Kenya.
- In December 2013, the SFO launched a criminal probe into Rolls-Royce following bribery and corruption allegations by a purported whistleblower relating to the company's sale of engines in Indonesia and China. Rolls-Royce has conducted an internal investigation into the practices of its overseas intermediaries in those two countries and other markets where concerns were identified.

Financial Conduct Authority

Organizational and Policy Changes. After opening its doors in April 2013, the FCA commenced several investigations under its new head, Martin Wheatley, and its head of enforcement, Tracey McDermott. The FCA inherited the FSA's civil and criminal powers relating to market abuse and insider trading, and both the FCA and the Prudential Regulatory Authority (PRA) have disciplinary and enforcement powers.

The Financial Services Act of 2012 introduced three new criminal offenses relating to the making of false or misleading statements and a discreet offense of creating a false or misleading impression in relation to a specified benchmark. The only benchmark to which the new offense applies is LIBOR, and only for conduct post-dating

The FCA's review of the asset management sector indicated that most firms failed to demonstrate adequate anti-bribery systems and controls.

the introduction of the Financial Services Act in April 2013. The thoroughness of this legislative effort might come under scrutiny in 2014 as evidence emerges of traders' manipulation of other benchmarks.

In October 2013, the FCA published the results of its "thematic review" into asset management and platform firms' anti-money laundering and corruption systems and controls, following visits to 22 firms within the sector. The review assessed whether such firms are taking adequate steps to mitigate money laundering and bribery and corruption risks. Failure by a firm to heed the regulator's warnings as set out in the thematic review can lead to the FCA initiating enforcement action. The FCA's review of the asset management sector indicated that most firms failed to demonstrate adequate anti-bribery systems and controls. Specifically, the report showed that the firms' anti-bribery and corruption policies and procedures are unduly focused on gift and entertainment spending limits while neglecting significant risk areas, such as monitoring relationships with agents, introducers and other third parties.

Notable Enforcement Proceedings. Like the SFO, the FCA pursued a number of important investigations and prosecutions in 2013. The FCA continues to successfully bring complex insider dealing cases and is increasingly working with the SEC and CFTC, as well as other European regulators, to investigate cross-border regulatory offenses. For example:

- In September 2013, the FCA fined ICAP Europe Limited £14 million for colluding with traders to manipulate the Yen LIBOR rate. The FCA also announced that it is carrying out an inquiry into the potential manipulation of ISDAFIX, the leading benchmark for annual swap rates for swap transactions globally.
- As part of a global probe regarding price manipulation in currency markets, the FCA opened an investigation into suspected price-fixing in the foreign exchange market in the United Kingdom. The FCA is cooperating with Asian, U.S. and European authorities in a joint investigation into whether currency traders at certain investment banks colluded with counterparts to manipulate the FX market. Switzerland's financial markets regulator, FINMA, is investigating several Swiss banks, the Hong Kong Monetary Authority is investigating banks in Hong Kong, and multiple U.S. regulators have initiated their own investigations.
- The FCA has continued its focus on insider dealing, with 14 arrests in 2013. "Operation Tabernula," an investigation into multiple, interlinked insider dealing rings, has produced its most complex insider dealing prosecution to date. It is widely believed that the FCA will bring at least three trials arising from Operation Tabernula, with multiple defendants in each trial. Eight people have been charged in the probe, including individuals from Legal & General Plc, Schroders Plc and GLG Partners Inc. One of the eight, former Legal & General Group Plc equities trader Paul Milsom, pled guilty and was sentenced in March 2013 to two years in prison.
- In an effort to reinforce the importance of effective systems and controls in the banking sector, and in a show of its civil enforcement powers, the FCA fined EFG Private Bank £4.2 million in April 2013 for failing to take reasonable care to establish and maintain effective anti-money laundering controls. RBS was fined more than £5 million in July for incorrectly reporting transactions in wholesale markets. In December 2013, the FCA fined Lloyds Banking Group more than £28 million for serious failings in its controls over sales incentive schemes.

- The extraterritorial reach of the FCA's market abuse regime also was evident when it fined U.S.-based high-frequency trader Michael Coscia and his company, Panther Energy Trading LLC, \$900,000 for deliberate manipulation of the commodities markets. The CFTC banned Coscia and his company from trading for one year and fined him \$2.8 million for creating false commodity futures contracts.

International Cooperation

Given the ongoing nature of various multijurisdictional and multi-agency investigations, U.K. regulators will continue to participate in significant international enforcement actions in 2014. The high levels of international cooperation observed in 2013 between U.K., U.S. and other regulators in conducting international investigations into market abuse, bribery, fraud and corruption is set to continue in 2014.

Intellectual Property and Technology: Patent Issues to Watch in 2014

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With key provisions of the America Invents Act (AIA) taking effect and a host of controversial U.S. Supreme Court decisions, 2013 was another active year for intellectual property law. Big cases and big changes will continue to be the trend in 2014, with eight intellectual property cases pending before the Supreme Court and a number of patent reform measures under consideration by Congress.

US Supreme Court

2013 Decisions

AMP v. Myriad Genetics. On June 13, 2013, the Supreme Court ruled that human DNA is not patentable, even when isolated, but “complementary” DNA (cDNA) is patentable because it is synthesized in a laboratory and does not occur naturally. The nuanced ruling followed a flood of amicus briefs from industry groups, human rights organizations and an unsolicited brief from the Department of Justice. As the U.S. Court of Appeals for the Federal Circuit had noted in its decision upholding gene patenting, the U.S. Patent and Trademark Office (PTO) has issued patents related to DNA for nearly 30 years. Not only does the Supreme Court’s decision call for a change in the approach to patenting employed by participants in the life sciences industry, it also continues the Court’s trend toward curtailing patent rights. Yet while the immediate industry reaction to the decision was sharp, a more reasoned view is emerging that sophisticated market participants had sought protection in various forms that remain patentable, including diagnostic tools and applications for DNA discoveries.

FTC v. Actavis. Just days after the *AMP* decision, the Supreme Court ruled on a common practice used in resolving pharmaceutical patent litigation, colloquially known as “reverse-payment” settlements. These settlements often are utilized by brand-name drug manufacturers to forestall a judgment that may result in negating their market exclusivity, in return for granting a generic patent challenger a license to enter the market prior to the scheduled patent expiration date. The practical result is an extended monopoly for the brand-name drug manufacturer and a delayed duopoly with the generic challenger. Whether such settlements have an anti-competitive effect has long been the subject of debate, with some advocating that the settlements allow an unfair extension of monopoly profits, while others maintain that the settlements ensure entry of a generic at an earlier date than might result if the cases were tried to judgment. In its decision on June 17, 2013, the Supreme Court held these settlements are subject to antitrust scrutiny but are not presumptively illegal (see [“Antitrust and Competition: Nonmerger Enforcement Activity Heats Up on Both Sides of the Atlantic”](#)).

Pending Cases

More intellectual property decisions are anticipated in 2014. On November 5, 2013, the Supreme Court heard oral arguments in *Medtronic, Inc. v. Boston Scientific Corp.*, and a ruling is expected on the burden of proof in declaratory judgment actions filed by patent licensees. *Certiorari* also was granted in eight additional intellectual property cases.

Patent. The Supreme Court will hear an extraordinary five patent cases in 2014. Two of these cases will be heard together and are related to the “exceptional case” standard for awarding attorneys’ fees in patent litigation (*Octane v. ICON*; *Highmark v. Allcare*). Currently, the Federal Circuit’s test for exceptional circumstances sufficient to give rise to attorneys’ fees results in only 1 percent of all prevailing parties receiving fees. The Supreme Court’s interest in the fee-shifting issue is no doubt related to the concerns over patent litigation costs and frivolous claims that have prompted the legislative initiatives discussed below. Fee-shifting is meant to curtail spurious patent claims and eliminate weak patents by giving parties the incentive to fight patent suits and collaterally prevent parties from reasserting weak patents. Additionally, the Court will once again tackle the issue of what kinds of inventions are patentable, this time in relation to computer-implemented inventions (*CLS Bank v. Alice Corp.*). The Court also will decide the limits of induced patent infringement where no one entity has committed all the acts necessary to prove infringement (*Limelight v. Akamai*) and the requirement of “particular and distinct” patent claiming (*Nautilus v. Biosig*).

Copyright. The Supreme Court will address two copyright cases. The first involves the application of the defense of laches in copyright cases (*Petrella v. MGM*) (see “US Supreme Court Cases to Watch in 2014”). The second will decide what constitutes “public performance” of copyrighted material (*ABC v. Aereo*). Aereo is accused of copyright infringement for retransmitting copyrighted material over the internet via remote antennas assigned to paid subscribers. In an unusual move, Aereo urged the Court to hear the case despite prevailing at the lower court.

Trademark. The Supreme Court will decide whether a private party may challenge a food or beverage label as misleading or false under the Lanham Act where that label is already regulated by the FDA (*POM Wonderful v. Coca-Cola*).

Electronic and Computer Patents

The viability of electronic and computer patents is rapidly evolving, with the Supreme Court granting *certiorari* to review the patentability of computer patents in CLS and both the Federal Circuit and the Patent Trial and Appeals Board (PTAB) taking steps toward decreasing patent protection for these patents. In its *en banc* decision in *CLS*, the Federal Circuit held a computerized method not patentable because it was merely an abstract idea. The decision may have ramifications for many computer patents, but the test in *CLS* is far from clear, with the 10-judge panel issuing seven different opinions. Indeed, the fractured *CLS* decision and subsequent grant of *certiorari* symbolizes the need for more objective standards to assess patentability of computer-implemented inventions and stands as proof that the Supreme Court’s prior decisions in cases like *In re Bilski* fall short of providing lower courts and industry participants with the necessary guidance on patentability standards.

The AIA created new routes for post-issuance review of patents, aimed at curbing litigation of weak patents by expanding the scope of review outside of litigation proceedings. In 2013 the PTAB began its evaluation of post-issuance review petitions and issued its first set of final decisions in Covered Business Method (CBM) and Inter Partes Review (IPR) proceedings. These review methods, along with Post Grant Review (PGR), may result in canceled patent claims, thereby preventing assertion of those patents. As of November 2013, the vast majority (roughly 70 percent) of AIA petitions related to

electrical/computer patents. Post-issuance review procedures are proving attractive to petitioners because the standard of review is significantly lower than at the district courts, and the PTAB has expressed a willingness to continue review even after petitioners withdraw or settle.

On June 11, 2013, the first and only CBM decision resulted in the cancellation of previously issued claims (*SAP v. Versata*). The PTAB in *SAP*, like the Federal Circuit in *CLS*, applied a broad definition of an unpatentable abstract idea that resulted in the cancellation of Versata's computer claims. The decision and subsequent denial of a rehearing demonstrate PTAB's willingness to cancel previously granted claims even after a final decision of infringement at the district court, affirmation from the Federal Circuit, and a \$300 million damages award. The PTAB decision also led to an influx of CBM petitions, with only 36 applications in the 10 months before the decision and 50 in the four months since *SAP*. However, without further legislation, CBM reviews will end when the AIA's eight-year sunset provision comes into effect in September 2020.

We expect the upward trend in post-grant filings to continue steadily through 2014.

IPR proceedings also have gained traction with 652 petitions and 239 decisions on whether to institute a trial, only 33 of which resulted in denied review. With more decisions likely to be issued in the coming months striking down patent claims, and growing familiarity with the PTAB procedures among practitioners, we expect the upward trend in post-grant filings to continue steadily through 2014.

Potential Patent Legislation

Efforts to revamp patent law and patent litigation are not limited to the Supreme Court or the PTO. In June, the White House Task Force on High-Tech Patent Issues recommended seven legislative measures, and, having just implemented the most extensive revision to the patent laws in decades, Congress continues to initiate patent reforms. While numerous bills have been introduced, the emphasis of most proposed amendments is on nonpracticing entities and the protection of end users. Of the many bills outstanding, the two most comprehensive are the Innovation Act in the House and the Patent Transparency and Improvements Act of 2013 in the Senate. Rep. Bob Goodlatte's (R-Va.) Innovation Act has gained the most traction, with the House passing an amended version, H.R. 3309. The most notable amendment came from Rep. Goodlatte himself, who removed the controversial provision calling for the expansion and permanence of the CBM program. Both bills are aimed at reducing abusive patent litigation by increasing transparency and eliminating hurdles to patent challenges, including heightening pleading standards and instituting mandatory attorney fee-shifting. A pending FTC study of nonpracticing entity litigation likely will embolden these reforms (see "Antitrust and Competition: Nonmerger Enforcement Activity Heats Up on Both Sides of the Atlantic").

Food and Beverage Labeling and Marketing Litigation Continues to Play Out in the Courts and Legislatures

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The food and beverage industry has experienced a recent spate of consumer class actions attacking various aspects of the labeling and marketing of products. Advertising and marketing claims by manufacturers that a product is “All Natural” have been an especially frequent target, with plaintiffs pointing to the inclusion of synthetic ingredients or genetically modified organisms (GMOs) or the processing of the product as grounds for suit. Many of these cases have been filed in California, where state laws are viewed as favorable to plaintiffs, although cases are pending throughout the country.

Consumers have contended that “All Natural” claims are false, misleading or deceptive under states’ applicable consumer fraud statutes, but several such claims have been stymied by plaintiffs’ inability to explain what, exactly, “All Natural” means. In the absence of an established, uniform legal definition, courts are sending mixed signals through conflicting rulings that will require careful consideration by industry participants seeking to avoid or minimize litigation risk.

Court Interpretations

Although the term “All Natural” is not defined by the U.S. Food and Drug Administration, the U.S. Department of Agriculture has issued draft guidance on the subject. In the absence of an FDA definition, courts often have reached conflicting conclusions regarding what constitutes an “All Natural” product and whether a legal challenge should proceed. For example:

- In *Pelayo v. Nestle USA*, the U.S. District Court for the Central District of California dismissed a proposed consumer class action on the grounds that the plaintiff failed to offer an objective or plausible definition of “All Natural.”
- However, in *Astiana v. Kashi Company*, the U.S. District Court for the Southern District of California refused to grant the defendant’s motion to dismiss and certified two classes of consumers who purchased Kashi products labeled “All Natural” or “Nothing Artificial” on the basis that certain of the challenged ingredients either were synthetic or were not permitted in organic foods.

As the *Kashi* decision suggests, in the absence of a uniform definition courts may look to USDA standards for organic foods to determine whether an ingredient is natural. The court in *Kashi* noted that consumers often equate natural with “organic” — or hold organic to a higher standard. For example, in *Thurston v. Bear Naked*, another decision from the Southern District of California, the court refused to certify a class of consumers who sought to challenge certain ingredients in granola products labeled “All Natural,” explaining that those ingredients are permitted in organic foods.

Genetically Modified Organisms. The inclusion of GMO ingredients in foods also has been litigation fodder for consumer plaintiffs. The lack of a definition of “All Natural” sometimes provides plaintiffs free rein to attack the processing of a food or beverage product without specifying how the processing converts natural ingredients into an unnatural product.

For example, the U.S. District Court for the Northern District of California recently rejected a motion to dismiss in *Parker v. J.M. Smucker Co.* The plaintiff alleged that the defendant's labeling of various Crisco cooking oils as "All Natural" misled consumers because of the chemical processing the oils had undergone. The court deemed the plaintiff's allegation that this processing results in the oils no longer "retain[ing] the chemical composition occurring in nature" sufficient to withstand the motion to dismiss, despite defendant's argument that merely describing the processing didn't explain how the oils had been "chemically altered." On the other hand, the court in *Pelayo* dismissed a challenge to an "All Natural" labeling claim involving the defendant's processed pastas, commenting that consumers of the pasta certainly must have understood that it was not "springing fully-formed from Ravioli trees and Tortellini bushes."

Looking to the FDA to weigh in on GMOs as a defense strategy has not proven successful. In early January, the FDA informed courts overseeing the class actions against three major food manufacturers that the agency was declining "to make a determination ... regarding whether and under what circumstances food products containing ingredients produced using genetically engineered ingredients may or may not be labeled "natural." Indeed, the U.S. District Court for the Eastern District of New York recently rejected a motion to dismiss in *In re Frito-Lay North America, Inc. All Natural Litigation*. The case is a purported class action in which the plaintiffs alleged violation of state and federal laws based on the manufacturer labeling SunChips and Tostitos "All Natural," despite the fact that GMO corn is an ingredient. The plaintiffs argued that "unnaturalness" is a defining characteristic of GMOs, and the court allowed the case to proceed, refusing the defendant's request for a stay to obtain guidance on the question from the FDA.

Raw Foods. Another emerging labeling controversy involves one of the latest trends in nutrition: raw foods. A group of plaintiffs championing the "raw foodist" movement recently brought suit against a juice manufacturer in the U.S. District Court for the Southern District of New York, alleging that the high-pressure processing (HPP) with which the defendant's BluePrint Juice and BluePrint Cleanse products are treated destroys "vital" enzymes and nutrients. The plaintiffs claim that the defendant's "100% raw" and "never-heated" labels mislead consumers, who pay nearly \$10 for a single bottle of juice. Little guiding precedent or regulation exists concerning how a product subject to HPP may be labeled or characterized; it is unclear whether the court in that case will allow the suit to proceed. The increasing popularity of HPP among food manufacturers marketing to health-conscious consumers indicates that this issue could present a new wave of litigation.

The absence of FDA guidance arguably gives courts wide latitude to decide cases involving 'All Natural' claims.

Regulatory Developments

The absence of FDA guidance arguably gives courts wide latitude to decide cases involving "All Natural" claims. Some courts have stayed class actions pending FDA comment, but others have refused to do so based on the FDA's 2010 statement that natural labeling is low on the agency's list of priorities. The recent FDA letter makes it clear that the agency has no intention of issuing such guidance in the near future. With no imminent solution at the federal level, legislation has been proposed in various states, like Proposition 37 in California and Initiative 522 in Washington, that would disallow labeling genetically modified food as natural and/or require that genetically modified food be labeled as such. While the California and Washington proposals recently failed to pass, similar labeling legislation in Vermont and Connecticut has the potential to change the landscape for food and beverage labeling in coming years; the Vermont proposal is awaiting state senate approval in January 2014, and the Connecticut proposal passed but requires a three-part "trigger" (including that four other states must enact similar legislation).

* * *

The use of "All Natural" labels already is fraught with difficulty, and as manufacturers develop new methods of processing foods and ingredients, this issue will become even more complex. In the coming year, attention likely will be focused on the FDA and state legislatures to see whether and how they weigh in on labeling; but in the meantime, manufacturers must make important decisions about how to market their products. Some companies are opting to remove, or refrain from the use of, the "All Natural" label, while others are stepping up their health-conscious labeling to appeal to certain consumers' increasing interest in what are perceived to be healthier ingredients. In addition, the impact and effect of FDA guidance — or lack thereof — will garner more attention given the Supreme Court's recent grant of *certiorari* in *POM Wonderful, LLC v. The Coca-Cola Co.*, a case that involves the interplay between false advertising claims, the FDA, and the Food, Drug, and Cosmetic Act.

US Supreme Court Further Limits Jurisdictional Reach of the US Courts Over Foreign Torts

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The U.S. Supreme Court began 2014 by issuing a decision limiting the ability of plaintiffs to assert tort claims against foreign corporations in the U.S. courts based on events occurring outside the United States. In *Daimler AG v. Bauman*, the Court held that federal due process prevents a court from exercising general personal jurisdiction over a foreign corporation in a dispute involving foreign activities based solely on unrelated contacts of its wholly owned U.S. subsidiary.

The *Bauman* decision follows on the heels of three of Supreme Court decisions curtailing the scope of the Alien Tort Statute (ATS), the Torture Victim Protection Act (TVPA) and the Securities and Exchange Act of 1934.¹ The ramifications of *Bauman*, however, are much more far-reaching than these prior decisions, which involved the extraterritorial application of particular federal statutes. Because the Court in *Bauman* addressed the broader issue of the federal constitutional limitations on personal jurisdiction, the decision affects the reach of both the federal and state courts over foreign defendants in cases involving both common law and statutory claims.

The *Bauman* Case

In *Bauman*, a group of 22 Argentine residents brought tort and statutory claims in the U.S. District Court for the Northern District of California, alleging that they and/or their relatives were victims of mistreatment and torture by Argentine police and military forces during the country's "Dirty War" of the 1970s and 1980s in which opponents of the government allegedly were subject to covert persecution by state security agencies. The plaintiffs alleged that Daimler AG's Argentinian subsidiary, Mercedes-Benz Argentina (MBA), collaborated with state security forces to injure the plaintiffs and/or their relatives during this period.

However, MBA did not conduct business in California, and none of the alleged tortious acts occurred in that state. Moreover, as the district court held, Daimler AG itself did not have a general presence in California sufficient to support the exercise of general jurisdiction over it.² The plaintiffs, however, asserted an alternative basis for jurisdiction, namely, that Daimler AG was "present" in California by virtue of having a Delaware-incorporated subsidiary, Mercedes-Benz USA (MBUSA). Headquartered in New Jersey, MBUSA undertook the distribution and sale (including in California) of Mercedes-Benz vehicles allegedly manufactured by Daimler AG. MBUSA, the plaintiffs claimed, was the "agent" in California of Daimler AG and, therefore, Daimler AG itself should be viewed as being present in California.

¹ See *Kiobel v. Royal Dutch Petroleum Co.*, 569 U.S. ___ (2013) (ATS); *Mohamad v. Palestinian Authority*, 566 U.S. ___ (2012) (TVPA); and *Morrison v. National Australia Bank*, 561 U.S. ___ (2010) (Exchange Act). For a detailed discussion of the *Kiobel* case, see the Skadden publication "US Supreme Court Greatly Restricts Scope of Alien Tort Claims; Holds Statute Does Not Apply Extraterritorially" (April 23, 2013), available at <https://www.skadden.com/insights/us-supreme-court-bars-extraterritorial-application-alien-tort-statute-rejects-claims-allege>.

² See *Bauman v. Daimlerchrysler AG*, No. C-04-00194 RMW, 2005 U.S. Dist. LEXIS 31929, at *31 (N.D. Cal. Nov. 22, 2005).

The District Court Decisions

In 2005, the federal district court tentatively ruled that the plaintiffs had failed to substantiate their claim, but postponed its final order of dismissal pending jurisdictional discovery by the plaintiffs into the relationship between MBUSA and Daimler AG.³ Two years later, following such discovery, the district court dismissed the claim, finding that evidence of “agency” was lacking. Specifically, it held that a subsidiary corporation should be considered an agent of its parent only if the subsidiary performed “services sufficiently important to the parent corporation that if it did not have a representative to perform them, the parent corporation would undertake to perform substantially similar services.”⁴ It concluded that MBUSA’s functions as distributor of vehicles in the United States was not a core activity of the kind that would lead to MBUSA being viewed as the agent of its parent.⁵ Thus, it concluded that Daimler AG should not be viewed as being generally present in California.

The Appellate Court Rulings

On appeal, the U.S. Court of Appeals for the Ninth Circuit initially agreed with the district court. In 2009, a three-judge panel held, by majority, that California had no jurisdiction over Daimler AG.⁶ A year later, however, the same panel granted a petition for rehearing and vacated its prior opinion, holding that it had been persuaded by arguments that it should focus more closely on the legal test for determining whether a parent corporation could be viewed as present in California through a subsidiary. In 2011, the Ninth Circuit issued a new opinion in which it reversed the district court’s decision, held that MBUSA’s activities did indeed establish an agency relationship between Daimler AG and MBUSA, and found jurisdiction over Daimler AG.

In this regard, the Ninth Circuit considered whether the subsidiary’s activities were “sufficiently important to the foreign corporation that if it did not have a representative to perform them, the corporation’s own officials would undertake to perform substantially similar services.”⁷ It found that agency was established under this test because:

the distributorship functions indeed were “sufficiently important to [Daimler AG] that they would almost certainly be performed by other means if MBUSA did not exist, whether by [Daimler AG] performing those services itself or by [Daimler AG] entering into an agreement with a new subsidiary or a non-subsi-dary national distributor for the performance of those services.”⁸

The U.S. Supreme Court granted *certiorari* to “decide whether, consistent with the Due Process Clause of the Fourteenth Amendment, Daimler is amenable to suit in California courts for claims involving only foreign plaintiffs and conduct occurring entirely abroad.”⁹

³ See *id.* at *61.

⁴ *Bauman v. DaimlerChrysler AG*, No. C-04-00194 RMW, 2007 U.S. Dist. LEXIS 13116, at *8 (citation omitted) (N.D. Cal. 2007).

⁵ See *id.*

⁶ *Bauman v. DaimlerChrysler Corp.*, 579 F.3d 1088 (9th Cir. 2009).

⁷ *Id.* at 920 (citation omitted).

⁸ *Bauman v. DaimlerChrysler Corp.*, 644 F.3d 909, 912 (9th Cir. 2011).

⁹ *Daimler AG v. Bauman*, 571 U.S. ___, slip op. at 6 (2014).

The Supreme Court held that the exercise of general jurisdiction over Daimler AG by the California courts was beyond the limits imposed by federal due process.

The Supreme Court's Decision

In its opinion issued on January 14, 2014, the Supreme Court unanimously reversed the Ninth Circuit and held that the exercise of general jurisdiction over Daimler AG by the California courts was beyond the limits imposed by federal due process.¹⁰

The Supreme Court focused on the difference between “specific or conduct linked jurisdiction” (*i.e.*, where the case has a specific connection with the forum in question) and “general” jurisdiction, where such a link does not necessarily exist. The *Bauman* plaintiffs sought to establish general jurisdiction: thus, even though the case involved “events occurring entirely outside the United States,” the plaintiffs contended that Daimler AG had a sufficient connection with California such that it could be subject to “on any and all claims” in that forum “wherever in the world the claims may arise.”¹¹ The Supreme Court disagreed, holding that “[e]xercises of jurisdiction so exorbitant ... are barred by due process constraints on the assertion of adjudicatory authority.”¹²

The Court began with the established principle that a state court may exercise general jurisdiction over a foreign corporation “only when the corporation’s affiliations with the State in which suit is brought are so constant and pervasive ‘as to render [it] essentially at home in the forum State.’”¹³ It recognized, however, that it had not previously considered “whether a foreign corporation may be subjected to a court’s general jurisdiction based on the contacts of its in-state subsidiary.”¹⁴

Although the proffered basis for jurisdiction was that MBUSA was the “agent” for Daimler AG, the Court held that it was not necessary to resolve the question of whether “agency” could be a valid ground for asserting “general jurisdiction” against a foreign company because, it held, “in no event” could the Ninth Circuit’s analysis be sustained.¹⁵ It held, first, that the Ninth Circuit’s analysis of the subsidiary’s contacts with the forum — which looked to whether a subsidiary’s actions in the forum were “important” to the parent — was unacceptable. This test, the Court observed, “stacks the deck, for it will always yield a pro-jurisdiction answer” and would almost always create jurisdiction based on the mere existence of a subsidiary.¹⁶

The Court also disagreed with the plaintiff’s position that a foreign corporation can be subject to general jurisdiction in any state where it “engages in a substantial,

¹⁰*Id.*, slip op. at 2. The Court’s opinion, in which eight Justices joined, was written by Justice Ginsburg. Justice Sotomayor concurred in the judgment of the Court, but not “with the path the Court [took] to arrive at that result.” Concurring Opinion, slip op. at 1. In her view, the court’s holdings were based upon issues that had not been squarely presented in the parties’ briefing and not supported by a full evidentiary record. *Id.* at 5-8. Instead, she would have reversed the Ninth Circuit on the grounds that it would be unreasonable for a court in California to exercise jurisdiction over Daimler in a case involving “foreign plaintiffs suing a foreign defendant based on foreign conduct [where] a more appropriate forum is available.” *Id.* at 2.

¹¹Majority Opinion, slip op. at 1-2.

¹²*Id.* at 2.

¹³*Id.* at 2-3 (quoting *In Goodyear Dunlop Tires Operations, S. A. v. Brown*, 564 U. S. _ (2011)).

¹⁴*Id.* at 16.

¹⁵*Id.* at 16-17. Although it noted the wide variety of potential forms of “agency,” and that certain forms of agency might only support “specific” jurisdiction, the Court declined to elaborate further. *See id.*

¹⁶*Id.* at 17. Although the Ninth Circuit also required a showing of “control” by the parent over the subsidiary’s actions, the Court remarked that this “hardly curtailed” jurisdiction in the circumstances. *Id.* at 17 n.16.

continuous, and systematic course of business.”¹⁷ This formulation, it explained, might be appropriate when used as part of a test to establish specific jurisdiction, but it was “unacceptably grasping” if used as a test for general jurisdiction.¹⁸ Rather, in ascertaining whether general jurisdiction existed, a U.S. court should inquire whether the corporation had to be viewed as “‘essentially at home’” in the forum state.¹⁹

Applying this test to the facts, the Court noted that neither Daimler nor MBUSA was incorporated in California or headquartered there and that “[i]f Daimler’s California activities sufficed to allow adjudication of this Argentina-rooted case in California, the same global reach would presumably be available in every other State in which MBUSA’s sales are sizable.” It then held:

It was therefore error for the Ninth Circuit to conclude that Daimler, even with MBUSA’s contacts attributed to it, was at home in California, and hence subject to suit there on claims by foreign plaintiffs having nothing to do with anything that occurred or had its principal impact in California.²⁰

In the final section of its opinion, the Court pointedly noted that “the transnational context of this dispute bears attention.”²¹ It admonished the Ninth Circuit for paying “little heed to the risks to international comity its expansive view of general jurisdiction posed.”²² “Other nations,” it observed, did not “share the uninhibited approach to personal jurisdiction advanced” by the Ninth Circuit.²³ In the European Union, for example, the Brussels Regulation imposes a rule that “a corporation may generally be sued in the nation in which it is ‘domiciled,’ a term defined to refer only to the location of the corporation’s ‘statutory seat,’ ‘central administration,’ or ‘principal place of business.’”²⁴ “Considerations of international rapport,” it held, “thus reinforce our determination that subjecting Daimler to the general jurisdiction of courts of California would not accord with the ‘fair play and substantial justice’ due process demands” imposed by the United States Constitution.²⁵

* * *

Bauman has significant implications for corporate defendants that lack a U.S. presence, but which have affiliates, distributors or other representatives in the United States.

Bauman has significant implications for corporate defendants that lack a U.S. presence, but which have affiliates, distributors or other representatives in the United States. The full impact of *Bauman*, however, will be determined, in the first instance, by trial and intermediate appellate courts addressing the multitude of situations where foreign companies find themselves defending claims in the U.S. courts, particularly where the dispute relates to events taking place in foreign jurisdictions.

¹⁷ *Id.* at 18.

¹⁸ *Id.* at 19.

¹⁹ *Id.* at 19-20. In a footnote, the Court stated that it “d[id] not foreclose the possibility that in an exceptional case, ... a corporation’s operations in a forum other than its formal place of incorporation or principal place of business may be so substantial and of such a nature as to render the corporation at home in that State.” *Id.* n. 19. It held, however, that such circumstances were not present in the case before it. *Id.*

²⁰ *Id.* at 21.

²¹ *Id.* at 22.

²² *Id.* at 22-23.

²³ *Id.* at 23.

²⁴ *Id.* (citing European Parliament and Council Reg. 1215/2012, Arts. 4(1), and 63(1), 2012 O. J. (L. 351) 7, 18).

The Court also noted the U.S. solicitor-general’s observation that past treaty negotiations had been “impeded” by some foreign governments’ objections to “some domestic courts’ expansive views of general jurisdiction.” *Id.* (citing *amicus* brief submitted by U.S. solicitor general).

²⁵ *Id.*

Litigants Continue to Use ‘Anti-Suit Injunctions’ to Protect Their Arbitration Rights

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Courts occasionally are asked to intervene in a pending arbitration and exercise their injunctive powers. In some cases, litigants seek to have the courts aid the arbitral process by stopping foreign proceedings that interfere with a pending arbitration. In others, courts are asked to enjoin arbitration itself. Decisions in both the U.K. and the U.S. in 2013 underscore the delicate relationship between the courts and arbitration and reveal a reluctance on the part of the courts to undermine arbitral agreements.

The UK

Enjoining Litigation in Non-European Courts: The dispute in *AES Ust-Kamenogorsk Hydropower Plant LLP v Ust-Kamenogorsk Hydropower Plant JSC* [2013] UKSC 35, concerned a long-term contract allowing a private company to operate a hydroelectric project in Kazakhstan. Although governed by Kazakh law, the parties’ contract provided that their disputes would be subject to arbitration in London administered by the International Chamber of Commerce (ICC). When a dispute arose, the Kazakh owner, rather than commence an ICC arbitration, brought proceedings against the owner in the courts of Kazakhstan. Although the operator argued that the dispute belonged in London arbitration, the Kazakh Supreme Court ruled that (i) the London arbitration clause was invalid on grounds of public policy and (ii) the reference in the contract to the ICC was not a binding submission to arbitration administered by the ICC.

The operator, however, sought and obtained an anti-suit injunction from the High Court of England enjoining the Kazakh proceedings, arguing that the Kazakh owner breached the agreement to arbitrate. The anti-suit injunction was affirmed by the English Court of Appeal, which held that it was not bound by the conclusions of the Kazakh Court as to the validity of the clause — and added that neither ground of invalidity was sustainable. The decision was then appealed to the U.K. Supreme Court.

The U.K. Supreme Court considered whether English courts could validly enjoin Kazakh court proceedings, even where none of the parties had commenced or intended to commence arbitration proceedings. In upholding the anti-suit injunction, the Court held that an arbitration agreement represents a binding undertaking to seek relief only within the prescribed forum — and a concomitant obligation to refrain from seeking relief in another forum. The fact that the claimant had not commenced a London arbitration was not relevant to the exercise of the Court’s power to uphold the parties’ agreement.

This was a significant case for UK arbitration practitioners because it confirmed the power of English courts to grant anti-suit injunctions to enjoin proceedings in non-European courts that violated a London arbitration clause. (An earlier decision, *West Tankers Inc. v Allianz SpA* [2009] AC 1138, had indicated that English courts are prohibited by the UK’s treaty and EU obligations from granting similar injunctions to enjoin proceedings in courts of European Union and European Free Trade Association countries — even when such proceedings are brought in violation of a London arbitration clause). The ability of English courts to enjoin non-European proceedings in such circumstances was further reflected in another English case in 2013, *Bannai v Erez* [2013] EWHC 3689 (Comm), in which the Commercial Court enjoined the commencement of legal proceedings in Israel

with respect to matters falling within the scope of an arbitration agreement governed by English law. The Court stated that: "If it was not already clear, the fact that an arbitration clause contains within it a 'negative promise not to bring foreign proceedings, which applies and is enforceable regardless of whether or not arbitral proceedings are on foot or proposed' is now clear at English law." Recalling the principle stated by Lord Millet in *The Angelic Grace* [1995] 1 Lloyd's Law Rep 87, the Commercial Court held that, although the jurisdiction of the courts to grant such injunctions is discretionary and not to be exercised as a matter of course, good reasons must be shown as to why it should not be exercised in a case where an arbitration agreement is being violated.

Another 2013 decision addressed the phenomenon of "anti-arbitration injunctions," *i.e.*, judicial orders restraining a pending arbitration. The dispute, *British Caribbean Bank Ltd. v. Belize*, originated in 2009, when certain measures were taken by the government of Belize to compulsorily acquire foreign-owned interests in the telecommunications sector. This prompted British Caribbean Bank (BCB), a Turks and Caicos company that owned investments affected by these measures, to raise a series of challenges. One challenge involved an effort to declare the laws invalid in the Belize courts. Another challenge was the commencement of an arbitration alleging a violation of the U.K.-Belize Bilateral Investment Treaty (the BIT) (which was applicable to it by virtue of an agreement to extend it to the Turks and Caicos Islands, a U.K. dependency). The BIT specified that investor-state disputes were subject to arbitration under the rules of the United Nations Commission on International Trade Law (UNCITRAL). Thus in 2010, a UNCITRAL tribunal, based in The Hague, was constituted to hear BCB's treaty claims.

Rather than participate in the arbitration proceeding, however, the government of Belize sought to enjoin it. In December 2010, it obtained an injunction from the Supreme Court of Belize, restraining BCB from proceeding with the UNCITRAL arbitration. The injunction later was upheld by the Belize Court of Appeal, which by majority justified the injunction on the grounds that, although a right to arbitrate existed under the BIT, the UNCITRAL/BIT claims should not be allowed to proceed until the dispute had "ripened" through the litigation of BCB's challenge to the telecommunications laws in the Belize courts. BCB took its case to the Caribbean Court of Justice, which recently has been granted final appellate jurisdiction over Belize disputes (thus supplanting the U.K. Privy Council).

In a 2013 judgment, the court held that the BIT constituted a "legally binding agreement by the state of Belize to submit to arbitration" of treaty claims by investors such as BCB. Noting that "[t]he approach to modern arbitration agreements contained in investment treaties is for the court to support, so far as possible, the bargain for international arbitration," it held that the Belize courts' intrusion into the matter had proceeded under an erroneous view of the BIT, and was inconsistent with the doctrine of *kompetenz-kompetenz*, which left the determination of appropriate jurisdiction to the arbitrators. It also noted that the issues in dispute in the BIT proceeding were qualitatively different from those in the local Belize courts. Accordingly, the anti-arbitration injunction was vacated, and the BIT arbitration resumed.

The US

In the United States, courts likewise have been willing to grant anti-suit injunctions when parties engage in tactics aimed at threatening arbitral proceedings. For example, in *Bailey Shipping Ltd. v. Am. Bureau of Shipping*, No. 12 Civ. 5959 (KPF), 2013 WL 5312540 (S.D.N.Y. Sept. 23, 2013), the U.S. District Court for the Southern District of

Federal courts have shown a reluctance to grant anti-suit injunctions against a pending or threatened foreign arbitration.

New York granted an anti-suit injunction enjoining the parties from proceeding with certain actions filed in Greece with respect to specific claims that were governed by the arbitral agreement.

At the same time, federal courts have shown a reluctance to grant anti-suit injunctions against a pending or threatened foreign arbitration. For example, in *Citigroup, Inc. v. Abu Dhabi Investment Authority*, 13 Civ. 6073, 2013 U.S. Dist. LEXIS 167310 (S.D.N.Y. Nov. 25, 2013), the Southern District dismissed an application to enjoin an arbitration proceeding brought by a sovereign wealth fund under an investment agreement, even though the bank already had obtained an award in its favor in a prior ICDR arbitration under the same contract. The court reasoned that, although the bank might be correct that the second arbitration was barred by the doctrine of “claims preclusion,” this was a “merits” issue properly left to the arbitrators, once appointed. And in *Sanofi-Aventis Deutschland GMBH v. Genentech, Inc.*, 716 F.3d 586 (Fed. Cir. 2013), the U.S. Court of Appeals for the Federal Circuit affirmed a California federal court’s refusal to enjoin an ICC arbitration in Zurich, even though the U.S. courts had granted declaratory relief on the substance of a related patent dispute. The Federal Circuit held that any potential preclusive effect of the prior U.S. court order was a matter for the ICC arbitral tribunal to consider. The Federal Circuit expressed reluctance to frustrate U.S. federal policy in favor of enforcing forum selection clauses, and thus the court did not deem it appropriate to relieve the defendant from its contractual obligation to “settle such disputes at the ICC” — a forum to which the parties assented in their agreement.

Finally, one litigant attempted to obtain an “anti-anti-suit injunction” in connection with arbitration in 2013. In *Maroc Fruit Bd. S.A. v. M/V Almeda Star*, No. 11-12091-JLT, 2013 WL 4407101 (D. Mass. Aug. 19, 2013), a lawsuit was brought in the U.S. District Court for the District of Massachusetts for breach of a sale of goods contract. In August 2013, the plaintiff discovered that the defendant was considering bringing a proceeding in the English courts to enjoin the Massachusetts lawsuit on the grounds that the sale of goods dispute was covered by a London arbitration clause. The plaintiff asked the Massachusetts federal court for an injunction to enjoin the defendant from bringing an anti-suit injunction in the London courts (effectively, an “anti-anti-suit injunction”). Rejecting this application, the Massachusetts federal court noted that the plaintiff “faces a very high bar in seeking an international antisuit injunction.” Relying on U.S. Court of Appeals for the First Circuit precedent, the court held that, although the plaintiff had satisfied the threshold showing for an injunction (namely, similarity of parties and issues), it had failed to demonstrate that the balance of equities favored an injunction. The court added that, because no English injunction proceedings had yet been commenced, it was not willing to engage in an “arms race.”

* * *

These cases reveal that courts on both sides of the Atlantic will be reluctant to use anti-suit injunctions to stop arbitration. However, upon a sufficient showing (and where jurisdiction exists), courts will be prepared to issue anti-suit injunctions to restrain foreign judicial proceedings that unreasonably threaten to undermine an arbitral agreement — even if no arbitration proceeding is under way.

Securities Litigation Landscape Continues to Evolve in 2014

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In 2013, the U.S. Supreme Court weighed in on significant securities litigation issues, including the fraud-on-the-market presumption and the SEC's use of the discovery rule. With numerous important cases pending on topics such as SLUSA, Sarbanes-Oxley and yet another fraud-on-the-market claim, the Court will further define the securities litigation landscape in the year ahead. Meanwhile, the circuit courts — most notably the U.S. Court of Appeals for the Second Circuit — have continued to impact the course of securities claims with rulings on key issues.

US Supreme Court's Interest in Securities Issues Continues Unabated

The Future of the Fraud-on-the-Market Presumption. In 2013, the Court held in *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*, 133 S. Ct. 1184 (2013), that plaintiffs alleging fraud on the market need not establish the materiality of a misleading statement at the class certification stage. Justice Ruth Bader Ginsburg, writing for the majority in this 6-3 decision, found that the question of materiality was a common one: “[T]he class is entirely cohesive: It will prevail or fail in unison.” Of potentially greater interest, however, were the concurrence by Justices Samuel Alito and dissenting opinions by Antonin Scalia, Clarence Thomas and Anthony Kennedy, in which they evinced a willingness to revisit — and perhaps discard — the increasingly beleaguered fraud-on-the-market presumption of reliance.

As economic criticism of the efficient market hypothesis has increased, so have attacks on the fraud-on-the-market presumption of reliance.

Since the Supreme Court's 1988 decision in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), plaintiffs have been permitted to satisfy the element of reliance in securities fraud suits through a presumption of reliance based on the efficient market theory, under which stock prices are believed to incorporate all publicly available information. This has not only made it easier for a plaintiff to bring a securities fraud action, but it also paved the way to class actions because without having to prove actual (or “eyeball”) reliance, this element has become a common rather than individualized factor. However, as economic criticism of the efficient market hypothesis has increased, so have attacks on the fraud-on-the-market presumption of reliance.

All eyes are thus fixed on the Supreme Court as it hears arguments in March of this year on a direct attack on the fraud-on-the-market doctrine for the presumption of reliance in *Halliburton Co. v. Erica P. John Fund, Inc.*, cert. granted (Nov. 15, 2013) (No. 13-317). Petitioner Halliburton, echoing criticism by academics and practitioners alike, claims that the efficient markets hypothesis underlying the fraud-on-the-market doctrine has been “almost universally repudiated” and is in tension with the Court's “recent, more rigorous approach to class certification.” As Justice Alito stated in his concurring opinion in *Amgen*, referring to the three-Justice dissent, “[a]s the dissent observes, more recent evidence suggests that the presumption may rest on a faulty economic premise. In light of this development, reconsideration of the *Basic Inc.* presumption may be appropriate.” Given this notion put forth by four Justices in *Amgen*, the possibility exists that the Court will completely repudiate fraud on the market. However, the need for a fifth vote may more likely lead to a less drastic result, perhaps a compromise allowing defendants to more easily attack the presumption at the class certification level (see “US Supreme Court Cases to Watch in 2014”).

Scope of the Securities Litigation Uniform Standards Act (SLUSA). Several years after first addressing SLUSA (in a case successfully argued by Skadden), the Court is poised to resolve a divisive circuit court split by interpreting the scope of SLUSA preclusion in three related cases arising from the Allen Stanford Ponzi scheme. SLUSA generally precludes state court securities fraud class actions under state law in which the fraud is “in connection with the sale or purchase” of a security traded on a national exchange or issued by a public company. In *Chadbourn & Parke LLP v. Troice*, cert. granted (Jan. 18, 2013) (No. 12-79), and its two related appeals, the Court will decide the scope of the “in connection with” element under SLUSA, as well as its application to aiding and abetting claims. In construing the “in connection with” element, several circuit courts have required the alleged misconduct to have “more than a tangential relationship” to a covered securities transaction to find preclusion under SLUSA, while others have deemed an alleged misrepresentation to be “in connection with” a covered transaction if it merely causes the plaintiff to invest in, or coincides with, a securities transaction in a covered security. At issue in *Troice* were alleged fixed-return CDs issued by a Stanford-controlled bank as part of its Ponzi scheme; the CDs themselves were not covered securities, but they were supposedly backed by investments in covered securities. During oral argument in October 2013, the justices seemed split and focused at length on whether preclusion could exist when there was no actual purchase of a covered security. The Court may end up issuing only a very narrow ruling tailored to *Troice*’s particular facts, but any such ruling is still likely to shape the future applicability of SLUSA preclusion.

Sarbanes-Oxley and SEC Actions. Several cases before the Court this past term and in the coming year involve the events leading up to filing a securities fraud claim. In *Gabelli v. SEC*, 133 S. Ct. 1216 (2013), the Court rejected the SEC’s use of the discovery rule to determine the statute of limitations for bringing a securities fraud civil suit. The SEC had argued that the five-year statute of limitations for such suits should start running when the fraud is (or should have been) discovered, not when it occurs. The Court disagreed, holding that the discovery rule is intended to protect defrauded individuals who might be unaware of the fraud for a significant period of time, not government agencies specifically charged with rooting out fraud and armed with powerful weapons to do so. Potential defendants may have breathed a sigh of relief at the finding, which shortens the period during which the SEC can bring a suit, but the decision also may incentivize the agency to bring suits with greater speed, fulfilling SEC Chairman Mary Jo White’s recent promise for “bold and unrelenting enforcement.”

The Court’s upcoming decision in a claim involving whistleblower retaliation protection may similarly augur changes in how securities fraud claims are investigated and brought. *Lawson v. FMR LLC*, cert. granted (May 20, 2013) (No. 12-3), will address whether Sarbanes-Oxley Section 806 protects the whistleblower employees of privately held companies that contract with public companies. Section 806 does list “contractors and subcontractors” as entities prohibited from retaliating against whistleblowers, but the justices appeared uncomfortable at oral argument with expanding the section beyond public companies, for which the plaintiffs argued. A 2013 decision by the U.S. Court of Appeals for the Tenth Circuit, *Lockheed Martin Corp. v. Administrative Review Board, U.S. Dep’t of Labor*, 717 F.3d 1121 (10th Cir. 2013), held that whistleblowers are shielded from retaliation even if the reported conduct doesn’t affect shareholders. Thus, if the Court finds that whistleblower protection extends even to the employees of some private companies, these cases together could signal a vast expansion in whistleblower protection — and encourage more whistleblowing.

Court Rejects Review of Class Standing Requirements

One final Supreme Court development over the last year sprang from inaction: The Court denied *certiorari* in *Goldman, Sachs & Co. v. NECA-IBEW Health & Welfare Fund*, No. 12-528, *cert. denied*, 133 S. Ct. 1624 (2013). In *NECA*, as the case is known, the Second Circuit drew from Supreme Court affirmative action jurisprudence to institute a controversial “same set of concerns” standard for finding that a putative class representative has standing to bring securities claims even for mortgage-backed securities offerings in which it did not purchase any securities. 693 F.3d 145 (2d Cir. 2012). The Second Circuit found that the plaintiff representative had standing to bring such claims provided the claims arose from the same set of concerns — in that case, the allegations focused on the same mortgage originator across securitizations. Many observers predicted the Supreme Court would grant *certiorari* to resolve *NECA*’s direct contradiction with the U.S. Court of Appeals for the First Circuit’s decision in *Plumbers’ Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp.*, 632 F.3d 762 (1st Cir. 2011), which held that the plaintiff could only bring claims for offerings in which it purchased securities. The Court’s decision to deny review makes it more likely that courts within the Second Circuit, and perhaps elsewhere, will expand the claims which can be brought by a class representative.

Circuit Courts Continue to Play Central Role in Key Securities Disputes

Several key issues were deliberated or decided at the circuit court level last year, including cases relating to the tolling of statutes of repose, the duty to disclose under Item 303(b), the role of confidential witnesses, and liability under the Commodity Exchange Act. As with past years, the Second Circuit continues to be the forum where many of these significant developments are taking place.

Statutes of Repose. In *Police & Fire Retirement System of Detroit v. IndyMac MBS, Inc.*, 721 F.3d 95 (2d Cir. 2013), the Second Circuit addressed the absolute nature of statutes of repose. The court held that the tolling rule set forth in *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974) — that the commencement of a class action tolls the statute of limitations for all potential members of the class — does not apply to the three-year statute of repose in Section 13 of the Securities Act. The three-year bar, the Second Circuit determined, gives defendants the substantive right, which cannot be abridged, to be free from liability after a certain amount of time. As a result, in 2014 we may see more institutions opting out of class actions earlier in the proceedings because the ability to pursue individual claims after the three-year statute of repose expires will be foreclosed as a result of *IndyMac*.

Corporate Disclosures. In addition, courts weighed in further on the importance of updating corporate disclosures to reflect evolving risks. Courts have adopted a more qualitative approach to examining nondisclosure set forth in *Panther Partners Inc. v. Ikanos Communications, Inc.*, 681 F.3d 114 (2d Cir. 2012), in which the Second Circuit determined that an issuer failed to update “generic cautionary language” to reflect a so-called adverse “known trend or uncertainty,” *id.* at 121-22, as required by Item 303 of Regulation S-K. In *Stratte-McClure v. Morgan Stanley*, 2013 WL 297954 (S.D.N.Y. Jan. 18, 2013), for example, the U.S. District Court for the Southern District of New York reversed an earlier decision that the defendants had no duty to disclose subprime assets during the real estate downturn. In doing so, the court determined that the defendants were “aware of factually-based uncertainties” that the plaintiffs needed

knowledge of in order to understand the risk's extent. The First Circuit likewise relied on *Panther Partners in Silverstrand Investments v. AMAG Pharmaceuticals, Inc.*, 707 F.3d 95 (1st Cir.), *cert denied*, 134 S. Ct. 174 (2013), in stating that Item 303's disclosure obligations "do not turn on restrictive mechanical quantitative inquiries." There the court rejected defendants' statistical analysis of pre- and post-offering severe adverse effects of a drug and, instead, viewed the duty to disclose based on more qualitative factors relating to the importance of the undisclosed information.

Janus, Corporate Scierter and Confidential Witnesses

Though it has been more than two years since the Supreme Court issued its decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), which held that secondary actors cannot be held liable for statements over which they did not have "ultimate authority," *id.* at 2302, district courts are still grappling with how to interpret *Janus*. Lower courts are divided on what level of involvement and control, exactly, is required for a secondary actor to have "ultimate authority" over a misstatement. In *Fezzani v. Bear, Stearns & Co.*, 716 F.3d 18 (2d Cir. 2013), for example, the Second Circuit held that a principal investor in a now-defunct broker-dealer could not be held primarily liable under Section 10(b) under *Janus* where he had merely facilitated the firm's misstatements and never directly interacted with its customers. Similarly, in the Southern District of Texas, the district court in *In re Anadarko Petroleum Corp. Class Action Litigation*, No. 4:12-cv-0900, 2013 WL 3753972 (S.D. Tex. July 15, 2013), found that a defendant could not be held liable for misstatements in regulatory documents made by its partner when (i) the misstatements had been made months before the defendant's involvement with the partner and (ii) the plaintiff had not alleged that the misstatements were made in the defendant's name or at its direction.

Courts continue to debate whether and how scierter (or intent) may be inferred from a relationship to 'core operations.'

Courts continue to debate whether and how scierter (or intent) may be inferred from a relationship to "core operations." Plaintiffs attempt to use the "core operations" doctrine to create a presumption of knowledge on behalf of senior management if the allegations relate to the so-called core operations of the company. However, in the absence of extraordinary facts, courts generally remain unwilling to use "core operations" as a stand-alone basis for inferring scierter and continue to require additional well-pleaded facts. Judge Richard J. Sullivan explained in *Shemian v. Research in Motion Ltd.*, No. 11 Civ. 4068 (RJS), 2013 WL 1285779 (S.D.N.Y. Mar. 29, 2013), that, absent further guidance from the Second Circuit, a relationship to core operations "is not 'independently sufficient to raise a strong inference of scierter.'" *Id.* at *18 (citation omitted). This decision is on appeal to the Second Circuit.

Plaintiffs also are on warning on how they use so-called confidential witnesses — putting forth allegations attributed to unnamed former employees. In *City of Livonia Employees' Retirement System v. Boeing Co.*, 711 F.3d 754 (7th Cir. 2013), the U.S. Court of Appeals for the Seventh Circuit affirmed dismissal of a Section 10(b) complaint against Boeing and remanded the case to determine whether sanctions should be imposed on the plaintiffs' lawyers for their reliance on confidential witnesses. Discovery had revealed that the plaintiffs' confidential "witness," a supposed senior Boeing engineer, had never actually worked for the company, let alone had access to the information attributed to him in the complaint. Judge Richard Posner criticized the plaintiffs' lawyers for making "confident assurances ... about a confidential source ... even though none of the lawyers had spoken to the source and their investigator had

acknowledged that she couldn't verify what (according to her) he had told her." *Id.* at 762. Likewise, in *City of Pontiac General Employees' Retirement System v. Lockheed Martin Corp.*, No. 11 Civ. 5026 (JSR), 2013 WL 3389473 (S.D.N.Y. July 9, 2013) (to be published in F. Supp. 2d), Judge Jed S. Rakoff, despite denying the defendant's motion for summary judgment, issued an opinion after the parties had settled criticizing the plaintiffs' use of confidential witnesses, five of whom had recanted: "[I]t appeared ... that some, though not all, of the [confidential witnesses] had been lured by the investigator into stating as 'facts' what were often mere surmises, but then, when their indiscretions were revealed, felt pressured into denying outright statements they had actually made." *Id.* at *3.

LIBOR and Foreign Exchange Manipulation Claims

Foreign exchanges and allegations of manipulation of foreign currencies continue to draw the attention of both civil plaintiffs and regulators. Regulators from various jurisdictions have commenced investigations into foreign exchange manipulation, including the U.K.'s Financial Conduct Authority and the U.S. Department of Justice and Commodity Futures Trading Commission. U.S. Attorney General Eric Holder has commented that the manipulation uncovered thus far "may just be the tip of the iceberg." Recently, plaintiffs have filed antitrust complaints against a variety of financial institutions alleging conspiracy to manipulate benchmark foreign exchange rates by increasing trade volume at the time the benchmark rates are established. Meanwhile, class actions asserting mainly state law claims (breach of contract, breach of fiduciary duty, unjust enrichment) have been filed by bank clients in several jurisdictions, including New York, Massachusetts and California. Judge Lewis A. Kaplan substantially denied a motion to dismiss such a class action in *In re Bank of New York Mellon Corp. Forex Transactions Litigation*, 921 F. Supp. 2d 56, 94 (S.D.N.Y. 2013). Meanwhile, in a victory for defendants, a financial institution accused of improperly adding a markup to foreign exchange transactions executed by clients succeeded in having such claims dismissed in *Louisiana Municipal Police Employees' Retirement System v. JPMorgan Chase & Co.*, No. 12 Civ. 6659 (DLC), 2013 WL 3357173 at *17 (S.D.N.Y. July 3, 2013). Judge Denise L. Cote endorsed the defendant's argument that the plaintiff had no "reasonable expectation" of having the defendant reveal its markup on FOREX transactions in addition to reporting the charged exchange rate. Suits against U.S. dollar LIBOR panel members were consolidated in 2011 before Judge Naomi Buchwald in *In re LIBOR-Based Financial Instruments Antitrust Litigation*, No. 1:11-MD-2262-NRB (S.D.N.Y. filed Aug. 12, 2011). In March 2013, Judge Buchwald ordered dismissal of antitrust and RICO claims while allowing Commodity Exchange Act claims to stand. *In re LIBOR-Based Fin. Instruments Antitrust Litig.*, 666, 738 935 F. Supp. 2d (S.D.N.Y. 2013). The Southern District of New York dismissed fraud-based LIBOR claims in a separate action for being inadequately particularized under Rule 9(b) in *Woori Bank v. RBS Securities, Inc.*, 910 F. Supp. 2d 697, 702-05 (S.D.N.Y. 2012). In a second round of recently filed complaints, plaintiffs now are trying to cure the pleading infirmities identified by Judge Buchwald in her March 2013 decision. In particular, large investors who had direct contact with the defendant banks are filing individual (rather than class) action complaints that focus primarily on state common law (rather than federal statutory) claims — *e.g.*, breach of contract, breach of the implied covenant of good faith, fraud, tortious interference, unjust enrichment, etc. In the next 12 months, we are likely to learn if this shift in strategy has gained traction.

Mortgage-Backed Securities and Put-Back Litigation in 2014

In 2013, the pace of new credit crisis-related filings decreased, while settlements increased. This decrease can be attributed primarily to the expirations of certain limitation periods on residential mortgage-backed securities sold from 2005 to 2007. Despite the slowdown in new filings, important issues regarding RMBS cases continue to percolate through the courts. Litigation continues for certain statutes that extend the limitations periods for certain government agencies that have taken over certain financial institutions to institute claims, known as extender statutes. For example, in *Nat'l Credit Union Administration Board v. Nomura Home Equity Loans, Inc.*, 727 F.3d 1246, 1257 (10th Cir. 2013) the Tenth Circuit found that "the plain meaning of the text best supports the conclusion that the Extender Statute supplants all other limitations frameworks," but a petition for certiorari to the Supreme Court is currently pending. See *Nat'l Credit Union Admin. Bd. v. Nomura Home Equity Loan Inc.*, 82 U.S.L.W. 3307 (U.S. Nov. 8, 2013) (No. 13-576).

In last year's *Insights*, we predicted that in 2013 the New York appellate courts would provide guidance on the state statute of limitations for so-called "put-back claims," in which holders and insurers of mortgage-backed securities have sought to "put back" loans on the theory that the loans violate contractual representations and warranties made at the time of the offerings. In deciding whether the statute of limitations begins to run on the date the representation was made or the date on which the alleged failure to repurchase occurred, the New York State Appellate Division, First Department, held in the waning weeks of the year that the former is true in *ACE Securities v. DB Structured Products*, 650980/2012. This is highly significant in that many of the mortgage securitizations at issue for such claims closed more than six years ago; thus, this decision should provide a strong statute of limitations defense against such claims in the future. In addition, the decision applies beyond mortgage-backed securities by confirming that a provision that sets forth the remedies for a breach of a representation or warranty should not be interpreted to expand liability by delaying the start of the accrual of the limitations period beyond the date of the alleged breach of the underlying representation or warranty.

Perhaps one of the more visible actions in put-back litigation was the trial in *Assured Guaranty Municipal Corp. v. Flagstar Bank, FSB*, 920 F. Supp. 2d 475 (S.D.N.Y. 2013), in which Judge Rakoff held that Flagstar made false representations with respect to loans upon which Assured issued financial guaranty insurance. *Assured Guar. Mun. Corp. v. Flagstar Bank, FSB*, No. 11 Civ. 2375 (JSR), slip op at 91-94 (S.D.N.Y. Feb. 5, 2013). Despite the fact that the plaintiff's expert "failed to articulate a clear standard" for when a loan origination file might be deficient on its face, and "was unable to give a clear reason" as to why she deemed certain breaches of representations regarding the loan origination standards to be material, the court found the expert's "methodology [for determining whether a loan was originated in conformance with guidelines] not only appropriate to the courtroom but corroborated by the Court's own review." *Id.* at 71. In 2014, we anticipate several more battles of the experts in determining the percentage of loans in a mortgage-backed securitization that did not comply with the

various origination representations and guidelines and therefore may be subject to being repurchased. This year is likely to bring both additional trials and settlements in the put-back arena.

* * *

“This year is likely to bring both additional trials and settlements in the put-back arena.”

As evidenced by the cases described here, securities litigation in the wake of the global financial crisis continues to evolve and, despite the decline in credit crisis filings, several important issues remain to be decided by the courts in the coming year. We also anticipate that more traditional stock-drop securities filings — not directly related to the credit crisis — will continue or perhaps even increase, both because the resources of the plaintiffs’ bar will shift away from credit crisis cases and because of anticipated volatility in the equity markets. We also anticipate that the plaintiffs’ bar will continue to seize upon any corporate crisis that causes a decline in stock price to try to assert securities claims. We will be paying close attention to the area of cybersecurity, where a breach of a public company’s data or network infrastructure cannot only cause reputational harm, but also will likely have a significant market impact (see [Regulatory/“Cybersecurity: Amid Increasing Attacks and Government Controversy, a Framework to Reduce Risk Emerges”](#)). And finally we note that the primary battlefields will remain at the motion-to-dismiss and class certification levels, although we also anticipate more cases reaching the summary judgment stage.

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Global M&A

Last year, the global M&A market was relatively subdued, with deal activity in the U.S. proving to be the highlight. Larger transactions drove U.S. deal volume throughout 2013, and activist shareholders played a heightened role in driving deal activity and influencing strategic transactions. The modest fourth-quarter uptick in the number of transactions may be indicative of increased M&A activity in 2014. Buyers and sellers will continue to face ongoing regulatory uncertainty, including in the federal antitrust and national security arenas. Nevertheless, the confluence of other factors — improved economic and financial conditions, access to debt on favorable terms, the accumulation of substantial capital available to be deployed by potential buyers and growing confidence among boards of directors — may spur increased M&A activity in the U.S. in 2014.

Elsewhere in the global market, European M&A activity is increasingly influenced by activist shareholders, who have imported the U.S. trend and appear poised to emerge more frequently and publicly in connection with M&A transactions. In Asia, varied approaches to risk allocation in negotiating private M&A transactions have given rise to challenges in cross-border deals. Increased M&A activity in certain Latin American countries in 2013 is an encouraging sign that opportunities in the region, particularly in Mexico, Peru, Colombia and Chile, will grow in 2014.

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US M&A: Looking Back at 2013 and Forward to a Brighter 2014

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U.S. deal activity was the bright spot in an otherwise relatively muted global M&A market in 2013. Several large U.S. transactions were announced in the first two months of the year, and although deal volume for transactions (involving U.S. targets) grew at a slower rate over the remainder of the year, large transactions continued to drive improved U.S. deal volume for 2013 generally. In addition, a modest uptick of deals in the fourth quarter may be a harbinger of increased confidence and heightened M&A activity in 2014.

Improving U.S. economic conditions could boost boardroom confidence levels and advance M&A activity that boards previously may have put on hold. In addition, shareholders are playing a more active role as drivers of M&A activity, prompting boards to consider divestitures, spin-offs and company sales. Corporate cash balances remain at historically high levels, and acquisition financing continues to be available on attractive terms. Equity markets have been stable, and stock prices are at near-record highs, creating attractive acquisition capital for potential corporate acquirers; however, this may often be offset by increased acquisition costs and a decreased number of targets perceived to be undervalued. Financial sponsors continue to sit on large reserves of capital to be deployed for acquisition-related investment (approximately \$395 billion worldwide and \$207 billion in North American-focused buyout funds as of January 2014, according to Preqin estimates), and private equity portfolio company exits should continue apace in 2014. All that said, favorable indicators have existed in recent years, including in 2013, without igniting robust levels of deal activity. As such, the outlook for 2014 remains encouraging.

General Observations

U.S. Activity Drives Global M&A Market. In light of continuing economic uncertainty and volatility in other markets, U.S. targets were attractive to buyers seeking to deploy cash and take advantage of low interest rates as well as the perceived safety of investing in the United States. The dollar value of announced M&A transactions for U.S. targets was \$1.04 trillion in 2013, representing approximately 43 percent of total global deal activity, according to Thomson Reuters data. Ten of the 15 largest transactions announced worldwide in 2013 involved a U.S. target.

Similar to last year, we expect the telecommunications and media and technology industries to remain among the most active in 2014. The telecommunications and media sector was the greatest contributor to deal volume (in dollar value) in 2013, largely because of the \$130.1 billion Verizon Wireless transaction. Meanwhile, the technology sector, despite a slight decline from the previous year, had the largest number of transactions last year. While several observers expect U.S. M&A activity in the health care sector to heat up due to consolidation fueled in part by the implementation of the Affordable Health Care Act, issues surrounding the act's initial implementation and other factors may contain deal activity in the near term (see [Regulatory/"Health Care and Life Sciences: Affordable Care Act Rollout to Impact M&A and Enforcement Activity"](#)).

Megadeals Return. After a notable lack of high-value deals in 2012, the “megadeal” returned in 2013, with 11 announced transactions in excess of \$5 billion involving U.S. public company targets. Several large deals were announced early in the year, including the acquisitions of H.J. Heinz Co. by Berkshire Hathaway Inc. and 3G Capital (\$27.4 billion) and Dell Inc. by Michael Dell and Silver Lake Partners (\$24.9 billion), fueling short-lived speculation of a rebound in 2013 M&A activity to prefinancial crisis levels. In September, Verizon Communications Inc. announced the acquisition of Vodafone Group’s 45 percent interest in Verizon Wireless for \$130.1 billion, the largest transaction of the year and the third-largest in history.

One-Step Mergers Remain Preferred Deal Structure ... for Now. The majority of acquisitions involving U.S. public company targets have been one-step mergers, which enable a buyer to gain 100 percent control of a target through a simple statutory process, requiring target shareholder approval. Buyers seeking speed often utilize a two-step structure — a first-step tender offer followed by a second-step short-form merger — because it does not require shareholder approval and can be completed more quickly than a one-step merger, often in as little as one month. However, if the number of shares tendered into the offer is not sufficient to permit a short-form merger, the parties are required to follow the long-form merger process.

Amendments to the Delaware General Corporation Law became effective in August 2013, which permit the use of a short-form second-step merger if, following the completion of a first-step tender offer, the buyer owns a sufficient number of shares to approve the second-step merger (typically a majority of the outstanding shares, compared to 90 percent of the outstanding shares prior to the amendments). After the amendments went into effect, the number of transactions structured as first-step tender offers followed by second-step short-form mergers increased (see “[Delaware Continues to Influence US M&A](#)”). Transactions implementing this structure in 2013 included Paulson & Co.’s acquisition of Steinway, Valeant Pharmaceuticals’ pending acquisition of Solta Medical and Endo Health Solutions’ pending acquisition of NuPathe. The amendments are particularly noteworthy in leveraged acquisitions, where the increased certainty of closing on the tender offer and second-step merger in the same day gives buyers and their debt financing sources greater comfort in their ability to use the target’s assets as collateral for financing the tender offer.

While we expect to see an increase in the number of deals structured as first-step tender offers, it is too early to tell whether the two-step merger will become the M&A acquisition structure of choice. Transaction parties will need to evaluate the various considerations of their particular deal — will the regulatory review process be lengthy, is the committed support of the target’s large shareholders desirable for deal certainty — as well as the fiduciary duties of the target board in determining the appropriate structure.

Psychology of Strategic Buyers and Sellers

Strategic buyers and sellers exhibited discipline in their dealmaking activities in 2013, adopting a risk-averse approach. With stock prices nearing historic highs, boards and management carefully evaluated buy-side opportunities to avoid overpaying, including deciding whether to participate in competitive auctions. Strategic buyers continued to look for “add-on” acquisitions to expand their existing product and service offerings, customer base and/or geographic footprint in an environment of low organic growth.

“The ‘megadeal’ returned in 2013, with 11 announced transactions in excess of \$5 billion involving U.S. public company targets.”

Although prevailing economic and market conditions were favorable, few big-ticket transformational transactions were announced during the year. It remains to be seen whether the completion of those transactions and the continuation of stable market conditions will give boards the confidence to undertake industry-changing transactions in 2014.

Strategic sellers continued to focus on their core businesses, divesting noncore businesses to an eager audience of buyers hungry for attractive acquisition candidates. Buyers took advantage of available credit, low interest rates and historically high levels of cash to pursue these candidates, while strategic sellers continued to use spin-offs to focus on their core competencies, unlock the value of high-growth business segments and boost stock prices.

Exits Drive Private Equity Deal Activity

Private equity sellers were ideally situated to realize sizeable returns on the sale of portfolio companies in 2013, as buyers actively sought attractive targets and stock market valuations were at historically high levels. In one of the largest private equity exit transactions of the year, Warburg Pincus sold its portfolio company, Bausch & Lomb Inc., to Valeant Pharmaceuticals for \$8.7 billion. IPOs also continued to be a popular exit strategy, as private equity firms looked to monetize the value of their investments while the IPO market remained open (see [Capital Markets/“The JOBS Act: The Resurgent IPO Market and What We Learned in Year Two”](#)).

However, despite record levels of callable capital reserves (or “dry powder”) and the availability of acquisition financing at historically low interest rates, private equity buyers have been struggling to find quality assets at attractive prices. In the absence of platform acquisition opportunities, private equity buyers are engaging in more add-on acquisitions, with a focus on enhancing the revenue and value of their existing portfolio companies. The low interest rate environment and accessible debt markets in 2013 also facilitated portfolio recapitalizations, a trend that carried over from 2012. Information technology, particularly software, was a popular industry for private equity buyers in 2013, with more traditional industries for private equity investment such as retail, media, and business products and services attracting lower levels of interest.

Contractual terms around deal certainty remain an important element in private equity acquisition activity. While variants on the theme exist, some form of specific performance, together with a reverse break-up fee typically in excess of levels of seller terminations fees (and concomitant caps on damages against the buyer/sponsor), continue to be the prevailing contractual mechanics to address certainty and redress for nonperformance by a private equity buyer. While transaction parties and deal practitioners will continue to find creative variations on existing contractual technology surrounding deal certainty (and related remedies), we do not expect to see any major structural changes to the private equity contractual terms in this area in the immediate future.

Shareholder Activists Influence M&A Activity

Increasingly, activist shareholders have been seeking to influence the strategic direction of companies; and in many instances, they have garnered support for their ideas from mainstream institutional investors. While activists historically have focused their efforts

All indications, including the activist community's fundraising efforts and commentary, point to a continuation of activism in 2014 and beyond.

on smaller, underperforming companies, in 2013 they turned their attention to large-cap and diversified businesses with multiple operating segments, including companies performing consistently with their peers. Boards and management are reassessing the strategic fit of noncore businesses, and activists are reinforcing this boardroom trend, often resulting in divestitures or spin-offs. Activists played prominent roles in several large M&A transactions last year — most notably Carl Icahn in his rival bid for Dell Inc. All indications, including the activist community's fundraising efforts and commentary, point to a continuation of activism in 2014 and beyond (see [Governance/"US Corporate Governance: Boards of Directors Face Increased Scrutiny"](#)).

Another trend capturing attention in boardrooms and the deal community in 2013 was shareholder activism in the context of opposing announced transactions, such as Soft Bank/Sprint/Clearwire, Plains Exploration/Freeport-McMoRan and Dell. Activist funds and arbitrageurs made their presence known in the public company M&A arena and, in several instances, led campaigns to improve deal economics. Transaction parties should be prepared in advance to address shareholder concerns and should not assume that an arm's length, heavily negotiated, carefully analyzed, good-faith determination to enter into a transaction will lead to shareholder approval without controversy.

Hostile Activity

Hostile and unsolicited activity was subdued for much of 2013, with only four hostile transactions announced during the first three quarters; however, activity picked up somewhat in the fourth quarter, with the announcement of seven unsolicited transactions.¹ Hostile activity often is perceived to correlate with higher levels of board and management confidence, and the fourth quarter may be an indicator for increased dealmaking activity in 2014.

Of particular note is the unsolicited \$2.3 billion acquisition proposal by Jos. A. Bank for Men's Wearhouse, a rival men's clothing company, announced in October 2013. After its proposal was rejected by Men's Wearhouse, Jos. A. Bank withdrew its offer. In a maneuver referred to as a "Pac-Man" defense transaction, Men's Wearhouse turned the tables and announced an offer to acquire Jos. A. Bank, the smaller of the two companies, for \$1.5 billion. This offer was rejected in late December by Jos. A. Bank. Men's Wearhouse formally launched an unsolicited tender offer for Jos. A. Bank on January 6.

* * *

Political, fiscal and monetary uncertainties persist in the U.S., and levels of M&A activity remain muted when compared to the historic highs of the pre-2008 market. However, some of the factors that contributed to an encouraging finish in 2013 could play a role in a brighter U.S. M&A market in 2014. While the pace of activity in the new year may be modest, the factors are in place to stimulate increased dealmaking.

¹For this discussion, we count Jos. A. Bank/Men's Wearhouse twice.

The New Barbarians — Shareholder Activists Have Europe in Their Sights

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Shareholder activism has risen significantly since the start of the financial crisis, with global shareholder campaigns increasing by 62 percent since 2010.¹ This growth is partially driven by activist hedge funds, reaping outsized returns of 19.9 percent compound annual growth rate on investments since 2009 versus 12.7 percent CAGR for S&P and just 7.6 percent for all hedge funds.² Shareholders have engaged companies in all sectors — although in certain geographic areas, activists have focused principally on a limited number of industries — and are targeting increasingly larger companies.

This wave of activity has hit the shores of the old continent, resulting in the creation of Europe's own mix of shareholder activism. Before the global financial crisis, shareholder activism in Europe could be characterized by spurts of activity in a handful of EU member states and complete absence in most others. Shareholder activism now is on the rise across the continent, with activity increasing in the more than \$100 million category from 22 campaigns in 2010 to 60 in 2012 (45 as of October 2013) and in the more than \$1 billion category from 12 campaigns in 2010 to 42 in 2012 (21 as of October 2013).

Activism has been most prominent in the United Kingdom, partly because of the size and structure of U.K. capital markets compared to the rest of Europe, enabling activist shareholders to leverage their knowledge of and expertise in the United Kingdom. There have been more than 80 campaigns (of any size) in the U.K. from 2010 to 2013, representing more than one-half of all activity in Europe during this period. France, Continental Europe's second-largest economy, has had more than 20 campaigns. Smaller economies with relatively dynamic capital markets and large listed companies have seen disproportionate levels of campaigning, relative to their economic size, including Switzerland, with 14 campaigns, and the Netherlands, Belgium and Finland, with 20 campaigns combined. Germany and Italy, the other two large European economies, have witnessed only 10 campaigns, but activism appears to be on the rise in these countries, despite the fact that many listed companies have concentrated ownership structures.

Increased Support of Activist Campaigns

European markets' prolonged weakness since 2009 and the poor performance of large European strategic players during that period has laid the groundwork for the recent rise of shareholder activism. U.S. hedge fund activists turned to Europe, seeking opportunities outside North America to replicate their successful U.S. campaigns. At the same time, European hedge funds and other players analyzed the success of prominent activist investor campaigns across the Atlantic, particularly those supported by more traditional institutional investors, and realized that they could leverage their knowledge of European mechanisms and dynamics through their own campaigns.

¹ "Shareholder Campaigns Double in Three Years," *Financial Times* (Nov. 10, 2013).

² *Rising Tide of Global Shareholder Activism*, Citigroup (November 2013).

While activists face numerous structural challenges in Europe, such as a lack of common proxy rules and limited regulatory precedent in some jurisdictions, and thus often do not have the tools available to them in the United States to carry out their campaigns, the number of players in the market that are prepared to hear activist shareholders out and support their campaigns has grown in recent years. Corporate governance matters and, specifically, executive pay, have been at the center of attention of lawmakers, regulators and shareholders since the beginning of the global financial crisis, resulting, for example, in binding and nonbinding say-on-pay regulations being adopted in several EU member states. Influential proxy solicitors, such as Institutional Shareholder Services (ISS) and Glass Lewis, generally are supportive of executive pay and corporate governance campaigns brought by activists. A momentous shift in the composition of the shareholder base of large EU companies also has occurred, with the proportion of U.S. institutional investors with a sympathetic ear for activist campaigns increasing significantly in recent years. Additionally, European institutional investors have been supportive of campaigns. We believe these are lasting factors that will cause shareholder activism to continue to expand in Europe.

The resulting landscape is a mixed bag of U.S. and European activists campaigning for changes to board composition, executive pay and richer consideration in takeover transactions, and fighting against strategic plans as well as management-proposed disposals or purchases.

Activist Strategies: Navigating the EU Landscape

Activists generally target large strategic players with diffuse and/or high institutional ownership, because the absence of a controlling shareholder increases the probability of a campaign's success. So far, the principal sectors targeted by shareholder activists have been financial institutions, which have been particularly weak in the European recession, and industrial and telecommunications groups.

Specifically, activists have targeted companies that have been underperforming significantly compared to their peers, are pushing controversial transactions or strategic plans, or have a diverse set of assets but for which a split-up to improve strategic focus could bring stronger returns. Other typical features of targets include perceived poor governance, low leverage and significant debt capacity, and/or steady cash flows but low distributions to shareholders.

Shareholder activists, however, continue to face an uphill battle against established European strategic players. Europe remains a very fragmented market, with 27 member states and rules, regulations and practices that largely require harmonization by EU institutions. Europe lacks a common set of proxy rules or rules on corporate governance. Europe's securities markets do not rely on disclosure and related judicial scrutiny as much as such markets do in the United States; as a result, European markets generally suffer from lower transparency than those in the U.S. with regard to board/company actions and shareholder transactions and intentions. The European system generally is more reliant on intervention by securities regulators. At the same time, the sophistication of regulators in Europe varies dramatically from country to country. In the U.K., where approximately 20 to 30 cases are regulated each year, regulatory action is largely consistent and reliable. In several other jurisdictions, however, regulators see one or two activist campaigns annually and have not yet built up sufficient regulatory history upon which market participants can rely.

Shareholder activists continue to face an uphill battle against established European strategic players.

Hedge funds and other players must structure and cater their campaigns in a different manner in each EU member state.

Activists also face material challenges borne out of the structure of capital markets in much of Continental Europe. In several European countries (including Germany, France and Italy), the ownership structure of listed companies is concentrated — for example, listed companies are controlled by founding families or their foundations — and, therefore, not favorable to shareholder activism. Also, shareholder activists favor liquid stocks; the absence of a liquid derivatives market, which is not a consistent feature across Europe, is a significant hurdle for activist shareholders.

Other than in the U.K. and France, where the largest proportion of campaigning in Europe occurs, activists seldom resort to the courts. In most EU member states (other than the U.K. and France) the court system is slow and/or relatively untested in shareholder matters, and it is impractical for shareholders to consider litigation as an effective tool to obtain an immediate result in a campaign.

As a result, hedge funds and other players must structure and cater their campaigns in a different manner in each EU member state. For example, activists generally will approach targets privately first, and a significant proportion of campaigns never make it to the public domain in Europe. Public campaigns are rare outside the U.K. and, at face value, often unsuccessful, as the proxy and corporate governance rules heavily favor target companies and incumbent boards.

The European Players

The principal activists in the European landscape include some of the usual suspects from the United States, such as Elliott Management and its affiliates, which recently was active in opposing McKesson's bid for Celesio (Germany), Vodafone's takeover of Kabel Deutschland (Germany) and DuPont's offer for Danisco (Denmark). Additionally, a number of European players have emerged in the past few years.

In the U.K., the increased presence of shareholder activism was apparent in the recent public offering of Royal Mail, where The Children's Investment Fund (TCI), a large London-based hedge fund and established activist, positioned itself as the largest shareholder with a nearly 6 percent stake in the postal service company. Hedge funds wasted no time, ratcheting up the pressure on Royal Mail to increase cost savings.

TCI also has been increasingly active in France, particularly in relation to both EADS and Safran. Following its acquisition of EADS (now Airbus) stock, TCI first demanded that the European aerospace giant sell its €4 billion stake in French jet maker Dassault Aviation, alleging that EADS was making poor use of its capital and that the sale proceeds should be given to shareholders. Having failed in its attempt to force a sale of Dassault Aviation, TCI now is demanding that EADS implement cost-cutting measures and focus on profit growth; it also is demanding that management announce further cuts in its defense unit in short order. No significant changes have made public, but TCI continues to hold talks with other key shareholders and to eye EADS' annual meeting in April. TCI also recently launched an attack on Safran, the French aerospace manufacturer, heavily criticizing the company's track record for acquisitions outside civil aerospace and requesting the appointment of new independent board members to review all proposed merger and acquisition transactions. TCI continues to hold a stake in Safran and exert pressure on the manufacturer.

Recent events involving ThyssenKrupp also serve as a reminder that the new culture of shareholder engagement may be here to stay. Even before say-on-pay came to its first vote, Gerhard Cromme, chairman of ThyssenKrupp, scheduled a meeting with investors to discuss executive compensation. The gesture was called “extraordinary” by investors. However, it was not enough. The dilution of the Krupp Foundation’s stake resulting from recent capital increases opened the door to potential investment by shareholder activists. Anglo-Swedish fund Cevian, which acquired stock in ThyssenKrupp, recently increased its stake, is seeking board representation and likely will push for significant changes to the company.

Telco, a joint venture company owned by Telefonica and certain Italian institutions, which is the largest shareholder in Telecom Italia and controls its board, faced the last high-profile campaign of 2013 from Findim (the holding company of Italy’s Fossati family and owner of a 5 percent stake). Although Findim’s proposal to replace the entire board of Telecom Italia failed to pass at the shareholder meeting held on December 20 (50.3 percent voted in favor of the incumbent board against just more than 42 percent for Findim’s list), the close vote shook Telecom Italia, causing two Telefonica representatives to resign from the Telecom Italia board in the run-up to the shareholder meeting and reportedly forcing Telecom Italia to consider changes to its corporate governance ahead of its spring annual shareholder meeting.

* * *

As these examples illustrate, shareholder activism has become a regular feature of European markets. Although activists will continue to be challenged by the characteristics of the European market, the search for value will continue to draw hedge funds and other players, regulation and policies friendly to minority shareholders, and with them will come Europe’s own brand of shareholder activism. Accordingly, European companies should not underestimate the risk of attack from activist shareholders, and boards should be prepared to handle requests appropriately and avoid being caught by surprise.

Trends to Watch and Opportunities to Catch in Latin America

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Concerns over slow growth in most economies; uncertainty about governments' incentive strategies, including the U.S. winding down its bond-buying program; volatility in the stock markets globally; and inflation and deflation trends have dominated the global discussion of financial and business expectations for 2014. M&A and finance-related deal flow typically is impacted by such concerns, so despite the expected stronger recovery in the U.S. and other positive financial and business indicators in other areas heading into 2014, cross-border transactional volume may not reach precrisis levels.

In Latin America, even though Brazil had been one of the most attractive emerging markets for investors until 2012, the Brazilian economy stalled, with just 1 percent growth in 2012 and little more than 2 percent in 2013. The country's rate of inflation was 5.9 percent at the end of 2013, and the government increasingly has interfered with private transactions. These factors have contributed to reduced interest by foreign investors in Brazil. Overall, deal volume decreased in Brazil in 2013: Brazil's 41 percent share of the region's investment banking revenue relating to debt and equity underwriting and M&A advisory services was the lowest since at least 2007 (when Brazil's share of such revenue was at a high-water mark of 63 percent), and down from 51 percent in 2012.

However, there are encouraging trends and opportunities elsewhere in Latin America. Mexico, Colombia, Chile and Peru all have recently captured much of the attention of sophisticated global investors looking for growth. While the pace of the region's economic growth slowed in 2012 and macroeconomic performance was mixed in 2013, these countries' economies are expected to grow at higher rates than the U.S. and most European countries in 2014. A solid transaction volume in 2013, with investment banking revenue from debt and equity underwriting and M&A advisory work in the region totaling nearly \$2 billion (according to Dealogic), is expected to increase in most of the region's countries in 2014. A few reasons for our optimism, as well as some areas of concern to monitor, are discussed below.

Mexico: Economic Reforms Among Signs for an Encouraging 2014

Mexico could finally deliver on its long-standing potential to become Latin America's top inbound investment market in 2014. During the recent global economic crisis, Mexico's close geographic proximity and economic ties to the U.S. and perceptions over security may have contributed to its underwhelming performance. However, during 2013, Mexico enacted a series of economic reforms aimed at improving the economy's growth rate, which had been flat during periods when Brazil, Colombia and Peru had record GDP growth.

Most of the reforms are promising. For example, Mexico's energy reform, which will allow private investment into the sector, has taken center stage as one of the most significant opportunities, not only in Latin America, but also among the global energy markets. According to Bloomberg, Jim O'Neill (the creator of the BRIC acronym that dominated the discussion about emerging markets during the past decade) predicted that these reforms would independently increase average annual GDP growth from 3 to 5 percent. Standard & Poor's already raised its sovereign long-term foreign currency credit rating for Mexico by one notch to BBB+, mainly on account of the expected

“Mexico could finally deliver on its long-standing potential to become Latin America's top inbound investment market in 2014.”

impact of the reform. The prospect of ending the government's monopoly over energy in a large market close to the U.S. affords Mexico an opportunity to be a global player in this sector. Of course, new investment regimes take time to develop. A smooth process will depend in large part on how the Mexican Congress reaches disciplined consensus on the enabling laws (expected within the next three months) and government agencies carry out the mandate of President Enrique Peña Nieto's government to create a functional, competitive market.

The country's financial reform, aimed at increasing availability of credit from development and commercial banks, encouraging competition in the financial sector and strengthening oversight over its participants, was signed by President Peña Nieto on January 9, 2014. Bolstering the financial sector will contribute to the long-term sustainable growth of the Mexican economy and provide much needed stability and opportunity to the productive sector — which is integral to cross-border investment into the country.

The tax reform package, which became effective January 1 and sought to raise additional non-oil income for the country, has elicited some concerns, including a fear that an increase on mining taxes may cause a diversion of capital available for mining investments to other jurisdictions. However, Mexico was under pressure to undertake even more aggressive tax reforms, as its tax collection is less than that of its main peers in the region and in more developed economies.

In general, Mexico's recent reforms appear to have been well-received by the investment public and have enhanced the perception that Mexico will be a leading Latin American destination for foreign investment in the next five years. The shift already may have begun. By the end of 2013, before any of the significant reforms had taken effect, Mexico, the second-largest market for investment-banking fees in Latin America, expanded its share of the total Latin American-related investment-banking fees to a record 34 percent, up from 21 percent in 2012.

Chile: Investors Monitoring New Government's Policies

For years, Chile has enjoyed its reputation as one of the most investor-friendly and stable economies in the region. A market of only 17.5 million people (compared to nearly 200 million in Brazil, 120 million in Mexico, 48 million in Colombia and 30 million in Venezuela), Chile has maintained a solid foreign investment regime and managed its mineral resources carefully. However, Chile's economic performance relies heavily on strong demand and general stability in commodities prices, making China's demand for metals and other external factors in the commodities markets crucial to Chile's performance in 2014.

Perhaps more notably, newly re-elected President Michelle Bachelet has promised a major education reform, and tax increases to help pay for it, at a time when the country is expecting slower economic growth. During the presidential campaign, Bachelet discussed raising corporate taxes from a rate of 20 percent to 25 percent. Although this rate is closer to that of more developed economies, it may have an impact on foreign investment appetite, further affecting the economy's growth.

Energy policy under the new government also will be critical. Chile has an important energy deficit that negatively impacts its mining industry. The government will need to assess local opposition to coal-fired plants and hydro projects, which has resulted

in a limited number of new power projects in recent years. Another key issue will be whether natural gas and alternative energy sources, like solar, get the traction they need to become a true alternative to the mining industry. The direction of energy policy also will have a significant impact on deal flow in Chile, affecting not only those transactions directly relating to alternative energy projects, but also deals relating to the opening of additional capacity for new mining operations and the expansion of existing mines.

Despite these challenges, we believe that the Chilean market offers many opportunities for M&A activity in the financial, retail and technology sectors, and finance activity in mining and energy. There was significant activity in the insurance and retail sectors in 2013, and there are still attractive assets in these sectors for new investors as well as those seeking to enhance their market share.

Colombia: Stability and Growth Drive Deal Activity

Colombia, through a combination of investor-friendly policies and an improvement in addressing security concerns, continues to rank as a leading destination for emerging market investments. The tax reform that came into effect in 2013 has been credited by the International Monetary Fund with helping drive Colombia's promising economy by, among other things, lowering nonwage labor costs, promoting job creation in the formal economy and reducing inequality. Although a reduction of the payroll tax was offset by a new equity tax, new investments do not appear to have been negatively impacted. Colombia's economic growth accelerated in the third quarter of 2013, expanding 5.1 percent from a year earlier and compared with 3.9 percent in the second quarter of 2013, according to Colombia's National Statistics Agency. (Colombia's third-quarter expansion was higher than Peru, with 4.4 percent growth, and Chile, with 4.7 percent.) In 2014, foreign trade is estimated to increase to \$63 billion and foreign direct investment is projected to reach \$13.2 billion.

Colombia also benefits from healthy natural resource reserves and a solid history of government support for foreign investment in this area. Colombia, Latin America's fourth-largest oil producer after Venezuela, Mexico and Brazil, allocated 49 oil reserve blocks to 37 local and foreign companies last year. While it currently produces only around 1 million barrels a day, it has oil reserves of about 2.38 billion barrels. Evolving environmental laws and enhanced enforcement of existing ones will have to be monitored by investors in these sectors, but the costs associated with such rules are still shy of the standards multinationals observe in the U.S. and Canada.

The growth of the middle class also will continue to create opportunities in the construction, retail, services and financial sectors; and, as 2014 is an election year, there is significant expectation for increased infrastructure investment, which already is attracting players from around the world. In November 2013, the Colombian Congress enacted a new transportation infrastructure law, seeking to promote infrastructure projects by, among other things, providing clear rules regarding the use of real estate and environmental licensing.

Peru: Metals and Mining Among Key Sectors to Watch

Peru, with a GDP of \$203.8 billion in 2012 according to the World Bank, is probably the Latin American country that has shown the largest increase in cross-border activity in the past decade. According to Thomson Reuters data, 2013 M&A activity with Peruvian targets was \$12.3 billion, which was more than double the previous year's total. Although its Central Reserve Bank recently lowered its outlook for economic growth for 2014 (activity has slowed because of weaker domestic demand and a decline in metal prices), Peru's GDP is expected to grow 6 percent in 2014.

Similar to Brazil, Colombia and Mexico, Peru is expected to invest heavily in infrastructure in the coming years, generating significant opportunities for foreign investment. Private equity funds, which increasingly are encountering expensive entry prices and difficult exits for their investments in Brazil and Chile, are expected to pour significant amounts of investment into Peru, mostly in the retail, entertainment, tourism and fishing industries. Strategic investors also will likely look to the Peruvian market for growth opportunities in these sectors.

Additionally, many mid-to-large local conglomerates are expected to continue to attract foreign investors as they seek capital for continued expansion, or as they evolve from family-owned businesses to large independently managed multinationals and some seek to avail themselves of the capital markets. This evolution also is likely to continue to occur in Colombia and Mexico.

The mining sector deserves a special mention, as it presents both challenges and opportunities. Similar to Chile, Peru is expected to suffer from volatility in the commodities market. Further, in 2013, environmental and administrative reforms impacting Peru's growing mining sector caused some anxiety, especially in connection with (i) the creation of the Servicio Nacional para las Inversiones Sostenibles, which is charged with managing a new system of environmental regulatory requirements; and (ii) the ongoing debate about whether a consultation with indigenous communities is required prior to approving new mining projects in their areas. The government appeared divided between trying to fuel continued economic growth through additional investments in the mining sector and meeting the demands for sustainability and inclusion policies. But it was revealing that in the third quarter of 2013, the Ministry of Mines announced plans to expedite commencement of hydrocarbon and oil projects and make investments of approximately \$8.1 billion in energy projects to increase sustainability and competitiveness in the mining sector.

Venezuela and Argentina: Anti-Market Policies Unlikely to Spread in the Short-Term

Venezuela and Argentina, which once were fertile grounds for cross-border finance and M&A transactions, have departed from pro-market policies and experienced significant declines in foreign investment as a result. Investor fears of expropriation materialized, including with the takeover by the Argentine government of oil giant YPF from Spain's Repsol last year, slowing the pace of foreign investments in those countries. Naturally, foreign exchange and remittance limitations also have negatively impacted cross-border activity in Venezuela and Argentina.

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Recognizing that politics always play a role in the stability of markets, investment banks, analysts and even nongovernmental organizations seem to agree that the recent results for the larger economies in the region and the ailing economies of the anti-market jurisdictions should be persuasive enough to prevent other nations in the region from adopting aggressive anti-market policies in the short-term. However, efforts to close the gap between Latin America's business elite and the underprivileged majority must be a priority. Hopefully, policymakers will be able to balance legal certainty for investors with policies that address inequality and social investment needs, not only to minimize the risk of internal conflict, but also to deliver on the promise of long-term economic growth, which depends to a significant extent on the sustained growth of the middle class.

Other Opportunities

Panama, Guatemala, Uruguay and Costa Rica should continue to evolve as frequent destinations for foreign investors. Each of these countries has sought a stable investment protection program and market-friendly policies. Although the size of these markets is not yet as significant as other countries in the region, the pursuit of growth likely will result in more multinationals entering them.

Final Outlook

Judging from the transaction pipeline we see today, the region will continue to generate a significant amount of activity and interest from global investors throughout in 2014. Despite its current challenges, the size of the Brazilian market will continue to make it attractive to many multinationals and, with the World Cup and the Olympics approaching, investment in infrastructure will still present an attractive opportunity for banks and construction, engineering, management and tourism companies. Additionally, deal volume lost in Brazil is likely to be offset by transactions in the rest of Latin America.

We also expect to continue to see large Latin American conglomerates participate in local and outbound deal activity. In the past three years, Brazilian, Mexican, Colombian, Chilean and other multinationals, or Multilatinas, have engaged in significant outbound M&A activity in other Latin American countries (*e.g.*, Banco Pactual's acquisitions in Chile and Colombia and Grupo Sura's acquisitions throughout the region), as well as in the U.S. markets (*e.g.*, Mexico's Grupo Bimbo's acquisitions in the U.S. to become the largest industrial baker in the Americas and Colombia's Grupo Argos' purchases in the U.S. and Central America). These and other Multilatinas have become extremely sophisticated through their experience in the growing Latin American markets, are decisive and efficient in exploring available M&A opportunities, and have accumulated cash that can be used to further expand their reach.

In any event, with upcoming elections in Colombia, Brazil, Uruguay and Bolivia, a new government in Chile and the difficult dynamics in Venezuela and Argentina, trends can change, and opportunities can shift, quickly. Investors should be prepared to adjust as market forces evolve.

Asia M&A: Understanding the Differences Between English and US Approaches to Negotiated Acquisition Agreements

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As the M&A markets in Asia continue to mature, U.S. and European multinationals involved in such markets are more frequently experiencing the clash in approaches to M&A risk allocation that Asia-based lawyers and financial advisors have seen for some time.

As a general matter, stock sale and purchase agreements negotiated by English-trained lawyers under English or Hong Kong law tend to place greater risk on purchasers than is typical in sale and purchase agreements between U.S.-based parties negotiated by U.S.-trained lawyers. While these differences can give rise to some lively negotiations, they make depth and diversity of experience in cross-border M&A all the more important for dealmakers and their advisors.

Due Diligence and the Data Room

Most U.S. buyers in privately negotiated acquisitions view due diligence as a process purely for the benefit of the buyer, to assist the buyer in gaining familiarity with the target business, assessing risks, effectively negotiating definitive documentation and arriving at an appropriate target valuation. Due diligence and the contents of the data room (be it physical or virtual) are not intended to qualify representations and warranties of the seller or provide the seller with a defense for a breach of representation and warranty.

Historically, the approach in English law-governed transactions or deals between European-based parties has been quite different: Sellers often insist that their liability for breach of “warranty”¹ be limited to the extent the matter was disclosed or “fairly disclosed” in the data room. These days, to ensure that all parties agree on what was disclosed, a CD-ROM containing the full contents of the data room generally is initialed by the parties and attached as part of the sale and purchase agreement or other definitive documentation.

“Fair” Disclosure. The meaning of “disclosed” or “fairly disclosed” for this purpose often is heavily negotiated. For example, a matter may be treated as being “fairly disclosed” and capable of limiting the seller’s liability under the warranties only to the extent that “information has been provided in sufficient detail to enable the Purchaser, [having regard to its skills and experience in similar transactions and the advice of its financial and legal advisors,] to identify and make a reasonably informed assessment of the nature and scope of the fact, matter or circumstance so disclosed.” To the extent matters are “fairly disclosed” therein, the data room will operate as a supplement to the

¹Under English law, a representation is a precontractual statement of fact on which the recipient was intended, and entitled, to rely and which induced it to enter into a contract. A false representation may give rise to a claim in tort with a remedy of rescission, under which the contract can be cancelled and the parties restored to their original positions. A warranty, however, is a contractual promise, which if breached, gives rise to a claim for damages designed to put the innocent party into the position in which it would have been had the warranty been true. Most sellers under English law share purchase agreements will intentionally refrain from using the term “representation” to limit the buyer’s ability to bring tortious, rather than contractual, claims, in particular, to rescind the contract. New York law generally does not recognize such a distinction and, in any event, most New York law-governed sale and purchase agreements will expressly exclude tortious remedies.

specific disclosures and exceptions contained in the disclosure letter delivered to the buyer contemporaneously with the sale and purchase agreement.

Additional Warranty Limitations. It also is not uncommon in English and European M&A for the warranties of the seller to be limited by additional matters, which would be very unusual in a typical sale and purchase agreement in the United States. For example, it is common for the warranties to be given subject to matters contained in the financial statements and other public filings or public records of the target. Furthermore, in sell-side auctions, where it is reasonably common in Europe for the seller's accounting and other advisors to prepare "vendor due diligence reports" which are shown to buyers, warranties are often qualified as to matters "fairly disclosed" in the vendor due diligence reports. Although not as common, some English law transaction documents also qualify warranties by matters "reasonably apparent from a physical inspection of the properties of the target," thereby forcing the buyer to actively and carefully inspect the target properties.

While matters disclosed in public filings with the U.S. SEC (including filed financial statements) are reasonably common qualifications in U.S. sale and purchase agreements, such other qualifications are extremely rare in the U.S. M&A context. Additionally, for both liability reasons and the fact that most U.S.-based purchasers would place very little weight on a due diligence report prepared by a seller's advisors, vendor due diligence reports are uncommon in the United States.

Bring-Down and MAC Conditions

English Law. In public acquisitions in the U.K., Hong Kong, Singapore and many other English common law-based jurisdictions, a bidder's financial advisor (or other financing sources) is required to provide a statement in the public documents, including in the initial transaction announcement, confirming the availability of the cash funds required to complete the transaction. The cash confirmations generally are not permitted to be conditioned on substantive matters, including that no material adverse change occurs in the target business prior to closing. For all practical purposes, the cash confirmation serves as an unconditional assurance that the bid will not fail because of withdrawal or unavailability of financing. If a financial advisor acts irresponsibly in providing a cash confirmation, it can be subject to regulatory censure and potentially be required to provide the funding itself.

While the cash confirmation process is applicable only in the public acquisition context, in privately negotiated acquisitions under English law, perhaps as a result of the unconditional cash confirmation practice in public transactions, a material adverse change (MAC) condition is less common than in transactions between U.S. parties. Furthermore, European sellers often will take the view that, so long as they operate the applicable target's business in the ordinary course between signing and closing, the risk of changes in the business that are beyond the seller's reasonable control should fall squarely on the buyer — and should not allow the buyer to terminate the agreement and refuse to close. While not always successful, it is common for English lawyers to argue strenuously that the warranties should not be brought down at closing, and that the buyer should rely solely on the warranties as of signing and the preclosing covenants.

U.S. Law. The U.S. experience is very different. While financing conditions are not common, in public transactions MAC conditions (at least for nonmacroeconomic, market-based or industry-wide events) are common and generally will track the MAC condition in the related financing commitments as closely as possible. Accordingly, if the financing sources terminate their commitments because of a material adverse change in the business, the purchaser will be able to terminate the agreement without liability. U.S. purchasers and their legal counsel in privately negotiated acquisitions invariably expect a bring-down certificate repeating the representations and warranties at closing (in addition to preclosing covenants). In some transactions, the seller even is required to provide representations and warranties at the time of signing “as of signing and as of closing,” though in such cases the seller often will successfully argue for the ability to update the disclosure schedules for matters occurring between signing and closing. Such updates will have the effect of qualifying the seller’s representations and warranties for post-closing liability purposes, though will be disregarded for purposes of the buyer’s “bring-down” condition and so its termination rights.

Post-Closing Recovery and Indemnification

U.S. Approach. U.S.-based purchasers in private M&A transactions almost always insist on indemnification by sellers for breaches of representation and warranty. Indemnification generally covers all losses, damages, costs and expenses (including legal and investigatory costs) arising from a breach of representation and warranty and, in some cases, covenants under the sale and purchase agreement. Various limitations may be negotiated to the right to indemnification (including caps, baskets and survival periods) and, in some cases, the ability to recover indirect losses may be limited or excluded, and obligations to mitigate may be imposed. However, the usual approach is for a general indemnification provision to be included.

English Approach. In a typical English law-governed sale and purchase agreement, indemnification for breach of warranty (or provision for payment of damages “on a full indemnification basis”) is less common. More often sellers insist that purchasers rely on their rights to sue for breach of warranty under a contract damages claim. The right to damages under contract law (whether English, Hong Kong or New York law) generally will not give rise to the same level of recovery as a typical, broadly drafted indemnification provision. This is because contract damages will be subject to common law limitations, such as a requirement for foreseeability of losses, the breach being the proximate cause of the loss, and a duty to mitigate losses. Even where there is no right to indemnification, caps, baskets and warranty claims periods will still generally be negotiated to limit the breach of warranty claim. In many English law-governed share sale and purchase agreements, indemnification rights often are included only for specific known matters (such as losses from a known litigation or liability) and for unpaid taxes relating to the preclosing period.

Furthermore, in a typical English law-governed sale and purchase agreement, seller’s counsel often insist on an “anti-sandbagging” provision (*i.e.*, an express bar to recovery for breach of warranty to the extent that the buyer had actual knowledge of the circumstances giving rise to the breach of warranty at the time of signing of the sale and purchase agreement). This approach finds some support in certain judicial statements in English case law. However, to most U.S. buyers, such a provision is unacceptable.

“In many English law-governed share sale and purchase agreements, indemnification rights often are included only for specific known matters.”

The idea that the seller should be excused from compensating the purchaser for a breach of a representation and warranty (including a failure to disclose matters in the disclosure schedule) because the buyer exercised due diligence and discovered facts that, while known to the buyer, may not have been taken into account in the agreed valuation, is seen as unfair in the U.S. M&A context. More common to U.S. purchasers is an express statement that the representations and warranties are not limited in any way by the investigation or knowledge of the purchaser.

* * *

While the foregoing examples are to some extent generalizations, and deal documents will of course differ depending on the negotiating power and circumstances of the parties, clients involved in negotiated cross-border M&A transactions should be mindful that counterparties (and their legal counsel and financial advisors) may have very different views on acceptable approaches to risk allocation.

National Security Reviews of Foreign Investments in US Businesses Show No Signs of Slowdown in 2014

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Over the past two years, the Committee on Foreign Investment in the United States (CFIUS) has applied increased scrutiny to foreign investments in U.S. businesses. CFIUS reviews the national security implications of such transactions and, where necessary, places conditions on the sale to mitigate risks to U.S. national security. Where the risks cannot be mitigated, the president blocks the transaction.

Certain factors, within and outside of CFIUS, have colored the environment in which its reviews take place. In its annual report released in December 2013, CFIUS stated that, "Based on its assessment of 2012 activity, the U.S. Intelligence Community (USIC) judges it unlikely that there is a coordinated strategy among one or more foreign governments or companies to acquire United States companies involved in research, development, or production of critical technologies for which the United States is a leading producer." This was a notable departure from its more aggressive stance a year earlier, when CFIUS stated that the USIC "judge[d] with moderate confidence" that such a strategy indeed existed.

Despite this more moderate position, the release of sensitive information relating to National Security Agency information collection highlighted the ease with which personnel with access to sensitive information can capture and disseminate it, underscoring the sensitivity of all classified U.S. government information. This sensitivity is most pronounced in reviews of transactions in the technology and telecom sectors, but filters through all reviews where the U.S. business has access to classified information.

Separately, the location of U.S. business assets remains a primary concern within CFIUS. In June 2013, CFIUS required the divestment by Chinese-owned Procon of its approximately 60 percent ownership interest in Lincoln Mining Corporation. This was a notable announcement that reminded many of President Obama's widely reported September 2012 block of the Chinese-owned Ralls Corp. purchase of wind generation facilities abutting restricted U.S. Naval airspace. Reports indicate that, as in the Ralls transaction, U.S. government sensitivity stemmed from the location of certain of Lincoln's projects. Also as in the Ralls transaction, the Procon-Lincoln deal had not been filed with CFIUS until after the committee became aware of the transaction and exercised its authority to compel a filing. The prolonged review of Canadian oil and gas company Nexen Inc.'s sale to China's CNOOC in 2013 further highlighted the sensitivity relating to project locations, as Nexen sites in the Gulf of Mexico created U.S. government concern in that sale.

Finally, the political scrutiny surrounding the sale of Virginia-based Smithfield Foods, Inc., the world's leading pork producer, to China's Shuanghui demonstrated the necessity for a forward-leaning approach to public and government relations in high-profile transactions, even where the U.S. business may not seem particularly sensitive.

Taken together, these factors illustrate the need for thorough due diligence and a proactive approach to the CFIUS process in the early stages of a transaction.

Trends in the CFIUS Review Process

Based on a review of the CFIUS 2013 annual report (which discusses transactions through the end of calendar year 2012), as well as our experience working closely with CFIUS, we believe the following trends will factor most heavily into reviews in 2014.

- **CFIUS continues to investigate a high number of transactions and has remained aggressive in demanding filings post-closing.** While the CFIUS process typically is initiated when the parties voluntarily notify the committee of their transaction, CFIUS has the power to compel filings when one is not made voluntarily. The spectrum of industries CFIUS reviews, from mobile app providers to pork producers, underscores its broad mandate and the numerous ways U.S. businesses may affect national security. Companies involved in cross-border transactions will need to consider whether a CFIUS filing could prove prudent.
- **Federal government disruptions have significantly hampered national security reviews.** During the government shutdown in 2013, CFIUS was forced to stop accepting new notices, and pending notices were moved automatically into the additional 45-day investigation period once operations recommenced. We expect the backlog of cases created by the shutdown to continue to weigh on CFIUS in the early part of 2014. Additionally, operations of the Defense Security Service, which separately reviews transactions when the U.S. business has access to classified U.S. government information, were disrupted significantly during sequestration and the shutdown.
- **CFIUS required mitigation agreements in more transactions.** CFIUS enters into mitigation agreements with parties to transactions to address national security concerns identified during the review process. Mitigation agreements generally govern the foreign purchaser's access to sensitive information of the U.S. business and can affect operability and expected transaction synergies. The 2013 annual report indicates that in 2012, eight mitigation agreements were entered into among the parties to a transaction and the U.S. government, while an additional 10 transactions were abandoned by the parties, which may indicate the parties' reluctance to accept mitigation terms required by CFIUS.
- **The length of CFIUS internal deliberations continued to increase.** The CFIUS regulations require that mitigation agreements be approved unanimously by CFIUS member agencies. Because those agreements often reflect the concerns of one particular member agency but not others, the unanimity requirement has resulted in more time being spent in internal deliberations. The 2013 annual report indicates that a record 22 CFIUS notices were withdrawn voluntarily, more than a 400 percent year-over-year increase. Of the 22 transactions withdrawn in 2012, 12 were later re-filed with CFIUS, indicating that the withdrawals were made to provide CFIUS additional time to conduct its analysis (the other 10, as noted above, were abandoned altogether). We have found that CFIUS attempts to be as flexible as possible in allowing parties to file for review prior to execution of definitive transaction documents to expedite the process, while still adhering to its statutory timeframes once the review commences. Companies facing timing pressure should consider involving CFIUS counsel as early as possible.

“Despite these trends and ongoing deal scrutiny generally, CFIUS continues to approve the overwhelming majority of transactions it reviews.”

- **Companies based in U.S. ally nations continued to file a significant number of transactions with CFIUS.** In 2012, CFIUS reviewed more acquisitions by Chinese acquirers than by any other country. This was the first time Chinese acquisitions composed the greatest number of transactions reviewed by CFIUS, and we believe that data for 2013 will show that this trend continued. Nevertheless, a significant plurality of transactions filed with CFIUS involve foreign purchasers based in countries considered to be allies of the U.S. This likely illustrates a greater willingness by such nations’ companies to invest in U.S. businesses, but also highlights that CFIUS reviews transactions involving sensitive U.S. businesses regardless of the identity of the purchaser, and that even “low-risk” purchasers are wise to file for review.

* * *

Despite these trends and ongoing deal scrutiny generally, CFIUS continues to approve the overwhelming majority of transactions it reviews, including those in sensitive sectors. Notable examples include the successful sale of the assets of A123 Systems, Inc. to China’s Wanxiang Group Companies, as well as the completion of the Sprint/SoftBank transaction. As companies evaluate M&A opportunities in 2014, careful advanced planning and continued attention to issues raised by the U.S. government during a CFIUS review will remain vital to a successful transaction.

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Delaware Continues to Influence US M&A

A number of recent Delaware judicial and legislative developments will have important implications for parties engaging in or advising on M&A transactions in 2014 and beyond.

Controlling Stockholder Transactions

We anticipate a decision from the Delaware Supreme Court in early 2014 regarding *In re MFW Shareholders Litigation*, which was argued on an appeal on December 18, 2013. If upheld on appeal, *MFW* will provide an important roadmap for those planning controlling stockholder going-private transactions.

In *MFW*, the Delaware Court of Chancery held in 2013 that the deferential business judgment rule — not the more rigorous entire fairness standard — is properly invoked in controlling stockholder going-private transactions if:

- the controller conditions the transaction on approval by both a special committee and a majority of the minority stockholders;
- the special committee is independent;
- the special committee is empowered to freely select its own advisers and to say no definitively;
- the special committee meets its duty of care;
- the vote of the minority is informed; and
- the minority is not coerced.

Prior decisions stated that entire fairness was the exclusive standard of review applicable to controlling stockholder going-private transactions. As a result, litigation challenging such transactions was difficult to defeat before trial. The *MFW* court explained that providing a path for review under the business judgment rule would improve the “benefit-to-cost ratio of litigation” because suits challenging transactions structured with the elements the court identified would no longer have settlement value “simply because there is no feasible way for defendants to get them dismissed on the pleadings.”

Exclusive Forum Provisions

We expect the 2013 Court of Chancery decision in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.* and *IClub Investment Partnership v. FedEx Corp.* to have a significant impact on stockholder litigation in the coming year.

In *Boilermakers*, the Court of Chancery addressed the validity of “exclusive forum provisions” as a matter of Delaware law. (An exclusive forum provision is a charter or bylaw provision specifying a particular venue as the exclusive jurisdiction in which stockholder derivative suits, fiduciary duty claims and other intracorporate actions must be brought, unless the company otherwise consents.) Increasingly, public companies are using exclusive forum provisions to reduce the risk of burdensome and costly multijurisdictional stockholder litigation.

The *Boilermakers* court held that director-adopted bylaws containing an exclusive forum provision are valid and enforceable as a matter of Delaware law. The court explained that:

The [Delaware General Corporation Law] allows the corporation, through the certificate of incorporation, to grant the directors the power to adopt and amend the bylaws unilaterally. The certificates of incorporation of Chevron and FedEx authorize their boards to amend the bylaws. ... In other words, an essential part of the contract stockholders assent to when they buy stock in Chevron and FedEx is one that presupposes the board's authority to adopt binding bylaws consistent with 8 *Del. C.* § 109. ... Therefore, this court will enforce the forum selection bylaws in the same way it enforces any other forum selection clause

Boilermakers is an important step forward for boards of directors considering the adoption of an exclusive forum provision. As-applied challenges to exclusive forum provisions already have begun in courts in and outside of Delaware; we expect more in 2014.

Other Important M&A Developments

“Don’t Ask, Don’t Waive.” In 2013, the Delaware courts provided guidance on a wide range of topics important to transaction planners. For example, in a series of decisions, the Court of Chancery considered the impact of so-called “don’t ask, don’t waive” standstill provisions sometimes used in connection with change-of-control transactions. The decisions indicate that while these clauses can have value in certain circumstances, boards must consider their use carefully, and in light of the overall sales process.

Good-Faith Negotiations. In *Siga Technologies, Inc. v. Pharmathene, Inc.*, the Delaware Supreme Court explained that a breach of the obligation to negotiate the terms of certain preliminary term sheets in good faith may permit a plaintiff to recover expectation damages, under certain circumstances. The Supreme Court affirmed the Court of Chancery’s finding that two parties to such a term sheet would have reached a definitive agreement but for one party’s bad-faith negotiations.

New Legislation. Also in 2013, Delaware Gov. Jack Markell signed into law legislation amending the Delaware General Corporation Law (the DGCL) in a number of important ways. For example, the DGCL has been amended to add Section 251(h), which, in certain circumstances, permits consummation of a short-form merger, which does not require a stockholder vote, following a tender or exchange offer for a majority of a corporation’s outstanding shares. We expect Section 251(h) to have a significant impact on mergers and acquisitions structures in 2014 (see “[US M&A: Looking Back at 2013 and Forward to a Brighter 2014](#)”). The DGCL also has been amended to add new Sections 204 and 205, which define corporate and judicial procedures for ratifying defective corporate acts.

Judicial Changing of the Guard. 2013 marked the retirement of Chief Justice Myron T. Steele of the Delaware Supreme Court. During his lengthy judicial career, Chief Justice Steele was an influential figure in the world of corporate governance. Gov. Markell has nominated Chancellor Leo E. Strine Jr. of the Delaware Court of Chancery as the next chief justice. We expect the Delaware State Senate to act on the nomination in early 2014.

Antitrust and Competition: Surveying Global M&A Enforcement Trends

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US: Agencies Continue Aggressive Enforcement

Despite changes in leadership at the U.S. Department of Justice's (DOJ) Antitrust Division and the Federal Trade Commission (FTC) (collectively, the Agencies) in 2013, the Obama administration's approach to antitrust enforcement remains unchanged: As the president continues to fill top vacancies with veteran litigators and enforcement-oriented personnel — such as Assistant Attorney General Bill Baer at the DOJ and Commissioner Terrell McSweeney at the FTC — the agencies will continue their aggressive antitrust enforcement.

Most significantly, the current leadership, especially at the Antitrust Division, has shown that they are not afraid to use litigation to obtain their desired enforcement results when they believe a transaction is likely to substantially lessen competition. Demonstrating its revitalized enforcement approach, the Antitrust Division challenged multiple high-profile transactions in 2013, a marked change from past administrations. (The DOJ went five years without litigating a single merger case in the early 2000s, for example.) The Agencies also have continued to challenge nonreportable and consummated transactions, a reminder that all transactions, no matter how small, are subject to the Agencies' watchful eyes.

Merger Challenges: HSR Reportable Transactions

American/US Airways. In August 2013, the DOJ, along with six state attorneys general, filed a suit challenging the proposed \$11 billion merger between US Airways Group Inc. and American Airlines' parent corporation, AMR Corp. The suit alleged that the merger would substantially lessen competition in two areas: scheduled air passenger service in hundreds of U.S. cities that constitute airline markets, and takeoff and landing slots at Ronald Reagan Washington National Airport (DCA). The DOJ further alleged that the merger would remove US Airways as a price "maverick" in certain markets and would otherwise facilitate coordination among the remaining network carriers — including Delta, United and the new American — leading to higher fares, higher fees and reduced service.

In a settlement resolving the litigation with the DOJ and the six states, the parties agreed to divest landing slots at DCA and New York LaGuardia International Airport and gates at five hub airports across the country. The parties also agreed, with certain exceptions, to maintain historical operations at their hubs for a period of three years and provide daily scheduled service from one or more of their hubs to airports in each of the six states involved in the case for a period of five years.

AB InBev/Modelo. In January 2013, the DOJ sued to enjoin the merger between Anheuser-Busch InBev SA/NV and Grupo Modelo S.A.B. de C.V. on the grounds that AB InBev's \$20.1 billion acquisition of the remaining interest in Modelo that it did not already own would substantially lessen competition in the U.S. beer market as a whole and in at least 26 metropolitan areas across the United States. In response, AB InBev and Modelo restructured the terms of their deal, agreeing to a perpetual license to

certain Modelo brands, as well as the divestiture of Modelo's Piedras Negras brewery and its interest in Crown Imports LLC, to Constellation Brands, Inc. The restructured transaction resolved the DOJ's concerns and allowed the merger to move forward.

Ardagh Group/Saint-Gobain. The FTC has used a similar approach, suing to enjoin Ardagh Group S.A.'s \$1.7 billion acquisition of Saint-Gobain Containers in July 2013. The FTC alleged that the merger between Ardagh Group and Saint-Gobain would reduce competition in the U.S. markets for glass containers for beer and spirits, and reducing the number of major competitors would facilitate coordination and result in supracompetitive prices that would harm consumers. *Ardagh Group/Saint-Gobain* is scheduled to go to an administrative trial. The parties remain in negotiations with the FTC; however, the FTC's conduct to date in negotiations and the parallel administrative proceedings in *Ardagh Group/Saint-Gobain* have been consistent with the Agencies' strategy of optimizing negotiating leverage through aggressive litigation.

Practitioners have begun to question whether this uptick in merger challenges is a change in enforcement policy and, if so, whether the approach is affecting antitrust risk assessment among potential merger partners.

Given what appears to be a new trend on the part of the Agencies to file lawsuits to increase settlement leverage, antitrust practitioners have begun to question whether this uptick in merger challenges is a change in enforcement policy and, if so, whether the approach is affecting antitrust risk assessment among potential merger partners. Regardless, in this environment, a company considering a merger must understand potential antitrust litigation risk and pragmatically and thoroughly assess the feasibility and impact of potential divestiture scenarios as early as possible. Considering the recent experiences in *American/US Airways*, *AB InBev/Modelo* and *Ardagh Group/Saint-Gobain*, it suffices to say that any potential merging party — especially one operating in a concentrated industry — must be prepared to litigate, even if only to maximize leverage in post-complaint settlement discussions.

Merger Challenges: Nonreportable Transactions

Further evidence of the Agencies' continued aggressive enforcement can be found in their increasing willingness to challenge transactions that do not meet the filing thresholds of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the HSR Act) — even in cases where a transaction already has closed. Last year both Agencies issued challenges to nonreportable transactions consummated in 2012, including Bazaarvoice, Inc.'s acquisition of PowerReviews, Inc. and Heraeus Electro-Nite LLC's acquisition of Midwest Instrument Company Inc. (Minco) (challenged by the DOJ), and Solera Holdings' acquisition of Actual Systems of America, Inc. and St. Luke's Health System Ltd.'s purchase of Saltzer Medical Group (challenged by the FTC).

Bazaarvoice/PowerReviews. The DOJ successfully challenged product ratings and reviews (PRR) platforms provider, Bazaarvoice's June 2012 acquisition of competing provider PowerReviews. The DOJ relied heavily on excerpts from company documents in seeking to unwind the completed transaction, which did not meet the filing thresholds of the HSR Act. The U.S. District Court for the Northern District of California agreed with the DOJ's claims that Bazaarvoice's internal documents showed the intent and ability of the company to raise prices for PRR platforms and eliminate PowerReviews as a competitor through the acquisition. According to the Court, evidence from company documents that Bazaarvoice and PowerReviews expected the transaction to have anticompetitive effects was overwhelming — the parties viewed themselves as operating in a "duopoly," and removing PowerReviews from the marketplace would eliminate Bazaarvoice's only meaningful commercial competitor.

The parties are scheduled for a conference to discuss possible remedies in January 2014. Assuming the company does not appeal, Bazaarvoice will be required to divest assets sufficient to create a separate and distinct competing business that can replace PowerReviews in the marketplace, and the DOJ has made clear that an effective remedy may require assets beyond those previously held by the acquired firm.

Heraeus/Minco. The DOJ required Heraeus to divest certain assets related to the development, production, sale and service of single-use sensors and instruments used to measure and monitor the temperature and chemical composition of molten steel in the steel manufacturing process, which it had obtained in its \$42 million acquisition of Minco in September 2012. According to the DOJ's complaint, prior to the acquisition, Heraeus and Minco had competed directly on price, service and innovation in supplying sensors and instruments to steel manufacturers. The settlement also required Heraeus to waive non-compete agreements it had with certain former employees.

Solera/Actual Systems. The FTC forced Solera to divest all of the assets it had acquired from Actual Systems more than a year earlier for \$8.7 million. According to the FTC, Actual Systems and Solera were close competitors and two of the only three manufacturers in an already concentrated market for yard management systems used by automotive recycling businesses. The FTC claimed the transaction likely would have resulted in higher prices and reduced innovation for yard management systems. The Solera matter underscores that no transaction is too small to escape antitrust scrutiny if the Agencies believe the transaction may harm consumer welfare.

St. Luke's/Saltzer. In early 2013, the FTC and Idaho's attorney general sued St. Luke's over its 2012 purchase of Saltzer, a 44-physician practice group that had been the state's largest independent collective of doctors' practices. According to the FTC, the acquisition of Saltzer created a dominant single provider of adult primary care physician services in Nampa, Idaho, with enough market power to charge higher rates for primary care services in the area. The FTC's suit followed a private antitrust suit brought in late 2012 by St. Luke's competitors, St. Alphonsus Health System and Treasure Valley Hospital. The FTC challenge in *St. Luke's/Saltzer* serves as a reminder that the FTC continues its aggressive enforcement in health care regardless of transaction size/reportability.

New HSR Rule Regarding Pharmaceutical Patents

In November 2013, the FTC (with the concurrence of the DOJ) announced changes to the HSR Act, which are intended to clarify when companies in the pharmaceutical industry must report the transfer of an exclusive license to a patent, or part of a patent, as an asset acquisition. Under the revised rules, the transfer of rights to a patent or part of a patent in the pharmaceutical, biologics or medicine manufacturing industries will result in a potentially reportable asset acquisition under the HSR Act if "all commercially significant rights" are transferred to another entity. Further, such transfer may be reportable even when the patent holder retains limited manufacturing rights or co-rights. The FTC suggests these changes are designed to provide the FTC with a better opportunity to assess the competitive impact of exclusive pharmaceutical patent license transfers (that may not have been reportable under the prior HSR approach) and to establish a more consistent assessment of patent transfers, whether they are in the form of license rights or outright transfers of a patent or part of a patent.

This new rule affects only transfers in the pharmaceutical industry, as the FTC has not found a need to address these types of exclusive license arrangements in other industries.

The European Commission continued its active merger enforcement policy, opening nine Phase II investigations.

EU: Competition Authorities Send Mixed Signals to Dealmakers

Despite the lingering effects of the global financial crisis, M&A activity increased in 2013, resulting in more than 200 merger notifications under the EU Merger Control (EUMR). The European Commission (Commission) continued its active merger enforcement policy under Competition Commissioner Joaquín Almunia's leadership, opening nine Phase II investigations. The Commission blocked two cases — the acquisition of TNT Express by UPS and Ryanair's third attempt to acquire Aer Lingus — raising the number of prohibitions during Commissioner Almunia's office to four. On the other hand, it granted unconditional approval in two Phase II cases based on the exceptional and rarely successful "failing firm defense."

With regard to legislative activity, in 2013 the Commission implemented a number of changes in its notification procedure and forms (which entered into effect on January 1, 2014) and launched a public consultation on a number of more substantive proposed reforms of the EUMR. It is not certain whether the Commission will be able to implement the proposed reforms before the end of Commissioner Almunia's term in November 2014. Other developments include the appointment of Professor Massimo Motta as EU Chief Competition Economist and the accession to the EU of Croatia, which now falls within the scope of the EUMR.

Reluctance to Accept Efficiency Arguments

In *UPS/TNT Express*, the Commission concluded that TNT's acquisition would have reduced competition in 15 member states of the European Economic Area (EEA) in the market for international express delivery of small packages. The Commission relied for its conclusions on the parties' and its own price concentration analyses. During the investigation, the parties acknowledged that the transaction would lead to price increases but argued that significant efficiencies (€500 million per year) would offset any potential adverse impact. However, the Commission rejected certain cost savings (in overhead costs) as unlikely to be passed on to consumers and concluded that the remaining cost efficiencies would not have been sufficient to outweigh the projected price increases. The case illustrates the Commission's reluctance to place weight on efficiency arguments when the economic evidence suggests significant price increases as a result of the transaction.

Acceptance of the Failing Firm Defense

In *Nynas/Shell/Harburg Refinery*, the Commission approved the acquisition of Shell's Harburg (Germany) refinery assets by the Swedish company Nynas, a transaction that resulted in Nynas becoming the only naphthenic base and process oil producer, as well as the largest producer of transformer oils, in the EEA. The parties demonstrated that the Harburg refinery set-up was economically unsustainable, no alternative buyers existed and, absent the acquisition, closure of the Harburg refinery was the most likely scenario and one that would lead to significant capacity reductions and price increases.

Likewise, in *Aegean Airlines/Olympic Air*, the Commission cleared the combination of the two major Greek air carriers, which would result in a monopoly for the combined firm on five domestic routes. The Commission had rejected similar failing firm arguments put forward during the parties' first attempt to merge in 2011. In its second decision, the Commission took into account the changes in market circumstances since its last decision and, in particular, the 26 percent drop in demand for domestic air transport, resulting from the ongoing Greek financial crisis. The Commission also considered Olympic's deteriorating financial situation, evidenced by its shrinking fleet and operations and the resulting reduction of overlapping routes with Aegean. In addition, Olympic's sole shareholder had decided to discontinue its support of the company, which would have led to its permanent shutdown in the short term.

Input Foreclosure and Customer Assurance Agreements in Lieu of Remedies

In two cases concerning the acquisition of a supplier of aviation components by an aircraft engine manufacturer, *UTC/Goodrich* and *GE/Avio*, the Commission decided that existing long-term agreements provided competitors with sufficient protection that access to important inputs would not be foreclosed. In addition, where existing contracts were not sufficient, the companies offered customer assurance agreements to competitors, allowing them to secure continuity of supply. These contractual arrangements were not offered as formal remedies, but they minimized the remedies the parties were required by the Commission to offer as conditions of approval.

In *UTC/Goodrich*, the Commission expressed concerns that UTC's competitors could be shut out from access to certain components, such as fuel nozzles and engine controls, developed or supplied by Goodrich. In *GE/Avio*, approved in Phase I, the Commission focused on the effects of the transaction on the competitive position of Eurojet, a consortium that designs and manufactures the engine for the Eurofighter Typhoon combat aircraft, and of which Avio was a member and supplier. The Eurofighter Typhoon competes with other combat aircraft powered by GE engines. According to the Commission, the transaction would have enabled GE to obtain significant influence over Eurojet's commercial decisions and access to its strategic information. GE offered commitments to eliminate any potential conflicts of interest and to ensure that Avio would continue to fulfill its share of the consortium's production.

Proposed EUMR Reform

At the end of the year, the Commission implemented a number of measures relating to its procedure and notification form (Form CO), which entered into effect on January 1, 2014. For cases that do not present any substantive problems, the changes expand the scope of the Commission's simplified procedure and reduce the information requirements in the Form CO. On the other hand, for cases where the parties' combined share in an overlap market exceed 20 percent or where their share in a vertically affected market (actual or potential buy-sell relation between the parties) exceeds 30 percent, information — and, more importantly, document production requirements have been expanded significantly in the new Form CO.

In addition, in June 2013, the Commission launched a public consultation on a number of proposed changes to the EUMR, including (i) the expansion of the EUMR scope to acquisitions of noncontrolling minority shareholdings (structural links) and (ii)

amendments to the current referral system of cases between the Commission and national competition authorities. Notably, the first proposal will significantly expand the Commission's powers, given that the Commission's jurisdiction under the EUMR is limited to transactions that involve a change of control. The Commission's consultation paper considers two alternative procedural options to address structural links: (i) a "notification system," in which all relevant minority shareholding acquisitions would be subject to ex-ante review and, possibly, a bar on closing pending the Commission's approval; and (ii) a "selective system," in which the Commission has discretion to investigate only selected acquisitions of minority shareholdings that could potentially raise concerns, either by relying on its own market intelligence and third-party complaints (a "self-assessment") or through a mandatory short information notice. The working paper also explores alternative options with regard to a number of other parameters, such as the possible adoption of safe harbor thresholds. The deadline for submitting comments has expired, but the Commission has yet to publish a draft legislative proposal. It is not certain whether any new proposal can come into effect still in 2014.

In 2013, China continued its vigorous merger enforcement under the Anti-Monopoly Law, often imposing far-reaching remedies.

Asia: China Completes Fifth Year of Enforcing Anti-Monopoly Law

In 2013, China's Ministry of Commerce (MOFCOM) continued its vigorous merger enforcement under the Anti-Monopoly Law, often imposing far-reaching remedies and arguably applying industrial policy and national economy considerations that could be considered to exceed the traditional scope of competition law in other jurisdictions.

In *Glencore/Xstrata*, MOFCOM was concerned about the impact of the proposed acquisition by Glencore of global mining rival Xstrata on the Chinese markets for copper, zinc and lead concentrates, in light of China's dependence on imports of these products and the limited influence of downstream Chinese producers as buyers. Confirming that MOFCOM does not consider its powers to impose remedies limited to China alone, it required Glencore to divest a Peruvian mine to secure regulatory approval for the deal. In *Marubeni/Gavilon*, the proposed merger between two global traders of agricultural commodities traders, MOFCOM voiced concerns over Marubeni's position as an important importer of soybeans into China. While Gavilon's activities in soybean imports in China were very limited, MOFCOM argued that Marubeni's access to Gavilon's U.S. assets involved in the origination/purchase of agricultural commodities would further strengthen its position. MOFCOM requested that the parties hold separate their Chinese soybean import operations for a period of at least two years. Similar hold-separate commitments were imposed in *MediaTek/MStar*, where the parties' commitment proposal included specific price reductions within predetermined timeframes.

Apart from far-reaching remedies, MOFCOM's extended review periods have become a major issue of consideration in global M&A transactions. The average review period for complex cases (involving remedies) has increased from 8.4 months in 2012 to 11.1 months in 2013. In addition, despite discussions of a simplified procedure for noncomplex cases, even those that present no antitrust issues can take three to four months to clear, which is significantly longer than in other jurisdictions.

Governance

Trends in corporate governance and shareholder activism have created an environment in which directors face increased and constant scrutiny. A paradigm shift from board-centric to shareholder-centric governance at public companies has made director elections more meaningful, giving shareholders greater influence in areas such as the framework of director elections, vote-no campaigns and proxy access. Adequate shareholder engagement and outreach is essential for public companies to address governance issues, including in the area of say-on-pay, where increased risk of proxy litigation and new disclosure rules have come into play.

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US Corporate Governance: Boards of Directors Face Increased Scrutiny

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In many ways, corporate governance in 2013 looked similar to corporate governance in 2012. Most public company directors were re-elected with shareholder support in excess of 90 percent of votes cast and only a handful of directors failed to achieve majority support. Most companies received strong support in their say-on-pay votes. And many shareholder proposals on topics such as board declassification, majority voting for directors in uncontested elections and elimination of supermajority vote requirements in corporate charters and bylaws continued to attract significant shareholder support.

Nevertheless, a number of developments in 2013 continued the paradigm shift from board-centric to shareholder-centric governance of public companies. These developments involved activist investors, governance activists such as state and labor pension funds, mutual funds and other traditional long-term investors or combinations of these market participants. And every indication is that this paradigm shift will continue to increase the scrutiny on boards of directors — including with respect to board composition and boards' substantive business and strategic decisions.

The Framework of Director Elections. Institutional investors and governance activists have largely succeeded, at least at S&P 500 companies, in changing the election framework so that most directors stand for election annually (rather than once every third year) and must submit their resignation if they fail to receive majority support from shareholders. As a result, the re-election of directors can no longer be taken for granted, and shareholder concerns need to be considered in a company's assessment of an upcoming proxy season. Notable trends and events include:

- Almost 90 percent of S&P 500 companies (and almost 60 percent of Russell 3000 companies) have annually elected boards. The Harvard Shareholder Rights Project led a campaign in 2012 and 2013 to wipe out classified boards, getting almost 100 large companies to declassify; shareholder proposals to declassify received average shareholder support of 79 percent in 2013.
- Approximately 90 percent of S&P 500 companies (and approximately 46 percent of Russell 3000 companies) have a majority voting standard in director elections and/or a policy requiring resignation if a director fails to get majority support; shareholder proposals on this topic received average shareholder support of 58 percent in 2013.
- Shareholder efforts to declassify boards of directors and to expand majority voting/resignation policies will continue in 2014 and will migrate to companies outside the S&P 500. Vanguard, a significant shareholder at many public companies, recently launched a letter-writing campaign, targeting approximately 350 companies, encouraging them to declassify their boards, adopt majority voting and give shareholders the right to call special meetings. Although Vanguard describes its approach as "quiet diplomacy," Vanguard's efforts on these issues may be difficult for companies to ignore.

"Vote-No" Campaigns. Although vote-no campaigns against directors are not a new phenomenon, they were more effective in 2013 than in previous years. Based on Institutional Shareholder Services (ISS) data, there were vote-no campaigns against 15 directors in 2013, resulting in average votes of 59 percent in favor and 41 percent

against targeted directors. Although many of these directors were re-elected, even under majority voting standards, the relatively low level of shareholder support in some cases achieved the campaigns' desired result. Although the number of attempts likely will be limited, vote-no campaigns will continue to be part of the landscape in 2014. Two of the more noteworthy campaigns were:

- **Hewlett-Packard:** CtW Investment Group (a labor pension fund-affiliated group) led a vote-no campaign arising from HP's acquisition of Autonomy Corp. and subsequent write-off. The campaign focused on the finance and investment committee chair and the audit committee chair, each of whom received more than 40 percent negative votes and (even though re-elected) resigned from the board. Also, the non-executive chairman received more than 40 percent negative votes and remained on the board but resigned as chair. In July, HP added three new directors.
- **JPMorgan Chase:** CtW Investment Group led a vote-no campaign against members of JPMorgan Chase's risk committee and the chair of the audit committee. The three risk committee members received 40 percent or greater negative votes, and two of them resigned. In September, JPMorgan Chase added two new directors.

A number of institutional investors look at proxy access as the next important step in the evolution of the director election framework.

Proxy Access. With many companies having annually elected directors and a meaningful (rather than symbolic) ability to vote against directors, a number of institutional investors look at proxy access as the next important step in the evolution of the director election framework. Proxy access would allow qualifying shareholders to nominate a limited number of director candidates and have those candidates appear in company proxy materials, alongside the board's nominees, presumably making it easier for investors to elect candidates they favor over the board's nominees. A consensus among institutional investors appears to be emerging to support proxy access proposals modeled on the vacated SEC rules. Those proposals allow a group of shareholders holding 3 percent or more of a company's shares for at least three years to include in company proxy materials candidates for up to 20 or 25 percent of the total number of board seats. Notable developments include:

- Pursuant to an agreement for the withdrawal of a proxy access shareholder proposal in 2012, Hewlett-Packard proposed a proxy access bylaw amendment for shareholders holding 3 percent of HP stock for three years to nominate candidates for 20 percent of the board; the bylaw was approved by holders of 68 percent of the shares outstanding.
- Western Union negotiated the withdrawal of a one-year/1 percent proxy access shareholder proposal in 2013 by adopting a three-year/3 percent proxy access bylaw.
- Nonbinding shareholder proposals to adopt proxy access with three-year/3 percent standards and relating to either 20 or 25 percent of the board seats achieved majority shareholder support at CenturyLink (72 percent of votes cast), Darden Restaurants (62 percent of votes cast) and Verizon Communications (53 percent of votes cast). Recently, in response to this shareholder support, Verizon announced the adoption of a proxy access bylaw, subject to shareholder approval at the company's 2014 annual meeting.
- Significantly, the universe of proponents of proxy access shareholder proposals is expanding. The proxy access proposal at Darden Restaurants was proposed by the Nathan Cummings Foundation. At a recent panel discussion, a representative of Nathan Cummings indicated the foundation was likely to submit at least three proxy

access proposals in the 2014 proxy season. In addition, CtW Investment Group, which has a history of governance activism and running vote-no campaigns, has proposed a three-year/3 percent proxy access proposal for Walgreen's 2014 annual meeting. These developments may portend an increase in three-year/3 percent proxy access shareholder proposals, and if 2013 voting trends continue many of these are likely to receive majority support.

Board Composition. The developments described above share a fundamental theme — making director elections more meaningful so as to give shareholders greater ability to influence the composition of the board. Where all is going well, shareholders may be content to defer to the judgment of a nominating committee consisting of independent directors and, ultimately, to the board to ensure that the board is comprised of men and women with the relevant skills, experiences and independence, as a group, to ably oversee and direct company management. Where shareholders perceive the company to be off course — languishing stock price, ill-conceived strategy or acquisitions, illegal or scandalous corporate actions, poor executive compensation practices or otherwise — or perhaps at increased risk of heading off course, that deference can dissipate and shareholders may ask themselves whether the team in the boardroom is the right one. The factors institutional investors focus on include:

- **Directors' Skill Sets:** Since the 2010 proxy season, companies have been required to discuss in their proxy statements the specific experience, qualifications, attributes or skills that led to the conclusion that a person should serve as a director. Over time, some companies' disclosures have become more detailed or elaborate, using skill matrices or other graphic representations to reflect the quality and diversity of skills and experiences in the boardroom. We anticipate continued investor scrutiny as to whether boards have the right skills relative to a company's business and competitive circumstances.
- **Diversity:** While board diversity includes having directors with a range of skills and experiences, it also includes racial and gender diversity. Gender diversity in the boardroom continues to be an area of particular focus, in the U.S. and internationally. The European Union is considering legislation that would require large public companies in which women comprise less than 40 percent of the non-executive directors to give priority to female candidates and permit sanctions for noncompliance. Although it is unlikely that such a scheme would be considered in the U.S., various institutional investors and other groups have touted data suggesting that companies with gender-diverse boards have better performance. Many of these investors, together with women's groups and others, formed the Thirty Percent Coalition, which has been engaged in letter-writing campaigns and has submitted shareholder proposals seeking commitments from companies to increase gender diversity on their boards. We expect these efforts to continue.
- **Director Tenure:** Long-tenured directors present a quandary for some institutional investors. On the one hand, these directors can bring to the boardroom significant experience and familiarity with a company and an industry. At the same time, some investors are concerned that long-tenured directors may lack independence or objectivity and that the absence of director turnover comes at the expense of introducing fresh perspectives into the boardroom. The Council of Institutional Investors added a provision to their corporate governance policies that boards should consider director tenure when making independence determinations. ISS has been engaged in a dialogue with market participants on this topic but did not change its

We expect institutional investors will want to engage with lead directors and nominating committee chairs to discuss director tenure.

2014 voting policies to incorporate any position on director tenure. ISS has decided to engage in additional market participant outreach and may consider voting policy changes relating to director tenure in the future. A number of non-U.S. jurisdictions already have adopted guidelines or requirements aimed at limiting director tenure. We anticipate that boards' consideration of director tenure — both in terms of individual directors and average tenure for the full board — will increasingly become an important topic. We expect institutional investors will want to engage with lead directors and nominating committee chairs to discuss director tenure, and that, over time, companies may consider proxy disclosure to preemptively address investor questions on this topic.

Activism and the Second-Guessing of Board Business Decisions. Traditional institutional investors understand that they do not necessarily know better than the board and management how a particular company should manage its businesses. But, perhaps more so than ever before, where a company has had long-term underperformance, institutional investors have become much more open to hearing from, and supporting, "activist" investors who have amassed significant investments in companies and who purport to know better than management and the incumbent board the steps a company should be taking to increase shareholder value.

Shareholder activism in the U.S. has increased significantly over the past several years, and activists now often target large, well-known companies once thought to be sufficiently large so as to be immune to these efforts. Although every activist campaign is unique, an increasing number of instances involve activists presenting operational and longer-term strategic changes rather than short-term financial gimmickry. Increasingly, activists are hiring experienced financial, legal and public relations advisers and are nominating candidates for boards who bring significant industry expertise and other strong credentials.

In one of the more interesting developments of the past year, a shareholder activist and a traditional institutional investor directly and very publicly teamed up to push a company to make an important strategic change. Relational Investors and the California State Teachers' Retirement System (CalSTRS) joined efforts to advocate that Timken Company separate its steel business from its bearings business. Relational presented its views to Timken management and CalSTRS submitted a 14a-8 shareholder proposal requesting that the company engage an investment bank to effectuate a spin-off of the steel business. That proposal received the support of 53 percent of the votes cast at the annual meeting and, shortly thereafter, Timken announced that the board had created a strategy committee to explore the separation of the steel business and the committee had retained an investment banker. In early September, Timken announced that it would spin-off its steel business in 2014.

Going Forward. This implicit or explicit alliance of activists and institutional investors can and will use the full arsenal of corporate governance tools to scrutinize boards of directors. Where applicable, they will seek to influence board decisions or, when necessary, seek to change board composition.

Among the key steps boards need to take before an activist enters the landscape is shareholder engagement. Institutional shareholders should know that the board and management have a strategy to create shareholder value and are actively executing on that strategy. Ongoing engagement and relationship building with a company's

long-term shareholders can help the board establish the credibility it needs when the benefits of strategies are not realized as quickly or as completely as originally envisioned or other unforeseen circumstances damage corporate performance. Engagement also provides an important avenue for companies and boards to hear investor concerns and attempt to address them before they develop into problems that damage a board's credibility or call into question the board's composition or strategic decisions. Robust shareholder engagement has become, and will continue to be, an important part of the corporate governance landscape in 2014 and beyond.

Executive Compensation: Avoiding Proxy Litigation and Say-on-Pay Pitfalls in 2014

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The spotlight on executive compensation further intensified during 2013, the third season under the Dodd-Frank Act's "say-on-pay" rules, with the release of additional disclosure requirements and increased risks of proxy-related litigation. To remain on top of these new developments, companies should consider the following as they head into the 2014 proxy preparation and equity award granting processes:

Proxy Litigation

Fiduciary Duties. As 2013 began, plaintiffs continued to file a wave of lawsuits alleging breaches of fiduciary duties by management and directors in connection with allegedly inadequate proxy disclosure relating to say-on-pay proposals and proposals to increase the number of shares reserved under equity compensation plans. While there has been a slowdown in reported litigation activity, companies should continue to prepare their compensation disclosures with the threat of such lawsuits in mind.

Equity Grant Activity. We also have observed a new wave of lawsuits claiming that companies have failed to meet the requirements of Section 162(m) of the Internal Revenue Code, particularly by granting awards in excess of the compensation plan's stated per-person limits or failing to get reapproval of performance goals every five years. In a number of cases, companies have voided the grants in question. As companies prepare for their next round of equity grants, they should carefully monitor any equity grant activity by involving internal counsel and equity specialists, as well as external advisers, to maintain compliance with all relevant laws and the terms of the applicable plans and arrangements.

Say-on-Pay

Avoid Complacency. The overall voting results for say-on-pay proposals at Russell 3000 companies have stabilized and even slightly improved. Seventy-three percent of proposals passed with 90 percent support or greater, 24 percent passed with between 50 and 89 percent support and 3 percent failed by obtaining less than 50 percent support.¹

Interestingly, of the companies with failed proposals in 2013, the vast majority had passed the year before, with almost half obtaining approval rates between 70 and 99 percent. As such, it is critical that companies approach each say-on-pay vote with a fresh eye and be mindful that past success will not guarantee approval in future years.

Advisory Firms: Traditional Factors and Emerging Themes. As always, companies should be aware of the factors that typically cause Institutional Shareholder Services (ISS) and other advisory firms to issue an "against" recommendation:

- the determination by ISS that there is a disconnect between the company's performance and the amount of the CEO's pay;
- equity award grants that are time- rather than performance-based, particularly if such grants represent a substantial portion of the company's equity grant program;

“Interestingly, of the companies with failed proposals in 2013, the vast majority had passed the year before.”

¹ All percentages follow the (for/for + against + abstain) formulation.

- retention (or “mega”) equity grants or bonuses, particularly without a rigorous justification; and
- performance goals that ISS deems to be insufficiently challenging.

As each proxy season unfolds, additional themes emerge from advisory firm reports, and companies should be aware of these recent developments:

- **Outreach Efforts:** ISS continued to express concern that certain companies had not conducted adequate shareholder outreach, especially where ISS viewed that the compensation committee had been insufficiently involved. As such, companies should document and describe any shareholder outreach efforts in detail in the proxy and emphasize the involvement of the compensation committee, whether via direct interface with shareholders or through determination of the content and direction of those communications.
- **Nonformulaic Bonuses:** Advisory firms have been looking closely at bonus programs that are not entirely formulaic. While a number of companies issued supplemental disclosures following an “against” recommendation explaining the strategic reasoning behind these plan structures, such filings generally do not result in a change in the recommendation. Companies should consider examining these plan designs and set forth their rationale clearly in the 2014 proxy.
- **Mistakes of Fact:** A number of companies alleged that the shareholder advisory firms had made mistakes of fact regarding the terms and parameters of compensation arrangements, particularly in the case of incentive compensation plans. While each situation has its own unique characteristics and context, the fact that multiple companies raised this issue is a reminder to be exceptionally clear when drafting proxy disclosure with respect to complex arrangements and to have the disclosure carefully reviewed by multiple parties to check for overall comprehensibility. Charts and graphics also can be useful in this regard. Additionally, companies should carefully review the advisory firms’ descriptions of their compensation arrangements for factual accuracy.

“Advisory firms have been looking closely at bonus programs that are not entirely formulaic.”

Pay-Ratio Disclosure

The SEC’s proposal to implement “CEO pay-ratio” disclosure requirements under the Dodd-Frank Act has received considerable press attention. The proposed rules would require certain SEC reporting companies to publicly disclose:

- median annual total compensation of all employees of the company (including all full-time, part-time, temporary, seasonal and non-U.S. employees);
- annual total compensation of the CEO; and
- the ratio of the median annual total compensation of all employees to the annual total compensation of the CEO.

Assuming the SEC adopts the final rules in 2014, a company with a December 31st fiscal year-end would be required to disclose pay-ratio information relating to 2015 compensation in its 2016 proxy. Items to watch for in the final rules are any parameters and details provided with respect to the permissible calculation methodology, and any relief provided by the SEC regarding the points that have drawn the harshest criticism from the business and practitioner communities (in particular, the inclusion of part-time, temporary, seasonal and non-U.S. employees). Companies also may want to consider submitting comment letters, even after the official deadline for such letters has passed.

2014 Insights / SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES

Regulatory

The themes dominating the regulatory landscape in 2014 are similar to those found in the years since the peak of the global financial crisis: large-scale attempts to reform a number of laws affecting corporations, difficulties implementing those that have received legislative approval, and debates over both the impact of new regulations and how recently appointed agency leaders may enforce them. From the rollout of the Affordable Care Act in the U.S. to the various proposals for sweeping tax reform being developed in coordination with G20 governments, increased regulation continues to be the norm, as do the business complexities and legal challenges that follow (for those related to financial institutions, see our [Financial Regulation](#) section).

Regardless of the nature of the new laws or issues they raise, companies and their boards will continue to consider a host of organizational or policy changes to ensure their businesses successfully navigate whatever impositions regulatory developments may present.

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Communications: With New Leadership, the FCC Readies for Action

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With a new chairman and a full complement of commissioners for the first time in more than six months, the Federal Communications Commission (FCC) is poised to take on a broad set of communications-related issues in 2014 and beyond. Chairman Tom Wheeler, with a background in both media and telecommunications advocacy, has indicated a desire to quickly refocus the FCC into action on a number of significant issues. The chairman's brief track record in office does not provide a detailed roadmap of his intentions, but the items he has addressed in his first two months in office serve as a harbinger of issues he likely will focus on during his stewardship of the FCC. These include policies that enhance competition in the marketplace and ensure the deployment of advanced networks and services. His background as a lobbyist for the cable industry also may lead Chairman Wheeler to reinvigorate the FCC's focus on media-related issues.

Spectrum Auctions and IP Transition on the Horizon

One of Chairman Wheeler's main priorities will be to prepare for a number of spectrum auctions that will help to further expand the availability of advanced wireless networks across the country. The most noteworthy upcoming auction is an extremely complicated undertaking involving the re-auction of existing television broadcast spectrum for mobile wireless services. This auction stems from the Middle Class Tax Relief and Job Creation Act of 2012, which requires the FCC to conduct: (i) a reverse auction in which television broadcast licensees establish prices at which they agree to relinquish some or all of their spectrum rights, and (ii) a traditional forward auction in which wireless carriers (or other participants) bid to acquire the right to use any relinquished spectrum.

The FCC has been conducting a variety of proceedings to establish the rules for the auction, which will be the most challenging ever undertaken by the Commission. While the FCC originally had stated it hoped to begin the auction in 2014, Chairman Wheeler recently pushed back this schedule to 2015. In doing so, he confirmed the beliefs of many industry participants that a 2014 auction was very unlikely to occur. Chairman Wheeler stated that additional time is required to ensure that both the auction process and the underlying technology can be optimized. As a result, auction participants can expect a number of new rulemaking proposals in the coming year requesting participant input on auction procedures. One of the major issues Chairman Wheeler must resolve in establishing these procedures will be whether to impose caps on the amount of spectrum AT&T and Verizon Wireless can procure at auction. Given his recent public statements regarding the need to implement policies that further marketplace competition, it appears that he may favor certain limitations on these carriers' participation in the auction.

Chairman Wheeler also recently stated that a so-called "network compact" with consumers is a principle that will guide his policymaking at the commission. In the chairman's view, this compact embodies the FCC's statutory responsibility to ensure that all Americans have access to wired and wireless networks and services. In recent months,

the chairman has made headlines for pushing wireless carriers to allow consumer-to-unlock handsets at the end of a contract term and for considering the elimination of in-flight wireless services. While these issues offer glimpses into this network compact, the chairman's primary focus is likely to be a commitment to transitioning the U.S. telecommunications systems to IP-based technologies. His most recent private sector experience involved investing in early state IP-based companies, and he clearly is eager to leverage this expertise at the commission. In fact, he recently indicated that the FCC will initiate a process to consider the legal, policy and technical issues that will constitute the commission's IP transition agenda.

Chairman Wheeler's leadership likely will result in a renewed FCC focus on media-related issues.

Media Issues Receive New Focus

Chairman Wheeler's leadership likely will result in a renewed FCC focus on media-related issues, reversing what many view as relative inattention to media issues in recent years. One of the chairman's first actions was to withdraw the never-released order resulting from the FCC's 2010 quadrennial review of media ownership. The order reportedly would have relaxed certain regulatory controls on the combined ownership of select media properties, such as a radio station and newspaper in the same market. In withdrawing the order, the chairman suggested an intent to take a look at the upcoming 2014 review with fresh eyes, and to consider a more sweeping set of changes to the media ownership regulations. The chairman has not tipped his hand as to his intentions, but the 2014 review is certain to significantly impact the investment climate in the sector because it will be the first ownership review in more than eight years.

The chairman also appears poised to pursue pro-growth policies in the media sector, including reconsidering restrictions governing investments in media-related properties. For example, the FCC recently signaled a new interest in encouraging foreign investment in broadcast licensees by clarifying how it will review such investment going forward. The Communications Act of 1934 limits foreign ownership of U.S. entities that control broadcast licensees to 25 percent, though it grants the FCC discretion to find that, in certain cases, this limitation is not in the public interest. The FCC previously refused to approve any foreign ownership interest greater than 25 percent in broadcast license holders. Despite this longstanding precedent, the commission issued a declaratory ruling in November lifting the de facto ban on indirect foreign ownership above 25 percent, clarifying that it intends to review applications for such ownership on a case-by-case basis going forward. By allowing broadcasters to attract foreign capital on the same terms as their cable and satellite equivalents, Chairman Wheeler made a decided policy shift that should open investment opportunities greatly benefitting broadcasters.

Cybersecurity: Amid Increasing Attacks and Government Controversy, a Framework to Reduce Risk Emerges

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2013 likely will be considered a watershed period in the role of cybersecurity in corporate strategy and management. While there were few significant legislative developments, a marked increase in cybersecurity attacks sensitized companies to this growing threat.

Companies are more cognizant that cyberattacks are not limited to the unauthorized access to and use of personal information; attacks that focus on the theft of intellectual property and corporate business plans have become equally prevalent. In addition, attacks from state-sponsored hackers are increasing at an alarming rate. The ability of companies to protect themselves against such cyberattacks is becoming a competitive differentiator.

A Lack of US Congressional Activity

In a year when both houses of Congress had difficulty agreeing on a number of critical national issues, it is not surprising that cybersecurity legislation gained little traction. The reality is that many organizations, let alone legislators, have trouble agreeing on what type of cybersecurity regulation is necessary or even appropriate. Many companies believe that they are already taking steps to address this risk, and do not require legislation to compel their actions. Congress also is reluctant to mandate specific technological solutions out of a concern that it might be seen as backing certain technology vendors over others.

Congressional activity instead has focused on amending laws that restrict information sharing among companies so that businesses can exchange cybersecurity data. The expectation is that increased sharing of information, especially about cybersecurity intrusions, will allow companies to coordinate security efforts and take their own prophylactic measures. Such information sharing would be required only of "critical infrastructure" industries, which include the energy, telecommunications and financial services sectors. While a focus on information sharing, as opposed to new regulation, increases the likelihood of some type of cybersecurity legislation emerging from Congress, many hurdles remain. Sharply divergent views on which entities would be covered by this information sharing, what form it would take, and what sort of legal protection companies would have if they shared information likely will be debated in 2014.

Some have suggested that the recent attack on Target Corp., resulting in the theft of credit and debit information of some 40 million customers, will be the "tipping point" incident that incentivizes Congress to take a more aggressive approach on enacting cybersecurity legislation. However, it remains unclear what type of laws would have prevented such a breach. To date, there has been no suggestion that Target lacked industry-standard cybersecurity protections. The reality is that, in the current environment, hackers continuously outsmart such protections.

The executive branch has stepped into the void created by the lack of any meaningful congressional activity.

President Obama's Executive Order and Its Ramifications

The executive branch has stepped into the void created by the lack of any meaningful congressional activity. On February 12, 2013, President Obama signed an executive order and a presidential directive that together set forth the administration's approach to two key issues: regulating critical infrastructure network security and sharing cyber-threat information between the public and private sectors.

The executive order discusses the cybersecurity of "critical infrastructure" — private sector systems and assets so vital to the U.S. that their incapacity or destruction would have a debilitating impact on security, the economy or public health. The executive order initiated a new process through which the administration asked federal agencies to assess the need for new regulation of cybersecurity standards at critical infrastructure companies. There are three key components: actions by the Department of Homeland Security (DHS), actions by the National Institute of Standards and Technology (NIST), and actions by sector-specific regulators named in the associated presidential directive. Of these three, NIST actions have done the most to shape the cybersecurity agenda.

The NIST Framework. The executive order required NIST to coordinate the development of a "framework" to reduce cybersecurity risks to critical infrastructure. Over the course of 2013, the institute solicited public comments and drafted a preliminary NIST Framework, which highlights the difficulty of enacting comprehensive cybersecurity legislation. Rather than prescribing specific requirements, the framework is far more open-ended. As NIST noted, there is no "one-size-fits-all approach for all critical infrastructure organizations."

The framework highlights five core functions that NIST considers part of a comprehensive view of cybersecurity risk:

- identifying which systems, assets and data require protection;
- protecting those systems, assets and data by implementing appropriate safeguards;
- detecting the occurrence of cybersecurity events;
- responding to cybersecurity events detected; and
- recovering capabilities impaired through a cybersecurity event.

The framework subdivides these core functions into categories and subcategories and provides cross-references to a number of different existing industry and government standards that address each subcategory within the functions. Organizations can review these references and select the standard that best addresses their particular needs.

The framework also includes implementation tiers describing the level of sophistication an organization applies to each core function. There are four tiers, ranging from partial, in which an organization does not have a formal risk management process, to adaptive, in which an organization regularly incorporates new information into its approach. Organizations that adopt the framework determine a desired tier at each function and category level based on organizational goals, expected reduction in cybersecurity risk and feasibility of implementation. For example, an organization may choose to put more resources into robust recovery from cybersecurity events and fewer into asset protection.

Once an organization selects tiers across all functions and categories, it has developed a framework profile — a cybersecurity risk mitigation response strategy. It can then regularly compare its current framework profile to its target version and take action as required.

Incentives for framework compliance remain unclear. In August 2013, the DHS made public a preliminary list that the government may offer to companies that opt to comply. How those incentives may be deployed in practice is uncertain.

While the preliminary framework does not propose new cybersecurity standards, the executive order mandates that agencies use it (once finalized) as the basis for reviewing critical infrastructure cybersecurity within regulated sectors. The executive order also asks those agencies to consider whether they have the legislative authority to enact any regulations that might be required.

The FTC Becomes Increasingly Proactive

In 2013, the Federal Trade Commission continued to take an aggressive approach in pursuing certain companies that suffered data breaches. This stance surprised many because there is no existing cybersecurity standard that such a company could have violated.

Instead, the FTC has taken the position that certain companies misled consumers (thereby violating Section 5 of the FTC Act) by purporting to have adequate security processes in place when, as “established” by the breach, they clearly did not. While at least two companies have challenged the FTC’s tactic as exceeding the agency’s jurisdiction, we anticipate that the FTC will continue this aggressive approach in 2014. At the end of 2013, the FTC also announced that in 2014 it will focus increased attention on “Big Data” (*i.e.*, the pooling of vast stores of data, often without consumer knowledge, let alone consent), mobile devices and protection for sensitive data, which includes health and financial information, as well as data about children.

What Companies Should Consider in 2014

The 2014 cyberthreat environment requires that companies implement, audit and update robust security measures frequently. Companies also should make organizational and policy changes that insulate them as best as possible from regulatory challenges and class actions:

At the Board and C-Suite Level: Board and company executives need to treat cybersecurity as another critical audit and control function of the organization. Long gone are the days when executives could dismiss cybersecurity questions by responding that this was the purview of the IT department. Instead, as part of their fiduciary responsibility to protect their corporations, board and C-suite executives need to be well-versed in the steps their companies are taking to safeguard systems and be involved in all major decisions in this regard. Boards also should receive regular reports on the state of the organization’s security. It is important to note that corporate audit committees increasingly are focusing on the critical nexus between cybersecurity and an organization’s financial health and controls. These committees realize that, in today’s environment, financial controls are heavily dependent on, and threatened by, cybersecurity issues.

The FTC continued to take an aggressive approach in pursuing certain companies that suffered data breaches.

Data Breach Response Planning: Organizations need to develop data breach incident response plans. If a company fails to do so and suffers a data breach, it runs the risk of a class action claim that it was ill-prepared to deal with cybersecurity, and any resultant harm could have been avoided if such a plan were in place.

Developing a Security Standard: Although the NIST Framework only provides general cybersecurity guidelines, merely points to existing standards and is limited to “critical infrastructure” companies, it does offer the first government-generated comprehensive overview of cybersecurity standards. Organizations should assume that plaintiffs’ lawyers, the FTC and regulators may view the framework as an important baseline document to measure an organization’s cybersecurity practices. Regardless of industry or existing cybersecurity policy, companies may want to carefully review the framework and technical standards it discusses.

Reviewing Security Assurances: The FTC’s actions provide an important reminder that organizations should be mindful of how they present their security standards to customers. Organizations understandably are tempted to laud their state-of-the-art security systems as a means to assuage customers’ concerns and provide a competitive advantage. However, these statements may come back to haunt organizations in the event of a data breach. We are in an era where more circumspect comments may be warranted.

Closely Track Third-Party Agreements: Third-party vendors have become increasingly cautious about cybersecurity issues, particularly in agreements through which they will handle client data. Therefore, vendors likely will seek limitations on liability, narrower indemnities and possibly even liability exclusions for any data breaches. Legal departments and procurement groups need to carefully review agreements for these clauses. Organizations also should consider establishing risk policies regarding whether they are willing to accept any such limitations or exclusions.

Cyberinsurance: For the last few years, organizations have asked whether cybersecurity was an insurable risk. Despite the demand, insurance companies initially struggled with creating a commodity insurance product for a risk that was so dependent on how a company secured its systems. Without performing company-by-company audits, which would be cost-prohibitive, selling insurance products against this risk seemed challenging. However, in 2013, the market for cyberinsurance products expanded dramatically. While premiums and scope of coverage vary widely, organizations may want to consider this option.

* * *

In 2014, companies and their executives need to stay focused on cybersecurity risks. While Congress has offered little direction on the levels of security required, aggressive plaintiffs’ lawyers and an active FTC have created an environment where security policies and activities are being closely scrutinized.

Government Affairs and Government Procurement: Pressure to Comply Continues to Grow in 2014

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With increased attention to transparency in corporate political spending, disclosure of so-called “dark money” and a new rule for municipal advisors, corporations and other organizations active in government affairs or government procurement will need to work hard to ensure a high level of compliance in 2014.

Shareholder Activism

A major issue surrounding corporate political activity is the extent to which a corporation must disclose its political contributions, lobbying and related activities to its shareholders and the general public. The Center for Political Accountability and activist shareholders have pressed for greater transparency of corporate political spending over the last decade by submitting proxy proposals on these topics to selected companies. This effort intensified in the wake of the U.S. Supreme Court’s ruling in *Citizens United v. FEC*, which allowed corporations to make unlimited independent expenditures for federal, state and local candidates. Since that 2010 decision, resolutions requiring disclosure have garnered a majority of the shareholder vote on several occasions. Proposals that did not receive majority support would have restricted political activity or required increased lobbying disclosure. The timing and thoroughness of lobbying and political expenditure disclosure raises significant political and public relations issues with a corporation’s investors, competitors and the public at large.

“Dark Money” Disclosure

Additionally, states likely will increase disclosure requirements in 2014. New York Attorney General Eric Schneiderman adopted regulations requiring nonprofits that file with his agency and make certain election-related expenditures to disclose those expenditures and their larger donors. The new regulations, which primarily target 501(c)(4) organizations that use so-called “dark money” to attempt to influence elections, took effect on June 5, 2013. Nonprofits and their donors — especially those who expect their contributions will not be disclosed publicly — should take these regulations seriously. In addition, while it does not address disclosure, the IRS has issued proposed new rules on the political activities of 501(c)(4) organizations.

Pay-to-Play Laws

Increasingly restrictive pay-to-play laws continue to emerge at the federal, state and local levels as a reaction to various scandals involving public officials. At the state and local levels in 2013, this included amended pay-to-play laws in Maryland, Michigan and New Hampshire. Recently adopted federal pay-to-play laws, including SEC Rule 206(4)-5 impacting investment advisers and CFTC Rule 23.451 affecting swap dealers, are challenging for companies to implement. This year it is likely the Municipal Securities Rulemaking Board (MSRB) will propose a new federal pay-to-play rule for municipal advisors, which will add further complexities to the pay-to-play landscape.

Municipal Advisor Rule. The compliance dates for the SEC rule defining and requiring permanent registration of “municipal advisors” under the Dodd-Frank Act (the Rule) were delayed by the SEC until July 1, 2014. Subject to certain exclusions and

exemptions, the Rule defines a “municipal advisor” as a person, other than a municipal entity or an employee of a municipal entity, who:

- provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such financial products or issues; or
- solicits a municipal entity or obligated person on behalf of certain unaffiliated third parties for the purpose of obtaining or retaining an engagement for or in connection with municipal financial products, the issuance of municipal securities or of an investment adviser to provide investment advisory services to or on behalf of a municipal entity.

Registered municipal advisors are subject to a fiduciary duty of care to clients and to all applicable MSRB rules. The MSRB recently released Proposed Rule G-42, which sets forth proposed standards of conduct for municipal advisors.

Forthcoming Pay-to-Play Rule for Municipal Advisors. The Rule’s adoption will prompt the MSRB to resubmit to the SEC for final approval its previously withdrawn pay-to-play rule for municipal advisors, the former MSRB Proposed Rule G-42. Based on the text of the initial proposal, once adopted, the new pay-to-play rule is expected to be modeled after and largely mirror existing SEC and CFTC pay-to-play rules.

SEC Rule 206(4)-5 Implications. In 2012, the SEC extended the compliance date for SEC Rule 206(4)-5’s restrictions on using third-party and affiliated entity solicitors until nine months following the “compliance date” of the Rule. Given the various compliance dates contained in the Rule, it is not clear when these placement agent restrictions will go into effect. In its June 2012 release extending the placement agent compliance date, the SEC stated that it will issue the compliance date for this restriction in a notice once the Rule has been finalized.

* * *

Because of the ever-increasing risk of enforcement action as well as negative media attention in the event of legal violations, 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.

Health Care and Life Sciences: Affordable Care Act Rollout to Impact M&A and Enforcement Activity

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Health care and life sciences companies face a variety of issues in 2014, including further difficulties with the Affordable Care Act (ACA) rollout because of legal and logistical challenges, the potential dampening of dealmaking due to ACA and regulatory scrutiny, and continued aggressive government enforcement activities in the industry.

Affordable Care Act Rollout

Much of the health care policy debate in 2013 focused on the Obama administration's botched rollout of the centerpiece of the ACA — the federal- and state-run exchanges where individuals and small-business owners were supposed to easily analyze and purchase health insurance, with generous subsidies for lower-income Americans. As is so often the case with health care issues, it is difficult to separate the administration's policy decisions from political considerations. The administration has been pushed, often by congressional Democrats, to delay or modify many ACA provisions. These measures have included postponing the mandate requiring employers with more than 50 employees to provide coverage to their workers, scaling back enforcement of applicant income verification requirements and — perhaps most controversially — enacting an automatic "hardship waiver" allowing individuals whose plans were cancelled for failing to meet the act's minimum coverage requirements to forego purchasing health insurance without paying the individual mandate tax. While these administrative actions may have answered complaints from some quarters, they have created havoc among insurers and resulted in increased premiums for the 2014 policy year.

The administration also faces continued legal challenges to the ACA, the most serious being a challenge by the Oklahoma attorney general arguing that the law only provides tax credits and subsidies to individuals who buy insurance on state-run exchanges. The complaint claims that Congress intended to limit subsidies as an incentive for states to create their own exchanges and that the administration's decision to extend credits and subsidies to federally run exchanges is not authorized by the ACA. With more than 30 states opting not to create their own exchanges, a successful challenge would upend the ACA and force the administration to work with Congress to address the problem. While a U.S. district judge refused to grant an injunction last month, he scheduled oral arguments on the merits of the case for February 2014.

Implementation Timeline. Despite these challenges, the administration remains committed to implementation of the ACA without further congressional action. The exchanges are just one of several important provisions of the ACA that will come into effect in 2014 and beyond. Among the other key provisions:

- **January 1, 2014: Expanded Medicaid Coverage.** Expands Medicaid to all individuals not eligible for Medicare under age 65 with incomes up to 138 percent of the federal poverty level. More than 1.4 million people signed up for Medicaid or states' Children Health Insurance Programs in October 2013, although 48 percent of those live in expansion opt-out states, making the Medicaid market a less attractive opportunity in the near term for insurers and providers.
- **Annual limits, pre-existing conditions.** Prohibits insurers from charging more or denying coverage to anyone with pre-existing conditions or charging higher rates due

to gender or health status in the individual and small-group market. Also generally prohibits annual dollar limits for plans starting January 1, 2014.

- **March 1, 2014:** Physician-Owned Hospitals. Pursuant to a Centers for Medicare & Medicaid Services (CMS) delay, physician-owned hospitals have until March 1 to report ownership and investment information. The ACA blocked the construction of any new physician-owned hospitals and prevented those operating from adding beds or operating rooms if they wanted to remain eligible for Medicare.
- **October 1, 2014:** New Procedural Coding System. As of this date, health care organizations must convert to the ICD-10 coding system. Under the final rule, all health insurers must use a unique health plan identifier.
- **January 1, 2015:** Employer Obligations. In July 2013, the White House delayed by one year the reform law's mandate that employers provide health insurance coverage for their workers. Employers with at least 50 full-time employees must offer health benefits or pay a penalty of \$2,000 per full-time employee, excluding the first 30 employees.
- **January 1, 2018:** Tax on High-Cost Insurance. The ACA will impose a 40 percent excise tax on the cost of health plans that exceed a certain threshold — \$10,200 annually for individual coverage and \$27,500 for family coverage.

Health Care M&A and Corporate Activity

Health care M&A activity picked up in the second half of 2013 after a relatively lackluster level of activity at the beginning of the year. Deal volume in the third quarter was up nearly 16 percent versus the previous quarter, with 267 deals announced; activity in this period also outpaced the third quarter of 2012 by almost 20 percent. Four of the largest health care sectors — services, pharma/biotech, medical device and supplies, and technology — posted year-on-year increases in deal activity, while five relatively smaller sectors posted decreases: behavioral health care (down 60 percent); home health and hospice (down 50 percent); labs, MRI and dialysis (down 20 percent); physician medical groups (down 6 percent) and medical devices (down 8 percent).

Notable Deals. Multiple factors contributed to the overall acceleration of health care M&A activity in the second half of 2013, including continued low interest rates for corporate borrowers and the imperative among providers to increase volume and scale to offset lower reimbursement rates mandated in the ACA. The largest transactions occurred in the pharmaceutical and hospital/health system sectors. Among the most notable in 2013 were:

- Valeant's \$8.7 billion acquisition of Bausch + Lomb, a leading provider of pharmaceuticals and medical devices in the eye care sector (announced in May). The deal reflects continued consolidation in the pharmaceutical industry.
- Amgen's \$10.4 billion acquisition of Onyx Pharmaceuticals, a biotechnology company focused on oncology therapies (announced in August). Specialty pharmaceutical and biotechnology companies with novel therapies that can support premium pricing models remain attractive acquisition candidates.
- Community Health Systems, the second-largest U.S. hospital chain, acquired Health Management Associates (announced in July). At \$7.1 billion, the deal was the biggest acquisition of a hospital company since 2006.

- Endo's \$1.6 billion acquisition of Paladin Labs Inc. (announced in November). The deal reflects the ongoing strategic transformation of certain pharmaceutical manufacturers into global specialty health care companies.

Caution in 2014. Cost pressures in the United States and abroad will squeeze margins for health care companies. Some combination of consolidation, changes in business models and increased use of technology (to improve patient outcomes and/or decrease costs) will be necessary to maintain or increase profitability. Continued turmoil in the implementation of the ACA's health care exchanges could increase regulatory uncertainty in the health insurance market, potentially dampening enthusiasm for major deals in that sector (see [Global M&A/US M&A: Looking Back at 2013 and Forward to a Brighter 2014](#)”).

Until recently, China was an especially attractive opportunity for growth for health care manufacturers and others. However, the Chinese government's recent, high-profile investigation of alleged fraud by foreign pharmaceutical companies — starting with a bribery scandal at GlaxoSmithKline and spreading to other major manufacturers — appears to have decreased inbound investment in its life sciences sector in 2013. News that China's National Health and Family Planning Commission plans to publish a blacklist in March 2014 of pharma and medical device manufacturers found to have paid bribes likely will add further complexities to dealmaking in the region. At a minimum, foreign companies are likely to (and should) beef up their preacquisition diligence efforts in the Chinese market, which could slow deal activity.

Enforcement, Compliance and Regulation

Health care enforcement continued to be a top priority for federal and state prosecutors and investigators in 2013, with \$2.6 billion in federal civil recoveries in fiscal-year 2013, down slightly from 2012 but still the second-largest annual recovery in health care fraud cases in U.S. history. Three enforcement actions resulted in criminal and civil recoveries of almost \$3 billion (\$1.5 billion from Abbott Laboratories, \$762 million from Amgen and \$505 million from Ranbaxy). The Ranbaxy case was notably the largest drug safety settlement to date with a generic drug manufacturer (including two felony charges for the distribution of adulterated products) and one of the largest settlements ever focusing on the manufacturing and quality practices of a pharmaceutical manufacturer. Johnson & Johnson's November 2013 settlement (\$2.2 billion in civil and criminal fines and penalties) means the government's fiscal-year 2014 likely will be a near-record year for health care fraud recoveries. However, we believe that settlements exceeding \$1 billion (four in the past four years) will decrease over time, as the industry has tightened promotional compliance controls, the number of blockbuster products has decreased, and the largest cases involving multiple products spanning five to 10 years (or more) largely have worked their way through the enforcement process.

False Claims Act Violations. While the number of billion dollar settlements may decrease in the coming years, enforcement is likely to continue at a torrid pace. One area of scrutiny likely will center on the ACA's requirement that providers report and repay overpayments within 60 days of identification, or face potential liability under the False Claims Act (FCA) for the knowing retention of an overpayment. Though the comment period for CMS's proposed rule closed in April 2012, CMS has yet to issue a final rule. 2014 might be the year that this program requirement gets off the ground,

“While the number of billion dollar settlements may decrease in the coming years, enforcement is likely to continue at a torrid pace.”

and providers quickly institute safeguards to ensure compliance, given that deferred action on internal (or third-party) audits that uncover overpayments is an easy mark for potential whistleblowers.

Hospitals and physicians should be on notice that their relationships are a target-rich environment for prosecutors looking for significant recoveries under the FCA, which often is used to prosecute alleged violations of the federal Stark Law. This is notable in the wake of the \$237 million judgment against Tuomey Healthcare System for improper financial relationships between the hospital system and physicians. Tuomey's settlement is based on \$39 million of claims it submitted over a two-year period. The judgment factored in treble damages (roughly \$117 million), plus an additional \$120 million penalty (or approximately \$6,000 per claim).

Stark Law compliance often relies on a hyper-technical reading of the statute and regulations, and hospitals should not only ensure that new contracts with physicians fully comply with the law, but also that they have in place a tracking mechanism to confirm that existing contracts remain compliant or are renewed as necessary.

FDA Enforcement Agenda. On the FDA front, there has been a relatively profound change in the agency's enforcement priorities. In the past two to three years, the FDA appears to have been less focused on, and devoting fewer resources to, drug promotion issues as reflected in a downward trend in the number of warning letters and notices of violations (known as untitled letters), while intensifying its focus on manufacturing and quality issues. This change coincides with the approach championed by FDA Commissioner Margaret Hamburg, who has directed the agency's enforcement and regulatory units to embrace a risk-based approach in allocating its enforcement resources, with priority placed on practices posing a significant risk to patient health and safety.

Fraud Settlements. Finally, notable changes have occurred during the past few years in the compliance provisions in health care fraud settlements. The Department of Health and Human Services Office of Inspector General (HHS OIG) continues to push for changes in what it perceives as drivers of corporate behavior — including incentive-based compensation for sales representatives and compensation packages and bonuses for executives. Several recent corporate integrity agreements (CIA) imposed by the HHS OIG have required companies to move away from territorial-based sales incentives while also implementing compliance-related financial “clawbacks” for more senior executives. Recent CIAs also have imposed significant oversight obligations on boards of directors and senior management, reinforced by annual compliance certifications.

More onerous compliance obligations are not limited to CIA requirements, however. In 2011, a U.S. district court judge accepted a proposed \$296 million settlement between Guidant Corporation and the U.S. Department of Justice involving the company's alleged concealment of safety data about one of its cardiac devices only after the judge added a three-year term of probation to the settlement; the judge had rejected a prior settlement that did not contain a term of probation. Since that time, several courts have included compliance obligations in the conditions of probation imposed on companies following the entry of criminal pleas. In other instances, the Department of Justice (DOJ) has incorporated compliance and reporting obligations in plea agreements, establishing new links between a company's post-settlement conduct and oversight by DOJ prosecutors. Both trends — *i.e.*, court-imposed conditions of probation and DOJ-imposed compliance obligations — will increase scrutiny of companies that have resolved health care fraud settlements and could expose companies to significant fines and penalties for future violations.

Does Leaning In Make Legal Sense for Employers? Definitely.

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With employment discrimination charges at a 15-year high, employers are seeing a particular increase in claims brought by workers who are pregnant or caring for young children or aging parents. A 2010 report by the Center for WorkLife Law at the University of California Hastings College of the Law shows that plaintiffs in these family-responsibility cases are more likely to prevail than plaintiffs in other types of employment discrimination cases, with average awards exceeding \$500,000.¹ In one notable class action, a jury awarded \$3.36 million in compensatory damages and an additional \$250 million in punitive damages when it found discrimination against women in the employer's pay, promotion, pregnancy and family leave policies. These trends raise the question of whether employers can better address sensitive issues relating to gender, pregnancy and caregiving responsibilities.

The Debate

Some companies aim to desensitize their workforces to differences between men and women and thus train managers not to ask employees questions related to gender, pregnancy or caregiver responsibilities. But management experts — and legal counsel — are rethinking these practices, particularly in the wake of Facebook Chief Operating Officer Sheryl Sandberg's book *Lean In: Women, Work, and the Will to Lead*, published in March 2013, in which Sandberg said she instead teaches managers "to encourage women to talk about their plans to have children and help them continue to reach for opportunities." Yet, critics argue companies put themselves at litigation risk because managers will not know how to engage in these discussions without running afoul of anti-discrimination laws. Such concerns have been exacerbated by recent well-publicized demand letters received by technology companies from female employees allegedly denied promotions or terminated after "leaning in" at the workplace.²

Legal Reasons to Engage

Employers should consider the greater litigation risk of not engaging with employees on these issues. Title VII of the Civil Rights Act of 1964, as amended by the Pregnancy Discrimination Act, makes it unlawful for an employer to discriminate on the basis of pregnancy or pregnancy-related conditions. While Title VII does not prohibit discrimination against caregivers per se, under a theory referred to as "sex-plus" (*i.e.*, sex plus another characteristic, such as caregiving), discrimination against working mothers has been held to violate Title VII even if the employer does not discriminate against childless women.³ Title VII also has been used to protect male employees' rights to engage in family caregiving.⁴ Moreover, the Americans with Disabilities Act "association" provi-

¹ Cynthia T. Calvert, *Family Responsibilities Discrimination: Litigation Update 2010*, The Center for WorkLife Law (2010).

² See Coe, Erin, "As 'Lean In' Claims Arise, Employers Must Watch Their Words," *Employment Law 360*, July 11, 2013.

³ *Phillips v. Martin Marietta Corp.*, 400 U.S. 542, 544 (1971) (Title VII prohibits an employer from hiring men with preschool-age children while refusing to hire women with preschool-age children).

⁴ See, e.g., *Schafer v. Board of Pub. Educ.*, 903 F.2d 243, 247 (3d Cir. 1990) (policy granting leave of absence for a child's birth to female employees but not to male employees may serve as the basis for a Title VII claim).

sion protects employees from discrimination based on their relationship or association with an individual with a disability. Plaintiffs also are relying on a growing number of state and local statutes prohibiting discrimination based on pregnancy and family status or responsibilities.

Plaintiffs are relying on a growing number of state and local statutes prohibiting discrimination based on pregnancy and family status or responsibilities.

Disparate Treatment. A plaintiff proves a disparate treatment violation under these anti-discrimination laws when the individual shows that he or she has been intentionally treated less favorably than others similarly situated on the basis of an impermissible characteristic. A survey of case law demonstrates that employers are more likely to succeed in disparate treatment cases when fulsome employee communication occurs. For example, in *Chadwick v. WellPoint, Inc.*, 561 F.3d 38, 42-48 (1st Cir. 2009), the court of appeals reversed the lower court's entry of summary judgment for the employer on plaintiff's Title VII "sex-plus" discrimination claim where the plaintiff, who was objectively the most qualified for promotion, was informed she had not been selected because, as a mother of four young children, she had "too much on her plate"; the court stated that "an employer is not free to assume that a woman, because she is a woman, will necessarily be a poor worker because of family responsibilities." Likewise, in *Lust v. Sealy, Inc.*, 383 F.3d 580 (7th Cir. 2004), the court upheld a jury's finding that a female sales representative was passed over for promotion in violation of Title VII, where the supervisor admitted he didn't consider recommending her for the position because she had children and he didn't think she would want to relocate her family, even though she had not told him that.⁵ In addition, in *Scheidecker v. Arvig Enterprises, Inc.*, 122 F. Supp. 2d 1031, 1045-46 (D. Minn. 2000), the court denied summary judgment on discrimination claims brought by female employees who were terminated during their pregnancies or while on maternity leave. The court was swayed by evidence that management had not discussed details of the plaintiffs' maternity leaves with them despite their requests. In contrast, in *O'Neill-Marino v. Omni Hotels Management Corp.*, No. 99 Civ. 3793, 2001 WL 210360, at *5 (S.D.N.Y. Mar. 2, 2001), the court granted summary judgment dismissing a former employee's claims that her employer imposed unreasonable work hours to force a resignation because she was a married woman with children. The hotel demonstrated the work hours were a requirement of the employee's position and management communicated with her about attendance, provided advance notice of her schedules and offered an opportunity to take another position in the hotel.⁶

Workplace Policies. Employers also would be well-served to openly communicate with employees about workplace policies in an effort to avoid findings of disparate impact discrimination. Disparate impact may result when rules applied to all employees have an unjustified adverse impact on members of a protected class. For example, in *Lochren v. County of Suffolk*, No. CV 01-3925, 2008 WL 2039458 (E.D.N.Y. May 9, 2008), the plaintiffs prevailed on their disparate impact challenge to the Suffolk County police department's restriction of light duty work to those with on-the-job injuries. The

⁵ See also *Trezza v. The Hartford, Inc.*, No. 98 Civ. 2205, 1998 WL 912101, at *7-8 (S.D.N.Y. Dec. 30, 1998) (denying employer's motion to dismiss discrimination claims where complaint alleged that employer assumed, without discussing, that plaintiff would not be interested in promotion to a managing attorney position because she had a family and the position required travel).

⁶ See also *Spann v. Abraham*, 36 S.W.3d 452 (Tenn. Ct. App. 1999) (no *prima facie* discrimination where, following the employee's absences due to pregnancy, the employer suggested the employee accept a temporary reassignment with no loss of pay and reinstatement to her position after she returned from maternity leave).

plaintiffs showed that prior to the restriction, pregnant women had been more likely to use light duty than other officers, and women had been affected more than men by the restrictions. Employers may not be cognizant that facially neutral policies are having a disparate impact on certain groups unless they encourage employees to come forward and discuss workplace policies and issues affecting them.

A number of employment laws explicitly require employers to engage with employees on family and medical issues.

Interaction Is Required

The flip side of discrimination is active engagement, and a number of employment laws explicitly require employers to engage with employees on family and medical issues. For example, under the federal Family and Medical Leave Act, when an employer acquires knowledge that leave requested by an employee may be for an FMLA purpose, the employer must inform the employee of his or her rights and responsibilities under the FMLA. And the ADA requires employers to initiate an interactive process with an individual with a disability who may be in need of a workplace accommodation.⁷ Thus, in *LaCourt v. Shenanigans Knits, Ltd.*, Index No. 102391/11, 2012 N.Y. Slip Op. 52379(U) (Sup. Ct. New York County Nov. 14, 2012), the court denied summary judgment on the plaintiff's ADA claims where the employer terminated an employee who had been diagnosed with breast cancer, because she planned an absence from work for more than three months following double mastectomy surgery. The court reasoned the employer did not engage in an interactive process and ultimately failed to establish that granting the employee a leave of absence would have resulted in an undue hardship.⁸ Notably, the ADA Amendments Act of 2008 expands the definition of "disability" under the ADA to include temporary impairments.⁹ Therefore, though pregnancy itself is not a disability covered by the ADA, certain impairments resulting from pregnancy, such as hypertension, gestational diabetes, severe nausea and sciatica, are now considered disabilities for which employers must engage in an interactive process and provide reasonable accommodation.

* * *

Engaging with employees on sensitive personal issues is serious business but, if undertaken correctly, can be a win-win for employees and employers. Such engagement requires that male and female employees, with proper training and support, feel comfortable broaching pregnancy, parenting, personal or family medical issues and an employee's related workplace needs. Likewise, supervisors must be trained with respect to preventing discrimination, harassment and retaliation based on gender, pregnancy or caregiving responsibilities, and they must encourage employees to raise these issues. This approach necessitates a focus on when and how to address the particular workplace needs of employees who are pregnant or disabled or who have caregiving responsibilities, whether or not the topic is raised by an employee. Employers who take the time to address these aspects of their employees' lives are more likely to retain the broadest array of a talented workforce.

⁷ 29 C.F.R. § 825.300(b)(1) (FMLA); 29 C.F.R. §1630.2(o)(3) (ADA).

⁸ See also *Erickson v. Board of Governors of State Colleges and Universities for Northeastern Illinois University*, No. 95 C 2541, 1997 WL 548030 (N.D. Ill. Sept. 2, 1997) (summary judgment on the plaintiff's ADA claims denied where the plaintiff underwent infertility treatments causing her emotional distress, and the employer failed to engage in an interactive discussion).

⁹ 29 C.F.R. § 1630.2(j)(1)(ix) ("effects of an impairment lasting or expected to last fewer than six months can be substantially limiting within the meaning of this section").

US Corporate Tax Reform: Stuck in Neutral

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Three significant international tax reform proposals in the United States have been released in the past three years: the International Tax Reform Discussion Draft released by House Ways & Means Committee Chairman Dave Camp (R-Mich.) in October 2011, President Obama's Framework for Business Tax Reform released in February 2012 and the Staff Discussion Draft on International Business Tax Reform released by Sen. Max Baucus (D-Mont.), Chairman of the Senate Finance Committee, on November 19, 2013. Despite these efforts, the United States seems no closer to fundamental corporate tax reform. And although certain structural similarities in the proposals might suggest areas for compromise, gridlock in Washington, the ongoing debate over appropriate corporate taxation levels and expected personnel shifts in Congress, continue to dim the prospects for tax reform.

The Baucus Proposal. The most recent international tax reform proposal — Sen. Baucus' Staff Discussion Draft — may be the most far-reaching. The discussion draft would eliminate the system of worldwide taxation and deferral for foreign subsidiary income, and replace it with a greatly expanded system of current taxation. This would include a limited exemption system for certain specified categories of foreign income, likely in the context of a reduced corporate tax rate (though no such rate reduction appears in the discussion draft itself).

In transitioning into this system, the proposal would impose a 20 percent tax on all accumulated, unrepatriated foreign subsidiary income; those earnings would not be subject to any further U.S. taxation upon repatriation. Given the magnitude of foreign earnings currently held by controlled foreign corporations (CFCs) and the relatively high tax rate imposed by the discussion draft (as compared to the 5.25 percent tax proposed under Chairman Camp's proposal), this tax burden would likely be substantial.

Under the discussion draft, future CFC earnings would be subject to one of two expanded regimes — labeled Options Y and Z — both of which would impose full current U.S. taxation on CFC income from the sale of goods or the provision of services to persons located in the United States. In that sense, both resemble the base erosion Option C from Chairman Camp's discussion draft, which likewise would tax CFC earnings from U.S.-destined sales and services. However, both Options Y and Z differ significantly from Option C in their taxation of CFC income from non-U.S. sales and services, including in the following ways:

- **Option Y** would impose a minimum tax on foreign earnings at a rate equal to 80 percent of the U.S. statutory rate (24 percent, assuming a 30 percent U.S. statutory rate). Items of foreign income subject to a higher local rate of tax would be exempt from U.S. taxation; items of foreign income bearing a lower local tax rate would be subject to a current U.S. residual tax that effectively subjects such income to an overall tax rate equal to 80 percent of the U.S. statutory tax rate, with no further tax upon the repatriation of such earnings.
- **Option Z**, in contrast, would provide a partial exemption for active income derived from non-U.S. markets, subjecting 60 percent of such income to full current U.S. taxation with a credit for any taxes paid on such income, and exempting the remaining 40 percent from U.S. taxation with no credit for the foreign taxes paid on such exempt income. Any income that does not qualify as active foreign market income would be subject to full current U.S. taxation.

The Baucus proposal also contains “anti-base erosion” provisions that would (i) deny an exemption in the United States for any CFC dividends that are treated as deductible payments in the CFC’s home jurisdiction and (ii) deny a deduction in the U.S. for related-party payments that are not subject to tax in the payee’s jurisdiction.

Status of the Camp Proposal. Since the release of Chairman Camp’s discussion draft in October 2011, its proposals have been at the center of the policy debate regarding international tax reform. Further developments on that front had been expected in late 2013, with Chairman Camp suggesting that a legislative mark-up was likely. However, any release of draft legislative language has been delayed, presumably due in part to the challenging policy compromises that such legislation would necessarily involve.

Whenever such legislation is released, it is anticipated that it will include a base erosion provision along the lines of Option C contained in Chairman Camp’s original discussion draft. The provision will include full taxation of profits from intangible property attributable to U.S.-destined sales or services, reduced taxation — likely at a 15 percent rate based on a statutory rate of 25 percent — of all other profit from intangible property, and a similarly reduced rate on intangible profits from exported property.

Common Themes in U.S. Tax Reform Proposals. Despite the substantial differences between the various reform proposals that have been released, some common themes suggest a potential path forward. These include (i) corporate tax rate reduction, (ii) base erosion protections that focus on increased taxation of foreign income earned with respect to the U.S. market and (iii) a narrowing of the U.S. worldwide taxation regime to reduce U.S. taxation on other foreign income and eliminate the disincentive under current law to repatriate foreign earnings.

Of course, substantial disagreements remain within those broad parameters, not the least of which is the political debate over whether any corporate tax reform should be revenue-neutral or revenue-raising over some relevant time horizon. Both the Camp and Baucus proposals claim revenue neutrality, but they adopt very different notions of the concept. While Camp’s proposal claims revenue neutrality over a 10-year horizon, the Baucus proposal claims revenue neutrality in a “steady-state,” excluding most importantly its one-time 20 percent tax on accumulated CFC earnings. Taking into account this one-time tax, the Baucus proposal likely is a substantial revenue raiser, which means substantial additional tax costs for many U.S. multinational corporations. If any progress is to be made on tax reform in the United States, policymakers will need to reach some agreement on the revenue goals of such reform.

Even if the issue of revenue neutrality were resolved in 2014, the prospects for reform have been dimmed by the announcement that Chairman Baucus will be nominated to become ambassador to China. His confirmation is likely to occur in early 2014, resulting in his resignation from the Senate. His successor is expected to be Sen. Ron Wyden (D-Ore.), who has been active on corporate tax reform but has sponsored a proposal that is not easily reconciled with Chairman Camp’s approach.

U.S. Tax Reform and the OECD BEPS Project. Despite the seeming tax reform inertia in the United States, the international community appears to be moving ahead with various of the tax reform items identified in the Organisation for Economic Co-operation

and Development's (OECD) project on base erosion and profit shifting (BEPS) (see "[Base Erosion and Profit Shifting: Key UK Issues](#)").¹ With the BEPS project moving forward and U.S. tax reform stuck in neutral, it becomes increasingly likely that the BEPS project's goals and proposals will find their way into any future U.S. tax reform legislation, with potentially significant consequences for U.S.-based multinational corporations.

Indeed, that trend already is on display in the Baucus discussion draft. As noted above, the Baucus proposal would disallow deductions in the United States with respect to payments made to foreign affiliates in so-called "base erosion arrangements." These arrangements include those involving hybrid instruments, hybrid entities and conduit financing arrangements. Likewise, the Baucus proposal would disallow an exemption in the United States for dividends that give rise to a deduction in the payor's jurisdiction. Sen. Baucus' focus on these types of hybrid arrangements that give rise to so-called double nontaxation is consistent with — and likely informed by — the BEPS project's focus on similar arrangements.

This apparent interplay between U.S. tax reform and the broader BEPS project means that both the content and the timing of U.S. tax reform, as unpredictable and even unlikely as its prospects may be, could have substantial — and potentially adverse — consequences for both U.S. multinationals with non-U.S. operations and non-U.S. multinationals with operations in the United States.

¹ See also "International Taxation – OECD Reboot for the 21st Century," Skadden Client Alert (July 19, 2013), available at <http://www.skadden.com/insights/international-taxation-oecd-reboot-21st-century>.

Recent Developments in Tax Law: Impact on Corporate Tax Strategies in 2014

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Recent changes in IRS private letter ruling policy likely will result in greater taxpayer reliance on tax opinions, which may impact certain corporate strategies in the coming year.

Tax-Free Spin-Offs

During 2013, the IRS announced two significant changes to its policy on issuing private letter rulings on spin-off transactions intended to qualify as tax-free under Section 355 of the Code¹.

Background. In a typical spin-off, a corporation distributes to its shareholders (and possibly its creditors), stock (and possibly certain debt securities) of a controlled subsidiary. To qualify as tax-free under Section 355, a spin-off must satisfy numerous technical requirements. Because a spin-off transaction can potentially result in significant tax liabilities to the parent corporation and its shareholders if the transaction fails to qualify as tax-free, taxpayers historically have sought, and the IRS typically has issued, private letter rulings confirming the tax-free status of a spin-off.²

No Rulings on Specific Spin-Off Issues. In January 2013, in conjunction with issuing its annual list of areas in which it will not issue private letter rulings (the 2013 No Rulings List), the IRS announced that it would no longer issue private letter rulings on three categories of issues that arise frequently in spin-offs: (i) debt-for-debt exchanges involving the parent company issuing debt in anticipation of the spin-off and exchanging it for the subsidiary's securities on a tax-free basis, (ii) recapitalizations into control of the spun-off subsidiary and other issuances of two or more classes of stock having different voting rights in anticipation of a spin-off and (iii) North-South transactions, which frequently involve pretransaction tailoring transfers among the parent company, the spun-off subsidiary and/or related corporations at or around the time of the spin-off.³ These changes represented a departure from IRS ruling guidelines that were carefully developed and applied over the last several years. As a result, this new policy has affected significantly the execution of business-driven spin-offs that involve these issues because such transactions typically require a private letter ruling to address the dearth of judicial or administrative guidance on many of the key tax issues. The IRS has since stated that it is studying these three issues with an intent to issue guidance, but the timeline for definitive guidance remains unclear.

No Rulings on Overall Spin-Off Transactions. In June 2013, the IRS announced a broader change to its private letter ruling policy, stating that it would generally stop

¹All "Section" references are to Sections of the Internal Revenue Code of 1986, as amended (the Code).

²Since 2003, the IRS's spin-off rulings generally have not addressed three of the specific technical requirements under Section 355: the business purpose requirement, the device requirement and the anti-Morris Trust rules under Section 355(e). Accordingly, prior to August 2013, taxpayers that received a favorable private letter ruling from the IRS on a spin-off typically obtained an opinion of counsel on these three technical requirements.

³For a more detailed discussion on these specific spin-off issues, see the Skadden publication "New IRS Policies and the Future of Tax-Free Spin-Off and Split-Off Transactions" (Feb. 13, 2013), available at <http://www.skadden.com/insights/new-section-355-no-rule-policies>.

To qualify as tax-free under Section 355, a spin-off must satisfy numerous technical requirements.

issuing rulings on spin-off transactions, effective August 2013.⁴ Instead, the IRS will issue rulings only on one or more significant issues presented in a transaction — not on the entire transaction. For this purpose, the IRS generally defines a “significant issue” as “an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction.”

Certain Considerations for Future Transactions. IRS officials have stated that these policies are driven in part by resource constraints and may be followed by additional cutbacks in the agency’s private letter ruling policy.⁵ In some respects, these changes may represent judgments regarding the best use of limited budget resources, particularly to the extent that some of the requirements related to spin-offs are more clearly addressed by public guidance. However, it remains to be seen how the IRS will handle significant issues that regularly arise, including those for which there is insufficient guidance for counsel to opine with a high level of comfort, as is often required for public company transactions (public company spin-offs are rarely completed on the basis of an opinion that provides less than a “should” level of comfort). It also is unclear whether transactions implicating the issues in the 2013 No Ruling List will proceed at all, or whether they will proceed only on the basis of structural revisions or lower levels of comfort than historic norms.

No matter how events unfold, these changes will increase the importance of opinions of counsel issued in connection with spin-offs, as compared to the previous era when rulings from the IRS often could resolve most of the issues, even the thorniest ones. Now, in the absence of an IRS ruling on those issues, there will be greater focus on counsels’ opinions, which will include the exhaustive analysis required by Circular 230 and other professional standards. Moreover, as those opinions are sought by the IRS in the context of an audit or litigation, and if the opinions are not otherwise protected by privilege, they may provide roadmaps to the IRS, potentially changing the dynamic of the audit or litigation.

Increased Reliance on Legal Opinions

As opinion practice becomes more central in the spin-off context, the ability to prevent disclosure of the opinion and underlying analysis by claiming privilege, and appreciating the situations that may give rise to a waiver, will become even more important.

Background. Legal opinions generally are protected by the attorney-client privilege, by the tax-practitioner privilege or, if prepared in anticipation of litigation, by the work product doctrine. While the case law addressing the work product doctrine is inconsistent,

⁴The new policy also applies to other many nonrecognition corporate transactions (e.g., tax-free business combination reorganizations under Section 368 and tax-free contributions under Section 351) where rulings could previously be obtained for the entire transaction when the transaction presented a “significant issue.” Because of timing considerations, taxpayers tend to request rulings on these types of transactions less frequently.

⁵Indeed, these policies of not issuing private letter rulings in the spin-off context appear to be part of a far broader trend. For example, in the 2014 version of its “no ruling list,” the IRS announced that it will no longer issue private letter rulings on disaffiliation transactions preceding a subsidiary liquidation (so-called “*Granite Trust*” transactions) and transactions involving subsidiary ownership of parent company stock (so-called “hook stock”). See Revenue Procedure 2014-3, 2014-1 I.R.B. 111 (Jan. 2, 2014). The IRS has also been studying its policies on key technical issues involving REITs and its private letter ruling practice in this area. For a more detailed discussion on this, see the Skadden publication “IRS Completes Review of REIT Ruling Standards and Resumes Issuing Rulings” (Nov. 15, 2013), available at <http://www.skadden.com/insights/irs-completes-review-reit-ruling-standards-and-resumes-issuing-rulings>.

“The case law addressing whether providing a legal opinion to independent auditors waives the work product doctrine has been in flux.”

multiple courts have held that the “in anticipation of litigation” requirement can be met even where a legal analysis is performed prior to the transaction being finalized.⁶ In the context of an audit, a taxpayer may be required to turn over an opinion to the IRS if protection already has been waived, or a taxpayer may decide to produce the opinion to counter a penalty assertion by the IRS.

Privilege Waivers. The question of whether the taxpayer’s provision of an opinion to its financial auditors effects a privilege waiver is an evolving issue both as a matter of administrative practice and in the courts. Historically, the IRS has refrained from asserting that this disclosure waives privilege, but there have been some exceptions to this policy of restraint.⁷ In 2010, the IRS reaffirmed a policy of restraint with Announcement 2010-76, stating that if a document is otherwise protected under the attorney-client, tax-practitioner or work product doctrines, and the document was provided to an independent auditor as part of an audit of the taxpayer’s financial statements, the IRS will continue to not assert during the audit phase that privilege had been waived by such disclosure.⁸ However, Announcement 2010-76 is clear that it relates only to the examination phase, which leaves open IRS Appeals and litigation.⁹ Moreover, despite this expressed policy of restraint, our recent experience shows that the IRS is more frequently asking taxpayers to provide legal opinions through Information Document Requests (IDRs). These IDRs often come early in the audit phase and are sometimes, but not always, linked directly to fact gathering associated with the determination of whether to assert a penalty.

In addition, the case law addressing whether providing a legal opinion to independent auditors waives the work product doctrine has been in flux, with a general trend toward finding no waiver to have occurred. The U.S. Court of Appeals for the D.C. Circuit — the only circuit court that has addressed this issue — has held that analyses prepared by a company’s employees or outside counsel that were provided to independent financial auditors did not waive work product protection.¹⁰

Waivers: Public Company Disclosures. Understanding the limitations of the work product doctrine is particularly important because the attorney-client privilege attaching to tax planning advice may be waived in the context of public company disclosures. The effects can be far-reaching: It generally is recognized that where a party relies on

⁶The U.S. Court of Appeals for the Second Circuit held in *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998), that the work product doctrine applies to protect memoranda evaluating the tax consequences of anticipated litigation with the IRS over a proposed corporate reorganization transaction. Similarly, the U.S. Court of Appeals for the Sixth Circuit in *United States v. Roxworthy*, 457 F.3d 590 (6th Cir. 2006), also found the work product doctrine to protect an analysis of the strengths and weaknesses of the taxpayer’s position prepared after closing of a loss transaction but before the return was filed, stating that “the IRS would appear to obtain an unfair advantage by gaining access” to such an analysis. However, the U.S. Court of Appeals for the First Circuit more recently determined in *United States v. Textron, Inc.*, 577 F.3d 21 (1st Cir. 2009), that the work product doctrine did not extend to tax accrual workpapers which were prepared internally by attorneys and others to support tax reserve entries on its audited financial statements.

⁷ See Announcement 2002-63, 2002-2 C.B. 72 (June 17, 2002).

⁸ See Announcement 2010-76, 2010-41 I.R.B. 432 (Sept. 24, 2010).

⁹ See the Skadden publication “IRS Issue Final Rules on Disclosing Uncertain Tax Positions; Policy Restraint Clarified” (Sept. 24, 2010), available at <http://www.skadden.com/insights/irs-issues-final-rules-disclosing-uncertain-tax-positions-policy-restraint-clarified>.

¹⁰ See *United States v. Deloitte, LLP*, 610 F.3d 129 (D.C. Cir. 2010); see also *Wells Fargo & Co. v. United States*, 2013 WL 2444639 (D. Minn. June 4, 2013); *SEC v. Roberts*, 254 F.R.D. 371 (N.D. Cal. 2008) (finding no waiver of work product protection based on disclosures to independent auditors).

or discloses the advice of counsel concerning the tax consequences of a transaction, it waives the attorney-client privilege not only as to the disclosed information but also as to the details underlying that information. For example, in *In re Pioneer Hi-Bred Int'l*, the U.S. Court of Appeals for the Federal Circuit, applying Eighth Circuit law, held that a company's disclosure to the SEC of the advice of counsel concerning the tax consequences of a merger waived the company's privilege with respect to the documents forming the basis for the advice.¹¹ Furthermore, in some recent cases, courts have questioned whether tax planning is subject to the attorney-client privilege at all.¹²

Even though the rationale behind these holdings and arguments should not withstand systemic appellate review, they do illustrate the risks taxpayers face in asserting the attorney-client privilege. Consequently, it is critical to understand the vulnerabilities to claiming privilege at any stage of a transaction, from the planning stage through IRS audit scrutiny. As such, it can be extremely valuable to consult with tax counsel who understand the sensitivities involved with respect to privilege issues as applied to legal opinions and who have the experience to navigate the audit process.

¹¹ See *In re Pioneer Hi-Bred Int'l*, 238 F.3d 1370 (Fed. Cir. 2001).

¹² See, e.g., *Schlicksup v. Caterpillar, Inc.*, No. 09-CV-1208, 2011 WL 4007670, at *7 (C.D. Ill. Sept. 9, 2011) (finding documents imparting tax analysis and tax-saving proposals by a tax practitioner to the company did not constitute legal advice from an attorney, and therefore was not protected by the attorney-client privilege).

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Base Erosion and Profit Shifting: Key UK Issues

Six months have elapsed since the Organisation for Economic Co-operation and Development (OECD) released its 15-point action plan to address Base Erosion and Profit Shifting (BEPS). During this time, OECD has been working toward achieving the goal of the action plan by coordinating with G20 governments, including the United Kingdom.

At its heart, the action plan seeks to eliminate double nontaxation of corporate income and curtail tax minimization strategies that involve the segregation of taxable income from the business activities that generate that income. The action plan also seeks to introduce dramatically increased transparency and information sharing between multinational entities and taxing authorities. It ultimately will affect many multinational tax and business structures, including those not viewed as involving aggressive or abusive planning.¹

The BEPS Action Plan: UK Implementation

The U.K. government officially supports the development of rules to implement the 15 points addressed by the action plan. From the U.K. government's perspective, the most important of these points are:

- preventing erosion through hybrid entities, such as partnerships and Delaware LLCs;
- preventing treaty abuse; and
- updating and strengthening transfer pricing rules (particularly in relation to intangibles).

The U.K. government also continues to work closely with the OECD and the EU in relation to reviews of the taxation of the digital economy, which is recognized as an issue to be addressed in parallel to BEPS.² Other BEPS action points, such as strengthening controlled foreign company (CFC) rules and reporting tax avoidance schemes, are not seen as areas of legislation that still need large amounts of work in the U.K. because the government views its existing rules as already fulfilling some of the action points, though there is an effort to refine the rules.³

The U.K. government also is on record as viewing transfer pricing as a key mechanism to combat BEPS. This is in contrast to the U.S. government, which may be favoring an expansion of CFC rules as a mechanism to deal with BEPS on a residence basis (see "US Corporate Tax Reform: Stuck in Neutral"). In fact, the U.K. government has narrowed the scope of the U.K.'s CFC regime — partly in an effort to make the U.K. a more attractive jurisdiction in which to locate business — and so it is unlikely that the U.K.'s CFC regime will be expanded. These different starting points for the collaborating jurisdictions highlight some of the headwinds the BEPS project may experience.

¹ For a more detailed discussion of the BEPS action plan and its 15 points, see the Skadden alert "International Taxation – OECD Reboot for the 21st Century" (July 19, 2013), available at <http://www.skadden.com/insights/international-taxation-oecd-reboot-21st-century>.

² A report by the EU Commission's High Level Expert Group on Digital Taxation is expected to be delivered in the first half of 2014.

³ *E.g.*, the U.K. government has proposed changes to the CFC rules to prevent their abuse by addressing U.K. base erosion through the transfer of profits from intra group lending offshore, as well as a new information disclosure and penalty regime for high-risk promoters of avoidance schemes.

The U.K. government (and other EU jurisdictions within the OECD) also must consider EU law, which implements the fundamental “freedoms,” such as the freedom of establishment and the free movement of capital. The Court of Justice of the European Union previously has found a prior iteration of the U.K.’s CFC regime to breach the freedom of establishment because, in certain instances, it applied to genuine commercial arrangements (*e.g.*, where a subsidiary company of substance resident in a low-tax EU member state was carrying on genuine economic activities).

Because, under EU law, CFC rules generally should apply only to wholly artificial arrangements, such governments are unlikely to expand or introduce CFC rules that could tax profits of companies carrying on genuine commercial activities in other EU member states. This is another example of possible disagreement between the U.S. and EU member states as to the direction that some of the BEPS action points should take. The action plan’s two-year timeframe looks challenging.

Pending that implementation of anti-BEPS rules, these issues will have to be addressed using local anti-avoidance provisions, and it is likely that we will see increasing instances of cross-border situations where unilateral actions by tax authorities will lead to double taxation. Taxpayers will need to pressure the U.K. government and other jurisdictions to improve (*i.e.*, cheapen and streamline) mutual assistance procedures whereby the competent authorities seek to agree which jurisdiction has taxing rights in certain circumstances falling within an applicable double-tax treaty. In this regard, we would welcome the implementation of another BEPS proposal: compulsory arbitration between countries in cases where the respective tax treaty demonstrably does not solve double taxation.

The U.K. government also continues to work closely with the OECD and the EU in relation to reviews of the taxation of the digital economy.

VAT Guidelines

Much focus in the past year has been on BEPS, which only deals with direct taxation. Separate from the BEPS action plan, the OECD also is reviewing VAT rules and producing guidelines for cross-border supplies of services and intangibles.⁴ While these guidelines do not focus on intra-group supplies or those between connected persons, they are helpful in showing the direction that the OECD may take on this issue.

Destination Principle

For VAT, the OECD favors the “destination principle” of taxation, whereby the tax charge arises in the jurisdiction in which the service/intangible is consumed. This makes sense for VAT because it is a consumption tax, and EU member states generally apply the destination principle for VAT on business-to-business supplies. Starting January 1, 2015, the destination principle also will apply to business-to-consumer supplies of telecommunications, broadcasting and electronic services.

Interestingly, the destination principle is one of a number of possible methods of corporate and income taxation that could be adopted to deal with BEPS. While adopting the destination principle for direct taxation may be attractive to countries with consumer economies, such as the U.S., it is unlikely to appeal to countries with manufacturing economies, such as China, or to countries that already have consumption taxes, such as the U.K.

⁴These guidelines also will apply to goods and services tax, which is a tax similar to VAT that has been adopted by various jurisdictions outside the EU.

Apportionment

The draft guidelines also consider the apportionment of a supply for VAT purposes where a business receives services that are used in different branches in different jurisdictions. Two methods are being proposed:

- The “recharge method” whereby VAT on the supply is levied in the jurisdiction of the contractual recipient. Then any internal recharges of the cost of the supply to different branches are treated as payments for separate supplies, which are then taxed. (In general, this currently happens where recharges are between two different entities but not where between different branches of same entity.) This is the preferred method, as it would track recharges that most businesses are expected to make in any event for nontax purposes; and
- The “direct-use method” whereby the business analyzes which establishment uses what portion of the supply, and VAT is levied in the different jurisdictions accordingly. This is not the preferred method, as it is expected to be administratively burdensome and costly for businesses.

There is therefore some similarity of approach between the VAT guidelines and what is being discussed to deal with BEPS, including the direct-use method as a possibility for transfer pricing. It will be interesting to see how the VAT guidelines develop alongside the proposals that are produced under the action plan, especially because the destination principle of taxation is one of a number of possible methodologies that could be adopted to deal with BEPS.

* * *

The BEPS action plan remains ambitious in its timeframe, with the potential to dramatically change international taxation. The VAT guidelines also could add an extra layer of complexity to the proposals that come out of the action plan. However, it remains to be seen whether the OECD can meet the ambitious deadlines set out in the action plan. There is likely to be some disagreement between governments on various points, and the political will that has driven the BEPS project to date may wane if countries’ economies continue to recover in 2014 and 2015.

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