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

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Dear Clients and Friends:

We are pleased to provide a collection of commentaries on the critical legal issues facing our clients in 2013.

There is hope that global economic and market conditions will continue to improve despite ongoing challenges. Lingering discord in the wake of the U.S. fiscal cliff negotiations, the mire of Europe's debt crisis and concern over the pace of recovery in Asia all have contributed significantly to the uncertainty felt by businesses globally. Regardless of how these issues are resolved, it has become clear that regulation will remain a major factor in how global business is conducted.

Our commentaries are arranged in seven broad sections that cover the areas in which our clients may find both the greatest challenges and the greatest opportunities:

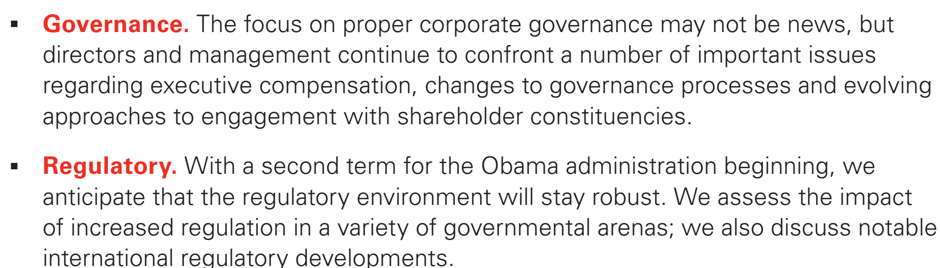
- **Capital Markets.** We examine trends and opportunities in various sectors of the financial markets and also discuss certain industry-specific and geographic developments.

- **Corporate Restructuring.** With an increased focus on global issues, we discuss current developments impacting creditors' rights, including the greater interplay between U.S. and international restructuring regimes.

- **Financial Regulation.** The new global regulatory environment continues to evolve, driven by the Dodd-Frank Act and other legislation in the U.S. and various developments in Europe. We highlight selected topics that reflect the increasingly interconnected nature of our global financial system.

- **Global Litigation.** Dispute resolution continues to globalize and become more complex, particularly in areas such as securities and other types of class actions, antitrust and white collar/government investigations. We discuss recent developments and anticipated decisions in the U.S. Supreme Court and elsewhere — as well as international litigation and arbitration trends — that likely will impact how corporations do business and manage disputes in 2013.

- **Global M&A.** In 2012, global M&A and other transactional activity continued to be constrained by the financial and economic environments, particularly the European stagnation and Asian slowdowns. Although our outlook for 2013 is cautiously optimistic, a meaningful increase in activity appears to hinge on the continued stabilization of global markets and economic conditions, aided by increased tax and fiscal clarity in the United States.



- **Governance.** The focus on proper corporate governance may not be news, but directors and management continue to confront a number of important issues regarding executive compensation, changes to governance processes and evolving approaches to engagement with shareholder constituencies.
- **Regulatory.** With a second term for the Obama administration beginning, we anticipate that the regulatory environment will stay robust. We assess the impact of increased regulation in a variety of governmental arenas; we also discuss notable international regulatory developments.

Whatever happens in 2013, we would like our clients to be well-positioned to anticipate and properly navigate the shifting environment. We will be in touch regarding upcoming Skadden seminars and webinars on these issues. In the meantime, if you have a particular interest in any of these topics, please call your usual Skadden contact.

With best wishes for the coming year,

Eric J. Friedman
Executive Partner

Table of Contents (Click on a title below to read the article.)

Capital Markets / page 1

Happy New Year: Encouraging Signs for Leveraged Loans 3

The US High-Yield Market: A Record-Breaking 2012 and What to Expect in 2013 7

The JOBS Act: What We Learned in the First Nine Months 10

Jumping the Gun: Social Media and IPO Communications Issues 18

A REIT Evolution: Renewable Energy and Excess Mortgage Servicing Rights 22

What the New German Prospectus Liability Regime for Selling Shareholders Means for Private Equity Exits 25

Hong Kong Equities Look for Brighter 2013 29

Corporate Restructuring / page 33

Expanding Use of Chapter 15 Tests Its Protections and Limits 35

US Recognition of Non-US Regulatory 'Bail-In' Powers 37

Circuit Splits Emerge Regarding Trademark Licensees' Bankruptcy Rights 40

Ninth Circuit Restricts Bankruptcy Courts' Ability to Adjudicate Fraudulent Transfer Actions 42

Forewarned Is Forearmed: Adapting for Business in a Eurozone Crisis 44

Negative Outlook for Exit Consents Under English Law 46

Financial Regulation / page 49

Swap Regulation: The CFTC and SEC Chart the Road Ahead 51

The JOBS Act: Important Questions for Private Funds 53

What Lies Ahead for US Economic Sanctions Against Iran 55

Year One at the Consumer Financial Protection Bureau 57

The EU's Short-Selling Regulation: Notable Requirements and Restrictions 58

Restructuring the UK Regulatory Framework: What the Financial Services Industry Can Expect 60

English Limited Partnerships: Liability Definition Remains Elusive 62

Global Litigation / page 65

The US Supreme Court Term: Business Cases to Watch 67

Antitrust and Competition: Antitrust Enforcement
on Both Sides of the Atlantic 70

Class Action Outlook: A Busy Year Ahead 74

Product Liability Issues to Watch in 2013 77

Government Enforcement: A Continued Push to Prosecute in the US,
the UK and China 79

International Litigation and Arbitration: Jurisdictional Challenges,
Cross-Border Enforcement Developments and Sovereign Debt Disputes 85

Intellectual Property and Technology: Patent and E-Commerce Issues
to Watch in 2013 91

Securities Litigation: Recent and Upcoming Supreme Court,
Appellate and District Court Developments 94

Global M&A / page 103

US M&A: Overcoming ‘Confidence Crisis’ Remains Key to a Healthy Market 105

Europe M&A: The Evolving Takeover Landscape 108

China M&A: Looking Ahead to 2013 113

High-Growth Markets: Despite Economic Uncertainty,
Dealmaking Opportunities Continue 118

Private Equity: Positive Signs for 2013 120

National Security Reviews of Foreign Investments in US Businesses:
An Enduring Trend? 122

The Continuing Impact of Delaware Courts on US M&A 124

Antitrust and Competition: Surveying Global M&A Enforcement Trends 126

Governance / page 131

US Corporate Governance: Sense of Déjà Vu Masks New Emphasis on Shareholder Engagement 133

Say-on-Pay: Keys to a Successful 2013 Proxy Season 138

Regulatory / page 142

Communications Law: The Relentless Pursuit of Broadband Competition 143

Network Security Threats and Cybersecurity Legislation and Regulation 145

Electric Power Generation: EPA Regulatory Developments 148

Oil and Natural Gas Exploration and Hydraulic Fracturing: Federal Regulatory Trends for 2013 152

Government Affairs and Government Procurement Compliance 155

Health Care and Life Sciences: Affordable Care Act Upheld, but M&A and Enforcement Trends Reflect Uncertainty 157

Affirmative Action in Employment 160

Recent Developments in Tax Law: Impact on Corporate Tax Strategies in 2013 165

Corporate Tax Reform: Prospects for Fundamental Change 169

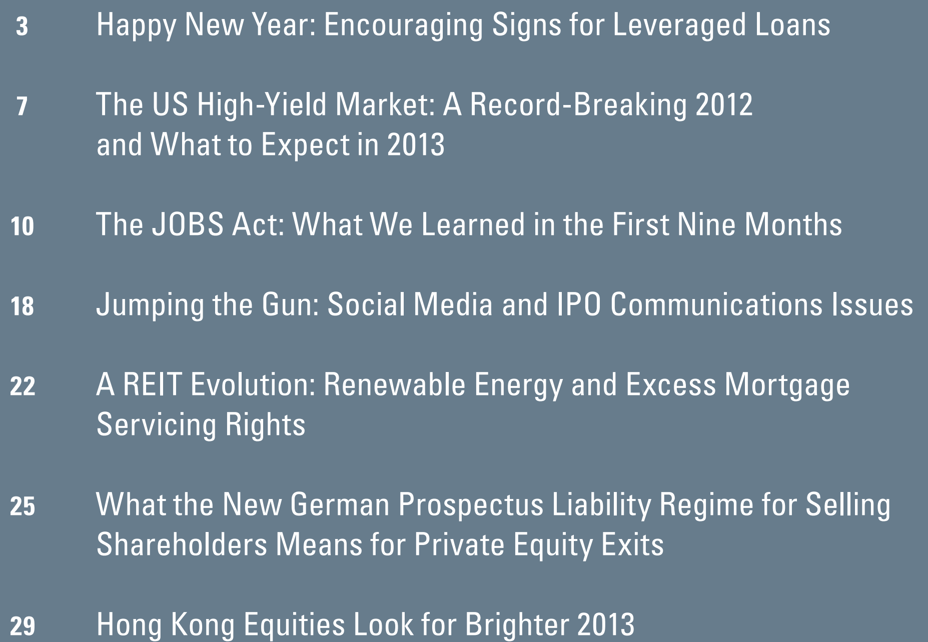
Capital Markets

In this section, we examine trends and opportunities in various sectors of the financial markets.

2012 was a robust year for both the U.S. leveraged loan and high-yield markets, including record-breaking deal volume for the latter. These conditions provided fertile ground for borrowers and issuers in U.S. markets to fund significant numbers of dividend recaps and achieve structures and terms that afford them more flexibility within their debt instruments. In contrast, the past year was a disappointing one for Hong Kong's equity and Europe's lending markets due in part to concerns about potential changes in tax treatments, new legislation and other regulatory developments.

Issuers also are considering what could be viewed as encouraging changes in the U.S. regulatory landscape in connection with their finance activity. Nine months have passed since the JOBS Act was signed into law, and the legislation's IPO-related provisions have yielded interesting results related to the market practices for emerging growth companies seeking to go public. And with the proliferation of corporate social media, companies of all sizes planning an IPO are becoming increasingly mindful of the role of web-based communication in publicizing their businesses.

We also discuss certain industry-specific and geographic developments. The steady evolution of real estate investment trusts continues to appeal to investors: We look at two emerging areas driving this growth — renewable energy assets and excess mortgage servicing rights. In Germany, the equity markets are showing signs of increased activity, but uncertainty continues for those engaged in secondary share placements. And in Asia, the last year marked a sharp retreat for Hong Kong's equity markets. However, there are indications that market sentiment and prospects are improving, and we examine some of the notable factors that suggest a better outlook in 2013.



3 Happy New Year: Encouraging Signs for Leveraged Loans

7 The US High-Yield Market: A Record-Breaking 2012 and What to Expect in 2013

10 The JOBS Act: What We Learned in the First Nine Months

18 Jumping the Gun: Social Media and IPO Communications Issues

22 A REIT Evolution: Renewable Energy and Excess Mortgage Servicing Rights

25 What the New German Prospectus Liability Regime for Selling Shareholders Means for Private Equity Exits

29 Hong Kong Equities Look for Brighter 2013

Happy New Year: Encouraging Signs for Leveraged Loans

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The U.S. leveraged loan market flourished in 2012, as borrowers took advantage of favorable pricing and terms amid strong investor demand. S&P Capital IQ Leveraged Commentary and Data (LCD) tracked $465 billion of leveraged loan issuance (up 24 percent from 2011), while Thomson Reuters LPC calculated $664 billion (up 17 percent from 2011).[1] This makes 2012 the third-highest year in volume of primary leveraged loan issuance, behind only 2006 and 2007.[2] The fourth quarter of 2012 was especially robust with $136 billion of loan issuance, the most since the post-credit crunch high of $141 billion in the first quarter of 2011.[3] Unlike 2006 and 2007, when mega-LBO deals drove the market, the 2012 market was driven primarily by opportunistic financings such as repricings, refinancings and dividend recaps. In fact, refinancings and repricings accounted for more than 50 percent of large syndicated institutional deal volume,[4] as borrowers took advantage of favorable market conditions throughout the year to loosen covenants, reduce interest rate margins, add new tranches of loans and extend maturity dates. LBO volume was moderate and weighted toward smaller deals than those that were prevalent during the height of the market in 2006 and 2007.

Dividend-related loan volume reached a record high of $56.4 billion for the year,[5] as private equity sponsors took advantage of issuer-friendly terms and strong EBITDA growth. Potential changes in dividend tax treatment added urgency to completing dividend recaps by year-end. Second-lien loan issuance also was strong: 2012 second-lien volume more than doubled to $17.1 billion, from $6.8 billion in 2011.[6]

One of the main factors contributing to positive market conditions in 2012 was the increased number of investors in both the primary and secondary loan markets. With an unexpectedly strong collateralized loan obligation (CLO) issuance in 2012 — topping the combined total of the past four years — structured finance vehicles rapidly increased their share of the primary institutional term loan market. According to Fitch Ratings, CLOs represent approximately 45 percent of the current leveraged loan buyer base through primary loan issuance and refinancings.[7] With more cash to put to work, and with secondary prices rallying and margins narrowing, CLOs pursued riskier wider-margin opportunities and thus participated more aggressively in lower-quality deals. Coupled with steady demand from banks and with loan mutual funds, pension funds and other institutional accounts enlarging their participations, borrowers took advantage of strong liquidity to push for more generous structure and terms. Given the unwavering investor demand for loans in late 2012, we expect borrower-favorable trends to continue in 2013.

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[1] Source: *S&P/Capital IQ/LCD*, Thomson Reuters LPC.

[2] *LCD*, Dec. 21, 2012.

[3] *Id.*

[4] Debtwire Analytics, 2Q12 Review.

[5] *LCD*, Dec. 21, 2012.

[6] *Id.*

[7] *Fitch Ratings*, Nov. 26, 2012.

Return to the Table of Contents

Covenant-Lite Loans

Covenant-lite loans were increasingly available to borrowers in 2012, in particular those backed by private equity sponsors. Covenant-lite loans do not contain financial maintenance covenants that are tested regularly, although a financial maintenance covenant that "springs" into effect under certain conditions often is included solely for the benefit of the revolving lenders when applicable. A springing financial maintenance covenant generally is tested on a quarterly basis as well as when revolving loans are drawn, but only when the aggregate outstanding amount of revolving loans exceeds a negotiated threshold. Waivers of and amendments to springing financial maintenance covenants generally can be accomplished solely with the consent of a majority of the revolving lenders.

"While covenant-lite loans almost disappeared from the market during the credit crisis, they have made a dramatic comeback over the last two years."

While covenant-lite loans almost disappeared from the market during the credit crisis, they have made a dramatic comeback over the last two years. In fact, covenant-lite deals comprised 29 percent of overall institutional loan volume in 2012, exceeding 2007's prior record of 25 percent.[8] The current popularity of covenant-lite loans can be attributed in large part to the predominance of CLOs, as well as the increasing influence of hedge funds, high-yield investors and other relative value investors who are familiar with the incurrence-test-only world of bonds.

First-Out Revolvers

First-out revolving credit facilities provide revolving lenders with structural priority over term lenders that share a lien on common collateral. These facilities have developed and are becoming more prevalent in response to the limited number of lenders willing to provide revolving credit facilities due to their lower economic returns (as they are drawn for shorter periods of time than term loans and often not to their full commitment).

The scope of "first-out" rights afforded to revolving lenders is not standard and continues to evolve in the market. While some deals simply provide that revolving lenders are paid first with the proceeds of collateral, others provide revolving lenders with payment priority with respect to proceeds of asset sales and other mandatory prepayments and even upon the occurrence of certain events of default. Revolving lenders' ability to control enforcement remedies as well as their rights in a bankruptcy often are highly negotiated and frequently depend on their leverage in any particular deal.

Amend-and-Extend Provisions

Amend-and-extend provisions allow borrowers to request that individual lenders extend the maturity date of their loans, generally in exchange for higher margins and other attractive terms that are applicable solely to the extended loans. Initially developed as a solution to address the limited ability of borrowers to refinance maturing debt during the credit crisis, amend-and-extend provisions have become a common feature of leveraged loans.

Borrowers may implement amend-and-extend provisions by making an extension offer to all lenders of a particular tranche of loans. Lenders are not obligated to extend the maturity of their loans and may choose to accept or reject any such offer. If an extension offer is accepted, the maturity of the loans of the accepting lender is extended and

[8] *LCD*, Dec. 21, 2012.

the terms of such loans are modified in accordance with the extension offer, without the need for the consent of other lenders.

Uncapped Incremental Facilities

Incremental facilities (sometimes called "accordion" facilities) have been a common feature of leveraged loans for many years. They provide borrowers with the ability to upsize their credit facilities without the need for lender consent. Traditionally, the size of these facilities was capped at a fixed amount. While many leveraged loans continue to include a fixed cap, a large number of deals in 2012 included an incurrence-based test that permits an unlimited amount of new incremental loans subject only to *pro forma* compliance with a specified leverage ratio. It will be interesting to see if these incurrence-based incremental facilities continue to gain traction in 2013.

Loan Buyback Provisions

Prior to the financial crisis, leveraged loans generally restricted the ability of borrowers and their affiliates to purchase outstanding loans made to such borrowers. These restrictions, however, began to be lifted during the financial crisis when practically all leveraged loans were trading at a substantial discount to par in the secondary market. Many credit agreements now permit borrowers, their sponsors and other affiliates to buy loans from some or all lenders, subject to certain common limitations.

> "A number of deals in 2012 permitted borrowers to make individual open-market loan purchases from lenders and this trend may continue to grow in 2013."

For example, in most cases, loans purchased by borrowers automatically are deemed to be repaid and canceled. In addition, borrowers generally have been required to conduct loan purchases through reverse Dutch auctions in order to provide all lenders with an equal opportunity to participate in such purchases. However, a number of deals in 2012 permitted borrowers to make individual open-market loan purchases from lenders and this trend may continue to grow in 2013.

Sponsors and other affiliates typically are permitted to conduct loan buybacks through open-market purchases with individual lenders. However, after they purchase loans and become lenders, they are not afforded the same treatment as other lenders. For example, the voting rights of most affiliate lenders generally are quite limited, as is their ability to receive lender-only information and attend meetings of lenders. Ownership by sponsors and other affiliates usually is limited to no greater than 25 percent of outstanding loans, although such limitation often does not apply to affiliates that are bona fide debt funds investing in loans and other long-term debt in the ordinary course of business. Often, these debt funds are subject to less stringent voting and information restrictions.

Call Protection

As interest rates have fallen and lenders attempt to preserve a portion of their anticipated rate of return, call protection has become a common feature of leveraged loans. Many new first-lien leveraged loans now include a "soft call" — a common term for a premium that is payable when a borrower refinances or amends a loan for the purpose of lowering interest rates. A soft call premium of 1 percent on the amounts refinanced or amended during the first year of a loan is most common. More onerous prepayment premiums continue to be included in most second-lien loans, where multiyear call premiums typically apply to most loan prepayments.

Precap Provisions

"Precapitalized" or "precap" provisions permit the sale of a borrower to a qualified purchaser without triggering a change-of-control defaulting event. These provisions were included in a handful of deals in 2012 and may become more common in 2013, as borrowers of syndicated loans continue to enjoy more flexibility in altering their capital structure without the need to refinance. Qualified purchasers generally are limited to sophisticated private equity purchasers that invest a minimum amount of equity in connection with the acquisition. Other requirements include minimum credit metrics with respect to the health and/or credit ratings of the loan parties following the transaction, and *pro forma* compliance with leverage ratio covenants. An increase in interest rate margins or payment of fees also may be required in connection with the change of control.

The inclusion of precap provisions may be the next step in the evolution of documentation flexibility in leveraged loans. Time will tell if precap provisions will join amend-and-extend provisions, loan buybacks and increased refinancing flexibility as common features of leveraged loans.

European Borrowers

One of the key themes of 2012 was the influx of European borrowers into the U.S. loan markets due to the weakness in the European lending market. In 2012, European borrowers issued $28.4 billion in leveraged loans in the U.S., a significant increase from $8.8 billion issued in 2011.[9] This includes the October refinancing for Fresenius Medical Care in the amount of $3.2 billion (€2.5 billion), the largest U.S. loan for a European borrower since the 2009 debtor-in-possession (DIP) facilities for LyondellBasell. U.S. loan transactions with European borrowers may raise various structural and documentation issues due to distinctions between the European and U.S. markets. For example, to increase deal certainty many European deals employ the concept of "certain funds" in acquisition financings requiring diligence to be completed and most loan documentation to be agreed upon before the acquisition agreement is signed. In addition, U.S. and European guaranty and collateral packages differ, and local laws governing secured transactions in European jurisdictions may present guaranty or collateral limitations not present in the U.S.

Regulatory Considerations

The flood of new regulations applicable to banks and the lending market — Basel III, the Foreign Account Tax Compliance Act (FATCA), risk retention, leveraged lending guidance, the Volcker Rule and Federal Deposit Insurance Corporation (FDIC) assessment rules — already has affected and likely will continue to affect the loan market for years to come.

Upon implementation, certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and Basel III will compel banks and certain other financial institutions to raise and maintain additional capital to satisfy stricter capital requirements, which may increase a lender's cost of funding or reduce its rate of return. Loan agreements traditionally have enabled lenders to pass on to the borrower increased costs resulting from changes in law implemented after the closing of the facility. Such provisions may cover the future implementation of the Dodd-Frank Act

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[9] *LCD*, Dec. 21, 2012.

Return to the Table of Contents

and Basel III. Given that Dodd-Frank already has been enacted and Basel III has been adopted (although the implementations of rules still are pending in the United States), it has become common for yield protection provisions to expressly allocate to the borrower the risk of any increased costs arising from enactment of Dodd-Frank and Basel III. As Dodd-Frank and Basel III continue to be implemented, loan agreements likely will continue to evolve.

In light of the London Interbank Offered Rate (LIBOR) manipulation scandal last summer, the Wheatley Review, released in September by Her Majesty's Treasury, recommended a 10-point plan for the comprehensive reform of LIBOR, but did not propose abandoning it altogether. Although the Wheatley Review questioned the use of LIBOR for products such as variable-rate mortgages, it seemed to accept its usage in the syndicated loan market. As a result of the proposed reforms, the British Bankers Association (BBA) no longer would have a role in setting LIBOR. Even though the scandal may have dealt a critical blow to LIBOR's credibility, it does not appear to have diminished the usage of LIBOR in the loan market. Whether regulatory reforms impact the usage or calculation of LIBOR remains to be seen.

The US High-Yield Market: A Record-Breaking 2012 and What to Expect in 2013

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With primary issuances totaling more than $340 billion, the U.S. high-yield market experienced record deal volume in 2012, exceeding the prior record of $287 billion in 2010 and representing an increase of more than 50 percent from 2011. Lower returns on other investments led to increased demand for high-yield paper in 2012, ultimately resulting in record-low yields.[10]

Under these issuer-favorable conditions, companies were able to negotiate more aggressive covenant packages and raise funds for more opportunistic purposes, including leveraged buyouts (LBOs) and dividend payments, in addition to taking advantage of lower rates to reduce interest expense and extend maturities through refinancings. Many issuers also came to market with structures generally considered riskier from an investor perspective, including "high-yield lite" bonds, which lack either or both a debt incurrence covenant and/or a restricted payments covenant, and "payment-in-kind" (PIK) notes, which allow the issuer to pay interest with additional notes.

So where will 2013 take the U.S. high-yield market? Many of the key drivers of the record volume in 2012 remain in place, but other macroeconomic and market-specific factors may temper expectations.

Key Trends of 2012

Use of Proceeds: Dividend Deals and Acquisitions/LBOs

The issuer-favorable climate in 2012, particularly in the fourth quarter, led to more speculative uses of proceeds, including for LBOs and dividend payments. For 2012, 61 percent of total deal volume was used for refinancings, 23 percent to fund

[10] HighYieldBond.com; Debtwire High Yield Database.

acquisitions (including LBOs) and 6 percent to fund dividends. However, in the fourth quarter, this mix shifted: Only 48 percent of total deal volume was used for refinancings, 28 percent to fund acquisitions (including LBOs) and 13 percent to fund dividends. For the month of October alone, almost 20 percent of deal volume was to fund dividends (the highest level since April 2011) and 33 percent was to fund acquisitions (including LBOs).[11]

Covenant Trends and Quality

The issuer-favorable climate in 2012 also led to more aggressive covenant packages and riskier structures from an investor perspective. Credit quality deteriorated to near-record levels in the September to November period, according to Moody's. The reduction in credit quality was a result of lower-rated credits going to market with more aggressive structures, including PIK notes, and more flexible covenant packages, including "high-yield lite" notes.[12]

PIK Notes. PIK notes allow the issuer to skip cash interest payments by paying interest in additional bonds, thereby removing the guaranteed fixed income offered by cash-pay bonds. Companies typically issue PIK notes at a holding company level, with proceeds frequently used for dividends to shareholders, including private equity sponsors.

More than 15 PIK issuances, totaling almost $6 billion, were completed in 2012. This volume represents an 83 percent increase over the previous three years combined, although still far below the 2007 level of $15.6 billion.[13] Of these issuances, $4.5 billion, or approximately 78 percent, were to fund dividend payments to shareholders, primarily private equity sponsors. The total number of PIK issuances in October and December 2012 exceeded the total of all PIK issuances between January 2011 and September 2012.[14]

Further illustrating the issuer-favorable state of the market in 2012, both Taminco's and Interactive Data's holding company PIK dividend deals priced lower than their previously issued LBO notes, even though the LBO notes are structurally senior. Taminco's $250 million 9.125 percent (cash) / 9.875 percent (PIK) five-year senior unsecured notes (which priced at 99 percent, for a cash yield of 9.38 percent) bear a cash coupon rate lower than its $400 million 9.75 percent eight-year second-lien notes issued at par in early 2012 to finance its LBO. Similarly, Interactive Data's $350 million 8.25 percent (cash) / 9 percent (PIK) five-year senior unsecured notes (which priced at 99 percent, for a cash yield of 8.50 percent) bear a coupon rate lower than its $700 million 10.25 percent eight-year senior unsecured notes issued at par in 2010 to finance its LBO.

Covenant Trends. During 2012, and in particular by October, issuers were enjoying the best of both worlds — more flexible covenant packages and historically low yields.

High-yield bonds issued by sponsor-owned issuers, which typically have looser covenants than those bonds issued by nonsponsor issuers, continued to have covenant packages that provided the issuers with greater operating flexibility — particularly in

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[11] Debtwire High Yield Database.

[12] Credit Outlook, Moody's Investors Service, Nov. 15, 2012.

[13] HighYieldBond.com.

[14] Debtwire High Yield Database.

optional redemptions and add-backs of restructuring charges and *pro forma* cost savings to EBITDA (a feature cited by Moody's in November 2012 as increasing a company's financial flexibility and weakening investor protections).

More generally, high-yield bonds in 2012 continued to see the loosening of certain covenants, including restricted payments, affiliate transaction and asset sale covenants. In addition, certain provisions that have appeared intermittently over the years gained traction in 2012, including a double-trigger change of control (which also requires a ratings decline and historically was only included in investment-grade issuances), change-of-control drag-along rights and covenant termination (instead of just covenant suspension) if the notes have an investment-grade rating. Additionally, 2012 saw the further utilization of "first-and-a-half lien notes," which fall between first- and second-lien notes, a relatively recent and novel structure that issuers have used to address secured leverage and lien covenant concerns.

High-Yield Lite Issuances. Some companies also were able to take advantage of the issuer-favorable atmosphere in the market to issue high-yield lite bonds, which, in the parlance of Moody's, are high-yield bonds lacking either or both a restricted payments covenant and/or a debt incurrence covenant. According to Moody's, 30 percent of November issuances had high-yield lite covenant packages, compared with approximately 17 percent historically. Typically, high-yield lite issuances are by more highly rated speculative credits, just below investment grade. However, in 2012, several lower-rated issuers also were able to access the market with high-yield lite bonds.

Potential Market Moderation and Managing Expectations

While 2013 could be another positive year for the high-yield market, there are factors that may moderate results compared to 2012.

Many key drivers of the 2012 record volume are continuing into 2013. In particular, the Federal Reserve policy anchoring interest rates remains in effect, and yields of other investments remain low. Corporate default rates also remain at low levels. In addition, the U.S. has dodged the worst of the automatic tax increases with the partial resolution of the fiscal cliff.

> "While 2013 could be another positive year for the high-yield market, there are factors that may moderate results compared to 2012."

However, market-specific and macroeconomic factors may temper results. A large number of high-quality issuers with debt maturities in 2013 and 2014 already have refinanced over the past two years, leading some to believe that the market will be left with lower-quality issues combined with low yield and little value for investors. Further, many private equity-owed issuers already took advantage of the 2012 market to fund dividends in anticipation of facing potential tax increases in 2013. In addition, the difference in yields between leveraged loans and high-yield bonds narrowed at the end of 2012, making loans more attractive, particularly if they have a senior position in the capital structure. Further, macroeconomic concerns persist, including those related to the still-unresolved U.S. fiscal cliff issues as well as eurozone fiscal policies and economic growth.

Despite these signs of caution, if issuers and investors are able to adjust their expectations following a record-setting 2012, 2013 may be another interesting year for the U.S. high-yield market.

The JOBS Act: What We Learned in the First Nine Months

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Nine months have passed since the Jumpstart Our Business Startups Act (the JOBS Act), a package of legislative measures intended to ease regulatory burdens on smaller companies and facilitate public and private capital formation, was signed into law.[15] While certain portions of the JOBS Act have yet to be implemented pending SEC rulemaking, the provisions related to IPOs have been effective since enactment. These provisions seek to encourage companies with less than $1 billion in annual revenue 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 a new category of issuers termed emerging growth companies (EGCs).[16]

Using nine-month data from the final prospectuses of 53 EGCs that successfully completed underwritten IPOs with gross proceeds of at least $75 million between April 5, 2012, and December 15, 2012, below is a summary of a number of developing market practices for EGC IPOs and certain related interpretative guidance issued by the staff of the U.S. Securities and Exchange Commission (Staff and SEC, respectively).

JOBS Act Benefit for EGC	Nine-Month Trends — Highlights
Confidential Submissions	**Strong acceptance.** A significant majority of EGCs that commenced their IPOs after April 15, 2012, submitted at least one confidential draft registration statement.
Reduced Financial Statement and Selected Financial Data	**Weak acceptance.** A substantial majority of EGCs continued to include three years of audited financial statements and, of those, most included five years of selected financial data.
Testing-the-Waters Communications	**Mixed acceptance.** Use largely has been deal-specific and is still evolving.
Publication and Distribution of Research Reports	**Mixed acceptance.** Underwriters generally are not publishing pre-deal research and publishing post-IPO research only after expiration of the 25-day prospectus delivery period.
Limited Executive Compensation Disclosures	**Strong acceptance.** Virtually all EGCs that commenced their IPOs after April 15, 2012, have provided scaled executive compensation disclosure.

[15] *See Skadden Corporate Finance Alert*: 'Jumpstart Our Business Startups Act' Signed Into Law" (Apr. 5, 2012), *available at* http://www.skadden.com/insights/corporate-finance-alert-%E2%80%98jumpstart-our-business-startups-act%E2%80%99-signed-law.

[16] 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.

Auditor Attestation Reports Under Section 404(b) of Sarbanes-Oxley	**Strong acceptance.** Virtually all EGCs have included disclosure that they intend to or may take advantage of the exemption to delay providing the auditor attestation report.
Extended Transition for New GAAP	**Weak acceptance.** A substantial majority of EGCs have elected not to take advantage of the extended transition period for compliance with new GAAP standards.

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, the most prominent of which are analyzed below.

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 no later than 21 days prior to the EGC's commencement of its roadshow. The new confidential submission process, formerly available only to foreign private issuers in select circumstances, 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.

Strong Acceptance. While the decision to take advantage of the confidential submission process always should be made based on the particular facts and circumstances facing an EGC, we believe that market practice will continue to trend strongly in favor of confidential submissions. Some EGCs, however, may determine not to do so for a variety of reasons. For example, we are aware of a number of EGCs that did not use 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

- **Press Releases.** The SEC cannot reject a confidential submission even if an EGC issues a press release that publicly announces the offering. However, any press release must comply with limitations imposed by Rule 135 to avoid gun-jumping issues.[17] We note that, to date, very few EGCs have issued press releases announcing a confidential submission.
- **Mergers and Acquisitions.** While the JOBS Act focused on IPOs and scaled disclosures for newly public companies, it does not contain language precluding

[17] Rule 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).

its application to registered business combinations conducted by EGCs. The Staff recently confirmed that an EGC may submit confidentially a draft registration statement for a merger or exchange offer that constitutes an IPO of its equity securities.[18]

- **Publicly Filing Confidential Submissions Ahead of the Roadshow.** 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 is permitted to present only two years of audited financial statements in its IPO registration statement, as compared to the three years required for non-EGCs. An EGC presenting only two years of audited financial statements in its IPO registration statement may limit the number of years of selected financial data to two years as well.[19]

Weak Acceptance. Several reasons typically are cited by EGCs for the decision to include three years despite the JOBS Act change. The primary reason is that the extra year of audited financial statements is 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. Also, buy-side investors often have been demanding the third year of audited financial statements. The decision to include two versus three years of audited financial statements did not appear to be linked to the size of the offering.

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.[20]

- **Abbreviated Financial Statements in Non-IPO Registration Statements.** Notwithstanding that the accommodation for abbreviated financial statements is limited to an EGC equity IPO, the Staff has stated that it will not object if, in other Securities Act registration statements (covering, for example, a follow-on equity offering or a debt offering), an EGC does not present audited financial statements for any period prior to the earliest audited period presented in the IPO prospectus.[21]

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[18] SEC, JOBS Act Frequently Asked Questions, Generally Applicable Questions on Title I of the JOBS Act (Title I FAQs), at Question 43. The Title I FAQs can be found here: http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm.

[19] Title I FAQs, at Question 11.

[20] *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.

[21] *Id.*, at Question 12.

- **No Abbreviated Financial Statements in a Form 10 Filed in Connection With a Spin-Off of an EGC.** The accommodation permitting an EGC to file only two years of audited financial statements is limited to sale transactions registered under the Securities Act. A typical spin-off will not involve a sale that would trigger Securities Act registration. Accordingly, any Form 10 filed by the EGC in connection with the spin-off must contain three years of audited financial statements (unless the EGC is a smaller reporting company, in which case two years would suffice).[22]

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.

"In our experience, the use of testing-the-waters communications has been uneven and largely deal-specific."

Mixed Acceptance. The frequency and degree to which EGCs or their authorized representatives have conducted testing-the-waters communications in the past nine months is not readily apparent from SEC filings, as these communications do not need to be publicly filed with the SEC. In our experience, however, the use of these communications has been uneven and largely deal-specific. Current market practices related to testing-the-waters communications are best understood if the communications are separated into pre- and post-filing communications. Pre-filing communications (which typically precede any confidential submission) increasingly are being used in connection with "Meet the Management" presentations between EGCs and underwriter-selected QIBs. The substance of these meetings generally is focused 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 are not part of the presentation, and there generally is no discussion of valuation or solicitation of non-binding indications of interest.

Post-filing testing-the-waters communications, on the other hand, have been used, albeit less frequently, 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 is heavily influenced by buy-side interest. Companies should note that many underwriters prefer to schedule substantive testing-the-waters meetings only after the draft registration statement has been through at least one (and preferably two) rounds of Staff legal and accounting comments, in an effort to ensure that the content of the communications will conform to the prospectus. Consideration must be given to the launch date of the offering, as investors increasingly have been unwilling to entertain a testing-the-waters meeting close in time to the actual roadshow. In this regard, a number of buy-side and sell-side participants have questioned whether the exploration of value in connection with testing-the-waters communications would present sufficient upside to investors to justify their attention given their limited resources.

In sum, market practice in this area — similar to when free writing prospectuses were first permitted — is developing slowly and cautiously. We expect practices will continue to evolve over the course of the next year.

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[22] The Form 10 may include only three years of selected financial data under Item 301 of Regulation S-K.

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 as would be the case 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 as would be the case with the roadshow.

- **SEC Comments.** Unlike an issuer free writing prospectus, a testing-the-waters communication does not need to be filed with the SEC. EGCs, however, should expect to receive a standard comment from the Staff requesting that any "written materials" used in connection with testing-the-waters communications be provided supplementally to the Staff in connection with its review of the registration statement. Senior Staff recently stated that "written materials" include slide decks or similar visual aids, even if the materials are taken back after the presentation.[23] 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 generally prefer oral presentations. We believe underwriters will continue to require that written materials be taken back after a presentation notwithstanding that they will have to provide the materials to the Staff.

- **Use of a "Pink Herring" Prospectus.** In connection with 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 are being 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.

- **Mergers and Acquisitions.** The Staff recently confirmed that an EGC may use testing-the-waters communications with QIBs and institutional accredited investors in connection with a merger or exchange offer.[24] While qualifying testing-the-waters

[23] Paula Dubberly, Division of Corporation Finance Deputy Director, Policy and Capital Markets, Remarks at PLI Securities Regulation Institute (Nov. 7, 2012).

[24] Title I FAQ, at Question 42.

communications would not be deemed pre-filing offers or post-filing prospectuses that would need to be timely filed under Rule 425 to ensure the protections of the Rule 165 safe harbor, the JOBS Act did not provide similar relief from the gun-jumping provisions of the proxy and tender offer rules. As such, tender offer communications and proxy solicitations by the EGC outside the business combination registration statement would be subject to the relevant filing and legending requirements of the Exchange Act.

"Underwriters, at least for now, appear to have settled on a cautious approach to the publication and distribution of pre-deal and post-deal research, based largely on liability concerns."

Publication and Distribution of Research Reports

The JOBS Act permits a broker-dealer to publish or distribute a research report about an EGC that proposes to register an equity offering under the Securities Act 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 recent NYSE and FINRA rulemaking,[25] the JOBS Act also eliminates, for IPOs of EGCs, 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.

Mixed Acceptance. Underwriters, at least for now, appear to have settled on a cautious approach to the publication and distribution of pre-deal and post-deal research, based largely on liability concerns. First, we are not aware of any underwriters publishing research before or during a traditional offering by an EGC. Second, as it relates to post-deal research, underwriters have settled on 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. We believe that market practices related to deal research will continue to evolve with the passage of time.

Streamlined or Exempt Disclosures

Under the JOBS Act, an EGC is eligible to make scaled disclosures or rely on exemptive relief from certain disclosure and other requirements for up to five years following its IPO. The EGC may elect to forego reliance on any disclosure accommodation or exemption available to it. As explained below, EGCs have moved aggressively to take advantage of many of these accommodations.

Limited Executive Compensation Disclosures

EGCs are permitted to avoid the detailed compensation disclosures that otherwise would be required by Item 402 of Regulation S-K and instead provide scaled executive compensation disclosure under the requirements generally available to smaller reporting

[25] *See Skadden Corporate Finance Alert:* "FINRA Amendments Adopted to Implement JOBS Act Changes," (Oct. 2012), *available at* http://www.skadden.com/insights/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.

companies. Accordingly, insofar as relevant to IPOs, an EGC may (1) omit the detailed Compensation Discussion and Analysis (CD&A); (2) provide compensation disclosure covering the top three (including the CEO), rather than the top five, executive officers; and (3) omit four of the six executive compensation tables required for larger companies.

Strong Acceptance. Data shows that a large majority of IPOs commenced after mid-April by EGCs 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.) are taking advantage of the reduced disclosure.

Practice Points

- **Abbreviated CD&A.** In our experience, most investors primarily are interested in the historical executive compensation data and, to the extent they desire an analysis and discussion of a company's executive compensation disclosures, these investors may be more interested in a forward-looking discussion of the company's executive compensation philosophy and practices as a newly public company as compared to 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 market successfully 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. It should be noted that, in many cases, the practical effect of this exemption is to extend relief already available to almost all newly public companies. That is, under current 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 less than $75 million) are permanently exempted.

Strong Acceptance. Virtually all EGCs have included disclosure that they intend to or may take advantage of the exemption to delay providing the auditor attestation report under Section 404(b). Many companies that did not affirmatively state that they would be taking advantage of the exemption preserved their optionality by disclosing that they "had not made a decision" as to whether to take advantage of the exemption. The decision almost universally is tied to potential significant savings in terms of time and money. However, there is some debate whether the perceived savings are over-estimated given the costs that companies already incur in connection with IPO due diligence related to internal controls and 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, 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.

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. Under this provision, an EGC will be permitted to follow a longer, private company transition where there is a different effective date for an accounting standard specified for private companies.

Weak Acceptance. We believe the reasons that EGCs are declining the extended transition period for new or revised financial standards in larger numbers are two-fold. First, EGCs and their advisers are concerned that taking advantage of the extended transition period will cause comparability concerns in the marketplace to those of peer 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 therefore is of limited utility, especially when the comparability issues are considered.

Practice Points

> "A determination by an EGC to opt out from or reject the transition period for complying with new or revised financial accounting standards is irrevocable."

- **Opt Out/Opt In.** A determination by an EGC to opt out from or reject the transition period for complying with new or revised financial accounting standards is irrevocable. An EGC should notify the Staff of 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.[26] An EGC that initially decides to opt in 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.[27]
- **Determining "New or Revised Financial Accounting Standards."** The term refers to any update issued by the Financial Accounting Standards Board to its Accounting Standards Codification after the JOBS Act enactment date, April 5, 2012.[28]
- **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.[29]

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[26] Title I FAQs, at Question 13.
[27] Title I FAQs, at Question 37.
[28] Title I FAQs, at Question 33.
[29] Title I FAQs, at Question 34.

Conclusion

We believe that the majority of the reforms, accommodations and exemptions discussed above have become or increasingly will become an established part of the EGC IPO "playbook." However, as is the case with any significant reforms, we expect market practices will continue to develop and the true impact of the JOBS Act on the IPO market only will become apparent with the passage of time.

Jumping the Gun: Social Media and IPO Communications Issues

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Increasingly, companies are using social media, such as Facebook, Twitter, YouTube and other platforms, to engage with clients, customers, employees, shareholders and other key constituents. Promising a fast and low-cost means of disseminating information, social media also offers the potential for even broader distribution through third-party word-of-mouth advocacy. However, when a company plans an IPO in the United States, social media's powerful benefits can pose significant risks.

To date, the SEC has not brought an action for violation of its IPO publicity restrictions involving social media; however, as corporate social media continues to proliferate, it is likely only a matter of time before the SEC acts. Companies preparing to go public need to understand the various SEC rules restricting communications during the IPO process. Instituting well-defined policies and procedures governing social media is critical to avoiding inadvertent violations and the penalties that can follow, which may potentially impact the IPO.

Gun-Jumping

"Gun-jumping" is an expression, not defined in the U.S. securities laws, that generally refers to a violation of U.S. securities law restrictions on issuer publicity and communications before, during or after a public offering. U.S. securities laws prohibit communications that improperly stimulate interest in the securities offered in an IPO. For an IPO, the restrictions start as early as the time the company reaches an understanding with the managing underwriter (potentially before the company even holds its IPO organizational meeting) and end 25 days after the pricing of the offering. Gun-jumping consequences can be serious and can include recission, a cooling-off period delaying the IPO or sanctions/fines.

"Gun-jumping" restrictions are wide-reaching: They apply to all forms of communications and cover press releases, media interviews, website postings, emails, internal company announcements, Facebook posts, Twitter tweets, YouTube videos and online commentary. The often casual and spontaneous nature of social media communications, combined with the ability to disperse messages instantly and broadly, heightens the risk of inadvertent gun-jumping. Additionally, companies often subject social media communications to less stringent review than traditional print publications or press releases.

> "Companies preparing to go public need to understand the various SEC rules restricting communications during the IPO process."

Given the broad application of "gun-jumping" restrictions, it is possible that the SEC could consider seemingly ordinary, noncontroversial communications as "gun-jumping." For example, if appropriate care is not taken, a significant increase in Internet advertising or a company website revamp immediately preceding an IPO could be viewed as "gun-jumping" if it is deemed to be stimulating interest in the IPO.

While a company is not responsible for third-party commentary posted on its social media platforms (including a company website), re-tweeting a third-party Twitter post could raise a red flag. The same holds true for repackaging posted commentary from third parties in company communications, particularly if the company is viewed as sponsoring or affirming the commentary.

Prominent Gun-Jumping Examples

While the following examples of gun-jumping did not involve corporate social media, they are instructive of the general risks and may point to areas in which future notable violations could occur through the use of interactive platforms.

- **Google.** In April 2004, approximately one week before Google Inc. filed its IPO registration statement with the SEC, the company's co-founders gave an interview to *Playboy* magazine. Four months later, the interview appeared in the magazine with the cover title "The Google Guys: America's Newest Billionaires." At the time, the media speculated that the SEC would impose a cooling-off period. While the SEC did not delay the much-anticipated IPO, in the face of SEC comments, Google included the text of the article as an appendix to the prospectus and, as a consequence, assumed prospectus liability for the article's contents. In doing so, Google (and its lawyers) proceeded with care: After careful review of the article's text, Google appended an addendum correcting what it believed were factual inaccuracies. The company also included a risk factor in the prospectus, which disclosed that, while Google "would contest vigorously any claim that a violation of the Securities Act occurred," the company could be subject to rescission claims if its involvement in the *Playboy* article were held by a court to violate the Securities Act.
- **Groupon.** In June 2011, Groupon, Inc. filed a registration statement with the SEC for its proposed IPO. The financial media and investment blogs were skeptical of Groupon's use of a non-GAAP accounting metric that made the company appear profitable. Groupon's business model also was questioned, as critics cited low barriers to entry into the industry and the potential of deep-pocketed competitors to the company. In August 2011, Groupon's CEO and co-founder sent an email to employees, which contained impassioned defenses of Groupon's business. The email leaked and quickly went viral. Because of SEC scrutiny and poor market conditions, Groupon's IPO was delayed for months. In addition, the SEC required Groupon to include the email as an appendix to the prospectus, and Groupon, like Google, assumed prospectus liability for the email's contents. Groupon also included a risk factor, which began, "In making an investment decision, you should not rely on an email sent by our Chief Executive Officer to certain employees that was leaked to the media without our knowledge."

SEC Actions in Other Areas Relating to Social Media Use

While the SEC has not yet brought an action for a gun-jumping violation involving social media, the SEC recently delivered a prominent notice to Netflix, Inc. and its founder and CEO Reed Hastings relating to a personal Facebook post under Regulation FD (an SEC

rule adopted in 2000 that prohibits selective disclosure of material, nonpublic information and aims to promote full and fair disclosure).

- **Netflix.** In December 2012, Netflix received a Wells notice from the staff of the SEC indicating their intent to recommend that the SEC institute a cease-and-desist proceeding and/or bring a civil injunctive action against Netflix and Hastings for violations of Regulation FD and certain Securities Exchange Act provisions. The notice related to Hastings' post to a personal Facebook page with more than 200,000 subscribers that stated, in relevant part, that Netflix's monthly viewing exceeded 1 billion hours for the first time.[30] While the materiality of the statement may be debated,[31] the SEC action drew attention as it suggests that a Facebook post — even if distributed to more than 200,000 people and made available on a platform that anyone can access — still is not a recognized method under Regulation FD. Critics of the SEC's action noted that the Facebook posting likely reached more people and was read more immediately than would have been the case with an SEC filing. Critics also expressed surprise that the SEC took its prominent stance on social media based on facts that, to some, seemed innocuous compared with violations alleged by the SEC in the past.

One takeaway from the Netflix case is clear: Communications on social media platforms are now a focus of the SEC. Accordingly, issuers preparing for an IPO should pay careful attention to their social media activities.

"One takeaway from the Netflix case is clear: Communications on social media platforms are now a focus of the SEC."

Brief Primer of the Gun-Jumping Rules[32]

Understanding the three distinct periods in which different SEC guidelines and restrictions apply may provide a practical framework for issuers in managing their social media use.

1. **Pre-Filing Period: No Offers (Not Even Oral Ones).** During the pre-filing period (after the company is "in registration" but before the registration statement is filed), no offer, whether oral or in writing, may be made under Section 5(c) of the Securities Act. Section 2 of the Securities Act defines "offer" as "every attempt or offer to dispose of, or solicitation of offers to buy, a security or interest in a security for value." Courts have given expansive interpretation to what constitutes an "offer," which includes any activity that creates a buying interest in an offered security. Most importantly, an issuer's intent is not required for a violation to be deemed to have occurred.

2. **Waiting Period: No Written Offers.** During the waiting period (after the registration statement is filed but before effectiveness), issuers may make oral offers, but written offers may only be made through a prospectus that complies with the Securities Act.

[30] The full post read: "Congrats to Ted Sarandos, and his amazing content licensing team. Netflix monthly viewing exceeded 1 billion hours for the first time ever in June. When House of Cards and Arrested Development debut, we'll blow these records away. Keep going, Ted, we need even more!"

[31] Attached to the same Current Report on Form 8-K disclosing the Wells notice was a response from Mr. Hastings arguing that the information, in addition to having been already public, was not material.

[32] *See Skadden Corporate Finance Alert*: "Securities Offerings and Gun Jumping: What You Can and Cannot Do" (November 2012) *available at* http://www.skadden.com/insights/corporate-finance-alert-securities-offerings-and-gun-jumping-what-you-can-and-cannot-do for a comprehensive description of safe harbors and exceptions to SEC's gun-jumping restrictions and practical guidance on what issuers can and cannot do with respect to communication activities generally.

3. **Post-Effective Period.** Once the SEC declares an issuer's registration statement effective, the issuer must continue to comply with communications restrictions until the end of the prospectus delivery period (25 days after the pricing of the IPO). A prominent example of an issuer navigating this requirement is Facebook, which waited until day 26 to respond to questions on its business model.

Safe Harbors and Exceptions

Numerous "safe harbors" and SEC exceptions to the gun-jumping restrictions do exist (*e.g.*, the JOBS Act allows "emerging growth companies" to test interest in a potential IPO with qualified institutional buyers and institutional accredited investors, Securities Act Rule 169 allows nonreporting issuers to continue regularly released business information excluding forward-looking statements and Securities Act Rule 163A provides a safe harbor for certain communications made more than 30 days before the registration statement is filed).[33] In general, companies planning an IPO should keep the following rule of thumb in mind: The U.S. securities laws are not meant to disturb "business as usual" activities and communications. If the communication consists of factual business information and is consistent with past practice, it generally will not violate gun-jumping restrictions.

Managing Social Media During the IPO Process: A Practical Guide

Before starting the IPO process (or, with respect to certain employees who will not know about the IPO beforehand, immediately after the initial registration statement filing), companies should:

- Identify the group of specific individuals within the company who will be authorized to conduct or sign off on all social media communications. For example, even if a sales force regularly employs social media to pitch products, it is not unusual for companies planning an IPO to temporarily halt or more closely monitor the sales force's use of social media during the IPO process to institute a measure of control over communications.
- Establish a social media policy that clearly sets forth the company's expectations with respect to social media communications, and which includes a list of unambiguous "dos and don'ts." The policy, which should be disseminated to all employees and others who may act on the company's behalf, should state that responses to any inbound inquiries through social media platforms are restricted to the small group of identified individuals, and to whom any inbound inquiries should be directed.
- Provide training to ensure persons subject to the social media policy understand how to comply. If the CEO or CFO delivers the message, it will help ensure employees and other persons subject to the policy understand and appreciate its importance.
- Make clear that it is everyone's responsibility to comply with the policy. Each person should understand that a single noncompliant communication could result in potentially severe consequences, such as suspension or delay of the IPO.
- Educate front-line managers and supervisors to monitor compliance with the social media communications policy.

[33] *See Skadden Corporate Finance Alert*: "Jumpstart Our Business Startups Act Signed Into Law" (Apr. 5, 2012), *available at* http://www.skadden.com/insights/corporate-finance-alert-%E2%80%98jumpstart-our-business-startups-act%E2%80%99-signed-law for a summary of the JOBS Act and a description of the JOBS Act's "testing-the-waters" provisions.

- Develop a process to control the type of information (*e.g.*, only factual business information) and how corporate information will be disseminated by social media platforms.
- Instruct company directors that their own personal or professional use of social media must follow company policy.

Finally, companies should consider having internal and/or outside counsel review all information before it is posted on its website or social media outlets. In several SEC actions relating to Regulation FD and the Foreign Corrupt Practices Act (FCPA), the SEC chose not to bring action against the company (and instead brought actions against the alleged infringing individuals only) where the SEC found the company had instituted a "culture of compliance," which included a written policy, controls and training. While instituting a "culture of compliance" may not prevent an SEC action with respect to an IPO gun-jumping violation, it may influence how the SEC views the violation and mitigate the penalty of noncompliance.

Intent is not required for the SEC to determine that gun-jumping has occurred and, given the number of followers an issuer may have on social media platforms, it may not be difficult for the SEC to find a violation. Thus, the best advice is for issuers to operate within SEC guidelines throughout any process that ultimately may culminate in an IPO.

A REIT Evolution: Renewable Energy and Excess Mortgage Servicing Rights

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In recent years, there has been a steady evolution of real estate investment trusts (REITs) and an increase in entities that have announced their intent to convert to REIT status, as well as an expansion of asset categories that they hold and the corresponding income sources (*e.g.*, cell phone towers, billboards, prisons, etc.). This progression likely will continue in the future, and new areas to watch include renewable energy assets (*e.g.*, wind and solar projects) and, in the mortgage REIT sector, excess mortgage servicing rights.

Renewable Energy Projects

The recent proliferation of renewable energy projects has been spurred in large part by federal income tax incentives. These incentives include: (1) a production tax credit (based upon sales of energy by a project within the first 10 years after it is placed in service); (2) an investment tax credit (a one-time, up-front tax credit equal to 30 percent of the cost of tangible personal property employed in the project); (3) cash grants from the U.S. Treasury (in amounts equal to, and in lieu of, the investment tax credit); and (4) accelerated depreciation (including first-year bonus depreciation equal to 50 percent of the cost of certain machinery and equipment used in such projects). The tax credits and cash grants are mutually exclusive alternatives for any given project. All or a portion of the investment tax credit or cash grant with respect to a particular project is recaptured upon a disposition of the project within a prescribed five-year period.

The existing tax incentives are designed to benefit tax-paying persons (*i.e.*, U.S. individuals and taxable corporations, or partnerships owned by such persons), which means that REITs, which generally incur little or no income tax, historically have not played a role in owning or financing assets associated with renewable energy projects. This may change, however, for one or both of two reasons. First, tax laws that provide the incentives currently are scheduled to sunset at the end of 2013. Although such incentives have been slated to expire on numerous occasions in the past, only to be extended each time, (including at the end of 2012 as part of the recent "fiscal cliff" legislation) in light of the escalating government budget deficits and the acknowledged need for greater revenues, the prospects for further extension are less certain in the current environment. The second factor that may bring change is that as the current owners of renewable energy projects exhaust the tax benefits available under existing law, they may, depending upon their circumstances and objectives, have a compelling incentive to divest.

REITs, with their own special and different tax benefits, could provide an abundant source of capital for acquiring or financing renewable energy projects or portions thereof. Unlike regular taxable corporations, REITs are entitled to deduct dividends that they pay to their stockholders and are required to distribute substantially all of their earnings each year. As a consequence of these two rules, REITs are viewed as yield vehicles that pay little or no income tax, and therefore have ready access to the capital markets, including important segments of investors that have, up until now, largely been excluded from renewable energy projects — namely, U.S. pensions and other tax-exempt entities, foreign portfolio investors (including governments and sovereign wealth funds) and retail investors.

To enjoy their special tax status, REITs must comply with myriad qualification requirements, including rules regarding the composition of their assets and income, which are designed to ensure that they invest principally (though not necessarily exclusively) in real estate, as well as distribution, stockholder diversification and other requirements. Subject to certain limits, REITs may house some activities in taxable subsidiary corporations *(i.e.*, taxable REIT subsidiaries, or TRSs) which, unlike the parent REIT, are subject to tax on their income but can facilitate indirect involvement in activities that otherwise would be precluded by the tax qualification requirements applicable to the parent.

The overarching principle in designing a REIT's role in a renewable energy project is to employ a structure that splits the economics associated with the project between a taxable entity (or a partnership owned by taxable entities), which can maximize the utilization of any available tax incentives linked to tangible personal property used in the project, and a REIT, which can hold or finance the real estate elements of the project in a tax-efficient manner. Such structures could take a variety of forms, and a given REIT might employ different structures in connection with different projects.

One such structure could involve a REIT holding the real estate components of a project (such as the land, towers, pads and supporting structures, and/or the gathering and transmission assets), and leasing them to a third-party lessee that could own the power generation assets. If desired, rent could be based, at least in part, on the lessee's gross (but not net) income from the project. In the case of an existing project, as distinct from a newly developed project, the structure might be effectuated via a sale/leaseback transaction (*e.g.*, the REIT buys the real estate elements from the current owner of the project, and leases them back).

As a possible alternative, a REIT could act as a mortgage lender to finance the real estate components of the project. As with the above leasing structure, the arrangement could provide for contingent interest based on the borrower's gross (but not net) income from the project. A mortgage also could provide the REIT with a share of the potential upside in the value of the mortgaged real estate via a shared appreciation provision. Unlike a leasing structure, the mortgage borrower/owner of the generation assets even could be a TRS. (This is not permitted in the case of a leasing structure because of restrictions under the REIT tax rules on the receipt of rents from related parties.)

More sophisticated and creative structures also would be possible, in which a REIT owns and leases certain real estate assets (*e.g.*, gathering assets and transmission lines) while financing other assets (*e.g.*, the land, tower and pads on which wind turbines are placed) via a mortgage loan, or where a TRS owns generation assets and sells energy to a buyer (*e.g.*, a public utility), and the parent REIT owns the gathering and transmission assets that it leases to the same public utility so that it can transport the energy.

Although REITs previously have not been involved in renewable energy projects, they may provide a ready and robust source of capital in connection with the real estate elements of such projects in the future, to the extent that existing tax law incentives sunset or are exhausted with respect to a particular project — thereby facilitating complete or at least partial exits by the current owners of such projects. Depending on the specific circumstances, tax-deferred exit strategies may also be viable (*e.g.*, through the operating partnership structures commonly used by many public REITs). Although structuring challenges will be very real, the political and economic conditions could lead to a groundswell of participation by REITs in such projects in the not-too-distant future.

"Although structuring challenges will be very real, the political and economic conditions could lead to a ground-swell of participation by REITs in renewable energy projects."

Mortgage Servicing Rights

While REITs may own mortgage loans and service them (*e.g.*, collect interest and principal payments, enforce remedies upon a default, etc.) for their own account, income derived from providing services to third parties generally is treated as nonqualifying, or "bad," income under the REIT rules. This would include fees for servicing mortgage loans owned by other investors. However, the IRS has ruled privately that the acquisition of "excess mortgage servicing rights" by a REIT may, if structured properly, give rise to qualifying real estate assets and the receipt of qualifying mortgage interest for purposes of the REIT gross asset and income requirements, respectively. This would allow REITs to acquire mortgage servicing rights from banks that are looking to exit the mortgage servicing business or from independent mortgage servicers who want to operate on a capital-light basis.

Here is how it works. Owners of large portfolios (or pools) of mortgage loans (*e.g.*, Fannie Mae, Freddie Mac and private securitization vehicles such as real estate mortgage investment conduits (REMICs)) often engage a third party to service the loans and may compensate the servicer by granting it a share of the interest income generated by the pool (*e.g.*, 35 basis points per year) — a so-called "interest strip" or "servicing strip." The strip also may be accompanied by a share of certain items of ancillary income derived from the pool, such as late fees. Often the servicer is a bank or other entity that originated the mortgage loans comprising the pool, bundles them and sells the resultant pool, or interests in the pool (*e.g.*, to Fannie Mae, etc.), while retaining the servicing strip.

Moreover, the amount of the servicing strip often exceeds the arm's-length reasonable compensation amount for the pure servicing activity — and really represents a retained economic interest in the underlying mortgage pool. By way of illustration, in the example in which the total amount of the servicing strip is 35 basis points per year, the value of the actual services for which compensation is provided might only be, say, 10 basis points. In that case, the remaining 25 basis points to which the servicer is entitled represents a retained interest in the underlying pool. These are so-called "excess" servicing rights (*i.e.*, the excess over 10 basis points in this example).

To the extent that a REIT purchases such excess servicing rights and does not undertake to service the mortgages, its investment may be treated as a "good" REIT asset (*i.e.*, an undivided interest in a pool of qualified mortgage loans), and the income derived over the life of the arrangement in this example could be treated as "good" mortgage interest for purposes of the REIT income tests. A REIT may even purchase the entire interest strip (*e.g.*, 35 basis points in the example), place the actual servicing component (*e.g.*, 10 basis points) in a TRS or other affiliate, along with the associated servicing obligations, and retain the excess rights (*i.e.*, 25 basis points) as a REIT-compliant investment asset. Because a private ruling issued by the IRS only may be relied upon by the taxpayer to whom it is issued, it may be advisable for a REIT that is interested in investing in excess mortgage servicing rights to seek a private ruling before undertaking such a transaction.

* * *

Investments by REITs in both renewable energy and mortgage servicing assets may be widely available and attractively priced in the months and years ahead. Current owners may seek to monetize assets and strengthen balance sheets under pressure from regulators, as an outgrowth of new laws and as existing tax incentives are exhausted.

What the New German Prospectus Liability Regime for Selling Shareholders Means for Private Equity Exits

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In 2011, the German Federal Court of Justice (FCJ) issued a judgment regarding the legal basis and scope of prospectus liability for selling shareholders in equity offerings of German corporates, which significantly changed the legal structuring of such transactions in Germany. More than a year later, with equity capital markets in Germany showing signs of increased activity going into 2013, shareholders, issuers, bankers and legal practitioners still are trying to define the new market standard for secondary share placements in Germany.

Background

In 2000, the German government (through its state-owned development bank Kreditanstalt für Wiederaufbau, KfW) implemented the third tranche of its privatization of Deutsche Telekom (DT) through a global share placement (the DT3 Offering), including public offerings of DT shares in Germany and the U.S. on the basis of a

prospectus. The transaction was structured as a secondary offering of DT shares only, without any placement of newly issued shares resulting from a capital increase of DT. In other words, KfW (as shareholder of DT) received all proceeds of the transaction. In the underwriting agreement relating to the DT3 Offering, DT assumed the entire prospectus liability risk (*i.e.*, DT indemnified the underwriting banks without receiving a back-to-back indemnity from KfW).

Between 2001 and 2005, DT was the target of several prospectus liability lawsuits on the basis of allegedly wrong and/or omitted information in the DT3 Offering prospectus. In 2005, DT agreed to settle the lawsuits for approximately $120 million and to pay a significant amount of related legal fees. DT requested reimbursement of the settlement amount and legal fees from KfW, but they and the German government rejected it.

DT subsequently brought a claim against the German government and KfW for reimbursement of the settlement amount and legal fees. The company stated that the assumption of prospectus liability in the DT3 Offering constituted an impermissible repayment of equity contributions to KfW, since the DT3 Offering was for KfW's benefit only; DT received nothing.

Court Decisions

District Court of Bonn. In 2007, the District Court of Bonn ruled in favor of DT and confirmed that the company had a claim for the repayment of benefits received by KfW up to the value of the assumed prospectus liability risk. Contrary to the prevailing view at the time, nonquantifiable benefits for the issuer such as increased free float, broadening of the international investor base, and publicity and marketing benefits in connection with a secondary share offering were not viewed as sufficient compensation to justify the assumption of prospectus liability by DT for the DT3 Offering.

Higher Regional Court of Cologne. On appeal in 2009, the Higher Regional Court of Cologne ruled in favor of KfW and found that the nonquantifiable benefits to DT from the DT3 Offering constituted a permissible compensation, in line with past practice, for the assumption of prospectus liability in a secondary share offering.

Federal Court of Justice (FCJ). In its ruling in May 2011 (the DT3 Decision), the FCJ agreed with the District Court of Bonn in principle and ruled that (1) nonquantifiable benefits for a German corporation are not suitable compensation for the assumption of prospectus liability in connection with a secondary share placement, (2) such compensation must comprise objectively quantifiable and financial benefits to avoid an impermissible repayment of contributions to shareholders, (3) the assumption of prospectus liability can, in principle, only be compensated by an enforceable and substantiated indemnification granted by the selling shareholder to the corporation, and (4) controlling selling shareholders also may be subject to claims for damages on the basis of the rules applicable to so-called *de facto* groups.

Scope of DT3 Decision

Pursuant to the DT3 Decision, the indemnification of the issuer by the selling shareholder against prospectus liability in connection with a secondary share placement must be for value (*werthaltig*) and enforceable. The compensation of the issuer must be quantifiable on the basis of a balance sheet analysis (*bilanzielle Betrachtung*). While

it is unclear how this test can be implemented in practice, the substantiated "full-value" analysis requires a prognosis that possible prospectus liability claims can be paid when due, which means in order for an indemnifying selling shareholder to satisfy the DT3 Decision requirements, tangible assets must be available, money must be kept in escrow, a liability insurance policy must be available or similar actions must be taken to establish "value."

Notably, the FCJ did not distinguish between transactions that only involve a secondary share placement (such as the DT3 Offering) and transactions that involve both a capital increase and a secondary share placement. It also did not distinguish between IPOs and transactions involving already publicly listed corporations.

Consequences for German Equity Capital Markets Transactions

The DT3 Decision has significant implications for the way equity capital markets transactions are structured and executed in Germany.

Corporation/Issuer. In the event that a German corporation assumes prospectus liability in connection with a secondary share placement, its management and supervisory board members may be held personally liable in the event that no enforceable indemnity is given, or costs are not reimbursed, by the selling shareholder.

As a result, a German corporation preparing a prospectus in connection with a secondary share placement must enter into an indemnification agreement with the selling shareholder with respect to any potential prospectus liability.

> "The DT3 Decision has significant implications for the way equity capital markets transactions are structured and executed in Germany."

Selling Shareholder. Following the DT3 Decision, selling shareholders in a German secondary share placement are obligated to assume the prospectus liability risk and reimburse the issuer for all related costs and expenses.

Such indemnity is less of an issue for corporations that have an operating business and a sufficient asset base. However, selling shareholders with no operating business — such as private equity investors — may find it difficult to demonstrate that the indemnity to the issuer required by the DT3 Decision is substantiated (*werthaltig*). In particular, private equity funds distribute (and typically are required to do so under the constituting documents) the proceeds from a secondary share placement to their investors, leaving the selling shareholder following the closing of a secondary share placement typically with no significant assets (other than remaining shares held in the issuer in the event of a partial exit) to back up the indemnity in a manner required by the DT3 Decision.

For such private equity investors, the purchasing of insurance cover, pledge of collateral and/or escrow arrangements are possible alternatives to manage the German prospectus liability risk in practice — all of which come at an additional cost. In most cases, the purchase of insurance will only support, but not replace, the indemnity obligations of selling shareholders, because obtaining insurance cover in excess of €200 million to €300 million is difficult in the German market.

If a selling shareholder controls a German corporation, it also may be held liable as a controlling shareholder pursuant to the rules for so-called *de facto* groups if it does not compensate the corporation through indemnification for any damages resulting from a possible prospectus liability relating to a secondary share placement.

Underwriters. Although the customary indemnity from prospectus liability granted by a German corporation to the underwriters in connection with a secondary share placement generally is viewed as being enforceable, the absence of an enforceable indemnity from the selling shareholder to the corporation also could affect the enforceability of such indemnity to the underwriters, if they are aware of the fact that the indemnity from the selling shareholder to the corporation is not for value (*werthaltig*) or not enforceable.

To make sure the underwriters have a valid indemnity claim against the corporation, they are well-advised to conduct at least some due diligence with respect to the substance of the indemnity that runs from the selling shareholder to the corporation. As a result, it has become market standard that underwriting agreements relating to German equity capital markets transactions also involving a secondary share placement include a representation by the corporation with respect to the valid existence of an indemnification agreement with the selling shareholder that meets the requirements of the DT3 Decision, as well as a condition precedent with respect to the execution and delivery of such agreement.

Legal Opinion Qualification. The legal opinions delivered by German counsel in secondary share placement transactions likely will include a qualification with respect to the enforceability of the underwriting agreement as it relates to the question whether the indemnity from the selling shareholder to the corporation is for value (*werthaltig*), since the analysis relates to a factual and not a legal issue.

Structural Alternatives for Selling Shareholders

To avoid the consequences of prospectus liability as defined in the DT3 Decision, selling shareholders have few structural alternatives:

- In an IPO scenario, conduct the initial transaction as a primary share offering only, and follow up with an undocumented placement after the expiration of the lockup period. While possible as a legal matter, this IPO structure will be difficult to implement from a valuation and liquidity perspective. The transaction structure must not be viewed as circumventing the need for a documented offering.
- In a secondary share placement scenario, implement block trades — typically on the basis of accelerated book-buildings with institutional investors — without the public offering of shares and without any marketing documentation. These transactions do not fall within the scope of the DT3 Decision.
- Reincorporate the issuer in another (European) jurisdiction with less stringent capital maintenance requirements (non-German holding structure). However, a foreign domiciliation of a previously German issuer will raise tax, governance and general market issues that need to be analyzed carefully on a case-by-case basis.
- Structure the transaction to distribute cash to shareholders prior to the IPO and refinance through proceeds from the primary-only offering.

Outlook

In connection with secondary share placements in Germany, selling shareholders (*e.g.*, private equity firms) will need to evaluate their options for managing the prospectus liability risk on a case-by-case basis. In transactions involving private equity investors as

selling shareholders, it is to be expected that the issues presented by the DT3 Decision will be addressed through some combination of an indemnification agreement between the selling shareholder and the issuer, the purchase of insurance cover and — depending on the size and structure of the offering — possibly the strengthening of the asset base of the selling shareholder (*e.g.*, a portion of the proceeds to be held in escrow) for a certain time period following the closing of the transaction.

In addition, because of the increased prospectus liability risk in Germany, selling shareholders are expected to retain separate legal counsel and be more actively involved in the due diligence and prospectus drafting processes.

Because of the personal liability risk resulting from an impermissible repayment of contributions to shareholders, following the DT3 Decision individual board members of German corporations also typically will retain their own legal counsel in connection with secondary share placements to ensure that the indemnification by the selling shareholders is enforceable and substantiated (*werthaltig*).

The DT3 Decision is one of the most disputed court decisions affecting capital markets transactions in Germany in recent years. Due to its broad tenor, German legal commentators and practitioners have been actively debating the DT3 Decision's potential impact on transaction structures that differ from the structure of the DT3 Offering (which involved a secondary share placement without any proceeds to the issuer), such as IPOs and mixed primary and secondary share offerings. It remains to be seen whether the attempts by legal commentators, practitioners and other market participants to limit the scope of the DT3 Decision — through applying a pro-rated liability scheme for mixed primary and secondary share placements — will be adopted and confirmed by the German courts.

Hong Kong Equities Look for Brighter 2013

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Following their leading role in primary equity capital raising for the previous three years, 2012 marked a sharp retreat for Hong Kong's equity markets. Last year's Hong Kong IPO market likely will be remembered for the following:

- **A Significant Drop in Capital Raised.** According to the Hong Kong Stock Exchange (HKSE), $10.76 billion was raised in IPOs, a 67 percent drop from 2011, and the exchange's average daily turnover in value terms was down 24 percent for the year. Many of the larger equity deals during the year consisted of secondary fundraising by established issuers, with total secondary funds raised remaining steady compared to 2011 at $26 billion.
- **Greater Dependency on Committed Investors.** Almost all IPOs of meaningful size depended on significant sales in the IPO to "friends and family" or were substantially supported by multiple cornerstone investors prior to launch. A number of transactions saw the introduction of new bookrunners very late in the process, with participation and economics closely tied to the ability to deliver committed investors.
- **Fewer Non-Chinese Listings.** With the notable exception of the Sunshine Oilsands IPO, and in contrast to the past few years, last year saw few listings on the HKSE by

businesses based or controlled outside of China. Several high-profile deals, including the Graff Diamonds IPO, were delayed or canceled. Likely causes include the lower valuations, the poor aftermarket performance and liquidity of some overseas companies that listed in the past few years, and the perceived time and expense that the Hong Kong listing process entails.

- **An Increased Focus on Regulating the IPO Process.** One investment bank's license to advise on IPOs was revoked as the result of performing inadequate due diligence, and the Hong Kong Securities and Futures Commission (SFC) issued a set of proposals intended to bring about heightened levels of responsibility for investment bank sponsors of new listing applications. While it remains to be seen whether the SFC's proposal to make sponsors criminally liable for prospectus misstatements ultimately will become law, a number of the other proposals, including the public disclosure of draft prospectuses at the initial filing stage and the requirement for sponsors to have completed due diligence prior to the initial filing, are now set to come into effect on October 1, 2013. We believe the increased focus on the role of sponsors should be coupled with further steps to streamline the listing process.

What to Expect in 2013

While it is difficult to be certain, there are indications that market sentiment and prospects are improving.

> "2013 could be the year that the first of the previously U.S.-listed China businesses taken private by their founders is relisted in Hong Kong."

With the successful closing of the IPOs of PICC Group (the largest IPO of 2012 by value) and China Machinery Engineering (the most oversubscribed IPO of 2012) in December, and the Hang Seng Index close to an 18-month high, the Hong Kong markets seem poised for positive momentum into 2013. Moreover, several of the uncertainties that cast a shadow over the Hong Kong market throughout 2012 — slower Chinese economic growth, China's leadership transition and the 18th Communist Party Congress, financial uncertainty in Europe and the U.S. presidential election — seem less likely to cause concern this year.

The Hong Kong market also may reap an indirect benefit from the inability of the United States Public Accounting Oversight Board (the PCAOB) to inspect Chinese accounting firms. Under Sarbanes-Oxley, the PCAOB is required to periodically inspect all accounting firms that audit U.S. reporting companies. Citing national security concerns, Chinese authorities have not been willing to permit these inspections and, to date, the PCAOB's efforts to agree on a regime of joint inspections have been unsuccessful. The deadline for completion of inspections was December 31, 2012. As of this writing, the PCAOB has not made any public statements that it is taking action. However, the deregistration or suspension of registration of PRC-based accounting firms, including the affiliates of the "Big Four," could commence at any time if an agreement on inspections is not reached. Upping the ante, the SEC announced on December 3, 2012, that it was bringing charges against the Chinese affiliates of the Big Four accounting firms for violating U.S. securities laws by refusing, in the context of a number of ongoing SEC investigations, to produce documents relating to their audits of China-based U.S.-listed companies. Discussions are ongoing and there is still a likelihood that a deal on inspections will be reached before any accounting firms are deregistered. However, the prospect of being unable to find an auditor (and the eventual delisting and deregistration in the U.S. that would follow) could further undermine investor interest in U.S.-based China businesses, and could result in some affected companies deciding to exit the U.S. in

favor of Hong Kong as a listing venue, or to pursue a dual listing in both venues as a contingency measure (see "Global M&A/China M&A: Looking Ahead to 2013").

Finally, 2013 also could be the year that the first of the previously U.S.-listed China businesses taken private by their founders (a trend we commented on in *Insights* last year[34]) is relisted in Hong Kong. While such deals likely would be subject to a good deal of regulatory scrutiny in light of allegations of widespread financial and other irregularities, particularly among Chinese businesses that were listed in the U.S. through reverse takeovers, we believe that the majority of U.S.-listed companies that have gone private likely will be suitable candidates for eventual relisting in Hong Kong.

[34] *See* "Global M&A," *Skadden Insights* (January 2012), *available at* http://www.skadden.com/insights/global-ma-0.

2013 Insights / SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES

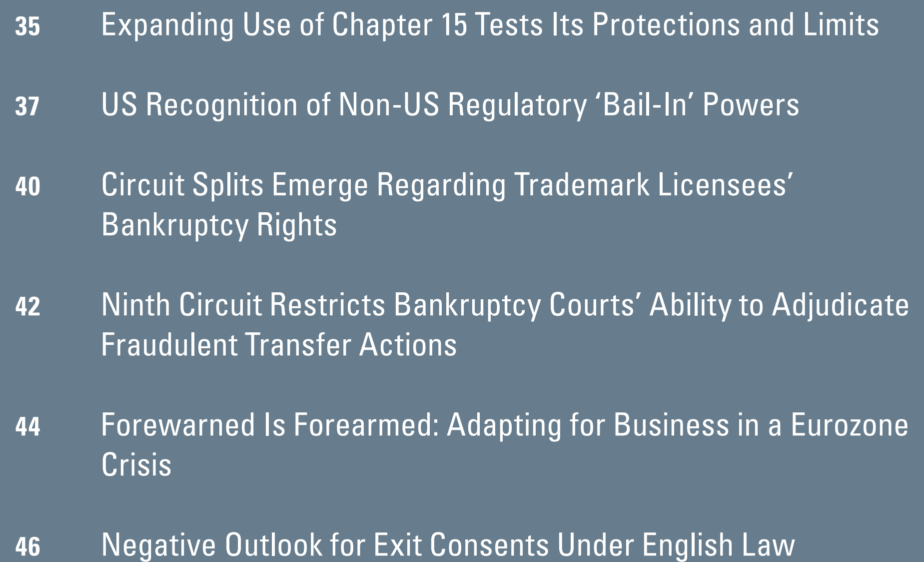
Corporate Restructuring

The global reach of capital markets, financial difficulties in the eurozone and the multinational nature of many businesses and financial institutions have increased the importance of understanding legal, business and other risks associated with distressed investments in non-U.S. companies.

Distressed debt investors and funds have deepened their involvement in Europe — a trend we expect to continue. Those invested (or interested) in debt of financially distressed foreign companies should understand what restructuring laws and practices may apply, given the potential interplay between U.S. and international restructuring regimes and regulations.

In this section, we examine several issues of importance to investors in foreign companies, who have expanded their use of Chapter 15 of the U.S. Bankruptcy Code, which permits representatives of a foreign debtor to seek cooperation from U.S. bankruptcy courts in support of the foreign debtor's foreign insolvency proceedings. Additionally, European regulatory bodies increasingly are recommending "bail-in" as a method of resolving the affairs of large, systemically important financial institutions (SIFIs) facing insolvency; we weigh the various factors a U.S. court may consider when deciding whether to recognize a non-U.S. regulator's use of this method to convert a non-U.S. SIFI's debt to equity. Focusing on the continuing eurozone crisis, we canvas the potential legal, currency and business risks that might result from the departure of one or more member states. Finally, we discuss the criticism of the use of "exit consents" — a common tool in U.S. bond restructurings — in a recent English court decision.

We also discuss recent developments on two topics of continuing importance in U.S. bankruptcy cases: bankruptcy court jurisdiction to enter final orders in fraudulent transfer actions, and bankruptcy treatment of trademark licensee rights.



35 Expanding Use of Chapter 15 Tests Its Protections and Limits

37 US Recognition of Non-US Regulatory 'Bail-In' Powers

40 Circuit Splits Emerge Regarding Trademark Licensees' Bankruptcy Rights

42 Ninth Circuit Restricts Bankruptcy Courts' Ability to Adjudicate Fraudulent Transfer Actions

44 Forewarned Is Forearmed: Adapting for Business in a Eurozone Crisis

46 Negative Outlook for Exit Consents Under English Law

Expanding Use of Chapter 15 Tests Its Protections and Limits

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Foreign companies engaged in insolvency proceedings abroad and holding assets in the United States increasingly have employed Chapter 15 of the U.S. Bankruptcy Code to achieve their restructuring objectives and avoid the costs and time associated with plenary proceedings of a traditional Chapter 11 filing. As these companies and their creditors test this strategy's protections and limits, there have been significant legal developments in Chapter 15 practice. While foreign debtors have pushed the boundaries of the relief available to them, some creditors have objected and sought to impose more of the restrictions applicable in Chapter 11 on debtors in Chapter 15 cases. In the coming year, we anticipate that more foreign companies will test the Chapter 15 waters — and judicial and creditor scrutiny will continue to increase.

The Appeal of Chapter 15

Enacted in 2005 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act, Chapter 15 incorporates most of the provisions of the United Nations' Model Law on Cross-Border Insolvency and acts as a mechanism by which foreign representatives may seek comity or cooperation from U.S. bankruptcy courts in support of foreign insolvency proceedings. A foreign representative is authorized in the foreign proceeding to administer the debtor's assets or generally to serve as a representative of the foreign proceeding in a Chapter 15 case. Courts have held, however, that judicial appointment of a foreign representative by a foreign court is not required for the foreign representative to be recognized in Chapter 15.[1]

Chapter 15 provisions confer broad powers upon a foreign representative, with only a few enumerated exceptions and catch-all protection provisions. Upon recognition of a foreign proceeding by a bankruptcy court, the foreign representative (which may be a debtor or an unaffiliated entity, such as a liquidator or a trustee appointed in the foreign proceeding) may pursue relief under certain provisions of the Bankruptcy Code that automatically are applicable to Chapter 15 proceedings, including Section 363 (which governs use and sale of debtor property outside the ordinary course of business). An asset sale in a Chapter 15 proceeding can be achieved either by requesting that the bankruptcy court recognize and enforce a sale order issued by a foreign court, or by motion for bankruptcy court approval of the sale under Section 363; the latter approach has become more prevalent.[2]

Foreign representatives are using another interesting tactic in the Chapter 15 context: employing a bankruptcy trustee's "avoidance" powers, despite express statutory exclusion of certain of the Bankruptcy Code's avoidance provisions (*e.g.*, Sections 522, 544, 545, 547, 548, 550 and 724(a)) from relief that is available to them under Section 1521.

[1] *See Ad Hoc Grp. of Vitro Noteholders v. Vitro S.A.B. de D.V.*, Nos. 12-10542 *et al.*, 2012 WL 5935630, *11 (5th Cir. Nov. 28, 2012) (affirming recognition of foreign representatives appointed by board of directors of foreign debtor rather than by court order).

[2] *See, e.g.*, *In re Qimonda AG*, Case No. 09-14766 (RGM) (E.D. Va. March 10, 2010); *In re Cinram Int'l Inc.*, Case No. 12-11882-KJC (D. Del. July 25, 2012); *In re Elpida Memory, Inc.*, Case No. 12-10947-CSS (D. Del. Nov. 16, 2012).

Some courts have authorized foreign representatives to exercise avoidance powers (powers to unravel and undo transactions detrimental to creditors) that are granted to the representatives under the laws of the jurisdictions in which the relevant foreign proceedings are being pursued,[3] and also have permitted them to pursue avoidance actions under Section 553 of the Bankruptcy Code (relating to avoidance of setoffs) because Section 553 is not listed specifically among the excluded provisions in Section 1521.[4] The willingness of U.S. bankruptcy courts to allow foreign representatives in Chapter 15 cases to commence avoidance actions (previously thought to fall outside a foreign representative's authority) may reduce a primary motivation for foreign debtors to commence plenary Chapter 11 filings rather than ancillary Chapter 15 proceedings.

Increased Scrutiny

Creditors are taking more active roles in Chapter 15 proceedings, resulting in increased litigation and judicial scrutiny.

Emerging Creditor Strategies. A bondholder group has been very active in connection with both Elpida Memory's Chapter 15 case (pending in the U.S. Bankruptcy Court for the District of Delaware) and the company's primary foreign insolvency proceeding (pending in the Tokyo District Court). The bondholders in the *Elpida* Chapter 15 case petitioned the Delaware bankruptcy court to appoint a court representative to facilitate and coordinate cooperation with the Tokyo District Court. The bondholders alleged that Elpida's foreign representatives had failed to adequately apprise the bankruptcy court of the ongoing Tokyo proceedings, to the detriment of the debtors' estates and the interests of U.S. creditors. Although the bankruptcy court declined to appoint a representative, the bondholders' request illustrates that creditors and other constituents also are employing creative Chapter 15 strategies to protect their interests.

"In 2013, we anticipate that more foreign companies will test the Chapter 15 waters — and judicial and creditor scrutiny will continue to increase."

Limits on Relief. Although Chapter 15 relief is broad, it is far from unlimited. In several recent decisions, U.S. bankruptcy courts have declined to grant requests for relief by foreign representatives. Courts have denied requested relief on the "narrow" exception contained in Section 1506 of the Bankruptcy Code, which provides that such requests may be denied if they would be "manifestly contrary to the public policy of the United States." For example, courts have applied Section 1506 to deny foreign representatives' requests to reject certain intellectual property licenses based on German law without providing the protections set forth in Section 365(n) of the Bankruptcy Code.[5]

Chapter 15 Risks. Relief requested by foreign representatives also may be denied based upon other sections of Chapter 15, even if a bankruptcy court does not directly rely on public policy considerations. A bankruptcy court may deny relief based on Section 1507 (listing factors for courts to consider in granting additional assistance) or Section 1522 (requiring that the interests of creditors and the debtor be sufficiently protected). In the *Vitro S.A.B.* case, the U.S. Court of Appeals for the Fifth Circuit relied upon Sections 1507 and 1522 to affirm a Texas bankruptcy court's decision to deny enforcement of a reorganization plan that had been approved by the Mexican court presiding over Vitro's primary reorganization proceeding. The *Vitro* plan provided for

[3] *See In re Condor Ins. Ltd.*, 601 F.3d 319 (5th Cir. 2010).

[4] *See In re Awal Bank, BSC*, 455 B.R. 73 (Bankr. S.D.N.Y. 2011).

[5] *See In re Qimonda AG*, 433 B.R. 547 (E.D. Va. 2010); and to access electronic communications in the United States in potential violation of a debtor's due process rights (*In re Toft*, 453 B.R. 186 (Bankr. S.D.N.Y. 2011)).

recoveries to Vitro's existing shareholders, but failed to pay the company's creditors in full and released certain of Vitro's nondebtor subsidiaries from guarantee obligations, thereby extinguishing guarantee claims held by Vitro's bondholders against the nondebtor entities. Although the bankruptcy court denied enforcement of the *Vitro* plan, relying upon the Section 1506 public policy exception, the Fifth Circuit instead relied upon the limitations contained in Sections 1507 and 1522 to affirm, stating that "Vitro has failed to show the presence of the kind of comparable extraordinary circumstances that would make enforcement of such a plan possible in the United States."[6] The Fifth Circuit's holding in *Vitro* suggests that in order to protect creditors, U.S. bankruptcy courts may deny enforcement of relief ordered by a foreign court, even if the bankruptcy court does not rely on public policy considerations in denying such requested relief.

Looking Ahead

Given recent Chapter 15 developments, foreign companies considering this strategy as ancillary to a foreign insolvency proceeding should consider both the relief available to a foreign representative in its native proceeding and that which may be available under various chapters of the U.S. Bankruptcy Code. Foreign companies should seek strategic advice from experienced U.S. bankruptcy counsel about the extent (and limits) of available relief in Chapter 15 proceedings, how their U.S. creditors and other interested parties may react, and whether there are alternatives to accomplish a foreign company's restructuring objectives.

[6] *In re Vitro*, 2012 WL 5935360 at *23.

US Recognition of Non-US Regulatory 'Bail-In' Powers

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The European Commission (EC), the Financial Stability Board (FSB), the Independent Commission on Banking (Vickers Commission) and other bodies have suggested "bail-in" as a method of resolving the affairs of large, systemically important financial institutions (SIFIs) facing insolvency or other crisis.[7] Thus far, only Spain and Switzerland have adopted restructuring laws contemplating this method,[8] but many more European nations are likely to do so in the coming years, as EU member states are required to achieve "substantial compliance" with the proposals by 2018.[9]

[7] Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms, COM (2012) 280 final, 2012/150 (COD) (June 6, 2012); Recovery and Resolution Planning: Making the Key Attributes Requirements Operational (Financial Stability Board), Nov. 2, 2012; Final Report and Recommendations of Independent Commission on Banking, Sept. 12, 2011.

[8] The Swiss bail-in statute is codified in the Swiss Banking Act, Arts. 28-32. The Spanish bail-in statute was enacted through Royal Decree-Law 24/2012 of Aug. 31, 2012.

[9] *See* Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms, at Art. 114, COM (2012) 280 final, 2012/150 (COD).

Bail-in allows the home regulator of a troubled SIFI to convert certain classes of debt of the SIFI into equity in the SIFI without the debt holders' consent. In theory, a troubled SIFI with dwindling capital and related capital ratios can, at the stroke of a pen, have its capital and related capital ratios significantly enhanced, thereby bolstering market confidence in its viability. In particular, while bail-in does not contemplate infusions of new equity, its implementation may stem the tide of margin calls that otherwise would be triggered by depleted capital.

"One question raised by the bail-in approach is the extent to which courts outside a SIFI's home country may recognize and respect the remedy."

The operations of most SIFIs, however, are not limited to their home countries. Rather, they have global operations, and the debt issued by their holding companies or operating subsidiaries may be governed by U.S. law, including, in the case of bonds, the Trust Indenture Act (TIA);[10] may be held by investors outside the home country; and may contain venue provisions requiring that litigated disputes be adjudicated in courts outside a SIFI's home country. Accordingly, one question raised by the bail-in remedy is the extent to which courts outside a SIFI's home country may recognize and respect the remedy.

Outside the SIFI context, it has not been uncommon for holders of debt issued by companies subject to non-U.S. insolvency proceedings to attempt to collect on that debt in U.S. courts notwithstanding the pendency of such insolvency proceedings.[11]

There are two ways that matters concerning recognition of a non-U.S. restructuring proceeding can be brought before a U.S. court. First, a foreign representative of an entity subject to non-U.S. insolvency proceedings may file a petition under Chapter 15 of the U.S. Bankruptcy Code.[12] If the petition is granted and the foreign proceeding is recognized, then the non-U.S. debtor is entitled to many of the protections of the Bankruptcy Code, including the benefit of a stay against efforts by creditors to exercise remedies in the United States.[13] Chapter 15, however, may not be available to all SIFIs, as foreign banks are precluded from filing bankruptcy in the United States[14] (see "Expanding Use of Chapter 15 Tests Its Protections and Limits").

As an alternative to Chapter 15, U.S. creditors may attempt to enforce their rights under their debt instruments in U.S. courts. As noted above, debt instruments commonly have U.S. choice-of-law or venue provisions, and the TIA generally prohibits, outside of Chapter 11, nonconsensual modification of a bondholder's debt maturity and payment terms.[15] Accordingly, U.S. creditors may invoke TIA provisions to seek U.S. court assistance enforcing the original terms of debt that have been restructured in a foreign proceeding. As a general matter, U.S. courts dismiss such actions, based on principles of international comity, if the claimant fails to establish prejudice or injustice as a result of the non-U.S. insolvency proceeding.[16]

[10] 15 U.S.C. §§ 77aaa-77bbbb.

[11] *See ABN Amro Bank N.V. v. Parmalat Finanziara S.p.A.*, 394 B.R. 696 (S.D.N.Y. 2008) (affirming permanent injunction against attempts to collect on debt that was restructured in Italian insolvency proceeding).

[12] *See* 11 U.S.C. §§ 1504, 1515.

[13] *See* 11 U.S.C. § 1520.

[14] *See* 11 U.S.C. § 1501(c).

[15] *See* 15 U.S.C. § 77ppp(b).

[16] *See Finanz AG Zurich v. Banco Economica*, 192 F.3d 240, 246 (2d Cir 1999).

There are limits, however, to how far a U.S. court will go in recognizing non-U.S. insolvency proceedings that are contrary to U.S. law. A U.S. court will recognize a non-U.S. insolvency proceeding that is unlike a U.S. insolvency proceeding, but the non-U.S. proceeding cannot violate basic notions of fairness. The U.S. Court of Appeals for the Fifth Circuit recently refused to recognize a Mexican insolvency proceeding of a parent holding company that purported to discharge the guarantee obligations of the company's U.S. nondebtor subsidiaries.[17] U.S. courts are split on the propriety of such releases and will enforce them only in extraordinary circumstances.[18] Because the Mexican debtor did not satisfy these U.S. standards, the Fifth Circuit refused to authorize the releases (see "Expanding Use of Chapter 15 Tests Its Protections and Limits").

There is no precedent for a U.S. court recognizing a non-U.S. regulator's unilateral bail-in conversion of a non-U.S. SIFI's debt to equity. If a non-U.S. SIFI were to face a crisis and its debt were in fact converted, U.S. holders of such debt could be expected to challenge the propriety of such bail-in in U.S. courts. While Chapter 11 allows U.S. debtors to reorganize their affairs, among other things, swapping debt for equity much like bail-in, Chapter 11 reorganization plans cannot be confirmed without some indicia of requisite creditor support.[19] Generally, impaired creditors are entitled to vote to accept (or reject) a Chapter 11 plan. The plan is not accepted by creditors of a class unless at least one-half of the creditors voting, holding at least two-thirds in dollar amount of claims, accept the plan.[20]

Chapter 11-like procedural and substantive protections for creditors are nonexistent in a regulatory bail-in. In bail-in, a non-U.S. SIFI's debt may be converted to equity without any advance notice to, input from or assent by holders of the debt instruments being converted to equity. Arguably, this is a fundamental lack of due process for creditors that is so contrary to U.S. policy that a U.S. court should not recognize the non-U.S. regulator's use of the bail-in remedy.

However, strong countervailing considerations suggest that a U.S. court faced with a challenge by a U.S. holder of debt bailed-in by a non-U.S. regulator may dismiss the creditor challenge and recognize the non-U.S. bail-in remedy. While Chapter 11 contemplates creditor due process and participation, there are two other significant U.S. insolvency regimes that, like bail-in, vest considerable authority in U.S. regulators to act swiftly, with little or no input from creditors or other stakeholders. The rationale behind these U.S. laws, like bail-in, ultimately is to protect the public interest.

One such law is the Federal Deposit Insurance Act (the FDIA).[21] Under the FDIA, a bank can be resolved by the Federal Deposit Insurance Corporation (FDIC) with no advance notice to or assent by the bank's creditors — including by transfers of selected assets to a purchaser or "bridge bank."[22] There is a very long history in the U.S. of banks being resolved rapidly — even over a weekend — under the FDIA. This regime, in short, vests great authority exclusively in the hands of the FDIC, much like bail-in.

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[17] *See* Judgment, *Ad Hoc Grp. of Vitro Noteholders v. Vitro SAB de CV*, No. 12-10542 (5th Cir. Nov. 28, 2012).

[18] *See, e.g., Deutsche Bank AG v. Metromedia Fiber Network, Inc.*, 416 F.3d 136, 141-43 (2d Cir. 2005) (describing extraordinary cases in which nondebtor releases are available).

[19] *See* 11 U.S.C. § 1129(a).

[20] *See* 11 U.S.C. § 1126.

[21] 12 U.S.C. § § 1811-1831aa.

[22] *See* 12 U.S.C. § 1821(n).

Likewise, Dodd-Frank contains a new insolvency regime exclusively for large, systemically important financial institutions.[23] Dodd-Frank was enacted in response to the 2008 financial crisis. Under this regime, known as the "Orderly Liquidation Authority," the FDIC may be appointed as receiver of a financial company with virtually the same powers as it has under the FDIA with respect to U.S. banks.[24] Again, such powers may be exercised with no advance notice to, or input from, creditors or other stakeholders. While such powers do not explicitly include the authority to unilaterally convert debt to equity, such powers are implicit, *e.g.*, if the FDIC transfers the institution to a bridge bank, it can later distribute equity in the bridge bank to holders of the bank's debt.

Accordingly, U.S. courts might ultimately conclude that foreign regulatory bail-in of an insolvent foreign SIFI is consistent with U.S. law and public policy. Indeed, bail-in is one of many pieces of legislation (including Dodd-Frank) enacted by numerous countries following the financial crisis that vests home regulators with the significant, centralized authority to act swiftly to avoid or mitigate a national, economic catastrophe. Accordingly, a U.S. court facing a challenge to non-U.S. bail-in likely would be very reluctant to second-guess a determination made by duly constituted, non-U.S. regulatory authorities, that such authorities needed to implement extraordinary bail-in measures in an effort to maintain economic and social stability.

[23] Pub. L. 111-203 (codified as amended in scattered sections of U.S.C.).

[24] *See* 12 U.S.C. § 5390.

Circuit Splits Emerge Regarding Trademark Licensees' Bankruptcy Rights

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The U.S. Bankruptcy Code generally protects intellectual property licensees when a licensor files for bankruptcy. In particular, Section 365(n) provides that if the debtor is the licensor under a patent or copyright license that is "rejected" in bankruptcy, the licensee has the option either to retain its rights as they existed on the bankruptcy petition date and continue its performance, or to treat the license as terminated. *See* 11 U.S.C. § 365(n). Section 365(n) was enacted in response to the U.S. Court of Appeals for the Fourth Circuit's decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), which held that a licensee of patents, copyrights and trademarks lost its license rights when its license was rejected in bankruptcy.

Although Section 365(n) was enacted to avoid the holding in *Lubrizol* and to protect businesses that depend on licensed intellectual property rights, trademark licensees historically have not benefited from these protections because, on its face, Section 365(n) does not apply to trademark licenses. Accordingly, in the Fourth Circuit at least, even after the enactment of Section 365(n), trademark license agreements that are "executory" may be rejected pursuant to Section 365 with the same adverse results for licensees as in *Lubrizol*: A licensee whose trademark is rejected in bankruptcy can be stripped of its rights to use a licensed trademark.

However, in S*unbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012), *cert. denied* 2012 WL 4812510 (U.S. 2012) (to be published in S. Ct.), the U.S. Court of Appeals for the Seventh Circuit reached a different conclusion, creating a split with the Fourth Circuit's decision in *Lubrizol* regarding the rights of a trademark licensee whose trademark license was rejected in bankruptcy.[25] Prior to the *Sunbeam* decision, if a trademark license was rejected in bankruptcy, there was considerable risk that the licensee would lose its right to use the licensed trademark, absent entry into a new licensing agreement. In *Sunbeam*, the Seventh Circuit held that a trademark licensee may continue to use its licensed trademark following the debtor-licensor's rejection of the trademark license. Accordingly, since *Sunbeam*, in the Seventh Circuit at least, when their licenses are rejected, trademark licensees have protections comparable to statutory protections expressly granted under Section 365(n) to licensees of other forms of intellectual property.

"Prior to the *Sunbeam* decision, if a trademark license was rejected in bankruptcy, there was considerable risk that the licensee would lose its right to use the licensed trademark."

Importantly, Section 365(n) protections are relevant and available only if an intellectual property license agreement is "executory" and therefore susceptible to "rejection" by a debtor under Section 365 of the Bankruptcy Code. Accordingly, a trademark licensee that seeks to avoid bankruptcy rejection of a license will want to show that its license terms are non-executory (within the meaning of Section 365), such that the license is not capable of rejection. Likewise, parties negotiating terms of trademark license agreements should consider whether prospective terms will (or will not) result in an "executory" license agreement that is susceptible to rejection in bankruptcy. In this regard, perpetual, royalty-free, exclusive trademark licenses may be non-executory, and the U.S. Court of Appeals for the Third Circuit has so held. *In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010) (holding that a perpetual, royalty-free, exclusive trademark license agreement was not an executory contract that can be rejected in bankruptcy). Prospective trademark licensees may want to negotiate for such perpetual, royalty-free, exclusive terms to reduce possible risk of future bankruptcy rejection and loss of their trademark use rights.

However, not all federal circuit courts agree that perpetual, royalty-free, exclusive trademark licenses are non-executory. In *Lewis Brothers Bakeries Inc. v. Interstate Brands Corp.* (In re Interstate Bakeries Corp.), 690 F.3d 1069 (8th Cir. 2012),[26] the U.S. Court of Appeals for the Eighth Circuit split with the Third Circuit by holding that a perpetual, royalty-free, exclusive trademark license agreement was executory and subject to rejection in bankruptcy.

This circuit-level split of views about whether perpetual, royalty-free and exclusive trademark license agreements are (or are not) executory agreements susceptible to bankruptcy rejection heightens the importance of the Seventh Circuit's Sunbeam ruling in favor of the rights of trademark licensees whose licenses ultimately are rejected in bankruptcy.

[25] *See* "Seventh Circuit Rules on Trademark Licensees' Bankruptcy Rights" (July 27, 2012), *available at* http://www.skadden.com/insights/seventh-circuit-rules-trademark-licensees-bankruptcy-rights.

[26] *See* "Rejection of Perpetual, Royalty-Free, Exclusive Trademark License Permitted by Eighth Circuit Ruling: *Lewis Brothers Bakeries Inc. v. Interstate Brands Corp.*" (Oct. 1, 2012), *available at* http://www.skadden.com/insights/rejection-perpetual-royalty-free-exclusive-trademark-license-permitted-eighth-circuit-rulin.

Ninth Circuit Restricts Bankruptcy Courts' Ability to Adjudicate Fraudulent Transfer Actions

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It's been more than 18 months since the U.S. Supreme Court issued its controversial decision in *Stern v. Marshall*.[27] The Court ruled in *Stern* that a bankruptcy judge could not constitutionally enter a final ruling on a debtor's state law "core" counterclaim against a litigant that filed a proof of claim against the debtor's bankruptcy estate, unless the debtor's counterclaim "stems from the bankruptcy itself" or adjudication of the debtor's counterclaim "necessarily" would resolve the creditor's proof of claim.

We previously wrote that the Supreme Court has rendered other rulings that, taken together with *Stern*, suggest bankruptcy judges' authority to enter final rulings in other categories of more significant core proceedings also may be in doubt.[28] In particular, in *Granfinanciera, S.A. v. Nordberg*, the Court ruled that defendants in fraudulent transfer litigation have a constitutional right to a jury trial, and Congress, therefore, cannot assign adjudication of such litigation to a "non-Article III court," *i.e.*, a court other than a federal district court vested with the authority to conduct jury trials, so long as the defendants have not appeared in the bankruptcy proceedings by submitting a proof claim.

As we previously stated, a possible implication of the reasoning in *Granfinanciera*, when combined with *Stern*'s ruling that bankruptcy judges have no constitutional authority to enter final rulings on a debtor's state law counterclaim, is that bankruptcy judges also may be foreclosed from entering final orders in fraudulent transfer actions, at least where the defendants have not filed proofs of claim. The Ninth Circuit Court of Appeals in *Executive Benefits Ins. Agency, Inc. v. Arkison*[29] followed this logic in recently ruling that bankruptcy judges are in fact precluded from entering final judgments in such actions, despite the fact the Bankruptcy Code classifies such actions as "core" proceedings that bankruptcy judges may finally adjudicate.

The implication of *Bellingham* is bankruptcy judges no longer can enter any type of ruling on fraudulent transfer actions at all. The reason is that the Bankruptcy Code creates only two types of bankruptcy proceedings: "core" proceedings and "noncore" proceedings. Whereas bankruptcy judges may enter final rulings in core proceedings, they only may enter proposed findings of fact and conclusions of law in noncore proceedings for further review by the district court, unless the parties consent to entry of final orders. As noted above, the Bankruptcy Code classifies fraudulent transfer actions as core proceedings. If, as the Ninth Circuit ruled, bankruptcy judges cannot enter final orders in such actions, then there arguably is no statutory basis for a judge to enter proposed findings in such actions, as that mechanism is only available for noncore matters — not core, fraudulent transfer actions.

However, the Ninth Circuit took a contrary view. It filled the statutory "gap" created by its ruling — *i.e.*, a "gap" that leaves fraudulent transfer actions unable to be adjudicated by bankruptcy judges in any fashion at all — by concluding that bankruptcy judges effectively

[27] 131 S. Ct. 2594, rehearing denied 132 S.Ct.56 (2011).

[28] *See* "Chapter 11 Litigation Strategies After the Supreme Court's Decision in *Stern v. Marshall*" (2011), *available at* http://www.skadden.com/insights/chapter-11-litigation-strategies-after-supreme-court%27s-decision-istern-v-marshalli.

[29] No. 11-35162, 2012 WL 6013836 (9th Cir. Dec. 4, 2012).

"The implication of *Bellingham* is that bankruptcy judges no longer can enter any type of ruling on fraudulent transfer actions at all."

may treat fraudulent transfer actions as noncore proceedings and, therefore, may render proposed findings of fact and conclusions of law in such proceedings for further review by the district court. This position is consistent with the rulings of numerous lower courts post-*Stern*,[30] though it conflicts with dictum from the Seventh Circuit.[31]

Although the Bankruptcy Code provides that parties nonetheless may consent to entry of final orders by bankruptcy judges in noncore matters, one of the controversies created by *Stern* is the type of consent necessary to evidence a party's agreement to entry of final orders. The Supreme Court held that a creditor's submission to a bankruptcy court's jurisdiction by filing a proof of claim did not constitute consent to adjudication of a separate litigation against the creditor.

The Ninth Circuit addressed this issue in its *Bellingham* decision. As an initial matter, the court noted there are certain bankruptcy rules that could be construed as requiring express consent, *i.e.*, that a litigant cannot impliedly waive its right to be heard by an Article III court, and thereby be deemed to have impliedly consented to final adjudication by a bankruptcy judge.[32] The Ninth Circuit concluded, however, that notwithstanding these rules, a litigant could impliedly waive such a right and thereby be deemed to have consented to final adjudication.

In doing so, the Ninth Circuit did not attempt to formulate a rule by which to determine implied waiver/consent. It concluded, however, that based on the facts of the case, the defendants "fully litigated the fraudulent conveyance action before the bankruptcy court and the district court, without so much as a peep about Article III." To allow a litigant to argue for the first time on appeal that the bankruptcy judge had no authority to finally adjudicate the matter would be to allow litigants to improperly sandbag the court.

Many other courts also have concluded that litigants may impliedly consent to final adjudication of fraudulent transfer actions.[33] However, the U.S. Court of Appeals for the Sixth Circuit has suggested otherwise.[34] In an effort to bring clarity to the issue of consent, certain courts have entered standing orders requiring that parties to bankruptcy adversary proceedings state explicitly whether or not they consent to final adjudication to the various claims asserted in the proceeding or, alternatively, whether they will seek withdrawal of the claims to the district court.[35]

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[30] *See, e.g., Retired Partners of Coudert Bros. Trust v. Baker & Mackenzie LLP* (*In re Coudert Brothers LLP*) No, 11-2785(cm) 2011 U.S. Dist. LEXIS 110425 (S.D.N.Y. Sept. 23, 2011); *In re Crescent Resources*, 2011 WL 3022554 (Bankr. W.D. Tex. July 22, 2011); *Sanders v. Muhs* (*In re Muhs*), No. 09-10564, 2011 WL 3421546 (Bankr. S.D. Tex. Aug. 2, 2011); *Paloain v. Am. Express Co.*, No. 11 C5360, 2011 U.S. Dist. LEXIS 99804 (N.D. Ill. Sept. 1, 2011).

[31] *In re Ortiz v. Aurora Health Care, Inc.*, 665 F.3d 906 (7th Cir. 2001).

[32] *See* Fed. R. Bankr. P. 7008 and 7012(b).

[33] *See In re Coudert Bros. LLP*, No. 11-2785, 2011 WL 5593147 *9 (S.D.N.Y. Sept. 23, 2011) ("There is an alternative basis on which Judge Drain might have possessed final adjudicative authority over the Claims, based on the parties' consent."); *In re Am. Hous. Found.*, No. 09-20232, 2012 WL 443967 *11 (Bankr. N.D. Tex. 2012); *Ardi Ltd. Partnership v. River Entertainment Co.*, 467 B.R. 808, 822–24 (Bankr. W.D. Pa. 2012); *cf. Burtch v. Huston (In re USDigital, Inc.)*, 461 B.R. 276, 279 (Bankr. D. Del. 2011) (noting lack of clarity).

[34] *Waldman v. Stone*, 698 F.3d 910, 918 (6th Cir. 2012) ("Waldman's [constitutional] objection … implicates not only his personal rights, but also the structural principle advanced by Article III. And that principle is not Waldman's to waive.").

[35] *See*, *e.g.*, Bankr. S.D.N.Y. R. 7008-1 (effective Apr. 16, 2012).

The Ninth Circuit's decision is important because it is the first appellate court ruling on fraudulent transfer issues since *Stern*. In many respects, however, it is not a surprise, since all arrows were pointing in this direction.

The notion still is something of a shock to the system, however, as bankruptcy practitioners have long understood fraudulent transfer actions to be the proper domain of bankruptcy judges in all respects. They still will be, so long as parties consent. Yet there is little question that many more fraudulent transfer actions will now become the province of the district courts; that litigants may face strategic choices that may lead to charges of forum shopping; and that absent clear rules regarding consent, parties can be expected to engage in litigation posturing if rulings do not go their way.

Forewarned Is Forearmed: Adapting for Business in a Eurozone Crisis

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The financial difficulties in the eurozone have been widely reported, in particular the weak position of peripheral sovereigns such as Greece, Spain, Portugal and Italy. While discussion of these issues may have taken on a less urgent tone, the risk remains that the eurozone may experience catastrophic events, potentially including one or more member states leaving the currency zone.

In addition to the extreme stress on sovereigns, a severe corporate credit crunch likely will affect the eurozone in the next few years. It has been estimated that between 2012 and 2015, $1.3 trillion of eurozone corporate debt will need to be refinanced, including $325 billion of speculative-grade, nonfinancial corporate debt. Moreover, a recent IMF report predicted that European financial institutions will experience deleveraging of between €2 trillion and €4 trillion before the end of 2013.

Legal Risk

Redenomination risk arising from the possible departure of one or more states from the eurozone, or the breakup of the currency union, remains the foremost legal issue.

The *lex monetae* principle provides that when a debt is expressed in a particular currency, there is an implicit choice that the law of that currency's country will determine what that money is. As the euro is a multinational currency, there is no one jurisdiction to which the *lex monetae* can refer. However, if a eurozone state were to leave the single currency, it is likely that contracts governed by its domestic laws, as well as domestic obligations of that state's government and accounts with domestic banks, would be redenominated by emergency legislation to a new legal tender. In response, it is likely that other eurozone states also would enact emergency legislation relating to currency and payment obligations.

Currency Risk

If a periphery state were to leave the euro, its new currency likely would devalue rapidly against the euro, which over time may strengthen considerably against other currencies,

including the U.S. dollar. As the international obligations of the government of the periphery state leaving the euro probably would be unaffected by any redenomination, such a periphery state is likely to undergo a default caused by currency devaluation.

Business Risk

The business consequences of a departing state are hard to predict and could range from manageable to disastrous. If a eurozone state were to leave, its government likely would enact oppressive controls on the movement of currency and goods. Such measures may be met by equivalent measures in other EU states and likely would lead to further negative impacts of currency changes. Businesses can take practical steps to reduce potential risks, including:

- Considering the governing law of significant contracts in light of redenomination risk. For example, assuming that contractual obligations governed by English law and denominated in euros will continue to be payable in that form despite the departure of a state, drafting or amending contracts so they are governed by English law may mitigate redenomination risk.
- Achieving greater certainty for euro-denominated contracts by defining euro with reference to the currency in circulation and accepted as legal tender in a specific eurozone state. For example, a U.S. company contracting with a Greek company may wish to avoid receiving payment in a devalued currency following a Greek exit from the euro — and this may be achieved by defining euro as the currency in circulation and accepted as legal tender in Germany.
- Identifying and evaluating other contractual clauses that may be implicated as a result of events in the eurozone. Particular care should be taken when drafting clauses governing matters such as place of payment, material adverse change, *force majeure*, the impact of rating downgrades, and the impact of market disruption on pricing, termination rights, cross-default, netting and setoff.
- Examining supply chains as far back as possible to identify any potential vulnerabilities. If a state leaves the eurozone, there is a likelihood of supply chain disruption, and this risk can be addressed by building up precautionary inventories of supplies and establishing or identifying alternative sources.
- Assessing the health of business-critical banks both within and outside the eurozone. Severe stress in the eurozone may put banks at risk and diminish their ability and willingness to lend.
- Sweeping cash held in eurozone bank accounts on a regular basis, in particular accounts in those states most at risk of leaving.
- Matching assets and liabilities on a national basis within the eurozone also may mitigate the effects of a redenomination.
- Considering the effect of a redenomination on a business' treasury functions, cash management systems, invoicing and billing, cash reserves and financial management policy also should be focuses of euro risk reduction efforts.

"The eurozone's shifting political context and continuing legal uncertainty are factors that must be considered in all transactions."

The eurozone's shifting political context and continuing legal uncertainty are factors that must be considered in all transactions. Companies should weigh practical measures to mitigate what could be extraordinary consequences resulting from any potential breakup of the eurozone. An ounce of prevention may have more worth than ever.

Negative Outlook for Exit Consents Under English Law

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An exit consent is a fairly standard tool in bond restructurings in the United States. An issuer makes offers to bondholders to exchange their bonds for new bonds on different terms, which provide that holders who accept the offer (exiting bondholders) agree to vote in favor of (consent to) changing the terms of the existing bonds. Incorporating such "exit consents" into an exchange offer incentivizes bondholders to accept the exchange offer because, if a sufficient majority of acceptances are received, the exchange offer will be consummated and any minority of nonaccepting bondholders will be left with significantly diminished rights under the modified terms of the pre-existing bonds that they continue to hold.

The use of exit consents in the restructuring of bonds governed by English law has been the subject of recent critical analysis by the English court in *Assénagon Asset Management S.A. v. Irish Bank Resolution Corporation (formerly Anglo Irish Bank Corporation Limited)* [2012] EWHC 2090 (Ch). This case involved the Anglo Irish Bank, formerly Ireland's third-largest bank, which focused on commercial property lending. As a result of the financial crisis, it required very significant support by the Irish state and was nationalized in January 2009. In the months that followed, the Irish government provided nearly €23 billion in capital. Assénagon, a hedge fund, held €17 million in subordinated floating rate notes, which were due to mature in 2017.

The Anglo Irish Bank proposed an exchange offer to the holders of its notes. Under the terms of the exchange offer, the holder of a subordinated note would receive a new unsubordinated note with a face value of 20 cents for every one euro under the original note. The exchange offer provided that the terms of existing notes that were not exchanged would be altered by exiting noteholder consents to an extraordinary resolution of the rights and value of the pre-existing notes. Under the proposal, a note with a face value of €1,000 subsequently would have a value of only €0.01. Assénagon did not participate in the proposed exchange offer, and its €17 million of notes were converted to a new note with a face value of only €170. For Assénagon and other holders who did not participate in the exchange, the value in their notes was destroyed.[36]

Assénagon sought a declaration in the English court that the resolution reducing the value of its nonexchanged notes was invalid. The issue of most interest addressed in the *Anglo Irish Bank* case is whether the resolution of nonexchanging noteholder rights constituted an abuse of the power of the voting majority or, in other words, whether

[36] In the U.S. there is a general prohibition on the modification of payment terms without unanimous consent of all holders under Section 316 of the Trust Indenture Act of 1939.

it can be lawful for the majority to lend its aid to the coercion of a minority by voting for a resolution that expropriates the minority's rights under their bonds for a nominal consideration. Mr. Justice Briggs answered in the negative. The judge described the exit consent as:

> quite simply, a coercive threat which the issuer invites the majority to levy against the minority, based upon the fear of any individual member of the class that, by rejecting the exchange and voting against the resolution, he (or it) will be left out in the cold. … Putting it as succinctly as I can, oppression of a minority is of the essence of exit consents of this kind.

While the facts of the *Anglo Irish Bank* case are extreme and may well be distinguishable in future cases, the judge expressed strongly critical views on the use of exit consents as a restructuring tool. The *Anglo Irish Bank* decision is under appeal, and the outcome will be eagerly awaited by restructuring professionals in Europe and elsewhere where English law is deployed in corporate finance.

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Financial Regulation

In the U.S., Europe and Asia, 2012 saw measured progress in the implementation of recent regulatory reforms, the Basel capital rules, the deleveraging of the financial services firms and deliberations about the role of financial supervision, in the midst of a halting recovery from the financial crisis. In Europe, the immediate financial crisis affecting certain EU member states has stabilized for the moment, while the debate continues regarding the shape and scope of EU-wide financial services regulation. At the same time, the U.S. and the U.K. are fundamentally restructuring their respective regulatory frameworks.

Despite the immense work left to be done, the regulatory progress to date offers the financial services industry at least the outlines of certainty in a number of important areas. This section reflects upon developments in financial regulation in 2012 and highlights important predictions for 2013.

President Obama's reelection and the retention of a Democratic majority in the U.S. Senate confirms that the Dodd-Frank Act is here for the foreseeable future. Two years after enactment, implementation of the act has been uneven, and much remains to be done. Many Dodd-Frank provisions took effect in 2012 without the benefit of implementing regulations. In addition, a number of the proposed rules generated a significant amount of substantive public comment and criticism — as well as legal challenges — leaving the industry with limited guidance on a number of important issues.

As the regulatory reform process has moved forward around the world, significant consequences and challenges for institutions operating across borders have emerged. Whether with respect to swaps regulation, short-selling, private fund restrictions or other opportunities for regulatory arbitrage, regulatory action in 2012 highlighted the continuing need for, and difficulty of, global coordination on financial regulation.

Last year also saw a renewed post-crisis focus by U.S. prosecutors and regulators on enforcement, with numerous ground-breaking and record-setting penalties. There were a large number of high-profile money laundering and sanctions-based settlements in 2012 — a trend that likely will continue to present a challenge to global financial services organizations throughout 2013 — as well as a record settlements with respect to practices in setting LIBOR. Large settlements regarding mortgage lending and servicing practices, coupled with the newly organized Consumer Financial Protection Bureau's proving to be a robust regulator with a series of large consumer lending settlements, also indicate that 2013 likely will see continued enforcement activity.

51 Swap Regulation: The CFTC and SEC Chart the Road Ahead

53 The JOBS Act: Important Questions for Private Funds

55 What Lies Ahead for US Economic Sanctions Against Iran

57 Year One at the Consumer Financial Protection Bureau

58 The EU's Short-Selling Regulation: Notable Requirements and Restrictions

60 Restructuring the UK Regulatory Framework: What the Financial Services Industry Can Expect

62 English Limited Partnerships: Liability Definition Remains Elusive

Swap Regulation: The CFTC and SEC Chart the Road Ahead

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The Dodd-Frank Act authorized the CFTC and the SEC to develop comprehensive regulations for swap transactions and security-based swaps, respectively. Considering swaps generally were unregulated before Dodd-Frank, the CFTC and the SEC have been writing for two years on a blank slate. In 2012, the agencies began to fill in many of the blanks, but much work remains for 2013 and beyond.

In 2012, the CFTC and the SEC finished the specific joint Dodd-Frank Act assignments Congress gave them: The agencies finalized the product definitions (rules defining "swaps" and "security-based swaps") and the entity definitions (rules defining "swap dealer" and "major swap participant"). These were seminal steps in the creation of a regulatory structure for swaps. In the bulk of the Dodd-Frank rulemaking areas, which Congress left to each agency to address separately, the SEC and CFTC approaches diverged, with the SEC taking a step back and concentrating on its other regulatory responsibilities, putting off the development of regulation for security-based swaps.

The CFTC, on the other hand, pushed forward in 2012 to adopt rules in many of the major areas Dodd-Frank required. The agency finalized rules setting out requirements for, among other things:

- swap reporting and recordkeeping;
- swap dealer registration and business conduct standards, including special customer protections and disclosures;
- swap documentation;
- special protections for swap customer margin funds (called legally segregated operationally commingled, or LSOC);
- the types of interest rate and credit default swaps that must be cleared by derivatives clearing organizations to prevent systemic risk; and
- the scope of the exemption from that mandate available to "commercial end users."

All of these new rules required fine-tuning; CFTC staff also issued a stream of more than 70 no-actions and interpretations to try to address the unintended direct and indirect consequences of many of the agency's new regulations.

These CFTC final rules were major, resource-intensive undertakings, but constituted at best only half of the major issues the agency must tackle in fashioning a swap regulatory structure. In 2013, the CFTC is expected to take final action on:

- required pre-trade price transparency for swaps;
- registration and regulation of swap execution facilities;
- the swap trading mandate;
- block trading standards for swaps;
- cross-border application of its new swap regulations;
- margin rules for uncleared swaps; and
- the scope of the clearing mandate for currency, equity and commodity swaps.

In addition, the CFTC will reconsider the issue of speculative position limits at the same time it pursues an appeal from a district court decision invalidating the physical commodity position limits the CFTC adopted in 2011.[1]

Trends to Watch

Some big-picture trends developed in 2012 that will necessarily permeate the CFTC's consideration of the yet-to-be-finalized rules and the implementation of the rules it already has adopted.

Cross-Border Issues. The CFTC's 2012 proposals for cross-border application of its rules have resulted in the expression of serious concerns from non-U.S. market regulators that the CFTC's swap rules exceed the agency's authority and superimpose rules on market participants outside of its jurisdiction. These proposals have had real consequences, with some market participants deciding to eschew transacting with U.S. entities to avoid becoming subject to CFTC swap regulation. These actions already have closed off some sources of liquidity to U.S. market participants.

The CFTC and its foreign counterparts can be expected to discuss how to achieve the coordinated international regulation of a global marketplace. Without this kind of cooperation, regulatory disparities and asymmetrical application of derivatives rules could lead to losses in liquidity and increased costs that could harm many market participants. The December 2012 announcement by the CFTC and its fellow international regulators pledging a harmonious and cooperative approach in the future seems like a solid step in the right direction.[2]

> "Without international cooperation, regulatory disparities and asymmetrical application of derivatives rules could lead to losses in liquidity."

Swap "Futurization." The CFTC also will need to adapt to market evidence that its new swap regulations (based on somewhat different statutory provisions and structures from futures) have caused exchanges and other market participants to try to achieve their trading and hedging goals through futures products rather than swaps. The Intercontinental Exchange's (ICE) October 2012 decision to shift its energy swap business to futures to take advantage of the decades of regulatory certainty that futures have experienced was the first evidence of this phenomenon, which some have dubbed the "futurization of swaps." This trend is widely viewed as a response to customers that feared the cost and uncertainty of many of the swap regulations the CFTC promulgated, a fear that as of yet is unabated.

These cross-border and futurization forces suggest that the CFTC's still-to-come final rules will need to focus more on, and be more attentive to, the expected costs of new regulations on market participants. Otherwise, in spite of more than two resource-intensive years developing swap regulations, the CFTC may find that the swap markets its rules were designed to cover are much less robust and have fewer market participants than the agency expected when it began this process. More practical attention to the cost of regulation also will allow the CFTC (and the SEC) to be more confident that the final rules it adopts are defensible in court should parties decide to challenge those rules, as we have seen in the past.

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[1] *See ISDA v. CFTC*, No. 11-cv-2146 (D.D.C. Sept. 28, 2012), *appeal docketed*, (D.C. Cir. Nov. 15, 2012).

[2] Joint Press Statement of Leaders on Operating Principles and Areas of Exploration in the Regulation of the Cross-border OTC Derivatives Market, CFTC Press Release (Dec. 4, 2012), *available at*: http://www.cftc.gov/PressRoom/PressReleases/pr6439-12.

The JOBS Act: Important Questions for Private Funds

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On August 29, 2012, the SEC proposed amendments to Rule 506 of Regulation D of the Securities Act of 1933 (Securities Act) that would eliminate its long-standing ban on general solicitation and general advertising for certain securities offerings. The proposal, which implements certain components of the Jumpstart Our Business Startups Act (JOBS Act), would require (1) all purchasers of securities sold in such offerings to be accredited investors and (2) that issuers take reasonable steps to verify that their purchasers are accredited investors.

The proposed amendments remain subject to further change prior to being finalized. In comment letters regarding JOBS Act rulemaking submitted in May and October 2012, the Investment Company Institute (ICI) recommended, among other things, that the SEC investigate the feasibility of crafting a rule similar to Rule 482 under the Securities Act for private fund advertisements. Rule 482 governs any registered fund advertisement containing performance advertising. It prescribes specific calculation methodologies for current yield, tax-equivalent yield, average annual total return and after-tax return, as well as requirements for the disclosures that must accompany performance data.

Recently, an SEC representative, speaking unofficially, indicated that the staff was seeking industry input on the ICI's recommendation, but that it was plausible to expect that certain standardized requirements for private fund performance advertising in the context of general solicitations will be established at the time the final Rule 506 amendments take effect. The SEC representative also confirmed that such standardized performance requirements would not apply to the content of materials presented in one-on-one meetings, whether a fund relies on the old or new provisions of Regulation D (Rule 506(b) and Rule 506(c), respectively). The scope and character of the standardized requirements remain unknown at this time, although the ICI is continuing to press for requirements that are similar to those of registered fund advertisements.

Regardless of the nature of the standardized requirements, private fund advertisements will remain subject to the Investment Advisers Act of 1940 (Advisers Act), specifically the anti-fraud provisions set forth in Section 206 and the rules promulgated thereunder. It should be noted that the definition of advertisement under the Advisers Act includes information communicated "by radio or television." Advisers that avail themselves of the opportunity to conduct radio or television interviews in connection with a general solicitation should be careful to ensure that such communications do not run afoul of the existing advertising rules or the new standardized requirements.

Important Questions

It is expected that a number of private funds will want to make prophylactic 506(c) filings to give themselves the flexibility to speak to the media and engage in other related activities. However, many unresolved questions remain surrounding 506(c) general solicitations by private funds, including:

- **Will a 506(c) election by an issuer that previously relied on 506(b) require the issuer to perform due diligence regarding the accredited investor status of its pre-existing investors?** The SEC has not yet provided guidance on this question. In the event that the SEC requires due diligence, we expect that many private funds will break their existing offerings under 506(b) and, after a certain period of time has elapsed, commence new offerings under 506(c).

- **Will an adviser be permitted to make separate concurrent offerings of similar products under 506(b) and 506(c)?** Logically, two issuers should not be integrated, but the matter is not free from doubt.

- **Will the CFTC harmonize its existing prohibition on advertising by certain commodity pools, including exempt commodity pools under CFTC Rule 4.13(a)(3)?** Given the expansion of the commodity pool definition to include entities using swaps and the removal of the primary exemptions historically used by hedge funds and private equity funds, CFTC regulations present significant open issues. Since the JOBS Act does not mention private funds in its text or the legislative history, the CFTC could conclude that commodity pool rules do not need to be addressed, although this extreme outcome seems unlikely. However, the pace is slow, and the impediment is real.

> "Great care needs to be taken with respect to the content of private fund advertisements to avoid state law issues."

- **How will issuers resolve the "world sky" requirements related to prohibitions on public offerings that exist in virtually all non-U.S. jurisdictions?** Such prohibitions will need to be analyzed on a country-by-country basis to ensure that a U.S. general solicitation does not taint the offshore offering.

- **How will the states respond?** Several states also have raised concerns regarding general solicitations. Given the federal override in Section 18 of the Securities Act regarding Regulation D offerings, such concerns may seem moot. However, in view of the recent activity of the states to prosecute fraud, great care needs to be taken with respect to the content of advertisements to avoid state law issues in addition to Section 206 anti-fraud requirements.

- **How will private funds verify accredited investor status?** The SEC has stated that it is a facts-and-circumstances determination, and standards are evolving. We anticipate that every adviser will ask each new investor to affirm that its subscription was funded without the use of financing.

Responses to these questions will emerge over the next year or two. We expect that standard practices will be established in due course for private fund offerings in the context of general solicitations.

What Lies Ahead for US Economic Sanctions Against Iran

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Economic sanctions appear to be having a dramatic impact on Iran's economy, with both the value of the rial and the volume of Iran's petroleum exports falling dramatically during 2012. Many observers credit the aggressive expansion of U.S. economic sanctions in recent years, and key U.S. policymakers maintain that such sanctions continue to be a promising method of pressuring Iran to abandon its nuclear program. Expect more of the same in 2013: more new sanctions focused on non-U.S. entities that trade with Iran and continued aggressive enforcement of existing U.S. sanctions against Iran, including more large penalty settlements.

Sanctions

Because U.S. persons have been prohibited from most business with Iran since 1995, there is relatively little more that the U.S. government could impose. Instead, the recent expansion of economic sanctions has consisted mainly of secondary sanctions against third-country (*i.e.*, non-U.S., non-Iranian) persons who engage in certain business with Iran. This trend shows every sign of continuing.

President Obama signed nine executive orders imposing new economic sanctions during 2012 alone, six of which related to Iran; the impact of these recent Iran-related orders has fallen primarily on non-U.S. persons. The year ahead undoubtedly will provide occasion for even more executive orders. In late November 2012, the U.S. government called for a deadline of March 2013 for Iran to show "substantive cooperation with" the International Atomic Energy Agency in the agency's efforts to investigate Iran's nuclear program. Assuming the Iranian government does not meet such a deadline to the satisfaction of U.S. leaders, new executive orders imposing more types of sanctions on third-country entities would be a relatively quick way for President Obama to respond.

New statutes also need to be implemented. On January 2, 2013, President Obama signed into law the Iran Freedom and Counter-Proliferation Act, which authorizes additional sanctions on persons doing certain business with Iran's energy, port, shipping and ship-building sectors — each of which already is the subject of wide-ranging U.S. sanctions, but the new law provides cumulative or incrementally broader authorities. As the sanctions pile on, the legal framework becomes increasingly complex, and it can be quite difficult for non-U.S. entities to understand what conduct risks the imposition of U.S. sanctions.

Despite the new authorities to impose sanctions on third-country entities, the U.S. government has been relatively restrained in exercising them. During 2012, the U.S. Treasury Department first applied a 2010 statute to prohibit U.S. financial institutions from opening or maintaining correspondent or payable-through accounts for a non-U.S. financial institution that has engaged in or conducted a significant transaction with a designated Iranian bank. Almost every major Iranian bank has been designated for sanctions, and there likely are some large third-country institutions that meet these criteria. The Treasury Department, however, chose to impose the sanctions against two banks, one based in Iraq and the other based in China, whose names were unfamiliar to many Westerners. Similarly, despite several expansions of the Iran Sanctions Act in recent years, the U.S. State Department has imposed sanctions against relatively few

companies for their involvement in Iran's energy sector. Perhaps that will change in the year ahead, as U.S. policymakers test their expansive and growing authorities in this area.

> "Despite the new authorities to impose sanctions on third-country entities, the U.S. government has been relatively restrained in exercising them."

Sanctioned persons should remember that U.S. government decisions involving economic sanctions are reversible. Although it rarely publicizes these decisions, the U.S. government has lifted such sanctions against hundreds of individuals or entities, including some individuals it previously had branded as terrorists or narcotics traffickers, over the past several years. These decisions usually are made after the sanctioned person petitions for administrative reconsideration to the agency responsible for implementing the sanctions (usually the Treasury Department). The government rarely will admit it made a mistake, but it appears willing to reconsider the imposition of sanctions based on a credible demonstration that circumstances have changed — for example, that the sanctioned person has stopped engaging in the activities that were the basis for sanctions and will never engage in such conduct again.

Enforcement

In addition to enacting new types of economic sanctions, U.S. authorities likely will continue to aggressively enforce existing sanctions against Iran through civil and criminal processes. We should expect continued steep fines against non-U.S. banks that have conducted business for Iranian and other sanctioned clients using U.S. accounts, particularly as regulatory and prosecutorial agencies at the federal and state levels continue to compete with one another for perceived leadership in sanctions enforcement. HSBC and Standard Chartered recently resolved U.S. enforcement actions relating to Iran by agreeing to make steep penalty payments, and similar investigations into non-U.S. banks continue.

Western European banks have been the focus of U.S. sanctions enforcement efforts in recent years, but it seems unlikely that banks from that part of the world are the only ones to have engaged in the conduct. A Japanese bank recently paid a settlement for processing funds transfers through the United States in violation of existing sanctions against Iran and other countries, and press reports have suggested that U.S. authorities are beginning to turn their attention to banks in China. In the year ahead, we may see more U.S. sanctions settlements involving banks from other parts of the world. These sanctions do not apply solely to banks, and perhaps there also will be penalties in new sectors, such as securities or energy.

Of course, it remains to be seen whether or how this continued wave of sanctions and penalties ultimately will persuade Iranian leaders to abandon their nuclear program. Long-standing U.S. economic sanctions against Burma were relaxed significantly during 2012 in response to perceived progress in Burma's transition to democracy, and perhaps 2013 will bring similar good news in another U.S. economic sanctions regime. More likely, however, U.S. economic sanctions with respect to Iran will continue to follow the unmistakable trends seen in recent years: an ever-widening net of new sanctions and continued high-profile enforcement cases.

Year One at the Consumer Financial Protection Bureau

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Since becoming fully empowered with the appointment of Richard Cordray as its director on January 4, 2012, the Consumer Financial Protection Bureau (CFPB or Bureau) has exercised its authority aggressively through the issuance of several groundbreaking enforcement actions, numerous intensive examinations of both banks and nonbanks, and the issuance of a number of proposed and final rules that will affect all consumer financial services providers. 2013 promises to be an even busier year.

The CFPB issued several enforcement orders in the latter half of 2012 that are notable for the high remediation and penalty amounts involved as well as for the specificity of the Bureau's findings. Three high-profile cases involved credit card "add-on" products:

- **Capital One (July 18, 2012).** The CFPB found that Capital One engaged in deceptive marketing and sales practices in connection with credit monitoring and payment protection products offered to its credit card customers. The CFPB alleged that the company's call center employees deviated from sales scripts and misled consumers about the optional nature of the product and whether they had agreed to purchase the service. The consent order required $140 million to be paid in restitution to an estimated two million customers, along with a $25 million civil penalty.
- **Discover Bank (September 24, 2012).** The CFPB found that Discover engaged in deceptive marketing and sales practices in connection with the offering of credit monitoring, identity theft protection and payment protection products. In the Discover order, the CFPB found that the customer service scripts themselves misled consumers by not making it clear that the consumers were purchasing a product, or that the product had a separate fee, as well as with respect to certain other product terms and pricing. The consent order required Discover to pay restitution of $200 million and a $14 million civil penalty.
- **American Express (October 1, 2012).** The CFPB found that American Express engaged in: (1) deceptive debt collection practices regarding waiving or forgiving debt in exchange for settlement; (2) deceptive marketing of a rewards program; (3) charging impermissible late fees; (4) failing to report accurate credit history information; and (5) improperly considering the age of applicants as part of a credit scoring system. The order required remediation payments of $85 million and a $27.5 million penalty.

Notably, each of these enforcement actions was paired with an action by the institution's prudential regulator, indicating that the CFPB and traditional bank regulators likely will work together closely in enforcement actions.

The CFPB has devoted tremendous resources to the exercise of its supervisory duties. The CFPB's depository examination program is in full swing, and the Bureau has commenced on-site examinations of certain nondepository financial institutions, including nonbank mortgage lenders. Examinations to date have proved to be both comprehensive and intensive. The Bureau recently finalized the rules to identify nondepository "larger participants" in the consumer reporting and debt collection markets for supervision by the CFPB. In 2013, the CFPB will continue with larger-participant rulemakings in other nondepository markets, which will subject a wider range of financial services companies to supervisory examinations.

Finally, the CFPB has exercised its rulemaking and guidance functions. In 2012, the CFPB issued proposals regarding loan servicing standards, TILA and RESPA disclosures, and loan originator compensation. In addition, it issued guidance regarding fair lending, marketing of ancillary credit card products and other topics. The Bureau also has conducted a number of consumer market studies, indicating it intends to engage in "data-driven" enforcement and rulemaking.

Looking Ahead

The Bureau will issue a number of important rulemakings in 2013, including mortgage origination rules addressing the "ability to repay" and "qualified mortgage" safe harbor. We expect that the Bureau will then turn to developing rules for new mortgage and small business data reporting requirements. The Bureau also may take action to limit the use of mandatory pre-dispute arbitration provisions in loan agreements and to limit overdraft fees and prepaid card fees.

The EU's Short-Selling Regulation: Notable Requirements and Restrictions

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Patrick Brandt / London

The European Union's regulation on short-selling and certain aspects of credit default swaps (Regulation (EU) No 236/2012) (the Regulation) came into effect across the EU in November 2012. The Regulation is designed to remove the panoply of short-selling requirements previously in place in different EU member states. However, there are two main exceptions. First, the Austrian short-selling regime will remain in place until the end of a transitional period that expires on July 1, 2013. Second, EU countries can introduce separate, emergency short-selling measures in liaison with the European Securities and Markets Authority (ESMA), the EU securities regulator, which Spain did in November 2012.

The Regulation also gives ESMA power to ban or restrict short-selling and impose additional disclosure requirements, which is part of a tentative trend toward EU regulation. It is supplemented by a number of delegated acts that apply across the EU and were introduced after very short consultation periods. The new regime is highly technical and has raised a large number of issues. It is possible that the regime will be amended after its review by the European Commission in 2013.

The Regulation focuses primarily on short positions taken in EU shares and EU sovereign debt, and on EU sovereign credit default swaps (CDS).

Notification and Disclosure

Holders of net-short positions in EU shares and EU sovereign debt that cross certain thresholds will trigger a number of regulatory notification and public disclosure obligations:

- Net-short positions in EU shares must be notified to the local regulator where the net-short position reaches/falls below 0.2 percent of the issued share capital of the company concerned (and in increments of 0.1 percent above that initial threshold).

Public disclosure must be made for net-short positions of 0.5 percent (and again, of increments of 0.1 percent above that initial threshold); and

- Net-short positions of EU sovereign debt and uncovered CDS positions that cross specific thresholds published by ESMA for each member state must be notified to the local regulator. There is no public disclosure obligation.

Calculating Net-Short Positions

The rules on calculating net-short positions contain complex underlying detail, but broadly:

- The net-short position in EU shares is the position remaining after deducting any long position held in the company's issued share capital from any short position held in relation to that capital; and
- The net-short position in EU sovereign debt is the position remaining after deducting (1) any long position in relation to issued EU sovereign debt and any long position in highly correlated debt instruments of a sovereign issuer from (2) any short position held in relation to the same EU sovereign debt.

There also are special rules for how fund managers and groups calculate and report net-short positions:

- A fund manager must aggregate the net-short positions of the funds and portfolios under its management for which the same investment strategy is pursued in relation to a particular issuer. This includes the positions of funds and portfolios that have been delegated to it by a third party but excludes net-short positions taken by its own delegates; and
- A group must aggregate the net-short and long positions held by the entities within that group, excluding the positions of fund management entities, and report any group net-short position.

Restrictions on Short-Selling and Uncovered CDS

Uncovered short-selling of EU shares or EU sovereign debt is banned. Therefore, short-sellers need to put arrangements in place to ensure that the relevant financial instrument is available for settlement. There are further restrictions as to what type of arrangements will be sufficient. For example, borrowing or location agreements only can be entered into with certain third parties.

CDS transactions only can be entered into for legitimate hedging purposes, which include:

- a long position in the EU sovereign debt of the relevant issuer;
- any position or portfolio used in the context of hedging exposures to the sovereign issuer referenced in the CDS;
- any assets or liabilities that refer to public sector entities in the member state whose EU sovereign debt is referenced in the CDS, such as exposures to central, regional and local administration, public sector entities or guaranteed exposures;

- exposures (such as loans, counterparty credit risk, receivables and guarantees) to private sector entities established in the member state that is referenced in the EU sovereign CDS; and
- indirect exposures to any of the above entities through indices, funds or special purpose vehicles.

"The regulation is designed to remove the panoply of short-selling requirements previously in place in different EU member states."

Exemptions

The Regulation contains a number of exemptions that can be used by market makers, authorized primary dealers on sovereign debt markets, and firms that enter into short sales or have net-short positions in relation to stabilization programs.

Extraterritoriality

The European Commission and ESMA have asserted that the Regulation has extraterritorial effect outside the EU. Therefore, non-EU persons contracting outside the EU are subject to the same reporting requirements and restrictions as EU-based persons. This is controversial, but we expect any non-EU financial services group with EU places of business will look to comply with the Regulation on a global basis. Those entities with no EU place of business or EU subsidiary will need to consider the legal and practical issues of whether to comply with foreign laws, which we expect may include an assessment of enforcement risk.

Restructuring the UK Regulatory Framework: What the Financial Services Industry Can Expect

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Patrick Brandt / London

An operational split of the U.K.'s Financial Services Authority (FSA), abolishing the agency and dividing its functions and staff between two new regulators,[3] began earlier this year. The formal handover will become effective in April 2013, when the two new regulators formally assume their roles.

The new financial services regulators will be:

- The Prudential Regulation Authority (PRA), which will be the prudential regulator of banks, building societies, insurance companies and systemically important investment firms with permission to deal as principal. The PRA will be a subsidiary of the Bank of England and will implement the macroprudential policies of the bank's Financial Policy Committee, which is charged with maintaining U.K. financial stability;
- The Financial Conduct Authority (FCA), a self-standing body that will oversee the conduct of business by all regulated firms, including those regulated by the PRA. It also will be the prudential regulator of any financial services firm that is not PRA-regulated. The FCA will inherit the FSA's role as listing authority and also will be responsible for regulation of U.K. wholesale financial markets, including investment

[3] The FSA's current regulatory responsibilities for settlement systems and recognized clearing houses will be transferred to the Bank of England and not to either of the new regulators.

exchanges. Finally, the FCA also may be given the Office of Fair Trading's current authority to regulate consumer credit.

The move to a new "twin peaks" model of regulation comes with implementing laws that require both regulators to consult with each other on a number of issues, including applications made by U.K.-regulated firms. Although not expressly stated — or even admitted — it appears that the PRA will have the upper hand, as it has been given, in certain circumstances, a right of veto and direction concerning certain FCA-regulated matters.

Impact on Firms

- Firms already regulated by the FSA will be grandfathered into the new regime — they will not need to reapply to the PRA or FCA to continue carrying out U.K.-regulated financial services business.
- Both regulators will, in time, have their own separate rulebooks. Initially, each regulator will adopt the relevant parts of the existing FSA Rulebook. Both, however, have indicated that they will review these rules with a view toward adopting separate rulebooks in the future. These separate rulebooks likely will increase the compliance burden for groups that contain both PRA- and FCA-regulated businesses.
- There will be a change in supervisory approach, which already is starting to be felt in the U.K. Both the PRA and FCA will take a more judgment-based and interventionist approach to regulation. Each regulator expects to challenge senior management business decisions that conflict with regulatory objectives, although they acknowledge that their own decisions may be proven wrong in time. In short, U.K. regulators will aim to prevent what they see as the flawed decision-making that led to the financial crisis.

> "The new U.K. regulatory model represents a toughening of standards and approaches in line with trends in other OECD countries."

- The effects of this new approach also will be felt in the wholesale and institutional markets. Recent FCA senior staff speeches make clear that there will be no *caveat emptor* assumption for entities operating in those markets. The FCA likely will judge whether counterparties are in fact equal and whether the treatment of a counterparty could have adverse effects on end investors, such as fund unitholders for example.
- At an operational level, the application process will be more complex, especially where the firm concerned is a PRA-regulated bank, insurer or investment firm. For example, entities looking to acquire threshold stakes in PRA-regulated firms that trigger U.K. change-of-control approval laws will find that their applications need to be vetted by both the PRA and FCA.
- The FCA will have the authority to block product launches and ban the sale of existing products. FSA staff have prepared for use of these new powers by announcing a ban on the sale of senior life-settlement products and other alternative funds to most U.K. retail investors. The FCA also will be able to order firms to withdraw and amend misleading marketing material, with immediate effect.
- Enforcement procedures will be tightened. Currently in the U.K., an entity or individual subject to enforcement action receives a warning notice setting out the regulator's case and providing a formal opportunity to rebut the allegations. These warning

notices normally are kept private and, if the entity or individual shows that there is no case to answer, there should be no reputational damage. Under the new regime, however, the regulator will be entitled to publish the warning notice allegations. This may not be particularly inconvenient for entities. For individuals who are charged, however, this could unnecessarily damage their reputations, particularly where the regulator subsequently agrees that there is no case to answer.

The new U.K. regulatory model represents a toughening of regulatory standards and approaches in line with trends in other Organisation for Economic Co-operation and Development countries. Given the importance of financial services to the U.K. economy, however, the industry hopes that the new regulators will use their new powers and approaches effectively — but proportionately.

English Limited Partnerships: Liability Definition Remains Elusive

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In November 2012, investors in an English limited partnership, Henderson PFI Secondary Fund II LP, lost their claim against the fund's manager and general partner for an alleged breach of the fund's investment policy.[4] While the investment policy claims were defeated, the case has highlighted a number of important issues for fund managers and investors who use English limited partnerships as fund vehicles.

Background

The limited partnership is the pre-eminent vehicle for private equity and related private investment funds throughout the Western world. Investors become limited partners and, provided they do not participate in the partnership's management activities, benefit from limited liability for the partnership's debts.

However, in England the vehicle's appeal comes with an opaque definition of limited liability, which has presented challenges over the years. Despite a 2003 Law Commission Report proposing reforms, the Limited Partnerships Act of 1907 (1907 Act) has gone virtually unchanged for a century. There also has been a dearth of relevant case law, but the *Henderson* decision highlights several factors that underscore the need for clarification of the 1907 Act.

Involvement in Management

Section 6(1) of the 1907 Act provides that "a limited partner shall not take part in the management of the partnership business, and shall not have power to bind the firm. … If a limited partner takes part in the management of the partnership business he shall be liable for all debts and obligations of the firm incurred while he so takes part in the management as though he were a general partner."

[4] Certain Limited Partners in Henderson PFI Secondary Fund II LP (a firm) and Henderson PFI Secondary Fund II LP (a firm) and others, [2012] EWHC 3259 (Comm).

This was relevant to the *Henderson* proceedings because the limited partners sought a declaration that they would not lose their limited liability by bringing a derivative action in the name of the partnership against its manager. In England, a derivative action is permitted where special circumstances justify it. Henderson's general partner, who has responsibility for managing the partnership, refused to do so on the basis that it did not consider the manager guilty of wrongdoing. Henderson also was conflicted due to its relationship with the manager.

In his decision, Mr. Justice Cooke held that a derivative action was available to the limited partners but that they would clearly be participating in management, noting that "there are potentially grey areas no doubt but the conducting of litigation on the part of the Partnership is not one of them."

Loss of Limited Liability

While the judge's view regarding participation in management through a derivative action is unsurprising, Mr. Justice Cooke went on to state that the liability wording in Section 6 has a temporal, rather than purposive, meaning. A limited partner will be liable for all debts and obligations incurred while he takes part in management, whether or not they are connected to the management activities undertaken by him. The judge also raised the possibility that the limited partner could be liable in place of the general partner, stating that "he supplants the general partner and becomes liable as if he were the general partner."

The suggestion that the general partner could be relieved of liability does not appear to be supported by the legislation and would put the general partner in a better position than an ordinary partner in a general partnership.

Importance of the Manager's Opinion

> "The *Henderson* decision highlights several factors that underscore the need for clarification of the 1907 Act."

The Henderson fund manager's powers included the ability "to do all or any other acts as are required of the Managers by this Agreement or as are necessary or desirable in the reasonable opinion of the Manager in furtherance of the foregoing powers and consistent with the terms of this Agreement."

Mr. Justice Cooke cited case law relating to the existence of a similar clause in the objects of a company's memorandum of association, which made the bona fide opinion of the directors sufficient to decide whether an activity of the company was *intra vires*. In doing so, the judge held that this clause makes "the reasonable opinion of the Manager the touchstone for its powers." He concluded that if, contrary to the judge's view, the investments were in fact outside of the restrictions in the limited partnership agreement's investment policy, but the fund manager "reasonably takes the view that the activities on which they embark are necessary or desirable in furtherance of the powers given to them and set out earlier in the clause, and are consistent with the terms of the Agreement," then the manager's actions are authorized.

Indemnification

In a similar line of reasoning, the judge held that the inclusion of an indemnity for acts (other than negligent or other culpable ones) "arising out of or in connection" with circumstances relating to or resulting from the provision of services to, or in respect of, the partnership, extended to making unauthorized investments where the manager reasonably believed them to be authorized. This was despite the manager's obligation to cause the partnership to make investments only in accordance with the investment policy. In this context, the manager was entitled to be indemnified if not negligent (or otherwise culpable).

The judge refused to apply the *contra preferentem* rule whereby a clause will be construed against the draftsman, on the basis that the parties were of equal bargaining power and were sophisticated commercial entities.

* * *

The years following the onset of the financial crisis have seen a number of disputes involving English limited partnerships and the rights and obligations of general and limited partners. Investors and managers should consider whether changes are required in light of *Henderson* and other cases.

Global Litigation

New legal ground is expected to be broken this year in areas of importance to companies and their directors, officers and executives. We see those developments coming from around the globe and defining the litigation landscape in 2013.

The U.S. Supreme Court is poised to rule on numerous cases — ranging from class actions and tort litigation to government enforcement and intellectual property — that will significantly affect the business community. In addition to examining these cases, we focus on the myriad issues that continue to linger after 2011 and 2012 Supreme Court and appellate court rulings, including those affecting class actions, product liability disputes and securities litigation.

Meanwhile, government enforcement activity on both sides of the Atlantic likely will exceed its intensity level in 2012. The U.S. Department of Justice, Securities and Exchange Commission and other authorities will vigorously pursue enforcement priorities under the Foreign Corrupt Practices Act, with respect to insider trading, and in response to increasing numbers of whistleblower complaints. All indications are that these same levels of enforcement intensity will define activity outside the U.S. in 2013.

On the antitrust front, we predict a continuation of the ambitious enforcement agenda witnessed over the last four years. U.S. regulatory authorities are expected to maintain their focus on issues at the intersection of intellectual property and antitrust, as well as criminal enforcement. We expect EU officials to concentrate on matters affecting the pharmaceutical, financial services, and high technology industries.

We also discuss developments in international litigation and arbitration, including jurisdictional challenges to cross-border arbitration proceedings, continuing disputes over sovereign debt and cross-border judgment enforcement; patent and technology issues; and ongoing consumer and government actions in the e-commerce sector.

67 The US Supreme Court Term: Business Cases to Watch

70 Antitrust and Competition: Antitrust Enforcement on Both Sides of the Atlantic

74 Class Action Outlook: A Busy Year Ahead

77 Product Liability Issues to Watch in 2013

79 Government Enforcement: A Continued Push to Prosecute in the US, the UK and China

85 International Litigation and Arbitration: Jurisdictional Challenges, Cross-Border Enforcement Developments and Sovereign Debt Disputes

91 Intellectual Property and Technology: Patent and E-Commerce Issues to Watch in 2013

94 Securities Litigation: Recent and Upcoming Supreme Court, Appellate and District Court Developments

The US Supreme Court Term: Business Cases to Watch

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The Supreme Court is poised to rule on numerous cases in 2013 — ranging from affirmative action and class actions to tort litigation, government enforcement and intellectual property — that will significantly affect the business community. In addition, the Court will rule in marquee cases on the Voting Rights Act and same-sex marriage.

Affirmative Action

On October 10, 2012, the Supreme Court heard argument in *Fisher v. University of Texas at Austin*, presenting the issue of whether the 14th Amendment's Equal Protection Clause prohibits the University of Texas at Austin (UT) from using race in undergraduate admissions decisions.

Under UT's admissions policy, race sometimes is a factor in the evaluation of applicants. Nine years ago, in a 5-4 decision in *Grutter v. Bollinger*, the Court upheld the University of Michigan Law School's use of race as one of a number of factors in its admissions policy. In the *Fisher* case, the litigant challenging the UT policy argues that it is invalid under *Grutter* — and, alternatively, that *Grutter* should be overruled. The author of the *Grutter* opinion, Justice Sandra Day O'Connor, retired and was replaced by Justice Samuel Alito. This shift in Court personnel could affect how the Court considers and resolves the case.

The *Fisher* case is important to the business community because businesses recruit extensively from UT and other public universities. A group of 57 leading American companies filed an *amicus curiae* brief supporting UT. The companies explained that they "are directly affected by the admissions policies at UT and similar colleges and universities" and that they "care deeply about what kind of education and training those institutions offer their students" (see Regulatory/"Affirmative Action in Employment").

Class Action Litigation and Arbitration

The Court has granted *certiorari* in five cases that significantly could impact class action litigation and arbitration.

Two cases address issues involving class action arbitration. In *Oxford Health Plans v. Sutter*, the Court will consider the authority of arbitrators to order class arbitration — an event with profound implications for the dynamic of the dispute. In a prior case, the Supreme Court held that class action arbitration is so fundamentally different from bilateral arbitration that a party cannot be compelled to submit to it unless there is a contractual basis for concluding it has agreed to do so. The U.S. Courts of Appeals have split over whether broad contractual language requiring arbitration is sufficient to infer consent to class action arbitration. In *American Express Co. v. Italian Colors Restaurant*, the Court will examine a U.S. Court of Appeals for the Second Circuit ruling invalidating an arbitration agreement that barred class arbitration because the court believed individual arbitration of the plaintiff's federal law claim would be economically infeasible.

Two other cases will allow the Court to provide additional clarity on the requirements of class action litigation in light of its decision in *Wal-Mart Stores, Inc. v. Dukes* (2011). In *Dukes*, the Court emphasized a plaintiff's burden in proving commonality in the class

before obtaining class certification. Now, in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, the Court will decide whether, before certifying a class in a securities case, plaintiffs relying on the fraud-on-the-market theory must prove that the misrepresentation was material. And, in *Comcast v. Behrend*, the Court will address whether a district court may certify a class without first resolving whether the plaintiff has introduced admissible evidence, including expert testimony, to show that the case is susceptible to awarding damages on a classwide basis (see "Securities Litigation: Recent and Upcoming Supreme Court, Appellate and District Court Developments").

The fifth class action case concerns the Class Action Fairness Act of 2005 (CAFA), a federal statute that created new safeguards against abusive class actions in federal court. In *The Standard Fire Insurance Co. v. Knowles*, the Court will decide whether a plaintiff in a putative class action can avoid removal to federal court under CAFA by stipulating that he seeks damages for the class of less than the $5 million jurisdictional minimum for CAFA removal. The question before the Court will be whether such a stipulation improperly undermines the federal removal provision of CAFA and violates the due process rights of absent class members (see "Class Action Outlook: A Busy Year Ahead").

Extraterritoriality of Alien Tort Statute

In the last three decades, plaintiffs have used the previously obscure Alien Tort Statute (ATS), which was first enacted in 1789, to sue corporations for alleged complicity in human rights abuses in other countries. In *Kiobel v. Royal Dutch Petroleum*, the Court will decide whether these causes of action may be brought for claims regarding conduct outside the United States involving foreign plaintiffs and foreign defendants.

In *Kiobel*, plaintiffs from Nigeria are seeking to sue foreign oil companies in U.S. courts alleging that the companies violated international law in aiding torture by the Nigerian government. Last term, the Court heard argument on the scope of the ATS, including whether corporations can be sued under the statute. At oral argument last February, it became clear that a number of justices were troubled by a fundamental question — whether Congress intended the ATS to apply to conduct outside the United States. The Court ordered the parties to address this threshold issue and heard re-argument in the case in early October.

If the Court decides that the ATS does not apply to such extraterritorial claims, it will dramatically narrow plaintiffs' use of the statute in litigation against corporations.

Statute of Limitations in Government Enforcement Cases

The statute of limitations for government enforcement actions is fundamental to the initiation and resolution of many government cases. In *Gabelli v. Securities and Exchange Commission*, the Court will consider the default five-year statute of limitations applicable to civil penalty actions brought by the federal government (28 U.S.C. § 2462). In *Gabelli*, the SEC seeks penalties for alleged unlawful conduct that occurred more than five years before the SEC filed suit. The Court will review the Second Circuit's holding that the five-year limitations period does not begin until the SEC discovers or should have discovered the claim. The case will have important implications for the permissible timing of government actions for claims sounding in fraud, both in SEC actions and in other contexts.

> *Federal Trade Commission v. Watson Pharmaceuticals, Inc.* is of enormous significance to the pharmaceutical industry.

Intellectual Property

The Court will consider three intellectual property cases of significance to companies that own patents, copyrights or trademarks.

The first case involves so-called "reverse-payment agreements" between brand-name drug manufacturers and potential generic competitors.[1] The case is of enormous significance to the pharmaceutical industry. In many instances, brand-name manufacturers have sued potential generic competitors under the Hatch-Waxman Act for patent infringement. In *Federal Trade Commission v. Watson Pharmaceuticals, Inc.*, the Court will determine whether, as the government contends, federal competition law renders settlements of Hatch-Waxman litigation presumptively unlawful if the settlement includes a payment from the brand-name manufacturer to a generic competitor as well as an agreement on the date the generic competitor will enter the market. In contrast, most U.S. Courts of Appeals have held that such Hatch-Waxman settlements are lawful if (1) the settlement agreement does not exceed the exclusionary scope of the patent, (2) the litigation to enforce the patent was not a sham, and (3) the patent was not procured by fraud. The second case raises a question at the intersection of copyright and international trade. In *Kirtsaeng v. John Wiley & Sons, Inc.*, the Court will try a second time to decide whether the first-sale doctrine — which allows a purchaser of a copyrighted good in the United States to resell the good without the copyright owner's permission — applies to copyrighted material manufactured and acquired abroad and then imported into the United States. In 2010, the Court split 4-4 on this issue, with Justice Elena Kagan recused. The case is important to businesses on both sides of the issue. Content owners argue that applying the first-sale doctrine to overseas goods will weaken intellectual property protection and further a gray market in copyrighted goods. Retailers and auction sites, meanwhile, argue that not applying the first-sale doctrine to goods manufactured and acquired abroad will unjustifiably inhibit legitimate sales (see "Antitrust and Competition: Antitrust Enforcement on Both Sides of the Atlantic").

The third case presents the question whether human genes are patentable. In *Association for Molecular Pathology v. Myriad Genetics, Inc.*, the Court will review the Federal Circuit's holding that isolated DNA sequences are patentable subject matter because they have been manipulated chemically to produce molecules different from the native DNA molecules in the human body (see "Intellectual Property and Technology: Patent and E-Commerce Issues to Watch in 2013"). The outcome of this case will have a profound impact on businesses that conduct genetic research. It also may have far-reaching implications for scientific advancement, including in the field of personalized medicine.

In addition to these three pending intellectual property cases, the Court already has decided one significant trademark case this term concerning the issue of federal court jurisdiction when a trademark owner, during the course of litigation, agrees not to assert a claim against an accused infringer. In *Already, LLC v. Nike, Inc.*, Nike filed a trademark suit, and the accused infringer filed a countersuit. Ultimately, Nike unconditionally and irrevocably committed to not asserting trademark claims against the defendant. It moved to dismiss its claims with prejudice and to dismiss Already's counterclaim without prejudice. The district court dismissed the case on the ground that there no longer was a case or controversy, and the Second Circuit affirmed. The Supreme Court unanimously agreed, confirming that a trademark owner's unequivocal assertion of non-enforcement moots the competitor's action to declare the trademark

[1] Skadden is representing one of the parties in this case.

invalid when the competitor faces no realistic prospect of trademark enforcement. In a concurrence by Justice Kennedy, four Justices cautioned that the case should be read narrowly and that there are limits to voluntary cessation as a strategy for terminating trademark litigation (see "Intellectual Property and Technology: Patent and E-Commerce Issues to Watch in 2013").

Other Cases

In addition to the opinions with a direct impact on the business community, the Supreme Court also will decide important cases regarding voting rights and same-sex marriage. In *Shelby County v. Holder*, the Court will consider whether Congress' reauthorization of the Voting Rights Act in 2006 exceeded its constitutional power because Congress lacked an adequate basis for continuing the requirement that certain covered jurisdictions with a history of voting rights abuses "pre-clear" changes in their voting laws. In *United States v. Windsor*, meanwhile, the Court will consider whether the federal Defense of Marriage Act's requirement that spousal benefits under federal law not be available to same-sex marriages is unconstitutional. And, in *Hollingsworth v. Perry*, the Court will consider the constitutionality of California's Proposition 8, which sought to invalidate a California Supreme Court decision approving same-sex marriage. (Both cases include questions about standing, which may prevent the Court from reaching the merits).

The Court will decide the cases in the current term by the end of June 2013.

Antitrust and Competition: Antitrust Enforcement on Both Sides of the Atlantic

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While leadership changes are afoot both at the Antitrust Division of the U.S. Department of Justice (DOJ) and at the FTC (see Global M&A/"Antitrust and Competition: Surveying Global M&A Enforcement Trends"), those changes are unlikely to have a significant impact on the agencies' enforcement stance in 2013. Both the FTC and the DOJ have undertaken ambitious enforcement agendas over the last four years and are likely to continue to do so. Notably, both agencies have commenced significant efforts related to the intersection of intellectual property and antitrust, and the DOJ continues to pursue significant global cartel activity in the financial services and auto parts industries. As businesses continue to look for ways to monetize their intellectual property, they will need to sharpen their focus on applicable antitrust laws. And companies that are the subjects of criminal antitrust investigations are now more likely than ever to face follow-on litigation in the U.S., Europe and elsewhere.

Intellectual Property

- "Reverse-payment" patent settlements will remain in the spotlight. On December 7, 2012, the U.S. Supreme Court granted *certiorari* in *FTC v. Watson Pharmaceuticals, Inc.*, a case brought by the FTC challenging the legality of so-called

"reverse-payment" settlements between brand-name and generic drug makers.[2] The Court will hear the FTC's appeal from a U.S. Court of Appeals for the Eleventh Circuit decision upholding the legality of such settlements under the antitrust laws; the FTC is expected to urge the Court to instead adopt the U.S. Court of Appeals for the Third Circuit's ruling finding that such settlements are presumptively unlawful.[3] A decision on the merits is likely by summer 2013 (see "The US Supreme Court Term: Business Cases to Watch").

- The antitrust agencies continue to monitor patent enforcement and licensing activities, particularly in high-technology industries. The DOJ and the FTC recently held a joint workshop exploring how activities of patent assertion entities — those that purchase patents from existing owners and then seek to license the intellectual property to (or litigate against) manufacturers who already are using the patented technology — impact innovation and competition. In addition, reaffirming its "longstanding commitment to safeguard the integrity of the standard-setting process," the FTC recently announced that, in appropriate cases, it "can and will" challenge a patent holder's attempt to obtain injunctive relief against willing licensees of standard-essential patents on FRAND ("fair, reasonable and nondiscriminatory") terms. More of this enforcement activity is, according to Chairman Jon Leibowitz, "on the way soon."[4] Indeed, on January 3, 2013, the FTC announced a consent order with Google pursuant to which Google will not seek injunctions or exclusionary orders to enforce patent rights that are essential to certain technology standards if Google has committed to license those on FRAND terms.[5]

Criminal Enforcement

- Criminal enforcement will continue to be a focus of the DOJ. We are likely to see the expansion of current investigations and an increase in penalties. There were several notable active investigations in 2012, including those involving LIBOR, EURIBOR, auto parts and batteries. Barclays admitted misconduct and agreed to pay $160 million

[2] *See Fed. Trade Comm'n v. Watson Pharms., Inc.,* 677 F.3d 1298 (11th Cir.) Watson Pharmaceuticals, Inc. is represented by Skadden.

[3] The Third Circuit decision is *In re K-Dur Antitrust Litigation*, 686 F.3d 197 (3d Cir. 2012). Petitions for *certiorari* were filed by the *K-Dur* defendants and were considered by the Supreme Court at the same conference as the *FTC v. Watson* petition, but the Court neither granted nor denied *certiorari* and likely will hold those petitions pending the outcome of *FTC v. Watson*.

[4] *See* Skadden, Arps, Slate, Meagher & Flom LLP, Statement of the Fed. Trade Comm'n at 1, 2, *In the Matter of Robert Bosch GmbH*, FTC File No. 121-0081 (Nov. 26, 2012), avail. at http://www.ftc.gov/os/caselist/1210081/121126boschcommissionstatement.pdf; *see also Global Competition Review*, "Leibowitz says to expect more enforcement over essential patents." (Dec. 10, 2012), *available at* http://www.globalcompetitionreview.com/news/article/32778/leibowitz-says-expect-enforcement-essential-patents/.

[5] *See* "FTC Ends Google Investigation With a 'Slap on the Wrist'" (Jan. 4, 2013), *available at* http://www.skadden.com/insights/ftc_ends_google_investigation. The FTC's investigation of Google did not result in any formal action against the company with respect to Google's search practices. The FTC closed its investigation with a voluntary commitment by Google to modify some of these practices.

> "While the DOJ is continuing to improve its investigatory techniques, it also is trying to increase corporate fines and individual sentences through aggressive prosecution and litigation."

to the DOJ to resolve the antitrust violations related to LIBOR and EURIBOR.[6] The DOJ can be expected to continue to follow through on its current investigations and, in doing so, uncover additional cartels in related areas or component parts (see "Government Enforcement: A Continued Push to Prosecute in the US, the UK and China"). The "cross-sell" of "do you have anything else to admit?" has become as common in the U.S. leniency program as "do you want fries with that?" It generally offers more than just a bargain price for the "combo," and can actually lower the already inevitable fine for the first violation and result in amnesty for the investigatory area(s) for which the firm provides new evidence. This situation, known as "leniency plus," provides a significant incentive for companies to conduct a thorough investigation and, if possible, uncover additional wrongdoing. The DOJ subsequently is able to expand its investigation into the new area(s), most often a related product/service or component part. There also has been increased coordination among government enforcement agencies around the globe in dawn raids (*e.g.*, auto parts and auto shipping) as well as the coordination of ongoing investigations. Finally, while the DOJ is continuing to improve its investigatory techniques, it also is trying to increase corporate fines and individual sentences through aggressive prosecution and litigation. The DOJ pursues trials for specific deterrence and general deterrence but, most importantly, to increase its ability to negotiate favorable pleas. In *AU Optronics*, a significant case in 2012, the DOJ obtained three-year sentences for individuals and $500 million in corporate fines. However, the DOJ had asked for $1 billion based on a statutory provision providing for up to twice the gain of all participants in an antitrust conspiracy, and may appeal.

Follow-On Litigation

- Companies face more than criminal fines for antitrust cartel behavior. Private litigation, often class actions, inevitably follows criminal investigations, and such follow-on litigations are now becoming common beyond the United States. The Foreign Trade Antitrust Improvements Act (FTAIA) generally excludes foreign commerce from the Sherman Act, but allows suits to be brought in the U.S. if the conduct involves import commerce or has a "direct, substantial and reasonably foreseeable effect" on domestic commerce. The meaning of "direct" is one of the key issues in *Agrium, Inc. v. Minn-Chem, Inc.*, known as the "Potash" case.[7] The case is particularly interesting given that the DOJ weighed in and advocated for "direct" to mean "reasonably proximate causal nexus," which is the interpretation that the U.S. Court of Appeals for the Seventh Circuit adopted *en banc*. The potash producers now are

[6] Note that Barclays simultaneously agreed to pay $200 million to the U.S. Commodities Futures Trading Commission (CFTC) and approximately $93 million to the U.K. Financial Services Authority (FSA). See A. Alper and K. Ridley, "Barclays paying $453 million to settle Libor probe," Reuters, (June 27, 2012), *available at* http://www.reuters.com/article/2012/06/27/us-barclays-libor-idUSBRE85Q0J720120627. On Dec. 19, 2012, the DOJ announced that it had reached agreement with UBS on a guilty plea for UBS's Japanese subsidiary in connection with the LIBOR probe, and that the bank had agreed to pay $1.2 billion in combined fines to the Department of Justice and the CFTC. UBS will additionally pay approximately $260 million to the FSA and will disgorge approximately $64 million to the Swiss Financial Market Supervisory Authority. In addition, two UBS traders will face criminal conspiracy charges. *See* Dept. of Justice Press Release, "UBS Securities Japan Co. Ltd. to Plead Guilty to Felony Wire Fraud for Long-Running Manipulation of LIBOR Benchmark Interest Rates," (Dec. 19, 2012), *available at* http://www.justice.gov/opa/pr/2012/December/12-ag-1522.html; *see also* E. Weinberger, "UBS Hit With $1.5 Billion Fine After Admitting Role in LIBOR Scandal," Law360, (Dec. 19, 2012), *available at* http://www.law360.com/competition/articles/402081?nl_pk=e3a2bfad-0bea-4ae8-a750-edbcfa37ad30&utm_source=newsletter&utm_medium=email&utm_campaign=competition.

[7] *Minn-Chem, Inc. v. Agrium, Inc.*, 683 F.3d 845 (7th Cir. 2012) (en banc), *petition for cert. filed* 81 U.S.L.W. 3309 (U.S. Nov. 23, 2012) (No. 12 650).

asking the U.S. Supreme Court to review the Seventh Circuit's decision. The outcome will not only affect the extraterritorial reach of the U.S. courts in civil actions, but also could broaden the extraterritorial reach of the DOJ in criminal prosecutions.

European Union

In 2012, the EU's competition law enforcement, much like the U.S. DOJ and FTC, focused on three key industries: pharmaceuticals, financial services and high-technology. Decisions by the EU Commission defining important aspects of the law relevant to each of these sectors are expected to be issued in 2013. In the area of private enforcement, the long-awaited EU legislation on collective redress also is expected to be adopted this year.

Pharmaceuticals

- Following its pharmaceutical sector inquiry in 2008 and 2009 and subsequent monitoring of patent settlements in the EU, the EU Commission has opened a number of investigations in relation to patent settlement agreements involving a reverse payment from the originator to generic firms. Four investigations are currently pending, two of which have proceeded to the issuance of a Statement of Objections in July 2012. In at least one of these investigations, it is expected that the EU Commission will issue a formal decision in 2013, which would be the first EU Commission decision establishing its enforcement policy in relation to reverse-payment settlements. The EU Commission already has indicated publicly that it supports a standard of review for reverse-payment settlements with a presumption of an anti-competitive effect, similar to the position of the FTC in the U.S. and the standard adopted by the Third Circuit in *In re K-Dur Antitrust Litigation*, *see supra note 2*.

Financial Services

- The financial services sector continues to be a focus of competition enforcement in the EU, with various high-profile investigations pending before the EU Commission. These include two antitrust investigations relating to credit default swaps, and the investigation of the alleged manipulation of the LIBOR and EURIBOR rates, which EU Competition Commissioner Joaquin Almunia considers a "top priority." The LIBOR probe also has resulted in the U.K. authorities arresting three individuals in connection with their own LIBOR investigation (see "Government Enforcement: A Continued Push to Prosecute in the US, the UK and China").
- Increased focus on the financial services sector also is reflected in the EU Commission's expansive application of its presumption of parental liability for infringements by owned entities, which extends to financial holdings. In August 2011, the EU Commission issued a Statement of Objections against Goldman Sachs, holding it liable for cartel conduct of a portfolio company held by Goldman Sachs' private equity arm, even for periods in which Goldman Sachs held a minority interest. The issuance of a formal decision is expected in 2013, which is likely to clarify the EU Commission's position on parental liability of financial holdings and private equity firms for conduct of their portfolio companies.

High-Technology

- Significant enforcement activities also are expected in 2013 relating to the high-technology sector, including the interplay between intellectual property and competition law. There is significant legal uncertainty in the EU in this area. For

example, with respect to standard essential patents, there is no clear obligation for the patent holder to license the patent under FRAND terms. There also is no clear definition of what FRAND licensing entails, including how licensing fees should be calculated and whether the patent owner could seek injunctive relief based on its patent, despite having entered into FRAND commitments. The latter issue is the subject of an antitrust investigation opened by the EU Commission against Samsung in January 2012.

Collective Redress

- After holding a public consultation on an EU Commission working document on collective redress in early 2011, the EU Commission appears set to issue legislation in 2013 on collective redress in private civil litigation, after an EU Parliament report in June 2012 backed the EU Commission's plans for legislation in this area. Collective redress and, in particular, the choice between an opt-out mechanism and opt-in modes of collective action, has been a hotly contested topic for years within the business community, within different EU Commission directorates, and between the EU Commission and the European Parliament. The EU legislation on collective redress is expected to encourage private enforcement by endorsing and enabling collective actions by consumers and businesses while attempting to avoid the extremes of "U.S.-style litigation," which the EU Commission has stated firmly it does not want to adopt. It is anticipated that separate legislation will be issued in relation to document disclosure issues regarding immunity and leniency applications on the one hand, and collective redress on the other, with the former expected in spring 2013.

* * *

It is evident that the U.S. and European antitrust agencies share many similar enforcement priorities. In light of the increased investigative coordination between the U.S. and European antitrust agencies, and particularly given the onset of private litigations in Europe, Asia-Pacific and Latin America, a holistic approach toward antitrust strategy in preparing for and defending against multiple government investigations and private litigations around the globe is critical.

Class Action Outlook: A Busy Year Ahead

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For those who may have hoped that 2012 would be the year in which class action lawyers threw in the towel — discouraged by broad judicial interpretations of the Class Action Fairness Act and the Supreme Court's ratcheting up of class action requirements in *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011) — it was not meant to be.

While nationwide classes based on state law are still moribund, a number of traditionally conservative courts around the country have embraced smaller, single-state consumer fraud and employment discrimination class actions, suggesting that 2013 may bring more class actions. Here are some key trends to keep an eye on in 2013.

- **Consumer Products.** Recent rulings by the U.S. Courts of Appeals for the Sixth and Seventh Circuits may set troubling precedents for class actions involving allegedly

defective consumer products. In two recent cases involving allegedly defective washing machines, these courts sanctioned sprawling class actions, even though the vast majority of class members experienced no problems with their products. *See In re Whirlpool Corp. Front-Loading Washer Products. Liab. Litig.*, 678 F.3d 409 (6th Cir. 2012); *Butler v. Sears, Roebuck & Co.*, --- F.3d ----, Nos. 11-8029, 12-8030, 2012 U.S. App. LEXIS 23284 (7th Cir. Nov. 13, 2012). Writing for the Seventh Circuit panel, Judge Richard Posner declared that the decision whether to certify is primarily one of "efficiency" and that the presence of uninjured class members is no barrier to class treatment. *Butler*, 2012 U.S. App. LEXIS 23284, at *4. A petition for *certiorari* is pending in *Whirlpool*, and one in *Butler* is likely forthcoming. Meanwhile, California continued to be a hotbed for consumer class actions in 2012 as well. *See, e.g., Keegan v. Am. Honda Motor Co.*, No. CV 10-09508 MMM (AJWx), 2012 U.S. Dist. LEXIS 91394 (C.D. Cal. June 12, 2012) (certifying consumer fraud claims under California law in defective car case where a majority of class members experienced no issues with their vehicles' rear suspension); *Johnson v. General Mills, Inc.*, 278 F.R.D. 548, 550-51 (C.D. Cal. 2012) (reaffirming propriety of certifying consumer fraud claims arising out of defendants' alleged misrepresentations that YoPlus yogurt products promote digestive health, even though many class members' yogurt products did not contain "an explicit statement regarding digestive health"). Plaintiffs' lawyers will no doubt rely on these developments and rulings as they attempt to certify unwieldy class actions in the future. Thus, absent Supreme Court intervention, automobile, appliance and food manufacturers can expect more class actions in 2013.

"Absent Supreme Court intervention, automobile, appliance and food manufacturers can expect more class actions in 2013."

- ***Daubert* Challenges.** *Daubert* challenges may begin to play a larger role at the class certification stage, depending on the outcome of a pending Supreme Court ruling in *Comcast Corp. v. Behrend* (No. 11-864). In *Wal-Mart Stores v. Dukes*, 131 S. Ct. 2541 (2011), the Supreme Court left open the question of whether an expert's testimony that is proffered as a form of classwide proof at the class certification stage must satisfy the requirements of *Daubert*. In the wake of *Dukes*, federal appeals courts have split on this question. Most have acknowledged that some level of scrutiny of expert evidence in support of class certification is necessary, but they have disagreed about whether courts must make a "conclusive," or merely "limited" or "tentative" assessment, of the evidence under *Daubert*. *Compare, e.g., Messner v. Northshore Univ. HealthSystem*, 669 F.3d 802, 812 (7th Cir. 2012) ("When an expert's report or testimony is 'critical to class certification,' we have held that a district court must make a conclusive ruling on any challenge to that expert's qualifications or submissions before it may rule on a motion for class certification."), *with, e.g., In re Zurn Pex Plumbing Products Liability Litigation*, 644 F.3d 604, 613 (8th Cir. 2001) (a full-scale Daubert analysis is not required because such an approach is inconsistent with the "tentative, preliminary, and limited" nature of a class certification proceeding). The Supreme Court's ruling in *Comcast*, which likely will be handed down in the next several months, will resolve this question once and for all (see "The US Supreme Court Term: Business Cases to Watch").
- **Employment Discrimination.** The full impact of *Dukes* on employment discrimination class actions remains in flux, as demonstrated by the Seventh Circuit's ruling in *McReynolds v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 672 F.3d 482 (7th Cir. 2012). Notwithstanding the Supreme Court's recent rejection of such a suit in *Wal-Mart Stores v. Dukes*, the Seventh Circuit concluded that a suit with similar allegations could receive class treatment for a single "issue." Judge Posner again wrote for the Court, holding that the plaintiffs' theory that Merrill Lynch's employment policies have a disparate impact on African-American financial advisors was amenable to classwide

treatment. This approach to class certification likely will prompt a new wave of efforts by the plaintiffs' bar to seek certification of classes that traditionally have not been approved for class treatment on the theory that one or more issues could be tried on a classwide basis in a so-called "issues trial." Such issues trials, which generally have been rejected by federal courts, tend to be unfair because they allow plaintiffs to try abstract questions before a jury without having to deal with the facts of their cases or with critical elements of their claims, such as causation.

- **Commonality Requirement.** At the same time, many federal and state courts have been faithful to *Wal-Mart Stores v. Dukes*, giving rigorous scrutiny to class action proposals and applying the Supreme Court's reinvigorated commonality requirement. *See, e.g., In re Sears, Roebuck & Co. Tools Mktg. & Sales Pracs. Litig.*, No. MDL–1703, 2012 WL 1015806, at *12 (N.D. Ill. Mar. 22, 2012) (explaining that the court could not "simply adopt [] plaintiff's assumptions" that the evidence will apply uniformly to the class); *Corwin v. Lawyers Title Ins. Co.*, 276 F.R.D. 484, 490 (E.D. Mich. Aug. 1, 2011) (while plaintiff identified "questions common to the absent class members and the plaintiff that must be decided before liability is established," class treatment was inappropriate because "the critical inquiry without which liability cannot attach requires individualized determination"); *Price v. Martin*, 79 So. 3d 960, 975 (La. 2011) (reversing an order certifying class because "inescapable is the fact that for this action, or any other action, to proceed as a class action, there must be 'significant proof,' subject to 'rigorous analysis,' of a common question — one where the 'determination of its truth or falsity will resolve an issue that is central to the validity of each one of the claims in one stroke'") (citing *Dukes*, 131 S. Ct. at 2551). And the import of *Dukes* has extended far beyond these basic requirements, affecting courts' assessments of such other class certification elements as ascertainability and standing of class membership. *See, e.g., Janes v. Triborough Bridge & Tunnel Auth.*, No. 06 Civ. 1427, 2012 WL 177420, at *4 (S.D.N.Y. Jan. 23, 2012) ("No class may be certified that contains members lacking Article III standing." (citation and internal quotation marks omitted); *Stone v. Advance America*, 278 F.R.D. 562, 570 (S.D. Cal. 2011) (rejecting class as unascertainable based on *Dukes*' instruction that courts consider the merits of a claim to the extent they overlap with class certification requirements).
- **Class Action Fairness Act.** Against this backdrop, there are efforts to expand CAFA even more to allow for a greater number of class actions to be removed from state to federal court. In particular, the National Association of Manufacturers (NAM) recently filed an amicus brief urging a novel interpretation of CAFA in *The Standard Fire Insurance Co. v. Knowles*, No. 11-1450 — a case that was heard by the Supreme Court on January 7, 2013. The question raised by the parties in Standard Fire is whether a class action plaintiff can defeat removal to federal court under CAFA by stipulating on behalf of the entire class to seek less than $5 million, which is the cutoff for state court class actions. NAM's amicus brief argues that the real question is whether a defendant has the right under CAFA to remove all class actions from state court provided diversity jurisdiction exists — irrespective of the amount in controversy. The gist of the argument is that CAFA's $5 million amount-in-controversy requirement applies only to class actions filed in federal court in the first instance — not to CAFA's separate provision authorizing removal of class actions from state court. Whether the Supreme Court will embrace this argument when it issues its ruling (likely before June 2013) is unclear (see "The US Supreme Court Term: Business Cases to Watch"). However, even if the Court were to accept this interpretation of CAFA, removal to federal court is no panacea to class action abuse, as illustrated by recent developments in the Sixth and Seventh Circuits.

Product Liability Issues to Watch in 2013

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The primary targets of product liability plaintiffs in 2013 include the makers of medicines and medical devices; manufacturers of food, beverages, tobacco and cosmetics; companies that sell consumer products, especially appliances and consumer electronics; and automobile manufacturers. Asbestos plaintiffs also continue their quest to find solvent companies with a plausible connection to asbestos, with the primary sellers of asbestos-containing products having been bankrupted by prior litigation. Ten issues to watch include:

- **Federal Preemption.** In the wake of *Pliva v. Mensing*, 131 S. Ct. 2567 (2011) — in which the Court held that state law failure-to-warn claims against makers of generic medicines were preempted by the federal requirement that generic warnings be identical to those of the name-brand medicines — plaintiffs have tried to cast their claims against manufacturers of generics as design defect claims. The Supreme Court is poised to decide whether a state law "design defect" claim that a generics manufacturer should not have placed the medicine on the market is preempted by federal law. *See Mut. Pharm. Co. v. Bartlett*, 81 U.S.L.W. 3305 (U.S. Nov. 30, 2012). At the same time, Congress has pending before it bills to reverse *Pliva* and remove federal preemption of failure-to-warn claims involving generic medicines. *See* Patient Safety and Drug Labeling Improvement Act, H.R. 4384, 112th Cong. (2012); Patient Safety and Generic Labeling Improvement Act, S. 2295, 112th Cong. (2012).

- **Similar Regulatory Defenses.** Manufacturers — particularly those in the food, beverage and cosmetic sectors facing challenges to labeling that complies with FDA regulations — can be expected to use the FDA's action or conscious choice not to act as a means of preventing other federal causes of action, such as the Lanham Act. *See Pom Wonderful LLC v. Coca-Cola Co.*, 679 F.3d 1170 (9th Cir. 2012) (dismissing Lanham Act claim because defendant complied with the Federal Drug and Cosmetic Act, which does not allow private enforcement). Such defendants also can be expected to argue that where the FDA has not reached a decision, a plaintiff's claims should be dismissed under the primary jurisdiction doctrine, so that the regulators (rather than courts) decide the issue in the first instance. *See Astiana v. The Hain Celestial Group, Inc.*, 2012 U.S. Dist. LEXIS 165368 (N.D. Cal. Nov. 19, 2012) (dismissing without prejudice state law claims based on the need for the FDA to be the first to decide what "natural" means with respect to cosmetics).

- **First Amendment Defense of Off-Label Promotion.** Numerous makers of medicines and medical devices have been sued for purportedly violating state fraud and consumer protection laws by promoting their products for uses that have not been approved by the FDA. It is lawful for a doctor to prescribe a medicine for an off-label use; indeed, the off-label use of particular medicines is often the standard of care in specialties like pediatrics, where studies are particularly difficult to conduct. The Second Circuit's decision in *United States v. Caronia*, 2012 U.S. App. LEXIS 24831 (2d Cir. Dec. 3, 2012), will ensure that manufacturers will continue to raise First Amendment defenses to product liability claims based on the promotion of lawful off-label use.

- **First Amendment Challenges to Labeling Restrictions.** Last year, tobacco companies were successful in challenging an FDA requirement that would have appropriated vast portions of cigarette packaging to display grotesque images

illustrating health warnings. *See R.J. Reynolds Tobacco Co. v. FDA*, 696 F.3d 1205 (D.C. Cir. 2012). Product manufacturers can be expected to continue to challenge government-compelled speech and government appropriation of their product packaging and advertising. And the Supreme Court can be expected to take up such cases to address these issues.

- **Safe Harbors From Punitive Damages.** Defendants can be expected to press for state law to recognize "safe harbors" from punitive damages where the defendant has complied with applicable regulations. For example, a federal court presiding over product liability claims involving cancer drugs recently held that the law of New Jersey — where the manufacturer resided — should govern on the issue of punitive damages. *Zimmerman v. Novartis Pharmaceuticals Corp.*, 2012 U.S. Dist. LEXIS 126002 (D. Md. Sept. 5, 2012). Because New Jersey prevents punitive damages from being levied against a company that complied with regulations unless it can be proven that the company knowingly misled the agency about material information, the court held that punitive damages were unavailable. Ordinarily, such safe-harbor provisions are adopted by statute, and one can expect state legislative efforts to adopt such statutes in 2013. *See* Ariz. Rev. Stat. § 12-689 (LexisNexis 2012).
- **Learned Intermediary Doctrine.** The learned intermediary doctrine will continue to be adopted in the majority of U.S. states. Last summer, Texas joined 35 other states in holding that a sufficient warning to a doctor (the "learned intermediary") satisfies a manufacturer's duty to warn in product liability cases involving medicines and medical devices. *Centocor, Inc. v. Hamilton*, 372 S.W.3d 140 (Tex. 2012).
- **Fight to Expand the Duty to Warn.** The struggle by plaintiffs to expand the pool of available defendants in asbestos litigation often leads to fights to expand fundamental legal principles. One of these principles is that a manufacturer has a duty to warn about risks posed by its product, but not the products of others. Last summer, the Washington Supreme Court fundamentally expanded liability, holding that manufacturers who made respirators that did not contain asbestos nonetheless had a duty to warn about the risks of asbestos exposure. *Macias v. Saberhagen Holdings, Inc.*, 282 P.3d 1069 (Wash. 2012). This victory, which allowed suits against defendants who were not in the chain of distribution of asbestos-containing products, will no doubt empower plaintiffs to try to similarly expand the duty to warn in other jurisdictions.
- **Increasing Use of Lone Pine.** "Lone Pine" orders are used in mass tort cases to require plaintiffs to submit statements and/or evidence supporting the basic elements of their claims, including exposure, injury and causation. Defendants increasingly are successful in persuading courts to include such orders in the early case management stage of mass tort litigation. The failure of plaintiffs to supply necessary information within the court-ordered deadlines can lead to evidentiary sanctions and even dismissal.
- **Local Regulation of Products.** Municipalities such as New York and San Francisco, as well as much smaller communities, increasingly are flexing their muscle to attempt to ban or otherwise restrict access to products that they view as health and safety risks. New York City's recent large soda ban is just one example. Localities' attempts to restrict "energy drinks" is another. Manufacturers can expect increasing attempts by localities to regulate products. Key defenses will be federal and state preemption, as well as the Commerce Clause.

- **Increasing Arbitration of Personal Injury Claims.** The Supreme Court made it plain in 2012 that personal injury and wrongful death claims can be subject to agreements to arbitrate. See *Marmet Health Care Center, Inc. v. Brown,* 132 S. Ct. 1201 (2012). In 2013, one can expect to see increased efforts to compel arbitration of product liability claims that fall within the scope of arbitration agreements.

Government Enforcement: A Continued Push to Prosecute in the US, the UK and China

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US: White Collar Trends for 2013

Hardly a week went by in 2012 without headlines of a significant investigation or settlement under the Foreign Corrupt Practices Act, prominent insider trading arrests and prosecutions, or allegations of corporate financial improprieties sparked by whistleblower complaints. The trends were clear and reinforced the DOJ's commitment to these enforcement priorities. We see these same trade winds blowing in 2013 and perhaps even intensifying in the president's second term.

Foreign Corrupt Practices Act

The impact of heightened FCPA enforcement by the DOJ's Criminal Division during the 45-month tenure of Assistant Attorney General Lanny Breuer, the longest-serving heard of the division in 50 years, will continue to be felt in 2013.

In a November 2012 speech, Breuer said this "global anti-corruption mission has seeped into the Criminal Division's core. And there is no turning back." The figures bear that out. During Breuer's tenure, the DOJ Frauds Section has more than doubled the number of prosecutors assigned to FCPA cases. In his speech, Breuer stressed two statistics regarding the growth of FCPA prosecutions: Since 2009, the DOJ has collected more than $2 billion in criminal penalties and secured convictions of more than three dozen individuals. His remarks indicated that both metrics — the magnitude of fines and the number of individuals held responsible — will continue to drive the enforcement program in this area.

Also in November of last year, the DOJ and SEC issued the long-awaited FCPA guidance in a 120-page publication.[8] Few believe that the FCPA "Resource Guide" will decrease the number of new investigations and proceedings instituted by the government. Instead, the greater value of the guidance may be in providing additional transparency to the process by which DOJ and SEC attorneys evaluate investigations and cases on their burgeoning docket.

This year, we will be watching for trends in the DOJ's resolutions of corporate criminal investigations. In the decade since its prosecution of Arthur Andersen put the firm out of business (with the Supreme Court later reversing the firm's criminal conviction), the DOJ has made wide use of deferred prosecution and nonprosecution agreements to

[8] *See* http://www.sec.gov/spotlight/fcpa/fcpa-resource-guide.pdf.

resolve corporate investigations without a criminal charge. In late 2012, however, some in the media began to question, and some editorials criticized, the DOJ's use of such agreements to resolve high-profile inquiries, even though large monetary payments and significant corporate reforms were secured. We hope to see the DOJ continue to view noncriminal resolutions as appropriate ways to avoid harsh collateral consequences for company employees and shareholders.

Whistleblowers

The False Claims Act (FCA) continued to generate a record $4.9 billion in recoveries in 2012. The DOJ reported that $3.3 billion of those recoveries resulted from whistleblower actions. The government's rate of intervention in private whistleblower suits has remained relatively constant, but the number of total *qui tam* claims overall continues to rise each year in the wake of FCA amendments providing additional incentives to private litigants. The DOJ has every incentive to make 2013 another record-breaking year.

"The U.S. government's relentless targeting of insider trading is poised to continue in 2013."

By comparison, the SEC whistleblower program is in its infancy, but we expect its impact to grow rapidly. The Dodd-Frank Act authorized the SEC program to reward high-quality information that leads to an SEC enforcement action resulting in more than $1 million in sanctions. In August 2012, the SEC announced a nearly $50,000 award, the first under a new program to reward individuals who provide evidence of securities fraud. In its annual report on the whistleblower program, the SEC reported receiving more than 3,000 tips in 2012, with the most common complaint categories being corporate disclosures and financials (18.2 percent), offering fraud (15.5 percent) and manipulation (15.2 percent). With awards ranging from 10 to 30 percent of the money collected, we expect the number of SEC whistleblower claims to climb in 2013 and become a more significant component of the agency's enforcement program.

Insider Trading

The government's relentless targeting of insider trading is poised to continue in 2013. The prosecutions of Raj Rajaratnam and more than 70 others resulting from the well-publicized wiretaps obtained by the U.S. Attorney's Office for the Southern District of New York are concluding, with an unbroken string of convictions. Although no new wiretaps have become public, the government surely will be looking to use that investigative tactic again, assuming the courts allow it. We expect to see decisions from the U.S. Court of Appeals for the Second Circuit this year on a series of appeals that challenged the government's use of wiretaps in the insider trading context. In any case, Southern District prosecutors brought one case to trial in late 2012 without the benefit of wiretap evidence and won a conviction, and they have made additional recent arrests without supporting wiretap evidence. As these efforts move forward, there is a danger of blurring the lines between legitimate research and insider trading if prosecutors and regulators fail to exercise restraint in applying the precedents that have developed on the elements of truly criminal conduct.

The UK Criminal Enforcement Evolution

U.K. criminal enforcement evolved and strengthened in 2012, with significant investigations and proceedings, policy developments, and proposed regulatory and criminal justice system reform.

As political demands for tougher regulatory responses to financial crime grew in 2012, the two primary regulators of serious corporate crime and misconduct, the Serious Fraud Office (SFO) and the FSA, continued to bring increasingly complex cases, often in conjunction with overseas enforcement authorities and regulators. Significantly, the Crown Prosecution Service (CPS), which prosecutes all general crime, also took up significant prosecutions of financial crimes in 2012.

In October 2012, the U.K. Ministry of Justice published the results of a consultation to introduce deferred prosecution agreements (DPAs). The government envisages that DPAs primarily will be used to provide incentives for corporations to cooperate with government investigations in fraud and economic crime matters. The model for DPAs has some similarities to U.S. law and practice but involve earlier and greater judicial oversight than U.S. DPAs. In particular, the DPA approval process would begin with a nonpublic "first appearance" before the "sentencing" judge for the judge to assess whether a potential DPA would be "in the interests of justice" and "fair, reasonable and proportionate."

Serious Fraud Office

Organizational and Policy Changes. In April 2012, David Green QC became director of the SFO, bringing in a new senior management team. Green has indicated that the SFO will focus on criminal prosecutions and not on civil settlements or prospective compliance guidance. In relation to the U.K. Bribery Act, the SFO announced policy revisions in October 2012 that superseded prior guidance regarding corporate hospitality, facilitation payments and corporate self-reporting. Most significantly, the SFO stated that while a company's voluntary disclosure of potential wrondoing is one factor in whether to initiate a corporate prosecution, "self-reporting is no guarantee that a prosecution will not follow."

Enforcement Proceedings. The SFO achieved some success in prosecution of individuals in 2012, while several corporate investigations were resolved by civil recovery agreements. The SFO also suffered public setbacks in its investigations into the collapse of Iceland's Kaupthing Bank.

In relation to corporate entities, the SFO reached "civil recovery" (or disgorgement) settlements with two companies. In January 2012, the agency obtained a civil recovery order against Mabey Engineering Holdings Ltd. for £131,000, representing dividends from a criminal benefit obtained by operating subsidiary Mabey & Johnson Ltd. from contracts in Iraq in contravention of U.K. sanctions laws. In what appears to be an industry-related investigation following the Macmillan Publishing settlement in 2011, in July 2012 Oxford University Press settled with the SFO and paid £4.2 million. Both settlements were negotiated and agreed to by the SFO prior to the new director's appointment. Whether Green will pursue civil recovery settlements is unclear.

As to individuals, in January 2012, Andrew Rybak and Ronald Saunders were sentenced after a trial to five and three years' imprisonment, respectively, for the illicit sale of confidential information to oil and gas companies bidding on projects in Iran, Russia, Egypt, Singapore and the United Arab Emirates. The SFO also achieved a conviction of Polly Peck International CEO Asil Nadir for theft from the company between 1987-1990 of £29 million and was sentenced to 10 years' imprisonment. Nadir absconded during the original trial in 1993 and, until his trial in 2012, remained a fugitive living in Northern Cyprus.

In the SFO's investigations regarding Kaupthing Bank, a court ruled that raids of the homes and business premises of property tycoons Robert and Vincent Tchenguiz were unlawful. The agency subsequently discontinued all investigations into suspected criminality surrounding the bank's collapse. The Tchenguiz brothers have launched a civil suit against the SFO for loss and damage to their businesses and already have recovered £3 million in costs.

Crown Prosecution Service

Enforcement Proceedings. The CPS oversaw three of the U.K.'s highest-profile criminal investigations in 2012, and we expect its efforts in relation to complex criminal matters to continue in 2013. In February 2012, James Ibori, the former governor of the Delta State of Nigeria, pleaded guilty to conspiracy to defraud public funds and money laundering in excess of £50 million. Ibori's wife, sister, mistress and attorney previously had pleaded guilty to connected charges of money laundering. In April, Ibori was sentenced to 13 years' imprisonment. The CPS also obtained a conviction in the prosecution of Kweku Adoboli, the trader in UBS's Global Synthetic Equities Division in London who traded beyond authorized limits in exchange-traded funds and caused a loss to the bank of approximately $2.3 billion. In connected regulatory enforcement actions, UBS was fined $47.6 million by the U.K.'s FSA for failures of systems and controls, and the Swiss Financial Market Supervisory Authority (FINMA) imposed capital restrictions and other supervisory measures on the bank.

Finally, the CPS is supervising the prosecution of cases investigated by the Metropolitan Police concerning alleged phone hacking and improper payments to public officials by journalists. Since January 2011, in three separate investigations, more than 100 people (mainly journalists) have been arrested and 20 charged with various offences.

Financial Services Authority

Organizational and Policy Changes. In 2012, the FSA appointed a new head of both Enforcement and Financial Crime, promoting Tracey McDermott from the ranks. In 2013, the FSA is expected to split into two distinct agencies: Enforcement of financial crime will be the responsibility of a new body, the Financial Conduct Authority; banking and regulatory functions will be handled by the Prudential Regulation Authority (PRA) (see Financial Regulation/"Restructuring the UK Regulatory Framework: What the Financial Services Industry Can Expect").

The FSA published the findings of its thematic review into anti-bribery and corruption systems and controls in investment banks. Since August 2011, the FSA has visited 15 firms, including eight major global investment banks and a number of smaller operations, to examine how firms mitigate bribery and corruption risk. The FSA found systems and controls failures involving readiness for the Bribery Act, including inadequate or no risk assessments, lack of top-level management oversight and inadequate controls around third-party risk. The FSA will consider further regulatory action against firms that fail to heed regulator remediation advice and issued guidance.

Enforcement Proceedings. Similar to the focus of US authorities on insider trading, the FSA brought several insider trading enforcement actions in 2012.

In January 2012, the FSA announced its decision to fine U.S. hedge fund Greenlight Capital Inc. and its owner, David Einhorn, £7.2 million for engaging in civil market abuse. Einhorn traded in Punch Taverns Plc stock after learning of an anticipated significant equity fundraising by the company in a telephone call with its management. The FSA asserted that although Einhorn had not sought to obtain inside information from company management, his trades were nevertheless based on material nonpublic information.

In a case involving parallel investigation by the SEC and DOJ, James Sanders, a director of Blue Index (a specialist Contract for Difference (CFD) brokerage), his wife, Miranda Sanders, and James Swallow, a Blue Index co-director and compliance officer, pleaded guilty to insider trading between October 2006 and February 2008. In June 2012, the defendants were sentenced to four years', 10 months' and 10 months' imprisonment respectively. Inside information relating to U.S. securities was passed by a senior partner in a large U.S. accounting firm to a relative of Miranda Sanders.

The banking sector continued to be a focus of FSA enforcement action throughout the year. The agency settled a number of enforcement actions against U.K. and foreign banks based on systemic failures of money laundering controls. Coutts was fined £8.75 million, and other foreign registered banks, Habib Bank AG Zurich and Turkish Bank (U.K.) Ltd., similarly were fined for money laundering controls violations. Bank of Scotland was fined £4.2 million for inadequate books and records in its mortgage business.

> "The diversifying regulatory risk environment in China cannot be wished away, but it can be managed."

The most significant fines against the banks have come in context of the ongoing LIBOR investigations, which are being conducted jointly by the FSA and SFO in the U.K. and the SEC, Commodity Futures Trading Commission and the DOJ in the United States (see "Antitrust and Competition: Antitrust Enforcement on Both Sides of the Atlantic"). In June 2012, Barclays settled its LIBOR cases with the FSA and was fined £59.5 million, as part of a multijurisdictional settlement valued at approximately $450 million. In December, UBS was fined £160 million by the FSA for manipulating the LIBOR rate between 2005-10, in a multijurisdictional settlement that also involved U.S., Swiss and Japanese regulators and totalled approximately $1.5 billion. Other banks face corporate enforcement proceedings by the FSA and criminal proceedings against executives, which will be led by the SFO. Arrests of traders in the LIBOR investigation in December will undoubtedly be followed by others in 2013 in both the U.K. and the United States.

China Continues to Present Enforcement Risks

Recent events have highlighted the increasingly complex and difficult regulatory environment for both foreign companies operating in China and Chinese companies operating in the United States. We expect these trends to continue in the coming year.

One of the primary regulatory risks facing U.S. companies in China has been the potential for liability under the FCPA, and recent developments indicate that this likely will remain the case. As noted earlier in this article, the DOJ and the SEC recently released the much-anticipated FCPA "Resource Guide," which largely reaffirms the government's commitment to its established positions on the FCPA's scope, enforcement considerations and sanctions. Given that the FCPA remains "a critically important statute for combatting corruption around the globe" and "a continuing priority" for the DOJ and

SEC, there is little reason to expect dramatic change in the U.S. government's aggressive enforcement posture on the FCPA as it relates to China. Indeed, FCPA enforcement activity targeting conduct in China continued last year, and U.S. regulatory focus likely will deepen as the world's two largest economies continue to interact.

There also are signs that U.S. regulatory focus is expanding into areas that previously had received less attention. Last year there was a spate of high-profile, non-FCPA regulatory activity against Chinese companies by the SEC, the Committee on Foreign Investment in the U.S. (CFIUS) and the Department of the Treasury's Office of Foreign Assets Control (OFAC), among others, in addition to increasing private litigation against Chinese firms. Just in the latter half of 2012, the Obama administration prohibited the acquisition of wind farm facilities by Chinese-owned companies on national security grounds,[9] Congress expanded its inquiries into the political ties of Chinese telecommunications companies, OFAC imposed sanctions on the Bank of Kunlun for dealings with certain Iranian banks,[10] and, most dramatically, the SEC leveled charges against the Chinese affiliates of all Big Four accounting firms for withholding certain audit work papers that the firms asserted was in compliance with local Chinese law.

This rising tide of enforcement activity has real implications for companies in both countries, as foreign business partners can expose U.S. firms to vicarious liability under increasingly expansive interpretations of U.S. regulatory jurisdiction, and companies can find themselves caught between the conflicting demands of local law in each country. All of this portends a wave of increasingly complex and disparate regulatory and litigation activity as the various U.S. regulators pursue their separate enforcement missions, often in uncoordinated fashion. This trend will place a premium on companies' abilities to view their regulatory risks globally, anticipate potential regulatory issues in multiple jurisdictions, bring expertise and resources to bear quickly to contain emerging problems, and orchestrate coordinated approaches to handle multiple simultaneous matters pending before different regulators in multiple jurisdictions. Dedicated teams of specialists on the ground in each jurisdiction with an understanding of local language, custom and regulatory practice will be required; and firms that are able to implement strong compliance programs and other preventative measures — both internally and with their foreign business partners — to catch potential issues before they develop into actual violations will be rewarded. Due diligence and other pre-transaction assessments will need to screen for a widening array of potential regulatory concerns and will demand that companies respond rapidly to contain and remediate emerging problems before they widen. The diversifying regulatory risk environment in China cannot be wished away, but it can be managed.

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[9] *See* http://www.whitehouse.gov/the-press-office/2012/09/28/order-signed-president-regarding-acquisition-four-us-wind-farm-project-c.

[10] *See* http://www.treasury.gov/resource-center/sanctions/OFAC-Enforcement/Pages/20120731.aspx.

International Litigation and Arbitration: Jurisdictional Challenges, Cross-Border Enforcement Developments and Sovereign Debt Disputes

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When Can US Courts Vacate an Arbitral Tribunal's Decisions for Lack of Arbitral Jurisdiction? The Debate Heats Up

Whether arbitrators have power to determine challenges to their own jurisdiction — known as "competence/competence" — was an intensely debated issue in the U.S. courts in 2012 and is likely to remain so in 2013. A number of recent appellate decisions have examined the role of the courts in reviewing arbitrators' jurisdictional decisions as well as the effect of an agreement by the parties to arbitrate under rules that include a competence/competence provision conferring on the arbitrators the power to decide objections to their jurisdiction.

The U.S. framework for determining the standard of judicial review of an arbitral decision concerning arbitral jurisdiction (sometimes referred to as "arbitrability") was established by the U.S. Supreme Court in *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938 (1995). In *First Options*, the Supreme Court held, in a case governed solely by the "domestic arbitration" provisions of the Federal Arbitration Act, that the scope of judicial review is determined by whether the parties agreed to submit questions of arbitrability to the arbitrator. *Id.* at 943. If so, the reviewing court will apply the same deferential standard of review applicable to any other matters that the parties agreed to arbitrate. If, on the other hand, the parties did not agree to submit the arbitrability question to arbitration, then the question of whether the dispute is arbitrable is subject to independent review by the courts. *Id.* The Supreme Court cautioned, however, that courts should not assume that the parties have agreed to arbitrate arbitrability without "clear" and "unmistakable" evidence of their intent to do so, and in this regard, held that merely submitting a jurisdictional objection to the arbitrator does not indicate a clear willingness to have the arbitrator decide the question of arbitrability. *Id.* at 945-46.

In *China Minmetals Materials Import and Export Co. v. Chi Mei Corp.*, 334 F.3d 274 (3rd Cir. 2003), a panel of the Third Circuit, which included then-Circuit Judge Alito prior to his elevation to the U.S. Supreme Court, held that *First Options* also applies to international arbitral awards where enforcement is sought under the New York Convention. In that case, the Third Circuit held that where a party alleged that the arbitration agreement had been forged, the court should make an independent determination of arbitrability. *Id.* at 289.

In 2012, the U.S. Courts of Appeals had the opportunity to apply these principles and consider how they interact with the arbitral rules chosen by the parties:

- In January, the D.C. Circuit vacated a $185 million damages award previously rendered by an UNCITRAL tribunal under the United Kingdom-Argentina Bilateral Investment Treaty (the U.K.-Argentina BIT). *See Republic of Argentina v. BG Group PLC*, 665 F.3d 1363, 1371 (D.C. Cir. 2012). The UNCITRAL tribunal had held that Argentina's 2001-02 legislation, redenominating energy tariffs from dollars to pesos, was a violation of the U.K.-Argentina BIT. Argentina argued the UNCITRAL tribunal lacked jurisdiction because the claimant had failed to litigate its grievances in the Argentine courts for 18 months as required by the U.K.-Argentina BIT. The D.C.

Circuit agreed, holding that, in ignoring this jurisdictional limitation, the UNCITRAL tribunal had exceeded its powers. It furthermore held that the "parties would likely have expected a court to determine whether a claimant's failure to abide by the 18-month pre-arbitration procedure would affect arbitrability," *i.e.*, there was no "clear and unmistakable evidence," for *First Options* purposes, that the arbitrators had the power to decide this jurisdictional issue. A *certiorari* petition before the U.S. Supreme Court was still pending at the end of 2012.

- In June, the Sixth Circuit, in *Crossville Medical Oncology, P.C. v. Glenwood Systems, LLC*, No. 11-5232, 2012 WL 2401722, vacated an AAA arbitrator's award against a counterclaim defendant who claimed that he was not a proper party to the arbitration. The lower court had concluded that the counterclaim defendant had waived the challenge by failing to put this jurisdictional objection to the arbitrator. Reversing, the Sixth Circuit ruled that under *First Options*, the counterclaim defendant had preserved his objection sufficiently, adding that the courts must determine the threshold question of whether there was an arbitration agreement between the counterclaimant and the nonsignatory. Absent such agreement, the question of arbitrability was for the court to decide. *Id.* at *4-5.
- In July, the Second Circuit, in *Thai-Lao Lignite (Thailand) Co. v. Government of the Lao People's Democratic Republic*, No. 11-3536-cv, 2012 WL 2866275, affirmed an international award issued under the UNCITRAL rules. The Lao government argued that one of the two claimants was not a signatory to the relevant arbitration clause, and thus not a proper party. The Second Circuit held however that Laos' agreement to arbitrate under the UNCITRAL rules, which provide that the arbitral tribunal has the power to rule on jurisdictional objections, constituted a "clear and unmistakable intent" to arbitrate arbitrability, and thus, in accordance with *First Options*, it would not independently review the issue. *See* 2011 WL 3516154, at **17-21 (S.D.N.Y. 2011), rehearing and en banc review denied (Oct. 18, 2012). At the end of 2012, it was possible that Laos would seek *certiorari* before the U.S. Supreme Court.
- Also in July, the Fifth Circuit in *Petrofac, Inc. v. DynMcDermott Petroleum Operations Co.*, 687 F.3d 671, affirmed an AAA award, rejecting a claim that the dispute was beyond the defined scope of the arbitration agreement. It held that by expressly incorporating the AAA rules into their agreement, the parties had clearly and unmistakably agreed to arbitrate this "scope" issue, meaning the arbitrators' decision on scope was conclusive. *See id.* at 674-75.
- Finally, in August, the Second Circuit in *Schneider v. Thailand*, 688 F.3d 68 (2d Cir. 2012), upheld a €30 million UNCITRAL award in favor of a German investor, following the Thai government's alleged breaches of the Germany-Thailand BIT. Thailand argued that the tribunal lacked jurisdiction because the investor's enterprise (a tollway project) was not an "approved investment," as defined by the investment treaty. The Second Circuit held that this question was reserved under the terms of the Germany-Thailand BIT to the arbitrators. It added that its view was fortified by the UNCITRAL rules, which stated (in relevant part) that "the arbitral tribunal shall have the power to rule on objections that it has no jurisdiction, including any objections with respect to the existence or validity of the arbitration clause or of the separate arbitration agreement." This, for *First Options* purposes, was "clear and unmistakable evidence" that the relevant jurisidictional question was for the arbitrators.

Each of these U.S. decisions appears to turn on the issue of whether the party challenging the award unequivocally agreed to submit to the arbitral rules that contain a competence/competence provision. In both *Petrofac* and *Thai-Lao*, submission to the rules by the party challenging the award was undisputed, while in *Crossville Medical Oncology* and *China Minmetals*, the jurisdictional dispute centered on whether the objecting party had agreed to arbitrate at all, let alone under any particular rules.

The BIT cases arguably raise a more nuanced issue. *BG Group* turns on whether the arbitration agreement should be viewed as having certain conditions, nonfulfillment of which would destroy jurisdiction based on the terms of the relevant treaty. Argentina argued that its submission to arbitration was conditioned upon the claimant following a certain pre-arbitration procedure, that it had failed to do so and that, under *First Options*, the parties to the relevant arbitration agreement (contained in an investment treaty) had chosen to allow the courts to have ultimate power to review this issue. *Schneider*, by contrast, concerned an issue that (again based on the terms of the particular treaty) appeared to have been entrusted to the arbitrators.

Regardless of whether the Supreme Court grants *certiorari* in *BG Group*, parties and courts need to consider carefully the individual terms of every arbitration agreement and applicable institutional arbitration rules to determine in each case whether and what issues of jurisdiction are to be determined exclusively before the arbitration tribunal, and whether any such issues may be raised afresh before the courts.

> "*BG Group* turns on whether the arbitration agreement should be viewed as having certain conditions, nonfulfillment of which would destroy jurisdiction based on the terms of the relevant treaty."

Attempts to Use New York Courts for Cross-Border Judgment Enforcement Against International Banks: The *Koehler* Controversy

For the past three years, New York courts have been embroiled in a battle between judgment creditors and international banks over the proper scope of the judgment enforcement mechanisms, resulting from the 2009 decision by the New York Court of Appeals — New York's highest state court — in *Koehler v. Bank of Bermuda Ltd.*, 12 N.Y.3d 533 (2009).

In *Koehler*, the New York Court of Appeals (answering questions certified to it by the Second Circuit) held that a New York court, when exercising post-judgment enforcement powers under New York's Civil Procedure Law and Rules, could validly order a bank to deliver to a judgment creditor the property of a judgment debtor (*e.g.*, stock certificates), even though the assets are held by the bank outside New York, so long as the court has personal jurisdiction over the bank in New York. Bank of Bermuda's Bermuda branch, which held the certificates, had consented to the jurisdiction of the courts of New York at the onset of the litigation, a fact emphasized by the New York Court of Appeals.[11]

In the years since *Koehler*, judgment creditors have sought to use the decision to reach judgment debtors' assets held in foreign bank branches that, unlike Bank of Bermuda in *Koehler*, do not consent to personal jurisdiction in New York. They have done so by serving petitions to turn over assets on the foreign banks' New York branches, arguing that the presence of a New York branch allows the New York courts to exercise jurisdiction over the entire bank's worldwide operations.

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[11] *See Koehler*, 12 N.Y.3d at 536; *see also Koehler v. Bank of Bermuda Ltd.*, 2005 WL 551115, at *12 (S.D.N.Y. Mar. 9, 2005).

In defending against such claims, bank garnishees have sought to invoke a long-standing rule of New York law known as the "separate entity rule." Under this rule, bank branches that are not separately incorporated nevertheless are treated as separate jurisdictional entities from their sister branches in other countries for judgment enforcement and other purposes. Accordingly, serving process on a New York branch of a foreign bank would not be sufficient to establish jurisdiction over the bank's foreign branches where a judgment debtor may have assets.

On numerous occasions over the last few years, New York's state courts have held that the separate entity rule remains intact and cannot be abrogated absent legislative action or a clear statement to that effect by the New York Court of Appeals. For instance, in *Global Technology, Inc. v. Royal Bank of Canada*, No. 15015½011, 2012 WL 89823 (N.Y. Sup. Ct. Jan. 11, 2012), a New York trial court held that "under the separate entity rule, service of the petitioner's restraining notice upon respondent's branch in Manhattan did not restrain [the judgment debtor's] bank accounts in Canada." *Id*. at *13.[12] Even more recently, in October 2012, a New York Supreme Court judge set aside a series of information subpoenas aimed at finding overseas assets allegedly controlled by French, Canadian and Swiss banks with branches in New York, holding, among other things, that the "separate entity" rule rendered such efforts improper. *See Ayyash v. Koleilat*, Index No. 151471/12 (N.Y. Sup. Ct. New York County, Oct. 22, 2012).

District Court Views

In contrast, certain federal district court judges sitting in Manhattan have been more equivocal about the survival of the separate entity rule after *Koehler*. For instance, in a January 2011 decision, one district judge took the view that "*Koehler* indicates that New York courts will not apply the separate entity rule in post-judgment execution proceedings." *JW Oilfield Equipment, LLC v. Commerzbank, AG*, 764 F Supp 2d 587, 595 (S.D.N.Y. 2011). The court based its decision, in part, on an apparent concession by Commerzbank that the separate entity rule had been preempted in certain instances. *Id*. Nine months later, another district judge cited *JW Oilfield* approvingly and rejected contrary precedents from the New York state courts.[13] Indeed, as *Global Technology* observed in January 2012, "federal courts are deeply divided from New York trial-level courts on this issue."[14]

Shortly after *Global Trading*, Judge Loretta Preska, Chief Judge of the Southern District, disagreed with prior federal decisions and instead joined the New York state trial courts in holding that the separate entity rule remains the law of New York. *Shaheen Sports, Inc. v. Asia Ins. Co.*, Nos. 98 Civ. 5951, 11 Civ. 920, 2012 WL 919664, at *3–8 (S.D.N.Y. Mar. 14, 2012). In *Shaheen Sports*, a judgment creditor petitioned for turnover of the judgment debtor's assets by Habib Bank Limited. The petitioner served Habib's New York branch even though it alleged that the judgment debtor's assets were held by a Habib branch in Pakistan. The court declined the petitioner's invitation to discard the separate entity rule and refused to order Habib to turn over assets held by the Pakistani branch.

[12] *See also, e.g., Samsun Logix Corp. v. Bank of China*, No. 105262/10, 2011 WL 1844061 (N.Y. Sup. Ct. May 12, 2011); *Parbulk A.S. v. Heritage Maritime S.A.*, Index No. 651285/11 (N.Y. Sup. Ct. June 7, 2011), slip op. at 3-4.

[13] *Eitzen Bulk A/S v. Bank of India*, No. 09 Civ. 10118, 2011 WL 4639823 (S.D.N.Y. Oct. 5, 2011) (Hellerstein, J.).

[14] *Global Technology*, 2012 WL 89823, at *1.

Chief Judge Preska took the view that if the New York Court of Appeals intended to abrogate the long-standing separate entity rule, "it is not unreasonable to expect that … it would have said so." *Id.* at *5. She also pointed out that there are "significant policy principles underlying the separate entity rule," including "the intolerable burden that would otherwise be placed on banking and commerce if mere service of a writ to a New York branch could subject foreign bank branches to competing claims" in New York and the foreign jurisdiction. *Id.* (citations omitted).

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Whether the appellate courts in New York will act in *Shaheen Sports* or another case to definitively address the viability of the separate entity rule after *Koehler* awaits determination. It seems likely that the issue eventually will reach the New York Court of Appeals for further adjudication.

Continuing Disputes Over Sovereign Debt

The recent sovereign defaults in several Latin American states and the specter of a similar fate for some Western nations once again have brought into focus the many legal and practical issues that arise when a sovereign fails to make payment on its bonds or other debt obligations.

The most prominent example has been the Argentine bond default of 2001-02, which led holders of Argentina's 1994 bonds to bring legal proceedings in the federal courts of New York (the agreed exclusive forum for disputes as specified in many of Argentina's sovereign bonds). Several creditors, having obtained judgments against Argentina, have attempted to attach state-owned (or allegedly state-owned) assets in an effort to enforce those judgments, leading to a host of decisions under the Foreign Sovereign Immunities Act about whether particular classes of assets (*e.g.*, state airlines, central bank deposits, state-administered pension funds — even the presidential jet) enjoy immunity from execution. While most of these decisions have been made in New York (by the U.S. District Court for the Southern District of New York or, on appeal, by the U.S. Court of Appeals for the Second Circuit), others have been made in California or overseas, with one recent attachment order (concerning the historic ship *Libertad*) made by the courts of Ghana.

In 2005 and 2010, in an effort to restructure its sovereign debt, Argentina made certain exchange offers, inviting its predefault bondholders to exchange their defaulted debt for new instruments to be issued by Argentina. The exchange offers met with a more-than 90 percent acceptance rate, with a small minority electing to continue their efforts at judgment enforcement. One of the steps taken by these holdouts was to challenge Argentina's right to make payments under the 2005 and 2010 exchange instruments. They argued that observance by Argentina of its obligations under these exchange instruments, without also making a "ratable payment" to the holdouts, would violate the pari passu clause of the original predefault bonds, which states:

> The [1994 bonds] will constitute ... direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank pari passu without any preference among themselves. The payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness.

In December 2011, Judge Griesa of the Southern District held that the pari passu clause applied and issued a mandatory injunction requiring Argentina, any time it made a payment under an exchange instrument, to make a ratable payment to the holdouts. In October 2012, a three-judge panel of the Second Circuit affirmed the finding of the district court, but held that certain issues, including the meaning of ratable payment and the effect of the district court's order on third parties, required further clarification, thus remanding these issues to the district court.

In November 2012, the district court held that the ratable payment rule meant that, any time a payment (of any size) is made on an exchange instrument, a simultaneous payment must be made equaling all of the debt currently due to the holdouts, *i.e.*, all principal and interest outstanding under the 1994 bonds (such principal obligations having been accelerated according to the terms of the 1994 bonds). Both this and the Second Circuit decisions are subject to further appeal.

The *Abaclat* Case

Not all holdout bondholders have elected to take their claims to the courts. In the case of *Abaclat v. Argentina*, a group of approximately 60,000 Italian holdouts have brought arbitral proceedings against Argentina pursuant to the Italy-Argentina Bilateral Investment Treaty (BIT) before the International Centre for Settlement of Investment Disputes (ICSID), a specialist investor-state arbitration forum governed by the 1965 Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (the ICSID Convention). The *Abaclat* claimants allege that their bond instruments constitute protected investments under the BIT and the ICSID convention, and Argentina has violated its treaty obligations.

> "The *Abaclat* case remains highly controversial in some quarters because the relationship between international law obligations and the private law contractual obligations have not yet been fully articulated."

In 2011, an ICSID tribunal held (by majority) that it had jurisdiction over the dispute in that the *Abaclat* claimants' bonds were an investment susceptible of protection against the potential violations of the BIT, including the fair and equitable treatment, most favored nation and umbrella clauses of the BIT. The *Abaclat* claims are now progressing toward a merits hearing. Two older ICSID cases involving Italian bondholders against Argentina may come to a final award over the next few months.[15]

The *Abaclat* case remains highly controversial in some quarters, not only because it represents the largest mass arbitration before ICSID, but also because the relationship between international law obligations (in a treaty) and the private law contractual obligations (such as those contained in a bond instrument) have not yet been fully articulated. For example, while the nonpayment of a debt obligation certainly would breach a private law obligation, it is not yet clear in what circumstances this could be held to constitute a treaty obligation.

The *Abaclat* tribunal has suggested that some state measures targeted at creditors (*e.g.*, the enactment of moratoria that purport to suspend or nullify creditors' rights) may constitute a treaty breach. In addition, certain past BIT cases have suggested that a state economic restructuring, if done in a manner that discriminates against classes of investors, may violate treaty rights. In *Saluka Investments v. Czech Republic* (UNCITRAL 2006), for example, state actions, taken in the midst of a debt crisis in the financial

[15] *Giordano Alpi and others v. Argentine Republic* (ICSID Case No. ARB/08/9) and *Giovanni Alemanni and others v. Argentine Republic* (ICSID Case No. ARB/07/8).

sector, improperly discriminated against foreign investors, thus creating liability under the Netherlands-Czech BIT.

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As many governments continue to struggle with their outstanding indebtedness, it remains possible that holdout litigation, or proceedings akin to the *Abaclat* case, may recur in another setting. Without an international insolvency regime applicable to sovereigns, litigation in the national courts and potential ICSID arbitration will continue over sovereign debt enforcement.

Intellectual Property and Technology: Patent and E-Commerce Issues to Watch

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Patent and Technology Issues to Watch

With the epic smartphone patent battle between Apple and Samsung making headlines, patent law met popular culture in 2012 in a way that rarely occurs. What was happening behind the scenes in patent law, however, promises to have much more lasting ramifications than will the outcome of that single lawsuit.

The America Invents Act (AIA). The AIA, which is the most significant revision to U.S. patent law since the 1950s, was rolled out in phases starting in late 2011. However, the most fundamental change imposed by the AIA — the move to a "first-to-file" patent system — will not come into effect until March 2013. Moreover, the rules implementing various Patent & Trademark Office (PTO) procedures for challenging patents are in a state of flux, and the statute itself may face amendment as questions about the viability of certain provisions are revealed. For example, the AIA allows for challenges to a patent via a postgrant review process, which becomes available upon issuance of the patent, and an *inter partes* review process, which becomes available nine months after issuance. The current wording of the AIA, however, limits the postgrant review process to patents issued on applications filed on or after the March 2013 date when the first-to-file system goes into effect. Because those patents likely will not be issued for a number of years, a situation has been created in which newly issued patents cannot be challenged for nine months, when the *inter partes* review becomes available. A bill has been introduced to remedy this gap.

Theft of Trade Secrets Clarification Act of 2012 (the Act). On December 28, 2012, President Obama enacted the Theft of Trade Secrets Clarification Act of 2012, which clarifies the scope of Section 1832 of the Economic Espionage Act of 1996 (EEA) and attempts to reverse the U.S. Court of Appeals for the Second Circuit's recent decision in *United States v. Aleynikov*, 676 F.3d 71 (2d Cir. 2012). Significantly, the Act clarifies that the EEA protects wholly internal proprietary information if the information relates to products or services that are used in interstate or foreign commerce.

As amended, Section 1832(a) will require that the trade secret relate to a product or service that is used or intended for use in interstate or foreign commerce. The offense will no longer be limited to theft of trade secrets related to a product that is produced for or placed in interstate or foreign commerce. The intended consequence of the amendment will be to reject the Second Circuit's interpretation of the scope of the EEA. *See, e.g.*, 158 Cong. Rec. H6849 (daily ed. Dec. 18, 2012) (statement of Rep. Smith) (noting the "dangerous loophole" created by the *Aleynikov* decision and calling on Congress to "take action in response to the Second Circuit's call and ensure that we have appropriately adapted the scope of the EEA to the digital age").

"Patent law met popular culture in 2012 in a way that rarely occurs."

The broader scope, combined with the recent publicity of the *Aleynikov* case, likely will spur an increase in criminal indictments under the EEA as companies increasingly recognize the Act as a powerful weapon in defense of trade secrets. For companies seeking such protection, referring matters to federal authorities for prosecution under the amended EEA may be an attractive alternative to litigating claims in state court. Likewise, the amended EEA creates an incentive for companies to re-examine the techniques they use for competitive intelligence gathering and the care with which they handle third-party proprietary information.

U.S. Supreme Court Outlook. In 2012, the Supreme Court continued its nearly decade-long run of patent decisions, ruling on patentable subject matter (*Mayo v. Prometheus*), patent-use codes for drug products (*Novo Nordisk v. Caraco*) and the scope of evidence in appeals from the PTO (*Kappos v. Hyatt*). Decisions are expected from the Supreme Court in still more patent cases in 2013 (see "The US Supreme Court Term: Business Cases to Watch"). The following are the most noteworthy:

- *AMP v. Myriad Genetics.* The Supreme Court has granted *certiorari* in this case on the question of whether isolated DNA is patent-eligible subject matter. The Federal Circuit ruled that isolated DNA is patentable subject matter because it is man-made, not found in nature and distinct from naturally occurring DNA. In its decision, the Federal Circuit relied in part on the PTO's nearly 30-year history of issuing patents related to DNA molecules. This decision clearly will be important to the life sciences industry, but its application may be more far reaching if the Supreme Court speaks to the degree of deference that courts should afford the PTO in determining patent-eligible subject matter.

- *Already, LLC v. Nike, Inc.* This case, which was decided by the Supreme Court on January 8, 2013, involved the question of whether a covenant not to sue for trademark infringement divests a district court of Article III jurisdiction over a challenge to that trademark. Nike first sued Already for trademark infringement, and when Already counterclaimed seeking to cancel the mark, Nike withdrew its infringement claim and agreed not to pursue litigation. The Supreme Court upheld the decision of the Second Circuit, which in turn had affirmed the district court's dismissal of Already's claim for lack of case or controversy. The Supreme Court reasoned that a trademark owner's unequivocal assertion of non-enforcement moots a challenge to the validity of the mark by a competitor that no longer faces the threat of enforcement action. While four justices joined in a concurrence urging a limited reading of the decision, it is expected that litigants in patent actions will attempt to extrapolate from the holding. Current precedent allows a patent holder to divest a court of jurisdiction over a declaratory judgment counterclaim of invalidity by agreeing not to sue the claimant for infringement, thus eliminating the required case or controversy, and the Supreme Court's decision in favor of Nike underscores that precedent.

E-Commerce: Industry Continues to Face Two-Front Battle

Enforcement action and litigation by government authorities against e-commerce companies continued in 2012, and this trend shows no signs of slowing down in 2013.

Government Actions. Taxing authorities across the country continue to assert claims against online travel service companies (OTCs) for alleged failure to collect and remit hotel occupancy tax owed on the amount each charges customers and retains as compensation for its online travel services related to the reservation of hotel rooms. To date, the OTCs have won 20 of the 28 cases in which judgment has been ordered, and obtained a ruling that no back taxes are owed in four of the remaining eight cases. In 2012, the scorecard was even more lopsided — of the 15 cases in which judgment was entered, the OTCs won 13 outright and obtained a ruling that no back taxes were owed in one of the two remaining cases. In each win, the court ruled in favor of the online companies and determined the companies do not operate hotels and are not liable for tax on the amount they charge customers and retain as compensation for their online services.[16]

Taxing authorities' efforts to impose sales tax on nonresident e-commerce companies also continued. Relying on representative nexus taxing theories, states continue to assert tax jurisdiction over e-retailers, requiring that each pay sales tax on sales to in-state customers even where the e-retailer itself does not have a physical presence in the state. While the validity of such taxing theories still is in question, states have been successful in convincing various e-retailers to begin collecting and remitting tax pursuant to them. In an effort to render those taxing theories moot, lobbying efforts are being made by, and on behalf of, traditional brick-and-mortar retailers for federal legislation (most notably, the Marketplace Fairness Act) to impose a uniform law governing the applicability of sales tax statutes that would require all e-commerce companies to collect sales tax on all transactions. Such congressional action is largely opposed by e-retailers.

Government authorities also continued to take action to protect the privacy of online consumers. For example, the FTC approved settlements in 2012 with a number of online companies resolving privacy issues. Facebook settled charges that it deceived customers regarding the privacy of their information, agreeing to make changes to its business practices and to permit periodic third-party audits of those practices. Meanwhile, Google agreed to pay a $22.5 million civil penalty to resolve charges relating to its practice of circumventing privacy settings to place advertising tracking cookies on consumers' computers. Finally, in settling charges that it (1) deceived consumers by misrepresenting its data collection practices, and (2) failed to adequately protect the data collected, Compete, Inc. agreed to abstain from making future representations, implement a comprehensive security program and conduct periodic, independent audits of its practices regarding consumer privacy.

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[16] Notable 2012 wins included *City of Columbus v. Hotels.com, L.P.*, Nos. 10-4531/4545, 2012 U.S. App. LEXIS 18949 (6th Cir. Sept. 10, 2012); *City of Birmingham, et al. v. Orbitz, Inc. et al.*, Case No. 1100874, 2012 Ala. LEXIS 43 (Ala. Sup. Ct. Apr. 13, 2012); *Expedia, Inc. v. City of Anaheim,* BC 230457 (Ct. App. Nov. 1, 2012); *City of Santa Monica v. Expedia, Inc., et al.*, BC 236166 (Ct. App. Nov. 1, 2012); *City of Goodlettsville v. Priceline.com Inc.*, Case No. 3:08-cv-00561 (M.D. Tenn. Feb. 21, 2012); *Leon County, et al. v. Expedia.com, et al.*, Case No. 09CA4319 (Fla. 2d Jud. Cir. Ct. Apr. 19, 2012); and *In the Matter of the Tax Appeal of Travelocity.com LP, et al.*, T.A. No. 11-1-0021 (and Consolidated Cases) (Tax Appeal Court, State of Hawaii, Oct. 22, 2012). The only adverse ruling came in *District of Columbia v. Expedia*, Case No. 2011 CA 002117 B (Wash. D.C. Sup. Ct. Sept. 24, 2012).

Consumer Claims. Consumers also took action against online companies in 2012 to protect their privacy interests. For example, in *In re Hulu Privacy Litigation*, the U.S. District Court for the Northern District of California ruled that a consumer class action could proceed against Hulu.com for alleged violations of the Video Privacy Protection Act. Specifically, the court allowed claims to proceed on allegations that a website illegally shared viewing histories and other private information with third-party advertisers, ruling that the Video Privacy Protection Act (VPPA) applied to such websites that allow users to stream video over the Internet. A similar suit (*In re Netflix Privacy Litigation*) alleging violations of the VPPA was brought by consumers against Netflix. Netflix reached an agreement to settle claims arising from allegations that it unlawfully retained and disclosed viewing histories and other private information for $9 million. The settlement agreement received preliminary approval from the court on July 5, 2012. However, in *Low v. LinkedIn Corporation*, the U.S. District Court for the Northern District of California dismissed claims brought pursuant to the Stored Communications Act against LinkedIn alleging illegal disclosure of browsing history to advertisers. The court ruled the consumers lacked a claim under the VPPA because the allegedly disclosed information did not relate to an electronic communication service and/or a remote computing service.

Consumers also continued to pursue consumer fraud claims against online companies. One such action, *Schnabel v. Trilegiant Corp.*, No. 11-1311 (2d Cir. Sept. 7, 2012), produced an important ruling applying the "shrinkwrap" principle in contract law to online agreements. The court ruled that an arbitration clause was unenforceable where the clause was not disclosed on the Web page where consumers enrolled in the discount shopping program, but rather was sent to consumers in an email after enrollment. Specifically, the court ruled the arbitration clause was unenforceable because it was "both temporally and spatially decoupled" from the consumers' enrollment in the program.

Securities Litigation: Recent and Upcoming Supreme Court, Appellate and District Court Developments

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Recent and Upcoming Supreme Court Decisions in Securities Cases

The U.S. Supreme Court continues to show interest in securities and class action issues. In 2012, for example, the Court unanimously decided *Credit Suisse Sec. (USA) v. Simmonds,* 132 S. Ct. 1414 (2012), holding that the statute of limitations governing the recovery of "short-swing" profits from corporate insiders under Section 16(b) of the Securities Exchange Act can begin to run regardless of whether the insiders filed a public disclosure of their transactions under Section 16(a). The Court noted that the Securities Exchange Act's plain text provides that the period for recovering short-swing profits commences on the "date such profit was realized." 15 U.S.C. § 78p(b). The Court was evenly split 4-4 (Chief Justice John Roberts took no part in the consideration of the case) regarding whether Section 16(b) provided a statute of repose rather than a limitations period.

Last year, the Court also heard argument in *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, No. 11-1085 (2012), on whether a securities fraud plaintiff alleging fraud on the market must establish materiality in order to obtain class certification. A decision is anticipated by the end of June 2013 (see "The US Supreme Court Term: Business Cases to Watch").

Supreme Court Could Rule on Evidentiary Standard for Expert Testimony at the Class Certification Stage

"The Supreme Court's 2013 *Comcast* ruling could impact securities class actions by directing district courts in their scrutiny of expert testimony regarding classwide damages."

In the antitrust context, the Supreme Court could decide a question left open by the Court's recent holding in *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011), with potential implications for the certification of securities class actions. The forthcoming ruling in *Comcast Corp. v. Behrend*, No. 11-864, could resolve whether expert testimony offered to support classwide damages at the certification stage must withstand a reliability assessment under *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993) (see "Class Action Outlook: A Busy Year Ahead"). The Supreme Court heard argument on November 5, 2012, and a ruling is expected by the end of June 2013. The result could impact securities class actions by directing district courts in their scrutiny of expert testimony regarding classwide damages.

New York State Court Rejects Extraterritorial Securities Lawsuits Already Excluded From Federal Court by the US Supreme Court's *Morrison* Decision

On December 27, 2012, New York's Appellate Division issued highly anticipated rulings in *Glenhill Capital LP v. Porsche Automobil Holding* and *Viking Global Equities LP v. Porsche Automobil Holding*, dismissing the U.S. component of several hedge funds' litigation against Porsche concerning Porsche's allegedly secret plans to acquire Volkswagen. The court found that New York state courts are not the proper forum for the particular fraud claims at issue, which were brought by a mix of foreign and domestic funds against foreign defendants over shares traded on a foreign exchange. In 2010, the U.S. Supreme Court held in *Morrison v. National Australia Bank*, 130 S. Ct. 2869, that such "foreign-cubed" claims cannot, as a matter of law, be brought under federal securities statutes because they are beyond the territorial reach of Section 10(b) of the Securities Exchange Act. Applying *Morrison*, a federal court in Manhattan dismissed the claims against Porsche in parallel litigation. That decision is on appeal to the U.S. Court of Appeals for the Second Circuit and a decision is expected this year. The plaintiff funds then filed a similar action in New York state court under state law, which was at issue in the December 27 opinion. Although New York's Appellate Division did not rely on *Morrison* in its ruling that the state litigation must be dismissed, the court determined under the *forum non conveniens* doctrine that the only connections between the alleged fraud and New York were inadequate to create a sufficient nexus to New York, particularly because the underlying transactions occurred overseas and many parties, witnesses and documents also were overseas. The court also credited Germany's interest in the alleged fraud, which is the subject of a pending parallel case filed there.

Credit Crisis Litigation Trends Continue to Evolve

Although the number of securities class actions decreased slightly in 2012 as compared to 2011, the decline in traditional class actions was offset by a significant rise in residential mortgage-backed security (RMBS) actions and actions related to

collateralized debt obligations (CDOs) brought by large institutional investors. As statutes of limitation and statutes of repose run out on causes of action under the federal securities laws, credit crisis litigation plaintiffs are increasingly asserting common law claims. On the securities class action front, there is anecdotal evidence that institutional shareholders are becoming more inclined to opt out of major class action litigation settlements, raising the specter of prolonged litigation and settlement negotiations with individual shareholders. M&A-related claims also continue to be a source of activity, and plaintiffs have shown an increased willingness to keep these litigations alive after the deals close.

In 2012, Circuit Courts Heard or Decided Several Significant Cases

Several key issues were deliberated or decided at the Circuit Court level last year, including in cases relating to the scope and applicability of statutes of repose; the standards for certifying class actions; the adequacy and actionability of various corporate disclosures; and the scope of *Morrison*. Not surprisingly, most of the significant developments are taking place in the Second Circuit.

Two cases addressing statutes of repose have been heard but not decided by the Second Circuit. The first, *FHFA v. UBS Americas Inc.*, No. 12-3207 (2d Cir. argued Nov. 26, 2012), turns upon the distinction between statutes of limitation and statutes of repose. In *FHFA*, the Second Circuit recently heard oral argument on whether FHFA's claims are time-barred by the statutes of repose found in Section 13 of the Securities Act and relevant state "Blue Sky" statutes. FHFA argued that its claims were timely because Congress purportedly extended the statutes of repose applicable to federal and state statutory claims when it enacted the 2008 Housing and Economic Recovery Act (HERA). UBS countered that FHFA's claims were time-barred because HERA, by its unambiguous terms, only extends statutes of limitation, not statutes of repose. UBS further asserted that HERA's plain language only applies to FHFA's state law contract and tort claims, not its federal claims or statutory claims.

The second statute-of-repose case, *In re IndyMac Mortgage-Backed Securities Litigation*, Nos. 11-2998-cv and 11-3036-cv (2d Cir. argued Dec. 5, 2012), promises to have a significant impact on the behavior of plaintiffs in securities actions. The Second Circuit is now considering two main issues: first, whether the statute of repose, as the district court found, is an absolute bar and cannot be abridged by the class action tolling principles enunciated in *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974); and second, whether *American Pipe* tolling applies to an intervenor's claims where, as in this case, the original named plaintiff lacked standing to sue on behalf of the intervenor in the first place.

The Second Circuit also heard several appeals with potentially wide-ranging effects on class standing and class certification in securities cases. First, in a class standing case, *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, 693 F.3d 145 (2d Cir. 2012), the Second Circuit considered whether class plaintiffs can represent investors in offerings other than the ones in which named plaintiffs bought securities. The case was a putative securities class action involving RMBS certificates issued in 17 offerings under one common shelf registration statement. The Second Circuit concluded that in all 17 offerings, the overlapping "concerns" involved mortgage origination standards. Thus, it only allowed the plaintiff to assert claims with respect to offerings involving

originators that had made at least some of the loans underlying the certificates purchased by the plaintiff. Defendants have petitioned the Supreme Court for *certiorari*.

In another class action-related case, *In re AIG Securities Litigation*, 689 F.3d 229 (2d Cir. 2012), the Second Circuit addressed the interplay between class certification and proposed settlements. Back in 2010, the district court held that it could not certify a settlement class because plaintiffs had previously failed in their efforts to certify a class on the merits. The Second Circuit reversed, holding that if a Rule 23 requirement would be resolved by the settlement itself, a court need not consider that element in certifying a class for settlement purposes.

The Second Circuit also is poised to weigh in on class certification in *Credit Suisse Securities (USA) LLC v. Vaszurele Ltd.*, No. 12-2790-cv (2d Cir. filed July 13, 2012). In *Vaszurele*, plaintiffs claim that the offering materials in this RMBS case misrepresented the underwriting standards employed by IndyMac in violation of the Securities Act. In certifying a class, the district court rejected Credit Suisse's argument under Rule 23(b)(2) that individual questions of investor knowledge about IndyMac's underwriting practices would predominate. The appeal presents two main issues. First, Credit Suisse claims that by certifying a class encompassing all investors, the district court made it impossible to have a classwide determination of investor knowledge, which it says increased over time as more information about IndyMac's underwriting became publicly available. Second, Credit Suisse contends that the district court erroneously shifted the burden of proof at class certification by, in effect, requiring it to prove the merits of its statutory knowledge defense.

In addition, the Second Circuit weighed in on the importance of updating corporate disclosures to reflect evolving risks. Following *Litwin v. Blackstone Group, L.P.*, 634 F.3d 706 (2d Cir. 2011), the Second Circuit, in *Panther Partners Inc. v. Ikanos Communications, Inc.,* 681 F.3d 114 (2d Cir. 2012), ruled that the plaintiff had adequately pled a Securities Act violation under Sections 11 and 12(a)(2). In so holding, the court focused in part on the issuer's failure to update "generic cautionary language" to reflect evolving conditions. Specifically, the plaintiff adequately alleged facts from which to infer that the defendant, a semiconductor manufacturer, knew of quality-control problems that could necessitate a widespread recall; thus, the court concluded, the plaintiff had adequately pled that the defendants failed to disclose a so-called adverse "known trend or uncertainty," as required by Item 303 of Regulation S-K.

Also on the disclosure front, both the Second Circuit and the U.S. Court of Appeals for the Sixth Circuit addressed the extent to which opinions are actionable misstatements under the federal securities laws. In *City of Omaha, Nebraska Civilian Employees' Retirement System v. CBS Corp.*, 679 F.3d 64 (2d Cir. 2012), in affirming the district court's dismissal, the Second Circuit held that statements regarding goodwill were opinions that are not actionable if they were believed at the time they were made. Consistent with its decision in *Fait v. Regions Financial Corp.*, 655 F.3d 105 (2d Cir. 2011) (a case involving Section 11 and 12 claims), the court ruled that subjective accounting judgments — like the valuation of goodwill — cannot support a securities fraud claim unless the statements in question are both objectively and subjectively false.

The Sixth Circuit, in *Ohio Police & Fire Pension Fund v. Standard & Poor's Financial Services LLC*, 2012 WL 5990337 (6th Cir. Dec. 3, 2012), ruled that credit rating

agencies cannot be sued for allegedly misrepresenting the credit quality of the securities they were asked to rate unless they knew their opinions were false. Based on publicly available information regarding the rating agencies' business practices, the plaintiff argued that the rating agencies could not have believed in the correctness of their RMBS ratings. The court found that this general criticism of the agencies' business practices, which it labeled "amorphous," was not enough to raise an inference that the agencies made actionable misrepresentations "on any particular occasion." The court also ruled, as a threshold matter, that the rating agencies did not owe a legal duty to RMBS investors. In so holding, the court has now joined the U.S. Courts of Appeals for the First and Second Circuits in rejecting efforts by plaintiffs to hold rating agencies liable for their opinions under a common law negligent misrepresentation theory.

The Aftermath of *Janus*

District courts are still grappling with how to interpret *Janus Capital Group, Inc. v. First Derivative Traders,* 131 S. Ct. 2296 (2011), particularly in relation to claims asserting Section 10(b) liability against corporate insiders.

One recurring issue is whether, in the wake of *Janus*, plaintiffs may use the group pleading doctrine to state claims against corporate officers. At least within the Second Circuit, courts appear to be divided. In *In re UBS AG Sec. Litig.*, 2012 WL 4471265 (S.D.N.Y. Sept. 28, 2012), the court held that group pleading "cannot survive" *Janus*. In *City of Pontiac Gen. Emps.' Ret. Sys. v. Lockheed Martin Corp.*, 875 F. Supp. 2d 359 (S.D.N.Y. July 13, 2012), the court held that it is "not inconsistent with *Janus*" to presume that certain corporate insiders have joint authority to issue written statements by issuer. In *In re Pfizer Inc. Sec. Litig.*, 2012 WL 983548 (S.D.N.Y. Mar. 22, 2012), the court ruled that corporate officers could be held liable for statements appearing in Pfizer press releases, even though disclosures "were not explicitly attributed to the Individual Defendants."

With respect to corporate insider liability post-*Janus*, district courts have adopted several divergent approaches to the issue, including (1) a fact-intensive inquiry that looks to whether attribution can be implied from the surrounding circumstances; (2) a bright-line test that asks whether the officer signed the disclosure in question; and (3) a framework in which *Janus* does not restrict claims against insiders.

As for underwriter liability, courts in 2012 rejected several invocations of *Janus* to avoid liability, reasoning that the plaintiffs in these cases had adequately pled attribution and facts suggesting control over the statements.[17] Courts also have wrestled with how to address attribution-related issues involving accounting firms. One emerging question is how to address attempts to sue not only the firm that issues the audit opinion but also affiliated entities. In *Ho v. Duoyuan Global Water, Inc.*, 2012 WL 3647043 (S.D.N.Y. Aug. 24, 2012), the court held that an accounting company's umbrella organization could

[17] In *Scott v. ZST Digital Networks, Inc.*, 2012 WL 4459572 (C.D. Cal. Aug. 7, 2012), the court denied a motion to dismiss where the plaintiff alleged that the underwriter was "architect of the fraud" and had its name "featured prominently on the offering documents." In *In re National Century Fin. Enters., Inc.*, 846 F. Supp. 2d 828 (S.D. Ohio 2012), the court held at summary judgment that a private placement memorandum could be deemed a "shared product" between issuer and underwriter, where facts showed that underwriters were actively involved in preparing materials "and excercis[ed] control over their content." In *In re Allstate Life Ins. Co. Litig.*, 2012 WL 176497 (D. Ariz. Jan. 23, 2012), allegations that "the names of [underwriters] were placed 'prominently and in bold type on the first page of the Official Statements'" were held to be sufficient under *Janus*.

not be held liable for an associated firm's allegedly improper audit of a Chinese company, where the plaintiff failed to show that Grant Thornton International "had ultimate authority over [Grant Thornton Hong Kong's] misstatements." In *Munoz v. China Expert Tech., Inc.*, No. 07 Civ. 10531 (AKH), slip op., (S.D.N.Y. Nov. 7, 2011), ECF No. 183, the court denied a motion to dismiss claims against the New York-based affiliate of a Hong Kong accounting firm, where the plaintiff alleged facts from which to infer that the U.S. firm exercised control over what was said in an audit opinion issued by the Hong Kong affiliate.

Other District Court Developments

The Southern District of New York continues to hear large multidistrict litigations. Most of the wave of shareholder, derivative and other lawsuits filed after Facebook's May 17, 2012, initial public offering have been centralized there as *In re: Facebook Inc. IPO Securities and Derivative Litigation,* MDL No. 12-2389 (S.D.N.Y. filed Oct. 5, 2012). The suits allege, among other things, that Facebook misled investors by concealing from its offering materials poor mobile revenue forecasts that it had selectively disclosed to certain investment bank analysts. Meanwhile, suits against U.S. dollar LIBOR panel members, 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), have proceeded to a motion to dismiss antitrust claims, but other claims remain undecided, and others may yet be filed.

Developments in Derivative Litigation

Although the derivative action is expected to remain an important basis for shareholder litigation, plaintiffs have met with mixed success in pursuing such claims in 2012. For example, in *Lambrecht v. O'Neal*, No. 1285, and *Sollins v. O'Neal,* No. 1589 (2d Cir. Dec. 4, 2012), the Second Circuit affirmed the dismissal of so-called double derivative lawsuits brought by former shareholders of Merrill Lynch. The suits alleged that Merrill's directors and officers breached fiduciary duties arising out of losses from collateralized debt obligations. The plaintiffs also alleged that directors breached their fiduciary duties in paying bonuses to employees in December 2008. One plaintiff made a pre-suit demand. The court held that the Bank of America board acted in good faith in refusing that demand. The other plaintiff alleged that demand was futile. The court held that Bank of America directors were disinterested and independent and therefore capable of considering demand.

"The Delaware courts, for their part, are increasingly skeptical of complaints filed by plaintiffs who failed to conduct proper pre-suit diligence, but at the same time appear to be more welcoming of subsequent derivative complaints filed by others."

The Delaware courts, for their part, are increasingly skeptical of complaints filed by plaintiffs who failed to conduct proper pre-suit diligence, but at the same time appear to be more welcoming of subsequent derivative complaints filed by others. In *La. Muni. Pol. Emps.' Ret. Sys. v. Pyott*, No. 5795 (Del. Ch. June 11, 2012), following Allergan's settlement with the Department of Justice for alleged off-label marketing activities, a derivative lawsuit was filed in federal court in California and dismissed for failure to plead demand futility. Meanwhile, defendants in the Delaware Court of Chancery moved to dismiss a duplicative suit on *res judicata* grounds. The Delaware court refused to apply *res judicata,* holding that the California court had determined only the standing of the California plaintiffs. In refusing to apply *res judicata* or collateral estoppel, the court noted that Delaware plaintiffs had made a books-and-records demand under Section 220 of Delaware General Corporation Law, and therefore drafted a more detailed complaint than the California plaintiffs.

Indeed, the books-and-records demand increasingly is seen as a prerequisite to a derivative demand under Delaware law. In *Klein v. Walton*, No. 7455 (Del. Ch. July 16, 2012), Chancellor Leo Strine Jr. stayed a derivative suit pending the outcome of one shareholder's Section 220 books-and-records demand. The court stated that the shareholder who makes a Section 220 demand should get lead plaintiff status over earlier filed plaintiffs. Similarly, in *South v. Baker*, No. 7294 (Del. Ch. Sept. 25, 2012), Vice Chancellor J. Travis Laster dismissed a derivative suit for failure to plead demand futility, but that dismissal was with prejudice to the named plaintiffs only. The court held that when a shareholder "rushes" to file a *Caremark* claim without first using Section 220 to conduct an investigation, there is a presumption of inadequacy of representation, and dismissal will be without prejudice to the right of other shareholders to file a similar suit.

Mortgage-Backed Securities and Put-Back Litigation 2013

The credit crisis continues to be the source of a wide range of litigation against issuers and underwriters of MBS, as well as credit-rating agencies and others. This year, approaching limitation periods on 2005- to 2007-vintage MBS resulted in the filing of a considerable number of lawsuits. These lawsuits are generally of two types: misrepresentation claims and contractual claims, each of which saw important rulings in 2012 that will present challenges to parties and courts in the new year.

Misrepresentation claims often are based on Sections 11 and 12 of the Securities Act, although some plaintiffs also have asserted state statutory and common law claims. As discussed above, the Second Circuit recently held that class standing extends to MBS deals not purchased by the named plaintiff, but which implicate the "same set of concerns" as the plaintiff's MBS, such as MBS issued pursuant to the same shelf registration and backed by loans originated by common lenders. Now, federal courts are reconsidering prior standing rulings, which may result in increased exposure for defendants. We also expect significant rulings from the Second Circuit in 2013 concerning statutes of limitation and repose. These rulings have the potential to dramatically reshape the scope of pending MBS actions.

There were a number of important developments last year relating to contractual put-back litigation. Holders and insurers of MBS 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 2012, parties litigated the meaning of various contractual provisions bearing on the availability and scope of damages. Courts divided on the impact of "sole remedy" provisions, which foreclose the availability of money damages. Courts are similarly divided on the availability of "rescissory damages," which plaintiffs seek in the alternative to cure or replacement remedies. We expect to see further decisions addressing these issues and the scope and extent of damages as these cases progress in 2013. Indeed, we are awaiting the results of one "put-back" trial in the S.D.N.Y.

We anticipate that in 2013 the courts will provide significant guidance regarding whether put-back claims brought on pre-2007-vintage MBS are time-barred. Thus far, courts have divided on the date on which such claims are deemed to have accrued, with at least one court holding that the relevant date is the date of purchase and another holding that the key date is the date on which the repurchase demand was made. We anticipate that additional decisions from both trial and appellate courts will come down throughout the year as these issues continue to percolate throughout the courts.

CDO Litigation Developments

Plaintiffs also filed a significant number of CDO-related claims in 2012. In this particular area, one central allegation continues to be that issuers, arrangers and underwriters marketed CDOs as being of high quality, despite possessing knowledge that the underlying collateral was in a distressed state and depreciating in value. As part of a continuing trend, courts refused to credit such allegations on several occasions in cases where plaintiffs could not link the defendants' purported wrongdoing to the specific CDOs at issue. This focus on particularity was illustrated recently by a decision from the Southern District of New York titled *Woori Bank v. RBS Securities Inc.*, No. 12 Civ. 4254, 2012 WL 6703352 (S.D.N.Y. Dec. 27, 2012). In dismissing the plaintiff's claim for common law fraud, the court held that, for all of its rhetoric, "this case lacks the usual telltale signals that have allowed courts in similar situations to find that the particularity requirements of Rule 9(b) were satisfied." *See also Landesbank Baden-Württemberg v. Goldman, Sachs & Co.*, 821 F. Supp. 2d 616 (S.D.N.Y. 2011) (refusing to infer falsity or scienter where plaintiff had "fail[ed] to allege any connection between the mortgages reviewed in the Clayton Report and those collateralizing" the CDO at issue), *aff'd*, No. 11-4443, 2012 WL 1352590 (2d Cir. Apr. 19, 2012).

In contrast, plaintiffs with more detailed complaints, based on internal company documents and the like, fared better in 2012. For instance, in a number of cases, courts sustained CDO-related complaints where plaintiffs alleged that arrangers were purportedly secretly betting against the same collateral that they were marketing to plaintiffs through the CDOs. *See Dodona I, LLC v. Goldman, Sachs & Co.*, 847 F. Supp. 2d 624 (S.D.N.Y. 2012); *Space Coast Credit Union v. Barclays Capital, Inc.*, No. 11 Civ. 2802 (LLS), 2012 WL 946832 (S.D.N.Y. Mar. 20, 2012).

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Global M&A

M&A activity in 2012 continued to be constrained by uncertain macroeconomic conditions, which have dampened dealmakers' confidence. Although there were several bright spots in transactional activity, momentum was difficult to sustain, and buyers and sellers are entering 2013 in a cautious mood. While the outlook for 2013 remains uncertain, we believe that a greater return of confidence to boardrooms and the executive suite should stimulate increased M&A activity. In this discussion, we review these trends and other factors likely to shape the M&A and private equity transaction landscapes in 2013.

The slowdown in M&A activity in Europe has provided limited opportunity to fully test the EU Directive on Takeover Bids, which was intended to consolidate EU takeover law and level the playing field for companies across Europe. We examine the basic principles of the directive and identify areas for potential improvement to foster harmonization of the takeover rules in Europe.

Despite global economic conditions, transaction activity in high-growth markets increased slightly in 2012, and we are cautiously optimistic that these markets will remain attractive options for opportunistic dealmaking in 2013. We discuss the factors that could impact M&A activity in these markets generally, as well as recent trends and developments affecting M&A in China, including the drive toward outbound transactions by state-owned enterprises, the going- private trend by listed Chinese companies and the potential impact that China's evolving regulatory framework could have on M&A activity.

We also review the recent trends of aggressive antitrust and competition scrutiny of M&A transactions and national security reviews of foreign investments in U.S. businesses, which we expect to continue in 2013.

105 US M&A: Overcoming 'Confidence Crisis' Remains Key to a Healthy Market

108 Europe M&A: The Evolving Takeover Landscape

113 China M&A: Looking Ahead to 2013

118 High-Growth Markets: Despite Economic Uncertainty, Dealmaking Opportunities Continue

120 Private Equity: Positive Signs for 2013

122 National Security Reviews of Foreign Investments in US Businesses: An Enduring Trend?

124 The Continuing Impact of Delaware Courts on US M&A

126 Antitrust and Competition: Surveying Global M&A Enforcement Trends

US M&A: Overcoming 'Confidence Crisis' Remains Key to a Healthy Market

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The sluggishness in U.S. deal activity that began in the second half of 2011 extended into 2012, as the macroeconomic climate continued to weigh heavily on investor confidence. Despite a few bright spots, 2012 U.S. M&A activity, as measured by both dollar deal volume and number of transactions, finished below 2011 levels.

In light of ongoing economic uncertainty, buyers and sellers are entering 2013 in a cautious mood. Many corporations have scaled back capital expenditures, and exports to markets such as China and Europe have slowed. Moreover, there is widespread concern in the business community that pending tax code changes could further depress business investment. Although corporate cash balances remain at historically high levels and financing for acquisitions is available on attractive terms, companies may continue to delay M&A activity until confidence returns to boardrooms and the executive suite. However, the strategic imperative for growth remains strong, and a further return of such confidence should stimulate increased M&A activity.

General Observations

Difficulty Sustaining Momentum. Despite several relatively strong periods of deal activity in 2012, momentum was difficult to sustain. Factors contributing to this lackluster activity included uncertainty about the U.S. "fiscal cliff"; more rigorous antitrust scrutiny; volatility in the securities and commodities markets; the sovereign debt crises in Europe and related unease over the fate of the euro; concern over the Chinese economy; and instability in the Middle East. There were, however, several bright spots as strategic buyers, who accounted for the majority of U.S. M&A activity in 2012, engaged in "add-on" acquisitions and spin-off transactions to focus on their core businesses, and private equity firms actively bought and sold mid-cap portfolio companies.

Decreased U.S. Activity. The dollar value of announced M&A transactions with U.S. involvement declined by approximately 3.8 percent in 2012 compared to 2011, according to Thomson Reuters data. However, activity picked up late in the year with a flurry of large transactions announced during the fourth quarter, including in the financial services sector with InterContinental Exchange's $8.3 billion acquisition of NYSE Euronext and GETCO LLC's $1.4 billion acquisition of Knight Capital Group. The small number of large public company acquisitions is noteworthy — only five transactions involving U.S. public company targets with consideration in excess of $5 billion were announced last year.

Energy and Power Sector Drove Dollar Deal Volume. The energy and power sector was the greatest contributor to dollar deal volume during 2012, with companies in this sector seeking to gain greater scale, reduce costs and diversify geographically. According to Thomson Reuters, transactions involving U.S. companies in the energy and power sector represented 18.5 percent of the dollar deal volume.

Health Care Sector Remained Active. Companies in pharmaceuticals, managed benefits and health insurance administration also were active M&A participants last year. Consolidation in the benefits management sector reflected the health care industry's focus on cost containment. Following the June 2012 U.S. Supreme Court decision upholding the Affordable Care Act, several companies, particularly those administering

Medicare- and Medicaid-related plans, announced mergers. In addition, pharmaceutical companies, many with large stockpiles of cash available for acquisitions, used M&A transactions to refresh their pipeline of product offerings (see Regulatory/"Health Care and Life Sciences: Affordable Care Act Upheld, but M&A and Enforcement Trends Reflect Uncertainty").

Tech Sector Led Deal Activity. The largest number of 2012 U.S. transactions were in the technology sector, according to Thomson Reuters, as targets in the social, mobile and cloud computing space were particularly attractive to buyers seeking to expand their portfolio of products and services.

Cash Was Preferred Form of Consideration. Cash continued to be the preferred form of consideration in acquisitions, although there was an increase in the number of transactions with stock as a component in the latter half of the year. The majority of acquisitions involving U.S. public company targets were one-step mergers, with approximately 24 percent structured as first-step tender offers followed by second-step mergers.

Strategic Buyers and Sellers Focus on Core Businesses

Strategic buyers — in particular, companies with substantial amounts of cash on their balance sheets and access to financing on favorable terms — focused on "add-on" acquisitions, which expand the buyer's existing product and service offerings, customer base and geographic footprint faster than an organic growth strategy. These less difficult acquisitions may be more attractive to corporate boards unwilling to engage in transformative deals in uncertain times.

"For companies seeking to divest noncore businesses, a spin-off transaction continued to be a popular alternative to a traditional business unit sale."

Strategic sellers shed noncore business units to focus on businesses with more attractive prospects for growth and profitability. Divested business units were sold to both strategic buyers (*e.g.*, the sale by Pfizer of its infant nutrition unit to Nestlé S.A.) and financial buyers (*e.g.*, the sale by DuPont of its automotive coatings business to The Carlyle Group). For companies seeking to divest noncore businesses, a spin-off transaction continued to be a popular alternative to a traditional business unit sale, particularly among larger companies as a means to unlock value for shareholders on a tax-free basis, while avoiding deal execution challenges and valuation issues associated with a business unit sale. Some companies that considered the divestiture of a business opted for a dual-track approach, pursuing a sale while simultaneously preparing the business for a potential spin-off. This approach provides a potential seller with negotiating leverage in the sale of a business and an alternate path if the sale process is not successful.

Strategic and Financial Buyers Continue to Use Hostile Tactics

Fifteen hostile offers for U.S. targets by strategic buyers were announced in 2012 as those buyers continued to use an unsolicited approach to acquire companies presenting growth opportunities at relatively attractive valuations. Again, this activity was fueled by historically high levels of cash on corporate balance sheets and the availability of financing at low interest rates. In addition, hedge funds and other financial buyers with significant cash have demonstrated a willingness to act on a unilateral basis. According to a recent *Financial Times* article, the dollar deal volume of hostile activity, however, declined approximately 33 percent below 2011 levels in yet another sign of lack of confidence among corporate dealmakers.

Many U.S. companies have found themselves vulnerable to unsolicited approaches, particularly if their shares are trading at depressed prices or if management is perceived to be underperforming. In some situations, activist shareholders have pushed corporate boards to consider a sale process and have attempted to use proxy contests as a mechanism to replace unsupportive board members. Companies without staggered boards are especially susceptible to this tactic.

Hostile transactions have not been uniformly successful and, in several noteworthy situations last year, the target succeeded in remaining independent. For example, Roche Holdings AG attempted to use a proxy fight to force negotiations with Illumina Inc., but ultimately dropped its offer when Illumina won the support of shareholders for its slate of directors. More recently, Carl Icahn abandoned his unsolicited bid to acquire Oshkosh Corp. after Icahn's tender offer received lackluster support from the company's shareholders. In other situations, the target has commenced a process to find an alternative buyer following the receipt of a hostile offer. While not always successful, the sale process may cause the initial offeror to raise its bid. For example, after receiving an unsolicited offer from GSK, Human Genome solicited interest from alternative buyers. Ultimately, the price at which it agreed to be acquired by GSK was well above GSK's initial offer.

During the second half of last year, several unsolicited management-led buyout proposals were announced, with hedge funds and other financial buyers backing management teams seeking to take public companies private. The most notable is the request by Best Buy's founder and former chairman for access to financial information to enable a group of private equity investors and him to bid for the company. Although Best Buy's board granted the request and a subsequent extension of the due diligence period, a public offer to acquire the company had not been made prior to year-end.

Reverse-Termination Fees

A resurgence in antitrust challenges by the U.S. Department of Justice's Antitrust Division and the Federal Trade Commission has resulted in buyers and sellers spending more time negotiating regulatory provisions in merger agreements, as well as higher reverse-termination fees (averaging in excess of 5 percent of deal value) if antitrust approvals are not obtained. Twelve transactions announced in 2012 involving strategic buyers of U.S. targets had a reverse-termination fee equal to 6 percent or more of deal value, including three transactions announced in December with a reverse-termination fee equal to 9 percent or more of deal value. For example, the merger agreement between InterContinental Exchange and NYSE Euronext includes a reverse-termination fee (9.3 percent of deal value) payable by ICE if antitrust and other regulatory approvals are not obtained (see "Antitrust and Competition: Surveying Global M&A Enforcement Trends").

Reverse-termination fee provisions tied to a financing for financial buyers have gotten tighter, as sellers increasingly are more focused on deal certainty. In strategic transactions, the majority of merger agreements include the traditional model of specific performance and full recourse against the buyer if the buyer fails to satisfy the closing conditions. In private equity transactions, the trend has been toward stricter provisions that permit a buyer to pay a reverse-termination fee and avoid closing only if the buyer's

debt financing is unavailable, notwithstanding the buyer's efforts. If the buyer fails to close for any other reason once the conditions to closing have been satisfied, the seller has the ability to require the buyer to draw upon its financing and close the transaction. This is in contrast to reverse-termination fee constructs during the private equity boom, where the reverse-termination fee was the seller's sole recourse if the buyer failed to close for any reason (see "Private Equity: Positive Signs for 2013").

Shareholder Activism

Shareholder activism continued into the 2012 proxy season, with well-known activist investors pushing for corporate changes, including transformative M&A transactions. Many shareholder activists apparently remained motivated primarily by short-term profits, focusing on companies with excess cash, companies that they believe were undervalued or companies with corporate governance issues. Although the number of activist campaigns was relatively steady in 2012 as compared to 2011, the average market capitalization of the companies targeted by activists increased. Notable companies targeted by activists in 2012 included household names such as Procter & Gamble, Hewlett Packard, Yahoo! and Clorox. Activists also targeted large diversified companies, which they believed might be worth more if split into their parts. Their efforts were a catalyst to the split-ups of McGraw-Hill and Fortune Brands, among others.

Activist shareholders often use companies' annual shareholder meetings as platforms for effecting corporate changes through the election of director nominees who will support their proposals. In part to avoid public battles with activist shareholders and the significant costs associated with proxy fights, companies often negotiate and reach settlements with activists. This is the case particularly when a board already has a plan underway that would address the activists' concerns.

Current market conditions may encourage increased shareholder activism in 2013. Companies with an inefficient capital structure, with corporate governance issues or that underperform their peers will be particularly at risk during the 2013 proxy season (see Governance/"US Corporate Governance: Sense of Déjà Vu Masks New Emphasis on Shareholder Engagement").

Europe M&A: The Evolving Takeover Landscape

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The European and global economic crises have encouraged limited takeover activity in the past few years, providing little opportunity for the EU Directive on Takeover Bids (the Takeover Directive) to be fully tested outside of the United Kingdom. While the grounds for a takeover system are in place across Europe, it is apparent that substantial progress and adjustments need to be made now to continue the process of harmonization and to promote takeover activity.

Basic Principles of the Takeover Directive

The Takeover Directive was intended to harmonize EU takeover law and foster consolidation among EU companies through the adoption of a pan-European takeover code modeled after the U.K. Takeover Code.

The Takeover Directive establishes general principles that are common to most takeover systems worldwide: equal treatment of target shareholders, ability of target shareholders to make informed decisions on bids, and prohibition of market manipulation or abuse. It introduced a broad framework that is heavily reliant on the mandatory bid rule, effective involvement by national supervisory authorities and, in several cases, board passivity/neutrality.

At the same time, however, the Takeover Directive made the adoption of guiding principles on the ability of target boards to defend against takeover bids optional, allowing member states to choose whether to implement the following provisions:

- **The board neutrality rule**, which provides that, from the time a target board is informed of a bid until the end of the offer period, the target board may not take any "frustrating action" that might cause the offer to fail, other than seeking alternative bids, without obtaining prior shareholder approval; and
- **The breakthrough rules**, designed to render unenforceable clauses in the articles of association of target companies and agreements between targets and target shareholders, or among target shareholders, that could limit the ability of target shareholders to tender into a bid or vote at shareholders meetings.

Takeover Directive Implementation

Mandatory Bid Rule

The mandatory bid rule is the cornerstone of the European takeover regulation model. Intended to prevent creeping takeovers, the rule provides that when a person — acting individually or in concert with other persons — acquires shares in a company above a specified percentage of voting rights in that company, giving him/her control of that company, such person is required to make a bid for the entire company and offer the same terms to all shareholders. In many EU jurisdictions, the mandatory bid rule is the only statutory defense mechanism available to target companies. It is therefore crucial that the mandatory bid rule provide an effective defense against any form of acquisition of control that does not involve a full offer to all shareholders, particularly where the board neutrality principle has been adopted.

> "In many EU jurisdictions, the mandatory bid rule is the only statutory defense mechanism available to target companies."

The system, however, is in need of adjustment:

- **The threshold is too high.** The threshold adopted by member states (between 30 and 33 percent) is set too high because, in many cases, shareholders are able to control a European company (and either block or have a nearly insurmountable advantage against other bidders) by accumulating ownership of shares just below the threshold. In most U.S. jurisdictions, mechanisms with similar objectives (*e.g.,* poison pills or anti-takeover statutes) are triggered at far lower thresholds (between 15 and 20 percent), providing a more effective structural defense against creeping takeovers.
- **The mandatory bid rule is flawed in several member states.** As was proven by the coercive takeover of German construction company Hochtief AG by Spanish rival Grupo ACS a few years back, if the mandatory bid rule is not propped up by additional rules, including requiring (1) any voluntary tender offer to obtain a mandatory minimum acceptance threshold set at 50 percent or (2) additional mandatory tender

offers upon further accumulation of stock after passing the mandatory bid threshold, the system can be gamed to the detriment of all shareholders.

- **"Acting in concert."** Another significant issue concerns the definition of "acting in concert" for the purpose of calculating the control threshold and determining whether two or more persons are subject to the mandatory bid rule. The definition of acting in concert is not harmonized among member states. Some jurisdictions (*e.g.*, the U.K., the Netherlands and Italy) have adopted the Takeover Directive's definition, while others (*e.g.*, France and Germany) have combined the Takeover Directive's definition with the more stringent definition contained in the EU Directive on Transparency. Moreover, each national supervisory authority has more or less developed its own interpretation of acting in concert, and several national supervisory authorities reserve the right to decide whether shareholders are engaging in this behavior on a case-by-case basis using a facts-and-circumstances analysis. This situation causes significant uncertainty and does not permit shareholders to adopt consistent strategies across jurisdictions in Europe. However, it allows sophisticated national supervisory authorities to prevent parties from acting together while circumventing the spirit of the law through strategies that fall outside strictly defined parameters for "acting in concert."

Optional Takeover Defense Rules (Portuguese Compromise)

Harmonization of the board neutrality and breakthrough rules remains the most serious obstacle to consolidating pan-European takeover rules and the establishment of a level playing field across member states.

The board neutrality rule has been adopted by 19 member states, including the U.K., France and Italy. Most of these states had a board neutrality principle in their pre-existing legal framework before the Takeover Directive became effective. By contrast, eight member states (including Germany and the Netherlands) have opted out of the board neutrality rule — none of these countries had a board neutrality principle in their pre-existing legal framework.

As for the breakthrough rules, they have been adopted (in full or in part) only in three member states.

Accordingly, the takeover landscape is widely inconsistent across Europe, including in the five jurisdictions where most of the takeovers have taken place historically (the U.K., Germany, France, Italy and the Netherlands).

Moreover, in the face of the economic crisis and the resulting weakness in the share price of many European companies, certain member states have made full use of the flexibility available under the Takeover Directive and changed their approach to board neutrality (in some cases multiple times) since the Takeover Directive's implementation to (1) provide shelter to their national champions, (2) safeguard employment and (3) protect strategic assets, even where such member states previously were staunch supporters of systems that did not allow takeover defenses. Certain member states have changed national regulation to reduce board neutrality, introduce industry-specific or ad hoc protectionist legislation, or otherwise raise procedural obstacles for bidders.

While a discussion of the merits of board neutrality and breakthrough rules can be complex, we believe that Europe would benefit from a uniform set of rules in this area.

The Key Role of (National) Supervisory Authorities

The Takeover Directive establishes a system that, as opposed to the U.S. disclosure-based system, requires a significant amount of oversight and involvement by national supervisory authorities at every stage of the takeover process. Any material announcement made or document published by the bidder or target during a takeover process is subject to clearance by the supervisory authority, which also has a significant say on the actual terms and conditions of the bid. Accordingly, efficient regulation or ad hoc decisions by the supervisory authority are a significant factor affecting target shareholders' ability to maximize the value of their investment.

Where national takeover authorities are constituted by practitioners or career regulators highly experienced in takeover matters, the system can guarantee a smooth process and minimize the opportunity for litigation post-takeover (disclosure-based systems typically rely heavily on pre- or post-takeover judicial scrutiny). However, in member states where takeovers occur less often or even rarely — *i.e.*, the vast majority — and where unsolicited offers are, at most, an annual or biannual occurrence, or have yet to occur under the current legislation, the reaction of national supervisory authorities to complex fact patterns is uncertain and can vary significantly from member state to member state.

Squeeze-Out Rules

The Takeover Directive requires member states to adopt a mechanism that allows bidders to "squeeze out" shareholders if the bidder reaches a certain ownership threshold (between 90 and 95 percent). France, Germany, the Netherlands and Italy opted for a 95 percent threshold, whereas the U.K. opted for 90 percent.

While the introduction of squeeze-out mechanisms has given bidders a tool to close takeover bids that previously was unavailable in many jurisdictions, it is the only practical way of achieving full control of a target in the vast majority of cases.

The high threshold required to squeeze out minority shareholders in several member states, particularly those requiring 95 percent thresholds, poses a significant practical hurdle for bidders. We believe that the high threshold, coupled with the lack of alternatives to achieve full control, is one of the reasons takeover bids are not as frequent in certain member states.

The European Commission's Review

Review of the Takeover Directive is currently under way — five years after the transposition deadline of April 2006, the European Commission was due to examine the Takeover Directive in light of the experience gained in applying it and, if necessary, propose revisions. In June 2012, the European Commission published a report on the application of the Takeover Directive, identifying the following key areas where the Takeover Directive would benefit from review (all focused on the correct functioning of the mandatory tender offer system):

- **The definition of acting in concert**, viewed by the European Commission as too broad and potentially inconsistent, could be clarified to provide more legal certainty to investors as to the extent to which they can cooperate with each other without running the risk of triggering the mandatory bid rule;

- **The wide range of national derogations to the mandatory bid rule** gives rise to concerns as to whether this rule adequately protects minority shareholders in situations of change of control. Some clarifications are expected in the scope of application of national derogations to the rule and the interaction between these derogations and the existing mechanism to protect minority shareholders;
- In several markets it has been acknowledged that there is an increasing number of **offerers obtaining de facto control of a target company without triggering the mandatory bid rule** by acquiring a stake that remains just below the triggering threshold; and
- **The exemption to the mandatory bid rule** for situations where the control threshold has been exceeded following a voluntary bid for all shares of the company has created a potential loophole. This enables offerors to subvert the intention of the rule by acquiring a stake close to the mandatory bid threshold and then launching a voluntary bid for a low price (where the consideration consists of shares) to breach the threshold without being required to make a mandatory offer (and without giving shareholders a fair chance to exit the company). As mentioned earlier, such concerns were raised in the context of the bid by ACS for Hochtief. The European Commission has indicated it will take steps to discourage the use of this technique, such as through bilateral discussions with concerned member states or through Commission recommendations. Possibilities to limit the use of this technique may include additional mandatory bid thresholds or minimum acceptance conditions to takeover offers.

A Missed Opportunity

The limited scope of review proposed by the European Commission does not address some of the most critical shortcomings of the Takeover Directive.

- **Harmonization of takeover defenses.** Despite the political debate that inevitably would ensue, the European Commission should propose a system that harmonizes the approach to takeover defenses.
- **Mandatory tender offer rule.** The European Commission should consider additional rules proposed by certain member states to enable the mandatory bid rule to operate more effectively and supplement the Takeover Directive to reflect these provisions; the European Commission also should consider proposing a lower threshold — there is no apparent reason why shareholders should be able to accumulate 30 percent of a company's stock before making a tender offer.
- **95 percent squeeze-out threshold.** Where squeeze-out thresholds are set at 95 percent, they should be lowered to 90 percent. Further, where a company reaches a dominating ownership through a tender offer that is lower than 90 percent but still delivers overwhelming majority, there should be an alternative mechanism to cash out minority shareholders (in several U.S. jurisdictions, for example, the alternative is the long-form cash merger).
- **Enhanced disclosure rules.** The European Commission should consider enhancing disclosure rules, including requiring a description of the process and negotiations leading to the bid.

- **National supervisory authorities.** The European Commission should consider a system that requires national supervisory authorities to coordinate their interpretations of takeover laws — at least on the principles that are common to all systems.

More progress is required to harmonize takeover law. Until the issues above are tackled head on, the system will remain fragmented.

China M&A: Looking Ahead to 2013

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China M&A 2012 Market Overview

The upsurge in both deal volume and value of Chinese M&A transactions that followed the height of the global financial crisis in 2008 and 2009 did not extend to 2012. Because of its myriad interconnections with global finance, China's economy was brought down to earth last year.

In addition to the effects of the global economic slump, China was impacted by several other circumstances, including, among others, the flight of capital, unstable inflation, rising cost of wages, a still-unclear regulatory approval system and collapsing black market loans. All of these factors caused a slowdown in GDP growth from 9.2 percent in 2011 to less than 8 percent for 2012, resulting in, among other things, muted investment interest into China:

- The total number of announced Chinese M&A transactions (inbound, outbound and domestic transactions) for the first half of 2012 declined 33 percent compared to the corresponding period for 2011. Deal value declined by 10 percent over the same period. The number of inbound M&A transactions suffered the most, with a decrease of 42 percent. (PricewaterhouseCoopers)
- For the third quarter of 2012, the number of closed transactions in the China M&A market decreased 28.1 percent compared to the same period in 2011, and disclosed transaction value declined by 48.4 percent. Among the reported 233 completed transactions in the third quarter of 2012, only six were inbound M&A deals, reflecting a 64.7 percent decrease in deal volume compared to the same period in 2011 and a 60 percent quarter-on-quarter decrease. (Zero2IPO Research Center)
- Despite the decline in inbound M&A activity, a handful of deals are noteworthy for both their size and their structure, including General Electric Company's acquisition of a 15 percent stake in Shanghai-listed China XD Electric Group for $535 million.

Amid the overall gloomy statistics, two trends continued and are expected to do so for the foreseeable future:

- China continues its emergence as a force in the global M&A market with the conclusion of several landmark outbound transactions. Its increasing energy consumption, championed by China's state-owned enterprises (SOEs), has solidified investment outflow into natural resources and energy supplies, despite the country's slowdown in economic growth.

- Lingering questions regarding accounting irregularities and other factors causing Chinese-listed companies to trade at a discount continue to stimulate the going-private trend.

Regulatory Framework and Implications

China's regulatory regime is a vital consideration for the feasibility and success of any M&A transaction with a Chinese component. The multilayer approval and registration process may affect the timeline for the completion of the transaction and, to a certain extent, could become the most critical — and problematic — step in deal consummation. While direct acquisition of a Chinese target is subject to stricter scrutiny, outbound M&A deals and certain indirect offshore acquisitions are not immune to regulatory restrictions or requirements.

Access to China's Industry or Market. Not all industries in China are open to direct foreign investment. The Chinese government regulates foreign access to the various industries and markets through its foreign investment guidelines and catalogues, adjusting them from time to time in accordance with the state's overall economic plan.

Foreign investments in China are divided into four categories that determine the relevant approval authority and level of scrutiny the transaction will receive: "encouraged," "permitted," "restricted" and "prohibited." The *Foreign Investment Industrial Guidance Catalogue* (Catalogue) specifies the sectors and activities under the encouraged, restricted and prohibited categories; those not covered in the Catalogue are deemed to be in the permitted category. Subject to the Catalogue, certain acquisitions of shares may be limited to only a minority interest given the requirement for a Chinese partner to hold the controlling or majority equity interest.

The relevant approval authority also depends on the scale and nature of the proposed transaction. In general, the two main authorities for acquisition approval are the National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOC) (or their local counterparts). In addition, investment or acquisition into certain industries also may require further approval by the specific industry's responsible authority. Examples include the Ministry of Industry and Information Technology for telecommunications, Internet and online commerce; the China Banking Regulatory Commission for banking; and the China Securities Regulatory Commission for securities investment. Other regular authorities likely to be involved in a foreign investment-related deal include the State Administration of Foreign Exchange (SAFE) for financing matters requiring conversion between RMB and foreign currencies and the State Administration of Industry and Commerce for company registration and reporting formalities.

As a comprehensive overview of specific regulatory approvals is not available, a foreign investor in China likely will need a thorough analysis of the required approvals. Because of these various regulatory approval hurdles, flexibility in structuring a direct inbound acquisition is limited and potentially time-consuming. For acquirers or investors to execute a deal quickly and minimize approval risks, the most straightforward strategy generally is to acquire or invest into the target's offshore holding company.

In terms of approvals, acquisition of an offshore holding company typically does not require governmental approval. However, in recent years, the advent of China's national security review scheme and anti-monopoly scheme has added another layer of barriers to the successful completion of the transaction.

National Security Review. In 2011, the Chinese government established a new type of process closely analogous to the Committee on Foreign Investment in the United States (CFIUS) for reviewing the national security implications of foreign investments in Chinese companies. The Security Review Committee, an interministerial committee led by the NDRC and MOC, must be notified to approve a transaction if it is deemed to (1) involve a foreign investor merging with or acquiring Chinese enterprises in (or supporting) the military sector or located near key or sensitive military facilities, and other entities relating to national defense; or (2) lead to the foreign investors taking control of Chinese enterprises in other sensitive sectors (including key agriculture products, key energy resources, important infrastructure, important transport systems, key technology and critical equipment manufacturing) that have a bearing on China's national security.

Circumventing the review by any means (including contractual arrangements) is explicitly prohibited. The implication of a catchall effect is widely thought to have had a significant impact on the current structuring and estimated completion time of M&A transactions involving targets or assets in China. In sectors where China has imposed stringent access restrictions (*e.g.*, telecommunications), foreign investors commonly utilize a variable interest entity (VIE) structure, through which the foreign investor can exercise effective control over the Chinese operations, even though it does not invest in a form of direct ownership. It is unclear whether one of the actual objectives of prohibiting any attempts, whether direct or indirect, to bypass the national security review is to take account of the VIE structure and its ability to avoid other regulatory reviews and approval process. For now, however, the national security review mechanism has forced investors and acquirers to be more wary of the scrutiny the VIE-related transactions may face.

Anti-Monopoly Clearance. Ever since the PRC Anti-Monopoly Law came into effect in 2008, the anti-monopoly filing with the MOC has been one of the key considerations in any M&A transaction, since it may affect the timeline of the transaction, and the authority may impose additional restrictions. This requirement may apply to both inbound and outbound M&A transactions, as well as transactions that are entirely between foreign entities with some revenues derived from China. A filing will be triggered if (1) in the previous financial year, the combined worldwide turnover of all parties to the transaction is more than ¥ 10 billion, and at least two of the parties each has turnover in China of more than ¥ 400 million; or (2) in the previous financial year, all parties to the transaction have a combined turnover in China of more than ¥ 2 billion, and at least two parties each had turnover in China of ¥ 400 million.

In addition, even if the above thresholds are not reached, the MOC may initiate a review if it views the concentration from the merger as affecting, or likely to affect, competition through elimination or restriction.

Since the adoption of the anti-monopoly clearance scheme in 2008, the MOC, as the authority responsible for merger control, has reviewed more than 450 transactions, 95 percent of which have been approved without additional conditions. At least 15 transactions were approved with additional conditions, and one deal, the proposed $2.5 billion bid by Coca-Cola Enterprises, Inc. for China's top domestic juice-maker, China Huiyuan Juice Group Limited, was blocked in 2008.

> "China's regulatory regime is a vital consideration for the feasibility and success of any M&A transaction with a Chinese component."

Important Developments in 2012

The VIE Structure Under the Regulatory Magnifying Glass. In August 2012, the MOC issued a decision on the conditional anti-monopoly approval of Walmart's acquisition of Yihaodian, a major China online retailer, which expressly precludes Walmart from engaging in value-added telecommunications business (VATB) services currently provided by Yihaodian via the VIE structure. This is the first time that the MOC explicitly prohibited the use of a VIE structure. One interpretation of this decision is that the ministry was concerned over Walmart getting access to the restricted VATB business without obtaining the requisite regulatory approval. Another interpretation is that the MOC's primary concern was competition in the online retail market and its position on the use of the VIE structure has not changed. However, despite this recent development and questions that continue to surround the long-term viability of the VIE structure, for now, it continues to be an important structuring tool for transactions that otherwise would not trigger the anti-monopoly filing threshold.

The Revised Catalogue for Market Access. The 2011 edition of the Catalogue provided further liberalization of several industry sectors in China. The change of market access is in line with China's latest national policy, reflected in its 12th five-year plan for national economic development, from 2011 to 2015.

The number of "encouraged" business activities was increased while the number of "restricted" and "prohibited" activities was reduced. More activities are now encouraged in sectors relating to environmental protection, renewable energy, high-technology and services. Restrictions have been removed from activities, including wholesale and retail of drugs and automobiles; operation of medical institutions, financial leasing companies and franchise management companies; importation and distribution of publications; and certain mining activities in a form of equity joint ventures. In contrast, activities added to the "prohibited" category include construction and operation of residential villas and domestic express delivery of mails.

Applicability of Share-Swap Mechanism. Use of equity as investment capital is not prohibited by Chinese law, per se. However, due to the absence of specific rules regarding such "share-swap" structures, inbound investments utilizing this structure have faced substantial regulatory obstacles.

In general, it has been practically impossible for foreign investors to either directly contribute equity to their Chinese subsidiary or joint venture, or directly use equity as consideration for purchasing shares in a Chinese company. This has forced parties to be creative in structuring transactions containing share-swap elements. One such new approach is to cross-invest with cash — whereby a foreign investor makes a cash investment into a Chinese company, and the Chinese company makes a corresponding cash investment into the foreign investor's offshore entities.

However, the regulatory situation on share-swap transactions may be improving following the MOC's October 2012 notice on this topic, which provided a clearer approval procedure and policy basis with respect to investment in a foreign-invested enterprise in the form of the equity of a Chinese onshore enterprise. The notice clarifies the type of equity that is ineligible to be used as capital contribution (*e.g.*, unpaid-up equity, pledged equity, the equity interest of real estate enterprise, a foreign-invested holding company or a foreign-invested venture capital company). As to the value of the contributed equity,

the parties can agree to an amount based on the appraised value of the equity, with a maximum capped at the appraised value. While the notice is directly addressed at investment into China by way of establishing a foreign investment enterprise or executing a capital increase in an existing enterprise, it also applies to circumstances in which shares are used as consideration for the acquisition of a Chinese company.

Although the notice does not further expand on how its guidance should be interpreted in share-swap transactions (and thus its practicability remains to be tested), it seems to provide greater flexibility for deal structuring. It can be expected that following the MOC's notice, ancillary rules from other regulatory authorities such as SAFE may be promulgated to further elaborate on the relevant procedures for consummation of equity contribution or share-swap-based transactions.

Looking to 2013

Two trends likely will continue. First, consistent with Chinese national macroeconomic interests, the SOEs will continue to take the lead in outbound M&A transactions, in particular, in the traditional energy and resources sectors. Second, given the announced going-private offers, these transactions will continue to account for a considerable share of China's M&A market. The SEC recently filed charges against China affiliates of the Big Four accounting firms for refusing to produce the audit work papers and other documents related to China-based companies, which sparked market speculation of a stronger wave of China-based U.S. companies opting for delisting in the coming years (see Capital Markets/"Hong Kong Equities Look for Brighter 2013").

At the same time, efforts are being made to encourage inbound investment into China. With the launch of a series of implementing guidelines under China's 12th five-year plan in 2011, the Chinese government signaled its proactive support for mergers and acquisitions and reorganizations. This provides a more positive policy environment for M&A transactions and cross-border investment in the relevant sectors.

In addition, the transition of China's top leadership in November 2012, together with statements issued from the new leaders regarding accelerating economic reform and liberalization, herald a new wave of domestic growth and, coupled with improving global market outlook, are stoking a positive outlook for Chinese M&A.

High-Growth Markets: Despite Economic Uncertainty, Dealmaking Opportunities Continue

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M&A activity in high-growth markets accounted for 28 percent of global deal volume in 2012, with the total value of announced M&A deals reaching approximately $723 billion, according to Thomson Reuters.[1] This activity represented a 9 percent increase compared to 2011, mainly due to strong activity in the fourth quarter of 2012 attributable to greater investor confidence in spite of the lingering effects of the euro crisis, the threat of the U.S. fiscal cliff and lower GDP growth, which affected activity in the first three quarters. Country rankings remained generally consistent compared to 2011, with China and Russia dominating all high-growth nations as the most targeted in terms of both deal volume and deal value, followed by Brazil, Mexico, India and Malaysia (see "China M&A: Looking Ahead to 2013").[2] Dealmaking in these markets was strongest in the energy and power sector (which represented 24.2 percent, with $174.9 billion in deal activity, according to Thomson Reuters), followed closely by the materials, financial and industrial sectors.

Following a lackluster first three quarters of 2012, fourth quarter M&A deal value for high-growth markets totaled $254.4 billion, up 69.4 percent from the third quarter of 2012 and 9.1 percent from the fourth quarter of 2011, thus proving the enduring attractiveness of high-growth markets for companies from both developed and high-growth markets alike. Supported by strong domestic consumption and a growing middle class, high-growth markets have proven durable and self-sustainable. Despite an environment of greater caution, opportunities remain, particularly in the retail and consumer products, technology, health care and pharmaceuticals sectors.

Encouraging Signs

We expect M&A activity in high-growth markets to be largely opportunistic in 2013, driven primarily by inbound acquisitions and heightened private equity activity. Lower valuations and the depreciation of local currencies have made businesses in high-growth markets particularly attractive, which may lead to increased inbound transactions in 2013. For example, the Brazilian real depreciated 10.4 percent against the U.S. dollar in 2012, while the Indian rupee depreciated 1.7 percent during the same period. Managers seeking a bargain may seize acquisition opportunities in high-growth markets in the near term.

Global buyout firms and sovereign wealth funds, flush with cash, also should propel M&A in high-growth markets in 2013. Following a decline in private equity investment in anticipation of decreasing prices, private equity funds remain highly liquid, with significant amounts of unspent funds earmarked for high-growth market investments. For example, private equity funds raised a record $6.3 billion for their Brazil investments in 2011, primarily slated for investments in retail, consumer goods and infrastructure, which were postponed due to the unstable economic conditions in 2012. Fueled by persistent investor demand, we expect much of this capital to be deployed in 2013, as prices stabilize and domestic measures to revive growth become more visible. In

[1] Statistics refer to Thomson Reuters' "emerging market" M&A category, which includes most of the world other than North America, Western and Central Europe, Japan, South Korea, Australia and New Zealand.

[2] Thomson Reuters, *Emerging Markets M&A Review: Financial Advisors, Full Year 2012* (Jan. 2013).

addition, due to generally dormant IPO markets in many high-growth nations, we also expect to see an uptick in high-growth market M&A in 2013, as private equity investors exit their existing high-growth market investments through M&A deals rather than capital markets transactions (see "Private Equity: Positive Signs for 2013").

In addition, the ongoing crisis has prompted many companies to accumulate cash on their balance sheets. Following the hopeful stabilization of local and global conditions, many of these multinationals, with high liquidity, access to cheap financing and limited growth opportunities in their main markets (U.S. and Europe), may seek strategic opportunities in high-growth markets more aggressively.

Potential Deterrents

Despite cautious optimism, we also remain cognizant of the ways in which local challenges may threaten high-growth market M&A activity even if global economic stability improves. For example, in Brazil last year, concerns about high valuations, some perceived signs of increasing state intervention (particularly in the banking, telecommunications and power utility sectors) and initial uncertainty surrounding the introduction of a new antitrust regime contributed to a three-year low in Brazilian M&A activity. In addition, we have witnessed a general slowdown of financial reforms in many high-growth nations, particularly in India, which struggles with inadequate industrial input and a significant account deficit. The ability of governments in high-growth nations to promptly and adequately address macroeconomic challenges and develop sound policies and financial reforms will be critical to the return of robust dealmaking in these markets.

> "Although high-growth market M&A activity decreased in 2012, these markets remain attractive options for companies from both developed and high-growth markets."

Regional Highlights

With no single high-growth economy driving global demand, we expect to see a greater diversity of high-growth and frontier nations shaping the M&A landscape in 2013. In Latin America, Colombia and Mexico are becoming especially attractive to investors. Foreign investment in Colombia has surged in recent years as the government has become increasingly forceful in curtailing organized crime, and Mexico's change in government is seen as an opportunity for forthcoming structural reform. While overall Asia deal volume remains relatively flat, Southeast Asian companies and sovereign wealth funds, with strong cash positions and vigorous growth, are aggressively pursuing outbound M&A opportunities, particularly in the energy, financial and retail sectors. In addition, we also are seeing an increase in M&A activity in the Middle East and North Africa, especially in Turkey and Egypt, as Western banks retreat and sell their local subsidiaries.

Over the past decade, the continent of Africa has continued to be one of the fastest growing regions in the world, second only to emerging Asia. The region's aggregate GDP expanded by 4.8 percent in 2012, according to the McKinsey Global Institute. Natural resource transactions continue to dominate deal activity in the region, in terms of both deal volume and deal value. This activity is driven in part by new or recent natural resource discoveries on the continent, such as natural gas discoveries in Mozambique and Uganda and the offshore Jubilee Field in Ghana. South Africa's renewable energy program provided significant deal activity in 2012 with the closing of 28 transactions in round one of an anticipated three-round process. We believe round two will close in the first half of 2013 with 19 transactions. Electricity privatization in Nigeria also will contribute to activity in 2013.

Increasingly, the agribusiness, telecommunications, retail and banking sectors are driving more deal activity on the continent. We believe this trend will continue, given the projected growth in Africa's consumer class, the primary driver of interest in these sectors. Global food security concerns continue to combine with Africa's heavy concentration of arable land (compared to the rest of the world) to drive deal activity in agribusiness.

* * *

Given the headwinds in developed markets, M&A and other deal activity in high-growth markets may well account for a greater percentage of global activity in 2013 than 2012. If that occurs, it will be the result of investors' search for yield, which will be tempered by execution and political risk concerns. Comprehensive due diligence on the targets, co-investors and sellers, coupled with an understanding of tax, and convertibility or remittance of currency issues, are critical factors for those investors seeking to make the most of their opportunities in these high-growth markets.

Private Equity: Positive Signs for 2013

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While U.S. and global private equity (PE) investment activity remained somewhat stagnant in 2012, the deal environment for leveraged acquisitions recently has been more favorable. Although economic uncertainty, particularly the debt celing resolution in the U.S., may continue to negatively affect overall M&A activity, we view the outlook for PE investing as more positive because of continued confidence in credit availability and the reported trillion-dollar level of PE purchasing power (or "dry powder") worldwide. Some of the key topics likely to shape the PE deal landscape in the year ahead include (1) PE fundraising/fund formation trends, (2) the impact on PE activity of the substantial dry powder, (3) the prevalence of limited partner (LP) co-investment in PE deals, (4) the decreased number of "mega/club deals" and (5) other trends, including increased "add-on" investments and secondary buyouts as well as use of standardized deal terms to allocate financing risk.

- **Fund Formation.** The PE fundraising environment seemingly has stabilized, with the aggregate number of new funds raised (by number and amount of capital) remaining constant in 2010, 2011 and 2012, according to Preqin data. However, recent fundraising levels still are substantially below the peak years. We expect this trend to continue in 2013, and we expect that PE sponsors will continue to form geographic-specific and industry-specific funds. In addition, although investors in PE funds may plan to cut the number of fund managers they commit to over the near term, many investors continue to be bullish on the asset class generally.
- **Dry Powder.** Some reports indicate that the dry powder, or callable capital reserves, of PE funds could be as high as $400 billion worldwide in 2013 (with $200 billion required to be invested this year) — which equates to more than a trillion dollars of purchasing power applying conservative leverage assumptions. PE funds have a strong incentive to invest this capital before the expiration of their fund investment period — at which time, without an extension from their limited partners, the PE funds lose the ability to call this committed capital and earn the corresponding carry. At the same time, due to the financial crisis and other market factors limiting exit alternatives, PE funds typically have held portfolio companies for longer than the

"While some observers have predicted that the need for PE funds to invest in new deals could result in a revival of the mega-buyouts, there are many countervailing factors that may continue to impede this re-emergence in 2013."

usual holding period and are actively seeking exit opportunities. The confluence of these factors, along with greater availability of credit, should provide a meaningful backdrop for increased PE activity in 2013, including through "secondary buyouts."

- **Increase in LP Co-Invests.** We have seen a significant increase in the number of transactions in which LPs have participated in PE buyouts as direct co-investors. Co-investment transactions serve many important purposes for their participants. For the PE fund, co-investments can help fill funding gaps created by tight debt markets, reduce the fund's risk exposure in any particular deal, increase the deal size the PE firm can pursue and solidify relationships with important LPs. For co-investors, these investments offer diversification, a chance to achieve better investment returns (including by investing capital into a PE fund on a no-fee (or very low-fee) basis), the acceleration of capital deployment, the ability to invest larger amounts in deals they find particularly attractive, and the opportunity to deepen relationships with the PE funds and benefit from the sponsors' diligence and expertise in executing the investment. Given the dynamics in the PE industry that we see for 2013 (*e.g.*, dry powder, absence of mega/club deals, LPs having increased bargaining power during fundraising), we would expect these co-investments to continue, as the participants seek to capitalize on the associated benefits.

- **Decreased Number of Mega/Club Deals.** Multibillion-dollar, mega-size buyouts that captured headlines during the peak of the credit bubble did not reappear in 2012 and are unlikely to return in the foreseeable future. PE investment activity largely has settled into — and been concentrated within — deals between $100 million and $5 billion, with an overwhelming percentage of deal volume occurring within the $100 million to $1 billion range. While some market observers have predicted that the need for PE funds to invest in new deals could result in a revival of the mega-buyouts since these deals allow more money to be deployed faster, there are many countervailing factors that may continue to impede the re-emergence of the mega-buyout in 2013 and beyond, including (1) smaller size of PE funds and corresponding inability (or hesitancy) to allocate large percentage of fund capital to any one deal, (2) reluctance of PE funds to participate in club deals, given the difficulty in managing the investment with multiple sponsors and view from the LPs that club deals undermine their diversification objectives, since they may be invested in each member of the club, and (3) LPs increasingly limiting the PE fund's ability to make investments over certain dollar thresholds.

- **Other Trends.**

  - **"Add-on" Investments.** PE firms are continuing to invest in add-on acquisitions involving businesses that are complementary to existing portfolio companies or investing in smaller companies in closely related businesses to increase the scope of their presence in an industry.

  - **Secondary Buyouts.** PE firms increasingly have been selling portfolio companies to other PE firms. These secondary buyouts accounted for 30 percent of 2012 aggregate PE deal value (up from the record level of 25 percent in 2011), according to Preqin data. This increase likely is driven by uncertain IPO markets and the pressure on PE firms to return capital to investors on deals made during the buyout boom. While secondary buyouts are vulnerable to criticism (*e.g.*, lack of investment thesis to improve results obtained by prior PE owners), given the

normal uncertainties surrounding the IPO market and lack of other available exit alternatives, we would expect secondary buyouts to continue to represent a significant portion of PE deal activity in 2013.

- **Standardized Financing Risk Allocation.** In 2011 and continuing into 2012, PE deals significantly trended toward a "standard" set of deal terms to allocate financing risk — no financing-out, a reverse-termination fee (ranging from 3-9 percent) as the sole remedy if debt financing is not available despite the buyer's efforts, and a limited specific performance right to force the buyer to close only if the debt financing is available. While there have been (and will continue to be) certain exceptions — *e.g.*, competitive auctions where PE firms may be willing to take more risk with a higher reverse-termination fee, more expansive "flex" provisions, a requirement to increase the equity portion of financing or an obligation to "take-down" bridge financing in lieu of bond financing, etc. — we expect this standardized set of deal terms to continue in 2013 and beyond.

National Security Reviews of Foreign Investments in US Businesses: An Enduring Trend?

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Two events over the past year underscored the increased importance of advance planning for national security reviews in a transaction involving a foreign investor in a U.S. business. First, in September, President Obama formally blocked an acquisition of a U.S. company, which was the first time this has occurred in 22 years. In that transaction, a Chinese-owned company sought to purchase four small wind farms in Oregon, one of which abutted restricted U.S. naval airspace used for unmanned aerial vehicle testing and training. The transaction's parties failed to notify CFIUS of the sale, and were compelled by CFIUS to file a post-closing notice when a CFIUS member agency learned of the deal.

Second, in its most recent annual report to Congress (which covers its activities through 2011), CFIUS officially declared for the first time that "the U.S. Intelligence community judges with moderate confidence that there is likely a coordinated strategy among one or more foreign governments or companies to acquire U.S. companies involved in research, development, or production of critical technologies for which the United States is a leading producer." Prior CFIUS annual reports described such a threat as "unlikely"; the revised analysis indicates heightened U.S. government sensitivity to — and, ultimately, closer scrutiny of — transactions involving technology firms.

CFIUS continues to approve the overwhelming majority of transactions it reviews. However, such reviews have become one of the most important gating items in many proposed foreign investments in U.S. businesses. Reports of cyber incidents involving U.S. government and corporate networks have fueled concerns relating to transactions involving telecommunications networks and technologies and critical infrastructure (see "Network Security Threats and Cybersecurity Legislation and Regulation"). Consolidation in the natural resources, telecommunications and critical technologies industries, coupled with increased concerns over the security of the industrial supply chain and defense industrial base, also have led to rigorous scrutiny of transactions in

these sectors. Additionally, the geolocation of energy projects, as well as the diffuse nature of wind generation facilities and their communication with supervisory control and data acquisition (SCADA) systems, can create unique sensitivities in energy transactions, which may cause the U.S. government to require that the parties enter into security agreements prior to approval.

Trends in the CFIUS Review Process

The Foreign Investment and National Security Act of 2007 (FINSA) mandated that CFIUS report annually to Congress regarding its activity for the prior year. The report issued in December of 2012 covers CFIUS activity through the end of 2011. The 2012 report confirmed an increase in the number of transactions submitted for CFIUS review during 2011, and our experience working closely with CFIUS indicates that this trend continued in 2012. Additional trends include:

- **CFIUS investigated more transactions.** The CFIUS process consists of a mandatory 30-day review followed by a discretionary 45-day investigation period, which CFIUS can impose if it determines that the transaction may impair national security. CFIUS generally sends a transaction into investigation if it would result in foreign government control of a U.S. business or foreign control of "critical infrastructure" (as defined in the CFIUS regulations), or if the U.S. business has government contracts or access to classified information.

> "CFIUS reviews have become one of the most important gating items in many proposed foreign investments in U.S. businesses."

- **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 Department of Defense increasingly recommended proxy agreements as the preferred mitigation instrument where the U.S. business required access to classified information.** While CFIUS does not publicly report the exact nature of mitigation it imposes in each transaction requiring mitigation, in our experience, the Department of Defense (a CFIUS member agency) has been more likely to recommend that proxy entities be set up to operate the U.S. business post-closing, particularly in cases in which a foreign government owns a significant interest in the acquiring company. Proxy entities are the most restrictive form of mitigation, and this trend reflects a growing requirement by the Department of Defense that its suppliers be cleared to access classified information. However, the Defense Security Service has been willing to discuss modifications to the standard form proxy agreement to provide the foreign parent with a greater and more versatile role in operating the U.S. business. We expect this trend to continue in 2013.
- **CFIUS made more demands for filings post-closing.** The CFIUS process usually is initiated by a voluntary notice made prior to closing. In 2011 and continuing in 2012, however, CFIUS became more active in requiring that filings be made post-closing when parties to sensitive transactions failed to file a notice, as was the case in the transaction blocked in September. Parties always are at a disadvantage when they fail to file with CFIUS; adopting a "chance it" mentality is not a viable option. We expect CFIUS to continue to step up its policing of non-notified transactions in 2013.

- **The length of CFIUS internal deliberations continued to increase.** FINSA requires that mitigation agreements must be approved unanimously by CFIUS member agencies. Because those agreements often reflect the concerns of one particular CFIUS member agency but not others, the unanimity requirement has resulted in more time being spent in internal deliberations. We expect this trend to continue in 2013, especially if the number of transactions subject to mitigation continues to increase.
- **Companies based in U.S. ally nations continued to file a significant number of transactions with CFIUS.** A significant plurality of transactions filed with CFIUS involve foreign purchasers based in countries considered to be an ally of the United States. This likely illustrates a greater willingness by such nations' companies to make investments in U.S. businesses — and highlights the interest CFIUS takes in transactions that might initially be perceived as "low risk."

As foreign investment in U.S. companies continues to increase, the competing policy goals of encouraging foreign investment while protecting against national security risks will continue to play out in the CFIUS review process and as a central issue in foreign investments in U.S. companies. Parties to cross-border transactions are encouraged to plan ahead for CFIUS reviews by consulting knowledgeable counsel as early as possible.

Delaware Courts Continuing to Impact M&A

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The past year of M&A litigation in Delaware resulted in several decisions with important implications for parties engaging in or advising on M&A transactions.

Controlling Stockholder Transactions

The 2012 Delaware Supreme Court opinion in *Americas Mining Corporation v. Theriault* provides dramatic evidence of the risks inherent in transactions in which a controlling stockholder stands on both sides of a transaction, thus implicating the entire fairness standard of review. In *Americas Mining*, the Supreme Court affirmed post-trial findings that "a focused, aggressive controller" extracted a deal that was "far better than market," resulting in "a manifestly unfair transaction." The court let stand a damages award of more than $2 billion against a controlling stockholder and its affiliate directors for breach of fiduciary duty, as well as an attorneys' fees and expenses award of more than $300 million.

Transactions involving companies with a controlling stockholder offer fertile ground for litigation, even where the controlling stockholder does not stand on both sides. In *In re Delphi Financial Group Shareholder Litigation*, the Court of Chancery declined to enjoin the stockholder vote on the Delphi/Tokio Marine Holdings merger, even though it concluded that a controlling stockholder likely breached his fiduciary duties by successfully demanding a premium for his high-vote shares. While confirming that a controlling stockholder generally is permitted to negotiate a control premium for its shares, the court found that, in this case, the controlling stockholder had already "sold his right to a control premium," via a provision in the company's certificate of incorporation that required equal consideration to be paid to the high-vote and low-vote shares in a

merger. As a result, the court found the controlling stockholder's attempt to "extract a *second* control premium for himself" at the expense of the minority stockholders likely to be a breach of fiduciary duty.

"Transactions involving companies with a controlling stockholder offer fertile ground for litigation, even where the controlling stockholder does not stand on both sides."

The court, however, refused to enjoin the stockholder vote on the merger and permitted stockholders to decide for themselves whether to accept the 76 percent premium offered in the merger. The court noted the absence of evidence "that another suitor is in the wings or is likely to be developed at a greater, or even equal, price." In so holding, the court noted the similarities present in its prior decision in *In re El Paso Corporation Shareholder Litigation*. In that case, the court identified numerous "debatable negotiating and tactical choices made by El Paso fiduciaries and advisors," which were compounded by a lead negotiator and financial advisor with interests in conflict with those of the El Paso stockholders. Nevertheless, the court declined to issue an injunction and permitted the El Paso stockholders to vote on the merger in light of the 37 percent premium it offered and the absence of other bids. In refusing to enjoin the Delphi/Tokio Marine Holdings merger, the court noted that the 76 percent premium offered in the merger "dwarfs the premium percentage in *El Paso*." The claims asserted in the *Delphi* litigation were ultimately settled for approximately $50 million.

In contrast to the *Delphi* decision, in a case involving a merger between Synthes, Inc. and Johnson & Johnson, the Court of Chancery found that stockholder plaintiffs had not stated a breach of fiduciary duty claim against a controlling stockholder. In dismissing the stockholder plaintiffs' claims in *In re Synthes, Inc. Shareholder Litigation*, the court explained that "although the controller was allowed by our law to seek a premium for his own controlling position, he did not and instead allowed the minority to share ratably in the control premium paid by J & J." The court found that, as alleged, the controlling stockholder did not have:

> any conflict with the minority that justifies the imposition of the entire fairness standard. The controlling stockholder had more incentive than anyone to maximize the sale price of the company, and Delaware does not require a controlling stockholder to penalize itself and accept less than the minority, in order to afford the minority better terms. Rather, pro rata treatment remains a form of safe harbor under our law.

In another case, the Court of Chancery confirmed additional procedures by which certain transactions involving a controlling stockholder may avoid entire fairness review entirely. In *Frank v. Elgamal*, the court stated that when a corporation with a controlling stockholder merges with an unaffiliated company, minority stockholders are cashed out, and the controller receives a minority stake in the surviving entity, entire fairness will not apply if the transaction includes "robust procedural protections." The court explained that these protections include the recommendation of the transaction by an independent and disinterested special committee and the approval of the transaction by the nonwaivable vote of a majority of the minority stockholders. When such procedural protections are included in these types of transactions, business judgment, rather than entire fairness, is the applicable standard of review.

Increase in Deal Litigation and Other Observations

The frequency of stockholder lawsuits challenging M&A transactions accelerated in 2012. The Court of Chancery has noted this trend. For example, in March, Vice Chancellor J. Travis Laster noted in *Stourbridge Investments, LLC v. Bersoff* that:

> the past decade has witnessed a dramatic transformation in the nature of public company M&A litigation. In 2010, 84.2 percent of announced deals attracted lawsuits. In 2010 and 2011, according to Cornerstone Research, 91 percent attracted lawsuits. According to the data for 2011, in the same study, 96 percent of deals valued at $500 million or more attracted lawsuits. That's compared to 53 percent in 2007. As these volumes have increased, merits-related outcomes have decreased.

In addition to increasingly frequent M&A litigation in the Delaware courts, the plaintiffs' bar continues to file M&A-related litigation outside of Delaware, even when challenging transactions involving companies domiciled in Delaware. We see no indication this trend will reverse in 2013.

Finally, as noted above, a number of 2012 decisions confirm Delaware's continued commitment to informed stockholder franchise. So long as disclosures are materially complete and accurate, the Delaware courts appear reluctant to take from stockholders the opportunity to decide for themselves whether or not to accept a premium transaction.

Antitrust and Competition: Surveying Global M&A Enforcement Trends

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US: Obama's Antitrust Agenda Enters Second Term

Following the November elections, in 2013 the U.S. Department of Justice's (DOJ) Antitrust Division and the FTC (the Agencies) likely will continue the trend of the last four years of aggressive antitrust enforcement. Thus far under the Obama administration, the Agencies have initiated more enforcement actions, including litigations and consent settlements, and issued more second requests (as a percentage of HSR filings) than over the previous four years. During President Obama's first term, the rates for both enforcement actions and second requests were up approximately 50 percent from 2006-09, and the current rate of enforcement actions is nearly double that of 2002-05. Significant leadership changes are on tap at both agencies in the coming year, but we fully anticipate a continuation of this record of aggressive enforcement, along with increased emphasis on economic and data-driven analysis.

Department of Justice. On December 30, 2012, the U.S. Senate voted to confirm Bill Baer to lead the Antitrust Division. Baer, an experienced antitrust practitioner and former head of the FTC's Bureau of Competition, will bring to the division a respect for economic theory and its importance in antitrust analysis. Under Baer's leadership, look for the Antitrust Division to continue investigating patent acquisitions aggressively, as it did in its recent investigations into acquisitions by Google from Motorola Mobility Holdings; Apple, Microsoft and Research in Motion from Nortel Networks; and

Apple, Microsoft, Oracle and EMC from Novell Inc. Also look for the division to continue advancing its use of economic analysis, including reliance on the upward pricing pressure test (the most significant economic tool introduced by the revised Horizontal Merger Guidelines in 2010), which has been utilized increasingly by the Agencies in their merger investigations.

Federal Trade Commission. The status of the leadership at the FTC remains less certain. In the coming months, J. Thomas Rosch (an FTC commissioner since 2006), whose term expired in September 2012, will step down once his replacement is confirmed; Jon Leibowitz (currently the FTC chairman and a commissioner since 2004) is rumored to be stepping down in the near future. George Mason University School of Law professor Joshua Wright will replace Rosch. Wright, who has both a J.D. and a Ph.D. in economics, will be the only economist on the commission. Contrary to Rosch, who has advocated for more aggressive antitrust enforcement, Wright is considered to have a relatively narrow view of the FTC's enforcement role and is likely to insist on a higher evidentiary threshold and substantial economic analysis prior to authorizing enforcement action.

"Under its new leadership, look for the DOJ's Antitrust Division to continue investigating patent acquisitions aggressively."

In addition to Wright's arrival, should Chairman Leibowitz resign, President Obama will need to replace him. For years, Leibowitz has focused his attention on antitrust enforcement in health care, and his departure comes at a time when economic pressures and the continuing rollout of the Affordable Care Act have driven record levels of industry consolidation. However, as a senior FTC merger enforcement official recently warned, regulators "are not viewing health care reform or the state of the economy as a blank check" to acquire a competitor. Regardless of who takes the helm if Leibowitz departs, the FTC likely will continue closely scrutinizing the pharmaceutical industry (see Global Litigation/"Antitrust and Competition: Antitrust Enforcement on Both Sides of the Atlantic") and health care consolidation, especially deals involving hospitals. In the past year alone, the FTC has challenged the proposed acquisitions by ProMedica Health System of St. Luke's Hospital, OSF Healthcare System of Rockford Health System, Universal Health Services of Ascend Health Corporation and Reading Health System of Surgical Institute of Reading LP. The FTC also has another hospital merger case, *Phoebe Putney Health Systems*, currently in front of the Supreme Court with the issue of state action immunity under review.

Nevertheless, the FTC proved in 2012 that it is willing to go against the political tide when the facts merit. For example, in its review of Express Scripts' acquisition of Medco, the FTC received a barrage of input from industry participants and Congress demanding a thorough investigation and, in the case of some, enforcement action. The FTC undertook a detailed review, but eventually determined that the proposed transaction would be unlikely to substantially lessen competition given the intensely competitive nature of the pharmacy benefit management business and the fact that the merging parties were not particularly close competitors.

Hart-Scott-Rodino. Further evidence of the administration's aggressive antitrust enforcement agenda came in the form of a criminal case against an executive for falsifying Item 4(c) documents submitted with a Hart-Scott-Rodino (HSR) notification and report form. In May 2012, the Antitrust Division announced that a Korean executive had agreed to serve five months in prison for altering Item 4(c) documents. The Antitrust Division pursued the matter, even though the parties abandoned the transaction a few

months after filing HSR and before the DOJ had made a decision about the merits of the transaction. This serves as a reminder of the seriousness with which the Agencies view companies' document production obligations pursuant to the HSR Act.

European Union

The recession continued in 2012 for a large portion of the European Union, as the sovereign debt crisis expanded beyond Greece. Against this background, the European Commission, and Competition Commissioner Joaquín Almunia specifically, have resisted calls for a more lenient implementation of merger control in the European Union. The EU commissioner for competition continues to view aggressive merger control enforcement as a key instrument for promoting growth and protecting consumers in the European Union.

Indeed, 2012 was characterized by an increased number of high-profile commission decisions adopted under the EU Merger Regulation (EUMR), reflecting a strict merger control policy. *Deutsche Börse/NYSE Euronext* was the second prohibition decision issued under Commissioner Almunia's watch, while the commission also opened nine Phase II investigations in 2012, five of which resulted in significant remedies, while two resulted in the parties abandoning the deal.

The continued recession in Europe has raised the question of whether the Commission should consider industrial policy and focus its merger enforcement on a more dynamic, forward-looking approach, as opposed to one relying mainly on pre-merger market conditions.

Industrial Policy Considerations: *Deutsche Börse/NYSE Euronext*

In *Deutsche Börse/NYSE Euronext*, the parties submitted that the merger would result in greater liquidity in Europe and would generate significant collateral savings. The Commission rejected these efficiency arguments on the basis that they were not sufficiently merger-specific and that it was unclear whether they would be passed on to consumers. Instead, the Commission prohibited the transaction, focusing on European exchange-traded derivatives. The Commission was concerned about the fact that the combination of Deutsche Börse's Eurex and NYSE Euronext's Liffe, the two leading European derivatives exchanges, would result in a "quasi-monopoly in exchange-traded financial derivatives based on European underlyings, where the two companies control more than 90 percent of the global market." As a result, the Commission requested the divestment of the whole of either Eurex or Liffe, which went beyond what the parties were willing to offer. The Commission blocked the merger, and Deutsche Börse appealed the prohibition decision in the General Court.

Counterfactual Analysis: *Olympic/Aegean*

The economic crisis, and its impact on the merging parties' ability and incentives to compete, has led some notifying parties in merger cases to claim that the Commission should adopt a more forward-looking approach in its merger analysis. The Commission in fact is required under the Horizontal Guidelines to compare the competitive

conditions that would result from the notified merger with the conditions that would have prevailed without the merger (the "counterfactual"). However, the Commission has continued to be very reluctant to consider a counterfactual that is significantly different from the pre-merger situation.

The *Olympic/Aegean* prohibition decision, which was published in 2012, provides a good illustration of the Commission's reluctance to adopt a more forward-looking approach in its merger analysis. In that decision, the Commission accepted that, given the financial situation of the two airlines in question and the state of the Greek economy, it was unlikely that the pre-merger situation would continue absent the transaction. However, the Commission rejected the counterfactual analysis of the parties, according to which that the declining demand in Greece no longer would be sufficient to sustain both parties' activities. The Commission instead established its own counterfactual based on the premise that both Olympic and Aegean would continue to operate in Greece and blocked the merger on the view that it would lead to a monopoly for certain Greek routes. Since then, both Olympic and Aegean appealed the Commission's prohibition decision. In addition, the companies are now attempting a new merger, which also will be reviewed by the European Commission.

The Commission's reluctance to adopt a more forward-looking approach stems from the view — endorsed by the General Court in recent judgments — that unless there is compelling evidence that the industry structure will change in the foreseeable future, it is prudent to base the competitive assessment of a transaction on current competitive conditions. This imposes a high threshold on merging parties, as the Commission always can take the view that the market could evolve in a way that is different from the parties' projections, as was the case in *Olympic/Aegean*.

Far-Reaching Remedies

The Commission also has been requesting far-reaching remedies. In *Universal/EMI*, the Commission obtained a divestiture package representing approximately two-thirds of EMI's European turnover, while the intellectual property rights contained in the package were worldwide in scope, so that the buyers could exploit the assets in a "viable and competitive" way. Similarly, in *Deutsche Börse/NYSE Euronext*, the Commission rejected the parties' original proposal to only divest the overlapping derivatives products, as they would be too small and not diversified enough to compete on a standalone basis, and requested the divestment of the entire Eurex or Liffe business.

Confidentiality

On the procedural front, the recent court judgments in *Odile Jacob* and *Agrofert* were a step toward preserving the confidentiality of the information provided by the merging parties during the Commission's merger investigations. In these cases, third parties had sought access to documents submitted by the notifying parties during merger investigations on the basis of Regulation 1049/2011 (the Transparency Regulation), which entitles private parties to seek access to Commission documents under certain conditions. The European Court of Justice upheld the Commission's refusal to provide the parties' documents and established a general presumption that disclosure of documents exchanged between the Commission and the merging parties during the course of the merger control proceedings should remain confidential.

China, Brazil and India

2012 was the fourth full year of enforcement of the Chinese Anti-Monopoly Law (AML) by China's Ministry of Commerce (MOFCOM). MOFCOM has continued to vigorously enforce the AML and clearly is one of the gateway merger control jurisdictions for global M&A transactions, often affecting the timing for closing in a significant way.

MOFCOM has not hesitated to impose far-reaching remedies that sometimes diverge from the practices of EU and U.S. agencies. Two of the most important examples were the Seagate/Samsung and Western Digital/Hitachi mergers in the hard disk drive (HDD) sector that were announced in 2011. After extensive review of both cases, MOFCOM, in early 2012, imposed extensive global behavioral remedies that were different from the outcome of the U.S. and EU merger reviews. Seagate/Samsung was cleared unconditionally in the EU and the U.S., but MOFCOM only agreed to approve the transaction subject to several commitments, including a one-year commitment by Seagate to operate Samsung's HDD business as a viable independent competitor worldwide, maintain and expand production capacity of Samsung, and invest at least $800 million in R&D in each of the next three years to continue to supply innovative products to consumers. In Western Digital/Hitachi, MOFCOM imposed similar commitments on Western Digital, but for a two-year period.

"China's Ministry of Commerce has not hesitated to impose extremely far-reaching remedies that have diverged significantly from the practices of EU and U.S. agencies."

On the procedural front, MOFCOM's increased expertise has not resulted in shorter merger reviews; in fact, review periods are now longer than in prior years. Pre-notification procedures have extended considerably, and MOFCOM opens Phase II investigations in the vast majority of cases, including those raising no competition concerns. As a result, even simple cases take several months to obtain MOFCOM's approval. Given that MOFCOM imposes a global bar on closing under the Chinese Anti-Monopoly Law, MOFCOM's, approval often is the last outstanding merger control clearance that can significantly affect the timing for closing global M&A transactions.

In Brazil, the new Brazilian Competition Law (Law No. 2529) entered into force on May 28, 2012. The new law marked the entry of a new merger control regime in Brazil, which imposes a bar on closing until the Brazilian competition authority (the CADE) approves the transaction. Certain CADE officials have taken the view that the bar on closing is global. Other significant merger control jurisdictions such as the EU, the U.S. and China impose a similar worldwide bar on closing. However, in contrast to China, the CADE has proven to be effective in terms of the timing of merger clearances. Under the new law, fast-track cases have been approved in less than 30 days, while non-fast-track cases have been approved in less than 50 days.

In India, the Competition Bill of 2007, which amends the Competition Act of 2002, introduced a mandatory pre-closing filing system that also applies to M&A transactions not involving Indian companies. The new regime entered into effect as of June 1, 2011. However, India has remained below the radar for many global M&A transactions, since the transitional *de minimis* exception relating to the target's sales and assets in India renders the Indian merger control inapplicable in many international transactions.

Governance

Say-on-pay has contributed to an environment where shareholder engagement is an increasingly critical component of corporate governance.

In this section, we take a broad look at the corporate governance landscape to review the new dynamics in shareholder engagement and the governance themes likely to impact public companies and their boards of directors over the 2013 proxy season and beyond.

In addition, we examine say-on-pay votes to offer suggestions as to how companies can best position themselves to achieve say-on-pay success in 2013.

133 US Corporate Governance: Sense of Déjà Vu Masks New Emphasis on Shareholder Engagement

138 Say-on-Pay: Keys to a Successful 2013 Proxy Season

US Corporate Governance: Sense of Déjà Vu Masks New Emphasis on Shareholder Engagement

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Corporate governance issues in 2013: say-on-pay, proxy access, shareholder proposals dismantling corporate defenses, questions concerning the integrity of audits, shareholder engagement. Wait a minute, haven't we seen this list before? Yes, we have. Broadly speaking, public companies and their board members may have a sense of déjà vu in 2013 as they face many of the same corporate governance issues they have considered over the past couple of years.

At the same time, as many public companies head into their third year of mandatory say-on-pay, we must recognize that say-on-pay has fundamentally changed the corporate governance landscape. In the ongoing (and perhaps never-ending) tension between board-centric and shareholder-centric models of corporate governance, say-on-pay — shareholders expressing in annual meeting voting their own view on the board's and compensation committee's executive compensation decision-making — has accelerated a paradigm shift in the relationship between corporations and shareholders, particularly institutional shareholders. This shift has led to a significant increase in the scope and depth of company "engagement" with shareholders. However, this shift is not limited to say-on-pay, nor is it limited to the few months of the year that comprise the traditional proxy season. Rather, company "engagement" with shareholders is becoming a year-round exercise that can cover the full range of the corporate governance spectrum.

2012 in Review

Once again, for many companies 2012 was an uneventful proxy season. Most public company directors continued to be re-elected with shareholder support in excess of 90 percent of votes cast. The number of directors failing to achieve majority support in 2012 was comparable to 2011 and down from 2009 and 2010 levels. The decrease remains attributable, at least in part, to shareholders being able to voice disagreement over executive compensation matters through say-on-pay votes rather than by voting against directors, particularly members of compensation committees.

Say-on-pay votes continued to go well for most companies, although not without significant efforts by some. Approximately three-fourths of companies received 90 percent or higher support for their executive compensation. The number of companies failing to achieve majority support in their say-on-pay votes remained low at approximately 60, although this represents a 50 percent increase from 2011. More noteworthy than the number of companies failing say-on-pay (or passing with low levels of support) is the fact that many receiving low levels of support in 2012 had received strong support in 2011. Companies need to remain vigilant regarding how year-to-year changes in the operation of compensation programs and changes in company performance impact investors' perceptions of a company's pay-for-performance (see "Say-on-Pay: Keys to a Successful 2013 Proxy Season").

In addition, certain corporate governance shareholder proposals remained popular in 2012. A board declassification campaign spearheaded by Harvard Law School's Shareholder Rights Project (SRP) submitted approximately 90 proposals. Roughly half of the recipients agreed to put management declassification proposals to a vote. The other

half allowed the shareholder proposals to be voted on, with the proposals averaging 81 percent of votes cast in favor. Also, shareholder proposals on majority voting in director elections passed at many companies, with proposals relating to shareholder ability to call special meetings or act by written consent having mixed results.

Perhaps the corporate governance shareholder proposal topic attracting the most attention in 2012 was proxy access, as this was the first year that proxy access shareholder proposals were submitted following the D.C. Circuit Court of Appeals' determination to vacate the mandatory proxy access rule adopted by the SEC. Although some investors view the concept of proxy access favorably, the voting results showed that shareholder support of proxy access has boundaries. A number of proxy access proposals that were fashioned to give proxy access rights to retail investors owning as little as $100,000 worth of company stock failed to gain traction and garnered support only in the single digits or low teens, as a percentage of votes cast. Binding bylaw amendments that would give proxy access rights to holders of 1 percent of company stock for one year, proposed by Norges Bank at a number of very large companies, did better, with support averaging approximately 35 percent of votes cast. Proxy access proposals modeled on the vacated SEC rule, submitted to companies perceived as having repeated and long-standing corporate governance issues, received majority support at Nabors Industries and Chesapeake Energy. Also noteworthy was that Hewlett-Packard was able to negotiate the withdrawal of a proxy access proposal by agreeing to submit its own three-year, 3 percent proxy access proposal in 2013. Based on public information to date, it is possible that there will be fewer proxy access proposals in 2013. Nevertheless, an HP proxy access proposal and any proxy access proposals put forth by Nabors or Chesapeake in response to the 2012 votes could represent bellwethers.

"Company 'engagement' with shareholders is becoming a year-round exercise that can cover the full range of the corporate governance spectrum."

Shareholder Engagement

While the corporate governance agenda in 2013 looks very similar to the agenda of the past few years, the landscape has shifted. This shift can catch the unwary off guard and may require companies to recalibrate their approaches to dealing with their shareholders. Historically, companies viewed shareholder "engagement" as their investor relations departments dealing with portfolio managers to explain the merits of an investment in the company. However, at most institutions, the proxy voting is handled by a specialized corporate governance group with little or no input from the portfolio managers making investment decisions. Also, not long ago, the cycle of shareholder engagement on corporate governance matters may have started when companies received a shareholder proposal in the late fall or early winter, involved attempting to negotiate with the proponent to have the proposal withdrawn and, if unsuccessful, extended to soliciting proxies for the annual meeting in favor of the company's position. When the annual meeting was concluded, the shareholder engagement cycle on corporate governance matters was done until the following season. Say-on-pay has changed all of that.

In the say-on-pay era, proxy statements (at least those for many larger companies) have transformed from black-and-white compliance documents to colorful, graphic and chart-filled materials that attempt to clearly communicate the company's performance, demonstrate why compensation decisions make sense in light of that performance, and highlight other corporate governance and executive compensation changes adopted by the company that show it in a positive light (often in response to direct or indirect shareholder feedback).

Consistent with the views expressed by Institutional Shareholder Services (ISS) and institutional investors, the substance of proxy statements in the say-on-pay era often contains a new narrative, and one that may have seemed highly unusual just a few years ago — a discussion of shareholder engagement efforts and how those interactions were considered by the board or relevant board committee and resulted in changed policies or programs. Specifically, ISS policy for 2012 indicated that recommendations would be made on a case-by-case basis for compensation committee members (and, in exceptional cases, the full board) if the company's previous say-on-pay proposal received the support of less than 70 percent of votes cast, taking into account the company's response to that vote, including "dislosure of engagement efforts with major institutional investors regarding the issues that contributed to the low level of support."

As a result, many companies that did not fare well in their 2011 say-on-pay votes engaged in a process in the second half of 2011 and into 2012 to meet or speak with larger investors to identify investor concerns and consider changes in response to those concerns. Proxy statements then summarized those efforts and explained how companies had been responsive to those interactions. Similarly, many companies that failed their 2012 say-on-pay votes have been going through a similar process in the second half of 2012, and we can expect to see disclosure of those engagement efforts in 2013 proxy statements.

Although we knew, anecdotally, that this shareholder engagement was not limited to executive compensation matters, recent updates by ISS and Glass Lewis — the two most influential proxy advisory firms — make explicit that this enhanced level of shareholder engagement applies across the board to all matters of corporate governance and beyond.

Specifically, ISS has updated its voting policy concerning majority-supported shareholder proposals. In past years and in 2013, ISS recommended/will recommend against directors who fail to act on a shareholder proposal receiving support of (1) a majority of the shares outstanding the previous year or (2) a majority of the votes cast in the last year and one of the two previous years. Beginning with shareholder proposals voted on in 2013 meetings (affecting 2014 voting recommendations for directors), ISS will recommend against directors who fail to act on a shareholder proposal receiving support of a majority of votes cast in the previous year.

In response to calls from the corporate community to more clearly describe how ISS views the sufficiency of a company's response to majority-supported shareholder proposals, ISS indicated that it generally expects full implementation of a proposal or, if a shareholder vote is required to implement the proposal, submission of a management proposal to shareholders at the next annual meeting. ISS then explained that responses involving less than full implementation are reviewed on a case-by-case basis, taking into account (among other things) "disclosed outreach efforts by the board to shareholders in the wake of the vote" and "actions taken by the board in response to its engagement with shareholders." This engagement process may very well support company-proposed action that does not go as far as the majority-supported shareholder proposal. Importantly, however, engagement is a two-way street. This is not simply a meet-and-greet with the corporate governance team. The investors with whom a company engages expect a serious discussion, reasonable consideration of their views and company follow-through. That engagement may indicate that less than full implementation will not be viewed favorably by investors.

Glass Lewis, the other leading proxy advisory firm, has a more expansive view of board responsiveness and the need for shareholder engagement. In its description of its 2013 voting policies, Glass Lewis states its view that "any time 25% or more of shareholders vote against the recommendation of management, the board should demonstrate some level of engagement and responsiveness to address the shareholder concerns." These policies, and the overall push for engagement — particularly institutional investor requests to include one or more company directors (typically the board chair or lead independent director, chair of the compensation committee and/or chair of the nominating and governance committee) as part of any meeting — require companies to devote more time, attention and strategic thinking to their overall corporate governance interactions with investors.

Corporate Governance: 2013 and Beyond

Say-on-Pay. Say-on-pay, and executive compensation more generally, will continue to be a significant topic for boards of directors and board committees in 2013 and beyond. Although directors must make executive compensation decisions that they believe are in the best interests of the corporation and most effectively attract, retain and incentivize management regardless of ISS or investors' policies, they need to: understand how those decisions will be viewed externally; make sure the rationale for those decisions is effectively communicated to investors in the proxy statement; and, where investors manifest disagreement through their votes, engage with investors in a meaningful way to show that the board is thoughtfully undertaking its oversight responsibilities, including with respect to executive compensation matters.

Shareholder Proposals. Companies also can expect to see many of the same shareholder proposal topics in 2013 that were popular in 2011 and 2012. With many S&P 500 companies already having declassified boards of directors or adopted majority voting in director elections, the recipients of proposals on those topics likely will include many companies outside of the S&P 500. Other common shareholder proposal topics will address shareholder ability to call special meetings or act by written consent, separation of the CEO and chairman roles, proxy access, elimination of supermajority voting requirements, and expanded disclosure and oversight concerning corporate political contributions and lobbying activity.

Dodd-Frank Act. Dodd-Frank will remain a significant part of the 2013 corporate governance discourse. The stock exchanges will finalize rules concerning enhanced compensation committee independence and committee consideration of compensation adviser conflicts of interests. On another front, unless and until the rules are vacated in pending litigation, many companies will have to continue to plan to comply with the conflict mineral rules and rules requiring disclosure of certain payments by resource extraction issuers. Finally, the SEC has yet to propose rules to implement the Dodd-Frank provisions on pay ratio disclosure, pay-for-performance disclosure, compensation clawbacks and disclosure on hedging policies.

Board Composition. The focus on board composition — particularly with respect to the skill sets and experiences of directors — has increased over the past few years. As the average age of directors of S&P 500 companies continues to increase and the number of new independent directors joining boards continues to decline (Spencer Stuart Board Index 2012), we anticipate that boards of directors will spend an increasing

amount of time considering director succession planning — *e.g.*, when should the company add new directors and what skills/experiences should they possess in light of when other directors may come off of the board due to reaching mandatory retirement age or otherwise. A related item is that some institutional investors remain concerned about the increasing tenure of directors and the need for new faces in board rooms. For some, the need for new faces raises particular questions about gender and race. The European Union has proposed legislation that listed companies in the EU target increasing women board members to comprise 40 percent of the board. Although such a bright-line numerical target seems unlikely to gain traction in the U.S., boards of U.S. companies are likely to face continued questions on the diversity of directors, in terms of both gender and race, as well as diversity of backgrounds and experiences.

Regulation of Auditors. In another case of déjà vu, auditors appear to be facing increased scrutiny. Over the past year or two, there has been increased discussion by the PCAOB and some institutional investors regarding audit firm rotation. Although recent public comments suggest that PCAOB action is not likely, the EU continues to consider legislation that would mandate audit firm rotation. Separately, the PCAOB issued a recent report critical of the eight largest audit firms' audits relating to internal control over financial reporting. Perhaps the greatest feeling of déjà vu, coming in part not long after the HP write-down of its Autonomy acquisition, stems from various public statements by regulators and others criticizing the levels of consulting work done by audit firms — an issue that was squarely addressed in the Sarbanes-Oxley Act.

Conclusions

Public companies and their board members may very well conclude that there is nothing new on the corporate governance front in 2013. In a sense, they may be correct. Yet, that sameness should not lull the corporate community into a sense of security. A lesson learned in 2012 is that prior say-on-pay success does not guarantee future performance. More importantly, across the corporate governance spectrum, there is a continued push to take shareholders' views — especially those of institutional investors — into account and, where those shareholders voice their disagreement with the board, to engage with them at levels beyond what many companies are accustomed to. As a result, public companies and their directors must remain vigilant — as always, their decision-making must be based on their views as to what is in the best interests of the corporation. What is new is that board members may find themselves, under the banner of "engagement," sitting across the table from their investors and being asked to justify their decision-making.

Say-on-Pay: Keys to a Successful 2013 Proxy Season

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Companies are preparing for the third proxy season under the "say-on-pay" rules established by the Dodd-Frank Act, which provide shareholders with the opportunity to vote on a company's executive compensation program on an advisory basis. Based on our experiences in 2012, we have the following suggestions for the 2013 proxy season:

Begin the proxy-drafting process now. Companies should begin the proxy-drafting process as soon as possible by identifying those individuals who will need to provide input for the proxy. Each piece of the puzzle should be integrated into a reader-friendly document that "tells the story" of the company's executive compensation programs in a compelling manner. This is a complex and nuanced area with a tremendous amount of media scrutiny, and we urge companies to consult with internal and external advisers as early in the process as possible to make the most appropriate strategic decisions with respect to their executive compensation programs.

Conduct shareholder outreach efforts. ISS made clear in its 2012 reports that it expects any company whose say-on-pay proposal failed (or passed without strong support) to conduct shareholder outreach efforts and to describe these efforts thoroughly in the next proxy. Companies in this situation should reach out to their largest shareholders to solicit reactions to the company's existing executive compensation program, as well as views regarding any concerns raised by ISS and others. Such outreach could include making presentations via teleconference, providing written materials regarding the company's current program and proposed changes, and holding in-person meetings.

Analyze last year's advisory reports. Companies should analyze the reports issued by ISS, Glass Lewis and other advisory firms in 2012 with respect to their 2011 executive compensation to better understand the concerns of those firms. Even if the company decides not to make changes, it should note in its next proxy that those concerns were reviewed and considered. If they do make changes, it may be viewed favorably by ISS and other services if the changes are described in some detail and explicitly linked to the concerns that were raised.

Focus on the lessons learned in 2012 by other companies. In the face of ISS "against" recommendations during this past proxy season, many companies issued supplemental filings as a rebuttal. This year, companies will be able to take advantage of the knowledge gleaned from the past season to both address known ISS concerns in 2012 proxy statements and make informed decisions regarding 2013 compensation:

- **Peer Groups.** One of the most controversial issues during the 2012 proxy season was the degree to which the peer groups chosen by ISS were different from the peer groups chosen by companies. Glass Lewis has indicated that it will employ a new model in 2013 that uses the company's peers — and the peers of those peers — to construct its peer group, and ISS similarly has indicated that it will use a more targeted industry classification analysis and will focus more closely on aligning its peer groups with those chosen by companies. As a general matter, companies should consider including additional information regarding the company's peer selection process to provide more context for shareholders to make decisions regarding the company's say-on-pay proposal.

"Companies should consider including additional information regarding their peer selection process to provide more context for shareholders."

- **Realizable Pay.** Many supplementary filings in 2012 focused on the perception by companies that ISS had materially overstated CEO pay by focusing on the theoretical full value of awards, without regard to the likelihood of whether any actual value would ever be received by the CEO. ISS has indicated in its 2013 policies that, for "large cap" companies, it will add a consideration of realizable pay to its research reports. It also has indicated that, for ongoing awards, it will focus on the target value, calculated using the stock price at the end of the performance measurement period. Companies may want to consider adding a realizable pay chart to the Compensation Discussion & Analysis (CD&A) in their next proxy to provide additional context to shareholders.
- **Equity Awards.** Despite many complaints by companies in their supplemental filings, ISS does not consider stock options to be performance-based pay, and a large grant of stock options can skew the ISS determination of CEO pay in the year of grant dramatically. Equity-based awards with time-based (rather than performance-based) vesting schedules are viewed extremely negatively by ISS, particularly when they comprise all or substantially all of the awards made under a company's equity award program. This should be kept in mind (among other relevant factors) in considering the terms of future grants.
- **Bonus Disclosure.** A number of negative ISS comments in 2012 addressed disclosure of incentive compensation. ISS indicated that it views vague descriptions of the manner in which annual and long-term bonuses are calculated as problematic, and we recommend that companies take a fresh look at whether the narrative description of such plans is detailed sufficiently. Further, ISS has not hesitated to analyze the actual payment thresholds and measurements in plans and to deem them insufficiently challenging. Companies should take care to use analytical rigor in setting goals and provide a description of the process through which any payment thresholds were set.
- **Total Shareholder Return.** ISS considers total shareholder return to be the most important measure of a company's performance in determining whether there is a "pay-for-performance disconnect." If a company believes that measures other than total shareholder return are more relevant to its stockholders — such as quality of assets held (in the case of financial institutions), safety (in the case of industrial companies), or low volatility and consistent dividends (in the case of utilities) — it should discuss this point in the CD&A to provide stockholders with that context.
- **Pay Disparity.** ISS indicated to a number of companies that it views a significant disparity between CEO pay and that of other executive officers to be problematic because it suggests inadequate succession planning and may impact executive morale. We recommend that a company with significant pay disparity provide disclosure regarding its reasons and a general description of any succession planning processes to show that the company has considered the issue.
- **Retention Bonuses.** Based on ISS reactions during the 2012 proxy season, we recommend that companies giving retention bonuses, stay bonuses or similar awards provide a detailed explanation of how the appropriateness of such an award was determined, the conditions under which it was to be paid and any other relevant information.

- **CEO Transitions and Tenure.** For companies that have gone through a CEO transition, we recommend that detailed disclosure be provided as to the rationale for any payments made to the departing CEO and any special payments or grants made to the new CEO in connection with the transition, together with any relevant factors considered in making any payments and grants. Conversely, companies with a long-tenured CEO who is highly compensated should consider highlighting the CEO's years of experience.
- **Excise Tax Gross-Ups.** ISS reserves its most negative comments for "golden parachute" excise tax gross-ups in new or renewed agreements and arrangements. The inclusion of such a provision can be sufficient on its own to draw a negative vote recommendation. In at least one case, the rescinding of the provision following a negative ISS reaction was sufficient to trigger a positive change in the recommendation. While most companies are aware of the issue in the context of new arrangements, they should be careful to monitor the renewal or extension of existing arrangements without the elimination of any existing provision for an excise tax gross-up. It also should be noted that ISS has changed its policies for purposes of its "say-on-golden-parachute" vote recommendation process and no longer will consider any existing provisions (such as existing gross-ups) to be grandfathered in that regard.

2013 Insights / SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES

Regulatory

143 Communications Law: The Relentless Pursuit of Broadband Competition

145 Network Security Threats and Cybersecurity Legislation and Regulation

148 Electric Power Generation: EPA Regulatory Developments

152 Oil and Natural Gas Exploration and Hydraulic Fracturing: Federal Regulatory Trends for 2013

155 Government Affairs and Government Procurement Compliance

157 Health Care and Life Sciences: Affordable Care Act Upheld, but M&A and Enforcement Trends Reflect Uncertainty

160 Affirmative Action in Employment

165 Recent Developments in Tax Law: Impact on Corporate Tax Strategies in 2013

169 Corporate Tax Reform: Prospects for Fundamental Change

Communications Law: The Relentless Pursuit of Broadband Competition

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As the Obama administration enters its second term, the Federal Communications Commission (FCC or Commission) is one of many federal agencies likely to experience turnover at the highest levels. While current FCC Chairman Julius Genachowski has not yet announced his intention to depart, many analysts expect him to do so at some point in the coming year. A new FCC chair can be expected to set his or her own priorities, and may refocus the agency on media issues or other areas that have seen less attention in recent years. However, Genachowski has devoted his attention to increasing the availability of broadband and enhancing competition within the ranks of providers of both wireless and wireline broadband services. Consolidation among existing broadband providers and the creation of new providers will continue to occupy a substantial portion of the Commission's time, even under new leadership. Moreover, existing initiatives designed to make more spectrum available to the public, including the auctions of federal and broadcast spectrum authorized by Congress in early 2012, will continue apace. The dearth of available wireless spectrum will make this newly commercialized spectrum a highly valuable commodity. As a result, the Commission can be expected to remain at the forefront of the ongoing battles over the consumer broadband market.

Wireless and Wireline Industry Transactions and Regulatory Initiatives

As consumer demand for both wireless and wireline broadband services continues its inexorable rise, providers are finding new ways to expand their service offerings. In particular, wireless providers are reshaping their industry with a series of acquisitions of wireless spectrum licenses and spectrum license holders. The Commission, in turn, has signaled that its primary goal in reviewing wireless and wireline transactions will be to foster competitiveness in the consumer broadband marketplace.

Despite the regulatory challenges that brought down the AT&T/T-Mobile merger in 2011, T-Mobile and Sprint responded over the past year with acquisitions of their own — competitor MetroPCS and Sprint's remaining unowned stake in Clearwire, respectively. Government and public interest groups thus far have taken a more favorable stance toward both transactions, recognizing the value of enhanced competition from smaller operators. Meanwhile, the FCC has continued to open up spectrum in the satellite bands, recently granting Ancillary Terrestrial Component authorities to Dish for the creation of a terrestrial broadband network. The Commission also has not shied away from addressing broadband-related policy issues within only tangentially related regulatory decisions. Recently, the FCC altered the general guidelines that limit the amount of spectrum held by individual wireless providers (the "spectrum screen") within a specific spectrum transaction approval. Going forward, the Commission likely will make spectrum resources available and approve the consolidation of existing providers when such transactions have the potential to bring new or newly enhanced competitors into the wireless broadband marketplace.

"The FCC has demonstrated a willingness to accept consolidation between wireline providers where it brings clear consumer benefits."

The FCC also has demonstrated a willingness to accept consolidation between wireline providers where that consolidation brings clear consumer benefits. During the first half of 2012, the FCC considered the proposed multibillion-dollar acquisition by Verizon of spectrum licenses held by a number of cable companies, as well as a series of ancillary agreements through which, among other provisions, Verizon would resell cable broadband services. While the Commission ultimately approved the transaction, it also conditioned its approval on an agreement by Verizon not to resell cable broadband in any areas served by its FiOS fiber-optic broadband service. This approval confirmed both the FCC's interest in making unused wireless spectrum available to the public and its continuing concern about the lack of competition in consumer wireline broadband.

The Middle Class Tax Relief and Job Creation Act: Spectrum Auctions and the Public Safety Network

On February 22, 2012, President Obama signed into law the Middle Class Tax Relief and Job Creation Act of 2012 (the Spectrum Act), which contained two major communications-related initiatives. First, to promote private sector spectrum use, the Spectrum Act requires the FCC to use new incentive auction authority to determine the prices at which participating TV broadcast licensees would be interested in relinquishing some or all of their spectrum rights, and then to use the Commission's existing auction authority to reallocate that spectrum to other users through a traditional forward auction. The Commission has stated that over the next year it expects to issue a series of rulemakings requesting public input on the design of both auctions and that it hopes to conduct the auctions in 2014. In addition, a number of related provisions require the FCC to conduct auctions over the next three years to commercialize several specified blocks of spectrum currently allocated for federal use. Given the continuing increase in the market value of wireless spectrum, spectrum license holders, especially broadcast licensees, should carefully monitor these auctions and the possibility of future incentive auctions going forward.

Second, the Spectrum Act also lays the groundwork for the creation of FirstNet, the authority responsible for establishing a new public safety wireless broadband network (the Network) to support the efforts of first responders nationwide. In addition, the Spectrum Act offers $7 billion in federal funding to support the creation of the Network. However, it remains unclear whether the funding (and the associated spectrum dedicated to the Network by the Spectrum Act) will be used to build out independent wireless communications infrastructure or to support a FirstNet partnership with existing commercial providers to build out the Network. While FirstNet will operate under the auspices of the National Telecommunications and Information Administration, the Network itself will be built pursuant to FCC minimum technical guidelines and roaming rules. Private sector wireless network operators and municipal governments with existing public safety networks should pay close attention to the work of FirstNet, the FCC and other related agencies in the near term, as they set rules governing those networks' interoperation with the Network and eligibility for federal funding.

Network Security Threats and Cybersecurity Legislation and Regulation

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Network security incidents, including attacks both simple (*e.g.*, distributed denial of service (DDOS)) and sophisticated (*e.g.*, advanced persistent threats), caused significant damage and loss at a range of companies in 2012. The frequency of such cyberattacks has skyrocketed, resulting in severe business disruptions and losses of valuable intellectual property, personally identifiable information and sensitive national security information. In an October 2012 speech to business executives in New York City, U.S. Secretary of Defense Leon E. Panetta emphasized the "unprecedented scale and speed" of recent cyberattacks, including those on major U.S. financial institutions, and expressed grave concern at the prospect of a "cyber Pearl Harbor." For his part, FBI Director Robert S. Mueller stated in March 2012 that, "in the not too distant future," he expects the "cyberthreat" to surpass terrorism as "the greatest threat to our country." Director of National Intelligence James R. Clapper has sounded a similar alarm, observing that "we face a cyber environment where emerging technologies are developed and implemented faster than governments can keep pace."

Network Security: Corporate Risk Factor

An easy mistake is to view network security risks as concentrated on national intelligence and defense information or private suppliers of critical infrastructure, such as electric and water companies, telecommunications providers, public transportation systems and hospitals. In fact, such risks extend much further and confront companies from Wall Street to Main Street — and everywhere between:

- In the U.S., several major banks have faced high-volume DDOS attacks that obstructed their ability to serve customers online.
- In Europe and the Middle East, a new generation of tenacious malware aimed at acquiring information about financial transactions and private communications was uncovered by network security researchers last summer.
- Last July, General Keith Alexander, director of the National Security Agency, put the total annual losses to U.S. companies from network security incidents, including losses of information and intellectual property, at an astonishing estimated $338 billion — or, as he put it, the "greatest transfer of wealth in history."

Cybersecurity is an increasingly important factor in a company's business and legal risk profile. As a result, in-house counsel continue to play an enhanced role in assessing risks, reviewing network security, evaluating disclosure considerations and developing policies to address concerns. Areas of responsibility include, but are not limited to:

- **Organizational Security:** setting and enforcing companywide security policies and procedures;
- **Personnel Security:** establishing screening, training and appropriate information security assurance procedures for employees who operate and maintain information technology (IT) systems;

- **System and Services Acquisition:** including security as part of the contracting and acquisition process to ensure that IT systems and related services are appropriately secured;
- **Strategic Planning:** planning to maintain operations in the event of an unexpected incident, whether natural, man-made and unintentional, or man-made and intentional;
- **Disclosures:** assessing the range of considerations necessary to determine whether to disclose or not disclose cyber risks and incidents in regulatory filings and other reports;
- **Information and Document Management:** restricting access to documentation about the operation and security of IT systems to appropriate personnel only;
- **Security Awareness and Training:** ensuring that personnel understand the security processes and procedures required to operate IT systems;
- **Monitoring and Reviewing Security Policy:** reviewing security policies periodically to ensure that they remain up to date; and
- **Risk Management and Assessment:** evaluating IT systems periodically to determine whether additional risks not adequately covered in existing security programs have emerged.

Network Security: Legislation and Regulation

The increasing prominence of network security threats has led to calls for action in Washington. At the end of 2011, it appeared that cybersecurity was one of the few congressional priorities without a fixed partisan valence and that the push for network security enhancement was likely to result in legislation. In 2012, both the House and the Senate proposed bills that contemplated new safeguards and exceptions to existing data privacy laws for businesses that share cybersecurity threat information with the government. In addition, the Senate bill asked the Department of Homeland Security (DHS) and regulatory agencies to work together to craft network security regulations that would be applied to critical private sector infrastructure operators. The House cybersecurity bill passed in April, and the Senate bill was brought to a floor vote in August and again in November. Today, however, action on both the Senate and House bills has stalled because of strong opposition from the business community and the White House, respectively.

> "Private sector network operators in critical infrastructure industries likely will be prioritized as regulatory targets."

After the Senate bill failed to win cloture in August, the White House signaled its intention to proceed with an executive order in the absence of legislation. Early drafts of that executive order indicate that the final order will include provisions to enhance the regulation of critical infrastructure. Under the most recent draft, which became public late in November, DHS would be required to identify critical infrastructure and create incentives to encourage entities that operate critical infrastructure to voluntarily comply with a security framework authored by the National Institute of Standards and Technology (NIST) in order to reduce cybersecurity risks. Meanwhile, agencies with responsibility for regulating critical infrastructure would be asked to provide reports to the White House detailing their respective authorities to regulate private sector entities' cybersecurity. If existing regulations are deemed insufficient, those agencies would be further requested to propose "actions" to mitigate cyber risk. Separately, the order would attempt to create incentives for critical infrastructure network operators to share more cybersecurity information with the federal government, whose agencies would promise to protect that shared information to the extent possible under existing law.

Given the increasing emphasis on regulatory solutions to network security problems in the executive branch, several independent regulatory agencies already have begun laying the groundwork for addressing network security practices. In October 2011, for example, the SEC issued CF Disclosure Guidance Topic No. 2, which asked registrants to report cyber risks and incidents. Last year, it followed up on that guidance, sending letters to several companies requesting that they disclose their status as cyberattack targets in future SEC filings. In September 2012, the Federal Energy Regulatory Commission announced its intent to create an Office of Energy Infrastructure Security to step up regulatory oversight of potential cyber and physical security risks to energy facilities under its jurisdiction. New requirements to disclose cybersecurity incident information to regulatory agencies will correspondingly increase litigation risk. Both federal securities law class actions alleging failures to disclose and those based on disclosed information are likely to become increasingly common. The decision whether to disclose or not disclose cybersecurity risks and incidents needs to be carefully considered.

Agencies likely will continue to draft guidance and, in some cases, regulations to address perceived vulnerabilities in network security in regulated industries. While existing information technology regulation focuses heavily on data security — *i.e.*, the protection of sensitive data, such as consumers' personally identifiable information — going forward, information technology regulation also can be expected to have a heightened focus on network security practices and policies. As a result, the aforementioned risk factors requiring corporate counsel attention may become additional regulatory compliance concerns.

Private sector network operators in critical infrastructure industries likely will be prioritized as regulatory targets. While the definition of "critical infrastructure" remains the subject of debate, organizations in the energy, financial services, defense, transportation, telecommunications and public health sectors likely will see increased regulatory attention.

What to Expect in 2013

If progress on cybersecurity legislation continues to falter, an executive order may be handed down in the first half of 2013, which would accelerate executive branch agencies' work on network security regulation. Agencies can be expected to offer several opportunities for regulated private sector entities to provide input into the regulatory process, including informal consultation with the government and formal notice-and-comment rulemaking.

Separately, in-house counsel will continue to navigate the complex issues surrounding corporate disclosures of cyber risks and incidents and the sharing of cybersecurity incident information with appropriate government agencies when faced with a serious breach. Given that an executive order will have limited power to streamline the sharing process, companies will need to weigh many competing considerations — including when and how to report a breach and to whom. In the absence of a legislative carve-out, various laws and regulations will need to be considered when disclosing information. Existing data privacy laws, including the Electronic Communications Privacy Act, can require heightened legal process before certain communications content information is disclosed. Considering these potentially significant implications, companies should engage knowledgeable counsel as part of assessing whether to exchange cybersecurity incident communications traffic and related logs with government officials.

Electric Power Generation: EPA Regulatory Developments

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More so than regulatory developments, inexpensive natural gas may be the most significant factor limiting the development of new coal-fired power plants and the dispatch of existing coal-fired plants. That said, environmental regulations will continue to play an important role in shaping the future of electrical generation. Of particular importance is the United States Environmental Protection Agency's (EPA) proposed rule that, for all intents and purposes, prohibits the construction of new coal-fired generation, absent a willingness to invest in relatively untested carbon capture and sequestration technology. Although unlikely, it also is possible that legislation could be passed in the next Congress that would impact one or more of the following regulatory developments (*e.g.*, legislation that could preempt EPA's ability to regulate coal combustion residuals in favor of the states).

Clean Air Act

Cross-State Air Pollution Rule. EPA has again struck out in its efforts to promulgate an allowance-based regulation to reduce the interstate transport of sulfur dioxide and nitrogen oxides. In July 2011, EPA issued the Cross-State Air Pollution Rule (CSAPR),[1] which was the agency's response to the U.S. Court of Appeals for the D.C. Circuit's 2008 ruling remanding the Clean Air Interstate Rule (CAIR). In August 2012, the D.C. Circuit vacated CSAPR in a 2-1 decision. *See EME Homer City Generation, L.P. v. Environmental Protection Agency*, 696 F.3d 7 (D.C. Cir. 2012). The court held that under the Clean Air Act (CAA), EPA could not require states to reduce emissions (1) by more than their "significant contribution" to downwind air quality concerns or (2) by more than their "fair share" relative to the contributions of other states. The court ruled that EPA, having used air quality modeling to define what a "significant contribution" was for purposes of deciding which states would be subject to an emissions reduction requirement, ignored the results of such modeling when establishing emissions caps. In the court's view, this meant that EPA was requiring some states to shoulder more than their fair share of the burden for reducing the impact of interstate air pollution.

The court also held that states did not have an obligation to prepare their own implementation plans (SIPs) to reduce interstate air pollution until EPA had determined (for each state) the amount of emission reductions that would be required. As a result, EPA did not have a legal basis to issue federal implementation plans *(i.e.*, directly applicable federal regulations that EPA is required to promulgate after it finds that a state has failed to develop a state implementation plan) for each state subject to CSAPR when CSAPR was finalized.

As a result, the less stringent and less comprehensive (in terms of states covered by the rule) Clean Air Interstate Rule will remain in effect for the forseeable future, subject to the outcome of EPA's petition to the D.C. Circuit for a rehearing en banc or possible petition for *certiorari* to the Supreme Court if EPA's petition for a rehearing is not successful. If EPA is not successful, it will have to go back to square one to determine how it will implement the CAA provision requiring states to eliminate air emissions that contribute significantly to downwind air quality problems. The decision in *EME Homer City Generation* may further limit EPA's ability to develop creative air emissions trading programs to reduce air pollution under the existing confines of the Clean Air Act.

[1] Details of the Cross-State Air Pollution Rule are discussed in *Skadden Insights* (January 2012), "Regulatory," *available at* http://www.skadden.com/insights/regulatory-0.

Hazardous Air Pollutants. EPA Administrator Lisa Jackson signed a final rule on December 16, 2011, limiting emissions of hazardous air pollutants (HAPs) from existing and new coal- and oil-fired electrical generating units (EGUs) (the Mercury and Air Toxics rule, or MATS).[2]

The MATS rule applies to those EGUs capable of combusting more than 73 megawatt-electric (MWe) heat input. For coal-fired EGUs, the regulation establishes numerical emission limits for mercury, particulate matter (as a surrogate for toxic non-mercury metals) and hydrochloric acid (as a surrogate for toxic acid gases), although the rule also provides alternative standards for certain subcategories (for example, limits on SO2 as an alternate to hydrochloric acid). For oil-fired EGUs, the regulation establishes numerical limits on total metals, hydrogen chloride and hydrogen fluoride. The final regulation relies on work practice standards, rather than numerical emission limits, to control the emission of organic acid gases such as dioxin/furan and to control emissions during start-up and shutdown. The rule also allows for emissions averaging among existing electrical generating units at a facility so long as the units are classified in the same subcategory. More stringent standards are established under the rule for new sources.

The MATS rule is subject to pending legal challenges filed by utilities, states and environmental groups. The utility petitioners argue that EPA's determination in 2000 that it was "appropriate and necessary" to regulate HAPs from EGUs was flawed both procedurally and substantively. In particular, the utility petitioners argue that the record compiled by EPA does not support EPA's findings that mercury, nonmetallic HAP metals and acid gas HAPs emitted by EGUs pose public health hazards; that EPA disregarded prior interpretations that it could only regulate those HAPs emitted by EGUs that were found to be a hazard to public health rather than all HAPs emitted by EGUs; and that EPA incorrectly determined that it was required to apply the stringent Section 112(d) "maximum achievable control technology" standard rather than more flexible alternatives. The utility petitioners further challenge specific aspects of the regulation as being substantively or procedurally defective.

In response to petitions filed by developers of proposed new EGUs, EPA proposed revisions to its regulation on November 30, 2012. Among the proposed revisions was an increase in the mercury emissions limit for high BTU coal-fired units to reflect practical issues associated with the monitoring of such emissions. EPA has stated that it intends to finalize these revisions by March 2013, an important milestone for project developers due to EPA's proposed New Source Performance Standards (NSPS) for greenhouse gas emissions for such units.

Greenhouse Gas (GHG) New Source Performance Standards/Permitting. On April 13, 2012, EPA published its proposed NSPS establishing carbon dioxide (CO_2) emissions limits from fossil fuel-fired EGUs pursuant to Section 111 of the Clean Air Act.[3] EPA's proposal combines fossil fuel-fired electric utility steam generating units (including boilers and integrated gasification combined-cycle units) and combined-cycle stationary gas turbines[4] into one source category and requires new sources in this category to meet an

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[2] *See* 77 Fed. Reg. 9304 (Feb. 16, 2012).

[3] *See* 77 Fed. Reg. 22,392 (proposed Apr. 13, 2012).

[4] EPA excluded simple cycle combustion turbines from the scope of the proposed rule because such units are not designed to serve base or intermediate loads.

output-based emissions standard of 1,000 pounds of CO_2 per megawatt-hour (MWh), based on a rolling 12-month average. The standard is based on EPA's determination that the "best system of emission reduction" that has been adequately demonstrated is new natural gas-fired combined-cycled (NGCC) turbines.

EPA's proposed standard does not require the construction of NGCC units, although its analysis is based in part on the projection that between now and 2020, new coal-fired electrical generating units will not be constructed primarily because of technological developments and discoveries that have driven down the price of natural gas. EPA nonetheless has proposed a compliance alternative for new coal-fired or petroleum coke-fired power plants, if such plants are designed to include the construction and operation of carbon capture and storage (CCS) or equivalent systems. Such power plants will be in compliance if their emissions of CO_2 do not exceed 1,800 lb/MWh on a rolling 12-month average basis for the first 10 years of operation; beginning in the 11th year, such plants must meet an emission standard of 600 lb/MWh for each 12-month period, so that over a 30-year period, the coal- or petroleum coke-fired plant will achieve compliance with the 1,000 lb/MWh standard.

The proposed regulation only applies to new sources; it does not apply to modified, reconstructed sources or existing sources. EPA also has stated that it does not have any intention in the next few years to propose emissions guidelines for existing EGUs pursuant to Section 111(d) of the Clean Air Act, although it will be under significant pressure from the environmental community to do so once EPA finalizes the NSPS.

The regulation also excludes proposed coal-fired electrical generating stations that have been issued major source air construction permits as of April 13, 2012, so long as construction begins on these stations by April 13, 2013.[5] Because the developers of these plants (which are not designed to meet the proposed GHG emission limit) have substantial concerns about their ability to comply with the new source MATS limits, these developers are pushing EPA to revise the MATS rule for new plants so that they can obtain financing and commence construction prior to the April 2013 deadline.

On the permitting front, the D.C. Circuit upheld EPA regulations that subject new or modified sources of GHG air emissions to the Prevention of Significant Deterioration (PSD) preconstruction permit program, but substantially increased the emissions thresholds that trigger an obligation to obtain a PSD permit. In particular, the D.C. Circuit held that EPA's determination that emissions of GHGs endanger public health and welfare was supported by the administrative record and that the petitioners challenging EPA's decision to substantially increase the thresholds triggering a PSD permit did not have standing to sue because they had not suffered an injury that could be remedied by a ruling in their favor. *See Coalition for Responsible Regulation v. EPA*, 684 F.3d 102 (D.C. Cir. 2012). Petitions for a rehearing en banc were denied. *Coalition for Responsible Regulation v. EPA*, Nos. 09-1322 (D.C. Cir. Dec. 20, 2012).

Ozone and Particulate Matter National Ambient Air Quality Standards. An important driver of more stringent air quality regulations (including regulations such as CSAPR and CAIR) are national ambient air quality standards (NAAQS) for "criteria" pollutants, including in particular ozone and fine particulate matter. State implementation plans

[5] EPA estimated that there were 15 projects that fell into this category.

are required to demonstrate how they will achieve or maintain compliance with these standards. Moreover, as standards become stricter, more areas will be considered out of compliance with such standards; as a result, owners and operators of major emission sources must comply with more stringent requirements to construct or modify their plants, including obtaining emissions offsets to ensure that the construction or modification of a plant will improve air quality by reducing emissions overall.

In 2008, EPA lowered the eight-hour primary and secondary ozone NAAQS from 80 parts per billion (ppb) (eight-hour average) to 75 ppb, notwithstanding that EPA's Clean Air Scientific Advisory Committee (CASAC) recommended a standard of between 60 and 70 ppb. In 2011, the Obama administration vetoed EPA's proposal to lower the ozone NAAQS to 70 ppb because the ozone standard is subject to statutory review again in 2013. EPA has been sued by environmental groups as a result of this decision. CASAC's initial policy assessment for the 2013 review has concluded that there is strong scientific justification for an ozone NAAQS between 60 and 70 ppb and there could be evidence supporting lowering the NAAQS to between 50 and 60 ppb. EPA anticipates finalizing a new ozone NAAQS in 2014.

The current primary and secondary NAAQS for $PM_{2.5}$[6] are 15 micrograms per cubic meter (annual average) (established in 1997) and 35 micrograms per cubic meter (24-hour average) (established in 2006). In June 2012, as part of its review of this standard and in response to litigation over the 2006 rulemaking, EPA proposed to retain the 24-hour average and to lower the annual $PM_{2.5}$ standard to between 12 and 13 micrograms per cubic meter (while taking comment on a standard as low as 11 micrograms per cubic meter).[7] Pursuant to a consent decree, EPA Administrator Jackson signed a final rule on December 14, 2012, that lowered the annual $PM_{2.5}$ NAAQS to 12 micrograms per cubic meter.

Clean Water Act

Cooling Water Intake Structures. In March 2011, EPA issued its proposed rule regulating cooling water intake structures (CWIS) for existing electrical generating and manufacturing facilities.[8] EPA was to have finalized the rule in 2012, but has reached agreement with environmental groups to extend the date to sign a final rule to June 27, 2013. In 2012, EPA issued a notice of data availability seeking comments on alternative methods for minimizing "impingement" of aquatic organisms that would provide even more flexibility than allowed by the 2011 proposed rule.[9]

Effluent Limitations Guidelines. EPA continues to work on revising its technology-based limitations for pollutant discharges from steam electrical generating units, last revised in 1982. The updated regulations are expected to address, among other things, wastewater pollutants arising from the operation of ash ponds and flue gas desulfurization air pollution controls, the use of which are expected to expand as a result of the air pollution control regulations discussed above. As a result of modifications to EPA's consent decree with the Sierra Club and Defenders of Wildlife (the most recent of which was submitted to the D.C. Circuit on December 10, 2012), EPA must propose regulations by April 19, 2013, and complete action on the regulations by May 22, 2014.

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[6] Particles less than 2.5 micrometers in diameter.

[7] *See* 77 Fed. Reg. 38,890 (June 29, 2012).

[8] *See* 76 Fed. Reg. 22,174 (Apr. 20, 2011).

[9] *See* 77 Fed. Reg. 34,315 (June 11, 2012).

Resource Conservation and Recovery Act

Coal Combustion Residuals. EPA issued a proposal in May 2010 to regulate coal combustion residuals (CCR) generated by the combustion of coal at electrical generating facilities.[10] EPA is still evaluating data and comments received on this rule proposal and subsequent notices of data availability and has stated that it does not contemplate finalizing a rule until 2014, although it also is fending off efforts by environmental groups and coal ash recyclers to obtain a court-ordered deadline for issuing final regulations.

[10] *See* 75 Fed. Reg. 35,128 (June 21, 2010).

Oil and Natural Gas Exploration and Hydraulic Fracturing: Federal Regulatory Trends for 2013

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Although most regulation of oil and natural gas exploration and production is conducted at the state level,[11] the federal government is becoming more active in this area, especially with respect to the controversial (in some circles) subject of "hydraulic fracturing." Hydraulic fracturing is a procedure to create fractures in rock formations by injecting fracturing fluids (primarily water with other additives depending on the formula used by drillers) and "proppants" (typically sand) to maintain fracture openings. This procedure allows the development of oil and natural gas resources in unconventional geologic formations.

Significant federal developments include:

Studies

EPA continues to work on a long-term study required by Congress of the potential impacts of hydraulic fracturing on drinking water resources. The study is looking at the "life-cycle" impacts of hydraulic fracturing, including the impact of large-volume water withdrawals on ground and surface waters; surface spills of hydraulic fracturing fluids, flow-back and produced waters; the injection and fracturing process; and the disposal of hydraulic fracturing wastewaters (including inadequate treatment of such wastewaters by public and private treatment works). A progress report on this study was released in December 2012 and a draft report purportedly will be released for peer review and public comment in late 2014. The study likely will impact the development of federal legislation and regulation of hydraulic fracturing and also may impact activities in the states. For example, legislation has been introduced in New Jersey to extend the moratorium on hydraulic fracturing in that state pending the results of this study.

EPA is investigating whether hydraulic fracturing in gas production wells in the area of Pavillion, Wyo., is impacting groundwater. In December 2011, EPA issued a draft report concluding that surface pits that had been used for the storage of drilling wastes and

[11] *See*, *e.g.*, Executive Order No. 13605, "Supporting Safe and Responsible Development of Unconventional Natural Gas Resources," 77 Fed. Reg. 23,107 (Apr. 13, 2012) (reaffirming that states are the primary regulators of onshore oil and gas operations).

produced and flow-back waters are a source of shallow groundwater contamination in the area. EPA also tentatively concluded that impacts to deeper water zones could be explained by hydraulic fracturing, although EPA also noted that it had not conclusively demonstrated a causal link between hydraulic fracturing and contamination in the Pavillion gas field. EPA recently extended the public comment period on the draft report to January 15, 2013.

"EPA continues to work on a long-term study required by Congress of the potential impacts of hydraulic fracturing on drinking water resources."

New Source Performance Standard — Green Completions

On April 17, 2012, EPA released a final rule for the oil and natural gas sector that included standards applicable to new wells that are completed after hydraulic fracturing and existing wells that are completed after refracturing.[12] Beginning on October 15, 2012, the effective date of the rule, all such wells must route flowback during the flowback period to a completion combustion device, such as a pit flare. Beginning on January 1, 2015, such wells (excluding exploratory, delineation or low-pressure wells) must use "reduced emissions completion" technology to separate flowback liquids from gases and route recovered liquids into a well; route recovered gases into a flow line or collection line or use the recovered gas as an on-site fuel source, with no direct release of the gas into the atmosphere; and, for gas that is not salable, direct such gas to the completion combustion device. Petitions for reconsideration of the rule have been filed with EPA and petitions challenging the rule have been filed in the D.C. Circuit. Most of the industry concerns have more to do with other aspects of the NSPS (and related hazardous air pollutant regulation promulgated by EPA) than the reduced emission completion requirement, although objections have been noted over the interim control requirements. Environmental groups have expressed their objection to the rule's failure to regulate methane emissions directly and the delay in imposing the reduced emission completion requirement until 2015.

Safe Drinking Water Act — Regulation of Underground Injection

Historically, EPA has considered hydraulic fracturing to be oil and gas production and outside the scope of its authority to regulate underground injection of fluids pursuant to the Safe Drinking Water Act (SDWA). This interpretation was called into question in *Legal Environmental Assistance Found. v. United States Environmental Protection Agency*, 118 F.3d 1467 (11th Cir. 1997). In the Energy Policy Act of 2005, Congress amended the SDWA to provide that underground injection (subject to the act) does not include fluids or propping agents (other than diesel fuels) used in hydraulic fracturing operations related to oil, gas or geothermal operations. In 2010, EPA posted a statement on its website that hydraulic fracturing operations using diesel fuel as an additive are regulated under the underground injection control (UIC) program. Given EPA's historical inactivity, its 2010 statement, unsurprisingly, led to a legal challenge from developers asserting that this was a policy change that could not be implemented without an opportunity for the public to comment.

On May 4, 2012, EPA released a document titled "Permitting Guidance for Oil and Gas Hydraulic Fracturing Activities Using Diesel Fuels-Draft — Underground Injection Control Program Guidance #84." In this guidance, EPA reaffirmed its position that the

[12] *See* 77 Fed. Reg. 49,490 (Aug. 16, 2012).

use of diesel fuel, either as a carrier fluid or an additive, as part of a fluid being injected for purpose of hydraulic fracturing for oil and gas production, is prohibited unless a UIC permit is issued. EPA further confirmed its view that wells used for hydraulic fracturing that are subject to the UIC program (because of the use of diesel fuel) should be subject to regulation as a Class II injection well (wells associated with oil and gas production). The draft guidance addresses a number of technical issues, including how diesel fuel should be defined, permit duration, well closure requirements, application requirements, well construction requirements, mechanical integrity, monitoring and enforcement requirements, and financial assurance. The public comment period on the draft permitting guidance closed on August 23, 2012.

Bureau of Land Management Proposed Regulations

On May 4, 2012, the U.S. Department of Interior, Bureau of Land Management (BLM), released proposed regulations governing hydraulic fracturing on federal and tribal lands.[13] BLM's proposed regulations would supplement (and in some cases duplicate) existing state and tribal regulations. The proposed regulation sets forth requirements for applications to conduct well stimulation, mechanical integrity testing, monitoring during well stimulation, storage of recovered fluids and information to be submitted after completion of well stimulation, including information on the volume of fluids used and the additives used in the well stimulation process. The BLM proposal generated much concern from industry and tribes about the necessity of the rule, given state and tribal regulation and potential costs, while environmental groups have asserted that the proposed rule does not go far enough to protect sensitive resources. The public comment period on the proposed rule closed on September 10, 2012.

Toxic Substances Control Act

In response to a petition by Earthjustice and other citizens groups, EPA in November 2011 declared that it would initiate a rulemaking under Section 8 of the Toxic Substances Control Act (TSCA) to require manufacturers and processors to submit data to EPA with respect to the substances and chemical mixtures used in hydraulic fracturing. Such data could include the quantity of substances manufactured or processed for uses, information on byproducts resulting from the use of chemicals and mixtures, estimates on the number of people exposed to such chemicals and mixtures, and data on health and environmental effects associated with such chemicals. Concerns have been raised by the oil and gas industry because of the potential breadth of the submittal requirements as well as the likelihood that many of the chemical additives used in hydraulic fracturing already have been subject to health and environmental effects submissions under TSCA or other environmental laws. EPA has not yet released a proposed rule under TSCA.

[13] *See* 77 Fed. Reg. 27691 (May 11, 2012).

Government Affairs and Government Procurement Compliance

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Corporations and other organizations engaged in government affairs or government procurement activities face laws regulating contributions, lobbying activities, conflicts of interest, gifts and related matters at the federal, state and local levels. Ensuring compliance with these laws will continue to be a challenge in 2013 for every industry. In addition, transparency in corporate political spending continues to garner attention in the boardrooms of the nation's largest corporations.

Inaugural and Transition Activities

2013 is notable for the special legal issues that arise from making contributions to the inaugural or transition committees or paying for inaugural events or transition-related activities. Contributions to state or local inaugural committees may be subject to restrictions under state or local ethics/election laws, and federal or state pay-to-play laws. Inauguration-related events may include inaugural balls, as well as breakfasts and luncheons celebrating the inauguration or related to viewing the inauguration and the inaugural parade. To the extent such events involve government officials or employees, a company must ensure compliance with applicable gift and entertainment laws. Contributions to state or local transition committees may be subject to state or local ethics/election laws, and federal, state or local pay-to-play laws. To the extent a corporate executive serves on a state or local transition team (such as for a governor-elect), he or she may, depending on the jurisdiction, be treated as a public official and subject to that state's or locality's conflict-of-interest law. Moreover, use of corporate resources, or volunteering during working hours, may result in an in-kind contribution to that committee. It also is important to be mindful of ethics disclosures and conflicts issues for incoming members of the legislative and executive branches at the federal, state and local levels.

Developments on Disclosure for Nonprofits Engaged in Advocacy

As a byproduct of the landmark *Citizens United v. Federal Election Commission* decision in 2010, nonprofits such as 501(c)(4)s and trade associations are under increasing scrutiny by state regulators with regard to disclosure of the sources of their independent expenditures, which are funds spent on communications advocating the election or defeat of a candidate, without coordinating with any campaign or committee. States including California, Idaho and Montana have been particularly aggressive toward that end. At the federal level, it is possible the IRS may take public action toward some of these nonprofits. It is somewhat less likely the Federal Election Commission or Congress will take action. Nevertheless, corporations should continue to monitor these issues as disclosure of certain contributions may ultimately become required, particularly at the state level.

Lobbying Laws and Restrictions on Placement Agents and Increased Enforcement

An increasing number of states and localities are enacting laws classifying certain activities of investment advisers and placement agents as requiring lobbyist registration and reporting. California, New York state and New York City have been particularly active toward that end. The regulatory environment with regard to lobbyist registration and reporting laws also is tightening, especially for government procurement activity. More restrictive laws are being passed with regard to gifts and entertainment of public officials and employees. Enforcement cases are being pursued for entertainment costs as small as $12.

Ongoing Issues: Pay-to-Play Laws, Shareholder Activism

"A corporate executive serving on a state or local transition team (such as for a governor-elect) may be treated as a public official and subject to that state's or locality's conflict-of-interest law."

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. Promulgated in 2010, the SEC's Pay-to-Play Rule 206(4)-5 continues to present challenges for companies by way of implementation. CFTC Rule 23.451 imposing pay-to-play restrictions on swap dealers took effect on December 31, 2012. At the same time, additional federal pay-to-play rules are on the horizon, including SEC Proposed Rule 15Fh-6 and MSRB Proposed Rule G-42. At the state and local levels, new and amended pay-to-play laws continue to emerge with activity in Connecticut, Philadelphia and Los Angeles.

We continue to see an increase in activity by the Center for Political Accountability and other groups regarding transparency in corporate political spending and lobbying activities. Such inquiries have increased, as has shareholder activism, as a result of the Supreme Court's decision in *Citizens United*. The timing and transparency of lobbying and political expenditure disclosure raises significant political and public relations issues with a corporation's investors and competitors and the public at large.

Implementing Compliance Programs

Because of the increased risk of enforcement action as well as negative media attention in the event of a violation of law, an increasing number of corporations continue to develop and refine compliance programs to address the areas of law discussed above. There are common elements among these programs, including practical policies and procedures; pre-clearance of certain contributions, gifts and/or lobbying activities; protocols to ensure registration and reporting requirements are fulfilled; training programs for key officers and employees; and protocols for updates on the latest developments in this area of law.

Health Care and Life Sciences: Affordable Care Act Upheld, but M&A and Enforcement Trends Reflect Uncertainty

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The Supreme Court's decision narrowly upholding the core provisions of the Affordable Care Act (ACA) paves the way for continued implementation of the law, including health insurance market reforms, new employer coverage mandates, reforms in Medicare payment and reimbursement, and new taxes on drug and device manufacturers.

However, the landmark ruling also has created a significant degree of uncertainty. The Court held that the act's Medicaid expansion violates Congress' spending authority: Capitol Hill cannot cut a state's entire Medicaid funding (as opposed to the incremental funds provided in the act) if the state chooses not to implement the expansion. Many states are poised to forego operating their own exchanges, and lawsuits have been filed challenging subsidies to federally run exchanges. In addition to the legal challenges that surfaced after the June 28 decision, the previous speculation leading up to the ruling, coupled with the debate during the second half of last year over how the U.S. presidential election would affect the ACA's implementation — or potential repeal — had a major impact on health care M&A and enforcement activity.

While the Supreme Court has ruled and the elections are over, lingering factors — the ACA's payment reforms, downward pressure on costs, enhanced focus among payers on outcomes and quality, and expanded Medicaid roles — will continue to influence M&A activity across industry sectors, increase regulatory and compliance costs, and provide additional incentives to federal and state enforcement agencies to boost enforcement efforts.

Health Care Reform Proceeds, Coupled With Uncertainty

The Supreme Court's decision and the 2012 election clear the way for further implementation of the ACA. The following provides a timetable for key milestones of the ACA's numerous provisions.

On or After January 1, 2013:

- State and federally run health exchanges must be up and running by October 1, 2013, so individuals and businesses can purchase health insurance by January 1, 2014.
- The amount of contributions to a flexible spending account for medical expenses will be limited to $2,500 per year, increased annually by the cost-of-living adjustment.
- Employers who receive Medicare Part D retiree drug subsidy payments will not be able to deduct those subsidies.
- An excise tax of 2.3 percent will be imposed on the sale of any taxable medical device.
- The Sunshine Act will be implemented, requiring disclosures by drug, device and medical supply manufacturers of payments to teaching hospitals and physicians. The Center for Medicare & Medicaid Services (CMS) has delayed implementation, announcing in May 2012 that data collection requirements will not begin before 2013.

On or After January 1, 2014:

- Funding for the Children's Health Insurance Program (CHIP) will be extended.
- A fee of $2,000 per full-time employee, excluding the first 30 employees, will be assessed on employers with more than 50 employees that do not offer coverage and have at least one full-time employee who receives a premium tax credit. Employers with more than 50 employees that offer coverage but have at least one full-time employee receiving a premium tax credit will pay the lesser of $3,000 for each employee receiving a premium credit or $2,000 for each full-time employee, excluding the first 30 employees.
- The Independent Payment Advisory Board (IPAB) will submit its first annual report of legislative proposals to reduce the per capita rate of growth in Medicare spending (in the event that spending growth exceeds a target growth rate).

On or After January 1, 2016:

- States will be permitted to form health care choice compacts that allow insurers to sell policies in any state participating in the compact.
- An excise tax will be imposed on insurers of employer-sponsored health plans with aggregate expenses that exceed $10,200 for individual coverage and $27,500 for family coverage.

Many important aspects of the ACA's implementation remain unclear, including how many states will elect not to operate their own exchanges, whether states will accept federal subsidies to expand Medicaid coverage, the process and criteria the IPAB will use to make recommendations to reduce health care costs, and the contours of the health care choice compacts allowing the sale of health insurance across state lines, among others.

Payment Cuts, Increased Regulatory and Compliance Costs Continue to Drive M&A Consolidation, New Business Models

The 934 deals worth $159.3 billion in 2012 were down from the 993 deals worth $196.5 billion in 2011 (mergermarket). Pharmaceuticals and biotechnology deals increased in the past year, but these gains were offset with declines in other major health care sectors, including medical equipment and supplies, hospitals and services.

With the Supreme Court's ACA ruling and U.S. presidential election decided, we expect the same factors that drove M&A activity in 2010 and 2011 — compressed margins due to payment cuts, increased regulatory and compliance costs, a desire for increased exposure to high-growth markets outside the United States — to increase activity in 2013 and beyond. Financially struggling providers will seek lifelines from larger, healthier systems. Larger systems will seek to offset a decline in reimbursement rates with increased scale. Similarly, payers will continue to seek enrollment expansion through M&A. Large pharmaceutical companies likely will continue to reshuffle their business portfolios and seek new avenues for growth in emerging markets and to fill near-term gaps in their pipelines due to patent expirations and the unpredictable results of their internal R&D efforts. Small- and medium-size medical device companies will explore the need to gain scale in the U.S. and abroad in their still-fragmented sector.

> "The continued focus on criminal and civil prosecution of health care companies makes the development and implementation of robust and comprehensive compliance programs more important than ever."

Federal and State Enforcement Continues to Increase, With Ever-Larger Settlements, More Suits in the Pipeline, and Strong Incentives to Continue or Boost Prosecution

The 2012 federal fiscal year set a new record for recoveries for civil and criminal cases against health care companies. The largest settlements included the $3 billion combined criminal and civil settlement with GlaxoSmithKline over sales, marketing and pricing allegations across a range of products, and the $1.5 billion settlement with Abbott Laboratories over the marketing of a neuroscience product. GSK paid $1.5 billion to resolve False Claims Act (FCA) allegations that the company (1) promoted off-label use for the drugs Paxil, Wellbutrin, Advair, Lamictal and Zofran, and paid kickbacks to physicians to prescribe those drugs as well as the medications Imitrex, Lotronex, Flovent and Valtrex; (2) made false and misleading statements concerning the safety of the drug Avandia; and (3) reported false best prices and underpaid rebates owed under the Medicaid Drug Rebate Program.

As in past years, the primary driver of civil recoveries generally, and health care settlements specifically, was the whistleblower provisions of the False Claims Act. Of the $4.9 billion in recoveries in fiscal year 2012, a record $3.3 billion was recovered in whistleblower suits. In fiscal year 2012 alone, relators filed 647 *qui tam* suits. Of the nearly 8,500 *qui tam* suits filed since the 1986 amendments, nearly 2,200 were filed since January 2009. Looking at *qui tam* recoveries for the same periods, the DOJ tallied $24.2 billion since 1986, with nearly $10.5 billion of that amount recovered from January 2009 through fiscal year 2012. Since 1986, whistleblowers have been awarded nearly $4 billion, with $439 million in awards in fiscal year 2012. The vast majority of these recoveries involved health care companies.

The number of *qui tam* suits likely will increase in response to whistleblower-friendly amendments to the FCA. Although the DOJ has lost several significant cases in the trial and appellate courts (including the U.S. Court of Appeals for the Second Circuit's rejection in *United States v. Caronia* of the government's core theory in the prosecution of off-label promotion by drug and device makers), considering the dollars at stake, these reversals are not expected to lessen the government's commitment to pursuing them — nor should it dampen the willingness of plaintiffs' lawyers to pursue such cases, even when the government declines to intervene.

The continued focus on criminal and civil prosecution of health care companies makes the development and implementation of robust and comprehensive compliance programs more important than ever, with new emphasis on top-level oversight and reporting mechanisms; enhanced accountability measurers for executives and employees; compliance safeguards to ensure incentive compensation plans and performance measures do not reward improper behavior; and comprehensive monitoring and auditing plans to ensure that compliance safeguards are effective and achieve proper behavior at all levels within the organization.

Affirmative Action in Employment

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The U.S. Supreme Court observed in 2003 that "major American businesses have made clear that the skills needed in today's increasingly global marketplace can only be developed through exposure to widely diverse people, cultures, ideas, and viewpoints."[14] Indeed, 10 years later, affirmative action policies adopted by many employers are not narrowly focused on remediating the effects of past discrimination. Rather, employers increasingly are establishing policies to advance diversity, either as a social good in its own right or as a means of offering better goods and services and competing more effectively in a global marketplace. They tend to focus on expanding and targeting outreach efforts and enhancing their reputations for diversity and inclusion in their communities.

The Supreme Court has not yet squarely addressed the question of whether promoting diversity can be a sufficient justification for an employer to consider race or another protected characteristic when making employment decisions. Yet, in expanding diversity programs, many employers have been relying on guidance from the Court's decisions on affirmative action in the higher education context. In February 2012, the Supreme Court granted *certiorari* in *Fisher v. University of Texas at Austin*, 631 F.3d 213 (5th Cir. 2011), *cert. granted*, 132 S. Ct. 1536 (2012), and now is poised to consider the use of racial preferences in higher education for the first time since 2003. The Court will confront issues surrounding the use of affirmative action in the name of diversity that may well influence the use of these practices by employers.

Government Contractors

Many businesses that contract with the federal government are subject to affirmative action obligations under Executive Order 11246. The executive order, enforced by the U.S. Department of Labor's Office of Federal Contract Compliance Programs (OFCCP), requires covered federal government contractors and subcontractors to take affirmative action to ensure applicants and employees are treated without regard to their race, color, religion, sex or national origin.[15] OFCCP regulations require each covered government contractor and subcontractor to implement a written affirmative action plan that includes an analysis identifying any underutilization of qualified minorities and women in its work-force and, where an underutilization is detected, sets forth placement goals, timetables for achieving a balanced workforce, and an outline of programs to achieve those goals and timetables.[16] However, such goals may not include quotas, set-asides or other preferential treatment.[17] The OFCCP also enforces similar affirmative action obligations pertaining to individuals with disabilities under Section 503 of the Rehabilitation Act,[18] and protected veterans under the Vietnam Era Veterans' Readjustment Assistance Act.[19]

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[14] *Grutter v. Bollinger*, 539 U.S. 306, 330 (2003).

[15] Exec. Order No. 11246, 30 Fed. Reg. 12,319 (Sept. 24, 1965), *amended by* Exec. Order No. 11375, 32 Fed. Reg. 14,303 (Oct. 13, 1967).

[16] *See* 41 C.F.R. §§ 60-2.15(b), 60-2.16(a) (2012).

[17] *See id.* at § 60-2.16(e).

[18] 29 U.S.C. § 793.

[19] *See* 38 U.S.C. §§ 4211-4215.

Voluntary Programs

A substantial number of affirmative action programs in the United States do not fall in the government contract category and are voluntary efforts implemented by employers to further equal opportunity. Such voluntary efforts face tension with Title VII of the Civil Rights Act of 1964, which makes it illegal for covered employers to make employment decisions "because of" an individual's race, color, religion, sex or national origin.[20] In fact, the Supreme Court has construed Title VII's prohibition against discrimination to recognize reverse discrimination claims by nonminority groups.[21]

In its first case to address the legality of voluntary affirmative action programs, the Supreme Court in *United Steelworkers of America v. Weber*, 443 U.S. 193 (1979), held that, given Congress' clear intent in enacting Title VII to remedy discrimination against minority workers, the statute's ban on discrimination "cannot be interpreted as an absolute prohibition against all private, voluntary, race-conscious affirmative action efforts to hasten the elimination of such vestiges."[22] Specifically, the Court ruled Title VII allows voluntary, race-conscious affirmative action plans when:

1. preferences are intended to "eliminate conspicuous racial imbalance in traditionally segregated job categories";
2. the rights of nonminority employees are "not unnecessarily trammeled" meaning the plan neither requires the termination of such employees and their replacement with minority employees, nor creates an absolute bar to advancement; and
3. preferences are temporary in their duration.[23]

Based on these factors, the *Weber* Court upheld Kaiser Steel's program designed to eliminate racial imbalances in the company's craft workforce by reserving half the openings in its craft-training program for black employees until the percentage of black craftworkers at the company mirrored the percentage of blacks in the local labor force.[24]

The Court extended *Weber* to cover gender-based preferences in *Johnson v. Transportation Agency, Santa Clara County*, 480 U.S. 616 (1987), where the agency had adopted a voluntary affirmative action plan advocating that gender be used as a plus factor in employment decisions within a traditionally male-dominated skilled job classification. Looking to the criteria utilized in *Weber*, the Court concluded the plan did not violate Title VII because women were underrepresented in certain skilled job categories and the plan was based on aspirations rather than quotas, did not unnecessarily trammel the rights of male employees because no positions were set aside for women, and was temporary.[25]

Weber and *Johnson* make it clear that race- or gender-conscious decisions made pursuant to an appropriately tailored voluntary affirmative action plan designed to remedy the

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[20] *See* 42 U.S.C. § 2000e-2(a)(1).

[21] *See McDonald v. Santa Fe Trail Transp. Co.*, 427 U.S. 273 (1976) (holding Title VII was violated where employer disciplined nonminority employees more harshly than minority employees for the same infraction).

[22] *Weber*, 443 U.S. at 204.

[23] *See id.* at 208-09.

[24] *See id.* at 209.

[25] *See Johnson*, 480 U.S. at 631-42.

effects of discrimination in traditionally segregated job categories will not violate Title VII. However, the Court has yet to address whether a private employer's voluntary affirmative action could be supported by a nonremedial purpose, such as a need or desire to achieve or maintain diversity in the workplace. The Court had agreed to confront this issue when it granted *certiorari* in *Taxman v. Board of Education*, 91 F.3d 1547 (3d Cir. 1996), *cert. granted*, 521 U.S. 1117, *cert. dismissed*, 522 U.S. 1010 (1997), in which the U.S. Court of Appeals for the Third Circuit held an affirmative action plan aimed at promoting racial diversity rather than remedying the historical effects of discrimination was prohibited by Title VII. However, the *Taxman* case was settled before the Supreme Court answered the question.

"Without clear direction in the employment context, cases decided by the Supreme Court in the educational context have provided guidance for private employers considering diversity initiatives."

Educational Context

Without clear direction in the employment context, cases decided by the Supreme Court in the educational context, while analyzed under the Fourteenth Amendment's Equal Protection Clause rather than Title VII, have provided guidance for private employers considering diversity initiatives. In the landmark case of *Grutter v. Bollinger*, 539 U.S. 306 (2003), the Court, by a 5-4 decision, upheld the affirmative action policy used by University of Michigan Law School that considered the race or ethnicity of applicants as a "plus factor" in its individualized review of each candidate. Applying a strict scrutiny analysis under the Equal Protection Clause, the Court found that "student body diversity is a compelling state interest that can justify the use of race in university admissions,"[26] and Michigan's plan, which sought to admit a "critical mass" of minority students but did not have a specific number in mind, was narrowly tailored to serve this compelling interest.[27]

The *Grutter* decision, by focusing on societal considerations to justify affirmative action in higher education, such as breaking down racial stereotypes and preparing students for "work and citizenship" in a global economy,[28] raised the question of whether these considerations may justify affirmative action in other contexts, such as employment. In fact, Justice Antonin Scalia's dissent in *Grutter* cautioned on the possible extension of the majority's reasoning to affirmative action in employment when he stated:

> If it is appropriate for the University of Michigan Law School to use racial discrimination for the purpose of putting together a "critical mass" that will convey generic lessons in socialization and good citizenship … surely private employers cannot be criticized — indeed, should be praised — if they also "teach" good citizenship to their adult employees through a patriotic, all-American system of racial discrimination in hiring.[29]

Following *Grutter*, the U.S. Court of Appeals for the Seventh Circuit concluded the Court's diversity rationale applies to hiring in public employment, ruling in *Petit v. City of Chicago*, 352 F.3d 1111 (7th Cir. 2003), that the Chicago Police Department "had a

[26] *Grutter*, 539 U.S. at 325.

[27] *Id.* at 340; *cf. Gratz v. Bollinger*, 539 U.S. 244, 273-76 (2003) (finding University's undergraduate admissions system of predetermined point allocations, which awarded 20 points to underrepresented minorities (with 100 points guaranteeing admission) had the effect of making race the decisive factor and was therefore unconstitutional).

[28] *Grutter*, 539 U.S. at 331.

[29] *Id.* at 347-48 (Scalia, J., dissenting).

compelling interest in a diverse population at the rank of sergeant in order to set the proper tone in the department and to earn the trust of the community."[30] It is unclear at this point what impact *Grutter* and *Petit* may have on private employers under Title VII.

Fisher Case

On October 10, 2012, the Supreme Court heard oral arguments in *Fisher v. University of Texas*.[31] The University of Texas at Austin follows a state mandate through which students in the top 10 percent of their high school graduating class are automatically admitted to the state university of their choice. In addition, since 2004, after *Grutter* was decided, the university allows race to be considered as one of several factors when admitting individuals who failed to qualify for admission under the top 10 percent rule. A nonminority Texas resident who was denied undergraduate admission to the University of Texas at Austin challenged the school's policy under the Fourteenth Amendment's Equal Protection Clause. She argued the policy should not have been adopted absent a "strong basis in evidence" that remedial action was necessary to address historical race discrimination by the university; the top 10 percent rule created racial diversity such that consideration of race in admission was not necessary; and the university's consideration of race involved "racial balancing" in violation of a general prohibition against quotas.[32] Relying on the *Grutter* precedent, the district court granted summary judgment in favor of the university[33] and the U.S. Court of the Appeals for the Fifth Circuit affirmed.[34]

Fisher is being closely watched to see whether, given the current composition of the Supreme Court, the Court will change its position with respect to consideration of diversity in school admissions, which may provide employers with additional guidance as they consider policies and programs designed to enhance workplace diversity. The outcome of the case, which is expected in 2013, could directly impact employers in the public sector, where constitutional restrictions apply (see Global Litigation/"The US Supreme Court Term: Business Cases to Watch"). And if the Court makes a sweeping declaration that preferences based on diversity goals at universities are unconstitutional, the legality of similar private employer programs may be open to question. Such an outcome also may have implications for the permissible scope of affirmative action under executive orders, such as Executive Order 11246. Thus, the Equal Employment Advisory Council filed an *amicus* brief supporting neither party, urging the Court not to issue a decision that makes it more difficult for federal contractors to comply with government-mandated affirmative action requirements or impedes employers' ability to maintain successful voluntary diversity initiatives.[35]

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[30] *Petit*, 352 F.3d at 1115.

[31] *See Fisher v. Univ. of Tex. at Austin*, 645 F. Supp. 2d 587 (W.D. Tex. 2009), *aff'd*, 631 F.3d 213 (5th Cir. 2011), *cert. granted*, 132 S. Ct. 1536 (2012).

[32] *See* 631 F.3d at 232-34.

[33] *See* 645 F. Supp. 2d at 599-613.

[34] 631 F.3d 213.

[35] Brief Amicus Curiae of the Equal Employment Advisory Council in Support of Neither Party, *Fisher v. Univ. of Tex. at Austin*, No. 11-345 (U.S. May 29, 2012).

Proposed Rule

In a related development, affirmative action obligations with respect to disabled workers may be expanded drastically pursuant to a proposed OFCCP rule that would require federal contractors to strive to hire specific numbers of individuals with disabilities. On December 9, 2011, the OFCCP issued a Notice of Proposed Rulemaking (NPRM) proposing changes to Section 503 of the Rehabilitation Act, which requires that federal contractors and subcontractors take affirmative action on behalf of qualified individuals with disabilities.[36] The NPRM proposes to establish a "utilization goal" of 7 percent for the employment of individuals with disabilities in each job group of a contractor's workforce.[37] The NPRM also contemplates a 2 percent sub-goal for individuals with "severe disabilities."[38]

OFCCP received approximately 400 comments in response to the NPRM. Critics claim the NPRM, by explicitly looking to numbers, imposes a quota that has long been held unlawful in the race and gender context. Defenders argue that a numerical goal is good to strive for and is only just a goal. The comment period closed on February 21, 2012, and the OFCCP has not scheduled a release date for a final rule.

* * *

It will be fascinating to watch developments in this controversial area in 2013 and beyond. An affirmance in *Fisher* would stand as a suggestion — but not a guarantee — that nonremedial, forward-looking, diversity-based affirmative action could be viable under Title VII. However, employers considering and implementing diversity programs should proceed with caution and with full awareness that the law in this area is unsettled.

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[36] *See* 76 Fed. Reg. 77056 (Dec 9, 2011).

[37] *Id.* at 77071.

[38] *Id.*

Recent Developments in Tax Law: Impact on Corporate Tax Strategies in 2013

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There have been a number of recent developments in tax law that may impact certain corporate tax strategies in 2013.

IRS Audits and Court Cases Reviewing Intercompany Debt

Many taxpayers have been experiencing IRS audits focusing on cross-border intercompany debt. In our experience, the potential challenges to date do not appear tightly coordinated, with theories ranging from debt-versus-equity and proper interest rates to economic substance, sham, conduit and treaty-shopping assertions. Often these disputes are resolved on audit or at IRS Appeals, but two decisions in 2012 provide new evidence of how debt/equity tax planning fares in the courthouse. The opinions reaffirm the validity of taxpayer favorable debt/equity authorities from prior decades. They make clear that tax planning is acceptable in choosing a capital structure, even when (1) that choice is informed in large part by tax considerations; (2) there is hybrid cross-border treatment; and (3) the tax planning is highly structured.

In *NA General Partnership v. Commissioner*,[39] the U.S. Tax Court considered the characterization of cross-border inbound debt. The IRS, in claiming the notes were equity, among other points, emphasized that (1) interest payments were missed and paid late and were financed by the lender; (2) the issuer subordinated the debt to third-party borrowings that also were used to pay interest; and (3) after a few years, the debt was repaid and capitalized when it appeared U.S. withholding and foreign tax obligations on the interest payments would increase. The tax court ruled for the taxpayer and concluded that debt treatment should be respected. The court held that the issuer generally was diligent in making its payments, and that borrowing to make interest payments, including from the lender, did not defeat debt characterization. In addition to citing the court's earlier rulings in *Litton Business Systems v. Commissioner*[40] and *Nestle Holdings, Inc. v. Commissioner*,[41] the court referred to *Kraft Foods Co. v. Commissioner*[42] in reiterating that the presence of tax planning does not defeat debt characterization.

In *Pepsico Puerto Rico, Inc. v. Commissioner*,[43] the parties' positions were reversed, but the court's view of tax planning was very similar. The taxpayers had issued outbound cross-border instruments that they treated as equity for U.S. tax purposes and debt for Dutch tax purposes. The instruments were long dated (40 years with a 15-year extension, becoming perpetual on default) and explicitly were repayable based only on the issuers' financial performance. The IRS emphasized the instruments' hybridity, focusing heavily on the taxpayers' representations about the likelihood of repayment when seeking a Dutch tax ruling that the instruments were debt. The court was comfortable with the line drawn by the taxpayers. It noted that the instruments "were meticulously structured to ensure that annual payments [on the instruments] remained, effectively,

[39] T.C. Memo. 2012-196.

[40] 61 T.C. 367 (1983).

[41] T.C. Memo. 1995-441.

[42] 232 F.2d 118 (2d Cir. 1956).

[43] T.C. Memo. 2012-276.

discretionary," but the court was not put off by the taxpayers' planning efforts or the hybrid nature of the instruments. It stated that the taxpayers "engag[ed] in legitimate tax planning, designing the ... agreements with an expectation" of hybrid treatment. Because the other objective factors, including ability to repay and right to enforce repayment, showed that the instruments should be treated as equity for U.S. law purposes, the court respected the taxpayers' reporting.

We expect to see continued focus on intercompany debt matters. With the recent taxpayer wins in this area, however, it may be that IRS scrutiny will turn more to appropriate interest rates than to debt/equity characterization and other theories.

The Foreign Account Tax Compliance Act Introduces New Challenges for Many

Both U.S. and international institutions continue to confront challenges and uncertainties introduced by the Foreign Account Tax Compliance Act (FATCA). Enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act in 2010, FATCA aims to prevent U.S. persons from evading U.S. taxes by holding offshore accounts. To collect information about U.S. holders, FATCA imposes sweeping new reporting and withholding obligations on foreign financial institutions (FFIs), defined broadly to include not only foreign banks, custodians and other financial institutions, but also hedge funds, private equity funds, mutual funds, insurance companies and other types of foreign entities.[44] FATCA requires FFIs to enter into agreements with the IRS to report the identities and other information about their U.S. holders or face the imposition of 30 percent U.S. withholding tax on U.S. source interest, dividends and gross proceeds from sales of U.S. stocks and securities. FATCA also requires participating FFIs to withhold on certain non-U.S. source "passthru" payments made to other noncompliant FFIs. In addition, FATCA imposes new reporting obligations on nonfinancial foreign entities, which must report information on their substantial U.S. holders to paying agents to avoid the 30 percent withholding tax.

> "As public attention to fiscal issues has increased worldwide, so has interest in multinational corporations' direct tax contributions as a proportion of their global operating income."

Originally scheduled to take effect in 2013, the U.S. Treasury Department and IRS have extended various deadlines and grandfathering dates to give companies more time to prepare. In addition, although the Treasury and IRS published proposed regulations in February 2012 and have issued additional guidance, many aspects of FATCA remain uncertain, including exactly what will be required of FFIs that enter into agreements with the IRS. Treasury received many comments on the proposed regulations from numerous institutions and industry groups throughout the world requesting, among other things, clarification of uncertainties, broadening of exemptions and relief from certain compliance burdens.

One hurdle to FATCA's implementation has been local bank secrecy laws, which may prevent disclosure of information required by FATCA. Over the past few months, the U.S. has been negotiating intergovernmental agreements with other countries that address the hurdle by allowing institutions in those countries to report information to their local jurisdictions' tax authorities instead of to the IRS, along with reciprocal information access privileges in the United States. The agreements also offer greater clarity, in certain cases, by providing a list of deemed compliant local institutions for a particular country.

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[44] The definition currently is so broad that it potentially could capture certain foreign holding companies that are not engaged primarily in a financial business.

FATCA will affect a wide range of transactions and market participants. In capital market transactions, U.S. issuers potentially will have to perform withholding on interest, dividends and gross proceeds if foreign institutions do not provide the required information. Further, FATCA may apply to stock or securities issued by non-U.S. companies under the "passthru payment" provisions if the issuers are considered to be FFIs.[45]

In credit agreements and other financings, lenders and borrowers must allocate the risk of FATCA withholding among the parties. While lenders in U.S. markets typically have accepted the FATCA risk to date, this has not necessarily been the case in European and other non-U.S. markets. Likewise, swaps and other derivatives involving foreign parties implicate FATCA withholding, the risk of which has been allocated to the payer in recent transactions.

Finally, institutions that may be considered FFIs, including hedge funds and other investment vehicles, must prepare for the new compliance and reporting requirements in the face of significant uncertainties. Many funds already have taken steps to amend their governing documents and subscription agreements to incorporate provisions designed to address reporting requirements and the imposition of potential withholding tax if an investor fails to comply. Increasingly, foreign investors in investment funds that may have exempt status (such as sovereign entities) are seeking to address FATCA through side letters with the funds.

The Treasury and IRS expect to finalize the FATCA regulations soon. Moreover, we expect to see more intergovernmental agreements in the coming months. The final regulations likely will integrate the structure of the intergovernmental agreements and respond to some of the significant comments received.

Headline Risk — New Challenges for Corporate Tax

As public attention to fiscal issues has increased worldwide, so has interest in multinational corporations' direct tax contributions as a proportion of their global operating income. Executive and legislative bodies not normally focused on international tax issues have conducted inquiries into multinational companies' tax affairs and summoned senior executives to testify on the subject. At the same time, media attention and public lobbying surrounding corporate taxes have increased.

In connection with this heightened interest in multinational tax planning, aggressive political inquiries and superficial media coverage can bring undesirable and unwarranted attention to a few companies targeted by government investigations or news stories. For example, U.S. senators have been quoted in *The Wall Street Journal* and *Bloomberg Businessweek* as referring to cross-jurisdictional transfer pricing rules as "gimmicks," "shenanigans" and "an unbelievable scandal." In the U.K., a Parliamentary committee held a hearing during which multinational technology companies and retailers were accused of "immorality." With statements like these, it is clear that corporate tax has become a frontline corporate social responsibility issue for multinationals on both sides of the Atlantic, as well as a particular vulnerability for B2C businesses' revenue lines.

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[45] Given significant uncertainty surrounding the breadth of the "foreign financial institution" and "passthru payment" definitions, the Treasury and IRS recently issued a notice extending the grandfathering date for obligations that would be subject to "passthru payment" withholding.

What it is all about. For most corporate groups, the effective tax rate on net operating income is essentially a function of where income is earned and how it is financed (tax base) and the tax imposed on that income (tax rate). Therefore, relevant to this calculation are:

- operating footprint — where a group undertakes research, manufacturing, sales, distribution and/or other services;
- asset ownership — where a group owns, develops and invests in its most important income generating assets; and
- corporate finance — how a group raises capital and deploys operating cash flow.

Most governmental and press attention to corporate tax has focused on the perceived disparity between where customer revenue initially is earned and where the associated income is taxed. The public inquiry questions why a corporate group that reports a large amount of revenue in the U.S. or the U.K. does not pay direct corporate tax in proportion to the revenue earned in that country.

The fundamental misconception underlying this inquiry is an assumption that one can allocate net income to a jurisdiction based on a group's gross revenues and a uniform profitability ratio that ignores the specific mechanism of the group's supply chain, financial structure and other aspects of its operating model. Put differently, some jurisdictions house profit centers and others house cost centers. Although the deductions available in a cost center jurisdiction can reduce taxable income, cost center jurisdictions can nevertheless collect significant amounts of tax from the group, *e.g.*, through payroll taxes, local business and real estate taxes, and supply taxes, such as value-added taxes (VAT).

Despite the suggestions of some governmental agencies and the press, tax outcomes tend to follow the facts. It is difficult to manipulate the operation of these rules, and multinationals regularly face inefficient tax outcomes due to the actual business processes that exist in various jurisdictions. Genuine substance and functionality are respected and taxed in a range of high-rate and low-rate jurisdictions as a result.

What it means for corporate groups. Government inquiries and press attention, and the underlying fiscal principles that prompt them, are largely outside of the control of most groups. However, sound preparation and organizational communication, as well as intelligent liaison with relevant fiscal and governmental bodies, can allow companies to manage the reputational consequences of such inquiries and coverage and avoid surprises. While the specifics of this vary by company and industry, some best practices include:

- Consider carefully the impact of any agreements with tax authorities on worldwide tax positions. While some companies appear willing to adjust their transfer pricing in response to these inquiries, such adjustments may have unforeseen consequences for positions taken in other jurisdictions and with respect to credits for foreign taxes paid.
- Ensure that key commercial, finance and legal teams understand the group's tax and transfer pricing structure. This reduces the risk of less informed responses to press and governmental inquiries and heightens awareness of the need for coordinated responses.

- Position the internal tax function to report to the board on the potential public relations impact of tax strategy as part of its overall reporting mandate and seriously consider the public relations risk in selecting appropriate tax strategies.
- Seek to control leaks and maintain confidentiality on sensitive tax strategy discussions and outcomes, particularly while they are in the gestation phase.
- Be prepared with a current synopsis of total fiscal contribution to key jurisdictions, highlighting payroll taxes administered at source, VAT and other supply taxes, stamp duties and transfer taxes, local business taxes and rates, and direct corporate taxes and withholding taxes. A "contribution statement" such as this illustrates the overall contribution of a corporate group to the local society it services. Get it right the first time — retracting or adjusting the statement, as has happened before, worsens public impression of the issues.
- Prepare economic arguments to illustrate reasons for low effective tax rates on apparently high revenues (*e.g.*, costs of growth, completion in the local market, high employer costs of adding to the payroll, etc.).
- Send the right person (*e.g.*, the CTO, CFO or CEO rather than a press officer or public relations expert) to field sensitive inquiries so that technical answers are available to difficult questions.

Corporate Tax Reform: Prospects for Fundamental Change

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Tax policy at the end of 2012, consumed as it was with the fiscal cliff, was focused on fixes to the individual income tax system. In contrast, in 2013 we may see the focus shift to fundamental tax reform, including proposals that would bring significant change to the corporate tax system.

Two major corporate tax reform proposals — with varying levels of detail — have been issued in the past year and a half: the President's Framework for Business Tax Reform, released in February 2012 (the President's Proposal), and House Ways & Means Committee Chairman Dave Camp's (R–MI) International Tax Reform Discussion Draft, released in October 2011 (the Camp Discussion Draft). While differing in their approach, the proposals share certain commonalities that provide the outlines of any likely corporate tax reform, including reduced corporate tax rates, a broadened corporate tax base and fundamental changes to the taxation of foreign income.

President's Proposal. The President's Proposal would reduce the corporate tax rate to 28 percent from the current 35 percent rate and expand the corporate tax base to compensate for the lost revenue. The proposal identifies a number of tax "loopholes" and "expenditures" that it says should be eliminated, including LIFO accounting, "preferences" for the oil and gas industry and insurance products, and preferential depreciation for corporate aircraft. Perhaps recognizing that these items would raise insufficient revenue to achieve the targeted rate reduction, the proposal includes a menu of other base-broadening options that it says should be considered. These other options include far more sweeping changes to the taxation of business income, including limiting the

deductibility of interest on indebtedness, lengthening depreciation schedules, altering the tax status of large pass-through entities such as large partnerships and S corporations, and taxing carried interests as ordinary income.

While the President's Proposal generally attempts to expand the corporate tax base to finance the reduced tax rate, it contains a number of proposals that would provide preferential treatment for manufacturing activities, such as (1) expanding the domestic production activities deduction to lower the effective tax rate on domestic manufacturing income to 25 percent, with a lower rate on "advanced" manufacturing income; (2) expanding and making permanent the simplified R&D credit; and (3) extending and making permanent various tax incentives for the development of clean energy.

The President's Proposal also contains significant changes to the taxation of foreign income, many of which also have been included in the president's annual budget proposals. The President's Proposal would limit substantially the deferral of taxation on foreign income by (1) imposing a minimum tax, at a currently unspecified rate, on all low-taxed foreign income, (2) subjecting to current U.S. taxation any "excess returns" earned on intangible property shifted from the U.S. to a foreign jurisdiction, and (3) deferring the deductibility of interest expense that is allocable to foreign income until such income is repatriated.

Camp Discussion Draft. In contrast to the President's Proposal, the Camp Discussion Draft focuses almost exclusively on international tax reform. The Camp Discussion Draft proposes a reduced corporate tax rate of 25 percent but leaves the details regarding the base broadeners necessary to finance that reduced rate for future consideration.

On the international tax side, the Camp Discussion Draft would replace the current worldwide taxation system with a largely territorial tax system under which dividends received by U.S. corporations from their foreign affiliates would be 95 percent exempt from U.S. tax. Whereas under current law, foreign earnings are subject to full U.S. taxation upon repatriation, with a credit for foreign taxes paid, under the Camp Discussion Draft, foreign earnings would be subject to an effective U.S. tax rate of 1.25 percent upon repatriation. The Camp proposal also would impose a transition tax on pre-reform accumulated unrepatriated earnings, which would be subject to current taxation at a 5.25 percent rate, with the tax payable in installments over eight years. The transition tax on accumulated income, together with the exemption for future foreign earnings, would greatly diminish, if not eliminate, the lockout effect that causes many U.S. multinational corporations to accumulate earnings abroad, lest they face full U.S. taxation at a 35 percent rate upon repatriation of those foreign earnings.

The Camp Discussion Draft also includes three "base-erosion" proposals that would subject certain types of foreign income to full, current U.S. taxation. These proposals are designed to limit the incentive that domestic corporations otherwise may have to shift income offshore under a territorial system in which that income would be permanently exempt from U.S. taxation.

- **Option A** would tax excess returns earned on intangible property in a manner similar to the president's excess-returns proposal.
- **Option B** generally would subject to full U.S. taxation any foreign income subject to an effective foreign tax rate less than 10 percent, with an exception for income earned in the foreign affiliate's home country.

> Though the President's Proposal and the Camp Discussion Draft differ fundamentally in many respects, there is a potential path toward compromise on corporate tax reform.

- Under **Option C** (which we understand Chairman Camp currently favors), foreign income earned on intangible property exploited within the U.S. (*i.e.*, income on foreign affiliate sales to the United States) would be subject to full U.S. taxation; foreign income earned on intangible property exploited outside the U.S. (*i.e.*, income on foreign-to-foreign sales) would be subject to a reduced 15 percent rate of taxation, as would income earned by a domestic corporation from the foreign exploitation of intangible property (*i.e.*, income on export sales).

These base-erosion proposals are suggested as potential alternative options with input requested from the public regarding their design.

Finally, the Camp Discussion Draft includes a "thin-capitalization" proposal that would limit the deductibility of interest by a domestic corporation if, and to the extent that (1) the U.S. members of the corporate group are over-leveraged as compared to the worldwide corporate group and (2) interest expense exceeds a certain — as yet unspecified — percentage of adjusted taxable income (taxable income before interest, depreciation, amortization and other specified expenses).

Outlook

Though the President's Proposal and the Camp Discussion Draft differ fundamentally in many respects, there is a potential path toward compromise on corporate tax reform. For example, agreement might be reached on a reduced tax rate around 28 percent, paid for with base broadeners, together with a territorial system that generally exempts foreign income from U.S. taxation but that (1) taxes foreign affiliates' intangible income on sales to the U.S. (as under Camp's Option C), and (2) imposes a minimum tax between 10 percent and 15 percent on all other foreign income (thereby combining the president's minimum tax with Camp's Option B). Such a compromise likely would have significantly differing impacts on multinational corporations depending on their tax and business profiles, making it unlikely that the business community would reach a consensus in support of such a proposal.

Ultimately, the timing and precise contours of corporate tax reform remain highly uncertain, but the prospects for corporate tax reform remain higher now than at any time in the recent past, and such reforms — whether changes to rates, the tax base or the taxation of foreign income — likely will have a significant impact on corporate taxation in the United States.

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