Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

Skadden

2010 Insights

Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

Dear Clients and Friends:

I am pleased to attach our second annual collection of commentaries on what we perceive to be the critical legal issues facing our clients in 2010. Policy makers around the world took extraordinary steps in 2009 to stabilize the global economy in the face of an unprecedented economic crisis. Many of these steps were both controversial and justified as emergency provisions necessary to foster stability.

As our clients and friends look to 2010, we see several macro themes that may have profound legal applications: First is how government will use, further broaden or change its newly expanded powers; second is how the global capital markets will respond to the new environment, including new intrusions by government into formerly unregulated areas; and third is how controversies between government and the private sector as well as controversies within the private sector will be affected and what strategies various parties will use to assert and protect their interests.

The commentaries are arranged into eight broad sections. While every piece will not be of interest to all, we hope the range of subjects covered will provide you with timely and pertinent information to help you meet the challenges and capitalize on the opportunities ahead.

- **Capital Markets.** The area of most direct interest to many of our clients is how the current financial environment may impact capital structure and the ability to raise capital. We recommend both advance planning and preventive measures that are applicable to most entities. We also examine opportunities created by the turmoil in financial markets and its impact on various capital markets sectors.
- **Corporate Restructuring.** It is generally expected that 2009's wave of corporate restructuring activity will continue in 2010. We provide information on various techniques that can assist both stressed entities looking to restructure their balance sheets and other entities seeking to benefit from that stress.
- **Emerging Markets.** As we did last year, we highlight certain developments in Brazil, China, India and Russia that continue to present great opportunities to our clients. We also discuss certain risks in those and other emerging markets more broadly.
- **Governance.** The financial and economic crises of the past few years and the response of various governmental bodies and other regulatory constituencies once again spotlight the importance of proper corporate governance. We explore subjects confronting directors and members of management in a series of pieces that assess trends and offer guidance on a range of issues, including executive compensation, shareholder activism, risk management and changes to governance processes.
- **Intellectual Property and Information Technology.** We address a number of areas of interest related to intellectual property and information technology, which we believe remain key economic drivers going forward.

- **Litigation/Controversy.** Resolution of disputes continues to become more global and complex. We discuss recent developments, the direction of various trends and likely strategies for managing disputes.
- **M&A/Transactions.** In 2009, global M&A and other transactional activity was somewhat constrained by the challenging financial and economic environments. Although it is hard to predict magnitude, we believe the global M&A and certain other transactional markets will see increased activity in 2010. We review a spectrum of issues faced in U.S., European, Asian and other M&A, energy and real estate transactional arenas.
- **Regulatory.** In the United States, the European Union, Asia and elsewhere, shifting governmental priorities in response to a variety of factors should impact our clients in a wide range of industries. We assess these developments in a variety of governmental arenas.

We hope you find these materials interesting and informative and would be happy to further discuss them with you. If you have a particular interest in any of these topics, please call your usual Skadden, Arps contact.

With best wishes for peace and prosperity in 2010,

Eric J. Friedman
Executive Partner

Skadden

Table of Contents

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

Capital Markets

Corporate Restructuring

Emerging Markets

Governance

Intellectual Property and Information Technology

Litigation/Controversy

M&A/Transactions

Regulatory

Capital Markets

"We believe there are likely to be more IPOs and public/Rule 144A offerings to reduce exposures of private equity sponsors and banks (especially in troubled credits)."

Corporate Finance | What We Expect

We have observed over the years that the level of corporate finance activity often has been a harbinger of things to come in the global economy. After a significant market disruption, interested parties try to salvage deals for a number of months, with activity eventually dropping off as few new deals enter the pipeline. This was illustrated in 2008 and through the first half of 2009, as corporate finance activity drastically declined.

Almost as often, corporate finance activity gains momentum about six months *before* a broader recovery. A significant revival in activity occurred in the second half of 2009 and, while the market remains both fragile and volatile, 2010 should continue to show further improvement, presenting both challenges and opportunities.

There have not been major regulatory developments that should dramatically affect corporate finance in 2010. Apart from the December 2009 announcement of a proposed liberalization of Rule 163 under the U.S. Securities Act of 1933 ('33 Act, discussed below), the SEC appears to be concentrating more on enforcement than on reforming the offering process.

Based on our recent experiences, we expect to see the following trends this year:

- **Advantage of being public.** 2009 demonstrated the advantage of being a public company in a difficult market. Although the banking sector remained frozen for much of the year, capital markets revived in the second half, with established public companies able to access debt (both investment grade and high-yield) and equity markets. Private equity portfolio companies suffered more as a result of the credit crunch because of their relative lack of access to public capital.

  We believe there are likely to be more IPOs and public/Rule 144A offerings to reduce exposures of private equity sponsors and banks (especially in troubled credits). After a prolonged dearth of new issues, so many of these deals are in the pipeline that there is real concern about hitting the market before it closes down because of excess supply. The advantages of having an effective "shelf" registration should be strongly considered in this environment.

- **Working off the wall of debt.** Billions of dollars of high-yield debt from the LBO boom will come due in 2010-2014. Issuers and investment banks are likely to try to mitigate refinancing risk by taking advantage of the revival of the high-yield markets. (See "The 'Wall of Debt': Identifying and Developing Long-Term Business Solutions for Near- and Medium-Term Debt Maturities") Refinancing activity also is being driven in part by historically low interest rates, as buyers are less concerned with safety (the dominant theme of the second half of 2008 and the first quarter of 2009) and more concerned with yield.

- **Real estate investment trust (REIT) market revival.** Although commercial real estate remains one of the most depressed sectors of the market, the demand for better yield has led to a significant revival of the REIT market as investors believe that values of health care facilities and some other sectors of the real estate market may have reached their low points. The advantages of being a public company were evident in real estate as public REITS have had easier access to capital. We anticipate that many REITs will accumulate cash and raise additional funds through offerings to take control of defaulting or troubled properties as the real estate investment community continues to go through its post-crash "shakeout."

Contributing Partners / Robert M. Chilstrom, Robert.Chilstrom@skadden.com, 212.735.2588 / David J. Goldschmidt, David.Goldschmidt@skadden.com, 212.735.3574

- **Challenges of excess supply.** The second half of 2009 also witnessed a broad revival of interest in the technology sector, and more Silicon Valley IPOs are predicted for 2010. In all sectors, however, U.S. IPOs will have to compete with emerging-market IPOs and general demand for emerging-market securities. The U.S. economic engine is no longer the sole engine of worldwide economic recovery. Offerings by Chinese and Brazilian companies have been significant in recent months and are likely to continue. In IPOs, securing commitments from "cornerstone" investors prior to filing a registration statement continues to present tricky legal issues.

  Again, there is a significant risk of supply exceeding demand and fears of markets closing down temporarily in response to regional or other economic crises, Dubai being the most recent example. In this environment, the pressure to clear SEC comments to hit "windows" of opportunity has been — and likely will continue to be — severe.

- **Looming intercreditor issues.** Several companies hit hard in the credit crunch entered into bank agreements that granted bank lenders upstream guarantees and security. As these companies now seek to refinance portions of their bank debt through high-yield offerings, as a practical matter they will have to replicate the security and guarantee packages they gave to the banks.

  Intercreditor issues between the banks and the new high-yield investors are likely to be more difficult than they were in the "silent second," "covenant lite" era. (See "Intercreditor Issues: Subtle Variations, Palpable Risk Differences")

- **Reconciling multiple disclosure standards.** Convergence in U.S. and European securities disclosure requirements in cross-border transactions has been one of the most significant regulatory trends of the past decade. The November 2009 decision of the Netherlands Supreme Court in the *World Online* case may herald a trend toward applying similar judicial review standards to securities disclosure documents in European offerings as in the U.S., and likely will further sensitize issuers and underwriters as to their potential liability in connection with European offering documents.

  This case arose from the 2000 IPO of an Internet service provider and thus preceded the adoption of the European Union prospectus directive and various enhancements during the past decade of European stock exchange prospectus disclosure requirements. The decision held the underwriters responsible for a number of material omissions in the prospectus.

  Notably, the Court ruled that the prospectus failed to disclose the price per share at which the then-CEO of World Online sold some of her shares shortly before the IPO. Although the sale was disclosed and there was no specific requirement to disclose the per-share sales price, the Court held that the price should have been disclosed because it was significantly lower than the IPO price.

  Increasingly, the task of an international securities lawyer will be to write a prospectus that would, if challenged, stand up to scrutiny under multiple disclosure standards.

- **Changes to WKSI practices.** As noted above, in December 2009 the SEC proposed to amend Rule 163(c) under the '33 Act to allow underwriters or dealers acting on behalf of a "well-known seasoned issuer," or WKSI, to offer securities prior to the filing of a registration statement without violating the '33 Act's "gun-jumping" provisions. The proposal points out, however, that WKSIs would continue to have an obligation under Regulation FD to make public any material information

not previously made public as a result of disclosures made in connection with prefiling solicitations of interest by the WKSIs or their underwriters or dealers.

If the proposed offering is large enough, it may itself be material to the issuer and holders of its securities, particularly in the case of equity offerings; and thus it is not clear how practical these proposed amendments would be for a WKSI issuer wishing to gauge market interest without telegraphing an offering to the market. However, in its release describing the proposal, the SEC commented favorably on the "wall-crossing" techniques developed by the private bar to require confidentiality agreements from investors being solicited as part of a premarketing effort.

- **New legislation affecting financial services industry and rating agencies.** Companies should be on the lookout for new legislation affecting the financial services industry and the regulation of derivatives. Similarly, although most of the criticism of rating agencies has been directed at their role in evaluating structured finance products, reforms in the regulation of Nationally Recognized Statistical Rating Organizations are likely to have significant effects both on the use of ratings in corporate and project finance offerings and the ability of broker-dealers and other purchasers of debt securities to use ratings for their net capital calculations and other regulatory compliance measures.

What the future holds for corporate finance activity in 2010 is, however, inherently uncertain. While economic recovery may be under way, the shocks to the global financial system in 2007 and 2008 were profound. It is unclear both how much of the recovery may be attributable to government stimulus money that is likely to run out and how much may reflect normal upward swings in the business cycle.

Confidence is returning but is still somewhat fragile, and volatility has not left the financial markets. In this environment, public companies that have positioned themselves to take full advantage of market opportunities when they arise should have a decidedly competitive advantage.

"While some of our clients continue to engage in the restructuring of existing equity-linked securities, the recovery of asset prices diminished the opportunities available in this market."

Corporate Finance | Equity-Linked and Other Financial Products

In 2009, the equity-linked market recovered from a complete halt in the last quarter of 2008, with overall issuance levels comparable to the first three quarters of 2008 although still significantly behind 2007.

The turmoil in the markets took a major toll on investors in convertible bonds, most notably hedge fund and other convertible note arbitrageurs, resulting in increased funding costs, margin calls, diminished liquidity and concern about the ability to engage in hedging activities. These outcomes presented unique opportunities for many convertible bond issuers to retire these securities on very favorable terms. The most common approach appears to have been open-market and privately negotiated cash purchases or common stock exchanges, often relying on the exemption from registration under the U.S. Securities Act's Section 3(a)(9). Other methods, such as public tender offers, also were employed. Transactions that involved a derivatives overlay (such as call spreads) required companies to unwind them in conjunction with the retirement of debt, as noted in our earlier mailing.[1] Tax-deferral provisions with respect to cancellation-of-debt taxable income adopted earlier in 2009 provided an additional boost to the repurchase activity. While some of our clients continue to engage in the restructuring of existing equity-linked securities, the recovery of asset prices diminished the opportunities available in this market. We expect the level of convertible bond restructuring activity to be significantly lower in 2010 than in 2009.

As noted, the new issue market in the U.S. in the latter part of 2009 was, perhaps surprisingly, robust, with more than two dozen new issuances in the last quarter alone and compared with no activity in the last quarter of 2008. Call-spread overlay transactions continued to be common. We did not observe major innovations in the market during the year, but rather incremental refinements, motivated in part by increased sensitivity to counterparty risk and lessons learned from the Lehman bankruptcy. We expect this trend of incremental improvements and structure enhancements aimed at reducing counterparty risk to continue into 2010.

As public merger and acquisition activity resumed, companies have been paying increased attention to the possibilities afforded by issuer derivatives, such as registered-forward transactions that provide companies with the ability to secure future share issuances at current prices. We expect this trend to continue. Commensurate with the increased M&A activity, target companies with existing convertible notes and call-spread transactions increasingly were seeking advice on how to optimize the retirement of the convertible and related derivatives of the target company, including the termination of the transactions on noncontractual terms, especially given the disparity between the contractual terms and the economic reality of these unwinds. As activity in the merger and acquisition market increases, we expect many more companies to be required to take similar considerations into account.

Contingent Convertible Securities

In November 2009, Lloyds Banking Group included as part of its £13.5 billion rights issue a new class of instruments named "enhanced capital notes." Unlike traditional "CoCo" securities, which typically couple the issuance of a debt instrument with an embedded call option on the company's common stock, these hybrid securities do not allow holders to convert them into shares at their election; rather, they are converted into equity upon the bank's Tier I capital ratio declining below a certain threshold. These securities provided Lloyds with much needed capital and have created an enormous amount of interest in Europe and the United States. Regulators have, to varying degrees, reacted favorably to the

Contributing Partners / John W. Osborn, John.Osborn@skadden.com, 212.735.3270 / Yossi Vebman, Yossi.Vebman@skadden.com, 212.735.3719

notion of contingent capital, and we have witnessed significant attention in the U.S. market to the search for a workable instrument.

Several challenges need to be overcome for this product to succeed in the U.S. market. One of the key structural challenges in making the securities qualify for the desired level of regulatory capital is finding the appropriate trigger levels at which the securities purchased by investors convert into the bank's common equity. These securities also must offer an attractive yield to investors, providing them with adequate compensation for the risks associated with the more junior ranking in the capital structure upon the bank's credit deterioration; however, they must not be prohibitively expensive to issuers. The rating agencies also still appear to be struggling with the appropriate metrics for rating these securities. Another significant challenge is making the securities more tax advantageous, by allowing for the deductibility of at least a portion of the ongoing payments made on the host contract. We are optimistic about the likelihood of a robust U.S. market developing for the new CoCos; however, we believe it may take some time until all of these challenges are adequately addressed in a workable structure.

1 "Convertible Bond Repurchases: Opportunities and Considerations," http://www.Skadden.com/content/Publications/Publications1568_0.pdf.

Derivatives | Enforceability of Counterparty Arrangements Post-Lehman

In September 2008, Lehman Holdings and several of its affiliates commenced insolvency proceedings around the world. In the wake of Lehman's collapse, its estate representatives, creditors and other parties-in-interest have been left to unwind more than 1 million open derivatives trades.

Due to the complexity of derivatives and other structured products, the Lehman insolvency proceedings have generated numerous litigations that may, if pursued to judgment, lead to important new precedents in these areas. Two of these areas are discussed here, and a third is discussed separately in "Lehman Challenges the Subordination of Derivatives Payments in Structured Products."

Ability of Nondebtor Counterparties to Defer Termination and Suspend Payments

Upon the occurrence of a bankruptcy or other default, an ISDA master agreement provides the nondefaulting party with the right to either (1) send a notice designating an early termination date for all transactions under the agreement or (2) suspend current payments otherwise due to the defaulting party under the agreement. Upon the designation of a termination date, the nondefaulting party is required to promptly determine the value for each of those transactions, net the values to a single number, and either pay the net amount to the defaulting party or demand that it be paid by the defaulting party, as applicable.

Many of Lehman's counterparties, especially those that would have owed a net termination payment to Lehman upon termination, delayed sending a termination notice to Lehman and/or suspended any current payments to Lehman.

Lehman has made various efforts to force such counterparties to either continue performing under the swap transactions or terminate and pay any net-termination payments due to Lehman under the transactions. The most notable of these efforts is Lehman's motion to compel Metavante Corporation to perform under an interest-rate swap. In connection with this motion, the bankruptcy court ruled that although the so-called safe harbor provisions of the Bankruptcy Code protect counterparties' rights to terminate derivatives transactions with a debtor, such rights may be limited in certain circumstances. (Hearing Transcript, at 99-113, *In re Lehman Bros. Holdings Inc.* (Bankr. S.D.N.Y. Sept. 15, 2009)).

The court indicated that Metavante's inequitable conduct, including the choice not to terminate the swaps for eight months after Lehman's bankruptcy filing (perhaps in the hope that favorable market movements would reduce any amount owed to Lehman), "constitute[d] a waiver" of Metavante's right to terminate the transactions under the Bankruptcy Code safe harbors. The bankruptcy court also suggested that the payment suspension right in an ISDA master agreement may be outside the Bankruptcy Code safe harbors and inconsistent with a debtor's ability, under the Bankruptcy Code, to compel counterparties to continue to perform under executory contracts.

Both elements of the court's decision regarding Metavante are controversial. Metavante has appealed the bankruptcy court's decision, and other parties have challenged the decision's substance and applicability. This area likely will continue to generate significant ongoing disputes.

Enforceability of Triangular Setoffs

ISDA master agreements between derivatives counterparties generally allow the parties to set off mutual obligations owing to one another. Obligations are "mutual" if they are due to and from the same persons

Contributing Partners / John W. Osborn, John.Osborn@skadden.com, 212.735.3270 / Mark A. McDermott, Mark.McDermott@skadden.com, 212.735.2290

in the same capacity. However, many derivatives counterparties modify the ISDA master agreement or enter into separate agreements to dispense with mutuality, thereby allowing so-called "triangular setoffs." In a typical triangular setoff, the setoff right extends to affiliates of the nondefaulting party. This arrangement is driven by many financial institutions' need to trade derivatives through affiliates for regulatory capital and other reasons. To the extent feasible, the insititutions want their counterparty exposure across such affiliates to be netted to a single number.

In 2009, however, the Delaware Bankruptcy Court in *In re SemCrude*, 399 B.R. 388 (Bankr. D. Del. 2009), ruled that Section 553 of the Bankruptcy Code, which preserves parties' setoff rights, explicitly requires "mutuality" as a condition to an effective setoff, and that parties may not contract around the mutuality requirement by agreeing to triangular setoffs among affiliates. While the *SemCrude* court did not explicitly interpret the safe harbor provisions of the Bankruptcy Code, the ruling nonetheless has called into question the enforceability of such arrangements in the derivatives context.

Numerous litigation matters are pending in the Lehman bankruptcy proceedings that ultimately may afford the Lehman bankruptcy court the opportunity to weigh in on, and provide guidance regarding, the widespread practice of contractual, triangular setoffs among derivatives counterparties.

Hedge Funds | Key Issues

In 2009, ongoing global economic uncertainty continued to influence the hedge fund space. It led some managers to introduce more investor-favorable terms in an effort to retain existing clients and to attract new capital. The year also brought with it tax, regulatory and enforcement developments and increased government involvement in the capital markets, with managers reacting to an unsettled landscape that included the continued repercussions of the Bernard Madoff case, the Galleon insider trading allegations, the introduction of the Term Asset-Backed Securities Loan Facility (TALF) program, developments in the treatment of deferred compensation, proposed "pay-to-play" legislation and the prospect of an evolving regulatory regime, both in the United States and abroad, intended to regulate systemic risks sometimes associated with the hedge fund industry. These developments can be expected to continue to influence hedge fund activity in 2010.

The Evolving Investor-Manager Relationship

- In view of the liquidity and performance issues encountered by many hedge funds in 2008 and 2009, certain institutional investors such as pension plans and sovereign wealth funds have expressed a desire for increasingly favorable terms. In March 2009, the California Public Employees' Retirement System (CalPERS) circulated a letter setting forth certain principles that, if implemented, would lead to a closer alignment of interests between managers and investors, as well as increased transparency. At this time, the extent to which standard hedge fund terms will shift as a consequence of recent investor pressures is uncertain.
  - Investor requests regarding improved alignment of interests include the following:
    - replacement of the traditional "two and 20" structure with a management fee structure corresponding to the fund's strategy and size of the fund, based on the rationale that management fees should be designed to sustain a manager's operations without encouraging asset gathering at the expense of returns;
    - performance fees being subject to a hurdle rate and calculated over longer periods of time, thereby aligning managers' interests towards long-term gains; and
    - maintenance of substantial levels of personal investments in a fund by principals of its manager ("skin in the game").
  - Investor requests regarding increased transparency include the following:
    - requirements for more comprehensive and frequent reporting regarding portfolio composition, sector concentrations, counterparty exposure, leverage and governance; and
    - third-party valuations with respect to illiquid investments, particularly in fund wind-down settings, in order to confirm manager valuations.
- Increased Use of Proprietary Vehicles
  - Concerned about liquidity issues associated with commingled funds (such as formerly diversified portfolios becoming increasingly concentrated in illiquid assets due to investor redemptions), some institutional investors now request proprietary vehicles such as single-investor funds or

Contributing Partners / Heather Cruz, Heather.Cruz@skadden.com, 212.735.2772 / Philip H. Harris, Philip.Harris@skadden.com, 212.735.3805 / **Associate** / Michael D. Saarinen, Michael.Saarinen@skadden.com, 212.735.2499

managed accounts, each of which also may provide the benefits of superior transparency, increased control over portfolio assets, more frequent liquidity and negotiated fee terms.

- Efforts to Address Illiquidity
  - Due to heightened investor sensitivity to illiquidity, many managers recently have relinquished their right to place new investments into side pockets, which are types of accounts used by hedge funds to hold illiquid securities until such securities' values are realized. There also has been a marked shift away from including side pocket features in recently launched funds.
  - Managers of existing funds that have restricted investor redemptions through side pockets and other restraints now occasionally seek to provide investors with liquidity by facilitating offshore secondary market sales of the investors' presently unredeemable hedge fund securities.

SEC Developments

- In view of several recent high-profile investment frauds, including the events relating to Bernard Madoff, the SEC announced certain initiatives to strengthen its oversight of broker-dealers and hedge fund managers, including:
  - increasingly focusing its examinations on side pocket arrangements, insider trading, activities outside of disclosed strategies and the possibility of preferential treatment in redemptions; and
  - developing third-party detection mechanisms through relationships with independent service providers such as auditors and custodians involved with hedge fund operations.
- The massive scope of the *Galleon* insider trading case, involving wiretaps, hedge fund and corporate personnel, as well as lawyers from a major law firm, has rocked the industry as it focuses on certain traditional market practices such as obtaining color from brokers and the chatter among traders, as well as the actual alleged criminal conduct. The *Galleon* case and the surrounding allegations have caused many managers to examine their processes and compliance regime in order to evaluate its robustness. The fallout from *Galleon* will continue for some time. For a more comprehensive review of *Galleon* and its underlying facts, see "The White Collar Crime Law Enforcement Agenda."

Regulatory Developments

- U.S. Legislation
  - Congress has introduced various bills that, if enacted, would impose new regulations on hedge fund managers. Most notably, the introduced legislation could require additional hedge fund managers to register with the SEC, while exempting registration for investment advisers to venture capital funds, certain small private funds and small business investment companies. The scope and content of these regulations are still uncertain, although the widespread expectation is that hedge funds will be operating under a more demanding regulatory regime in the future.

- The EU Directive
  - The Alternative Investment Fund Managers Directive (the AIFM) proposed by the European Union Commission in April 2009 (and revised in November 2009) generally would require all managers managing or marketing funds in the European Union to be authorized by the relevant national regulator. In addition, the AIFM would subject managers operating in the European Union to greater regulatory scrutiny and likely increased operating costs, but it also would make pan-European marketing of funds easier by permitting fund managers authorized under the AIFM to freely market, at a minimum, funds based in the European Economic Area to professional investors.
  - The AIFM would impose certain additional disclosure obligations and operational requirements on a number of areas, including valuation, depositaries and minimum level of capital. In addition, the AIFM would impose certain restrictions on the remuneration policies of authorized fund managers, similar to those applicable to credit institutions. The current draft of the AIFM will be subject to further debate and amendment, and it is unlikely that final text will be agreed upon before the middle of 2010.
- The SEC's Pay-to-Play Proposed Rule 206(4)-5 Under the Investment Advisers Act of 1940
  - Rule 206(4)-5, as currently proposed, has the following features:
    - makes it unlawful for a manager to receive compensation for advisory services provided to a government entity within two years after the manager or any of its covered associates makes a political contribution to an official of the government entity;
    - prohibits a manager or its covered associates from paying any third party for soliciting investment advisory business from a government entity; and
    - requires a manager to keep records of, among other things, all government entities for which the manager or any of its covered associates is "providing or seeking to provide" investment advisory services or are "investors or are solicited to invest" in a covered investment pool.
  - A number of comments have been submitted to the SEC regarding the proposed rule and the final form of the rule is uncertain. See "Government Affairs and Government Procurement Compliance" for additional information regarding proposed Rule 206(4)-5 and other recent pay-to-play developments.

Tax and Deferred Compensation Developments

- Tax Legislation Regarding Carried Interest
  - A number of legislative proposals have been introduced to treat income from certain partnership interests held by service providers, so-called "carried interest," as compensation income taxed at ordinary marginal rates rather than as long-term capital gains, which are taxed at a favorable 15 percent federal rate. (See "Tax | Monitoring Developments and Careful Planning Amidst Uncertainty")

- Deferred Compensation — Section 457A
  - In January 2009, the Internal Revenue Service issued interim guidance (Notice 2009-8) under new Section 457A of the Internal Revenue Code. Section 457A generally provides that, effective with respect to services performed after December 31, 2008, any compensation that is deferred under a nonqualified deferred compensation plan of a "nonqualified entity" (such as an offshore hedge fund) is includible in gross income when the compensation is no longer subject to a substantial risk of forfeiture (or, if later, when the amount first becomes determinable, in which case the compensation is subject to the payment of an additional 20 percent tax and interest). (See "Executive Compensation | The Financial Crisis's Legacy of Change?")

The Impact of TALF

- As part of the continuing effort to support the credit markets in the wake of the financial crisis, the Federal Reserve Board and the U.S. Department of the Treasury launched TALF in March 2009. The TALF program provides market participants with generally nonrecourse financing at favorable terms to purchase highly rated asset-backed and commercial mortgage-backed securities.
- Since TALF launched, the prices of highly rated asset-backed and commercial mortgage-backed securities have risen, and they are widely seen as not being as undervalued as before the program was implemented. A number of hedge funds have received financing through the TALF program to date, and the TALF program is expected to continue to play a significant role in the marketplace until its scheduled termination in mid-2010.

Investment Management | Impact of *Jones v. Harris Associates* on Fund Advisory Fees

The U.S. Supreme Court's decision in *Jones v. Harris Associates L.P.*, expected to be announced in early 2010, will have a direct impact on the procedural and substantive review by mutual fund independent directors of the advisory fees paid to fund investment advisers. Under the Investment Company Act of 1940, the advisory contract between a U.S.-registered investment company and its investment adviser — including the advisory fee — must be annually approved by a vote of a majority of the independent directors of the investment company, and the investment adviser has a "fiduciary duty with respect to the receipt of compensation" paid by the investment company.

Since 1982, the standard to review an adviser's compensation, as well as for determining whether an adviser has breached its fiduciary duty with respect to the receipt of such compensation, has been "whether the fee schedule represents a charge within the range of what would have been negotiated at arm's length in the light of all of the surrounding circumstances." To be in breach of fiduciary duty under the so-called *Gartenberg* standard, the investment adviser "must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." In the *Jones v. Harris Associates L.P.* litigation, the plaintiffs argued that the fiduciary duty of the investment adviser derives from the common law term and that — contrary to the *Gartenberg* "so disproportionately large" standard — the common law standard requires that the fiduciary's fee must be "fair" to the fund.

The Supreme Court's decision in the *Jones* case has not been published as of the date of this summary, but whichever way the Supreme Court rules on the specific facts involved, the case brings into issue the relevance of differences between the advisory fees charged to a registered investment company and the fees charged by the adviser to its institutional clients such as pension accounts and other nonfund clients. Although *Gartenberg* and other courts have rejected the relevance of such fee comparisons, under the standard proposed by plaintiffs in *Jones*, a breach of fiduciary duty could be established when an adviser charges the investment company a fee that is significantly higher for comparable services than the fees charged by the adviser to its unaffiliated clients.

The *Jones* case represents the most comprehensive review by the Supreme Court of the fiduciary duty standard. Based on the arguments presented and on industry commentaries on the issues in the case, advisers and fund boards face a re-examination of the substantive information to be provided to the boards in connection with their review of fund advisory contracts. They also may wish to consider a restructuring of the contracts by which the adviser provides both advisory services and nonadvisory services to the fund.

Contributing Partner / Thomas A. Hale, Thomas.Hale@skadden.com, 312.407.0570

"In the aftermath of the *Huntsman* and *Clear Channel* litigations, lenders learned that they also can be exposed to lawsuits when a proposed acquisition terminates."

Leveraged Finance | Recent Developments in Financing Commitments

The upheaval in the financing markets over the last two years has taught borrowers and lenders many new lessons relating to financing commitments. These lessons have led to changes in several important aspects of commitment letters, as well as how parties approach new financings, particularly in the acquisition financing context.

Importance of Mitigating Potential Risks If an Acquisition Terminates

- In the aftermath of the *Huntsman* and *Clear Channel* litigations, lenders learned that they also can be exposed to lawsuits when a proposed acquisition terminates. As a result, lenders will seek to mitigate these risks when providing commitments for acquisitions. They can do this by receiving certain protections in the acquisition agreement itself and requesting third-party beneficiary rights with respect to these protections.
  - **Capping liability.** Acquisition agreements often include specific termination fees payable by the buyer if it terminates the acquisition as a result of its lender's failure to fund. Lenders may request that the agreement specifically state that payment of this fee is the sole and exclusive remedy available against both the buyer and its financing sources. Separately, the buyer and the lender may agree under what circumstances, if any, the lender will be responsible for a portion of this fee.
  - **Jurisdiction and jury trials.** Lenders will request that the acquisition agreement state that litigation involving the financing take place either in Delaware or New York courts. Lenders also may ask that the buyer and seller waive their rights to a jury trial in litigation involving the commitment letters.

Importance of Having Clearly Defined Conditions to Funding

- Recent events have demonstrated the difficulties lenders may face in asserting "material adverse effect" or "market material adverse change" conditions as reasons not to fund a commitment. While those conditions may, in some circumstances, still be valid reasons not to fund, lenders also will seek to include more specific, objective conditions in their commitment letters.
  - **Minimum ratings conditions.** Commitment letters, particularly those involving investment grade borrowers, often include a minimum credit rating test. The commitment letter should make clear whether this rating must come from one or two rating agencies, whether negative outlook is permitted and within what period of time prior to closing this rating must be affirmed.
  - **Financial performance conditions.** In leveraged transactions, lenders will seek to test the borrower's financial performance prior to funding, usually by including a maximum *pro forma* leverage ratio test as a condition to funding. To avoid ambiguities, this condition should specify what, if any, *pro forma* adjustments will be permitted, whether or not leverage will be calculated net of cash on hand at the borrower, and which period's financial statements will be used to calculate this ratio.
  - **Forms of solvency certificates.** Despite recent litigation involving solvency conditions, a solvency certificate still is generally required prior to funding. Lenders and borrowers should agree in the commitment letter whether this certificate will be delivered by an officer of the borrower or a third party, and the form of the certificate that must be delivered.

Contributing Partner / Stephanie L. Teicher, Stephanie.Teicher@skadden.com, 212.735.2181

We expect the availability of financing commitments to increase in 2010. The terms of the new financings will be similar in many respects to those from 2006 and 2007; however, lenders and borrowers can expect to see a few key differences, particularly those described above. All parties involved in the transaction, including sellers in the acquisition context, will need to take these changes into account when structuring transactions in 2010.

Private Equity Funds | Key Issues

Private equity fund sponsors and investors have focused on evaluating and adjusting to the ongoing effects of wide-ranging economic uncertainty, constrained capital markets activity and disrupted trading markets for most types of financial assets. These general factors had marked consequences in the private fund sector, affecting asset class target allocations within investment portfolios, the pace and price received from investment dispositions, investor liquidity available for funding undrawn commitments, and investor appetites for new fundraising proposals. Although trading markets and confidence levels have recovered in part, these factors can be expected to color private fund activity in 2010.

A significant outgrowth in the private fund sector from general market turmoil has increased differentiation within the markets for private fund terms as certain sponsors and investors develop particular negotiated variations. Thus far, however, speculation regarding changes to private fund terms has been more widespread than actual changes made. In fact, there appears to be a remarkable continuity of core economic and contractual terms between performing managers and their traditional investor bases. Looking ahead, we anticipate that the factors contributing to relatively lower fundraising levels also are likely to sustain increased differentiation of fund terms, especially at the margin. As in the past, less well-established private fund sponsors can be expected to witness and react to investor demands first. Increased differentiation also will be reflected in more numerous co-invest structures tailored to meet the needs of extremely large institutional investors. Depending on expectations regarding relative stability in valuations, the availability and cost of financing, and medium- or longer-term target prospects, sponsors and investors may be expected to increase consideration of strategic transactions while maintaining the existing focus on distressed, emerging market and opportunistic transactions.

The following summary highlights certain leading issues for sponsors and investors relating to the formation and operation of private equity funds, and the relationships between sponsors and investors. See "Recent Developments in Private Equity Transactions" with respect to transactional activity of private equity funds and "Hedge Funds | Key Issues" regarding hedge funds.

Sponsor, Investor and Market Developments

Ongoing Constraints on Sponsors. Limits on financing availability, low and uncertain valuations, investor defaults and general market uncertainty required exceptional sponsor resources for portfolio management and investor relations, and resulted in constricted capital deployment in 2009. The significant decline in distributions from earlier vintage funds, and the resulting commitment overhangs and concern regarding defaults, prompted investor requests for negotiated commitment reductions. Sponsors in 2010 likely will continue to be required to consider and respond to such requests, informally or formally. In some cases, negotiating "dry powder" arrangements, such as amendments extending investment periods and capital recycling rights, may prove necessary.

Investors Struggle to Match Funding Capacity With Investment Opportunities. Investors experienced the effects of similar constraints, accompanied by volatility in valuations and liquidity across all classes of financial assets, significant declines in available cash to cover unfunded commitments and variations of actual results from target ranges for asset-class portfolio allocations and diversification thresholds. Possible changes to historically successful strategies for integrating decisions on overall portfolio management with those on strategy-specific or manager-specific opportunities will receive ongoing investor attention in 2010.

Contributing Partners / John M. Caccia, John.Caccia@skadden.com, 212.735.7826 / James M. Schell, James.Schell@skadden.com, 212.735.3518 / **Associate** / Ke Geng, Ke.Geng@skadden.com, 86.10.6535.5522

Differentiation of Economic and Contractual Terms. Although investor portfolio losses led to widespread and ongoing speculations that material changes in favor of investors were imminent, thus far, no general shift in economic or contractual terms has emerged. The absence to date of any broad-based change may be viewed simply as reflective of the structural ability of private equity funds to accommodate pauses in deal flows, exits and new capitalization. However, an equally compelling view is that relative stability of important long-standing relationships between sponsors and their investor bases from an alignment-of-interest perspective defined the majority of sponsor-investor interaction in 2009. In either case, material changes to economic and contractual terms are likely to occur slowly and to be visible first with less well-established sponsors. We believe this view is supported by a number of factors:

- **Continuing stability of core terms.** The preponderance of negotiations between established, performing asset managers and well-capitalized investors in 2009 has thus far reflected traditional dynamics and yielded relatively traditional terms.
- **Selective variations, on case-by-case basis.** Given substantial variations among investors with respect to going-forward needs for risk management, portfolio diversification, access and capital deployment, requests for investor-favorable changes (such as the terms published and promoted by the Institutional Limited Partners Association), likely will vary substantially and on a case-by-case basis in 2010 negotiations.
- **Changes to sponsor-investor dialogue.** Similar pressures on traditional views within investor institutions on alignments of interest likely will arise from important disparities of performance of assets that traditionally have been classed together within portfolios, including differing performance of products of a given sponsor. Negotiation dynamics in 2010 also will be impacted by perceptions of the effect on performance and deal flow attributable to strategic capital, and the terms upon which strategic capital was deployed with managers in 2009 commensurate with opportunities in the current environment for such investors.

Increased Attention to Team Status. Important changes in teams at sponsors and investors in 2009 were accompanied by pressures on team structures and compensation, as historical assumptions were undermined by uncertainties of valuations, lack of exits, and anomalies and large disparities of performance within benchmark periods traditionally used for compensation and promotion decisions. In 2010, the continuation of uncertainty may prompt changes in some managers' compensation and retention models, influenced by levels of lateral mobility and fundraising activity.

Certain Regulatory and Tax Matters

United States Federal Regulation, State Regulation and Tax Matters; and Offshore Regulation. As of December 2009, legislative initiatives in the United States have not yielded clear indications of the scope of any changes to regulation of private funds and sponsors. Legislative deliberations reflect a renewed focus on registration of advisers, information and disclosure protections, and integration of the roles of the SEC and other regulatory bodies such as the CFTC. While there are important differences between private equity funds and hedge funds from the perspective of systemic risk management and other policy objectives, legislative initiatives may include relatively general requirements, such as registration requirements, for a larger group of managers.

High-profile attention during 2009 to pay-to-play inquiries, changes in certain investor protocols and code-of-conduct proposals also may yield changes in formal practices and regulatory requirements at the state level in 2010.

Proposed regulations outside the United States, including proposed European Union regulatory initiatives, also may add compliance obligations for a broader group of U.S.-based and other non-European sponsors. See "Hedge Funds | Key Issues" regarding this issue and certain tax matters.

Emerging Market Developments

China RMB Private Equity Funds Bear Watching. Forecasts published by the International Monetary Fund suggest that over the next 10 years gross domestic product in China will grow to 85 percent of that of the United States, an amount projected to exceed the combined economies of Germany, France, the United Kingdom, Italy and Russia. As a result, investors and their advisers try to be especially alert to developments in China. In this regard, renminbi-denominated private equity investment vehicles organized under the laws of the People's Republic of China (RMB PE Funds) are likely to continue to gain traction this year as an attractive private equity platform in China. This is primarily due to central and local government policy initiatives to promote the development of the Chinese private equity industry, the positive growth outlook for the Chinese economy and increasing demand for alternative asset classes from Chinese investors.

By way of background, foreign investors have traditionally structured private equity deals in China either as foreign direct equity investments or using offshore holding companies that invested in Chinese operating companies before finally exiting on offshore stock exchanges (the "round-trip structure"). However, the implementation of Regulations on Mergers and Acquisitions of Domestic Companies by Foreign Investors in 2006 has made the round-trip structure difficult to execute in many instances.

By contrast, an RMB PE Fund structure generally will facilitate access to the vast capital pool available within China, streamline government approval procedures in deal execution and enable exits on the Chinese securities markets. While China's central government is still in the process of drafting national regulations with respect to the formation and management of private equity funds in China, local governments in certain cities such as Tianjin, Shanghai and Beijing recently have promulgated rules that permit the formation of private equity funds and fund management companies by foreign investors. An RMB PE Fund may take the form of a limited partnership or a limited company in China, with the limited partnership being generally preferred because of tax reasons.

While RMB PE Funds sponsored by foreign private equity firms are still few in numbers and many uncertainties remain in the legal framework, we expect that existing and soon-to-be-formed RMB PE Funds may well benefit from significant early-mover advantages, such as early name recognition, more connections with and access to domestic investors, and accumulation of local private equity investment management experience. In addition, the launch of the growth enterprise board on the Shenzhen Stock Exchange in November 2009 has contributed to market enthusiasm for the RMB PE Fund structure. It is expected that China's central government soon will promulgate within China national regulations on the formation and management of private equity funds, which should provide much-needed clarification on the legal framework for foreign direct investment in China's private equity industry. We believe that during 2010, developments affecting RMB PE Funds will merit close attention.

"Without action on the part of the FDIC, this safe harbor would no longer have been available, which could have resulted in downgrades of ratings of securities issued in reliance upon the rule."

Structured Finance | New Securitization Accounting Rules and Their Implications for Bank Capital and Legal Isolation

In June 2009, the Financial Accounting Standards Board (FASB) issued two new accounting standards with major implications for participants in the securitization markets. Taken together, the new standards will cause most previously off-balance-sheet securitizations by entities subject to United States generally accepted accounting principles (GAAP) to be brought back onto a bank's balance sheet. Insured depository institutions will be required to maintain risk-based capital and loan-loss reserves with respect to the additional loans added to their balance sheets. Also, insured depository institutions have had the benefit of a legal isolation safe harbor under a Federal Deposit Insurance Corporation (FDIC) rule that applies to securitizations and participations. But this is the case only if the related transfer of financial assets satisfied the conditions for sale-accounting treatment under GAAP other than the legal isolation condition. Without action on the part of the FDIC, this safe harbor would no longer have been available, which could have resulted in downgrades of ratings of securities issued in reliance upon the rule. The FDIC has agreed to grandfather securitization transactions issued on or prior to March 31, 2010, that meet the requirements for a GAAP sale under the prior accounting standards and has released an Advanced Notice of Proposed Rulemaking with an example of regulatory text for a new safe harbor with significant additional conditions attached.

New Accounting Rules

On June 12, 2009, FASB issued Financial Accounting Standards No. 166 (FAS 166), which amends Financial Accounting Standards No. 140 (FAS 140), and Financial Accounting Standards No. 167 (FAS 167), which amends FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities (FIN 46(R)). Under FAS 140, securitizations of credit card receivables, mortgages, auto receivables and other financial assets generally were structured to achieve off-balance-sheet treatment. Among other things, the new standards:

- eliminate the concept of a qualifying special purpose entity (QSPE);
- make key changes to the consolidation model of FIN 46(R) that will change the method of determining which party to a variable interest entity (VIE) should consolidate the VIE; and
- require reconsideration of the party that consolidates the VIE on an ongoing basis.

The new standards are effective at the beginning of each reporting entity's first fiscal year that begins after November 15, 2009.

A transfer of financial assets to a QSPE was not subject to a consolidation analysis under FIN 46(R). With the death of QSPEs, most securitization trusts will be viewed as VIEs and must undergo a consolidation analysis. The new guidance changes the approach for determining the primary beneficiary of a VIE from a quantitative risk-and-reward model to a qualitative model based on control and economics. Under most current structures, the result of this analysis will be consolidation of the transferred assets back onto the balance sheet of the transferor, which, in turn, will preclude sale treatment under FAS 166. Some structures will continue to allow off-balance-sheet treatment, such as a transfer to a VIE where a third party has a significant economic interest and "kick-out rights" that entitle it to unilaterally remove the holder of the controlling economic power, generally the servicer. Other struc-

Contributing Partner / Andrew M. Faulkner, Andrew.Faulkner@skadden.com, 212.735.2853

tures likely will emerge as the market adjusts to the new standards. But removing assets from a balance sheet through securitization has become significantly more difficult, which means a major benefit of securitization will no longer be present for traditional structures.

Capital Requirements

Capital requirements for insured depository institutions look to GAAP as an initial basis for determining whether an asset is on- or off-balance sheet for capital purposes. When the assets of most securitization trusts that have been off-balance-sheet return to the originator's balance sheet under the new accounting standards, insured depository institutions will lose the capital benefits of securitization because they will be required to hold capital against those assets. Bank regulators believe that the higher capital requirements that will result from changes in GAAP better reflect the risk retained by banks. Final rules providing a modicum of transitional relief from the increased capital requirements were approved by the FDIC on December 15, 2009. The final rules include an initial, optional two-quarter delay in maintaining risk-based capital against assets of newly consolidated VIEs and an additional two quarters during which risk-based capital need not be held against 50 percent of risk-weighted assets. There is no specific carve-out for asset-backed commercial paper conduits for risk-based capital purposes as there had been under FIN 46(R). Higher capital requirements will mean increased costs for banks that either will be passed through to counterparties or result in a reduction in securitization issuance. A reduction in the amount of securitization activity may result in a reduction in the amount of consumer lending that has been funded through securitization as well as a reduction in lending to businesses that financed their receivables through asset-backed commercial paper conduits and other securitization structures.

FDIC Legal Isolation Rule

In August 2000, the FDIC adopted a regulation entitled "Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation" (the Legal Isolation Rule). The Legal Isolation Rule says the FDIC, as receiver or conservator for an insured depository institution, will not use its authority to repudiate contracts to reclaim, recover or recharacterize as property of a financial institution assets transferred in connection with a securitization or participation. But a significant condition to application of the rule is that the transfers must meet all conditions for sale-accounting treatment under GAAP other than legal isolation. Because under the new accounting rules transfers of financial assets by most originators will no longer satisfy the conditions for sale-accounting treatment, absent action on the part of the FDIC the safe harbor of the Legal Isolation Rule will no longer be available. Without the safe harbor provided by the FDIC Legal Isolation Rule, the FDIC, as conservator or receiver, could repudiate the transfer of financial assets and would be required to pay "actual direct compensatory damages" measured as of the date of conservatorship or receivership. These damages do not include damages for lost profits or opportunity, and no damages would be required to be paid for the period between the date of conservatorship or receivership and the date of repudiation or repayment. The FDIC could delay its decision to repudiate for a reasonable period following its appointment as conservator or receiver. The lack of an applicable safe harbor could have significant ratings implications for bank-originated securitizations.

Also, the Federal Deposit Insurance Act was amended in 2006 to build in a consent requirement that limits the ability of any person to exercise remedies (including termination, acceleration or declaration of a default under a contract) or obtain possession of or exercise control over property of an institution,

or affect any contractual right without the consent of the conservator or receiver for:

- 45 days following a conservatorship; or
- 90 days following a receivership.

This stay provision is of heightened concern for bank-originated securitizations, where assets remain on a bank's balance sheet.

On November 12, 2009, the FDIC adopted an Interim Rule amending the Legal Isolation Rule to extend its benefits to any securitization for which transfers of financial assets are made. For revolving securitization trusts, the extension applies to beneficial interest issued on or before March 31, 2010, so long as the conditions for sale-accounting treatment, other than legal isolation, that were in place before November 15, 2009, are satisfied. The Interim Rule did not address stay risk explicitly, but through a memorandum released at the same time as the Interim Rule and a subsequent press release, the FDIC clarified its position that financial assets transferred in a transaction qualifying for the protection of the Interim Rule will not be treated as property of the institution or receivership. Therefore, the stay will not apply.

At its December 15, 2009, meeting, the FDIC released an Advance Notice of Proposed Rulemaking (ANPR) outlining potential requirements for the Legal Isolation Rule for post-March 31, 2010, transactions. The ANPR includes sample regulatory text for a new safe harbor and a series of 35 questions regarding potential parameters for the new safe harbor. Significantly, the regulatory text includes requirements that:

- the sponsor retain no less than 5 percent of the credit risk of the financial assets, which retained interest must not be hedged;
- the sponsor to provide at least Regulation AB level disclosure for all securitizations, including private transactions; and
- compensation for transaction parties be disclosed.

In addition, for securitizations of residential mortgage loans (RMBS), the text includes:

- All mortgage loans transferred must be held for not less than 12 months prior to transfer to the securitization.
- The securities generally cannot be enhanced through external credit support or guarantees.
- The sponsor must disclose loan-level information about the financial assets.
- The servicing agreement must provide servicers with authority to mitigate losses consistent with maximizing NPV, including through mortgage modifications.

The sample text also requires documentation of the transfer of the financial assets and the duties of the transferor to be separate from the documentation of the duties of the servicer, paying agent and other participants, and says the safe harbor will apply only if the securities issued were not sold predominantly to an affiliate or insider.

The requirements of the FDIC's proposal are similar in some respects to provisions in Congressional legislation addressing securitization, but not identical, leaving the potential for multiple standards that must be met by bank securitizers.

The ANPR will have a 45-day comment period. If a final rule is adopted in the form of the sample regulatory text, insured depository institutions that rely on the legal isolation safe harbor for their securitizations would be forced to make significant modifications to their structures and documents, which could result in delays and increased costs for those securitizations.

Structured Finance | Lessons for the CMBS Market and the Securitization World in the General Growth Properties Bankruptcy

In April 2009, General Growth Properties (GGP) and its operating partnership subsidiary, GGP Limited Partnership (GGP LP), commenced voluntary cases under Chapter 11 of the Bankruptcy Code. Along with its more than 750 subsidiaries and affiliates, GGP operates a nationwide network of shopping malls.

The filings by GGP and GGP LP were not themselves a surprise because they followed widely publicized efforts to voluntarily restructure. What surprised and concerned the commercial mortgage-backed securities (CMBS) market and the securitization world in general was the concurrent voluntary bankruptcy filings of more than 150 of its affiliated special purpose entities (SPEs). The SPEs had been organized to own individual shopping malls and to finance themselves by issuing CMBS to third-party investors.

Like SPEs used in the issuance of CMBS and of residential mortgage-backed and other asset-backed securities, the SPEs were organized as so-called "bankruptcy remote" subsidiaries. The goal of using a bankruptcy remote subsidiary is to isolate it from the effects of a bankruptcy of its parent or an affiliate (here GGP and GGP LP). If the goal is attained, the creditors of the bankruptcy remote subsidiary (here the holders of the CMBS) can rely solely on the performance of the assets held at the subsidiary.

Two key factors in structuring a bankruptcy remote subsidiary are (1) to require that it have one or more directors (or similar functionaries) independent of the parent or affiliate, and (2) to require the unanimous consent of all directors prior to the filing by the subsidiary of a voluntary bankruptcy proceeding. Generally, these factors are coupled with a requirement that the independent director(s) consider the interest of the subsidiary and its creditors in determining whether to consent to a voluntary filing by the subsidiary. Prior to the *GGP* proceeding, the prevailing industry opinion was that so long as the bankruptcy remote subsidiary's assets are performing, the independent directors will not consent to a voluntary filing by the subsidiary.

In the *GGP* case, however, the independent directors consented to the filings by GGP's SPEs, notwithstanding that the SPEs (1) were structured as bankruptcy remote subsidiaries and (2) were not in imminent danger of defaulting.

A number of creditors of the various SPEs filed objections to the voluntary filings. The objections primarily asked that the voluntary filings be dismissed as bad-faith filings because they were premature, given that the SPEs were solvent.

The bankruptcy court rejected the creditors' objections and allowed the SPEs to continue their bankruptcy cases. The court cited a number of reasons for its decision, principal among which were: (1) a debtor need not be insolvent to voluntarily file for bankruptcy; (2) in light of the collapse of the CMBS market and the market for real estate loans generally, it made sense for the SPEs to commence bankruptcy proceedings prior to when their CMBS were scheduled to mature; and (3) the SPEs were entitled, in determining whether to voluntarily file, to consider the interest of GGP.

In November 2009, GGP announced "agreements in principle" to restructure the mortgage loans made to certain of its SPEs. On December 15, 2009, the bankruptcy court confirmed the plans of reorganization for 194 debtors associated with $10.25 billion of secured mortgage loans. On December 22, 2009, the bankruptcy court confirmed the plans of reorganization for an additional 16 debtors associated with

Contributing Partner / Mark A. McDermott, Mark.McDermott@skadden.com, 212.735.2290 / **Of Counsel** / C. Thomas Kunz, Thomas.Kunz@skadden.com, 212.735.3240

$1.3 billion of secured mortgage loans. Notably, the SPE debtors agreed to strengthen the bankruptcy remoteness features of their organizational documents as part of the plan of reorganization. GGP announced that rolling confirmation will continue in 2010 with additional project and parent-level entities.

While predictions that the GGP affiliates' bankruptcy proceedings would be the death of securitization proved premature, the proceedings have taught the securitization markets a number of lessons. Among the most important:

- "Bankruptcy remote" indeed means "bankruptcy remote," not "bankruptcy proof."
- The use of the independent director structure may require enhanced charter document provisions regarding their fiduciary duty if the structure is to perform as many market participants anticipated.
- Historically, the risk of a voluntary filing by bankruptcy remote subsidiaries has been underestimated by the market.
- Securitization transactions involving the operating assets (in contrast to financial assets such as receivables) of complex, integrated entities such as GGP and its SPEs involve heightened risk because, when faced with a bankruptcy court's desire to allow a debtor to reorganize, there is pressure to find ways to access operating assets that have been securitized.

Despite the implications of these lessons, we anticipate that, with an improving economy and improving credit availability, securitization (particularly of traditional financial assets) will continue and the market for securitization products will grow.

Structured Finance | Lehman Challenges the Subordination of Derivatives Payments in Structured Products

The devastating impact of the Lehman Brothers bankruptcy filing on already-fragile global financial markets is well known, as is the fact that more than a year later, hundreds of billions of dollars of assets remain entangled in a thicket of third-party and intercompany claims.

Less known is the potential fallout for a variety of structured products that either are based upon the performance of derivatives or use derivatives for hedging purposes. While the future of some of these products — such as synthetic CDOs — may be in question, there are a substantial number of these transactions now outstanding that may be adversely affected by issues raised in the Lehman bankruptcy proceedings. Other derivatives-related issues litigated in these proceedings are discussed in "Derivatives | Enforceability of Counterparty Arrangements Post-Lehman."

- **Synthetic Securities in the Lehman Estate**
  - Before its bankruptcy, Lehman Brothers was one of the largest global originators of structured products with embedded credit derivatives, known as credit-linked notes or synthetic CDOs (synthetic securities).
  - Synthetic security structures were thought to have been designed to effectively protect investors from counterparty credit risk. Among other standard requirements, the providers of the swaps that underlie the synthetic securities must be highly rated when they enter the swap, are required to post collateral for their obligations if downgraded and are subject to termination if they default. However, these features alone would not insulate investors from counterparty credit risk, because swaps generally provide for a mark-to-market payment on termination that is payable to the party "in the money" regardless of whether that party is the defaulting party. And a mark-to-market at a given point in time can result in losses that might never have been incurred had the swap gone to maturity.
  - The key structural feature that the rating agencies relied upon to insulate the performance of the synthetic security from the mark-to-market risk in the wake of a counterparty default is a requirement that any termination payment payable to a defaulting swap counterparty be subordinated to the payment of all rated notes. This feature has been standard in rated structures for many years, not only in synthetic securities, but also in other securitization structures in which a swap is used, whether a credit derivative or a standard interest rate or currency hedge.
- **Lehman's Challenge to Subordination Provisions**
  - In a series of adversary proceedings, beginning in February 2009 with a case involving the Ballyrock CDO, Lehman has challenged the subordination of termination payments on the basis that they are so-called *ipso facto* clauses that seek to deprive Lehman of property rights solely as a result of its bankruptcy and, as such, are unenforceable under the U.S. Bankruptcy Code. Lehman also instituted actions in the English courts making similar arguments based on anti-deprivation principles under English law.
  - None of the actions pending in the U.S. proceedings has yet resulted in a ruling on this issue, although this could occur in one or more of the actions in the near future.

Contributing Partner / Paula S. Greenman, Paula.Greenman@skadden.com, 212.735.2789

- However, in July 2009, an English court ruled against Lehman and upheld the enforceability of the subordination provisions in an action (known as the *Perpetual* case) based upon documents similar to those underlying numerous synthetic security issuances by Lehman-sponsored SPEs.
- The *Perpetual* ruling was upheld by an English appeals court in November 2009. It is not yet known whether the English Supreme Court will hear an appeal of that decision, nor is it known whether the English courts will permit the application of U.S. insolvency laws.

- **Market Uncertainty**
  - More is at stake in the Lehman proceedings than the relative interests of the Lehman estate and the investors holding the billions of dollars of synthetic securities issued by Lehman-sponsored SPEs. Lehman's challenge to the subordination provisions also may adversely affect many billions of dollars of synthetic securities and other structured products, and even vanilla securitizations that use swaps to hedge interest rate or currency risk.
  - In an August 2009 press release, Fitch Ratings announced that "[r]atings on global structured finance transactions with material derivative exposure to U.S.-based counterparties may be adversely affected by pending litigation related to the Lehman Brothers bankruptcy filing … The outcomes of the court cases in favor of Lehman will have clear rating implications for synthetic CDOs and other similar securitizations[.]"
  - In other words, depending on the outcome of the pending adversary proceedings, holders of synthetic securities and other structured products with exposure to U.S.-based derivatives counterparties — even where the swap counterparty is currently a creditworthy institution — may see the ratings downgraded and their investments devalued. In any event, they may see lower liquidity or market prices as long as the outcome remains uncertain.
  - Not incidentally, this also could create a competitive disadvantage for U.S.-based swap providers.
  - While it is not possible to predict the outcome of the various actions, it seems very likely, given the significant dollar amounts at stake, that initial decisions will be appealed and the ultimate resolution could be years away.
  - Further, it may be that no bright-line test emerges from the litigation in the Lehman proceedings. In a number of the cases to date, the key issue — the validity of the subordination provisions — is complicated by technical drafting issues such as whether a particular condition precedent to swap termination applied or when certain rights and obligations vested under the documents, or by technical legal/factual distinctions, such as the timing of swap termination.
  - Therefore, we believe that market uncertainty and the potential for downgrades (or actual downgrades) may persist for an indefinite period.

- **Other Issues**
  - The disputes that have arisen in the Lehman proceedings also have highlighted other structural features that can aggravate enforcement issues when the sponsoring entity fails.

- For example, it has proven problematic to have affiliates of the sponsor/swap counterparty for performing key roles in the structure such as calculation agent, collateral liquidation agent or custodian. When the sponsor/swap counterparty becomes insolvent, the same fate is likely to befall its affiliates, which can substantially complicate and delay enforcement action if they are the parties required to perform key actions in connection with termination or liquidation.

We anticipate that the answers to some of these issues will begin to materialize in 2010. Structuring practices will evolve to address these and other challenges that have emerged through the Lehman proceedings, and some existing documents and structures may be modified to deal with these issues.

Insights 2010 / Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

Corporate Restructuring

"A virtual 'wall of debt' [is] scheduled to mature in the near and medium term. Hundreds of billions of dollars of bank debt, high-yield debt and commercial real estate debt come due between 2010 and 2014."

The 'Wall of Debt': Identifying and Developing Long-Term Business Solutions for Near- and Medium-Term Debt Maturities

Two years into one of the worst credit crises in history, the capital markets finally are showing signs of improvement. In recent months, credit slowly has become more available at lower costs and on less restrictive terms. And the high-yield debt market arguably has stabilized, with a surge of new issuances beginning in May 2009, after having been effectively frozen the previous five quarters.

However, while there are many hopeful signs, it is too soon to conclude that the economy has recovered or that capital markets will improve. Lenders and investors continue to hoard cash, unemployment remains high, consumers remain uncertain and the federal government likely will not be an ongoing source of rescue financing in the face of soaring national debt. As a consequence, the future of the capital markets remains highly uncertain.

Moreover, one of the key challenges that will soon face Corporate America is a virtual "wall of debt" that is scheduled to mature in the near and medium term. Hundreds of billions of dollars of bank debt, high-yield debt and commercial real estate debt come due between 2010 and 2014. The staggering amount of this debt may be beyond the capacity of the leveraged-loan and high-yield markets to absorb. Even if these markets enjoy a broad recovery in the coming year, companies with deteriorating financial performance will have difficulty accessing them.

Businesses that have debt maturing within this window may face a reduced range of options, given aggregate debt maturities and the continued uncertainty plaguing the capital markets. Accordingly, leveraged businesses, their lenders and other stakeholders will need to proactively anticipate and explore business options to develop strategies for implementing value-additive business solutions long before scheduled debt maturities. Only through long-term liability management can a business maintain optionality and avoid expensive and value-destructive alternatives, such as a traditional bankruptcy filing.

There are several time-tested techniques that leveraged companies and their stakeholders can utilize in developing and implementing long-term, value-enhancing business solutions. For example, in so-called "amend-to-extend" transactions, borrowers effectively refinance their revolving credit and/or term loan facilities through loan modification amendments that allow consenting lenders to extend their maturities on a non-*pro rata* basis with the vote of a majority of the lenders. Leveraged companies also may negotiate covenant-relief amendments as well as refinancings of term loan facilities with secured and unsecured high-yield debt offerings that extend maturities and relax covenants.

A company with debt that is trading below par also may consider pursuing debt tender offers whereby it offers to purchase debt at a discount to face and a premium over its trading price. Companies also have amended their credit facilities to permit loan buybacks, on a non-*pro rata* basis, at attractive discounts. Alternatively, companies with liquidity constraints can exchange existing debt for new debt with longer maturities and other more favorable terms pursuant to debt-exchange offers structured to be exempt from the registration requirements of the securities laws, thus enabling them to be implemented quickly. Companies also can exchange existing debt for new equity securities in transactions that are exempt from the registration requirements of the securities laws.

One possible drawback of an exchange offer is that only debt holders who affirmatively agree to the proposal are bound. To mitigate against holdouts, exchange offers may be coupled with a consent

Contributing Partners / Jay M. Goffman, Jay.Goffman@skadden.com, 212.735.2120 / Mark A. McDermott, Mark.McDermott@skadden.com, 212.735.2290 / Sarah M. Ward, Sarah.Ward@skadden.com, 212.735.2126

solicitation whereby restrictive covenants in existing debt instruments are eliminated.

Another method for eliminating holdouts is to pursue a partial in-court alternative pursuant to either a "prepackaged" or "prenegotiated" Chapter 11 plan of reorganization. In this case, the Chapter 11 restructuring plan is negotiated and agreed upon by the company and a critical group of debt holders before commencement of Chapter 11 proceedings, thereby minimizing the length of the company's stay in Chapter 11. Whereas out-of-court solutions typically require 100 percent approval by affected creditors, Chapter 11 plans can be confirmed and made binding on dissenters much more easily, *i.e.*, if at least one-half of affected creditors, holding at least two-thirds in amount of affected debt, vote to accept.

Several of these techniques were employed by The CIT Group Inc. in resolving billions of dollars in debt obligations.[1] CIT pursued a cash tender offer for $1 billion of debt funded by a $3 billion rescue financing (later upsized to $7.5 billion), followed by an exchange offer with a "fall-back" prepackaged Chapter 11 reorganization plan that resulted in the elimination of approximately $10.5 billion of debt. Although this was the fifth-largest bankruptcy in history and involved $65 billion in debt, CIT was in bankruptcy for only 40 days. It is the largest and only financial institution ever to successfully file and implement a prepackaged Chapter 11 plan.

Charter Communications, Inc. successfully implemented a prenegotiated plan in a case described by the bankruptcy court as "perhaps the largest and most complex prearranged bankruptcy ever attempted, in all likelihood rank[s] among the most ambitious." Under the plan, Charter reinstated approximately $12 billion of senior secured debt, shed approximately $8 billion of debt and raised more than $1.6 billion through a fully backstopped rights offering.[2] The linchpin of the plan was a settlement with the shareholder that created more than $3 billion in tax-related value for the reorganized company.
(See "Recent Trends in Balance Sheet Restructurings Utilizing Reinstatement in Bankruptcy")

[1] Skadden represented CIT.

[2] Skadden represented the largest shareholder of Charter Communications, Inc.

Fiduciary Duties in the Distressed World

In October 2008, we wrote that directors and senior management of public companies should pay close attention to the risk profile of their companies.[1] We expressed concern that many companies — far beyond those in the financial sector — were facing, or might face, the perfect liquidity and capital storm of declining operating cash flow, fixed (or increasing) costs, limited availability of new credit and equity capital, and/or the withdrawal of existing credit. Over the last year, 185 companies with liabilities of $75 million or more filed for Chapter 11 reorganization; 58 companies sought judicial protection in order to attempt to restructure liabilities of $1 billion or more. The Fed and many economists forecast a relatively modest recovery from the recession during 2010, with continuing sustained high levels of unemployment and a measured outlook about the economy in 2011 and beyond.

Looking forward, directors and officers must evaluate these potential risks and continue to consider opportunities presented within their companies, across their sectors and in regional, national and global economies. This assessment will be made through the prism of current economic conditions and near-, intermediate- and long-term prospects. One feature of the current economic landscape is the looming "wall of debt maturities" from the financing boom in the middle part of the last decade. Thus, companies continue to examine their liquidity needs and sources and their capital needs and sources, factoring in the prospect of decreasing operating cash flow and more limited, more costly or perhaps no access to credit or equity capital. (See "The 'Wall of Debt': Identifying and Developing Long-Term Business Solutions For Near- and Medium-Term Debt Maturities")

Assessing the "risk-reward" ratio of potential corporate opportunities while maintaining diligent and effective risk oversight is a basic function of senior management and directors of all U.S. public companies, whether or not they are currently distressed. (See "A Renewed Focus on Board Assessment of Enterprise Risk") State corporate law, Sarbanes-Oxley provisions and stock exchange rules each address this function.

Under Delaware law, directors and officers owe fiduciary duties of care and loyalty, including a duty of oversight to implement a reporting system or other controls allowing management and the board to monitor the company's business and become informed about potential material risks. In general, they are expected to exercise informed, disinterested and good-faith business judgment in seeking to identify and manage material business risks. If they act in this way, the decisions they make should continue to be judged under the deferential business judgment rule presumption. However, if there are "red flags" signaling risk — a judgment often made in hindsight after potential risks are actually realized to the detriment of the company — ignoring or paying little attention to them may later lead to claims of failure of oversight, particularly questioning the directors' good faith.

In this period of gradual recovery overlaid by serious continuing challenges in the global economy, senior management and directors repeatedly will be reminded of their duties in distressed contexts where basic corporate governance principles, such as the business judgment rule, continue to apply. The fundamental nature of the fiduciary duties does not change when the company is insolvent or in the so-called zone of insolvency, and directors still are protected by the business judgment rule. Indeed, directors must continue to discharge their fiduciary duties to the corporation and its shareholders. The former notion that the zone of insolvency was intended to operate as a "sword" for creditors to force directors to favor creditor interests has been dispelled by Delaware courts, which also have made clear that the focus for Delaware directors does not change when a solvent corporation is navigating in the

Contributing Partners / Peter Allan Atkins, Peter.Atkins@skadden.com, 212.735.3700 / John (Jack) Wm Butler Jr., Jack.Butler@skadden.com, 312.407.0730 / J. Eric Ivester, Eric.Ivester@skadden.com, 312.407.0920

zone of insolvency. Instead, directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.

While fiduciary duties do not change, the potential beneficiary of any recovery received as a result of a breach of fiduciary duties shifts when dealing with a company that is insolvent. Under Delaware law, a claim alleging a breach by directors or officers of fiduciary duties owed to the corporation may be brought by the corporation or through a shareholder derivative suit when the corporation is solvent, or through a creditor derivative suit when the corporation is insolvent. Thus, shareholders of a corporation typically have standing to enforce claims on behalf of a solvent corporation through a derivative suit "because they are the ultimate beneficiaries of the corporation's growth and increased value." Upon insolvency, however, creditors become the appropriate parties to bring a derivative suit on behalf of the corporation when those in control of it refuse to assert a viable claim belonging to it, because the creditors are the beneficiaries of any increase in value. Whether prosecuted by shareholders or creditors, a derivative action is brought on behalf of the company (as opposed to an individual, direct claim) so the recovery ultimately goes to the corporation — for it is the corporation that suffered the harm as a result of the breach of fiduciary duties.

As senior management and directors continue to navigate through improving but uncertain economic conditions, they should continue to make informed assessments as to whether a particular company needs to initiate a risk review and, if so, what actions make sense in order to implement an effective review. They should recognize and be prepared to deal with disclosure requirements that may apply to the risk review and related matters discussed above. They need to focus on their responsibility to oversee the business and affairs of their companies, and to take action reasonably designed to identify and respond to these risks. Prompt consideration is the best means of mitigating damage and satisfying their responsibilities.

---

[1] See "Managing In Today's Troubled Environment: A Primer for Directors and Senior Management," at http://www.skadden.com/sitefiles/files/Managing_In_Todays_Troubled_Environment.pdf

Recent Trends in Balance Sheet Restructurings Utilizing Reinstatement in Bankruptcy

As a result of the crisis in the credit markets, the concept of "reinstatement" of pre-petition debt has had a considerable impact in several recent reorganization cases. This is a legal, loan market and economic phenomenon attributable to the change in availability, legal terms and cost of bank financing that currently prevails in the loan market.

The period prior to the Lehman bankruptcy filing on September 15, 2008, is viewed as a recent "high water" mark from the borrower's point of view for economic terms and availability of bank financing. At that time, loan transactions were available at interest rates — in principal amounts and with covenant restrictions (or absence thereof) — that are no longer available. As a result, significant financings now on the balance sheets of leveraged companies are assets to such companies in the sense that under current market conditions, neither the amounts, the economic nor legal terms of such financings can be duplicated.

Accordingly, borrowers who find that they now need to restructure their balance sheets may consider restructuring "around" such loans by "reinstating" them under the Bankruptcy Code, *i.e.*, by leaving such loans in place while restructuring other debt obligations, thereby retaining the economic value of the reinstated loans. Holders of the reinstated debt, on the other hand, may face a borrower whose risk profile has changed, and who therefore wishes to utilize the restructuring opportunity to enhance the economics of its loan arrangements to comport with current market conditions.

In order to reinstate debt under the Bankruptcy Code, a borrower must cure any outstanding defaults under the debt instrument, reinstate the original maturity and otherwise leave unaltered the legal, equitable and contractual rights of the lender. A loan that complies with these requirements is considered "unimpaired" and is deemed to accept a reorganization plan. A default that is quantifiable, and thus able to be cured through monetary payment, likely will not be a bar to reinstatement. The more difficult defaults are nonmonetary or other defaults that are "historical facts," such as alleged misrepresentations or noncompliance with ratios or reporting requirements.

Spectrum Brands[1] and Charter Communications[2] each sought to reinstate pre-petition bank debt in 2009 in accordance with these requirements. However, in each case, the pre-petition lenders asserted that their claims were "impaired" — and hence opposed confirmation of a plan that provided for their debt to be reinstated — either as a result of alleged (1) "incurable" pre-petition events of default or (2) events of default resulting from the reorganization itself.

For instance, Charter's lenders challenged confirmation of the plan that reinstated their debt and asserted Charter had misrepresented it was able "to pay its debts as they become due" in connection with pre-petition borrowings. The lenders claimed that, because the alleged misrepresentation was "historical," it was incurable, and hence, the loan could not be reinstated. The lenders urged a prospective interpretation of the phrase "pay its debts as they become due" to apply to future obligations that Charter had no ability to satisfy at the time it made the representation. However, the bankruptcy court rejected the lenders' forward-looking reading of the clause as "not practical," held there was no incurable default and ruled that Charter was not precluded from reinstating the lenders' debt on this account.

Contributing Partners / Jay M. Goffman, Jay.Goffman@skadden.com, 212.735.2120 / Mark A. McDermott, Mark.McDermott@skadden.com, 212.735.2290 / Peter J. Neckles, Peter.Neckles@skadden.com, 212.735.2466

The loan agreements in Spectrum and Charter also provided for events of default in a "change of control" of the borrower. The provision in Spectrum was typical of change-of-control provisions contained in many loan agreements whereby a default occurs if a person or "group," as such term is used in Section 13(d) of the Securities Exchange Act of 1934, acquires a certain amount of the borrower's stock. In Charter, the change-of-control provision would have been triggered if a "group" held an equal or greater percentage of voting securities than the required amount to be maintained by Charter's majority shareholder. Both Spectrum's and Charter's reorganization plans contemplated conversion of bond debt into substantial percentages of the reorganized entities' equity, thereby implicating the change-of-control defaults. Although Spectrum settled, the *Charter* court ruled that significant bondholders who negotiated the plan terms and entered into a plan support agreement did not constitute a "group" as contemplated by the change-of-control provisions of the loan agreement. As a result, Charter's majority shareholder maintained the requisite percentage of Charter's voting securities upon emergence from Chapter 11.

Other issues raised in these cases, although not addressed in any ruling, concerned default interest and the impact of a revolving credit facility. With respect to default interest, the unresolved question is whether post-petition interest must be paid in order to "cure" the bankruptcy-related defaults. Charter paid its lenders such interest, which the bankruptcy court noted in its ruling allowing reinstatement. And the potential problem with a revolver is that revolvers, as executory contracts to make loans, cannot be assumed and thus, are likely not able to be reinstated. In *Charter*, the borrower avoided litigation over this issue by unilaterally agreeing to waive any future right to draw on its revolver.

The potential for future reinstatement efforts by leveraged borrowers remains economically significant at present. Over time, however, the economic value of the "legacy debt asset" will diminish because reinstatement does not allow the borrower to extend the final maturity of the legacy debt arrangements. "Legacy" term loans closed before September 2008 typically had five- to seven-year maturities, and therefore only three to five years of such economic terms now remain available. That said, the reinstatement strategy can be expected to be utilized during this remaining window by leveraged borrowers seeking to implement balance sheet restructurings.

---

[1] Skadden represented Spectrum.

[2] Skadden represented the largest shareholder of Charter Communications, Inc.

Increased Use of 'Prepackaged' and 'Prearranged' Bankruptcy Strategies

As we predicted last year, the number of "prepackaged" bankruptcies increased substantially during 2009 because many companies were unable to refinance pending debt maturities in what remained a closed-debt market for most companies. For instance, while seven prepackaged bankruptcy cases were filed in the District of Delaware during 2008, the number doubled to more than 14 during 2009. Likewise, "prearranged" bankruptcy cases filed in Delaware tripled from six in 2008 to 20 cases in 2009.

A "prepackaged" Chapter 11 reorganization case permits a company and its stakeholders to negotiate and obtain requisite creditor acceptances of a fully documented Chapter 11 reorganization plan before the company files its bankruptcy case. A "prepack" strategy:

- significantly reduces the in-court time required to complete a Chapter 11 restructuring to a month or two (and sometimes even less than 30 days);
- minimizes costs and expenses associated with Chapter 11;
- reduces or eliminates "uncertainty of outcome" because votes needed to confirm a plan over dissenting stakeholders are obtained before the Chapter 11 case is filed; and
- permits a Chapter 11 restructuring that does not adversely affect trade creditors, customers, employees and ordinary course business operations.

Similarly, a "prearranged" Chapter 11 case strategy permits a company to negotiate and document its reorganization plan before entering bankruptcy. Immediately upon commencing its Chapter 11 case, or soon thereafter, the company files its Chapter 11 plan and seeks expeditious approval of its disclosure statement, as well as acceptances and speedy confirmation of its plan, thereby reducing costs, expenses, risks and uncertainties otherwise associated with negotiating a plan during in-court proceedings.

We predict increased frequency of prepackaged and prearranged Chapter 11 cases in 2010, as companies and their creditors focus on cost-effective restructuring strategies with predictable outcomes. We also expect to see these strategies employed more often by third-party investors who seek to acquire ownership of financially troubled companies or their assets.

Contributing Partner / Mark S. Chehi, Mark.Chehi@skadden.com, 302.651.3160

"*TOUSA* underscores the need for lenders and buyers to exercise appropriate diligence in assessing whether a proposed transaction may potentially result in the insolvency of an affiliated guarantor."

Fraudulent Transfer Issues

With an increase in bankruptcy filings, buyers and lenders face more challenges to prebankruptcy transactions, including fairly common types of financings and leveraged buyouts. This is especially true when the bankruptcy results in a liquidation of the debtors' assets instead of a restructuring of the existing business. In 2009, we saw novel attempts — some successful — by trustees and creditor trusts to unwind prepetition transactions. This trend is likely to continue in 2010.

Financing Unwound as a Fraudulent Transfer

Perhaps the most noteworthy development in 2009 involved a recent decision by a Florida bankruptcy court in the TOUSA liquidation[1] that unwound upstream subsidiary guarantees and liens made in connection with a $500 million financing notwithstanding the delivery of a solvency opinion. In that case, a group of lenders provided financing to TOUSA, the proceeds of which were used to settle litigation instituted against an affiliated joint venture. To obtain the financing, the lenders required subsidiary guarantees and liens that, according to the court, left the subsidiaries with unreasonably small capital. The *TOUSA* court criticized the solvency opinion because it relied on dated projections prepared by management and incorporated a valuation methodology based upon EBITDA that was inappropriate for the home building industry in which TOUSA competed. Coupled with the multitude of other objective indicators of insolvency, the court found that the solvency opinion did not support a good-faith defense under Section 548(c) of the Bankruptcy Code.

The court also voided a "savings" clause that purported to limit the subsidiary guarantor's liability to the extent necessary to prevent the subsidiary's insolvency in the event the guarantee was attacked as a fraudulent transfer. The court's far-reaching opinion held that savings clauses are generally unenforceable because they represent an attempt to revise, by contract, provisions of the Bankruptcy Code that allow a trustee or debtor in possession to recover fraudulent transfers for the benefit of the estate.

In the face of the *TOUSA* decision, a buyer or lender cannot rely on the delivery of a solvency opinion based upon erroneous assumptions, or the mere inclusion of a savings clause in the transaction documents, to shelter a transaction from a possible fraudulent transfer challenge. *TOUSA* underscores the need for lenders and buyers to exercise appropriate diligence in assessing whether a proposed transaction may potentially result in the insolvency of an affiliated guarantor and to ensure that the financial material used by any financial expert is accurate, current and standard in the applicable industry.

Leveraged Buyout Found to be Fraudulent Transfer

The Seventh Circuit joined a growing number of appellate courts in holding that transfers made in connection with a leveraged buyout (LBO) can be avoided under the Uniform Fraudulent Transfer Act. In the *Crown Unlimited Machine, Inc.* bankruptcy in November 2009, the Seventh Circuit held that payments to shareholders by the buyer will be deemed to be fraudulent when an LBO creates a debt burden so heavy that the corporation has no reasonable prospect of surviving once the transaction is completed. Moreover, the overall transaction can be "collapsed" (*i.e.*, all primary and secondary transfers will be deemed part of the LBO) to allow the bankruptcy estate to avoid and recover both the initial transfer to shareholders and any second-stage transfers to subsequent transferees. On the facts, the Court determined that the trustee could avoid all transfers made in connection with the LBO, including a secured promissory note and a cash payment to the debtor's parent. In addition, the trustee was allowed to avoid a dividend made by the debtor's parent to its shareholders from the parent's own

Contributing Partners / Eric M. Davis, Eric.Davis@skadden.com, 302.651.3190 / John K. Lyons, John.Lyons@skadden.com, 312.407.0860 / Kayalyn A. Marafioti, Kayalyn.Marafioti@skadden.com, 212.735.2350

segregated cash because the dividend was not an ordinary dividend but rather one made possible by the LBO of the subsidiary.

Safe Harbor Provisions of Bankruptcy Code Section 546(e) Can Apply to the Redemption and Retirement of Debt Instruments

In the *Enron* bankruptcy, on appeal, a district court in the Southern District of New York held that the "safe harbor" of Bankruptcy Code Section 546(e) applies to bar the avoidance of transactions in which commercial paper is redeemed by the issuer prior to maturity without regard to extrinsic facts about the nature of the redemption, the motive behind the redemption or the circumstances under which the payments were made. Although this decision arose from a preference action, the holding is relevant because Section 546(e) applies to all avoidance actions brought under the Bankruptcy Code, including fraudulent transfer actions. In *Enron*, the debtor sought to avoid $1.1 billion paid to retire certain of its unsecured and uncertificated commercial paper. The defendants were paid by J.P. Morgan (acting as the debtor's agent) through Depository Trust Company accounts. The debtor retired its paper before maturity even though the paper was not redeemable or subject to voluntary prepayment at that time. The Bankruptcy Court held that such premature redemptions of commercial paper were not "settlement payments" within the ambit of Section 546(e)'s safe harbor. On appeal, the District Court reversed. In reversing, the District Court held that Section 546(e) is to be applied broadly, is not limited to settlement payments "commonly used in the securities trade," and is designed to capture transactions beyond the ordinary course of business — including the premature redemption of securities. Additionally, the District Court held that the redemption of debt securities (including commercial paper), and not just purchases and/or sales of securities, qualifies as a "settlement payment" transaction for purposes of Section 546(e).

[1] See http://www.skadden.com/content/Publications/Publications1904_0.pdf

Opportunities and Developments in Credit Bidding

While the recent economic downturn has limited the capital available to finance traditional reorganizations, credit bidding — exchanging secured debt for collateral — as part of a sale under Section 363 of the Bankruptcy Code or a plan of reorganization has become more prevalent in today's environment. But case law emerging from the Fifth U.S. Circuit Court of Appeals could diminish secured creditors' influence over Chapter 11 proceedings by taking away their right to credit bid when collateral is sold under a plan of reorganization.

- Secured lenders may seek to credit bid to protect the value of their collateral. Credit bidding also presents an opportunity for investors to purchase controlling positions in secured debt at a discount.
- Before 2009, the lending community and practitioners debated the threshold of debt necessary to implement a credit-bidding strategy. Among the concerns were traditional unanimous-consent provisions (*e.g.*, release of liens). Recent rulings, however, such as in the *Chrysler*, *Delphi*, *Foamex*, *GWLS*, *Metaldyne* and *Propex* bankruptcies, have recognized the rights of "required lenders" (*i.e.*, the requisite threshold of secured lenders in a credit facility, as provided in the applicable credit documents) to direct the agent bank to exercise remedies on behalf of all lenders under the facility — even over the objection of lenders in the minority. (Depending on the terms of the credit facility, in some instances, the agent bank, in its discretion and without direction from the required lenders, may exercise remedies.) In many circumstances, secured lenders holding a majority stake in a secured credit facility — possibly acquired at a discount — may, therefore, be able to purchase a company through the exercise of remedies by directing a credit bid up to the full amount of the outstanding debt.
- Developing case law, however, has challenged what frequently was considered the automatic right of secured creditors to credit bid or otherwise protect their rights as secured creditors. In September 2009, the Fifth Circuit, in the *Pacific Lumber* bankruptcy, affirmed a plan of reorganization that provided for a sale of collateral at a purchase price considerably less than the outstanding amount of secured debt, but at the same time prohibited the debtors' largest secured creditor from credit bidding. Instead, the plan cashed out secured creditors at the debtors' appraised value of the collateral, which was significantly below the face amount of the debt. Although the class of secured creditors voted against the plan of reorganization, the bankruptcy court approved a cramdown plan of reorganization upon finding that the secured creditors received the "indubitable equivalent" of their secured claim — one of three alternatives under the Bankruptcy Code that can be used to approve a plan of reorganization over the objection of an impaired class of secured creditors who voted against the plan.
  - Soon after the Fifth Circuit's decision, the Third Circuit was faced with a similar situation in the *Philadelphia Newspapers* bankruptcy. Philadelphia Newspapers sought approval of sale procedures, in connection with a plan of reorganization, to sell substantially all of the secured creditors' collateral. Although the stalking-horse bid of $30 million in cash and approximately $14 million in assumed liabilities fell far short of the $295 million face amount of the secured debt, the sale procedures barred the secured creditors from submitting a credit bid. As in the *Pacific Lumber* bankruptcy, the Chapter 11 debtors asserted that the approximately $36 million cash distribution to secured creditors under the proposed plan represented the fair value of the collateral. The bankruptcy court rejected the proposed sale procedures barring the secured creditors' credit bid

Contributing Partner / Ron E. Meisler, Ron.Meisler@skadden.com, 312.407.0549

but the District Court for the Eastern District of Pennsylvania reversed. The Third Circuit Court stayed the sale proceedings pending appeal and heard oral arguments from the parties in December. As of the submission deadline for this compendium, the Third Circuit has not reached a decision, and it remains uncertain whether other jurisdictions will side with the Fifth Circuit.

- The competing view to that of the Fifth Circuit and the Eastern District of Pennsylvania is that the theory adopted by those courts represents an end run around protections granted in the Bankruptcy Code to secured creditors because secured lenders (with recourse rights) are deprived of both (1) the ability to credit bid in the event their collateral is divested under a plan of reorganization; and (2) to the extent a secured claim is undersecured, the option to have the entire amount of their claim (as of the date of the bankruptcy filing) treated as a secured claim (as opposed to having only the portion of the claim equal to the value of the collateral treated as a secured claim, with the remainder treated as an unsecured deficiency claim).

- Secured creditors' influence over formation of a plan of reorganization — particularly secured creditors that presumed they held the fulcrum security in a Chapter 11 case — likely will be curtailed in jurisdictions adopting the Fifth Circuit's approach. Historically, secured creditors held considerable influence over any plan that did not provide for either payment in full of secured creditors' claim or a sale of collateral subject to the secured creditors' right to credit bid. But under the Fifth Circuit's approach, debtors may be able to rely on the appraised value of their assets to implement a cramdown plan, if required. Expect debtors with substantial secured debt to consider filing bankruptcy petitions in the Fifth Circuit.

Intercreditor Issues: Subtle Variations, Palpable Risk Differences

During the capital markets boom of the middle years of the last decade, second-lien and multi-lien tranched financings experienced exponential growth and became prevalent alternatives to other types of financing. With the weakened economy and continued lack of access to refinancing options, many of those transactions will be scrutinized as a result of bankruptcy filings. Recoveries of second-lien debt will be affected based on how courts interpret the many subtle variations of intercreditor agreements and other material terms of second-lien financing. In light of the uncertainty surrounding the treatment of second-lien financings and the various resulting disputes, it is important to have a comprehensive understanding of the complex intercreditor issues that may arise under these transactions.

- **Development of intercreditor agreements.** Different phases of the boom in second-lien financing produced materially different intercreditor agreements. For instance, early second-lien financings produced first-lien-friendly intercreditor agreements. As second-lien financing grew, intercreditor agreements became more second-lien-friendly. In addition, during negotiation of these transactions, more subtle variations were introduced into intercreditor agreements. Therefore, it is extremely important to have a clear understanding of the terms of an intercreditor agreement that may be relevant.

- **Involuntary bankruptcy proceedings against mutual borrowers.** A second-lien lender's right to commence an involuntary bankruptcy proceeding against the borrower is among the many unsecured creditors' remedies that second-lien lenders try to retain. First-lien lenders have generally opposed permitting second-lien lenders to commence such involuntary bankruptcy proceedings because their filings are viewed as a potential disruption to the first-lien lenders' ability to realize on the common collateral. A potential and common solution that has arisen in intercreditor negotiations is to allow the second-lien lender to file an involuntary bankruptcy proceeding after a "standstill period" has expired.

- **Debt-for-equity conversions.** Another issue frequently found in distressed situations and that should be considered when negotiating or understanding intercreditor agreements is the determination of which layer of debt, among multiple layers, is entitled to receive new equity in a debt-for-equity conversion in a restructuring. Distressed investors try to acquire this so-called "fulcrum" security in an effort to take control of a distressed company. This issue is an important consideration in the context of second-lien financings because intercreditor agreements may impair a junior-lien creditor's ability to implement a debt-for-equity conversion. Intercreditor agreements typically require that all proceeds received by junior creditors be paid over to senior creditors. While an intercreditor agreement may occasionally contain certain exceptions to this general rule, careful attention should be paid to such provisions.

In sum, the increased popularity of second-lien financings and the revival of the high-yield market in 2009 will give rise to disputes over the meaning and enforceability of provisions of intercreditor agreements. Parties to intercreditor agreements and investors looking to take advantage of opportunities in distressed assets must, therefore, ensure that they have a complete understanding of these complex and important issues.

Contributing Partners / Robert M. Chilstrom, Robert.Chilstrom@skadden.com, 212.735.2588 / Chris L. Dickerson, Chris.Dickerson@skadden.com, 312.407.0786 / Felicia Gerber Perlman, Felicia.Perlman@skadden.com, 312.407.0758

"The enactment of Chapter 15 into the Bankruptcy Code … has helped solidify the approach to cross-border cases in the United States, but it is important to understand what Chapter 15 does not do as well."

Cross-Border Issues: Distressed Companies in a Global Environment

To organize a truly global restructuring, careful planning and coordination are necessary. The Lehman insolvencies are a good example of how devastating a lack of planning can be. For instance, although the debtor had relied historically upon an integrated information technology platform, the multiple insolvency proceedings around the world effectively cut off the debtor's fiduciaries from access to critical information for a few months after the filings. In court filings, the company has blamed this lack of access on the initial lack of coordination among the various insolvency proceedings. A more recent example is the insolvency of Stanford International Bank Limited, which has given rise to a complex series of issues as the U.S. receiver and Antiguan liquidator of the bank have claimed recognition and jurisdiction over the bank's assets overseas.

The world debt markets are dominated by two systems of law: English law and New York law. In addition, English insolvency law provides the foundation for the laws of many of the most important offshore jurisdictions (Cayman, BVI, Bermuda, the Channel Islands, Hong Kong and Singapore, to name a few). A company of any size, anywhere in the world, that requires restructuring, is likely to need assistance from English-qualified restructuring lawyers.

With the globalization of the economy, almost every restructuring involves some measure of cross-border issues. The enactment of Chapter 15 into the Bankruptcy Code at the end of 2005 has helped solidify the approach to cross-border cases in the United States, but it is important to understand what Chapter 15 does not do as well.

- Chapter 15 is a codification of both new and existing rules for the filing and management of cross-border bankruptcy cases in the United States. Among other things, it provides for the recognition of foreign proceedings that may be "main" or "non-main." For example, rulings and actions taken in a foreign main proceeding are entitled to more deference than a non-main proceeding. Status as a main proceeding is determined by reference to a company's center of main interest. In 2007, Bear Stearns attempted to establish the Cayman Islands as the center of main interest for two of its offshore funds that were managed in New York. The bankruptcy court in New York refused, because it believed that the funds, although offshore, were run by Bear Stearns from New York. This ruling continues to have an impact today. Further, recent cases in the U.S. underscore the point that the U.S. bankruptcy courts will decide the issue of where the "center of main interest" lies on a case-by-case basis, and each decision likely will be based on several factors, rather than just a few. They also confirm the courts' willingness to look to foreign law for guidance.

- While Chapter 15 is useful in its recognition of foreign main proceedings in the United States, it does not (and cannot) force a foreign court to recognize a Chapter 11 case as a foreign main proceeding. Special attention should be paid to the global impact of a Chapter 11 case on a company's operations. In this regard, it is important to note that certain jurisdictions have enacted equivalent procedures to Chapter 15 and/or have other statutory or common law provisions which allow for the recognition and enforcement of overseas insolvency and restructuring procedures, including Chapter 11. However, while many countries have revitalized their restructuring regimes in recent years, they still are very different from Chapter 11 in many cases, and many countries still lag behind this progress.

Contributing Partners / N. Lynn Hiestand, Lynn.Hiestand@skadden.com, 44.20.7519.7120 / Chris Mallon, Chris.Mallon@skadden.com, 44.20.7519.7236

"As industries continue to struggle with the consequences of the recession, … it will be important to stay abreast of potential changes in the bankruptcy laws, along with courts' interpretations of the newest sections of the Bankruptcy Code."

Potential Changes to the Bankruptcy Code

Since the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) was enacted, certain aspects of that law have been targeted for clarification, most significantly the treatment of reclamation claimants in Chapter 11. Additionally, the failure of BAPCPA to address continuing concerns about venue selection for Chapter 11 cases has drawn increasing scrutiny. As industries continue to struggle with the consequences of the recession, and companies face increasingly distressed relationships with lenders, customers and suppliers, it will be important to stay abreast of potential changes in the bankruptcy laws along with courts' interpretations of the newest sections of the Bankruptcy Code (Code). Potential modifications under consideration are described below.

- **Exclusivity — Section 1121(d)(2)(A).** This section of the Code modified by BAPCPA was designed to shorten the duration and costs of complex Chapter 11 cases by imposing an absolute 18-month expiration on the time period within which only the debtor can propose a plan of reorganization. As the number of complex cases that are subject to this new limitation grow, however, this change in the law has come under more and more intense criticism. In 2010, we expect proposals to allow bankruptcy judges to grant exceptions to the absolute expiration of the debtor's exclusive period, particularly for large, complex Chapter 11 cases.

- **Deadline to assume/reject leases — Section 365(d)(4).** BAPCPA has restrained the ability of retailers to reorganize through the modifications to this section of the Code. Under BAPCPA, a debtor has a maximum of 270 days within which to assume or reject leases of nonresidential real property. The practical impact of this change has been severe — stakeholders of retailers have insisted that retailers devise their reorganization plans well in advance of the expiration of this deadline before they will commit to support a reorganization. Retailers that have failed to meet these short deadlines have been forced to liquidate, which has resulted in the loss of tens of thousands of retail jobs. Allowing debtors more time to make these crucial decisions will enhance the ability of debtors such as retailers to reorganize, rather than liquidate.

- **Employee retention plans — Section 503(c).** BAPCPA changed prior law with respect to post-petition employee retention programs by requiring, among other things, that a debtor demonstrate that an employee had a bona fide offer from another business before a debtor could make a retention payment to such employee. Thus, under these circumstances, a debtor was forced to encourage employees to find other employment before it could successfully implement a broadly based retention program. In 2010, we anticipate that general criticisms of BAPCPA will result in adjustments of these perverse incentives as well.

- **Goods provided just before a Chapter 11 filing — Section 503(b)(9).** This section of the Code added by BAPCPA was meant to offer more comfort to creditors while they continued to provide goods to a company in financial trouble via an administrative claim for goods shipped within 20 days of a bankruptcy filing. Recent bankruptcy cases across various industries have magnified the ambiguities present in the section, however, and the section may require revision. The following issues, among others, have been raised with regard to Section 503(b)(9):

  – **Definitions.** Several terms used by Section 503(b)(9) are not defined by the Code, including "Goods," "Receipt" and "Value," leading to differing applications of the section.

Contributing Partners / Chris L. Dickerson, Chris.Dickerson@skadden.com, 312.407.0786 / Van C. Durrer II, Van.Durrer@skadden.com, 213.687.5200 / J. Gregory St. Clair, Greg.StClair@skadden.com, 212.735.2424

- **Date of payment.** Section 503(b)(9) is silent as to when an administrative expense claim must be paid, leading to conflict between claimants and debtors regarding payment timing.
- **Interplay with Section 502(d).** Whether a debtor may use Section 502(d) of the Code as a basis for disallowing administrative expenses according to pending preference actions against claimants is currently a hot topic in many courts. Although the Second Circuit recently ruled that such a defense is unavailable to a debtor, other courts are examining the issue and may reach a different conclusion.

- **Venue.** One of the most significant considerations in a prospective debtor's strategic planning, in light of the wide disparity of experience with large/complex bankruptcy filings and the inconsistency of legal precedent throughout the circuits, is the most favorable venue for the bankruptcy filing. Under current law, venue is proper where (1) the company is incorporated, (2) it has its principal place of business, or (3) an affiliated company has filed for bankruptcy.
  - While this issue also was the focus of debate in 2005, it has seen a resurgence with the filings by GM and Chrysler in New York and other cases in Delaware, where the debtor was incorporated, rather than where the debtor's principal place of business was located. Those raising the issue, and seeking to remove the first and third options, believe the current rules impose unfair costs and burdens on suppliers, creditors and employees who would have better access to the case if it was filed where the company maintains its principal place of business.
  - Those who do not believe the current venue rules are problematic see the process as one in which the most experienced bankruptcy judges are allowed to handle the most complex cases, and lawyers can predict the outcome of certain decisions where the law is more developed.

These particular issues have been thrust into the limelight based on the distress faced by the retail and automobile industries during the recession. As other industries, such as energy, confront challenges in 2010, it will be important to stay abreast of potential further Code changes and how these changes might affect a company's attempts at reorganization.

Sectors to Watch

While many believe the worst of the recession is over, dwindling revenues, tight credit markets and declining consumer spending continue to threaten many industries. The sectors that were hit hardest in 2009 have yet to make it out of the woods, and other sectors are likely to confront similar distress in 2010. Many of these industries, including those listed below, also will confront difficult times as suppliers, vendors, financiers and others deal with their own bankruptcy concerns.

- **Retail.** The retail industry, which suffered significant losses in 2009, appears to be similarly situated for 2010. With soaring unemployment rates and continued mortgage foreclosures, discretionary purchases have decreased, and consumers are attempting to save more and spend less.
  - Many struggling chains have been severely debilitated by this recession, and another six months or more of this environment may be more than their financial resources can bear. The timing of an economic turnaround is definitely an issue here, and some will inevitably succumb if the retail landscape does not show considerable improvement in 2010.
  - Similar to 2009, retailers may be unable to reorganize as a result of the credit environment, which may make liquidations more likely.
- **Energy.** While most industries have felt the burden of the credit crunch, the biofuel energy sector has been exposed to the perfect storm of events, which likely will lead to more bankruptcies in 2010: an increase in production costs, despite the desire for cleaner energy, and a lag in demand resulting from falling oil prices.
  - The corn-based ethanol industry is poised to see another spate of bankruptcies in 2010 to follow an already tumultuous year. With stabilizing gas prices, the demand for biofuels has decreased, while capital markets largely remain frozen, and the cost of corn has increased. Biodiesel companies also may find themselves struggling to stay solvent, as an increase in soybean prices affects production and profitability.
  - In these cases, courts likely will face more questions with regard to what constitutes a forward contract and who is entitled to the safe-harbor protections of the Bankruptcy Code with regard to commodities.
- **Real Estate.** As we witness the partial emergence of General Growth Properties from bankruptcy, expect to see others mimic that restructuring. (See "Lessons for the CMBS Market and the Securitization World in the General Growth Properties Bankruptcy") Also, we are seeing many out-of-court restructurings in the real estate arena. Nonetheless, condominium projects, multifamily projects, mixed-used complexes and commercial real estate generally will continue to underperform, particularly in situations where their primary financing was placed with regional banks, which also are failing as the FDIC focuses more intently on that system. In 2010, we expect developers to be opportunistic in terms of converting from one proposed use to another, particularly in the hospitality area.
- **Transportation.** The transportation industry faced one of the highest rates of bankruptcy in 2009. That trend seems likely to continue as the tight credit markets take a continuing toll.

Contributing Partners / Chris L. Dickerson, Chris.Dickerson@skadden.com, 312.407.0786 / Van C. Durrer II, Van.Durrer@skadden.com, 213.687.5200 / J. Gregory St. Clair, Greg.StClair@skadden.com, 212.735.2424

- The trucking industry seems particularly vulnerable at the moment. Freight rates, fuel surcharges and actual fuel costs appear to be the main sources of problems; and asset-based companies are suffering the greatest losses.
- Although there are modest signs of recovery, the airline industry is plagued by oversupply. The volatility in the cost of fuel also has made raising revenue difficult. Airlines will need to find new ways to generate fees, other than seat cost, if they want to see increased revenues at a time when many people and businesses continue to cut back on travel. Bankruptcy or industry consolidation appear to be imminent.

- **Publishing.** The newspaper industry has seen continued, significant declines since the Tribune Company filed for bankruptcy at the end of 2008. A continuing lag in advertising revenue and declining circulation, along with the tight credit markets plaguing most industries, could lead to more bankruptcies in 2010.

Emerging Markets

“Brazil is viewed as having a unique combination of emerging market growth potential and political, societal and legal stability approaching that of developed countries.”

Brazil | Accelerating Activity in 2010[1]

Last year marked the first time that Brazil went through a global economic downturn with less disruption than more developed countries. Due in part to a decade of disciplined Brazilian Central Bank regulation and a stable banking sector, Brazil never experienced the economic "crisis" seen in many other parts of the world. Although economic activity slowed modestly at the end of 2008 and in the first several months of 2009, Brazil was one of the last countries to experience the downturn and one of the first to resume growth.

Today, Brazil is considered one of the most attractive countries for near- and long-term economic prospects. It is viewed as having a unique combination of emerging market growth potential and political, societal and legal stability approaching that of developed countries. *The Economist* recently predicted that in the next 10-15 years, Brazil will become the fifth-largest economy in the world, surpassing Britain and France.

As a result, investors from all corners of the world have shown tremendous interest in Brazil. Multinationals from the U.S., Europe and Asia all are looking at acquisitions and joint ventures in sectors perceived to have the greatest promise, including energy, resources, infrastructure, health care, technology, consumer products, agribusiness and real estate. We see a broad range of interest by global clients that are considering investing in Brazil, including from companies that previously thought Brazil posed too much "country risk."

Although there were fewer large private equity deals in 2009, almost every major international private equity firm is looking to participate in Brazil, lured by the opportunity to achieve attractive returns more through growth prospects and less through leverage. In 2010, several large Brazilian private equity firms also are expected to increase their deal activity. Additionally, sovereign funds from the Middle East and Asia are stepping up their level of investment.

Global institutional investors have shown increased enthusiasm for Brazil stocks. The local stock market rose approximately 83 percent in 2009 and featured two of the largest IPOs in the world, those of Banco Santander Brasil (US$8 billion) and VisaNet (US$4.3 billion). In addition to a robust market for Brazilian issuers of equity and debt, more IPOs of Brazilian subsidiaries of multinationals are possible. Investors are attracted by the growing economy, increased liquidity in the market, and stronger, more sophisticated securities regulation and corporate governance providing greater predictability and stability.

In recent years, an expanding number of Brazilian companies have become leading "world class" competitors. They are expected to increase their international activity and investment throughout Latin America and globally. Companies such as Petrobras (the state-controlled oil company), Vale (mining), Embraer (aircraft), BTG Pactual (investment banking), BM&FBovespa (stock/futures exchange), Gerdau (steel) and JBS (meat) are all global leaders in their industries.

Several legal developments are expected to impact transactions in Brazil in 2010. In the financing area, the CVM, the Brazilian securities regulator, will for the first time permit "shelf" offerings by Brazilian issuers. In M&A, as more and more Brazilian companies have become publicly traded over the last several years, international acquirers of such targets will have to deal with developing Brazilian regulations governing tender offers, minority shareholder rights and fairness opinions/valuations.

[1]Skadden opened an office in São Paulo in 2008. Like all international law firms in Brazil, Skadden is not permitted to practice Brazilian law.

Contributing Partners / Richard S. Aldrich Jr., Richard.Aldrich@skadden.com, 55.11.3708.1830 / Paul T. Schnell, Paul.Schnell@skadden.com, 212.735.2322

"As recent cases indicate, in today's enforcement environment, a robust anti-bribery compliance program is a must for multinational companies doing business in China."

China | Anti-Bribery Compliance for Multinational Companies Doing Business in the PRC

Global anti-corruption enforcement rose to unprecedented levels in 2009. In the U.S., a number of enforcement actions under the Foreign Corrupt Practices Act (FCPA) with record fines and penalties were announced. In addition, regulators in Asia and Europe have strengthened their laws, investigation efforts and prosecution strategies. The Chinese government, in particular, has stepped up enforcement of its anti-bribery law and has begun to target multinational companies.

Against this backdrop of increased anti-bribery enforcement, U.S.-based multinational companies are aggressively pursuing new opportunities in China. However, while China's booming economy provides significant commercial opportunities, it also can foster an environment of corruption. It is critical for multinational companies to develop, implement and monitor internal controls that recognize the unique problems in China before those problems create a need to consider self-reporting and/or remedial measures, or lead to enforcement actions.

Corruption Risks of Doing Business in China

Several factors require multinational companies doing business in China to pay special attention to the FCPA and China's anti-bribery law. First, the Chinese economy is heavily influenced by state-owned enterprises. Under the FCPA, U.S. regulators take the position that all employees of a state-owned or state-controlled entity are government officials, so improper payments to such individuals are considered in violation of the FCPA. China's anti-bribery law similarly prohibits payments to government officials ("public corruption") and to employees of private enterprises ("private corruption").

Second, third-party agents or consultants may be important in providing expertise and business connections. However, a number of investigations and settlements have shown that such third-party agents or consultants pose significant corruption risks if their primary purpose is to influence government officials from whom business is being sought, or if they are used as a conduit for improper benefits to government officials. U.S. regulators have adopted a theory of "willful blindness" to prove improper intent in such cases, arguing that a failure to investigate red flags, such as flat-fee commissions or offshore payments, is evidence of conscious disregard for the likelihood that a payment will be passed along to a government official.

Third, travel, meals and entertainment are an expected part of Chinese business culture — but these benefits can be viewed as an improper influence on official decision makers. For example, gifts and entertainment may be culturally expected but have been viewed as improper bribes. Similarly, it may be common for a state buyer to insist on an inspection trip to a Western business or factory when confirming a contract, but entertainment or side trips during such travel have been the bases for corruption investigations and prosecutions.

Best Practices for Anti-Bribery Compliance

As recent cases indicate, in today's enforcement environment, a robust anti-bribery compliance program is a must for multinational companies doing business in China. Companies should adopt the following practices to enhance compliance with the FCPA and China's anti-bribery law:

Contributing Partners / Jon L. Christianson, Jon.Christianson@skadden.com, 86.10.6535.5588 / Gary DiBianco, Gary.DiBianco@skadden.com, 44.20.7519.7258

- **Comprehensive written policy:** The company should publish a comprehensive, written anti-bribery policy and make it a priority to educate local employees on such policy. The company should translate its policy into Chinese and conduct regular training sessions.
- **Reporting mechanism:** The company should facilitate the reporting of suspected violations of its policy by establishing an internal division to handle complaints and investigations, and to ensure that employees who make such reports may do so on an anonymous basis.
- **Third-party agents:** The company should implement a thorough due diligence process before engaging a third-party agent. The process should focus on the source of the agent's referral, qualifications for the engagement, disclosure of ownership or familial relationships to government officials and disclosure of any prior corruption charges or investigations. In addition, it is essential to have written agency agreements that include anti-bribery representations and warranties and monitor the agent through periodic training, audit and annual compliance certification.
- **Gifts and entertainment:** The company should establish internal control procedures that require preauthorization from the corporate legal or compliance department before such expenditures can be offered or made.
- **Monitoring and audit functions:** Regular monitoring and internal auditing are necessary to evaluate the effectiveness of the company's compliance program and confirm accurate books and records.
- **Due diligence procedures for acquisitions or investments:** A company could be "buying the problem" and held liable for the preacquisition bribery activities of a target. Thorough preacquisition due diligence and implementation of robust compliance and internal controls can protect the company from such liability.

China | Outbound Investments: Beyond Hunting for Resources

With the world's largest foreign exchange reserve of US$2.2 trillion in September 2009, China has become the largest creditor of the U.S. government, holding more than $1 trillion in U.S. Treasury debt. Chinese outbound investments also have increased drastically in recent years, with a record US$52 billion in 2008, up more than 100 percent from 2007. Chinese overseas investments in 2009 are estimated to have recorded a modest growth over 2008 levels, despite the global financial crisis. With the Chinese government's openly stated political support and financial backing from Chinese state-owned banks, more Chinese companies, both state-owned and private, are likely to look for expansion opportunities around the world.

A significant portion of the announced high-profile Chinese outbound investments in 2009, as in previous years, involved natural resources. Deals making news included Sinopec's US$8.8 billion acquisition of Addax Petroleum of Switzerland; Minmetals' US$1.4 billion acquisition of OZ Minerals of Australia; and CIC's US$939 million acquisition of 11 percent of KazMunaiGas of Kazakhstan, as well as Chinalco's US$19.5 billion failed bid for 10 percent of Rio Tinto. Will China's hunt for overseas natural resources continue? The answer is yes, and the reason is simple: China has limited domestic deposits of most natural resources, including oil and gas, iron ore, copper and other minerals; and it needs to secure long-term supplies of all these resources to meet industrial demand and national security.

Resource hunting is not the only game China has played and will continue to play. After all, resource investments are estimated to account for less than 20 percent of China's total foreign investment stock. Until the current financial crisis, China's robust economic growth had been driven, to a large extent, by an export-focused manufacturing sector. Chinese manufacturers face tough domestic and foreign competition, and their profitability often is squeezed on both ends of the value chain: by upstream foreign suppliers in R&D, product design, branding and raw materials sourcing; and by downstream foreign players in marketing and distribution. To capture the more lucrative portion of the value chain, Chinese manufacturers would have to look beyond their country's borders. Lenovo's acquisition of IBM's PC unit a few years ago is a classic example of this rationale.

The most notable driving forces behind Chinese manufacturers' overseas investments are technology and foreign market access. A few announced deals by Chinese automakers in 2009, including Tengzhong Heavy Industries' acquisition of Hummer, Beijing Auto's acquisition of Saab's intellectual property assets, and Geely's proposed acquisition of Volvo, all seem to support these underlying motives. As with other multinational corporations expanding into new markets, Chinese companies have recognized this shortcut to establishing themselves as a world-class player with the latest technologies and an efficient distribution network. One can expect that any visionary Chinese company will look hard for potential foreign targets that have better technologies, stronger brands, an established distribution network and professional management to strengthen its market position and competitiveness.

The Chinese government also has recognized the importance of outbound investments and that its onerous approval process often serves as a major impediment to the successful consummation of a proposed transaction. For example, Tengzhong's acquisition of Hummer is still awaiting Chinese government approvals, even though the deal was announced in July 2009 and executed in October 2009. Under the current Chinese regulatory regime, any Chinese company seeking overseas investment must go through a multiple-step approval process from government agencies, including the National Development and Reform Commission, Ministry of Commerce and State Administration of Foreign

Contributing Partner / Peter X. Huang, Peter.Huang@skadden.com, 86.10.6535.5599

Exchange, which may take months, even for compelling deals for Chinese buyers. In 2009, the Chinese government announced a few new regulations that indicated its willingness to relax some of its outbound investment control measures. The government clearly has an interest in the nation having a stronger role in the global economy and is likely to further liberalize its regulatory framework to support Chinese companies in their outbound investment activities. With this notion, Chinese outbound investments are poised to grow at a faster rate than the world average in the years to come.

India | Will New Government Continue to Improve Investment Environment?

The National Congress party won a landslide victory and near majority in the Indian Parliament in the May 2009 elections. Congress' victory, along with weak voter support for the Communist party, was favorable news for Indian capital markets and direct foreign investment generally.

The new government's stated goals included plans for infrastructure development, liberalization of direct foreign investment and a measured approach to privatizations. The ruling Congress party also stated an intention to implement reforms that encourage a favorable and stable climate for investment. The capital markets, partly in response to the elections, performed well in 2009 with the BSE Sensex ending the year up more than 80 percent, as compared to being down more than 50 percent in 2008. Key drivers for the capital markets were substantial inflows from foreign institutional investors.

The investment avenue of choice in 2009 was the Qualified Institutional Placement (QIP), by which a listed company sells shares in a follow-on offering to foreign and domestic qualified institutional buyers on a discretionary basis, subject to a two-week trailing average floor price. The primary advantage of a QIP is the ability of an issuer to tap markets quickly, usually in four to six weeks. The ability of issuers to take advantage of market windows by moving quickly was particularly important given the volatile markets in 2009.

While QIPs, particularly in the real estate and power sectors, led the capital-raising boom in 2009, issuers also undertook rights issues, IPOs, convertible bonds, and American and global depository receipts in increasing numbers. Capital markets activity appears set to continue in 2010: More issuers than the number doing offerings in all of 2009 already have filed applications with the Securities and Exchange Board of India to undertake QIPs or IPOs in 2010.

Inbound M&A and private equity activity into India, on the other hand, declined again in 2009 — for the second consecutive year. While activity did not increase substantially in late 2009, optimism remains for 2010. Outbound M&A by contrast, while perhaps not seeing increases in dollar terms, continues to create headline news, with Indian companies pursuing acquisitions of assets overseas.

While the outlook for investment activity in India is favorable for 2010, substantial capital inflows in 2009 continuing into 2010 are giving rise to fears of inflation and an overheating market, which will pose challenges going forward.

Contributing Partners / Rajeev P. Duggal, Rajeev.Duggal@skadden.com, 65.6434.2980 / Jonathan B. Stone, Jonathan.Stone@skadden.com, 852.3740.4703

“Recent developments in Russian securities legislation offer flexibility for structuring cross-border public M&A transactions involving non-cash consideration.”

Russia | Legislative Developments — New Opportunities for Cross-Border M&A Transactions

Cross-border acquisitions of Russian targets financed (at least in part) by issuances of equity securities of non-Russian bidders may become of increasing interest, given the limited availability of acquisition financing and recent developments in Russian law.

- As the global crisis has affected purchasers' abilities to secure financing for M&A transactions, market players increasingly are looking for "non-cash" consideration arrangements in M&A deals.
- Recent developments in Russian securities legislation have increased the feasibility of using equity securities as consideration in acquisitions of public Russian targets.
- A number of public Russian M&A transactions are pending (*e.g.*, Telenor and Altimo's US$30 billion exchange offer for OJSC VimpelCom's shares and ADRs) that contemplate a non-cash consideration component.

Recent developments in Russian securities legislation offer flexibility for structuring cross-border public M&A transactions involving non-cash consideration.

- The adoption of the amendments to the "On Securities Market" and "On Protection of Rights and Legal Interests of Investors on Securities Markets" laws, which came into force on May 16, 2009, as well as of a number of pieces of supporting legislation, introduced a new regulatory framework for the placement[1] and circulation[2] of securities in non-Russia issuers. The amendments also enable Russian issuers to place with the Russian public global depositary receipts (GDRs) and American depositary receipts (ADRs) issued in respect of shares of Russian companies. Previously, this was impossible, as GDRs and ADRs were not recognized as securities in Russia (only the underlying shares were recognized as such).
- Pursuant to the amendments, certain "qualified foreign securities" that meet certain origination/jurisdiction requirements now may be legally offered as consideration to the public in M&A transactions where the target is a public, Russian open-joint stock company.
  - Under the securities regulations previously in effect, non-Russian securities could be placed or offered to the public in Russia only if permitted by an international treaty to which Russia was a signatory or pursuant to an agreement between the Russian Federal Service for Financial Markets (the FSFM) and a foreign securities regulator. There were no such treaty or cooperation agreements entered into between the FSFM and the securities regulators in the U.S., UK or other EU jurisdictions; and this, therefore, presented a significant obstacle for the use of non-Russian securities as consideration in public M&A transactions.
  - The amendments eliminate this constraint by introducing new principles under which non-Russian securities that meet certain requirements ("qualified foreign securities") can be admitted for placement, including public placement and public circulation in Russia.
  - As a result of the amendments, non-Russian securities that have been assigned ISIN and CFI codes as specified in the FSFM regulation automatically qualify as "securities" under Russian law and therefore may be eligible to serve as consideration in M&A transactions. Those non-

Contributing Partners / Alexey V. Kiyashko, Alexey.Kiyashko@skadden.com, 7.495.797.4600 / Dmitri V. Kovalenko, Dmitri.Kovalenko@skadden.com, 7.495.797.4600

Russian securities that lack the codes required by the FSFM regulation may be designated as "securities" by the FSFM in accordance with newly established procedures.

- Non-Russian securities that do not qualify under Russian law or that do not meet the requirements for public placement and/or public circulation established by the amendments, cannot be offered in any form or by any means, including by means of advertisement, to an unlimited number of persons. However, such instruments may be offered to Russian "qualified investors" via licensed Russian brokers pursuant to the amended Securities Market Law.

Non-Russian bidders intending to offer equity securities as consideration for Russian targets will continue to face challenges in Russia.

- Pursuant to the amendments (as in the U.S. and Europe), a non-Russian bidder intending to offer to the public its equity securities must register a prospectus in respect of such securities with the FSFM. However, the regulations implementing the procedures for obtaining registration of a Russian prospectus in respect of qualified foreign securities have not yet been adopted; thus, in practice, public placement and public circulation may not be available for qualified foreign securities for some time yet. Offers of non-Russian securities will have to continue to be made solely to Russian "qualified investors" via licensed Russian brokers until these implementing regulations are in place. The FSFM is working on these regulations, but at the moment there is no indication as to when they will be adopted.
- If a transaction triggers the application of the Russian mandatory or voluntary tender offer rules, a cash alternative to any non-cash consideration must be offered. Also, in the case of a mandatory tender offer, Russian statutory appraisal of the non-cash consideration is required.
- The unwinding of an acquisition would be difficult in the context of the Russian tender offer rules.
- Other rules that may constrain M&A transactions, including anti-monopoly approvals, foreign investment control regulations and other governmental clearances, continue to apply.

---

[1] "Placement" of securities means the initial sale of securities by the issuer to the first holders thereof. "Public placement" of securities means the placement of securities by an open subscription, *i.e.*, to an unlimited number of persons, including placement of securities on stock exchanges. According to the amendments, a placement of securities to Russian qualified investors through a stock exchange is exempt from the definition of public placement.

[2] "Circulation" of securities means transactions with securities that result in the transfer of title thereto (other than the initial sale by the issuer). "Public circulation" of securities means the circulation of securities on stock exchanges or an offering of securities to an unlimited number of persons, including by means of advertising. According to the amendments, the circulation of securities intended for Russian qualified investors on a stock exchange is exempt from the definition of public circulation.

Liabilities in Developing Country Investments: Recent Experiences of U.S. Companies

In the last decade, plaintiffs have shown a significantly increased willingness to bring claims in the United States and elsewhere against companies investing in developing countries, expanding the legal theories on which those claims have been based. The specter of being subject to "unusual" (and possibly retroactive) legal procedures in developing country jurisdictions has required Western companies to refocus their legal defense and risk management strategies. Companies investing in emerging markets should be conscious of the special litigation risks that are presented by the courts and legislative systems of the countries in which they invest, including the potential for such risks to be magnified (even retroactively) in high-profile or politically charged cases.

Examples of high-profile litigation emerging from investments by U.S. companies in developing countries include:

- **Nicaragua.** Claims by Nicaraguan banana plantation workers against U.S. companies allegedly responsible for making or using an agricultural pesticide, dibromochloropropane (DBCP), have given rise to a series of very large judgments in the Nicaraguan courts against those U.S. companies. Whether such judgments will be enforced abroad, particularly given the political context in which they were made, remains an open question.

- **Ecuador.** Significant environmental remediation claims have been brought in the courts of Ecuador against a major U.S. oil company, Chevron, in connection with Texaco's former operations in the Ecuadorian Amazon. Chevron has questioned the fairness of those proceedings, and, as in Nicaragua, current political developments in Ecuador may play a significant role in the local outcome of these claims and in the willingness of other legal systems to recognize them if asked to do so.

- **Nigeria.** A series of human rights claims were brought in the past decade in the U.S. District Court for the Southern District of New York against several companies pursuant to the Alien Tort Claims Act of 1789, 28 U.S.C. Section 1350 (ATCA). In those claims, which have been settled, it was alleged that the defendants were legally liable in connection with certain alleged human rights violations by the Nigerian government.

- **Papua New Guinea.** Similar claims under ACTA have been brought in the U.S. District Court for the Central District of California by a group of plaintiffs against certain mining companies. In those claims, which the District Court has permitted to go forward, plaintiffs alleged that the defendants are legally responsible for certain human rights violations by governmental authorities in Bougainville (a province of Papua New Guinea). This case is now before the U.S. Court of Appeals for the Ninth Circuit.

The last two of these claims were brought in U.S. courts pursuant to ACTA, which states that "district courts shall have original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States," which has been interpreted by some plaintiffs as entitling foreign citizens to bring claims in U.S. courts for violations of international human rights obligations. However, it remains possible that the availability of ACTA in such situations may be circumscribed (or even precluded) by the Supreme Court's decision in *Sosa v. Alvarez-Machain*, 542 U.S. 692 (2004), which arguably narrowed the permissible scope of ACTA claims.

Contributing Partners / Bruce Macaulay, Bruce.Macaulay@skadden.com, 44.20.7519.7274 / Timothy G. Nelson, Timothy.G.Nelson@skadden.com, 212.735.2193 / Marco E. Schnabl, Marco.Schnabl@skadden.com, 212.735.2312

In sharp contrast, the first two claims — and certain other similar claims — have been brought in the courts of the countries affected, sometimes under special laws or procedures designed to make it easier to sue Western companies. The Nicaraguan pesticide cases illustrate this phenomenon well. In 2000, the Nicaraguan government passed a "Special Law for the Conduct of Lawsuits Affected by the Use of Pesticides Manufactured with a DBCP Base" (otherwise known as Special Law 364), which specifically regulates the future conduct of DBCP litigation against certain named U.S. companies — and "tilts" the process against the defendants.

The features intended to affect the litigation process in Special Law 364 included, among others, (1) an irrefutable presumption that DBCP caused plaintiffs' injuries, (2) large filing fees required to be paid by the defendants at the beginning of the lawsuit, (3) an accelerated procedure for trying the claims and (4) guarantees of minimum damages awards for plaintiffs. Since its enactment, thousands of plaintiffs have filed suit in Nicaraguan courts pursuant to Special Law 364, and various large damages awards have been rendered against U.S. companies — $97 million in one case.

- **Arguing lack of international due process.** The specter of being subject to "unusual" (and possibly retroactive) legal procedures in foreign jurisdictions has required companies to refocus their legal defense and risk management strategies. In the case of Nicaragua, two companies have argued — to date, successfully — that the U.S. courts should not recognize Nicaraguan court judgments rendered under Special Law 364 because, among other things, the law fails to comply with international due process. It remains to be seen whether the legal systems of other countries may reach the same conclusions if attempts are made to enforce these awards.

- **Relief under bilateral investment agreements.** Another strategy for U.S. companies has been to seek relief against the outcomes of these unusual legal proceedings under applicable bilateral investment agreements (BITs) and free trade agreements. Chevron, for example, has brought an international arbitration against the Republic of Ecuador before the Permanent Court of Arbitration at The Hague, claiming that the remediation proceedings are so unfair that they violate the treaty guarantees of fair and equitable treatment in the U.S.-Ecuador BIT.

Companies investing in emerging markets should be conscious of the special litigation risks that are presented by the courts and legislative systems of the countries in which they invest, including the potential for such risks to be magnified (even retroactively) in high-profile or politically charged cases. While every form of legal risk cannot be eliminated, companies still can take a variety of measures to preserve legal remedies in the event of adverse sovereign action, including by:

- ensuring that investments are covered by an investment treaty that permits arbitration against the host state (See "Maximizing Treaty Protection for Foreign Direct Investments"); and/or

- attempting to ensure that large projects are covered by concession agreements with the host state, providing for similar forum rights and guarantees of fair treatment.

Governance

“Companies should consider how the proposed reforms will impact them based on their unique circumstances.”

U.S. Corporate Governance | Washington's Reform Agenda

Economic uncertainty, large-scale job losses and populist outrage over Wall Street bailouts and executive compensation have set the stage for Washington — the Obama administration, the House of Representatives, the Senate and the Securities and Exchange Commission — to enter the fray in an attempt to address the perceived shortcomings of Corporate America.

Many of the proposed fixes would federalize significant aspects of corporate governance — traditionally the purview of state law — and represent a continuing shift away from a board-centric model of corporate governance and toward a shareholder-centric model. The question at the heart of the debate is whether the proposed reforms will lead public corporations to a renewed or continued focus on long-term value creation or exacerbate the problems of "short-termism" resulting, at least partially, from the activities of short-term-focused market participants.

These efforts in Washington remain a work in progress but may be completed in early 2010. Companies should consider how the proposed reforms will impact them based on their unique circumstances, including their current governance structures, directors' skill sets, shareholder profiles and any other relevant constituencies.

Proxy Access and Director Elections

- The SEC has proposed rules to implement mandatory proxy access — the ability of shareholders to include their own nominees for election to the board of directors in a company's proxy statement and proxy card. If adopted, proxy access would provide activist investors with increased leverage to pressure public companies to take short-term-focused actions and subject companies to more frequent director election contests that distract boards and management from running their businesses. Proxy access also may deter qualified directors from continuing to serve on boards of public companies. Due to the complexity of the issues and the large number of public comments, the SEC delayed its consideration of final rules and reopened the public comment period, but it is expected to consider adopting proxy access as early as late-February or March 2010.
- A discussion draft of The Restoring American Financial Stability Act of 2009, presented by Sen. Christopher J. Dodd (D-CT), would mandate a majority voting standard for uncontested director elections and prohibit classified boards of directors unless approved or ratified by shareholders. The Senate team working toward a bipartisan compromise on the corporate governance and executive compensation aspects of the legislation consists of Sens. Charles E. Schumer (D-NY) and Mike Crapo (R-ID). Senate action is expected in early 2010.
- The SEC approved an NYSE rule change eliminating brokers' discretionary authority to vote uninstructed shares in uncontested director elections. This change — particularly at companies with majority voting standards and those with large retail shareholder bases — may increase the influence of institutional investors, shareholder activists and proxy advisory firms (such as RiskMetrics) and require companies to engage in additional investor outreach and proxy solicitation efforts.

Board Leadership and Composition

- The SEC has adopted rules, effective for the 2010 proxy season, requiring disclosure of the board's leadership structure, of the rationale for choosing the structure and, where the chairman and CEO

Contributing Partner / Marc S. Gerber, Marc.Gerber@skadden.com, 202.371.7233

roles are combined, whether the company has a lead independent director and his/her specific role in the leadership of the company's board. This disclosure could influence the ongoing debate on whether the chairman and CEO positions should be combined or separated.

- The SEC also has adopted rules, effective for the 2010 proxy season, requiring enhanced disclosure regarding the specific experience, qualifications, attributes or skills of each director and nominee. Beyond the challenges of collecting this information and determining what to disclose, it is unclear whether those disclosures will have an impact on board dynamics and overall function and whether those disclosures could increase the liability risks for directors based on the disclosed skills and attributes.

- The SEC's new rules also require disclosure about whether the nominating committee considers diversity in identifying potential board nominees and, where a policy on the topic is in place, a description of how the policy is implemented and how the effectiveness of the policy is assessed. The SEC indicated that companies may view diversity in different ways. Certainly, the proponents of this new rule hope that it will impact the ways in which nominating committees conduct searches for new board members and, ultimately, impact the composition of boards of directors.

Risk Oversight

- In light of the increased attention on risk management resulting from the recent economic crisis, the SEC has adopted rules, effective for the 2010 proxy season, requiring disclosure about the board's role in overseeing the company's risk management processes. Although oversight of risk management has traditionally been a component of a board's oversight of business and strategic issues, this new requirement highlights the increased focus by regulators, legislators, investors and others on risk management and the board's role in that process. The new requirement may result in boards taking a more formal or structured approach to risk oversight and cause companies to evaluate ways to better incorporate risk assessments into their strategic decision making. As this occurs, boards must bear in mind both that some level of risk is inherent in conducting business and risk management should not attempt to eliminate all risk. (See "A Renewed Focus on Board Assessment of Enterprise Risk")

- This focus on risk management, together with concerns over executive compensation, caused the SEC to adopt rules, effective for the 2010 proxy season, requiring disclosure if a company's compensation policies and practices for its employees are reasonably likely to have a material adverse effect on the company. This new requirement will mandate a broader review of compensation policies and risk management than has traditionally been undertaken by board compensation committees. (See "U.S. Executive Compensation | The Financial Crisis's Legacy of Change")

"Say on Pay" and Enhanced Compensation Committee Independence

- The issue of shareholder advisory votes on executive compensation for all public companies remains on the legislative agenda. The House of Representatives approved "say on pay" as part of The Wall Street Reform and Consumer Protection Act of 2009, and the Senate is likely to consider say on pay as part of The Restoring American Financial Stability Act of 2009. Although nonbinding, the efforts by board compensation committees to achieve favorable votes — and, as part of those efforts, to achieve favorable recommendations from RiskMetrics and other proxy advisory firms —

have the potential to erode compensation committees' creativity and discretion and result in a corresponding increase in the influence of proxy advisory firms.

- The legislation approved by the House and expected to be considered by the Senate also would place enhanced independence requirements on compensation committee members. If passed, it remains to be seen whether these additional requirements unduly restrict the pool of potential compensation committee members or cause compensation committees to be made up of directors who do not have the experience to ensure that company compensation programs — in addition to paying for performance — attract and retain the executive talent necessary to implement business strategies and create long-term value for shareholders.

“In light of this increased shareholder activism, public companies should, among other things, have a well-coordinated communications and investor relations strategy.”

U.S. Corporate Governance | Increasing Shareholder Activism and Board-Shareholder Communications

Shareholder activism has continued to increase in recent years and is likely to intensify in light of the many corporate governance reforms recently adopted by, or currently pending before, Congress and the SEC. As a result, a well-thought-out strategy of active and ongoing engagement and dialogue between companies and institutional investors is increasingly important.

Shareholder Proposals

- Shareholder proposals submitted under Rule 14a-8 of the U.S. Securities Exchange Act of 1934 continue to be a favorite tool of some institutional investors — particularly labor unions and public pension funds. According to RiskMetrics, 37 percent of governance proposals going to a vote in the 2009 proxy season received majority support, up from 30 percent in 2008; and the proposal topics with the most majority votes in 2009 were board declassification, the right of shareholders to call special meetings and majority voting standards in director elections. Other shareholder proposals that achieved very high average votes in favor related to eliminating or reducing supermajority voting provisions and poison pills. An increase in shareholder proposals relating to CEO succession planning is likely in light of the recent guidance published by the SEC staff that it would no longer exclude such proposals on "ordinary business" grounds.

Activist Hedge Funds

- For some hedge funds, shareholder activism is an investment strategy in which companies are pressured to engage in transactions that maximize short-term returns. These activists can take a much more aggressive approach than passive, long-term investors, but often win their support by incorporating "good corporate governance" elements into their platform. Of the 39 proxy contests in which RiskMetrics issued voting recommendations through the first nine months of 2009, dissidents won one or more board seats at 56 percent of companies. RiskMetrics notes that another 36 proxy fights settled during that period. Typically, settlements involve placing one or more of the dissident's candidates on the board. Companies often settle proxy fights because of an expectation that RiskMetrics will support one or more nominees on the dissident slate.

Engagement: Board-Shareholder Communications

- In light of this increased shareholder activism, public companies should, among other things, have a well-coordinated communications and investor relations strategy. Some companies have had governance roadshows in which they meet with a number of their larger institutional shareholders and engage in a dialogue regarding corporate governance and executive compensation matters. This proactive engagement with investors — and investors' sense that, even where principled differences exist, there is an open channel of communication through which their views can be heard and considered — can be a critical resource in a proxy contest.

- Increasingly, institutional investors are requesting or insisting that one or more directors — often the lead independent or presiding director, the chair of the compensation committee and/or the chair of

Contributing Partners / Marc S. Gerber, Marc.Gerber@skadden.com, 202.371.7233 / Richard J. Grossman, Richard.Grossman@skadden.com, 212.735.2116 / Daniel E. Stoller, Daniel.Stoller@skadden.com, 212.735.3360

the corporate governance committee — participate in such dialogue. This is particularly the case when institutional investors are interested in discussing executive compensation.

- The push for greater director-shareholder communications can take varied forms. For example, as part of the United Brotherhood of Carpenters and Joiners Pension Fund campaign for an advisory vote on executive compensation every three years, the Fund sought a "forum conducted by the compensation committee" via webcast or other means in which committee members would discuss executive compensation policies and practices, and shareholders would "directly comment on and ask questions" regarding those policies and practices.
- When directors are involved in dialogue with shareholders, they should be briefed both on the background of any prior communications and the relevant legal considerations, including Regulation FD. The SEC's newly formed Investor Advisory Committee has identified director-investor communications as one of its key issues and likely will recommend ways in which the SEC can facilitate those communications.

U.S. Corporate Governance | A Renewed Focus on Board Assessment of Enterprise Risk

Corporate management and boards of directors had quite a ride in 2009. After facing the severe shocks caused by the financial crisis of 2008 and its impacts on business conditions, management and boards have begun to assess what risk management measures should be implemented or enhanced to better serve the interests of the corporation and its stakeholders.

While board focus in late 2008 and most of 2009 was on liquidity risk issues — specifically, assuring that the entity had sufficient capital resources to weather the storm — attention has turned to an assessment of other business risks.

Although the all-clear siren has not yet been heard in all quarters, 2010 brings with it a renewed sensitivity both toward risk assessment beyond liquidity and capital access, and how best to view risk on the management level and oversee risk management on the board level.[1]

Increased Regulatory, Legislative and Rating-Agency Scrutiny

In addition to being a sound element of internal corporate governance practices, corporate risk oversight is receiving increased scrutiny from regulators, ratings agencies and shareholders. This focus will push companies to move risk management higher on the already-full list of priorities in 2010.

In July 2009, as part of the announcement of proposed rules relating to executive compensation and corporate governance disclosure (See "U.S. Executive Compensation | The Financial Crisis's Legacy of Change?"), the Securities and Exchange Commission acknowledged the role that risk and the adequacy of risk oversight played in the recent market crisis, and stated the importance for investors to understand the board's role in this area. The new rules, which will become effective on February 28, 2010, would require companies to include enhanced and new disclosures in their proxy statements to shareholders.

Specifically, the rules require new disclosures about a company's board leadership structure, the board's role in the risk management process, and how a company's compensation policies and practices for employees generally create incentives that affect the company's risk along with enhanced director and nominee disclosures regarding qualifications, skills and experience.[2]

Signs of increased attention and governmental focus on risk include the creation of the SEC's Division of Risk, Strategy and Financial Innovation in September 2009 and pending legislation introduced by Sen. Charles E. Schumer (D-NY) entitled The Shareholder Bill of Rights of 2009, which would require all public companies to establish a standing risk committee composed of independent directors.

Having effective risk management policies and procedures in place also could impact a corporation's cost of capital. In May 2008, Standard & Poor's (S&P) announced that it would begin to enhance its credit ratings process for nonfinancial companies through an enterprise risk management (ERM) review. The other ratings agencies have not gone as far as S&P with respect to ERM at this point. While Fitch and Moody's implicitly review risk management techniques and programs when they rate companies, they are taking a wait-and-see attitude with respect to more pointed action.

Contributing Partner / Brian J. McCarthy, Brian.McCarthy@skadden.com, 213.687.5070

Board Review of Risk Governance Issues

In anticipation of these new disclosure requirements and other concerns, boards and individual committees have begun taking steps to enhance and approach risk issues in a more systematic and organizationally holistic manner.

As a guide to assist boards in fulfilling their risk oversight role, the Blue Ribbon Commission on Risk Governance of the National Association of Corporate Directors (NACD) released a report in October 2009 entitled, "Risk Governance: Balancing Risk and Reward." The Commission believes that, as a general rule, the full board should have primary responsibility for risk oversight, with its standing committees supporting the board by addressing the risks inherent in their respective oversight areas.

Boards should review the report and the following recommended principles as they work, together with management and their advisors, to achieve their risk oversight objectives.

1. Understand the company's key drivers of success.
2. Assess risks in the company's strategy.
3. Define the role of the full board and its standing committees with regard to risk oversight.
4. Consider whether the company's risk management system — including people and processes — is appropriate and has sufficient resources.
5. Work with management to understand and agree on the types and format of risk information the board requires.
6. Encourage a dynamic and constructive risk dialogue between management and the board, including a willingness to challenge assumptions.
7. Closely monitor the potential risks in the company's culture and its incentive structure.
8. Monitor critical alignments of strategy, risk, controls, compliance, incentives and people.
9. Consider emerging and interrelated risks.
10. Periodically assess the board's risk oversight processes.

In reviewing risk management policies and practices, a board should take into consideration best practices and industry standards for risk management programs. The integrated framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) is widely accepted, and boards should be aware of its approach to oversight of enterprise risk. However, in developing appropriate risk management processes and procedures, it is important to recognize that one size does not fit all and each corporation's unique circumstances and characteristics should be taken into account in risk identification and response.

The board's oversight role in setting the tone at the top is an important step in establishing the appropriate company-specific risk management program. In the post-meltdown new world order, the winners will be boards and managements that work together to establish an acceptable risk level that produces the greatest opportunity for reward.

[1] For a discussion of directors' oversight duties with respect to risk assessment, see "Directors' Duty of Oversight and Assessment of Business Risk in a Meltdown Environment: Some Comments in the Wake of *In Re Citigroup Inc. Shareholder Derivative Litigation*" at http://www.skadden.com/content/Publications/Publications1709_0.pdf.

[2] For further details, see "SEC Adopts Amendments to Executive Compensation and Corporate Governance Disclosure" at http://www.skadden.com/content/Publications/Publications1946_0.pdf.

“The heightened scrutiny of executive compensation likely will continue and, perhaps, intensify.”

U.S. Executive Compensation | The Financial Crisis's Legacy of Change?

Some of the businesses hit hardest by the global financial crisis apparently have begun to recover. However, their recent struggles may leave a legacy of change for executive compensation practices.

- Additional congressional restrictions on executive compensation practices at public companies are likely in the coming year, continuing a trend of greater federal involvement in executive compensation matters. Under some pending legislation:
  - An annual nonbinding say-on-pay vote would be required, applying specifically (but not exclusively) to so-called golden parachute payments, and greater independence would be required for compensation committee members and compensation consultants.
  - Financial institutions would be subjected to additional regulation of compensation practices that are seen as excessively risky.
- More than ever, the government appears to view executive compensation taxation as a revenue source. Given projected budget deficits, there is little reason to expect this tendency to abate.
  - The Internal Revenue Service has significantly increased audit focus and enforcement of executive compensation tax rules, including Section 280G (relating to golden parachutes) and Section 162(m) (relating to the $1 million deduction limit on public company executive compensation) of the U.S. Internal Revenue Code.
  - In the past several years, two new major revenue-raising taxes have been enacted — new Sections 409A and 457A (relating to deferred compensation practices).
  - A recent IRS memorandum signals a new focus on the deductibility of annual bonuses. The IRS takes the view that bonuses paid after year-end, requiring the employee to be employed on the payment date, generally may not be deducted before the year of payment.
  - Recently proposed legislation would limit employer deductions for pay based on the company's average level of employee compensation as well as employer stock-option deductions. While the adoption of this legislation is uncertain, these proposals highlight Congress' focus on executive compensation taxation as a revenue source.
- What we noted last year remains equally true today: The heightened scrutiny of executive compensation likely will continue and, perhaps, intensify.
  - As witnessed by the new SEC rules with respect to proxy statement disclosure regarding the relationship between a company's policies and practices for compensating employees (not limited to executive officers), risk-taking incentives and risk management (discussed below), some observers assert that compensation rewarding excessive risk-taking was a driver of the economic downturn.
  - Public outrage at the compensation practices of entities receiving funds under the Troubled Asset Relief Program (TARP) was palpable and stoked increased media attention on those practices.

Contributing Partners / Stuart N. Alperin, Stuart.Alperin@skadden.com, 212.735.3920 / Neil M. Leff, Neil.Leff@skadden.com, 212.735.3269 / Regina Olshan, Regina.Olshan@skadden.com, 212.735.3963

- Public companies need to continue to prepare for SEC proxy disclosure rule changes.
  - The SEC has adopted amendments to the proxy rules requiring additional disclosures regarding executive compensation and corporate governance matters.
  - Among the new disclosures required are a discussion on compensation policies and practices for employees (including non-executive officers) that are reasonably likely to have a material adverse effect on the company, the board of directors' role in the company's risk management process, the board's leadership structure (particularly the combination or separation of CEO and chairman positions) and the independence of compensation consultants.
- Various initiatives relating to the regulation of compensation at institutions that received TARP or other public money have affected the mindset of shareholders even at businesses that did not take any public money.
  - Recently, the White House "pay czar" (Special Master for TARP Executive Compensation, Kenneth R. Feinberg) announced limits on compensation by TARP-money recipients of less senior executives. These rules are in addition to those announced last year that affected the more senior executives at those businesses.
  - The Federal Reserve Board proposed separate guidelines for bankers' compensation earlier this year.
  - While these rules have no direct impact on other businesses, the requirements may be perceived as a model for their future pay practices — a result expressly endorsed by Feinberg.
- Evolving views of best practices will continue to complicate standard methods of compensating and incentivizing employees.
  - Shareholder activist groups likely will continue to agitate for replacing directors at companies with perceived poor pay practices.
  - Shareholders likely will demand increased reliance on stock-based, pay-for-performance compensation and longer holding periods. More companies will abandon the use of tax gross-ups (whether relating to executive severance or other benefits) and "single-trigger" change-in-control vesting of equity awards.
  - Incentive compensation clawbacks may become more common, even in the absence of malfeasance.
  - There likely will be increasing pressure to reduce severance entitlements, particularly for underperforming companies. Payments viewed as excessive are likely to continue to receive embarrassing media coverage.
  - As evidenced by some recent high-profile cases, talented executives may prefer to shift employment to companies with more liberal pay practices (which may be private companies that are exempt from SEC disclosure requirements).

French Corporate Governance | Implementing Binding Regulations on Bonuses

On November 3, 2009, France was the first country to adopt binding regulations implementing the Financial Stability Board's (FSB) "principles for sound compensation practices" for financial market professionals, endorsed by the G-20 leaders at the Pittsburgh summit in September 2009. New rules of conduct elaborating on the regulations were issued concurrently by the French Banking Federation. Both were published on the eve of the G-20 finance ministers' November 2009 meeting in Scotland, with the expectation that other participants would follow suit.

While the FSB principles are aimed only at significant financial institutions, the French regulations have a larger scope, applying to all credit institutions or investment firms operating in France[1] and to the foreign branches and subsidiaries of those incorporated in France. Although the regulations do not apply to portfolio management firms and insurance companies, the French Banking Federation has indicated that the new rules are meant to be extended to them by their competent professional bodies.

Within these institutions, the new compensation principles must be applied to all "financial markets professionals whose activities may have a material impact on [their] risk exposure" as well as to the members of their executive bodies. They do not concern support and compliance staff, whose compensation must be set independently from the front office activities and at a level adequate to attract qualified and experienced personnel.

The new regulations comprise general principles on the alignment of compensation practices with sound risk management, as well as specific rules governing variable compensation:

- Bonuses must be based on the achievement of financial and nonfinancial objectives defined individually and collectively, after deduction of all costs (essentially the cost of risk, liquidity and capital).
- Guaranteed bonuses are prohibited except in the case of new recruitments (in which case the guarantee must be limited to one year).
- At least 50 percent (60 percent for the highest earners) of the variable compensation must be deferred over at least three years following the year of award, with installments vesting no faster than *pro-rata temporis*.
- At least 50 percent of the bonuses must be paid in the form of shares or share-linked instruments subject to a minimum vesting period of two years.
- Payment of the deferred component (whether cash or equity-linked) must be contingent on the results of the institution, the relevant business division and, as the case may be, the individual on the date of payment.
- Employees must be prevented from using personal hedging strategies to offset risk-alignment effects in their compensation arrangements.

While the deferral guidance is not completely out of line with current market trends, its use as a means of placing the bonus at risk of forfeiture is still far from market practice and could conflict with provisions of existing employment agreements, which cannot be modified without individual employee consent.

Contributing Partner / Pierre Servan-Schreiber, Pierre.Servan-Schreiber@skadden.com, 33.1.55.27.11.30 / **Associates** / Alexander Crosthwaite, Alexander.Crosthwaite@skadden.com, 33.1.55.27.11.45 / Stephane Heliot, Stephane.Heliot@skadden.com, 33.1.55.27.11.03

Similarly, payments in the form of shares or share-linked instruments are common for senior bankers, but they may raise difficulties in smaller nonlisted institutions.

Under the new regulation, financial institutions also are required to adopt guidelines governing compensation and, except for the smaller ones, set up a compensation committee comprising a majority of independent members to review compensation practices in light of risk policy. Reports on compensation practices must be filed annually with the French Banking Commission, which is in charge of controlling the enforcement of the new rules.

France's adoption of the FSB principles has been supported by the French financial industry, despite concerns of unfair competition resulting from less stringent implementation in other jurisdictions.

Of greater immediate concern to the Paris financial center is the announcement, on December 16, 2009, of the French government's plan to follow the UK in imposing a one-off 50 percent payroll tax on bonuses in excess of €27,500 paid to financial market operators in 2010. The government has presented the tax, which would be paid by employers, as a means of encouraging banks to allocate 2009 earning to capital reserves rather than pay bonuses. The proceeds from the tax would help fund the increase of the state's guarantee on bank deposits from €70,000 to €100,000. The French government is believed to be waiting to better understand the UK tax proposal before providing further details regarding the draft legislation that it will submit to the French Parliament in early 2010, with a view not to put Paris at a disadvantage to London.

Together with the French binding compensation rules, these tax proposals in France and the UK emphasize the contrast with the U.S., where the federal government's crackdown on bonuses has so far been limited to institutions receiving financial compensation under the Troubled Asset Relief Program. (See "U.S. Executive Compensation | The Financial Crisis's Legacy of Change?")

[1] Excepted are those incorporated in other member states of the European Economic Area that are regulated by their respective home-state regulators.

German Corporate Governance | New Rules for Management Remuneration and D&O Insurance

As with the U.S. and several other countries in Europe, the financial and economic crisis of 2008 and 2009 resulted in new regulation in Germany. Among its reactions to the crisis, Germany introduced revised rules (VorstAG) on the remuneration of management board members of German stock corporations (Aktiengesellschaft) on August 5, 2009.

The new rules are designed to increase management board members' accountability by (1) clarifying and expanding the criteria that a corporation's supervisory board must apply in determining the remuneration of management board members and/or in deciding whether to reduce such remuneration if the corporation's finances deteriorate; (2) establishing minimum deductibles and caps on directors' and officers' insurance funded by a corporation to protect its board members; and (3) setting minimum periods before management board members are permitted to rotate to a company's supervisory board.

Management Board Remuneration

- The new law does not provide for a specific amount of remuneration. However, in principle, the remuneration (including any retirement payments) must not exceed "common remuneration," a concept that is benchmarked against both the remuneration of management board members in other companies of the same size and sector (horizontal comparability) and the remuneration structure of a company itself (vertical comparability).
- With respect to listed entities, the remuneration structure needs to be aimed at creating sustainable business development. The performance-based element of a management board member's total remuneration package may be based on a combination of short- and long-term incentives, so long as the latter incentives are the more significant component. Stock options issued as part of such a remuneration package may not be exercised until at least four years following their issuance.
- If, following the initial determination of a corporation's management board's remuneration packages, the corporation's financial situation deteriorates such that the continued payment of that level of remuneration would be unreasonable, the supervisory board is required to reduce the compensation to an appropriate level. This principle also applies with respect to retirement payments, which can only be reduced within three years after the relevant board member leaves the company.
- With respect to listed companies, the general shareholders' meeting may, upon either receiving a proposal from the management board and the supervisory board or at the request of a quorum of shareholders, resolve to endorse a particular remuneration package. However, any such resolution is not legally binding on the corporation.

Directors' & Officers' (D&O) Insurance for Management Board Members

- If the company enters into D&O insurance contracts for the benefit of management board members, the relevant executives must pay the deductible. Such deductible has to be an amount equal to at least 10 percent of any individual damage covered by the insurance. The rules also provide for an annual cap that limits annual insurance payments on all damages to a maximum of 1.5 times the annual fixed salary of any individual management board member. The relevant management board members are not prohibited from arranging for private insurance to cover the required deductible.

Contributing Partner / Peter Veranneman, Peter.Veranneman@skadden.com, 49.69.74.220.0

Rotation From Management Board to Supervisory Board

- For listed companies, former management board members may not rotate to the supervisory board of the same company for a period of two years following the end of their management board service, unless they are elected by shareholders holding more than 25 percent of the company's voting rights.

While the intention for the above-mentioned rules was both to establish an adequacy standard for management remuneration and increase the accountability of management board members, the rules also could have undesirable effects. In light of the global competition for talent, horizontal comparison also might result in (1) an increase in the fixed remuneration component; (2) future executive remuneration to contain an additional element to cover the expenses for supplementary insurance contracts on a private basis; (3) talent leakage from German management boards; and/or (4) a migration of existing group parent companies to management board-friendly jurisdictions.

UK Corporate Governance | Proposed Revisions to the UK Combined Code on Corporate Governance

In the wake of one of the worst recessions in recent history and the resulting scrutiny of corporate risk-taking, regulators on both sides of the Atlantic have been re-examining and revising the rulebook with respect to corporate governance and compensation of public company senior executives.

In the UK, the Combined Code on Corporate Governance (the Code) is the key source of corporate governance recommendations for companies with a primary share listing on the London Stock Exchange (or a Premium Listing, as it will become known effective April 6, 2010). Compliance with the Code is ensured through the "comply-or-explain" mechanism, which requires listed companies incorporated in the UK to disclose the degree to which their corporate governance practices comply with the main principles of the Code and explain the reasons behind any noncompliance.

At present, non-UK incorporated companies with a primary share listing need only disclose whether or not they comply with the corporate governance regime of their own country of incorporation and the significant ways in which that regime differs from the Code. Following the changes to the listing regime that become effective on April 6, 2010, non-UK incorporated companies listed in the UK with a primary share listing (or a Premium Listing as it will then become known) will need to report against the Code in the same way as is currently required of UK incorporated companies with such a listing.

Proposed Revisions to the Combined Code

The Financial Reporting Council (FRC) regularly reviews the Code and on December 1, 2009, published a report following its most recent review of the effectiveness of the Code. The FRC proposed a number of changes related to corporate governance and compensation and a number of follow-up actions in a consultation document that includes a draft revised Code.

In its report, the FRC concluded that while the Code and its related guidance require some updating, it remains broadly suitable for its purpose of promoting good corporate governance. The report noted that there was recognition both that the quality of corporate governance depends on behavior rather than process and the flexibility allowed by the Code remains preferable to a more prescriptive framework. The FRC does not intend to extend its formal activities to monitoring or enforcing reporting against the Code but will continue informally to monitor standards of disclosure.

The FRC report culminated in a consultation paper that is currently open to comment until March 5, 2010. It is therefore possible that at least some of the proposals may be modified or dropped entirely depending on the responses received by the FRC. With the exception of the first proposal described below, we do not believe that the proposals will give rise to any fundamental changes in the existing UK corporate governance regime. Moreover, it is difficult to say at this stage how much support there will be for any particular proposal.

Assuming the FRC's proposals are positively received, the revised Code should be published in April or May 2010 and will apply to accounting periods beginning on or after June 29, 2010 (subject to the necessary changes being made to the UK Listing Rules and UK Disclosure Rules and Transparency Rules to reflect the revisions to the Code).

Contributing Partners / Michal Berkner, Michal.Berkner@skadden.com, 44.20.7519.7074 / Danny Tricot, Danny.Tricot@skadden.com, 44.20.7519.7071

The principal proposals made by the FRC are the following:

- With respect to the frequency of director re-election, the FRC has proposed that either the board's chairman or all its members should stand for annual re-election. Under the comply-or-explain regime, whichever option is chosen, boards would be free to decline to comply, provided they were prepared to justify the decision. The revised draft also proposes that the chairman should agree and regularly review development requirements with each director. In addition, the senior independent director's job description should be slightly expanded to include acting as a sounding board for the chairman and serving as an intermediary for the other directors.

- The revised Code draft elevates three principles relating to the responsibilities of the chairman and directors from supporting principles to main principles, with the effect that companies with a primary share listing (or a Premium Listing, as it will become known with effect from April 6, 2010) will be required to report on their application in their annual reports. The intention is to place a greater emphasis on the following principles, presumably because of perceived failings by nonexecutive directors on the boards of financial institutions in recent years:

  – The chairman is responsible for leadership of the board and ensuring its effectiveness.

  – Nonexecutive directors should constructively challenge and help develop proposals on a company's strategy.

  – Directors must be able to allocate sufficient time to perform their responsibilities effectively.

- In the area of board balance and composition, the FRC proposes to change the Code's existing focus to stress the idea that the board should consist of directors "with the appropriate balance of skills, experience, independence and knowledge of the company." The existing version of the Code may tend to encourage a perception that independence is the primary consideration when assessing the board's composition. While the Code will still require at least half the board (excluding the chairman) to be independent, the wording of the revised Code draft is intended to emphasize that the board should look beyond the mere fact of independence when selecting nonexecutive directors and consider a candidate's skills, experience and knowledge as a whole.

- A proposed new provision recommends that an external evaluation of board performance be carried out at least every three years. The results of this evaluation process would be made public in the company's annual report. Additionally, the preface to the revised Code draft envisages that the chairman will report in each annual report on how the Code's principles relating to the board's role and effectiveness have been applied.

- There is no proposal to require companies to establish risk committees. This is in contrast to the recent recommendations published for banks and other financial institutions in November 2009 following the *Walker Review of Corporate Governance of the UK Banking Industry*. However, consistent with the focus in the United States and elsewhere on risk management of nonfinancial companies (See "A Renewed Focus on Board Assessment of Enterprise Risk"), several changes are proposed to strengthen the Code's guidance on risk management. These include requiring a clear statement in the company's annual report of the board's responsibility for defining the company's risk appetite and tolerance and maintaining a sound risk management system, and an explanation in the company's annual report of the company's business model and overall financial strategy. The

board will be required to satisfy itself that appropriate systems are in place to identify, evaluate and manage the significant risks faced by the company.

- The Code's position on compensation is to be revised slightly to require that performance-related compensation be aligned with risk policies and systems and that bonuses be risk-adjusted. It is proposed also that "nonfinancial performance metrics" be taken into account when considering compensation. The revised draft Code also requires that consideration be given to arrangements for reclaiming variable components of compensation in certain exceptional circumstances.
- The title of the Code will be changed to the "UK Corporate Governance Code." The FRC believes this will make the Code's status as the UK's recognized corporate governance standard clearer to foreign investors and foreign companies listed in the UK.

“The charge against directors is strident and indiscriminate — that they have failed to fulfill their responsibility to protect their companies, their shareholders and their country.”

Raising the Bar | A Self-Help Program for Re-Establishing Director Credibility and Combating Federal Preemption of State Corporate Law

In a Nutshell

This article[1] highlights that publicly traded business corporations and their directors have lost the confidence and trust of many, leading to an onslaught of proposed federal legislation which, if enacted, will catapult the federal government into the role of primary regulator of those companies and directors, which heretofore have been regulated under state law. This article further suggests that to stem this tide of federal intervention in an area central to our private enterprise system, U.S. public company directors must act promptly in a concerted, clear and convincing way to restore their credibility. Finally, this article proposes a program for doing so, premised on those directors voluntarily embracing a set of "Basic Principles of Director Oversight" publicly reflecting focused and real commitment by the directors to comprehensive, high-quality board oversight of corporate affairs.

The Current Environment

The financial crisis of 2008-2009 appears to have been largely overcome and the economic abyss it threatened has been averted. In its wake, however, is another quite serious threat. This threat is the product of a combination of circumstances: the psychological trauma of the financial crisis, severe real damage to the economic well-being and prospects of many Americans, a painful recession marked by massive job losses and unemployment, and, ultimately, an overwhelming need to lay blame. The target of this blame for many is American Capitalism — our private enterprise system — and, in particular, those with the responsibility for overseeing it, the boards of directors of the public companies that drive the system.

The charge against directors is strident and indiscriminate — that they have failed to fulfill their responsibility to protect their companies, their shareholders and their country. In particular, that they have missed — or worse, condoned — massive financial risk. And that they have permitted, indeed encouraged, overpayment of senior corporate executives and others and, in so doing, exacerbated out-of-control systemic risk.

Accusers seem to be everywhere — in the White House, in Congress, among financial and other regulators, among state attorneys general, in traditional print and electronic media, on Internet blogs, in the ranks of organized labor, in academia, among investors and on Main Streets across the country.

Loss of confidence and demands for more government regulation and intervention are a natural response to these types of situations — and this one is no exception. The call for "reform" seems to be everywhere, often wrapped in words of outrage against and mistrust of Corporate America and the directors who oversee it. And, in response, actions are being proposed on the legislative and regulatory fronts that would, if implemented, make sweeping changes in the role of the federal government in our economic system.

[1] This essay, which had earlier been circulated and has been published on *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, reflects the views of Peter Atkins, a senior partner of the firm, and are not presented as those of the firm. If you have any questions regarding the matters discussed in this essay, please call Mr. Atkins at 212.735.3700 or your regular Skadden contact.

Contributing Partner / Peter A. Atkins, Peter.Atkins@skadden.com, 212.735.3700

Of course, students of history might say this is all just a case of *déjà vu* and suggest that this cyclical repetition represents no threat at all. They could point to other examples in this country's history, including to the broad federal legislative response to the Great Depression and, more recently, to the enactment of Sarbanes-Oxley in response to the "Enron Era." And they could note, with some truth, that America survived the "excess" of federal legislation and government intervention in the economy each time, just like it survived the debacles which gave rise to the legislation and intervention.

However, we should find no comfort in this benign view of history or the lessons some might take from it. I and many others are genuinely concerned that the direction in which the federal government is heading in terms of involvement in the business of doing business is far too intrusive.

But that concern, however deeply and broadly shared and articulated, will not alone change anything. There is a convergence of power and purpose in Washington, supported by many voices around the country reflecting a loss of confidence in the private sector and those who oversee it. Bemoaning lack of confidence or trust, or the consequences that may flow from it, is not enough. What is needed is a re-establishment of confidence and trust.

The Perception of State Law Deficiency

To accomplish this requires a clear understanding of the problem. In this regard, a primary source of discontent with our current system is the perceived laxity of a central feature of state corporate law — the business judgment rule — in imposing meaningful responsibility on corporate directors. The business judgment rule was developed as a key mechanism for permitting informed, disinterested and rational decision-making (particularly risk-taking decisions) by directors on behalf of equity investors, without those directors being inhibited by constant fear of being second-guessed if and when decisions turn out less well than expected — and in some cases quite badly. Such a rule provides seemingly sensible, indeed necessary, protection in a system that relies on attracting private citizens to serve as corporate directors and oversee the management of the multiplicity of business corporations which fuel our economy.

However, the benefit of this important protection is being undermined by a growing sentiment that it promotes lack of accountability which, in turn, leads to poor oversight, excessive risk-taking and self-protectionism. Various state court decisions in areas such as executive compensation (*Disney*), risk oversight (*Citigroup*) and corporate governance (*Axcelis*) are cited as examples of the fallout of an overly protective and insufficiently demanding standard of conduct imposed on directors under state law.

Washington "To the Rescue"

As matters stand today, a wave of reactive proposed legislation has been introduced in Washington. None squarely proposes to abolish the business judgment rule. But the premise of this legislation is that the federal government must intercede in the traditionally state-governed area of oversight of business corporations because the current system is not working adequately. In short, directors are being accused of not doing their jobs because they are not held to a high enough standard of conduct under state corporate law, and the federal government must come to the rescue.

At the moment, the proposed federal legislative "fixes" aim at:

- **greater empowerment of shareholders vis-à-vis directors** (*e.g.*, mandatory majority voting in the election of directors, eliminating classified boards, requiring shareholder access to company proxy statements in the election of directors, granting shareholders the right to call special meetings, requiring cumulative voting and mandating annual "say-on-pay" votes by shareholders);
- **increased public disclosure about directors** (*e.g.*, regarding their experience, qualifications, attributes and skills), **about pay practices** (*e.g.*, disclosure of specific performance targets for incentive compensation, and disclosure regarding compensation paid to the lowest- and highest-paid employees and related matters) and about risk-taking (*e.g.*, discussion and analysis of risk-related overall compensation policies and practices for employees generally, if the risks arising from those policies and practices "may have" a material affect on the company, and disclosing the relationship of a company's overall compensation practices to risk management);
- **mandating certain board structural requirements** (*e.g.*, that every board have a risk committee, and that every board separate the board chair and CEO positions, and that the chair be independent); and
- **mandating certain specific pay practices** (*e.g.*, barring severance agreements for executives terminated for poor performance, requiring that executives hold equity awards until retirement, and requiring companies to develop and disclose claw-back policies).

Once this bridge is crossed — once Washington intercedes so directly and broadly in the regulation of state-chartered business corporations — there is no place to draw the line. It is entirely possible that the business judgment rule, and other important elements of corporate governance, will end up on the legislative chopping block in Washington. The checks and balances of federalism will no longer operate to prevent this.

A (Difficult) Path Forward

Some clearly would applaud this outcome. I would not — but that is beside the point. The real point is: Do enough people see this as a significant danger to our economic system (and to our political system of pluralism supported by respect for states' rights absent demonstrable and substantial systemic risk) that they are prepared to counteract the Washington tide — and, if so, how can this be done in a timely and effective way?

I offer the following suggestion as to "how." I believe the answer lies in the willingness and ability of public company directors across the country to unite in common commitment to a set of voluntary principles of conduct to demonstrate that vigilant, independent and honest oversight can be counted on as the driving forces of Corporate America.

The genesis of this suggestion lies in a comment by Chancellor William Chandler in the *Citigroup* decision. The chancellor observed that " … director liability is not measured [under Delaware law] by the aspirational standard established by the internal documents detailing a company's oversight system." The question it provoked is whether a set of principles could be developed for director conduct that would be higher than the standard of fiduciary duty (and potential liability for breach) attaching under state corporate law, and judged sufficiently meaningful and credible to warrant acceptance by current critics of director conduct and persuade Washington to stand down.

Not an easy task, I suspect, as a matter of substance, timing or persuasion. However, it seems one worth exploring as a means of upgrading the perception (and perhaps the reality in some cases) of board conduct without proceeding down the current path of federal government intervention.

Critical Elements

For any program of this nature to work, it would need at least the following critical elements:

- A set of Basic Principles of Director Oversight (Basic Principles) that reflect focused and real commitment to comprehensive board oversight of corporate affairs, including self-evaluation of compliance to reinforce quality oversight and support credibility.
- A means of galvanizing broad and demonstrable support for the program among U.S. public company directors.
- A mechanism for communicating that support to Washington and other constituencies promptly to, at minimum, slow down the federal legislative freight train now on the track effectively to preempt state corporate law.

Some Thoughts About Basic Principles

The Basic Principles should mandate that a board will be committed to identify and publicly disclose all key areas it determines are appropriate for board oversight. Among the key areas of oversight expected to generally be identified are: (1) financial systems, controls and reporting; (2) disclosure controls and reporting; (3) operations of material business segments; (4) identifying and understanding material risks inherent in and taken by the company, and evaluating the efficacy of the company's risk-management programs; (5) evaluating key management strengths, weaknesses and performance; (6) establishing and monitoring compensation policies and practices; (7) succession planning; (8) nominating and governance policies and practices; (9) health, safety and environmental policies and practices; (10) tax policies and practices; (11) diversity policies and practices; (12) asset protection policies and practices; (13) public/governmental affairs policies and practices; (14) privacy/data protection policies and practices; (15) corporate sustainability and reporting; and (16) other material company specific areas appropriate for board level oversight (*e.g.*, technology-related matters in a technology driven company).

The Basic Principles should mandate that a board identify, implement and disclose a responsible framework for performing quality board oversight. This framework would be expected to include, among other things: (1) in all cases a majority of, and in many cases exclusively, independent, disinterested directors performing the oversight function; (2) identification of desired/required director experience and skills for the particular oversight area; (3) use of outside advisors/consultants/specialists at the sole discretion of the board or committee performing the oversight function; (4) direct interaction with and support from appropriate company personnel; and (5) in some cases, attendance of directors at educational seminars/programs to obtain or enhance relevant knowledge.

The Basic Principles should mandate that a board will invite and evaluate commentary from its company's shareholders and employees as to (1) possible additional areas that should be the subject of board oversight and (2) possible improvements to the board's framework for performing quality oversight.

The Basic Principles should mandate that a board will evaluate annually whether it has fully satisfied each of the foregoing mandates and report its findings publicly.

And finally, the Basic Principles should mandate that a board go on record that it will, and expects each and every other company person to, act at all times honestly, with integrity and in compliance with law.

A simple and straightforward set of principles such as those set forth above represents a clear commitment to responsible oversight in a very public way. It will expose publicly the key areas of oversight as perceived by the board (and if shareholders or employees see it as too limiting, they will have a voice) as well as the directors' definition of a responsible framework for quality oversight (again subject to comment by shareholders and employees). By voluntarily subscribing to these principles, a board will be putting itself publicly on the line with all constituencies that its commitment is, to the best of its ability, to oversee the business and affairs of its company thoughtfully, carefully, comprehensively and proactively, and to send a clear message that such business and affairs are to be conducted legally and ethically. Having done so, directors are likely to be highly motivated not to fall short of their public commitment — even while voluntarily accepting a higher standard of conduct than may be imposed as a matter of fiduciary duty under state law.

Some Thoughts About Process

The program outlined above represents a positive initiative for those who oversee our private enterprise system to seek to regain credibility at a critical time. No doubt it has some flaws. But perfection is not the goal. An actionable plan is. And time is of the essence. A key ingredient for success is developing widespread support for the initiative and channeling it into effective communication on the Washington legislative front and to other important audiences. Existing director organizations may have a role in implementing this initiative; however, a grass roots response from independent boards across the full geographic and business spectrum of U.S. public companies may have a more potent impact. In addition, broader support than just from public company directors may be available (*e.g.*, from state governors and other officials, members of the U.S. Senate and House of Representatives, various investor groups and even shareholder activists who may see the affirmative commitment imbedded in the Basic Principles as a better step forward than federal legislative fiat). This support should be marshaled as well.

A Final Thought

The private enterprise system is central to America's strength and vitality. It should not be tampered with lightly. I believe that a commitment to responsible stewardship of this system by the key group responsible for overseeing it — the directors of U.S. public companies — should be given a chance. As a risk assessment matter, the risk that they will not keep that commitment is exceedingly small. On the other hand, the risk of harm to our system, intended and unintended, from Washington continuing on its current path of preemption of state corporate law is quite real. Taking that risk even without the program outlined above, and clearly with that program, is simply not a responsible act.

“ Today’s reality is not about the need for federal preemption of corporate governance regulation under state law. Yet, here is what seems to be happening.”

Raising the Bar | A Postscript

This postscript to *Raising the Bar: A Self-Help Program for Re-Establishing Director Credibility and Combating Federal Preemption of State Corporate Law*[1] is intended to expand on the proposition that U.S. federal preemption of state corporate law, particularly in the area of corporate governance, presents significant risk to America's private enterprise economic system. The current multipronged preemption effort is largely predicated on the view that it is necessary to forestall excessive risk-taking in the private sector. However, the federal preemption "cure" is a carrier of its own systemic disease. Before imposing this "cure," it is essential to make a responsible assessment of its need and consequences.

State Regulation of Public Business Corporations: A Cornerstone of Capitalism

The modern U.S economic system — variously called capitalism, free enterprise or private enterprise — is centered around the publicly traded business corporation organized under state law. It is the principal vehicle for gathering non-government capital, investing it and managing the businesses in which it is invested. Historically, the governance of these companies has been regulated by their states of incorporation, with limited exceptions. And, in general, the state law-based corporate governance model has been very respectful — indeed protective — of the core concepts of the U.S. private enterprise system: freedom, capital-raising, risk-taking, experimentation, innovation and value maximization. The model recognizes that publicly traded business corporations, as key enablers of the U.S. capitalist system, should be regulated in a manner that permits these core private enterprise concepts to operate with minimal interference.

The Price of Free Enterprise Is Eternal Vigilance

Economic systems can crash and burn — as we recently almost witnessed. Fortunately, the mechanisms in place and those that were quickly added permitted a rescue operation that averted the abyss.

However, economic systems also can die due to changes imposed on them and the vitality-sapping effects of such changes over time. The U.S. private enterprise system has worked remarkably well for more than 200 years. The fundamental productivity, creativity, adaptability, growth capacity, power and global leadership of our economic system cannot be denied. Like all systems, however, America's free enterprise economy faces the constant danger of systemic erosion due to (1) the failure of vigilance in continuing to recognize its importance and what makes it tick and (2) the desire to "improve" the system without identifying and carefully weighing the downside to the system of the improvements. Systemic erosion is a creeping phenomenon, without red flags flashing danger signals. Moreover, such erosion is susceptible to acceleration when systemic speed bumps occur (as is inevitable) and, in response, a heightened sense of the need for repair takes over (augmented, often, by political and special group agendas).

The Current Danger Zone

The U.S. appears to be in that danger zone right now. However, before examining that zone in greater detail, it needs to be noted that the thrust of this article is not a rant against government intervention in economic matters. The U.S. free enterprise system has never been perfectly free, nor should it be. Clearly there is a role for government regulation and oversight. And times of crisis can point out areas where a larger role is appropriate on a temporary basis and, in some cases, longer term.

[1] This essay reflects the views of Peter Atkins, a senior partner of the firm, and they are not presented as those of the firm. If you have any questions regarding the matters discussed in this essay, please call Mr. Atkins at 212.735.3700 or your regular Skadden contact.

Contributing Partner / Peter A. Atkins, Peter.Atkins@skadden.com, 212.735.3700

That said, today's reality is not about the need for federal preemption of corporate governance regulation under state law. Yet, here is what seems to be happening. In the aftermath of the financial system crisis of 2008, the publicly traded business corporation has come under siege by the federal government. The main assertion is that the near collapse of the financial system was the product of excessive risk-taking by Corporate America, permitted by lax directorial oversight and incentivized by excessive compensation practices. The proposed cure is federal preemption of corporate governance by enacting in Washington a raft of uniform federal "good governance" requirements for U.S. publicly traded business corporations. What seems to be missing is adequate identification and a true appreciation of the near- and longer-term adverse effects that could flow from these requirements.

It is not difficult to ask many questions that need to be answered before federal preemption is implemented — and the answers to these questions should have a direct bearing on whether any steps are taken in that direction and, if so, which ones. These questions include:

- Did U.S. public company boards and businesspersons really cause the financial crisis of 2008? What about all of the companies that were not part of the financial sector — were their directors and executives even involved? And what about the failure to regulate the financial markets in order to guard against "excessive risk" — was that a failure of private enterprise or of the federal government, including existing oversight agencies?

- Is there any demonstrable correlation between any of the proposed federally imposed corporate governance "fixes" and reining in "excessive risk-taking" — or even, for that matter, producing significantly better governance for all public companies? Even if so, is such improvement necessary to avoid material systemic risk to the U.S. free enterprise system?

- In the absence of a clear showing that it will result in the avoidance of material systemic harm, what is the justification for federal government preemption of corporate governance under state law?

- Have the proposed "fixes" been individually critiqued for the possibility of causing harm to the private enterprise system? If so, what is the assessment? For example, what is the potential negative effect of the increased empowerment of shareholders vis-à-vis directors on the need for risk-taking by directors as an essential element of capitalism and on the willingness of directors to serve on public company boards?

The Need for and Meaning of Responsible Assessment

The basic message is this: In assessing the need for and nature of governmental intervention to effect reforms today in our economic system, the federal government (both the executive and legislative branch) has a special duty to act responsibly. Acting responsibly should mean at least the following:

- Understanding — and placing a high priority on — the critical importance of the U.S. private enterprise system to America and all its people.

- Understanding — and guarding against unnecessary damage to — the core concepts on which the U.S. private enterprise system rests: freedom, capital-raising, risk-taking, experimentation, innovation and value maximization over time.

- Requiring (except for emergency actions in a time of crisis, which clearly is not present now) that every act of government intervention intended to affect the existing U.S. economic system undergo a rigorous economic impact assessment.
- Applying in such assessments a principle of restraint in the form of a presumption against intervention unless it is shown:
  - that the harm to be mitigated by the intervention is systemic and substantial;
  - by credible evidence, that the intended mitigation is very likely to be achieved; and
  - that the adverse effects, if any, of the intervention are not likely to have as great or greater systemic impact than the benefit to be obtained by the intervention.

A Final Word

The message from Washington to Corporate America appears to be: "You have a responsibility to stay alert, make informed decisions and not put at risk the system on which we all rely." If there was ever a time when Washington — the White House, the Senate, the House of Representatives, the Securities and Exchange Commission and other federal agencies — should heed its own advice, it is right now in relation to the attack by Washington on a cornerstone of capitalism, state regulation of public business corporations. And when Washington considers applying its medicinal powers to "cure" systemic ills, it should pay close attention to the medical aphorism, "First, do no harm."

Insights 2010 / Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

Intellectual Property and Information Technology

“Today, 45 states in the U.S. have laws requiring data breach notification, and the European Council recently approved such a rule for Europe’s telecom firms.”

Privacy and Data Security

In recent years, data privacy and information security have become increasingly important issues for most organizations. We expect this trend to continue, and even intensify, as senior executives are forced to deal with an ever-changing landscape of international, federal and state data privacy regulations, as well as a significant increase in both government regulatory activity and private class action lawsuits.

In 2009, data breaches resulted in the exposure of more than 220 million individuals' records, up from 35 million in 2008. Such breaches are costly, not only in terms of an organization's reputation, but also with respect to the expense of notifying affected individuals and attorneys general, remediating the breach and responding to lawsuits that may be filed. For example, a 2008 breach of the computer network at Heartland Payment Systems resulted in the theft of more than 130 million bank card numbers and was followed by the prompt filing of nearly 20 separate lawsuits in more than 10 judicial districts across the United States.

This past year also has seen an increase in the number of laws governing data breaches and information security. Today, 45 states in the U.S. have laws requiring data breach notification, and the European Council recently approved such a rule for Europe's telecom firms (with an expansion to financial services and health entities being debated). On the federal level, the Health Information Technology for Economic and Clinical Health Act was enacted, requiring notification for security breaches involving personal health information and specifying the technologies and methodologies that can be used to secure such information. In 2010, companies also will have to comply with new information security standards in Massachusetts (and potentially other states) as well as the FTC's "red flag" rules for detecting identity theft.

Companies need to take a number of steps to limit their risk and exposure in these areas. First, companies should implement a process for tracking their compliance with myriad data privacy laws, including through existing internal audit protocols. This is critical because a significant percentage of regulatory activity in this area involves companies that were not in compliance with their stated policies. Second, today's regulatory environment means that creating and implementing an effective information security plan requires the participation not only of technology experts, but also of legal counsel who can assess the plan from a compliance perspective. Third, companies should put in place a response team to deal with data security breaches. Typically, such teams are comprised of representatives from the technology, legal and communications groups who can manage the breach in a manner that minimizes a company's legal and reputational exposure. Taking these steps will limit "front-end" risk and be helpful on the "back end" in defending against class actions. (See "Mass Torts and Consumer Class Action Trends")

Finally, companies should be mindful that compliance with state data-breach notification laws can be costly, particularly given the trend for them to pay for a one-year credit watch for potentially impacted consumers. According to one study, a data breach easily can cost a company more than $200 per compromised record. Therefore, when negotiating liability caps in agreements with vendors who will have access to a company's data records, it is important that data breach violations be excluded from the cap or have a separate, higher cap so that the data owner has an appropriate level of protection.

Contributing Partners / James R. Carroll, James.Carroll@skadden.com, 617.573.4801 / David S. Clancy, David.Clancy@skadden.com, 617.573.4889 / Stuart D. Levi, Stuart.Levi@skadden.com, 212.735.2750

"The Ninth Circuit decision [in *Real Networks, Inc. v. DVD Copy Control Assoc., Inc.*] may be a milestone in interpreting the scope of DMCA prohibitions for all participants in digital media."

Copyright and Digital Media Litigation

2009 was a busy year in digital media copyright litigation. Novel approaches to copyright were tested as existing law was applied to evolving, new technologies. We expect this trend to continue through 2010, as businesses on both sides of the copyright fence continue to battle over the scope of copyright law in its application to digital media. Three of the most significant recent cases involve circumvention, actual knowledge and a new remote-storage DVR system.

Circumvention

Movie studios and the DVD Copy Control Association brought litigation against RealNetworks (*RealNetworks, Inc. v. DVD Copy Control Assoc., Inc.*) for violations of the Digital Millennium Copyright Act (DMCA) prohibition against trafficking in devices to circumvent technological measures that control access to a copyrighted work. In that case, a California district court issued an injunction barring RealNetworks from selling or licensing its RealDVD software:

- RealDVD software permits users to create and save personal copies of DVDs onto hard drives and, in doing so, circumvents technology that scrambles DVD content to render it unplayable unless decrypted.
- In response to RealNetworks' arguments that personal "backup" copies of DVDs are permitted under the "fair use" doctrine, the court noted that fair use is not an exception to the DMCA trafficking prohibitions.
- RealNetworks appealed.
- The Ninth Circuit decision may be a milestone in interpreting the scope of DMCA prohibitions for all participants in digital media.

Actual Knowledge and the DMCA Safe Harbors

Universal Music Group (UMG) brought a copyright infringement action in the Central District of California against Veoh (*UMG Recordings, Inc. v. Veoh Networks Inc.*), an online video hosting service. UMG argued that Veoh knew, or should have known, that infringing activities were being conducted through its service and thus should have removed that content to be eligible under the DMCA safe harbors. The court held for Veoh on the grounds that the safe harbors do not require affirmative policing of content, and there was no evidence of actual knowledge of infringing activity.

- UMG appealed.
- The Ninth Circuit decision may be important in determining the obligations of Internet service providers and Web sites regarding infringing content.

Cablevision's Remote-Storage DVR

The U.S. Supreme Court denied certiorari in the closely watched *Cablevision* case (*CNN v. CSC Holdings*) from the Second Circuit. Media and entertainment companies alleged that Cablevision's new Remote-Storage DVR (RS DVR) system infringes their copyrights. (RS DVR allows customers to record programs on Cablevision's central servers.) The Second Circuit found for Cablevision on three separate claims of copyright infringement:

Contributing Partner / Cliff Sloan, Cliff.Sloan@skadden.com, 202.371.7040 / **Counsel** / Mary Rasenberger, Mary.Rasenberger@skadden.com, 212.735.3565

- The buffer copies made by Cablevision are not infringing because the data resides in the buffer no more than 1.2 seconds, so they are not "copies" under the Copyright Act, which requires "more than transitory duration." The opinion gives little guidance about how long is "long enough": We know only that 1.2 seconds is too short to be a "copy," at least in the context of buffering in this case.
- Cablevision is not directly liable for the copy made for the customer's later playback because it is the customer, not Cablevision, who instigates the creation of that copy.
- There is no violation of the "public performance" right arising from the playback to the customer because it emanates from a unique copy designated solely for that customer, and thus, is not "public."

Other Cases of Interest

Other important digital media copyright litigation is pending. Viacom's copyright infringement suit against YouTube in the Southern District of New York — alleging that YouTube was hosting copyrighted video content with knowledge of its infringing nature — is still in discovery. Also in the Southern District, an amended settlement agreement is under consideration in the "Google Books" class action suit brought by publishers and authors against Google regarding its book digitization project. The amended settlement was submitted in response to objections to the initial agreement, and a hearing is scheduled for mid-February.

An Uncertain Future for Business Method Patents

The U.S. Court of Appeals for the Federal Circuit ushered in the era of the "business method" patent when it ruled in 1998 in *State St. Bank & Trust Co. v. Signature Fin. Group* that a method for converting data into a particular share price constituted a patentable invention. By confirming that a method of doing business could be the subject of a valid U.S. patent, the *State Street* decision precipitated a flurry of patenting activity in areas where patents previously had been unheard of, such as the financial services industry. Patenting activity also expanded dramatically in other areas such as Web-based methods and medical diagnostic techniques. The Federal Circuit's acceptance of business method patents also gave rise to a cottage industry of litigation enforcing business method patents, with many such cases filed by entities whose sole purpose was to acquire and enforce patents against large corporate institutions in notoriously plaintiff-friendly jurisdictions such as the U.S. District Court for the Eastern District of Texas.

In 2010, the U.S. Supreme Court will weigh in on the patentability of business method patents.[1] Specifically, the Supreme Court will review the Federal Circuit's 2008 *In re Bilski* decision, which reined in business method patenting by holding that a claimed process is "patent-eligible under [U.S.C. Section] § 101 if: (1) it is tied to a particular machine or apparatus, or (2) it transforms a particular article into a different state or thing." The Federal Circuit concluded in *Bilski* that certain methods of hedging risk in commodities trading were not patentable because the claims at issue were not limited to any specific machine and did not transform an article to a different state.

The adoption of this "machine-or-transformation" test by the Supreme Court could significantly impact the scope of patent-eligible subject matter and the validity of patents that were issued prior to *Bilski*, particularly in industries where business method patents are prolific, such as banking and financial institutions, online businesses and medical diagnostic businesses. In recognition of the possibility that the Supreme Court will affirm the "machine-or-transformation" test for patent eligibility, or otherwise limit the ability to patent business methods, companies already are taking steps to maximize the strength of their patent portfolios and bolster their positions in pending patent infringement suits. Such steps include:

- patent applicants modifying pending claims of any business method patent application so that claims are limited to specific machines, or revising the claims to require the physical transformation of an article into a different state or thing while simultaneously pursuing broader claims;
- patent owners reviewing their existing patent portfolios for compliance with the "machine-or-transformation" test, and where claims appear to be deficient, filing reissue applications to modify the scope of the claims accordingly; and
- alleged infringers of business method patents assessing the merits of validity challenges based on *Bilski* and, where appropriate, moving to amend the claims to include such a challenge or moving for summary judgment on invalidity on this basis.

[1] Further analysis of U.S. Supreme Court's potential adoption of the Federal Circuit's "machine-or-transformation" test in its 2008 *Bilski* decision can be found in the December 2009 edition of the *Skadden IP Review* at http://www.skadden.com/content/Publications/Publications1942_0.pdf.

Contributing Partner / Douglas R. Nemec, Douglas.Nemec@skadden.com, 212.735.2419

“Nearly all [agreements] require the App provider to license its trademarks to the smartphone provider both for use in a relevant App store and for marketing and promotional purposes.”

Trademark and Related Intellectual Property Considerations in Mobile Phone Applications

2009 was, among other things, the year of the App. Mobile phone applications (Apps) swiftly emerged in number and prominence, to the point where Apps now are becoming as important to mobile phone users as the use of the phone itself. The number of Apps is growing exponentially as they are created for virtually every aspect of human interest and interaction, whether social networking; locating the nearest restaurant, bank or store; or identifying and playing songs. Put simply, there appears to be an App for everything, and if there is not, there will be. As individuals' lives and attention increasingly are organized around and devoted to their Apps, businesses are following. Most businesses are in the process of developing and implementing App strategies in an effort to maintain and increase market share.

Prior to launching an App, a company should consider associated legal risks and how best to address them. First, many companies do not have the in-house capability to develop an App and, instead, partner with a third-party software developer. As software developers frequently create Apps for many of their clients, the company should determine in advance whether the particular technology (and perhaps purpose and functionality) of the App is to be owned exclusively by the company and, if so, provide for such in its App development agreement.

Second, prior to launching an App, the App provider must enter into one or more click-through App license agreements with the smart phone provider (App Agreements). Although App Agreements vary, nearly all require the App provider to license its trademarks to the smartphone provider both for use in a relevant App store and for marketing and promotional purposes. Many of the click-through App Agreements lack or contain limited quality control or other brand-protection provisions, and accordingly, the App provider should consider the potential legal and brand implications resulting from such potentially broad and unqualified grants. Since App Agreements generally are terminable on short notice, it is possible by monitoring the use of a company's marks by the mobile phone provider (either formally by engaging a trademark monitoring service or informally by relying on company employees to report misuses) to curtail misconduct with respect to the company's brand.

In addition, App Agreements typically require the App provider to indemnify against any third-party intellectual property infringement claims. Accordingly, companies should attempt to ensure that the trademarks and content in the App, and the technology underlying the App, do not infringe third-party rights.

In this connection, a company should consider potential risks if a third-party software development company launches the App on the company's behalf (which frequently occurs). In such instances, the technology provider and not the company would be the party to the App Agreement. Therefore, the company may have to rely on the technology provider to terminate the App Agreement at the company's request and to provide the company with relevant notices received from the smart phone provider. (Notices may include updates and modifications to the App Agreement, and contractual changes could affect the legal risks associated with launching and maintaining the App.)

Finally, as with all new frontiers in which brands are present, beware of counterfeits. Specifically, certain App publishers are labeling their applications with popular brands, without the authorization of the brand owner, to catch the attention of smartphone users. Accordingly, brand owners should consider adopting policies regarding monitoring and enforcement of their trademarks with respect to smartphone applications, akin to policing policies that they already pursue with respect to domain names and the Internet.

Contributing Partner / Bruce Goldner, Bruce.Goldner@skadden.com, 212.735.2972 / **Counsel** / Mary Rasenberger, Mary.Rasenberger@skadden.com, 212.735.3565

“The key to the hybrid approach is that the same vendor that is providing the outsourced services also houses the customer’s captive entity.”

Hybrid Outsourcing

Companies that have decided to move certain operations offshore often find themselves deciding between retaining a third-party outsourcing vendor and setting up a wholly owned "captive" subsidiary to provide the services. A captive provides certain benefits of outsourcing without many of the attendant risks. For example, using a captive entity allows a company to benefit from labor arbitrage or other cost savings that can be enjoyed through the use of employees in another country, but without sacrificing operational control. In other cases, a captive entity is useful when a company is concerned about providing a third-party outsourcer with access to the company's sensitive data or technology. However, captive entities do not provide the benefits that can be gained from outsourcing, such as transferring performance risk to the provider and obtaining best-of-breed services. In such cases, companies should consider using a "hybrid solution" that marries the benefits of the captive and third-party vendor approaches.

Under a hybrid model, a company outsources certain services to the third-party vendor and has the remaining services provided by a captive entity. The key to the hybrid approach is that the same vendor providing the outsourced services also houses the customer's captive entity, typically in the same building from which the outsourced services are being provided. The vendor also will provide the captive with infrastructure services such as computer networks, phone services and general administrative support. Therefore, the captive employees generally are in close proximity with their vendor counterparts, allowing for close integration and a strong working relationship.

The hybrid model, if structured correctly, provides the customer with maximum flexibility. The customer can include in its captive entity those services that are commercially sensitive or highly complex, that involve the use of confidential information or that cannot be outsourced for regulatory reasons. The vendor can provide those services that are less sensitive or that simply require the provision of processing capabilities. During the term of the agreement, the customer should have the ability to shift services between the captive and outsourced entities.

For example, the customer may not want to outsource certain sensitive processes until it is confident about the vendor's capabilities. The hybrid model allows the vendor to keep these services "in-house" at the captive entity, but then seamlessly migrate them to the vendor if/when appropriate. The employees working on this service would become employees of the vendor and could simply continue their same functions in a different part of the facility. Similarly, a customer could become concerned that certain outsourced services need to be managed internally or are under increased regulatory scrutiny. The customer could migrate these services from the vendor to the captive, this time simply by hiring the vendor employees who provide the service and having them work from the captive areas of the facility.

Creating a hybrid solution requires careful planning and contract drafting to address the various issues that could arise. However, once implemented, a hybrid solution can provide many customers with the benefits of both the captive and outsourced models with minimal risk.

Contributing Partner / Stuart D. Levi, Stuart.Levi@skadden.com, 212.735.2750

Insights 2010 / Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

Litigation/Controversy

“The Supreme Court has agreed to hear several cases this term that have significant ramifications across all sectors of the business community.”

U.S. Supreme Court Cases to Watch

Recently, the U.S. Supreme Court has taken a keen interest in cases affecting the business community, and that trend appears likely to continue in the current term. The Supreme Court's newest member, Justice Sonia Sotomayor, spent several years in a private commercial litigation practice, which may suggest that she has an interest in and familiarity with legal issues affecting private enterprise. It remains to be seen how her approach differs from that of her predecessor, Justice David Souter, in such important areas as the constitutional limits on punitive damages.

The Supreme Court has agreed to hear several cases this term that have significant ramifications across all sectors of the business community. Decisions in all of these cases are expected by July 2010.

- Three such cases involve the constitutionality and reach of 18 U.S.C. Section 1346, the statute that broadly attempts to criminalize the use of a "scheme or artifice to deprive another of the intangible right of honest services." *See Black v. United States*, No. 08-876; *Weyhrauch v. United States*, No. 08-196; *Skilling v. United States*, No. 08-1394. Although the statute originally was aimed primarily at misconduct by public officials, prosecutors have relied on it increasingly to pursue business executives and other private parties. Indeed, two of the cases are appeals of the convictions of former Hollinger CEO Conrad Black and former Enron President Jeffrey Skilling. *Black* claims that the statute should not extend to situations where the individual did not contemplate economic or other property harm to the party owed the honest services, and *Skilling* asserts that the statute should not extend to situations where the defendant undertook the conduct to advance an employer's interests rather than for private gain. A decision narrowing the law or declaring it unconstitutional would rein in some of the more egregious prosecutions.

- In *Hertz Corp. v. Friend*, No. 08-1107, the Supreme Court likely will decide how courts should determine a nationwide corporation's principal place of business for purposes of determining federal diversity jurisdiction. The outcome of the case could impact corporate defendants' ability to remove lawsuits filed in state courts to federal courts. The circuit courts have been divided over whether the principal place of a corporation's business is the location of its corporate headquarters or its "place of operations." The latter standard adopts a test that examines, among other factors, the primary location of a company's employees and sources of income. If the Supreme Court adopts this test, many nationwide corporations would be deemed to have their principal place of business in California, based solely on the size of that state.

- In *Shady Grove Orthopedic Associates, P.A. v. Allstate Ins. Co.*, No. 08-1008, the Court is considering whether a state legislature can prohibit federal courts from allowing state law claims to proceed as class actions. In this case, a New York law prevents plaintiffs from recovering on state law claims through a class action suit, unless the law creating the claim specifically allows class actions. The plaintiffs assert that the New York law is unenforceable in federal courts. The decision likely will determine the role that states will play in setting limits on class and other state claims litigated in federal courts.

- In *Morrison v. National Australia Bank*, No. 08-1191, the Supreme Court will confront when, if ever, foreign investors can bring a securities fraud action in U.S. courts against foreign companies for injuries sustained abroad as part of an alleged transnational fraud scheme that has a U.S. component. In this case, the plaintiffs seek recovery for alleged accounting fraud by a U.S. subsidiary of an Australian company that decreased the share prices of the Australian company on an Australian

Contributing Partners / Amy R. Sabrin, Amy.Sabrin@skadden.com, 202.371.7699 / Cliff Sloan, Cliff.Sloan@skadden.com, 202.371.7040

stock exchange. A ruling for the plaintiffs could subject many corporations headquartered abroad to securities litigation in U.S. courts, even where their stock is traded on foreign exchanges. A detailed discussion of this case appears in "The Year of 'Foreign-Cubed.'"

- The issue of whether class action arbitrations can be forced on parties that did not explicitly agree to arbitration of class claims is before the Supreme Court in *Stolt-Nielsen S.A. v. Animal Feeds International Corp.*, No. 08-1198, which is discussed in detail in "The *Stolt-Nielsen* Case and the Future of 'Class Action Arbitration.'"

- There are two other pending Supreme Court cases of note, which are discussed more fully elsewhere in this compendium. First, in *Jones v. Harris Associates L.P.*, No. 08-586, the Court is expected to address mutual fund independent directors' review of the advisory fees paid to fund investment advisers. (See "Impact of *Jones v. Harris Associates* on Fund Advisory Fees") Also, in *Bilski v. Kappos*, No. 08-964, the Supreme Court will consider the patentability of business methods. (See "An Uncertain Future for Business Method Patents")

Securities Class Action Filings Remain High

Behind the Numbers

Although the number of federal securities shareholder class actions filed in 2009 was slightly less than in 2008, it is still significantly higher than in 2005 and 2006, before the onset of the credit crisis.[1] Indeed, the 2009 figures are commensurate with the large number of filings in the wake of the bursting of the technology bubble earlier last decade. A significant portion of the 2009 filings continued to contain some credit crisis-related allegations, and more than half of the filings named a financial sector defendant. While credit crisis-related class actions declined in the latter half of 2009, the more standard cases, according to NERA Economic Consulting, made up for the difference. This includes suits brought by investors in various exchange-traded funds, and the health technology and services sector remains a prime target for securities class actions.

While the number of 2010 filings will depend on numerous factors, ranging from market volatility to the resources of plaintiffs' securities firms, expect that this year's filings will be at a level similar to those in 2008-09. Factoring in the numerous CDO/CDS litigations and other non-class action credit crisis suits filed in state and federal court would result in an increase in overall securities litigation in 2010. One certainty is that we will continue to see the resolution of a number of significant motions to dismiss, which will provide more guidance on the application of the heightened pleading standards to credit crisis securities litigation.

Motions to Dismiss Subprime Cases

- Not surprisingly, the battleground remains the application of the *Tellabs*, *Twombly* and *Iqbal* pleading standards. (See "*Iqbal*'s 'Tightened' Pleading Standards Subject to Debate and Potential Legislation")
- Many of the motions to dismiss filed in 2008 and 2009 remain sub judice, and a number of significant decisions are expected in 2010.
- For those motions that have been decided, the most common grounds upon which courts have dismissed subprime actions are the failure to plead loss causation and the failure to plead scienter adequately.
- Defendants in such motions must transport the court back in time to the midst of the credit crisis and the context in which disclosures were made. Plaintiffs have had difficulty differentiating a company's negative performance from the overall decline in the markets and the economy.
- Many courts have dismissed cases due to the plaintiffs' failure to plead scienter, noting that making only conclusory allegations that subprime assets should have been written down earlier or that the magnitude of a write-down or decline in a company's stock are insufficient to demonstrate a strong inference of scienter, especially in light of the overall credit crisis and market downturn.
- Sen. Arlen Specter (D-PA) has introduced a bill — The Notice Pleading Restoration Act — to circumvent the heightened pleading standards set out by the Supreme Court. If passed, this bill could minimize the pleading standards, thereby allowing numerous meritless suits to get by the motion-to-dismiss stage.

Contributing Partner / Scott D. Musoff, Scott.Musoff@skadden.com, 212.735.7852

Auction Rate Securities Cases

- The slight decline in securities class actions in 2009 also can be attributed in part to the reductions in auction rate securities (ARS) suits.
- For ARS class actions, 2009 was the year of the dismissal. At least for those firms that entered into regulatory settlements or repurchase agreements, the auction rate securities litigation by primary purchasers could be coming to end.
- The remaining ARS litigation will focus on so-called secondary and downstream purchasers (those that either did not buy directly from the firms managing the auctions or that were not otherwise covered by any repurchase obligations) and point-of-sale cases (non-class actions based on alleged misrepresentations or omissions in face-to-face transactions).
- These remaining cases still will face significant hurdles in light of the robust disclosure relating to the risks involved in ARS investments.

The Extraterritorial Application of the U.S. Securities Laws

- The reach of the U.S. securities laws to private actions brought against foreign corporations by foreign investors who purchased their shares on foreign exchanges (the so-called "F-Cubed" cases) continues to be of interest, and the Supreme Court will hear an appeal from the Second Circuit that dismissed an F-Cubed case. (See "The Year of 'Foreign-Cubed'")
- If the Investor Protection Act, recently introduced by Rep. Paul E. Kanjorski (D-PA) is passed, it will legislatively mandate a more expansive jurisdictional standard for extraterritoriality than that set out by the Second Circuit.

Statute of Limitations for Securities Class Action Suits — "Notice" or "Diligent Investigation"

- The Supreme Court heard argument on November 30 in the *Merck Vioxx* case, on appeal from the Third Circuit following the district court's grant of defendant's motion to dismiss for failure to file suit within the statute of limitations.
- Based on the oral argument, the Court may address whether so-called "inquiry notice" is sufficient to trigger the running of the statute of limitations, as well as whether the shareholder had to be on notice of scienter.

---

[1] Stephanie Pancich & Svetlana Starykh, NERA Economic Consulting: "Recent Trends in Securities Class Action Litigation: 2009 Year-End Update" (December 2009).

Credit Default Swap and CDO Litigation on the Rise

In 2009, the number of CDO defaults continued to rise, affecting hundreds of billions of dollars of CDOs and spawning an increase in structured financial product litigation. This litigation ranges from investor suits to actions by and against monoline insurers to trustee interpleader actions brought on by tranche versus tranche disputes.

Financial Institutions That Sponsored CDO Issuances Have Been Targets

Key targets of structured financial product litigation have been the financial institutions that sponsored and marketed CDO issuances. Generally, the claims have alleged that false statements and material omissions were made in connection with the marketing and structuring of the CDOs. As the number of CDO events of default increased, a commensurate number of actions have alleged that such arrangers misrepresented the quality of the underlying mortgage-backed collateral. This has been the case especially with products created at the peak and decline of the cycle. Other claims relate to the independence of the collateral manager and challenges to the deal structure, including the waterfalls and subordination priorities.

Sophisticated Plaintiffs and Disclaimer Language Are Key Defenses

One of the unique features of this type of litigation is the sophistication of the plaintiffs initiating it. Because of the significant dollar amount at stake, institutions that typically would refrain from litigation have begun to file actions, and we expect that trend to continue. Some recent suits have been brought by various monoline insurers that are considered some of the most sophisticated players in this arena.

In light of the sophistication of such parties, a key defense on motions to dismiss has been the lack of their reasonable reliance, especially in light of the disclaimer and other waiver language typically found in the underlying documentation. The underlying documents often contain language indicating that the counterparty/investor is capable of doing and has done its own due diligence, is not relying on any representations and understands the risks involved in such an investment. In such disputes, the level of specificity of the disclaimer/waiver language and how closely it tracks the alleged misrepresentations are major factors considered by the courts.

In the *VCG Special Opportunities Master Fund v. Citibank* and *CDO Plus Master Fund v. Wachovia* cases, the courts dismissed the complaints, in part, based on the sophistication of the plaintiffs and the disclaimer language contained in the documents. In opposing such motions, plaintiffs often raise the argument that the complication of the underlying structured financial products outweighs the sophistication of the plaintiff. In the *M&T Bancorp v. Gemstone* decision, for example, the court found that the complexity of the product countered the sophistication of the investor and denied the motion to dismiss. Several significant motions to dismiss still are pending and are expected to be decided in 2010, providing further guidance in this area.

Tranche v. Tranche Disputes, Disputes Over Documents and Interpleader Actions

Another key battlefield has been, and will continue to be, disputes between various stakeholders in a CDO. These disputes arise, among others, between senior noteholders and junior noteholders, between noteholders and trustees, and with the swap counterparties to the CDOs and credit default swaps.

Contributing Partner / Scott D. Musoff, Scott.Musoff@skadden.com, 212.735.7852

Because of the inherent complexities of these products (and, in some cases, the speed at which they were put together), often ambiguities, and even inconsistencies, exist in the underlying deal documentations. One such area has been disputes regarding documentation between the provisions governing the payment under the waterfall and the provisions governing the subordination of tranches. These ambiguities and the underlying complexities involved have created opportunities for various parties to raise disputes in an attempt to either realize any value that might remain or to forestall the payment of liabilities that may be owed. For example, in the seminal *Merrill Lynch International v. XL Capital Assurance* case, XL attempted to avoid obligations on several billions of dollars of credit default swaps by trying to create an ambiguity over certain voting rights provisions. In granting summary judgment, the court rejected this endeavor and held the parties to the language of the agreements.[1]

Such disputes manifest themselves in a variety of ways, including interpleader actions brought by trustees that allow a trustee facing competing instructions from parties to force the dispute into court. Other actions are brought by parties seeking declaratory relief, or for breach of contract and disputes over the occurrence of an event of default. A key in both prosecuting and defending these types of disputes is to find a way to simplify very complicated material and educate the court and factfinder as to the intended purpose and operation of the mechanics of the deal.

[1] Skadden represented Merrill Lynch in this case (*Merrill Lynch International v. XL Capital Assurance et al.*, 08-cv-2893 (S.D.N.Y.)).

Iqbal's 'Tightened' Pleading Standards Subject to Debate and Potential Legislation

Last year, the U.S. Supreme Court decided *Ashcroft v. Iqbal*, which clarified its 2007 holding in *Bell Atlantic Corp. v. Twombly*. In *Twombly*, the Supreme Court officially declared dead the long-criticized 50-year-old case of *Conley v. Gibson*, which held that before a court dismisses a complaint, it must appear "beyond doubt that the plaintiff can prove no set of facts in support of the claim which would entitle the plaintiff to relief." Under the *Twombly* standard, a plaintiff can only survive a motion to dismiss by alleging sufficient facts to show that his or her claim is plausible on its face, and "thread-bare recitals" and "conclusory statements" do not suffice. At the outset, application of the *Twombly* holding was relatively limited, as lower courts struggled with whether *Twombly* was confined to the antitrust context in which it was decided or otherwise limited only to particularly complex cases. In *Iqbal*, the Court made clear that *Twombly*'s "plausibility" standard applied to all civil cases.

The immediate reaction of commentators to *Iqbal* was that it tightened pleading standards significantly and would provide defendants with a robust argument in favor of disposing of factually baseless claims prior to the initiation of expensive discovery. In some respects, such predictions have proven accurate. Courts of appeal have invoked *Iqbal* to affirm district court dismissals of complaints in various contexts. For example:

- The Sixth Circuit affirmed dismissal of a trademark infringement claim, concluding that the plaintiff had failed to plead likelihood of confusion when the complaint merely stated that there was a "strong likelihood of confusion in the marketplace as to the source or origin and sponsorship of the goods of the Plaintiff and Defendant." The allegations were too "formulaic" under *Iqbal*, and the plaintiff's speculation that "facts *may exist* to establish a level of consumer confusion" failed to state a claim that was "plausible on its face."

- The Ninth Circuit affirmed dismissal of claims by factory workers against a retailer that purchased goods from the workers' factories. The plaintiffs' allegation that they were the retailer's employees because the retailer "exercised control over their day-to-day employment" was a conclusion that the court was not required to accept as true.

- The Eleventh Circuit affirmed dismissal of claims brought against a soft drink manufacturer under the Alien Tort Claims Act, concluding that the plaintiffs' recitations concerning state action and conspiracy were too conclusory to state a claim.

Some who have studied the effects of *Iqbal*, however, have suggested that it has only resulted in the dismissal of cases that were clearly meritless and that would have been dismissed previously as well. In addition, new data collected by the Judicial Conference shows no significant increase in the rate of dismissals since the *Iqbal* and *Twombly* rulings.

Certainly, citing *Iqbal* is no guarantee that defendants will prevail on motions to dismiss. For example:

- The Third Circuit reversed the district court's dismissal of an employment discrimination claim, concluding that *Iqbal* applied in the employment discrimination context, but that allegations as to "how, when and where" were sufficient to satisfy the "plausibility paradigm."

- The Seventh Circuit affirmed the district court's dismissal of a fraud claim. However, the court distinguished *Twombly* and *Iqbal*, concluding that *Twombly* involved complex and costly litigation and *Iqbal* involved defendants who were high-level officials not to be "deterred [or] detracted from the

Contributing Partner / Peter B. Morrison, Peter.Morrison@skadden.com, 213.687.5304

vigorous performance of their duties" — two reasons to dismiss a suit in its early stages that are not present in all litigation.

- The Eighth Circuit reversed the district court's dismissal under *Iqbal* of claims arising under the Employee Retirement Income Security Act. The Circuit Court found that the district court erred by ignoring reasonable inferences in the plaintiff's favor and by drawing inferences in the defendants' favor, while faulting the plaintiff "for failing to plead facts tending to contract those inferences."

Congress is considering two bills (S. 1504 and H.R. 4115) that would seek to impose the defunct and unworkable standard from *Conley v. Gibson* (and eviscerate the long-standing heightened pleading standards for fraud claims under Federal Rule of Civil Procedure 9(b)). Such legislation would prohibit federal judges from dismissing a case unless "it appears beyond doubt that the plaintiff can prove no set of facts in support of the claim which would entitle the plaintiff to relief." While the exact forms of the bills are expected to change as they move through the legislative process, they may receive full committee consideration and advance to floor debate in both houses during the first quarter of 2010.

Class Action Fairness Act Developments

The Class Action Fairness Act of 2005 (CAFA) is intended primarily to: (1) expand federal court jurisdiction by making it easier for defendants to remove to federal court high-stakes class actions originally filed in state court; and (2) create a "Consumers' Class Action Bill of Rights" that protects against unfair class action settlements. During the last year, federal courts and litigants have debated whether and how CAFA impacts securities class actions. Amid this debate, the following two issues surfaced:

The Removability Under CAFA of Claims Brought in State Court Based on the U.S. Securities Act of 1933

- During the last year, courts have grappled with a statutory conflict between the U.S. Securities Act of 1933 (the '33 Act) and CAFA regarding whether claims initially filed in state court arising under the '33 Act for alleged false and misleading statements in registration statements or prospectuses may be removed to federal court under CAFA. The conflict arises because the '33 Act contains an anti-removal provision purporting to prohibit the removal to federal court claims asserted under that statute, while CAFA expressly permits the removal of actions asserting certain claims under the '33 Act.
- While this potential conflict has existed since CAFA was passed, the issue recently resurfaced because the financial crisis spawned a number of class actions brought by purchasers of mortgage-backed securities asserting claims under the '33 Act that would otherwise be removable under CAFA.
- A split of authority has developed over this issue. The Ninth Circuit held in *Luther v. Countrywide Home Loans Servicing LP*, 533 F.3d 1031 (9th Cir. 2008), that claims under the '33 Act cannot be removed under CAFA because the '33 Act has an anti-removal provision. Meanwhile, the Seventh Circuit in *Katz v. Gerardi*, 552 F.3d 558 (7th Cir. 2009), and a district court in the Southern District of New York in *New Jersey Carpenters Vacation Fund v. HarborView Mortgage Loan Trust 2006-4*, 581 F. Supp. 2d 581 (S.D.N.Y. 2008), both rejected the Ninth Circuit's view, holding that CAFA permits removal of all class actions of national import, even those that assert claims under the '33 Act.
- Notably, following the *Katz* and *HarborView* decisions permitting removal of the '33 Act's claims, the author of the California District Court opinion affirmed by the Ninth Circuit in *Luther* observed that there appear to be "nonfrivolous arguments for a change in the law [in the Ninth Circuit] due to post-*Luther* developments." *Public Employees' Retirement System of Mississippi v. Morgan Stanley*, 605 F. Supp. 2d 1073, 1075 (C.D. Cal. 2009).
- This split of authority remains important because the differences in how various circuit courts of appeals address this issue may lead to forum shopping by plaintiffs who seek to preserve a state court venue. Defendants, on the other hand, typically prefer to litigate federal securities law claims in federal court, where the majority of securities cases are filed. The ultimate resolution of this jurisdictional conflict remains unknown, but courts likely will continue to debate the interplay of the '33 Act and CAFA until either the Supreme Court or Congress intervenes.

CAFA's Settlement Notice Requirements

- Another issue receiving growing attention is the purported notice requirement pursuant to CAFA's "Consumers' Class Action Bill of Rights," 28 U.S.C. Sections 1711-1715, requiring defendants to notify various government actors before a federal court may finally approve a class action settle-

Contributing Partner / Peter B. Morrison, Peter.Morrison@skadden.com, 213.687.5304

ment. While commentators have questioned whether the notice provisions in the "Consumers' Class Action Bill of Rights" apply to securities class actions, the statute's text appears to extend to all class actions filed in federal court, including securities class actions.

- The application of this notice requirement is significant because the penalty for noncompliance is harsh: "A class member may refuse to comply with and may choose not to be bound by a settlement agreement" if the defendant fails to satisfy CAFA's notice requirements. 28 U.S.C. Section 1715(e)(1).

- Generally CAFA requires that, within 10 days of the filing of any class action settlement, notice be given to the U.S. Attorney General and the "appropriate State official" located in each state in which class members reside. 28 U.S.C. Section 1715(b). The notification must include, among other things, "the names of class members who reside in each State" or, if not feasible, "a reasonable estimate of the number of class members residing in each State." 28 U.S.C. Section 1715(b)(7)(A),(B). The notice also must identify for each state "the estimated proportionate share of the claims of such [state's] members to the entire settlement." *Id.*

- Compliance with the statute, however, is complicated. As an initial matter, because the notice must issue within 10 days of filing a class action settlement with the court, such notice often must issue before the court has set a date for a hearing on final approval of the settlement at issue. This timing renders notification to the required government actors of the date of the final fairness hearing within the 10-day time frame difficult, if not impossible. Moreover, including the names or a reasonable estimate of class members in each state is difficult for nationwide securities class actions, particularly because most securities are held in "street name" by a broker, and not by the actual security holder.

- Given (1) the difficulties associated with strict compliance with the notice requirements; (2) the suggestion that Congress did not intend the notice provision to apply to securities, as opposed to consumer class actions; and (3) failure to comply may undermine the *res judicata* effect of the settlement, litigants should remain focused on CAFA's notice provisions in connection with any class action settlement.

The White Collar Crime Law Enforcement Agenda

As much as prosecutors would like to pick and choose which matters they will pursue in any year, criminal law enforcement is a reactive business. Events in the broader economy, or a serendipitous development such as the arrival of an important cooperator at the Department of Justice's (DOJ) door, often drive law enforcement priorities. Rarely does a prosecutor get to set the agenda for the coming year. While crystal-ball gazing also is a low-probability enterprise for white collar defense lawyers, we do see a series of trends that likely will influence the law enforcement agenda in 2010:

- The 2008 credit crisis prompted a series of government investigations and prosecutions, and the initial wave of credit crisis cases came in 2009. In 2010, we expect there to be additional prosecutions or enforcement actions.
- The credit crisis also brought foreseeable criticism of the DOJ and civil regulators for not getting out in front of events. Although the decibel level of that criticism is finally dying down, the increased focus on financial crime has resulted in an increase in resources devoted to white collar prosecutions. More vigorous law enforcement should follow.
- Extraterritorial law enforcement is here to stay. Numerous U.S. criminal statutes reach the conduct of U.S. citizens outside the United States. We expect that the DOJ will continue to see itself as a global prosecutor.
- Historically, the U.S. Attorney's Office in the Southern District of New York has led the charge in white collar criminal prosecutions. In 2009, both the DOJ Frauds Section and the SEC filled senior and key leadership positions with alumni from that office. As a result, we expect that the DOJ and the SEC will be more aggressive and, perhaps, more successful.
- It is a fair question whether white collar law enforcement is more effective when it targets institutions or when it targets individuals. In the current environment, we see the sword swinging in the direction of individuals.

The 2010 Law Enforcement Agenda

Insider trading has returned to the top of the DOJ's agenda. Last autumn, the U.S. Attorney's Office in the Southern District of New York charged 14 hedge fund executives and their associates in a wide-ranging series of insider trading cases. The government has alleged that the Galleon Group was at the hub of a multispoked insider trading wheel, and that Galleon executives collected material, nonpublic information from a wide variety of sources.[1] Already there have been guilty pleas in the case, and we expect that in 2010 the government will prosecute the remaining defendants aggressively. Of greater interest is whether the government will be able to "flip" key defendants in the Galleon matter and use information provided by them to make cases against other individuals or institutions. Press reports indicate that the government's ambitions extend beyond Galleon to the wider hedge fund community. It has been reported that the SEC has sent at least three dozen subpoenas to hedge funds and brokerages as part of a sweep for potential insider trading violations.

Regulators also have indicated their willingness to push insider trading prosecutions into new areas, including those related to financial products. For example, in May 2009, the SEC charged two individuals with insider trading in connection with credit default swaps. We expect that the government will

Contributing Partners / John K. Carroll, John.Carroll@skadden.com, 212.735.2280 / Richard Marmaro, Richard.Marmaro@skadden.com, 213.687.5480 / David M. Zornow, David.Zornow@skadden.com, 212.735.2890

continue to use the "misappropriation" theory to bring insider trading cases against professional traders in markets other than the traditional equities market.

Extraterritorial conduct remains a focus of government resources. Last year was another landmark year for FCPA enforcement, and the coming year likely will yield even more FCPA actions against both companies and individuals. One trend to look for is increased enforcement against individuals and foreign companies and executives. In a recent speech, Lanny Breuer, the assistant attorney general in charge of the Criminal Division at DOJ, stated that his division will be looking at corruption in the pharmaceutical industry in particular. The possibility of bribery in the industry is widespread, as pharmaceutical companies regularly interact with government health officials in many emerging markets. The DOJ also has stepped up its efforts to prosecute foreign officials for conduct relating to foreign bribes. In a recent case involving a bribery scheme in Haiti, the DOJ charged the U.S. actors with FCPA violations. Because FCPA jurisdiction does not reach foreign government officials, the Haitian officials involved in the corrupt conduct were charged with money laundering violations.

We also expect a continuing government focus on OFAC and cartel violations. In each of these areas, as with FCPA violations, companies with U.S. operations doing business overseas confront the difficult challenge of implementing U.S. business and ethical norms in markets where non-U.S. competitors may be adopting less-upright business standards.

Credit crisis cases. Finally, we also see 2010 as the year when the DOJ and the SEC try to bring to a conclusion their efforts to apportion blame for the 2008 meltdown in the financial markets. The recent acquittals in the Bear Stearns prosecutions highlight the difficulties that the government has faced in identifying and convicting financial institution professionals of crimes relating to the crisis. In that prosecution, the executives were accused of conspiring to mislead investors about the worth of certain funds. After a lengthy trial, the jurors were not convinced that the defendants intentionally misled investors. We expect the government's efforts to blame individuals for the systemic meltdown to continue.

Strategic and Tactical Choices

New sheriffs in town. Obama appointees at the DOJ, in the U.S. Attorneys' Offices and at the SEC are entering their second year in office. With their offices tainted by the Madoff scandal and the collapse of numerous financial institutions, all have uniformly pledged to take very aggressive action to combat white collar crime.

One sign of this aggressive posture already is public. In the *Galleon* matter, the DOJ employed court-approved wiretaps on multiple telephones used by the defendants. To date, wiretaps have, almost without exception, been used to investigate narcotics trafficking, organized and violent crime, and terrorism. While it remains to be seen whether law enforcement will commit the resources necessary to support wiretaps in multiple cases, their widespread use would add a very powerful tool to the government's kit.

Institutions or individuals. Perhaps the most interesting issue to watch in 2010 will be how the government apportions blame between institutions and individuals. Misallocation of punishment is one of the flaws in a prosecution strategy that punishes corporations for the conduct of their former managers. Because the shareholders and, frequently, the managers of an institution may have changed several times between the time of misconduct and the time of prosecution and punishment, corporate prosecutions almost always impose punishment on an innocent generation of owners. In his September

2009 decision in *SEC v. Bank of America Corp.*, Judge Jed Rakoff challenged the idea of resolving investigations by blaming the institution without punishing any of its managers. In the decision, Judge Rakoff rejected a $33 million SEC settlement with BOA over bonuses paid to Merrill Lynch executives. Rakoff rebuked the SEC for its failure to prosecute individuals who made the decisions about what to tell the BOA shareholders, and called the settlement a "contrivance designed to provide the SEC with the façade of enforcement." We expect that the *Bank of America* decision will make it harder for corporations to protect their employees when they resolve cases.[2]

The targeting of individuals will not be limited to financial crisis investigations. The DOJ has shown an increased willingness to pursue individuals in FCPA cases as well. Recently, Mark Mendelsohn, the outgoing chief of the FCPA unit at the DOJ was quoted as saying, "to really achieve the kind of deterrent effect we're shooting for, you have to prosecute individuals."

Prosecutorial misconduct. In the recent Broadcom options backdating case and in the prosecution of former Sen. Theodore F. Stevens (R-AK), the DOJ suffered two very prominent black eyes.[3] In both cases, the courts found the line prosecutors engaged in acts of misconduct as they overzealously pursued convictions while losing sight of their responsibility as federal prosecutors to be fair. Justice Department leaders will find themselves in a difficult position in 2010. While Congress and the public are placing extreme pressure on law enforcement institutions to step up their efforts to combat perceived financial crime, judicial rulings are making clear that prosecutors cannot engage in conduct that causes the public to lose confidence in the fairness of the process. We expect judges to continue to hold prosecutors to a very high standard because the DOJ's reputation has been tarnished, which may make the courts a more hospitable environment for defendants who wish to take their cases to trial in 2010.

---

[1] Skadden is representing Rajiv Goel, managing director of Treasury at Intel Capital, and New Castle Partners LLC in connection with this matter.

[2] Skadden represented Merrill Lynch in the U.S. District Court for the Southern District of New York in connection with a derivative action related to the Bank of America/Merrill Lynch merger.

[3] Skadden represented William Ruehle, former CFO of Broadcom, in this matter.

“Foreign plaintiffs increasingly are using U.S. courts to sue companies for incidents that occurred abroad.”

Mass Torts and Consumer Class Action Trends

In 2009, the plaintiffs' bar began a coordinated attempt to undo the legislative and case law developments that had somewhat leveled the playing field for corporate defendants in mass tort and consumer class action litigation. In 2010, the assault will continue, presenting the defense bar and companies with challenging battles to wage in the courts, Congress, state legislatures and beyond on such issues as the following:

- After the Supreme Court's decisions in *Dura*, *Twombly* and *Iqbal* (see "*Iqbal*'s 'Tightened' Pleading Standards Subject to Debate and Potential Legislation") made clear that plaintiffs must plead the basic facts that support their claims, congressional leaders sought to remove motions to dismiss from the defense arsenal by introducing legislation to change the governing pleading standards. Some proposals seek to impose a literal interpretation of *Conley v. Gibson* that was never the law and would make dismissal nearly impossible. Notwithstanding claims to the contrary, however, there has been no "tidal wave" of dismissals that would warrant Congress usurping the Judicial Conference's authority to study and propose changes to the Rules of Civil Procedure.

- Increasingly, state attorneys general are seeking aggregate relief on behalf of citizens, under the rubric of consumer fraud and other state statutes, often by deputizing consumer class action lawyers to litigate the claims. This trend will expand significantly if Congress passes various bills, giving state AGs the right to "enforce" federal laws by seeking "restitutionary" relief.

- After the California Supreme Court held in *In re Tobacco II* that absent class members need no injury to have standing under California's Unfair Competition Law (UCL), there was fear that the gains made by defendants under Proposition 64 (which required a UCL plaintiff to have an injury) might be eviscerated. But several recent appellate cases in California have upheld trial court decisions denying class certification under pre-*Tobacco II* law, substantially reducing the effects — for now — of the California Supreme Court's ruling.

- Third-party litigation financing already exists in Europe and is coming to the United States. It should be regulated closely and disallowed in the consumer class action/mass tort context.

- Forms of consumer class actions are spreading to Europe and South America and are rampant in Canada. If "aggregate litigation" is the wave of the future across the globe, companies need to focus on ensuring that the worst provisions of the U.S. system are not exported abroad.

- Foreign plaintiffs increasingly are using U.S. courts to sue companies for incidents that occurred abroad. U.S. defendants must continue to use forum *non conveniens* motions and fight the expansion of the Alien Tort Claims Act if the U.S. is to avoid becoming the world's tort litigation forum.

- Although the consumer class action plaintiffs' bar is making efforts to loosen class action standards, the defense bar has made good law on — and must defend vigorously — the following issues:

  – **Class Definitions.** The class must not be "overbroad" such that it contains people who are uninjured, it must not be "indefinite" such that one cannot know who is in the class at the outset, and it cannot have a "fail-safe" definition that turns on a resolution of the merits.

  – **Trial Plans.** Courts are being urged to analyze rigorously how the case is going to be tried manageably, with plaintiffs being required to submit a detailed trial plan.

Contributing Partners / J. Russell Jackson, Russell.Jackson@skadden.com, 212.735.7839 / Jessica D. Miller, Jessica.Miller@skadden.com, 202.371.7850

- **Choice of Law.** Despite plaintiffs' attempts to impose the law of the manufacturer's residence on all class members, nearly all courts hold that the "place of the tort" is where each class member resides and used the product.
- **Tolling.** Depending on the jurisdiction, the filing of a class action may toll the statute of limitations for absent class members, but it does not toll the statute of limitations for subsequent class actions.
- **Issues Classes.** Most courts hold that an issues class cannot be certified in cases where the class overall does not meet the requirements of Rule 23(b), and defendants must resist attempts to use Rule 23(c)(4) to certify issues-only classes.
- **Classwide "Statistical" Proof.** Most courts reject presumptions of reliance and fluid recovery to infer injury, causation and damages across the class, but "price differential" theories continue to present challenges.

Litigation Targets

The consumer class action plaintiffs' bar likely will pursue the following in 2010:

- **Medicines and Medical Devices.** Any time a negative study comes out, or a significant label change is made, expect consumer class actions, *qui tam* suits and state AG investigations seeking "restitution" on behalf of third-party payors, governments and patients.
- **Food and Beverages.** It is increasingly easy to bring consumer fraud claims under state statutes, and food and beverages are among the consumer products with the most claims based on product composition and alleged false advertising.
- **Energy, Mining and Transportation.** Climate change litigation has passed initial hurdles and is moving into the public consciousness, although proximate cause still is challenging for plaintiffs.
- **Plastics and Packaging.** The global mistrust of Bisphenol-A (BPA) means more lawsuits against the makers of children's products and food and beverage containers.
- **Tobacco.** The post-*Engle* era has individual plaintiffs trying to score judgments with "common liability findings" derived from the trial of a decertified class action.
- **Privacy.** Entities that hold identifying information about large numbers of individuals will face class action lawsuits where such information is stolen or inadvertently disclosed. (See "Privacy and Data Security")
- **Technology.** Technology products, such as cameras, computers, printers, digital music players, televisions and video game players, continue to evolve with new features and designs, making them targets for breach of warranty and consumer fraud suits.
- **Advertising in General.** Expect increased regulatory and court scrutiny of all forms of product advertising (food, drugs, beverages, toys), based on the underlying theory that consumers are "victims who are not responsible for their actions."

Mass Tort and Consumer Class Action Plaintiffs' Litigation Tools

Plaintiffs will rely on the following:

- **"Equitable Relief" and "Declaratory" Class Actions** – to attempt to avoid Rule 23(b)(3)'s "predominance" and "superiority" requirements;
- **State Consumer Fraud Acts** – to take advantage of proof standards that are lower than common law fraud, as well as statutory multipliers and attorneys' fees;
- ***Qui Tam* Suits** – to take advantage of favorable relator recovery provisions;
- **RICO** – to avoid the conflict-of-law problems inherent in national class actions involving state consumer fraud acts;
- **Public Nuisance** – to take advantage of loose language in opinions regarding the elements of such claims;
- **Unjust Enrichment** – despite growing scepticism by courts, as an alternative to traditional tort and warranty claims; and
- **Medical Monitoring** – although most courts have rejected medical monitoring as a separate cause of action, recent successes in West Virginia and Massachusetts will ensure continued pleading of this cause of action where plaintiffs have suffered no present physical harm from exposure to a product.

“The shipping companies have vigorously attacked the propriety of allowing a class action where the parties have not explicitly agreed upon such a procedure.”

The *Stolt-Nielsen* Case and the Future of 'Class Action Arbitration'

In December 2009, the U.S. Supreme Court heard oral argument in *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*, which raises the issue of "[w]hether imposing class arbitration on parties whose arbitration clauses are silent on that issue is consistent with the Federal Arbitration Act."[1] The Supreme Court's decision may have significant implications for companies that include arbitration clauses in their standard terms and conditions, particularly in the credit card and other consumer-related sectors, which have witnessed a spate of "class action arbitrations" in recent years.

The dispute in *Stolt-Nielsen* began in 2003 when a group of plaintiffs, purporting to represent all buyers of parcel tanker shipping services, attempted to bring an antitrust class action in a U.S. federal court against a group of shipping companies, accusing them of "horizontal" price fixing in the world market for parcel tanker shipping services. In 2004, these claims were referred to AAA arbitration pursuant to the arbitration clauses in the parties' contracts.

Once forced into arbitration, the buyers applied to bring all their antitrust claims together as one "class action arbitration." They did so under the AAA's recently enacted Supplemental Rules for Class Action Arbitration — rules that were promulgated in light of *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 444 (2003), an earlier Supreme Court case holding that parties have the power to consent to having "class actions" adjudicated by an arbitrator. Over the shipping companies' objections, the buyers obtained a ruling — ultimately upheld by the U.S. Court of Appeals for the Second Circuit — that the claims could indeed proceed as a "class action arbitration."

In mid-2009, the Supreme Court indicated it would review this decision and determine whether, in the absence of specific contractual language authorizing class action arbitration, such an action could proceed over the objections of the respondents in the arbitration.

In their briefs and during oral argument, the shipping companies have vigorously attacked the propriety of allowing a class action where the parties have not explicitly agreed upon such a procedure. Imposing class arbitration where the parties have not agreed to it, they argue, "cannot be reconciled with th[e] [Supreme] Court's mandate that arbitration under the [Federal Arbitration Act] is a matter of consent, not coercion." Involuntary class action arbitration, they argue, "fundamentally alters the risks and benefits of the original arbitral bargain" and "transforms bilateral, inherently limited commercial disputes into sprawling, high-stakes matters that the parties never agreed to resolve without the safeguards afforded by actual litigation (such as full appellate review)."[2]

For their part, the buyers urge that "[c]lass proceedings are not incompatible with arbitration," the AAA's class action arbitration procedures are adequate to handle such matters, and the *Bazzle* case expressly permits class action arbitration.

Should the Supreme Court side with the buyers and dismiss the appeal, class action arbitration under the AAA rules and other procedures may continue to increase. If, however, the Supreme Court upholds the appeal and answers the question presented in the negative, this could have a profound effect on the future of class action arbitrations. In such a scenario, these appeals only will be possible where arbitration clauses specifically permit them. Effectively, a win for the shipping companies will force participants in the market to determine whether class action arbitrations are more desirable than class actions conducted in a judicial forum.

Contributing Partners / Lea Haber Kuck, Lea.Kuck@skadden.com, 212.735.2978 / Timothy G. Nelson, Timothy.G.Nelson@skadden.com, 212.735.2193 / Marco E. Schnabl, Marco.Schnabl@skadden.com, 212.735.2312

The *Stolt-Nielsen* case also may have an effect on the practice of inserting so-called class action arbitration waivers in standard agreements. In recent years, reacting to *Bazzle*, many companies have attempted to avoid class action arbitrations by including "class action arbitration waivers" in their standard contractual arbitration clauses. In one recent case, *In re American Express Merchants' Litigation*, 554 F.3d 300 (2d Cir. 2009), the Second Circuit struck down an arbitration clause "preclud[ing] the signatory from having any claim arbitrated on anything other than an individual basis." In doing so, the Second Circuit held that, by denying parties the right to pursue small claims as part of a larger class, the arbitration clause created a procedure that was prohibitively expensive, and thus invalid.

The *American Express* case is itself the subject of a pending certiorari application to the Supreme Court in which the petitioners strongly argue in favor of the validity of class action arbitration waivers. But, if the Supreme Court upholds the shipping companies' arguments in *Stolt-Nielsen*, it may not even need to reach the issue of class action arbitration waivers. In other words, if the Supreme Court eventually decides that "class action arbitration" may only occur in cases where the arbitration clause expressly authorizes such a procedure, then "waivers" and their validity (or invalidity) arguably become moot.

For all of these reasons, the *Stolt-Nielsen* decision is highly anticipated by U.S. companies with standard contracts that call for arbitration of disputes.

---

[1] Order by the U.S. Supreme Court dated June 15, 2009, in *Stolt-Nielsen S.A., et al. v. AnimalFeeds Int'l Corp.*, No. 08-1198.

[2] Brief of Petitioners Stolt-Nielsen S.A., in *Stolt-Nielsen S.A., et al. v. AnimalFeeds Int'l Corp.*, No. 08-1198, at 13.

Increased Recoveries in Whistleblower Actions and Expansion of the False Claims Act's Reach

In the fiscal year ending September 30, 2009, the Department of Justice recovered $2.4 billion in False Claims Act settlements and judgments — nearly $2 billion of which was recovered in cases initiated by whistleblowers. Since 1986, when Congress amended the False Claims Act to strengthen its *qui tam* provisions, the DOJ has recovered more than $24 billion. The DOJ has stated that "[r]ooting out fraud and safeguarding taxpayers from illegal conduct are among the Justice Department's highest priorities," and Congress enacted laws in 2009 that expand and strengthen the statute.

Focus of Enforcement Activity — Health Care and Procurement Fraud

- Of the $2.4 billion recovered in 2009:
  - procurement fraud recoveries totaled $608.4 million, $422 million of which was attributable to Department of Defense contracts; and
  - health care fraud recoveries totaled $1.6 billion, $866.7 million of which was recovered in cases involving the pharmaceutical and medical devices industries.
- The DOJ has recovered $76 million related to contracts in support of the wars in Southwest Asia and has stated that there are "many matters still pending."
- In May 2009, the attorney general and the secretary of the Department of Health and Human Services (HHS) created the Health Care Fraud Prevention and Enforcement Action Team to increase coordination and optimize criminal and civil enforcement.
- With respect to its investigation of the pharmaceutical industry, the DOJ has stated that it is pursuing a variety of "schemes," including:
  - "off-label" marketing;
  - the payment of kickbacks to physicians, wholesalers and pharmacies to induce drug or device purchases; and
  - the submission of false or inflated drug pricing information to government agencies to obtain higher reimbursements or to reduce rebates due to the Medicaid program.
- DOJ and HHS officials have stated that medical device makers are under scrutiny for engaging in alleged unlawful marketing activities and providing illegal inducements to physicians and health care institutions.
- In October 2009, Sen. Chuck Grassley (R-IA) announced that 1,040 *qui tam* cases remain under seal, 985 *qui tam* health care cases are pending, 200 *qui tam* cases address pricing and marketing activities in the pharmaceutical industry, and 205 *qui tam* cases allege procurement fraud in Department of Defense contracts.

Contributing Partners / Mitchell S. Ettinger, Mitchell.Ettinger@skadden.com, 202.371.7444 / Jen Spaziano, Jen.Spaziano@skadden.com, 202.371.7872

The Fraud Enforcement and Recovery Act of 2009

On May 20, 2009, President Obama signed the Fraud Enforcement and Recovery Act of 2009 (FERA), which was focused primarily on enhancing the government's ability to prosecute financial frauds and frauds against the Troubled Asset Relief Program. FERA also amends the False Claims Act by:

- eliminating the intent to secure federal funds element imposed by the Supreme Court in *Allison Engine*;
- lessening the False Claims Act's presentment requirement by changing the definition of "claim" to include requests or demands to certain third parties who are not government officials;
- expanding the False Claims Act's "reverse false claim" provision, creating liability for persons who knowingly conceal the retention of an overpayment of government money;
- expanding the relation-back doctrine in *qui tam* cases to give the government the benefit of the filing date of the *qui tam* complaint; and
- easing the process associated with the issuance of civil investigative demands that DOJ lawyers use to obtain documents and testimony in civil investigations and facilitating the sharing of such materials with whistleblowers and their counsel.

Proposed False Claims Act Amendments

In addition to those implemented through FERA, Congress is considering the following changes to the False Claims Act:

- authorizing only the government to assert a public disclosure bar to a whistleblower's allegations and limiting the circumstances when such a bar may be raised;
- adopting a single, 10-year statute of limitations for both the United States and the whistleblower; and
- limiting the scope of releases provided by whistleblowers to former employers to exclude FCA claims.

Disclosure Obligation on Certain Federal Contractors (FAR 52.203-13)

Effective December 12, 2008, federal contracts valued in excess of $5 million and more than 120 days in duration include a disclosure obligation regarding possible False Claims Act violations. In particular, contractors are required to disclose in writing, among other things, possible violations of the False Claims Act to the Office of Inspector General and the contracting officer. Disclosure is triggered whenever the contractor has "credible evidence" of a False Claims Act violation.

The Year of 'Foreign-Cubed'

One way or another, through Supreme Court ruling or Congressional enactment, 2010 will be a significant year for foreign issuers whose foreign investors trading shares in foreign markets seek to bring class action federal securities fraud suits in United States federal courts. The U.S. Securities Exchange Act, adopted in 1934, is silent on extraterritorial application. But after 75 years, both the U.S. Supreme Court and Congress are preparing to address the issue in potentially very different ways. On November 30, 2009, the U.S. Supreme Court accepted certiorari to hear an appeal from a U.S. Court of Appeals for the Second Circuit decision holding that U.S. courts did not have jurisdiction over so-called "foreign-cubed" federal securities class actions. That case involves a foreign plaintiff class who purchased securities abroad of an Australian issuer, National Australia Bank (NAB), whose U.S. subsidiary, Florida-based Homeside Lending, Inc., allegedly provided knowingly inflated financial results that NAB included in NAB financial statements, issued and distributed from NAB's headquarters in Australia.[1]

The Second Circuit declined to adopt a "bright-line" rule and applied a test that the Court acknowledged is "not easy to apply," namely deciding whether a U.S. court has subject matter jurisdiction based on determining what conduct [foreign versus domestic] is "central or at the heart of a fraudulent scheme versus what is 'merely preparatory' or ancillary."

While this is a fairly fact-intensive inquiry, it also is laden with controversial consequences. On a positive note, such a standard avoids the danger of permitting courts to exercise jurisdiction over federal securities (Rule 10b-5(b)) claims in foreign-cubed cases where the activities in the U.S. were merely preparatory to statements made by an overseas entity. Otherwise, a nondeclarant U.S. subsidiary's input to parent company statements (and those of its executives), which constitute mere "aiding and abetting" of the parent's statements, could be subject to suit in U.S. courts.

However, foreign corporations throughout the world, from Canada to Germany and Switzerland to China (as the NAB decision suggests), can no longer take full comfort that their respective jurisdictions limit securities remedies and/or class actions, if the potential of U.S. securities class action exposure now looms.

Most importantly, in 2010, when deciding the NAB case, the U.S. Supreme Court could adopt a different standard, and Congress already is on track to do so.

Currently pending is H.R. 4173 (Financial Stability Improvement Act), introduced by Rep. Barney Frank (D-MA), as part of a potential regulatory overhaul in response to the financial crisis of 2008. The proposed legislation provides that U.S. federal securities jurisdiction would exist for any case involving "conduct within the United States that constitutes significant steps in furtherance of the violation." This is an open-door policy for U.S. courts and would be troubling for both foreign issuers and their U.S. subsidiaries because "significant steps" potentially could include any manner of U.S.-based executive and adviser activity in "furtherance" of statements by the foreign issuer.

This bill could have other consequences as well. U.S.-based auditors are required under current SEC procedures to review foreign-prepared and foreign-audited financial statements of foreign SEC registrants to provide so-called "negative assurance" that they see no departure from U.S. reporting requirements. Yet, they do not necessarily see the underlying audit or issuer work papers. However, auditors are one necessary step in that foreign filer's SEC registration process, though by no means at its "heart." Thus, the Second Circuit's standard in NAB stands in stark contrast to H.R. 4173. Between the Supreme Court's upcoming NAB decision and Congress's upcoming final enactment (which would trump any court ruling), 2010 will be an important year for foreign issuers and their U.S. counterparts.

[1] *Morrison v. National Australia Bank Ltd.*, 547 F.3d 167, 174 (2d Cir. 2008), *cert. granted*, 78 U.S.L.W. 3319 (U.S. Nov. 30, 2009) (No. 08-1191).

Contributing Partner / Thomas J. Dougherty, Thomas.Dougherty@skadden.com, 617.573.4820

“Unlike a foreign investment contract … protections arising under investment treaties do not have to be negotiated specifically with the host state.”

Maximizing Treaty Protection for Foreign Direct Investments

In recent years, foreign investors increasingly have become attuned to the ways in which bilateral or multilateral investment treaties can hedge their investment risk. With more than 2,500 bilateral investment treaties (BITs) spanning more than 170 countries across the globe, BITs provide a potential safeguard against the threat of expropriation or unfair treatment by hostile host states, particularly in politically volatile regions within the former Soviet Union, Latin America and Africa.

BITs, and their multilateral counterparts, such as the ASEAN multilateral investment treaty, NAFTA (Chapter 11), DR-CAFTA (Chapter 10) and the 1994 Energy Charter Treaty (ECT), typically offer two bundles of rights:

- A series of substantive investor protections, including: a duty on host states to grant "fair and equitable" treatment to foreign investments; a requirement to pay compensation if the host state expropriates a foreign investment, equal at least to the fair market value of the taken asset; prohibitions on "unjustified or discriminatory measures"; and the duty to permit repatriation of foreign capital and earnings. (See "Foreign Investment Controls | Europe")
- Procedural forum rights, enabling qualifying investors to arbitrate their disputes before an international arbitration tribunal. The investment treaties usually offer a menu of arbitral forums, such as arbitration under the 1965 Convention on the Settlement of Investment Disputes between States and Nationals of other States (the ICSID Convention) or under the arbitration rules of the United Nations International Commission on Trade Law (UNCITRAL).

Unlike a foreign investment contract (*e.g.*, a concession agreement), protections arising under investment treaties do not have to be negotiated specifically with the host state; they arise as a matter of law and can be arbitrated before an international tribunal on the basis of the state's standing consent to arbitration in the treaty.

2009 witnessed significant developments in this area that likely will continue to shape the legal landscape in 2010. Among these, on July 6, 2009, the World Bank received a written notice that Ecuador had denounced the ICSID Convention. The denunciation took effect on January 7, 2010. This does not, however, necessarily affect the substantive rights available to foreign investors under BITs signed by Ecuador, which in many cases can be arbitrated through the other forums provided for in those BITs, such as UNCITRAL arbitration.

Furthermore, in August 2009, the Russian Federation announced its intention to withdraw from the ECT, which took effect on October 18, 2009. Nevertheless, a December 2009 ruling by an arbitral tribunal hearing claims by former Yukos shareholders is reported to have found, pursuant to the legal doctrine of "provisional application," that Russia was bound by the ECT — including its guarantees of fair treatment for foreign investors — from its date of signature in 1994 to the date of its withdrawal in October 2009. This holding is significant for other investors in Russia, not only because it might enable some investors to make arbitral claims against Russia with respect to past conduct, but also because it means that, under the "grandfathering" provisions of the ECT, Russia remains bound to apply the ECT's investment protections for the next 20 years to all qualifying energy investments made in Russia during the period in which the ECT was effective. This includes not only substantive protections, but also the right to have disputes resolved through international arbitration.

Contributing Partners / Bruce Macaulay, Bruce.Macaulay@skadden.com, 44.20.7519.7274 / Timothy G. Nelson, Timothy.G.Nelson@skadden.com, 212.735.2193

Thus, investors always are well advised to plan their investments in a way that benefits from the available treaty protections. This type of investment protection should be featured on a transaction at the outset, in the same way that companies traditionally have structured their investments on the basis of efficient tax planning.

Using National Courts to Obtain Injunctive Relief in Support of International Arbitration

The power of national courts to grant injunctive relief in support of international arbitration proceedings is used increasingly as a strategic tool in international arbitration and cross-border disputes.

There are a number of scenarios in which a party to an arbitration agreement should consider making an application to a court for interim injunctive relief:

- to preserve the status quo (*e.g.*, to compel a party to continue performing a contract until the conclusion of the arbitration, or to prevent one party from conducting itself in a manner that may cause irreparable harm to the other);
- to preserve evidence or property that is the subject of the proceedings and at risk of being lost (and/or permit inspection of the same);
- to prevent the dissipation of assets by way of a freezing order (to ensure that any arbitral award can be enforced); and/or
- to prevent a party from commencing or pursuing court proceedings in breach of an arbitration agreement (an "anti-suit injunction").

The scope of a national court's powers to grant injunctive relief will depend upon a number of factors, including: (1) the terms of the arbitration agreement (the parties are free to expressly include or exclude recourse to any national court for interim or injunctive relief); (2) the provisions of any applicable arbitration rules (for example, the parties' ability to approach a national court in limited circumstances is preserved under the ICC, LCIA, AAA, ICDR and UNCITRAL rules); and (3) the national law of the place of the arbitration and/or (if different) of the court where the relief is sought.

Many countries' national arbitration laws explicitly recognize their courts' powers to intervene in support of arbitral proceedings. For example, under the Arbitration Act 1996 (UK), the courts of England have the same powers to make orders in relation to arbitral proceedings as they have in relation to litigation proceedings (unless such powers are expressly excluded in the arbitration agreement). For its part, New York's CPLR 7502 grants broad powers to the courts of New York to grant injunctive relief in aid of arbitration.

Injunctive relief from a national court sometimes will be ordered on a provisional basis, *i.e.*, until it can be reviewed by the arbitral tribunal. Often, national courts will require a showing that the requested injunctive measures are protective (to prevent unfair and irreparable injury) and temporary (pending the outcome of the arbitration or until such time as the arbitral tribunal is able to act). Their purpose is to ensure the effectiveness and fairness of the arbitration process, not to prejudge the merits of the claims or issues in the arbitration itself.

By way of illustration, under the English Arbitration Act, an applicant must prove "urgency" in order for the English court to have jurisdiction to make any order; and the court's power under Section 44 of the Act has been described as "plainly intended to cover the crack between the moment of the application and the time when the arbitral tribunal can be formed and make its own decisions."[1]

However, in a number of recent English law cases, claimants appear to have delayed commencing arbitration proceedings in order to invoke the power of the English court, perhaps calculating that: (1) a court is more likely to grant injunctive relief than an arbitral tribunal; and (2) once relief has been granted

Contributing Partners / John L. Gardiner, John.Gardiner@skadden.com, 212.735.2442 / Bruce Macaulay, Bruce.Macaulay@skadden.com, 44.20.7519.7274 / Timothy G. Nelson, Timothy.G.Nelson@skadden.com, 212.735.2193

by the court, an arbitral tribunal is likely to uphold such relief. Although some have criticized this approach as inconsistent with the threshold requirement of "urgency," this practice has met with some success in the English courts. In *Belair v. Basel*,[2] for example, a court found that the applicant had made the required showing of "urgency," even though it had delayed commencement of the arbitration proceedings for several months. In contrast, another English court more recently held (in a confidential judgment) that a similar period of delay by the applicant in commencing arbitration proceedings defeated the applicant's claims of "urgency" and precluded the court from granting interim injunctive relief.

Another kind of injunction that might be sought in aid of arbitration is the anti-suit injunction, pursuant to which one party applies to the national court of the seat of the arbitration to restrain the other party from commencing or continuing with any court proceedings in breach of the arbitration agreement. Significantly, however, in 2009 the European Court of Justice held, in the *West Tankers* case,[3] that the national courts of European Member States do not have power to grant anti-suit injunctions to restrain proceedings brought in the courts of another member state, even when those proceedings are in breach of an arbitration agreement. This decision does not, on its face, affect the ability of English courts to grant anti-suit injunctions to restrain proceedings in non-EU states (*e.g.*, the United States or in Asia), nor does it affect the ability of arbitrators based in London to make orders potentially having the same effect as judicial anti-suit injunctions. However, the *West Tankers* case has diminished the ability of UK courts to restrain proceedings in other EU courts brought in breach of arbitration agreements, and the decision thus affords increased scope for EU parties to use court litigation strategically (and potentially obstructively) in a manner that frustrates arbitration agreements.

We expect the increased use of strategic litigation in furtherance of (or obstruction of) arbitration proceedings to continue.

---

[1] *Econet Wireless Ltd v. Vee Networks Ltd* [2006] EWHC 1568 (Comm) per Morison J.

[2] *Belair LLC v. Basel LLC* [2009] EWHC 725 (Comm) per Blair J.

[3] *Allianz SpA and Generali Assicurazinoi Generali SpA v. West Tankers Inc.* (2009) Case C-185/07 of the European Court of Justice.

M&A/Transactions

“Cash on corporate balance sheets and access to acquisition financing should increase the flexibility of buyers to structure transactions as cash deals, although stock deals still will be common.”

U.S. M&A | Strategic Deal Activity Gains Momentum as Market Challenges Persist

The M&A market in 2009 continued to be relatively restrained compared to the robust deal markets seen through 2007, as the aftermath of severe global financial dislocation and the attendant weakness in the global economy and financing markets weighed on deal activity. Corporate boards and management spent substantial time and focus on enterprise risk management rather than acquisitions. However, as economic growth returns and financial and credit markets stabilize, merger and acquisition activity appears to be resurfacing across industries and geographies.

While prognostication of trends at a time such as this is inherently risky, an apparent pickup in deal discussions in the fourth quarter of 2009 suggests that M&A activity may increase in 2010. Several likely trends for 2010 merit attention.

Continued predominance of strategic M&A. Strategic transactions likely will continue to dominate the M&A landscape, as highlighted by recent headline activity in the pharmaceutical, oil and gas, and media industries in particular. Companies will continue to seek growth, efficiencies and geographic diversification to position themselves both for current market conditions and for any economic turn-around. Cash on corporate balance sheets and access to acquisition financing should increase the flexibility of buyers to structure transactions as cash deals, although stock deals still will be common. Access to capital, and the ability to provide buyers with greater certainty, frequently will result in a preference by sellers to pursue transactions with strategic buyers rather than private equity.

Restrained but growing private equity activity. Private equity activity in 2009 was modest, given the paucity of debt financing for leveraged transactions during much of the year. A meaningful portion of private equity activity in 2009 was composed of equity-financed, or equity-weighted, transactions. However, recent signs suggest that leveraged transactions are reappearing, as acquisition financing has again become available to financial buyers, although it is likely that the terms of private equity deals and financing will continue to evolve in the new environment.

Hostile M&A activity will remain on the landscape. The past two years have seen a number of unsolicited transactions (both cash offers and exchange offers), although the volume of hostile transactions in 2009 was below many commentators' expectations. Hostile activity will continue — and may well increase — in 2010, as opportunistic acquirers with available cash or access to improving capital markets seek to acquire attractively priced assets. Furthermore, the dismantling of structural protections such as staggered boards in response to shareholder activism and corporate governance campaigns has left public companies increasingly vulnerable to hostile activity. Identification of potential threats and advance preparation will continue to be critical for potential targets.

Cross-border transactions. Cross-border M&A is returning as a significant component of overall mergers and acquisitions activity. While cash transactions are often the norm for these deals, paper deals may be more feasible than in the past and are worth keeping an eye on.

Deal-related issues. As M&A activity begins to increase, focus will remain on key deal issues around closing certainty and remedies for nonperformance. Legal issues relating to deal process, disclosure and other matters also are likely to receive significant attention. (See "U.S. M&A | Deal Certainty: Breakdown in the Distinction Between Private Equity and Strategic Deals")

Contributing Partner / Stephen F. Arcano, Stephen.Arcano@skadden.com, 212.735.3542

Increasing scrutiny of transactions. Parties to M&A deals will need to prepare for increasing scrutiny of transactions by third parties such as regulators and activists. On the regulatory front, reinvigorated enforcers at the FTC and the Antitrust Division of the Department of Justice, the FCC, the CFIUS agencies and elsewhere seem to suggest that there will be greater regulatory (and perhaps political) review of M&A deals. In addition, corporate governance trends and resurgent shareholder activism suggest that more deals may become subject to intense shareholder scrutiny.

U.S. M&A | Deal Certainty: Breakdown in the Distinction Between Private Equity and Strategic Deals

In 2009, there was continued focus on contract provisions in M&A agreements related to "deal certainty," including terms dealing with financing conditions, termination rights and reverse termination fees. Specifically, in several transactions strategic deal provisions began to mimic the reverse break-up fee/elimination of specific performance provisions found in private equity acquisition agreements over the last few years.

The traditional model for a private equity transaction included the equity sponsor utilizing a shell company without substantial assets to effect an acquisition. Moreover, due to the private equity model's heavy reliance on third-party debt financing, financing conditions also typically were included, making private equity deals, as a contractual matter, highly conditional.[1] Sellers accepted this structure largely on the theory that severe reputational damage would occur if the private equity sponsor tried to back out of the deal (*i.e.*, failure to finance a signed deal would, in theory, have severe consequences for a private equity firm whose business is, in effect, to make acquisitions).

As the M&A market heated up after 2005 and the number of private equity funds proliferated amid a sea of liquidity, private equity acquirers looked for a competitive edge. Faced with sellers seizing upon the incremental bargaining leverage of a "seller's market," they eliminated financing conditions from their offers and migrated to a structure that gave sellers an exclusive remedy to pursue a reverse break-up fee if the private equity bidder failed to close. Specific performance clauses frequently were eliminated from such agreements. Many sellers to private equity entered into acquisition agreements that, in essence, gave them the option to walk away from a deal upon payment of liquidated damages, often in the range of 3-5 percent of equity value.[2]

On the other hand, strategic buyers were expected to execute merger agreements without financing conditions or reverse termination fees, and with specific performance clauses, resulting in greater deal certainty for sellers than in private equity deals. In effect, the strategic buyer's balance sheet stood behind its contractual obligations.

During the summer of 2007, much liquidity dried up — quickly — as the "credit crunch" began. Among other things, the crunch left many private equity-led acquisitions uncompleted. For several private equity sponsors, the acquisition model that developed in the private equity arena may have saved them (and their debt financing sources) from severe losses. Corporate buyers were, of course, severely affected by the lack of global liquidity as well. Strategic buyers faced a changed landscape in which financing a deal was no longer a foregone conclusion, leading many such buyers and their advisers to re-examine the possible benefits of the private equity deal model.

As the credit crunch accelerated into 2009, several strategic cash buyers negotiated reverse break-up fee "outs" that could be exercised only upon a financing failure, with specific performance otherwise applicable. In some strategic deals, the parties eliminated specific performance from the acquisition agreement entirely, but provided for significant uncapped damage remedies by allowing an aggrieved party to seek expectancy and similar damages from the breaching party, should the agreement be terminated.

- The Pfizer/Wyeth merger agreement in January 2009 contained a financing condition that became available to Pfizer in two circumstances: the existence of a material adverse effect or failure to receive

Contributing Partner / Nancy A. Lieberman, Nancy.Lieberman@skadden.com, 212.735.2050

a specified credit rating. Such provisions were in sync with Pfizer's underlying debt commitments. If Pfizer exercised the financing condition, it was required to pay a large reverse break-up fee equal to 6.7 percent of the purchase price. Both Wyeth and Pfizer retained the right to seek specific performance of the merger agreement, and Wyeth could seek specific performance requiring Pfizer to seek to require its lending banks to honor their financing commitments.

- The Merck/Schering-Plough merger agreement of March 2009 also contained a financing condition. But it went one step further, allowing Merck to walk from the deal upon payment of a 6.2 percent reverse break-up fee, if financing was unavailable for any reason at the drop-dead date. Subject to the broad financing condition, specific performance was available to either party. Given the specific performance provision, Merck, like Pfizer, could be required to sue its lenders to enforce the terms of the financing commitments it received.

Leveraged private equity deals were few and far between in 2009. In several cases, sellers successfully required that sponsors agree to 100 percent equity-financed deals in which the parent funds guaranteed the acquisition vehicles' obligations to perform and close the deal. Additionally, in such cases, specific performance of acquirer's obligations and payment of draconian reverse break-up fees equal to the deal price were components of the acquisition agreements. In a few circumstances, sellers also became third-party beneficiaries of the sponsor's commitment letters (although this third-party beneficiary construct was not all that uncommon in pre-2007 private equity transactions). As credit markets gradually began to loosen later in 2009, the "belt and suspender" approach of having both guarantees for the aggregate purchase price, plus third-party beneficiary provisions under commitment letters, began to ease.

While some leveraged strategic deals, including Pfizer/Wyeth and Merck/Schering-Plough, have gravitated to the private equity model, using reverse break-up fees and limits on the use of specific performance clauses, the traditional strategic acquisition model continued to dominate in 2009.

Where Does the Blending of Private Equity and Strategic Deal Provisions Regarding Deal Certainty Leave Us Going Forward?

If credit markets continue to ease, it is possible that sellers in 2010 will begin to relax the requirement that private equity buyers must either do 100 percent equity deals or agree to pay break-up fees approaching or equal to the deal price. The buyer protections reflected in the large, leveraged pharmaceutical transactions described above may be short-lived responses to the lack of financing available in 2009. It seems likely that most strategic buyers, particularly those not employing leverage, will continue to follow the historical merger format of no reverse break-up fee for termination, coupled with a specific performance provision. However, in selected situations these private equity-like terms may continue to find their way into strategic deals.

MAC Clauses Have Yet to Be Enforced

As credit markets seized up in 2008, acquirers (and, in particular, private equity buyers) sought to walk away from deals or renegotiate their prices, alleging the occurrence of a material adverse change (MAC). In a number of cases, these claims were resolved with buyers paying substantial fees. MAC claims abated in 2009, perhaps because of the dramatic decrease in leveraged acquisitions, or possibly due to recognition that it is difficult to successfully pursue a MAC "out" from a merger agreement.

In the current environment, MAC clauses remain highly negotiated provisions in which buyers seek broad language enabling them to walk from a deal, and sellers continue to seek carve-outs from MAC clauses based on general market events. Buyers must recognize that there will continue to be significant hurdles to avoiding closing on the basis of the alleged occurrence of a MAC.

Renewed Focus on Regulatory-Related Provisions

With the change of administration in Washington, D.C. and the resulting changes in the senior levels of the Department of Justice's Antitrust Division and FTC (coupled with, for example, the vigorous enforcement regime in the EC and political sensitivities inherent in transaction-related reviews by CFIUS or similar regulatory regimes), additional focus is being given in the boardroom and by practitioners to the regulatory efforts provisions in acquisition agreements. How regulatory "risk" is allocated between buyers and sellers and, in some cases, potential remedies tied to nonapproval of the deal are likely to be closely scrutinized in 2010 and beyond.

---

[1] While beyond the topical scope of this commentary, the conditionality inherent in the traditional private equity acquisition model also stemmed from the terms of the debt commitments that the equity sponsor would deliver to the seller (typically) at the time the deal was signed.

[2] The amount of the reverse termination fee often mirrored the termination fee that a public company target would pay if the merger agreement was terminated, for example, due to the target's receipt of a "superior proposal" from a third party. The reasonableness (or logic) of this fee symmetry has been heavily debated.

"Plaintiffs challenged the extent to which boards of directors can rely on a rights plan to ward off an unsolicited bidder. More of these challenges are anticipated in 2010."

U.S. M&A | Delaware Law Developments

Despite the impact of the economic downturn in M&A activity in 2009, the Delaware courts had the opportunity to issue significant deal-related opinions that will have a bearing on mergers and acquisitions activity in 2010.[1] Potential issues on the horizon relate to a board of directors' reliance on rights plans in the face of an unsolicited offer.

Director Fiduciary Duties — Sale-of-Control Transactions

Boards of directors considering a "sale-of-control" transaction, which implicates so-called *Revlon* duties under Delaware law, will want to pay close attention to the following three decisions.

- *Lyondell Chemical Company v. Ryan* (Del. 2009). In this case, the Delaware Supreme Court ruled in favor of the members of the Lyondell Board of Directors, which approved a cash merger with a "blowout" price approximately a week after receiving the merger offer. The Court held that there was no evidence from which to infer that the directors knowingly ignored their responsibilities, thereby breaching their duty of loyalty by failing to act in good faith.
  - Critically, the Delaware Supreme Court reinforced that "there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties" when selling a company and that "[n]o court can tell directors exactly how to accomplish that goal, because they will be facing a unique combination of circumstances, many of which will be outside their control." The Supreme Court concluded that the Delaware Court of Chancery improperly imposed *Revlon* duties on the Lyondell directors before they either had decided to sell, or before the sale had become inevitable, and that the Court of Chancery mistakenly read *Revlon* and its progeny as creating a set of requirements that must be satisfied during the sale process.
  - The Supreme Court concluded that the Lyondell directors were shielded from liability pursuant to the corporation's Section 102(b)(7) exculpatory charter provision because plaintiffs had not demonstrated the "extreme set of facts" required in the transactional context to sustain a claim premised on the notion that disinterested directors acted in bad faith. The Supreme Court noted that the Court of Chancery had wrongly equated an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of one's duties that constitutes bad faith. The Supreme Court also confirmed that directors not alleged to have a financial or other conflict in a transaction could only be held liable for a nonexculpable breach of the duty of loyalty if they "knowingly and completely failed to undertake their responsibilities," which they did not do here.
- *Wayne County Employees' Retirement System v. Activision, Inc.*, No. 3534-CC (Del. Ch. July 24, 2009). Relying on *Lyondell*, the Court of Chancery dismissed claims against the Activision board because it failed to allege any claims relating to Activision's $18 billion combination with Vivendi Games that were not barred by Activision's exculpatory charter provision.[2]
  - The Court of Chancery concluded that plaintiffs had not adequately alleged that any of the Activision board members were improperly interested or otherwise conflicted in the transaction. The Court also held that it was permissible for the board to allow certain insider-executive directors to conduct merger negotiations. The Court further found that there was no viable claim that the outside directors breached their duty of loyalty and failed to act in good faith where the board "met several times in the months leading up to the transaction, regularly evaluated financial reports and analyses, and considered several facts and analyses in reaching a decision to approve

Contributing Partners / Edward B. Micheletti, Edward.Micheletti@skadden.com, 302.651.3220 / Edward P. Welch, Edward.Welch@skadden.com, 302.651.3060

the Combination." The Court of Chancery also held that allegations that a board failed to "probe for alternatives" did not state a claim for a breach of the duty of loyalty under *Revlon*.

  – In addition, the Court concluded that allegations that the directors did not obtain a "'control premium' or other protective devices" did not state a claim for breach of the duty of loyalty. The Court held that there is no *per se* rule requiring that in all cases, "the board obtain some separate consideration that could be separately identified as a 'control premium.'" The Court noted, "Delaware law does not hold directors liable for failing to carry out a perfect process in a sale of control," and the "relevant question" in a sale of control is whether directors "utterly failed to attempt to obtain the best sale price."

- *In re NYMEX S'holder Litig.*, C.A. Nos. 3621-VCN, 3835-VCN (Del. Ch. Sept. 30, 2009). The Court of Chancery, again relying on *Lyondell*, dismissed two actions challenging the now-consummated $10 billion acquisition of NYMEX Holdings, Inc. (NYMEX) by CME Group, Inc. (CME).

  – The Court held that NYMEX's exculpatory charter provision protected the NYMEX directors from monetary damages stemming from the breaches of the duty of care, and that it would be unreasonable to infer from the plaintiffs' allegations that the board acted in any way disloyally or in bad faith. The Court found that the NYMEX board was "clearly independent," and that "[i]t is well within the business judgment of the Board to determine how merger negotiations will be conducted," which included the decision to have management conduct the negotiations and to not bargain for a collar. The Court also dismissed the claim that management failed to disclose and pursue a supposedly higher bid from another suitor on the ground that such claim was derivative and plaintiffs lost standing to bring such a claim following the merger.

Director Fiduciary Duties — Controlling Stockholder Transactions

A board of a company with a controlling stockholder who is considering a transaction with a third party will want to carefully consider the following decision.

- *In re John Q. Hammons Hotels Inc. S'holder Litig.*, C.A. No. 758-CC (Del. Ch. Oct. 2, 2009). In this case, the Court of Chancery found that the standard of entire fairness set forth in *Kahn v. Lynch* — which applies when a controlling stockholder appears on both sides of a transaction — did not apply to a merger involving a controlling stockholder where an independent third party made the merger offer to the minority shareholders.

  – Specifically, the Court held that, "[i]n this case — which, again, I have determined is not governed by *Lynch* — business judgment would be the applicable standard of review if the transaction were (1) recommended by a disinterested and independent special committee, *and* (2) approved by stockholders in a non-waivable vote of the majority of all the minority stockholders."

  – Despite this conclusion, the Court found that the entire fairness standard of review would apply in any event, not because it was mandated by *Lynch*, but rather because the controlling stockholder had bargained for certain considerations not received by the common stockholder, and the plaintiffs had sufficiently alleged challenges to both the special committee process used in connection with the transaction, as well as the majority of the minority vote (which was neither nonwaivable or of all outstanding minority shareholders). The Court left open for trial the possibility that either the special committee process or the majority of the minority vote could be sufficient to shift the burden of proving entire fairness to the plaintiffs.

Director Fiduciary Duties — Rights Plan Considerations

By way of background, in some recent lawsuits filed in the Court of Chancery, including a matter arising from Broadcom's proposed acquisition of Emulex, plaintiffs challenged the extent to which boards of directors can rely on a rights plan to ward off an unsolicited bidder.

Under settled Delaware law, a court will apply enhanced scrutiny to defensive board action to determine whether it is proportionate and reasonable in relation to a perceived threat. Directors must show that (1) they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed, and (2) any defense measure taken must have been reasonable in relation to the threat posed. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

The Delaware Supreme Court subsequently identified "substantive coercion" as one of the threats posed by an unwanted, all-cash, all-shares offer. See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989). The Supreme Court defined "substantive coercion" as "the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value."

In *Moore Corp. Ltd. v. Wallace Computer Servs.*, Inc., 907 F. Supp 1545 (D. Del. 1995), the case that has become synonymous with the "just say no" concept, the U.S. District Court for Delaware, applying Delaware law, held that a board had made a reasonable determination that an all-cash, all-shares tender offer from a competitor posed a threat to target stockholders where there was a risk that stockholders might tender without appreciating that the target's earnings were beginning to reflect the benefits of substantial capital investments. The Court further explained that "because they are uninformed, [stockholders might] cash out before realizing the fruits of the substantial technological innovations." The Court also held that the board's decision not to redeem the target's pill was reasonably proportionate to the perceived threat, since it would have no discriminatory effect on shareholders and would not have any effect on the success of a proxy contest. Five years later, in *Chesapeake Corp. v. Shore*, 771 A.2d 293 (Del. Ch. 2000), the Court of Chancery suggested *in dicta* that defensive mechanisms utilized based on a threat of substantive coercion should be "time-limited and confined to what is necessary to ensure that the board can tell its side of the story effectively." The Court also cited an article by two well-known academic commentators suggesting that "demonstrating the existence of a threat of substantive coercion requires a showing of how — and when — management expects its target shareholders to do better." An additional issue that arises in this context is the impact of Delaware's anti-takeover statute on the board's decision making.

As indicated above, at least twice in 2009 the Court of Chancery expressed a willingness to schedule trials that would have addressed the above-described issues. For various reasons, the lawsuits ended before the Court was able to reach the substantive issues or render a decision. As the M&A market begins to heat up again in 2010, many corporations may find themselves targets of unsolicited acquisition offers. It would not be surprising — particularly in light of the Delaware Court's recent willingness to schedule expedited trials on these issues — to see intensified rights-plan litigation in the coming year.

---

[1] Skadden represented certain of the parties mentioned in this article, including Basell (and, after the deal closed, Lyondell), Activision (and its board members) and CME.

[2] As of this writing, the case is on appeal to the Delaware Supreme Court.

“There are no assurances that cautionary language, however drafted, will satisfy the SEC during the comment process.”

U.S. M&A | Disclosure Issues: Titan and Bank of America

The SEC's 2005 report on its action against The Titan Corporation[1] outlined the liability risk companies face when disclosing and summarizing the terms of a merger agreement. The Titan Report states the SEC's position that, in disclosing the terms of a merger agreement (whether in a proxy statement or other report under the Securities Exchange Act of 1934 (Exchange Act)), a company must consider whether additional disclosure is necessary for such disclosure not to be misleading.[2] Last year, in the midst of defending its proposed settlement with Bank of America (BofA) in connection with BofA's acquisition of Merrill Lynch, the SEC affirmed its commitment to the positions outlined in the Titan Report.

- In response to the Titan Report, many companies follow the practice of supplementing disclosure with cautionary language intended to limit investors' ability to reasonably rely on representations and warranties set forth in a transaction agreement. This cautionary language alerts investors that such representations and warranties reflect a negotiated risk allocation, are not necessarily statements of fact, and are qualified by confidential disclosure schedules.

- In the BofA matter, the SEC alleged that BofA (1) "represented in the [BofA/Merrill Lynch] merger agreement" that Merrill Lynch had agreed not to pay bonuses to its executives prior to the acquisition's closing by disclosing in its joint proxy statement/prospectus a covenant providing that, subject to certain scheduled exceptions and actions taken with the prior written consent of BofA, Merrill would not, among other things, "pay any amounts to [directors, officers or employees] not required by any current plan or agreement (other than base salary in the ordinary course of business)"; and (2) was liable for a material omission as a result of failing to disclose Merrill was permitted, pursuant to the terms of a nonpublic disclosure schedule, to pay up to $5.8 billion in bonuses.[3]

- The allegations against BofA suggest that the SEC takes a broad view regarding which provisions of a transaction agreement (*e.g.*, covenants) may constitute actionable factual representations, and raises the issue of whether companies that use cautionary language that references only an agreement's representations and warranties have charted too narrow a course.

- Companies may conclude that including cautionary language in a proxy statement/prospectus or other Exchange Act filing continues to be a useful tool that aids shareholders in interpreting and understanding the purpose and proper context of the terms of material contracts[4] that are filed as exhibits to a company's Exchange Act reports. Consequently, companies should consider seeking the assistance of legal counsel when preparing such language so it is properly tailored to the context and purpose of a particular filing.

- There are no assurances that cautionary language, however drafted, will satisfy the SEC during the comment process, or a court if a company is forced to defend against allegations of a material misstatement made in, or omission from, disclosure regarding a material contract. The SEC is on record as stating that a company's reliance on, and nondisclosure of, confidential disclosure schedules containing material information is "not legally sound" in light of the Titan Report.[5] Additionally, in January 2009, the Ninth Circuit in *Glazer Capital Mgmt. v. Magistri* questioned whether a publicly filed transaction agreement that references a nonpublic disclosure schedule would "as a matter of law, prevent a reasonable investor from relying on [such agreement's] terms."[6] In light of all of these concerns, we recommend that companies approach Exchange Act disclosure issues with a critical eye and work closely with legal counsel when assessing facts and developments which relate to, but may not be described in, material contracts required to be filed pursuant to the Exchange Act.

Contributing Partner / Eric L. Cochran, Eric.Cochran@skadden.com, 212.735.2596

[1] Exchange Act Rel. No. 51283 (Mar. 1, 2005).

[2] Titan had made a representation in an acquisition agreement (which was filed with, and summarized in, Titan's proxy statement) stating that it was not in violation of the Foreign Corrupt Practices Act. In fact, Titan and its subsidiaries had engaged in practices that violated the Foreign Corrupt Practices Act.

[3] Complaint at 2, 6-8, *SEC v. Bank of America Corp.*, 09 Civ. 6829(JSR) (S.D.N.Y. filed Aug. 3, 2009) (alteration in original).

[4] Although the Titan Report and proposed BofA settlement focused on merger agreements, companies should consider a consistent approach when filing or disclosing the terms of any material contract in a filing under the Exchange Act or in a registration statement under the Securities Act of 1933.

[5] Reply Mem. of Pl. SEC in Supp. of Entry of the Proposed Consent J. at 6, No. 09 Civ. 6829(JSR), 2009 WL 2842940 (S.D.N.Y. filed Sept. 9, 2009).

[6] 549 F.3d 736, 741 (9th Cir. 2008).

U.S. M&A | Hostile Transactions

Hostile or unsolicited M&A transactions featured prominently among deals that were announced last year, even though the total volume of such transactions had declined from the previous year. It is likely that hostile transactions will continue to play a significant role in M&A in 2010. Many companies — including those with larger market capitalizations — could find themselves vulnerable to an unsolicited takeover approach. Strategic acquirers that put M&A transactions on hold during the downturn may find that there are now attractive acquisition opportunities that should be pursued in the improving environment, even in circumstances where the intended target may not be amenable to a sale.

Factors Contributing to Hostile M&A Activity

- A number of factors make it likely that hostile transactions will continue to be a significant part of the M&A landscape in 2010, including the following:
  - Even with the modest rebound of the equity markets, equity values of many public companies continue to be substantially below what they were prior to the downturn, which has contributed to a gap between the valuations placed on such companies by potential acquirers and the valuations attributed to such companies by their boards and management teams.
  - Improving economic, credit and financial conditions — including the greater availability of acquisition financing, the stabilization of equity markets and improving financial footing of many companies — may embolden potential acquirers, particularly well-capitalized companies with access to the capital markets, who suspended their M&A activity during the financial crisis to aggressively seek growth opportunities through strategic acquisitions.
  - Many public companies, in response to pressure from shareholder activists, proxy advisory firms and others, have dismantled their corporate protections, such as staggered boards and shareholder rights plans, and implemented other governance features, increasing their vulnerability to takeover pressures.
  - Recent and proposed federal and state regulation, such as the proposed proxy access rules, may enhance the influence of investors seeking to exert pressure on boards to pursue a sale to an unsolicited bidder or other fundamental changes.
  - Some shareholders have lost confidence in existing boards and management teams in light of the substantial loss of shareholder value during the downturn, which could result in such shareholders being more receptive to an unsolicited bid.
  - Activists, hedge funds and proxy advisory firms, such as RiskMetrics Group, recently have had an increasing role and influence in unsolicited bid situations and may be more willing to support takeovers and focus on short-term returns.

Review of Takeover Vulnerability and Preparedness

In light of these trends, companies should review their vulnerability to an unsolicited takeover proposal and other activist tactics in light of current market, industry, economic and regulatory conditions; and companies also should take steps to review their takeover preparedness — in advance of receiving an

Contributing Partners / Brian W. Duwe, Brian.Duwe@skadden.com, 312.407.0816 / Thomas W. Greenberg, Thomas.Greenberg@skadden.com, 212.735.7886

unsolicited bid — to maximize their ability to respond promptly and effectively in the event a proposal is received, identifying potential acquirers and activists and considering the tactics that they may employ. Among other things, companies should:

- identify a core response team consisting of executives and outside advisers to review the company's preparedness and develop an initial response plan for any approach;
- implement a stock watch program to monitor changes in the company's shareholder base, including derivative transactions and any unusual trading activity; and
- review their charter, bylaws, debt instruments, benefit plans and other documents, and consider areas to enhance a board's ability to effectively respond to an unsolicited proposal. Companies that do not have a shareholder rights plan in place should consider having a fully documented rights plan reviewed with the board and placed "on the shelf" for adoption, if and when needed. In this context, companies should be cognizant of the recently amended policies of RiskMetrics Group with respect to the adoption or renewal of shareholder rights plans (including short-term rights plans) and the possibility of a withhold vote recommendation if the plan does not comply with RiskMetrics' guidelines.

Even if appropriate provisions are in place, boards and management teams should be aware of the legal and practical implications applicable to their conduct in connection with responding to an unsolicited bid. Passing comments made by the Delaware Court of Chancery during recent litigation involving Broadcom's unsolicited bid for Emulex — where the Emulex board refused to redeem a shareholder rights plan when faced with Broadcom's offer for the company — have led to active discussion among M&A practitioners that Delaware judges may be more willing than they have been in recent years to establish limits on the extent to which a board may be able to "just say no" under Delaware law in some circumstances. (See "U.S. M&A | Delaware Law Developments")

Boards and management teams also should regularly assess their companies' strategic plans and strategic alternatives to maximize value and ensure that their companies have in place effective communications plans for shareholders, analysts, proxy advisory firms and other constituencies. Having regular and open communications will help companies ensure that their plans are understood by important constituencies and may bolster credibility in responding to an unsolicited bid.

U.S. M&A | Preserving the 'Benefit of the Bargain' for Target Shareholders in a World of Unintended Consequences

In the face of volatile financial markets and an evolving business environment, both buyers and targets in recent M&A transactions increasingly have found the need to carefully scrutinize, and at times litigate, their rights and the rights of their shareholders under acquisition agreements — a process which, on occasion, has yielded unexpected results. While most in the M&A community are familiar with the requirements for obtaining specific performance in the merger agreement context, only more recently has the issue of whether shareholders of a target in a merger can bring damage claims, and how such damages are measured, become an area of focus. Under evolving case law, it is possible that, at least in some jurisdictions, targets may be quite limited in the types of damages they can recover for preclosing buyer breaches of merger agreements while, at the same time, target shareholders may not have standing to bring actions for such breaches.

Rights of Target Shareholders and Targets Under "Typical" Merger Agreements

- In a "typical" merger, the acquiring and target companies enter into a merger agreement. Target shareholders are not parties to the agreement. As contract parties, the companies generally have the right to pursue claims against each other for nonperformance. This obviously differs from a stock purchase agreement in a private context, where the selling shareholders are, themselves, parties to the acquisition agreement.
- "Typical" merger agreements expressly negate rights in favor of target shareholders and other third parties, reflecting the parties' intent to avoid the potential for uncoordinated claims by multiple shareholders and targets losing control of preclosing litigation, including settlements.
  - Generally, the only exceptions are third-party beneficiary rights of target directors and officers to post-closing indemnification and insurance, and of target shareholders to make post-closing claims for the merger consideration.
- Careful consideration of the above construct raises at least two questions:
  - Can target shareholders sue to compel the buyer to close or, alternatively, pay damages (reflecting the deal premium and benefit of the bargain to such shareholders)?
  - While the target clearly has the right to sue for the buyer's breach, what damages are available beyond its out-of-pocket expenses, such as for the lost benefit of the bargain for target shareholders?

Enter the Law of Unintended Consequences: *Consolidated Edison v. Northeast Utilities*[1]

- Con Ed agreed to acquire Northeast Utilities (NU) pursuant to a merger agreement that eliminated all third-party beneficiary rights, subject to the two "general" exceptions described above. Con Ed subsequently sued to get out of the transaction, claiming breach of contract, fraudulent inducement and that NU had suffered a material adverse effect. NU disputed these claims and sought substantial damages, including the lost premium that was to have been paid to its shareholders, due to Con Ed's refusal to close. A class of NU shareholders joined the litigation on the NU side.

Contributing Partner / Lou R. Kling, Lou.Kling@skadden.com, 212.735.2770 / **Associate** / Brandon Van Dyke, Brandon.VanDyke@skadden.com, 212.735.3743

- The U.S. Court of Appeals for the Second Circuit, applying New York law, held that NU shareholders did not have the right to sue for Con Ed's failure to close because they were not the express third-party beneficiaries of that obligation and, as to NU, its damages were limited to out-of-pocket expenses. NU ultimately agreed to pay Con Ed $49.5 million to settle Con Ed's claims.
- For many M&A practitioners, the outcome in *Con Ed* was unexpected and has led to a reconsideration, when representing targets, of the prevailing contractual approach.

Preserving the "Benefit of the Bargain" for Target Shareholders: Possible Contractual Approaches

- The Con Ed/NU agreement was governed by New York law, and the case was decided by a federal court. It is unclear whether a Delaware court faced with a Delaware merger would apply a similar construction. However, in light of the similarity in the language relating to third-party rights contained in merger agreements regardless of governing law, the potential for the case's broader application has been recognized by M&A practitioners.
- In response, and to clarify target shareholders' rights and remedies, a number of merger agreements (although still a minority — and in recent large stock-for-stock transactions, a small minority — as of this writing) have included one or more of the following contractual approaches:
  - **Reverse Termination Fees.** Parties expressly agree that in the event the buyer fails to close, the target's damages will equal an agreed-upon termination fee in excess of target's expenses. This approach traditionally has been limited largely to transactions involving private equity funds, but, as credit markets have tightened, has started appearing in highly leveraged acquisitions by strategic buyers. (See "U.S. M&A | Deal Certainty: Breakdown in the Distinction Between Private Equity and Strategic Deals") Such fees generally have been relatively small compared to the premium inherent in the relevant transactions. Therefore, from a target's perspective, they not only fail to compensate for the "lost" premium but also create, on the buyer's part, a relatively inexpensive option on completing the transaction.
  - **Other Approaches to Damages.**
    - In employing alternative approaches to address damages outside the reverse termination fee context (in which the parties agree to an exact quantification of damages), it is important to distinguish two separate but related issues. First, are target shareholders' damages recoverable by the target? And, if so, how are such damages measured, *e.g.*, premium, "benefit of the bargain" or changes in target stock price? When addressing the first of these issues (which was presented directly in *Con Ed*) through one of the approaches described below, the parties may determine that it also is beneficial to address the second, which arises in many transaction contexts, *e.g.*, determining the damages of one or more selling shareholders resulting from the unexcused failure to close by a stock purchaser.
    - In addition to reverse termination fees, which have the drawbacks described above, two alternative approaches to the issue raised by *Con Ed* have been developed, neither of which has yet been the subject of litigation and each of which poses certain issues.

- The first approach, based around an "agency" concept, is to provide that target shareholders are beneficiaries of the buyer's obligation to close, but that the target has the sole and exclusive right, on behalf of shareholders, to bring claims for damages. The second approach is to expressly agree that the target's damages will be deemed to include those of its shareholders.

– **Specific Performance.** Parties expressly agree that the target, on behalf of itself and on behalf of target shareholders, has the right to obtain injunctive relief directing the buyer to close. This approach often is combined with one or more of the other approaches, although there may be issues as to the availability of this remedy, particularly in cash transactions.

Conclusion

These complicated and evolving issues are expected to receive further attention in 2010. While a greater number of merger agreements are addressing these issues, a substantial percentage appear to continue to ignore them. As of yet, no court has considered or ruled on either of the two alternative approaches discussed above. While the outcome may vary in different transactions, we recommend that these issues be considered when negotiating merger agreements, and that targets' boards of directors and management teams be made aware of them.

---

[1] *Consolidated Edison, Inc. v. Northeast Utilities*, 426 F.3d 524 (2d Cir. 2005). Skadden represented Northeast Utilities in the litigation.

"We expect a continued uptick in competition for assets in 2010 as the M&A environment improves … and this momentum will be an important driver of technology M&A in 2010."

U.S. M&A | Trends to Watch in Technology

After a dismal start to 2009, the technology M&A market began to turn during the second quarter and continued to improve throughout the year. Although deal volume remains low compared to that of just a couple years ago, in our view recent activity level has reached a tipping point so that substantially increased M&A in the technology sector is likely throughout 2010. We expect the following trends to be part of the M&A landscape in 2010:

Healthier Deal Volume

We believe important drivers of technology M&A activity in the coming year will include:

- improved buyer, and particularly CEO, confidence levels as financial markets and the economy appear to be recovering after having bottomed out (according to many observers);
- shareholder pressure to deliver earnings growth in the face of limited organic growth prospects and aggressive cost-cutting measures of the past year having run their course;
- a favorable cost-of-capital environment that supports accretive acquisitions;
- major strategic acquisitions of the past year (including Oracle/Sun, Dell/Perot Systems, Cisco/Pure Digital, HP/3com, Adobe/Omniture), some of which can be characterized as transformative transactions, forcing others to rethink fundamental strategies;
- narrowing of the divergent valuation expectations of buyers and sellers as the stabilization of equity markets pushes sellers to adjust their expectations to reflect new market realities; and buyers, faced with less market volatility, offering premiums more attractive to sellers that nonetheless permit buyers to take advantage of attractive current valuations;
- unprecedented (and growing) cash balances accumulating on the books of larger strategic players waiting to be deployed. (For example, Microsoft, Google, Cisco, Apple, Oracle, IBM and HP together had more than $163 billion in cash and short-term marketable securities as of their most recent quarter-ends based on their most recent public filings.);
- need for venture capital exits after several years of constrained liquidity; and
- after a period of intense internally focused restructuring, many companies being ready to shed noncore assets.

More Competitive Landscape

- Strategic acquirers dominated the technology M&A landscape in 2009 and will continue to do so in 2010.
- Private equity buyers are re-emerging (*e.g.*, Silver Lake/Skype) with large amounts of capital to deploy, along with some thawing of credit markets, lower leverage ratios, creative deal structures (*e.g.*, Apax/Bankrate) and even minority investments (*e.g.*, Elevation Partners/Palm). The strength of the re-emergence, however, remains to be seen given the continued challenging credit environment and seller discomfort with financing conditions and uncertainty of closing.
- We did see competition for assets among strategic acquirers in 2009, including a number of topping

Contributing Partners / Thomas J. Ivey, Thomas.Ivey@skadden.com, 650.470.4522 / Kenton J. King, Kenton.King@skadden.com, 650.470.4530 / Leif King, Leif.King@skadden.com, 650.470.4662 / Amr Razzak, Amr.Razzak@skadden.com, 650.470.4533

bids (*e.g.*, EMC/Data Domain, MicroFocus/Borland). We expect a continued uptick in competition for assets in 2010 as the M&A environment improves, and we believe this momentum will be an important driver of technology M&A activity in 2010.

- Unsolicited advances, whether by strategic players (*e.g.,* Broadcom/Emulex) or activist investors (*e.g.,* Riley/Transmeta) have become a familiar part of the technology M&A toolbox and will remain prominent in 2010. In view of the unprecedented cash balances that are common on the balance sheets of many technology companies, we expect event-driven investors, who spent a great deal of 2009 addressing internal issues and a wave of redemptions, to re-emerge as a catalytic force in technology M&A.
- Cross-border transactions will continue to feature ever more prominently in the landscape (*e.g.,* Cisco/Tandberg).
- It is our sense that the IPO window for technology companies has finally reopened after an extended drought. We believe that there is a healthy buildup of the IPO pipeline that will result in a strong impetus for venture-backed companies that are in a position to go public to do so in the early part of 2010. If this is sustained, the IPO market also could emerge as a source of negotiating leverage against strategic acquirers as private technology companies, for the first time in years, could have the opportunity to pursue a credible dual-track IPO/M&A process.

Continued Focus on Deal Certainty

- Not surprisingly, deal certainty has emerged as a key consideration both for buyers and sellers of technology companies. (See "U.S. M&A | Deal Certainty: Breakdown in the Distinction Between Private Equity and Strategic Deals") Innovations introduced into private equity-backed technology transactions of the summer of 2007 and before — such as "go-shop" provisions, reverse termination fees tied to financing failures and the elimination of specific performance as a remedy, together with capped dollar damages generally — do not appear to be finding their way into current strategic technology transactions. With increasing competition for assets, we do not expect these innovations to take hold in the strategic market in any but the most pro-acquirer circumstances.
- An important issue will be how parties address concerns regarding the risk of more activist antitrust/competition law enforcement in the U.S. (*e.g.,* Google/AdMob), Europe (*e.g.,* Oracle/Sun) and elsewhere, including in emerging jurisdictions such as China and India. In the past, parties have used approaches such as a reverse termination fee, an obligation to litigate, an obligation to divest material assets and "come hell or high water" provisions, either alone or in some combination, to allocate this risk between them. We expect this to continue to be a highly negotiated area as dealmakers reflect on the experience of the Oracle/Sun transaction (obligation to litigate, but no obligation to divest even immaterial assets) and the perception of increased closing risk associated with antitrust/competition law approvals on a global basis.
- While practitioners have long expected changes in the formulation of the typical MAC clause and the carve-outs to it in view of the increasing number of cases that have declined to find a MAC, at least in the world of public company technology M&A, we have not seen a great deal of change in this area, and these formulations continue to be predominantly pro-buyer.
- Through 2009, the overwhelming majority of technology M&A transactions were all-cash deals. With the technology companies carrying large cash balances, we expect cash to continue to be the currency of choice for all but the largest, transformative technology M&A deals.

U.S. M&A | Recent Developments in Private Equity Transactions

2009 remained a difficult year for implementing traditional private equity acquisition and exit strategies in light of the constrained credit markets. However, the credit markets had begun to thaw as the year ended.

If liquidity in the credit markets continues, we expect the pace of private equity acquisitions and dispositions to increase throughout 2010. In addition, we expect the distressed-asset acquisition market to continue to be very active in 2010 with distressed debt funds, traditional private equity funds and strategic buyers all playing a role.

Achieving the Elusive Exit Event

- According to a published report, the aggregate value of private equity firms' exit transactions for the first half of 2009 was down approximately 82 percent from the comparable period in 2008.[1] Although the credit markets have begun to improve, they will likely continue to temper the ability of private equity firms to sell their portfolio companies in 2010. If so, private equity firms will be compelled to ascertain viable alternatives to a traditional sale of their portfolio companies, including a partial sale, refinancing of debt, debt-for-equity exchanges or equity infusions by the sponsors or other investors pending a more favorable environment for sale of the portfolio company.

- Despite the difficulties in the credit markets, the revival of the capital markets is promising for the initial public offerings of private equity firm-backed operating companies. Recent private equity-backed IPOs include: Dollar General Corp. (backed by Kohlberg Kravis Roberts & Co.); Talecris Biotherapeutics (backed by Cerberus Capital Management); Dollarama (backed by Bain Capital); and RailAmerica (backed by Fortress Investment Group). Although there are an increasing number of private equity-backed companies in the IPO pipeline, the return of IPOs as an exit strategy in the current environment is not without difficulties, as evidenced by the recent postponement of the $800 million offering by AEI due to "market conditions."

New Approaches to Address Deal Certainty in Private Equity Acquisitions

- Several new approaches to address deal certainty in private equity acquisitions have emerged over the past year. While it is still too soon to tell whether any of these approaches will become "market" practice in private equity transactions, we may see an increasing number of transactions using one or more of the following approaches in 2010.

  – Transactions in which the private equity firm commits to fund the full purchase price of the acquisition through an equity commitment to the purchasing entity. In these transactions, there is no financing condition or reverse break-up fee, and the target is typically a party to, or a third-party beneficiary of, the equity commitment letter, entitled to enforce the private equity firm's obligation to fund the payment.

    Private equity firms may find this structure attractive — especially in smaller and middle market transactions where the amount of the equity commitment may be more manageable from the firm's perspective — given that they avoid the risk of third-party debt financing being unavailable at closing and may have more flexibility to operate the business and incur leverage post-closing. By providing greater certainty to the target, the private equity firm also could improve the

Contributing Partners / Kimberly A. deBeers, Kimberly.deBeers@skadden.com, 312.407.0982 / Thomas W. Greenberg, Thomas.Greenberg@skadden.com, 212.735.7886 / Eileen T. Nugent, Eileen.Nugent@skadden.com, 212.735.3176 / Joseph M. Yaffe, Joseph.Yaffe@skadden.com, 650.470.4650

attractiveness of its bid in a competitive sale process, especially if there are strategic bidders involved.

In addition, private equity firms may find that, in appropriate transactions, their investment returns from such all-equity-financed transactions are not materially lower than the returns they would have received in debt-financed transactions (particularly in light of the increased amount of equity funding required by lenders in today's market).

– Transactions in which a reverse break-up fee payable by the private equity buyer in connection with certain termination events is included in the acquisition agreement and guaranteed by the private equity firm, but is set at an amount higher than traditional reverse break-up fees (which tended to be approximately 2-3 percent of purchase price).

  By setting the fee at a higher level, the seller may gain greater assurance that the private equity firm would be properly incentivized to close the acquisition. At the same time, the private equity firm may take comfort in the fact that its liability is capped at the amount of the reverse break-up fee in the event of a terminated transaction. In some cases, in order to provide a seller with even greater certainty, the reverse break-up fee is bifurcated so that higher fees or amounts of damages are payable in certain circumstances, such as where the buyer has willfully breached its obligations under the acquisition agreement.

Distressed Asset Acquisition Opportunities

- The economic climate continues to produce numerous bankruptcy filings and distressed companies, providing many opportunities for private equity firms to acquire distressed assets at bargain prices. One avenue through which private equity firms may make such bargain acquisitions is an asset purchase via Section 363 of the Bankruptcy Code, which provides a structured auction process for a sale of a company's assets under Chapter 11.

  Acquirers looking to make a bid for assets from a company in bankruptcy would do well to contact the company directly to gain the advantage of entering the process early. The initial or "stalking horse" bidder for assets in a Section 363 sale has many advantages in the auction, including:

  – bidding incentives such as a break-up fee and expense reimbursement if its bid is topped at auction; and

  – the ability to negotiate bidding procedures directly with the debtor, potentially allowing the bidder to influence the auction process in the bankruptcy court (including the bid increments, procedure and timeline, and even the form and substance of transaction structures of competing bids).

- Firms with a larger appetite for risk may be able to obtain even greater bargains by purchasing the deeply discounted debt of distressed target companies in the secondary debt markets. Because of the difficulty of obtaining all the debt in a large target company, many of the acquisitions conducted by purchasing distressed debt are "club deals," where multiple debt holders join together for a controlling stake in the company. These deals are done primarily through one of two methods: credit bidding under Section 363 or a plan of reorganization.

- Bankruptcy courts generally permit debt holders to credit bid at face value even if the debt was acquired at discount, thus allowing an acquirer of distressed debt to bid on the company's assets dollar-for-dollar against a cash bidder with less expense. Because of this dynamic, credit bids of valid debt are very difficult to defeat at auction. (See "Opportunities and Developments in Credit Bidding")

- In addition, credit facilities often provide that lenders holding a majority of debt may direct the credit facility agent to exercise all legal remedies, which include a credit bid of the debt. Accordingly, where less than all the debt is owned by an acquirer, other minority lenders have been dragged along and forced to receive equity in the new company acquiring the assets.

  While the ability to "drag" nonconsenting lenders remains an area of some uncertainty — resulting in the need to buy out minority, nonconsenting lenders at the effective value of the credit bid — several court decisions in 2009 clarified the ability of majority lenders to drag along minority lenders pursuant to customary loan terms regarding the exercise of remedies.

- A second acquisition option using distressed debt is an exchange of debt for equity in the target company through a plan of reorganization. After purchasing a debt position in the secondary markets, the acquirer(s) will negotiate a restructuring and plan-support agreement with the target company and other debt holders, setting forth the basic terms of the plan of reorganization that the acquirer will support.

  A comprehensive plan-support agreement will contain, *inter alia*:

  - restrictions on transfers of company debt,
  - a forbearance agreement among the debt holders,
  - a milestone schedule for achieving certain bankruptcy filings and approvals,
  - the corporate governance arrangements among the acquiring debt holders, and
  - the consideration proposed to be given to junior debt holders or unsecured creditors for their support of the plan of reorganization.

Greater Difficulties in Incentivizing Management at Portfolio Companies

- Section 457A of the Internal Revenue Code which substantially revised the taxation of certain deferred compensation arrangements. Specifically, Section 457A impacts deferred compensation arrangements established by private equity firms with meaningful direct or indirect ownership by tax-exempt partners and/or partners that are not subject to U.S. tax or a comprehensive non-U.S. tax, as well as portfolio companies formed by such funds if they are established as partnerships.

  - The definition of "nonqualified deferred compensation" subject to Section 457A is extremely broad and can cover arrangements such as severance, phantom equity pools and change-in-control bonus plans.

  - Under the new rules, nonqualified deferred compensation will be taxable when it vests, rather

than when it is paid. If the amount of compensation cannot be determined at the time of vesting, then it is included in income at the time it is determinable. At that time, the compensation will be taxed not only as ordinary income, but also will be subject to a 20 percent penalty tax, plus interest from the later of the date of deferral or vesting.

– Vesting must solely relate to continued performance of services. Therefore, if a fund is subject to Section 457A and its deferred compensation arrangement provides for payment with respect to realizations or other events that may occur after an employee is no longer employed, the award may subject the employee to the 20 percent penalty tax.

[1] Cyrus Sanati, "No Exit for Private Equity Funds," *New York Times-Dealbook*, July 21, 2009, edited by Andrew Ross Sorkin.

Europe M&A | Use of Stock Consideration in Acquisitions by U.S. Bidders

Trans-Atlantic stock-for-stock deals may be increasingly attractive to U.S. strategic buyers, given the limited availability of acquisition financing opportunities for consolidation and the convergent regulatory trends in the U.S. and Europe.

- As market values have stabilized and confidence levels improve, strategic players may consider pursuing M&A opportunities using shares, rather than cash, as consideration.
- Although acquisition financing markets improved in the second half of 2009, the availability of acquisition financing on commercially attractive terms may continue to be limited for some bidders in 2010. At the same time, there is a continuing (and perhaps increasing) need for consolidation across numerous sectors (such as energy, natural resources, banking, airline and automobile manufacturing), presenting strategic opportunities (from a relative value standpoint) for companies with strong balance sheets.

Intra-EU and U.S./EU regulatory convergence will facilitate combinations where stock is offered by U.S. bidders as consideration for EU targets.

- With the implementation of the EU Prospectus Directive and EU Prospectus Regulation, which came into force in 2005, the EU adopted a uniform set of detailed disclosure rules applicable throughout Europe and aligned its disclosure requirements with U.S. standards.
- The Commission of European Securities Regulators (CESR) provides uniform interpretative guidance on the new European disclosure rules, resulting in consistency among European jurisdictions.
- Until recently, the new disclosure rules and other European securities laws remained largely untested in the cross-border M&A context because of the infrequency of transactions involving share consideration in Europe. This is beginning to change, following Kraft's offer for Cadbury and Xstrata's (now withdrawn) offer for Anglo American.
- The content requirements for an EU prospectus now are very similar to those of a U.S. registration statement because both are based on the 1998 International Disclosure Standards published by the International Organization of Securities Commissions (IOSCO).
- The EU and the U.S. have comparable timing and process for clearance of registration statements and prospectuses in transactions where shares are being offered as consideration.
- There is increasing coordination between securities regulators on both sides of the Atlantic.
- Although no EU competent authority has made a general determination that any non-EU offer documents provide equivalent disclosure as an EU prospectus, CESR is considering whether a U.S. registration statement should be viewed as equivalent to an EU prospectus by EU competent authorities.

Developments in the EU have eliminated traditional disclosure hurdles for U.S. bidders offering share consideration for EU targets.

- On January 1, 2009, rules recognizing U.S. GAAP as equivalent to IFRS came into force in the EU, permitting U.S. bidders to present financial results in U.S. GAAP in the EU.

Contributing Partners / Lorenzo Corte, Lorenzo.Corte@skadden.com, 44.20.7519.7025 / Scott V. Simpson, Scott.Simpson@skadden.com, 44.20.7519.7000 / Ann Beth Stebbins, AnnBeth.Stebbins@skadden.com, 212.735.2660

- EU disclosure requirements regarding *pro forma* financial information are similar to disclosure requirements applicable to acquisitions of U.S. public companies.
  - *Pro forma* financial statements are required for the most recent full year of historical financial information and the most recent interim period where the transaction involves a significant gross change (size of target represents 25 percent of the bidder's business), and these statements must be prepared using a basis that is consistent.
  - For hostile bids, EU rules contain a principle similar to that of Rule 409 of the U.S. Securities Act of 1933. A target is not required to cooperate with the bidder, and if the bidder cannot obtain necessary financial information from the target with reasonable effort, the bidder may seek a dispensation from the requirement of including *pro forma* financials in the bidder's offer document.
- Typically, an EU prospectus is cleared by the bidder's "home Member State."
  - EU rules allow U.S. bidders that have not made a public offer of their equity securities in Europe since the adoption of the EU Prospectus Directive in 2005 to choose their home Member State. The bidder may choose to use the target's jurisdiction as its home Member State or may apply for admission to trading on an EU-regulated market in another Member State, which will then serve as the bidder's home Member State going forward.
  - The initial decision by a U.S. bidder can have strategic implications for the transaction (particularly if hostile) and should be evaluated in light of several factors, including stock market liquidity, market interest in the bidder's industry, the perceived approach of local regulators and tax considerations.

U.S. bidders, however, will continue to face challenges in paper bids for EU targets.

- While there is uniformity in disclosure rules in Europe, there is not uniformity in takeover regulation among EU Member States. Although the EU Takeover Directive was intended to harmonize takeover regulation in the EU, the directive only provides a basic framework, which is implemented by each EU Member State.
- The EU Takeover Directive allows EU Member States to choose whether targets incorporated in their jurisdiction can or cannot defend against takeover bids (*i.e.*, take frustrating actions), and there is no uniformity in the way EU Member States have adopted this rule. Further, if an EU Member States adopts rules preventing a target company from defending against hostile bids ("passivity rules"), the EU Takeover Directive allows EU Member States to introduce "reciprocity rules" that allow targets to defend against bidders incorporated in countries that do not adopt the same passivity rules. By definition, any U.S. bidder will fall into the category of bidders against which the reciprocity rule can be used.
- U.S. bidders that use shares as consideration for EU targets will, in some instances, need to list their shares on an EU-regulated market. Most EU Member States (*e.g.*, France and Germany) require bidders to provide cash alternatives in exchange offers if shares offered are not liquid securities listed on an EU-regulated market.

- Certain EU Member States may require that a prospectus (or, in some cases, a summary of the prospectus) be translated into the local language.
- Several EU Member States have introduced legislation to control foreign investment, which is summarized in "Foreign Investment Controls | Europe."

“For a scheme to be approved in the UK and in Bermuda, the resolution must be passed by a majority of shareholders representing three-quarters in value, present and voting, at the meeting.”

Europe M&A | UK Bids — How a Scheme of Arrangement May Unlock a Target Board That Repeatedly Says 'No'

In 2009, M&A activity and, in particular, the size of transactions decreased significantly in the UK. The total value and number of acquisitions announced for public UK targets dropped to £41.8 billion and 117 deals, respectively, from £184.6 billion and 141 deals, respectively, in 2008.

Acquisitions of UK corporations funded solely by the bidder's "paper" (usually consisting of the bidder's common stock) were few because a key enabling condition, the stability of the relative stock market valuations of bidder and target, became somewhat achievable only in the latter part of the year. Target boards receiving an approach from a bidder whose offer included a significant proportion of "paper" would plead their fiduciary duties made them reluctant to permit negotiation or due diligence to commence until they were satisfied with the value of the bidder's stock relative to the target's stock.

Cash-only bids or "paper" bids with a significant cash component also were rare because of the difficulty in obtaining debt funding in 2009. Moreover, with the share register of the larger global corporations increasingly populated by "short-term" funds as compared to the traditional "long-term" funds,[1] the bidder's existing institutional investors were unlikely to provide an underwritten cash alternative.[2] Bidders thus were increasingly forced to rely upon alternative means of raising cash, which in many cases could be complex to arrange and not available on particularly favorable terms.[3]

Therefore, a UK bidder looking to raise cash from its own equity in 2010, having seen the 2009 market frequently underwrite rights issues only at a high discount, would likely not consider an underwritten cash alternative as the most appropriate structure to support any hostile "paper" bid. Under these market conditions it would appear that the tactical advantage should be with the prospective target.

However, when the bidder analyzes the target share register and, in particular, the number of "short" funds that have bought into the target (likely to increase as arbitrageurs invest in a target where there is a possibility of a bid), the bidder could reverse the target's perceived tactical advantage by considering a "hostile" scheme of arrangement. Conventional wisdom has been that a scheme — a UK court-sanctioned process that enables the bidder and UK target to combine upon a favorable vote of the target shareholders in a general meeting — can only be relied upon to implement a bid if the "offer" is recommended by the target board. Yet, Skadden's recent experience in another common law jurisdiction suggests that a "hostile" scheme could work in the UK and that the UK Takeover Panel would be willing to consider such an approach.[4]

The leading authority on so-called "hostile" schemes in the English High Court concerned the attempted takeover of the Savoy Hotel group in the early 1980s. Recently, this decision has been considered by the Bermudan courts in the context of the merger of two reinsurance companies.[5] Although the successful takeover of the reinsurance company was not implemented by a scheme of arrangement, at an earlier stage of the transaction the eventual successful bidder (which had a nominal holding of target stock), in its capacity as a shareholder, sought an order from the court to exercise its discretion to convene a general meeting of the other target shareholders. The purpose of this meeting would have been to give the opportunity to those shareholders to consider and approve a scheme of arrangement being proposed by the bidder which, if sanctioned by the court, would oblige those shareholders to transfer their shares to the bidder. For a scheme to be approved in the UK and in Bermuda, the resolution must

Contributing Partner / Adrian Knight, Adrian.Knight@skadden.com, 44.20.7519.7270

be passed by a majority of shareholders representing three-quarters in value, present and voting, at the meeting.

The target board in the Bermudan case objected to the eventual successful bidder seeking this order. The target board argued that it had the authority to manage the target's "business" and had decided to implement the target's merger agreement with the eventual unsuccessful bidder (which contained a "no talk" provision and termination fee for breach), that before a scheme could be put to shareholders it had to be approved by the target board since for the purposes of the relevant Bermudan legislation only the "board" could properly constitute "the company," and that the "shareholders" alone could not. As a matter of jurisdiction, the court did not agree with the target board. However, principally because the eventual successful bidder did not then have sufficient proxies to convene a shareholders' meeting (the bidder's proxy statement had not yet been approved by the SEC) and since the court declared that the bidder required "some real and solid indication of independent shareholder support sufficient to show it had some reasonable hope of success," the Bermuda court decided not to exercise its discretion. Therefore, it did not order that a shareholders' meeting be convened.

However the court concurred with the judgment in the *Savoy Hotel* case and agreed that the "shareholders" in a general meeting could constitute the "company" for the purposes of approving a scheme of arrangement, notwithstanding that the board may continue to refuse to recommend shareholders to vote in favor.

Therefore, depending upon the circumstances and, in particular, the extent of the support that the bidder may receive from target shareholders (probably at least 10 percent, being sufficient to convene a general meeting) to vote in favor of a scheme, a bidder could consider making its offer by way of a "hostile" scheme. In order for this tactic to succeed, it would be necessary to ensure that target shareholders which had given their proxy or other indication of support to the bidder were considering the scheme in their capacity as a "shareholder" and did not have any "personal or special interest" in the outcome that may entitle the court either to determine they were ineligible to be included in the "class" of shareholders to consider the scheme or, at a sanction hearing, serve as grounds to justify its refusal to sanction the scheme.[6]

If the target is subject to the UK Takeover Code, the bidder will be required to consult in advance with the UK Takeover Panel.[7] Depending upon the circumstances, it is more likely that the bidder would announce its "hostile" scheme by means of declaring it as a "possible offer" (in contrast to the announcement of a "firm intention to make an offer"). It is understood that as soon as the court makes an order to convene the court meeting, the UK Takeover Panel would regard the bidder as having announced a "firm intention to make an offer." Should the court meeting/general meeting not be convened for any reason, the Panel would require the bidder to amend its offer and replace the scheme with a takeover offer by way of contract.

It is expected that the bidder would be required to give the target and the shareholders sufficient notice that it had applied to the court for it to exercise its jurisdiction to convene a general meeting of the company. Depending on the facts and circumstances, a "hostile" scheme could result in the target board including in affidavit evidence why its fiduciary duties did not oblige it to commence a formal dialogue with the bidder.[8]

The court hearing would be an appropriate public forum to evaluate the fiduciary duties imposed on the target board. Such a forum may enable the bidder and target to more cogently evaluate their respective legal arguments and analyze whether there is scope for them to commence a more formal dialogue. Therefore, a "hostile" scheme (or a threat of one) may be able to unlock a target board that had earlier said "no."

---

[1] Traditionally, many UK companies relied upon the existence of a relatively stable share register comprised of traditional funds perceived to be long-term holders of their stock. Over the last 10 years UK share registers have become increasingly populated by "short-term" funds, with consequential changes as to how UK corporations have sought to raise cash.

[2] In the 1980s/early 1990s, many hostile UK "paper" bids featured an underwritten cash alternative to fund the cash portion of the offer consideration. The cash was provided by the bidder's institutional investors agreeing to purchase new bidder stock from those accepting target shareholders who elected for cash rather than retain their stock. This funding mechanism, as with an underwriting of a "conventional" rights issue, relied upon the commitment of the long-term holders. In contrast to a rights issue (an issue of new stock to existing shareholders on a preemptive basis), however, the underwritten cash alternative was in effect a placing of stock with the bidder's major institutional investors, not subject to preemption rights.

[3] During 2009, many larger UK corporations needing to raise a material amount of cash for liquidity purposes resorted to a rights issue. However, without the same level of support of "long-term" holders and against a background of instability in stock market valuation, companies were generally advised that any new issue of shares would have to be priced at a high discount. Moreover, the investment protection committees (which generally "protect" the interests of the "long" funds in UK equities) generally limit the amount of cash that can be raised other than through a rights issue on a preemptive basis.

[4] The UK Takeover Panel recognizes that an offeror may seek to rely upon a "hostile" scheme. See paragraph 14 to Appendix 7 of the UK Takeover Code, which needs to be considered in the context of Rule 2.4 or, as the case may be, Rule 2.5 of the Takeover Code. It is understood that in 2009 the Panel was asked to consider at least one "hostile scheme."

[5] *Validus Holdings Ltd. v. IPC Holdings Ltd.*, in the Supreme Court of Bermuda, Civil Jurisdiction (Commercial Court) 2009: No. 135.

[6] The proper composition of "class" and appropriate test to be applied in a scheme hearing is discussed by Mr. Justice Richards in *Re Telewest Communications plc* [2004] AER (D) 276, who refers to the judgment of Lord Millett in *re UDL Holding Ltd* [2002] 1 HKC 172.

[7] See note 3.

[8] Whether or not the target board "should" submit affidavit evidence to the Court will depend upon bid tactics and the facts and circumstances prior to the hearing. The target could decide: (1) to agree with the bidder to an alternative process for negotiating a possible offer; (2) not to attend the hearing hoping the judge would exercise his discretion not to convene the meeting (as occurred in both the *Savoy Hotel* and reinsurance case discussed above); or (3) to appear at the hearing to oppose the application and submit an affidavit in support of its position, where cross-examination by the bidder may be permitted.

“Size increasingly will be an advantage. Through consolidation, companies can tap into global markets by leveraging existing market capabilities and distribution networks.”

Asia M&A | Opportunities for Public Stock Deals in Hong Kong

As the markets emerge from the financial crisis, companies that have weathered the downturn have begun to identify strategic opportunities for growth. It is expected that companies across different sectors will seek to consolidate to achieve cost-cutting, productivity gains and economies of scale on an accelerated basis. Further, intensified competition, global liberalization and greater demand by customers for sophisticated services suggest that size increasingly will be an advantage. Through consolidation, companies can tap into global markets by leveraging existing market capabilities and distribution networks.

The number of recent proposed transactions between U.S. companies and People's Republic of China (PRC) companies, or Hong Kong-listed companies with operations in the PRC, has been growing as more U.S. companies look to gain immediate access to the Chinese market, and Chinese businesses seek access to developed markets through mergers and acquisitions. An example is the recent US$521 million proposed combination of the printed circuit board (PCB) businesses of NASDAQ-listed TTM Technologies, Inc. (TTM) and Hong Kong-listed Meadville Holdings Limited (Meadville), which operates a laminate business and a PCB business through operating subsidiaries.[1] The transaction is structured so that Meadville's PCB subsidiaries are to be sold to TTM and the laminate subsidiaries are to be sold to the controlling shareholder of Meadville. Announced in November 2009, the combination is expected to allow TTM to serve growing Asian market demand, broaden its product offering, access lower-cost manufacturing, and expand its customer base and end market, with the combined business becoming the third-largest PCB manufacturer (by revenue) globally. The transaction raises a number of interesting issues, making it a landmark transaction in Hong Kong and the PRC.

Stock as Consideration

- In today's market, where access to debt financing is more limited but market volatility is lessening, companies are pursuing opportunities to utilize their stock as consideration rather than cash.
- The consideration payable by TTM for the PCB subsidiaries consists of cash and stock in TTM. This is the first transaction in Hong Kong in which part of the consideration offered to shareholders of a Hong Kong-listed company is stock of a U.S.-listed company. The issue of new TTM stock will be subject to the approval by the shareholders of TTM and registration with the U.S. Securities and Exchange Commission.

Distribution of the Sale Proceeds

- The payment of the cash and stock consideration from the two disposals will be made to Meadville, which in turn will distribute the sale proceeds to its shareholders as dividends.
- To provide attractive alternatives for Meadville retail shareholders who receive TTM stock as dividends, the shareholders of Meadville are being given the option to choose whether they wish to have the TTM stock: (1) held in electronic form by the transfer agent of TTM, (2) transferred to a nominated U.S. securities account or (3) sold through a dealing facility to be provided by Meadville with the cash proceeds from the sale to be distributed to electing shareholders.

Contributing Partners / Nicholas Norris, Nicholas.Norris@skadden.com, 852.3740.4733 / Jonathan B. Stone, Jonathan.Stone@skadden.com, 852.3740.4703

Hong Kong Takeovers Code and Listing Rules

- As Meadville is listed on the Hong Kong Stock Exchange, the transaction is subject to shareholders' approval, disclosure and reporting requirements (including reporting on TTM's financial statements) pursuant to the Hong Kong Listing Rules.
- While the transaction is not a public takeover of Meadville, the result of the disposal of both businesses of Meadville that, following closing, Meadville will become unsuitable for listing on the Hong Kong Stock Exchange. As such, in applying recently amended rules of the Hong Kong Takeovers Code, the Hong Kong Securities and Futures Commission (SFC) is treating the transaction as an effective privatization of Meadville by TTM and the controlling shareholder of Meadville. This is the first M&A transaction that the SFC has deemed to fall within the Hong Kong Takeovers Code under such provisions.

Regulatory Approvals

- The transaction is subject to antitrust approval in the U.S. and the PRC.
- In addition, due to TTM's significant defense business in the United States, the transaction also is subject to national security reviews in the U.S. by CFIUS. The controlling shareholder of Meadville, who will become the largest shareholder of TTM, has agreed to limit the exercise of its voting rights on certain matters, including TTM board appointments and control-related shareholder resolutions.

The TTM/Meadville combination is an example of the trend toward consolidation between U.S. companies and Hong Kong-based companies with substantial operations in the PRC. The transaction provides a useful model for U.S.-listed companies seeking to use their stock as acquisition currency for the stock of Hong Kong-listed companies.

---

[1] Skadden is advising Meadville.

Asset Management | Navigating the Sea Change

The consequences of recent events will require buyers and sellers of asset management firms to reconsider basic and long-established premises, assumptions and practices. The agents of change include asset management clients seeking new transaction terms and governmental authorities imposing new regulations. We expect the following developments to affect asset management M&A transactions in 2010:

The Voice of Investors in Transactions

- Asset management transactions, particularly those involving SEC-registered investment advisers, often require the target firm to seek the consent of its clients as a result of legal and/or contractual requirements. This process used to be a predictable one where time and effort resulted in obtaining these consents without any cost to the target or the buyer. Times have changed.
- Fundamental shifts in the attitudes and behavior of investors — particularly limited partners in alternative investment funds — are introducing uncertainty into the "client consent" process. Limited partners are using the consent process as a means to renegotiate the terms of their investments in alternative investment funds, including seeking a reduction in fees and/or their capital commitments. Potential acquirers need to assess the impact of these demands on the economics of existing and planned funds. For example, recent transactions involving the sales of private equity managers have resulted in meaningful concessions being given to fund limited partners, even though the funds were in the middle of their life cycles and the limited partners were "locked up." Due diligence, valuations and transaction terms must accommodate these effects. This trend and pending regulatory developments listed below are discussed in greater detail in "Private Equity Funds | Key Issues."
- Buyers also must assess the risk of defaults by limited partners experiencing liquidity constraints. The prospect of significant limited partner defaults on capital calls is no longer unimaginable. Where the acquisition of a manager of existing funds requires limited partner consent, reduced capital commitments are among the changes that limited partners may seek. Again, imaginative crafting of acquisition agreement provisions can help the acquirer address these issues.

Impact of Increased Regulation

- Legislation is pending in the United States and in the European Union that would increase the regulation of asset managers. Although this legislation has generated controversy on both sides of the Atlantic, it has (thus far) persisted.
- In the U.S., pending legislation would impose registration requirements on managers of hedge funds and (in at least one House bill) private equity funds. Alternative asset managers would be required to comply with new recordkeeping and reporting requirements and would be subject to examinations by regulators. In addition, and perhaps most important given the potential economic impact, the tax advantages of carried interests might be eliminated.
- As of this writing, the European Parliament and the Council of the European Union are considering a directive that would impose a new framework for the regulation of alternative investment fund managers. The current draft of the directive would impose limitations on compensation that might

Contributing Partners / Michael D. Dorum, Michael.Dorum@skadden.com, 212.735.3595 / David C. Hepp, David.Hepp@skadden.com, 212.735.3635

affect the means by which acquisition targets attract and retain investment professionals. Acquirers from outside the EU hoping to capitalize on their existing capabilities to provide services to potential acquisition targets, such as marketing and distribution of products that are undersold in their preacquisition platform, might be faced with new restrictions on the provision of management and marketing services to EU-based alternative investment funds. Other provisions of the directive would limit leverage used by alternative investment funds and impose new disclosure obligations on private equity funds that hold a controlling block of portfolio company securities.

- In 2010, purchasers of asset management firms should be alert to the evolving dynamics of adviser-client relations and the prospect of related changes in the terms of advisory agreements and arrangements. In addition, purchasers need to consider the potential impact of increased regulation on asset managers that operate or plan to operate in the affected jurisdictions. Insightful and creative responses to these developments will be features of the most successful asset management M&A transactions in 2010 and beyond.

Bank M&A | Industry Recapitalization and Failed Bank Deals to Continue

- Asset quality and balance sheet transparency concerns and resulting valuation and capital implications should remain major impediments to any significant resurgence in strategic bank and thrift M&A transactions in 2010.
- Bank and thrift M&A activity in 2010 likely will continue to consist primarily of sales by the FDIC of failed banks and their assets and deposits out of receivership, as well as capital-raising and other transactions designed to facilitate participation by healthy institutions and private investors in such sales. Banks and thrifts also will continue to divest select assets, subsidiaries or divisions for the purpose of enhancing capital.
  - FDIC auctions of failed banks should become more competitive, as more bidders enter the process, including "blind-pool" and "inflatable charter" bidders as well as existing institutions bolstered by new capital and/or an improving outlook.
  - As the number of bank failures continues to climb, the FDIC may begin offering smaller failed bank franchises in packages, grouped by geography and/or other criteria.
  - The FDIC can be expected to use more complex and creative structures for disposing of failed banks or their assets (particularly in cases where it perceives that better value can be achieved through selling some or all of the assets separately from the deposit franchise), including through providing seller (or, if available, competitively bid third-party) financing.
  - Open bank assistance remains an unlikely alternative for FDIC resolutions in light of the procedural requirements involved and the fact that such transactions may benefit stakeholders other than depositors (*e.g.*, subordinated debt holders, other creditors, stockholders).
  - The FDIC also will explore further how it can participate in the value realized by bidders and their investors in assisted transactions.
  - Banks seeking to participate in FDIC auctions will be permitted to bid only on those opportunities determined by the regulators to be appropriate for such banks in light of their size, available capital, geography, management capabilities and current regulatory status. Banks seeking to participate in FDIC resolutions should coordinate with the regulators ahead of time, including providing the FDIC with a list of possible opportunities in which the bank is interested.
  - Experienced bank managers seeking opportunities to raise capital and participate in FDIC transactions have several alternatives for doing so.
- "Blind pool" investment vehicles became increasingly popular in the latter half of 2009 as a way of quickly raising capital with a view to participating in FDIC auctions.
  - Blind pool vehicles are new, and their success in FDIC auctions has yet to be demonstrated. It is unclear how long the window for these capital-raising transactions will remain open.
  - Bank managers seeking to explore this avenue will need to identify an investment banking firm to provide a view on available financing in the market and to function as agent in accessing the capital markets.

Contributing Partners / David C. Ingles, David.Ingles@skadden.com, 212.735.2697 / William S. Rubenstein, William.Rubenstein@skadden.com, 212.735.2642 / William J. Sweet, Jr., William.Sweet@skadden.com, 202.371.7030

  - Identification of an appropriate slate of directors for the new bank investment vehicle is an important step that should be taken as early as possible in the process leading up to the capital raise.
  - Blind pool vehicles require a bank charter and other clearances from more than one regulator before being permitted to participate in FDIC auctions. Investors in blind pools are increasingly focused on the ability of the management team to obtain a bank charter and these other regulatory clearances in a timely manner.

- "Inflatable charters" or "platform banks" remain an attractive alternative for management and/or investors seeking to participate in FDIC transactions. An inflatable charter transaction involves the recapitalization of an existing bank, frequently coupled with the replacement of the bank's existing management team, so that it may be used as a platform for future acquisitions.
  - This alternative is perceived as a potentially faster regulatory path than seeking approvals necessary to organize a new bank.
  - The perceived timing advantage of these transactions can be undermined to the extent that the new investors and the legacy board of the bank engage in extensive negotiations with respect to the pricing of the new investment where the investors and the bank have varying expectations as to future losses in the legacy loan portfolio. Convertible preferred stock or other types of contingent value securities can bridge the value gap resulting from these disagreements but require careful structuring to address accounting, regulatory and securities law considerations.
  - Participants in an inflatable charter transaction will need to obtain the requisite comfort that any legacy regulatory issues at the platform bank (*e.g.*, poor regulatory examination ratings, a memorandum of understanding, or other regulatory order or supervisory agreement) can be resolved appropriately so that the platform bank is eligible to participate in FDIC transactions.
  - These transactions raise numerous other issues for legacy shareholders and new investors, particularly where the new investors comprise a concentrated consortium.
    - Important considerations will be the timing of funding investors' capital contributions into the platform bank, and whether "dead money" risk can be addressed appropriately while also providing for sufficient upfront funding to give the new investors a control position.
    - Investing in the platform bank through one vehicle, such as a newly organized limited liability company, can simplify the governance arrangements that must be implemented at the platform bank, but may affect regulatory requirements and raise timing issues and director duty considerations depending upon the aggregate size of the new investment.
    - Shareholder vote requirements may be triggered where the platform bank is a listed company or has insufficient authorized shares or classes of shares to complete the transaction.
    - Providing some or all of the legacy shareholders with a right to invest or receive contingent value in the future raises securities law considerations and may require SEC registration where the transaction also requires a legacy shareholder vote.

- Banking regulators, including the Federal Reserve, will continue to refine and articulate the framework for approving consortium transactions involving private equity investors.

- Consortium transactions often include ownership levels just below regulatory control thresholds (*e.g.*, 24.9 percent) and governance arrangements often found in "club" deals outside the banking industry (*e.g.*, shareholder approval rights, board representation, board observer rights, buy/sell arrangements). The Federal Reserve made significant progress at the end of 2009 in developing a framework for reviewing consortium transactions to ensure that investors not otherwise subject to banking regulation do not exercise a "controlling influence" over banks.
- Parties considering a consortium transaction should seek advice regarding the regulatory implications of the structure and terms of the proposed transaction as early as possible in the process. The regulators will review carefully all of the facts and circumstances surrounding the transaction, including its origins and any existing or past relationships among the parties involved (*e.g.*, past co-investment relationships among investors, consulting or employment relationships between management and any investor).
- Private equity consortia must address a range of issues in structuring their investments in institutions seeking to bid on individual FDIC opportunities (*e.g.*, securing investor access to the FDIC data room in a timely manner prior to the bid date, pricing of and opt-outs on subsequent capital calls and related penalties (if any), timing for funding capital calls in connection with an FDIC bid, and meeting any related FDIC requirements).
- Private equity investors may consider numerous other structures for investing in banking institutions (*e.g.*, functioning as a lead investor in an equity offering transaction, making a significant minority investment in a banking organization either alone or with other investors).

• Banking institutions and their investors must consider the potential application of the FDIC's Statement of Policy on Qualifications for Failed Bank Acquisitions (the Policy Statement) when structuring any bank investment transaction or considering any bid to acquire a failed bank from the FDIC. Released in August 2009, the Policy Statement imposes significant requirements on potential bidders in FDIC auctions that are subject to its application, including a three-year minimum 10 percent Tier 1 common equity ratio requirement and a three-year holding period requirement for investors.

- There is little official guidance on when, how and to whom the Policy Statement applies. To date, the FDIC has implemented the Policy Statement on a case-by-case basis.
- The Policy Statement includes an exception for investors that own less than 5 percent of the voting stock of an institution. Many blind pool and inflatable charter transactions have been structured with a view to relying on this exception in order to avoid application of the Policy Statement.
- Even where an investor or institution is not subject to the Policy Statement, the FDIC and other regulators may impose analogous requirements based on "safety and soundness" considerations.
- Any institution with private investors seeking to bid in an FDIC whole bank transaction will need to obtain advice regarding the application of the Policy Statement to the institution and its investors.
- The FDIC has indicated that it will review the operation and impact of the Policy Statement in late February 2010. It may seek input from investors and industry participants in connection with that review.

“Expect acquirers to remain selective in assessing M&A alternatives given the breadth of available opportunities, particularly in the Bermuda P&C market.”

Insurance | Key Developments and Deals in the Insurance Industry

Other than several insurers requiring TARP fund support and, in certain cases, relief in the first quarter of 2009 in the form of permitted practices to alleviate reporting the full decline in the market value of their investments, the insurance industry generally has weathered the credit crisis storm without requiring government intervention or significant restructurings of insurance operations. However, this has not stopped Capitol Hill from putting forth (and the National Association of Insurance Commissioners (NAIC) dutifully responding to) a number of legislative proposals that would impact the insurance industry. While neither an optional federal charter nor the repeal (or meaningful limitation) of the federal antitrust exemption for insurance companies is currently on the table, the legislative winds are blowing.

In fact, the creation of a Federal Insurance Office to monitor and report on developments in the insurance industry, passed by the House Financial Services Committee in concert with legislation establishing a Financial Services Oversight Council, is highly likely in 2010. Within hours of the bill passing the committee, the NAIC announced that state insurance regulators were undertaking a review of the regulatory framework for insurance markets in the U.S. as part of the Solvency Modernization Initiative. Some industry observers believe that, several years from now, this and related legislation under consideration will be viewed as a watershed moment for incremental federal oversight of the insurance industry. Going forward, the debate on federal oversight will involve an interplay of systemic risk regulators, holding company regulators and functional regulators, including how best to address the unique needs of insurance holding companies and their insurer subsidiaries.

2009 was not wholly consumed by legislative initiatives. The year saw a steady stream of insurance M&A deals, including, among others, the pioneering acquisition of IPC Holdings by Validus Holdings, the strategic acquisition of Paris Re by Partner Re, Fairfax Financial's going-private acquisition of Odyssey Re, and AIG's disposition of its personal lines business to Farmers.[1] As the global economy continues to stabilize and slowly improve, the stage is being set for increased M&A activity, as some strategic acquirers and even private equity firms, including many that have been active in the past, capitalize on market dislocations.

In particular, 2010 could see the following developments and trends for strategic and private equity-insurance M&A:

- **Strategic**
  - Expect acquirers to remain selective in assessing M&A alternatives given the breadth of available opportunities, particularly in the Bermuda P&C market.
  - Presigning rating agency feedback could necessitate material changes to deal terms and governance structures or, in extreme cases, may scuttle potential transactions shortly before their planned announcement.
  - Following the success of Validus' pursuit of an unsolicited acquisition in driving IPC toward an ultimate deal with it, other industry participants likely will take a closer look at hostile deal tactics, ranging from private and public "bear hugs" to hostile exchange offers and proxy contests, being mindful of "proxy presumption-of-control" triggers in many domiciliary states.
  - Although most deals will continue to be stock-for-stock transactions, the use of a cash component can be a key element of a successful transaction depending on, among other factors, the target's shareholder makeup.

Contributing Partners / Todd E. Freed, Todd.Freed@skadden.com, 212.735.3714

- Noncore subsidiary dispositions and book-of-business reinsurance transactions may increase as financial institutions continue to focus on core competencies and markets.

- **Private Equity**
  - Expect industry-focused firms to ramp up their acquisition and investment activity in the insurance sector in 2010.
  - Transactions may take the form of control positions with attendant governance rights or acquisitions of divisions, instead of outright whole-company acquisitions.
  - Private equity and alternative investment vehicles may serve as conduits for disposals of troubled divisions and investment asset portfolios or as sources of funding for capital intensive or growth lines of business.
  - The potential exists for private equity to partner with strategic acquirers, whether as joint venturer, financing source or as purchaser of specified businesses or assets. (See "U.S. M&A | Recent Developments in Private Equity Transactions")

Given all of the above factors, 2010 should be an exciting time for corporate and other dealmakers in the insurance M&A market.

[1] Skadden represented Validus Holdings and the financial advisor to Farmers in these transactions.

Energy and Infrastructure Projects | The Continuing Effects of the Financial Crisis on Growth Potential

We see several key factors that present tremendous potential for growth in the renewable energy and transmission industries in the United States: the Department of Energy's Loan Guarantee Program, the Treasury Department's program for cash grants in lieu of investment tax credits for specified energy property, and expectations for a comprehensive energy and climate bill.

Such potential, however, is offset by the continuing effects of the financial crisis and delays in the implementation of federal incentives for energy projects. Conditions in the credit markets and the availability of government support will continue to influence the volume and nature of transactions in 2010.

Department of Energy Loan Guarantee Program

- The Department of Energy (DOE) is authorized to provide approximately $100 billion in loan guarantees for energy projects under its Title XVII Loan Guarantee Program. DOE is currently accepting loan guarantee applications for:
  - renewable energy, energy efficiency, and advanced transmission and distribution projects that employ innovative technologies under a program in which a project developer or sponsor applies directly to DOE, and the loan may be funded by the Treasury Department's Federal Financing Bank;[1] and
  - renewable energy generation projects that employ commercial technology under the Financial Institutions Partnership Program (FIPP), where an eligible lender applies to DOE for a guarantee of a loan after agreeing to basic terms with the borrower.[2]
- Administrative delays continue to undermine DOE's Loan Guarantee Program. DOE has closed only one loan guarantee since the Energy Policy Act of 2005 created the Title XVII Loan Guarantee Program, and hundreds of applicants are waiting for DOE to review their applications and reach financial closing. Such delays are primarily attributable to environmental review requirements under the National Environmental Policy Act, limited resources of DOE and project-by-project reviews by the Office of Management and Budget.
- While DOE is seeking to leverage the resources and expertise of private commercial banks under FIPP, many private commercial banks are deterred by FIPP's complex and unfamiliar rules, as well as requirements for lender certifications.
- DOE is addressing certain procedural inefficiencies that have impaired the Loan Guarantee Program to date. For example, in December 2009, DOE adopted new regulations for the Loan Guarantee Program, which give DOE flexibility to negotiate intercreditor agreements and provide for the sharing of project collateral in the event of default on a *pari passu* basis.
- At the same time, Congress is supporting improvements to DOE's Loan Guarantee Program. The House Energy bill, passed June 26, 2009, and the Senate Energy Committee bill, passed July 16, 2009, include amendments to Title XVII of the Energy Policy Act that would reduce borrower fees and accelerate DOE's review process.

Contributing Partners / Lance T. Brasher, Lance.Brasher@skadden.com, 202.371.7402 / Martin Klepper, Martin.Klepper@skadden.com, 202.371.7120 / Paul S. Kraske, Paul.Kraske@skadden.com, 202.371.7234

Proposed Federal Clean Energy Bank

- Both the House Energy bill and the Senate Energy Committee bill include provisions that would establish the Clean Energy Deployment Administration (CEDA) to provide direct loans, letters of credit, loan guarantees and other forms of credit support for clean energy technologies in the United States.
- The House Energy bill would create CEDA as an independent corporation and provide it with an initial capitalization of $7.5 billion through the issuance of Green Bonds by the Department of Treasury. The Senate Energy Committee bill would create CEDA as a new administration within DOE and fund CEDA with a direct transfer of $10 billion from the Treasury.
- Under the House Energy bill, CEDA would coexist with DOE's Title XVII Loan Guarantee Program. The Senate Energy Committee bill would transfer control over the Title XVII Loan Guarantee Program to CEDA within 18 months of passage.
- CEDA's primary objective would be to support the development of "breakthrough technologies," although CEDA also would be authorized to support conventional clean energy technologies. Both the House Energy bill and the Senate Energy Committee bill would direct CEDA to provide the "maximum practicable percentage of support to promote breakthrough technologies."
- CEDA would be governed by a Board of Directors and an Energy Technology Advisory Council. One duty of the Board would be to ensure that CEDA's operations are "consistent with the development of a robust private sector that can provide commercial loans or financing products." The council would be responsible for developing methodology for assessing technologies and advising on technological approaches that CEDA should support.

Tax Incentives for Renewable Energy

- Section 1603 of the American Recovery and Reinvestment Act authorized the Secretary of the Treasury to provide cash grants in lieu of investment tax credits that otherwise would be available for investments in specified renewable energy property. The Recovery Act provides that grants will be provided only with respect to energy property (1) that was/is placed in service during 2009 or 2010 or (2) whose construction began/begins during 2009 or 2010 (and is placed in service before the end of the applicable tax-credit period).
- Although general market conditions have improved, a shortage of tax equity financing capacity persists and, thus, pressure to extend the program for cash grants in lieu of tax credits should be significant.
- Unless and until the program for cash grants in lieu of tax credits is extended, developers of, and investors in, renewable energy projects will make significant efforts to ensure that, for tax purposes, construction of otherwise eligible projects has begun prior to December 31, 2010.

Electric Transmission Expansion Driven by Renewable Energy Goals and Favorable Regulatory Climate

- Development of renewable energy resources requires a significant expansion of the electric transmission grid to move electricity from areas with plentiful renewable resources to load centers.

- Rate recovery principles applied by the Federal Energy Regulatory Commission (FERC) to regulated transmission projects are favorable to project sponsors and designed to encourage development of electric transmission.
- For merchant transmission lines, which do not qualify for regulated rate recovery, FERC now permits anchor tenants to subscribe to a line's capacity without requiring a project sponsor to hold an "open season" first in which bidders compete for the line's capacity. This reform reduces uncertainty for merchant projects and allows merchant developers to partner with anchor tenants in funding the line's construction.
- Despite the favorable federal regulatory environment for transmission project development, siting transmission projects remains a challenge under state and local law. Several federal legislative proposals have attempted to address this problem, but none has been enacted yet.

Natural Gas and LNG

- In recent years, a combination of global factors created a strong market for natural gas sellers. Those factors included the expectation that continued strong economic growth would drive greater global demand for gas, marked declines in gas production in North America, a lack of new major development projects, and the combination of high oil prices and the competition between gas and oil in the Asian market. The strong gas demand led to a significant increase in investments in the development of gas fields, the infrastructure needed to supply that gas — including several new projects to develop LNG liquefaction plants and regasification terminals as well as gas pipelines — and new technologies for extracting gas from unconventional sources and in delivering LNG.
- In the last two years, however, the global recession, unexpected growth in the project availability of gas from shale and other unconventional sources in North America, and a significant increase in new LNG supply have combined to create an oversupply of gas that has dramatically pushed down the spot price. Not surprisingly, this downward price pressure has affected investment plans both for upstream development projects and gas supply infrastructure projects like the various LNG regasification terminals that were being developed for the U.S.'s Atlantic coast.
- This dramatic turn in supply and demand of gas in the major markets is likely to make it even more difficult to secure limited recourse project financing for new gas development and infrastructure projects from an already-tight credit market for new project financings.
- On a brighter note, gas sellers may find new market opportunities in Latin America and the Caribbean. Both regions continue to show interest in importing LNG to diversify their energy supply sources and have recovered from the recession more quickly than North America and Europe. In addition, climate change concerns and the resulting carbon pricing regimes will likely continue to favor cleaner-burning natural gas as a short- to medium-term solution to facilitate the transition away from existing coal and oil-fired thermal plants that provide base load power.

Solar

- Solar energy, which generally follows daylight peak loads, arguably has the highest potential of renewable energy resources. Technological advances, an abundant and reliable resource, and favorable regulatory policies are causing an explosion in the development of utility-scale solar power projects

in the U.S. and many other countries. Efficiency improvements in photo-voltaic and concentrating solar power systems, together with declining production costs, are leading to more competitively priced solar energy.

- The impetus for the U.S.'s tremendous growth in solar power is a favorable regulatory environment. This environment includes the proliferation of state Renewable Energy Portfolio Standards across the country with solar set-asides and expectations for a national standard, the extension of the solar investment tax credit in-service date requirement to 2016, the expansion of the Department of Energy Loan Guaranty Program, the creation of the Treasury grant under the American Recovery and Reinvestment Act, and the anticipation of climate change legislation regulating greenhouse gas emissions.
- Availability of the solar ITC and the related Treasury grant have led to utilities' keen interest in the ownership of utility-scale solar projects. Utility ownership generally results from one of four types of arrangements: (1) a power purchase agreement with a purchase option, (2) a build-transfer arrangement, (3) a joint ownership arrangement or (4) a construction contract.
- Transmission availability, Bureau of Land Management siting and the related National Environmental Policy Act process will continue to drive the development schedule and attractiveness of sites. Smaller utility-scale solar projects of a size of 10-25 MW may represent a sweet spot for many utilities, given a relative ease in siting and less challenging interconnection and transmission issues.
- Until solar costs become more competitive, solar power will need to rely heavily on subsidies such as the solar ITC, related Treasury grant and feed-in tariffs, and renewable energy portfolio requirements with solar set-asides. Projects seeking to employ new technologies in the short term will need to rely heavily on the DOE programs for initial project financing.

Project Financing Availability and Refinancing Risk

- Conventional bank financing is still available for well-structured projects but is highly competitive. With the bank collapses and acquisitions over the past year, the number of key lenders has been substantially reduced. Capital markets for project financing appear to be providing some relief for the best-structured projects.
- Projects getting done will rely heavily on alternatives to bank financing. Developers will need support from contractors and equipment vendors and their access to Export Credit Agency financing. In particular, Chinese vendors and contractors have actively provided related bank and Export Credit Agency financing.
- In recent years, billions of dollars have been loaned on "covenant lite" terms under mini-perm structures and short-term revolvers for projects and project portfolios. These loans will need refinancing over the next few years.
- Given the difficulty in the market and the fewer number of available lenders, the process for securing refinancing must commence as quickly as possible.

[1] Please see Skadden, "Department of Energy Issues New Loan Guarantee Solicitation Announcements for Innovative Technologies Projects and Commercial Transmission Projects," August 3, 2009, available at http://www.skadden.com/content%5CPublications%5CPublications1851_0.pdf.

[2] Please see Skadden, "Department of Energy Issues First Loan Guarantee Solicitation Under the Financial Institutions Partnership Program," October 9, 2009, available at http://www.skadden.com/content%5CPublications%5CPublications1937_0.pdf.

[3] Please see Skadden, "Department of the Treasury Releases Guidance Establishing Application Procedures and Eligibility Requirements for Grants for Specified Renewable Energy Property in Lieu of Tax Credits," July 10, 2009, available at http://www.skadden.com/content%5CPublications%5CPublications1833_0.pdf.

“Given the prevalent use of bankruptcy remote entities in commercial mortgage-backed securities financing transactions, we expect further testing of the ‘remoteness’ of special purpose entities.”

Real Estate | Challenges to Real Estate Transactions and REITs

Dramatic price depreciation, limited financing options, uncertainty over the length of the economic downturn, numerous regulatory changes and the lack of investor confidence in real estate markets have resulted in complex challenges for many real estate clients and REITs. These tumultuous times will continue until greater price certainty and transaction volume take hold in the real estate markets.

Workouts and Restructuring

- Recent bankruptcy rulings have tested the effectiveness of bankruptcy remote real estate financing structures.
  - Given the prevalent use of bankruptcy remote entities in commercial mortgage-backed securities (CMBS) financing transactions, we expect further testing of the "remoteness" of special purpose entities (SPEs). (See "Lessons for the CMBS Market and the Securitization World in the General Growth Properties Bankruptcy")
  - The potential of substantive consolidation among SPEs and parent entities in bankruptcy will be tested.
- Bankruptcies are generating questions on the enforceability of fundamental provisions in loan documents, including heightened scrutiny of "bad act" guarantees and nonrecourse carve-outs.
- Lenders may find themselves exposed to risks as a result of heightened scrutiny of traditional tests for lender liability, fraudulent transfers and equitable subordination.

New Litigations in Real Estate

- Real estate-related bankruptcies, delinquencies and workouts will test CMBS structures, duties among CMBS stakeholders, exculpation and indemnification provisions, and "accepted servicing practices" standards.

Real Estate Private Equity Funds

- Liquidity issues and significant declines in the value of real estate assets have generated challenges and opportunities for real estate funds.
  - Fund managers may experience difficulty enforcing their investors' obligations to fund additional capital.
  - Financial pressures and recent investment fraud cases may result in increased investor sensitivity to affiliate transactions, including scrutiny of conflict and fiduciary duty provisions.
  - The downturn created opportunities for investments in real estate, including in distressed debt, undervalued real estate assets and over-leveraged properties without refinancing options. Vulture funds could re-emerge to capitalize on such opportunities.

Contributing Partners / Michael Beinus, Michael.Beinus@skadden.com, 213.687.5334 / Evan R. Levy, Evan.Levy@skadden.com, 212.735.3889

Public Markets

- Available distressed investment opportunities have led to an increase in mergers and acquisitions of public REITs, as well as IPOs of real estate vehicles and mortgage REITs that were created to capitalize on market conditions and purchase toxic assets under the U.S. Treasury's Public-Private Investment Program. In addition, recently there have been a number of filings for IPOs by "blind pool" REITs — entities seeking to raise money from the public to pursue opportunities in acquiring commercial real estate at opportunistic prices.
- Many existing REITs have raised large sums of money through equity offerings. The equity may be used to pay down debt or serve as "war chests."

Tax Issues

- Restructurings and workouts resulting from the downturn may have unexpected tax consequences for parties to real estate transactions.
  - Non-U.S. investors may find themselves subject to U.S. income taxation and FIRPTA issues.
  - The rise in mortgage and mezzanine loan foreclosures may result in a focus on state and local transfer taxes.
  - Restructurings, workouts and foreclosures, or deeds in lieu of foreclosure, may result in the recognition of cancellation-of-indebtedness or "phantom" income.

Issues of Particular Relevance to REITs

- The distribution by REITs of taxable income solely in cash in order to satisfy the distribution requirement applicable to REITs may burden REITs desiring to retain cash. Under recently issued Revenue Procedure 2010-12, a stock dividend paid by a publicly traded REIT that is declared on or after January 1, 2008, and on or before December 31, 2012, with respect to a taxable year ending on or before December 31, 2011, may be treated as a taxable dividend if each stockholder has an option to elect to receive the dividend in cash, even if the aggregate cash amount paid to all stockholders may be limited, as long as the cash portion represents at least 10 percent of the total dividend payment to be made to all stockholders and certain other requirements are satisfied.

The challenges facing participants in real estate markets today also create the potential for significant opportunities for real estate investors, lenders and REITs to capitalize on market and regulatory shifts. Limited transaction activity based on price uncertainty has left many market participants waiting on the sidelines looking for the right opportunities to enter the real estate markets.

Regulatory

“As severe economic challenges continue, businesses may face heightened temptation to engage in risky behavior, and global enforcers are on the lookout.”

Antitrust | A New Era of Convergence?

As President Obama's first year in office draws to a close, new leaders at the U.S. antitrust agencies are proclaiming an era of vigorous antitrust enforcement, touting a new, more unified U.S. antitrust enforcement policy and continuing to work toward convergence among international antitrust regimes. However, these goals of vigorous enforcement and convergence face obstacles, including a weak global economy and differing regional views toward competition-related policies, as demonstrated by the public disagreement between the U.S. Department of Justice and the European Commission regarding Oracle Corporation's proposed acquisition of Sun Microsystems.

Outside the United States, the European Commission continues its strong enforcement efforts despite the financial crisis, the new antitrust regime in China is off to a strong start, and India is completing the implementation of its new competition regime. For 2010 and beyond, it will be interesting to see whether and how global regulators move past rhetoric and display greater convergence in practice.

U.S. Antitrust Enforcement

- Former Federal Trade Commissioner Christine A. Varney was confirmed in April 2009 as the new assistant attorney general in charge of the DOJ's Antitrust Division. Consistent with President Obama's vow to reinvigorate antitrust enforcement, Varney's early actions, reflecting convergence with FTC positions and international enforcement trends, have included:
  - immediately withdrawing the Antitrust Division's controversial Section 2 Report, which had been issued in 2008 to address single-firm conduct. The Section 2 Report had received harsh criticism from the FTC and others that it was too lenient;
  - announcing a special interest in exploring competitive effects of vertical relationships, particularly in high-tech and Internet-based markets;
  - undertaking, along with the FTC, a comprehensive review of the agencies' Horizontal Merger Guidelines, which were last overhauled in 1992. With input from the public and the antitrust community, the agencies are studying whether the Guidelines reflect current merger-review practices. Updates may include the incorporation of newer economic theories and more flexibility in existing standards; and
  - enhancing the Antitrust Division's merger and litigation capabilities with seasoned senior staff that include economist Carl Shapiro and litigator William F. Cavanaugh, Jr.
- At the FTC, vigorous enforcement continues under the new leadership of Democrat Jon Leibowitz, who was named chairman in March 2009.
  - The FTC has shown continued interest in the health care sector, including court challenges to so-called reverse payment settlements of patent infringement suits as well as vocal support for pending bills in Congress that would outlaw certain reverse payment settlements.
  - Changes to FTC Rules adopted in April 2009 have revitalized administrative adjudications by expediting proceedings and enhancing the FTC's ability to obtain preliminary injunctions against mergers perceived to be anti-competitive.

Contributing Partners / Ian G. John, Ian.John@skadden.com, 212.735.3495 / Gary A. MacDonald, Gary.MacDonald@skadden.com, 202.371.7260 / James S. Venit, James.Venit@skadden.com, 32.2.639.4501

- Chairman Leibowitz and Republican Commissioner Thomas J. Rosch have advocated use of Section 5 of the FTC Act to challenge unfair or anti-competitive conduct that may not violate the Sherman Act or other antitrust laws, and on December 16, the FTC filed a Section 5 complaint against Intel. Clear standards for enforcement have yet to emerge, much to the frustration of the business community.
- In November 2009, President Obama nominated fellow Democrats Julie Brill and Edith Ramirez to fill the two vacant FTC seats, which would tip the party balance to three Democrats and two Republicans and provide a party majority for Chairman Leibowitz.

Global Cartel Enforcement

- Cartel enforcement remains strong, often reflecting cross-border cooperation among enforcement agencies. Companies should be alert for any signs that employees might engage or have engaged in collusive agreements with competitors. As severe economic challenges continue, businesses may face heightened temptation to engage in risky behavior, and global enforcers are on the lookout.
- Recently, several jurisdictions — China, India, Singapore and Taiwan — have introduced leniency/amnesty programs to encourage disclosure of cartel conduct, joining a global trend.

Twombly, Iqbal Private Litigation

- The pro-defense, heightened pleading standard articulated in *Bell Atlantic v. Twombly* was amplified in the Supreme Court's May 2009 decision in *Ashcroft v. Iqbal*. These decisions have proven enormously helpful in seeking dismissal of speculative antitrust actions prior to expensive discovery. (See "Mass Torts and Consumer Class Action Trends")

European Union (EU) Enforcement

- Assuming approval of the new European Commission by the European Parliament, current European Competition Commissioner Neelie Kroes will be replaced as of February 2010 by Joaquín Almunia, a close and trusted adviser to José Manuel Barroso, President of the European Commission. Almunia, who also will serve as one of the five vice presidents of the Commission, has a strong macro-economics background and significant policy-development experience, having served as Commissioner for Economic and Monetary Affairs in President Barroso's first Commission. There will be a number of immediate challenges for Almunia, including state aid to the financial sector, the Commission's fining policy, the scope of private damages for competition law infringements and EU/U.S. convergence.
- Outside the area of state aid, the 2009 financial crisis has not affected the European Commission's antitrust enforcement agenda materially, although the crisis and its aftermath may impact fining decisions in the future.
  - In May 2009, the European Commission imposed a €1.06 billion fine on Intel for exclusionary pricing practices allegedly designed to foreclose AMD from the market for x86 central processing units. The decision has drawn criticism for the level of the fine, disrespect for rights of due process and inconsistency with the effects-based approach advocated by the Commission's

2008 guidance on Article 102 (formerly Article 82) enforcement priorities. The decision is on appeal before the General Court (formerly known as the Court of First Instance). The decision's significance for the future enforcement of Article 102 will be largely determined by the outcome of this appeal, which could take five or more years.

  - In June 2009, the Commission imposed a fine of €20 million on Belgian utility Electrabel. This is the largest gun-jumping fine ever imposed under the EC Merger Regulation.
  - The Commission continued its aggressive enforcement in cartels. The largest fines were imposed on E.ON and GDF Suez (€553 million each) in July 2009 for a market-allocation agreement in the gas market.

- Under Commissioner Kroes, the European Commission supplemented its enforcement with sector-specific inquiries in the energy, financial services and pharmaceutical sectors. In July 2009, the Commission issued its final report on its inquiry in the pharmaceuticals sector, which focused, in particular, on competition from generics. The Commission has initiated investigations through surprise inspections of several pharmaceutical companies based on its findings in the sectoral inquiry.

China and India

- In 2009, China's Ministry of Commerce (MOFCOM) issued a number of decisions under its Anti-Monopoly Law, reflecting a strong enforcement policy in the merger control area. MOFCOM prohibited one direct acquisition and took enforcement action in four foreign-to-foreign transactions in the form of divestments or other remedies. In one of these four transactions (Panasonic/Sanyo), MOFCOM imposed extraterritorial remedies (divestments in Japan).
- Despite the creation of the new Competition Commission of India (CCI), the Competition Act 2002 has yet to be fully implemented. As a result, as of January 2010, there is no merger control law in India. However, the new regime on abuses of dominance and cartels is up and running, and the CCI has opened investigations in more than 10 cases.

"The … amendments are part of a current trend of stricter review and enforcement of the anti-monopoly regime, including longer waiting periods and increased scrutiny from the JFTC."

Antitrust | Trends in Japanese Anti-Monopoly Act Enforcement

As a result of amendments to the Japanese Anti-Monopoly Act and increased scrutiny by the Japan Fair Trade Commission (JFTC), we believe the number of international business combinations subject to Japanese filing requirements and enforcement actions will increase.

The Anti-Monopoly Act was amended to include a preclosing notification requirement for share acquisitions to make them more in line with other forms of business combinations. The Act also was amended to provide for the aggregate Japanese domestic turnover of a "corporate group" (the ultimate parent company of the acquiring corporation and its corporate subsidiaries) as the triggering basis for preclosing notification. The primary effect of these amendments is to close perceived loopholes permitting transactions to avoid preclosing notification by structuring as a share acquisition or by using a newly incorporated subsidiary or small indirect subsidiary as the acquisition vehicle.

Under the new rules, a preclosing notification is triggered if the aggregate domestic turnover of the acquiring "corporate group" exceeds ¥20 billion and (1) the aggregate domestic turnover of the target corporation and its subsidiaries in a share acquisition exceeds ¥5 billion; or (2) in business combinations other than share acquisitions, the aggregate domestic turnover of the target "corporate group" exceeds ¥5 billion. Regardless, a share acquisition will not require notification if the acquiring "corporate group" holds 20 percent or less of the voting rights of the target following the transaction (50 percent, if the acquiring corporate group held 20-50 percent of the target voting rights prior to the transaction).

In addition, under the new rules, share acquisitions by partnerships (limited liability partnerships, limited partnerships and similar foreign partnerships) will require a preclosing notification by the entity substantially controlling such partnership. The notification must contain a general description of the "ultimate parent company" (name, address, incorporation date, gross assets and turnover) as well as a description of the ultimate parent company's control rights, which may present an issue for investment funds wishing to avoid disclosing its fund structure.

The amended rules go into full effect on January 31, 2010, after a one-month transition period.

The above amendments are part of a current trend of stricter review and enforcement of the anti-monopoly regime, including longer waiting periods and increased scrutiny from the JFTC as a response to consolidations taking place across many industries in Japan. In one recent example, the JFTC required a Japanese conglomerate to take remedial action in connection with the acquisition of a majority interest in a Japanese company in a highly concentrated market, because the conglomerate already held an indirect, significant minority interest in a competitor company that also held a significant market share.

Although the conglomerate previously agreed to waive its right to (1) nominate any officers, (2) access certain confidential information and (3) vote all shares with regard to the indirect interest in order to allay concerns of another antitrust authority in connection with a different acquisition, the JFTC still found that the proposed acquisition would result in an anti-competitive concentration in light of the fact that the two companies were the only real competitors in the relevant market. To mitigate JFTC concerns, the conglomerate was required to decrease its indirect interest in the other company, indicating that the JFTC may require an acquirer to dispose of shares in a company it does not control, if it wishes to acquire a competitor in an oligopolic market. As industries continue to consolidate in Japan, we expect to see increased scrutiny of business combinations by the JFTC.

Contributing Partners / Mitsuhiro Kamiya, Mitsuhiro.Kamiya@skadden.com, 81.3.3568.2228 / Michael J. Mies, Michael.Mies@skadden.com, 81.3.3568.2619

"Reductions in GHG emissions on the scale currently contemplated under leading congressional approaches would impact the U.S. economy profoundly and force a substantial restructuring of energy and other major sectors."

Climate Change | U.S. Climate Policy Debate to Heat Up Post-Copenhagen

2010 should mark a critical turning point in the course of U.S. action on climate change. Legislation was passed by the House of Representatives in 2009 that would reduce greenhouse gas (GHG) emissions markedly, and most observers anticipate a Senate vote on its preferred approach by the end of April 2010. Positions within both the executive and legislative branches also will be informed by the outcome of international negotiations that started in Copenhagen and also are likely to be concluded in 2010. Reductions in GHG emissions on the scale currently contemplated under leading congressional approaches would impact the U.S. economy profoundly and force a substantial restructuring of energy and other major sectors.

While the ultimate fate of U.S. climate change legislation remains uncertain, two scenarios appear particularly plausible. Under the first, legislation passes, likely featuring three major components: (1) a cap and trade program requiring affected sectors to reduce their emissions gradually over a prescribed time horizon; (2) subsidies to encourage energy efficiency, spur renewable energy deployment and facilitate projects to avoid tropical deforestation; and (3) a range of new regulatory standards, *e.g.*, measures requiring energy companies to generate a fixed amount of their energy from renewable sources. Significantly, the cap and trade scheme would require companies to obtain "allowances" to emit CO_2, with the number of allowances dropping each year. Some of the allowances would be given away for free, and some would have to be purchased, with the amount of free allowances varying by industry. Companies also would be able to purchase "offset credits" from nonregulated portions of the U.S. economy and from unregulated foreign sources.

Under a second scenario, cap and trade legislation is defeated. Given the likelihood that — as almost always happens in midterm elections — the incumbent party loses seats, it is very doubtful that a cap and trade bill would re-emerge for serious consideration before 2013. The issue of global warming will not go away, however, and most businesses can expect to face tighter emissions constraints eventually, along with ever-increasing scrutiny of carbon performance by major stakeholders. Along the way, in the absence of a clear policy framework, uncertainty would continue to crimp investment decisions.

A failure of the domestic climate policy debate to yield an agreement on national legislation would have substantial implications. First, states and regional groups would push ahead with their own cap and trade schemes, albeit with widely varying provisions, including differing emission reduction requirements. Second, without revenues from cap and trade, funding for subsidies for renewables, carbon capture and other essential technology, investment would be reduced substantially. Third, the U.S. Environmental Protection Agency (EPA) would start regulating GHG emissions in earnest. Since the EPA has expressed reservations about the extent to which it can adopt a cap and trade approach to reduce GHG emissions under the Clean Air Act (CAA), it can be expected instead to require covered sources to meet "best available control technology standards" for new and modified plant construction. The CAA requires that the EPA take this action as soon as it puts into effect any regulation of CO_2 emissions. The EPA also could regulate CO_2 emissions at existing plants on a sectoral basis under its New Source Performance Standards program, but doing so would entail a much longer regulatory process. Finally, the continuing void in climate legislation would fuel an explosion of litigation targeting enterprises and projects with a carbon footprint, as evidenced by recent developments in two federal courts of appeals, allowing nuisance tort actions to go forward seeking damages and a cap on emissions at defendants' facilities.

Contributing Partner / Kenneth Berlin, Kenneth.Berlin@skadden.com, 202.371.7350

“The National Broadband Plan ... will recommend legislative changes and regulatory proposals to increase broadband deployment, investment and adoption.”

Communications | A New Focus at the FCC

New leadership at the Federal Communications Commission and in relevant congressional committees has refocused the agency on implementing key aspects of the president's economic revitalization and technology agendas. Under the leadership of Chairman Julius Genachowski, the FCC has commenced several comprehensive proceedings that could result in sweeping changes to the FCC's regulation of telecommunications, media and Internet-related entities. These proceedings will dominate the FCC's agenda in the coming year and influence its reviews of pending and future transactions *(e.g.*, Comcast-NBC Universal).

National Broadband Plan

- The economic stimulus legislation required the FCC to create and deliver a National Broadband Plan (the Plan) to Congress by February 17, 2010. Because the Obama administration views increased broadband deployment and adoption as a key component to its economic agenda, the FCC has dedicated substantial resources to development of the Plan, which will recommend legislative changes and regulatory proposals to increase broadband deployment, investment and adoption.
- Of particular importance, the Plan is expected to address what many view as a looming shortage of available spectrum for broadband wireless services, leading to increasing calls for reallocation of unused or underutilized government and private sector spectrum holdings (*e.g.*, broadcast television spectrum). The Plan also is likely to include recommendations to reform regulations of cable set top boxes and programs such as the federal universal service fund (USF), which could support the deployment of broadband infrastructure and services. To further the president's calls to build a "clean energy superhighway," the Plan also likely will include initiatives to increase the deployment and utility of wireless broadband infrastructure for energy-related services (*e.g.*, smart grid, etc.).
- The FCC's focus on broadband deployment, especially mobile broadband, could make the agency more receptive to transactions that are viewed as advancing broadband deployment and adoption. Given the current regulatory landscape, consolidation among smaller wireless operators likely would be viewed as advancing competition against the market leaders. Also, the availability of additional spectrum, and continued migration of content and video to mobile devices, could lure nontraditional participants into offering wireless services directly.

Network Neutrality

- Commencing a regulatory proceeding with broad ramifications for Internet-related businesses and content owners, the FCC released a Notice of Proposed Rulemaking in October 2009 that contains proposals to adopt "network neutrality" regulations to govern the activities of broadband network service providers. These regulations would codify several nonbinding principles that ensure consumers access to the lawful Internet content, applications and services of their choosing. The regulations also would prevent network operators from discriminating in the carriage of content and would require increased transparency, such as disclosure of network management practices.
- The regulatory debate triggered by the proposals will pit third-party application providers (*e.g.*, Google) and critics of consolidation against network operators and distribution outlets that view increased regulatory oversight as unnecessary in a competitive and innovative marketplace. Much of the debate

Contributing Partners / Antoinette C. Bush, Antoinette.Bush@skadden.com, 202.371.7230 / Ivan A. Schlager, Ivan.Schlager@skadden.com, 202.371.7810

will surround adoption of a nondiscrimination requirement and the parameters of "reasonable" network management. Broad implementation of these concepts could prevent network operators from selling Internet "fast lanes" to content owners or offering service level guarantees for certain applications (*e.g.*, streaming movies, voice services, etc.). Such an approach also could complicate content owners' efforts to increase and, more importantly, monetize the online content availability.

- Although the proposals represent a significant departure from the light-touch approach that regulators previously have taken toward the Internet, they appear to provide sufficient flexibility for operators to manage network traffic and take reasonable action to curtail the transmission of unlawful content, including stolen copyrighted works. The fairly general nature of the proposals, moreover, indicates that the FCC could be planning to move incrementally in adopting definitive restrictions on broadband service providers' activities. Indeed, while formal adoption of the proposals in some form is likely by the middle of 2010, the precise contours of the regulations may not be known for several years as the FCC details its specifics in case-by-case enforcements.

USF and Intercarrier Compensation Reform

- In the context of making broadband universally available, the FCC also appears determined to reform the politically charged $7 billion USF and the highly complex intercarrier compensation regime. While both systems currently support legacy networks and set compensation for carriage of voice traffic, the Plan is expected to recommend their transition to supporting broadband services and next-generation infrastructure.

- Wireless broadband operators and broadband applications service providers stand to gain from the transition to a broadband-centric support structure. Rural carriers that currently use the USF and/or intercarrier compensation systems to support their legacy voice services could see a significant reduction in their federal subsidies, requiring them to locate additional revenue or increase their scale to compete in the marketplace.

Media Ownership

- 2010 marks the resumption of the FCC's required quadrennial review of its media ownership rules. Because the current economic climate has been particularly challenging for media properties, there is widespread speculation that the FCC could finally eliminate some of its legacy regulations restricting the ownership of media outlets (such as ownership of a daily newspaper and television station in the same market). At the same time, the current FCC and Congressional leadership remain somewhat wary of consolidation.

- Media ownership issues will receive close scrutiny during the FCC's review of the Comcast-NBC Universal transaction. Among other things, the FCC will aggressively examine the impact that a marriage of distribution and content could have on competition, both in terms of consumers' and rivals' access to desired programming and in connection with independent programmers' ability to obtain cable carriage. Most importantly, the review process could serve as the touchstone for future M&A activity in the communications sector during the Obama administration. As the combined entity's competitors evaluate the impact of the deal on their own businesses and the regulatory conditions required for approval, the transaction could have a domino effect in encouraging/discouraging other media businesses to consider combinations. All will look to the Comcast-NBC Universal merger for guidance on the scope of what the FCC intends to allow.

Consumer Financial Services | Is There a New Federal 'Watchdog'?

Turmoil in the financial markets has led to a flurry of proposed legislation that would alter regulation of financial institutions significantly. Legislation is pending to enact the Obama administration's proposal for the creation of a new agency, the Consumer Financial Protection Agency (CFPA). Often referred to as a consumer financial services "watchdog," the CFPA would be an independent agency with broad authority to regulate financial products and services, conduct examinations of financial institutions and enforce consumer protection laws.

One of the other hotly contested issues in the debate over the proposed legislation is the extent of federal preemption of state banking laws. Just last summer, in *Cuomo v. The Clearing House Association*, 129 S. Ct. 2710 (2009), the Supreme Court held that states are not preempted by federal banking laws from suing national banks to enforce state laws, although they are prohibited from exercising "supervisory" powers over national banks. Proposed legislation would go even further and would (1) authorize states to sue and issue subpoenas to federal banks to enforce state and federal law, and (2) require federal banks to comply with stricter state consumer protection laws. One proposal, however, would give federal banking regulators authority to preempt state laws on a case-by-case basis.

In addition, the proposed legislation would significantly expand the scope of loan data that lenders would be required to disclose to regulators and the public. These disclosures traditionally have served as the primary basis for the initiation of regulatory and enforcement actions alleging unlawful lending discrimination.

After significant revisions to the initial proposal, CFPA legislation was passed by the House of Representatives on December 11, 2009, as part of the Wall Street Reform and Consumer Protection Act (H.R. 4173). A similar bill has been circulated in the Senate by Sen. Christopher J. Dodd (D-CT).

The CFPA proposals have engendered much debate in Congress. Regardless of its final contours, if this legislation becomes law, financial services firms will face increased regulatory and enforcement scrutiny of their lending and other consumer practices. In addition, although the legislation does not focus on the creation of new private causes of action for aggrieved consumers, an increase in state and federal enforcement actions as a result of the legislation likely would lead to an increase in consumer class action litigation.

Contributing Partners / Joseph L. Barloon, Joseph.Barloon@skadden.com, 202.371.7322 / Anand S. Raman, Anand.Raman@skadden.com, 202.371.7019

“Swaps shall be cleared if the CFTC/SEC has determined that they are the type which must be cleared and if they are accepted for clearing by a regulated clearinghouse.”

Derivatives Regulation | House Bill Sets Up Senate Consideration of New Regulation

On December 11, 2009, the House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009 (the House Bill). A portion of the House Bill is dedicated to the over-the-counter derivatives market and the regulation of market participants, clearing houses and trading platforms. The House Bill divides the over-the-counter derivatives market between swaps (regulated by the Commodity Futures Trading Commission (CFTC)) and security-based swaps (regulated by the Securities and Exchange Commission (SEC)) based on the characteristics of the underlying instrument or interest, and then imposes significant new restraints on the derivatives market and its participants, dramatically altering the existing regulatory environment.[1]

The following summary highlights provisions in the House Bill relating to regulatory obligations imposed on market participants that qualify as major swap participants (MSPs) or major security-based swap participants (MSSPs).[2]

Clearing and Exchange Trading Requirements

- Swaps shall be cleared if the CFTC/SEC has determined that they are the type which must be cleared and if they are accepted for clearing by a regulated clearinghouse. Swaps subject to the clearing requirement also must be traded on a registered trading facility, unless no facility will list them for trading.
- The clearing requirement is not applicable if one of the counterparties (1) is not a swap dealer or MSP/MSSP, (2) is using the swap to hedge commercial risk and (3) notifies the CFTC/SEC as to how it meets its financial obligations respecting noncleared swaps.
  - A MSP/MSSP is any person who is not a swap dealer and (1) maintains a "substantial net position" in outstanding swaps or (2) whose outstanding swaps create substantial net counterparty exposure that could have "serious adverse effects on the financial stability of the United States banking system or financial markets."
- Swaps not cleared are subject to reporting requirements.

Capital and Reporting Requirements

- Capital requirements will be set to (1) help ensure the safety and soundness of MSPs/MSSPs and (2) mitigate the risks associated with noncleared swaps.
- Registration with the appropriate regulator(s) is required for MSPs/MSSPs. These entities also must, among other things:
  - maintain books and records and make reports;
  - comply with business conduct standards;
  - disclose to counterparties, among other things, risks and conflicts of interest;
  - disclose information to the appropriate regulator(s); and
  - implement conflicts-of-interest systems and procedures.

Contributing Partner / John W. Osborn, John.Osborn@skadden.com, 212.735.3270 / **Of Counsel** / Jerrold E. Salzman, Jerrold.Salzman@skadden.com, 312.407.0718 / **Associate** / Christal Lint, Christal.Lint@skadden.com, 312.407.0705

Segregation of Collateral

- If a swap is not cleared, a swap counterparty who provides funds or other property to a swap dealer for initial margin or collateral to secure the obligations of the counterparty is entitled to have its initial margin and collateral held in an account carried by an independent third-party custodian (as defined by the legislation) and designated as a segregated account for the counterparty, in accordance with rules and regulations set by the appropriate regulator.

In the near future, the Senate is expected to consider a bill offered by Sen. Christopher J. Dodd (D-CT), which like the House Bill, includes a section dedicated to reforming the over-the-counter and regulated derivatives markets.

---

[1] The term "swap" is used herein to refer both to "swap" and "security-based swap" as those terms are defined in the House Bill.

[2] The distinction between MSP and MSSP hinges on whether the entity deals in swaps or security-based swaps, the former being regulated by the CFTC and the latter by the SEC. For all material purposes, the terms have the same meaning, with the exception noted in the previous sentence, and are subject to substantially similar regulation under the House Bill.

Energy Regulation and Litigation | Policy Trends

The electric and natural gas industries are undergoing significant change driven, in part, by policymakers in Washington. 2009 witnessed personnel changes in executive branch agencies in charge of energy regulation, including a new chairman of the Federal Energy Regulatory Commission (FERC) and Secretary of the Department of Energy. Additionally, significant new energy legislation was introduced in Congress. We expect to see a continuation in 2010 of many of the policy trends that dominated the debate last year, including the following:

Transmission

The single most complex and important transmission issue on which policymakers in Washington are focused is the integration of renewable resources, particularly wind resources, into the electric grid. The policy issues associated with the dramatic increase in wind development include:

- Congress will continue to debate proposed legislation regulating greenhouse gas emissions, and importantly, the shape of this legislation will significantly affect the incentives for renewables development. For example, Congress could pass a cap and trade program or a renewable energy standard (RES) or a combination of both, with such actions posing very different incentives for the location and type of renewable resources that may be developed. (See "Climate Change | U.S. Climate Policy Debate to Heat Up Post-Copenhagen")

- Congress also is likely to consider granting the FERC additional authority over the siting of electric transmission facilities. The FERC's existing authority was curtailed significantly this year by the U.S. Court of Appeals for the Fourth Circuit, and there are several proposals to expand that authority.

- The FERC will remain watchful of the debate in Congress. However, even if Congress does not act, the FERC is likely to initiate action on its own, particularly in the area of transmission cost allocation and planning. The staff of the FERC recently sought industry views on the main impediments to increased construction of transmission to enhance reliability and integrate renewable resources. In addition, this year the FERC likely will consider remand of the Seventh Circuit's decision reversing the PJM Regional Transmission Organization's method for allocating the costs of 500 kv-and-above facilities.

Electricity Markets

Organized electricity markets will continue to undergo change as they respond to technological developments and political pressures. The issues on the horizon for 2010 include:

- Key technological advancements are spurring changes in market design, including wind projects, the introduction of new battery technologies, growing levels of demand responses, and the continuing evolution of a variety of smart grid initiatives. These technological changes will encourage policymakers to explore ways to reduce regulatory barriers to entry and otherwise encourage these technologies without providing undue subsidies.

- Several regions have faced the challenge of subsidized new entry of generation, particularly through programs adopted by state governments to encourage new construction that lowers the clearing price for capacity resources. The FERC has, in prior cases, rejected key elements of those state programs as inconsistent with efficient market design, but the challenges presented by state policies continue.

Contributing Partner / John S. Moot, John.Moot@skadden.com, 202.371.7890

- The long-simmering conflict between the FERC and the Commodities Futures Trading Commission (CFTC) over whether certain financial products that are governed by FERC tariffs also can be regulated by the CFTC — potentially including exclusive regulation by the CFTC — has intensified in recent months. For example, a provision in the House financial services reform bill would give the CFTC authority to regulate certain of those products, provided it considers the advice of the FERC.

Enforcement

The FERC continues to consider adjustments to its enforcement program, which was significantly expanded by the Energy Policy Act of 2005 (EPAct 2005). In 2009, the FERC appointed a new enforcement director and announced the settlement of several major enforcement actions, including leading cases in which Skadden represented the target (*e.g.*, the ETP market manipulation case and the FP&L reliability enforcement case). The FERC also signaled its willingness to reduce the paperwork and oversight burdens associated with minor reliability violations. Continued evolution in this area is expected in 2010, including:

- In several enforcement cases, Commissioners Marc Spitzer and Philip Moeller have written separately to express their concern that the FERC was seeking the enforcement of rules that are ambiguous. The split on the commission over this issue may continue unless newly confirmed Commissioner John Norris takes a different position from that of outgoing Commissioner Suedeen Kelly.

- The FERC can be expected to continue to refine the procedures applicable to investigations, as it gains more experience with the modern enforcement program established after EPAct 2005. For example, at its December 2009 open meeting, the Commission adopted (1) a new policy allowing it to disclose the facts and allegations associated with previously nonpublic investigations once the target has formally responded to staff's investigative conclusions, and (2) a policy clarifying the applicability of the Brady rule to exculpatory information collected in the course of FERC's civil investigations.

Financial Institutions Regulation | Anti-Money Laundering and Sanctions Developments

Financial institutions should be alert in 2010 to the potential for increased enforcement of U.S. economic sanctions and money laundering laws and the possibility of significantly larger penalties associated with such actions. In 2009, we witnessed a continued emphasis on enforcement of U.S. sanctions and money laundering laws by federal and state regulators and prosecutors. Internationally active financial institutions have been, and will continue to be, a focal point of such inquiries as the authorities concentrate on those sectors that are perceived to present higher compliance risks.

- The U.S. Treasury's Office of Foreign Assets Control (OFAC), which is responsible for administering the U.S. economic sanctions programs, has focused its enforcement efforts on what it views as more serious violations that warrant higher fines. This is evident in the number and amounts of penalties levied by OFAC in 2009 as compared to 2008. In 2008, OFAC issued 99 penalties totalling $3.5 million. Through late 2009, OFAC had issued approximately 27 penalties, but the penalty total was much higher — approximately $774 million ($753 million of which was in conjunction with settlements involving other state and federal law enforcement authorities, as discussed below). OFAC issued a final rule to implement new enforcement guidelines, and the trend for more high-dollar penalty assessments is expected to continue in 2010.

- The Department of Justice (DOJ) and the District Attorney for New York County (Manhattan DA) have intensified their criminal enforcement efforts of the sanctions laws. Examples of law enforcement's focus on international financial institutions' processing of transactions though the U.S. financial system include the deferred prosecution agreement entered into between Lloyds TSB Bank plc (Lloyds) and the DOJ and the Manhattan DA whereby Lloyds remitted $350 million to settle allegations of violations of the sanctions laws; and the deferred prosecution agreement entered into between Credit Suisse AG and the DOJ and the Manhattan DA whereby Credit Suisse remitted $536 million to settle allegations of sanctions violations.

- U.S. and home country bank regulators also have been active in reviewing sanctions compliance at internationally active financial institutions. The Board of Governors of the Federal Reserve Board issued an Enforcement Order in the Credit Suisse matter, and the U.K.'s Financial Services Authority and Switzerland's FINMA also cooperated in the Lloyds and Credit Suisse inquiries.

- The Financial Action Task Force (FATF)[1] issued a report in October 2009 addressing money laundering and terrorist financing risks in the securities industry. In response to the issues identified in the report, the securities industry may see more scrutiny by regulators, particularly where electronic and cross-border transactions are involved.

- Recent advisories released by the Treasury Department's Financial Crimes Enforcement Network (FinCEN) concerning foreclosure rescue scams and loan modification fraud are leading to more suspicious activity filings by financial institutions and more referrals to law enforcement.

  – The increase in foreclosure rescue and loan modification fraud was an impetus for FinCEN's proposal to require nonbank residential mortgage lenders and mortgage originators to implement anti-money laundering compliance programs.

Contributing Partner / William J. Sweet, Jr., William.Sweet@skadden.com, 202.371.7030

- FinCEN also has issued a notice of its proposed rule to include mutual funds within the definition of "financial institution" for purposes of Bank Secrecy Act regulations. The effect of the proposed rule would subject mutual funds to additional anti-money laundering requirements.

[1] The FATF is an inter-governmental body with the purpose of developing and promoting policies, both at national and international levels, to combat money laundering and terrorist financing. (see www.fatf-gafi.org)

Foreign Investment Controls | The Obama Administration

As the M&A market continues to recover in 2010, we expect even greater attention to be paid to foreign investment activity and to the interagency Committee on Foreign Investment in the United States (CFIUS), which reviews the national security implications of foreign acquisitions of, mergers with or investments in U.S. businesses. The U.S. Treasury Department's new CFIUS regulations, which became effective in December 2008, provided the new administration with greater discretion and flexibility in its implementation and application of the regulations. While facing a significantly lighter caseload compared to previous years, CFIUS has shown a willingness to clear transactions and a desire to continue an open investment policy. However, the administration's recent decision to block a Chinese investment in U.S. miner Firstgold Corp. highlights the importance of anticipating CFIUS' concerns when negotiating and structuring a transaction. In addition, while the Senate Banking Committee spent much of 2009 focused on the financial crisis, CFIUS oversight may become a priority issue in the upcoming 2010 elections. We expect to see more rigorous reviews of foreign investment transactions, particularly those involving foreign government-controlled entities or sovereign wealth funds.

New Administration First to Implement Modified Regulations

- **Key Focus.** 2009 was the first full year under the regulations adopted by the Treasury Department to implement the The Foreign Investment and National Security Act of 2007 (FINSA).
  - FINSA substantially revised U.S. national security reviews of foreign investments in U.S. businesses, making reviews more rigorous, especially for transactions in certain sensitive sectors, including both critical infrastructure and technologies, as well as transactions involving an entity controlled by a foreign government. In particular, CFIUS has shown an increasing interest in transactions that involve energy assets and natural resources. The Department of Defense is particularly concerned with long-term access to strategic minerals. This concern likely was a principle objection to an acquisition of Firstgold by a Chinese state-owned entity.
  - The U.S. government has focused significant resources on the prevention of cyber attacks on the country's telecommunications, technology and power infrastructure. The potential for an investment to increase the vulnerability in this sector has become a key component of the CFIUS review process.
- **Control and Covered Transactions Subject to CFIUS Review.** The new regulations continue CFIUS' long-standing approach of eschewing a bright-line equity ownership test for purposes of determining whether a foreign entity has acquired "control" over a U.S. business. The regulations instead analyze control in functional terms, taking into account all relevant factors, including equity ownership, representation on the board of directors and ability to direct matters of importance to a U.S. business.
  - Accordingly, while the new regulations and examples help clarify the concepts of control and what constitutes a covered transaction subject to review, the regulations make clear that CFIUS will continue to evaluate control on a case-by-case basis, considering all relevant facts and circumstances, including the identity of the foreign investor and the nature of the U.S. assets involved.
  - The regulations also provide greater detail regarding the parameters of minority shareholder rights that do not, in the absence of other rights, confer foreign control over a U.S. entity. In so doing, the new regulations should provide dealmakers with additional guidance in structuring transactions, especially passive minority investments in U.S. entities.

Contributing Partner / Ivan A. Schlager, Ivan.Schlager@skadden.com, 202.371.7810

- **Process Management.** The new regulations reflect CFIUS' careful balancing of U.S. national security with continued openness to foreign direct investment in the United States. The new regulations give vast discretion to the Committee in terms of application and implementation. Nonetheless, with reasonable assessment of, and timely planning for, U.S. national security considerations, parties that properly approach the CFIUS review process can expect a fairly straightforward and expeditious CFIUS review.

Balancing Economic Considerations and the National Security

- Economic agencies like the Departments of Treasury and Commerce have long sought to provide an open investment environment for foreign firms, while the Department of Homeland Security and other national security agencies such as the Departments of Defense and Justice and the National Security Agency tend to have a more focused approach to national security. These two factions have long battled over the need to impose agreements to mitigate perceived threats to national security, and the internal debate may slow the review process. A recent case in the telecommunications equipment sector was delayed as the agencies debated the need for mitigation. Economic agencies are concerned that the imposition of mitigation agreements that impact governance may have a chilling effect on foreign investment. Security agencies are focused on eliminating perceived risk associated with certain foreign investors. In a departure from the previous administration, it appears that the balance has shifted to the national security agencies, with CFIUS willing to require meaningful mitigation without a protracted internal struggle.

Sovereign Wealth Funds

- With economic changes in both Asia and the Middle East, we expect to see adjustments in the activity of sovereign wealth funds (SWFs) in these regions.
  - Given the global economic downturn, funds in these regions may no longer be satisfied with passive investment roles and may seek more governance rights associated with their significant investments in the United States. These additional governance rights may subject investments to other regulatory reviews, including CFIUS.
- Another factor that may affect the activity of SWFs is the emergence of global standard-setting for these funds.
  - In September 2008, many of the world's largest SWFs agreed to a voluntary code of conduct that establishes a set of Generally Accepted Principles and Practices for SWFs aimed at increasing transparency, accountability and global economic confidence in these funds. Among the core principles of the code is the concept that SWFs should have operational independence from their governing bodies and must have the freedom to pursue investment decisions and investment operations free of political influence.
- Given the latitude provided to CFIUS under the new regulations, the Obama administration may take a more aggressive stance in reviewing U.S. investments by SWFs.
- Finally, recent events in Dubai raise special concerns over sovereign debt and the potential assertion of sovereign immunity. These issues highlight the conflicting aims of many SWFs to operate as commercial actors while seeking the certain protections afforded to sovereigns.

Foreign Investment Controls | Europe

Over the past two years, several countries across Europe introduced new regulations restricting foreign investment activity. This trend of greater restrictions on foreign investment is largely attributed to the rise of Sovereign Wealth Funds (SWFs), or special purpose investment funds that are owned and operated by national governments rather than private persons. Similar to the interagency Committee on Foreign Investment in the United States (CFIUS), which reviews the national security implications of foreign investments in U.S. companies or operations, these regulations are aimed at foreign investors that may raise security concerns. (See "Foreign Investment Controls | The Obama Administration") While the U.S. chose to adopt stricter CFIUS review rules, EU institutions decided not to create ad hoc legislation and/or specific mechanisms to deal with SWFs, but rather to rely on existing rules, which allow Member States to derogate the principle of freedom of capital movement. The following provides a brief summary of the types of foreign investment control laws that have been adopted across Europe and Russia.

Germany

- On April 24, 2009, the new German foreign investment control law (Aussenwirtschaftsverordnung) entered into force. It enables the German Federal Ministry of Economics and Technology (the MET) to review and either prohibit or impose restrictions on any direct or indirect acquisition of 25 percent or more of the voting rights of a German company or the acquisition of a German company by way of an asset deal (*e.g.*, impose restrictions on the exercise of voting rights). The MET's review right applies if the purchaser is (1) not a resident in the European Union (EU) or a country that is part of the European Free Trade Association (EFTA); or (2) is an EU/EFTA resident, but a non-EU/EFTA resident holds 25 percent or more of the voting rights of the purchaser, and this ownership structure was set up to circumvent the MET's right to review. The review is not limited to specific industry sectors or types of investors.

- The new law allows the MET to prohibit or restrict any acquisition that threatens "public order or security" in Germany. This may have far-reaching implications, because the European Court of Justice expressly has recognized that public security may be affected by a threat to the security of supply in the area of telecommunications or electricity, or by a threat to the guarantee of any service with strategic importance.

- The new law does not confer any legal obligation on a company to notify the MET about any acquisition, and indeed, failure to notify the MET does not render an acquisition void. The MET has the right to initiate its review of an acquisition within three months of the signing of the acquisition agreement or of the publication of a takeover bid. The MET then has two months after receiving all of the information relating to a transaction to prohibit (*i.e.*, retroactively render it invalid) or restrict it.

- In order to obtain transaction security, however, a potential acquirer may apply to the MET for clearance even before signing any acquisition-related agreements. If the MET does not initiate a review within one month of receiving such application, the transaction is deemed cleared. Clients making investments in Germany, particularly in the context of hostile bids, should obtain advice as to whether they should seek preannouncement clearance of their transactions.

Contributing Partners / Lorenzo Corte, Lorenzo.Corte@skadden.com, 44.20.7519.7025 / Walter R. Henle, Walter.Henle@skadden.com, 49.89.244.495.110 / Dmitri V. Kovalenko, Dmitri.Kovalenko@skadden.com, 7.499.270.2100 / Pierre Servan-Schreiber, Pierre.Servan-Schreiber@skadden.com, 33.1.55.27.11.30

France

- In late 2005, France issued Decree No. 2005-1739, 30 December 2005 (the Decree), regulating foreign investment for national security considerations. The Decree short-listed sensitive sectors where "enhanced scrutiny" is exercised over foreign investment, whether private or through a SWF, leaving all other sectors open to foreign investment.
- Direct or indirect foreign investment in, or acquisition, of one-third or more of the shares or voting rights in a business that carries on "sensitive activities" requires, in principle, a prior approval by the French government (the Prior Authorization Rule). This applies to businesses active in gaming, private security and protection services; the fight against biological terrorism; communication interception activities; safety of computer systems, encryption, "double-use" goods and technologies; and defense, arms, weapons and ammunitions.
- Direct or indirect foreign investment in "nonsensitive" businesses requires a post-signing filing, but no prior authorization is required.
- Additionally, there are special authorization or license requirements for investment by non-European investors in certain regulated activities such as banks, insurance/reinsurance or media companies.
- Less stringent restrictions apply for investors based in Europe (EU or EEA) (*e.g.*, approval only will be required if the investor acquires direct or indirect "control," and with respect to a more limited number of sensitive activities).

Italy

- Italy does not have foreign investment control laws, other than laws relating to investment in defense companies.
- However, Parliamentary discussions of a potential wave of foreign investment by SWFs resulted in a legislative proposal in 2008 that certain takeover principles that prevented Italian companies from defending against takeover attempts be repealed. Since 1998, Italy had embraced the "passivity rule," which prevented target boards from taking actions that could frustrate a takeover bid. Effective April 2009, the passivity rule was repealed, and Italy became one of six EU countries where target boards can mount defenses against takeover bids, subject to compliance with the boards' fiduciary duties.
- In July 2008, the Interministerial Strategic Committee for Development and Protection Abroad of Economic National Interests (Comitato Strategico per lo Sviluppo e la Tutela all 'Estero degli Interessi Nazionali in Exonomia) was established to develop, and advise the government on, foreign investment policy. The committee's preliminary guidelines distinguish between "welcome" and "unwelcome" foreign investors and indicate that investments by funds with transparent operations that tend to make passive investments (less than 5 percent stakes) would be considered "welcome." The guidelines also state that in determining whether foreign funds would be "welcome," the committee would consider whether funds had adhered to the Santiago Principles, a voluntary code of conduct for SWFs adopted by the International Working Group of Sovereign Wealth Funds in 2008.

Russia

- On May 7, 2008, Federal Law No. 57-FZ, On the Procedure for Implementing Foreign Investment in Commercial Enterprises Having Strategic Importance for Securing the National Defense and Security of the State (the Law on Strategic Enterprises), came into effect and introduced a new regulatory framework for foreign investment control in Russia. This new regime replaced the previous "informal" and undefined practice of foreign investors getting approvals from the Russian government to invest in industries that might have been considered strategic for Russia.

- The new law lists 42 types of activities considered to be of strategic importance to Russia. A company engaged in any of these activities is considered a "Strategic Enterprise." Prior consent from the Russian Government is required for a foreign investor to acquire, directly or indirectly, more than (1) 10 percent of a Strategic Enterprise engaged in activities relating to the exploration of natural resource deposits that are of "strategic importance" as determined by criteria specified by law, or (2) 50 percent of other types of Strategic Enterprises. Additional limitations apply to foreign investors that are foreign states, companies owned or controlled by foreign states, or multinational organizations such as the IFC or EBRD.

- The consent required under the Law on Strategic Enterprises is in addition to any clearances required under Russian anti-monopoly laws, although the approval processes may be run in parallel. In addition, other earlier established limitations and/or special rules on foreign investments in certain industries (*e.g.*, TV broadcasting) or certain assets (*e.g.*, agricultural land) continue.

- The Russian Federal Anti-Monopoly Service (FAS) acts as the coordinating agency to issue such consents, which require approvals by various governmental agencies, including clearance by the Russian Federal Security Service and approval by the Foreign Investments Supervision Commission (the Commission), headed by the Prime Minister of Russia.

- While the Law on Strategic Enterprises provides that the consent process should take three months, with a possible three-month extension, the actual review period may be much longer depending on the frequency of meetings of the Commission. To date, only five Commission meetings have been held. Based on publicly available information, the Commission considered only 18 transactions during its first four meetings and currently has 80 consent applications for consideration. It has been reported that the Commission and/or FAS rejected or delayed its decision on several consent applications. Given "the limited precedents," it is not yet possible to extrapolate any trend or public policy underlying such rejections/delays, which seem to have been made on a case-by-case basis.

- The Law on Strategic Enterprises seems to have a number of unexpected (though not clearly unintended) consequences in application. For example, most Russian commercial banks fall under the definition of "Strategic Enterprises" solely because they use encryption systems in their regular banking activities (*e.g.*, for "bank-client" systems). In addition, the law does not distinguish between foreign entities controlled by Russian beneficial owner(s) and other types of foreign investors. As a result, acquisitions between ultimately Russian parties via offshore vehicles are subject to the same rules.

- The Russian government announced plans to introduce amendments to the Law on Strategic Enterprises in the near future, with a declared intent to ease and clarify the consent application process.

“In mid-2009, the SEC proposed pay-to-play Rule 206(4)-5 for investment advisers, prohibiting certain political contributions and banning third-party placement agents.”

Government Affairs and Government Procurement Compliance

Corporations and other organizations engaged in government affairs or government procurement activities will face several new pay-to-play laws at the federal and state levels in 2010. Campaign finance regulation also may be rehauled as a result of important First Amendment court cases. In addition, new trends are emerging with regard to laws regulating gifts and entertainment of public officials, as well as lobby registration and reporting for procurement activity.

A Second Wave of Pay-to-Play Laws

An increased interest in pay-to-play laws by enforcement agencies and legislatures continues as a result of various scandals, including federal and state public corruption cases, particularly the indictment on pay-to-play allegations of former Gov. Rod Blagojevich (D-IL) and former political consultant Hank Morris in New York. The landscape has become even more treacherous with a second wave of laws that has swept the country.

State pay-to-play laws apply to virtually every company that has government contracts or sells products or services to a government entity. These laws automatically ban such companies from entering into or having government contracts if certain executives or members of the board of directors (including their spouses and children) make or solicit a political contribution. In some cases, there also may be personal liability for the executive or director. A small contribution by a covered executive or family member can cause a company to lose millions of dollars in contracts.

Proposed SEC Pay-to-Play Rule for Investment Advisers

- In mid-2009, the SEC proposed pay-to-play Rule 206(4)-5 for investment advisers, prohibiting certain political contributions and banning third-party placement agents. The SEC is expected to finalize and implement this rule in early 2010.
- The proposed rule covers investment advisers registered (or who are required to register) with the SEC, as well as those who are not required to register under Section 203(b) of the Investment Advisers Act of 1940. It covers investment advisory services provided by such firms (1) directly to a state or local governmental entity or (2) to an investment pool in which such governmental entity invests.
- The proposed rule prohibits an investment adviser from being compensated by a government investor for two years if the investment adviser, its PAC or its covered associate contributes to an official of that governmental entity.
- The proposed rule prohibits an investment adviser or a covered associate from paying any third-party placement agent.

Corporations with government contracts should be vigilant in monitoring the progress of these new rules and establish procedures to ensure that such contributions are not made.

Campaign Finance Decisions Loom

Judicial action at the federal level may alter federal campaign activity in 2010. In particular, a Supreme Court ruling expected later this year may result in independent expenditures by corporations being

Contributing Partners / Kenneth A. Gross, Kenneth.Gross@skadden.com, 202.371.7007 / Ki P. Hong, Ki.Hong@skadden.com, 202.371.7017

permitted without limit for the first time in more than 30 years. At the state and local levels, an increasing number of jurisdictions are imposing contribution bans and limits for corporations.

Increased Enforcement of Gift and Lobby Laws

Increasingly restrictive laws are being passed with regard to gifts to and entertainment of public officials. Enforcement cases are being pursued for entertainment as small as $12. The regulatory environment with regard to lobbyist registration and reporting laws also is tightening, especially for government procurement activity.

Health Care | Key Trends Affecting the Legal and Regulatory Environments

A number of powerful trends are reshaping health care, creating both opportunities and risks. Congress is likely to pass comprehensive health care reform legislation in early 2010, which we believe will accelerate these trends and affect every sector of the health care industry.

Expanding basic health care coverage to tens of millions of Americans will increase demand for health care goods and services — but will be accompanied by burdensome government oversight.

- Health care legislation is all but certain to provide coverage for a substantial portion of the more than 46 million previously uninsured Americans at a cost of nearly $1 trillion. This spending will translate into increased demand for a wide range of health care goods and services, creating business opportunities for insurers, health care providers, drug and device manufacturers, and support companies.
- With government spending will come more government oversight, including new regulatory requirements, more record-keeping and reporting obligations, and heightened scrutiny for fraudulent activities. The scrutiny will extend to the profitability of health care companies and executive compensation practices at for-profit and nonprofit entities.

Pay-for-performance (P4P) and cost-effectiveness strategies will be adopted to replace current payment models.

- Current payment systems — including fee-for-service and prospective payment systems — are neutral or negative with respect to quality. They reward providers for the number of procedures performed, not for effective outcomes. The Centers for Medicare and Medicaid Services (CMS) has implemented a number of P4P initiatives — including the Hospital Quality Initiative, the Physician Group Practice Demonstration and the Chronic Care Improvement Program — but lacks authority to implement broader payment reforms.
- Health care reform likely will accelerate the adoption of P4P and cost-effectiveness models. For example, the legislation will begin the process of implementing value-based purchasing mechanisms for Medicare.
- The shifting emphasis means that companies will need to develop expertise to demonstrate the cost-effectiveness of their products and services, including systems to capture and report the data supporting such analysis.
- For manufacturers, considerations of cost-effectiveness will need to be addressed at every stage of the product life cycle, from research and development through FDA approval, to post-approval reimbursement. Clinical trials will need to gather data to obtain FDA approval and coverage and reimbursement.
- These new activities — outside the traditional focus of providers and manufacturers — will create new legal and regulatory risks.

Contributing Partners / John T. Bentivoglio, John.Bentivoglio@skadden.com, 202.371.7560 / Jennifer L. Bragg, Jennifer.Bragg@skadden.com, 202.371.7980 / Gregory M. Luce, Greg.Luce@skadden.com, 202.371.7310

New transparency requirements will lead to greater scrutiny of costs, prices, industry-physician relations, health outcomes and quality.

- Congress and state legislatures, spurred by watchdog groups, are pushing for greater transparency throughout the health care industry. These efforts will gain strength with the passage of federal reform.
- The legislation is likely to require drug and device manufacturers to disclose payments and other transfers of value to physicians and certain health care providers.
- Pharmacy benefit managers contracting with Medicare or exchange plans may have to disclose details of discount/rebate negotiations with manufacturers, including the savings passed on to consumers.
- Manufacturers, group purchasing organizations and certain health care providers may have to report the nature of ownership arrangements by physicians.
- Transparency will empower the government in its regulatory and enforcement activities, providing new opportunities for plaintiffs' lawyers and fueling nonlegal actors, such as media and advocacy groups, to highlight perceived abuses.

Fraud and abuse enforcement activities will increase, with a new emphasis on the accountability of boards of directors and senior executives.

- The government's intense focus on health care fraud enforcement will continue in 2010. Amendments enacted to the civil False Claims Act (FCA) in mid-2009 (See "Increased Recoveries in Whistle-blower Actions and Expansion of the False Claims Act's Reach") will bolster such efforts, as will some health care reform provisions:
  - Millions of dollars in increased funding likely will be dedicated to hire more prosecutors, agents and others to fight Medicare and Medicaid fraud.
  - Mandatory compliance programs for nonphysician providers and suppliers likely will be established.
  - Existing fraud and abuse laws may be amended (*e.g.*, a claim from a kickback law violation will constitute a false claim for purposes of the FCA).
- Nearly 500 pharmaceutical companies already are under corporate integrity agreements (CIAs), including seven of the 10 largest pharmaceutical manufacturers and six of the 10 largest device manufacturers. CIA provisions establish *de facto* industry compliance standards. Recent CIAs have imposed more burdensome oversight responsibilities on boards of directors, saddled senior management with strict accountability obligations like annual compliance certification, and subjected companies to intrusive monitoring and auditing of key sales and marketing activities.
- Prosecution of individuals for health care fraud has increased and will continue to do so in 2010 and beyond. More than 20 pharmaceutical and device executives and managers have faced criminal charges since 2007. Increasingly, prosecutors are relying on the responsible corporate officer doctrine, which

imposes strict liability on executives for some offenses, regardless of the executive's involvement in or knowledge of the activity.

Legal and regulatory risks are increasing, as states adopt more aggressive enforcement postures and plaintiffs' lawyers increasingly influence enforcement activities.

- States are becoming more active enforcers against health care fraud. Traditionally a tertiary line of enforcement after the FDA and DOJ, states have become formidable independent forces in recent years, securing multimillion-dollar civil settlements with drug and device companies. Currently, dozens of state investigations are pending, including multistate actions likely to settle in 2010.
- Plaintiffs' lawyers have unprecedented influence on government enforcement actions. The vast majority of major federal health care fraud cases are initiated by whistleblower actions under the FCA. Whistleblower counsel influence the legal theories pursued by the DOJ, play an increasingly active role in investigations and have a major say in settlements. Some states are outsourcing affirmative litigation to plaintiffs' firms, with lucrative fees paid to successful firms.
- The failure of Congress to adopt meaningful tort reform is likely to embolden plaintiffs' lawyers to target the health care industry. The Congressional Budget Office estimates that tort reform could save $54 billion in federal spending in the next decade.

Health care executives and counsel must consider additional factors when assessing emerging legal and regulatory risks.

- Delegating compliance and risk management to lower-level personnel and providing limited resources will be insufficient in the current environment.
- Boards and executive management will need to devote more attention and resources to compliance efforts. Company leaders should consider the following emerging practices:
  - enhancing accountability among management and supervisory personnel, through such efforts as requiring periodic compliance certifications, holding managers accountable for personnel within their span of control, incorporating compliance into performance objectives and compensation, and requiring managers to promptly report and address compliance issues;
  - leveraging technology to bolster both upfront compliance controls (*e.g.*, policies and training) and back-end efforts (*e.g.*, monitoring, auditing, tracking of compliance incidents, management reporting);
  - implementing rigorous procedures for receiving, investigating and resolving compliance complaints, and tracking their resolutions;
  - more frequently monitoring, auditing and conducting risk assessments to identify and correct problems before they become widespread; and
  - renewing efforts by senior management to set a "tone at the top" that conveys — in words and actions — the importance the company attaches to compliance.

"Some form of the Employee Free Choice Act, which would amend the National Labor Relations Act with respect to the unionization of employees, is likely to pass in 2010."

Labor and Employment Law | Looking Ahead

As the economy recovers, we expect employers to make regular additions to the workforce only after using alternative means of increasing labor capacity. Likewise, as transaction activity increases, employers will face the challenge of combining workforces. Employment law developments will guide these efforts.

Legislative Initiatives and Considerations

- Health care reform legislation continues to work its way through Congress. Employers will be impacted in the areas of limits on the deductibility of employer-paid plans, the extent of coverage and portability of benefits. ("See Health Care | Key Trends Affecting the Legal and Regulatory Environments") In particular, the issue of mandated coverage divides the health care reform bills recently passed by the House and Senate. The House version requires that employers with payrolls of at least $500,000 provide employees with health insurance and imposes penalties for noncompliance based on business size. Such employers would be required to contribute 72.5 percent of the premium cost (individuals) and 65 percent (families) for the lowest-cost plan that meets benefits requirements. While the Senate version does not explicitly mandate employer coverage, firms with at least 50 full-time employees would be penalized for each employee obtaining subsidized coverage through a health care exchange.

- Some form of the Employee Free Choice Act (EFCA), which would amend the National Labor Relations Act with respect to the unionization of employees, is likely to pass in 2010. While the anticipated compromise on the EFCA would not contain card check recognition, it is expected to contain elements such as quick certifications of elections, tougher penalties for employer violations and binding interest arbitration. Nevertheless, card check recognition may end up in the final legislation, thereby making it easier for workers to organize by allowing them to bypass traditional union election procedures.

- Potential new IRS statutory provisions would, if passed, enable workers considered to be independent contractors by their employers to obtain IRS rulings on their proper classification more efficiently and significantly increase employer penalties for misclassification. The legislation also would limit an employer's ability to avoid employment tax liability for misclassification by eliminating the safe harbor provisions of the Internal Revenue Code and replacing them with a more stringent provision. As employers continue to expand the use of independent contractors during the economic recovery, they will need to remain mindful of such enhanced enforcement initiatives.

- The COBRA subsidy, enabling employees to receive subsidized health insurance coverage following involuntary termination, was extended into 2010. In particular, the subsidy eligibility date now extends to February 28, 2010, and the subsidy period has been expanded by six months (from nine to 15 months). Employees who previously were terminated and informed of the nine-month subsidy will need to be informed of the new 15-month subsidy.

- In addition to expanding the COBRA subsidy, the Department of Defense Appropriations Act for fiscal year 2010 contains a provision that significantly restricts the use of arbitration agreements for dispute resolution between defense contractor employers and their workers. Specifically, the provision prohibits federal contractors receiving Defense Department funds for contracts in excess of $1 million from requiring their employees or independent contractors to sign, as a condition of

Contributing Partners / Karen L. Corman, Karen.L.Corman@skadden.com, 213.687.5208 / John P. Furfaro, John.Furfaro@skadden.com, 212.735.2624 / David E. Schwartz, David.Schwartz@skadden.com, 212.735.2473

employment, agreements to arbitrate certain disputes, including claims under Title VII of the Civil Rights Act of 1964 and tort claims arising from sexual assault or harassment.

- Immigration reform efforts will continue to develop, and employers can expect stringent government enforcement initiatives focused on the employment of illegal immigrants. For example, legislation was passed in 2009 requiring federal contractors and subcontractors to use the E-Verify system to verify certain of their employees' U.S. work eligibility. Recently, increased funds have been appropriated for audits of employer records.
- Regulations implementing the ADA Amendment Act will be revised to more broadly define "disability." As such changes are likely to spur additional requests for accommodation based on disability, companies will devote increased attention to refining their leave policies and ensuring an open channel of communication with employees to properly address such issues.
- States continue to increase employer responsibilities, with a focus on ensuring that employees are fully informed with respect to wage-and-hour rights as well as layoff potential. For example, New York recently passed legislation requiring the provision of notice to employees of their straight time and overtime pay rates, and several states have expanded upon existing federal requirements pertaining to WARN notices.

Increased Wage-and-Hour Private Litigation and Government Enforcement

- Anticipate increased private federal opt-in collective actions and state opt-out class actions alleging wage-and-hour violations. Recently, these types of lawsuits have focused on the retail, restaurant, delivery and financial services industries.
- Increased federal wage-and-hour investigation activity has affected the mindset of employers across the country. Employers can expect continued vigorous enforcement by the Department of Labor of federal wage hour laws, including more investigations into overtime and minimum wage compliance, especially given Secretary of Labor Hilda Solis' announcement earlier this year that the Department would dramatically increase its enforcement of federal employment laws, boosting its departmental investigative staff by one-third.

Collective Bargaining Negotiations and Union Relations

- Employers will continue to seek moderate changes in union contracts to help contain costs during the economic recovery. Unions and employers likely will have to address changes made by health care legislation.
- In light of the recent economic instability and large scale reductions in force, employers also can expect increased unionization efforts.

Post-Employment Restrictive Covenants

- As employers begin hiring again, given the large numbers of terminations during the recession, they may face more challenges to the enforcement of noncompetition and nonsolicitation covenants.

- Our observation last year remains equally true today: Courts will continue to struggle with balancing employee mobility against employer interests in safeguarding their businesses. This struggle likely will be even more pronounced during these sensitive economic times.

Managing Employee Retaliation Claims and Employee/Family Leave Issues

- Retaliation claims are growing and, as reported by the EEOC, currently represent the largest category of claims handled by the agency. Given the fairly low threshold for retaliation claims, employers will continue to face challenges in defending them, despite an employee's poor job performance or questionable protected activity. Employers are advised to examine their current policies regarding anti-discrimination and harassment to ensure that they address retaliation and reevaluate their internal procedures aimed at reducing the risk of retaliation, including reporting and discipline procedures.
- Expect to devote increased attention to the management of staffing and development of employee leave policies in response to FMLA and ADA amendments as well as the swine flu epidemic.

Ongoing Attention to Hiring and Employment Decisions

Diversity efforts and affirmative action remain important to employers and will continue to be a priority in 2010. The administration of such programs should include consideration of recent developments upholding reverse discrimination claims in other contexts, such as the Supreme Court's decision in *Ricci v. DeStefano*, holding that a municipality committed disparate treatment race discrimination when it set aside the results of a firefighters' promotion exam based solely on statistical disparities, raising the potential of disparate impact liability.

"We believe this initiative likely will yield aggressive, proactive efforts to identify emerging issues that the Enforcement staff perceive to merit inquiry."

SEC Enforcement | New Initiatives

In the face of withering criticism of perceived deficiencies in the SEC's enforcement efforts and effectiveness in recent years, new SEC Enforcement Director Robert Khuzami announced a number of initiatives intended to reinvigorate the Enforcement Division and equip it with additional authority to streamline investigations. We expect these initiatives to lead to greater aggressiveness and sophistication on the part of the Enforcement Division staff conducting investigations.

Two particularly significant initiatives involve specialization and streamlining management and internal processes.

Specialization

In an effort to develop and sustain intellectual resources to keep pace with a continuously evolving industry, the Enforcement Division is creating five national units dedicated to investigating particular, highly specialized and complex areas of securities law. National leaders of those units are to be appointed shortly and will be responsible for the following areas:

- **Asset Management** will focus on issues involving investment advisers, investment companies, hedge funds and private equity funds.
- **Market Abuse** will focus on large-scale market abuses, insider trading and complex manipulation schemes by institutional traders, market professionals and others.
- **Structured and New Products** will focus on complex derivatives and newly developed financial products.
- **Foreign Corrupt Practices Act** will develop new approaches to identifying violations of the FCPA.
- **Municipal Securities and Public Pensions** will focus on municipal securities offering and disclosure issues, tax- and arbitrage-driven activity, unfunded or underfunded liabilities, and "pay-to-play" schemes.

We believe this initiative likely will yield aggressive, proactive efforts to identify emerging issues that the Enforcement Division staff perceive to merit inquiry. Significantly, a number of these units are in areas in which state regulators recently have outdone the SEC in their enforcement efforts. We anticipate that sustained national attention to these matters is apt to lead to novel approaches to investigating and addressing these issues. Such approaches already are evident in an increase in the number of cases filed against individuals without contemporaneous settlements, including the series of insider trading investigations and prosecutions that were publicly reported in the last quarter of 2009.

Streamlining Management and Internal Processes

Director Khuzami also launched initiatives to flatten the Division's management structure by eliminating the branch chief position, which historically has been the first-level supervisory function. Additional changes in processes and procedures have devolved certain decision making from the SEC to the senior Enforcement Division staff. These efforts are intended to expedite the Enforcement staff's investigations and to deploy more of the Enforcement Division's personnel to staff investigations. However, they inevitably will increase the decision-making authority of line staff (who will now be

Contributing Partners / Erich T. Schwartz, Erich.Schwartz@skadden.com, 202.371.7660 / Charles F. Walker, Charles.Walker@skadden.com, 202.371.7862 / **Counsel** / Andrew M. Lawrence, Andrew.Lawrence@skadden.com, 202.371.7097

operating with less supervisory support) with respect to investigations and enforcement recommendations, and may simultaneously reduce the SEC's ability to review that process meaningfully. This dynamic seems likely to increase the challenges for parties under investigation and their counsel.

Whether these efforts will be successful in enhancing the SEC's reputation as one of the premier law enforcement agencies in the federal government remains to be seen. What seems clear is that these changes herald a period of increased enforcement activity as the new leadership of the Enforcement Division strives to drive the agency toward that goal.

Tax | Monitoring New Developments and Careful Planning Amidst Uncertainty

2010 promises a number of enforcement, legislative and regulatory developments. A variety of proposals under consideration as 2009 ended (described below) will present significant compliance questions for taxpayers and implementation concerns for the government if (or when) enacted.

Enforcement Initiatives

Recent trends involving cooperation among governments in tax enforcement likely will accelerate, and the IRS will continue to focus on international issues, especially involving transfer pricing, structured capital market transactions, and cross-border investment activities by hedge funds and other financial institutions. The IRS recently announced that high-wealth individuals and their enterprises will be subject to intensified, integrated focus during 2010. Several thousand employers will undergo employment tax audits, many for the first time. On the litigation front, the DOJ is more frequently seeking jury trials, changing the complexion of large-dollar tax refund suits traditionally decided by judges. In addition, the continuing deterioration of state and local budgets is spawning increased and novel enforcement activities, especially by localities (*e.g.*, use of contingency fee tax collectors, class action lawsuits, creative interpretations of law and enactment of pay-to-play litigation procedures).

Business Tax Developments

Withholding Tax

Bills pending in Congress would significantly change the U.S. withholding tax rules by placing new burdens on foreign investors in U.S. securities. The bills would impose U.S. withholding tax on U.S. source payments made to foreign financial institutions, broadly defined to include hedge funds, private equity funds and securitization vehicles. No withholding would apply if the foreign financial institution entered into an agreement with the Treasury Department to report annually certain information on accounts held by certain U.S. persons and foreign entities with substantial U.S. owners. The bills also impose new documentation requirements with respect to payments to other foreign entities. The House-passed bill would apply generally to payments made after December 31, 2012, but would not require any amount to be deducted or withheld from payments under any obligation outstanding on the date that is two years after the date of enactment. These rules are more generous than the original proposals, which would have applied to payments made after December 31, 2010. The Senate also is likely to pass these rules, perhaps with the same effective dates as in the House bill.

Debt Restructurings

In the aftermath of the recent financial crisis, companies continue to restructure and renegotiate their outstanding debt obligations, many of which trade or are valued at significant discounts. New Section 108(i) allows taxpayers to elect to defer cancellation of indebtedness income arising from repurchases and exchanges (including deemed exchanges resulting from existing debt modifications) during 2009 and 2010 and to include that income ratably over a five-year period beginning in 2014. The exemption from the interest deductibility limitations of the "AHYDO" rules for certain debt-for-debt exchanges scheduled to have expired at the end of 2009 has recently been extended to 2010 by an IRS Notice. The extension further requires that the debt obligation received in the exchange have an effective interest rate that is subject to the AHYDO rules only as a result of the depressed trading price of the debt surrendered.

Contributing Partners / Stuart M. Finkelstein, Stuart.Finkelstein@skadden.com, 212.735.2841 / Victor Hollender, Victor.Hollender@skadden.com, 212.735.2825 / Pamela F. Olson, Pamela.Olson@skadden.com, 202.371.7240

Taxation of Carried Interests

The Obama administration's FY 2010 budget (Budget) and several bills introduced in Congress would treat income from partnership interests (including the sale of such interests) held by service providers, so-called "carried interests," as compensation income taxed at ordinary marginal rates and subject to payroll taxes. Under current law, such income retains the character of the income earned by the partnership. The House's version of the legislation would apply to income, distributions or dispositions realized in taxable years ending after December 31, 2009. As this goes to press, it is unclear whether this provision will be passed by the Senate and, if so, what its effective date would be.

International Tax Reform

The Budget proposed sweeping changes to international tax provisions affecting U.S. multinationals, including (1) deferring certain deductions associated with income earned offshore until such income becomes subject to U.S. tax, (2) limiting foreign tax credit planning and (3) eliminating the use of disregarded entities in foreign tax planning. Congress deferred action on these proposals until 2010 and likely will examine them as part of a broader review of taxation of U.S. businesses. For taxpayers with significant overseas operations, now is the time to evaluate the impact of these proposals.

Codification of Economic Substance

Congress appears poised to enact legislation codifying the economic substance doctrine. In addition, a strict liability penalty would be imposed on (1) transactions that lack economic substance or violate "any similar rule of law," and (2) other "tax shelters" (defined broadly as transactions with a significant tax avoidance purpose) by eliminating the reasonable cause exception. Lastly, large corporations (with gross receipts in excess of $100 million) and publicly traded companies would need to show a reasonable belief that a position was more likely than not correct to avoid the "substantial understatement" penalty for all other transactions.

NOLs

New Section 172(b)(1)(H) permits a five-year carryback of NOLs generated in 2008 or 2009. The carryback to the fifth preceding year is limited, however, to 50 percent of the taxpayer's taxable income for such year.

Personal Tax Developments

Changes to Individual Tax Rates

Absent Congressional action, the Bush tax cuts will expire at the end of 2010, restoring the highest marginal ordinary income tax rate to 39.5 percent and capital gains rate to 20 percent. Additionally, to finance health care reform, the administration proposed restrictions on itemized deductions, the House proposed an additional tax on adjusted gross income (including capital gains) of as much as 5.4 percent, effective for taxable years beginning after December 31, 2010, and the Senate would raise the Medicare tax from 1.45 percent to 2.35 percent for individuals earning more than $200,000 a year ($250,000 for joint filers), effective for taxable years beginning after December 31, 2012. With mounting concerns regarding budget deficits, expiration of the Bush tax cuts for high-income individuals is inevitable and these types of proposals will proliferate.

Estate Tax Extension/Repeal

Under current law, the estate tax is repealed in 2010 and returns in 2011 at pre-2001 levels. In addition, for 2010, assets transferred on death will have a carryover, rather than fair market value, basis. The House passed a permanent extension of the 2009 rate (45 percent) and exclusion level ($3.5 million for individuals and $7 million for couples), but the Senate could not reach agreement. Senate leaders have discussed reinstating the estate tax retroactively early in 2010; however, as this goes to press, there has been no agreement to move forward on reinstatement.

New York
Four Times Square
New York, NY 10036
T 212.735.3000

Boston
One Beacon Street
Boston, MA 02108
T 617.573.4800

Chicago
155 N. Wacker Drive
Chicago, IL 60606
T 312.407.0700

Houston
1000 Louisiana
Suite 6800
Houston, TX 77002
T 713.655.5100

Los Angeles
300 South Grand Avenue
Suite 3400
Los Angeles, CA 90071
T 213.687.5000

Palo Alto
525 University Avenue
Suite 1100
Palo Alto, CA 94301
T 650.470.4500

San Francisco
Four Embarcadero Center
Suite 3800
San Francisco, CA 94111
T 415.984.6400

Washington, DC
1440 New York Avenue, N.W.
Washington, DC 20005
T 202.371.7000

Wilmington
One Rodney Square
P.O. Box 636
Wilmington, DE 19899
T 302.651.3000

Beijing
30/F Tower 2
China World Trade Center
No. 1, Jianguomenwai Avenue
Beijing 100004 China
T 86.10.6535.5500

Brussels
523 avenue Louise
Box 30
1050 Brussels, Belgium
T 322.639.0300

Frankfurt
An der Welle 3
60322 Frankfurt am Main
Germany
T 49.69.74.220.0

Hong Kong
42nd Floor, Edinburgh Tower
The Landmark
15 Queen's Road Central
Hong Kong
T 852.3740.4700

London
40 Bank Street
Canary Wharf
London, E14 5DS, England
T 44.20.7519.7000

Moscow
Ducat Place III
Gasheka Street 6
Moscow 125047
Russian Federation
T 7.495.797.4600

Munich
Karl-Scharnagl-Ring 7
80539 Munich
Germany
T 49.89.244.495.0

Paris
68, rue du Faubourg Saint-Honoré
75008 Paris, France
T 331.55.27.11.00

São Paulo
Av. Brigadeiro Faria Lima
3311-7° andar
04538-133
São Paulo, SP Brazil
T 55.11.3708.1820

Shanghai
Plaza 66, Tower 1, 36th Floor
1266 Nanjing West Road
Shanghai 200040, China
T 86.21.6193.8200

Singapore
9 Temasek Boulevard
Suite 29-01
Suntec Tower Two
Singapore 038989
T 65.6434.2900

Sydney
Level 13
131 Macquarie Street
Sydney, NSW 2000, Australia
T 61.2.9253.6000

Tokyo
Izumi Garden Tower
21st Floor
1-6-1 Roppongi
Minato-ku, Tokyo 106-6021
Japan
T 813.3568.2600

Toronto
222 Bay Street
Suite 1750, P.O. Box 258
Toronto, Ontario
Canada M5K 1J5
T 416.777.4700

Vienna
Schwarzenbergplatz 6
A-1030 Vienna, Austria
T 43.1.7107730.0

Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates

Beijing
Boston
Brussels
Chicago
Frankfurt
Hong Kong
Houston
London
Los Angeles
Moscow
Munich
New York
Palo Alto
Paris
San Francisco
São Paulo
Shanghai
Singapore
Sydney
Tokyo
Toronto
Vienna
Washington, D.C.
Wilmington