2016 Insights

Skadden

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

Editorial Board

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Capital markets in 2015 were characterized by periods of strength and stretches of heightened volatility. The markets may experience similar patterns in 2016 as a result of macroeconomic conditions, geopolitical events and investor concerns regarding increased risk, among other factors. Regulatory proposals and amendments in markets around the world seek to encourage issuer access to the capital markets while maintaining an appropriate balance of investor protection.

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SEC Rulemaking Update: A Year of Changes, With More to Come

Contributing Partners

Brian V. Breheny / Washington, D.C.

Stacy J. Kanter / New York

Law Clerks

Michael Ju / New York

Kathleen A. Negri / New York

Former Counsel

Ted Yu

Last year, the Securities and Exchange Commission (SEC) made major progress in completing its rulemaking mandates under the Jumpstart Our Business Startups Act (JOBS Act) and the Dodd-Frank Act. Additionally, Congress enacted the Fixing America's Surface Transportation Act (FAST Act), which made a number of key changes to federal securities laws, including creating new accommodations for initial public offerings (IPOs) by emerging growth companies (EGCs), private resales of securities and reduced or streamlined disclosures for public companies.

Many of these changes became effective in 2015 or are expected to become effective in 2016, leading to the prospect of both new capital-raising opportunities and updated disclosure obligations for companies. Beyond rulemaking changes, the SEC itself is likely to be reshaped in 2016 with the arrival of two new SEC commissioners who will bring their own perspectives on the issues facing the agency, and the election of a new president, which could result in a new SEC chairman.

Capital Formation Changes

On December 4, 2015, President Barack Obama signed into law the FAST Act, which contained a number of capital formation provisions that have been referred to as "JOBS Act 2.0." The provisions ease the Securities Act registration process for EGCs in several ways, allowing them greater flexibility in assessing market conditions and determining the timing of their IPO launch; greater certainty regarding the use of EGC benefits during the registration process; and the ability to avoid the expense of preparing certain financial statements that would be unnecessary at the time of the offering.

In addition, with the SEC's completion of the JOBS Act rulemakings, companies have new avenues for raising capital. In March 2015, the SEC adopted final rules expanding Regulation A, an existing exemption from Securities Act registration for smaller issuances of securities. Often referred to as "Regulation A+," the new exemption allows eligible companies to sell up to $50 million of securities in a 12-month period, subject to certain disclosure and reporting requirements.

In October 2015, the SEC adopted final rules for equity crowdfunding, which allows companies to raise capital by soliciting small investments from a large number of investors. The new Regulation Crowdfunding rules permit an eligible company to raise up to $1 million through crowdfunding offerings in a 12-month period. All transactions relying on the new rules are required to take place through an SEC-registered broker-dealer or funding portal.

Companies should consider the impact of the new Securities Act registration exemption the FAST Act created for private resales to accredited investors. Under the new Section 4(a)(7) exemption, a resale would be exempt from registration as long as:

- the purchaser is an accredited investor as defined in Rule 501 of Regulation D;
- the seller (or any person acting on the seller's behalf) does not use general solicitation to offer securities;
- the seller and prospective purchaser obtain certain information from the issuer for situations in which the issuer is not subject to Exchange Act reporting obligations;

- neither the seller (nor any person compensated for the sale) is subject to an event that would trigger the "bad actor" disqualification provision of Securities Act Rule 506(d);
- the securities have been outstanding for at least 90 days prior to the date of the resale; and
- the securities are not part of an unsold allotment to an underwriter (such as an investment bank acting as an underwriter in an IPO).

Consistent with its purpose of facilitating resales, the new exemption is not available for sales by the issuer or its subsidiaries but is available for other affiliates of the issuer. The exemption should provide security holders of private companies greater trading liquidity for their securities and may give rise to a marketplace for sales of securities of private companies. At the same time, the issuer information requirement will place greater pressure on private companies to publicly disclose information.

Disclosure Modernization

Reforming the disclosure requirements for public companies continued to be a priority for the SEC and Congress in 2015. In October 2015, the SEC issued a request for public comment on the need for possible changes to Regulation S-X, which covers financial information. The release, which is the first product resulting from the SEC's Disclosure Effectiveness project, focuses on disclosure requirements for certain entities other than a registrant, such as financial statements of a target company in a business acquisition. The next phase of the SEC's Disclosure Effectiveness project will focus on Regulation S-K, with the SEC expected to solicit public comment on these disclosure requirements in 2016. Public comments largely will determine whether the SEC will then propose and implement changes to these requirements.

Congress, in the meantime, continued to press for changes that would reduce the disclosure burdens on public companies. In addition to the Disclosure Effectiveness project, the FAST Act requires the SEC to undertake new studies and rulemakings to simplify disclosure requirements. Companies should begin to see the first results of these new efforts in 2016.

FASB's New Lease Accounting Standards and Materiality Proposals

The Financial Accounting Standards Board (FASB) voted in November 2015 to issue new lease accounting standards for companies under generally accepted accounting principles (GAAP) that also will impact financial statements. The long-awaited standards are intended to increase transparency for investors and will require companies to include leases (operating and capital) in their financial statements instead of disclosing leases in the notes to those statements. The changes will impact companies that rely heavily on leases, causing an increase in their balance sheets and potentially posing issues for complying with existing debt covenants. Companies should review their indentures and credit agreements to determine if any covenants will be implicated, particularly maintenance covenants. However, the impact may be limited in some markets, such as in high-yield bonds, where indentures often contain provisions limiting the impact of changed accounting principles or freezing GAAP. Companies entering into indentures and credit agreements should also take this change into consideration.

The final accounting standards are scheduled to be published in early 2016. Public companies must comply for fiscal years and interim periods beginning December 15, 2018, and retroactive to annual and interim statements for 2017 and 2018. Private companies must comply for annual periods beginning December 15, 2019, and retroactive to financial statements for 2018 and 2019.

Separately, in September 2015, FASB issued two proposals intended to clarify the concept of materiality in financial reporting and eliminate unnecessary disclosures in financial statements. The first proposal would amend Chapter 3 of FASB Concepts Statement No. 8, Conceptual Framework for Financial Reporting, to clarify that materiality is a legal concept not defined by FASB. The proposal removes any existing discussion of materiality in Chapter 3 and replaces it with a broad reference to the U.S. Supreme Court's definition of materiality. Under this framework, information would be considered material if there is a substantial likelihood that a reasonable investor would view its omission or misstatement as having significantly altered the total mix of information. The second proposal promotes the use of discretion in determining which disclosures are material. This proposal stresses that materiality applies to quantitative and qualitative disclosures, both individually and in the aggregate in the context of financial statements taken as a whole. Nondisclosure due to immateriality would not be considered an accounting error. Comments were due on both proposals in early December 2015.

Conclusion

Further changes are on the horizon for 2016. Congress continues to show great interest in effecting policy goals through legislative modifications to the federal securities laws. Recent bills have been introduced in Congress that would change the accredited investor definition used for determining investors eligible to participate in private offerings, to expand the number of investors that can rely on the definition. In addition, the bills introduced new disclosure requirements for public companies regarding their directors' expertise in cybersecurity. Political contributions disclosure remains a hot topic for the SEC, which also is expected to continue completing the rulemakings mandated by the JOBS Act, Dodd-Frank Act and FAST Act.

Volatility Continues in US and European High-Yield Markets

Contributing Partners

Michelle Gasaway / Los Angeles
James A. McDonald / London
Michael J. Zeidel / New York

Associates

Robert C. Goldstein / Los Angeles
Riley Graebner / London

The continuation of a strong M&A market in both the U.S. and Europe, energy companies returning to the U.S. market and quantitative easing in Europe resulted in a strong first half of 2015 for U.S. and European high-yield markets. However, the markets experienced a significant slowdown in the second half of the year due to global events, weakness in commodity sectors and liquidity concerns, raising uncertainty for 2016. The U.S. high-yield market ended the year 22 percent lower by dollar value than in 2014, with $285 billion (503 issuances) compared to $364 billion (730 issuances) in 2014. The European high-yield market edged higher by value in 2015, with €106 billion (202 issuances) over the previous record of €101 billion (284 issuances) set in 2014, although there was a 29 percent decrease in the number of issuances.[1]

In 2016, repeat issuers and companies with strong fundamentals will continue to have the best access to the market. New issuers and more highly leveraged companies may find traditional high-yield issuances to be more challenging and as a result may seek alternative financing solutions and more creative structures, as has been seen in the energy sector.

Common Trends

The U.S. and European high-yield markets shared some key trends in 2015:

Large M&A Financings. M&A financings accounted for approximately 28 percent and 32 percent of U.S. and European high-yield market deal volume in 2015, respectively. Of note were several large issuances, including Valeant Pharmaceuticals ($10.1 billion, acquisition of Salix Pharmaceuticals), Frontier Communications ($6.6 billion, acquisition of Verizon's wireline operations), GTECH S.p.A. ($5 billion, acquisition of International Game Technology) and Altice N.V. ($4.8 billion, acquisition of Cablevision Systems Corporation). (See "*Insights* Conversations: M&A.")

Volatility. Both markets slowed dramatically in the second half of the year due to continued commodities weakness, speculation about a market correction, liquidity concerns, anticipation of Federal Reserve and Bank of England interest rate increases, and global events. (The Federal Reserve announced on December 16, 2015, that it was raising short-term interest rates by 25 basis points, the first interest rate increase since 2006.) The year ended with the first negative annual return to investors since 2008 and a prominent high-yield mutual fund freezing withdrawals.

U.S. Issuers in Europe. A number of U.S. companies looked to the European market in 2015, particularly in the first half of the year; 22 issuances (16 percent of issuances by deal volume in Europe) in that period came from across the Atlantic, due in part to U.S. companies taking advantage of European interest rates and improved trading liquidity in Europe.

US High-Yield: Key Trends

Distress in Energy Sector Impacts Market. The energy sector accounted for a significant number of high-yield issuances. Many of these, particularly for exploration and production (E&P) companies, were not traditional marketed deals. Instead, they were direct placements by issuers (without the use of an

underwriter) or debt exchange offers with investors to reduce leverage or interest expense or to extend upcoming maturities. (See "Oil and Gas Companies Utilize Restructuring Strategies to Navigate Industry in Flux.") In addition, bankruptcy filings, missed interest payments, downgraded credits and restructurings by distressed issuers resulted in an increased default rate for the sector and for high-yield bonds overall. In November 2015, the percentage of high-yield bonds in the U.S. that was considered distressed (where the spread between its yield and the yield of U.S. Treasuries surpasses 10 percentage points) reached its highest level since September 2009, and default rates rose to around 3 percent for the preceding 12 months. In Europe, by contrast, default rates remained steady at around 2 percent overall, due in part to oil and gas companies comprising a smaller percentage of high-yield bond issuers in Europe.

Increase in Private-for-Life Bonds. In reaction to recent case law under the Trust Indenture Act (TIA) and an increase in activist bondholders, issuances of private-for-life bonds increased in 2015. In such bond offerings, the issuer (even if already a public company) has no obligation to register the bonds with the Securities and Exchange Commission (SEC), and accordingly the indenture governing the bonds is not subject to the TIA. Based on deals reviewed by Xtract Research, an estimated 53 percent of new issuances in 2015 were private-for-life bond offerings, up from an estimated 39 percent in 2014.

Because reporting covenants for such bonds often are significantly less burdensome than SEC reporting requirements, issuers of private-for-life bonds historically could avoid the expense of the SEC registration and/or reporting process. In addition, following amendments to Rule 144 which shortened the period that investors are required to hold restricted securities before unrestricted resales can be made, such registration was no longer as important for transferability of the bonds. Recent decisions by the U.S. District Court for the Southern District of New York may add another reason for issuers to turn to private-for-life bonds. In those cases, the court held that certain indenture amendments required bondholders' unanimous consent because such amendments "impaired" nonconsenting bondholders' right to receive payment in violation of the TIA (even though the amendments did not directly change any indenture term explicitly governing the right to receive payment, and even though the indentures expressly permitted the action taken). Depending on the circumstances, these cases, if upheld, may have the effect of limiting the ability of some issuers and majority debtholders to conduct nonconsensual out-of-court restructurings/reorganizations involving debt securities subject to the TIA (or debt securities subject to similar provisions). Private-for-life bonds can give issuers the ability to preserve flexibility for future changes to their debt capital structure, as they can decide not to include TIA-mandated or similar provisions.

European High-Yield: Key Trends

Repeat Issuers Dominate Market in 2015. The market in 2014 was marked by a large number of first-time issuers (88 total with 67 in the first half of 2014 alone). In 2015, just 23 first-time issuers came to market, including 11 in the first half of 2015, due in part to increased volatility in the high-yield market, investor preference for stronger credit and competition from the leverage loan market.

Covenant Flexibility. In 2015, covenant trends continued to favor issuers, with an increase in the prevalence of soft-cap baskets (incurrence thresholds determined by a percentage of assets or EBITDA — earnings before interest, taxes, depreciation and amortization — rather than a fixed monetary amount) and other exceptions to restrictive covenants. In particular,

US and Europe High-Yield Issuances From 2014 to 2015

+5%
Europe
€101 billion to €106 billion
284 to 202 Issuances

-22%
United States
$364 billion to $285 billion
730 to 503 Issuances

Sources: Debtwire and Bloomberg

exceptions typically only found in the U.S. high-yield market appeared in Europe, such as the ability to redeem the last 10 percent of notes outstanding if the rest of the notes have been tendered in a change-of-control offer. Covenant-lite issuances also saw an increase, growing from 8 percent of issuances in 2014 to 20 percent of issuances in 2015. A covenant package typically is considered to be "covenant-lite" if it lacks either a debt incurrence covenant or a restricted payment covenant, or both (covenant-lite deals often also lack other traditional high-yield covenants and have investment-grade style redemption provisions). One key exception to this trend of "looser covenants" was issuances containing a portable change-of-control provision (which permits the issuer to not make an offer to repurchase the bonds at 101 percent of par upon a change of control, provided a leverage test is met), which fell to 12 percent, compared to 33 percent of issuances in 2014. The trend toward fewer instances of portability brings Europe closer to the U.S. standard that infrequently features portability.

Voice of the Investor. Investors in Europe were vocal in 2015 on increasingly issuer-friendly covenants and the shortening of call periods, and they sought improved access to issuers' periodic reports. U.S. issuers may hear similar investor concerns, as issuer-friendly covenants are prevalent in the U.S. market — Moody's reported that its covenant quality index (based on protection for investors) for U.S. issuances reached a record low in November 2015.

Outlook

The market for 2016 may continue to benefit from M&A activity and companies needing to refinance near-term bonds, but expectations remain tempered due to continued volatility and concerns about increased risk as the market looks to rebound from a slow fourth quarter.

[1] Sources for the data in this article are: Debtwire, highyieldbond.com, S&P Capital IQ LCD, Thomson One, Bloomberg, Xtract Research and Mergermarket.

Investment-Grade Notes Increase, IPOs Decline in 2015

Investment-Grade Notes

The U.S. investment-grade notes market ended the year 13 percent higher by dollar value (2 percent higher by issuances)[1] than in 2014, with $1.3 trillion (2,021 issuances).[1] The increase came at a time when many issuers were looking to access the market ahead of the anticipated interest rate increase (which was also true, but to a lesser extent, in the high-yield market), and despite the fact that the spread over Treasury for investment-grade notes was at its highest since 2011. European investment-grade issuances were down 18 percent by deal value over 2014 issuances with $793 billion in 2015. Dollar value in the U.S. and Europe was driven by several large issuances related to M&A financing, including Actavis Plc ($21 billion, acquisition of Allergan Inc.), AT&T Inc. ($17.5 billion, acquisition of DirecTV), AbbVie Inc. ($16.7 billion, acquisition of Pharmacyclics, LLC) and Visa Inc. ($16 billion, acquisition of Visa Europe Ltd.).

Initial Public Offerings

Initial public offerings in the U.S. in 2015 had their weakest year since 2009, declining 42 percent by dollar value (32 percent lower by issuances) from 2014 levels to $34 billion (172 issuances). A decrease in the number of technology and Internet companies going public in the U.S. contributed significantly to this decline, with IPOs in those sectors dropping from 62 offerings ($41 billion) in 2014 to 29 offerings ($9 billion) in 2015. IPOs in Europe were up by value, with €50 billion in 2015 (€42 billion in 2014) but down by deal volume, with 175 offerings (228 deals in 2014).

[1] Sources for the data in this article are: Bloomberg, Standard & Poor's Ratings Services, Dealogic, Reuters and Mergermarket.

Contributing Partners

Michelle Gasaway / Los Angeles

James A. McDonald / London

Michael J. Zeidel / New York

Associates

Robert C. Goldstein / Los Angeles

Riley Graebner / London

Renewable Energy Project Warehouse Facilities Are on the Rise

Contributing Partners

Lance T. Brasher / Washington, D.C.

Paul S. Kraske / Washington, D.C.

An important development in the financing of solar, wind and other renewable energy projects in 2015 was the use of a flexible investment and financing vehicle referred to as a "warehouse." Akin to traditional warehouse financing in a number of respects, it is a vehicle to provide financing for a portfolio of energy projects, in the form of debt, equity or both. Initially an outgrowth of the yieldco sector, the benefits of warehouse facilities have led sponsors to begin considering other applications, which could lead to an expansion of their use in the year ahead.

Warehouses and Yieldcos

Warehouses hold assets similar to those acquired by yieldcos — renewable energy assets with long-term power purchase agreements. These agreements between the generators and buyers of the energy produced are crucial to the funding of renewable energy projects; they allow the generators to more easily secure loans as well as tax and cash equity to cover the costs of developing and constructing the project while ensuring lenders and other investors that a market exists for the power that will be generated.

By holding these projects with long-term contracts, yieldcos generate predictable cash flows and ultimately pay distributions to their investors. To grow distributions, yieldcos rely principally on having access to a pipeline of new projects, known as "drop downs." Warehouses can provide a bridge for the acquisition and related financing of these assets, giving yieldcos more flexibility to address mismatches in timing between the availability of an asset in the market and the schedule for a drop-down and, in today's market, mitigate the reliance on accessing equity capital markets.

The warehouse also may be designed to provide construction financing for assets a sponsor develops or development assets the sponsor wants the warehouse to acquire. The projects can then be transferred from the warehouse to the yieldco at their completion with minimal construction risk to the yieldco. The warehouse also allows the sponsor to provide investors in the related yieldco with greater confidence in the yieldco project pipeline.

Realizing the flexibility of these structures and the availability of debt and equity capital, sponsors are pursuing other applications for warehouse facilities.

The Warehouse Facility Structure

A warehouse typically is managed by the sponsor, which also is an equity owner in the warehouse and often provides equity capital. Some warehouse facilities have third-party investors, who commit to making equity contributions to fund the acquisition or construction of qualifying projects over a period of time.

An investor committee led by the sponsor is often used to make investment decisions. The committee sets criteria, including project type and contracted output, that a project must satisfy to be eligible for acquisition or construction financing. Investors want their equity commitment to be used fully and timely; consequently, they may require a commitment fee or seek support from the sponsor if commitments are not utilized or returns not met, including through subordination of the sponsor's right to distributions.

Warehouses can design debt facilities to support the acquisition of operating projects; these contain many terms similar to holding company or mezzanine portfolio financing. Warehouses also can obtain construction loan facilities, which they in turn provide to project companies through downstream loans. Construction loans contain project finance-like conditions, covenants, defaults and other terms. The warehouse also has the ability to recycle capital from project sale proceeds and project company distributions for additional acquisitions and project construction financings.

Warehouses typically have a term of three to five years. An important issue for investors and lenders is the arrangements and expectations for the disposition of assets from the warehouse. Some warehouse facilities require these arrangements to be in place at the time the warehouse acquires the asset, including arrangements for tax equity financing, drop-down to the yieldco or sale to a third party. Others focus on the terms of the sale, placing minimum floors on sale prices. Investors may require asset calls for themselves or puts to sponsors or third parties. It is important to note that acquisition and disposition arrangements must include all relevant tax considerations.

Potential Uses for Warehouses

Sponsors, realizing the flexibility of the warehouse structure and the availability of debt and equity capital, are pursuing other applications for it. The large drop in yieldco stock prices in the latter half of 2015 has made current conditions inopportune for yieldcos to access the equity capital markets. Warehouse facilities offer a convenient structure to hold assets pending market recovery or sale of assets to a third-party buyer. Sponsors looking to create affiliated yieldcos are using warehouse facilities for a similar purpose: to hold the portfolio of assets pending creation and initial public offering of the yieldco. Certain sponsors are looking to warehouse facilities to create a portfolio specifically for the purpose of selling assets or groups of assets to third parties. Others are looking to warehouse construction financing features to support their affiliates engaged in construction, equipment supply, and operations and maintenance.

There is some debate about the cost-effectiveness of warehouse financing. Proponents point to the ability to recycle capital and the efficiency of a single facility and common agreed-upon terms applicable to multiple qualifying projects. Others assert that the cost of equity and debt is expensive and point out that one-size-fits-all may not be efficient, as equity and debt investors price operating and construction projects differently. What is clear is that an increasing number of sponsors — whether yieldco sponsors, strategic investors, manufacturers, contractors or financial players — are looking seriously at warehouse facilities, which may lead to more of them in 2016.

European Commission's New Initiative Aims to Promote Access to Capital Markets

Contributing Partner

Danny Tricot / London

Associate

Adam M. Howard / London

In early 2015, the European Commission (Commission) launched the Capital Markets Union (CMU), one of its flagship initiatives, to address its perception that capital markets-based financing in the European Union could be further developed and that businesses in the EU are too reliant on banks as a source of financing. The CMU objectives are to: (1) develop European capital markets as alternative sources of financing to banks, (2) produce a single market for financial services that is deeper, more liquid and more competitive, and (3) promote growth and financial stability throughout the EU. The Commission is aiming to fully implement the CMU initiative by 2019.

As part of the initiative, the Commission intends to replace the European Prospective Directive, which currently governs the prospectus required when securities are offered to the public or admitted to trading on a regulated market. The new regulation would make it easier for companies to prepare a prospectus and access the capital markets. Following a public consultation earlier this year, the Commission published a draft of the regulation on November 30, 2015.

The proposed amendments to the European prospectus regime constitute the most significant and wide-ranging changes for the preparation and publication of prospectuses since the current regime came into force in 2005. It remains to be seen how compatible the regulation, once approved, will be with the requirements and practices of key non-EU jurisdictions into which securities are marketed.

Highlights of the Proposed Regulation

Prospectus Contents. The summary section at the beginning of a prospectus would be limited to a maximum of six sides of A4-sized paper (currently, it is limited to 7 percent of the length of the prospectus or 15 pages, whichever is longer). It would contain three sections covering key information on the issuer, the securities and the offer/admission. Each section would have a general heading and an indication of the underlying content, but issuers would be free to develop brief narratives.

The regulation would allow the issuer to incorporate a greater amount of information by reference in a prospectus, provided that the information is published electronically and complies with the regulation's language requirements. This information may include material from other prospectuses and regulated information that issuers are required to disclose under the Transparency Directive and the new Market Abuse Regulation.

In order to prevent issuers from including a multitude of generic risk factors in a prospectus that obscures the more important ones, only risk factors that are material and specific to the issuer and its securities would be permitted. The issuer would be required to categorize its risk factors and differentiate them by their relative materiality and probability of occurrence.

High-Denomination Nonequity Securities. In an attempt to remove the incentive to issue debt securities in high denominations because they benefit from a lighter disclosure regime, the amendments would remove the existing

The proposed amendments to the European prospectus regime constitute the most significant and wide-ranging changes since the current regime came into force in 2005.

prospectus exemption for offers of securities with a denomination above €100,000. A uniform prospectus disclosure requirement would be introduced for all nonequity securities offers regardless of denomination. This would be based on existing disclosure standards for high-denomination debt but would call for additional information to ensure retail investor protection. Issuers that restrict their offerings of debt securities to qualified investors would still benefit from a prospectus exemption and avoid the regulation requirements.

Disclosure for Secondary Issuances and SMEs. A "proportionate disclosure regime" currently exists for secondary issuances and small- and medium-sized enterprises (SMEs), allowing a reduced level of disclosure in prospectuses from these issuers. Although this regime was intended to reduce the administrative burden and cost for such issuers, the Commission views it as unsuccessful and has proposed a replacement. Under the proposal, an existing issuer that: (1) already has been admitted to trading on a regulated market or an SME growth market for at least 18 months and (2) wishes to make an offer of securities or apply for the admission of securities, would be permitted to produce a short-form "alleviated prospectus" with the minimum financial information covering the last fiscal year. In certain circumstances, SMEs also would have more flexibility in the format of their prospectuses and could, for instance, adopt a question-and-answer format.

Universal Registration Document. The regulation introduces the concept of an annual universal registration document (URD), a form of "shelf" registration document for use by companies that frequently access the capital markets. This would contain all the necessary information on a company that wants to list shares or issue debt. Issuers that regularly maintain an updated URD with their regulators would benefit from a five-day fast-track approval process when they wish to issue shares, bonds or derivatives.

Exemption for Further Issuances of Shares. Any existing issuer already admitted to trading on a regulated market would not need to produce a prospectus for the subsequent admission of shares of the same class to that market, provided that such shares represent less than 20 percent (up from 10 percent) of the existing shares already admitted over the previous 12 months. This would facilitate the listing of further shares issued by existing issuers.

Prospectus Publication. Certain changes would be made to how prospectuses must be published. In addition, the European Securities and Markets Authority would be tasked with developing an online storage mechanism for all prospectuses, with a free search tool for EU investors.

Next Steps

The draft regulation will next be sent to the European Parliament and the Council of the EU for discussion and adoption and would come into force by mid-2017 at the earliest. Despite the remaining steps before implementation, the proposals provide clear evidence of the Commission's intention to simplify the working of, and therefore hopefully improve access to, the capital markets in Europe. All clients seeking to offer securities to investors in Europe or list those securities on markets in Europe will need to be mindful of the proposed changes.

New German Delisting Rules Aim to Protect Investors

Contributing Partner

Lutz Zimmer / Munich

Associate

Julian von Imhoff / Munich

On October 1, 2015, the German Parliament amended the German Stock Exchange Act to provide more protection to investors in delistings, remediating the perceived lack of protection that the German Supreme Court created through its *Frosta* decision in 2012. Rules established by *Frosta* did not require that shareholders of a company being withdrawn from a stock-market listing be offered any compensation for their shares. The amended law requires that a delisting be accompanied by an unconditional tender offer in which all shareholders are offered the same price per share that is equal to the weighted average share price over the preceding six months. The new law went into effect on November 27, 2015, but is retroactive to September 7, 2015, in certain cases.

Background

In 2002, the German Supreme Court stipulated in the *Macrotron* case three requirements in order to delist a company for reasons other than a merger or similar event:

- the approval of stockholders by simple majority;
- a public purchase offer, by the company or the major shareholder, to all shareholders in order to ensure that stockholders received adequate compensation reflecting the fair value of the company; and
- the option for shareholders to request a review of the purchase price through a special court proceeding.

According to the Supreme Court, these stipulations were necessary in light of the requirements under the German Constitution to protect the tradability of shares at a stock exchange. But 10 years later, the Federal Constitutional Court ruled in the *Frosta* case that the tradability of shares was not in fact protected by the constitution. Thus, the requirements established by the *Macrotron* decision were eliminated. Contrary to expectations, the Supreme Court abandoned its prior case law in favor of the *Frosta* decision in 2012. As a result, investor protection was reduced to only those protections that stock markets established themselves. For example, the Dusseldorf Stock Exchange continued to require stockholder approval and a purchase offer, while the Munich and Frankfurt stock exchanges only required an announcement six months in advance of a delisting.

In the wake of the *Frosta* decision, the number of delistings increased significantly, and once an announcement of an intention to delist was made, the company's share price generally dropped precipitously. As a result, shareholders were forced to dispose of their shares at a lower price if they wanted to avoid holding shares in a private company.

Legislative Action

On October 1, 2015, the German legislature amended the Stock Exchange Act to address what it perceived was inadequate investor protection. Under the amendment, a delisting requires that a tender offer be made to all shareholders and that the consideration paid not be lower than the weighted average stock price over the six months prior to publication of the intent to launch the offer. The tender offer materials also must make reference to the intended delisting and be published prior to submitting the application for delisting to the relevant

The German legislature amended the Stock Exchange Act to address what it perceived was inadequate investor protection.

stock exchange. Unlike the *Macrotron* requirements, approval by a company's stockholders is not required. A listing may be withdrawn without a tender offer only if the shares are still expected to be listed on a domestic regulated market or organized market in the European Union. The fair value of a company has to be used to determine the consideration to be offered rather than the weighted average stock price if: (i) the issuer did not properly inform capital markets about any insider information, (ii) the issuer or offeror violated rules regarding market manipulation or (iii) the stock price was not properly fixed in the relevant six-month period.

Additionally, the tender offer must not be subject to any conditions, such as antitrust clearance or a requirement to acquire a minimum percentage of shares. Thus, as currently drafted, the tender offer may not be used in most, if not all, cases where a party is seeking to acquire control over the listed company (as would be the case in "customary" takeover offers). This is because attaining control will normally trigger the need to obtain antitrust clearance.

Conclusion

The new legal framework for delistings may be considered a compromise between *Macrotron* and *Frosta*. Although the standard for investor protection has improved, many German legal authorities are critical of the fact that stockholder approval is not required under the amended law and that the consideration paid in the tender offer is calculated based on average stock price instead of actual company value. We expect delistings will occur less frequently under the amended rules, as the process will not be considered very attractive by parties contemplating a company takeover. Whether this will change in the future remains to be seen.

Acquisitions of Controlling Interests in Hong Kong-Listed Companies Through Primary Issuances

Contributing Partners

Edward Lam / Hong Kong

Jonathan B. Stone / Hong Kong

Acquisitions that result in a change of control of a Hong Kong-listed company — defined as 30 percent or more of the voting power — trigger a mandatory general offer to all shareholders of the company. The Hong Kong Securities and Futures Commission (SFC) will typically waive the general offer requirement in situations where a primary issuance of new shares has been approved in an independent vote at a shareholders' meeting. In 2015, there was increased scrutiny by the Hong Kong Stock Exchange (HKEx) on primary issuance acquisitions that result in a change of control. A relatively large number of the deals announced in 2015 were aborted or restructured due to failure to address one or more regulatory issues raised by the HKEx and/or SFC.

Under the Hong Kong Listing Rules, if a transaction constitutes a reverse takeover, the HKEx treats the company like a new listing applicant, requiring a Hong Kong prospectus, appointment of a sponsor and a full vetting process with the HKEx's Listing Division, all of which carry cost and timing implications. The HKEx has wide discretion to deem a transaction a reverse takeover, with acquisitions of assets that constitute "a very substantial acquisition" (see sidebar) resulting in such a designation.

However, a new investor can acquire a controlling shareholder stake without triggering a reverse takeover if the deal involves a cash subscription of new shares (or a combination of new shares and convertible securities). Many primary issuance acquisitions in the last few years have relied on this structure, which in most cases effectively removes the risk of the transaction being deemed a reverse takeover. We believe investors and listed companies will continue to structure change-of-control transactions through primary issuance acquisitions, as structuring an acquisition in this manner will not require the relevant investors to launch a mandatory general offer to all company shareholders. Companies and investors that do so should consider the following issues that may arise.

A relatively large number of deals in 2015 were aborted or restructured due to failure to address one or more regulatory issues raised by the Hong Kong Stock Exchange and/or Hong Kong Securities and Futures Commission.

Cash Company

Under Hong Kong Listing Rule 14.82, if for any reason the assets of a listed issuer (other than an "investment company" as defined in Chapter 21 of the listing rules) consist wholly or substantially of cash or short-dated securities (less than one year to maturity), it will not be regarded as suitable for listing and the HKEx may request that it suspend trading. Once it is considered a cash company, the listed issuer must apply for resumption of trading, an application that the HKEx scrutinizes as it would a new listing applicant. As a result, most third-party investors abandon the transaction if the HKEx determines that a listed issuer will, upon consummation of the primary issuance, become a cash company.

The HKEx issued a guidance letter in December 2015 on the cash company rules. The HKEx has indicated that there are no quantitative criteria to define a cash company and that the assessment is a qualitative test. Historically, transactions that result in the company having 90 percent or more of its assets in cash or short-dated securities immediately after the transactions typically have triggered the designation. However, the guidance letter clarifies that under the rules, companies with less than half their assets in cash as a result of a fundraising exercise typically would not be regarded as having assets consisting wholly or substantially of cash.

A number of companies have in the past tried to address cash company concerns by providing further details about their business plans and signing agreements to commit the use of the cash proceeds. The HKEx clarified in the letter that such actions would not reduce the cash proceeds for the purpose of the cash company rules, as the cash company assessment is made based on a company's cash balance as a result of the fundraising and the pertaining situation at the date of fundraising completion.

To decrease the risk of the listed issuer being deemed a cash company, the parties can reduce the amount of cash the issuer receives from the third-party investor. However, this runs the risk of attracting HKEx scrutiny if the discount to the prevailing market price is too large and the dilution on existing shareholders too significant.

Share Price Extremity

When a primary issuance acquisition provides the third-party investor a significant discount to the then-prevailing market price of the listed issuer's shares, the HKEx may require a share consolidation (*i.e.*, a reverse stock split). The HKEx will calculate the theoretical trading price of the shares based on the market capitalization of the listed issuer, discount and expected dilution. If that price is below HK$0.1, it may be difficult to convince the HKEx that there is no share price extremity issue.

Should the HKEx take that view, the listed issuer will need to include a proposal at the shareholders' general meeting for a consolidation of its shares as a condition of the transaction. Shareholders almost always vote in favor of share consolidation, as the failure to do so may cause the HKEx to suspend trading. The share consolidation could result in a capital reduction, requiring a special resolution and resulting in a potentially longer notice period to convene a general meeting. The HKEx has indicated that the listed issuer should address this issue pre-emptively instead of taking a wait-and-see approach.

Public Float

As a general rule, the HKEx requires all listed issuers to have a public float — shares held by the public and excluding those held by any "core connected person" such as a director, chief executive or substantial shareholder — of at least 25 percent. The HKEx has the right to suspend trading of the shares until appropriate steps have been taken to restore the public float.

If a proposed primary issuance acquisition involves a third-party investor who is seeking to acquire close to 75 percent of a company's issued share capital, the shares held by directors, chief executives, substantial shareholders and their respective close associates must be factored into the public float calculation. One challenge is that information on this type of shareholding may not be available at the time the agreement is signed, in which case an amendment to the agreement may be required, or the third-party investor may sell down its shareholding in order to restore public float and resume trading.

Shareholders' Vote

Third-party investors often enter into share subscription agreements with the listed issuer and one or more of the largest shareholders and/or directors. Sometimes the third-party investor will negotiate

Notifiable Transactions Explained

Under the Hong Kong Listing Rules, transactions of a listed issuer are classified into different categories depending on their "size" relative to the listed issuer. For this purpose, Hong Kong-listed companies are required to calculate five size test ratios to determine the category. They are:

Assets Ratio
The total assets that are the subject of the transaction divided by the listed issuer's total assets.

Profits Ratio
The profits attributable to the assets that are the subject of the transaction divided by the listed issuer's profits.

Revenue Ratio
The revenue attributable to the assets that are the subject of the transaction divided by the listed issuer's revenue.

Consideration Ratio
The consideration divided by the listed issuer's total market capitalization.

Equity Capital Ratio
The number of shares to be issued as consideration divided by the total number of the listed issuer's issued shares immediately before the transaction.

If one or more of these ratios equals 25 percent or more, shareholders' approval is required. A "very substantial acquisition" is an acquisition (or a series of aggregated acquisitions) through which one or more of these ratios equals 100 percent or more.

representations and warranties relating to the issuer's business and operations. However, once a shareholder becomes a party to the share subscription agreement, it is "involved in" the transaction and, as such, is unable to participate in the independent shareholders' vote. A third-party investor seeking to acquire control in a listed company should weigh the benefit of having representations and warranties given by a major shareholder against the inability to participate in the independent shareholders' vote. Two or more shareholders becoming party to the share subscription agreement may also lead the SFC to conclude that such shareholders are acting in concert and recognize them as a group for the determination of voting right changes and the obligation to make mandatory offers.

Conclusion

The regulatory environment for primary issuance acquisitions has changed significantly in 2015, with the HKEx taking a more conservative approach on a number of issues, including those raised above. Specifically, with the new guidance letter on the cash company rules, it is important that investors and companies structure their transactions carefully to fit within the rules. The HKEx has wide discretion to interpret the listing rules, and interpretations may change from time to time. As such, companies should seek legal advice before structuring an acquisition of a controlling interest in a Hong Kong-listed company.

Corporate Restructuring

Feeling the pressure, oil and gas companies are relying on various restructuring strategies to weather precipitous commodity price declines. Meanwhile, bankruptcy courts have weighed in with important decisions on make-whole provisions, fraudulent transfers and U.S. restructurings in cross-border insolvencies.

Absent precise language in indentures, bankruptcy courts may rule that a make-whole premium is not payable.

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E&P companies that cannot work through financing constraints may have to seek bankruptcy protection.

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A plaintiff must show the actor's primary motivation is to move assets beyond a creditor's reach.

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The *Berau* decision could have widespread implications for cross-border restructuring transactions.

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Oil and Gas Companies Utilize Restructuring Strategies to Navigate Industry in Flux

Contributing Partners

Frank E. Bayouth / Houston

K. Kristine Dunn / Los Angeles

Michelle Gasaway / Los Angeles

Ron E. Meisler / Chicago

George N. Panagakis / Chicago

Associate

Jessica S. Kumar / Chicago

Precipitous commodity price declines that began in mid-2014 continued to disrupt the oil and gas industry in 2015, outlasting the expectations of many analysts. By the end of 2015, prices for both Brent and WTI crude were fluctuating in the mid- to high $30s per barrel, down from highs of over $100 a barrel in mid-2014.

Exploration and production (E&P) companies, which face high operating costs for drilling, production and transportation — particularly in those basins with limited access to transportation and processing infrastructure — have been most impacted by falling prices, with some experiencing revenues below the break-even point. Compounding the issue is the fact that E&P companies, which have in large part funded their substantial capital budgets with borrowed money, also are burdened by material financial debt and liquidity constraints.

While some E&P companies have relied on various restructuring techniques to weather these challenges, not all have successfully navigated those options, seeking bankruptcy protection instead. If commodity prices remain low, E&P companies will have to continue to work through these financing constraints or seek to restructure through the bankruptcy process.

Banks Feel Pressure to Limit Exposure to Oil and Gas Producers

Generally, E&P companies rely on a combination of reserve-based revolving loan (RBL) financing facilities and unsecured bonds to fund their capital programs. RBL facilities typically provide for semiannual redeterminations of their borrowing base and a yearly discretionary redetermination at the election of the borrower or lenders. While RBL lenders and their agents have significant discretion to set borrowing bases, lower reserve values and the ongoing roll-off of favorable hedges will likely translate into lower revolver availability for many companies, further reducing the liquidity available to already stressed companies.

Increasing regulatory pressure on U.S. banks engaged in oil and gas lending also is causing certain RBL lenders to reduce their exposure to the sector. This may be a pivotal driver in borrowing base redeterminations during the spring of 2016. Federal regulatory agencies, including the Office of the Comptroller of the Currency, the Federal Reserve and the Federal Deposit Insurance Corp., have warned banks to limit their exposure to increasingly risky oil and gas producers, thereby pressuring banks to tighten and increase the frequency of oil and gas loan reviews. Bank regulators have advised that a significant number of outstanding loans to E&P companies should be classified as "substandard" (meaning there is uncertainty as to underlying collateral value and/or borrower ability to repay the loans). Bank regulatory agency actions appear to be causing banks to take steps to limit loans in the oil and gas sector. The fall 2015 redetermination season resulted in borrowing base reductions for certain E&P companies — although to a lesser extent than many analysts had predicted — averaging approximately 9 percent overall, as reported by *The Wall Street Journal* on December 3, 2015.

Restructuring Strategies for E&P Companies

Given these challenges, during the past year many E&P companies have taken steps beyond cost cutting to improve their liquidity and reduce their leverage.

As the financial crisis for exploration and production companies has continued, the restructuring strategies available to such companies have become more limited.

Strategies include taking on first-, second- or third-lien secured debt; issuing unsecured notes; exchanging unsecured notes for new secured debt at a discount; buying back notes at a discount; issuing equity; selling noncore assets; and entering into joint venture or similar agreements to share costs of developing mineral interests. However, as the financial crisis for E&P companies has continued, the options available to such companies have become more limited.

One frequently used E&P company financial restructuring strategy has been the nonratable debt exchange, whereby a group of unsecured noteholders is given the opportunity to exchange their unsecured notes for secured debt (plus, in some cases, cash and/or equity). In such a transaction, the E&P company's overall indebtedness is reduced because a lower principal amount of secured debt is issued in exchange for unsecured notes at a discount to par value (but at a premium to current trading levels). These exchanges offer certain advantages. In many cases, the agreement governing the relevant unsecured notes permits new secured debt to be incurred without the consent of the noteholders. In addition, because these exchanges are negotiated with a small number of individual noteholders, they typically are not subject to tender offer rules and can be accomplished quickly and privately. However, because all holders of unsecured notes do not have the opportunity to participate in such exchanges, nonparticipating noteholders may raise issues or consider litigation strategies.

Another exchange structure that companies may find useful in the current climate, depending on their timing and goals, is a reverse Dutch auction, which allows a company to buy back (including by exchange) its debt at the lowest market-clearing price. A reverse Dutch auction process may be more time-consuming and complicated than other strategies (including a private exchange transaction) because it must comply with the debt tender offer rules. However, it offers the advantage of potentially identifying the lowest market-clearing price and may be structured to give a greater number of noteholders an opportunity to participate in the transaction. If a company has the goal of ensuring that all noteholders have a chance to participate, it may want to consider conducting an SEC-registered exchange offer.

Debt exchanges and debt issuance transactions generally require the consent of the E&P company's RBL lenders because RBL financing facilities generally provide little leeway for companies to incur material amounts of additional debt or liens. In contrast, indentures governing E&P company bonds typically provide more flexibility for additional debt and lien incurrence. It follows that E&P companies will look to accomplish financial restructuring transactions that comply with existing indenture baskets and then negotiate the requisite consent from their RBL lenders. In some cases, obtaining such consent may necessitate offering protective accommodations to RBL lenders, including a borrowing base reduction.

Despite possible capital-raising and debt-reduction strategies, in 2015, more than three dozen oil and gas companies filed for bankruptcy. If commodity prices remain low or continue to decline, we expect additional distressed or highly leveraged E&P companies to seek bankruptcy protection to effectuate restructurings.

Recent Rulings Underscore Importance of Careful Drafting of Make-Whole Payment Provisions

Contributing Partner

Mark S. Chehi / Wilmington

Counsel

Sarah E. Pierce / Wilmington

Robert A. Weber / Wilmington

Under long-established common law, loans must be paid only upon maturity, not before. This "perfect tender in time" rule is the default rule in a number of jurisdictions. Many indentures and credit agreements therefore either bar prepayments altogether with "no call" provisions or permit prepayments with "make whole" provisions that require the payment of a specified premium to make up for the loss of future income.

A recent trilogy of decisions by the Bankruptcy Court for the District of Delaware in the *In re Energy Future Holdings Corp.* (*EFH*) Chapter 11 cases serves as a reminder of the need for careful drafting of make-whole provisions. (See *2014 Insights* article "Enforcement of Make-Whole Provisions in Bankruptcy: The Importance of Careful Drafting.") In *EFH*, Bankruptcy Judge Christopher S. Sontchi scrutinized and narrowly construed make-whole provisions in indentures governed by New York law. The decisions, which set a high bar for trustees seeking payment of make-whole premiums, follow and adopt a New York bankruptcy court's September 2014 decision in *In re MPM Silicones, LLC* (*Momentive*). (See *2015 Insights* article "Recent Cases Highlight Potential Pitfalls for Distressed Investors.")

Background

In *EFH*, the first-lien notes issued by the debtors provided for automatic acceleration of payment to the lender upon debtor bankruptcy and for payment of a make-whole premium in the event of an optional prepayment prior to maturity. The EFH debtors sought to avoid payment of make-whole premiums, and before bankruptcy had publicly disclosed their intent to do so. At the outset of their Chapter 11 cases, the debtors obtained approval of debtor-in-possession (DIP) financing to pay in full the first-lien notes except for make-whole amounts. The first-lien noteholder trustee objected and attempted to preserve its make-whole payment claims by waiving the bankruptcy filing default under the first-lien indenture and decelerating the payment of notes. The trustee also moved for relief from the automatic bankruptcy stay, to rescind and reverse the automatic acceleration of the notes.

March Decision

In March 2015, the Delaware bankruptcy court ruled that the EFH debtors' payment of the first-lien notes with the DIP financing did not constitute a redemption that triggered the make-whole premium. The court decided that under the express terms of the indenture, the first-lien notes automatically accelerated upon the bankruptcy filing and were due and payable without further action or notice. Likewise, the acceleration provision did not require payment of the make-whole premium, nor did it trigger the optional redemption provision. Instead, Judge Sontchi determined that the make-whole concept only was included in regard to an optional redemption under the indenture.

The bankruptcy court reasoned that New York law requires an indenture to "contain express language requiring payment of a prepayment premium upon acceleration; otherwise, it is not owed." The EFH indenture did not include such a provision, although such negotiated clauses have been upheld by courts.

Moreover, New York law directs that specific contract provisions supersede more general provisions. The bankruptcy court concluded that the acceleration provision was a specific provision. Because it did not refer to either the make-whole premium or the optional redemption term, the court rejected the trustee's argument that the optional redemption provision was a wholesale bar to repayment before the original maturity date.

Judge Sontchi decided under New York law that "a borrower's repayment after acceleration is not considered voluntary" because the acceleration date becomes the new maturity date, rendering prepayment impossible, and EFH's bankruptcy filing automatically accelerated the notes, rendering them due and payable. Accordingly, the court concluded that post-petition repayment of the notes was not a voluntary prepayment and, under the indenture, did not trigger the make-whole premium.

July Decision

In July 2015, Judge Sontchi denied the trustee's motion for automatic stay relief to rescind the automatic acceleration of the EFH first-lien notes. The trustee argued that because the debtors were solvent, make-whole payments could not constitute harm, but Judge Sontchi ruled that payment of the make-whole amounts would deprive the estates of an equal amount of distributable value, and that the interests of EFH equity holders could be considered. The court observed that if the automatic stay were lifted, decelerating the notes and triggering the make-whole payment obligation, the resulting harm would be no less than any harm to the noteholders from nonpayment of the make-whole premium. The court also rejected claims that nonpayment of the make-whole obligation would injure "investor expectations" because the noteholders continued to acquire first-lien notes after EFH publicly disclosed its intention not to pay make-whole premiums in bankruptcy.

October Decision

Judge Sontchi's third ruling addressed make-whole claims arising under EFH's second-lien notes. The terms of EFH's second-lien indenture were virtually identical to the indenture at issue in *Momentive*. Judge Sontchi explained that "there are only two ways to receive a make-whole upon acceleration under New York law: (i) explicit recognition that the make-whole would be payable notwithstanding the acceleration, or (ii) a provision that requires the borrower to pay a make-whole whenever debt is repaid prior to the *original* maturity." Adopting *Momentive*, Judge Sontchi held that the EFH second-lien indenture was not sufficiently specific to trigger the make-whole premium following acceleration.

Implications

The Delaware bankruptcy court's *EFH* rulings expressly adopt the rule in *Momentive* and provide guidance for the clear drafting of indentures with make-whole or prepayment premiums: An indenture should either explicitly state that such premiums are payable notwithstanding automatic acceleration or explicitly require payment of make-whole or prepayment premiums if notes are at any time repaid before their original maturity date. Absent precise language in indentures, bankruptcy courts may rule that a make-whole premium is not payable following automatic acceleration upon a bankruptcy filing.

The Delaware bankruptcy court's rulings provide guidance for the clear drafting of indentures with make-whole or prepayment premiums.

Bankruptcy Court Tightens Intentional Fraudulent Transfer Pleading Requirements

Contributing Partner

Mark S. Chehi / Wilmington

Counsel

Robert A. Weber / Wilmington

Associate

Stephen J. Della Penna / Wilmington

On November 18, 2015, the U.S. Bankruptcy Court for the Southern District of New York dismissed intentional fraudulent transfer claims asserted by a bankruptcy litigation trustee against former shareholders of Lyondell Chemical Company in *Weisfelner v. Fund 1* (*In re Lyondell Chemical Co.*) (*Lyondell II*). By adopting a strict view of what constitutes intent, the opinion tightens pleading standards applicable to these cases. It bears watching whether other courts will apply *Lyondell II*'s more demanding pleading standards.

Background

In December 2007, Lyondell Chemical Company was acquired by Basell AFSCA in a leveraged buyout (LBO). As is typical in such transactions, Lyondell itself borrowed money to finance the LBO, and approximately $12.5 billion of borrowed funds were transferred to Lyondell's pre-LBO shareholders to acquire their Lyondell shares.

Just 13 months after the LBO, Lyondell filed a voluntary Chapter 11 petition. Under the company's bankruptcy plan, litigation trusts were formed to pursue causes of action on behalf of Lyondell and its creditors. Eventually, the trustee asserted fraudulent transfer actions seeking to recover $12.5 billion from Lyondell's former shareholders.

A plaintiff must show that the actor's primary motivation is to move assets beyond a creditor's reach.

Bankruptcy Court Decisions

The bankruptcy court dismissed the trustee's intentional fraudulent transfer allegations in his initial complaint (*Lyondell I*) but granted leave to replead. After the trustee filed amended intentional fraudulent transfer allegations, the shareholder defendants moved to dismiss them, and the court agreed in *Lyondell II* that the new allegations failed to state intentional fraudulent transfer claims. Specifically, the bankruptcy court said that the plaintiff must plead facts that show actual intent, as opposed to implied or presumed intent.

Moreover, a plaintiff cannot sustain an intentional fraudulent transfer claim based on a careless, imprudent or aggressive business strategy that has the effect of impeding creditor recoveries. Rather, a plaintiff must show that the actor's primary motivation is to move assets beyond a creditor's reach. A plaintiff must allege some sort of "intentional action to injure creditors." Alleging "[o]ther wrongful acts that … may be seriously prejudicial to creditors" — such as negligence or a breach of fiduciary duty — will not support an intentional fraudulent transfer claim.

The *Lyondell II* court adopted the Restatement (Second) of Torts standard in which intent exists when "the actor desires to cause consequences of his act, or that he believes that the consequences are *substantially certain to result* from it" (emphasis in original). The court rejected the more lenient "natural consequences" standard set forth by the U.S. Court of Appeals for the Seventh Circuit in *In re Sentinel Mgmt. Grp.*

As for what allegations are necessary to prove intent, the court considered traditional "badges of fraud," "motive and opportunity" and "recklessness" allegations. The court concluded that traditional badges of fraud allegations (*e.g.*, a concealed transfer, a transfer to an insider, a transfer where the transferor retains possession or control of the transferred property, or a transfer of substantially all the debtors' assets) are indicative of the kind of specific intent required by the restatement.

The court recognized that "motive and opportunity" allegations, if proven, might show a defendant's motive and opportunity to commit fraud or provide strong circumstantial evidence of conscious misbehavior or recklessness. However, the court also acknowledged that apparent "motive and opportunity" might be pleaded in benign situations and, therefore, such allegations are not a strong indicator of the intent needed to support an intentional fraudulent transfer claim. The court said that in order to plead restatement-level specific intent with motive and opportunity allegations, a plaintiff also must allege additional facts indicative of intent. Moreover, an inference of fraudulent intent discerned through "motive and opportunity" allegations must outweigh opposing inferences that could be drawn from the same allegations. The court emphasized the distinction between motive to injure creditors (which could indicate the requisite intent) and mere "motive for self-enrichment" or attempt to maximize shareholder value (which is insufficient to support an intentional fraudulent transfer claim).

As for allegations tantamount to "recklessness," the court ruled such allegations may survive a motion to dismiss only if a plaintiff also alleges facts showing a state of mind approximating actual intent. Lesser allegations, such as allegations of negligence, cannot support an intentional fraudulent transfer claim.

The *Lyondell II* court held that the trustee's amended allegations did not satisfy the heightened restatement standard of intent. While the trustee's amended complaint alleged that Lyondell's board of directors did not exercise proper care in pursuing the LBO, and that one director had intent to defraud other parties to the LBO, dismissal with prejudice was required because the trustee failed to allege facts supporting the conclusion that the board of directors "*intended* that any creditor be hindered, delayed or defrauded" (emphasis in original).

Berau May Expand US Restructuring Options for Foreign Issuers

Contributing Partners

Adrian J. S. Deitz / Sydney

Jay M. Goffman / New York

John K. Lyons / Chicago

A recent decision in the U.S. Bankruptcy Court for the Southern District of New York clarifies that restructuring options under Chapter 11 or Chapter 15 are available to foreign issuers of U.S. debt, even if those issuers have no operations in the United States (*In re Berau Capital Resources PTE Ltd.*). The decision could have widespread implications for cross-border restructuring transactions involving U.S.-issued debt, since the ability to utilize Chapter 11 or Chapter 15 offers many advantages for foreign issuers.

Background

Over the past five years, foreign issuers without significant, or even any, U.S. operations have accessed the U.S. capital markets for high-yield, term loan B and other debt. Foreign issuers have been drawn to the U.S. debt markets because of historically low interest rates, which often were substantially better than prevailing rates in their home countries, and the greater levels of leverage available in the U.S. Particularly for commodity producers, which comprised a substantial proportion of the foreign borrowers in the U.S. debt market, being able to match U.S. dollar borrowing costs against the U.S. dollar revenue in which commodities are typically priced was appealing.

With recent economic pressures, especially in the energy and mining sectors, some of these foreign issuers now have little or no realistic prospect of repaying their debt obligations. Much of this debt has traded at substantial discounts to par value and thus has attracted private equity and hedge funds that invest in distressed businesses. Given the continued economic challenges within these sectors, funds invested in highly leveraged businesses are likely to increase pressure on those businesses to execute transactions to decrease debt in order to realize value by creating a viable business with a sustainable capital structure.

In *Berau*, which was decided on October 28, 2015, the company commenced a foreign insolvency proceeding in Indonesia and subsequently sought enforcement of that case in U.S. bankruptcy court under Chapter 15 of the U.S. Bankruptcy Code. The debtor, Berau Capital Resources PTE Ltd., was a Singaporean company that issued (and defaulted on) over $450 million of U.S. dollar-denominated notes. The company's debt documents contained typical provisions found in a U.S. debt issuance — an indenture governed by New York law, a New York forum selection clause and a provision appointing an authorized agent for service of process in New York. When determining whether Chapter 15 could be invoked, the bankruptcy court addressed whether contractual provisions in the company's debt documents satisfied the Bankruptcy Code Section 109(a) eligibility requirement of "property in the United States" that must be satisfied for U.S. bankruptcy jurisdiction.

The *Berau* court held that contractual terms invoking New York law were sufficient to satisfy the eligibility requirement. It stated that contracts create property rights for parties, and state law governs such rights in bankruptcy cases. The court concluded that applicable New York law reflects a "legislative policy" that allows contract counterparties with transactions that meet specified threshold amounts to establish New York "property" by designating New York governing law and applying a New York forum selection clause.

The *Berau* court held that contractual terms invoking New York law were sufficient to satisfy the Bankruptcy Code's eligibility requirement for U.S. bankruptcy jurisdiction, which may expand restructuring options for foreign issuers.

The *Berau* decision bolstered a binding, yet often criticized, 2013 U.S. Court of Appeals for the Second Circuit decision: *In re Barnet* held that Section 109(a) applies to Chapter 15 cases and thus requires a Chapter 15 foreign debtor to reside or have a domicile, place of business or property in the United States to be eligible to file a Chapter 15 bankruptcy petition.

Advantages for Foreign Issuers

Because the eligibility standard applies equally to Chapter 11 and Chapter 15 proceedings, many foreign issuers will now have a clearer path to invoke U.S. bankruptcy court jurisdiction to implement balance sheet restructurings. Bankruptcy Code options present several advantages for foreign issuers, whether filing a separate Chapter 11 proceeding or using Chapter 15 in tandem with a foreign proceeding. They include:

Global Reach of the Automatic Stay. Section 362 of the Bankruptcy Code will provide certainty to foreign issuers (especially global companies with assets and operations in various jurisdictions) that plans of reorganization will be honored by global creditors with U.S. contacts.

No Insolvency Requirement. Unlike other insolvency regimes in host countries, companies do not have to be insolvent to take advantage of Chapter 11. Accordingly, directors and other fiduciaries of a foreign issuer may use Chapter 11 to proactively restructure a company's balance sheet before it faces a liquidity crisis.

Existing Management Remains in Place. Chapter 11 allows a company's directors and management to remain in control during a restructuring. Other types of foreign insolvency regimes mandate the appointment of an administrator or monitor to oversee the business.

Familiarity With Chapter 11. If debt that is being restructured is issued in the United States and is subject to U.S. governing law, global investors and creditors will be familiar with the Chapter 11 process. As a result, they should be more likely to support a deleveraging restructuring, given Chapter 11's certainty of outcome and binding effect on holdout creditors.

Plan of Reorganization as a Tool to Raise Additional Capital. The ability to raise additional capital through a U.S. capital markets transaction under a prepackaged Chapter 11 plan may provide additional liquidity not otherwise available to foreign issuers in their home countries.

In light of the *Berau* decision, we anticipate more foreign issuers will seek relief under the U.S. Bankruptcy Code to implement cross-border restructuring transactions.

M&A/ Governance

Following a record year in 2015, strategic M&A remains at the forefront of corporate agendas. Successfully navigating the many regulatory and governance challenges, including shareholder activism, will be essential for companies and boards in their execution of plans to grow and maximize value.

New SEC requirements could increase public scrutiny of executive compensation policies.

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66%
of golden-parachute votes received greater than
80%
support from shareholders

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Stichtings' unique characteristics have allowed them to play a significant role in a number of high-profile M&A situations.

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Shareholder activism in Asia increased 85% from 2014 to 2015

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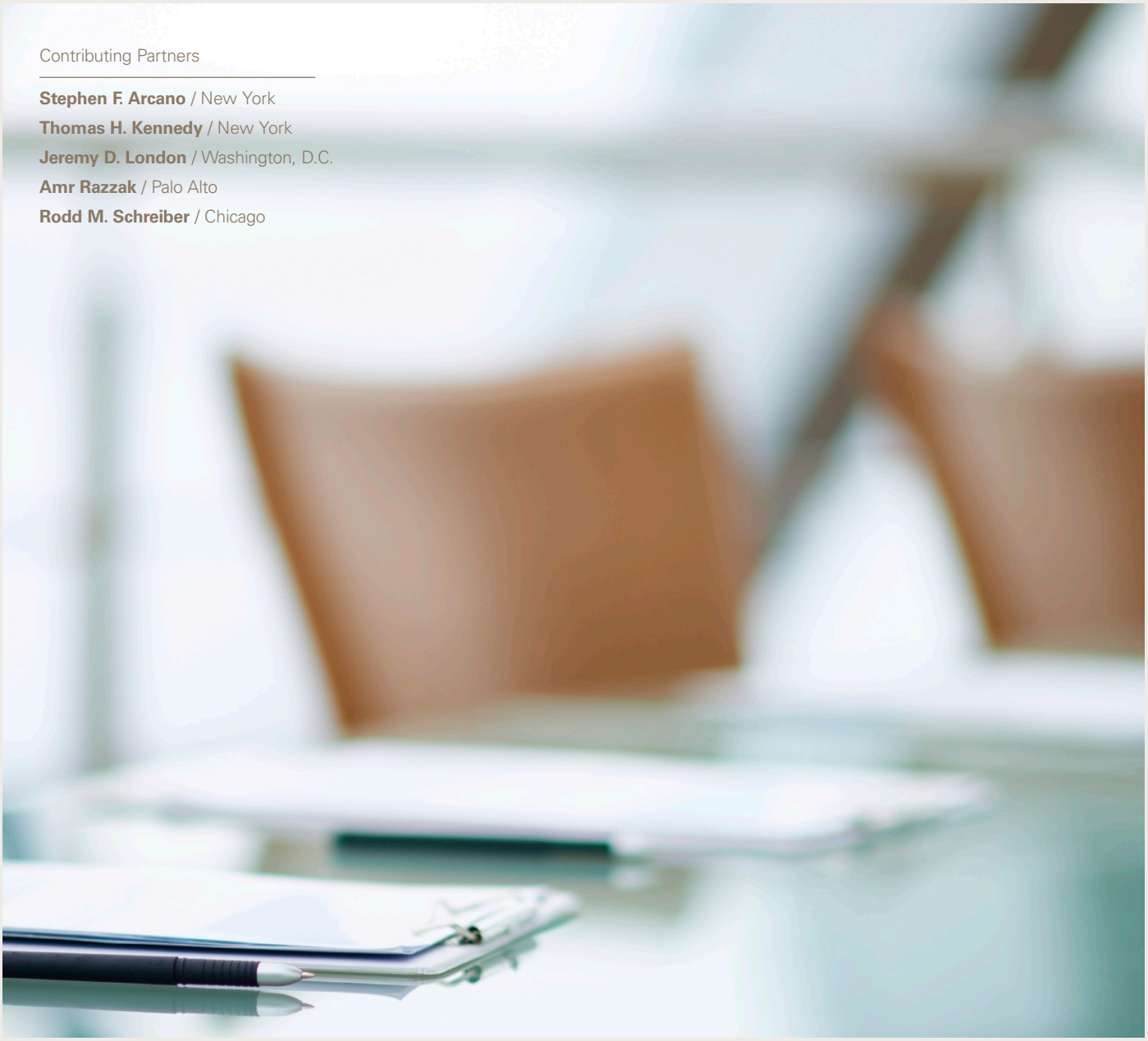
Insights Conversations:

Mergers & Acquisitions



Contributing Partners

Stephen F. Arcano / New York
Thomas H. Kennedy / New York
Jeremy D. London / Washington, D.C.
Amr Razzak / Palo Alto
Rodd M. Schreiber / Chicago

Skadden M&A partners Steve Arcano, Tom Kennedy (moderator), Jeremy London, Amr Razzak and Rodd Schreiber discussed their perspectives on M&A activity in 2015 and the outlook for 2016. The conversation covered the current environment, the role of activism, board process and the impact of regulatory activity. The discussion took place prior to recent market volatility following developments in China. We will continue to monitor the impact of these developments in future communications.

Tom: Let's start by looking at the overall M&A environment as we head into 2016. Is there depth to the market? What is driving the pace of activity?

Steve: The environment continues as of year-end to be conducive to M&A activity, particularly in the U.S. The economy has continued on its slow-growth trajectory. Corporate balance sheets are in good shape, equity markets have been relatively stable for most of the year, and access to debt financing has been generally available on attractive terms, though there has been some dislocation recently in the high-yield market. (See "Volatility Continues in US and European High-Yield Markets.") Many of these trends have been present beyond the U.S. as well.

There is still sufficient confidence in the boardroom about longer-term prospects to support strategic M&A. Corporations face a continued imperative to grow at a rate that exceeds economic growth — and M&A is an important tool to achieve that. The robust market has been driven by strategic transactions in response to forces that likely will remain the reality for the foreseeable future. At the same time, there are risks and uncertainties in the global economy and equity markets, and other factors that could impact activity levels.

Tom: What are the factors that might restrict activity? And how do you assess their impact on the market?

Jeremy: I don't think the factors that exist have had an overall impact on the pacing, but they definitely affect the market in terms of the specifics. For example, finding financing on acceptable terms has become more difficult for lower-rated issuers. Despite record levels of M&A activity last year, leverage loan volume was down considerably. Asset prices, competition from strategics and regulatory restrictions all may contribute to that. I do expect continued use of stock as currency in strategic M&A.

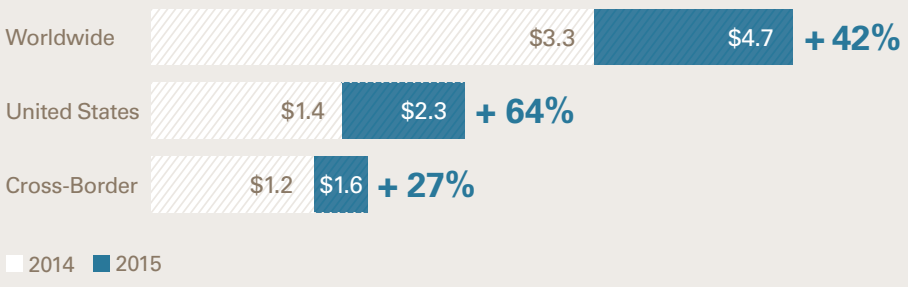
On the regulatory front, I see continued, robust antitrust enforcement and scrutiny, but boards and advisers have shown resilience to sign deals, allocate risk and ultimately get deals done. Especially in the health care space, individual states and state AGs are taking a more active role in this area. (See "Antitrust and Competition: Trends in US and EU Merger Enforcement.")

The stock price reaction to announced deals also is interesting. In a strategic deal, if a company goes after a target with lower margins or a lower growth rate, the acquirer stock can take a hit. Acquirers have to do their homework and have a good handle on what their shareholders think — not necessarily only about the target and the deal, but what they think about the acquirer too.

Rodd: As for other issues, I don't see volatility or rising interest rates as creating an impediment to deal-making right now, but that could change as the new year unfolds.

Many of the biggest deals that have been driving the market have been stock-for-stock transactions, so financing considerations haven't been at the forefront. Likewise, investment-grade and the better

Year-Over-Year Comparison of M&A Deal Values (in trillions)



Source: Thomson Reuters; announced deals

Health Care
$702 billion

Technology
$624 billion

Real Estate
$411 billion

Oil & Gas
$372 billion

Finance
$351 billion

Source: WSJ/Dealogic

ranked high-yield issuers have continued to have access to the credit markets at pretty favorable pricing. Private equity firms, which accounted for approximately 6 percent of global M&A activity in 2015, and other acquirers that rely on leverage were not key drivers of M&A activity last year and are not likely to be in 2016.

Tom: What geographies or industries showed particular strengths last year, and which ones might be stronger or weaker going into 2016 with regard to M&A activity?

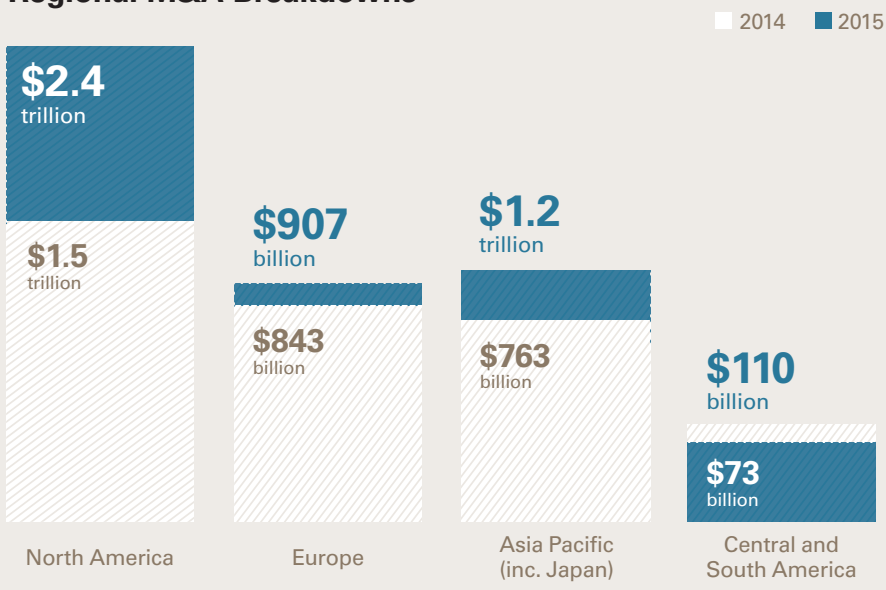
Amr: Geographically, M&A activity has generally been robust across the board. As Steve noted earlier, the U.S. has been particularly strong this year, but Europe and Asia also have picked up. Latin America was a bit of a slow spot.

In terms of industries, technology and health care have both been very strong. Within tech, the semiconductor space has been a real standout, with long-anticipated consolidation finally happening. The market imperatives for M&A remain strong, so I would expect the activity to continue in the coming year. With technology, products and markets evolve quickly. Folks who were your best friends last year may be your biggest competitors this year. Whole industries emerge and disappear within a span of just a few years, so even very large, established companies have to constantly reinvent themselves and that continues to be a driving force for M&A.

In health care we've seen mega pharma deals, like Pfizer-Allergan, as well as lots of interest in biotech companies. Pharmaceutical companies face the challenge of patents expiring on big drugs in coming years, so biotech companies, particularly at current price levels and with only spotty capital market windows, present attractive buying opportunities.

On the private equity front, others have noted that PE firms haven't been as prominent in the current M&A landscape, but they've still been involved, perhaps in different roles. For example, Silver Lake played a significant role in the Dell-EMC deal. To a certain extent, we're going back to a world where synergies and strategic imperatives are driving deals and valuations. That's an environment which

Regional M&A Breakdowns



Source: Thomson Reuters; announced deals

probably favors strategic over financial buyers. In the coming year, it will also be important to see how the debt markets evolve and the extent to which relatively cheap financing remains available.

Activism

Tom: Rodd, what about the impact of activism on the landscape?

Rodd: Activists are a catalyst for M&A activity. These funds have substantial capital and must deliver returns to their limited partners. As a result, they frequently focus on short-term, stock price-lifting outcomes like mergers, divestitures or spin-offs. Activists also have begun to join up with strategic investors to attempt to force significant transactions.

As long as these funds can generate attractive returns employing this type of strategy, activism generally, and activist-instigated M&A activity specifically, will continue. Whether it's board activity, encouraging hostile activity or causing strategic reassessments, activism will remain a facilitator of transactions for the foreseeable future.

Jeremy: Echoing what Rodd said, the vast majority of the Standard & Poor's 500 index has one or more investors with a noted activist bent or previous activity. The impact is such that boards often are addressing the issues even before the agitation begins — something that may not have happened a couple of years ago.

Steve: In today's market, traditional "long" institutional investors such as mutual funds are already in regular dialogue with management and in certain cases with outside members of the board of directors. Those institutional investors have been beating the drum on capital allocation and on looking at what else to do with the business to improve the stock price. Boards are looking at these types of initiatives, not just because of activists but because that is what the market is demanding of them. At times, activists may be catalysts for the adoption of these types of initiatives; at other times, they may be making well-timed investments.

Board Process

Tom: Steve, let's stick with the concept of board duties and process. When there is a bid on the table, what's the proper process and response with regard to target reaction? Where do we stand in Delaware with *Revlon* duties these days?

Steve: The Delaware courts, including the Delaware Supreme Court in *C&J Energy*, have again made clear that well-motivated directors have a great deal of flexibility in how they approach any proposal or plan to sell the company. (See "Delaware Supreme Court Clarifies Earlier Rulings, Chancery Court Stakes Out New Positions.")

Today's public company boards are very conscious of their fiduciary duties and aware of the implications of the enhanced scrutiny courts apply to a sale process. Directors understand that a high proportion of M&A transactions are subject to litigation challenging the board's process. Accordingly, most boards are very careful and focused on the structure of the sales process. However, in any deal, there are some very difficult situations that boards have to face in terms of how they seek to maximize value for shareholders. The recent case law in Delaware recognizes the fact that directors, not courts, are best situated to make those difficult decisions.

Jeremy: When you are advising an acquirer with a stock component that will require a vote under the NYSE/Nasdaq rules, it's important not to underestimate the target's reaction. Targets can be very skittish about a vote on the acquirer's side. Last year, several Delaware decisions focused on appropriately vetting bankers and banker conflicts, and the target board's responsibility for looking into those situations. These issues seem to be getting as much judicial focus as questions on the quality of the process that was run after the engagement.

360*
activist campaigns in the U.S. in 2015

127
board seats secured in those campaigns

More than
$120
billion in investor capital managed by activists

*As of December 17, 2015
Source: WSJ FactSet Activism Scorecard

Tom: Do you think hostiles work? Does the buyer try to position itself as friendly or is there a spectrum in between?

Rodd: Broadly speaking, if you look at the percentages, hostile transactions are difficult to complete but are increasing. The deal volume and transaction value for hostile transactions in 2015 were at their highest levels in more than five years. Clearly, the governance trend of limiting defensive provisions in company charters has made companies more vulnerable. The tactics haven't changed all that much on the defense side. It is often a question of what the buyer is prepared to do and how successfully it can rally the target shareholders in favor of a transaction.

Tom: Amr, obviously the Delaware Supreme Court has focused recently on control shareholder transactions in *MFW* and *Swomley*. What are your thoughts on what those cases are telling us?

Amr: The Delaware court is clearly giving controlling shareholders a road map: An independent and empowered special committee coupled with the nonwaivable approval of a properly informed majority of the minority is the path to the business judgment rule. *MFW* opened the door with a ruling outlining the steps necessary to rely on business judgment, but there was a question as to whether it could be applied on a motion to dismiss at the pleading stage. *Swomley* seems to have settled that question by saying that it can. It will, of course, still be up to controlling stockholders to determine whether they are willing to take the route the court has laid out.

Impact of Regulatory Activity

Tom: Can deals be completed in the current antitrust environment?

Rodd: Our antitrust colleagues might say today isn't much different than it was, say, 18 months or two years ago in terms of the aggressiveness of the regulators in challenging transactions. The answer likely depends on the industry you are talking about and what consolidation has already taken place. There clearly is a premium on preplanning and understanding what the remedies, including potential dispositions, are and offering potential fixes earlier rather than later, because it could be too late at the end of the review process.

Steve: While there has not been a shift in the substantive antitrust analysis applied, there has been greater governmental willingness to pursue enforcement actions in the recent past. However, I don't think this is having any meaningful impact on overall M&A activity.

Tom: As you approach antitrust and regulatory risk, what is the role of reverse termination fees?

Steve: I see them being discussed in an increasing number of situations. In part, that may be a function of the regulatory issues associated with some of the notable deals in the past couple of years. Reverse termination fees can provide a seller comfort that the buyer will work to get regulatory approvals as well as offer some compensation if approval is not obtained. *(Editor's note: We are aware of at least 24 transactions in 2014 and 2015 that contained such provisions.)*

Rodd: Reverse termination fees are a useful way to allocate regulatory risk, particularly in larger deals. Nevertheless, the numbers can be very large in an absolute sense. So you are still making big bets on antitrust and have to be comfortable with the potential outcomes.

Concluding Thoughts

Tom: Anyone care to predict what the environment might generally look like if we sat down and had this conversation again in six months?

Steve: My expectation is that there is a stratum of transactions that will remain difficult to get done, and that private equity activity will continue to be constrained. Those leveraged transactions that Jeremy referred to before are likely to be constrained if current conditions persist given where the high-yield markets seem to be, at least for now. But absent adverse developments, strategic corporate transactions should continue because the needs for growth, consolidation and a global footprint aren't going away.

Rodd: I agree, and I would add that it may not become more attractive in the near future to make acquisitions. Valuations are ticking up, interest rates will continue to increase for those who need to borrow, and the U.S. and European economies seem to be improving or stabilizing. That indicates to companies whose avenues for organic growth are limited that they may be better off doing something in the shorter term rather than the longer term.

M&A Techniques in a Complex Environment

While the headlines in 2015 focused on the "megadeal" transactions over $5 billion (there were at least 137 such deals in 2015, according to Thomson Reuters), many transactions involving cross-border activities required dealmakers to address a variety of corporate, tax and regulatory issues.

In a number of industries, especially the technology sector, a range of interesting techniques were utilized to address business and legal issues and to position companies to achieve business objectives:

Splits/Spins. A number of companies effected the separation of units (including eBay/PayPal and HP/HP Enterprise) by a split-up or spin-off. In the recently announced merger of DuPont and Dow Chemical, the companies stated they intend to subsequently pursue a separation of Dow/DuPont into three independent, publicly traded companies through tax-free spin-offs.

Contingent Value Rights. In the pharmaceutical industry and elsewhere, contingent value rights — which provide shareholders of an acquired company with additional consideration upon the occurrence of a specified event — continue to be considered in various transactions. However, valuation discounts of such instruments and legal complexities (sometimes including litigation) often result in the decision not to utilize such instruments in a transaction.

Joint Ventures/Collaborations/"Virtual Mergers." Companies will use various structures to effectively combine business units without a merger. Google and Johnson & Johnson formed a collaboration to develop robots for surgical operations. Cisco and Ericsson announced a "broad strategic partnership" in the networking area.

Tracking Stock. The EMC/Dell transaction will involve the creation of a tracking stock for EMC's interest in virtualization company VMware. A tracking stock permits investors to hold a security whose economics mirror the performance of a specific business unit.

Strategic Investments. GM announced an investment in Lyft, and Microsoft made a significant investment in Uber.

White Squire. Cerberus made a "white squire" investment in Avon.

Asset Transfers/Swaps. In the pharmaceutical space, a number of companies sold or exchanged asset portfolios of products or patents/intellectual property. Such transactions included those involving Sanofi/Boehringer, GSK/Bristol-Myers and AstraZeneca/Takeda.

Contributing Partner

Thomas H. Kennedy / New York

US Corporate Governance: Have We Crossed the Rubicon?

Contributing Partner

Marc S. Gerber / Washington, D.C.

The general themes on the corporate governance front — shareholder activism, governance activism, scrutiny of board composition, concerns regarding board oversight of risk management, director-shareholder engagement — remain ever-present. Debate continues as to whether the paradigm shift from a more deferential, board-centric corporate governance model to a more skeptical, shareholder-centric model ultimately will damage the ability of U.S. public companies to invest in the future, innovate, and create jobs and economic growth. Boards of directors must assess how to navigate their companies through this turbulence as well as through the challenges presented by evolving marketplaces, economic events and disruptive technological changes.

Shareholder Activism. Shareholder activism remains a significant presence on the corporate landscape, with no signs of abating. Shareholder activists have taken ownership positions in companies and agitated for changes in business strategy, operations, structure, capital allocation, management and board composition. In 2015, following DuPont's successful proxy fight against Trian Partners and Nelson Peltz, some commentators suggested that shareholder activism had peaked and the tide was about to turn. These predictions proved premature. Following the retirement of DuPont's then-CEO, Trian remained an active and engaged shareholder, even consulting with DuPont (under a confidentiality agreement) in connection with the announced transaction in which DuPont and Dow Chemical — a large chemical company in which shareholder activist Third Point has a significant stake — would merge with the intention to eventually split the combined company into three independent, publicly traded companies.

While every activist situation must be assessed on its own facts and circumstances — for example, Ethan Allen successfully defended itself in a proxy contest with activist Sandell Asset Management — companies nevertheless are settling with activists at a faster pace than ever before, sometimes entering into agreements to appoint activists as directors in as little as days or weeks following the initial public disclosure of the activist's position in the company's stock. In fact, well-established activists such as Carl Icahn, Pershing Square and Starboard were able to secure board seats without running a proxy contest in 2015. The end result is that activists increasingly are transitioning from outside agitators to influential insiders.

Governance Activism and Proxy Access. Governance activism — often spearheaded by state, local and union pension funds and other individual investors — already has changed the framework of director elections and eliminated many so-called anti-takeover protections. As a result, at most large-cap companies and even many mid-cap companies, all directors are elected annually to one-year terms and must submit their resignations if they fail to receive the support of a majority of votes cast at the annual meeting. But until recently, the goal of "proxy access" — allowing certain shareholders or shareholder groups to nominate a limited number of candidates for election to the board and have those candidates appear in the company's proxy materials in side-by-side competition with the board's nominees — had remained elusive.

Following the Securities and Exchange Commission's (SEC) adoption of a proxy access rule in 2010, the judicial vacating of that rule in 2011, and the early but limited success of proxy access shareholder proposals in 2012-14, the New

Debate continues as to whether the paradigm shift to a more skeptical, shareholder-centric corporate governance model ultimately will damage the ability of U.S. public companies to invest in the future.

York City comptroller, on behalf of various New York City pension funds, launched its "Boardroom Accountability Project" proxy access campaign, which has significantly transformed the dialogue around proxy access. (See "Proxy Access: Latest Developments" from the September 17, 2015, Skadden webinar.) In 2015, at least 116 companies received a shareholder proposal seeking a proxy access bylaw along the parameters of the vacated SEC rule: requiring ownership of 3 percent of a company's shares for three years to gain access to the company's proxy statement for nominees for up to 25 percent of the number of directors. Company responses varied from opposing proxy access on principle, to expressing openness to the idea and pledging further shareholder engagement on the topic, to adopting or agreeing to adopt proxy access on the terms proposed by shareholders or on terms the board believed were more appropriate for the company — typically a 5 percent ownership threshold — to putting competing management and shareholder proxy access proposals in the company's proxy statement. When the dust settled, approximately three-fourths of these companies either saw the shareholder proposal receive majority support, making adoption of proxy access likely, or had adopted, agreed to adopt or expressed a willingness to adopt proxy access.

As a result of this campaign, together with companies proactively adopting proxy access or adopting access in response to shareholder proposals submitted for 2016 annual meetings, approximately 125 companies had a proxy access bylaw by the end of 2015, with more companies expected to follow before the start of the 2016 proxy season. Most of these are large-cap companies; at the current pace, it is likely that a majority of S&P 500 companies will have a proxy access bylaw in place within the next year or two.

During the 2015 proxy season, the debate centered on whether to have proxy access at all and, if so, whether the appropriate ownership threshold was 3 percent or 5 percent. Shareholders do not possess uniform views on either of those questions, and a board should assess its particular shareholders when considering action on this topic. Nevertheless, for many corporate governance participants, the discussion has moved on to more nuanced questions, such as whether and for how long an access candidate elected to the board and renominated by the board should count against the limit on the number of access candidates, and whether a company should be subject to an access election contest while simultaneously engaged in a traditional proxy contest.

While no proxy access contest has occurred to date, and there is some debate over which shareholders are likely users of the proxy access mechanism, the turbulence boards face will only increase when the first access nominations are submitted and access contests undertaken.

Board Composition. Investors continue to question whether boards have the right personnel to effectively oversee management. These questions range from skill sets and expertise, to gender and racial diversity, to whether long-tenured directors are sufficiently independent of management. Related questions include whether board self-assessments are robust enough to help boards identify the need to replace directors and whether director succession planning is being done to ensure necessary board "refreshment."

The issue of director tenure, and whether tenure impedes independence, has been the topic of continuing discussions among investors and companies. The California Public Employees' Retirement System (CalPERS) is considering

Approximately

125

companies had a proxy access bylaw by the end of 2015

Parameters of the SEC's vacated proxy access rule require ownership of

3%

of a company's shares for

3 years

to gain access to the proxy statement to nominate up to

25%

of the directors

Directors need not always be part of a company's engagement efforts, but there is no doubt that directors engage with shareholders to a much greater extent than they did a few years ago.

a change to its governance principles, which would call for companies in which it invests to undertake "rigorous evaluations" of directors after 12 years of board service and either classify them as nonindependent or provide detailed disclosure explaining their continued independence. Recently, even though a 2013 shareholder proposal seeking director term limits failed to attract much support, General Electric adopted term limits of 15 years for directors. While term limits remain an uncommon governance feature among U.S. public companies — and create the risk of losing valuable and experienced directors at inopportune times — investors are likely to continue to focus on the question of director tenure and its impact on independence.

In addition to concerns about tenure and whether boards lack the diversity of a company's employees or customers and the diversity to avoid "group think," the critical concern regarding board composition remains whether the right skills are present in the boardroom. Companies continue to expand and refine their proxy disclosure concerning the use of skill matrices, and that trend is likely to continue. Nevertheless, boards need to be sensitive to having members knowledgeable enough to ask the right questions and understand the implications of the answers without becoming a balkanized board made up of numerous single-area subject matter experts.

In this regard, the recently introduced Cybersecurity Disclosure Act of 2015 is troubling. This bill would require public companies to disclose whether any board member has cybersecurity expertise or experience (based on standards to be established by the SEC and National Institute of Standards and Technology) and, if not, to describe the cybersecurity measures taken by the company that were considered by the board or nominating committee in lieu of having a director with that background. While cybersecurity is unquestionably a significant issue for most companies, a high-functioning board can utilize the necessary advisers and subject matter expert consultants and, depending on the business, should not need a cybersecurity expert on the board to understand how those issues may interact with the company's business model and methods, industry and regulatory developments, and other strategic opportunities and risks. (See "Emerging Trends in Privacy and Cybersecurity.")

Shareholder Engagement. Shareholders continue to seek more robust engagement from the companies in which they invest. Recently, the Council of Institutional Investors published an investor-company roundtable on effective engagement and a paper highlighting good examples of company disclosures about shareholder engagement efforts. Clearly communicating the company's long-term strategy, and explaining how that strategy is reflected in the board's composition, may help companies establish credibility with their long-term shareholders and reduce the risk of activists or others claiming that certain board members are ineffective or irrelevant, or should be replaced. This clarity and focus of message should be

part of the company's disclosure to all investors and incorporated into investor meetings and other forms of engagement.

In addition, certain investors continue to seek and encourage engagement directly with company directors. While so far only a handful of companies have adopted policies describing when and how directors may be available to meet with shareholders, as the practice continues to evolve, more companies are likely to adopt and disclose formal guidelines governing director-shareholder engagement. Directors need not always be part of a company's engagement efforts, but there is no doubt that directors engage with shareholders to a much greater extent than they did a few years ago. Doing so can provide a board of directors with valuable insights and unfiltered feedback, potentially allowing the board to address a small issue before it becomes a larger problem. Some boards have begun to factor in the "camera readiness" of director candidates as they consider new nominees or who should serve as the lead independent director.

The turbulence wrought by shareholder activism, governance activism and other scrutiny of boards cannot be eliminated, but shareholder engagement efforts are an important component of any effort to mitigate the effects.

Majority of Say-on-Golden-Parachute Votes Receive Shareholder Support

Pursuant to the Dodd-Frank Act, Securities and Exchange Commission rules require companies seeking shareholder approval of a merger or acquisition to also hold a separate shareholder advisory vote on disclosed golden-parachute compensation arrangements of its named executive officers.

In 2015, 66 percent of golden-parachute votes last year received greater than 80 percent support from shareholders, and 92 percent of the votes received the support of a majority of the company's shareholders, according to Equilar. These results indicate lower overall support for compensation paid to executives in connection with a merger or similar event as compared with the levels of support for executives' annual compensation in say-on-pay advisory votes. However, they nevertheless indicate that shareholders widely support the golden-parachute arrangements in place for their companies' executives.

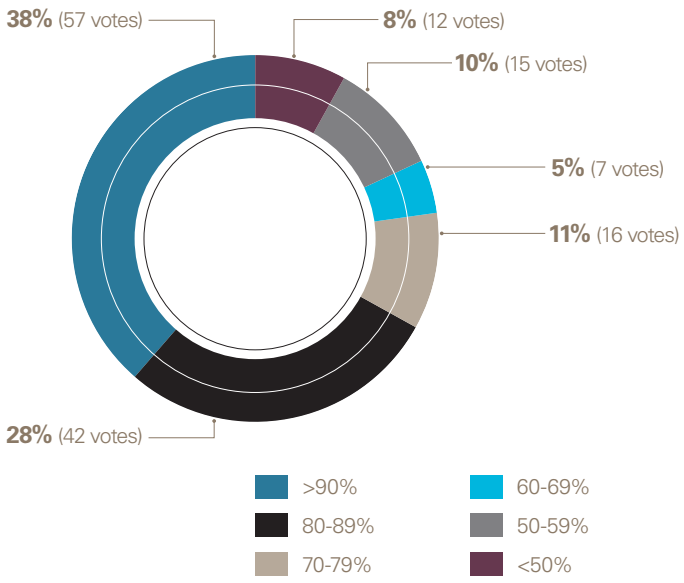
Contributing Partner

Neil M. Leff / New York

Counsel

Kristin M. Davis / Palo Alto

2015 Say-on-Golden-Parachute Proposal Support Levels
(Percentage of say-on-golden-parachute proposals supported by shareholders)



Sources: Equilar

SEC Moves to Complete Final Rules for Executive Compensation Disclosures

Contributing Partner

Brian V. Breheny / Washington, D.C.

Law Clerk

Michael Ju / New York

Former Counsel

Ted Yu

Public companies should start preparing for the new executive compensation disclosures mandated by the Dodd-Frank Act as the Securities and Exchange Commission (SEC) moves to complete these rulemakings in the next year. The requirements could impose significant disclosure burdens on companies and increase public scrutiny of the companies' executive compensation policies.

CEO Pay Ratio. In August 2015, the SEC adopted final rules implementing the controversial CEO pay ratio disclosure requirements required by the Dodd-Frank Act. The new rules require companies to disclose the median annual total compensation for all company employees except the CEO, the CEO's annual compensation and the ratio of those two amounts. Companies are required to provide the new pay ratio disclosures for the first fiscal year commencing on or after January 1, 2017. As a result, companies with a fiscal year ending December 31, 2017, will need to disclose the pay ratio information (based on 2017 compensation) in their registration statements, annual reports on Form 10-Ks or proxy statements for 2018.

Pay Versus Performance. The pay-versus-performance disclosure requirements were proposed in April 2015 and, once adopted, would require companies to disclose the relationship between the compensation actually paid to named executive officers and the company's financial performance. The proposed rules would require companies to include in the proxy or information statements a new table with the following:

- the total executive compensation of the CEO and the average of the total compensation of the other named executive officers (NEOs), as reported in the Summary Compensation Table and already required in the proxy or information statement;
- the executive compensation actually paid to the CEO and the average of the executive compensation actually paid to the other NEOs, calculated according to the proposed rules; and
- the cumulative total shareholder return (TSR), calculated in the same manner as the performance graph already required by the SEC rules, for the company and its peer group.

Companies would be required to describe (1) the relationship between the executive compensation actually paid and the company's TSR and (2) the relationship between the company's TSR and the TSR of its peer group. While the timing of the adoption of the final rules is unclear, companies should plan for the possibility that the new pay-versus-performance requirements could go into effect as soon as the 2016 proxy season.

Hedging Disclosures. The hedging disclosure requirements, which the SEC proposed in February 2015, would require companies to disclose in their proxy or information statements whether they permit employees and directors to hedge the company's securities (such as through prepaid variable forward contracts, equity swaps, collars or any other transactions with economic consequences comparable to the purchase of these financial instruments). While the proposed rules do not prohibit hedging or require the adoption of a policy addressing hedging, companies may face greater pressure from investors and other interested groups to adopt new hedging policies or revise existing ones when the rules go into effect and disclosures about peer companies' hedging policies become available. Therefore, companies should consider reviewing the need for new or revised hedging policies for future proxy statements.

Director Compensation in the Spotlight

Contributing Partner

Neil M. Leff / New York

Counsel

Kristin M. Davis / Palo Alto

Individuals serving on company boards of directors should carefully examine director compensation programs and decisions involving their own compensation following an April 30, 2015, ruling by the Delaware Court of Chancery. In *Calma v. Templeton*, the Court of Chancery denied Citrix Systems Inc.'s motion to dismiss the plaintiff's breach of fiduciary duty claim, holding that the claim would move forward under the heightened "entire fairness" standard rather than the business judgment rule.

The plaintiff claimed that the directors of Citrix had breached their fiduciary duty in approving excessive compensation for themselves, which included both cash and equity. Although decisions made by boards of directors generally are afforded the protection of the business judgment rule, which requires a plaintiff to show that a decision had no rational business purpose, decisions involving self-interest are reviewed under the business judgment rule only if ratified by the company's shareholders. The *Calma* court rejected Citrix's contention that prior approval by its shareholders of its equity plan was tantamount to ratification of the directors' equity grants made under that plan. The court found that the "entire fairness" standard applied because the equity plan lacked "meaningful limits" on director awards — the plan did not have director-specific equity award limits, only a general per-person limit of 1 million shares in a year.

Companies and boards should consider taking one or more of the following steps to maintain the protection of the business judgment rule and reduce exposure to claims similar to those asserted in *Calma*:

- Carefully review existing director compensation arrangements.
- Add to the current equity plan a meaningful annual share limit or annual formula-based grant for director awards and seek shareholder approval of that limit or grant. Alternatively, companies may consider adopting, and seeking shareholder approval of, a stand-alone director compensation plan.
- If shareholder approval or ratification is not feasible, the board of directors should develop a factual record of its director compensation program, aimed at withstanding "entire fairness" scrutiny, including peer group analysis, possibly with assistance from a compensation consultant.
- In the company's annual proxy disclosure, consider expanding the description and rationale supporting the company's director compensation program beyond the minimum required under the applicable rules.

The *Calma* court rejected Citrix's contention that prior approval by its shareholders of its equity plan was tantamount to ratification of the directors' equity grants made under that plan.

European M&A: Multifunctional Stichtings

Contributing Partners

Lorenzo Corte / London

Scott V. Simpson / London

The use of "stichtings," or Dutch foundations, in the M&A context became more widely known outside of Europe in 2015 in connection with Mylan N.V.'s use of a Dutch poison pill defense against Teva's unsolicited offer. The stichting Mylan relied upon is a commonplace defense mechanism in the Netherlands. Used for more than 100 years to hold individual or family assets for religious and charitable purposes, their unique characteristics have allowed them to play a significant role in a number of high-profile M&A situations over the last couple of decades.

Stichtings are legal entities that can own assets. In contrast with other corporate entities, they have no shareholders or members — nobody "owns" a foundation. Given the absence of owners, board members are not fiduciaries; they simply must administer the stichting in a manner consistent with its organizational documents. Moreover, a stichting can be formed so as not to have beneficiaries, which is how it is typically structured in M&A situations. Because a stichting does not have owners and beneficiaries, a court cannot end the stichting's administration of assets (as can happen with trusts) in the interest of its owners or beneficiaries. This, ultimately, is the strength (and, perhaps, the danger, when not properly constituted) of stichtings.

How Stichtings Are Used in M&A

The Dutch Poison Pill. The classic use of a Dutch foundation in the Netherlands in an M&A context is the Dutch poison pill that Mylan used to defend against Teva's unsolicited offer and protect its corporate interest. A stichting is formed and given the right to call preference shares of the target (Mylan) in the event of a threat to the target's corporate interest (*e.g.*, an unsolicited takeover that undervalues the target). While the Dutch poison pill is on the surface similar to the typical U.S. poison pill, it differs in a couple of significant ways: (1) the power to trigger the call is given to an entity over which the target company has no control, and (2) preference shares dilute all shareholders, not only the bidder, because they are acquired by the stichting rather than issued to all shareholders except the bidder (as in the U.S. context). The reason for this difference is that in the Netherlands, corporate law does not allow the issuance of shares to all but one shareholder.

This mechanism was used with varying degrees of success in a number of high-profile cross-border takeover battles over the years: Mylan (2015), KPN's defense against America Movil (2013), Rodamco North America (2001-02), Gucci (1999-2000). As in the U.S., the mechanism can only be used temporarily, to protect the target company's corporate interest, and then only where the offer is demonstrably unfair. Furthermore, shareholders of the target company can challenge the implementation of the poison pill defense in the Enterprise Chamber of the Amsterdam Court of Appeal, as has been done on a number of occasions (Rodamco North America, Gucci).

Crown-Jewel Defense. The stichting also has been used to protect assets from corporate waste in takeover offers. When Mittal Steel launched its offer against Arcelor, it announced that it had agreed to pre-sell Dofasco, an asset that Arcelor had just acquired, for lower than the acquisition value. Mittal Steel had agreed to sell Dofasco to a competitor of Arcelor to solve an antitrust issue that would have otherwise arisen. In response, and to avoid corporate waste,

Arcelor housed the asset under a stichting. The objective of the stichting in that context was to maintain ownership of the asset. It was structured such that Arcelor would retain control of the operations of the asset and would be able to derive all of the economic benefits of ownership but would not, without the consent of the stichting's board, be able to sell the asset, even if Mittal Steel successfully acquired a majority of Arcelor. Eventually, when Mittal Steel did acquire control of Arcelor, the third-party buyer of Dofasco challenged the stichting structure. However, the Dutch courts upheld it.

Enabling Continuing Operation of Assets Where Government Sanctions Are Imposed. The stichting has been used in at least two different contexts to allow oil and gas assets to continue to operate (in the interest of consumers) where sanctions were a consideration. Tamoil, the Dutch-incorporated, Libyan government-controlled oil and gas company, temporarily transferred its shares to a stichting in order to continue operations of its assets despite European Union sanctions. More recently, the U.K. government did not provide its consent to a company's acquisition of U.K. North Sea assets (as part of the company's acquisition of a much larger pan-European oil and gas company with widespread interests) because of concerns that the U.K. North Sea assets would have had to cease operations if the acquirer or its owners were sanctioned. In response, the acquirer housed the U.K. North Sea assets under a stichting with the purpose of continuing operations of its North Sea assets and, if and when sanctions were imposed on the acquirer or its shareholders, to sever all ties with the acquirer and its owners (including economic ties) and sell the U.K. North Sea assets to a third party capable of operating the assets.

Conclusion

The use of stichtings in connection with Dutch poison pills is a tried and tested defense mechanism, including in the cross-border M&A context, and we expect that it will continue to feature in takeover battles in years to come. Given their unique characteristics, however, the use of stichtings as a vehicle goes beyond the Dutch poison pill and even the defense context. We believe stichtings will continue to feature in European cross-border M&A going forward.

Skadden is not admitted to practice Dutch law. This article is for general informational purposes only.

Because a stichting does not have owners and beneficiaries, a court cannot end the stichting's administration of assets in their interest.

Recent Shareholder Activism in Asia Could Signal Changing Attitudes

Contributing Partner

John Adebiyi / Hong Kong

Levels of shareholder activism are reaching record highs in the United States, and such activity has become increasingly prevalent in Europe. But with the exception of Japan, Asia often is seen as a relative backwater in this regard. In 2015, the number of companies subjected to public activist demands was 350 in the United States and 58 in Europe, compared to 24 in Asia (not including Japan), according to Activist Insight. By comparison, in 2014, 320 companies in the United States, 44 in Europe and 13 in Asia (excluding Japan) were publicly subjected to activist campaigns, according to the same source.

Reasons often cited for the significantly lower prevalence of shareholder activism in this part of the world include: the greater propensity for listed companies to have controlling shareholders (often founders and their family interests), the prevalence of cross-shareholdings among groups of affiliated listed companies, greater relative passivity among institutional and retail investors, cultural resistance to U.S.-style activism, and local environments that are generally less litigious and confrontational. However, a handful of situations that played out in Asia in 2015 may indicate increased shareholder activism in the future. This may be particularly the case with increasing foreign investment in the region: Of the 59 investors who made a public demand of an Asian company since 2010, 46 percent were headquartered in the United States, 15 percent were headquartered in the United Kingdom and 34 percent were headquartered in Asia, according to Activist Insight.

South Korea

One of the most notable activist campaigns in Asia in 2015 was Elliott Associates' attempts to scuttle the merger between Samsung C&T Corporation and Cheil Industries, two companies in the Samsung group. Elliott, a U.S. hedge fund and Samsung C&T shareholder, opposed the merger, alleging that its terms significantly undervalued Samsung C&T and did not comply with applicable corporate governance standards.

Ultimately, Elliott's attempts to take legal action to prevent the merger and to persuade a sufficient number of other shareholders to vote against it were unsuccessful (despite Institutional Shareholder Services also advising Samsung C&T shareholders to vote against it and opining that the merger would significantly disadvantage them), and the deal was approved at the company's shareholder meeting in July 2015.

The decision of the National Pension Service (NPS), the largest owner of equities in South Korea, to vote in favor of the merger disappointed onlookers who had hoped that an NPS vote against the merger would constitute a positive statement for activist investors in South Korea. Meanwhile, the local criticism that arose from Elliott's campaign against the merger prompted certain Korea-based investors in Elliott's funds to ask Elliott to stop investing in South Korean companies, as well as calls from South Korean legislators for tighter restrictions on overseas investment in domestic companies.

A somewhat more successful campaign in South Korea involved Netherlands-based APG Asset Management. APG took issue with the opacity of Hyundai Motor Company's decision-making process over a bid for land in Seoul's affluent Gangnam District. APG and other investors expressed dissatisfaction at Hyundai's shareholder meeting in March 2015 and called on management to revamp its corporate governance structure and procedures. In response to this pressure, Hyundai took steps to address investors' concerns, including announcing a share buyback and dividend increase, and establishing a

Headquarter locations of the 59 investors who made a public demand of an Asian company since 2010:

46%
United States

34%
Asia

15%
United Kingdom

board-level corporate governance and communication committee to protect shareholders' interests.

Hong Kong

In March 2015, The Bank of East Asia, Limited (BEA), a large local bank in Hong Kong, announced that it had agreed to raise capital by issuing further shares to a substantial shareholder in BEA, thereby allowing that shareholder to increase its stake in BEA significantly. Elliott, whose related funds held a small position in BEA, criticized this transaction as unnecessary and contrary to minority shareholders' interests and took the somewhat unusual step (in Hong Kong) of commencing legal proceedings against BEA. In a decision handed down in June 2015, which may be encouraging to activist investors in Hong Kong-incorporated companies, Hong Kong's Court of First Instance granted Elliott's request to obtain disclosure from BEA of certain documents relating to the placing.

In fact, in some situations Hong Kong's regulatory regime allows minority shareholders in Hong Kong-listed companies to enforce corporate governance standards. This is exemplified by the saga of the proposed acquisition by GOME Electrical Appliances Holding Limited of certain assets from GOME Electrical's controlling shareholder and founder (who happened to be serving a prison sentence for corruption in mainland China). Given that the deal involved an acquisition from a substantial shareholder, the transaction required independent shareholder approval under the Hong Kong Stock Exchange's listing rules (*i.e.*, the controlling shareholder and parties associated with him could not vote on the deal). In October 2015, GOME Electrical announced that the terms of the transaction had been revised to reduce the aggregate consideration payable by it for the proposed acquisition by nearly 20 percent of the originally proposed amount.

According to GOME Electrical's rationale for the revised terms, the company and the vendor had "received valuable feedback from a number of independent shareholders regarding the acquisition" since the original announcement. This feedback may well have included a clear indication that the transaction stood little chance of being approved by the independent shareholders on the terms originally proposed. As of December 2015, the transaction was still pending.

While shareholder activism is far less prevalent in Asia than in the United States or Europe, there are indications that under the right circumstances, shareholders in listed Asian businesses who take an active interest in the affairs of their investee companies can have a notable degree of influence over them. Such circumstances may include investee companies with widely dispersed shareholder bases and sophisticated and motivated institutional investors — particularly from those jurisdictions where shareholder activism is more commonplace — and where a supportive legal and regulatory regime exists. As such, it may behoove listed companies in the region to consider the implications of increasing levels of shareholder activism with a heightened degree of urgency and seriousness.

*Not including Japan
Source: ActivistInsight.com

Indian Insurance Sector Welcomes Foreign Investment With Limits on Control

Contributing Partners

Rajeev P. Duggal / Singapore

Jonathan B. Stone / Hong Kong

As part of the Indian government's plans to encourage foreign investment, in 2015 it increased the foreign ownership cap in the Indian insurance sector from 26 percent to 49 percent. The increase, however, did not affect the long-standing rule that Indian insurance companies must remain "Indian owned and controlled." Thus, for many foreign investors, the challenge has been understanding the interpretation of "control" according to India's Insurance Regulatory and Development Authority (IRDA). For example, would IRDA permit a foreign investor to make nominations to the board, designate senior management positions or hold minority protection rights?

In October 2015, foreign investors received some clarification when IRDA released control guidelines that provide partial guidance on the meaning of "control." However, the guidelines leave several questions unanswered.

What Constitutes 'Control'?

The guidelines make clear that the Indian shareholders and the board should be responsible for making the company's key policy decisions. Specifically, they clarify that control can be gained not only by direct or indirect shareholding but also through management rights, shareholder agreements and voting agreements, among other methods. Indian shareholders are required to appoint the majority of the nonindependent board of directors, as well as the chairman if he or she has a casting vote. Furthermore, a majority of the Indian-appointed directors must be present for a board quorum, though this does not prevent a requirement that one or more foreign shareholder nominees also be present.

Key management positions (such as chief executive officer, managing director or principal officer) must be appointed by either the board or the Indian shareholders. However, the guidelines permit the foreign investor to nominate key managers other than the CEO, as long as the appointment is approved by the board or the Indian shareholders. The guidelines state that the board must control the insurance company's "significant policies," but no guidance is given as to the meaning of "significant."

The CEO and chief compliance officer are required to certify compliance with the "Indian owned and controlled" requirement, and the certificate must be accompanied by a board resolution similarly confirming compliance and any amendments to shareholder or voting agreements that give effect to these requirements.

Unanswered Questions

While the guidelines provide a broad picture of the term "control" and answer some questions on board composition and management appointments, they do not address typical minority protection rights, such as approval rights over business plans, budgets and material transactions. They also do not address the extent to which foreign investors providing operational expertise, licensing intellectual property or seconding employees can exert influence through

ordinary-course covenants in business agreements. These elements are of critical importance to investors seeking to enter or increase their stakes in Indian insurance companies.

To date, there have been only a handful of cases approving the 49 percent foreign ownership level (and those cases were primarily in the context of increases in existing stakes). It is too early to detect a discernable trend in IRDA's attitude toward such minority protections; foreign investors will need to wait for additional transactions to understand what rights are permitted. A balance will need to be achieved between the Indian government's desire for foreign expertise and capital in the insurance sector and the regulatory mandate for Indian control.

Skadden is not admitted to practice law in India. This article is for general informational purposes only, and Indian counsel should be sought for specific transactions.

Compliance Requirements Under the New Guidelines

Indian insurance companies and intermediaries (such as insurance brokers, third-party administrators, surveyors and loss assessors) have three months (or six months, at the Insurance Regulatory and Development Authority's discretion) to comply with the authority's control guidelines.

Companies applying for initial insurance registration with IRDA must comply as a condition of registration.

Antitrust and Competition: Trends in US and EU Merger Enforcement

Contributing Partner

Maria Raptis / New York

European Counsel

Thorsten C. Goetz / Frankfurt

Associates

Athanasia Gavala / Brussels

Joseph M. Rancour / Washington, D.C.

Amaury S. Sibon / Brussels

Merger activity in 2015 was at its highest level in years, and competition authorities in the U.S. and European Union continued to be very aggressive, challenging a number of high-profile deals in court and causing some parties to abandon their transactions rather than litigate. The authorities are poised to remain active in 2016, and the agencies' recent string of successes ensures that merging companies can expect an aggressive approach to deals with competition issues. Merger parties also should be aware of antitrust enforcers' preference for an "upfront buyer" in any proposed merger remedy. U.S. agencies, particularly the Federal Trade Commission (FTC), regularly require upfront buyers, and in recent years, the European Commission (Commission) has increasingly sought upfront buyer commitments.

Aggressive Enforcement and Litigation Success in M&A

United States

In the U.S., the FTC and the Department of Justice Antitrust Division (DOJ) successfully opposed several transactions in 2015 and continue to pursue enforcement actions against mergers in concentrated markets.

Comcast/Time Warner Cable. Comcast and Time Warner Cable (TWC) abandoned their proposed $45 billion merger in April 2015 after facing opposition from the Federal Communications Commission (FCC) and DOJ based in part on concerns that the merger would make the combined company a "gatekeeper" for Internet-based services. The FCC staff recommended the FCC designate the merger for an administrative hearing, indicating apprehension over the transaction under the FCC's public interest standard, and the DOJ informed the two companies of its competition concerns, leading Comcast and TWC to abandon the deal. In the wake of the abandoned Comcast/TWC transaction and AT&T's failed attempt to acquire T-Mobile in 2011, merging parties in industries requiring both antitrust and FCC approval need to give careful thought to the agencies' concurrent jurisdiction and how their parallel review can impact deal timing and outcome.

Sysco Corp./US Foods. The FTC secured a significant litigation victory in challenging Sysco Corp.'s proposed acquisition of US Foods. The FTC issued an administrative complaint and, along with a number of state attorneys general, sought a preliminary injunction in federal district court claiming that the merger would have combined the only two broadline food-service distributors equipped to serve large national customers. According to the FTC, the companies accounted for a combined market share of 75 percent in that market. Sysco and US Foods attempted to resolve competition concerns by entering into an agreement to divest 11 distribution centers to Performance Food Group, but the court found that the proposed remedy was insufficient to restore the potential loss to competition. The court issued a preliminary injunction, and the parties abandoned the transaction shortly thereafter.

General Electric/Electrolux. The DOJ filed a complaint in federal court challenging General Electric's proposed acquisition by AB Electrolux. The DOJ alleged the transaction would combine the two leading suppliers of wall ovens, ranges and cooktops in the U.S. to so-called contract-channel purchasers. According to the complaint, contract-channel purchasers are homebuilders, property managers of apartments and condominiums, hotels and governmental

Governance activism has changed the framework of director elections and eliminated many so-called anti-takeover protections.

entities that individually negotiate contracts for major cooking appliances with suppliers such as GE and Electrolux. The DOJ rejected settlement offers from Electrolux to sell assets to a third party, demonstrating the U.S. agencies' willingness to litigate when they believe a divestiture proposal would not fully address competition concerns. Four weeks after the trial began, GE terminated the transaction.

Staples/Office Depot. The FTC filed an administrative complaint challenging Staples' proposed $6.3 billion acquisition of Office Depot. The complaint came 18 years after the FTC successfully sued to block the same parties' original merger attempt and alleges that the current Staples/Office Depot deal would violate antitrust laws by significantly reducing competition in the market for "the sale and distribution of consumable office supplies to large business-to-business customers in the United States." According to the FTC, these customers constitute a separate, relevant market distinct from the more competitive retail markets for office supplies sold to consumers.

European Union

The EU Commission was similarly active in 2015.

GE/Alstom. Following a long and intensive investigation, the Commission approved GE's $9.5 billion acquisition of Alstom's power and grid business, with remedies. The Commission was concerned that the transaction would have eliminated one of GE's main global competitors in the heavy-duty gas turbines market. The parties committed to divest Alstom's heavy-duty gas turbine business to Italy-based Ansaldo, including key personnel, upgrades, pipeline technology, and research and development.

TeliaSonera/Telenor/JV. Scandinavian telecom operators TeliaSonera and Telenor announced in September 2015 that they would abandon plans to combine mobile telecom operations in Denmark after the EU Commission raised competition concerns. The Commission said the transaction would have created the largest mobile network operator in Denmark, and the company would face insufficient competition from the remaining operators in the Danish markets. According to Commissioner for Competition Margrethe Vestager, the Commission would have prohibited the merger because the proposed remedies were deemed insufficient to address competition concerns. The abandonment of the transaction marks another successful intervention by the Commission in a series of telecom mergers in the past two years. In a number of these mergers (Hutchison 3G UK/Telefonica Ireland, Telefonica Deutschland/E-Plus, Orange/Jazztel), the Commission obtained substantial remedies from the parties that eliminated competitive overlaps, strengthened the position of competitors and facilitated entry into national telecom markets.

Convergence of US and EU Approach to Merger Remedies

Notwithstanding the number of cases litigated in 2015, most in-depth merger reviews ultimately are being resolved through settlement, usually by means of a divestiture. In the U.S., when the agencies have any concerns about the viability of a divestiture package, they are likely to require merging parties to identify an "upfront buyer" — a buyer with whom the merging parties have entered into a binding agreement for sale of the divestiture assets, and whom the authorities have approved. Over the past several years, the U.S. agencies have required upfront buyers in nearly two-thirds of divestitures.

There are indications that the EU approach to remedies is converging with U.S. methods. Over the past few years, an increasing number of conditional approvals in the EU have contained an upfront buyer commitment, despite statements from EU Commission officials that they remain the exception. Upfront solutions are particularly prevalent in Phase II investigations, which are more in-depth and only required if clearance isn't possible after an initial Phase I investigation. As of November 30, 2015, the Commission had used upfront buyer commitments in seven out of 12 Phase II conditional approvals made in 2014 and 2015, a substantial increase over prior years. A similar trend can be observed in relation to Phase I conditional approvals. Examples where upfront buyer remedies were used in 2015 include GE's acquisition of Alstom's energy business, which was approved in a Phase II decision subject to the divestiture of Alstom's heavy-duty gas turbines business, and NXP's proposed acquisition of Freescale, where the Commission conditioned Phase I approval of the transaction on NXP's divestiture of its leading radio frequency power transistors business.

Upfront buyer remedies are designed to incentivize the parties to implement the remedy within a short time frame after approval, lessening the risk that the assets being divested will deteriorate in the interim period. However, upfront buyer remedies create significant additional pressure on the parties, as they can extend the merger timeline while the authorities vet the divestiture buyer and test the buyer's ability and incentives to restore the competitive status quo. Greater remedy demands across jurisdictions mean that merging parties must consider the possibility of a divestiture that includes an upfront buyer as they negotiate transactions that may generate significant antitrust scrutiny.

Litigation/ Controversy

A number of groundbreaking decisions by appellate and trial courts will influence the litigation landscape in the year ahead, while the persistently aggressive enforcement environment will challenge both institutions and individuals — and do so on a worldwide scale. The parties that anticipate the implications of these trends will be best prepared to respond to them.

The Supreme Court is poised to address a range of disputes relevant to businesses.

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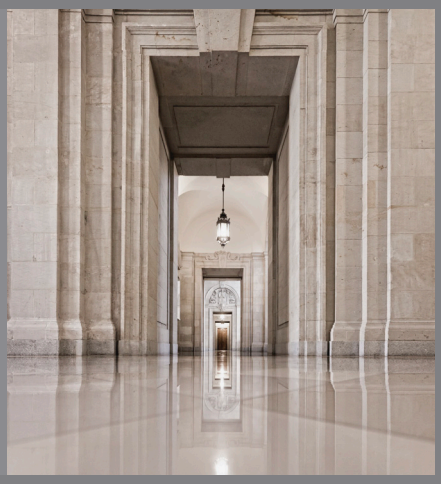

Over the last five years,

80%

of the SEC's enforcement actions have involved charges against individuals.

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The future of overbroad or no-injury class actions could turn on the resolution of two cases before the Supreme Court this year.

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E-commerce will remain at the forefront of global antitrust enforcement in U.S. and EU jurisdictions.

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Insights Conversations:

Securities Litigation

Contributing Partners

Scott D. Musoff / New York

Susan L. Saltzstein / New York

From the impacts of U.S. Supreme Court *Omnicare* and *Halliburton* cases to the uptick in Securities Act class actions, litigation partners Scott Musoff and Susan Saltzstein discuss the latest securities litigation developments.

What were the most notable securities or credit crisis-related litigation trends of 2015?

Scott: The pace of federal securities class action filings increased last year, with over 180 class actions filed. While this number is slightly lower than the annual average between 2005 and 2014, it actually represents a higher percentage when compared to the number of public companies, which has decreased. Thus, the chance that a public company will be named in such an action is similar — if not higher — than prior averages.

Also, accompanying the uptick in initial public offerings in 2014 was an increase in Securities Act cases filed in 2015. In some jurisdictions, these cases can be brought in state court and will not appear in the federal filing statistics. In bringing Securities Act claims, plaintiffs have relied on allegations in connection with Item 303 disclosure, which relates to trends that are known to management and are reasonably expected to have a material impact. Plaintiffs also have been pursuing Securities Act claims when an IPO occurred at the close of a quarter but that quarter's financial statements had not yet been issued. In defending these cases, it's important to put the alleged trends and results in context, which may defuse the inference that there was an undisclosed trend known to management.

As we predicted at the end of 2014, the median number of cases settled and the settlement amounts increased in 2015. Also, as expected, the number of new credit crisis-related litigations declined as statutes of limitations expired. However, there still are a number of existing cases percolating through the courts, and we may see some trials in 2016 relating to both residential mortgage-backed securities "putback" and misrepresentation cases.

One of the biggest developments in 2015 was the Supreme Court's *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund* decision. What is the significance of that case and how is it playing out in the lower courts?

Susan: Statements of belief captured the Supreme Court's interest in *Omnicare*, which led to a new test for assessing whether statements of opinion or belief in registration statements are actionable pursuant to Section 11 of the Securities Act. Justice Elena Kagan, joined by six other justices, vacated the U.S. Court of Appeals for the Sixth Circuit's assessment that a statement of opinion could be actionable under Section 11 if the opinion later turned out to be untrue, regardless of the speaker's belief in the statement's truth at the time it was given. The Sixth Circuit's standard was far afield of the standard adopted by other circuits that had assessed opinion statements in the Section 11 context over the years.

The Supreme Court's analysis injected an objective standard into the assessment of whether an opinion is actionable based on claimed omissions. Ultimately, the Court determined that to steer clear of Section 11 violations, "an issuer need only divulge an opinion's basis, or else make clear the real tentativeness of its belief." And even if an issuer does not do so, to establish liability, plaintiffs must be able to point to specific material facts whose omission makes the opinion misleading in light of the registration statement when read fairly and in context.

Lower courts have begun to apply *Omnicare* in earnest, and some courts have extended its reach to cases arising under Section 10(b) of the Exchange Act. This application of *Omnicare* by lower courts suggests that plaintiffs will continue to face substantial hurdles when alleging claims based on expressions of belief or opinions.

Scott: This is certainly one of those cases that would have been really harmful to corporate America, had it gone the other way. The result brought the Sixth Circuit more in line with the U.S. Court of Appeals for the Second Circuit and others.

Another important case was *Halliburton v. Erica P. John Fund,* known as *Halliburton II,* decided by the Supreme Court in 2014. The impact of that case is still being sorted out. Can you discuss the key developments there and any other important lower court decisions from 2015?

Susan: The 13-year-old *Halliburton* saga continued to play out in 2015 in the Northern District of Texas, where the court grappled with how to apply *Halliburton II*. *Halliburton II* reaffirmed the fraud-on-the-market presumption and clarified that defendants must be allowed to rebut it at

the class certification stage by demonstrating that each alleged misstatement did not affect the stock price.

Halliburton II followed the Supreme Court's 2013 decision in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, in which the Court held that a class of plaintiffs was not required to demonstrate the materiality of alleged misstatements before class certification because it did not bear on Rule 23(b)(3)'s predominance requirement. In *Halliburton II*, however, the Court distinguished *Amgen* by noting that, unlike the materiality of an alleged misstatement, price impact informs the issue of predominance at class certification. It remains to be seen how lower courts will square *Amgen*, which precludes courts from examining materiality of alleged misstatements at class certification, with *Halliburton II*, which requires courts to allow defendants to demonstrate a lack of price impact (which would seem to be indicative of materiality), especially since *Halliburton II* declined to address how a defendant could show this impact.

On remand, the *Halliburton* district court tackled that gap. The district court weighed the evidence submitted by the parties and the arguments advanced by their competing experts, especially the use of event studies. The court focused on the experts' use of confidence intervals, requiring the plaintiffs' expert to demonstrate with 95 percent confidence that the alleged corrective disclosure impacted price. The court found that Halliburton's expert demonstrated that the plaintiffs' expert failed to meet the standard for some disclosures. Further, the court rejected the plaintiffs' use of a two-day window for measuring price impact, reasoning that the stock price in an efficient market should reflect a corrective disclosure within a day. Finally, despite claiming it would not consider whether a disclosure was actually corrective, the court refused to find a price impact where the plaintiffs' experts had "demonstrated" one using information previously disclosed to the market.

In all, Halliburton won big: Weighing the parties' competing experts, the district court found no price impact for five of the six disclosures.

In the coming months, circuit courts will begin to review district court decisions that analyze price impact and other arguments at the class certification stage. The U.S. Court of Appeals for the Fifth Circuit recently agreed to hear an appeal of the *Halliburton* remand. Additionally, the U.S. Court of Appeals for the Eighth Circuit also will address *Halliburton II*'s contours in a case that was argued on October 22, 2015. *IBEW Local 98 Pension Fund v. Best Buy Co.* is an appeal of the district court's grant of class certification. Analyzing issues similar to those the *Halliburton* district court examined, the Eighth Circuit is expected to address Best Buy's argument that the district court incorrectly applied *Halliburton II* by purportedly ignoring evidence that the supposed misrepresentations had no impact on Best Buy's stock price. Best Buy contends that the alleged misrepresentations occurred during a 10 a.m. conference call and uncontroverted evidence shows the alleged misrepresentations had no effect on its stock price, pointing to the fact that the closing price of its stock that day was virtually unchanged from when the call began. If the Eighth Circuit affirms the *Best Buy* district court, a potential split with the Fifth Circuit could set the stage for the Supreme Court to revisit price impact in *Halliburton III*.

In addition to these specific issues that are playing out, what are the big-picture trends that could define securities litigation in 2016?

Scott: As mentioned earlier, Securities Act class actions in connection with IPOs saw an uptick last year, which is likely to continue in 2016 if the window for IPOs opens. We also have observed an increasing trend of institutional individual actions or so-called "opt-out" cases — cases where institutional plaintiffs choose to pursue securities claims individually or in

groups, rather than participate in a class action. This is due, in part, to the Second Circuit's 2014 decision in *IndyMac*, which held that there could be no tolling of the Securities Act's two-year statute of repose. As a result, some institutions feel they cannot wait until the resolution of a class action before deciding whether to file an individual action and thus avoid the risk of the claims being time-barred. This may be the year we see *IndyMac* play out in the class certification context as well.

We also have observed additional litigation over the meaning of domestic transactions, even years after the Supreme Court's *Morrison* decision, which held that the anti-fraud provisions of the federal securities laws applied only to securities traded on U.S. exchanges or in other domestic transactions. In a world of global offerings, courts are paying particular attention to whether plaintiffs can adequately allege they purchased securities in a domestic transaction. Both the institutional individual action and *Morrison* phenomena are evident in the current Petrobras securities litigation pending in the Southern District of New York. In that case, Judge Jed S. Rakoff dismissed certain note claims by foreign investors, who were unable to adequately allege that they purchased securities in a domestic transaction.

Finally, as the initiation of financial crisis cases wanes, we predict an increase in more traditional stock-drop cases. Plaintiffs will seize upon volatility in the marketplace as well as any corporate crises, such as cybersecurity breaches, to initiate securities fraud class actions.

If the Eighth Circuit affirms the *Best Buy* district court's ruling, a potential split with the Fifth Circuit could set the stage for the Supreme Court to revisit price impact in *Halliburton III*.

2015-16 Supreme Court Update

Contributing Partner

Boris Bershteyn / New York

Associates

Sam Auld / New York

Spencer Gottlieb / New York

Eli S. Rubin / New York

In its current term, the U.S. Supreme Court is once again poised to address a range of disputes relevant to businesses. These include significant constitutional issues, class action practice and other procedural matters, and emerging questions concerning cross-border litigation.

Constitutional Powers and Limits

First Amendment and Union Dues

In one of the term's most watched cases, the Court will consider — or perhaps reconsider — First Amendment questions with potentially significant effects on operations of public sector unions. Nearly 40 years ago, in *Abood v. Detroit Board of Education*, the Supreme Court rejected a First Amendment challenge to "agency shop" arrangements, which allow public sector unions to collect mandatory fees from nonmembers. Those "fair share" fees are meant to offset the costs of contract negotiation or administration that, in principle, benefit both union and non-union members. But the First Amendment protects non-union members from being forced to pay "non-chargeable fees" that support other union activities.

In California, the public school teachers union requires that non-union teachers opt out each year from paying nonchargeable fees. In *Friedrichs v. California Teachers Association*, argued on January 11, 2016, the Supreme Court will decide (1) whether to overrule *Abood* and (2) whether requiring non-union teachers to opt out of paying the "non-chargeable" fee — rather than requiring the union to affirmatively obtain consent — violates nonmembers' First Amendment right to be free from compelled speech. *Amicus* briefs filed with the Court largely split along ideological lines, with states divided on both sides of the case and the federal government arguing on the side of the teachers union.

Affirmative Action

The Supreme Court also will revisit a familiar affirmative action dispute — Abigail Fisher's challenge to the constitutionality of public university admissions policies in *Fisher v. University of Texas at Austin*, which was argued on December 9, 2015. Fisher, who is white, argues that Texas' flagship public university violated the 14th Amendment's Equal Protection Clause in considering her race when it denied her application for undergraduate admission. *Insights* covered Fisher in 2012, when the Supreme Court remanded the case to the U.S. Court of Appeals for the Fifth Circuit with instructions to apply "strict scrutiny" to the affirmative action program. This demanding standard requires the government to prove that its method of promoting diversity in higher education was narrowly tailored to serve a compelling state interest. Applying it to Fisher's case, the Fifth Circuit upheld the program, and the case has once again found its way onto the Supreme Court's docket. Various educational, academic and business organizations have filed *amicus* briefs supporting the university's position, including one on behalf of such *Fortune* 100 companies as American Express, Apple, Deloitte, PepsiCo, Pfizer and Walmart, in which the companies argue that affirmative action enables them to "hire highly trained employees of all races, religions, cultures, and economic backgrounds."

Separation of Powers

The Supreme Court also will consider whether separation of powers permits the enactment of a statute directing the outcome in a single pending case. The case arose after the victims of several terrorist acts sued Iran's central bank, Bank Markazi, unsuccessfully seeking to attach nearly $2 billion of bonds in which the bank held an ownership interest. Congress responded by passing the Iran Threat Reduction and Syria Human Rights Act of 2012, which provides for the execution or attachment of "the financial assets that are identified in and

the subject of proceedings in" the victims' litigation. The question in *Bank Markazi v. Peterson*, argued on January 13, 2016, is whether Congress overstepped its authority by dictating what assets the plaintiffs could attach in a particular case. As business disputes, including those involving major financial institutions, continue to draw political and judicial scrutiny, *Bank Markazi* could help clarify the limits of Congress' power to affect outcomes of discrete adjudications.

Federal Civil Procedure and Class Actions

Standing

Congressional influence on the work of the judiciary also may be clarified in *Spokeo, Inc. v. Robins*. The case was argued on November 2, 2015, and considers whether Congress may by statute confer Article III standing upon a plaintiff who suffers no concrete harm. The plaintiff alleged that Spokeo, which gathers public data about individuals for credit reports, published inaccurate information about him in violation of the Fair Credit Reporting Act. The district court held that the plaintiff lacked Article III standing in the absence of actual harm, but the U.S. Court of Appeals for the Ninth Circuit reversed. As *amicus* briefs filed by the U.S. Chamber of Commerce and certain technology companies argue, availability of Article III standing without actual harm could open federal courts to class actions on a scale previously unseen. Ultimately, the Court may bypass the question: At oral argument, some justices appeared open to the narrower course of finding that the plaintiff suffered actual harm from Spokeo's alleged misconduct.

Complete Relief and Mootness

In another case affecting the scope of class actions in federal courts, the Court in *Campbell-Ewald Company v. Gomez*, argued on October 15, 2015, will decide whether a plaintiff's claims become moot when a defendant offers to provide complete relief — including when the plaintiff has asserted a class claim under Federal Rule of Civil Procedure 23 and receives the offer of complete relief before the class is certified. As in *Spokeo*, the dispute in *Campbell-Ewald* asks the Court to define the contours of "cases" and "controversies" susceptible to judicial resolution under Article III. The case could help class action defendants manage litigation by strategically offering relief to class representatives prior to class certification.

Class Certification

The Court is taking up another dispute with potentially broad implications for federal class actions in *Tyson Foods, Inc. v. Bouaphakeo*, argued on November 10, 2015. The case, which involves alleged violations of the Fair Labor Standards Act (FLSA), calls into question reliance on the use of statistical averages in calculating liability and damages in class litigation, as well as inclusion of arguably uninjured members in a class. The U.S. Chamber of Commerce, the Business Roundtable and the National Association of Manufacturers, among others, filed *amicus* briefs arguing that doing so ignored the individual harm requirements of Article III standing. Should their view prevail, class action plaintiffs could face significant additional hurdles in certifying classes. But the oral argument did not suggest that this outcome is likely, as the justices appeared less interested in broad class certification issues than questions particular to the FLSA.

Federal Jurisdiction and Securities Claims

The lone securities case so far this term, *Merrill Lynch, Pierce, Fenner & Smith v. Manning,* argued on December 1, 2015, asks whether the Securities Exchange Act of 1934 confers exclusive jurisdiction on federal courts for state law claims predicated on violations of the Exchange Act or its implementing regulations. The defendants argued that the plaintiffs' state law claims can be removed to federal court because the alleged wrongdoing is predicated on a violation of an Exchange Act regulation governing short-selling. The plaintiffs, in turn, argued that their state law claims are separable from Exchange Act regulation. As the Securities Industry and Financial Markets Association contended in an *amicus* brief, a ruling for the plaintiffs could open a path for keeping securities litigation in state courts, thereby avoiding the requirements of such federal procedural statutes as the Private Securities Litigation Reform Act.

Cross-Boundary Disputes

Foreign Sovereign Immunities Act

Mirroring the trends in complex civil litigation, cross-boundary disputes are taking center stage at the Supreme Court. In one of this term's first decisions, on December 1, 2015, the Court clarified how the commercial activity exception to foreign sovereign immunity applies to events that span the world. In *OBB Personenverkehr AG v. Sachs,* a California resident purchased a Eurail pass online from a Maine travel agent and subsequently suffered severe injuries while boarding a train in Innsbruck, Austria. She sued the Austrian railway, which invoked immunity from suit under the Foreign Sovereign Immunities Act (FSIA). The plaintiff, in turn, relied on an exception from immunity for suits "based upon a commercial activity carried on in the United States by the foreign state." The Court unanimously held that immunity applied and the "commercial activity" exception did not, because the connection to the United States was too ancillary. The decision could have implications beyond FSIA, as the problem of distinguishing between domestic and foreign activity is commonplace in modern litigation.

RICO and Extraterritoriality

Finally, the Court will again address the extraterritorial application of U.S. laws — a subject it confronted several years ago with respect to federal securities laws in *Morrison v. Australia National Bank Ltd.* This time, the statute at issue is the Racketeer Influenced and Corrupt Organization Act (RICO). In *RJR Nabisco v. The European Community,* the European Community (now the European Union) and its member states alleged that Nabisco directed a global money-laundering scheme by selling cigarettes wholesale to international drug dealers. The U.S. Court of Appeals for the Second Circuit held that RICO can apply extraterritorially, at least to the extent that the relevant predicate offenses necessarily occur abroad. The Supreme Court will consider whether this conclusion is consistent with the presumption against extraterritoriality set forth in *Morrison*.

Aggressive Government Enforcement Continues: How Will Individual Prosecutions Impact Activity Against Institutions?

Contributing Partner

Jocelyn E. Strauber / New York

Associates

Sean P. Shecter / New York

Nicholas J. Moscow / New York

U.S. authorities have been increasingly aggressive in their law enforcement and regulatory actions against multinational corporations and financial institutions, as well as individuals, in areas including market manipulation and foreign public corruption. There is no reason to expect that activity will abate this year.

Recent announcements indicate that U.S. authorities plan to continue their focus on Foreign Corrupt Practices Act (FCPA) enforcement in the coming year. In a November 2015 speech, Andrew J. Ceresney, director of the Securities and Exchange Commission's (SEC) Division of Enforcement, emphasized the SEC's lead role in combating corruption worldwide, reflected on actions taken in the past year and predicted that 2016 would be another active year for FCPA enforcement. Leslie R. Caldwell, assistant attorney general for the Criminal Division of the Department of Justice (DOJ), also spoke in November about the DOJ's efforts throughout the year to increase the resources devoted to FCPA prosecutions; the FBI has added three new squads focused on FCPA investigations, and the DOJ has committed to add 10 new prosecutors — a 50 percent increase — to the FCPA unit. With these additional resources, the DOJ can be expected to increase its FCPA cases this year, in parallel with foreign counterparts, which have ramped up their own corruption enforcement efforts in recent years.

Both the DOJ and SEC also have stated their intentions to prosecute more individuals for corporate misconduct. Statements from those agencies, including the guidance outlined in the September 2015 memo by Deputy Attorney General Sally Quillian Yates (Yates Memorandum), indicate that the federal government expects to devote substantial resources to building criminal and civil cases against individuals this year. In his speech, SEC Enforcement Director Ceresney said that over the last five years, 80 percent of the SEC's enforcement actions have involved charges against individuals (including but not limited to FCPA actions). He noted that FCPA cases present particularly formidable challenges to establishing individual liability because, among other things, they involve foreign defendants and witnesses and documentary evidence located overseas. He stressed, however, that the SEC will bring cases against individuals where there is evidence to do so, including in conjunction with cases against corporate entities.

The DOJ's recent public statements have gone even further. The Yates Memorandum purported to partly change the DOJ's approach to corporate investigations in order to facilitate individual prosecutions. (See September 15, 2015, Skadden client alert "DOJ Issues Guidance to Prosecutors to Facilitate Individual Prosecutions in Corporate Investigations.") The guidance in the memo makes plain the DOJ's intentions to focus on individuals from the inception of civil or criminal corporate investigations. The Yates Memorandum also states both that companies under investigation must provide all relevant facts to the DOJ about individuals involved in alleged corporate misconduct in order to receive cooperation credit, and that corporate cases may not be resolved without a clear plan to resolve related individual cases. In November 2015, the DOJ amended the U.S. Attorneys' Manual to reflect the principles outlined in the memo.

It remains to be seen how the DOJ will apply the Yates Memorandum and whether the principles it articulates will result in an increase in individual prosecutions. In most instances, it is very difficult to single out individual corporate actors for criminal prosecution and, in our view, the DOJ's inability to prosecute corporate managers in the past has been the result of a lack of evidence, not a lack of focus or will. For example, since late 2011, the DOJ has successfully settled FCPA cases against individuals but taken only a handful

of cases to trial, all of which ended poorly for the government — either with acquittals or mistrials (such as in the so-called Africa Sting case), dismissals of indictments post-trial (as in a case against executives of an electrical products company) or case resolutions midtrial with plea deals favorable to the defense (as in the recent case against Joseph Sigelman, the former co-CEO of PetroTiger). In that case, the government's case faltered most significantly when its critical cooperating witness made false statements in his trial testimony. Despite extensive cooperation and assistance from PetroTiger, Sigelman — who initially faced up to 20 years' imprisonment — ultimately received a sentence of probation.

These cases illustrate the challenges that trials — particularly FCPA trials — pose for the government, including securing foreign documentary and other evidence, obtaining testimony of foreign witnesses and completing complex investigations within the statute of limitations. And while the DOJ successfully tried and convicted two London Interbank Offered Rate (Libor) defendants in November 2015 (see below), it has yet to bring any charges against individual defendants in the May 2015 foreign currency exchange investigation, despite the guilty pleas — and cooperation — of the five major financial institutions.

Deputy Attorney General Yates noted in a recent speech that "as a matter of basic fairness, we cannot allow the flesh-and-blood people responsible for misconduct to walk away, while leaving only the company's employees and shareholders to pay the price." While her statement, on its face, raises questions as to whether the DOJ might refrain from taking action against a corporation if it anticipates insurmountable challenges in a case against individual employees, we do not expect fewer prosecutions of corporations.

The government's public statements in connection with the Libor and foreign exchange resolutions make clear that the DOJ's efforts to hold financial institutions accountable for complex financial crimes, including market manipulation, are ongoing. There is every reason to conclude that those efforts will continue into 2016 regardless of the feasibility of individual prosecutions. In light of the DOJ's aggressive enforcement efforts in 2015 and its apparent commitment to continue those efforts in 2016, we do not see the Yates Memorandum as signaling a decrease in prosecutions of companies. To the contrary, the memo may raise the bar for institutional cooperation — getting companies to provide even more incriminating information about individuals in order to obtain credit for their assistance to the government.

Enforcement Actions Involved Steep Penalties in 2015

April

The DOJ required a guilty plea from a financial institution's subsidiary, entered into a deferred prosecution agreement with the parent entity and imposed hundreds of millions of dollars in criminal penalties.

May

The DOJ required guilty pleas — this time at the parent company level — from five major financial institutions in connection with manipulation of the euro/U.S. dollar exchange rate. Four banks pleaded guilty to antitrust conspiracy and another pleaded guilty to wire fraud; the DOJ imposed criminal fines exceeding $2.5 billion in aggregate.

September

The SEC announced a resolution of its FCPA investigation of BNY Mellon in which the bank agreed to pay $14.8 million to settle charges that it violated the FCPA by providing valuable internships to family members of foreign government officials.

November

In the first federal trial arising from the Libor investigation, two former Rabobank derivative traders were convicted of rate manipulation. U.S. authorities have charged a total of 13 individuals in the investigation, and a number have pleaded guilty. Only these two have gone to trial to date.

Delaware Supreme Court Clarifies Earlier Rulings, Chancery Court Stakes Out New Positions

Contributing Partners

Paul J. Lockwood / Wilmington

Edward B. Micheletti / Wilmington

Associate

Lori W. Will / Wilmington

Delaware courts tackled a number of issues of importance in 2015. The Delaware Supreme Court clarified prior inconsistent case law by reiterating that deference must be given to decisions made by disinterested directors. It also addressed the relatively new issue of financial advisor liability. Meanwhile, the Court of Chancery began to question the propriety of settlements that provide nonmonetary benefits in exchange for a broad release of claims. The courts undoubtedly will continue to shape these key areas of the law in the coming year, though how unresolved areas of law will be interpreted in 2016 remains to be seen, given the continued turnover in the courts.

The Courts

Since January 2014, four of the five justice positions on the Delaware Supreme Court have changed. The Court of Chancery also has experienced turnover, including Andre G. Bouchard becoming the chancellor of the court in May 2014. And with Vice Chancellor John W. Noble retiring in early 2016 and Vice Chancellor Tamika Montgomery-Reeves replacing Donald F. Parsons, Jr., Vice Chancellor J. Travis Laster (who joined the court in 2009) will be the longest-tenured member. Practitioners are watching closely to see how the relatively new members of these courts interpret Delaware law.

Deference to the Board's Business Judgment

Two important Delaware Supreme Court decisions in 2015 clarified prior inconsistent case law and reinforced that Delaware law is deferential to the decisions of disinterested, well-informed boards that act in good faith. Both decisions address the importance of the standard of review applied by the Court of Chancery.

The first decision, *In re Cornerstone Therapeutics Inc. Stockholder Litigation*, resolved the uncertainty of whether breach of fiduciary duty claims against a board can be dismissed where entire fairness review — a heightened standard that typically requires defendants to prove the fairness of a deal's price and process — applies. The Court of Chancery, constrained by its reading of the Supreme Court's decision in *Emerald Partners v. Berlin*, applied entire fairness review at the pleadings stage to claims involving a controlling stockholder freeze-out merger. It found that directors could not prevail on a motion to dismiss, despite the fact that the claims against them were cleared under the company's exculpatory charter provision that shielded directors from personal liability for nonintentional breaches of fiduciary duty. On interlocutory appeal, the Supreme Court reversed, stating that "plaintiffs must plead a non-exculpated claim for breach of fiduciary duty against an independent director protected by an exculpatory charter provision, or that director will be entitled to be dismissed from the suit … regardless of the underlying standard of review for the transaction."

The Delaware Supreme Court clarified prior inconsistent case law by reiterating that deference must be given to decisions made by disinterested directors.

The Delaware Supreme Court's decision in *Corwin v. KKR Financial Holdings LLC* ended the debate that emerged after its 2009 *Gantler v. Stephens* opinion on what effect stockholder approval of a transaction should have on the standard of review applied to breach of fiduciary duty claims. The Court of Chancery rejected the plaintiffs' argument that KKR, which owned less than 1 percent of its merger counterparty, was a controlling stockholder due to a contractual arrangement whereby KKR managed the counterparty through an affiliate. The court found that entire fairness did not apply to the plaintiffs' post-closing damages claims regarding the stock-for-stock merger. In dismissing the plaintiffs' claims, the court held that the business judgment rule — a presumption that the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was taken in the company's best interest — applied because "the transaction was approved by an independent board majority and by a fully informed, uncoerced stockholder vote."

On appeal, the plaintiffs argued that the Court of Chancery erred in deciding entire fairness review did not apply, and that *Revlon* review — which requires the court to assess whether the board undertook reasonable efforts to obtain the highest price realistically available in a sale of corporate control — should apply if entire fairness did not. In particular, the plaintiffs claimed that under the Supreme Court's decision in *Gantler*, a fully informed stockholder vote required by statute (as was the case in *KKR*) did not invoke the business judgment rule. The Supreme Court affirmed the lower court's decision that entire fairness was inapplicable and found that the plaintiffs' *Revlon* argument was not raised by the plaintiffs at the trial-court level. However, the Supreme Court noted, even if the applicability of *Revlon* was before it, the business judgment rule applied. The Supreme Court also made clear that *Gantler* should be read narrowly, as applying to stockholder ratification and not as affecting the standard of review applied to a transaction approved by informed, uncoerced stockholders that is not subject to entire fairness.

Uncertain Future of Disclosure-Based Settlements

Throughout 2015, the Court of Chancery chipped away at the long-standing practice of settling stockholder lawsuits for benefits such as supplemental disclosures in exchange for a broad release of claims against defendants. Vice Chancellor Laster first took a stance against disclosure-based settlements in *Acevedo v. Aeroflex Holding Corp.*, rejecting a settlement in which the parties had agreed to supplemental disclosures as well as a reduced termination fee and matching rights period for a broad release. Vice Chancellor Laster permitted the parties one of three options: reframe the case as a dismissal of disclosure claims due to mootness, narrow the settlement release to only Delaware fiduciary duty claims or have the defendants move to dismiss the case. (A motion to dismiss was later filed and granted.) In a subsequent decision, *In re Aruba Networks, Inc. Stockholder Litigation*, Vice Chancellor Laster also rejected a disclosure-based settlement due to "inadequate representation," where the court found the claims were unmeritorious when filed. The court, calling the practice of settling for only disclosures while providing a broad release of all claims a "systemic problem," also refused to certify the class and dismissed the cases filed by the named plaintiffs.

Other members of the Court of Chancery have expressed similar criticisms of disclosure-based settlements of stockholder deal cases. For example, Vice Chancellor Sam Glasscock III in *In re Riverbed Technology, Inc.* remarked that any weight given to the court's prior practice of approving settlements of disclosure claims for global releases would be "diminished or eliminated going forward," suggesting that settlement consideration of "small therapeutic value" warranted an equally narrow release. In *In re CareFusion Corporation Stockholders Litigation,* however, Vice Chancellor Noble took a more pragmatic approach in approving a disclosure-based settlement with broad releases: "When plaintiffs' counsel represent that they have seriously looked at other possible claims and can explain why they chose not to pursue them because of the merits and not because of sloth or short-term greed, approval of a global release may make much more sense."

Given the uncertainty over the future of disclosure-based settlements in Delaware, many are anticipating Chancellor Andre G. Bouchard's written decision on these issues in *In re Trulia, Inc. Stockholder Litigation*. In particular, Chancellor Bouchard is expected to address whether disclosures must be material to support a settlement and whether the scope of a release should include claims unknown at the time of settlement.

Development of Aider and Abettor Liability

In one of the most anticipated decisions of 2015, the Delaware Supreme Court in *RBC Capital Markets, LLC v. Jervis* (*Rural Metro*) affirmed the Court of Chancery's post-trial decision that a financial advisor was liable for aiding and abetting claims for $75.8 million in damages based on joint and several liability, in a case in which the director defendants had settled before trial. The Supreme Court made clear that its opinion should be confined to the "unusual facts" of the case and emphasized that a financial advisor must have acted with scienter to be found liable for aiding and abetting a breach of the board's fiduciary duty, making such claims "among the most difficult to prove." Notably, the Supreme Court rejected the Court of Chancery's view of financial advisors as "gatekeepers" in M&A transactions, explaining that such a standard would suggest that any failure by a financial advisor to prevent breaches of the board's duty of care could give rise to an aiding and abetting claim against the banker. Whether the Court of Chancery will limit the affirmance in *Rural Metro* to its facts or apply it more broadly to aiding and abetting claims against financial advisors will be closely watched in 2016.

Enforceability of Corporate Forum-Selection Bylaws Continues to Strengthen

Contributing Partner

Allen L. Lanstra / Los Angeles

In recent years, corporations have responded to the threat of duplicative stockholder lawsuits in multiple courts across the country, as well as "forum shopping" by plaintiffs, by enacting forum-selection bylaws. Under these bylaws, shareholders must pursue deal litigation, breach of fiduciary duty claims and derivative lawsuits filed on behalf of the corporation in a particular jurisdiction established by the bylaws. The state of incorporation (most often Delaware) is commonly the required forum. Though these bylaws have been criticized and challenged legally, a growing number of courts across the U.S. have supported their enforceability.

Recently, those challenges have played out in California in the context of derivative litigation. In 2015, a federal court in the Central District of California (a popular forum of the plaintiffs' bar) departed from a prior California federal decision that refused to enforce a forum-selection bylaw. The analysis employed in this new decision, *In re CytRx Corp. Stockholder Derivative Litigation*, likely will be employed by other federal courts and promises to strengthen the trend of courts enforcing forum-selection bylaws.

Boilermakers

Central to current case law on forum-selection bylaws is a Delaware Court of Chancery decision from two years ago. The Court of Chancery held in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.* that a forum-selection bylaw adopted by the board of directors of a Delaware corporation is valid, binding and enforceable. At the heart of the *Boilermakers* reasoning was the contractual nature of the relationship between a Delaware corporation and its shareholders. During the past year, the Delaware legislature amended the Delaware General Corporation Law to effectively codify the *Boilermakers* decision.

Most state courts encountering forum-selection bylaws since *Boilermakers* have followed its reasoning and dismissed actions filed in the wrong venue. However, due to the constructs of federal jurisdiction, a federal court faced with a forum-selection bylaw requiring a derivative case to be filed in a state court (such as the Delaware Court of Chancery) encounters unique jurisdictional issues.

Atlantic Marine

Recently the U.S. District Court for the Central District of California, in *In re CytRx*, dismissed a suit that was required to be filed in the Delaware Court of Chancery under the corporation's bylaw, becoming the first within the U.S. Court of Appeals for the Ninth Circuit to enforce a forum-selection bylaw unilaterally adopted by a board of directors. Unlike the prior courts that had addressed the enforceability of a forum-selection bylaw, however, the Central District of California followed the framework set forth by the U.S. Supreme Court in *Atlantic Marine Const. Co. v. U.S. District Court W.D. Tex.* (2014), which addresses a forum-selection clause in a contract as opposed to a corporate bylaw. The Court in *Atlantic Marine* held that when a federal court is presented with a forum-selection contractual clause, it should not consider the clause in the procedural context of a motion to dismiss for improper venue; rather, the court should apply a modified version of the doctrine of *forum non*

The analysis from *In re CytRx* likely will be employed by other federal courts and promises to strengthen the trend of courts enforcing forum-selection bylaws.

conveniens. This doctrine affords a court the discretionary power to decline jurisdiction for the convenience of the parties, if justice would be served by the action being heard in another forum. The Court further held that under this modified *forum non conveniens* doctrine, "forum-selection clauses should control except in unusual cases," largely because the two parties to the contract agreed to the expectation of the forum to resolve a dispute.

In *In re CytRx*, the Central District of California held that the *Atlantic Marine* framework applies equally to forum-selection bylaws. The court agreed with *Boilermakers* regarding the enforceability of forum-selection bylaws, accepting that the bylaws are consistent with the contractual nature of the corporation-shareholder relationship. The court further determined that, under the public interest factors at play in a *forum non conveniens* analysis, the *CytRx* forum-selection bylaw did not present one of those unusual cases where selection should not be enforced.

The decision by the Central District of California continues the trend of courts enforcing forum-selection bylaws. The *In re CytRx* decision extends to forum-selection bylaws the Supreme Court's framework in *Atlantic Marine* that strongly favors enforcement of contractual clauses to forum-selection bylaws. That extension, if followed by other federal courts, will further the trend of forum-selection bylaws being enforced absent unusual cases. The expected result is that derivative plaintiffs who file in either a state or federal court will now face a growing body of case law that will compel them to adhere to corporate forum-selection bylaws.

Mass Tort and Consumer Class Action Outlook: Opportunities and Challenges

Contributing Partners

John H. Beisner / Washington, D.C.

Jessica D. Miller / Washington, D.C.

Associate

Jordan M. Schwartz / Washington, D.C.

In 2016, the U.S. Supreme Court is expected to hand down several decisions addressing overbroad or "no-injury" class actions, and a number of important issues are percolating in the lower courts as well. Below are some issues that are likely to be at the forefront of class action practice in the coming year.

The Future of Overbroad Class Actions. The future of overbroad or no-injury class actions could turn on the resolution of two cases before the Supreme Court. The first is *Spokeo Inc. v. Robins*, a case involving Article III standing under the Fair Credit Reporting Act. The specific question at issue in *Spokeo* is whether Congress can confer Article III standing on a plaintiff who has not suffered any concrete harm apart from alleging a bare violation of a federal statute. The second case is *Tyson Foods, Inc. v. Bouaphakeo*, a wage-and-hour class action that, according to the petition for *certiorari*, involves the question "whether a class action may be certified … when the class contains hundreds of members who were not injured and have no legal right to any damages." Although there are other issues at play in this closely watched case — and several justices suggested at oral argument that the Court might not address the overly broad certification issue — the Court's ultimate decision still could have significant implications for no-injury class actions. (See "2015-16 Supreme Court Update.")

Ascertainability Law Remains in Flux. Defendants in 2015 were dealt a setback in their bid to strengthen the law governing ascertainability in consumer class actions outside the U.S. Court of Appeals for the Third Circuit. Most recently, in *Mullins v. Direct Digital, LLC*, the U.S. Court of Appeals for the Seventh Circuit expressly parted ways with the Third Circuit's landmark 2013 decision in *Carrera v. Bayer Corp.*, which had recognized a defendant's due process right to challenge class membership at the class certification stage. The Seventh Circuit disagreed with what it described as a "heightened" ascertainability requirement that would serve as a death knell for consumer fraud class actions involving products of so little cost that no consumer would bother to keep a receipt. The *Mullins* decision highlights a deep circuit split on the parameters of the implied requirement of ascertainability, offering the Supreme Court a prime opportunity to weigh in on this important issue. While it remains to be seen whether the Supreme Court will take up the *Mullins* case and resolve the divide, ascertainability will continue to make its way through the federal appellate courts. Notably, the U.S. Court of Appeals for the Ninth Circuit, which has previously strived to avoid the question, likely will be the next circuit court to offer its views on ascertainability in *Jones v. ConAgra Foods Inc.* A decision is expected in early 2016.

No Changes to Issues Certification Provision. After studying issues classes in 2015, the Rule 23 Subcommittee of the federal Judicial Conference Advisory Committee on Civil Rules recently decided against pursuing changes to the provision governing issues classes (Rule 23(c)(4)) that many believed would encourage more frequent use of that device. This is a positive development for defendants given that the subcommittee had considered a proposal under which class treatment of certain issues would have been permitted whenever there are any common questions capable of resolution on a classwide basis — even if the predominance requirement of Rule 23(b)(3) was not met as to other issues. Such a proposal would have effectively codified the trend by the Sixth and Seventh circuits of employing Rule 23(c)(4) as a means to facilitate class certification in cases where individualized issues would otherwise predominate. The subcommittee decision all but guarantees that issues classes will remain a hotly debated issue in 2016.

Multidistrict Litigation Abuses. Congress enacted the multidistrict litigation (MDL) statute years ago so that overlapping cases could be centralized before a single judge for coordinated pretrial proceedings, generating much-needed efficiencies for parties and courts. However, rather than use this mechanism to efficiently resolve cases and conserve resources, plaintiffs' attorneys increasingly are using MDLs to warehouse meritless claims in the hope that the sheer number of cases will pressure defendants into settlements. One way to weed out baseless claims is by expanding the use of plaintiff fact sheets and *Lone Pine* orders that would require plaintiffs to satisfy a minimum evidentiary threshold at the outset of litigation, before the parties proceed to expensive and burdensome discovery. While fact sheets and *Lone Pine* orders have become increasingly popular in MDL proceedings, they often are imposed as requirements late in the litigation. With growing awareness that MDL proceedings are becoming magnets for meritless suits, in 2016, MDL courts may start using these tools earlier in litigation to maximize their value and impose serious sanctions for failure to comply with them, including the dismissal of cases.

Cy Pres. In 2015, plaintiffs continued to test the limits of *cy pres*, the practice of distributing class funds to third-party charities instead of the allegedly aggrieved class members. Federal appellate courts have continued to be somewhat skeptical of *cy pres*, including the U.S. Court of Appeals for the Eighth Circuit, which recently vacated a district court's order distributing residual funds to a third-party legal services organization after two rounds of direct distribution to class members. The Court of Appeals recognized that *cy pres* distributions "have been controversial in the courts of appeals," but stated that district courts are "ignoring and resisting circuit *cy pres* concerns and rulings in class action cases." Indeed, the practice is on the rise, as demonstrated by a comparison of the number of reported decisions approving/denying class settlements with *cy pres* components in 2009 and 2014. Thus, it is not surprising that the Rule 23 Subcommittee decided to look into the issue. However, after studying it throughout 2015, the subcommittee recently decided not to add a Rule 23 provision governing *cy pres*. As a result, the battle over *cy pres* — and whether it effectuates the interests of absent class members — will continue to play out in federal courts.

Third-Party Litigation Funding. Several noteworthy developments in the third-party litigation funding (TPLF) arena took place in 2015, including the announcement by Senate Judiciary Committee Chairman Chuck Grassley, R-Iowa, and Sen. John Cornyn, R-Texas, chairman of the Judiciary Committee's Subcommittee on the Constitution, of an investigation into TPLF usage and practices. According to a press release Sen. Grassley issued on August 27, 2015, the two senators are "examining the impact third party litigation financing is having on civil litigation in the United States." To that end, the senators sent letters to Burford Capital, Bentham IMF and Juridica Investments Ltd., three of the largest TPLF funders, requesting information regarding their TPLF activities in the United States. Another development over the past year has been TPLF's expansion into the mass tort arena, as illustrated in a breach-of-contract complaint recently filed in Texas state court against the plaintiffs' law firm AkinMears. The suit was brought by a former employee of the law firm, who was hired to secure third-party litigation funding for television ads and the direct purchase of transvaginal-mesh mass tort lawsuits from other plaintiffs' lawyers. This lawsuit is worthy of close attention because it may provide new information about the ways in which TPLF is being used to fund and expand mass tort litigation.

Global Antitrust Enforcement in the Digital Age: Recent Developments in E-Commerce

Contributing Partner

Maria Raptis / New York

European Counsel

Thorsten C. Goetz / Frankfurt

Associates

Athanasia Gavala / Brussels

Luke T. Taeschler / New York

Competition authorities worldwide ramped up scrutiny of e-commerce business practices in 2015. The European Commission (Commission) launched an expansive sector inquiry in May 2015 aimed at identifying anticompetitive barriers affecting European e-commerce markets. While U.S. enforcers have not announced a similarly broad investigation, 2015 marked the Department of Justice's (DOJ) first-ever criminal prosecution in the e-commerce sector. These recent developments suggest that the online realm will be at the forefront of antitrust enforcement in 2016.

European Union

In May 2015, as part of the Commission's broader Digital Single Market strategy, the EU Commission's competition directorate launched a sector inquiry into e-commerce to identify and gather data regarding competitive practices that hinder cross-border online trade or otherwise affect EU e-commerce markets. Commissioner for Competition Margrethe Vestager noted in particular that the Commission will closely examine "geo-blocking," a practice whereby companies prevent users from accessing certain content based on the users' geographic location. Further, the EU's inquiry will focus on barriers companies have developed in areas where e-commerce is a popular means of purchasing products (*e.g.*, electronics, clothing, footwear and digital content).

As part of the sector inquiry, the Commission has been sending questionnaires to businesses in all 28 EU member states. On November 27, 2015, for example, it sent questionnaires to manufacturers of branded goods such as cosmetics, clothing, toys, electronics and household appliances concerning their online distribution policies. The Commission expects to publish a preliminary report on the status of its inquiry in mid-2016 and a final report in the first quarter of 2017. If the Commission identifies specific competition concerns, it also may launch more targeted investigations under Article 101 of the Treaty on the Functioning of the European Union, which prohibits restrictive agreements, and Article 102, which prohibits the abuse of a dominant position.

The Commission launched a number of high-profile investigations in the e-commerce sector in 2015 and will continue to do so in 2016. The investigations include:

- **March 2015:** The Commission confirmed an investigation into the online video game industry.
- **April 2015:** The Commission sent formal objections to Google, alleging that the company has abused its dominant position in the market for Internet search services by prominently displaying its own comparison-shopping service in its search results pages, and thus artificially diverting traffic from rival comparison shopping services. As a result, according to the EU Commission, Google's competitors "may not get the commercial opportunities that their innovations deserve."
- **June 2015:** The Commission opened an investigation into Amazon's "most-favored nation" (MFN) clauses in its contracts with book publishers for the distribution of e-books. MFN clauses require publishers to inform Amazon about more favorable or alternative terms offered by its competitors and/or offer Amazon equal or better terms. The Commission has concerns that such clauses may stifle competition and innovation by other e-book distributors, thus limiting customer choice.

- **July 2015:** The Commission sent formal objections to a U.K. broadcaster and six major U.S. film studios concerning contractual arrangements that prevent Sky UK from providing access, via satellite or online, to television content available in the U.K. and Ireland to customers located elsewhere in the EU.

- **August 2015:** The Commission reportedly sought information on pricing and contract terms from online marketplaces such as Amazon and eBay.

National antitrust authorities also have launched a number of high-profile investigations into online sales restrictions at the EU member state level, including sector inquiries and enforcement actions in the online hotel booking sector.

United States

To date, U.S. enforcers have not followed the EU Commission's lead with respect to online giants Amazon and Google. Thus far the Federal Trade Commission (FTC) has declined to challenge Google's practices in court, and neither the DOJ nor the FTC has opened an investigation into Amazon's practices, despite urging by authors, literary agents, booksellers and publishers. U.S. regulators also have not announced a wholesale investigation of the e-commerce industry. Notwithstanding a generally aggressive enforcement posture, U.S. competition authorities have proceeded cautiously when applying traditional antitrust principles to rapidly innovating and technological markets, particularly where companies can offer competitive justifications for their conduct. In its investigation of Google's ranking and displaying of search results, for example, the FTC acknowledged that Google's conduct had "procompetitive justifications" and "was premised on its desire to innovate and to produce a high quality search product in the face of competition," according to a March 26, 2015, op-ed piece in *The Wall Street Journal*. Despite significant concerns about Google's business practices, the FTC voted not to challenge Google's conduct in court and instead settled the matter. (Subsequent reports revealed that the FTC team that investigated Google recommended the FTC take action.)

Since the Google probe, U.S. authorities have continued to expend significant resources to scrutinize e-commerce practices:

- **April 2015:** The DOJ prosecuted David Topkins, who worked for an online seller of posters and framed art, for price-fixing. According to the plea agreement, Topkins conspired with other online sellers to fix the price of certain posters and then agreed to adopt specific pricing algorithms that would implement the agreed-upon prices. The DOJ's investigation is ongoing, and although the Topkins case involved an affirmative agreement rather than mere use of an algorithm, it remains to be seen whether dynamic pricing models, which can monitor the market and automatically adjust pricing according to competitors' prices, will attract antitrust scrutiny in the future.

- **July 2015:** The FTC reportedly issued subpoenas to Apple relating to Apple's App Store rules, such as the fee Apple charges to other subscription services that use Apple's store to sign up new users. The FTC also may investigate claims that Apple has illegally stifled competition in the music-streaming market.

Although U.S. and EU regulators have not always moved in tandem, it is clear that e-commerce will continue to remain at the forefront of global antitrust enforcement in 2016 in both jurisdictions. Counsel for companies involved in e-commerce should evaluate their business practices, including pricing and distribution models, for areas of vulnerability and remain aware of the potential antitrust implications in the jurisdictions in which they do business.

Auditors Must Beware the Consequences of Settling SEC Enforcement Actions

Contributing Partner

Michael Y. Scudder / Chicago

Associate

Andrew J. Fuchs / Chicago

The Securities and Exchange Commission (SEC) launched "Operation Broken Gate" in October 2013 to hold accountable those auditors who have intentionally or negligently violated professional auditing or accounting standards. Since then, the SEC has increasingly prioritized enforcement actions against auditors, especially under SEC Rule of Practice 102(e), which was codified in the Sarbanes-Oxley Act and allows the SEC to seek sanctions against accountants. The SEC charged 22 individuals under Rule 102(e) in the last four months of 2015, a trend that is expected to continue in 2016.

Auditors often seek to settle these Rule 102(e) actions to minimize the sanctions imposed, which could include permanent or temporary bars from practicing before the SEC, censures, cease-and-desist orders, fines and remedial actions. Settlements of Rule 102(e) charges are far from risk-free, with the potential for severe, if not career-ending, harm.

In assessing the true impact of settling a Rule 102(e) proceeding, the reputational harm from these settlements is of critical concern to auditors. Such settlements are public and become common knowledge in the profession — they are posted on the SEC's website and frequently are announced by a press release. The SEC order that documents the settlement not only contains the agreed-upon sanction(s) but also details the SEC's view of the intentional or negligent violations of professional standards.

Reputational harm, additional investigations and the impact on an auditor's license to practice are all relevant considerations in any settlement with the SEC.

One must consider the likely negative impact of any Rule 102(e) settlement on an audit committee's acceptance of the auditor. Regardless of the auditor's seniority, most audit firms and auditors would consider it a best practice (if not a duty) to bring the settlement to the attention of the audit committees of the sanctioned individual's existing or potential clients. An audit committee's duty to the company's shareholders and the availability of other qualified auditors may mean that what may be perceived as the risk of hiring an auditor publicly sanctioned by the SEC is unacceptable. Thus, even a "short" practice bar may effectively operate as a permanent bar on the auditor's practice.

Another concern is the potential for additional investigations due to the overlap in enforcement responsibilities between the SEC and the Public Company Accounting Oversight Board (PCAOB). Although the PCAOB's statutory mandate requires that it maintain a certain level of cooperation with the SEC, and regular coordination does occur between the two regulators, a settlement with the SEC does not preclude the PCAOB from commencing or continuing

an investigation into the same activity and seeking its own penalties, which can include censures, fines and bars on public company accounting work. Thus, there is some uncertainty about whether a settlement with the SEC will bring finality to the matter for the auditor.

Finally, a significant consideration is the effect of a settlement on the auditor's license to practice as a CPA. Most states require auditors to disclose any SEC disciplinary action to their state board of public accountancy, either as an affirmative duty or in connection with periodic license renewals. Once they learn of SEC settlements, state boards are able to open their own investigations and have the authority to revoke or suspend auditors' CPA licenses, even where the SEC sanctions did not involve practice bars. Examples abound of state boards revoking or suspending an auditor's CPA license for periods at least equal to the SEC's practice bar. To make matters worse, an auditor's loss of ability to practice as a CPA may effectively prolong the length of any practice bar because a current CPA license is a prerequisite to reinstatement to practice before the SEC. These possibilities entail great risk for an auditor seeking to settle with the SEC.

Understanding the true range of outcomes from seemingly favorable settlement terms of Rule 102(e) charges is essential. As Rule 102(e) enforcement actions continue in 2016, it is important to keep in mind that without proper assessment of the repercussions of a resolution with the SEC, an auditor may not understand the full exposure and career risks of settling, rather than litigating, these actions.

The Trans-Pacific Partnership and What It Means for Pre-Existing Treaties

Contributing Partners

Julie Bédard / São Paulo and New York

Lea Haber Kuck / New York

Timothy G. Nelson / New York

On November 5, 2015, after seven years of high-stakes negotiations, the Office of the United States Trade Representative released the draft Trans-Pacific Partnership (TPP), a proposed free trade agreement among the United States and 11 other countries (Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam) that would cover approximately 40 percent of the global gross domestic product. The TPP's 30 chapters address a range of subject areas, from the protection of intellectual property rights to labor rights and environmental protections.

The agreement provides certain legal rights and guarantees to foreign investors from one TPP country who are making, or are looking to make, an investment in another TPP country. If the agreement is ratified and enters into force, U.S. companies' investments in any other TPP country will be legally protected by the agreement. This is meant to protect and therefore foster investor activity, but how these protections affect actual activity remains to be seen.

Legal Protections for Investments in the TPP

A fundamental right against expropriation without compensation is found in the agreement. While the TPP does not prevent a country from expropriating a foreign investment, it requires (similar to other investment treaties) any expropriation to be nondiscriminatory, conducted with due process, performed for a public purpose and, most importantly, accompanied by fair market value compensation paid without delay. This may, in fact, be seen as an international version of the Takings Clause in the Fifth Amendment of the U.S. Constitution.

The TPP explains that an expropriation is not only found when a government formally seizes title to a foreign investment, but also when a government commits acts that indirectly expropriate an investment. This is intended to protect investors from government acts that deprive an investor of its rights in an investment, even if that is not expressly stated to be the government's goal. Determining whether such an indirect expropriation has occurred is a fact-intensive exercise, and, according to the TPP, "[n]on-discriminatory regulatory actions" undertaken for "legitimate public welfare objectives" are rarely considered indirect expropriations.

Other protections include a guarantee of "minimum standard of treatment" for investors under "customary international law" (defined by the TPP as the "general and consistent practice of States that they follow from a sense of legal obligation") as well as guarantees that an investor and its investment will be afforded the same treatment given to the nationals of a TPP country and nationals of third states (so-called "national treatment" and "most-favored nation treatment"). In most treaties, the most-favored nation treatment standard allows an investor to claim not only the legal protections of that particular treaty but also the best possible legal protections given to any other investor in any other treaty signed, or that will one day be signed, by a host country. However, all the TPP countries appear to have expressed in some form that the most-favored nation treatment protection in the TPP will not extend to legal protections provided in treaties that are currently in force; they will extend only to protections in those treaties a host country signs in the future.

TPP parties can exempt themselves from certain protections by listing existing nonconforming measures or sectors in which they reserve the right to take such measures. Notably, however, those exemptions are not intended to apply to the expropriation protections in the agreement.

Finally, the agreement grants foreign investors the right to bring claims against a TPP party for a breach of legal rights, as well as certain other claims, to an arbitral tribunal. This investor-state arbitration provision is intended to give the TPP's investment protections a neutral international forum for the resolution of any disputes.

Pre-Existing Treaties Remain in Effect

Foreign investors should not look solely to the TPP to provide international legal protection for their investments. Pre-existing treaties between TPP countries continue in force — and there is no inconsistency when a prior treaty provides "more favorable treatment of … investments or persons" than provided by the agreement. In this respect, investors also should be aware that the United States already has entered into free trade agreements containing investment protection chapters with every other TPP country except Brunei, Japan, Malaysia, New Zealand and Vietnam. Although the investment chapters of many of these agreements contain provisions that are similar to those in the agreement, these treaties also may be interpreted (in certain circumstances) to provide additional protection and/or may not contain carve-outs from investment protection that are found in the TPP. As a result, these treaties also should be considered when assessing the legal protection of a foreign investment in a TPP country.

Ratification of the TPP

In the United States, the ratification process is governed by the Trade Promotion Authority, which requires the president to notify Congress of his intent to sign the TPP at least 90 calendar days prior to signing it (and further requires the TPP's text be made publicly available at least 60 calendar days before signature). President Barack Obama notified Congress of that intention on November 5, 2015, the same day the agreement was released to the public. Current reports suggest that the TPP will be signed in February 2016. Following signature, Congress will have an additional 90 legislative days to review the agreement before voting on ratification. Taking into account the congressional spring and summer recesses, some have speculated that a vote on the TPP will not take place until after the November 2016 elections. If adopted, the TPP may become an important element of the protection of foreign investment among its various signatories.

The Trans-Pacific Partnership

Australia
Brunei
Canada
Chile
Japan
Malaysia
Mexico
New Zealand
Peru
Singapore
United States
Vietnam

Challenging the Selection of Party-Appointed Arbitrators

Contributing Partners

Julie Bédard / São Paulo and New York

Lea Haber Kuck / New York

Timothy G. Nelson / New York

As arbitration continues to be widely utilized in international commerce, the issue of how arbitrators should handle conflict checks, and who is suitable for appointment as arbitrator in complex cases, will remain a vital one. A pending case is likely to shed light on challenges to arbitral awards based on an arbitrator's conflicts or partiality.

Under most modern international arbitration rules (as well as those of the leading U.S. domestic commercial arbitration bodies), all members of an arbitral tribunal are expected to be neutral and independent of all parties. Thus, under the rules of most international arbitral institutions as well as the arbitration rules of the United Nations Commission on International Trade Law (UNCITRAL), each arbitrator — not just the chair — is subject to challenge if there is a conflict that compromises independence or impartiality. Where, as often occurs, the arbitration agreement or rules provide for a three-person tribunal (a chair plus two arbitrators appointed by the parties), the opposing party's choice of arbitrator is often scrutinized to ensure there are no disabling conflicts or other considerations that would make the appointment inappropriate.

For an arbitration seated in the United States, issues of arbitrator "conflicts" are occasionally raised after an award has been rendered, through a petition to vacate the award under Section 10(a)(2) of the Federal Arbitration Act (FAA) on grounds of evident partiality. There are myriad cases dealing with evident partiality, with some disagreement among various federal circuits as to the precise test to apply when an arbitrator conflict is alleged. For example, the U.S. Court of Appeals for the Second Circuit has suggested that there is a duty to check conflicts, and that "a failure to either investigate or disclose an intention not to investigate [conflicts] is indicative of evident partiality." *Applied Indus. Materials Corp. v. Ovalar Makine Ticaret Ve Sanayi, A.S.*

In the pending case of *Republic of Argentina v. AWG Group*, a challenge was filed in the U.S. District Court for the District of Columbia that raises similar points on conflicts and evident partiality. In that case, a U.K. investor sought and obtained a significant damages award from an UNCITRAL tribunal after Argentina impaired its interests in an action found to violate the Argentina-U.K. bilateral investment treaty. In the course of that arbitration, Argentina challenged the claimant's choice of arbitrator on the basis that she was the director of an international bank that held an investment portfolio that included shares in one of the claimants. At an early stage in the case, the challenge was heard and rejected pursuant to Article 11 of the UNCITRAL rules, on the grounds that the arbitrator was not aware of the investment and that it was, in any event, immaterial.

In 2015, an award of damages was rendered against Argentina, which prompted it to seek *vacatur* of the award on the same grounds as stated in its prior arbitrator challenge, but this time, the issue was framed as whether the arbitrator's ties revealed evident partiality warranting *vacatur* under Section 10 of the FAA. Among the issues to be determined by the D.C. court is whether the prior decision rejecting the challenge should be granted deference, or whether the question of evident partiality can be litigated afresh. The case is pending, and practitioners will be watching closely

Expropriation Damages in Cases Involving Investment Treaties

Most investment treaties assure investors that, in the event of expropriation, they will receive compensation based on the market value of the enterprise at the time of seizure (excluding the negative valuation effects of any prior announcement or threat of expropriation). Should the state fail to honor that commitment, investors typically have to recover their losses through arbitration. One method for quantifying compensation in investment treaty disputes is the discounted cash flow (DCF) analysis. This method uses available data to project a cash flow for the business that was expropriated, then discounts the projected cash flow back to the date on which value is being reckoned (*e.g.*, the date of seizure or the date of the award). The inputs in the DCF model can be vigorously contested, however. For example, in *Quiborax S.A. v. Bolivia* (ICSID 2015), a tribunal awarded $49 million for expropriation of a boron mine, a substantial sum, but one that was lower than what was claimed (owing, in part, to the tribunal imposing a higher discount rate in the DCF model than the investor had urged).

In *Khan Resources N.V v. Mongolia* (UNCITRAL 2015), which involved expropriation of a uranium mine, the tribunal opted not to rely on DCF at all, rejecting it and other methods proposed by the parties. Instead, the tribunal awarded $80 million in damages, plus interest from the time of seizure, based on evidence of three prior offers by third parties for the assets in question.

Where DCF is used, one contentious issue is how to account for "country risk," a component of the discount rate that plays a factor when the host state has a track record of seizing assets. In *Gold Reserve Inc. v. Venezuela* (ICSID AF 2014), a tribunal awarded over $700 million for expropriation of a gold mining license. In calculating the discount rate, the tribunal held that "it is not appropriate to increase the country risk premium to reflect the market's perception that a State might have a propensity to expropriate investments in breach of BIT obligations." This approach has some support in previous cases: In 1981, a tribunal held that "there should be no reduction in the value placed on the venture on account of" threats of wrongdoing by a host state. *Phillips Petroleum Co. v. Iran*, Award ¶ 111 (Iran-U.S. Cl. Trib. 1989). The issue of country risk for a "repeat seizure host state" should be monitored, as it is likely to arise again.

Contributing Partners

Julie Bédard / São Paulo and New York

Lea Haber Kuck / New York

Timothy G. Nelson / New York

Regulatory

Financial Regulation

Market forces, implementation of recent rulemaking and aggressive enforcement efforts continue to define the landscape for financial institutions. Given the heavily regulated nature of the industry — especially post-financial crisis — the options available to these institutions in any particular situation require a detailed understanding of the rules governing their activity.

As the bank M&A market continues to strengthen, more bank shareholders are expected to agitate for sales in 2016.

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As a result of the Basel III leverage ratio, Clearing Firms may need to hold more capital than they have available.

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Bitcoin

derivatives and blockchain applications could test the CFTC in coming years.

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The easing of sanctions allows non-U.S. financial institutions to engage in certain business with Iran.

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Bank Shareholders Step Up Activist Efforts as M&A Activity Picks Up

Contributing Partners

David C. Ingles / New York

Sven G. Mickisch / New York

Bank management teams and boards of directors have made shareholder activism a key area of focus in light of significant activity in 2015. With the bank M&A market showing signs of life, the most basic end-game of investor activism in the industry — a sale of the institution — has become viable. Encouraged by activists' results in the publicly announced sales of institutions such as Metro Bank and Astoria Financial in 2015, and as the bank M&A market continues to strengthen, more bank shareholders are expected to agitate, either privately or publicly, for sales in 2016.

Activist Tactics in Banking

Many of the activist pursuits in the banking industry have involved a handful of investment funds that are focused on the sector, although there also have been situations involving more generalist activist investors, such as Nelson Peltz, who now has a representative on the board of Bank of New York Mellon. While these industry-focused funds generally are passive investors, some have sought to affect an institution's business and strategic direction.

Activist investors generally have fewer options when targeting a banking institution compared to companies in other industries. This is due to the relative simplicity of the business model of most community and regional banks as well as the industry's complex regulatory framework, which affects both the operational and financial flexibility of the banking institution and the degree to which one or more investors are legally permitted to work together to take actions that may affect control. These factors generally limit the activist's ability to propose many of the transactions or initiatives that comprise the typical activist playbook, such as splitting up the company, disposing of noncore businesses, implementing substantial cost-reduction measures or utilizing excess capital more profitably (including by returning it to shareholders). Meanwhile, industry consolidation through M&A activity continues to be the most attractive and viable means for many institutions to address their strategic and operational needs; it provides what may be the most efficient use of excess capital for the acquiring institution and the best means of addressing a selling institution's profitability and growth issues.

Several recent activist situations have involved larger banking institutions and have resulted in publicly announced sales or mergers. Based on the trading prices of the acquiring companies' stocks since announcement, the market's receptivity to those deals appears mixed. However, these cases point to the increasing viability of a sale or merger proposal as an activist tactic in the banking industry. They also sound a warning to bank management and boards across the industry that preparedness for shareholder activism should be a top priority as they manage their institutions through persistently difficult regulatory and economic conditions.

Preparing for and Responding to Activism

Even though each activist campaign is unique, the best course of action to address the activism threat is for an institution to continually analyze and seek to improve its operational and share price performance, develop and implement a long-term strategic plan and regularly communicate this information to investors, and build stronger relationships with significant investors before an activist surfaces. Oftentimes, doing so means that the institution already has considered many of the proposals an activist would suggest.

Given recent M&A activity in the industry, more bank shareholders are expected to enter the fray and be increasingly active in pushing their agendas, including pressuring institutions into a sale.

Banking institutions also should have in place a plan to more directly anticipate, identify and respond to activist investors when they surface. The plan should include a program to monitor activity in their stocks and a contingency plan for coordinating a team both within the institution and among its outside advisers to review and analyze any activist proposals and respond directly to the activist. If the activist campaign is public, the program also should include information on how to address the campaign publicly and with the institution's various constituencies.

The typical activist agenda — to improve shareholder value by demanding that the company implement one or more suggested proposals — will implicate the institution's current financial performance, business model and/or strategic direction, all of which are within the purview of the institution's board of directors. Once an activist investor has taken a position in a banking institution's stock and has begun publicly or privately agitating for change, the board of directors, with the guidance of its financial and legal advisers, will need to review and consider the appropriate response to the activist campaign. In doing so, the board will need to take into account all applicable legal and regulatory factors as well as the strategic and operational alternatives available and the expected value and risks associated with each. Depending on the circumstances, this may include consideration of an activist's demand for board representation and/or the issues involved in a possible sale of the institution.

Activism will remain a central issue for boards of directors and senior management teams of banking institutions in 2016. Given recent M&A activity in the industry, more bank shareholders are expected to enter the fray and be increasingly active in pushing their agendas, including pressuring institutions into a sale. Advance preparation for activist campaigns by boards and senior management teams will be crucial to best positioning institutions to respond to activists when they surface.

Bulk Transfers of Accounts in Broker-Dealer M&A: Regulatory Developments

Contributing Partner

Michael D. Dorum / New York

Associate

Jonathan A. Dhanawade / New York

Former Counsel

David E. Barrett

The volume of acquisitions involving broker-dealer firms continues to increase as the industry experiences further consolidation and realignment. In 2015, the Financial Industry Regulatory Authority (FINRA) proposed a rule that would clarify prior guidance regarding the legal and regulatory framework applicable to the transfer of customer accounts between broker-dealer firms. The customer accounts of any broker-dealer firm — and the trading and other transactions that are conducted through such accounts — generate the core revenues for most broker-dealers. For that reason, the success of any transaction depends on ensuring that the transfer of customer accounts is carried out properly and effectively.

FINRA, which serves as the principal self-regulatory body for U.S. broker-dealer firms, generally requires broker-dealers to obtain affirmative written consent before transferring a customer's account to another broker-dealer. In most broker-dealer M&A transactions, however, seeking and obtaining the affirmative written consent of each customer would be impracticable, given that a broker-dealer of significant scale may have thousands — or tens of thousands — of customers.

FINRA's Prior Guidance

In response to concerns raised by practitioners regarding the transfer of customer accounts "in bulk" — including in the context of an M&A transaction — the National Association of Securities Dealers (NASD), which was the predecessor to FINRA, published Notice to Members 02-57 (2002). In that notice, the NASD staff confirmed its general view that a transfer of a customer account to another broker-dealer requires the affirmative consent of the customer, but prescribed several circumstances — including an acquisition or merger of a member firm — in which broker-dealers could consider a customer to have provided consent even if the customer did not provide its affirmative consent in writing.

The NASD staff acknowledged that, in the context of an acquisition or merger of a member firm, a customer's consent could be obtained if the transferor broker-dealer notifies a customer that the broker-dealer intends to transfer the customer's account, and the customer fails to object after some appropriate period of time. This manner of consent is commonly referred to as "negative consent."

In an M&A transaction, the negative consent process affords speed and efficiency in obtaining customer consents and predictability of overall transaction timing. Broker-dealers using a negative consent process commonly request that customers provide any objection to the proposed transfer within at least 30 days of the customer's receipt of notice. (Given that almost all brokerage agreements can be terminated on short notice, a customer could at any time elect to terminate its account with the acquirer broker-dealer and transfer its account to a different broker-dealer.) By setting a deadline of at least 30 days, the parties in an M&A transaction can attain certainty regarding the length of time it may take to obtain the customer consents necessary to consummate the transaction. Negative consent would not be permitted if the terms of the agreement between the broker-dealer and the customer expressly require the customer's written consent for the assignment of the contract. In our experience, however, brokerage customer agreements do not normally require written consent for such purposes.

FINRA's Proposed Rule

In June 2015, FINRA proposed Rule 3260, which would codify certain of its prior guidance regarding the use of negative consents, including in the context of M&A transactions involving a broker-dealer. If adopted, Rule 3260 would permit a broker-dealer to rely on negative consents to effect a bulk transfer of customers' accounts when the broker-dealer is:

- divesting itself of a specific business line;
- merging with another broker-dealer; or
- being acquired by another broker-dealer.

If adopted, the rule would codify for the first time FINRA's guidance regarding the use of negative consent to transfer accounts in bulk.

Conditions for Use of the Negative Consent Procedure

30-Day Notice Requirement. Rule 3260 would require a broker-dealer relying on negative consent to send a notice to each affected customer at least 30 calendar days before it effects the bulk transfer. The notice would be required to contain the following elements:

- a brief description of the circumstances necessitating the transfer or change in broker-dealer of record;
- a statement that the customer has the right to object to the transfer or change, and the date by which the customer must respond if such objection is to be made (at least 30 calendar days after the letter is sent);
- information on how the customer can effectuate a transfer or change in broker-dealer of record to another firm;
- disclosure of any costs to the customer if the customer initiates a transfer of the account or change in broker-dealer of record after the account is moved or the broker-dealer of record has been changed; and
- a statement regarding the broker-dealer's compliance with SEC Regulation S-P (Privacy of Consumer Financial Information) in connection with the transfer or change in broker-dealer of record.

Prohibition Against Charging Transfer Fees. Rule 3260 would not permit a broker-dealer that utilizes a negative consent to charge a fee for the related transfer of a customer's account. In addition, the broker-dealer would be prohibited from charging a fee to a customer who, in response to receiving a notice, decides to move his or her account to another broker-dealer during the allowed opt-out period.

Special Requirements for Divestments of a Line of Business. If a broker-dealer is divesting itself of a specific business line, Rule 3260 would require the broker-dealer to provide a letter to FINRA (at least 30 days prior to sending customers the notice letter pursuant to which negative consent is sought), along with any legal agreements entered into with the receiving broker-dealer detailing the terms of the transfer of accounts.

Additionally, Rule 3260 would provide that, if the broker-dealer seeks to effect a bulk transfer of customers' accounts because of a divesture:

- the accounts can only be transferred to one introducing or clearing broker-dealer;
- the accounts subject to transfer must be currently held at a clearing broker-dealer that is a FINRA member, whether or not the transfer of the accounts will result in a change in clearing broker-dealer;
- the transfers cannot occur until there is a fully executed agreement between the divesting and receiving broker-dealer; and
- the transfers can only be to entities that are permitted, due to the nature of their registration with the appropriate regulatory authorities, to service the accounts transferred.

Transactions That Require Rule 1017 Applications

If a proposed divestiture, acquisition or merger requires one or more of the broker-dealer firms involved in the transaction to file an application with FINRA under NASD Rule 1017 (see *2015 Insights* article "Broker-Dealer M&A Transactions: Toward a More Accommodating Regulatory Process"), the application must be approved before the applicable firm sends the notice pursuant to which negative consent is sought under Rule 3260. The 30-day period described above would begin to run after the completion of the period required for Rule 1017 approval, and as a result, the total time for the approval of that application and the subsequent notice and waiting period for obtaining negative consent would be at least three months and as much as six months (or longer).

Conclusion

As M&A transactions involving broker-dealers become more frequent, participants in these transactions are placing greater emphasis on the rules governing the bulk transfer of customer accounts. Once implemented, Rule 3260 would provide participants with clear rules and expectations for the treatment of customer accounts in such transactions. We expect that these rules would ultimately enhance the efficiency of broker-dealer M&A by allowing participants to more accurately assess and more effectively plan for the execution risk and conditionality of such transactions.

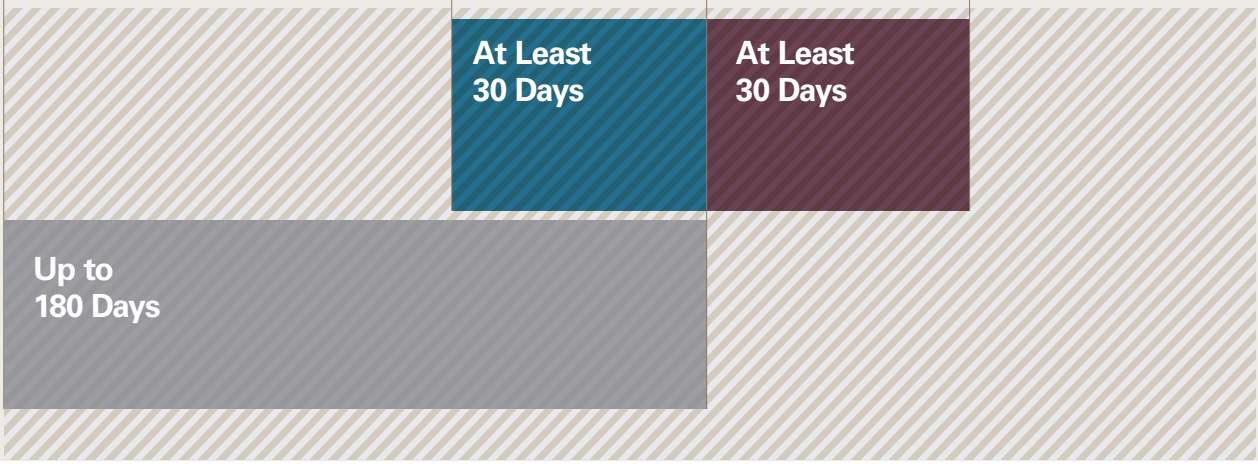
Timeline for Bulk Transfer Under Proposed Rule 3260

Rule 1017 Application Process
If a proposed transaction requires a broker-dealer firm to file an application under NASD Rule 1017, the application must be approved before any negative consent notice is sent to customers.

Notice to FINRA
Broker-dealer divesting itself of a specific business line is required to provide notice to FINRA at least 30 days before any negative consent notice is sent to customers.

Negative Consent Notice
Broker-dealer relying on negative consent is required to send a notice to each affected customer at least 30 days before the bulk transfer.

Bulk Transfer
Bulk transfer of customer accounts is permitted under Rule 3260.



Basel III Leverage Ratio Could Undermine Efforts to Address Systemic Risk in Derivatives Markets

Contributing Partner

Mark D. Young / Washington, D.C.

Counsel

Rachel Kaplan Reicher / Washington, D.C.

Associates

Prashina J. Gagoomal / New York

Elizabeth A. Mastrogiacomo / Washington, D.C.

Following the 2008 financial crisis, regulators across the globe have pondered how to ameliorate systemic risk in derivatives markets. At the 2009 G-20 summit, international regulators committed to address this risk through clearing and capital requirements for market participants. The implementation of a particular capital requirement known as the Basel III leverage ratio, however, may undermine derivatives clearing for clients of clearing firms that are banks subject to the leverage ratio (Clearing Firms). Coordinated regulatory intervention will be required to ensure the leverage ratio does not compromise derivatives clearing and the overarching objective of reducing systemic risk.

The Dodd-Frank Act implemented the G-20 commitment to clearing by requiring the clearing of certain standardized swaps through a regulated central counterparty or clearinghouse (CCP). The Commodity Futures Trading Commission (CFTC) has implemented the Dodd-Frank mandate by requiring most interest rate swaps and credit default index swaps to be cleared. In order to avoid counterparty credit risk, market participants also have elected increasingly to clear less-standardized swaps and other swaps that the CFTC has not required to be cleared. Today, about 75 percent of transactions in the markets that the CFTC oversees (which also include futures markets) are centrally cleared — an exponential increase from about 15 percent as of the end of 2007, according to testimony from CFTC Chairman Timothy G. Massad before a Senate committee in May 2015.

The Basel Committee on Banking Supervision (BCBS), an international regulatory body, addressed the G-20 commitment to strengthen bank capital requirements by promulgating a global framework that includes, among other initiatives, the Basel III leverage ratio. The ratio measures a bank's core capital (*e.g.*, equity capital and disclosed reserves) against an exposure standard that includes the bank's on- and off-balance sheet sources of leverage and its derivatives exposure. Under the minimum leverage ratio requirement set forth by the BCBS, a bank's core capital should be at least 3 percent of its total exposure. (The BCBS will revisit this requirement in 2017 at the latest.) This is intended to constrain the buildup of leverage in the banking sector and improve banks' ability to withstand stresses of the magnitude associated with the 2008 financial crisis.

Clearing Firms, their clients, CCPs and the CFTC have raised concerns regarding the manner in which the Basel III leverage ratio calculation takes into account a Clearing Firm's exposure from client clearing. In particular, the Basel III leverage ratio framework states that a Clearing Firm will "calculate its related leverage ratio exposure resulting from the guarantee [of its client's cleared derivative trade exposures to the CCP] as a derivative exposure … as if it had entered directly into the transactions with the client." If the leverage ratio framework treats a Clearing Firm as a direct party to the cleared derivative trade with its client, then the Clearing Firm's exposure would be greater than it would be as an intermediary and financial guarantor for that trade. For instance, by creating the legal fiction that the Clearing Firm is its client's counterparty, the leverage ratio framework would preclude the Clearing Firm from reducing its derivatives

exposure by the collateral (or performance bond) posted by the client. This would be the case even though such collateral is held by the relevant CCP (which is effectively the client's true counterparty) and is legally and operationally segregated and thus not available for the Clearing Firm to use as leverage.

As a result (albeit unintended) of the Basel III leverage ratio treatment of their exposure from client clearing services, Clearing Firms may need to hold more capital than they have available or reduce their leverage, or both. Faced with an increased capital requirement, Clearing Firms may pass capital costs to cleared derivatives clients, which might in turn forgo trading cleared derivatives. Clearing Firms also may have to off-board certain clients or, if costs become prohibitive, cease offering client clearing services altogether. At least for futures and certain standardized swaps, which must be cleared under U.S. law, a market participant's inability to access clearing services would effectively preclude that participant from entering into these products. Overall, the reduced availability of clearing services would run counter to the globally endorsed and Dodd-Frank-codified goal of promoting clearing to address systemic risk.

CFTC Chairman Massad recognizes this issue and is working toward a proposed solution. In a 2015 speech before the Institute of International Bankers, Chairman Massad stated in regard to the U.S. implementation of the Basel III leverage ratio: "I am concerned that the rule as written could have a significant, negative effect on clearing, which is obviously a key policy goal of the Dodd-Frank Act. I have spoken with my fellow regulators on this issue and our staffs are talking to see if there is a way to address these concerns."

We hope that in 2016 the CFTC, bank regulators and the BCBS will collaborate to resolve the unintended consequences of the leverage ratio in order to avoid discouraging (at best) the salutary effects of clearing.

Basel III Leverage Ratio
(3% minimum)*
*to be revisited by 2017

$$\text{Basel III Leverage Ratio} = \frac{\text{Tier 1 Capital}}{\text{Exposure Measure}}$$

Tier 1 capital includes a bank's equity capital and disclosed reserves, among other elements.

A bank's total exposure measure is the sum of the following exposures:

- **On-balance sheet exposures**
- **Derivative exposures**
  A bank's guarantee exposure arising from client clearing is treated as a derivative exposure, as if the bank had entered directly into the derivative transactions with the client
- **Securities financing transaction exposures**
- **Off-balance sheet items**

Published in 2014, the Basel III leverage ratio is not legally binding on any jurisdiction. Along with the rest of the Basel III framework, it forms a general basis for national (or regional) rulemaking, and the BCBS members have been promulgating implementing rules. Such rules have been issued in a majority of the jurisdictions that are members of the BCBS, including the United States and the European Union. However, the timing of phasing in certain rules, such as leverage and liquidity requirements, is not consistent across jurisdictions. The supplementary leverage ratio under the U.S. rules implementing Basel III will take effect January 1, 2018.

MiFID II Expected to Have Significant Impact on Investment Managers

Contributing Partner

Stephen G. Sims / London

Counsel

Patrick Brandt / London

When implemented, revisions to the EU's Markets in Financial Instruments Directive (MiFID II) will radically change the regulation of EU securities and derivatives markets, and significantly impact the investment management industry. MiFID II is expected to come into effect in or around January 2018, a year later than originally planned.

The current MiFID framework (MiFID I) imposes direct obligations on discretionary portfolio managers who manage segregated accounts. Many investment fund management entities such as UCITS (undertakings for the collective investment in transferable securities) management companies and alternative investment fund managers (AIFMs) fall outside the framework but are nevertheless indirectly impacted by MiFID I because they delegate portfolio management to MiFID-regulated firms and because some EU member states voluntarily "gold plate" national laws so as to impose MiFID requirements on non-MiFID firms. UCITS management companies and EU AIFMs also are governed by their own sets of directives.

The MiFID II framework will continue to apply directly to EU discretionary portfolio managers. It will be extended to apply to UCITS management companies and EU AIFMs who manage separate discretionary accounts, while UCITS companies and EU AIFMs acting as management companies will continue to be indirectly impacted. MiFID II also is expected to harmonize the EU's regulatory approach to non-EU investment managers.

EU-Based Discretionary Portfolio Managers

EU-based discretionary portfolio managers will need to plan for the following MiFID II regulatory challenges:

Investment Research. MiFID II will allow EU lawmakers to distinguish between permissible and impermissible third-party benefits to discretionary portfolio managers. There has been significant debate since the European Securities and Markets Authority (ESMA) proposed characterizing the investment research that brokers provide to discretionary portfolio managers as an impermissible nonmonetary benefit. It is not clear whether ESMA's proposals, which are not yet final draft laws, will be adopted given that the United Kingdom, France and Germany have jointly challenged ESMA's view. If ESMA's original proposals are adopted, discretionary portfolio managers may no longer be able to receive generic or (even) tailored investment research from brokers unless they pay for that research themselves, raise management charges to absorb the extra costs or, with client agreement, use research payment accounts that are funded in advance. It is widely believed that adoption of ESMA's original proposals would put pressure on smaller managers who may not be able to afford the research themselves, would result in discretionary portfolio managers being more selective in the investment research for which they pay, and would call into question the business models of some investment banking research desks. However, at the time of writing, it is expected that ESMA's original proposals will be watered down to a position slightly more palatable to the investment management industry.

Best Execution. MiFID I already requires MiFID investment firms to seek best execution for customer and portfolio orders, but MiFID II will raise the bar. Order execution policies will need to be amended to ensure that the factors used to choose trading venues are applied to more subcategories of financial instrument than the five used currently. Managers will need to provide greater transparency by publishing annually the top five execution venues used for each subclass of financial instrument they trade for managed portfolios. This

will require disclosure of information that currently is regarded as confidential: commercial relationships with execution brokers, a breakdown between passive and aggressive orders, conflicts of interest and execution venue fee arrangements. When combined with an expanded obligation to monitor execution quality, these new requirements will significantly increase compliance burdens.

Scope of Transaction Reporting Rules. In order to enable EU regulators to monitor transactions for potential market abuse, MiFID investment firms are currently required to report transactions in financial instruments admitted to trading on EU-regulated markets and related tradable assets such as derivatives, which have an underlying reportable instrument. MiFID I contains an exemption that was flexibly interpreted in the U.K. to allow managers to rely on sell-side EU MiFID firms to report on their behalf. Other EU jurisdictions determined that only the market-facing counterparty had the reporting obligation. MiFID II will increase the scope of reportable transactions to include financial instruments traded, or admitted to trading, on all EU trading venues, not just EU-regulated markets. Discretionary portfolio managers are potentially within this scope, because the reporting requirement will apply to both counterparties that are market-facing and those that are not. However, there will be a carve-out for "transmitting firms," such as portfolio managers who send orders to a broker for execution. That exemption, though, will apply only if the portfolio manager passes on specific transaction details and flags to the broker, and the broker also is an EU MiFID investment firm. This means that portfolio managers passing on trades to non-EU brokers or executing trades directly with a counterparty will need to report transactions to the relevant EU regulator. Transaction reporting itself will become more onerous because of an increase in the information that must be reported.

Transaction Recording Requirements. Discretionary portfolio managers also will need to comply with new, more burdensome transaction-recording requirements. This will be supplemented by a formal requirement that telephone conversations that lead to, or are likely to lead to, portfolio transactions be recorded.

Trade Transparency. MiFID II extends pretrade transparency requirements to nonequities and restricts trading venues' use of waivers from those requirements, both of which will impact investment managers' trading strategies. Although draft ESMA secondary legislation indicates that fewer bonds will be subject to pretrade transparency requirements than originally feared, credit fund managers nevertheless will need to identify how the requirements will affect the funds they manage. Post-trade transparency for over-the-counter transactions raises similar types of issues given the extension of scope to nonequities. The possibility remains that certain portfolio managers will themselves have new formal obligations to report trade details. Although those obligations may be outsourced, they still represent a new type of compliance burden for managers.

Product Governance. MiFID II will introduce a number of requirements that in broad terms will require fund distributors to identify target markets, ensure that funds are compatible with those markets and carry out regular reviews.

EU-Based Management Companies

MiFID II will apply directly to UCITS management companies and EU-based AIFMs when they manage separate discretionary portfolios. In those circumstances, management companies will need to comply with most MiFID II conduct of business requirements.

MiFID II also will indirectly impact the investment funds managed by UCITS management companies and EU-based AIFMs when they delegate portfolio management to a MiFID discretionary portfolio manager who is obliged to comply with MiFID II requirements. Management companies may benefit from MiFID II investor protection requirements (such as enhanced best execution and, if adopted, the unbundling of investment research from order execution). However, other measures such as trade transparency (which may impact orders executed for client portfolios) and restrictions on the distribution of complex UCITS will place indirect burdens.

Some EU jurisdictions will "gold plate" their regulatory requirements so that some MiFID-style requirements will be applied to management entities that fall outside MiFID scope. The U.K., for example, has in the past extended MiFID investor protection requirements to non-MiFID firms where considered appropriate to secure policy goals but has recently indicated a softening of that approach in stating that more onerous MiFID II transaction reporting requirements will not be extended to EU management companies when not performing MiFID investment services.

Finally, EU lawmakers may in due course seek to amend the UCITS directive as well as the AIFM directive so as to extend certain MiFID-style requirements to EU management companies.

Non-EU Discretionary Portfolio Managers

MiFID II will introduce new "third country" requirements for non-EU managers who wish to provide portfolio management investment services to EU investors. Generally, non-EU portfolio managers wanting to access retail investors will need to set up an EU branch that will be regulated essentially in the same way as other MiFID investment firms. In order to access professional clients, non-EU discretionary portfolio managers will have to register with ESMA (but are not required to set up a branch), assuming that regulatory equivalence and reciprocity determinations have been made by the European Commission. In the absence of such determinations, EU national rules will prevail, meaning that discretionary portfolio managers will need to ensure that they provide cross-border services in a way that does not infringe local EU member state licensing requirements. We expect that MiFID II will focus non-EU discretionary portfolio managers on how to access EU clients in a compliant manner, in a similar fashion to the way the Alternative Investment Fund Managers Directive focused non-EU management entities' minds on how to compliantly market funds to EU professional investors.

Bitcoins and the Blockchain: The CFTC Takes Notice of Virtual Currencies

Contributing Partner

Mark D. Young / Washington, D.C.

Of Counsel

Maureen A. Donley / Washington, D.C.

Counsel

Gary A. Rubin / Washington, D.C.

Associate

Theodore M. Kneller / Washington, D.C.

As interest in bitcoin derivatives has increased, the Commodity Futures Trading Commission (CFTC) has turned more of its attention toward virtual currencies. For a little more than a year, at least two trading facilities registered with the CFTC have offered bitcoin derivatives for trading in the United States. Another company plans to offer bitcoin derivatives on its platform and applied in 2014 to register a derivatives clearinghouse for bitcoin derivatives. More recently, the CFTC brought two enforcement actions related to bitcoin derivatives. In *In re Coinflip, Inc.*, it asserted jurisdiction over bitcoin-based derivatives contracts and shut down an unregistered facility offering bitcoin options; in *In re TeraExchange, LLC*, the CFTC issued a cease-and-desist order to a registered swap market called a SEF, for "swap execution facility," after finding that the SEF publicly claimed certain bitcoin trades represented actual market liquidity when the trades were in fact prearranged wash trades.

The CFTC also has taken notice of an innovative ledger system known as the "blockchain," which verifies and records all bitcoin transactions. In speeches in late 2015, CFTC Chairman Timothy G. Massad and Commissioner J. Christopher Giancarlo each commented on the potential impact of blockchain technology on financial ecosystems. The blockchain's impact on derivatives markets was a topic at a CFTC advisory committee meeting, which included a discussion of "smart futures contracts." As Commissioner Giancarlo observed, there are numerous potential innovations that may be possible with "smart derivatives" using blockchain technology, including contracts that "value themselves in real time, automatically calculate and perform margin payments and even terminate themselves in the event of a counterparty default."

Many industry observers predict that bitcoin or the blockchain will significantly disrupt existing financial market infrastructures and reshape traditional payment systems, transaction clearing and settlement services, derivatives markets, and other financial market processes that rely on third-party intermediaries. Tellingly, a number of exchanges and investment banks are investing heavily in research related to bitcoin and blockchain applications, according to press reports.

Susceptible to Manipulation?

Market participants should expect the CFTC's interest in and scrutiny of bitcoin spot markets to grow as more CFTC-registered trading facilities self-certify bitcoin derivatives contracts for trading. In particular, one should expect the CFTC to focus on whether particular bitcoin derivatives that are listed for trading are not readily susceptible to manipulation — a statutory requirement under the Commodity Exchange Act (CEA) applicable to all CFTC-registered trading facilities.

TeraExchange's self-certification of its bitcoin derivatives illustrates the CFTC's interest. TeraExchange's bitcoin contract is a nondeliverable U.S. dollar/bitcoin forward that is cash-settled in dollars to the bitcoin spot price. CFTC staff questioned TeraExchange's initial proposal for a settlement index because it included too few price inputs. In response, TeraExchange developed its own proprietary index based on a volume-weighted average of bitcoin spot market transactions from multiple bitcoin exchanges. The CFTC staff ultimately did not object to TeraExchange self-certifying the bitcoin contract that settled to the new index.

In similar contexts, the CFTC has aggressively investigated and brought enforcement actions related to manipulation of indices comprising spot market transactions. In this regard, the CFTC's recent settlements with multiple investment banks related to the World Market/Reuters foreign currency exchange

What Are Bitcoins?

Bitcoins are digital assets that can be used as a medium of exchange to purchase goods and services and can be electronically transferred, stored or traded.

Unlike traditional coins or bills, notes or coupons, or even tokens, bitcoins do not exist outside the blockchain. The blockchain exclusively records how many bitcoins exist and who owns them.

Bitcoins are not legal tender, they are not pegged to any fiat currency and no government backs them.

Bitcoin transactions differ from transactions involving traditional money, which rely on trusted third parties like banks to stand between the involved parties. In a traditional transaction, a bank, which maintains its own internal ledger of deposits, transfers, payments and withdrawals, provides certainty to the seller that the buyer has sufficient money for the transaction. The bank then records the transfer of that money from the buyer to the seller and ensures that the buyer cannot use that same money in a subsequent transaction. Bitcoin transactions do not involve a trusted third party but instead rely on mathematical cryptography to create a secure and accurate public ledger.

Every bitcoin transaction is recorded on the blockchain, a decentralized computer-based ledger that is distributed across multiple network nodes that are owned by no one person or institution. The owners of each of these nodes contribute computing power to run cryptographic math functions that verify and record transactions on the blockchain — a process referred to as "mining." The process of mining causes new bitcoins to come into existence on the blockchain, and the miners are incentivized to continue mining with these new bitcoins. The blockchain maintains a secure transaction history and record of ownership as bitcoins are transferred from one party to the next.

(FX) benchmark serves as a warning to bitcoin market participants. These settlements demonstrate that the CFTC will investigate alleged attempts to manipulate an index used to settle derivatives contracts, even if the conduct is limited to trading in the underlying commodity itself, which is outside the CFTC's jurisdiction for nearly all other purposes. Therefore, as the bitcoin derivatives market grows, we may see CFTC investigations focused on activity in the bitcoin spot market and any impact on bitcoin price indices, even though the CFTC's jurisdiction is largely limited to derivatives on bitcoin.

An 'Exempt' Rather Than 'Excluded' Commodity

In its recent order shutting down *Coinflip*'s unregistered bitcoin options trading platform, the CFTC shed light for the first time on how it classifies virtual currencies under the CEA. Whether bitcoin should be regulated as a currency or other form of property is a question that has vexed many U.S. regulators. (See September 30, 2015, Skadden client alert "CFTC Asserts Jurisdiction in Bitcoin Markets.") The CFTC concluded in *Coinflip* that bitcoin and other virtual currencies are "commodities," but, consistent with other federal regulators, the CFTC's order did not conclude bitcoin was a "currency" within the meaning of the CEA.

Many had wondered whether the CFTC would classify bitcoin as a currency, which is enumerated in the CEA definition of "excluded commodity" (and includes most financial commodities such as interest rates, exchange rates and currencies). Transactions in currency are eligible for exemptions from most CFTC regulations if offered in the form of FX swaps

or FX forwards between nonretail counterparties. Furthermore, retail customers are prohibited from engaging in off-exchange derivatives transactions except for FX transactions with certain financial institutions such as retail foreign exchange dealers, futures commission merchants, broker-dealers and banks. Off-exchange FX transactions generally are considered to be subject to lighter regulation than transactions executed on a CFTC-registered designated contract market (*i.e.*, futures exchange).

Whether intentional or not, the CFTC's legal analysis in the *Coinflip* settlement order implies that bitcoin and other virtual currencies are "exempt commodities" (defined as "a commodity that is not an excluded commodity or agricultural commodity" that includes metals, energy and weather events). Categorizing bitcoin as an exempt commodity would preclude bitcoin operators from relying on regulatory exemptions for certain FX transactions under the CEA. In its analysis, the CFTC notes that Coinflip's bitcoin options were illegal in part because they could not rely on the "trade option exemption." Such exemption is only available to options on exempt or agricultural commodities (not excluded commodities such as currencies). Notably, the CFTC made no mention of the trade option exemption's inapplicability to excluded commodities when it concluded that Coinflip could not claim the exemption. Instead, the CFTC concluded that Coinflip could not rely on the trade option exemption because participants on Coinflip's platform did not satisfy the exemption's requirement that the option buyer be a commercial user of bitcoin.

The *Coinflip* order clearly suggests that a bitcoin option could satisfy the trade option exemption if the option buyer was a commercial bitcoin user, and therefore, bitcoin could only be an exempt commodity. This conclusion has other implications as well. Commercial users of bitcoin (*e.g.*, retailers that accept bitcoin as payment, participants on the blockchain network that mine bitcoins or bitcoin merchants) could claim the trade option exemption. Similarly, as an exempt commodity, forward contracts that result in delivery of bitcoin between commercial market participants could be excluded from the CEA and CFTC jurisdiction.

Conclusion

As long as interest in bitcoin derivatives persists, the CFTC is likely to continue to regulate them actively. Bitcoin market participants should be aware that the CFTC could assert itself on a number of fronts that have only an indirect relationship to bitcoin derivatives. Furthermore, the CFTC is likely to be presented with fresh challenges as new applications for blockchain technology are developed. Many already have speculated that the blockchain could be adapted to significantly enhance efficiencies in collecting margin and collateral on derivatives and for clearing and settling securities transactions. As with any type of innovative technology, bitcoin derivatives and blockchain applications have the potential to test both the industry and the CFTC in the coming years.

Developments in Oversight of Virtual Currency Businesses

Virtual currency businesses saw increased oversight by U.S. regulators in 2015, and continued interest by federal and state authorities is expected as regulation evolves. Two recent developments in this arena are particularly noteworthy.

In May 2015, the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) took its first civil enforcement action against a virtual currency exchanger when it assessed a $700,000 penalty against Ripple Labs Inc. and its wholly owned subsidiary, XRP II, LLC. FinCEN's assessment stemmed from Ripple Labs' acting as a money service business and settling its virtual currency without registering with FinCEN, and failing to implement and maintain an adequate anti-money laundering (AML) program. In the action, FinCEN pointed to guidance it issued in March 2013 clarifying that Bank Secrecy Act requirements apply to certain virtual currency businesses.

In June 2015, the New York State Department of Financial Services (NYDFS) unveiled its long-awaited virtual currency licensing regime, the "BitLicense." The BitLicense framework, which NYDFS called "the first comprehensive framework for regulating digital currency firms," is intended by NYDFS to protect consumers and reduce the risk that virtual currency businesses will be used for illicit activities, particularly money laundering. In establishing this regime, NYDFS' regulations impose specific AML and cybersecurity requirements, among others. NYDFS approved its first BitLicense in September 2015; as of October 2015, it had received 25 applications.

Virtual currency businesses can expect continued interest by federal and state regulators in 2016 as the use of, and investment in, virtual currency grows.

Contributing Partners

Jamie L. Boucher / Washington, D.C.

William J. Sweet, Jr. / Washington, D.C.

Counsel

Eytan J. Fisch / Washington, D.C.

Associate

James E. Perry / Washington, D.C.

US Enforcement Authorities Tighten Post-Settlement Scrutiny of Financial Institutions

Contributing Partners

Jamie L. Boucher / Washington, D.C.

William J. Sweet, Jr. / Washington, D.C.

Counsel

Eytan J. Fisch / Washington, D.C.

Associate

Lindsey F. Randall / Washington, D.C.

Last year, financial institutions continued to settle in record numbers with federal and state criminal and civil authorities in areas including benchmark interest rate manipulation, economic sanctions and anti-money laundering compliance. While each settlement is unique, U.S. authorities have made it universally clear that a settlement should not be viewed as the end of the road. In addition to paying significant fines and sometimes pleading guilty, financial institutions have been required to enter into increasingly more stringent and often costly post-settlement commitments.

Two enforcement trends in 2015 are particularly notable and likely to continue. First, although financial institutions have historically been required to maintain and enhance their compliance programs as a condition of settlement, U.S. authorities have increased their post-settlement oversight. In many of its recent settlements, the New York State Department of Financial Services (NYDFS) has required the settling institution to engage an independent monitor or consultant for a term of one or more years to review the institution's compliance policies and practices, make recommendations, oversee implementation of those recommendations and regularly report back to NYDFS. Similarly, civil and criminal authorities increasingly require institutions to file regular reports detailing the remedial steps taken to ensure ongoing compliance with the agreement.

Second, U.S. authorities are requiring greater cooperation and more self-reporting of potential violations. Federal and state criminal authorities traditionally have required ongoing cooperation from the institution, although more fulsome cooperation and self-reporting are now expected, and the length of time such cooperation is required often is longer. Other agencies also are following suit. The Federal Reserve now regularly makes clear in its orders that it expects ongoing cooperation from the institution with investigations into whether separate actions against employees are appropriate.

Failure to comply with post-settlement commitments could have serious legal consequences for the institution, including prosecution, additional monetary penalties and extensions of the terms of the settlement agreement. Financial institutions have already faced such consequences, and we expect to see further scrutiny in these areas in 2016.

Banking Regulators Increasingly Assert Jurisdiction Beyond Financial Institutions

Contributing Partners

Joseph L. Barloon / Washington, D.C.

Brian D. Christiansen / Washington, D.C.

Stuart D. Levi / New York

Federal and state banking regulators have broad and largely discretionary supervisory and enforcement powers over the financial institutions they regulate, which include banks and their affiliates. Key regulators in this area include the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Consumer Financial Protection Bureau and state banking authorities, such as the New York State Department of Financial Services. Over the past several years, these regulators have increasingly applied their examination and enforcement powers to companies that do business with regulated financial institutions. Targets have included technology and other service providers, consultants, law firms and marketing companies. We expect this trend to continue in 2016.

Banking regulators employ a number of tools to examine or bring enforcement action against otherwise unregulated service providers and business partners of regulated financial institutions. Regulators have asserted direct jurisdiction based on provisions in several old and new statutes, including the Bank Service Company Act; the Financial Institutions Reform, Recovery and Enforcement Act of 1989; and Title X of the Dodd-Frank Act. Regulators also have leveraged their substantial direct power over banks as a tool to oversee the companies that do business with them. For example, banking regulators have issued guidance on third-party relationships that directs banks to include certain provisions in their contracts with service providers, including that the banking regulator may access and examine the service provider's conduct of activities for the bank.

The bank regulatory regime has become, and will remain, an important consideration for companies that enter into service contracts and other business partnerships with regulated financial institutions.

CFTC Aims to Lower the Bar on Proving Manipulation in Pending Cases

Contributing Partner

Mark D. Young / Washington, D.C.

Of Counsel

Maureen A. Donley / Washington, D.C.

Counsel

Gary A. Rubin / Washington, D.C.

Chad E. Silverman / New York

Associate

Theodore M. Kneller / Washington, D.C.

In two separate Commodity Futures Trading Commission (CFTC) enforcement actions before district courts in New York and Chicago, the CFTC has asked each court to adopt holdings that would significantly enhance the CFTC's ability to win price-manipulation cases by diminishing the elements it must prove to establish a violation. Market participants are closely watching *CFTC v. Wilson & DRW Investments*, filed in New York, and *CFTC v. Kraft Foods Group, Inc.*, filed in Illinois. The parties have fully briefed the issues in *DRW*, and the court is expected to rule in the coming year. On December 18, 2015, the *Kraft* court declined to adopt the CFTC's most expansive interpretation of its price-manipulation authority but also declined to grant the defendant's motion to dismiss.

Lowering the Traditional Bar to Proving Manipulation

The Commodity Exchange Act (CEA) prohibits manipulation and attempted manipulation of the price of a commodity. Under precedents stretching back 40 years, in order to prove price manipulation, the CFTC must show the defendant specifically intended to cause an artificial price — that is, a price that does not reflect the legitimate forces of supply and demand. The CFTC has always chafed at that high bar, and its arguments in *DRW* and *Kraft* seek to lower it. In *DRW* (and in some recent CFTC settlement orders), the CFTC has attempted to lop off the artificial-price component at least for purposes of proving an attempted manipulation. And in *Kraft*, the CFTC has invoked new Rule 180.1 to try to circumvent both the artificial-price and the specific-intent elements of proof for manipulative trading.

CFTC v. Wilson & DRW Investments

In *DRW*, the CFTC charged the defendants with attempting to manipulate and manipulating the settlement price of an interest rate future. The CFTC moved for summary judgment on its attempted-price-manipulation claim, arguing in its brief that it need only prove that the defendants: (i) intended to affect the price of a commodity (but not to create an artificial price) and (ii) took an overt act in furtherance of that intent. The CFTC cited numerous statements from DRW's general counsel, who, according to the CFTC, admitted that DRW placed bids intending to move the settlement rate to reflect DRW's view of "fair value."

DRW countered that the CFTC's statement of the law — that it need only prove an intent to affect price — contradicts U.S. Court of Appeals for the Second Circuit precedent and the CFTC's own prior administrative decisions. DRW contended that the CFTC must prove the same intent standard for both attempted and completed manipulation: that a defendant "specifically intended to create an artificial price." DRW asserted that attempting to trade at the best available price with the intent to reflect fair value cannot be construed as an intent to create an artificial price and cannot form the basis of a manipulation claim.

In addition to the *DRW* complaint, several recent CFTC administrative orders finding manipulative intent have relied heavily on traders' statements related to trading to affect price — even if not to an artificial level. The *DRW* court could follow suit and uphold the CFTC's recent efforts to lower the manipulation bar or reaffirm that artificial price is a necessary element of a claim for attempted price manipulation.

CFTC v. Kraft Foods Group, Inc.

In *Kraft*, the CFTC charged Kraft with attempting to manipulate and manipulating wheat prices, and with violating new CFTC Rule 180.1. The Dodd-Frank Act, which authorizes the CFTC to promulgate Rule 180.1, amended the CEA

to prohibit "employ[ing] … any manipulative or deceptive device or contrivance." Rule 180.1, which mirrors Securities and Exchange Commission (SEC) Rule 10b-5, prohibits anyone from "intentionally or recklessly" using or employing any manipulative device, scheme or artifice to defraud.

Before *Kraft*, the CFTC had primarily used Rule 180.1 as an anti-fraud tool. When the CFTC adopted Rule 180.1 in 2011, however, it specifically said that the rule does not require the CFTC to prove specific intent or that an artificial price existed in order to establish a violation. In other words, the CFTC also views Rule 180.1 as an anti-manipulation enforcement tool that does not require satisfaction of the traditional elements of price manipulation. In *Kraft*, the CFTC is testing that view.

The CFTC alleged that Kraft violated Rule 180.1 through a scheme to use the futures market to affect prices in the cash wheat market to Kraft's benefit. According to the CFTC, Kraft established an "enormous" wheat futures position and appeared to stand for delivery on its futures contracts, even though it never intended to take delivery because the grade of wheat was unsuitable for Kraft's purposes. The CFTC alleged that Kraft instead established its futures position to cause wheat spot prices to decline, intending that, as other market participants perceived that Kraft would satisfy its significant demand for wheat in the futures market, the apparent reduction in demand in the cash market would cause spot prices to fall.

Kraft moved to dismiss the CFTC's complaint, arguing that the CFTC's adopting release interprets Rule 180.1 only to "prohibit fraud and fraud-based manipulations" consistent with the jurisprudence under SEC Rule 10b-5. Kraft argued that the CFTC did not allege a scheme to defraud but merely alleged an open market transaction to purchase wheat at the best available price. According to Kraft, to state a claim for a CEA violation, the CFTC must allege either: (i) fraud (as under Rule 10b-5) or (ii) a specific intent to create an artificial price (as under traditional price manipulation), but the CFTC cannot shoehorn a price-manipulation claim into Rule 180.1 without a fraud allegation.

In its answering brief, the CFTC argued that the phrase in Rule 180.1 prohibiting "any manipulative device, scheme, or artifice to defraud" separately prohibits (i) manipulative devices and (ii) deceptive devices (artifices to defraud), but that only claims for the latter sound in fraud. The CFTC argued that its manipulation claim against Kraft is "premised on [its] abuse of its market power" — establishing an "enormous" futures position and standing for delivery.

In ruling on the motion to dismiss, the court agreed with Kraft that Rule 180.1 "prohibit[s] only fraudulent conduct." The court rejected the CFTC's assertion that the statutory authority for Rule 180.1 — prohibiting "manipulative or deceptive devices" — should be read to prohibit manipulative conduct in the absence of fraud. Instead, the court held the CFTC is required to meet the heightened pleading standard for fraud claims. Nevertheless, the court denied the defendant's motion to dismiss after finding that the CFTC's complaint, when construed in the light most favorable to the CFTC, adequately alleged a plausible violation of Rule 180.1 under the heightened pleading standards.

Despite rejecting the CFTC's argument that would have permitted the CFTC to use Rule 180.1 to establish manipulative trading in the absence of fraud without having to prove either specific intent or creation of an artificial price, the court broadly construed the types of schemes that may be considered fraudulent. It observed that fraud-based manipulation could include traditional fraud by misrepresentation or omission or, alternatively, by fraudulent manipulation (*i.e.*, deceiving market participants by artificially affecting prices through open-market transactions). The court found the CFTC's pleading sufficiently alleged fraudulent manipulation, as Kraft established a "huge" futures position intended to signal the company's demand in a way that would "mislead" other market participants into thinking that Kraft would take delivery in the futures market, causing cash wheat prices to fall. As the *Kraft* case proceeds, the CFTC may attempt to construe the court's articulation of fraudulent manipulations as another way to avoid the traditional elements of proof for manipulative trading.

Iran Sanctions Changes Will Impact Foreign Financial Institutions in 2016

Contributing Partners

Jamie L. Boucher / Washington, D.C.

William J. Sweet, Jr. / Washington, D.C.

Counsel

Eytan J. Fisch / Washington, D.C.

Associate

Katherine Nakazono / Washington, D.C.

Editor's note: This article includes news developments through January 18, 2016. For a comprehensive update on the Iran sanctions relief, see our January 28, 2016, client alert available at skadden.com.

The historic agreement that the P5+1 (the United States, the United Kingdom, France, China, Russia and Germany) and the European Union reached with Iran on July 14, 2015, which came into effect January 16, 2016, will uniquely affect non-U.S. financial institutions. In recent years, such institutions have been the focal point of U.S. efforts to increase sanctions pressure on Iran, and the present easing of U.S. secondary sanctions provides measured relief for foreign financial institutions and other foreign companies engaged in certain activities involving Iran. Still, the U.S. embargo on Iran remains very much in place, and the vast majority of transactions involving Iran continue to be prohibited for U.S. persons.

The easing now means that non-U.S. financial institutions will be able to engage in certain business with Iran, including many Iranian financial institutions, without the threat of secondary sanctions. Some secondary sanctions risks persist, and restrictions applicable to U.S. persons remain largely unchanged, so non-U.S. financial institutions must approach their potential business with Iran with caution and diligence.

The Agreement. As discussed in our July 23, 2015, client alert, the agreement provides Iran with phased relief from United Nations, United States and European Union nuclear-related sanctions in exchange for technical steps Iran takes. U.N., U.S. and EU sanctions relief was to begin on "Implementation Day," if and when the International Atomic Energy Agency verified that Iran had taken specific actions set out in the agreement. Implementation Day occurred on January 16, 2016, and the United States is carrying out its relief by terminating select executive orders issued by the president, committing not to exercise certain discretionary authorities, waiving specific statutory provisions and issuing certain licenses.

Secondary Sanctions Relief. The vast majority of U.S. sanctions relief provided under the agreement affects only "secondary sanctions," a set of measures that targets foreign banks and other foreign companies engaged in certain activities involving Iran. The U.S. embargo on Iran remains in place, with only limited openings created by the agreement for U.S. individuals and entities.

The U.S. secondary sanctions that were lifted on Implementation Day include those with respect to financial activities conducted by non-U.S. financial institutions, such as: transactions with specific individuals and entities, including the Central Bank of Iran, most Iranian financial institutions and certain other important Iranian commercial actors (such as the National Iranian Oil Company and the Islamic Republic of Iran Shipping Lines); transactions in the Iranian rial; and the provision of U.S. banknotes to the government of Iran.

In addition, non-U.S. financial messaging service providers are now allowed to readmit delisted Iranian financial institutions to their networks without exposure to secondary sanctions. Secondary sanctions on financial transactions in support of certain trade activities (*e.g.*, energy, automotive, shipping, shipbuilding and precious metals) have also been suspended.

Pursuant to a general license issued by the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) on Implementation Day, non-U.S. financial institutions that are owned or controlled by U.S. persons and are established or maintained out of the United States are now permitted, with certain exceptions, to engage in these activities subject to sanctions relief.

Secondary Sanctions Risks Expected to Remain. Significantly, much of the U.S. secondary sanctions architecture, including statutes such as

the Comprehensive Iran Sanctions, Accountability and Divestment Act of 2010 and the Iran Freedom and Counter-Proliferation Act of 2012, remains in place. As a result, non-U.S. financial institutions that engage in significant transactions with Iranian individuals and entities that remain on the OFAC List of Specially Designated Nationals and Blocked Persons (SDN List) continue to risk losing access to dollar-clearing through U.S. financial institutions. While many significant commercial enterprises in Iran were removed from the SDN List on Implementation Day, certain Iranian banks and other entities — such as Bank Saderat and Khatam al-Anbiya — remain listed and are not scheduled for removal by OFAC as part of the agreement. The likelihood that additional Iranian individuals and entities will be added to the SDN List continues, particularly as U.S. sanctions on Iran related to terrorism or human rights generally are not affected by the agreement. Indeed, on January 17, 2016, OFAC designated 11 entities and individuals involved in procurement on behalf of Iran's ballistic missile program.

No Return of the U-Turn. Since the agreement does not significantly change the sanctions landscape for U.S. persons, most transactions involving Iran remain prohibited for U.S. persons. Until November 2008, a general license permitted U.S. financial institutions to clear "U-turn" transactions, *i.e.*, Iranian U.S. dollar transactions that began and ended with a non-U.S. and non-Iranian financial institution. Many observers wondered whether the U-turn general license would be reinstated as part of the U.S. sanctions relief under the agreement, but the U.S. Department of the Treasury publicly sought to dispel that prospect ahead of Implementation Day, and no accommodation was made to allow U-turn transactions on Implementation Day. Transactions involving Iran processed by or through U.S. financial institutions will continue to present a risk of sanctions violation for non-U.S. financial institutions and could result in civil or criminal penalties.

Possibility of Sanctions Snapback. Any member of the P5+1 retains the ability to snap back U.N. sanctions if it deems Iran is not meeting the terms of the agreement. Similarly, the president can re-impose suspended U.S. sanctions if Iranian obligations are not met. To ensure compliance, it will be important for non-U.S. financial institutions to closely monitor the specific contours of the relief and observe the progress of the relief as it is phased in.

US Economic Sanctions: New List-Based Programs

Contributing Partners

Jamie L. Boucher / Washington, D.C.

William J. Sweet, Jr. / Washington, D.C.

Counsel

Eytan J. Fisch / Washington, D.C.

Associate

Joseph M. Sandman / Washington, D.C.

While economic sanctions against Iran, Russia and Cuba have dominated the headlines over the past year, sanctions remain a dynamic component of U.S. foreign policy on other fronts. In 2015, President Barack Obama issued three executive orders that established new list-based sanctions programs: one related to the political and human rights situation in Venezuela, another targeting actors behind the violence in Burundi and a third intended as a new tool to combat threats posed by malicious cyber actors. The Venezuela sanctions implement, and expand upon, the Venezuela Defense of Human Rights and Civil Society Act of 2014.

Each of the three new sanctions programs targets specific individuals and entities engaged in enumerated activities. Unlike U.S. sanctions imposed on Crimea, Cuba, Iran, Sudan and Syria, the executive orders issued with respect to Venezuela and Burundi do not impose broad sanctions. To date, seven individuals have been listed under the Venezuela program and eight under the Burundi program. Any entity that is 50 percent or more owned, whether individually or in the aggregate, directly or indirectly, by one or more sanctioned persons also is subject to the same sanctions, even if the entity is not itself listed. No individual or entity has yet been included in the cyber sanctions program.

Also in 2015, in response to improvements in the political situation in Liberia, President Obama terminated the sanctions program put in place in 2004 with respect to the actions and policies of former Liberian President Charles Taylor.

The executive branch continues to use economic sanctions as an agile and active tool to advance specific foreign policy goals. We expect this approach to continue in the coming year.

CFPB Pursues Aggressive Enforcement Agenda and Arbitration Restrictions

Contributing Partners

Joseph L. Barloon / Washington, D.C.

Anand S. Raman / Washington, D.C.

Counsel

Austin K. Brown / Washington, D.C.

Darren M. Welch / Washington, D.C.

Associate

Neepa K. Mehta / Washington, D.C.

In 2015, the Consumer Financial Protection Bureau (CFPB) continued to aggressively enforce federal consumer protection laws across a broad spectrum of consumer financial products and services. Additionally, the CFPB took a significant step toward proposing a ban on arbitration clauses that would preclude consumers from being able to file class action lawsuits. Together, these actions demonstrate the increased scrutiny of consumer compliance for providers of consumer financial products and services.

CFPB Enforcement Actions

Last year, the CFPB initiated more than 50 enforcement actions, reaching settlements in most of those cases for a total of over $1.6 billion in compensation to consumers (more than $30 million per settlement, on average) as well as approximately $190 million in civil penalties.

The CFPB's enforcement program has relied most heavily on its authority to enforce the Dodd-Frank Act prohibition on unfair, deceptive, or abusive acts or practices. The CFPB has used this authority to bring actions relating to credit reporting and consumer information, debt collection, ancillary products, payday lending, student lending, mortgage marketing and other areas.

Fair lending is another enforcement hot spot, with the CFPB bringing enforcement actions relating to indirect auto finance and mortgage redlining. In June 2015, the U.S. Supreme Court upheld the disputed "disparate impact" theory of liability under the Fair Housing Act in the case of *Texas Department of Housing & Community Affairs v. Inclusive Communities Project, Inc.* while also articulating limits on application of the disparate impact theory. The *Inclusive Communities* decision has no doubt emboldened the CFPB and other regulators to aggressively pursue disparate impact cases under the federal fair lending laws, including the Equal Credit Opportunity Act. Accordingly, we expect to see increased fair lending enforcement in 2016.

Arbitration Restrictions Proposed

On October 7, 2015, the CFPB published a long-awaited "potential rulemaking" on predispute arbitration agreements that would effectively ban arbitration clauses in any consumer financial products or services if those clauses would prevent class action cases. The potential rulemaking is the latest and most substantive step in a three-year review that the CFPB has undertaken with respect to arbitration agreements.

The CFPB's announcement of potential rulemaking relating to arbitration agreements is not unexpected in light of its public scrutiny of arbitration agreements over the past few years. In March 2015, the CFPB published a study, required by the Dodd-Frank Act, concluding that arbitration agreements are a substantial barrier to pursuing claims on a class action basis and that consumers benefit far more from class actions than from arbitrations.

The CFPB stopped short of banning arbitration agreements altogether. In particular, the potential rulemaking proposes to accomplish the following:

1. Arbitration agreements that preclude consumers from participating in a class action lawsuit would be prohibited, reflecting the CFPB's view that consumers may benefit from class actions; and

2. Consumer financial companies that use arbitration agreements with consumers would be required to give the CFPB copies of claims filed and awards issued in any arbitration. The CFPB may publish the claims and awards on its website.

The CFPB will gather feedback on its proposal from a small-business review panel process and likely will issue a formal proposed rule in 2016. If the regulations are finalized as expected, many companies will need to make significant changes to their business practices and will encounter increased compliance burdens and costs. The impact of a ban on arbitration would be widespread: The prohibition would apply to many products that the CFPB regulates, including credit cards, checking and deposit accounts, prepaid cards, money transfer services, certain auto loans, auto title loans, small dollar or payday loans, private student loans and installment loans.

We expect that a number of industry and consumer groups will file comments once the rule is formally proposed, and any final CFPB rule restricting arbitration provisions may lead to a showdown at the Supreme Court. In recent years, the Court has issued a number of decisions upholding arbitration provisions, quashing attempts by numerous states and lower courts to limit or prohibit consumer contract arbitration agreements. The Court's most recent decision upholding such arbitration provisions, *DIRECTV, Inc. v. Imburgia* on December 14, 2015, elicited a strong dissent by Justice Ruth Bader Ginsburg, who relied on the CFPB's arbitration study in arguing that "take-it-or-leave-it arbitration agreements mandating arbitration and banning class procedures" have harmed consumers.

Conclusion

In light of the CFPB's recent enforcement activity and anticipated rulemaking restricting arbitration agreements, consumer financial services companies would be well-advised to review consumer complaints as well as their policies and procedures to proactively address practices that may present enhanced risk of enforcement or consumer litigation.

Limited English Proficiency: An Emerging Compliance Risk

How consumer financial services providers can meet the needs of a growing population of "limited English proficiency" (LEP) consumers without running afoul of laws prohibiting deceptive practices and discrimination has emerged as a significant industry compliance concern for the Consumer Financial Protection Bureau (CFPB) and bank regulators.

In the last two years, the CFPB entered into two consent orders with lenders stemming from LEP issues. One of those actions alleged that a lender excluded Spanish-speaking customers from debt repayment and settlement offers, and the other alleged deceptive telemarketing of ancillary products to Spanish-speaking consumers. In an April 2015 Fair Lending Report, the CFPB also encouraged lenders to "provide assistance to LEP individuals in order to increase access to credit and to reach out to the Bureau with ideas of how to promote access."

Compliance risks relating to LEP include both fair lending issues, where consumers may be treated differently based on their language abilities or preferences (which are likely to be considered proxies for ethnicity or national origin); and unfair, deceptive, or abusive acts or practices risks, particularly where a company communicates through marketing or offers customer service in a foreign language but requires that documents be filled out in English.

The risks associated with LEP policies and procedures can vary significantly depending on the product, market area, reliance on third parties and other fact-specific considerations. Consequently, there is no one-size-fits-all approach for effectively mitigating LEP risk.

Contributing Partners

Joseph L. Barloon / Washington, D.C.

Anand S. Raman / Washington, D.C.

Counsel

Austin K. Brown / Washington, D.C.

Darren M. Welch / Washington, D.C.

Regulatory Developments

Opportunities and challenges persist for businesses in heavily regulated industries. Many government agencies are tightening rules and increasing enforcement activity, creating new risks and altering existing business models. Understanding the latest rules and the current regulatory environment is key for companies in these industries.

The upcoming spectrum auction will be one of the most complicated undertakings the FCC has ever attempted.

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A recent trend in labor and employment law is the expansion of the definition of employees.

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Consistent themes are emerging from regulators as to what constitutes cybersecurity best practices.

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A new law alters how the IRS treats partnerships for U.S. tax purposes.

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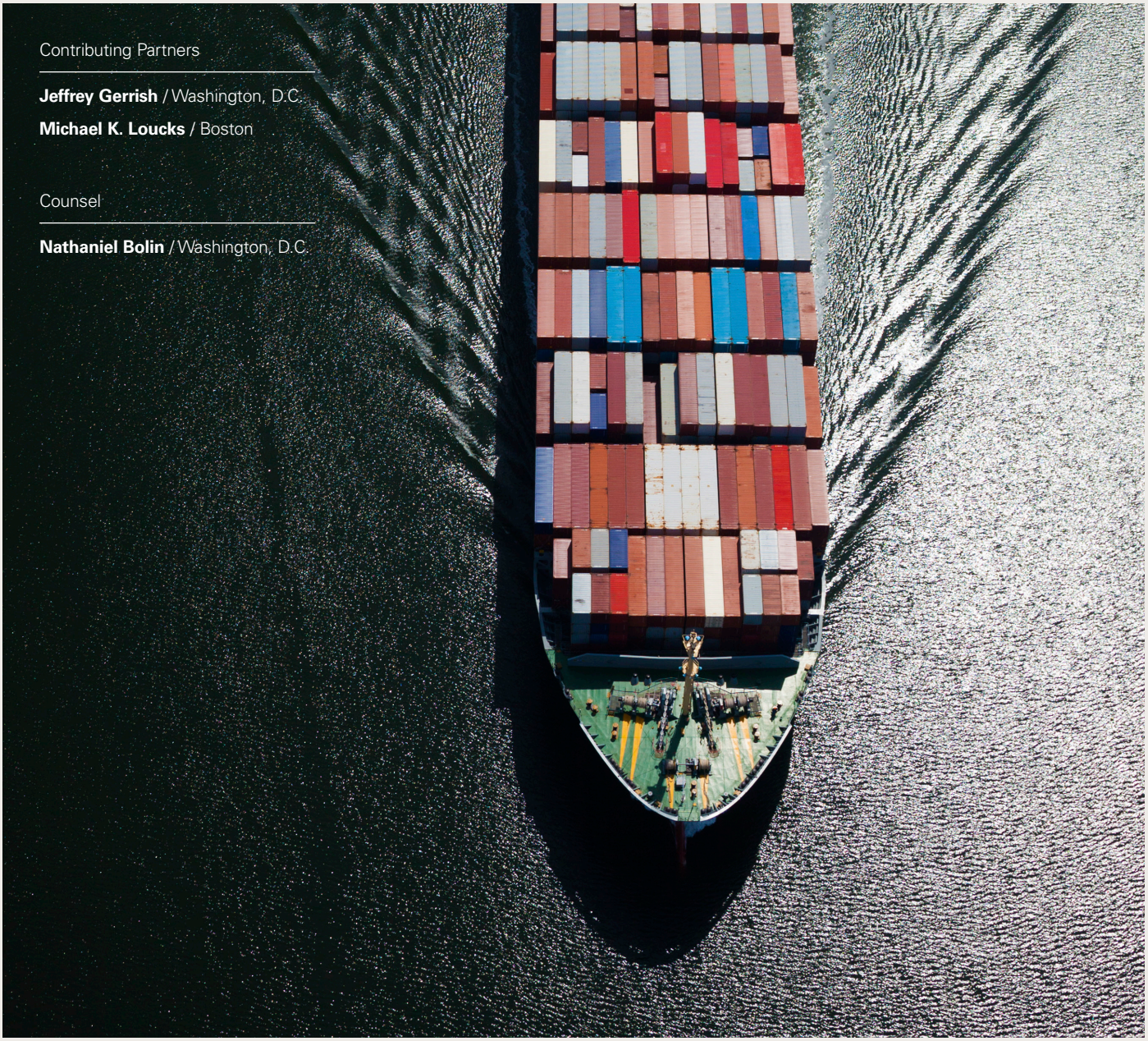
Insights Conversations:

Developments in US Export Controls



Contributing Partners

Jeffrey Gerrish / Washington, D.C.

Michael K. Loucks / Boston

Counsel

Nathaniel Bolin / Washington, D.C.

The U.S. export control system has undergone major reform in recent years, and companies have experienced both increased enforcement of export control laws and fines for violations, with more changes on the way. Skadden partners Jeff Gerrish and Mike Loucks and counsel Nate Bolin discuss developments in export control laws and how companies can stay ahead of the changes.

What are export controls and how do they affect companies?

Mike: The U.S. has a thicket of laws and regulations applicable to exports to a broad array of countries. These include not only countries that are subject to comprehensive embargoes, such as Iran, Syria and Cuba, but also close U.S. allies and countries such as China that are substantial trading partners. Accordingly, all companies that export products, technology, technical data or services must be cognizant of the rules, as violations, depending on intent, can result in criminal prosecutions of the business and of specific employees. Over the past decade, the U.S. Department of Justice (DOJ) has substantially increased its resources to prosecute export control violations; businesses that have been prosecuted range from defense contractors to transportation companies to banks. The need to comply with export control laws and regulations arises not only when companies are exporting, re-exporting, and transferring controlled items and services, but also when they acquire companies that are engaged in such activities. This is a complex arena with different federal enforcers than the norm, including the U.S. Departments of Commerce and State, as well as the DOJ.

In 2009, the Obama administration began reviewing the system and implementing changes to make it more efficient. These have been described as some of the most far-reaching changes since the end of the Cold War. Where does this process stand today?

Jeff: The process can be divided into three phases. Phase I laid the regulatory ground rules for the reform process, consistent with congressional notification requirements. In Phase II, the two main export control agencies — the Department of State's Directorate of Defense Trade Controls (DDTC) and the Department of Commerce's Bureau of Industry and Security (BIS) — are cooperating to revise the lists of items each agency controls. Phase II is nearly complete. Phase III, which has not yet begun, will involve a transition to a single control list, a single licensing agency, a unified information technology backbone for licensing and compliance, and more closely coordinated enforcement.

Nate: One goal of this reform effort was to facilitate U.S. companies' engagement and trade with our NATO and other allies by moving certain items from the U.S. Munitions List (USML), which covers defense articles and defense services controlled by the International Traffic in Arms Regulations (ITAR), to the somewhat less restrictive Commerce Control List (CCL) under the Export Administration Regulations (EAR), which govern mainly items with both civilian and military applications (so-called "dual-use" items). The idea was to reduce the licensing burden on U.S. exporters and rationalize the system. Previously, certain fairly

Phases of Reform

Phase 1
Laid regulatory ground rules for the reform process

Phase 2
The two main export control agencies cooperate to revise the lists of items each agency controls

Phase 3
Transition to a single controls list, single licensing agency, unified information technology backbone for licensing and compliance, more closely coordinated enforcement

run-of-the-mill components like aircraft tires were on the USML, forcing companies to get an ITAR license in order to export those to, say, our NATO allies' air forces around the world.

Another goal of the reform is to place tighter controls around the so-called crown jewels in the U.S. defense industry and critical technologies for our national security. So in Phase II of the reform, we have seen enhancements to those controls and enforcement efforts related to certain critical national defense items, as well as controls being imposed or clarified on cutting-edge materials and techniques such as nanotechnology materials and 3-D-printable technology. And finally, the agencies recently have begun talking in more detail about their plans to move toward having a single licensing and enforcement agency that can handle both the defense articles and services under ITAR and the dual-use and other articles under the EAR. The public likely will be asked to comment on at least some of these plans in a proposed rulemaking in the near future.

What trends in enforcement actions and penalties are you seeing?

Mike: In the last two years, there have been prosecutions across the country of defense contractors, optical systems manufacturers, foreign manufacturers and major financial institutions for conducting financial transactions related to export control violations. These cases have been related to illegal exports to various countries. There were a couple of Chinese nationals who were prosecuted for exporting sensors. One was in the U.S. on a student visa and was enlisted by his brother to acquire the sensors under the guise that he planned to use them at a U.S. university where he was a graduate microbiology student. Another company was prosecuted for essentially lying about where its production took place. It stated that it made products in the U.S. but was in fact sending the technical data and samples of the military articles to plants in China to be made there, then importing them into the U.S. to sell to customers here, including Department of Defense prime contractors. Another prosecution stemmed from a company called Robbins & Myers' acquiring a Belgian subsidiary. In a routine check, an auditor spotted that the Belgian subsidiary had been shipping a particular controlled item to a customer in Syria. The auditor kicked it upstairs to management, but the practice continued for a while, with the Belgian subsidiary hiding the transactions to Syria with fake documents.

Jeff: Criminal penalties can be severe, potentially reaching $1 million for a single transaction and resulting in up to 20 years' imprisonment for individuals. Additionally, each event or other action can be charged as a separate offense, so these penalties can quickly get up into the tens and hundreds of millions of dollars. There also is the possibility of losing export privileges, which can be the most severe penalty of all for companies relying on exports. Violators also can be subject to denial orders that prevent other U.S. persons from doing business with them and be debarred from federal government contracting. Of course, there is always the possibility of reputational damage and *qui tam* lawsuits against such companies.

Are individual company employees subject to criminal prosecution?

Mike: The short and clear answer is yes, and clients should expect, given the recent issuance of the Yates memorandum by the deputy attorney general, that in any investigation of an alleged violation of the export control laws, the DOJ will strongly consider whether any individual corporate employee should be prosecuted.

At the outset, Mike mentioned that companies also can run into violations when acquiring another company. What should be considered when evaluating a target for acquisition?

Nate: Because there is successor liability for past export control violations, you should learn everything you can about a target's track record in this area, including the target's business lines and the products that the company manufactures.

Sometimes companies may unwittingly have become manufacturers, exporters or brokers of defense articles or other controlled articles or technology. For example, a software startup may rely on high-level encryption for its software products but, because it didn't know better, never have gotten around to applying for export licenses. Similarly, a company may be making defense articles or defense services but be unaware of the ITAR registration and licensing requirements. A fundamental understanding of the business lines and how the company has been operating over the applicable statute of limitations period, which is five years, is critical.

Jeff: The U.S. government enforcement agencies take the position that it doesn't matter whether it's a merger or asset purchase. In their view, as long as there is substantial continuity of the business, successor liability can be imposed. A classic example is the 2002 Sigma-Aldrich case, in which there was an asset purchase of a company that had committed export control violations. BIS took the position that successor liability applied, and the case was ultimately settled for $1.76 million. DDTC also takes the position that successor liability applies in the ITAR context. Here, the classic case is Hughes Space and Communications, which settled charges of violating the U.S. arms embargo against China. The Hughes assets were subsequently sold several times, and the purchasers were required to pay the remaining unpaid amounts of the $32 million settlement.

So from the perspective of U.S. enforcement authorities, even if a company has gone through a merger, acquisition or asset purchase, that isn't going to eliminate liability for past violations. Regardless of the type of investment or transaction, export control issues and compliance with the export control laws need to be addressed appropriately in purchase agreements and through representations, warranties and indemnification provisions. They have to, in some circumstances, be factored into your valuation decisions. And you may even have to simply walk away from a transaction.

What should companies governed by export laws do when they learn of a potential violation? Should they make a voluntary disclosure?

Jeff: First, such companies need to stop the conduct that is the source of the potential violation. They then need to make sure they preserve all the relevant documents and records, put a legal hold on them and get an investigation going. At that point, they have to decide whether to make a voluntary disclosure or not.

If it turns out that there was a violation and the company decides to disclose it, they want to be in a position to say, "We did something about this right away." Also, if a voluntary disclosure is made, it needs to be accurate and complete. BIS has indicated that it gives great weight to voluntary disclosures as a mitigating factor. However, if a voluntary disclosure is not accurate and complete, most, if not all, of the benefit of that mitigating factor will be lost, and the problem could be exacerbated by an inaccurate or false statement in the voluntary disclosure that could lead to additional violations.

An effective compliance program is key to addressing weaknesses before they become violations. It's an obvious point, but compliance policies can't just sit on a shelf. Regular training is critical because changes in this area are frequent. Also, it's not enough to do spot checks on an ad hoc basis. If you don't conduct regular audits, there's no way of knowing if your policies and procedures are working until it's too late.

What do you see in the short-term future for export control reform?

Jeff: The Obama administration has devoted an enormous amount of resources and time to this issue, and they are going to want to get as much done as possible in the president's last year in office. We may see some accelerated activity in areas like proposed and final rules on the remaining USML categories. Companies should be reviewing their licenses and registrations and updating their procedures and policies, given all the changes that have occurred on the licensing front. Lastly, it's important for companies to track agency efforts to update and improve regulations and weigh in on issues that are relevant to what they do.

This discussion is taken from the October 22, 2015, Skadden webinar "The Latest Developments in US Export Controls: Export Control Reform and Compliance Strategies."

Criminal penalties can be severe, potentially reaching $1 million for a single transaction and resulting in up to 20 years' imprisonment for individuals.

CFIUS Trends Inform Cross-Border Activity

Contributing Partner

Ivan A. Schlager / Washington, D.C.

Counsel

John M. Beahn / Washington, D.C.

Jonathan M. Gafni / Washington, D.C.

Malcolm Tuesley / Washington, D.C.

Associates

Joshua F. Gruenspecht / Washington, D.C.

John P. Kabealo / Washington, D.C.

In a reflection of current M&A activity, Committee on Foreign Investment in the United States (CFIUS) cases have shifted in their geographic and industry focuses over the years, from the United Kingdom and other locations to China, and to information and communications technologies (ICT) and related services.

Careful due diligence, advance planning and a proactive approach to the CFIUS process will be vital to the success of cross-border investments targeting U.S. businesses.

2015 Highlights

Some of the most publicized CFIUS-approved transactions of 2015 included the acquisition of the Waldorf-Astoria New York Hotel and Towers by China's Anbang Insurance, the acquisition of Freescale Semiconductor by the Netherlands' NXP, and the acquisition of telecommunications equipment vendor Alcatel-Lucent by Finland's Nokia. These transactions attracted attention for reasons including size, structure and prominence of the target assets, but they also reflect the emerging trends within CFIUS described below.

Shifts in Caseload and Geographic Focus

CFIUS' caseload generally has tracked the level of mergers and acquisitions activity in the marketplace. However, the caseload represents only a fraction of cross-border M&A activity, reflecting the fact that participation in the CFIUS process is mainly voluntary.

Another indication of the broader M&A market is the origin of CFIUS cases. For several years through 2011, acquirers in the United Kingdom, Canada, France and Israel led CFIUS' caseload. In recent years, however, the geography of CFIUS has changed; the United Kingdom has been the source of fewer cases, while in 2012, China leapfrogged other countries to become the leading originator of CFIUS-reviewed transactions. Japan, a consistent source of CFIUS-reviewed transactions over the years, also became more active in 2013, the most recent year for which we have official statistics. Based on our direct experience, we believe CFIUS' caseload in 2015 was close to, if not greater than, the level reported for 2007, which was CFIUS' second-busiest year in the past two decades. We also expect that when CFIUS statistics for 2015 become available, China will again be the leading source of transactions reviewed by CFIUS.

However, even before this geographic shift, another notable change in CFIUS' caseload was becoming apparent: Starting in 2009, a consistently greater percentage of CFIUS cases (nearly 40 percent from 2009 to 2012, and 49 percent in 2013) were not completed within the initial 30-day review period and required second-stage investigations of up to 45 additional days. The implication for participants in cross-border M&A is that it would be imprudent to budget fewer than 75 days, plus preparation time, for the process.

The complexity of acquired businesses and the security issues implicated by their technology and services likely have contributed to an increase in second-stage investigations by CFIUS.

Growing Attention on ICT Transactions

Part of the increase in CFIUS' use of second-stage investigations may be the number of acquisitions of companies providing ICT and related services. CFIUS has had to develop an understanding of the technologies, services and applications in each of these cases and find the tools to mitigate any related national security risks. Meanwhile, data breaches and cybersecurity issues associated with ICT and communications services have attracted greater government and public attention. The complexity of the acquired businesses and the security issues implicated by their technologies and services likely contributed to the number of CFIUS cases requiring second-stage investigations.

Nevertheless, CFIUS has allowed an increasing number of these transactions to move forward. In 2013, it cleared the acquisition of one of the main four telecommunications carriers, Sprint Nextel, by Japan's SoftBank. In 2014, CFIUS permitted the acquisition of Alcatel-Lucent's enterprise business by China Huaxin Post and Telecommunications, in the first major telecommunications acquisition by a Chinese entity. In 2015, CFIUS cleared the acquisition by Nokia of Alcatel-Lucent.

The semiconductor industry, years ago the impetus behind the 1988 enactment of the Exon-Florio amendment to the Defense Production Act of 1950, has returned as a focus of CFIUS cases in recent years. This reflects significant M&A activity in the sector generally, augmented by new Chinese government policy and resources aimed at acquiring integrated circuit technologies. In 2015 alone, CFIUS reviewed and cleared foreign acquisitions of Broadcom, Freescale, OmniVision and Integrated Silicon Solution. Reviews of similar transactions can be expected in 2016 and beyond.

Communications: 2016 Could Be Defining Year for Net Neutrality, Spectrum Auction

Contributing Partners

Ivan A. Schlager / Washington, D.C.

Cliff Sloan / Washington, D.C.

Counsel

John M. Beahn / Washington, D.C.

Associates

Joshua F. Gruenspecht / Washington, D.C.

David H. Pawlik / Washington, D.C.

Last year, the Federal Communications Commission (FCC) closed in on two historic accomplishments. After years of laying the groundwork, the FCC issued its net neutrality regulations as well as final rules and opening bid prices for the upcoming broadcast television incentive spectrum auction. While both items could put the FCC on a path to significantly expand its regulatory reach and role in U.S. technology development, each could encounter serious setbacks early in the year.

Net Neutrality

The 10-year debate over network neutrality — a policy that would prohibit telecommunications providers from blocking, degrading or discriminating against legal content flowing through their networks — culminated in early 2015 when the FCC issued its long-awaited net neutrality regulations. Forced to revisit the issue after federal appeals courts overturned its two prior attempts, the FCC adopted sweeping regulations that, if allowed to stand, will have far-reaching implications for the media, content, broadband and Internet industries.

The new regulations include a number of specific rules applicable to providers of broadband Internet access services, including strict prohibitions on blocking or degrading lawful traffic and restrictions against paid prioritization of lawful traffic. In addition, the regulations include a catch-all conduct rule that prohibits broadband providers from unreasonably interfering with or disadvantaging end users or "edge providers" (*e.g.*, certain online service providers) with respect to Internet content, traffic or applications.

The most contentious aspect of the FCC's net neutrality proceeding, however, was the reclassification of broadband services as "telecommunications services" under the Communications Act of 1934 (known as Title II). Reclassification under Title II is significant, as it expands the FCC's authority to broadband services not previously subject to its jurisdiction, including Internet edge providers, streaming services, and "Internet of Things" devices and services.

Challengers quickly appealed the regulations to federal court, claiming that the FCC lacked the statutory authority to issue the rules and reclassify broadband services under Title II. They also argued that the FCC failed to provide sufficient advance notice of the sweeping regulations it ultimately enacted. The Court of Appeals for the District of Columbia Circuit heard oral arguments in December 2015, during which the three-judge panel vigorously questioned the FCC's regulations, particularly the extension of Title II requirements to broadband services. The panel also debated the FCC's prohibitions on blocking or degrading lawful Internet traffic. The panel could approve the regulations or overturn them in whole or in part and remand the issue to the FCC for further review. A final ruling is not likely for several months and could be subject to further judicial review, including by the U.S. Supreme Court.

Broadcast Incentive Spectrum Auction

While the broadcast incentive spectrum auction did not garner the same headlines as net neutrality, the FCC took important steps last year to prepare for the March 2016 auction, which could be one of the most influential actions in the FCC's history. In the auction, the FCC will attempt to recover spectrum from broadcasters in exchange for incentive payments and then auction any recovered

spectrum for wireless services. A successful auction could reap upward of $60 billion to $80 billion in proceeds and shape the wireless and broadcast industries for decades by providing carriers with the spectrum necessary to deploy next-generation networks with greater capacity and speeds. Well-funded new entrants also may view it as an opportunity to acquire spectrum to offer innovative wireless broadband services. The broadcast TV industry could be similarly reshaped, as widespread participation by station owners could lead to the transition of many free over-the-air broadcast services to narrower digital channels (or, conversely, to their demise).

In October 2015, the FCC released the opening bid prices for the spectrum, which in top markets generally range between $100 million and $400 million for each TV station's spectrum, with the highest opening bid of $900 million offered for one broadcaster's spectrum in New York City. On the issue of whether to reserve a certain amount of spectrum for bidders other than AT&T and Verizon Wireless, the FCC opted to set aside up to 30 MHz in certain markets exclusively for smaller carriers in order to promote competition. While some of these carriers, including T-Mobile, had asked the FCC to reserve more spectrum, the fact that the FCC decided to create a reserve at all has been viewed by many as a significant victory for smaller carriers.

The FCC has been preparing for the auction, which will be one of the most complicated undertakings it has ever attempted, for nearly four years. FCC Chairman Tom Wheeler has acknowledged that the auction could fail to generate the anticipated proceeds; broadcasters could ultimately decide not to part with their spectrum; or wireless carriers could view the costs as excessive in light of the brutal competition now playing out in the marketplace. Whatever the outcome, the auction will be one of the most closely watched FCC actions in history.

Emerging Trends in Privacy and Cybersecurity

Contributing Partner

Stuart D. Levi / New York

Entering 2016, the relentless stream of cyberattacks continues unabated, having become a "business as usual" reality to which companies must adapt. All companies, regardless of size or industry, are potential targets, and the pool of attackers is expanding. Below is an overview of the key themes that emerged this year and what we expect to see in 2016.

Best Practices for Cybersecurity Preparedness

In 2015, a number of regulators, including the Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE), issued guidance and alerts about cybersecurity preparedness. The good news for companies, whether regulated or not, is that consistent themes are emerging as to what constitutes best practices. They include:

- **Conducting a Risk Assessment.** Cybersecurity preparedness needs to start with assessing the company's risks and designing a plan that addresses those risks.
- **Strong Governance.** A cybersecurity plan must involve the active participation of senior management, and where applicable, the board.
- **Data Access.** Employees should be able to access only the data they require, with appropriate authentication steps.
- **Training.** Many attacks prey on employees who may unknowingly surrender their passwords or click on malware links. Regular employee training on cybersecurity is therefore critical.
- **Vendor Management.** Attacks are often launched through a third-party vendor that has access to the company's system for business purposes. Companies must have robust cybersecurity requirements for vendors.
- **Incident Response Plan.** All companies should have incident response plans to deal with cyberattacks and run tabletop exercises to walk through different scenarios.
- **Cyber Insurance.** Cyber insurance is emerging as an important component of any risk mitigation strategy.
- **Information Sharing.** Companies across multiple industries have begun to appreciate that sharing cyberthreat information and best practices with their competitors is a critical tool to reduce risks. The White House has been encouraging this practice, and in February 2015, President Barack Obama issued an executive order encouraging the development and formation of Information Sharing and Analysis Organizations. We expect these efforts to greatly expand in 2016, and all companies should consider joining an information-sharing group in their industry.

Outlook on Legislation

As in previous years over the past decade, Congress attempted to enact various privacy or cybersecurity legislation. These initiatives were expected to gain more traction following President Obama's release of a number of proposed bills in January 2015, including a federal data breach notification law and information-sharing legislation. However, the only piece of legislation that was enacted was the Cybersecurity Act of 2015, a bill that made it through Congress at the end of the year as part of the 2016 omnibus spending bill. The act creates

a voluntary framework for real-time sharing of "cyber threat indicators" and "defensive measures" and provides liability protections and an antitrust exemption for such sharing. We do not anticipate any other meaningful additional privacy or cybersecurity legislation being enacted in 2016. Indeed, state attorneys general responded to widespread calls for a federal data breach notification law by urging Congress to preserve state authority in this area. Such a federal law will probably continue to be discussed but is unlikely to pass in 2016.

The Role of the FTC

The Federal Trade Commission (FTC) has long been the most active regulator in the areas of privacy and cybersecurity. In 2015, the FTC won a significant victory when the U.S. Court of Appeals for the Third Circuit held in the *Wyndham* case that the agency has authority to deem a company's cybersecurity practices unfair under Section 5 the FTC Act, and that companies had fair notice as to what practices could violate that section. However, as the year drew to a close, the FTC was handed a defeat when its own administrative law judge held in the *LabMD* case that the FTC must show more than the mere "possibility" of harm from a cybersecurity incident in order to sustain a Section 5 case. Despite this setback, we anticipate that the FTC will remain highly active in this area, and that companies should be familiar with the types of cases the FTC is bringing in order to understand the issues on which the agency is focused.

EU Emerges as a Force to Be Reckoned With

Although the European Union has had a robust privacy regime for close to 20 years, the impact on U.S. companies has been relatively limited. A dramatic shift in this equation occurred this year. In December 2015, the EU announced completion of a new General Data Protection Regulation (GDPR), which will replace and significantly broaden the current EU Data Protection Directive. The GDPR is widely expected to be approved in early 2016 and go into effect two years later. The impact on any company doing business with European residents — even if not situated in Europe — will be significant.

The expanding impact of the EU was also felt two months earlier, when the Court of Justice of the European Union invalidated the U.S.-EU Safe Harbor framework on which thousands of companies had relied to send personal data from the EU to the U.S. The court also empowered local data protection authorities to decide for themselves whether personal information was being protected by international agreements. These developments suggest a far more activist European privacy regime than had been in place — one that could have a significant impact on global commerce in 2016 and beyond.

Class Action Lawsuits Must Remain Part of a Company's Risk Calculus

Most data breaches result in multiple class action lawsuits against the victim company. The gating issue has been whether the plaintiffs' alleged injury is sufficiently concrete and imminent to establish Article III standing, especially since these plaintiffs often have not suffered any monetary loss or other tangible injury. Cases from the past year offered little clarity on this issue. For example, in June 2015, in the *Zappos* litigation, a Nevada district court held, as have many other courts, that the possibility that a "credible threat may occur at some point in the future" is insufficient to confer standing. However, the U.S. Court of Appeals for the Seventh Circuit adopted a more lenient position, finding standing in the *Neiman Marcus* case because the presumed purpose of the theft of personal information was to make fraudulent charges or engage in identity theft, and plaintiffs should not be required to wait until such harm occurs. The decision by the Seventh Circuit and other courts that have found standing may further incentivize plaintiffs' counsel to bring class action lawsuits. The potential for such suits should therefore be part of the risk calculus of any company that collects or processes personal information.

Financial Relationships Likely to Be a Focus in Life Sciences Enforcement and Litigation

Contributing Partners

John T. Bentivoglio / Washington, D.C.

Jennifer L. Bragg / Washington, D.C.

Michael K. Loucks / Boston

Gregory M. Luce / Washington, D.C.

Counsel

Maya P. Florence / Boston

Alexandra M. Gorman / Boston

For more than a decade, the Department of Justice (DOJ) has zealously pursued enforcement actions against the health care industry. Given the continued growth in government spending on health care and the billions of dollars in revenue that are paid to the federal government as a result of these cases, we expect this focus to continue. Nevertheless, in recent years we have seen a notable shift in the types of cases that the government is pursuing, away from so-called off-label promotion practices and toward the financial and commercial relationships between health care providers and companies.

In 2016, we expect DOJ to continue focusing on financial relationships with physicians and that recent DOJ guidance may spur an increased effort to hold individuals criminally and civilly responsible in these investigations. Additionally, the unrelenting flow of *qui tam* lawsuits means federal enforcement agencies will continue to investigate allegations that providers and others submitted false claims for payments to federal health care programs.

Historically, federal criminal and civil investigations have focused on the following types of alleged conduct:

- claims submitted for a service, drug or device that was not medically necessary;
- a health care professional prescribing a service, drug or device based on inducements the manufacturer provided;
- a hospital, managed care organization or pharmaceutical benefit manager including a product on its formulary because of a manufacturer's inducement;
- claims submitted for a drug or device that was promoted for off-label use and where the physician would not have prescribed the product but for that off-label promotion; and
- claims paid for a drug or device based on false or misleading information provided in connection with reimbursement support services.

Financial Relationships With Physicians and Other Health Care Professionals

As in past years, DOJ continues to actively investigate life science companies' financial relationships with physicians and other health care professionals, with particular focus on speaker programs. At least two of the significant pharmaceutical or medical device settlements in 2015 involved allegations of improper inducements through these programs. Of note, the allegations in these cases stretched beyond the question of whether the programs were conducted in exchange for payment and also focused on whether their nature, quality and content were of adequate value for the payment made. Given the likely continued government scrutiny of these relationships, many companies are choosing to enhance their assessments of their speaker programs.

Cooperation and Focus on Individuals

In September 2015, Deputy Attorney General Sally Quillian Yates issued a memorandum (Yates Memorandum) outlining six "steps" prosecutors are required to take when investigating a company, in order to ascertain whether there are responsible individuals who also should be charged. While the

DOJ continues to actively investigate life science companies' financial relationships with physicians and other health care professionals, with particular focus on speaker programs.

prosecution of individuals is not new, the Yates Memorandum suggests that DOJ is now going further, for example by directing prosecutors to withhold all cooperation credit unless corporations provide all relevant facts about individual(s) involved in alleged corporate misconduct. Recent indictments also demonstrate that DOJ's approach to prosecuting individuals is evolving, for instance by charging individuals with securities fraud in addition to violations of the Food, Drug and Cosmetic Act. It remains to be seen how the Yates Memorandum will affect prosecutors' charging decisions, but it may portend an uptick in prosecutions of individuals, something DOJ and the Food and Drug Administration (FDA) have long threatened. (See "Aggressive Government Enforcement Continues: How Will Individual Prosecutions Impact Activity Against Institutions?")

The Slow Demise of Truthful, Nonmisleading Off-Label Promotion Prosecutions

Despite public statements to the contrary, the court decisions in *United States v. Caronia* and *Amarin Pharma, Inc. v. United States Food & Drug Administration* appear to have had some impact on DOJ's pursuit of off-label enforcement in cases where there is no evidence of false or misleading statements by a manufacturer. In *Caronia*, the U.S. Court of Appeals for the Second Circuit ruled in 2012 that restricting off-label marketing that was not misleading or untruthful would violate the First Amendment. Following that decision, *Amarin* sought an injunction specifically allowing off-label promotion, and in August 2015 the district court granted it, ruling that Amarin's statements were truthful and not misleading and thus protected by the First Amendment. (See September 28, 2015, Skadden client alert "The Future of Government Regulation, Enforcement of Off-Label Promotion.") Unless and until other circuits reject the *Caronia* holding, *Amarin* may substantially limit FDA's ability to prohibit truthful and nonmisleading speech outside a product's approved labeling. In addition, there likely will be a steady flow of litigation similar to *Amarin* until FDA issues guidance to the industry that demonstrates its commitment not to engage in regulatory or enforcement actions that necessarily or consequently abridge manufacturers' First Amendment rights. To avoid direct First Amendment challenges, DOJ likely will direct its efforts toward cases with evidence of false and misleading statements. We also expect DOJ and FDA will closely examine a company's conduct rather than its marketing designed to promote a product for an unapproved use.

*For additional information on health care enforcement and litigation trends in the United States and beyond, read "*Getting The Deal Through: Healthcare Enforcement & Litigation*."*

A New World for Joint Employers

Contributing Partner

John P. Furfaro / New York

Counsel

Risa M. Salins / New York

A recent trend in labor and employment law is the increase in entities found responsible as employers and the simultaneous expansion of the definition of employees. This is manifesting itself through a new test for joint employer status, potentially impacting franchisors in particular, as well as through restrictions on the use of independent contractors, which likely will have significant implications for the "on-demand" economy. (See "Restrictions on Use of Independent Contractors.")

Upending years of precedent, the August 2015 ruling by the National Labor Relations Board (NLRB) in *Browning-Ferris Industries of California, Inc.* vastly expanded the definition of a "joint employer" under the National Labor Relations Act (NLRA). Previously, joint employment required an actual exercise of direct and immediate control over workers. Following *Browning-Ferris*, joint employment may exist where an entity has indirect control over the workers, or even where the entity has the right to control the workers but does not exercise that right. *Browning-Ferris* makes it significantly more likely that businesses engaging contractors or staffing agencies to supply workers will be considered joint employers under the NLRA and therefore potentially responsible for unfair labor practices and collective bargaining obligations regarding employees of a separate employer. Moreover, the NLRB's ruling may have far-reaching effects beyond the unionized workplace as the Department of Labor (DOL) and the Equal Employment Opportunity Commission (EEOC) also consider the joint employer standard in light of *Browning-Ferris*.

Browning-Ferris involved the relationship a Browning-Ferris Industries (BFI) recycling plant had with staffing agency employees (sorters, housekeepers and screen cleaners) that it subcontracted from Leadpoint Business Services. The case arose when the International Brotherhood of Teamsters, Local 350, which was the certified representative of a unit of BFI employees, petitioned to represent the Leadpoint employees, naming both Leadpoint and BFI as joint employers. Under the NLRB's pre-*Browning-Ferris* joint employer standard, which was applied for three decades, a business was a joint employer only if it affected employment relationship matters such as hiring, firing, discipline and supervision. The essential element in this analysis was whether a putative joint employer had direct and immediate control over employment matters. Applying this standard, the NLRB regional director found Leadpoint was the sole employer and directed an election because, among other things, BFI had no direct control over the employees' recruitment, hiring, discipline or termination, and BFI did not directly supervise the employees or set their pay rates.

On review, the NLRB's three-member majority, citing "changing economic circumstances, particularly the recent dramatic growth in contingent employment relationships," decided to restate the NLRB's legal standard for joint employer determinations. The NLRB announced that the joint employer inquiry should not be limited to "directly and immediately" exercised control. Instead, a putative joint employer may be liable if it "reserve[s] authority to control terms and conditions of employment," regardless of whether such control is exercised. The NLRB also stated that direct control and "control exercised indirectly — such as through an intermediary — may establish joint-employer status." Under this new standard, the NLRB found that BFI was a joint employer with Leadpoint because, among other factors, the parties' contract allowed BFI to reject any worker that Leadpoint referred to its facility; BFI managers provided Leadpoint employees with work direction; BFI specified the number of workers that it required, set the timing of work shifts and decided when overtime would be necessary; and under the parties' contract, Leadpoint was barred from paying its employees more than any BFI employee performing the same

work. The NLRB recognized that the parties' "cost-plus" contract, through which BFI reimbursed Leadpoint for labor costs plus a certain percentage markup, did not establish joint employer status alone. However, the NLRB stated that it could support a joint employer finding when it coupled the contract with the ceiling on Leadpoint pay.

Businesses in every industry sector are potentially affected by the *Browning-Ferris* ruling, including those that previously structured their business arrangements with the understanding that absent direct control, the entity would not be a joint employer under the NLRA. As the two-member dissent in *Browning-Ferris* cautioned, "the number of contractual relationships now potentially encompassed within the majority's new standard appears to be virtually unlimited." The dissent listed several examples, including any company that negotiates specific quality or product requirements with contractors; any company that grants access to its facilities for a contractor to perform services there and then regulates the contractor's access to the property; and businesses that dictate times, manner and some methods of performance of contractors.

Browning-Ferris left franchisors with great uncertainty as to how the NLRB's new joint employer test applies to franchising. After all, the very basis of franchising is required adherence to franchisor standards. However, NLRB Chairman Mark Gaston Pearce and Member Philip A. Miscimarra recently stated that the application of joint employer liability on the franchise system is an issue that still has to be considered by the NLRB. In *McDonald's USA LLC*, the franchisor for the McDonald's franchise system is currently battling the NLRB about whether it is a joint employer of its franchisees' employees. The decision on that question is hotly anticipated.

The NLRB's expanded concept of a joint employer may be adopted by other government agencies. The Fair Labor Standards Act, Title VII of the Civil Rights Act of 1964, the Americans With Disabilities Act and the Age Discrimination in Employment Act all have been interpreted to impose joint employer liability. Those statutes, however, have required the exercise of direct control over employees' day-to-day activities for joint employer liability to attach. The NLRB's new *Browning-Ferris*

Restrictions on Use of Independent Contractors

In recent years, the "on-demand" economy, an industry built on apps that instantly connect customers with services performed by independent contractors, such as drivers and delivery workers, has thrived. However, regulatory battles that could force many on-demand companies to convert their independent contractors to employees threaten the model on which these businesses are based and put all companies that rely on services of independent contractors at risk.

A number of federal and state government agencies, led by the Department of Labor (DOL), are heavily invested in restricting the use of independent contractors and increasing the number of workers classified as employees. Some jurisdictions have limited application of the traditional "right to control" test, which looks primarily to the degree of control exerted or retained by the company to determine if a worker is an employee. Many courts have relied on a more expansive "economic realities" test, which looks at multiple factors including whether the work is integral to the business, the worker's opportunity for profit and loss, the relative investments of the company and worker, the permanency of relationship and the company's degree of control. Under this test, the ultimate question is whether the worker is economically dependent on the company (an employee) or is in business for himself or herself (an independent contractor).

On July 15, 2015, the DOL's Wage and Hour Division issued guidance on the economic realities test and concluded that most workers will be considered employees. Furthermore, a number of states have adopted what is arguably the most difficult standard to overcome: the "ABC" test, which presumes an individual is an employee unless the employer can make a three-prong showing as to the individual's autonomy and independent nature of services. Cases against on-demand ride-sharing companies Uber and Lyft and delivery services companies Postmates and Shyp, among others, are currently pending in federal district courts in California. These cases should be closely monitored, as they will have significant implications on businesses' growing use of independent contractors.

Contributing Partner

John P. Furfaro / New York

Counsel

Risa M. Salins / New York

standard may influence the agencies charged with their enforcement, particularly the EEOC and the DOL's Wage and Hour Division (WHD). In fact, the EEOC filed an *amicus* brief in *Browning-Ferris* in which it recognized that the "[NLRB's] joint employer standard influences judicial interpretation of Title VII" and advocated that the NLRB adopt a joint employer standard that is "flexible enough to encompass a broad range of evolving workplace relationships and realities." In addition, the WHD recently issued an administrator's interpretation describing its broad "economic realities" test to determine how to distinguish employees from independent contractors, which reflects a similarly sweeping view of what counts as an employment relationship. If a company is found to be a joint employer with a contractor that has misclassified employees as independent contractors, it also is possible that the company may be liable for the wage and hour liabilities resulting from the contractor's misclassifications.

Federal appellate courts and the U.S. Supreme Court likely will eventually review *Browning-Ferris* and any similar decisions by other government agencies. Moreover, on September 9, 2015, congressional Republicans introduced the Protecting Local Business Opportunity Act seeking to overturn the *Browning-Ferris* decision. Therefore, it may take years for the true long-term impact of *Browning-Ferris* to become apparent. That said, the immediate impact is significant. A thorough review of contracts and arrangements with contractors, staffing agencies and franchisees is a prudent step in reducing the chance that apparently separate businesses will be treated as joint employers.

Proposed Rules to Tighten Wage and Hour Exemptions

In June 2015, the Department of Labor (DOL) unveiled a proposed rule that, if enacted, will result in federal overtime requirements covering an additional estimated 5 million people. The proposed rule was issued in response to President Barack Obama's March 2014 directive that the DOL update and modernize the overtime regulations concerning white collar workers' eligibility for overtime pay under the Fair Labor Standards Act (FLSA). The FLSA exempts executive, administrative, professional, outside sales and certain computer employees (white collar employees) from overtime pay if, among other factors, certain salary thresholds are met. Highly compensated white collar employees are more likely to be considered exempt under the FLSA.

The DOL's proposal seeks to dramatically raise the minimum salary threshold required to qualify for the white collar exemptions, from $23,660/year ($455/week) to $50,440/year ($970/week). The proposed rule also seeks to increase the threshold to be considered a highly compensated employee, from $100,000 to $122,148 per year. Further, in order to prevent the salary thresholds from becoming outdated, the DOL has proposed automatically updating them annually. Since 2004, when the white collar exemptions were last amended, employers have seen an explosion of wage and hour litigation under the FLSA. The DOL's proposed changes likely will trigger more activity by private litigants and federal and state agencies.

Contributing Partner

John P. Furfaro / New York

Counsel

Risa M. Salins / New York

Class Action Waivers: Are They Enforceable?

Class action waivers in arbitration agreements continue to occupy the attention of the National Labor Relations Board (NLRB), and uncertainty in this area of law raises ongoing concerns for employers. In *D.R. Horton, Inc.*, 357 NLRB 184 (2012), the NLRB held that requiring employees to sign an arbitration agreement waiving the right to pursue class and collective actions violates the National Labor Relations Act (NLRA). The NLRB took the position that joining together to pursue class relief is protected concerted activity under Section 8(a)(1) of the NLRA. The U.S. Court of Appeals for the Fifth Circuit in *D.R. Horton, Inc. v. NLRB*, 737 F.3d 344 (5th Cir. 2013), denied enforcement of the NLRB's ruling, finding that use of collective action procedures is not protected concerted activity. Yet, the NLRB has stood by its earlier position, holding again in *Murphy Oil USA, Inc.*, 361 NLRB No. 72 (2014), that the inclusion of class action waivers in arbitration agreements constitutes an unfair labor practice. Most recently, the Fifth Circuit in *Murphy Oil USA v. NLRB*, No. 14-60800 (5th Cir. Oct. 26, 2015), once again ruled that such waivers are enforceable and not unlawful.

The law in this area is unsettled, and it remains to be seen whether the issue will be taken up and resolved by the U.S. Supreme Court, which has traditionally favored arbitration and has held that the Federal Arbitration Act provides broad authority to enter into and enforce arbitration agreements.

Contributing Partner

John P. Furfaro / New York

Counsel

Risa M. Salins / New York

Important FIRPTA and REIT Reforms Enacted

Contributing Partners

Victor Hollender / New York
David F. Levy / Chicago
David Polster / Chicago
Sarah E. Ralph / Chicago

Associates

Bradley S. Ahrens / Chicago
James A. Jones / Chicago

The newly signed Protecting Americans from Tax Hikes Act of 2015 (the Act) includes several reforms to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) and the taxation of real estate investment trusts (REITs). The Act's FIRPTA reforms constitute the most significant changes to FIRPTA since its enactment 35 years ago and demonstrate continued legislative commitment to attracting additional foreign capital into the U.S. real estate market. Of the Act's many REIT reforms, the most significant is a provision preventing companies from performing tax-free spin-offs of their real estate assets into separate REITs. The anti-REIT spin-off provision removes a significant tool that activists seeking the separation of real estate and operating assets have been using in their fights against corporate boards. With this technique now unavailable, activists will likely push for other means for companies to separate operating and real estate assets so they may be valued separately by the markets. The Act also includes favorable REIT reforms, such as a provision that permanently reduces the recognition period for built-in gains to five years from 10. These reforms will make it easier for managers to operate REITs in a more flexible manner.

FIRPTA Reforms

Foreign Pension Funds

The Act completely exempts "qualified foreign pension funds" and entities wholly owned by such funds from FIRPTA taxation, providing foreign pension funds with the same tax treatment on the disposition of U.S. real property interests as domestic funds. A foreign pension fund is "qualified" if it is subject to government regulation and certain reporting requirements in its home jurisdiction, is established to provide retirement benefits to current or former employees, has no greater than 5 percent beneficiaries, and enjoys tax benefits on either contributions or investment income in its home jurisdiction. The new exemption applies to both direct investments and investments through partnerships.

Threshold Increased for Publicly Traded REIT Stock

For publicly traded REITs, the Act opens the door to substantial new foreign investment by expanding the FIRPTA exemption available to small foreign "portfolio investors." Under prior law, foreign investors owning 5 percent or less of a publicly traded REIT were not subject to FIRPTA taxation upon a sale of the REIT's stock or the receipt of a capital gain dividend from the REIT. The Act increases this ownership threshold from 5 to 10 percent, bringing the FIRPTA regime in line with the definition of a portfolio investor used in most U.S. tax treaties. The Act also provides for the first time that the exemption for small foreign portfolio investors applies to interests in REITs held through certain widely held, publicly traded "qualified collective investment vehicles," including certain listed Australian property trusts and certain foreign publicly traded partnerships that qualify under a comprehensive income tax treaty with the United States.

Domestically Controlled Determination

The Act contains important clarifying presumptions that will allow publicly traded REITs and their shareholders to rely on the domestically controlled exception to FIRPTA taxation with greater confidence. (See December 18, 2015, Skadden client alert "New FIRPTA Reform: The Long-Awaited Game Changer for US Real Estate.")

The FIRPTA reform provisions are effective immediately.

REIT Reforms

Restrictions on Tax-Free Spin-Offs

Effective immediately, the Act severely restricts the ability to engage in REIT spin-offs on a tax-free basis. Previously, corporations (regardless of REIT status) could spin off their real estate assets tax-free into a REIT or spin off other operations and elect REIT status following the spin-off. Under the Act, a spin-off involving a REIT does not qualify for tax-free treatment unless both corporations that are party to the spin-off are REITs immediately after the distribution. Otherwise, neither corporation is permitted to elect REIT status for 10 years following a tax-free spin-off. A REIT's tax-free spin-off of a taxable REIT subsidiary (TRS) is still permitted if, at all times during the three-year period preceding the distribution date, (1) the distributing corporation has been a REIT and the distributed corporation has been a TRS, and (2) the REIT has had control of the TRS.

Permanent Reduction of Built-in Gains Tax From 10 to Five Years

A corporate-level built-in gains tax, at the highest marginal rate applicable to corporations (currently 35 percent), is imposed on a REIT's built-in gains (calculated as of the date a corporation converts to a REIT or a REIT acquires assets from a corporation in a carry-over basis transaction) that are recognized during the recognition period. The Act makes permanent the reduction of the recognition period from 10 to five years.

Reduction of TRS Percentage Limit

The Act reduces the percentage of its gross assets that a REIT can hold in TRS securities. Current law permits such securities to constitute up to 25 percent of the value of a REIT's gross assets. The Act reduces this 25 percent limitation to 20 percent, making it more difficult for REITs to operate the non-real estate portions of their businesses in fully taxable corporations. This provision is effective for tax years beginning after 2017. (See December 18, 2015, Skadden client alert "Extenders Bill Makes Important REIT Reforms and Closes Door on REIT Spin-Offs.")

Conclusion

Investment in U.S. real estate is central to the U.S. economy's health. FIRPTA taxation substantially deters foreign investment in U.S. real estate by creating unintended economic distortions that drive foreign capital to real estate opportunities abroad. The FIRPTA reform provisions reduce some of these barriers to foreign investment and should increase foreign capital investment in U.S. real estate. Also, although the Act's REIT provisions may inhibit certain REIT transactions by closing the door on spin-offs, many of the other reforms will help REIT managers by loosening certain operational requirements and providing helpful clarifications. This is unlikely to be the final chapter in REIT and FIRPTA reform. We may very well see further reforms in the near future that facilitate foreign investment in U.S. real estate and provide REIT managers with greater flexibility.

Increase in Ownership Threshold

For publicly traded REITs, the Act opens the door to substantial new foreign investment by expanding the FIRPTA exemption available to small foreign "portfolio investors."

Major Changes to Tax Audit Procedures to Impact Most Partnerships

Contributing Partner

Armando Gomez / Washington, D.C.

Counsel

Paul Schockett / Washington, D.C.

Legislation enacted in November 2015 will fundamentally change the way the Internal Revenue Service (IRS) examines entities treated as partnerships for U.S. federal tax purposes, including how it assesses and collects tax underpayments. The new rules reflect the IRS' interest in auditing more partnerships more thoroughly. Many partnerships may need to amend certain tax and economic provisions of their governing documents to adjust to the new regime. The new rules create the potential for a shift in the liability for an underpayment of federal income tax with respect to a partnership — a sea change that will affect due diligence, negotiation and drafting in transactions involving the acquisition of interests in partnerships.

Importantly, Congress left many significant details of the new rules to the Treasury Department to establish in the future but did not provide a deadline by which Treasury must promulgate those procedures. As a result, key details of the new regime are not yet known and likely will be developed over the next few years.

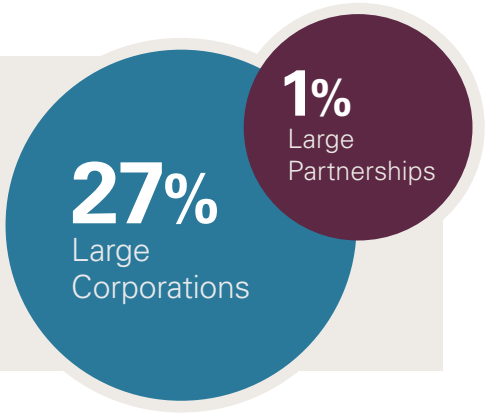
Background

Under rules enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (commonly referred to as the TEFRA unified partnership audit procedures), partnerships generally are subject to IRS audit in a proceeding at the partnership level controlled by a "tax matters partner" and subject to certain rights of "notice partners," but any resulting underpayment of tax is assessed and collected separately at the partner level. However, as partnerships (and entities taxable as partnerships, such as multimember limited liability companies) have become more numerous, this complex system of partnership-level audit/partner-level assessment has proven to be difficult for the IRS to administer. In 2014, the Government Accountability Office (GAO) presented testimony that in 2011, there were more than 10,000 large partnerships, a majority of which had more than 1,000 direct/indirect partners (many with more than 100,000) and more than five tiers of partnership ownership. Also, in 2012, less than 1 percent of large partnerships were audited, compared with more than 27 percent of large corporations; of those partnership audits, approximately two-thirds resulted in no change to net income and the other one-third averaged less than $2 million in adjustment. GAO cited the requirements of the TEFRA unified partnership audit procedures and the complexity of tiered partnership structures as contributing to the lack of meaningful partnership audits.

New Procedures

As part of the Bipartisan Budget Act enacted on November 2, 2015, the TEFRA unified partnership audit procedures were repealed effective for partnership taxable years beginning after December 31, 2017. In their place will be a new regime intended to simplify the IRS' audit function and ability to assess and collect tax underpayments from partnerships, including several novel provisions that may require amendments to many partnerships' governing documents before those partnerships file their 2018 tax returns. Several provisions of the new law are unclear and will require substantial guidance, if not statutory clarification, before the law takes effect. (Several technical corrections were enacted on December 18, 2015, as part of the Consolidated Appropriations Act, 2016. Further technical corrections are likely to be required before the new regime takes effect.)

In 2012, **less than 1%** of large partnerships were audited, compared with **more than 27%** of large corporations.



Opting Out

Certain partnerships with 100 or fewer members/partners will be able to opt out of the new regime. However, pending the Treasury regulations, partnerships whose partners include another partnership (*i.e.*, tiered partnerships) will not. When partnerships opt out, the IRS will have to make any adjustments through audits of the partners rather than through an entity-level proceeding.

Imputed Underpayments

Under the new regime, the IRS can assess and collect any underpayment of taxes with respect to a partnership from the partnership itself rather than from the partners separately. Although the imputed underpayment will be computed based on income, gain, loss, deduction or credit of the partnership for a past year (the "reviewed year"), the assessment of the imputed underpayment will be in the current year (the "adjustment year"), potentially shifting the economic burden of the tax from former to current partners. Further, no payments the partnership makes under the new procedures (including interest) will be deductible. Under procedures to be issued, imputed underpayments can be reduced if a partner amends its reviewed year return and pays its share of the tax, or if the partnership proves that all or part of the adjustments are allocable to tax-exempt entities or, in limited circumstances, are eligible for a lower rate of tax. Alternatively, the new rules include a special election whereby the partnership may pass the imputed underpayment onto the "reviewed year" partners. However, if such an election is made, the underpayment interest rate is increased by 2 percentage points.

Partnership Representative

The new rules replace the concept of the "tax matters partner" with a "partnership representative," a position with significantly more power over the tax affairs of the partnership. The partnership representative will have the sole authority to act for the partnership with regard to the new rules. The partnership representative can be any person, not necessarily a partner, but must have a "substantial presence in the United States." If no partnership representative is chosen by the partners, the government will select one. There are no "notice partner" or similar provisions under the new rules.

Conclusion

Significant questions remain about the income tax effects of the new rules, the state and local tax consequences, and the financial accounting treatment for partnership tax liabilities, among other concerns. Amid the uncertainty, and while Treasury develops details of the new rules, many existing partnership agreements will need to be amended, and future partnership agreements and M&A transactions with respect to entities treated as partnerships will need to address the application of these new rules.

No Gains, Just Pain: Increasingly Uncomfortable Taxation Environment for Private Equity Executives' Compensation

Contributing Partners

Thomas Perrot / Paris

Johannes Frey / Frankfurt

James Anderson / London

Arguing that their compensation should count as capital gains — since it derives from the appreciation in value of portfolio companies — private equity executives in Europe generally have been taxed under the more favorable capital gains principles, rather than employment or other income principles. However, this fundamental proposition is now being challenged by European tax authorities and courts, which are increasingly tightening the rules and thereby shrinking the boundaries within which compensation can remain safely taxed as capital gains. In some cases, European jurisdictions are developing severe penalties for what they deem to be abuse of law in this area, or even a criminal treatment — and sometimes where the arrangements are not particularly artificial. This article highlights recent developments in France, Germany and the United Kingdom.

France

In 2013, France more closely realigned tax rates for income derived from capital gains and ordinary employment. Despite that realignment, compensation income remains generally more heavily taxed than gains derived from the sale of equity instruments. Social security charges, which apply only to employment income (as opposed to capital gains), further accentuate this difference in treatment. As a result, parties in leveraged buyouts (LBOs) and in the corporate world more generally have still pursued equity-based incentives, but are utilizing increasingly sophisticated instruments.

In return, French tax authorities have begun actively investigating management packages, applying the abuse of law theory (which carries an 80 percent penalty) in order to challenge taxpayers' characterization of certain income. Such challenges have become so routine that managers in successful LBOs can almost always expect a tax audit. In cases deemed particularly egregious, the tax authorities also have brought criminal charges against the parties involved. While the abuse of law committee (the administrative body that reviews cases in which the tax authorities apply the abuse of law theory) and courts of first instance and appeals generally have been split on the treatment of management packages, the first case to reach the Supreme Court (Conseil d'Etat, September 26, 2014, no. 365573, Mr. and Mrs. Gaillochet) was decided in the tax authorities' favor. While the ruling was limited to the particular facts and circumstances at issue, most practitioners have interpreted the decision as a clear warning that management packages will be scrutinized under the abuse of law theory, and many will not pass muster. In April 2015, the tax authorities signaled as much, publishing a notice classifying management packages generally as "abusive schemes."

Private equity houses, managers and their advisers will need to review their options. One approach is to structure incentive packages in the form of ordinary shares, to which managers subscribe at market value. The Macron Law, which relaxed a number of regulations in France in August 2015 (including reducing the mandatory vesting and holding periods for restricted stock units), has renewed interest in qualified restricted stock unit plans. Discussions are underway between professional organizations and the government to set a clearly defined legal framework for stock-based incentives for management compensation plans. Given their courtroom victory, it remains to be seen whether the tax authorities will be amenable to such a compromise.

Germany

The tax treatment of management equity programs (MEPs) has recently become a major topic in German tax audits. Generally, payments under an MEP could be treated as employment income or capital gains income, which have significantly different tax rates (47.5 percent for employment income, 26.375 or 28.5 percent for capital gains depending on shares owned). Employment income also is subject to the wage withholding tax and social security contributions. The tax authorities recently introduced special task forces to analyze and challenge MEPs in tax audits.

The tax authorities tend to classify payments received under an MEP as employment income, even if such payments were received as part of a purchase price for the shares held by managers. Their argument is threefold:

1. The managers' benefits under an MEP are predominantly employment-based, as evidenced by specific clauses for departure (so-called good leaver/bad leaver provisions), downside protection for equity investments and vesting periods.

2. The managers are not the beneficial owners of the shares in the company. Their shareholder rights are limited and, apart from the participation in the sales proceeds, economically irrelevant.

3. Based on the abuse of law theory, the MEPs constitute employment income.

Case law does not provide clear guidance, since the underlying cases relate to fairly egregious structures that deviate from the common setup in which managers, through a partnership, directly or indirectly hold shares in the company for which they work. Case law suggests that a capital gains treatment could be established if the managers bear a relevant downside risk and if the acquisition and sale of the MEP shares comply with third-party standards and do not include any preferential treatment for the managers.

These issues come into play especially during acquisitions and takeovers. In the acquisition of a company with an MEP, it is important that the parties agree on the treatment of the payments to the managers resulting from the sale. Any employment income leads to a wage withholding tax and a reporting obligation for the company, and contractual arrangements typically allocate any such tax risk to the seller.

For new MEPs, whether to provide a relevant downside risk for management and to track third-party terms are often considered. Such elements do mitigate the risk of a reclassification as employment income. Usually, these MEPs maintain any vesting periods or good leaver/bad leaver provisions.

For existing MEPs, new case law should be monitored. It remains to be seen whether the Federal Fiscal Court will confirm the view taken by the tax authorities that MEPs constitute employment income or will recognize MEPs as a vehicle of co-investment, making them taxable as capital gains.

United Kingdom

In 2015, fund manager executives encountered three unfavorable changes to their taxation treatment:

1. In April, the "disguised investment management fee" rules eliminated certain structures seeking to turn management fee income into capital gains. The rules spawned the concept of a statutorily defined "carried interest," which could enable private equity executives to navigate the new rules by using market standard carry structures.

2. In July, after a successful Conservative Party election result, a new set of rules on carried interest came into force, with immediate effect. Importantly, the new rules eliminated the ability of U.K. resident nondomiciliaries receiving carried interest to argue that compensation paid from investment vehicles outside the U.K. should be exempt from U.K. taxation on the grounds that it was non-U.K. situs gains.

3. In December, the government confirmed that carried interest must relate to fund assets, the average holding life of which must be at least four years, before it can receive capital treatment.

French tax authorities have begun actively investigating management packages, applying the abuse of law theory in order to challenge taxpayers' characterization of certain income.

Case law suggests that a capital gains treatment could be established in Germany if certain conditions are met.

Circumstances under which fund managers can obtain capital gains treatment in the U.K. are diminishing.

Therefore, circumstances under which fund managers can obtain capital gains treatment are diminishing. Additionally, HM Revenue & Customs (HMRC), the U.K.'s tax and customs authority, is pressing through the courts a growing number of cases based on specific schemes that seek to structure executives' gains outside the scope of employment income.

In parallel, the government has announced that in 2016, it will press ahead with new rules that make it a criminal offense for a taxpayer not to declare income or gains above a certain threshold (where the taxation loss is greater than £25,000), even if the omission is inadvertent and does not involve negligence. The government also would criminalize an organization's failure to take steps to prevent its agents or employees from evading taxes. Important questions arise over whether it is appropriate to group strict liability offenses with instances of undeliberate underdeclaration of income. For example, if a person files a tax return genuinely believing he or she is a nondomiciled U.K. resident, or that he or she is in receipt of carried interest as defined, should that person potentially face prison time under the new rules if the judgment is made wrongly? Each of the new carried interest rules poses interpretation challenges for even experienced tax practitioners.

Conclusion

European tax authorities and courts are increasingly enforcing the view that compensation cannot be taxed as capital gains except in the most straightforward and publicly approved contexts. We expect 2016 to be a year when the PE industry considers its options in light of the new landscape, and fewer compensation arrangements will pursue the goal of capital gains taxation for its executives.

Navigating a More Complex Outsourcing Industry With Well-Crafted Agreements

Contributing Partner

Stuart D. Levi / New York

Outsourcing is once again on the rise, due to three key factors: (1) the increased use of cloud computing to deliver more services at a lower price, (2) a marked increase in the number of midsized, high-quality service providers offering a wide range of services, and (3) a maturation of the outsourcing industry, which has created stability and reduced risk.

However, this industry growth also has resulted in a more sophisticated approach to issues by both vendors and customers, requiring careful negotiation and clear drafting. Simple formulaic provisions can no longer be used to address the complex issues that exist today. Rather, vendors and customers are each attuned to the nuances of these deals, and the difference between a successful outsourcing arrangement and one that fails often comes down to the negotiation of the agreement and the related schedules. Below are a few key areas to keep in mind when crafting a deal:

- As the outsourcing market has matured, the variety of available pricing models has expanded greatly. Straightforward fixed-fee and "per unit" pricing structures have given way to algorithms that take a number of factors into account. Customers need to understand how those models will work in various contexts and how they will evolve during the life of the agreement. Once the pricing model is negotiated, careful drafting is required to translate that model into clear contract language.

- Service levels are a key component of any outsourcing deal. However, all too often customers view these solely as a remedy in the event of a service failure. The reality is that service levels drive how a vendor allocates its resources. A carefully negotiated service level agreement (SLA) will take into account multiple factors, such as the importance of a function to the customer's operations and the penalty level that will drive the vendor's resource allocation. In many cases, a smaller number of carefully crafted service levels will be far more effective than a scattershot approach that tries to cover every measurable event.

- Perhaps the most difficult issue to resolve in an outsourcing negotiation is the limitation of liability. This is often due to the fact that the benefit each party stands to gain from the deal does not necessarily align with the liability exposure if there is a breach. Provisions that set a single liability cap for all breach events are often rejected since they do not account for the risks inherent in different types of incidents. Using a framework with different caps for different types of breach events is often more acceptable to the parties. This approach requires careful negotiation and drafting to ensure that the caps work together and protect both parties.

- Cybersecurity is front of mind for every company today, including when negotiating an outsourcing deal. Companies are concerned not only about data breaches but also about cyberattacks on vendors that might disable services, or weak cybersecurity that might lead to the introduction of malware on the other party's system. From a contractual point of view, there are four points of negotiation: (1) the cybersecurity standards to which the party must adhere, (2) the type of breach of those standards that would trigger liability, (3) what losses a party will cover, and (4) the liability cap amount. As with other provisions of outsourcing agreements today, a single approach to this complex issue is no longer sufficient. Rather, the parties need to carefully parse this issue and create various standards and caps, taking into account the types of damages that might result and which party should bear liability.

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