2009 Insights

Navigating Tumultuous Times

Skadden

2009 INSIGHTS
EDITORIAL BOARD

Casey T. Fleck

David J. Goldschmidt

Thomas W. Greenberg

Thomas H. Kennedy

Lea Haber Kuck

John D. Rayis

Ivan A. Schlager

Skadden

SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP AND AFFILIATES

This collection of memoranda provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates is for educational and informational purposes only and is not intended and should not be construed as legal advice. These memoranda are considered advertising under applicable state laws.

January 12, 2009

Dear Clients and Friends:

As we begin the new year, we all are confronted with a variety of significant business and legal issues. Many are related to the global economic situation and recent dislocations in the capital markets. Others result from changing governmental priorities, including the likely views of the Obama administration. Finally, diverse constituencies, including shareholders, creditors, employees and communities, continue to assert various, often competing, agendas.

This collection of memoranda highlights current legal issues we hope will be of interest to directors, senior management and counsel of our various clients. We also have sought to identify potential opportunities and suggest blueprints for responses to the current global situation. Not every memorandum will be of interest to all, but we hope the range of subjects covered will provide you with timely and pertinent information.

The topics are arranged into 10 broad sections:

- **Capital Markets and Hedge and Private Equity Funds:** For many of our clients, the area of most direct interest is how the tumultuous financial environment may impact your capital structure. We emphasize both advance planning and prophylactic measures that are applicable to most entities, whether or not currently under distress. We also examine potential opportunities created by the turmoil in financial markets and the impact on various capital markets sectors.

- **Corporate Restructuring:** It is generally expected that 2009 will be dominated by a global wave of corporate restructuring activity. We provide information on various techniques that will be of assistance to stressed entities looking to restructure their balance sheets, as well as entities that may seek to acquire or consolidate with a troubled entity.

- **Financial Institutions:** The events of recent months have led to a series of financial crises and dramatic governmental responses. We examine the latest legislative developments in the US and Europe, provide guidance regarding the current enforcement and litigation landscape, and look ahead to future developments affecting financial institutions.

- **Global M&A:** A significant amount of recent merger and acquisition activity has focused on restructuring prompted by the demands of governments or creditors. As corporations around the world continue to assess their financial and business environments, new strategic M&A scenarios likely will develop. We include information designed to apprise you of current influences on mergers and acquisitions.

- **Governance:** The financial and economic crises and the response of various governmental bodies, once again, put focus on the importance of proper corporate governance. The range of issues confronting directors and members of management are explored in a series of memoranda that assess trends and offer guidance on a range of issues, including directors' duties, executive compensation and financial reporting.

- **Governmental, Regulatory and Tax Enforcement:** In the US, the EU and elsewhere, shifting governmental priorities in response to various factors, including the economic environment, will impact our clients in a wide range of industries. We assess these developments across governmental arenas.

- **Intellectual Property and Information Technology:** We address a number of areas of interest related to intellectual property — the most valuable asset of the so-called "new economy."
- **Litigation and International Arbitration:** We anticipate the upheavals of the last year and a half will continue to result in increased litigation, much of which will be complex and international in nature. We discuss the expected trends and likely strategies for managing such disputes.
- **New Markets:** Brazil, China, India and Russia are not immune to the global financial crisis, and their status as emerging markets creates unique circumstances for conducting business there. We discuss various issues, trends and laws relevant to business activity in each country.
- **Real Estate:** In the eye of the economic storm, the real estate industry, including REITs, faces a number of issues, which we discuss here.

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

With best wishes for peace and economic recovery in 2009.

Robert C. Sheehan
Executive Partner

Eric J. Friedman
Executive Partner-Elect
(as of April 2009)

Skadden

Table of Contents

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

Capital Markets and Hedge and Private Equity Funds

Corporate Restructuring

Financial Institutions

Global M&A

Governance

Government, Regulatory and Tax Enforcement

Intellectual Property and Information Technology

Litigation and International Arbitration

New Markets

Real Estate

Survival Strategies for a Difficult Corporate Finance Market

There is no escaping the hard fact that 2008 was a brutal year for corporate finance, particularly the fourth quarter, with both debt and equity markets suffering major losses, and with the liquidity crisis, originally spawned by subprime securitizations, spreading into all areas of finance, including conventional corporate finance. The very structure of the securities industry has been fundamentally changed with the disappearance, through bankruptcy and acquisition, of major investment banks and the conversion of many others into institutions now regulated under the Bank Holding Company Act.

Access to government bailout money and historically low discount rates from the Federal Reserve were not very successful in restoring lending activity or market confidence in 2008. Although the Obama administration and Democratic Congress have a mandate for reform, and a new SEC commissioner has been announced, the contours of the coming reforms are still invisible. Historically, markets eventually have recovered from burst bubbles, but even the most optimistic prognostications do not foresee a quick turnaround. Thus, the beginning of 2009 is likely to see a continuation of the crisis management responses companies used in the fourth quarter of 2008, presenting novel issues and some intriguing possibilities.

Deleveraging Strategies

The financial crisis and fears of a deepening recession are causing companies to do what they can to improve their balance sheets, including adopting a variety of deleveraging strategies:

- With debt, even of investment grade companies, trading at historically deep discounts, CFOs are expected to continue to consider repurchases of their outstanding debt, including through debt tender offers. Debt repurchases involve a surprisingly complicated set of legal issues. Tender offers for "straight" debt are generally covered by a limited number of tender offer rules under the Securities Exchange Act of 1934 (the 1934 Act), although the requirement under those rules that a tender offer be kept open for 20 business days is relaxed by a series of "no-action" letters for "straight" investment grade debt. Additional 1934 Act rules come into effect if the debt is convertible or exchangeable. If the company repurchases or exchanges the debt in private transactions or engages in open market purchases, care needs to be taken so that those purchases will not be considered a *de facto* tender offer. The tax and accounting implications of debt repurchases by issuers are significant, and debt repurchases by an issuer's major shareholders are fraught with tax pitfalls. See "Government, Regulatory and Tax Enforcement: Developments on the Tax Front: Monitoring Proposals and Careful Planning Is Increasingly Important."
- "Refinancing risk" is also a current hot topic: If a company can borrow long term to replace in advance debt that matures in 2009, its liquidity position is significantly improved, even if the amount of leverage remains the same.
- Rights offerings, which historically have been used mainly in international contexts, have recently achieved greater interest among US companies as an effective way of raising equity in a tight market. These offerings require consideration of SEC issues and entail compliance with stock exchange requirements, negotiation of standby purchase arrangements and a variety of other issues.
- Similarly, new techniques of "equity lines of credit," "registered-direct" offerings and "at-the-market" offerings are being used to take advantage of windows of opportunity in volatile equity capital markets to delever and strengthen a company's balance sheet.

Contributors | **Partners** | Robert M. Chilstrom, Robert.Chilstrom@skadden.com, 212.735.2588 | Casey T. Fleck, Casey.Fleck@skadden.com, 213.687.5341 | David J. Goldschmidt, David.Goldschmidt@skadden.com, 212.735.3574 | Stacy J. Kanter, Stacy.Kanter@skadden.com, 212.735.3497 | Matthew J. Mallow, Matthew.Mallow@skadden.com, 212.735.3930

- PIPE transactions, once largely the province of start-up companies, are being considered by more established issuers.
- Bringing key potential investors "over the wall," subject to confidentiality restrictions and prohibiting their trading in a company's securities until a public deal is announced, is increasingly being used as a means to determine whether a deal is even feasible in these volatile markets. Over-the-wall procedures need to be carefully structured to avoid "gun jumping" and other securities law issues.
- Exchange offers and debt restructurings of troubled companies are presenting new issues of contract interpretation as well as more conventional securities law issues (for example, whether exchange offers should be structured to be exempt from registration under Section 3(a)(9) of the Securities Act of 1933 (the 1933 Act), be conducted as private placement exchange offers, or as registered exchange offers). The December 2008 *Realogy* case decided by the Delaware Chancery Court, involving a challenged exchange of bank debt for outstanding public debt at significant discounts, ultimately turned on interpretation of a complicated provision in a credit agreement. Because the intricate interplay between the bond indentures and credit agreement provisions in *Realogy* is unlikely to be replicated, *Realogy* is likely to have limited precedential value but serves as a warning that bondholders are becoming increasingly litigious in the current economic environment.
- Companies are expected to continue using new loans (which, in many cases, may be secured) under uncommitted "accordion" provisions and to continue using incremental facility provisions of existing credit agreements as consideration to existing holders of debt securities in debt-for-debt exchanges.
  - Companies can try to take advantage of low market prices for their existing debt by offering to exchange a reduced principal amount of new loans for such outstanding debt. Leverage would be reduced and the company's interest burden also may be reduced.
  - Compliance with the securities laws applicable to tender offers and exchange offers may be required.
  - Careful review of the restrictive covenants in the company's debt agreements and other material agreements, including restricted payment covenants and debt and lien covenants (including provisions restricting the refinancing of unsecured debt with secured debt), will be necessary before launching any exchange.
  - For example, while debt-for-debt exchanges at a discount should reduce overall leverage, using senior or secured debt in exchange for subordinated or unsecured debt may negatively affect compliance with financial covenants, such as senior leverage ratios and senior secured debt leverage ratios.

Registration Issues

The financial crisis presents its own set of disclosure issues, but several other issues affecting registration and reporting cropped up in 2008 and are expected to influence issuers' responses in the coming year:

- As more fully explained in Skadden's November 3, 2008, mailing to clients ("Being Prepared to Access the Capital Markets in Today's Troubled Environment"), as a result of the December 2005 Securities Act reforms, many shelf registrations needed to be renewed beginning December 1, 2008, and all shelf registrations need to be periodically renewed (they expire after three years). With the decline in the market, several issuers that were Well-Known Seasoned Issuers (WKSIs) or eligible to use Form S-3 or F-3 may no longer be eligible to have their registration statements become effective automatically or to use those forms.

- The recent *Glazer* case in the Ninth Circuit has indicated an issuer may have liability under Rule 10b-5 for representations and warranties made in a merger agreement that is filed as an exhibit to a 1934 Act filing. This case may have profound implications in the 1933 Act context as well, since exhibits are filed with 1933 Act registration statements, and 1934 Act filings also are incorporated by reference as exhibits to 1933 Act registration statements. Traditionally, neither issuers nor underwriters focused on conducting due diligence on the representations and warranties contained in these exhibits in the context of securities offerings. In an effort to limit the potential effect of the *Glazer* case, we recommend that language be included in 1933 Act and 1934 Act filings where the filing contains exhibits to the effect that investors should not rely on the representations, warranties and statements contained in these exhibits.
- In light of the general liquidity crisis, companies need to revisit their risk factors and the "liquidity and capital resources" section of their MD&A in both their 1933 Act registration statements and their 1934 Act filings. Fortunately, many issuers began that process with the filing of their third quarter 10-Qs.
- For foreign private issuers, 2008 brought a number of changes in the 20-F annual report form as well as a much easier procedure for claiming and maintaining the exemption from 1934 Act reporting provided by Rule 12g3-2(b). This liberalization has resulted in the expansion of "unsponsored" ADR programs. In November 2007, the SEC permitted foreign private issuers that are reporting companies to eliminate a US GAAP reconciliation if their results were reported under IFRS, as adopted by the IFRS Board.
- The SEC is in the early stages of making IFRS the standard for US reporting companies as well. American company CFOs should begin to examine the implications of such a conversion to IFRS on their financial statements.

Return to the Table of Contents

Scrutiny and Opportunity in Bank Finance

The cataclysmic upheaval in the financial markets has caused most companies to devote significant time and energy to examining their existing and potential financing needs and sources. While the turmoil in the financial markets has adversely affected many institutions, as is the case during most market turbulence, opportunities also have been created.

Importance of Maintaining and Utilizing Existing Credit Arrangements

- Given the disruptions in the public debt, bank loan and commercial paper markets and the resulting limited availability of new credit, companies are expending greater time and resources in maintaining and utilizing their existing credit arrangements.
  - Companies are increasingly drawing down their revolving credit facilities, whether or not there is a current need for the cash proceeds of the resulting loan. Lenders may attempt to resist these requested borrowings, so careful attention by legal counsel is warranted with respect to the ability to meet lending conditions, including the making of representations and warranties (which would customarily include the representation and warranty that a material adverse change has not occurred).
  - In the aftermath of the Lehman Brothers bankruptcy, fronting banks (*e.g.*, letter of credit issuers in syndicated credit facilities) and, to a lesser extent, borrowers will request and receive additional protections against defaulting lenders and potential defaulting lenders (*e.g.,* fronting banks are requiring borrowers to "backstop" defaulting lender participations and borrowers are requesting the ability to withhold certain payments to defaulting lenders).
  - As borrowers experience the effects of a prolonged economic downturn, those that are subject to financial maintenance covenants may be in jeopardy of defaulting on such covenants. Given the limited ability to refinance existing debt (and, when such financing is available, the cost), many borrowers are being proactive and seeking amendments to their covenant packages. However, most lenders, as a quid pro quo for covenant relief, are likely to seek (i) repricing of the related loans in an attempt to mitigate mark-to-market losses suffered by them, (ii) deletion of provisions such as "equity cure rights" that were the hallmark of the credit bull market, and (iii) inclusion of new provisions developed to deal with some of the effects of the current upheaval in the financial markets (*i.e.*, credit-default-swap pricing, LIBOR floors and defaulting lender provisions). Lender requests are constantly changing, so it is important for CFOs to be up to date on changing market conditions.

Low Market Prices for Debt Present Companies With Opportunities to Acquire Debt at Deep Discounts

- In contrast to bonds and notes issued under indentures, loans made under traditional credit agreements have not customarily been considered subject to below-par acquisitions by their relevant borrowers or their affiliates. (Loan acquisitions are customarily effected via "assignments" of the loans.) However, powerful economic incentives have arisen for borrowers and their affiliates to acquire loans from cash-strapped lenders at significant discounts from par and, in cases where a retirement of the debt is contemplated, to effect a meaningful deleveraging of the relevant borrower. Unfortunately, most existing credit agreements did not contemplate all the issues involved in such acquisitions, including the following:

Contributors | **Partner** | Sal Guerrera, Sal.Guerrera@skadden.com, 212.735.3910 | **Counsel** | Andrew Bettwy, Andrew.Bettwy@skadden.com, 212.735.2095 | Steven Messina, Steven.Messina@skadden.com, 212.735.3509

- Many credit agreements prohibit an assignment of loans to the borrower or its affiliates. Amendments to this prohibition usually require the consent of lenders holding a majority of the outstanding extensions of credit and commitments ("majority-lender approval"). In addition, an assignment to the borrower may be considered a prepayment by the borrower and will, in many cases, require an amendment of the pro rata requirements described below. As a quid pro quo for any such amendments, lenders are likely to request that any affiliate of the borrower that acquires loans agree to (i) relinquish any voting rights with respect to such loans, (ii) waive any entitlement to certain information that would ordinarily be available to all lenders, and (iii) not acquire or further assign such loans if it is in possession of material nonpublic information of the borrower. Loan "participation" provisions may be a means to avoid the prohibitions on assignments discussed above, but may run afoul of the pro rata sharing provisions discussed below.

- Almost all credit agreements require that payments by the borrower (and, in many cases, members of its credit group) be made on a pro rata basis and that any payment received by one lender and not other lenders be shared ratably with the other lenders. Amendments to these provisions may only require majority-lender approval, but in some cases will require unanimous approval of the lenders affected. In seeking these amendments, borrowers and their controlling shareholders usually will need to respond to lender inquiries as to, among other things, (i) the source of the funds for the loan acquisition (some lenders may require that the borrower's cash flow not be used to fund the loan acquisition or, at a minimum, that its revolving credit facilities not be drawn to fund such acquisitions), (ii) the relationship of such funding to other prepayment provisions in the relevant credit agreement, including "excess cash flow sweeps," (iii) whether purchases will be offered to all lenders on a pro rata basis (it is in response to this request that recent loan buyback arrangements have utilized a modified Dutch auction process), (iv) the minimum and maximum amount of loans that can be acquired and the time periods during which such acquisitions can be effected, (v) how any income resulting from the acquisition of loans that increases EBITDA (or similar metrics) and makes the satisfaction of financial covenants easier will be dealt with, and (vi) whether the acquisition conflicts with covenants in the relevant credit agreement (*e.g.*, the investment covenant) and in other material agreements to which the borrower or relevant affiliate is subject.

- Borrowers and their affiliates also must be mindful of the tax implications of these loan buyback arrangements, including original issue discount and the cancellation-of-indebtedness income that is likely to result. See "Government, Regulatory and Tax Enforcement: Developments on the Tax Front: Monitoring Proposals and Careful Planning Is Increasingly Important."

Hedge Funds in Focus

The crisis in the global credit markets is likely to perpetuate the redemption pressures that plagued the last two quarters of 2008 and may foment increased competition among hedge fund managers for new capital. In addition to the traditional investor-friendly features, such as increased liquidity and transparency and lower fees, hedge fund terms and conditions are likely to be influenced by investor pressure for managed accounts and other arrangements that provide investors with a degree of control over their managed assets.

The following summary highlights certain issues relating to the formation and operation of hedge funds and the relationships between managers and investors. Please see "Global M&A: New Developments in Private Equity Transactions" with respect to transactional activity of private equity funds and "Capital Markets and Hedge and Private Equity Funds: The Shifting Private Equity Fund Landscape" regarding private equity funds.

Response to Market Disruption

- Ongoing redemption pressures, coupled with the extraordinary level of dislocation and volatility in the financial markets and the constraints of leverage, are expected to compel funds to respond by further limiting the outflow of capital.
  - Increased redemptions create a conflict for funds with a large proportion of relatively illiquid assets. Payment of redemption proceeds requires liquidation of the fund's more liquid assets. Absent a rebalancing of the portfolio — which may entail an unacceptable impact on performance — the remaining investors are left with a portfolio that is increasingly less liquid and often subject to greater volatility than an intentionally constructed portfolio. Moreover, a concentration of illiquid assets can undermine fundraising activities, limiting the likelihood that new investors will inject the liquidity necessary to rebalance the fund's portfolio. Among the measures used to strike an equitable balance between the interests of redeeming and nonredeeming investors in this context are the creation of side-pocket classes, implementation of redemption gates, suspension of redemptions, deferral of redemption payments and restructuring.
    - Creation of a side-pocket class requires an investment manager to make certain decisions, such as whether an investment can only be allocated to a side pocket at the time of investment or at a later date, and the appropriate grounds for allocation of an investment to a side pocket. Some funds may find that their governing documents provide little or no guidance regarding these issues and will need to devise a policy governing the allocation of side pockets that minimizes legal and reputational risk.
    - Gates may be used by funds to temper the impact of redemptions. When implementing a gate, the manager should consider whether putting down a gate will create an incentive for other investors to submit redemption requests.
    - A suspension of either redemptions or of NAV calculation and redemptions must be based on grounds typically specified in a fund's governing documents or offering materials. Timing of a suspension is particularly important because at a certain point an investor's request for a redemption crystallizes and the investor becomes a creditor of the fund.
    - Restructurings frequently involve segregating, either by outright or synthetic transfer, the fund's illiquid assets into a special purpose vehicle. Redeeming investors receive both

Contributors | **Partners** | Heather Cruz, Heather.Cruz@skadden.com, 212.735.2772 | Philip H. Harris, Philip.Harris@skadden.com, 212.735.3805 | **Associates** | Anna Rips, Anna.Rips@skadden.com, 212.735.3237 | Michael D. Saarinen, Michael.Saarinen@skadden.com, 212.735.2499 | Aubry D. Smith, Aubry.Smith@skadden.com, 212.735.2614

cash redemption proceeds and interests in the special purpose vehicle by way of in-kind redemption. To the extent the proportion of cash to in-kind redemption proceeds is the same as the fund's proportion of liquid to illiquid assets, this permits continuing investors to retain their proportionate share in the liquid assets of the fund while providing an exit to those investors that have requested a redemption. Restructurings also may involve the movement of investors from a fund that is winding down to another continuing fund managed by the same investment manager.

    - Fund liquidation may be effected through the use of a liquidating trust. Redemptions are commonly suspended during the wind-down phase. One of the key issues in liquidations is identifying liabilities and creating appropriate reserves for such liabilities. Use of a liquidating trust facilitates identification of liabilities.

- Valuation

  - The disruption in the financial markets has left many previously liquid investments in a highly volatile and illiquid state. Further, certain assets are held by custodians that have filed for bankruptcy or liquidation. Funds holding these investments continue to struggle to find an adequate valuation methodology for these assets.

  - The dislocation of financial markets, coupled with increased redemptions, has depressed net asset values and assets under management of funds, metrics frequently used as a termination trigger in arrangements with trading counterparties. This has necessitated renegotiation of termination triggers with counterparties and has complicated the ability of funds to permit further redemptions.

Anticipated Evolution of Terms in Response to Recent Events

- Going forward, investors will be interested in structuring hedge funds in a manner that gives investors greater control over and/or visibility into the operational aspects of the funds. One way for large investors to do so is to set up managed accounts or single-member funds that invest *pari passu* with the fund. Smaller investors for whom managed accounts are not an option may call for investor committees with certain limited oversight rights.

  - Investor demands for greater liquidity are likely to conflict with the funds' desires to have a stable investor base, which became more acute after the large-scale redemptions during the last two quarters of 2008. It is likely that investors will require even more beneficial economic terms in return for restrictions on liquidity. In light of the conflicts of interests among relatively more- and less-liquid classes, funds will be faced with investor demands to remove liquidity term variances between classes and feeders and under side letters.

  - Concerns about liquidity and the experiences of 2008 also will lead investors to carefully consider funds' rights to provide in-kind redemptions and the circumstances under which such redemptions are appropriate.

  - Investors also are likely to demand increased transparency, including disclosure with regard to prime broker information and leverage. In line with increased appetite for information, funds may come under pressure to offer increased frequency and scope of reporting and open communications with portfolio managers. These trends may result in less investor interest in funds of funds. In order to protect proprietary information, hedge fund managers will need to consider developing increasingly sophisticated nondisclosure agreements as they are forced to provide greater depth of information to their investors.

- Investors also will seek, and funds may offer, restrictions on managers' discretion, including limitations on strategy, liquidity criteria and leverage limits. Strategy limitations may be in form of percentage limits, prohibitions/limitations on investments in other managers' funds and an increased demand for single-strategy funds.
- To successfully attract investors, funds will make a number of changes to alleviate investors' concerns and make their products more economically attractive in an increasingly competitive environment, including:
  - new approaches to custodial risks, such as multiple prime brokers and custodians and possibly the use of banks as custodians;
  - alternative fee structures, such as moves to an internal expense/time-based management fee (as opposed to assets under management-based fees);
  - addition of hurdles for incentive fee calculations;
  - increase in efficiency through vertical integration, such as using captive brokers to reduce costs and capture fees;
  - in light of potentially prohibitive high-water marks, agreements to reduce incentive fees until the high-water mark is exceeded by a certain amount in return for ability to collect the incentive fee prior to earning back the high-water mark amount; and
  - improved risk monitoring policies, especially for complex derivative investments and investments in potentially less-liquid markets.

Regulatory Response

- The level of losses sustained by the hedge fund industry in 2008 and the industry's perceived role in the recent market dislocation has created an expectation that hedge funds will be subject to greater regulation and that changes to the favorable tax treatment of incentive fees may be forthcoming. However, the likelihood and direction of regulatory developments are at this point uncertain.

Return to the Table of Contents

The Shifting Private Equity Fund Landscape

Widespread disruption of the capital markets will constrain new investment activity, exits and valuations. Investor liquidity needs and performance concerns will impact fundraising and sponsor-investor relationships, notwithstanding the availability of favorably priced new and follow-on investment opportunities. Private fund terms and conditions are likely to be influenced by these challenges, especially by investor pressure for negotiated revisions and informal understandings addressing the size and timing of commitments in response to short-term and medium-term commercial pressures on the private equity community.

The following summary highlights certain leading issues for sponsors and investors relating to the formation and operation of private equity funds, and the relationships between sponsors and investors. Please see "Global M&A: New Developments in Private Equity Transactions" with respect to transactional activity of private equity funds and "Capital Markets and Hedge and Private Equity Funds: Hedge Funds in Focus" regarding hedge funds.

Asset Valuations and Performance

- Investors can be expected to sharpen their focus on asset valuations and investment performance both as a means to prioritize investment allocations and to establish their own commercial and fiduciary standards. Lower valuations and slowed investment activity may be expected to generate pressures on established private equity fund terms, such as management fees and carried interest, and a reexamination of current and going-forward alignments of interest.
    - Early period losses may be expected to substantially alter incentives applicable to key members of private equity fund investment teams, particularly when the team composition changes. Selective changes to incentive arrangements within the investment team may be expected to have an increased role in supporting the short- and medium-term stability of the investment team as a whole. For example, sponsor retention of key professionals may entail compensation for positive performance levels below full reversal of prior losses.

Defaults and Default Remedies

- Substantial capital call default risk will continue to apply to private equity funds. Sponsor management of the risks and opportunities associated with default risk will likely expand to include negotiating and managing formal and informal arrangements to defer capital calls or reduce commitments, facilitation of assignments and selective buyback strategies.
    - Sponsor's management of default risk may attract disclosure requirements, most-favored-nations obligations and other compliance considerations.
    - Transactional opportunities and risk for sellers and purchasers in the secondary market for private equity fund limited partnership interests also will reflect widespread liquidity pressure and default risk.

Fundraising and Fund Terms Generally

- Limited liquidity and uncertainty regarding performance, valuation and incentives will impact fundraising negotiations, notwithstanding existing substantial commitments by many institutional investors, endowments and high-net-worth individuals to alternative investment programs. Investor groups may

Contributors | **Partners** | John M. Caccia, John.Caccia@skadden.com, 212.735.7826 | James M. Schell, James.Schell@skadden.com, 212.735.3518

be expected to consider altering manager classifications for allocation purposes in view of the divergence of risk, performance and liquidity history within the alternative investment marketplace. Investors' internal discussions will likely remain focused on sponsor-favorable terms by reference to recent performance and market dislocation, as well as sponsor management of such dislocation. In addition, access to leading opportunities generated by the 2009 environment will be central to sponsor-investor negotiations.

Governance

- General partner and manager governance procedures are likely to be reexamined to better reflect prevailing standards for professional risk management.
- Actual and perceived litigation risk associated with valuation, distribution and management issues may lead investors and sponsors to increase the role of investor advisory committees. Sponsors will reexamine risk management opportunities presented by these committees, and investors may view these committees as a means to further transparency and alignment of interest.

Sponsor Opportunities for Strategic Transactions

- Sponsors will have access to significant strategic M&A opportunities for asset managers in view of the performance of investment management assets and the impaired relationships between certain investors and their respective investment managers.

Taxation of Carried Interest and Likelihood of New Regulation

- Historic performance as well as perceptions of the causes of 2008 market dislocation may be expected to support initiatives for increased regulation of private funds and changes to the favorable tax treatment of carried interest.

Return to the Table of Contents

Scarce Liquidity Makes Chapter 11 Emergence Difficult, but Yields Opportunities for Distressed Investors

The downturn in the economy is anything but ordinary, and stressed and distressed issuers that would ordinarily look to Chapter 11 to restructure their financial affairs are unable to find sufficient liquidity sources to fund an in-court process and are forced to liquidate. Even companies that have successfully negotiated an approach to a reorganization are unable to emerge from Chapter 11 due to a lack of exit financing. Otherwise healthy companies with scheduled maturities must look to Chapter 11 as the only means of refinancing. On the other hand, yields for distressed investing are compelling. Investors with liquidity and an appetite for risk have numerous opportunities.

Concealed Economic Interests

- Concealed economic interests refer primarily to derivatives, or complex financial instruments that are designed to monetize risk of default. Trading in derivatives remains largely unregulated, although the market in such instruments has exploded in the last 10 years, from a market of nearly $80 trillion in 1998 to approximately $600 trillion in 2008 (growth of more than 800 percent). Although the impact of such instruments is not entirely known or appreciated, we do know the following:
  - When Delphi Corporation filed Chapter 11, its public bonds traded up, rather than down. The number of credit default swaps exceeded the number of instruments protected by these derivatives by a multiple. The resulting trading in the bonds to take advantage of the swaps caused a rise in trading price. Thus, while the default event triggered by the bankruptcy would ordinarily cause the bond prices to fall, it caused just the opposite to occur.
  - The proliferation of derivatives that exist in such situations makes it difficult for a company to identify and negotiate with its key constituents to effectuate efficient restructurings. First, the issuer may not be able to identify the entities that actually bear the risk of loss from a credit default. Second, in cases where the issuer does not know its constituencies, it may not understand their motives and goals, because of the existence of derivatives. Derivatives will continue to play a role in public restructurings in 2009.

Equitable Subordination Post-Enron

- In a 2007 decision that rocked the trading community, the United States District Court for the Southern District of New York, hearing an appeal in the Enron bankruptcy case, held that a transferee of a claim could be subject to equitable subordination and disallowance based solely on the conduct of the transferor if the claims were transferred by way of an assignment, but not by sale. The court reasoned that assignments and sales are distinct. With respect to assignments, an assignee stands in the shoes of the assignor and is subject to all equities against the assignor. By contrast, a purchaser does not stand in the shoes of the seller. The court found that a personal disability that has attached to a creditor who transfers its claim will travel to the transferee if the claim is assigned, but will not travel to the transferee if the claim is sold.
  - Following the appeal in Enron, the case was remanded to the bankruptcy court for a determination as to whether the transfer in question was an assignment or a sale. The issue was never

Contributors | **Partners** | John (Jack) Wm Butler, Jr., Jack.Butler@skadden.com, 312.407.0730 | Mark S. Chehi, Mark.Chehi@skadden.com, 302.651.3160 | Chris L. Dickerson, Chris.Dickerson@skadden.com, 312.407.0786 | Van C. Durrer II, Van.Durrer@skadden.com, 213.687.5200 | Jay M. Goffman, Jay.Goffman@skadden.com, 212.735.2120 | Ron E. Meisler, Ron.Meisler@skadden.com, 312.407.0549 | J. Gregory Milmoe, Gregory.Milmoe@skadden.com, 212.735.3770 | **Associate** | Andrew M. Thau, Andrew.Thau@skadden.com, 212.735.3769

ultimately decided, however, because the matter settled shortly thereafter. Clients should take care to document a claim's purchase to avoid personal disabilities that may follow a claim.

- It is uncertain whether other courts will adopt the assignment versus sale distinction from Enron. Traders should stay abreast of developments in the various jurisdictions where they do business.

Collective Bargaining Agreements

- The negotiation and potential rejection of collective bargaining agreements in Chapter 11 will continue to be a topic of interest in 2009. While the rejection of executory contracts in bankruptcy often requires only the articulation of a valid business judgment that the contract in question is more harmful than beneficial, the issue is much more complex in the case of collective bargaining agreements.
  - The United States Bankruptcy Code requires a complex proposal process before a debtor can even request the rejection of a collective bargaining agreement. The Bankruptcy Code does authorize interim changes to a collective bargaining agreement pending the proposal process.
  - In the case of Performance Transportation, however, notwithstanding the debtor following the prescribed procedures for rejection of a collective bargaining agreement, the union went on strike anyway, causing a default on the debtor's Chapter 11 financing and the liquidation of the company. Thus, the power of unions to strike looms as a real issue even for companies in Chapter 11.

"Captive" Financing

- In this tumultuous market environment, public companies are experiencing difficulty raising debt or equity capital. Chapter 11 can be a means for "captive" financing where a company can fill its capital need in unconventional ways.
  - In a Chapter 11 plan of reorganization, a company can offer secured lenders new debt securities with new maturities, interest rates and financial covenants. Such a plan can be approved so long as the company provides the same collateral package and otherwise provides the "indubitable equivalent" of the lenders' claims. In a market where prospects for refinancing are virtually nonexistent, this is a powerful tool. It also is important to note that trade creditors and equity need not necessarily be impaired in this context so long as the standards for confirmation of a plan are otherwise met.
  - Likewise, a public company can "raise" equity in this manner. For instance, it can offer its public securities as currency to creditors. Specifically, an acquirer of distressed assets can force what is in essence seller-financing if the assets are acquired through a plan of reorganization. In other words, stock of the public company is offered to creditors of the debtor to purchase the debtor's assets. This approach allows a public company to continue strategic acquisitions where the market environment might otherwise frustrate the pursuit of such goals.

Fiduciary Duties

- In this downturn, directors will be reminded repeatedly of their duties in distressed contexts. In the distressed area, these rules are substantially the same as nondistressed companies. For example, the business judgment rule still applies. In addition, the exculpation or limitation on liability found in a company's charter likewise applies. This is true even if suit is brought or threatened by creditors seeking to impose liability on directors. The rationale here is that the directors still owe their duties to the corporation and not to creditors. In the situation where a corporation becomes insolvent, creditors have standing to enforce such duties, but the duty is still owed to the corporation. There is still no litmus test for insolvency, however. The rule of thumb continues to be, if a corporation must inquire as to its insolvency, it is sufficiently in the "zone of insolvency" to assume that creditors may be able to enforce such duties.

- Scrutiny of the motives and conduct of members of official committees of unsecured creditors is more intense than ever. The past year was witness to substantial settlements by committee members for perceived misconduct. Serving on a committee can be valuable because it provides a higher degree of access to information regarding a restructuring and a real ability to influence the process. However, before agreeing to serve, keep the following in mind. First, members of the official committee owe a duty to unsecured creditors and to the bankruptcy estate, meaning that they typically cannot pursue their own agendas to the detriment of the debtor or its other creditors. Second, open disclosure regarding any benefits that a committee member receives (release of a preference, assumption of a contract, allowance of a claim, etc.) is paramount.

- Last year saw the welcome retirement of a commonplace threat made against directors and senior management of distressed companies — liability for so-called "deepening insolvency." In multiple decisions, the federal and state courts in Delaware put this issue to rest.

  - Specifically, the Delaware courts reasoned that inasmuch as a board protected by the business judgment rule cannot be held liable for not generating a bigger profit, it likewise cannot be held liable for rendering a company more insolvent. The key is the business judgment rule. A board is not a guarantor of success, and the law allows for decisions that are revealed to be incorrect with the benefit of hindsight. In other words, a decision protected by the business judgment rule will not give rise to liability. The best way for a board to ensure that it is protected by the business judgment rule is to equip itself with timely advice.

  - "Deepening insolvency" has not been forgotten as a measure of damages, however. Where directors and officers have failed to exercise due care (and are thus not protected by the business judgment rule), they will be liable. If the actions of directors and officers in failing to exercise due care caused the corporation to lose value, the amount of such lost value (even in insolvency) can be a proxy for damages.

Expanding Use of the Prepack

- A prepackaged bankruptcy is one where the votes of one or more classes of creditors are solicited before a bankruptcy is ever filed. In fact, the most successful prepack is never filed. This is fundamentally different from the situation where key creditor constituents agree to support a particular form of restructuring but there is no formal voting before bankruptcy. In 2009, we predict that prepacks will see expanded use.

  - Prepackaged bankruptcy will continue to be used as a "stick" to accompany the proverbial "carrot" of an exchange offer. For example, out of court, a company can restructure its balance sheet by asking certain creditors voluntarily to exchange existing debt securities for a new security. This process only makes economic sense if a substantial majority of such creditors agree to the exchange. In court, the company can force the restructuring through bankruptcy, but bankruptcy may involve other costs and disadvantages. By combining an exchange offer with the solicitation of a prepack, the company can promote the exchange offer as the better alternative and hopefully avoid the need for bankruptcy altogether.

- Beyond the traditional use described above, prepackaged bankruptcies will increase in 2009 because of the number of healthy companies that will be unable to refinance pending debt maturities in what remains a closed debt market. Such companies may be able to use a prepackaged bankruptcy to extend maturities. By using a prepack, the company can exit bankruptcy in weeks, as opposed to months, and avoid much of the costs and value loss that bankruptcy may sometimes occasion. This approach would be substantially similar to the carrot-and-stick method described above. For example, the company would propose an extended maturity through an exchange offer, coupled with a prepack. In the context of a syndicated bank facility, unanimous consent may be required for such an out-of-court extension. In court, however, only a two-thirds majority in dollar amount and more than half in number is required. The threat of the prepack (usually offered on less favorable terms than the out-of-court proposal) is often sufficient to achieve the desired extension. Even if bankruptcy is necessary, the duration of prepacks is becoming much shorter than in the past.

Intercreditor Issues

- During the last capital markets boom, second-lien and multi-lien tranched financings experienced exponential growth. Now that the downturn has arrived, many of those transactions will enter bankruptcy court. Bets on second-lien debt may be won or lost based upon how courts will interpret the many subtle variations of intercreditor agreements and other material terms of second-lien financing.
  - Different phases of the boom in second-lien financing produced materially different intercreditor agreements. For instance, early second-lien financings produced first-lien friendly intercreditor agreements. As second-lien financing grew and leverage shifted, intercreditor agreements became more second-lien friendly. In addition, during negotiation of these transactions, more subtle variations were introduced into intercreditor agreements. It is therefore very important to have a clear understanding of the terms of an intercreditor agreement that may be relevant to you.
  - In late 2008, disputes had already arisen between first-lien and second-lien lenders over whether intercreditor agreements prohibited second-lien lenders from filing an involuntary petition in bankruptcy against their mutual borrower. It is unclear how such disputes will be resolved, although many of these bankruptcies are now pending in various jurisdictions around the country.
  - Another challenging issue that arises in this context is determining, among multiple layers of debt, which layer is likely to receive new equity in a debt-for-equity conversion. Distressed investors try to acquire this so-called "fulcrum" security in an effort to take control of a distressed company. An additional complication in the context of second-lien financings is that intercreditor agreements may impair a junior-lien creditor's ability to implement a debt for equity conversion. Intercreditor agreements typically require that all proceeds received by junior creditors be paid over to senior creditors. There is sometimes an exception for equity securities, but careful attention should be paid to such provisions.

Sectors to Watch

- **Retail.** With consumer confidence at an all-time low and same-store sales revealing crippling impairment, it is expected that there will be a large number of retail bankruptcies in 2009. Under the new bankruptcy laws that went into effect at the end of 2005, the issues that debtors and creditors will face are substantial.

  - The primary problem yet to be solved in a retail bankruptcy is how to maximize value for leaseholds of store locations. Under the 2005 amendments to the bankruptcy code, retailers have a maximum of 210 days within which to determine to assume or reject store leases. In the past, retailers would typically file bankruptcy in January, when they were cash rich and could maximize operational fixes over the course of the year, test them during the Christmas holiday selling season, and make store lease decisions thereafter based on results. Now, 210 days is insufficient for that type of process. If a retailer chooses to file bankruptcy in July to attempt the same process, the retailer would probably impede its ability to stock its stores for the holiday selling season, creating a different problem.

  - In recent months, retailers have seen their bank facility lenders pushing for liquidations because those lenders often achieve better recoveries in a store closing or going-out-of-business liquidation than they might in a reorganization. This will be compounded by the fact that it will be harder in 2009 to obtain financing to fund a retail reorganization effort.

- **Real Estate.** Veterans of the last real estate downturn are polishing their armor, readying for the familiar battleground of real estate bankruptcies. The fundamental question remains the same: Who bears the risk if and when the market will turn around?

  - Courts are already being tested on the scope of the restrictions on "single-asset" real estate bankruptcies. Single-asset real estate debtors must commence making payments on secured debt or file a plan within 90 days in order to avoid the termination of the automatic stay. Courts have disagreed on whether a bankrupt homebuilder is a single-asset debtor. In the Pacific Lumber case, the bankruptcy court refused to find that the debtor subsidiary which held timberlands as its only asset was a single-asset debtor. Some courts have ruled that the secured creditor must obtain a ruling that a debtor is a single-asset debtor before the special single-assets restrictions will apply.

  - As in the last downturn, success or failure of real estate Chapter 11 cases will depend upon a debtor's ability to access property income, the bankruptcy court's determination of the property's value and the market rate of interest on the restructured debt.

  - The ruling from the Pacific Lumber case, which is still on appeal, will spawn further litigation in the real estate context. There, the debtor was permitted to sell its real estate and reorganize through a plan without permitting the secured creditors to credit bid. Among other things, the bankruptcy court ruled that the secured creditor received the "indubitable equivalent" of its collateral. There will certainly be more cases in which courts will examine the scope of what "indubitable equivalent" secured creditors can be offered in the real estate context.

  - The impact of the Lehman Brothers bankruptcy will be far-reaching as well. Lehman and its various subsidiaries were a major force in real estate lending. The interplay of the Lehman bankruptcy with other real estate bankruptcies developing around the country will create procedural complexities that many courts have never faced.

For more information on this topic, see "Real Estate: Real Estate and REITs."

Trustees and Examiners

- Based on recent experience, we expect to see more trustees and examiners appointed in 2009. For example, when banks fail, although the FDIC puts the bank itself in conservatorship, there is typically a bank holding company that exists independently from the bank and effectively outside the FDIC's receivership power. Some of those holding companies have opted for Chapter 7 bankruptcies (where trustee appointment is mandatory). Even in the Chapter 11 bankruptcies of such holding companies, issues of mismanagement may prompt the appointment of trustees.
  - More trustee appointments means the possibility of more trustee elections. In the past, the power of creditors to elect a trustee has been seldom utilized in large cases. The procedure is detailed, and the failure to be precise may be fatal to an attempt to elect a trustee. The election can be requested in conjunction with the first meeting of creditors by at least 20 percent of creditors entitled to vote. If a valid request is made and a quorum is present, the creditors can select their own trustee (provided the candidate is otherwise qualified to serve — in Chapter 11, the requirements are modest).
  - An alternative to the appointment of a trustee is the appointment of an examiner. Examiners do not possess the full powers of a trustee, and they typically are appointed for a particular purpose, such as conducting an investigation with respect to a transaction. In circumstances where a court declines to appoint a trustee, the appointment of an examiner is mandatory under the Bankruptcy Code if the debtor's unsecured liabilities exceed $5 million and such appointment is in the interests of creditors or the debtor's estate. Expect to see an examiner appointed in the Lehman case and in other massive failures that may come in 2009.

Cross-Border Restructurings

- With the globalization of the economy, almost every restructuring involves some measure of cross-border issues. The enactment of Chapter 15 into the Bankruptcy Code at the end of 2005 has helped solidify the approach to cross-border cases in the United States, but it is important to understand what Chapter 15 does not do as well.
  - Chapter 15 is a codification of some new and some existing rules for the filing and management of cross-border bankruptcy cases in the United States. Among other things, it provides for the recognition of foreign proceedings that may be "main" or "nonmain." For example, rulings and actions taken in a foreign main proceeding are entitled to more deference than a nonmain proceeding. Status as a main proceeding is determined by reference to a company's center of main interest. In 2007, Bear Stearns attempted to establish the Cayman Islands as the center of main interest for two of its offshore funds that were managed in New York. The bankruptcy court in New York refused because it believed that the funds, although offshore, were run by Bear Stearns from New York. This ruling continues to have an impact today.
  - While Chapter 15 is useful in its recognition of foreign main proceedings in the United States, it does not (and cannot) force a foreign court to recognize a Chapter 11 case as a foreign main proceeding. Special attention should be paid to the global impact of a Chapter 11 case on a company's operations. While many countries have revitalized their restructuring regimes in recent years, they are still very different from Chapter 11 in many cases, and many countries still lag behind this progress. To organize a truly global restructuring, careful planning and coor-

dination is necessary. The Lehman insolvencies are a good example of how devastating a lack of planning can be. For instance, although the debtor had historically relied upon an integrated information technology platform, the multiple insolvency proceedings around the world effectively cut off the debtor's fiduciaries from access to critical information for a few months after the filings. In court filings, the company has blamed this lack of access on the initial lack of coordination among the various insolvency proceedings.

Return to the Table of Contents

Financial Industry Pressures and Reforms After the Meltdown

Past efforts to reform the banking and financial regulatory regime have encountered strong resistance from many different stakeholders. The market meltdown during 2008, Democratic control of the executive and congressional branches, and widespread calls for financial regulatory reform open the door for the implementation of potentially far-reaching measures that could have significant implications for the domestic and global economies beyond the financial sector. The Obama administration and Congress will immediately face the issue of the terms under which additional Troubled Asset Relief Program (TARP) funding authorized by the Emergency Economic Stabilization Act of 2008 (EESA) should be released.

Broad Reform of Financial Regulatory Structure

- Advocates for reform contend that deregulation and lax regulatory oversight helped contribute to the current financial crisis. President-elect Obama and key congressional leaders have expressed support for revamping the regulation of financial services. Given the number of stakeholders involved, we expect a vigorous debate over the form and content of any regulatory reform package.
  - Two EESA-mandated reports on regulatory reform will be released in early 2009, a Congressional Oversight Panel report is due by January 20, 2009, and a second report is due from Treasury by April 30, 2009. Collectively, the reports will consider whether:
    - the current regulatory system is effective in overseeing market participants;
    - unregulated entities/products (*e.g.*, private equity/hedge funds/OTC derivatives) should be regulated; and
    - existing mechanisms for consumer protection and for clearing and settlement of OTC swaps are adequate.
  - Treasury's March 2008 "Blueprint for a Modernized Financial Regulatory Structure" likely will factor into the debate. The blueprint called for moving to an "objectives-based" regulatory structure with four primary regulators: a Market Stability Regulator, a Prudential Financial Regulator, a Business Conduct Regulator and a Corporate Finance Regulator.
- The Federal Reserve has played a historic role in the financial crisis and could emerge as the empowered regulator with broad responsibility for market stability. However, there is concern about the dramatic growth in the Fed's balance sheet and the amount of risk that the Fed is taking on as part of its efforts to support credit markets and economic activity.
- Agencies perceived as ineffective or with missions that have been diminished as a result of market forces may be absorbed into other agencies.
- We do not expect the new administration to take a "go-it-alone" approach. Ensuring that US financial institutions remain globally competitive will be an important consideration. We anticipate that the new administration will be an active participant in multilateral discussions about financial services sector reform.

Contributors | **Partners** | Jamie L. Boucher, Jamie.Boucher@skadden.com, 202.371.7369 | David C. Ingles, David.Ingles@skadden.com, 212.735.2697 | William S. Rubenstein, William.Rubenstein@skadden.com, 212.735.2642 | William J. Sweet, Jr., William.Sweet@skadden.com, 202.371.7030 | **Associates** | Brian D. Christiansen, Brian.Christiansen@skadden.com, 202.371.7852 | Sven G. Mickisch, Sven.Mickisch@skadden.com, 212.735.3554

Continued Government Intervention in the Banking and Financial Markets

- The first $350 billion of TARP funds is fully committed. Two hundred and fifty billion dollars were allocated to purchase preferred stock of eligible financial institutions under the Capital Purchase Program (CPP). As of December 23, 2008, Treasury had purchased approximately $172 billion in preferred stock from approximately 208 eligible financial institutions, and it is continuing to review applications from other financial institutions.
- Critics of the CPP assert funds have been extended with few "strings" attached and that stronger oversight and reporting mechanisms are imperative to ensure that participating financial institutions comply with requirements on executive compensation, dividend payments and stock repurchases. This concern was echoed in a December 2008 report on the operation of the TARP from the Government Accountability Office (GAO).
- In the near term, Congress and the new president must determine the terms under which the second $350 billion in TARP funds should be extended. There will be calls for greater oversight of financial institutions' use of TARP funds and proposals to extend the use of funds to other areas such as reducing foreclosures.
  - The chairman of the House Financial Services Committee is preparing draft legislation that would impose more restrictions on the use of TARP funds and direct that a portion of the funds be used for foreclosure prevention. This could include a role for Fannie Mae and Freddie Mac in reducing rates for new 30-year mortgages through the issuance of mortgage-backed securities.
  - Some members of Congress may push controversial legislation to permit bankruptcy judges to modify terms of mortgages on primary residences. Any such modifications could create exposure for servicers to lawsuits from investors. To address this risk, some proponents of mortgage modifications have called for a temporary safe harbor from such litigation for creditors, assignees, servicers and securitizers of modified mortgages.

Ongoing Pressure on Financial Institutions to Raise Capital

- Deteriorating economic conditions and continuing losses and volatility in financial assets will drive the need for financial institutions to raise additional capital and will result in more institution failures.
- Banks and thrifts that are not approved to receive funding under the CPP likely will need to quickly raise capital from alternative sources or consider seeking a buyer. Banks and thrifts with applications pending under the CPP may seek contemporaneous investments of private capital to increase the likelihood of timely approval of their applications.
- In addition, bank and thrift participants in the CPP must complete qualifying equity capital offerings by year-end 2009 in order to reduce by one-half the number of warrants issued to the federal government under the program.
- Private equity firms and other investment funds will continue to seek acquisition and investment opportunities in the financial services sector in 2009, and the environment is ripe for increased participation by them.
  - The Federal Reserve Board in 2008 issued revised guidance regarding parameters for noncontrolling investments in bank holding companies, relaxing certain limitations on the terms of these

investments. The Fed has suggested that it may provide further guidance regarding "silo" fund structures for investments in banks and thrifts.

- The Office of the Comptroller of the Currency's "shelf charter" approval program will make it easier for private capital to participate in the market for acquisitions of troubled and failed financial institutions. Other banking agencies have indicated that they will offer similar streamlined approval processes.
- Bank and thrift holding companies may further test the circumstances under which the "financial viability" exception to the stockholder approval requirement of the stock exchange rules are available to gain a substantial or controlling equity investment without a shareholder vote.
- Equity capital offerings constituting the sale of a control position will raise important fiduciary considerations for the boards of directors of troubled financial institutions.

Financial Institutions M&A

- The mergers and acquisitions market in financial institutions likely will continue to be dominated by acquisitions of, and investments in, troubled or failed institutions, as asset quality and valuation issues persist and market participants await further developments from Congress and the new administration.
- Acquisitions of failed institutions generally are completed quickly and with substantial deal certainty, especially when the transaction involves a purchase of a banking business from receivership. Depending on the size and character of the asset portfolio being acquired, the FDIC may provide loss-sharing arrangements for the benefit of the acquirer.
  - In light of these factors, nontraditional buyers (including private equity firms) will seek to participate more frequently in these acquisitions.
  - It will be important for these sources of private capital to be able to demonstrate to the FDIC and the other banking regulators that they have a business plan and an experienced management team to run the acquired banking business following the transaction.
- Certainty of closing will remain a central issue in mergers and acquisitions where a shareholder vote requirement and/or other preclosing conditions precipitate a delay between signing and closing.
  - Target companies will seek further protection from the risk of a "material adverse change" occurring between signing and completion of the transaction.
  - Acquirers will seek firmer deal protection mechanisms for pending acquisitions (*e.g.*, golden shares, crown jewel options) particularly where the acquirer has made undertakings in favor of the target prior to closing (*e.g.*, Bear Stearns, Wachovia).
- Boards of directors of troubled institutions will continue to be called upon to make difficult business decisions, often under significant time constraints. Recent decisions involving the conduct of the boards of directors of Bear Stearns and Wachovia suggest that courts will take into account the particular facts and circumstances involved, including relevant timing and informational constraints, and the specific risks faced by the institution.

Increased Regulatory Oversight and Enforcement

- We anticipate that the federal and state bank regulatory agencies will vigorously examine financial institutions' risk management controls and aggressively utilize mechanisms such as public enforcement orders and nonpublic written agreements to ensure that any identified weaknesses in areas such as risk management, underwriting, and fraud and money laundering protection and detection are promptly corrected.

Impacts of Government Regulatory Action and Litigation on Financial Services Enforcement

In 2009, federal bank regulators, law enforcement agencies, state attorneys general, Congress and class action lawyers will increasingly place attention on the financial services industry, resulting in more investigations, prosecutions, enforcement actions and lawsuits against financial services companies.

Government Ownership Interests in Financial Institutions

- The government's ownership interests in financial institutions will lead to government demands on those institutions to implement public policy objectives.
  - Executive pay, lending volume and strategies, dividend payments, acquisitions and mortgage loan modifications are likely areas in which government policies may be forced upon financial institutions.
  - The False Claims Act (FCA) will be used to litigate against financial institutions based on representations they made to obtain TARP monies and how those monies were spent. Notably, Sen. Charles Grassley (R-IA) wrote Treasury Secretary Henry Paulson and Attorney General Michael Mukasey in November 2008 to highlight that those committing fraud against the government in connection with the TARP may be subject to civil penalties and treble damages under the FCA and to encourage support for whistleblowers making FCA claims.

Systemic Mortgage Loan Modification Demands and Risks

- Mortgage loan servicers are being subjected to dramatic cross-pressures from government/consumers and loan owners/investors.
  - Demands from Congress, federal regulatory and federal and state enforcement agencies for systemic loan modifications to permanently reduce principal and interest rates are increasing and will be exacerbated by a wave of "option ARM" rate adjustments, causing a significant increase in delinquencies.
  - These demands for principal and interest reductions are potentially in direct conflict with loan servicing agreements requiring servicers to maximize return to loan owners who sit in different positions with respect to the effect of loan modifications on their earnings. Owners of loans have demonstrated a willingness to sue servicers they deem are acting in contravention of their contractual servicing obligations in modifying loans (see recent action against Countrywide by investors following Countrywide's $8.6 billion settlement with state attorneys general).

Obama Administration Will Focus on Discriminatory Mortgage Lending and Servicing

- An increased focus on race discrimination issues at the federal level will result in federal enforcement agencies (DOJ and FTC) and bank regulatory examinations and referrals to law enforcement focusing on allegations of disparate impact discrimination arising from the exercise of discretion that can cause:
  - higher rates of denials of minority mortgage lending applications;

Contributors | **Partners** | Benjamin B. Klubes, Benjamin.Klubes@skadden.com, 202.371.7508 | Anand S. Raman, Anand.Raman@skadden.com, 202.371.7019 | Andrew L. Sandler, Andrew.Sandler@skadden.com, 202.371.7400

- higher pricing of loan products to minority borrowers; and
- differential treatment of minorities in loan servicing and foreclosures.

The Upcoming Credit Card Credit Crisis

- A dramatic increase in credit card delinquencies will occur just as federal bank regulatory agencies' new regulations limit the ability to reprice credit based on risk. As a result, federal bank regulators and state attorneys general will focus examination and investigative efforts on credit card marketing and disclosures.

Increased Criminal Investigations and Prosecutions

- The DOJ will focus criminal investigations on failures of major hedge funds, mortgage finance companies, investment banks and commercial banks, and, in particular, will prosecute individuals deemed responsible for criminal conduct that led to the failures.

State Attorneys General Will Continue Aggressive Litigation With Novel Theories

- Certain attorneys general will continue to pursue aggressive and novel theories (*e.g.*, Massachusetts AG theory of "structurally unsound" loans that, despite complying with all existing laws and regulations, were illegal as "unfair") seeking major, systemic loan modification relief for consumers.

Cities Turn to Litigation Against Financial Institutions

- At least four major cities resorted to lawsuits against the financial services industry for alleged harm caused by subprime lending/foreclosures (allegedly reduced property taxes, increased crime and fire costs) on a variety of theories such as public nuisance (Cleveland); race discrimination (Baltimore; Birmingham, Ala.); and municipal abandoned property regulations (Buffalo, N.Y.). Absent decisive victories early in these litigations by financial institutions, other cities pressed to address various socioeconomic problems likely will turn to litigation.

Congressional Oversight Investigations and Hearings and Regulatory Reform

- Led by the House Financial Services (chaired by Rep. Barney Frank (D-MA)) and Oversight and Government Reform Committees, Congress will aggressively assert its oversight function, particularly with respect to loan modification practices and potential disparate impact discrimination in mortgage lending and servicing practices.
- There is a real potential for legislation mandating and funding specific loan modification practices and foreclosure moratoriums if the foreclosure crisis continues and Congress deems industry efforts insufficient.

Return to the Table of Contents

The Effect of the Credit Crisis on the Insurance Industry

While the insurance industry generally has not required government intervention or significant restructurings to stave off the effects of the global credit crisis and slowing economic outlook, there have been exceptions, most notably financial guaranty insurers. For the most part, life and property and casualty insurers have not been plagued with the same problems confronting other financial institutions but have nevertheless felt capital constrained.

As we enter 2009, a number of key developments and trends face the insurance industry.

- **Renewed Focus on Optional Federal Charter**
  - Insurance in the United States has historically been regulated by an insurance company's state of domicile.
  - However, many insurance industry participants and observers view the current system as archaic, complex, anti-competitive and burdensome.
  - Reform proposals at the federal level are taking two directions. One is a combined (federal/state) chartering regime similar to the banking industry's dual regulatory system that would permit companies to elect between the state system and a national regulatory structure, which would eliminate the need to comply with 51 sets of state regulations. The other is an overhaul and modernization of the state system.
  - With continued pressure on the economy in 2009, there are likely to be additional insurance company impairments, which will increase the push to have a central regulator responsible for insurance industry oversight and licensing, as well as place additional pressure on state insurance regulators to increase their monitoring and oversight.
- **Private Equity Investment**
  - Expect industry-focused private equity firms to ramp up their acquisition and investment activity in the insurance sector in the latter part of 2009.
  - These transactions likely will take the form of control positions with attendant governance rights or acquisitions of divisions, instead of outright whole-company acquisitions.
  - Private equity and alternative investment vehicles may serve as conduits for disposals of troubled divisions and investment asset portfolios or as sources of funding for capital-intensive or growth lines of business.
- **Strategic M&A**
  - Given the breadth of available opportunities, including continuing AIG asset disposals, expect strategic acquirers to remain selective in assessing M&A alternatives in 2009.
  - Asset/division swaps between industry participants looking to enter/exit particular lines of business/exposure may be an area of growth.

Contributors | **Partners** | Todd E. Freed, Todd.Freed@skadden.com, 212.735.3714 | Robert J. Sullivan, Robert.Sullivan@skadden.com, 212.735.2930

- Foreign acquirers, particularly from the UK, Germany and Asia, are likely to continue to show interest in the US life and property and casualty industries at current valuation levels.
- Uncertainty and volatility in investment asset portfolios of life insurers in particular, but also certain property and casualty insurers, may serve as a check on significant M&A activity in these sectors.
- Unless and until credit markets recover and funding techniques such as "XXX" and "AXXX" (commonly used by life insurers to finance the statutory reserves required by United States Regulation XXX and Actuarial Guideline 38), sidecars and other alternative funding structures once again become available, acquirers may propose increased use of stock as acquisition currency.
- Reinsurance coverage for legacy liabilities (*e.g.*, asbestos and environmental) at a likely significant cost may be explored as a means of risk mitigation by potential acquirers.
- Use of other than nonpublic limited auctions may be reexamined, as the damage to the target company from a publicly announced (or leaked) "failed auction" may be difficult to overcome with respect to investor, counterparty and rating agency perceptions.
- Increased activity in connection with financially impaired institutions, possibly accompanied by streamlined multistate approval processes, is likely.

2009 should be another eventful year for the insurance industry, with anticipated M&A and investment activity, which will likely take a variety of forms, including stock-for-stock mergers, subsidiary carve-out transactions and control position investments.

Return to the Table of Contents

The French Bank Relief Act

French President Nicolas Sarkozy proposed a €360 billion rescue plan in response to the global financial crisis, and the resulting legislation, French law no. 2008-1061, "*Loi de finance rectificative pour le financement de l'économie*" (the French Bank Relief Act), came into effect on October 17, 2008. In order to respond to liquidity and solvency problems faced by banks, this law created special entities authorized to refinance and recapitalize banks in France with the benefit of a French state guarantee.

- The French Bank Relief Act created a Refinancing Company (*Société française de refinancement de l'économie* or *SFRE*) and a Recapitalization Company (*Société de prise de participation de l'Etat* or *SPPE*) and established a guarantee by the French state for debt securities issued by these two companies.
- The Refinancing Company can obtain state guarantees for up to €320 billion, while the Recapitalization Company can obtain state guarantees for up to €40 billion.
- In the event of a potential emergency, the Ministry of the Economy may grant a direct guarantee by the French state to underwrite debt issued by a credit institution (*établissement de crédit*).
- The Refinancing Company is a French joint stock company (*société par actions*) — 66 percent of its share capital is held by six major banks and 34 percent is held by the French state.
- The Refinancing Company may grant loans with a maturity not to exceed five years to credit institutions licensed in France, including the French subsidiaries of foreign groups, provided that such institutions satisfy regulatory capital requirements. These loans bear interest payable to the Refinancing Company and such interest includes a guarantee fee payable to the French state.
- To benefit from a loan, a credit institution must grant qualifying financial collateral to the Refinancing Company and must agree to certain undertakings, including certain minimum ethical rules regarding executive compensation and reporting standards, as well as an engagement to provide financing to individuals, small and midsized businesses and local authorities.
- The Recapitalization Company, which was initially created in order to invest in the share capital of Dexia, is wholly owned by the French state. It has the authority to raise funds in order to make equity or quasi-equity investments in credit institutions and other financial institutions (*établissements financiers*) for the purpose of allowing such institutions to meet their regulatory capital requirements.
- The Dexia group (which consists of local banking operations in Belgium, Luxembourg, Slovakia and Turkey, as well as being a global player in local public sector financing) was the object of a recapitalization carried out on October 3, 2008, by the French, Belgian and Luxembourg governments. As a continuation of this plan, the French Bank Relief Act authorizes the Ministry of the Economy to extend a state guarantee to cover fundraising by certain Dexia entities on the interbanking market or through the issuance of debt securities to institutional investors. The French state will only extend this guarantee if the governments of Belgium and Luxembourg also provide guarantees in a *pro rata* proportion to their participation in Dexia. The French state has already guaranteed €55 billion in fundraising by Dexia, which is included in the €320 billion limit on guarantees available to the Refinancing Company.

On October 20, 2008, the Recapitalization Company injected €10.5 billion into six French banks through the subscription of super subordinated securities that are eligible for the equity rank Tier 1. On November 12, 2008, the Refinancing Company issued bonds with a three-year term for an amount of €5 billion. The operation received an AAA rating by the three main rating agencies. The funds raised by this first issuance were used by the Refinancing Company to grant loans to several banks.

Contributors | **Partner** | Pascal Bine, Pascal.Bine@skadden.com, 33.1.55.27.11.01 | **Associate** | Sidne Koenigsberg, Sidne.Koenigsberg@skadden.com, 33.1.55.27.11.39

The German Financial Market Stabilization Act

The German Financial Market Stabilization Act came into force on October 18, 2008. The Act creates a Financial Market Stabilization Fund and a package of instruments designed to stabilize financial markets, provide needed liquidity to and strengthen the capital basis of financial sector companies, restore confidence in the inter-bank market and prevent a further aggravation of the financial crisis.

Stabilization Instruments Available to the Fund

- The Fund has the authority to issue credit guarantees in an aggregate amount of up to €400 billion for certain liabilities accepted by financial sector companies between October 18, 2008, and December 31, 2009.
  - Credit guarantees can be granted for up to 36 months. In any event, an annual fee of at least 2 percent of the guaranteed amount must be paid to the Fund by the beneficiary of the credit guarantees.
- The Fund may recapitalize distressed financial sector companies and acquire risk positions of financial sector companies acquired before October 13, 2008, in the aggregate up to an amount of €80 billion.
  - Recapitalization measures include equity instruments as well as mezzanine instruments. The measures allow for a return in line with market conditions. In order to ensure fast implementation of the recapitalization measures, the Act contains various provisions that materially modify German corporate and capital markets law. The recipient of recapitalization must pay an adequate return to the Fund.
  - The assumption-of-risk positions comprise receivables, securities and derivative financial instruments. The Fund will assume risk positions at book value or at a lower value against delivery of German government bonds. The Fund must ensure an adequate return reflecting the assumed risks.

Conditions to Be Imposed by the Fund

- As stabilization measures shall only be taken vis-à-vis financial sector companies that have a sound and prudent business policy, the Act requires the Fund to impose certain conditions, relating to such issues as general business policy rules, risk management, distribution of dividends and remuneration of directors and officers of the beneficiary.

Amendment of the German Insolvency Code

- The Act also materially affects the German Insolvency Code by amending the definition of over-indebtedness. An over-indebted company that is expected to be able to successfully restructure and carry on its business is no longer required to file for insolvency.

Contributor | **Partner** | Peter Veranneman, Peter.Veranneman@skadden.com, 49.69.74220170

Return to the Table of Contents

UK Financial Stabilization Measures

In the United Kingdom, the banking sector is facing the most apparent consequences of the 2008 financial markets crisis. The government's response has included a major bank rescue package, involving a recapitalization scheme, a credit guarantee scheme and a special liquidity scheme, as well as the introduction of the UK Banking Bill.

Recapitalization Scheme

- The recapitalization scheme aims to shore up certain financial institutions' resources through, among other things, injections of money by the UK government in the form of both preference and ordinary share capital.
    - Under the recapitalization scheme, seven major UK banks and the largest building society have committed to increase their total Tier 1 capital by £25 billion in aggregate.
    - To facilitate their efforts, the government has pledged to make available to the eligible institutions up to £50 billion to be invested either as preference shares, as permanent interest bearing shares or for assistance to ordinary fundraising. In short, the government has committed to act, if need be, as an underwriter or capital provider of last resort to enable banks to meet the capital standard required.
    - In return for the government's investment and financial support, the banks have agreed to a series of commitments regarding lending, remuneration and dividend policy.
- To date, the government has announced a total capital investment of £37 billion in The Royal Bank of Scotland, as well as in HBOS and Lloyds TSB on completion of their proposed merger, which will leave each bank with a Tier 1 capital ratio in excess of 9 percent.
    - Part of this government support is in the form of preference shares carrying an annual coupon of 12 percent, while the rest is in the form of underwriting assistance through placing of ordinary equity.
- A new independent body, UK Financial Investments Limited, has been established to manage the government's holdings in the relevant financial institutions, with a mandate to realise value for the taxpayer. Although fully owned by the government, the stated intention is for UK Financial Investments Limited to manage shares in the relevant financial institutions on a commercial, arms-length basis.

Credit Guarantee Scheme

- Under the credit guarantee scheme, the government has sought to provide, for an interim period and to the same eight UK financial institutions that are eligible to participate in the government's recapitalization scheme, a government guarantee in support of their commitment to strengthen their respective capital positions.
- The guarantee covers certain types of new short- and medium-term debt issued by the eligible financial institutions and is designed to assist in refinancing their wholesale funding.
- The government estimated that the take-up of the guarantee would be £250 billion.

Contributor | **Partner** | Danny Tricot, Danny.Tricot@skadden.com, 44.20.7519.7071

Special Liquidity Scheme

- The Bank of England has agreed to provide banks with short-term liquidity support through an extension and possible widening of its existing special liquidity scheme, according to which banks and building societies can swap certain high-quality mortgage-backed and other securities for UK Treasury Bills.
- An amount of at least £200 billion will be made available under the scheme.

UK Banking Bill

- The UK Banking Bill represents a large part of the government's legislative response to the financial crisis and, if enacted, will introduce significant changes to UK banking regulation and oversight.
- At the heart of the government's legislative proposals is a special resolution regime that confers new powers on the Bank of England, Her Majesty's Treasury and the UK Financial Services Authority for dealing with a failing or failed bank.
- Options that would be made available to these authorities include: temporary public ownership of the bank, sale to a private sector purchaser of all or part of the bank and sale to a so-called bridge bank of all or part of the bank.
- At the same time, a special insolvency regime, based on the existing liquidation procedure, is proposed in relation to insolvent banks.
- The UK Banking Bill is expected to be enacted in February 2009.

In the final weeks of 2008, amid concern that the publicly funded bank rescue package has not done enough to get credit flowing to businesses, there was media speculation that the UK government is planning to announce, sometime in January 2009, a new guarantee over bank lending to businesses.

M&A Market Outlook

In 2009, credit shortages, volatile financial markets and other economic issues that plagued the M&A market in 2008 are likely to continue to prevail. Accordingly, we expect the overall level of M&A activity in 2009 to be well off the mark of the past several years. However, periods of adverse economic and financial circumstances often provide opportunities for certain types of deals, and we anticipate that this may be the case in 2009. Companies should expect the following trends to be part of the 2009 M&A landscape.

Strategic Transactions Will Continue to Dominate the M&A Market

- Stronger strategic players will continue to be in the deal business, seeing opportunities for combinations that will make them better able to survive current difficult economic conditions and prosper when the markets improve.
- While stock deals appear difficult because of weak and volatile trading prices, companies should not be deterred from pursuing deals that otherwise make sense.
  - The relative pricing of merger partners — and the percentage ownership of the combined company that will be held by each company's shareholders — should be the key factor in stock deals, rather than whether their stock prices are a fraction of where they were a few months prior.
  - Seller boards should be able to properly approve a stock deal, even if the transaction pricing relative to current or recent trading prices falls outside of traditional boundaries, assuming the transaction makes sense based on other typical considerations (*e.g.*, strategic rationale, operational fit, synergies and traditional valuation methodologies). This is so even if the seller board's financial advisor seeks to take an exception in its fairness opinion for how the transaction pricing looks relative to current or recent trading prices and the board allows the financial advisor to take such an exception.
  - Recent regulatory changes in Europe may help facilitate cross-border stock deals. See "Global M&A: A Fresh Perspective on Cross-Border Paper Deals."
- Buyers may utilize exchange offers more often — seizing upon timing advantages and related reduced pricing risks compared to more traditional merger structures.
- Cash deals will continue to be challenging, as obtaining financing will likely remain difficult, even for many of the strongest companies.

Distressed Company M&A Will Be More Prominent

- Distressed company M&A will rise as companies face financial or liquidity crises.
- Companies will seek to generate cash by sale of surplus assets or as part of a restructuring or reorganization/insolvency process.
- The lack of debtor-in-possession financing availability may force rapid transactions as an alternative to more traditional bankruptcy reorganizations.

Contributors | **Partners** | Thomas W. Greenberg, Thomas.Greenberg@skadden.com, 212.735.7886 | Susan S. Hassan, Susan.Hassan@skadden.com, 312.407.0527 | Mitsuhiro Kamiya, Mitsuhiro.Kamiya@skadden.com, 81.3.3568.2228 | Thomas H. Kennedy, Thomas.Kennedy@skadden.com, 212.735.2526 | Adrian Knight, Adrian.Knight@skadden.com, 44.20.7519.7270 | Chris Mallon, Chris.Mallon@skadden.com, 44.20.7519.7236 | Paul T. Schnell, Paul.Schnell@skadden.com, 212.735.2322 | **Associate** | Keitaro Kusunoki, Keitaro.Kusunoki@skadden.com, 81.3.3568.2438

Expect Continued Hostile M&A Activity

- The greater number of companies with undervalued stock prices, short-term liquidity issues or temporarily constrained performance will present an expanded universe of potentially attractive opportunities to buyers.
- A decreased prevalence of structural takeover protections will allow some companies to be "put in play" more easily.

Cross-Border Activity

- Foreign acquisition activity in the US was strong for the first nine months of 2008, but dropped significantly in the fourth quarter. Whether (and when) such activity in the US will rebound is unclear.
- There will be buyers with access to cash that will consider M&A opportunities on a global basis. These will include a limited number of strategic buyers in the US and Europe with strong market positions and ready access to funding and strategic buyers in other jurisdictions — particularly Japan — which can access funding from their strong local banks and are likely to have an exchange rate advantage when considering M&A opportunities in the US and Europe. There also will be certain financial buyers that do not depend upon a highly leveraged capital structure to fund their equity return. These financial buyers are likely to include certain sovereign wealth funds, private equity funds with available equity and other specialist funds, including distressed debt funds.
- As discussed above, we expect to see cross-border stock deals as companies effect consolidating transactions on a global basis. A company with a primary listing outside the US or EU that is considering a substantial consolidating transaction may be advised by its bankers to seek a secondary listing for its securities on a securities market established in the US or EU. Such a listing can increase the attractiveness of the transaction to institutional investors wishing to invest or retain their investment in the enlarged group by permitting them to obtain the advantage of the enhanced standards of corporate governance, ongoing financial reporting, disclosure and transparency imposed on issuers by the regulators of those markets.

Increased Focus on Key Deal Terms

- The volatility of stock trading prices will cause buyers and sellers in stock deals to consider alternatives to address the risk of fluctuations in the buyer's stock price post-signing, including floating exchange ratios, collars and walkaway rights.
- As buyers seek maximum optionality and sellers seek deal certainty, key contract terms related to deal certainty, such as financing conditions, Material Adverse Change (MAC) provisions and reverse break-up fees, will receive significant focus.
    - We may see more agreements containing express financing conditions as buyers contend with frozen credit markets. On the flip side, we may also see a movement toward "UK-style" financing structures where fully committed funding is put in place at the time a deal is signed.
    - Sellers will seek a broadening of key carve-outs to MAC definitions relating to general economic conditions and industry conditions. In light of recent US case law reaffirming the high threshold

for demonstrating that a MAC has occurred, buyers will seek more certainty in MAC definitions, including by limiting MAC carve-outs or quantifying what constitutes a MAC, or by adding additional conditions tied to the target company meeting specified performance metrics.

- Increasingly, buyers may attempt to use reverse break-up fees to walk away from transactions under pressure of a drastic decline in either party's stock price or because financing cannot be obtained. In the US market, sellers may seek to increase the dollar amounts of reverse break-up fees above the current typical 3.0 to 3.5 percent range to attempt to ensure that the reverse break-up fee does not provide buyers with an incentive to walk away in tough market conditions.

- Buyers may seek stronger deal protection measures such as crown jewel "lock-ups" and significant target equity issuances to protect against the risk of an interloper which may be tempted to make a competing bid for one of the merger parties because of its depressed stock price. Sellers will need to consider the fiduciary duty implications of and regulatory limitations on the use of these measures.

New Developments in Private Equity Transactions

The global credit crisis and economic downturn will have a continuing impact on the size, nature and terms of private equity transactions that are entered into in 2009, as traditional private equity investment strategies remain difficult to pursue in light of the constrained credit markets. Private equity firms also will find it necessary to consider alternatives to assist their existing portfolio companies in addressing liquidity and other issues in the current environment.

Private Equity Acquisitions in the Current Environment

- After the significant number of terminated transactions and related litigation involving private equity firms in 2008, the question of how private equity acquisitions will get done in 2009 has yet to be answered.
  - Transactions will be smaller in size and have less leverage and more equity than in the past.
  - There will be an increased focus by both sellers and buyers on the wording of conditions, termination rights and recourse provisions in acquisition agreements and financing documentation, including:
    - financing and/or solvency conditions;
    - reverse break-up fees;
    - limitations on sponsor liability and specific performance;
    - definitions of "Material Adverse Change," including specifying certain matters as a Material Adverse Change; and
    - conditions tied to the target meeting specified performance metrics.
  - Financing will continue to be difficult to obtain, and the terms of any new financing (including pricing, leverage levels, covenants and interest payment features) that is obtained will not be as favorable to private equity buyers as in the past. In exchange for more onerous terms, private equity firms may seek to have "UK-style" financing structures where fully committed funding is put in place at the time of deal signing.
  - Assuming the difficult financing environment continues, there may be a trend of private equity firms partnering with strategic buyers in making acquisitions.

Investments in the Financial Services Sector

- Private equity firms continue to view the financial services sector as a desirable investment opportunity. However, they struggle with the federal regulations governing control of banking organizations as they review potential equity investments in banks. The current trend appears to be moving toward "club" deals with multiple investors coming together and no single investor being fully in "control" of the investment. In such cases, careful attention needs to be paid to the post-closing contractual arrangements among the different investors relating to governance or other matters. See "Financial Institutions: Financial Industry Pressures and Reforms After the Meltdown" for further details.

"Loan to Own" Strategies

- Private equity firms have begun to review and pursue acquisition opportunities through acquiring the highly discounted debt of a distressed target company on the secondary market and then credit bid-

Contributors | **Partners** | Kimberly A. deBeers, Kimberly.deBeers@skadden.com, 312.407.0982 | Casey T. Fleck, Casey.Fleck@skadden.com, 213.687.5341 | Thomas W. Greenberg, Thomas.Greenberg@skadden.com, 212.735.7886 | Rick C. Madden, Rick.Madden@skadden.com, 213.687.5379 | Eileen T. Nugent, Eileen.Nugent@skadden.com, 212.735.3176

ding the face value of the debt in subsequent asset sales pursuant to Section 363 of the Bankruptcy Code or converting the debt into equity of the reorganized entity in other bankruptcy proceedings. This "loan-to-own" strategy typically will require a longer time period to realization and involve greater execution risks given the interplay with the bankruptcy process, but it presents the potential for significant gains.

- Private equity funds must consider a number of potential issues when reviewing the potential acquisition of a target's debt, including:
  - the scope of the fund's permissible investments;
  - potential conflicts in the acquisition of the debt with any confidentiality agreements previously executed by the fund;
  - limitations contained in the debt instrument on the permitted holders of the debt, particularly voting;
  - the complexities of negotiating with multiple stakeholders in a bankruptcy process and the ability to end up the sole owner of the target; and
  - the potential for recovery in the event that the target is not able to complete a successful restructuring in bankruptcy and determines instead to liquidate.

Assumable Financing Structures

- Given the limited availability of credit, private equity firms are considering sales of noncontrolling equity stakes in their existing portfolio companies to other private equity firms in transactions that are structured to avoid triggering the change-in-control provisions in the existing debt. This structure allows the private equity buyer to acquire an equity stake and put money to work while benefiting from the favorable terms of existing financing, and it enables the private equity seller to achieve some liquidity on its existing investment at a time when other exit opportunities may not be available.
- Depending on the terms of the existing financing, transactions with special purpose acquisition companies, or SPACs, may be an alternative means of achieving liquidity without triggering onerous change-in-control provisions in existing debt.

Additional Equity Investments in Portfolio Companies

- Many private equity firms will find it necessary to make additional investments in their portfolio companies to deleverage, cure or stave off defaults under the portfolio company's debt agreements, or to provide emergency liquidity. In making these additional investments, the private equity firm needs to consider carefully the conflicts of interest that are often present in these transactions and take appropriate steps to ensure that the board of directors is complying with its fiduciary duties to avoid potential liability to other investors in the company (*e.g.*, co-investors, management investors or other "club" investors).
- When contemplating additional equity investments, private equity firms should bear in mind the following:
  - The most sensitive areas in these transactions are the amount of dilution to be suffered by existing equity holders and the terms of any "preference" given to the securities acquired in the subsequent investment.

- Because the private equity firm is typically the majority stockholder and has appointed a majority of the members of the board, courts will want to see that the procedural safeguards that were practical under the circumstances were implemented.
- Although not all safeguards are possible or desirable in every transaction, facts that can support the fairness of a transaction include: disinterested members of the board or minority shareholders approving the transaction, a record of attempts to raise alternative financing from third-party sources, opinions from independent financial advisors as to the fairness of the equity investment from a financial point of view, requirements imposed by debt holders that the private equity firm invest additional funds and the opportunity for all equity holders to invest on the same terms.

- Another source of potential liability for a private equity firm can arise if subsequent equity infusions are made from a fund that is managed by the same private equity firm but is a different fund than the fund making the initial acquisition. In this circumstance, there is a heightened concern as the private equity firm needs to ensure that the investment is not only good for the new fund as a stand-alone investment, but also that the rights of the existing equity holders in the portfolio company are respected. In these transactions, in addition to following the conflict-of-interest procedures contained in the fund documents, private equity firms have often found it helpful, where practical, to allow other members of the initial consortium to lead the negotiations on behalf of the portfolio company or to allow other new money investors to lead the negotiations on their behalf.

Debt Repurchases/Exchanges

- A number of private equity firms will seek to take advantage of the deeply discounted trading levels of the bank debt and public bonds of their portfolio companies through debt repurchase or exchange programs that will have the effect of reducing the overall debt level and increasing the equity value of the portfolio company. See "Capital Markets and Hedge and Private Equity Funds: Survival Strategies for a Difficult Corporate Finance Market."

A Fresh Perspective on Cross-Border Paper Deals

The merits of paper deals, including where US registration is required, should be revisited as a result of the recent changes to US securities laws and convergent regulatory trends in the US and Europe.

- As the market value of companies stabilizes (even at substantially lower levels), the best-positioned and strongest strategic players should be prepared to continue to pursue M&A opportunities utilizing shares rather than cash as consideration.
- Debt financing may continue to be unavailable or not available on commercially acceptable/sustainable terms in 2009. At the same time, there is continuing (and, perhaps, increasing) need for consolidation across several sectors (such as the banking, airline and automobile manufacturing industries), and there may be strategic opportunities (from a relative value standpoint) for companies with strong balance sheets.
- Importantly, there has been significant regulatory convergence between the EU and the US over the last 18 months that may enable use of paper as consideration in a higher number of strategic combinations, even where US registration would be required by EU bidders.

Excluding US shareholders in cross-border combinations is becoming harder.

- Excluding US shareholders to avoid registration under the US Securities Act of 1933 (the 1933 Act) and compliance with US tender offer rules is becoming increasingly more difficult in Europe.
- All EU member states have implemented EU legislation requiring bidders to treat all target shareholders equally in the context of tender/exchange offers and mergers.
- This means that in EU tender/exchange offer and merger situations, most EU jurisdictions will not allow the bidder to exclude US shareholders and that, where securities are offered as consideration, registration under the 1933 Act will be required unless an exemption from registration is available.

US/EU Regulatory convergence will facilitate combinations where paper is offered as consideration.

- US registration is less burdensome than in the past because of the process of regulatory convergence in the EU and the US over the past 18 months. Disclosure principles in the US and the EU are almost identical, and post-transaction ongoing reporting requirements, exposure to potential US litigation and increased oversight by US regulators may be avoided after some time through deregistration.
- The requirement that foreign private issuers (FPIs) report financial results through US GAAP accounts or a US GAAP reconciliation of accounts prepared under a different standard was arguably the most burdensome aspect of US registration. In December 2007, the SEC introduced new rules that enable FPIs to report financial results through International Financial Reporting Standards (IFRS) accounts, as adopted by the International Accounting Standards Board (IASB), as an alternative to US GAAP. Because IFRS as adopted by the IASB is not materially different to IFRS as adopted by the EU (other than for financial institutions), European public companies generally will be able to use their IFRS financial statements for purposes of US registration and ongoing reporting requirements.

Contributors | **Partner** | Scott V. Simpson, Scott.Simpson@skadden.com, 44.20.7519.7040 | **Counsel** | Lorenzo Corte, Lorenzo.Corte@skadden.com, 44.20.7519.7025

- With the implementation of the EU prospectus directive and regulation (based on the same disclosure principles as SEC Form 20-F), EU public companies are subject to transactional disclosure requirements that are very similar to those applicable to FPIs in the US. Furthermore, the US and the EU require comparable clearance processes for registration statements and prospectuses in transactions where shares are being offered as consideration.
- The SEC also has effectively addressed the difficulties experienced by FPIs with deregistration and termination of ongoing US reporting obligations. The changes to the deregistration rules that came into effect in June 2007 allow EU companies that are thinly traded on US exchanges to deregister with relative ease no earlier than 12 months following completion of the transaction.

However, bidders will need to overcome certain challenges, perceived and real.

- European bidders facing registration in the US will continue to regard the Sarbanes-Oxley Act with some skepticism and hesitation, inquiring about the costs and liability it imposes on directors and officers. In practice, however, many of the provisions of Sarbanes-Oxley that apply to foreign private issuers do not impose new significant obligations on European companies because they are similar to corporate governance regulations that are already applicable under national law or stock exchange rules and to the practice of sophisticated EU multinationals. Further, empirical data suggests that initial compliance costs should not be an impediment to any significant transaction or any significant company.
- European bidders will need to be convinced that the somewhat inevitable higher exposure to litigation and regulatory oversight arising from registration under the 1933 Act — for example, by the SEC and the DOJ in connection with the Foreign Corrupt Practices Act — is outweighed by the merits of the strategic combination being considered.
- Structuring alternatives that enable EU bidders to achieve deregistration as soon as possible following completion of a US registered transaction (for example, by not listing securities offered as consideration on US exchanges) may be helpful in assuaging some of the perceived risks associated with US registration.

US Takeover Preparedness in the Current Environment

Recent declines in stock market valuations have made many public companies vulnerable to potential unsolicited takeover offers from opportunistic buyers. Unsolicited or hostile transactions increased dramatically in 2008 and are likely to play a significant role in M&A in 2009. Companies that are unwilling to be sold at depressed market valuations may become the targets of acquirers that have access to cash or are willing to issue shares to make acquisitions. In addition, many companies have removed key takeover protections, such as classified boards and shareholder rights plans, in response to pressure from institutional shareholders, activists and proxy advisory firms, thereby increasing their vulnerability to an unsolicited takeover.

Accordingly, it will be important for companies to be proactive and take steps to better prepare their boards and management teams for a possible unsolicited takeover approach.

Review of Takeover Protections

- Companies should review their existing takeover protections in their charter, bylaws and other documents to identify areas of potential vulnerability and consider areas for possible enhancement.

  Shareholder Rights Plans

  - Companies considering the adoption or renewal of a shareholder rights plan will need to consider the potential adverse investor and public relations implications of doing so, including potential actions that may be taken by proxy advisory firms such as RiskMetrics (formerly ISS).
    - For example, RiskMetrics may issue a withhold vote recommendation for boards that adopt or renew a rights plan without shareholder approval if it is not put to a shareholder vote within 12 months of adoption.
    - As a result, many companies will opt to have a rights plan "on the shelf" for adoption at a future date if needed or, alternatively, will adopt a short-term rights plan to address temporary periods of vulnerability.
  - Some companies are now including provisions in their rights plans addressing undisclosed equity derivative positions, such as cash-settled total return swaps, that may not be covered under traditional "beneficial ownership" definitions.
    - Issues to consider include how to ascertain when the applicable threshold has been crossed and whether it is effective or appropriate to dilute the share ownership of swap counterparties.
    - The SEC recently acknowledged the need for certainty regarding the treatment of equity derivatives under Section 13(d) reporting requirements. Any possible changes to Section 13(d) reporting could affect existing and new rights plans.

  Advance Notice Bylaw Provisions

  - Companies should review their advance notice bylaw provisions and confirm that they are "state of the art" and avoid the ambiguities that were present in the *CNet Networks* and *Office*

Contributors | **Partners** | Margaret R. Cohen, Margaret.Cohen@skadden.com, 617.573.4859 | Thomas W. Greenberg, Thomas.Greenberg@skadden.com, 212.735.7886

Depot cases (where shareholder nominations for board seats were permitted to be presented after the apparent deadlines set forth in the bylaws). Companies also should confirm that their advance notice bylaws provide sufficient information about the proponent, including any derivative holdings and short positions.

Change-in-Control Provisions in Debt Agreements

- Companies should review the change-in-control repayment obligations in their existing debt agreements. Such provisions may have a greater impact on a potential takeover in the current environment than they had in the past, given the constrained credit markets.

Additional Preparedness Actions

- In light of changing market conditions, industry and regulatory developments and the evolving M&A environment, boards and management teams should regularly review their strategic plan and alternatives to increase shareholder value. In addition, companies should engage in regular and proactive communications with shareholders, analysts, proxy advisory firms and others regarding their strategic plan and initiatives, as well as their accomplishments.
    - If a determination is made to defend against an unsolicited takeover offer, boards and management teams will need to convince shareholders that they have a better plan for their company and can generate greater value for shareholders than the bidder. This has become increasingly difficult to do in the current environment, given pressure from activists, hedge funds and other investors to achieve short-term results.
    - Companies will have greater credibility in responding to an unsolicited takeover offer if they have a well-defined strategic plan in place and have been discussing it with investors before a bidder approaches the company.
- Boards and management teams should be sensitized that unsolicited approaches can come in a variety of forms and with little or no advance notice.
- Companies should identify a takeover response team, including key executives and outside advisers, and develop a response plan in the event of a takeover approach.
- Companies should maintain a stock watch to monitor changes in their shareholder base and any unusual trading activity.

Return to the Table of Contents

Asset Management M&A in the Current Market

Current markets present unique difficulties and opportunities for buyers and sellers of asset management firms. Acquisitions of asset managers, even in less troubled times, have presented challenging, industry-specific issues. In the current environment, however, deal participants will face an additional set of new and evolving issues.

Impact of Market Volatility on Valuation and Deal Certainty

- Depressed values for asset management firms present an opportunity for buyers to acquire these firms at attractive prices. However, ongoing market volatility (and the resulting volatility in the pricing of asset management firms) requires new approaches to valuation, price adjustments and closing conditions. Buyers will need to rethink the well-established principle of market-neutral purchase price adjustments and consider the benefits (and disadvantages) of including preclosing market increases and decreases in the purchase price adjustment mechanism. Buyers will need to ensure that purchase price structures take into account the negative redemption trends in the industry and increased market volatility, including through the use of earn-outs and purchase price clawbacks.
- Like market-neutral purchase price adjustments, market-neutral revenue run-rate (and similar) closing conditions will need to be rethought, or at least supplemented by an appropriate market-inclusive condition. For example, the proposed sale of Neuberger Berman to Bain Capital and Hellman & Friedman (although later abandoned) included a closing condition that required the S&P 500 Index to remain above a specific level. This was a unique transaction that included a number of unusually buyer-friendly provisions, but the approach is nonetheless reflective of the current market environment. Similarly, "typical" carve-outs for changes in the markets in "Material Adverse Change" definitions will receive increased attention to ensure that the parties are clear which of them bears the risk of market declines.

Attracting and Retaining Key People

- Asset management firms remain dependent on a select group of key individuals. Recent events highlight the need for appropriate cash and equity compensation arrangements. In many firms, new approaches, including increased emphasis on cash compensation, may be necessary in light of the prospect of diminished carried interest and "underwater" performance fees for future years, the termination of tax-advantaged fee deferrals, and possibly the end of tax advantages of carried interests.
- Effective restrictive covenants, together with attractive compensation arrangements, remain essential to ensuring the continuity of a firm through good and bad market periods. Noncompetition and nonsolicitation restrictions in particular become increasingly critical in volatile markets.
- Buyers will need to recognize the "hidden cost" (and "hidden opportunity") of acquiring firms that have not had adequate resources to compensate individuals properly or otherwise put adequate compensation arrangements in place. For example, the levels of compensation at asset management units of global financial services firms may have suffered recently due to the parents' liquidity issues. By separating the target firm from its parent via a lift-out or other acquisition, a buyer may be able to acquire the firm at an attractive price while using a portion of that "savings" to fund the necessary going-forward compensation arrangements.

Contributors | **Partner** | David C. Hepp, David.Hepp@skadden.com, 212.735.3635 | **Counsel** | Michael D. Dorum, Michael.Dorum@skadden.com, 212.735.3595

Impact of Increased Regulatory Oversight

- Recent events have put the regulatory spotlight on the asset management and broker-dealer industries. While significant regulatory changes generally take some time to implement, the prospect of increased regulatory oversight of these industries is present and will need to be considered carefully by buyers, especially financial buyers not already familiar with this regulatory landscape. Buyers will need to consider changes to their due diligence process to ensure an appropriate risk-based approach is utilized in their regulatory due diligence.

As in other industries, buyers with strong balance sheets will be well-positioned to benefit from the current market environment and should have the opportunity to acquire quality asset management firms at attractive prices. While it is too early to predict any trends, pressing needs for liquidity provide strong motivation for many financial services firms to sell a stake in — or all of — their asset management units in 2009.

Return to the Table of Contents

Trends to Watch in Technology M&A

With the prices of many technology companies at historic lows, other traditional exits closed and a number of cash-rich potential acquirers in view, the depressed technology M&A landscape of the latter half of 2008 may give way to a more active technology M&A market. We expect the following trends to be part of the technology M&A landscape in 2009:

The Continued Presence of Unsolicited Offers and Activist Shareholders

- The technology sector is no longer immune to hostile M&A activity as other factors have overcome apprehension of employee defections in the face of an unsolicited offer. This change presents both opportunities and risks.
- Strategic investors have used and will continue to utilize unsolicited proposals (*e.g.*, Microsoft/Yahoo, Samsung/SanDisk, Microchip/Atmel).
- In many instances, technology companies have not had particularly robust protective measures in place and recent pressure to enact additional governance changes by proxy advisory firms, shareholder activists and others have reinforced this vulnerability.
- Activist shareholders were busy within the technology sector in 2008 and should continue to be active in 2009.
  - In the current economic climate, many hedge funds are seeking to exit their positions but are unable to do so absent a change of control — particularly in small-cap technology companies with low trading volumes. We expect to see more shareholder activism in 2009 as hedge funds seek to exit their positions and put these small-cap technology companies in play.
- Economic turbulence has severely impacted stock prices and resulted in many technology companies trading close to, or even below, the value of their cash, making them attractive targets to potential acquirers.
- See "Global M&A: US Takeover Preparedness in the Current Environment" for a review of certain actions that should be considered to improve a company's preparedness for an unsolicited offer.

The Continued Globalization of the Technology Industry and the Technology M&A Market

- Technology companies can expect continued cross-border M&A activity, including increased inbound investment in the US from foreign acquirers.
- US technology companies will continue to make fill-in acquisitions outside the US to better position themselves in an increasingly global technology industry.
- Foreign investment from offshore strategic investors and possibly sovereign wealth funds may increase.
- Foreign acquirers, like their domestic counterparts, are willing to make unsolicited offers (*e.g.*, Samsung/SanDisk), and we expect to see more of this in the coming year as hostile M&A activity in general increases.
- The globalization of the technology sector has been accompanied by a globalization of antitrust regulatory regimes. It is no longer enough to focus on the US and European antitrust regimes. The recent

Contributors | **Partners** | Thomas J. Ivey, Thomas.Ivey@skadden.com, 650.470.4522 | Kenton J. King, Kenton.King@skadden.com, 650.470.4530 | Leif King, Leif.King@skadden.com, 650.470.4662 | Amr Razzak, Amr.Razzak@skadden.com, 650.470.4533 | **Associate** | Richard Flores, Richard.Flores@skadden.com, 650.470.4548

adoption of a new Anti-Monopoly Law in China and the update to the merger notification law expected in India in 2009 require parties to think more globally about competition filings, issues and their potential impact on expected timelines and agreement terms. See "Government, Regulatory and Tax Enforcement: Antitrust: The Rising Tide."

- Other regulatory issues, such as national security reviews (*e.g.*, CFIUS in the US) and privacy and export control protections, are increasingly significant and will also need to be navigated across borders. See "Global M&A: CFIUS: Is the US Still Open for Business?"

Economic Turmoil Will Impact the Ways Parties Approach Deal Structures and Terms

- Depressed financial markets have severely impacted the value of employee options and other equity compensation. Widespread underwater options mean acquirers may need to provide new incentives (at an additional cost to the acquirer) to incentivize key target employees to remain.
- As a result of the boom in convertible debt issuances at technology companies in recent years, there is the potential for increased distressed M&A or debt-to-equity conversions as this convertible debt comes closer to maturity.

Intellectual Property Issues Continue to Be Critical

- Well-thought-out IP diligence is more important than ever as companies respond to economic pressures by implementing cost-cutting measures that inadvertently may dilute the value of their IP assets.
- Conversely, as technology companies trade close to their cash value, rather than on less predictable cash flow metrics, the value of IP on a stand-alone basis may become an increasingly important component of overall valuation.
- From the standpoint of the acquirer, key IP issues in this environment will include:
  - valuation challenges and determining appropriate valuation methodologies for various IP assets;
  - managing open source and other "upstream" licensing risks where target companies, because of budgetary constraints, opt to use no-fee open source code rather a proprietary code;
  - evaluating a target company's IP portfolio in light of litigation trends, licensing requests and demands received by the target company and third-party infringement claims;
  - determining the adequacy of trade secret protection where a target company's practice includes the disclosure of material source code to third parties (in particular, in a dynamic M&A landscape);
  - considering the implications of a change of control on the value of IP assets and third-party rights that may be triggered by a change of control (*e.g.*, source code access rights through escrow arrangements, extension of IP rights of the acquirer to a third party) where weaker technology companies may have entered into agreements with third parties with unfavorable terms;
  - implications of government or institutional funding on intellectual property ownership as target companies increasingly turn to such funding sources to stay solvent;

- implications of joint ownership of intellectual property as target companies collaborate with third parties to meet product development goals in a cost-effective manner;
- evaluating, in view of budgetary constraints, the adequacy of a target company's efforts to enforce its IP rights against third-party infringers and assessing the implications of inadequate enforcement efforts on the value of the target company's IP assets;
- managing the IP risks associated with high employee attrition as the value of equity compensation declines, in particular with respect to key inventors of IP who land positions with direct competitors; and
- understanding particular IP issues raised by cross-border transactions and identifying related risks.

CFIUS: Is the US Still Open for Business?

In 2009, with the arrival of the Obama administration and increased Democratic control over Congress, we expect to see greater attention paid to foreign investment activity and to the interagency Committee on Foreign Investment in the United States (CFIUS), which reviews the national security implications of foreign acquisitions of, mergers with, or investments in US businesses. The US Treasury Department recently issued its new CFIUS regulations, which will give the new administration great discretion and flexibility in its implementation and application of the regulations. In addition, the Senate Banking Committee has stated that implementation of CFIUS regulations will be a priority issue in the upcoming session. We expect to see more rigorous reviews of foreign investment transactions, particularly those involving foreign government-controlled entities or sovereign wealth funds.

New CFIUS Regulations

- The Treasury Department issued its final regulations in November 2008, implementing the Foreign Investment and National Security Act of 2007 (FINSA), which President George W. Bush signed into law on July 26, 2007.
    - FINSA substantially revised US national security reviews of foreign investments in US businesses, making reviews more rigorous, particularly for transactions in certain sensitive sectors, including both critical infrastructure and technologies, as well as transactions involving an entity controlled by a foreign government.
- Consistent with FINSA, the new regulations build upon the current CFIUS review procedures and do not replace them. Most notably, the regulations formalize existing practices by encouraging parties to meet with CFIUS officials during the prefiling CFIUS period and to provide CFIUS with a draft notification at least five days before the formal filing.
- The new regulations also significantly increase the amount of information that must be submitted with the formal notification, including information not historically provided to CFIUS. By solidifying the prefiling consultation process and expanding the notification requirements, the new regulations will extend the overall timetable for CFIUS review and clearance of covered transactions.
    - Parties to a covered transaction should factor these expanded obligations into their deal timetable to ensure that CFIUS staff do not delay review of a transaction because of an incomplete filing, and revise the closing schedule accordingly.
- In addition, the new regulations continue CFIUS' long-standing approach of eschewing a bright-line equity ownership test for purposes of determining whether a foreign entity has acquired "control" over a US business. The regulations instead analyze control in functional terms, taking into account all relevant factors, including equity ownership, representation on the board of directors and ability to direct matters of importance to a US business.
    - Accordingly, while the new regulations and examples help clarify the concepts of control and what constitutes a covered transaction subject to review, the regulations make clear that CFIUS will continue to evaluate control on a case-by-case basis, considering all relevant facts and circumstances, including who the foreign investor is and the nature of the US assets involved.
    - The regulations also provide greater detail regarding the parameters of minority shareholder rights that do not, in the absence of other rights, confer foreign control over a US entity. In so

Contributors | **Partners** | Warren G. Lavey, Warren.Lavey@skadden.com, 312.407.0830 | Ivan A. Schlager, Ivan.Schlager@skadden.com, 202.371.7810

doing, the new regulations should provide dealmakers with additional guidance in structuring transactions, especially passive minority investments in US entities.

- Finally, the regulations provide for civil penalties, including liquidated damages, for the breach of any agreement or requirement imposed on a party as a condition to obtaining CFIUS clearance of a transaction.

- The new regulations reflect CFIUS' careful balancing of US national security with continued openness to foreign direct investment in the United States. The new regulations give vast discretion to the Committee in terms of their application and implementation. Nonetheless, with reasonable assessment of and timely planning for US national security considerations, parties that properly approach the CFIUS review process can expect a fairly straightforward and expeditious CFIUS review.

Changes in Sovereign Wealth Fund Activity

- With the global economic downturn affecting both Asia and the Middle East, we expect to see changes in the activity of sovereign wealth funds (SWFs) in these regions in the upcoming year.
  - Given the global economic downturn and sharp decrease in the price of oil, funds in these regions may no longer be satisfied with passive investment roles and may seek more governance rights associated with their significant investments in the United States.
- At the same time, the creation of multiple new funds in these and other regions will likely generate new SWF activity and new foreign investment in the United States.
  - Some countries are viewing the creation of new SWFs as a way to buffer themselves against the global financial crisis and help their businesses boost trade and expand overseas. For example, France, Brazil and Terengganu (a sultanate state of Malaysia) all have recently announced the creation of new funds.
- President-elect Obama has announced that former Treasury Secretary and Harvard University President Larry Summers will be the new chair of the National Economic Council. In the past, Mr. Summers has expressed a particular interest in the activity and effect of SWFs.
  - In an article in the *Financial Times* last year, he wrote that a "signal event of the past quarter-century has been the sharp decline in the extent of direct state ownership of business as the private sector has taken ownership of what were once government-owned companies. Yet governments are now accumulating various kinds of stakes in what were once purely private companies through their cross-border investment activities."
  - Mr. Summers also has clearly expressed the opinion that SWFs should be viewed differently from other types of investors, stating "Governments are very different from other economic actors. Their investments should be governed by rules designed with that reality very clearly in mind."
- Another factor that may affect the activity of SWFs is the emergence of global standard-setting for these funds.
  - In September 2008, many of the world's largest SWFs agreed to a voluntary code of conduct that establishes a set of Generally Accepted Principles and Practices (GAPP) for SWFs aimed at increasing transparency, accountability and global economic confidence in these funds. Among the core principles of the code is the concept that SWFs should have operational independence from their governing bodies and must have the freedom to pursue investment decisions and investment operations free of political influence.
  - It remains to be seen how the Obama administration will resolve the tension between these voluntary principles and Mr. Summers' previous statements, and whether he will pursue a unilateral approach to governance of SWFs.
- Given the latitude CFIUS will have in enforcement under the new regulations, the Obama administration's approach to SWFs remains to be seen. However, we expect that CFIUS in the new administration will take a more aggressive stance in reviewing US investments by SWFs.

Contributors | **Partners** | Warren G. Lavey, Warren.Lavey@skadden.com, 312.407.0830 | Ivan A. Schlager, Ivan.Schlager@skadden.com, 202.371.7810

Return to the Table of Contents

Managing in Today's Troubled Environment: A Primer for Directors and Senior Managements (Updated Version)*

The Challenge

On Tuesday, October 7, 2008, *The Wall Street Journal* reported on page one: "The deepening malaise illustrates how the financial crisis has moved far beyond US subprime mortgage troubles to a much more fundamental breakdown of trust. … The problem has become so severe that it's affecting not only banks, but regular companies, which are finding it more difficult to borrow money for everyday activities such as paying workers and buying supplies. If sustained, the freeze in short-term-lending markets will weigh heavily on the weakening global economy. Investors are now coming to recognize this harsh reality."

The credit crunch is constraining needed borrowing — and spending — not only by large and small businesses, but by consumers as well. The equity capital markets as well have experienced a global meltdown. These circumstances, combined with weakening economic performance in the US and globally, present an extremely challenging business environment — one which is wide-ranging, deep and of uncertain duration.

In this troubled environment, directors and senior managements of public companies should pay close attention to the risk profile of their companies. Many companies — far beyond those in the financial sector — are or may be facing the perfect liquidity and capital storm of declining operating cash flow, fixed (or increasing) costs and limited availability of new credit and equity capital and/or the withdrawal of existing credit.

This memorandum highlights for directors and senior managements key matters they should consider as they address in the current environment their role as overseers of the business and affairs of the public companies they serve.

Start With the Basics

Risk oversight is a basic function of senior management and directors of US public companies. State corporate law, Sarbanes-Oxley provisions and stock exchange rules each address this function.**

Under Delaware law, applicable to many public companies, directors and officers owe fiduciary duties of care and loyalty, including a duty of oversight to implement a reporting system or other controls allowing management and the board to monitor the company's business and become informed about potential material risks. In general, they are expected to exercise informed, disinterested and good faith business judgment in seeking to identify and manage material business risks. If they act in this way, the decisions they make should continue to be judged under the deferential business judgment rule presumption. How-

* We first provided this memorandum to our clients on October 13, 2008. Although the actions taken by the US and various European governments were designed to help the restoration of the financial markets, the effects thereof are not yet completely clear, and we believe this memorandum remains relevant.

** While certain legal considerations discussed in this memorandum relate to US law and rules, the key message — in these troubled times, directors and senior managements should consider the need for risk reviews, focusing particularly on liquidity and capital resources — would seem appropriate for publicly traded companies regardless of the jurisdictions in which they are organized.

Contributor | **Partner** | Peter Atkins, Peter.Atkins@skadden.com, 212.735.3700

ever, if there are "red flags" signaling risk — a judgment often made in hindsight after potential risks are actually realized to the detriment of the company — ignoring or paying little attention to them may well later lead to claims of failure of oversight, particularly questioning the directors' good faith. See "Governance: The Next Wave of Governance Litigation: Delaware."

How does this apply today? Given the daily flood of reported events and commentary regarding the current credit crunch, the capital markets meltdown, the slowing economy and the adverse effects in general on financial and other businesses, boards and managements would be prudent to consider company specific risk reviews appropriate to their circumstances. In addition, given the lightning speed with which companies previously regarded as sound have been rendered distressed or even insolvent, boards and senior managements should also understand how to exercise properly their fiduciary responsibilities in the event that their companies were to become distressed or considered to be in the zone or vicinity of insolvency.

The importance of the risk oversight function at the board and senior management level is underscored by, among other things, the post-Enron Sarbanes-Oxley 404 requirement that public companies assess the effectiveness of their internal controls over financial reporting (and that senior officers quarterly and annually certify as to their adequacy) and the NYSE requirement for listed companies that the audit committee, at a minimum, discuss the company's guidelines and policies with respect to risk assessment and risk management and the company's major financial risk exposures and processes by which management monitors and seeks to control such exposures.

Beyond legal and regulatory requirements, one reality of today's world is the prospect that perceived failures of risk oversight, which arguably lead to demonstrable damage, will result in media, shareholder and perhaps governmental scrutiny. Prompt examination into currently identifiable or anticipated risks to the company's business is the best way to avoid that spotlight.

What to Do Now

Few industry sectors would seem to be safe from pressure on their businesses resulting from the current troubled environment. Each sector and each company is different, and there is no "one size fits all" approach to identifying and dealing with risk. However, in the present environment, the initial inquiry seems clear: "Show me the money." Companies should examine their liquidity needs and sources and their capital needs and sources, factoring in the prospect of decreasing operating cash flow and more limited, more costly or perhaps no access to credit or equity capital.*

Among the actions directors and senior management should consider are:

- Initiate a prompt review of the company's current business/operating plan for the next 12 to 24 months, using the most current data and trends in doing so, with specific focus on liquidity and capital requirements and sources, and develop a revised plan as appropriate.
- Identify and, if appropriate, implement cost reduction and other cash conservation measures, including suspension/termination of stock buyback programs (in today's environment, liquidity and capital preservation may well have priority over repurchases at "cheap" prices).

---

* An article in the January 5, 2009 *Financial Times* noted that large companies in Europe and the US are seeing the "terms of their credit facilities tighten faster and more severely than smaller companies."

- Establish a program for monitoring, on a real time basis, the key indicators of the company's performance, with prompt reporting to the board (or appropriate group within the board) of material variances and their potential consequences.
- "Stress test" the company's business plan against downside scenarios, including, if of concern, possible negative credit rating agency announcements.
- Pay particular attention to assumptions regarding key contributors to operating cash flow — such as projected year-end holiday sales (for a retail business), projected level of parts orders (for a parts supply business) or projected vacation traveler bookings and cancellations (for a travel-related business).
- Understand and take into account direct and indirect exposure to derivatives and risks around "mark to market" assets.
- Identify and evaluate risk issues related to the increasingly globally interconnected nature of many US businesses, such as business process outsourcing or supply chain interruptions or shutdowns in Asia or elsewhere.
- Determine what capital expenditures in the company's existing plan are "essential" and those commitments which can or should be deferred or are discretionary.
- Reexamine the company's sources of liquidity and capital underlying the current business/operating plan, and assess whether and the extent to which they should be considered reliable going forward. In particular, assess the accessibility, and risks to accessibility, of the company's (1) short term liquidity resources, including cash and cash equivalents temporarily invested in third parties, revolving credit facilities, open lines of credit, normal deferred payment terms for third party goods and services, and commercial paper markets, and (2) longer-term capital resources, including free cash flow and capital markets for debt and equity. Consider contingency planning for access to alternative sources of liquidity and capital beyond the company's traditional sources.
- Review debt agreements (including affirmative, negative and financial covenants) and the company's other material agreements against the company's current plan, and downside scenarios, to evaluate potential compliance issues with respect to covenants and agreements (for example, collateral calls, covenant defaults, cross defaults and accelerations, put rights and joint venture governance rights).
- Consider communications planning, internally and externally, on a contingency basis, should circumstances develop to the point where special communications to the company's various constituencies are warranted.
- Consider (with experts) whether and how to respond to misinformation and rumors that may be having an immediate impact on the company's stock price.
- Review the company's current disclosures and continue to oversee them going forward, in light of the company's financial position and risk profile under current and developing conditions.
- Evaluate the appropriate frequency of board and senior management meetings in order to devote the time necessary to understand the issues facing the company, the options available to it and the risks of each, and then properly and contemporaneously document the efforts of the board and senior management.

- Undertake a thorough corporate governance review (including a review of exculpatory charter provisions and the scope and limits of liability insurance coverage, as well as the financial strength of the carriers) and implement (or continue to monitor compliance with) corporate governance best practices with an emphasis on the board's and senior management's good faith exercise of their responsibilities and reaffirming the right "tone at the top" of the company.

Not all of the actions outlined above will be appropriate for each risk review. What is important is that an informed assessment be made as to whether, in the current environment, a particular company needs to initiate a risk review and, if so, which of the outlined actions (or other actions) make sense to take in order to implement an effective review.

Disclosure

Directors and management should recognize and be prepared to deal with disclosure requirements that may apply to the risk review and related matters discussed above. The management discussion and analysis (MD&A) section of periodic reports on Forms 10-K and 10-Q filed by SEC-registered companies expressly requires discussion of liquidity and capital resources. Moreover, the SEC has provided detailed guidance on what the MD&A section should address with respect to liquidity and capital resources. Any risk review program undertaken should have the benefit of this guidance. Beyond quarterly reporting, disclosure issues related to liquidity or capital resources may arise on an interim basis, including in response to certain Form 8-K reporting obligations or to correct or update prior company disclosure. Previously issued forecasts should be evaluated carefully to determine whether they need to be modified or withdrawn, and forward-looking statement "safe harbor" language should be reviewed in light of the current environment. Furthermore, the disclosure rules of the various exchanges and the duty of candor under state corporate law should be considered.

Use of Experts

To be timely and effective, and to enable directors to rely on expert advice, in many cases it will be prudent to engage outside assistance in planning and executing a review of the type described. Almost always this will include legal counsel familiar with the type of review contemplated, including the duties of directors and senior management in these potentially difficult situations, the processes used and issues addressed, the manner in which the review should be documented, and the disclosure issues which may arise and how the company can satisfy its disclosure obligations. Accounting firms, financial advisory firms and communications firms specializing in these types of situations often prove helpful, as well.

Conclusion

Many businesses are under real pressure from external sources — a severe credit crunch, an equity markets meltdown and weakening economies in the US and elsewhere — which may well present unusual business risks. Directors and senior managements need to focus on their responsibility to oversee the business and affairs of their companies, and to take action reasonably designed to identify and respond to these risks. Prompt consideration is the best means of mitigating damage and satisfying their responsibilities.

Continued Rise of Shareholder Activism

Over the last several years, we have seen a dramatic increase in shareholder activism. This has been manifested in both the large number of Rule 14a-8 shareholder proposals and increase of actual or threatened proxy contests that have been led primarily by activist hedge funds. As a result of the success of shareholder proposals, many companies are taking a more proactive approach in discussing governance- and compensation-related matters with their large shareholders.

Shareholder Proposals

- The proponents of Rule 14a-8 shareholder proposals — largely labor unions, public pension funds, religious organizations and other shareholder groups — have been successful in producing changes in both traditional governance matters (*i.e.*, declassification of boards and redemption of rights plans) and in executive compensation-related areas.

Activist Hedge Funds

- Activist hedge funds are typically motivated by a desire to maximize short-term returns and often are willing to use very aggressive tactics against their targets, including publicizing critical letters to the board or management and launching proxy contests to replace some or all of a company's directors.
  - In light of the recent credit crisis, activists will be less likely to push for a sale of the company or special dividends and more likely to agitate for a split-up of the company or specified operational improvements.
- RiskMetrics (formerly ISS) continues to have a strong influence on the process and more often than not supports dissident shareholders who seek minority board representation.

Preparations

As it is increasingly difficult to "just say no" to activists, it is important for public companies to be both proactive and prepared in this area. In this regard, public companies should:

- establish a core team to respond to an activist situation, including proxy solicitor, legal adviser, financial advisor and public relations firm;
- maintain an active stock watch program to facilitate early detection of accumulation of shares by a potential activist;
- maintain an active and well-coordinated communications and investor relations strategy;
- benchmark the company's performance against a variety of industry peers using metrics that matter to general investors and RiskMetrics;
  - under a new policy, RiskMetrics may issue withhold recommendations for companies with one- and three-year shareholder returns in the bottom half of their peer group;
- undertake a corporate takeover preparedness review, including a review of charter, bylaws and employee benefit plans; and
- prepare the board of directors to deal with the potential for an activist situation.

Contributor | **Partner** | Richard J. Grossman, Richard.Grossman@skadden.com, 212.735.2116

Return to the Table of Contents

Corporate Governance Remains in the Spotlight: Washington

Political changes in Washington, DC, together with the recent economic turbulence and the associated market losses suffered by investors across a wide spectrum will keep corporate governance in the spotlight in 2009. Congress, the SEC, institutional investors and others will continue the push for best practices to be enshrined in statutes and SEC rules and for power to shift from boards of directors to shareholders.

Risk Management

- The spectacular failures of numerous companies are causing politicians, regulators, commentators and plaintiffs to ask, "Was the board aware of the risks?" In light of this renewed emphasis on risk management, boards of directors and management should consider:
  - What structures and processes are in place to identify, monitor and manage risks?
  - Is risk management sufficiently integrated with the company's business and strategic planning?
  - Does the board or a board committee receive regular and robust briefings on the company's risk management, and are the directors sufficiently educated about risk management generally?
  - Should the board oversee risk management directly or have a board committee oversee it (and, if so, which board committee)?

Risk and Incentive Compensation

- In addition to risk management generally, politicians and regulators have focused on the issue of corporate managers and others becoming incentivized to take significant risks in order to achieve substantial amounts of compensation. Accordingly, the Emergency Economic Stabilization Act of 2008 (EESA) requires "limits on compensation that exclude incentives for senior executive officers of a financial institution to take unnecessary risks that threaten the value of the financial institution."
  - Treasury regulations implementing EESA require compensation committees to meet with senior risk officers annually, to discuss and review the relationship between the company's risk management policies and incentive compensation arrangements, and to certify in the Compensation Discussion and Analysis (CD&A) that this has been done.
  - A speech by the then-director of the SEC's Division of Corporation Finance suggested that such an examination would be prudent for all compensation committees, not just those of companies participating in TARP funding under EESA.

"Say-on-Pay"

- Shareholder advisory votes on executive compensation continue to remain high on institutional investors' agendas. Say-on-pay was approved by the House of Representatives in April 2007 and introduced in the Senate by then-Sen. Barack Obama. Say-on-pay was included in an early version of EESA but was not part of the final legislation. Many commentators expect say-on-pay to become legislatively mandated in the near future.

Contributor | **Partner** | Marc S. Gerber, Marc.Gerber@skadden.com, 202.371.7233

- Say-on-pay could erode compensation committees' discretion to set executive compensation.
- Institutional investors believe that a negative advisory vote should result in greater dialogue between a company and its shareholders regarding executive compensation.

"Proxy Access"

- Another item high on the institutional investor wish list is "proxy access" — the ability to include shareholder nominees for a company's board of directors in a company's proxy materials. "Proxy access" also was included in an early version of EESA but not the final legislation. Separately, the NYSE's proposed amendment to its rules that would prohibit brokers from voting shares in director elections absent instructions from beneficial owners remains pending.
  - Either "proxy access" or the adoption of the NYSE amendment (coupled with the majority voting standards adopted by many large companies) could increase the likelihood of directors not being reelected and could deter qualified directors from continuing to serve on boards of public companies.

The Next Wave of Governance Litigation: Delaware

Inevitably, the current worldwide economic conditions have been felt to some degree by nearly all corporations. Distinguished commentary, including a paper recently presented by Vice Chancellor Leo Strine of the Delaware Court of Chancery, has pointed out that investors have "taken it on the chin" and that there may be, in some circumstances, just cause for anger. It is no stretch to suggest the next wave of litigation may involve attempts to hold directors accountable for these problems. The claim is likely to be that the directors took on far too much risk; ignored critical warning signs; were grossly negligent, reckless or worse; and should be forced to pay damages. The question thus becomes one of personal liability.

Director Duties

- Under Delaware law, directors owe fiduciary duties of care and loyalty.
- Subsumed within these duties is the so-called *Caremark* duty to implement a reporting system or other controls that permit management and the board of directors to monitor the company's business and become informed of potential material risks.
  - It is widely anticipated that breach of *Caremark* duty claims will be the centerpiece of lawsuits blaming the recent economic downturn on directors.
  - Stockholders likely will argue that directors breached their fiduciary duties and damaged the company by failing to implement appropriate oversight systems or, in the alternative, by failing to heed "red flag" warnings of risk and potential harm to the company.

How Can Directors Defend Against Such Attacks?

- The first line of defense will be the business judgment rule and statutory exculpatory provisions, such as Delaware's 102(b)(7), which generally protect directors from duty-of-care violations but not disloyal or bad-faith judgments.
  - Many stockholders will no doubt argue that the lack of oversight was so egregious that it amounts to disloyal or bad-faith conduct.
  - But directors have strong defenses. The Delaware Supreme Court has emphasized that for a derivative complaint to withstand a motion to dismiss, only a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information reporting system exists — will establish the lack of good faith that is a necessary condition to liability. In other words, a bad outcome does not equate with bad faith.
- In general, the best approach for directors is to make informed, disinterested and good-faith business judgments when seeking to identify and manage material business risks.
  - This includes taking steps to ensure proper oversight controls are in place and to remain actively informed about the company's business and material developments to ensure that material "red flags" will be identified and appropriately dealt with in a timely fashion.
  - Stockholders, who are unable to identify a faulty reporting system and cannot identify "red flags" that a director missed or ignored, will not get very far with litigation challenging director conduct.

Contributors | **Partners** | Edward B. Micheletti, Edward.Micheletti@skadden.com, 302.651.3220 | Timothy G. Reynolds, Timothy.Reynolds@skadden.com, 212.735.2316 | Edward P. Welch, Edward.Welch@skadden.com, 302.651.3060

  - In contrast, if directors fail to ensure an appropriate control system is in place and fail to heed or, even worse, turn a blind eye to material "red flags" signaling risk, Delaware Courts will likely allow an oversight claim to proceed to trial, and plaintiffs will likely seek money damages from directors personally.

Potential Legislative Developments

- Another consequence of the current economic crisis is likely to be some form of legislative developments on both the federal and state level.
- Many commentators, academics and stockholder advocates have asserted in the press and elsewhere the need for amendments to be made to federal and state statutes that will provide stockholders with more say on how the company is managed.
  - Say-on-pay proposals at the federal level, along with proxy access and related provisions, are obvious examples.
  - On the state level, the Delaware Corporation Law Council is a standing committee of the Bar Association charged with proposing legislative amendments to the Delaware General Corporation Law. The deliberations of the Council are confidential, and there can be no certainty that any amendments will be proposed. However, since Delaware is the state of incorporation for more than 60 percent of the *Fortune* 500, developments under Delaware law are important and obviously should be monitored on an ongoing basis.

D&O Insurance Considerations

The events of 2008 can be expected to result in pricing pressures on directors and officers (D&O) and other forms of insurance, and to make insureds more concerned about policy terms and insurer ratings and capitalization, as described below.

- As a consequence of the crises in the financial markets, we can expect breach of fiduciary duty claims against companies to increase, resulting in higher costs for D&O insurance.
- We also can expect increased bankruptcy filings, and thus companies should review the terms of their D&O policies to be certain they contain adequate protections relating to bankruptcy.
- Most insurers likely remain well-capitalized, as they were not allowed to participate in riskier market activities, but the anticipated increase in claims may place pressure on D&O insurers, making their ratings and capitalization even more important to insureds.
- The general counsel of the New York Insurance Department issued a ruling last summer requiring D&O insurers to include within their policies a duty to defend that cannot be allocated between covered and uncovered claims. We can expect the insurance industry to challenge this ruling early in 2009, and if the challenge is unsuccessful, some D&O insurers may choose to flee the New York market or substantially raise rates to pay for this new duty.

Return to the Table of Contents

Executive Compensation: Emerging Trends and Driving Forces

The world financial crisis and the accompanying bankruptcies, bailouts and economic downturn have dramatically affected executive compensation. Regardless of the extent to which those financial and economic trends continue, 2009 is likely to present additional dramatic changes in the way employers compensate their executives.

- It appears likely that the executive compensation restrictions included in the recent Troubled Asset Relief Program (TARP) will be expanded to other industries and to include additional restrictions.
  - Restrictions similar to those imposed under TARP, as well as additional restrictions that were not part of TARP, were included in the recent automobile industry bailout legislation.
  - In the current environment, there appears to be little opposition (in fact, there seems to be a groundswell of support from a political, media and institutional shareholder perspective) to adopting further executive compensation restrictions, particularly, although not necessarily exclusively, in industries receiving some sort of government financial assistance.
- The heightened scrutiny to which executive compensation has been subjected in recent years is likely to continue and, perhaps, intensify.
  - Momentum appears to be building toward greater ballot access for shareholder proposals (*e.g.*, "say-on-pay").
  - RiskMetrics (formerly ISS) and other shareholder activist groups will continue to develop and apply their standards to withhold votes for directors generally or, in some circumstances, compensation committee members, based upon the company's executive compensation practices and policies.
  - Pay practices that are viewed as excessive, including, for example, substantial severance packages paid to executives in underperforming companies or industries, are likely to continue to receive significant, and embarrassing, press coverage.
  - With the presidency and both houses of Congress soon to be held by Democrats, there is likely to be renewed pressure to impose additional restrictions on executive compensation.
- Be prepared to react to evolving views of "best practices."
  - The movement toward pay-for-performance that has gained so much momentum in recent years is likely to become even more pronounced in light of the financial crisis and the outcry against Wall Street bonuses.
  - As existing equity plans expire or use up their existing share reserves and are replaced by newly approved plans, so called "single-trigger" vesting of equity awards in the context of a change in control may become more rare.
  - Tax gross-ups, whether relating to executive perquisites or excess golden parachute payments, will continue to be viewed as being not shareholder friendly and may continue to become less common.

Contributors | **Partners** | Stuart N. Alperin, Stuart.Alperin@skadden.com, 212.735.3920 | Neil M. Leff, Neil.Leff@skadden.com, 212.735.3269

  - There will be intensified attention to limiting severance payouts, particularly in cases of poor performance.
  - Similarly, clawbacks of incentive compensation will become increasingly common and expected by shareholders.
  - Some companies, in an effort to meet the expectations and pressures of the current environment surrounding executive compensation, may begin to voluntarily impose upon themselves some or all of the restrictions that were imposed as part of TARP.

- The current financial climate and accompanying market turmoil will continue to complicate standard methods of incentivizing employees.
  - The use of stock option repricing programs may gain momentum unless equity valuations correct significantly. Most companies will be required to obtain shareholder approval in order to implement a stock option repricing program. Institutional shareholders and advisory services seem willing to recommend that shareholders approve a properly designed stock option repricing program, if the program satisfies certain requirements, including, for example, that executive officers be excluded from participation.
  - Similarly, performance goals under long-term performance programs may need to be reset in order for them to provide a meaningful incentive and an opportunity to pay out.

- Companies should consider the ramifications of the possible increase in income tax rates that were a part of the campaign promises of President-elect Obama.
  - These increased tax rates, should they become reality, may increase employee appetite for compensation devices that defer income to a future date, at the same time that deferrals are becoming more challenging because of new Internal Revenue Code sections 409A and 457A.
  - Moreover, future legislation may make income deferrals even more difficult to achieve.

Financial Reporting and Disclosure: Continued Scrutiny and Evolution

Scrutiny

The severe economic downturn and liquidity "crunch" — and their related impact on, among other things, companies' results of operations, liquidity, capital expenditures, workforces, research and development, investments and ability to respond to further unanticipated challenges — require that companies, their disclosure committees, their audit committees and their boards of directors take a fresh look at their disclosures in upcoming annual and quarterly reports, in particular the risk factors and MD&A sections of those reports.

- Many companies started this process with their Form 10-Qs for the third quarter of 2008 but should continue to evaluate and assess their disclosure in light of the continued deterioration of the economic environment.
- Similar scrutiny would apply to any registration statement disclosures.

Additional reasons for scrutiny include:

- **PCAOB Alert.** In December 2008, the PCAOB published Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* (PCAOB Alert). Given this preview of the issues to which a company's auditor may apply additional scrutiny, company management and audit committees should work to preempt any surprises during the audit and attendant risk of delays in filing annual reports. The PCAOB Alert highlights the topics listed below, among others.
  - Auditors may need to reassess audit risks to reflect the impact of current economic conditions.
  - Additional audit procedures may be necessary in light of the changes in audit risks.
  - Economic pressures could increase the risk of fraudulent financial reporting.
  - Internal control over financial reporting may require greater auditor attention.
  - Fair value accounting continues to present challenges due to illiquid markets.
  - The reasonableness of accounting estimates should be subject to increased audit scrutiny.
  - Disclosure concerning risks and uncertainties should receive additional auditor attention.
  - Questions about a company's ability to continue as a going concern may require more mitigating evidence to avoid a negative "going concern" audit opinion than in the past.
- ***Glazer Capital Management.*** In addition to internal and auditor scrutiny, a recent Ninth Circuit Court of Appeals decision serves as an important reminder of scrutiny by plaintiffs and courts. In *Glazer Capital Management*, although the defendant prevailed on other grounds, the court concluded that alleged misstatements in merger agreement representations, where the merger agreement was attached as an exhibit to a company's Form 10-K, could provide the basis for a 10b-5 claim by plaintiffs.
  - The decision is consistent with the SEC's view articulated in its 2005 Report of Investigation pursuant to Section 21(a) of the Exchange Act concerning The Titan Corporation.

Contributors | **Partners** | Robert M. Chilstrom, Robert.Chilstrom@skadden.com, 212.735.2588 | Marc S. Gerber, Marc.Gerber@skadden.com, 202.371.7233

- As a result of the Titan SEC report, merger proxy statements often contain a legend/ disclaimer that investors should not rely on the merger agreement representations for factual information concerning the companies.

- In light of *Glazer Capital Management*, similar legends should be considered when agreements are included as exhibits to other SEC filings (including when incorporated by reference).

Evolution

The substance of disclosure, as well as the methods of delivery, continue to evolve. Some components of this evolution are longer term and will be affected by, among other things, the new SEC chair and the impact on the SEC of the Obama administration's as yet unannounced plans for regulatory overhaul (including a possible combination of the SEC and the CFTC or combination of the SEC with other regulatory bodies). Developments to monitor include:

- **XBRL:** Over a three-year phase-in period, companies will be required to provide their financial statements in interactive data format using eXtensible Business Reporting Language (XBRL). Approximately 500 of the largest companies will start in 2009, with their quarterly reports on Form 10-Q, or annual reports on Form 20-F or Form 40-F, for fiscal periods ending on or after June 15, 2009. Companies will need to get up to speed on XBRL and incorporate this process into their financial reporting timetables. See Skadden's December 23, 2008, mailing to clients, "SEC Adopts Mandatory Use of XBRL for Financial Reporting."

- **Transition from US GAAP to IFRS:** The SEC has proposed a roadmap (comments due February 19) setting forth several milestones that, if achieved, could lead to the required use of International Financial Reporting Standards (IFRS) by US public companies that are "large accelerated filers" as early as 2012 for internal purposes and 2014 for external reporting purposes (with "accelerated filers" following the next year and other companies the year after).

  - Companies should begin to understand the differences between US GAAP and IFRS and what impact the transition could have on their financial reporting. For example, IFRS does not allow for last-in, first-out (LIFO) accounting for inventory; according to the SEC release, changing to first-in, first-out (FIFO) could impact taxable income.

  - Also, as companies enter into credit facilities and other agreements that reference US GAAP financial reporting, companies may want to incorporate the flexibility to use IFRS if required or permitted by SEC rules.

  - The European Commission recently extended a rule permitting US companies (as well as companies from certain other countries) listed on EU markets to file their financial statements under US GAAP rather than IFRS. This mirrors the SEC's rule change, adopted at the end of 2007, allowing foreign private issuers to file financial statements under IFRS without reconciling to US GAAP.

    - 2008 saw a number of other SEC actions relating to foreign private issuers, including making it easier to claim and maintain an exemption from Exchange Act reporting, which has resulted in the expansion of "unsponsored" ADR programs.

- **SEC's 21st Century Disclosure Initiative:** Similar to XBRL for financial statements, the preliminary concept is to evolve from document disclosure to data disclosure by organizing all company disclosure in an interactive data file. Periodic reporting (annual and quarterly), current reporting (8-Ks) and transactional reporting (registration statements) would involve supplementing or updating the relevant data in the interactive data file.
  - This SEC staff's study is expected to be published early this year.
  - The initiative contemplates formation of an advisory committee in 2009 to make specific recommendations on implementation.
- **Fair Value Accounting:** On December 30, 2008, the staff of the SEC delivered to Congress a report on mark-to-market accounting mandated by the Emergency Economic Stabilization Act.
  - The report recommended against suspending fair value accounting standards but did recommend improvements, including reconsidering accounting for impairments. The report also recommends enhancing existing disclosure and presentation requirements relating to the effects of fair value in financial statements.
- **Disclosures About Loss Contingencies:** In June 2008, FASB published an exposure draft to expand disclosures about certain loss contingencies under FAS 5 and FAS 141(R) (relating to assets and liabilities acquired in a business combination).
  - In light of significant negative comments by public companies and other groups, FASB decided to consider the issue further, to develop and field test alternative approaches and to delay the proposed effective date.
    - A public roundtable is expected in March 2009.
  - FASB has proposed a FASB Staff Position that would modify the guidance in FAS 141(R) to address concerns that have been raised on accounting for assets acquired and liabilities assumed in a business combination that arise from contingencies.
    - Comments are due January 15, 2009.

Challenging Times Impact Endowment Funds and Donors' Rights

Endowments are a vital part of the financial base of many nonprofit organizations, and today's unusually challenging economic environment poses serious questions for those seeking continuing or increased access to them. At the same time, donors of endowment and restricted funds have become ever more vigilant in seeking to hold institutions faithful to expressed promises. The tensions inherent in navigating among these competing concerns are likely to become more pressing in 2009. The recent adoption of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) in many states further complicates the analysis.

- In states that still have the Uniform Management of Institutional Funds Act (UMIFA) as governing law regarding the use and expenditure by nonprofit organizations of endowment and other restricted gifts, the need to preserve "historic dollar value" (*i.e.* the original primary amount of one or more gifts) can impose serious constraints in a declining market on endowment spending.
- Many institutions used to spending appreciation in a long bull market may be unaware of UMIFA limitations.
- Problems arise where "principal" is invaded without obtaining proper consents.
- Remedies may include release of restrictions with living donor consent and/or through court action under the *cy pres* doctrine, affording relief from restrictions that no longer can be fulfilled as a result of changed circumstance.
- Donors are increasingly emboldened and may be more likely to impose restrictions and less likely to release them when asked.
- In some UPMIFA states, governing boards are permitted to adopt a specified spending rate as presumptively prudent.
- In other UPMIFA states, directors merely must make "prudent" decisions on a spending rate without a safe harbor, which can leave them more exposed.
- Governing boards need guidance on protecting themselves while aiding their organizations in gaining access to needed or necessary funds.

Contributors | **Partner** | Daniel L. Kurtz, Daniel.Kurtz@skadden.com, 212.735.3390 | **Of Counsel** | Sarah E. Paul, Sarah.E.Paul@skadden.com, 212.735.2480

Increased Prosecutions, Regulatory Reforms Highlight Expected Enforcement Trends

We foresee that criminal and civil investigations and prosecutions will increase significantly in the coming year. We also anticipate significant regulatory reforms enhancing oversight, particularly with respect to areas that have historically fallen outside the scope of government supervision. Our predictions are based on:

- the widespread desire to identify the "villains" responsible for the credit crisis;
- the likelihood that, as in the Madoff situation, market losses will make it more difficult to conceal misconduct that might have been hidden in better markets;
- the pressure on regulators, such as the SEC, to adopt an aggressive enforcement approach as a result of the public's perception that the credit crisis has been due in part to regulatory weakness; and
- the likelihood that the incoming administration will place a greater emphasis on enforcement and regulation, particularly of the financial markets.

Below are the issues and trends that we believe will emerge as prosecutorial and regulatory priorities over the course of the next year.

- The DOJ, the SEC and the state attorneys general will respond to the public outcry to punish Wall Street, business executives, investment advisers and hedge fund managers by aggressively prosecuting business misconduct.
  - Increased investigations and prosecutions of companies and individuals that the government believes engaged in lying (misrepresenting facts to the investing public), cheating (manipulating valuations) or stealing (insider trading) are expected.
  - Investigations and prosecutions alleging fraud in offering statements will increase. In the wake of the Madoff fraud calamity, regulators can be expected to scrutinize more closely whether hedge funds are complying with investment guidelines. Regulators also can be expected to scrutinize closely whether "feeders" of Madoff's funds knew of or should have detected Madoff's fraud. Criminal and enforcement cases are likely when the government believes that funds deliberately disregarded offering statement restrictions, or permitted investments or the use of leverage not contemplated by these restrictions.
  - Investigations and prosecutions alleging improper disclosure or selling practices and quasi-suitability issues will increase. One of the largest cases of the 1990s involved Orange County, California, and the county's ill-fated investment decisions. Beginning in 1996, the SEC instituted several enforcement actions against the county and various individuals and entities, including underwriters and financial advisors, in connection with the county's issuance of securities prior to its collapse in 1994. Now, more than a decade later, municipalities are suffering losses relating to their investments in complex instruments. Undoubtedly, federal and state governments will conduct similar investigations of municipalities, financial institutions and intermediaries in connection with these issues.
  - Regulators have yet to satisfy calls for prosecutions of anyone who the public perceives to have profited improperly from the demise of numerous institutions in 2008 by intentionally spreading false or misleading rumors. As a result, prosecutors and regulators are investigating conduct that they believe involved manipulating the markets, either by disseminating false rumors concerning

Contributors | **Partners** | John K. Carroll, John.Carroll@skadden.com, 212.735.2280 | Steven R. Glaser, Steven.Glaser@skadden.com, 212.735.2465 | Colleen P. Mahoney, Colleen.Mahoney@skadden.com, 202.371.7900 | David Meister, David.Meister@skadden.com, 212.735.2330 | Charles F. Walker, Charles.Walker@skadden.com, 202.371.7862 | David M. Zornow, David.Zornow@skadden.com, 212.735.2890 | **Counsel** | Louis D. Greenstein, Louis.Greenstein@skadden.com, 202.371.7108

particular companies and selling short, or perhaps by using credit derivatives as a means to flame the downward price spirals. These cases certainly will continue.

- The subprime meltdown brought a new wave of accounting investigations concerning the valuation of illiquid assets. Marking an asset according to a model is a complex exercise, which one would think should be protected from a prosecutor's 20-20 hindsight. Nonetheless, the DOJ and SEC have indicated that they will examine whether models were manipulated to obtain a preconceived result.

- The types of cases described above are complex and, therefore, difficult to charge. However, where a prosecution concerning valuation or accounting becomes too complicated, the government will fall back on a simpler path against alleged wrongdoers — by charging insider trading. It is easier for the government to make a case against an executive who sold stock before a company's public announcement than it is to prove the falsity of a statement involving complex underlying transactions.

- The economic meltdown will continue to prompt a large volume of bankruptcy filings. We expect the government to scrutinize closely those who choose this course to ensure that the bankruptcy laws are not abused or manipulated. Public issuers also will face SEC inquiries into their financial reporting and disclosure practices preceding a bankruptcy filing.

- The anticipated increase in criminal and enforcement investigations and prosecutions described above are expected to result in an escalation of financial penalties levied by the government.

• The DOJ and SEC will continue to expand enforcement authority over extraterritorial conduct.

  - As investigations cross borders, we are likely to see greater cooperation among regulators. The new administration, which appears to have a desire to reach out to and work with governments outside the US, will likely be successful in enlisting their support in cross-border investigations. As a result, we expect to see growth in enforcement actions involving crimes of international scope. In particular, we believe that such cooperation will have a noticeable impact on the number of FCPA investigations and prosecutions, which are already on the rise.

  - Interagency cooperation is not the only ingredient for the DOJ's expansion of authority. We have seen the DOJ begin to prosecute more readily so-called "clash-of-culture" crimes, where conduct is illegal in the US but not criminal elsewhere. For example, the DOJ has started to take an aggressive stance with respect to online gaming by proceeding against those who process related payments. The DOJ also has begun to take an aggressive stance on extraterritorial tax misconduct, where the DOJ believes that US or international investors have attempted to evade US tax laws. These types of prosecutions will continue.

  - Cross-border prosecutions mean an increasing risk of extraditions and investigations of non-US persons for participation in schemes touching the US markets, even when the impact on the US seems somewhat slight.

• The incoming administration will have a significant effect on regulation and enforcement.

  - Structural regulatory reform is a stated priority of the incoming administration. The financial crisis of the past year has eroded confidence in US markets and increased calls for regulatory revamping and modernization in an effort to streamline regulation and shed overlap.

- As a result, we expect to see new regulations strengthening disclosure, liquidity and capital requirements on financial institutions and increasing oversight of unregulated businesses such as hedge funds and credit rating agencies.
- In addition, we expect that enforcement activity in areas traditionally considered Democratic priorities, such as antitrust, will be enhanced. Also, certain Obama-specific priority areas, such as the environment, will likely receive heightened regulatory and prosecutorial scrutiny.

- Federal, state and foreign regulators will seek to take the lead in major investigations.
    - Given the current economic climate, we anticipate that prosecutors and regulators will seek to take the lead in major investigations. This is particularly true of state attorneys general, who, in recent years, have discovered the benefits of aggressive enforcement. For example, the New York State Attorney General's Office took a leading role in the 2008 auction-rate securities investigations.
    - As a result of the anticipated increased prosecutorial and regulatory zeal, companies and individuals under investigation will need to strategize more than ever about how best to navigate the multilayered parallel proceedings likely to ensue.

Return to the Table of Contents

Climate Change Will Figure Prominently in National Agenda

In 2009, decision makers in government and business will renew their focus on the environment generally, and climate change in particular, in recognition of the implications of the latter for economic recovery and energy security, and of the need for stronger policy and commercial responses in the United States. Climate change will figure prominently in the agendas of both the Obama administration and the 111th Congress, as well as those of their state counterparts in the West and Midwest. Disputes over greenhouse gas (GHG) emissions and related liability and regulatory issues will persist, and scrutiny of carbon governance and disclosure practices from financial and environmental stakeholders will intensify, as the rest of the world watches the United States for signs of meaningful progress ahead of international negotiations in Copenhagen. If the election of President Obama is a harbinger of change from the environmental policy of his predecessor, one area to watch for such signs in months ahead is air regulation.

We expect that the Obama administration will use the Clean Air Act to regulate GHG emissions while it awaits passage of climate change legislation.

- President-elect Obama has promised to "put a price on carbon pollution," and his administration is likely to rescind its predecessor's December 18, 2008, decision that the EPA should not require carbon dioxide limits in air permits for power plants and industrial facilities. As a follow-up, the EPA will decide what the response of EPA should be to the decision that was the subject of the December 18 letter, including whether to require that the EPA conduct a best available control technology (BACT) review to determine possible carbon dioxide emissions controls for each permit.
- In response to the 2007 Supreme Court ruling in *Massachusetts v. EPA*, the EPA is likely to make a finding that carbon dioxide emissions "endanger" health and welfare and that they must, therefore, be regulated under the Clean Air Act (CAA). The EPA would then begin the process of finalizing a notice of proposed rulemaking issued by the Bush administration. While it is still too early to tell what regulations the EPA will propose to address carbon dioxide emissions, it is very unlikely that the EPA will propose a cap-and-trade system using CAA authority. It is unclear if any regulations will be finalized before the passage of climate change legislation and what effect the legislation would have on the CAA regulatory scheme.
- The EPA is likely to reverse the Bush administration decision not to grant a waiver to California's regulations reducing vehicle tailpipe emissions of carbon dioxide. Eighteen other states, comprising 45 percent of the US auto market, have adopted the California standards.

Congress will consider strong climate change legislation in 2009 and 2010, and odds are better than 50 percent that it will pass climate change legislation during this period.

- Legislation is likely to include strong emission reduction targets under a national cap-and-trade program, although it is unclear how aggressive the targets will be in the early years, how many sectors of the economy will be covered, and how responsibility for implementation and oversight will be allocated among various government entities.
- The legislation is likely to include an auction of credits, but it is unclear what percentage of credits will be auctioned in the early years or where auction revenues will be directed. The legislation also is likely to allow use of offsets credits from avoided deforestation and other means, but with limits on percentages of offsets credits allowed from domestic and international sources.

Contributors | **Partner** | Kenneth Berlin, Kenneth.Berlin@skadden.com, 202.371.7350 | **Counsel** | William L. Thomas, William.Thomas@skadden.com, 202.371.7640

- State and regional initiatives to address climate change, including the development of emissions trading schemes and mandatory greenhouse gas emissions reporting, will continue their gradual advance, especially in California and in the Western Climate Initiative. The fate of state programs after federal legislation is enacted is still unclear.

The Obama administration will seek to promote climate, energy security and clean technology priorities through green elements of a broad economic recovery package.

- The DOE is likely to push strongly "decoupling" initiatives — initiatives to separate utility profits from the amount of electricity sold by a utility.
- The Obama administration will propose major initiatives to encourage renewable energy sources, a "smart" grid and the needed infrastructure investments, as well as a host of other green recovery projects. During the campaign, then-Sen. Obama supported a federal renewable portfolio standard requiring utilities to generate 25 percent of their energy from renewable sources.

The Obama administration will attempt to renew American leadership in international climate negotiations.

- The US will support emission reduction mandates.
- The US will seek agreement by advanced developing countries like China, India, Brazil, Indonesia, South Africa and Mexico to emission mandates, but these mandates will be substantially different than those imposed on developing countries.

The Obama administration is likely to propose or reopen other important Clean Air Act rules in its first year.

- In February 2008, the DC Circuit decided *New Jersey v. EPA*, unanimously vacating two EPA rules under the CAA regarding emissions of mercury from electric utility steam generating units. In October, industry groups and the solicitor general petitioned the Supreme Court for certiorari. It is unclear if the Obama administration will continue to support the appeal. If the decision is not reversed, the EPA will have to propose new rules for mercury emissions. The decision and the new rulemaking could raise the question of whether other hazardous air pollutants emitted by power plants would be subject to maximum achievable control technology rules. If so, many power plants might have to install or accelerate their introduction of pollution control equipment.
- Look for the EPA to review all air regulations passed by the Bush administration in 2008 and to seek to reopen any it finds inadequate. In addition, the EPA will have to address the DC Circuit's remand of the Clean Air Interstate Rule and determine how it will attack interstate transport of air pollutants given the limitations imposed by the DC Circuit.

Return to the Table of Contents

Developing Energy and Infrastructure Projects: Challenges and Opportunities

The continuing effects of the current financial crisis, along with the election of a new president whose campaign platform emphasized investment in renewable energy and domestic infrastructure development, provide developers, lenders, investors, contractors, vendors and operators of energy and infrastructure projects with unprecedented challenges and opportunities. Many of the issues stakeholders will face in 2009 will be further defined during the early months of the Obama presidency.

Challenges in the Current Credit Markets Affecting Project Financing

- A highly difficult atmosphere exists for financing and refinancing energy and infrastructure projects, even with strong credit. Credit is often inaccessible, terms have become more restrictive and transaction timelines have been extended. Borrowers must commence refinancing efforts early and consider alternative lending sources and financing structures.
- Strong preference will be given to projects with sound structures based on proper contractual allocation of risks to creditworthy counterparties. Continued risk aversion likely will lead to an additional need for equity.
- Increasingly, borrowers will rely on government loan and guaranty programs, multilaterals and export credit agencies to provide financing, where available. This will result in a greater burden on construction contractors and equipment suppliers to provide financing support.
- The current shortage of tax equity financing capacity is expected to become more profound and will likely lead to expanded eligibility for tax credits or alternative government subsidy and incentive structures.

Construction and Financing of Nuclear Energy Projects

- Construction costs, liability questions, completion assurance concerns and operational issues associated with nuclear projects will continue to challenge sponsors and lenders.
- Project approval will remain contingent upon addressing nuclear waste disposal concerns.
- Construction financing will initially rely on the DOE's loan guarantee program. This program, however, is in need of substantial modification and expansion if it is to achieve its purpose.
- Developers and contractors must negotiate construction contracts that fairly allocate cost and scheduling risks inherent in nuclear construction but are still able to be financed.

Renewable Energy Policies

- President-elect Obama has pledged to spend $150 billion over 10 years on climate-friendly energy development and to create a federal Renewable Portfolio Standard that will require 25 percent of US electricity to be derived from renewable sources by 2025.
- The administration's goal of expanding solar, wind and geothermal energy investment may be achieved through a combination of expanded tax-credit eligibility, direct federal subsidies, greater access to federal lands and other yet-unannounced actions.

Contributors | **Partners** | Lance T. Brasher, Lance.Brasher@skadden.com, 202.371.7402 | Martin Klepper, Martin.Klepper@skadden.com, 202.371.7120 | Paul S. Kraske, Paul.Kraske@skadden.com, 202.371.7234

- Efforts will intensify for a national renewable portfolio standard. Such a standard will need to address regional distinctions and take into account existing state requirements.
- Continued emphasis will be placed on developing transmission infrastructure to support renewable resources. An increasing percentage of new transmission infrastructure will be developed by independent transmission providers. Regulatory policies (including incentive rate structures) are expected to be expanded to facilitate transmission development.
- Federal policy will promote the development of energy storage technology (*e.g.*, batteries, capacitors and solar thermal storage).

Increased Energy Conservation and Efficiency

- Energy suppliers and consumers will be impacted by programs mandating energy conservation standards in government (and other) buildings and linking conservation to government fiscal stimulus.
- Federal, state and local governments are expected to provide funding and loan guarantees for developers meeting conservation standards.
- Greater emphasis will be placed on efficiency standards and technologies.
- Ultimately, conservation efforts will mitigate growth in the demand for energy.

Impact of Climate Change Legislation

- Fossil-fuel project owners, especially owners of coal-fired generation, must evaluate the economic impacts of new regulatory requirements and assess their contractual flexibility to pass compliance costs to customers.
- Project developers should consider grandfathering in provisions for projects in construction or late-stage development.
- Approval for new coal projects may be made contingent upon inclusion of carbon capture and sequestration mechanisms.
- Utilities should consider how they will manage their existing power generation portfolio to maximize value and minimize costs to ratepayers and shareholders in light of potential climate change rules.
- Generation project owners and developers will need to understand the competitive and economic effects of any climate change legislation.

Increased Emphasis on Infrastructure Development

- A substantial portion of federal dollars will be invested in infrastructure via public-private partnerships. These PPPs will present significant investment opportunities for infrastructure funds.
- The new administration has indicated an intention to dedicate billions of dollars to infrastructure investment. These funds may be made available, in part, through a new National Infrastructure Reinvestment Bank (as already proposed in legislation sponsored by Sens. Christopher Dodd (D-CT) and Charles Hagel (R-NE)). Federal programs will feature new requirements and processes for project approval and contracting, impacting the construction and materials industries.

- Published expectations for investment in road construction alone will challenge states and localities to process projects in a fair and prudent fashion. States will be under tremendous pressure to meet schedule requirements and create jobs by rapidly disbursing government funds.
- Government contracting at the federal and state level will be under intense scrutiny, highlighting the importance of high ethical standards and the necessity of following government contracting rules to the letter.

The Electric Industry at a Crossroads: What It Means for Regulation

In 2009 and beyond, the electric industry will sit at the crossroads of climate change strategies, volatile fuel prices, which mean volatile electric prices, and the economic slowdown. We see these trends raising the issues described below.

- The electric industry may feel the economic effect of climate change legislation more than any other industry. The legislation will "shuffle the deck" regarding the value of generating assets. FERC will look for ways to facilitate carbon emissions reductions but has no direct authority to do so. It does, however, regulate the wholesale power markets where the costs of compliance, which will be substantial, will need to be recovered.
- Renewables will continue to be favored as a carbon-reduction tool but are expensive. In addition to the higher cost of renewable energy:
  - Wind, in particular, will require large investments in transmission. The question is "Who will pay?"
  - Increased renewables typically force system operators to add resources to support the reliability of the system for contingency purposes, which increases costs.
- In sum, both carbon-reduction initiatives and increased renewable supply will create significant new costs, ultimately increasing power costs for consumers. Political and consumer backlash probably will result as the costs of these measures start appearing on retail electric bills. If fuel prices rise again, which also would increase power costs, the backlash will intensify.
- Enforcement, a priority of FERC for the past several years, will receive the same, if not greater, focus.
  - Market manipulation has been one of the primary focuses of FERC enforcement, which will only increase with an administration that is already focused on consumer protection. High and volatile prices will increase the level of scrutiny.
  - Reliability enforcement will be a major issue in 2009, as hundreds of violations work their way through the system and the new FERC essentially sets reliability enforcement policy.
- M&A activity will receive varying levels of scrutiny, depending on the transaction.
  - Transactions designed to aid companies adversely affected by the downturn, particularly in the merchant sector, probably will be received favorably at FERC unless there are significant competition issues.
  - Larger transactions involving vertically integrated companies may receive closer scrutiny, not only on competition issues but in the area of consumer protection (cross-subsidization).

Contributor | **Partner** | John N. Estes III, John.Estes@skadden.com, 202.371.7950

Return to the Table of Contents

Antitrust: The Rising Tide

From merger notifications to cartel enforcement to private litigation, antitrust and competition laws are affecting more businesses in more places than ever before. In the US, President-elect Obama has pledged to "reinvigorate" antitrust enforcement efforts. Outside the US, an increasing number of countries are actively enforcing antitrust laws. The growing number of active competition agencies plus increased international private enforcement call for a global antitrust strategy for any significant business activity.

Reinvigoration of US Antitrust Enforcement

- With the new administration, senior leadership will change at the Department of Justice's Antitrust Division, which has been criticized for lax merger enforcement in recent years. The Antitrust Division's recent "Section 2 Report," addressing monopolization-type offenses and outlining certain safe harbors for businesses, also has drawn criticism (including from the Federal Trade Commission) for being too weak on enforcement and may be ripe for revisions under the new administration.
    - Increased horizontal merger enforcement is expected, but the push for increased enforcement could be tempered by the need to stimulate the economy and protect jobs. Obama has indicated sensitivity to the need to strike this balance by pledging to "step up review of merger activity and take effective action to stop or restructure those mergers that are likely to harm consumer welfare, while quickly clearing those that do not."
    - Cartel enforcement has been strong over the past few years as global cooperation has improved, and we expect that trend to continue. History shows that cartel activity increases in difficult economic times, and so implementation or reinforcement of compliance programs is well advised at this time.
- FTC enforcement is already vigorous, with regard to both mergers and anticompetitive conduct, and this is likely to continue in 2009.
    - The current four commissioners do not change with the new administration, and the activist-minded new president will appoint a new commissioner to fill the one existing vacancy. It is likely that a new chairman will be designated and there will be turnover in senior management to reflect President-elect Obama's antitrust policies.
    - The FTC has been scrutinizing the pharmaceutical industry, including reverse payments and other conduct that allegedly delays generic entry. This is a murky area that pits intellectual property rights against antitrust policy.
    - The FTC has been actively asserting itself as an adjudicative body and experimenting with new procedures. Formal rule changes are pending that would make FTC administrative trials faster and likely more effective at blocking mergers.

European Commission Activity

- By November 2009, Alexander Italianer, a macroeconomist with expertise in the financial sector, will succeed Philip Lowe as director-general of the EC's Directorate General for Competition.

Contributors | **Partners** | Steven C. Sunshine, Steven.Sunshine@skadden.com, 202.371.7860 | James S. Venit, James.Venit@skadden.com, 32.2.639.4501 | **Associate** | Sara L. Bensley, Sara.Bensley@skadden.com, 202.371.7032

- The EC has undertaken a "sectoral inquiry" into competition in the pharmaceutical industry, including dawn raids of several companies. In late 2008, the EC issued a preliminary report highlighting the costs of delayed entry of generic drugs, and enforcement actions against individual companies could soon follow, as happened in the EC's first sectoral inquiry into the energy industry.

New Antitrust Regimes

- After almost 15 years in the making, China's new Anti-Monopoly Law went into effect in 2008, revamping China's merger notification process and adding new prohibitions against abuse-of-dominance and cartels. See "New Markets: Testing New Chinese Laws on Competition and Bankruptcy." It remains to be seen what factors will be important to regulators in applying the new law and whether Chinese companies will be treated the same as foreign ones.
- India's updated merger notification law is expected to trigger many more filings than previously required. The new law is expected to go into effect in 2009, as soon as a new agency and implementing regulations are established.
- The UK brought its first criminal cartel charges against individuals in 2008 (resulting in prison terms of 2½ to 3 years for three businessmen), and Australia is in the process of enacting a criminal law against cartels.

Cartels: Increasingly Coordinated Global Enforcement

- More than 30 significant jurisdictions enforce laws against cartel activity, which has classically meant agreements among competitors to fix prices, rig bids, allocate markets or restrict output.
  - Vigorous cartel enforcement jurisdictions include: US, EU, UK, Germany, France, Canada, Australia, New Zealand, South Korea, South Africa, Brazil, Mexico and Japan.
- An increasing number of jurisdictions have Leniency Programs, making a coordinated global approach to leniency critical and more complicated for businesses.
- The trend is toward higher fines and (in applicable jurisdictions) longer prison terms. Prosecutions of cartel-related offenses, such as foreign bribery and wire/mail fraud, are also on the rise.

Class Actions: Spreading to Europe?

- The EC has been actively encouraging private enforcement efforts, including group actions, but so far is resistant to US-style class-action proceedings.
- Variants of class actions and group actions are permitted in the UK and a few other EU member states.
- In 2008, a US-based plaintiffs' firm opened an office in London to be at the vanguard of European class actions. That firm, along with other plaintiffs' lawyers from the US, are lobbying to change the UK opt-in rule to a US-style opt-out class action procedure, as well as for contingency fees and relief from the English fee-shifting rule in class actions.

Health Care: An Uncertain Regulatory Future

Health care initiatives introduced in Congress and proposed by President-elect Obama reflect a key change in the direction and tenor of health care reform, but with so much at stake, a clash for control between administration and congressional leaders appears inevitable. In Congress, the False Claims Correction Act threatens to open a floodgate of *qui tam* suits, and Sens. Max Baucus (D-MT) and Ted Kennedy (D-MA) are promoting their "Call to Action — Health Care Reform 2009" in an effort to remake the health care system. Meanwhile, Obama's appointment of former Sen. Tom Daschle to the head of the Department of Health and Human Services raises the possibility that a federal health board or health czar might emerge as the industry's supreme regulatory body. The uncertainty surrounding the future of health care regulation makes a global understanding of the industry and its oversight mechanisms more vital now than ever before.

Government Enforcement

We expect continued vigorous federal enforcement of health care laws, with some members of the enforcement community employing both the Foreign Corrupt Practices Act (FCPA) and the False Claims Act (FCA) for prosecutions of the same subject matter and transactions.

- False Claims Correction Act (s.2041) — if adopted, would increase the viability of numerous whistleblower claims.
  - Proposed revisions in many cases would permit federal employees to bring *qui tam* actions and largely eliminate "original source" requirements.
  - "Retention of overpayments" — the retention of a known overpayment could serve as basis for an FCA suit.
  - The FCA would no longer require a false claim to be presented to an officer or employee of the government, provided the money or property are spent on behalf of the government.
- Increasing Role of State Medicaid Fraud Control Units (MFCUs)
  - Be prepared for additional scrutiny from MFCUs. Over the 2007 fiscal year, MFCUs were responsible for 1,205 convictions and $1.1 billion in restitution, settlements and penalties. Additionally, MFCU investigations resulted in 805 of the 3,308 (24 percent) Office of the Inspector General (OIG) exclusions for FYE 2007.
- Supreme Court Action
  - On December 8, 2008, the Supreme Court invited the solicitor general to file a brief on an appeal of the Fourth Circuit's holding in *Graham County Soil and Water v. US ex rel Wilson* that the phrase "congressional, administrative, or GAO report, hearing, audit, or investigation" includes only federal administrative reports, hearings, audits or investigations.

Pharmaceutical and Device Manufacturing

- In addition to FCA enforcement, we expect increased scrutiny of physician financial relationships and funding of clinical research.

Contributor | **Partner** | Gregory M. Luce, Greg.Luce@skadden.com, 202.371.7310

- We expect significant Food and Drug Administration "reformation" efforts by the new administration and Congress.
- Teaching and research hospitals' disclosures of all industry funding sources for grants, stipends, and other industry-sponsored gifts will be more closely examined.

IRS Scrutiny by Congress of Not-for-Profit Hospitals

- Legislation has been introduced to Congress that would affect nonprofit hospitals' charitable contributions and establish charity care and community benefit standards for these hospitals. The proposal also would create accountability measures for failure to meet the prescribed standards.

Increased Antitrust Scrutiny and Enforcement in Health Care Industries

- President-elect Obama has specifically pledged to step up antitrust scrutiny and enforcement in critical health care industries, including the pharmaceutical and insurance sectors. We expect significant attention to be paid to new health care antitrust legislation and enforcement efforts.
- The president-elect has promised to ensure that the antitrust laws prevent anti-competitive agreements that artificially retard the entry of generic pharmaceuticals onto the market, and that insurance and drug companies are not "abusing their monopoly power through unjustified price increases — whether on premiums for the insured or on malpractice insurance rates for physicians."

Return to the Table of Contents

New Labor and Employment Law Issues Further Complicate Business Decisions

Employers are reorganizing their businesses, reducing their workforces and modifying compensation. Complicating these actions are recent legislative and regulatory developments in the labor and employment arena, as well as an increased propensity among employees to litigate.

New Legislative Protections

- The Employee Free Choice Act, co-sponsored by President-elect Obama and expected to be enacted, would make it vastly easier for unions to organize workers by requiring the NLRB to certify a union without a secret-ballot election if a majority of the bargaining unit signs authorization cards, and by providing for interest arbitration for contract disputes.
- Amendments to the WARN Act, also co-sponsored by the president-elect, would require covered employers to provide 90 days notice of a plant closing or mass layoff instead of the current 60 days and double the back-pay penalty for insufficient notice.
- Many states recently enacted tougher WARN laws, and others will follow. For example, in New York a new law becomes effective in February.

Increased Private Class Action Litigation

- Employers can expect a continued high level of federal opt-in collective actions and state opt-out class actions alleging wage-and-hour violations, such as misclassification of workers as exempt or as independent contractors.
- Large layoffs also will lead to increased discrimination and ERISA class actions.

Collective Bargaining Negotiations and Union Relations

- Employers with CBAs expiring in 2009 will push for concessions during negotiations.
- Employers who recently negotiated CBAs may seek midterm modifications.
- Expect greater union and employee protections with the anticipated appointment of new members to the NLRB and possible reconsideration of previous employer-friendly precedents.

Post-Employment Restrictive Covenants

- High-level and technical employees seeking to move from potentially troubled employers to competitors may challenge their noncompetition and nonsolicitation agreements.
- Troubled employers may increasingly seek enforcement of such covenants.
- Courts will continue to struggle with protecting individual mobility versus safeguarding the business enterprise.

Contributors | **Partners** | John P. Furfaro, John.Furfaro@skadden.com, 212.735.2624 | David E. Schwartz, David.Schwartz@skadden.com, 212.735.2473

Employee Requests for Accommodations and Leaves of Absence

- The ADA Amendments Act of 2008, expanding coverage to employees with various conditions, including diabetes, epilepsy, heart disease, mental disabilities and cancer, likely will result in increased requests for accommodations.
- 2008 FMLA amendments requiring up to 26 workweeks of leave to care for members of the Armed Forces, and other new regulations, should mean increased requests for leave.
- A growing state trend (in California, Washington and New Jersey) to provide paid family leave through state insurance funds also will result in increased use of leave.

Greater Attention to Employee Terminations

- With mounting government investigations, more executives likely will face termination, presenting disputes over "cause," restrictive covenants, and cooperation and indemnification issues.
- Employee releases will be closely scrutinized and challenged in light of recent decisions finding inartfully drafted waivers ineffective.

Communications: A Changing of the Guard

The policy changes expected to be ushered in by the Obama administration, coupled with new leadership for both the Federal Communications Commission (FCC) and the relevant committees in Congress, will profoundly influence developments in communications-related sectors. President-elect Obama has indicated that his administration will rely upon the "transformative power" of technology and the Internet to improve America's competitiveness and to help solve national problems, making communications policy an important part of his governing agenda.

Communications Regulation in Economically Uncertain Times

- The presidential transition will result in Democratic leadership of the US government executive branch and independent agencies with jurisdiction and authority over communications-related industries, including the FCC, for the first time in eight years. The transfer of power, together with increased Democratic majorities in both the House and Senate, normally would be expected to result in a renewed emphasis on governmental regulation of communications-related issues. The incoming chairmen of the relevant Senate and House committees (Sen. Jay Rockefeller (D-WV) and Rep. Henry Waxman (D-CA)) are considered activist legislators who will work closely with the incoming administration.
- President-elect Obama's personal interest in technology matters (as demonstrated by his commitment to appoint the nation's first chief technology officer), however, he is expected to focus regulatory and legislative initiatives on forward-looking policies aimed at promoting innovation, growth and efficiency in the telecommunications and media industries.
- The current economic downturn also will drive the agenda, forcing both Congress and the administration to center their efforts on stimulating growth in the telecommunications and media space and to closely consider whether legislative or regulatory actions would impose further financial distress on regulated entities.

Impact on M&A Activity

- Given this background, regulators' analyses of sector-specific transactions will be largely driven by the economic and public interest benefits that stem from any combinations. Transactions involving telecommunications and media entities may encounter scrutiny from Congress and the FCC, which will be concerned with concentration and consolidation. Nevertheless, the cross-current of difficult economic times and leveraged companies' needs for relief may compel policymakers to permit consolidation of certain businesses.
  - The FCC has broad authority to review transactions involving regulated entities and often attempts to impose on merger parties transaction-specific conditions before granting consent to deals.
  - While government reviews of mergers could proceed more quickly under the Obama administration, we expect the trend of the FCC pressuring parties to accept conditions in order to complete deals to continue.

Infrastructure Deployment and Network Openness

- The coming year will see a concerted legislative and regulatory effort to stimulate the nationwide deployment of next-generation telecommunications and broadband infrastructure.

Contributors | **Partner** | Antoinette C. Bush, Antoinette.Bush@skadden.com, 202.371.7230 | **Counsel** | John M. Beahn, John.Beahn@skadden.com, 202.371.7392 | **Associate** | Jared S. Sher, Jared.Sher@skadden.com, 202.371.7574

  - Policymakers have expressed an interest in undertaking innovative approaches to promote the development and deployment of broadband facilities, technologies and applications, including adoption of new tax incentives and loan programs, reform of existing federal policies (*e.g.*, universal service fund, spectrum auctions, etc.) and revisions to the US government's usage of information technology services.
  - Broadband service providers, especially wireless and competitive wireline operators, as well as manufacturers of next-generation equipment and facilities, stand to benefit from the expected emphasis on infrastructure deployment, and investment should flow into these sectors.
- Legislative, regulatory or executive action mandating so-called "network neutrality" also will be a primary area of focus during 2009. Although previous efforts to establish policies and regulations governing the operation of the Internet have been the subject of fierce debate, policymakers likely will endeavor to establish the legal rights and authority of network providers to manage and control the flow of data and content on their networks.
  - Independent content providers, as well as stand-alone Web site operators, could benefit from these efforts, but policymakers will be sensitive to the fact that excessive governmental regulation in this area could stifle investment and innovation.

Media Ownership

- While many legislators (especially the Democratic leadership in Congress) have expressed significant concern with respect to ownership concentration in the media industry, the current economic climate and resulting slump in advertising revenue have left many media companies reeling.
- Any effort to review or tighten existing ownership restrictions could exacerbate difficulties confronting already struggling businesses — particularly daily newspapers and radio.
  - During the last year, media-centric transactions have largely focused on deconsolidation, and it is possible that this trend will continue as beleaguered companies seek to raise cash by selling noncore assets.
  - Struggling media enterprises that file for bankruptcy protection to reorganize may force the FCC to consider waivers of certain media ownership rules that the agency normally would not be inclined to grant.

Return to the Table of Contents

Legislative, Enforcement and Other International Trade Issues

The crisis facing US manufacturers and the severe downturn affecting the worldwide economy raise a number of key issues relating to international trade.

Enforcement of US Trade Laws

- President-elect Obama has signaled that he will take a more aggressive approach to enforcing US trade laws. US manufacturers facing import competition and/or perceived trade barriers likely will look to several avenues for relief under US statutes:
  - **Antidumping and countervailing duty laws**. Antidumping and countervailing duty laws generally represent the most effective legal option for domestic producers in terms of dealing with injury from unfairly traded imports. Where the legal requirements of material injury and unfair trade (*i.e.*, dumping or subsidies) are met, the United States will impose tariffs on imports in order to facilitate a level playing field.
  - **Other trade laws.** Other statutory remedies also may be available to domestic producers. So-called "safeguard" provisions of US law, for example, allow for imposition of temporary and discretionary relief against import surges (even of fairly traded products) — and can be pursued either on a global basis or under a "China-specific" provision. In addition, US producers facing barriers in international markets may invoke market-opening provisions of US law (*e.g.*, "Section 301") designed to ensure that other countries comply with their international obligations and do not unfairly discriminate against US products. Such actions often require prosecution of formal WTO dispute settlement cases before relief can be implemented.

Legislative Issues

- In 2009, the Obama administration and the new Congress will likely consider major new legislation in the trade area. Three key issues merit particular attention:
  - **Potential changes to US trade laws.** 2009 will likely see a major effort to strengthen US trade laws in terms of dealing with unfair trade from China and other countries — including currency manipulation and government subsidies.
  - **Trade in the context of climate change.** Trade will play a major role in the debate over climate change, as Congress and the administration consider proposals to avoid placing US companies at an unfair disadvantage vis-à-vis countries with weaker environmental regulations (*e.g.*, proposals to impose climate-related requirements on imports and/or to assist exporters in trade-sensitive industries). See "Government, Regulatory and Tax Enforcement: Climate Change Will Figure Prominently in National Agenda."
  - **Stricter standards in existing and future trade agreements.** President-elect Obama has pledged to renegotiate existing trade agreements and to structure future agreements to ensure that every US trade agreement includes specific minimum labor standards, environmental standards, and protections for American workers and consumers.

Contributors | **Partners** | Jeffrey Gerrish, Jeffrey.Gerrish@skadden.com, 202.371.7381 | James C. Hecht, James.Hecht@skadden.com, 202.371.7370 | Robert E. Lighthizer, Robert.Lighthizer@skadden.com, 202.371.7770

International Negotiations

- The Obama administration will face the question of how strongly to push for reinvigoration of WTO Doha Round negotiations, which could have a significant impact on industrial tariffs, agricultural subsidies and quotas, and laws that address unfair trade.

Export Controls/Economic Sanctions/Anti-boycott Laws

- The Obama administration is likely to maintain a relatively strict policy in terms of enforcing US export controls and economic sanctions. Country-specific policies, however, may see significant changes — for example, with the possibility of weakening certain restrictions on trade with Cuba or of strengthening current sanctions on Sudan. The incoming administration is also expected to continue actively enforcing US anti-boycott laws, particularly in the context of the Arab League's boycott of Israel.

Return to the Table of Contents

Developments on the Tax Front: Monitoring Proposals and Careful Planning Is Increasingly Important

The coming year may include a number of legislative and regulatory changes on the tax front that need to be closely monitored. A variety of tax proposals relating to tax rates, the treatment of income earned offshore and service providers in partnerships, among others, were previously introduced in Congress and are likely to be revisited, and possibly enacted in some form, under an Obama administration. The Treasury Department and IRS also have been formulating a multifaceted response to the recent credit crisis by releasing guidance addressing a number of issues relating to liquidity, the use of losses in acquired banks and the government's bailout investments. In addition, the current environment requires careful planning to preserve the benefits of net operating losses and other valuable tax attributes and to prevent certain adverse tax consequences arising from restructurings and debt modifications.

Distressed Debt

- Debt restructurings, debt-for-debt exchanges, acquisitions of indebtedness at a discount by a related party (such as the private equity sponsor of a portfolio company) and even modifications of credit and other loan agreements (including relatively modest changes in yield and extensions in maturity) may give rise to cancellation of indebtedness income to an issuer and may result in unexpected gain or loss to a holder.
- Non-US taxpayers acquiring distressed debt should be mindful that workouts and restructuring of debt instruments may give rise to their being treated as engaged in a US trade or business, subject to US net-basis taxation and the requirement of filing a US tax return.

International Tax Developments

- The IRS has increased its focus on international activities and structures of US taxpayers, particularly with respect to its enforcement efforts in the international area. For example, the application of withholding taxes, as a general compliance matter and in relation to synthetic investments (such as total return equity swaps), has recently been added to the IRS's Tier I audit list of issues.
- In order to address liquidity concerns, the IRS released Notice 2008-91 to permit US taxpayers to borrow more flexibly from their offshore corporations on a short-term basis without incurring a repatriation tax. Obligations that are collected within 60 days from the time incurred (provided that such obligations are not held by the taxpayer for 180 or more calendar days during its taxable year) generally will not result in a repatriation. The rule is generally effective for 2009 and 2010.

Limitations on Utilization of Net Operating Losses and Other Tax Attributes

- Corporations with net operating losses or other tax attributes (including unrealized losses inherent in their assets) must consider the impact of purchases and sales of their equity on their continued ability to utilize such tax attributes. Charter amendments restricting purchases and sales of equity by significant shareholders or, as a number of corporations have adopted recently, rights plans may be effective ways for corporations to preserve their valuable tax attributes.

Contributors | **Partners** | Stuart M. Finkelstein, Stuart.Finkelstein@skadden.com, 212.735.2841 | Victor Hollender, Victor.Hollender@skadden.com, 212.735.2825 | Mitchell J. Solomon, Mitchell.Solomon@skadden.com, 212.735.2138

- Corporations considering the sale or purchase of a subsidiary from a US consolidated tax group should consider the impact of new consolidated return regulations in pricing the transaction and negotiating the purchase agreement. Without appropriate contractual provisions, a buyer may be surprised to learn that the target has lost valuable tax attributes that it or the buyer could otherwise use post-closing.
- IRS Notice 2008-83 generally would permit certain built-in losses of target banks to be used by an acquirer without limitation. This notice has been the subject of considerable congressional attention recently and may be revisited.

Taxation of Carried Interests

- A number of legislative proposals have been introduced to treat income from certain partnership interests held by service providers, so-called "carried interests," as compensation income taxed at ordinary marginal rates rather than as long-term capital gain, which is currently taxed at a favorable 15 percent federal rate.
- The New York State Executive Budget Proposal for 2009-10, recently proposed by Gov. David Paterson, defines income derived from carried interests in an investment fund as New York source income and subjects it to New York personal income tax (including for nonresidents) to the extent the fund manager conducts business in New York. This provision would appear to impact only New York-based fund managers. Currently, it is unclear whether this proposal would impact the New York City Unincorporated Business Tax exemption for income from self-trading activities.

Information Technology: Developments in Data Privacy and the Role of New Media

Data Privacy and Information Security

For a number of years, the United States relied primarily on industry self-regulation to protect the privacy of personal data. This stood in sharp contrast to many other countries and regions, such as the EU, which have enacted robust statutory regimes to control the collection, use and distribution of personal information. While the US has not yet enacted an omnibus federal data privacy statute, laws that protect the privacy of specific types of information (such as the protection of health information through HIPAA) are now in place.

Moreover, individual states have become increasingly active in this area, and almost all states have enacted laws governing the use of personal information or disclosure requirements in the event personal information is accessed without authorization. For example, in 2008 Massachusetts enacted sweeping new regulations that apply to all entities that own, store, license or maintain personal information about Massachusetts residents.

This expanding regulatory environment comes at a time when threats to data and information security are prevalent. For example, use of malware on Web sites to steal passwords and other sensitive information hit an all-time high in 2008. However, companies also are looking at ways to legitimately exploit personal data that is in their possession (*e.g.*, through packaging and selling data) to generate new sources of revenue. In this complex environment, companies should make sure they take the following steps in 2009:

- Companies must develop, implement and maintain a comprehensive data privacy and information security program. This program, and a corresponding written policy, should be developed with business and information technology stakeholders as well as counsel knowledgeable about the nuances of the various international and US federal and state privacy laws. A key component of this program will be the procedures to follow in the event of a data security breach so that proper disclosures are made as required by state law.
- To the extent that a company has data privacy and information security programs and policies in place, it may want to audit them to make sure they remain current with the evolving legal landscape.
- We anticipate that the expansion of privacy and information security laws, coupled with the growing use and misuse of data, is likely to lead to increased litigation in this area. Companies should therefore have defined protocols in place to deal with threatened and actual litigation.
- Companies need to be prepared for increased pressure on regulatory agencies, such as the FTC, and on individual states to enforce existing statutes, particularly as individuals become more concerned about identity theft and other misuses of their personal information.
- We anticipate greater enforcement of data privacy laws by international regulatory agencies and efforts by them to enforce activities beyond their borders. Companies that own or process information about citizens of other countries should be vigilant in their compliance with those other countries' privacy and information security laws.

The Expanding Role of New Media in Strategic Business Initiatives

In the last two years we have witnessed a dramatic change in the use of the Internet. Companies must now deal with customers and employees who not only create and share their own content, but expect

Contributors | **Partners** | Jose A. Esteves, Jose.Esteves@skadden.com, 212.735.2948 | Rita Rodin Johnston, Rita.Rodin@skadden.com, 212.735.3774 | Stuart D. Levi, Stuart.Levi@skadden.com, 212.735.2750

that proprietary content will be freely available as well. These individuals also expect a social networking experience, not only when communicating with their friends and colleagues, but when interacting with companies as well. All of these developments are layered on top of an explosion of new devices and access points that have made it difficult for companies to control content and manage their own messages.

Companies are no longer fighting these trends but rather are exploring ways to incorporate them into their organizations' strategic business initiatives. In order to do so, they must develop and implement corporate policies that establish how customers and employees can take advantage of these new media opportunities. Consistent monitoring and enforcement of these policies also will be crucial to ensuring that companies exploit new technologies in a manner that will protect a company's intellectual property rights and minimize its legal risks.

Companies also must be mindful that they are operating in a changing legal environment. A number of statutes — such as the Communications Decency Act — protect companies from passively publishing user-generated content. However, courts have recently begun to scale back on this broad immunity and have found that a variety of actions by companies can vitiate these important statutory protections. Understanding this evolving body of law and the steps required to avoid legal liability will be critical in 2009.

Leveraging IP as a Strategic Asset

Intellectual property assets have always been an important component of any company's overall value. For example, such assets are estimated to make up about 70-80 percent of S&P 500 companies' corporate value. In the current economic environment, companies are focusing on how to leverage intellectual property and other intangible assets to improve their top and bottom lines. We therefore anticipate that IP monetization techniques, including the following, will receive increased attention in 2009:

- sales of patents and other intellectual property (with a license-back or other similar arrangement);
- sales of royalty interests, such as the sale of a future royalty stream for a guaranteed up-front payment;
- creative risk-sharing ventures for technology development; and
- financings that use IP as collateral through new and complex vehicles.

Companies should look for ways to take advantage of such new opportunities in what is likely to be a receptive market and be prepared for inquiries regarding their own IP assets.

Return to the Table of Contents

Emerging Trends and Forces Affecting Intellectual Property

Patent Litigation

Historically, economic downturns have resulted in significant increases in patent litigation, as companies seek to protect or enhance market share or capitalize on the potential value of patent assets that are not being utilized. Recommended action items, based on recent case law development, include the following:

- Examine patent portfolios to identify valuable assets for potential enforcement.
- Patent notice letters must be carefully evaluated. Patent holders need to consider whether to forego such letters and file suit without notice. Recipients should consider filing for a declaratory judgment in a more convenient jurisdiction.
- If litigation ensues, patent holders must consider suits in "rocket dockets," ITC or other plaintiff-friendly venues; the impact of the threat of preliminary injunction against competitors; and less-costly enforcement actions on foreign counterparts.
- Defendants should consider patent reexamination and counterclaims. Previously cited prior art can support reexamination, and reexamination may be used to stay litigation.

Copyright

- **Open Source.** A 2008 decision in the Federal Circuit applied copyright principles, with their increased penalties, to open-source software disputes. In December 2008, the Free Software Foundation filed a copyright infringement lawsuit against Cisco based on Cisco's alleged failure to comply with the terms of various FSF open-source licenses. Expect to see an increase in such lawsuits or the threat of such lawsuits.
- **New Injunction Principles.** Although it involved a patent case, the US Supreme Court's ruling in *eBay* — that sweeping injunctions are not automatic following infringement findings — drew support from the "traditional equitable considerations" applied in copyright decisions. Several district court injunctions issued recently in significant copyright disputes are now on appeal. Look for leading decisions to establish new injunction legal principles for copyright cases.
- **Providing Remote Services.** A petition for cert. has been filed seeking high court review of the Second Circuit's *Cablevision* decision. That case opened the door for content service providers to design technologies for delivering content while avoiding infringement issues.
- **Digital Millenium Copyright Act (DMCA) Rulemaking.** The Copyright Office commenced its fourth triennial DMCA Rulemaking in October 2008 for exemptions to the anticircumvention provisions of Section 1201 of the Copyright Act. A total of 19 comments were submitted both to create new and continue existing exemptions, including exemptions to permit circumvention of audiovisual protection measures in order to obtain clips for documentaries and teaching, computer programs that enable wireless telephone handsets to execute software applications and also to connect to a wireless communication network, television broadcast flags, and motion picture anti-access measures requiring certain platforms.

Contributors | **Partners** | Daniel A. DeVito, Daniel.DeVito@skadden.com, 212.735.3210 | Bruce J. Goldner, Bruce.Goldner@skadden.com, 212.735.2972 | David W. Hansen, David.Hansen@skadden.com, 650.470.4560 | Kenneth A. Plevan, Kenneth.Plevan@skadden.com, 212.735.3410 | Allan M. Soobert, Allan.Soobert@skadden.com, 202.371.7780 | **Counsel** | Mary E. Rasenberger, Mary.Rasenberger@skadden.com, 212.735.3565

Trademark

- **Bankruptcy Concerns.** Unlike other types of intellectual property licenses, a trademark licensor in bankruptcy may reject/terminate a trademark license. As bankruptcy filings increase, so does the prospect of trademark licensees losing their rights before the expiration of the term. Current and prospective licensees of significant trademarks should take the steps available to mitigate bankruptcy risk.

- **Trademark Trial and Appeals Board (TTAB)/Fraudulent Filings.** The TTAB continues to come down hard on material misstatements in trademark filings, treating them as fraudulent filings that invalidate a registration — even where there is a mistake through inclusion of a single good or service in the trademark application that is not being offered under the name. This risk is magnified where registrations of key marks have been used as loan collateral in businesses covered by state franchise statutes.

- **Famous Marks Doctrine.** In 2007, the Second Circuit rejected the famous marks doctrine. At the same time, however, the New York Court of Appeals, responding to a certified question, held that a party that owns a foreign mark with reputation and goodwill in the United States nonetheless can prevail under New York's common law of unfair competition by misappropriation. One New York federal court has now applied New York misappropriation law to issue an injunction on behalf of a foreign mark holder.

Advertising/Consumer Issues

In a down market, expect advertising claims to become more aggressive as marketers fight to maintain or increase share with limited advertising budgets. While company-against-company Lanham Act litigation will likely fall off, consumer class action (plaintiffs' bar contingency) lawsuits filed under state statutes will likely continue to increase. The Supreme Court's 5-4 decision in the *Altria Group* (light cigarettes) case will inevitably lead to more such suits. Also expect increased activity at the National Advertising Division of the Better Business Bureau, Inc. (NAD), particularly in its efforts to monitor "green claims" advertising. The FTC's proposed tightening of the endorsement guidelines will likely be adopted, making advertising principles more applicable in the blogosphere.

Return to the Table of Contents

Cost-Cutting Spurs Outsourcing, Close Scrutiny of Contracts

In the current economic environment, almost all companies are looking to outsource as a means to cut costs and/or reduce headcount. Such savings are not limited to the dollar-for-dollar cost reductions that can come from labor arbitrage. Rather, companies increasingly want to transition from their own fixed-cost model to the variable pricing model offered by outsourcing providers. The flexibility offered by such variable pricing (*i.e.*, paying only for the resources consumed) is particularly important in an environment where companies are facing material fluctuations in their business requirements, either because of a business slowdown or as a result of divestitures or acquisitions.

- Companies also are finding that service providers — many of whom have been impacted by decreasing demand from their existing customer base — may be somewhat more flexible when negotiating service fees or other material terms. Indeed, because of this changing market dynamic, customers who are already outsourcing should give serious consideration to renegotiating their current agreements. These customers may find that the service provider is willing to reduce fees in exchange for extending the term of the agreement.
- However, while outsourcing presents significant business opportunities, there are also increased risks in the current environment. Certain outsourcing providers, particularly those delivering niche business process services, may be unable to survive the economic downturn.
  - It is therefore imperative that companies conduct careful financial due diligence of potential providers. Companies should not only request financial reports, but also ask probative questions, such as whether the provider relies on one or two customers for the bulk of its business.
  - Companies also should be prepared for "reverse due diligence" by the service provider. Increasingly, providers want to make sure customers will be able to pay service fees and are otherwise on firm financial footing before they commit resources to the relationships.
- Companies also are facing increased internal pressure to consummate outsourcing transactions as quickly as possible. This often means that they are readily willing to concede business and legal points if it will result in a quicker path to signing. While proceeding too quickly in negotiations is always risky, the current environment has magnified that risk for the following two reasons:
  - First, many issues in an outsourcing agreement that once seemed like remote "what if" scenarios, now need to be carefully considered. For example, there is a greater possibility that one or both of the parties will face: dramatic fluctuations in business requirements, an acquisition or divestiture, or a bankruptcy event that impacts performance. The customer will want to make sure that the agreement fully addresses the rights and obligations of the parties in such scenarios.
  - Second, service providers are under increasing pressure to identify any "hidden" revenue opportunities in their outsourcing agreements. As a result, they are far more likely to take a hard-line approach with respect to any ambiguity in the contract that might impact revenue. For example, in the past, if a specific task was not identified in the statement of services, the service provider might have agreed to perform it at no additional charge in order to maintain goodwill with the customer. Today, that same vendor is more likely to argue that service fees must be increased to accommodate the change. It is therefore essential for companies to define carefully the services that are to be delivered, as well as any costs that are the responsibility of the service provider. Failure to do so will only lead to protracted and costly disputes.

Contributor | **Partner** | Stuart D. Levi, Stuart.Levi@skadden.com, 212.735.2750

- In sum, the following action items are among those that are essential for companies seeking to outsource in 2009:
  - review whether there are opportunities to renegotiate existing agreements, particularly by trading lower service fees for longer terms;
  - conduct thorough financial due diligence of potential service providers, including looking for any "red flags" that might cause problems down the line;
  - pay particular attention to any provision in the agreement that might be impacted by changing business conditions, and make sure these provisions detail the parties' respective rights and obligations; and
  - eliminate any ambiguity in the agreement because service providers will rely on such ambiguities to extract higher service fees going forward.

Strategic Choices Help Companies Manage Complex Multijurisdictional Disputes

The complex litigation arising from the current global financial crisis will require management and co-ordination of parallel litigation proceedings simultaneously in multiple jurisdictions, often both in courts throughout the world and international arbitral forums. To assess the risks of such litigation and, to the extent possible, exert control over the international dispute process, companies need to consider a number of strategic issues.

Evaluating Potential Forums

In determining where to initiate litigation and how litigation should be coordinated, and in assessing the risk of litigation in various jurisdictions, companies should evaluate:

- the ability to obtain jurisdiction over the parties necessary to the litigation, but located in numerous jurisdictions;
- the availability and scope of discovery or disclosure required in each forum, including the role of the court or the arbitrator in the evidence-gathering process;
- the ability to obtain evidence from third parties located outside the jurisdiction;
- the manner in which evidence will be presented to the fact finder, including the availability of a jury and whether the parties or the court will examine witnesses;
- the availability and manner of presentation of expert testimony, including whether experts are permitted to communicate directly with each other and whether they are retained directly by the parties or report to the court;
- complex issues concerning what law or laws will apply to various aspects of the dispute;
- the availability of certain types of damages, such as punitive and consequential damages, as well as the jurisdiction's attitude toward fee-shifting and cost-shifting; and
- the ability to obtain recognition and enforcement of foreign awards and judgments, including the location of assets and the ability to locate those assets through discovery.

Methods of Exerting Control Over the Forum and Timing of Litigation

Once a company determines the optimal forum for resolving its disputes, it may attempt to assert control over the forum using a variety of strategies, including invoking choice-of-forum and international arbitration clauses. Within the United States, forum selection or "choice-of-court" provisions are generally enforceable with some limited exceptions, although interpretation of forum selection clauses can vary from state to state. However, there is no international treaty guaranteeing recognition of forum selection clauses and, consequently, no guarantee that foreign states will recognize and enforce such clauses.

Arbitration agreements usually provide a greater certainty of forum because of treaties providing that written arbitration agreements will be recognized by the courts of the contracting states. When requesting that a court compel arbitration or issue an injunction in aid of arbitration, a party usually will seek to stay or dismiss any claims covered by the arbitration clause, and also may seek a discretionary stay of

Contributor | **Partner** | Lea Haber Kuck, Lea.Kuck@skadden.com, 212.735.2978

related litigation that, while not arbitrable itself, is nevertheless sufficiently dependent upon the outcome of the arbitration that a stay is prudent and an efficient use of judicial resources.

Even where there is no applicable arbitration or forum selection clause, companies may attempt to manage the litigation by seeking anti-suit injunctions, in which one court enjoins a party from proceeding with parallel litigation in another jurisdiction, or forum non conveniens dismissals, where a court that has jurisdiction over the parties nevertheless dismisses the case based on a finding that the interests of justice require the dispute to be heard in another forum. While the use of anti-suit injunctions in the United States is widely recognized, their availability in the European Union is an open question that we expect will be resolved in 2009.

Coordination of Proceedings

Where parallel litigation is inevitable, devising an overall strategy and carefully coordinating the proceedings is essential. Such litigations are likely to proceed on different timetables and positions taken or information disclosed in one proceeding may come back to haunt a party in another proceeding. Moreover, in fact-gathering and in producing documentary evidence, care must be taken to preserve privilege and confidentiality under what may be very different rules among jurisdictions, and the parties also must be aware of various data protection legislation and blocking statutes that may apply. They also must be cognizant of any applicable restrictions on communicating with and gathering evidence from fact witnesses and experts.

Return to the Table of Contents

Securities Class Actions: No Shrinking Ice Cap

Securities class action filings reached a 10-year low in 2006. Some attributed the decline in filings to the effects of Sarbanes-Oxley while others believed it was caused by, among other things, the bull market and lack of volatility. Though the filings increased a bit in 2007, the number was still well below the 10-year average, and some in the legal community had predicted a permanent decline in the number and influence of securities class actions. One academic proclaimed that class action securities fraud litigation was "shrinking faster than a polar ice cap."

Far from a "shrinking ice cap," however, the combination of the sudden onset of the global credit crisis and the increased volatility in the securities markets in the last 18 months has led to an unprecedented resurgence in securities litigation. While plaintiffs are filing such actions in record numbers, and we believe will continue to do so, 2009 will be the year in which the bulk of such claims will be tested. This flood of securities litigation will serve as an opportunity for lower courts to apply the recent Supreme Court jurisprudence seen in such cases as *Dabit, Tellabs, Stoneridge* and *Dura*, which has raised the bar for private plaintiffs.

Examining the Surge in Securities Litigation

- The first wave of subprime litigation — arriving in 2007 — was brought against various subprime or nonprime lenders that had collapsed under the weight of rising defaults.
- Securities litigation has expanded to include nearly every major financial institution due to their exposure to CDO and RMBS markets backed by subprime securities. Of the more than 250 filings last year (a 10-year high), 110 cases were related to the credit crisis, and almost 50 percent of cases involved defendants in the financial sector, as compared to only 16 percent of cases in 2005-06.
- The litigation has since spread to companies that were not directly exposed to subprime assets but which had ties to companies that were exposed.
- These actions have followed the economic decline — beginning with claims against mortgage originators and then spreading to financial services firms with subprime exposure. The same will be true in 2009, and we expect to see more actions based on exposure to other securities that may be negatively impacted, such as commercial mortgage-backed and other asset-backed securities.

So-Called "F-Cubed" Litigation

- As the financial and credit crisis spreads globally, many non-US companies are finding themselves subject to securities litigation in the United States. A significant issue is whether such suits can be brought on behalf of foreign purchasers of foreign company stock listed on foreign exchanges — otherwise known as "foreign-cubed" or "F-Cubed" cases.
- The Second Circuit recently addressed an F-Cubed case for the first time, holding that, although it was not willing to establish a bright-line test, the district court lacked subject matter jurisdiction over the foreign issuer because the allegedly fraudulent conduct, involving the issuance of purportedly misleading financial statements, did not occur in the United States, even though a US subsidiary allegedly had provided manipulated financial statements to the foreign parent.

Contributors | **Partners** | James E. Lyons, James.Lyons@skadden.com, 415.984.6470 | Scott D. Musoff, Scott.Musoff@skadden.com, 212.735.7852

- To the extent a court finds subject matter jurisdiction over an F-Cubed litigation, the inclusion of such plaintiffs can still be challenged at the class certification stage.

Pleading Scienter in the Wake of *Tellabs*

- As the Fourth Circuit recently explained, the Supreme Court in *Tellabs* gave "teeth" to the pleading standard for scienter under the Private Securities Litigation Reform Act "by using adjectives like 'cogent,' 'compelling,' 'persuasive,' 'effective,' and 'powerful.'" Under *Tellabs*, an inference of scienter can only be strong — and compelling and powerful — when it is weighed against the competing inferences that may be drawn from the facts in their entirety.
- The *Tellabs* standard will prove to be especially useful in defending subprime-related securities because the general economic downturn and ensuing financial crisis give rise to numerous more cogent and compelling nonfraudulent inferences and it will be imperative to give the courts the necessary context of the impact of the unprecedented global credit crisis.
- Plaintiffs' securities law firms often attempt to reach out to former employees (the number of which have increased in this economic environment) seeking so-called confidential witnesses. Allegations based on these so-called anonymous sources must be challenged both at the motion-to-dismiss stage and, if the complaint survives, in discovery.
- Another common pleading tactic we expect to continue is allegations that defendants "must have known" about the fraud because it related to "core operations" — sometimes referred to as the "core operations inference."
  - This doctrine raises fundamental questions under *Tellabs*, such as to what extent should core operations theories be considered in performing a comparative evaluation of competing inferences?
  - In a similar vein, recent decisions have indicated that general allegations of a corporation's collective knowledge will likely be deemed insufficient.

Class Certification Will Continue to Be a Major Battlefield

- The potential for appellate review under Federal Rule of Civil Procedure 23(f) will continue to make class certification a major tool in defending securities class actions.
- Loss causation will continue to be an area of attack by defendants, especially in light of the general market downturn, which arguably was the primary cause of the decline of the company's stock price.

Mass Torts and Consumer Class Actions: Pleading Artificial Homogeneity

Plaintiffs' key objective in mass tort and consumer class actions is obtaining the settlement leverage that comes from aggregating claims. In 2009, we anticipate the plaintiffs' bar will continue to creatively package their claims to look more like securities claims.

Circumventing the Commonality, Typicality and Predominance Requirements

- Plaintiffs increasingly will use RICO and state consumer fraud statutes that may not require proof of individual reliance or may not require all class members to have suffered harm.
  - They will plead "fraud on the market" or "fraud on the regulator" claims outside the securities litigation context.
  - They will define the class to include people far enough removed from the underlying transactions to make individual representations irrelevant.
- Plaintiffs will try to use "issues classes" where Rule 23(b)(3) classes are inappropriate.
- Plaintiffs will urge use of a single state's law (*e.g.*, the manufacturer's residence) rather than the law of myriad states.
- Plaintiffs will plead economic harm and "loss of the benefit of the bargain" rather than personal injuries, because the latter requires individualized proof.
- Plaintiffs will plead theories with somewhat amorphous elements, such as "unjust enrichment" and "public nuisance."
- Plaintiffs will request "equitable" or "declaratory" relief, even where damages are the ultimate objective.
- Plaintiffs will continue to plead medical monitoring as a cause of action.

Achieving the Threat of Aggregation Through Other Means

- Plaintiffs increasingly will use the False Claims Act (FCA) to seek treble recovery on behalf of the federal government for alleged misrepresentations.
  - These claims can present thorny settlement problems; many courts hold that a class action plaintiff cannot be barred from subsequently asserting an FCA claim.
- Plaintiffs will sue on behalf of "third-party payors" and others who have funded many purchase transactions.
- Punitive damages will remain an important issue, as the ratio articulated in *Campbell* remains embattled in application.
- Arbitration also will be an important issue, because many courts refuse to enforce certain arbitration provisions that preclude class action treatment.

Contributor | **Partner** | J. Russell Jackson, Russell.Jackson@skadden.com, 212.735.7839

Attacking Effective Defenses

- The doctrine of federal preemption is imperiled as a result of the US Supreme Court's ruling in *Altria v. Good*.
- A federal legislative backlash against preemption is possible.
- In some states, the "safe harbor" for compliance with existing regulations contained in consumer protection statutes is under attack.
- State attorneys general may be emboldened by the Consumer Product Safety Improvement Act of 2008 to pursue products liability and consumer fraud suits more traditionally thought within the province of the CPSC (Consumer Product Safety Commission).

Untethering Duty and Liability From Product Identification and the Actual Sale of a Product

- In 2008, a state appeals court held a brand-name drug manufacturer liable for failure to warn the consumer of a competitor's generic drug. This decision, which is on appeal, may have important implications on the scope of risk in transactions involving the sale or purchase of pharmaceutical companies.
- In the federal MDL litigation involving the fuel additive MTBE, the court in 2008 used a form of enterprise liability to cure plaintiffs' inability to identify the product(s) that caused their injuries. Experimentation with such theories also is expected in 2009.

Unraveling Settled Claims

- Recently the US Supreme Court granted *certiorari* in a case involving the authority of a bankruptcy court to settle and extinguish the claims of people who will be injured by a product in the future. The use of section 524(g) of the Bankruptcy Code to resolve future products liability claims will continue to be a subject of heated litigation.

Investors Seek Arbitral Remedies Following Increased Expropriation of Assets in Latin America

Over the last two years, the governments of Venezuela and Bolivia have expressly urged "nationalization" of key industries, including oil and gas, steel, communications and construction. These governments also have combined with other countries throughout the region (including Cuba and Nicaragua) in a new coalition, the *Alternativa Bolivariana para las Américas* (ALBA), whose "alternative" trade agreement explicitly rejects *laissez-faire* free trade principles.

Given the current economic crisis and the volatility of energy prices, these trends show no signs of abating in 2009. Accordingly, many companies with investments in those countries (or other politically volatile regions) are already reviewing their ability to pursue international arbitration to challenge adverse host state actions.

Today, literally thousands of bilateral investment agreements (BITs) and free trade agreements (FTAs) exist among the world's major capital-importing and capital-exporting states, including in Latin America. Some treaties are multilateral (*e.g.*, NAFTA and the Dominican Republic-Central America Free Trade Agreement); others are bilateral (*e.g.*, the US-Ecuador BIT, Spain-Venezuela BIT, Germany-Argentina BIT). Typically, these treaties guarantee against expropriation and other unfair or discriminatory measures by the host state and provide for international arbitration of treaty claims before the International Centre for Settlement of Investment Disputes (ICSID).

Recently, in an apparent reaction against the ICSID/BIT system, numerous members of the ALBA coalition have attempted to curtail investors' rights to pursue ICSID arbitration:

- In May 2007, Bolivia denounced the ICSID Convention, meaning that investors with treaty claims against Bolivia now need to rely on the "fall-back" arbitration venues in their respective BITs.
- In December 2007, Ecuador unilaterally modified its submission to ICSID jurisdiction by excluding any disputes involving Ecuadorian natural resources.
- In April 2008, Nicaragua threatened to withdraw from ICSID — a move that would curtail investors' arbitration rights under numerous BITs and DR-CAFTA, of which Nicaragua is a member.
- In November 2008, Venezuela caused the Venezuela-Netherlands BIT to lapse, claiming "abuse" of treaty rights by certain investors.

Despite these obstacles, avenues remain open for investors to secure some measure of treaty protection in these states. For example, Venezuela is still party to 25 BITs, some of which define "investor" or "investment" in broad terms, as are other members of the ALBA coalition. By properly structuring investments through companies incorporated in BIT-protected jurisdictions, companies can potentially preserve their ability to seek ICSID arbitration in the event of future nationalization.

Alternatively, investors may negotiate direct agreements (or concessions) with their host state, providing for "stabilization" of rights, guarantees against expropriation and the right to seek damages through international arbitration in the event that the government adversely alters the local investment environment.

While little can be done to eliminate political risk, a variety of means still exist to preserve legal remedies in the event of adverse sovereign action. Taken as part of an overall risk-mitigation strategy, ICSID/BIT rights and "stabilization" clauses are a potentially valuable source of such protection.

Contributor | **Partner** | Timothy G. Nelson, Timothy.G.Nelson@skadden.com, 212.735.2193

Return to the Table of Contents

US-Style Class Actions Begin to Spread to Europe

Historically, Europe has been immune from US-style class action litigation, but recent legislative acts and policy pronouncements by European lawmakers, cases involving US and European parties and counsel, and the migration of leading US plaintiffs' firms to Europe suggest a new synergy is emerging between European and US class action litigation. These developments indicate companies should take a holistic, multinational approach to mitigating risk and to formulating legal-defense strategies.

Recent Policy Statements and Legislation

- One reason class actions have not yet emerged in Europe is that damages in European litigation generally are compensatory, without large punitive elements. That may be changing, however. In December 2005, the Commission of the European Communities presented its *Green Paper*, proposing several methods to calculate damages awards in antitrust cases, including "double damages." In March 2007, the European Commissioner for Consumers issued the *Consumer Policy Strategy*, which built on the *Green Paper*'s increased-damages proposals, adding a collective-litigation element for consumer cases. Several European Union member states have put these proposals into action, setting a trend toward class or collective actions in Europe.
  - Italy has most recently adopted class litigation. A new law scheduled to take effect on January 1, 2009, permits collective actions — *azione collettiva risarcitoria* — in Italian courts. In a significant departure from previous law, the new law empowers consumer groups and court-approved plaintiff classes to sue on behalf of injured persons under a number of legal theories including antitrust, breach of contract, tort and unfair competition.
  - In Germany, the Bundestag will consider renewing the Capital Markets Model Case Act (*KapMuG*), which provides for collective litigation in securities cases and which is set to expire in November 2010. Germany originally enacted the Model Case Act in November 2005 in order to manage mass securities litigation by permitting the Higher Regional Court to stay related cases pending in other courts and decide common questions of fact or law for one case — a model case — which then would be binding on the other cases. In February 2007, the Stuttgart Court of Appeals dismissed the first-ever model case when it rejected an investors' claims that the company had not informed them properly of a board of management member's resignation. The decision is on appeal to Germany's supreme court.
  - Germany also is experimenting with contingency-based attorney fees. In March 2007, Germany's supreme court struck down Germany's prohibition on contingency fees in cases where a client would not otherwise be able to enforce his rights. In mid-2008, the Bundestag began debating a bill to permit contingency fees in such circumstances. Whether contingency fees will lead to a rise in multiplaintiff litigation in Germany, as they have in the United States, is an issue European lawmakers likely will follow in the months ahead.
  - Other member states with substantive group-litigation legislation include Austria, Czech Republic, Hungary and Spain. In addition, England and Wales and Sweden have procedural rules permitting courts to manage multiplaintiff cases centrally. Other member states are considering introducing multiplaintiff procedures in their courts, which may impose burdens similar to those US businesses have experienced with class action litigation in the United States.

Contributors | **Partner** | Gary DiBianco, Gary.DiBianco@skadden.com, 44.20.7519.7258 | **Counsel** | Gary A. Rubin, Gary.Rubin@skadden.com, 202.371.7205

Increased Activity in Europe by US-Based Plaintiffs' Firms

- Plaintiffs' firms based in the US have been increasingly active in Europe.
  - US-based firms have announced interest in pursuing collective antitrust, products liability, securities and shareholder derivative litigation in a number of European jurisdictions. In September 2006, one Philadelphia-based plaintiffs' firm announced a "strategic partnership" with a Frankfurt firm; and in April 2007, a firm based in Washington, DC, opened an office in London.
  - In April 2007, three US plaintiffs' firms spearheaded a $400 million settlement with Royal Dutch Shell on behalf of a class of European investors. Plaintiffs had filed the class action underlying the *Shell* settlement in the United States, but the European investors had opted out of that class. Shell and the European investors structured their settlement under a new Dutch law permitting a special-purpose representative entity to settle claims on collective terms on behalf of plaintiffs.

Expected Developments

- In the near term, plaintiffs will continue to sue in the United States in order to take advantage of contingency fees, punitive damages, jury trials and no-fee shifting.
- But the European Commission's continuing efforts to create a single market, together with new member state laws and procedures for multiplaintiff litigation, will lead to increased class litigation in Europe, especially in the antitrust, consumer protection and securities areas.

US Statute Increasingly Invoked to Obtain Discovery for Use in Foreign Arbitrations

In the last three years, US courts have shown an increased willingness to allow parties to a foreign arbitration (*e.g.*, arbitral proceedings based in London, Geneva or Vienna) to obtain court-ordered discovery under 28 USC. § 1782 from persons resident in the United States, including persons who are not parties to the foreign proceeding. Section 1782 is a federal statute that authorizes US district courts to order US-style discovery (including depositions) against persons or companies "found" in the district for use in proceedings before a "foreign or international tribunal."

The proliferation of Section 1782 discovery comes in the wake of a 2004 Supreme Court decision, *Intel Corp. v. Advanced Micro Devices*, which arguably broadened the interpretation of "foreign or international tribunal" to embrace "foreign or international" arbitral tribunals.

While a number of recent court decisions permit Section 1782 discovery from US companies and individuals, doubts persist concerning the availability of Section 1782 in cases that involve arbitrations rather than judicial proceedings.

The growing use of Section 1782 in foreign arbitrations presents an opportunity for foreign litigants — and a potential challenge for US companies. Foreign litigants may seek to capitalize on Section 1782 by seeking documents or deposition testimony from US-based parties that ordinarily would not be subject to discovery. The pendency of Section 1782 discovery requests also may safeguard against destruction of documents by such third parties.

Conversely, Section 1782 poses a direct challenge to US companies that wish to avoid the cost and disruption posed by "subpoena-style" discovery requests. To minimize such interference:

- US companies can challenge the applicability of Section 1782 to arbitration, pointing out that this issue has not yet been fully tested by appellate courts (indeed, prior to *Intel*, such use was expressly rejected by both the Second and Fifth Circuits).
- US companies can urge courts not to interpret Section 1782 in a manner that creates an anomaly between domestic arbitration (in which arbitral "subpoenas" arguably have limited geographic reach) and foreign/international arbitration.
- US companies can urge courts to exercise greater discretion in allowing discovery in the first place, particularly if the foreign arbitral tribunal has not yet been convened or has not authorized discovery between the parties.
- Companies also can remind the US courts of the enormous costs associated with wide-ranging electronic discovery and may seek to have sensible limits placed on such discovery.

Whether the continuing proliferation of the use of Section 1782 should be viewed as positive or negative depends on whether one is pursuing or defending a discovery application. We expect the scope of Section 1782 to be addressed by US appellate courts over the next few years.

Contributor | **Partner** | Timothy G. Nelson, Timothy.G.Nelson@skadden.com, 212.735.2193

Return to the Table of Contents

M&A and Strategic Investments in Brazil: What's Next?

While Brazil's economy has grown at record rates since 2004, GDP is projected to decelerate from an estimated 5.1 percent in 2008 to as low as 0.5 percent in 2009. Growth in the Brazilian public capital markets has already slowed, with the number of IPOs on the São Paulo Stock Exchange (Bovespa) dropping from a record of 64 in 2007 to only four in 2008.

We expect these factors to have a positive impact on Brazilian M&A activity in 2009. Following the frenzy of IPOs and follow-on offerings in 2004-07, consolidation in various fragmented industries is expected to ensue, particularly in real estate, energy and commodities. We expect Brazilian, other Latin and global entities to all participate in this consolidation. In addition, financial institution M&A should rise as a competitive response to the pending merger of two of Brazil's largest private banks (Itaú and Unibanco) into one of the top 10 financial institutions in the Americas.

More private equity investments are expected, both by local and international firms. The strong growth prospects of many local targets will allow for private equity firms to realize favorable returns with less debt leverage. Middle-market M&A also should remain relatively busy.

M&A Hot Topics

Mandatory Tender Offers

- Many Brazilian companies that recently went public adopted provisions in their bylaws requiring any buyer of a certain percentage of a company's stock to make a mandatory tender offer for all of the company's shares, sometimes at a premium to market price.
- Incorrectly dubbed in the local market as "poison pills," these provisions in reality are intended to protect minority shareholders. They are not meant to confer negotiating leverage to boards of directors in fighting hostile bids.
  - Boards have no power to remove these provisions from the bylaws in a friendly deal.
- The typical trigger for these provisions ranges from 15 percent to 30 percent. The premium required to be paid can be has high as 30 percent of the greater of the target's trading price, "fair value" and other measures.
- In contrast, under existing regulations (CVM Instruction no. 361) of the Brazilian Securities Commission (CVM), no premium is required for the mandatory tender offer.
- In some cases, these provisions have resulted in the unintended consequence of discouraging sales of a strategic stake to large investors, such as private equity funds, or the sale of the entire company.
- With funding becoming a central issue in the global credit crisis, it remains to be seen how the market will deal with these provisions and if the CVM or Brazilian courts will impose criteria that try to restrict such provisions.

Exchange Ratio Asymmetry in Stock-for-Stock Business Combinations

- In response to a 2006 attempted corporate restructuring by one of Brazil's major telecoms, the CVM published an opinion (*Parecer de Orientação CVM no. 34*) addressing a perceived conflict of interest in stock-for-stock business combinations where different exchange ratios are offered to common and preferred shareholders.

Contributors | **Partner** | Paul T. Schnell, Paul.Schnell@skadden.com, 212.735.2322 | **Associates** | Fernando M. Almeida, Fernando.Almeida@skadden.com, 55.11.3071.1847 | Filipe B. Areno, Filipe.Areno@skadden.com, 212.735.3462 | Lizbeth Flores, Lizbeth.Flores@skadden.com, 55.11.3071.1848

  - Many Brazilian companies, particularly large infrastructure companies privatized by the Brazilian government in the '90s, have a significant amount of preferred shares outstanding as part of their equity capitalization.
  - Pursuant to Brazilian corporate law, preferred shareholders may not vote in stock-for-stock business combinations.
  - The only remedy for preferred shareholders is appraisal rights paid out at book value.
- The CVM concluded that, in instances where different exchange ratios were offered to common and preferred shares, preferred shareholders should be allowed to have a separate class vote on the transaction in order to avoid an intrinsic conflict of interest on the part of the common shareholders, arising from their having the exclusive right to approve the transaction.
- It is still unclear whether the CVM will conduct a case-by-case analysis of each deal when determining whether to impose a separate vote for preferred shareholders, or if a line will be drawn to define the extent of an acceptable difference between uneven exchange ratios.
- Some legal experts argue that through CVM Opinion no. 34, the CVM has exceeded its authority and stepped into Congress's turf by altering Brazilian corporate law.

The Case with Derivatives

- With the credit crisis, the Brazilian real experienced a sudden and significant depreciation relative to foreign currencies such as the US dollar and the Japanese yen.
- Many companies that had entered into speculative derivative currency transactions experienced significant losses.
- Some companies are trying to renegotiate payment terms with their counterparties.
- Other companies are considering whether to challenge the contracts in court based on the argument that such contracts were unconscionable and/or ambiguous. Local practitioners are expecting a wave of litigation deriving from these derivative contracts.
- In addition, the CVM has recently published a new regulation (CVM Instruction no. 475) requiring heightened disclosure of derivative instruments in the financial statements of public companies.
  - Such disclosure must include quantitative and qualitative information regarding derivative instruments, including a sensitivity analysis of the impact of these instruments under different economic scenarios.

Hot Topics in Reporting Obligations

Proposed Changes to CVM Instruction No. 202

- CVM Instruction no. 202 governing the registration of public companies is currently under review. Proposed changes include:
  - more detailed mandatory disclosure of director/officer remuneration;

  - heightened responsibilities for management with respect to disclosure; and
  - restrictions on the issuance of Brazilian Depositary Receipts (BDRs) in the local stock market by foreign affiliates of companies that have more than 50 percent of their operations/management located in Brazil.

- This last change is in response to irregularities committed by certain Brazilian companies that have used BDRs to raise funds through Bermuda affiliates.
- Even though their business was significantly conducted in Brazil, under the legal and regulatory framework then in force these foreign issuers were not subject to Brazilian corporate law or CVM regulatory authority, which could have protected Brazilian investors.

Adoption of IFRS

- Pursuant to recently adopted Brazilian corporate law amendments, the CVM is currently adopting regulations to make Brazilian GAAP consistent with International Financial Reporting Standards (IFRS).
- As a result of variations in IFRS, it is still uncertain whether the new Brazilian GAAP, as modified to be consistent with IFRS standards, will be acceptable in other IFRS countries, so that Brazilian issuers listed in those other countries may be able to comply with foreign reporting obligations by publishing a single set of financial statements solely in accordance with the new Brazilian GAAP.

Testing New Chinese Laws on Competition and Bankruptcy

Two new Chinese laws, the Anti-Monopoly Law and the Bankruptcy Law, are expected to face important tests in the next year. The laws were modeled on Western precedent, but how they will be interpreted and applied is not yet clear. The results will be important to foreign firms doing business or investing in China.

Anti-Monopoly Law

- China's Anti-Monopoly Law (the AML) went into effect on August 1, 2008, a year after it was adopted and more than 14 years after the drafting process began. Modeled on the European Union's competition law, it contemplates an active antitrust enforcement policy. Like the laws in many Western countries, the AML regulates monopoly agreements between businesses, abuse of dominant market positions and anticompetitive business concentrations. Like many of its counterparts, the AML also applies to business combinations outside China that may have anticompetitive effects in China. The implementation of the AML will be overseen by several government agencies, including the Ministry of Commerce (Mofcom), the National Development and Reform Commission (NDRC) and the State Administration for Industry and Commerce (SAIC).
- The AML requires preclosing notification of any business concentration involving a merger or the acquisition of control or "decisive influence," if the parties involved met certain financial thresholds (mainly revenue thresholds) in the preceding fiscal year. If the thresholds are met, the transaction must be approved before it can close. The process is overseen by Mofcom.
- While experience with premerger notification is limited, the treatment of the recent US$52 billion acquisition of Anheuser-Busch by InBev sheds some light on how the process is likely to work. Mofcom's November 2008 decision, and an interview with the director of its Anti-Monopoly Bureau (the Q&A) published on its Web site, marks the first decision Mofcom has published, although through November 19, 2008, it stated that it had considered 13 applications and decided eight. Several conclusions can be drawn from the InBev transaction.
    - First, the process of evaluating the potential competitive impact of a transaction will be consultative. The documents state that, in conducting its review, Mofcom consulted both with central and local government departments and a broad range of industry participants. It seems likely that future transactions will include a similar consultative process.
    - Second, Mofcom will not hesitate to take measures if it finds that the proposed transaction may raise competitive concerns, and will consider the potential for future anticompetitive impact. In the Q&A, Mofcom explicitly stated that the results of its review indicated the acquisition would not eliminate or limit competition in the Chinese beer market, but to prevent any structure that is harmful to competition, Mofcom decided to impose restrictive conditions on its approval. Mofcom also clarified the types of restrictions it can choose to impose. These include requiring companies to spin off assets and imposing restrictions on certain types of behavior by the parties. In the InBev case, InBev was required to freeze the level of its holdings in certain companies and was prohibited from acquiring stakes in certain other companies.
    - Finally, the Q&A emphasizes that prefiling consultation is available in the context of business consolidations and encourages parties to take advantage of this.

Contributors | **Partners** | Frederic Depoortere, Frederic.Depoortere@skadden.com, 32.2.639.0334 | Van C. Durrer II, Van.Durrer@skadden.com, 213.687.5200 | Alec P. Tracy, Alec.Tracy@skadden.com, 852.3740.4710

- Overall, the InBev decision suggests that Mofcom intends to achieve at least some degree of transparency in its review process. It remains to be seen, however, whether this will apply in all cases, particularly those that are culturally or politically sensitive.

Bankruptcy Law

- China's new Bankruptcy Law, the product of 13 years of discussion, went into effect in June 2007, almost a year after its adoption. Experience with the implementation of the Bankruptcy Law has been limited, particularly insofar as foreign investments are concerned. Current economic conditions seem likely to increase the law's application.

- The law was modeled on international precedent (principally the US bankruptcy laws), and is intended to provide China with a comprehensive legal regime for restructuring assets of insolvent businesses. The law also reflects important Chinese policy issues, which differ somewhat from Western precedents. Key aspects of the new law include:

  - **Restructuring.** In line with international practice, the law includes restructuring provisions. These also are intended to help maintain social stability by allowing insolvent institutions to continue to function rather than liquidate.

  - **Administrator.** The law introduces a bankruptcy administrator with broad powers to manage the debtor's property and assets and convene a creditors' meeting and review creditors' claims. Local courts are required to establish a panel of bankruptcy administrators. Personnel from government departments, liquidation groups that oversaw liquidations under the old bankruptcy law, and law, accounting and other professional firms can serve as administrators. In practice, it seems liquidation groups, which may not have significant experience in restructuring, have had the lion's share of administrator roles.

  - **Creditors' Rights.** The law empowers creditors to oversee the administrator, influence the verification of creditors' claims, impact whether the debtor can continue operating and approve or reject a restructuring plan.

  - **Priority.** Generally, the law grants priority to secured claims. However, employment-related claims (which were preferred under the old law) incurred before the adoption of the new law will be granted priority over secured claims where the unsecured assets are insufficient to satisfy the claims.

  - **Fraudulent Conveyances.** The law creates a one-year prebankruptcy look-back window. Fraudulent conveyances during this period can be unwound by an administrator on petition to the bankruptcy court.

- Local bankruptcy courts retain significant power under the Bankruptcy Law. In addition to their control over who may serve as administrator, these courts retain significant control over the restructuring process. For instance, in a recent case pending in the bankruptcy court in Shanghai, the court approved a restructuring over the objection of several state-owned enterprises whose creditors were offered a discounted payoff of cents on the dollar. Unfortunately, notwithstanding the power available to the bankruptcy court, a change-of-control transaction within a bankruptcy restructuring still requires all of the regulatory approvals that would pertain outside of bankruptcy. The delays and uncertainty that such regulatory approvals occasion may impair the effectiveness of the new China bankruptcy regime. These approvals are particularly limiting in restructurings that involve a debt-to-equity conversion, a popular structure in Western insolvency regimes.

- Another limitation of the Bankruptcy Law is the absence of any express provisions for cooperation with related insolvencies in other jurisdictions. Although the Bankruptcy Law does contemplate recognition and enforcement of decisions of foreign courts in certain circumstances, this is not the real-time coordination developed by other courts to deal with dynamic, multijurisdictional insolvencies. Commentators view this as a serious shortcoming of the Bankruptcy Law in today's global economy. Again, this is particularly true in the aftermath of a wave of structured foreign investment in China.
- Notwithstanding these flaws, however, in light of the state of the economy, Chinese companies will be forced to confront the challenges of the Bankruptcy Law in their efforts to restructure in the coming year. It remains to be seen whether Chinese bankruptcy courts will rise to the occasion, given the power that the Bankruptcy Law affords.

Changes and Opportunities in M&A and Foreign Investments in India

Mergers and acquisitions activity by Indian companies, which reached record levels in 2007, slowed in 2008 as a result of the global financial crisis and will likely continue to be constrained in the near term due to a lack of funding options caused by projected slowing economic growth in India, lack of credit and the downturn in the Indian securities markets. However, the current economic slowdown may present unique investment opportunities in India in the near term as debt-laden companies seek to raise capital to satisfy maturing debt obligations, weather the current economic slowdown or enter into restructuring situations. Indian companies, including leading corporate houses, are also increasingly turning to private equity to raise capital as traditional sources of finance are in short supply. Additionally, Indian regulatory authorities have adopted certain changes over the past several months aimed at increasing companies' access to capital, including foreign capital. The recent revelation of fraudulent accounting practices at a significant Indian outsourcing company may impact foreign perception of the Indian securities market and Indian governance and accounting practices.

Recent Regulatory Changes

- In an apparent response to the current financial crisis, Indian regulatory authorities have instituted several changes aimed at increasing Indian companies' access to capital and stimulating activity in the Indian securities markets.
    - The Securities and Exchange Board of India (SEBI) adopted regulatory amendments permitting the issuance of warrants and nonconvertible debentures by listed companies to qualified institutional buyers (QIBs) in qualified institutional placements (QIPs), whereas previously only issuance of equity shares and convertible debentures were permitted.
    - SEBI relaxed the requirement that listed companies issue and maintain a public shareholding of at least 10 percent in an effort to facilitate the issuance of warrants by listed companies in QIPs.
    - The Indian Foreign Investment Promotion Board is considering approving the issuance of options convertible into equity shares.
    - SEBI relaxed certain requirements relating to investments by Foreign Institutional Investors (FIIs) in debt securities, including increasing investment limits in corporate debt and removing the 70:30 equity to debt investment ratio for FIIs.
    - SEBI removed certain restrictions on the issuance of Offshore Derivative Instruments (ODIs, also known as Participatory Notes or P-Notes), including allowing the issuance of ODIs having derivatives as underlying assets and removing the restriction prohibiting FIIs from having ODIs outstanding with a value in excess of 40 percent of their assets under custody in India.
    - SEBI has adopted amendments to the Indian Takeover Code providing that a shareholder with 55 percent or more of the shares in a company but less than 75 percent may acquire up to an additional 5 percent of shares in the aggregate without making a public announcement, if (i) such shares are acquired on the stock exchange or such increase occurs as a result of a buyback of shares by such company and (ii) such shareholder's stake does not increase beyond 75 percent.

Contributors | **Partners** | Michael V. Gisser, Michael.Gisser@skadden.com, 213.687.5213 | Jonathan B. Stone, Jonathan.Stone@skadden.com, 852.3740.4703 | **Associate** | Robert Graffum, Robert.Graffum@skadden.com, 852.3740.4788

- The Reserve Bank of India recently approved a number of applications for Foreign Venture Capital Investors, after having previously placed such applications on hold. Investors are eligible to invest only in certain sectors (infrastructure, IT related to hardware and software development, seed R&D, biotechnology, nanotechnology, pharmaceutical R&D, diary and poultry industries, bio-fuel production and hotel-cum-convention centers with a certain seating capacity).
- The Reserve Bank of India also relaxed regulations relating to buybacks of Foreign Currency Convertible Bonds through March 2009.

Protecting Russian Assets as Economic Volatility Triggers Nationalization

Political reform, the existence and privatisation of substantial natural resources in oil, gas, coal and minerals, and rapid growth in the past 10 years have combined to make Russia a prime focus of investment. However, the global economic crisis and substantial volatility in energy prices have caused a contraction in the Russian economy and an increased stake in privatised industries being taken by the government; this has been viewed by some as a reversal of the sale of state-owned assets in the late 1990s.

Taken together with a legal system that some investors consider unstable and historically corrupt, it is increasingly imperative that both potential and existing investors consider how best to secure their assets in Russia. When problems arise, it is important for investors to be positioned to act swiftly and effectively, using legal remedies outside Russia, in order to protect their investments and enforce their rights.

A first step is usually the use of an offshore company as a vehicle for holding the Russian asset, typically domiciled — in the case of Russia — in Cyprus or the British Virgin Islands. But the use of such vehicles gives only limited protection that needs to be supplemented by other measures.

At the Contract or Investment Stage

- The prospects of protecting assets and enforcing rights can be substantially enhanced, and many potential later problems can be avoided, if investors adopt a dispute resolution mechanism in their agreements that:
  - removes jurisdiction from the local courts in Russia; and
  - allows the investor to choose its decision-making body and exclude, to the extent possible, unwanted local influence.
- Generally this will involve contractual stipulation either of national courts outside Russia or international arbitration under the auspices of one of the well-known institutions such as AAA, ICC or LCIA.
- International arbitration has a number of advantages over national courts as a method of dispute resolution, especially in that it:
  - allows for a tailored mechanism to suit the type of contract and industry concerned, and to cater to the most likely type of dispute;
  - limits court interference — particularly because of the New York Convention, which requires national courts in the vast majority of trading nations to recognize arbitration agreements to the exclusion of court litigation;
  - enables parties to stipulate for confidentiality; and
  - provides more readily enforceable arbitration awards, again by virtue of the New York Convention, than foreign court judgments, particularly in Russia.

If a Dispute Arises

- The first step once a dispute has arisen is often direct action against directors, officers and shareholders of the offshore investment vehicle; this may typically take the form of injunctive relief in the courts where the vehicle is domiciled in order to:

Contributors | **Partner** | Paul Mitchard, Paul.Mitchard@skadden.com, 44.20.7519.7050 | **European Counsel** | Kambiz Larizadeh, Kambiz.Larizadeh@skadden.com, 44.20.7519.7169

- safeguard the assets' value by preventing disposals or entering into new security or other impairment, thereby defeating investor claims;
- prevent actions being taken to hinder the enforcement of security; and/or
- prohibit parallel spoiling litigation in unfavorable jurisdictions.

It is important to note that in most cases such urgent steps are possible in national courts, even where there is an arbitration clause, provided jurisdictional requirements are met.

- Where there is noncompliance with a court order, further enforcement measures may be available, such as:
  - the service of a winding-up notice or the commencement of winding-up proceedings;
  - proceedings for contempt of court; and
  - the appointment of a receiver or manager to take actions on behalf of a company in breach of a court's order.
- Claims for amounts due, damages and other relief can then be separately pursued in court, or in accordance with the arbitration rules stipulated in the agreement.

Taking Management Control Over Russian Companies

- Having obtained control of overseas holding companies, a number of steps can be taken inside Russia to obtain further protection:
  - Replacing the existing general director and other senior management and notifying the relevant authorities and other parties of these changes;
  - Revoking existing powers of attorney; and
  - Securing the company's seal.
- It also may be necessary to apply to the local courts for injunctive relief against former management and protect the investment from unauthorized disposals.

Secured Transactions

- With the possibility of future enforcement in mind, certain measures should be taken at the time the security documentation is entered into and thereafter. These notably include:
  - Including adequate disclosure and information rights in the relevant agreements;
  - Knowing your secured assets;
  - Properly understanding corporate governance issues in order to enable proper monitoring and policing of the investment;
  - Storing all security documentation in an organized and easily accessible manner (shortcomings in this respect are a surprisingly frequent practical obstacle when urgent enforcement steps are required); and

  - Obtaining and maintaining an understanding of the costs and timing involved in exercising enforcement rights.

- In the current economic climate, a number of lenders are faced with the problem of obtaining control over secured Russian assets through enforcement of pledges or guarantees.

- In the case of pledges:

  - Ensure that you are familiar with any regulatory issues that may arise and that you have a clear understanding of enforcement rights and necessary steps at the local level. In many cases, this will simply be a case of registering self-executing transfer documentation.

  - Once enforcement steps have been taken, consider the possibility of replacing the management of offshore companies in order to secure control.

  - If necessary, take the steps identified above in order to take management control of the Russian company having immediate ownership of the asset.

- Where enforcement is sought of a personal guarantee from corporations or individuals based (or having assets) outside Russia:

  - Ascertain if the guarantee is enforceable immediately as a primary obligation (as it should ideally be) or otherwise take such steps as first required by way of notice or prior recourse against the debtor;

  - Consider attaching assets outside Russia in order to satisfy any liability;

  - Consider whether individual guarantors within Russia also have foreign domicile or residence so that courts in such locations outside Russia may have personal jurisdiction over them; and

  - Consider initiating personal bankruptcy proceedings outside Russia where this may be possible.

Real Estate and REITs

Under the current credit-constrained environment, many real estate clients, including REITs, are having liquidity problems due to their inability to raise equity, obtain new debt financing, and/or refinance existing debt. Legislative and regulatory responses to the downturn, including the Emergency Economic Stabilization Act of 2008 (EESA), have further complicated the landscape.

Loan Modifications and Strategies for Distressed Assets

- Compared to prior downturns, workouts of distressed assets in the current environment are proving to be more complex, because of financing structures that have become increasingly prevalent in recent years.
  - Parties to repurchase agreements that are at risk of default or in default face the prospect of immediate loss of their collateral without the safeguards common to a UCC foreclosure process that are applicable to financings structured as secured credit facilities.
  - In complex debt structures, parties whose interests were not originally expected to be in conflict may find themselves in this situation as a result of abrupt, steep declines in asset value, wiping out junior positions and shifting control of the foreclosure and workout process.
- The ongoing implementation of EESA has diverged materially from what was contemplated originally, and the ultimate effects on distressed assets remain uncertain.
  - The purchase of troubled assets contemplated to take place under the Troubled Asset Relief Program (TARP) authorized by EESA has created tremendous uncertainty regarding the pricing of debt instruments, causing wild fluctuations.
  - Similarly, the guaranty program mandated by EESA, pursuant to which the Treasury would guarantee payment on certain distressed assets, has not yet been created, giving rise to further uncertainty.

Bankruptcies

- Bankruptcies involving real estate assets in the current climate are generating novel questions and results.
  - International and global transactions mean that when workouts or bankruptcies occur, the difficult choices of law and forum questions, including the complex interplay of the laws of multiple jurisdictions, must be addressed.
  - Borrowers who obtained loans to fund equity distributions could be subject to clawback challenges as fraudulent transfers or preference distributions.
  - The prevalence of guaranties under which debtor bankruptcy triggers a nonrecourse carve-out to the equity owners, making the equity owners liable on a recourse basis for loans that are otherwise nonrecourse, discourages many entities from entering bankruptcy.

Evolution of Regulatory Frameworks and New Strategies for Compliance

- In some circumstances, significant declines in the value of qualifying real estate assets in comparison to the value of investment securities could raise concerns with the continuing qualification of a com-

Contributors | **Partners** | Michael Beinus, Michael.Beinus@skadden.com, 213.687.5334 | Evan R. Levy, Evan.Levy@skadden.com, 212.735.3889 | Barnet Phillips, IV, Barnet.Phillips@skadden.com, 212.735.2220 | **Associates** | Elizabeth B. Stein, Elizabeth.Stein@skadden.com, 212.735.3713 | Brett R. Willis, Brett.Willis@skadden.com, 213.687.5564

pany for one or more of the real estate-related exceptions from investment company status under the Investment Company Act.

- For offshore investors whose investments in the US were structured to avoid income effectively connected to a US trade or business (ECI), active participation in workouts of distressed assets or foreclosing on loan collateral may create ECI for holders of the loan.

Occupancy Contraction

- The downturn has decreased the occupancy needs of many companies.
  - Many tenants find themselves unable to avoid defaulting under existing leases, or needing to make use of assignment and subleasing rights to avoid defaults.
  - Entities that previously benefited from economic incentive agreements face enforcement of minimum workforce requirements.
  - Parties unable to meet obligations under existing agreements may seek to be excused from such obligations based on arguments that frozen credit markets constitute *force majeure* or commercial impracticability.

Issues of Particular Relevance to REITs

REIT Distribution Requirement

- The distribution of taxable income solely in cash may be a burden to REITs desiring to retain cash.
  - For public REITs, Rev. Proc. 2008-68 permits REITs to preserve cash by making their required annual distributions in the form of newly issued REIT stock (up to 90 percent of the distribution) instead of cash.
  - For private REITs, consent dividends may be used to satisfy the REIT distribution requirement if the shareholders of the REIT consent to include as taxable income, even without the receipt of cash, the amount that the REIT needs to distribute to satisfy the distribution requirement.

Taxable REIT Income Without Cash

- Transactions involving a REIT’s debt may result in a substantial amount of taxable income without a corresponding receipt of cash.
  - Routine amendments or other modifications to debt instruments may cause the recognition of substantial amounts of taxable cancellation-of-indebtedness income.
  - The repurchase of debt at a discount also will give rise to cancellation-of-indebtedness income.
  - The bankruptcy and insolvency exceptions to cancellation-of-indebtedness income do not apply to partnerships because bankruptcy and insolvency are tested at the partner level (not at the

partnership level). Therefore, even if a lower tier partnership in which the REIT is a partner is in bankruptcy or insolvent, the REIT itself must be in bankruptcy or insolvent for these exceptions to cancellation-of-indebtedness income to apply.

- The foreclosure of real property subject to nonrecourse debt may give rise to potentially substantial amounts of taxable gain without the receipt of cash. In addition, the foreclosure of real property that is subject to a tax protection agreement with a limited partner could impose upon a REIT substantial tax indemnification obligations.

New York
Four Times Square
New York, NY 10036
T 212.735.3000

Boston
One Beacon Street
Boston, MA 02108
T 617.573.4800

Chicago
333 West Wacker Drive
Chicago, IL 60606
T 312.407.0700

Houston
1000 Louisiana
Suite 6800
Houston, TX 77002
T 713.655.5100

Los Angeles
300 South Grand Avenue
Los Angeles, CA 90071
T 213.687.5000

Palo Alto
525 University Avenue
Suite 1100
Palo Alto, CA 94301
T 650.470.4500

San Francisco
Four Embarcadero Center
San Francisco, CA 94111
T 415.984.6400

Washington, DC
1440 New York Avenue, N.W.
Washington, DC 20005
T 202.371.7000

Wilmington
One Rodney Square
P.O. Box 636
Wilmington, DE 19899
T 302.651.3000

Beijing
East Wing Office, Level 4
China World Trade Center
No.1 Jian Guo Men Wai Avenue
Beijing, 100004, China
T 86.10.6535.5511

Brussels
523 avenue Louise
Box 30
1050 Brussels, Belgium
T 322.639.0300

Frankfurt
An der Welle 3
60322 Frankfurt am Main
Germany
T 49.69.742200

Hong Kong
42nd Floor, Edinburgh Tower
The Landmark
15 Queen's Road Central
Hong Kong
T 852.3740.4700

London
40 Bank Street
Canary Wharf
London, E14 5DS, England
T 44.20.7519.7000

Moscow
Ducat Place III
6 Gasheka Street, 11th Floor
Moscow, Russia 125047
T 7.495.797.4600

Munich
Karl-Scharnagl-Ring 7
80539 Munich, Germany
T 49.89.2444950

Paris
68, rue du Faubourg Saint- Honoré
75008 Paris, France
T 331.55.27.11.00

São Paulo
Av. Brigadeiro Faria Lima,
3311-7° andar
Itaim Bibi - CEP 04538-133
São Paulo SP Brazil
T 55.11.3708.1820

Shanghai
Plaza 66, Tower 1, 36th Floor
1266 Nanjing West Road
Shanghai, 200040, China
T 86.21.6193.8200

Singapore
9 Temasek Boulevard
Suite 29-01
Suntec Tower Two
Singapore 038989
T 65.6434.2900

Sydney
Level 13, 131 Macquarie Street
Sydney, NSW 2000, Australia
T 61.2.9253.6000

Tokyo
Izumi Garden Tower
21st Floor, 1-6-1 Roppongi
Minato-ku, Tokyo 106-6021
Japan
T 813.3568.2600

Toronto
222 Bay Street
Suite 1750, P.O. Box 258
Toronto, Ontario
Canada M5K 1J5
T 416.777.4700

Vienna
Schwarzenbergplatz 6
A-1030 Vienna, Austria
T 43.1.710.77.30.0

Beijing
Boston
Brussels
Chicago
Frankfurt
Hong Kong
Houston
London
Los Angeles
Moscow
Munich
New York
Palo Alto
Paris
San Francisco
São Paulo
Shanghai
Singapore
Sydney
Tokyo
Toronto
Vienna
Washington, D.C.
Wilmington

SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP AND AFFILIATES