

CORPORATE PRACTICE NEWSWIRE

JANUARY 2012

IN THIS ISSUE

FEATURE ARTICLES

- 1** Rights Plans in a New Era: Recent Drafting Trends
- 7** Capital Loans to Private Equity Funds: When Investors Become Part of the Borrowing Base
- 11** Are You Paying Too Much? How Smart Companies Use FCPA and UK Bribery Act Due Diligence to Ensure Their Deals Are Valued Correctly
- 15** Minority Investments in U.S. Insurance Companies — Rebutting the Presumption of “Control”
- 19** 2011 Case Nuggets
- 23** Recent Trends in Financing & Structuring Green Energy M&A Deals
- 27** SEC 2011 Roundup
- 30** ISS Proxy Season 2011 Review & 2012 Forecast
- 35** The Next Say on Say-on-Pay: Litigation
- 37** SEC Staff Continues to Focus on Litigation Contingency Disclosure
- 40** Boilerplate Matters: Giving Notice

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**CORPORATE
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NEWSWIRE**

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TO OUR READERS

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RIGHTS PLANS IN A NEW ERA: RECENT DRAFTING TRENDS

By Marc A. Alpert, Kessar Nashat and Garrett Lynam

Shareholder rights plans, commonly referred to as “poison pills,” are a tested and effective takeover defense for a board of directors to use against hostile takeovers.¹ In the event any person acquires a specified percentage of a company’s stock, a poison pill grants the company’s shareholders (other than the acquirer) the right to buy shares of the company’s stock (or, in certain cases, the acquiring company’s stock) at a discount (typically the shareholders can buy common stock with a market value equal to twice the right’s exercise price). By granting all shareholders except the acquirer the right to buy shares at a discount, the poison pill effectively dilutes the acquirer’s voting and economic interest and substantially raises the cost of its hostile bid. Rights plans consequently dissuade acquirers from initiating a hostile takeover without the board of director’s approval and revocation of the pill.

Companies that have older rights plans in effect or “on the shelf” and ready to be adopted in the event of hostile activity may find that their poison pills lack the diverse array of new provisions increasingly becoming prevalent in modern rights plans. Consequently, companies seeking to adopt a new poison pill or put one “on the shelf” need to consider whether their rights plans should be updated to take advantage of these new provisions.

We reviewed 27 rights plans adopted between September 1, 2010 and October 31, 2011 by U.S. companies with market capitalizations of over \$250 million to survey how companies are using newer provisions to tailor their poison pills.² Our survey encompassed the following provisions and demonstrates how boards of directors can better engineer their poison pills to respond to the realities of today’s hostile acquirers:

- Ownership Percentage Triggers
- Duration
- Use of “Qualifying Offers”
- Coverage of Derivatives
- Use of a Trust to Facilitate an Exchange
- Window for Redemption or Amendment Post-Trigger
- Coverage of Persons Acting in Concert

Trend to Keep Rights Plans “On the Shelf”

Given the effectiveness of rights plans as a viable takeover defense and their potential to be used as a tool to entrench management, it is of little surprise that Institutional Shareholder Services (“ISS”) and other corporate governance advisory firms have strong views on poison pills. ISS’s guidelines make clear that it does not favor the adoption of poison pills that are not approved by shareholders and do not have the following attributes³:

- A trigger of at least 20%;
- A term of no more than three years;
- No dead-hand, slow-hand, no-hand or similar feature that limits the ability of a future board of directors to redeem the rights plan; and
- A shareholder redemption feature (*i.e.*, a “qualifying offer” clause).

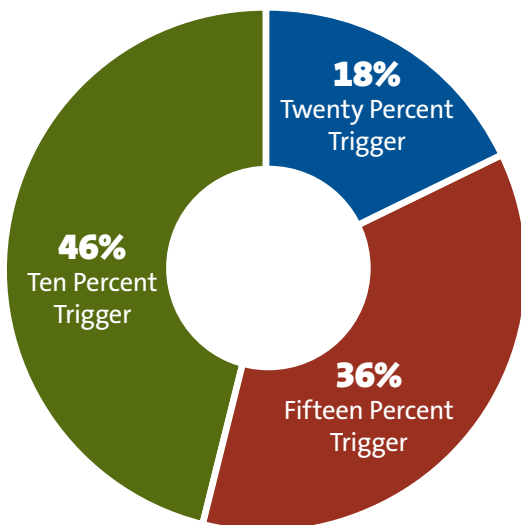
Given the influence of ISS and other corporate governance activists, the clear trend over the past several years is that many companies have allowed their rights plans to lapse and, instead of adopting new rights plans, have kept rights plans “on the shelf” and ready to be adopted in response to a specific threat. In 2001, over 2,200 U.S. companies had a poison pill in place, whereas by early 2010 this number had fallen to just under 1,000.⁴

At least 75% of the rights plans we surveyed were adopted in response to a hostile takeover threat or in connection with a merger agreement. As our survey demonstrates, larger companies that have recently implemented poison pills are not necessarily following ISS's guidelines in respect of their favored provisions, which is not surprising as these poison pills were often adopted in the context of hostile activity.

Ownership Percentage Triggers

Most of the rights plans we reviewed use a threshold ownership percentage of 10% or 15% as an ownership triggering percentage (i.e., the percentage of the company's shares the acquirer must beneficially own to trigger the provisions of the poison pill allowing for dilution).

Rights Plan Trigger Percentages

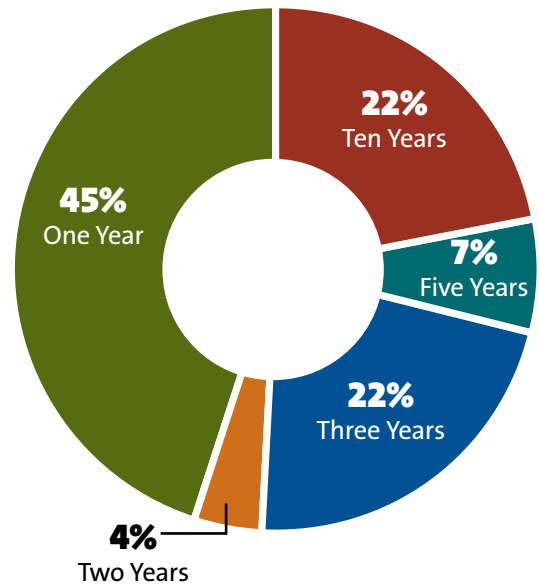


Despite ISS's recommendation that poison pills have a trigger of no less than 20%, the vast majority (82%) of the rights plans we surveyed used a lower trigger.

Duration

The rights plans we surveyed have substantial variance in their duration.

Rights Plan Durations



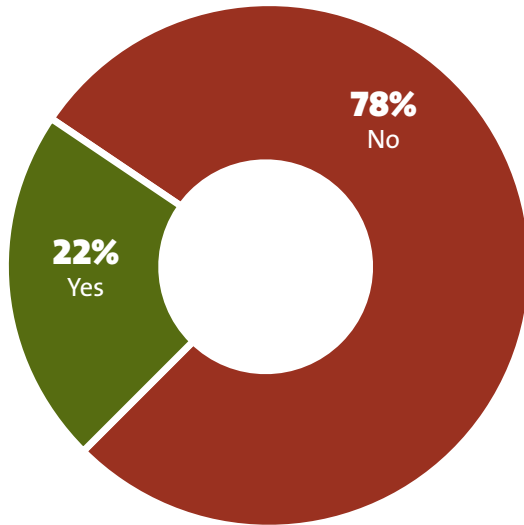
Companies covered by our survey largely comply with ISS guidelines regarding the duration of their rights plans. Seventy-one percent of these poison pills used a duration of three years or less, which contrasts sharply with the historically prevalent duration of 10 years. Boards of directors appear to be foregoing longer durations in their rights plans in exchange for the flexibility to adopt revamped and cutting-edge plans on a more frequent basis in response to specific threats.

Furthermore, our survey indicates that a small but not insignificant percentage of poison pills provide for termination if they are not approved by shareholders prior to the completion of the company's next annual shareholder meeting. In

Given the influence of ISS and other corporate governance activists, the clear trend over the past several years is that many companies have allowed their rights plans to lapse and, instead of adopting new rights plans, have kept rights plans "on the shelf" and ready to be adopted in response to a specific threat.

practice, this means that some rights plans actually have a shorter term than their stated duration. Approximately 22% of the rights plans we reviewed allow for early termination.

Early Termination If Not Approved by Shareholders Prior to the Next Shareholder Meeting?



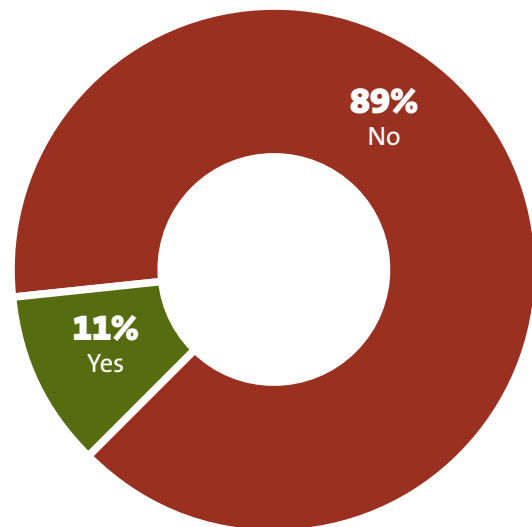
Of the rights plans that provided for early termination if not approved by shareholders prior to the next shareholder meeting, approximately 17% had a stated term of one year, approximately 17% had a stated term of two years, approximately 50% had a stated term of three years and approximately 17% had a stated term of 10 years.

Use of “Qualifying Offers”

Only a few recent rights plans that we surveyed contain a provision stating that if the board of directors does not redeem the poison pill to accommodate an offer that meets certain pre-defined characteristics (such as full all-cash financing, premium pricing over the highest reported market price in the past 12 months and a grace period for the board to solicit advice regarding the adequacy of the offer), often referred to as a “qualifying offer,” then the company’s shareholders may call a special shareholder meeting to vote on redeeming the poison pill. ISS advocates that rights plans allow holders of 10% of a company’s shares to call a special meeting or seek a written notice to vote on rescinding the rights plan in the event that the board of directors refuses to redeem the poison pill 90 days after a “qualifying offer” is announced. In effect, a “qualifying offer” provision allows shareholders to override the board of directors’ business judgment to not redeem the poison pill in the event the

company receives an offer that constitutes a “qualifying offer” under the rights plan. Despite ISS’s recommendation, our survey indicates that the “qualifying offer” provision is not widely implemented.

Can Shareholders Vote to Redeem the Rights Plan in Response to a Qualifying Offer?

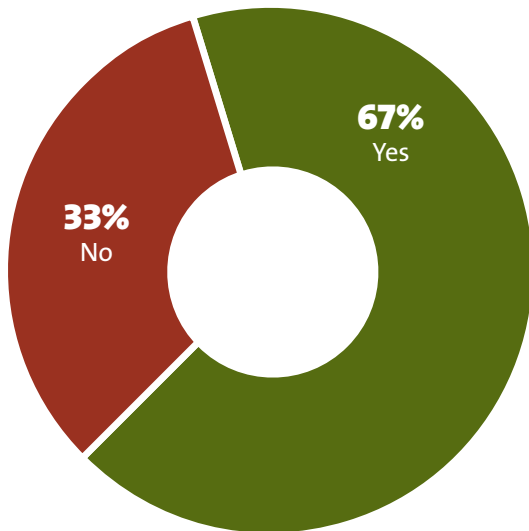


Coverage of Derivatives

An important drafting trend that is not connected with ISS’s recommendations concerns the role of derivatives in triggering a poison pill. Generally, an acquirer who “beneficially owns” more than a defined threshold percentage of the company’s shares triggers the poison pill. The traditional definition of “beneficial ownership” includes ownership of shares that a person or its affiliates has the right to acquire, either directly or indirectly. However, given the increasing prevalence of financial instruments such as derivatives that allow for the acquisition of economic interests in shares without actually acquiring those shares, many modern rights plans are expressly adding the ownership of derivatives to the definition of “beneficial ownership.” Including this provision in the definition of “beneficial ownership” means that a person who holds, for example, more than 15% of a company’s shares through “derivatives” will trigger the poison pill despite the fact that they do not actually own or have the right to acquire the requisite threshold percentage of shares.

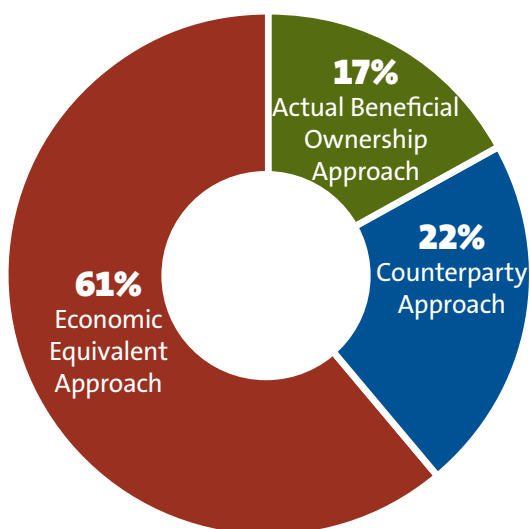
Two-thirds of the rights plans we surveyed incorporate the ownership of “derivatives” into the definition of beneficial ownership.

Are Derivatives Included in the Definition of “Beneficial Ownership”?



Our survey showed variation in how rights plans are actually defining the term “derivative.” There are three approaches that poison pills generally use in defining “derivatives” and determining the amount of shares that a person owns by virtue of entering into a derivative instrument: the “Economic Equivalent Approach,” the “Counterparty Approach,” and the “Actual Beneficial Ownership Approach.”

Approaches Used to Define “Derivatives”



The Economic Equivalent Approach

A large majority of the rights plans we surveyed used the “Economic Equivalent Approach” in defining the term “derivative.” Under this approach, a person beneficially owns all the shares for which the derivative provides the “economic equivalent of ownership.” The fact that the derivative does not provide voting power or that the acquirer does not have the right to acquire the shares is irrelevant.

The number of shares that a holder of the derivative beneficially owns under the Economic Equivalent Approach is the notional amount of shares subject to the derivative, regardless of whether any shares are actually owned by the counterparty (or successive counterparties) to the derivative. Once the poison pill is triggered, it appears that any shares actually underlying the derivative will be tainted by virtue of the acquiring person’s nexus and such shares will be ineligible to receive rights pursuant to the rights plan, even when the ultimate holder of the shares is otherwise unconnected with the acquiring person.

The Counterparty Approach

The Counterparty Approach uses the beneficial ownership of the derivative’s counterparty as a reference point for calculating the number of shares that the derivative’s “receiving party” beneficially owns. Under this approach, a receiving party who enters into a derivative with a counterparty beneficially owns only the shares that the counterparty in turn beneficially owns, including any shares beneficially owned by the counterparty (and successive counterparties) under any other derivative that such counterparty (or successive counterparties) is a party to. However, no receiving party can be deemed to beneficially own more than the notional amount of shares subject to such receiving party’s derivative. Once a poison pill is triggered, the shares beneficially owned by the acquiring person pursuant to a derivative that are held by the acquiring person’s counterparty (or successive counterparties) will be ineligible to receive rights pursuant to the rights plan.

The Actual Beneficial Ownership Approach

Under the Actual Beneficial Ownership Approach, derivatives are generally defined in the same manner as the Economic Equivalent Approach; however, a person’s ownership of derivatives would trigger the poison pill only if such person otherwise actually beneficially owns a specified percentage of the company’s shares without regard to the derivatives held by such person. Each of the rights plans we surveyed that use the Actual Beneficial Ownership Approach required an actual beneficial ownership of at least 5% of the company’s shares

in order to capture derivative interests. In essence, the Actual Beneficial Ownership Approach means that a person who only owns derivatives cannot trigger the poison pill. Since this approach requires a shareholder to beneficially own at least 5% of a company's shares separate and apart from any derivatives prior to triggering the rights plan, a person could theoretically accumulate and use derivatives to mount a hostile takeover while maintaining actual beneficial ownership of less than 5% and never triggering the rights plan.

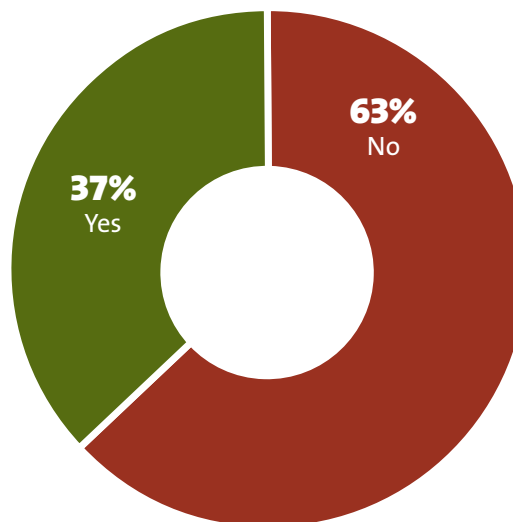
Use of a Trust to Facilitate an Exchange

Once the poison pill is triggered, the board of directors typically may exchange the company's shares for rights on a one share-for-one right basis, instead of permitting the shareholders to exercise their rights. An exchange will also result in the intended dilution of the acquirer's interest (although, as compared to allowing shareholders to exercise their rights, there will virtually always be less voting dilution and there may or may not be less economic dilution depending on the exercise price of the rights and market price of the shares when the pill is triggered). Given the sudden nature of hostile threats and the likelihood that some shareholders will wait until the end of the expiration period to exercise their individual rights, an exchange may be preferable to allowing shareholders to exercise their rights as a company will not be able to determine the dilutive effect of the rights plan until all shareholders individually exercise their rights.

In one of the first instances of a poison pill being triggered, Versata Enterprises, Inc. and certain affiliates triggered Selectica, Inc.'s poison pill in late 2008. As the triggering of Selectica's poison pill demonstrates, it is very helpful to have certain procedures covered in the rights plan to facilitate an exchange if the poison pill is triggered. Selectica's board elected to exchange each outstanding right for one share of its common stock, but Selectica struggled with how to certify which shareholders were eligible to participate in the exchange. Consequently, trading in Selectica's common stock was suspended for approximately one month while Selectica wrestled with the exchange mechanics. Selectica ultimately created a process through which holders of rights, or brokers who held rights through a "street name," would certify through The Depository Trust Company that the rights being exchanged were not held by Versata.

As a result, a growing number of rights plans grant the board of directors broad powers in managing an exchange, and many recent rights plans now specifically permit the board of directors to use a trust to facilitate the mechanics of an exchange.

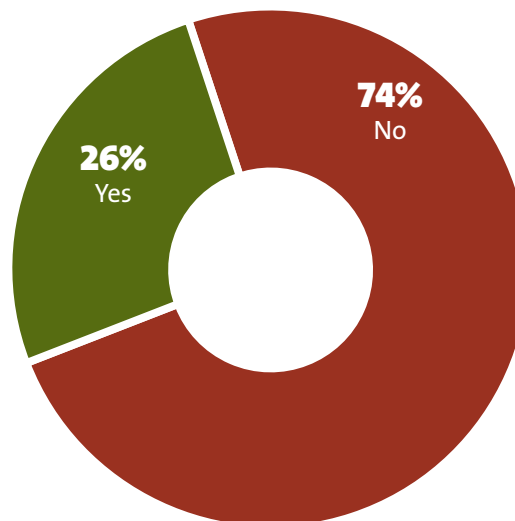
Does the Rights Plan Specifically State That a Trust May Facilitate an Exchange?



Window for Redemption or Amendment Post-Trigger

Generally, a board of directors cannot redeem rights or amend a rights plan in a manner that adversely affects a rights holder once an acquirer crosses the prescribed ownership threshold. To allow otherwise may create a disincentive for acquirers to negotiate with the board prior to triggering the poison pill because the acquirer knows that the board can still redeem the pill after the ownership threshold is crossed. Despite this, over a quarter of the rights plans we surveyed allow the board a window of time to redeem rights or amend the rights plan after an acquirer crosses the ownership threshold so as to, for example, make the poison pill inapplicable to the acquirer.

Does the Board Have a Window Post-Trigger to Redeem the Rights or Amend the Rights Plan?

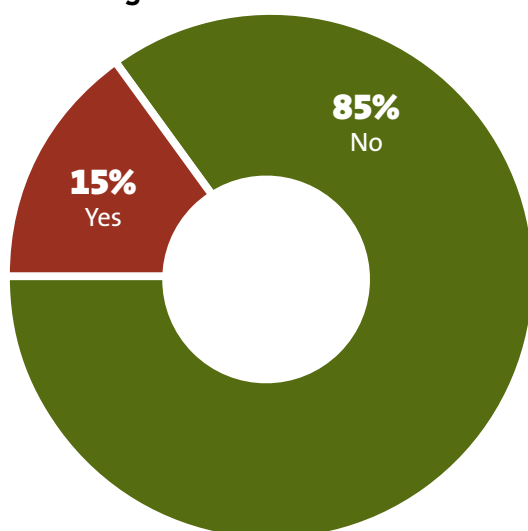


These rights plans typically grant the board of directors the ability to redeem rights or so amend the rights plan for a window period of 10 business days after the acquiring person crosses the prescribed ownership threshold.

Coverage of Persons Acting in Concert

Although poison pills traditionally contemplate that a person “beneficially owns” all shares that such person has the right to acquire through any oral or written understanding, a small minority of recent rights plans we reviewed expand this concept to take into account shares owned by anyone who “acts in concert” with an acquiring person. “Acting in concert” is a broader standard than having the right to acquire shares through an oral or written understanding. The concept of “acting in concert” captures tacit understandings between shareholders and persons otherwise seeking to acquire a company’s stock, such as “wolf pack” activity by hedge funds. Also, the board of directors has discretion to determine who is acting in concert, which is a feature whose scope is yet to be tested in courts.⁵ It is unclear whether the “acting in concert” concept will become commonplace in rights agreements given its broad language concerning tacit knowledge. Nonetheless, a small percentage of rights plans we surveyed are utilizing this “acting in concert” concept.

Does the Definition of “Acquiring Person” Include Persons “Acting in Concert”?



Poison pills have evolved to include different terms and new features to respond to hostile threats. Companies preparing rights plans for adoption or to keep rights plans “on the shelf” in the event of a specific threat should consider all available features.

Conclusion

Poison pills have evolved to include different terms and new features to respond to hostile threats. Companies preparing rights plans for adoption or to keep rights plans “on the shelf” in the event of a specific threat should consider all available features. Doing so will enable companies to tailor their poison pills to provide optimal protection against hostile activity. ©

¹ Recent Delaware cases upholding the legality of rights plans include *In re Orchid Cellmark Inc. S’holder Litig.*, 2011 Del. Ch. LEXIS 75 (Del. Ch. May 12, 2011); *Air Products & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. Feb. 15, 2011); *Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310, 2010 Del. Ch. LEXIS 172 (Del. Ch., Aug. 11, 2010); *Selectica, Inc. v. Versata Enters., Inc.*, 2010 Del. Ch. LEXIS 39 (Del. Ch. Feb. 26, 2010).

² This survey does not include rights plans enacted to preserve a company’s net operating losses (commonly referred to as “NOL plans”).

³ See INSTITUTIONAL SHAREHOLDER SERVICES INC., 2011 U.S. PROXY VOTING GUIDELINES SUMMARY (Jan. 27, 2011), available at http://www.issgovernance.com/policy/2011/policy_information.

⁴ John Laide, *A New Era in Poison Pills - Specific Purpose Poison Pills: The Number of Companies with Poison Pills Falls Below 1,000 for First Time in Twenty Years*, SHARKREPELLENT.NET (Apr. 1, 2010), https://www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20100401.html&Specific_Purpose_Poison_Pills&rnd=372936.

⁵ Note that Barnes & Noble removed an “acting in concert” provision from its rights plan in connection with litigation concerning the legality of its pill.

CAPITAL LOANS TO PRIVATE EQUITY FUNDS: WHEN INVESTORS BECOME PART OF THE BORROWING BASE

By Morton E. Grosz, Vincent Dunn and Yan Kuznetsov

Private equity funds receive capital from their investors pursuant to capital calls issued periodically by the general partner or other manager of the fund. When issuing capital calls, the manager faces potential uncertainties relating to whether or not the funds will be received as required, as well as built-in time delays imposed by fund governing documents which typically require 7 to 15 business days advance notice. This, at the very least, hampers a fund's flexibility in deciding when to call capital and also creates risk of a potential default by a fund in meeting its contractual obligations, such as paying the purchase price at a closing, because it does not have the money in hand. To deal with these concerns, funds are increasingly turning to lenders as a quick and certain source of interim funding.

In this article, we address some issues that the lenders face in structuring these loans and some matters that fund managers should consider in negotiating the loan documents.

The pre-negotiation planning stage for a capital loan is very important for a fund manager. As discussed further below, prior to finalizing the fund's organizational and other documents, a fund manager (with the assistance of counsel) should examine what steps can be taken to facilitate a future capital loan program, including addressing any potential restrictions or impediments under the terms of any proposed or existing documents or otherwise.

Background

Typically, capital loans are revolving credit loans to the fund secured by a pledge of the fund's rights against its investors to enforce the capital commitments, including the right to make the capital calls.

The capital funding obligations of the investors are set forth in the fund's governing instruments, typically a limited partnership agreement (or a limited liability company agreement) to which the investors are parties, and the subscription agreements executed by each investor. These provisions include the amount of each investor's capital commitment, the procedures for calling capital, the permitted uses of capital, the date by which the capital must be received by the

fund, the dates or circumstances after which capital may no longer be called and the rights and remedies of the fund in the event of a default by an investor.

Collateral for Capital Loans

For the most part, capital loans are secured revolving credit facilities with a term between one and three years. Unlike traditional secured loans for an operating company where the collateral securing such loan is comprised of a broad range of assets (e.g., inventory, equipment, intellectual property, accounts and real property), the collateral securing capital loans to private equity funds is often very limited. The primary collateral securing capital loans are the capital commitments of the investors in the fund. Additional collateral will include the rights of the fund manager to call, enforce and receive payments with respect to the capital commitments. The final element of the collateral is frequently a lien on a deposit account into which proceeds of all capital calls are to be deposited.

It would be unusual for a lender under a capital call loan arrangement to have a lien on or a claim against any management fees owing to the fund manager; however, a lender may seek to require that the payment of management fees be subordinated to the repayment of the capital loan after the occurrence of an event of default. The fund manager

needs to consider carefully whether to agree to subordination since this could affect the operations of the fund manager, including the ability to pay the professionals and other staff of the manager and to satisfy overhead expenses.

Documenting and Perfecting Liens on the Collateral

The manner in which a lender would document and perfect its lien on the collateral securing a capital loan is similar to the steps a lender would take in connection with other types of secured loan transactions. The fund and the general partner of the fund will enter into a security agreement pursuant to which they grant a lien in favor of the lender in their respective rights under the partnership agreement and their respective rights to the capital commitments and the capital contributions made by the fund's investors. As mentioned above, the lien will also cover the fund's rights to a designated deposit account into which capital contributions are deposited.

Documentation — Specific Provisions

The documentation for a capital loan will look substantially similar to a traditional secured loan credit facility. Some of the key provisions for a capital loan include the following:

A. Borrowing Base. Many capital loan facilities provide that the amount of the loans made from time to time (and outstanding) will be based on a certain percentage of the unfunded capital commitments of certain investors. For instance, an investor rated AA- could have a 100% advance rate but an investor rated BBB- could have an 80% advance rate. In addition, for unrated investors, the advance rates could be tied to the net assets of such investors. There would also be concentration limits such that the aggregate unfunded commitment of any one investor included in the borrowing base cannot exceed more than a specified percentage of the entire borrowing base.

B. Eligible Investors/Excluded Investors. Not every investor will be included in the borrowing base. If the investor meets the minimum requirements (e.g., rating and/or net worth) then the investor is included, but if certain events occur, such investor can become an "excluded investor." Such events include (i) bankruptcy or insolvency events, (ii) the investor fails to make a capital contribution or defaults under the terms of the partnership agreement or its subscription agreement or (iii) the investor challenges or declares unenforceable its obligations to make a capital contribution or repudiates any material terms of the partnership agreement or its subscription agreement.

C. Maturity of Loans. As noted above, capital loans typically have a term between one and three years. From a lender's perspective, the maturity date for a capital loan should be well before the end of the fund's commitment period during which the fund manager is permitted to make capital calls (generally 4 to 5 years, subject to certain exceptions such as for follow-on investments or satisfaction of liabilities).

D. Specific Covenants. On a regular basis the fund will be required to provide the lender with the following information: the amount of unfunded capital commitments, the amount of capital commitments funded, the calculation of the borrowing base, and notices of the occurrence of any event which makes an investor an "excluded investor." The lender will normally require a copy of each capital call notice.

Certain restrictions will be imposed on the fund under the terms of the loan agreement, including, unless the lender consents, restrictions on changes to the management company and restrictions on amendments to the management agreement that would be adverse to the lender.

The time for a fund manager to plan for a capital loan program is before, not after, the formation of the fund.

Additional common restrictions imposed on the fund capital loan arrangements include (i) a prohibition on distributing investment proceeds to the investors if an event of default has occurred or perhaps if any principal or interest on the loans is then outstanding and (ii) a prohibition on the right of the general partner to consent to an investor transferring its rights and capital commitment if after giving effect thereto an event of default exists or the outstanding loans would exceed the borrowing base or perhaps if the lender has not approved the transferee.

Financial covenants are normally limited and may comprise simply of a minimum funding covenant (*i.e.*, unfunded capital commitments plus the net worth of the fund must be in excess of a certain multiple of the fund's total debt).

E. Select Closing Conditions. Many of the conditions to closing a capital loan agreement will mirror those in any other secured financing arrangement. Conditions that are specific for a capital loan may include (i) delivery to the lender of

a blank capital call notice addressed to each investor and signed by the general partner and (ii) a letter from the general partner to the investors notifying the investors that the fund has entered into a loan arrangement with the lender and that the capital commitments have been pledged as collateral for the loan.

F. Events of Default. The capital call loan agreement will contain events of default specific for an equity fund, such as (i) the occurrence of events under the partnership agreement which would terminate the right of the fund manager to call unfunded capital commitments, (ii) the occurrence of a “Key Person Event” under the organizational documents, e.g., the death, resignation or departure of certain key persons in the fund manager and (iii) the resignation, withdrawal or removal of the fund manager without the appointment of a successor acceptable to the lender.

Because the occurrence of an event of default can trigger onerous consequences, such as full acceleration of all amounts outstanding, the fund manager should review whether certain proposed events of default should instead be merely bars to further loan drawdowns or prepayment events so as not to trigger cross-default provisions under other agreements. For example, a Key Person Event which does not result in a termination of the right to call unfunded capital commitments might be excluded from the definition of events of default.

G. Remedies of the Lender. If an event of default occurs under a capital loan the lender will typically have the right to (i) require the fund manager to deliver capital call notices to the investors to satisfy the default loan amounts, (ii) designate investors as “defaulting investors” and (iii) require the fund manager to exercise some or all of the penalties and remedies under the partnership agreement against defaulting investors directly (including taking legal action to collect the defaulted payment obligation and interest and collection expenses and/or causing the sale of the defaulting investor’s interest in the fund in accordance with the fund’s organizational documents).

The lender may also want to have the right to exercise these remedies directly, without the involvement of the fund manager. Thus, the collateral documents frequently grant a power-of-attorney to the lender to take these actions in the name of the fund or the fund manager. In addition, it is not uncommon to have blank capital call notices signed by the fund manager of the fund and delivered to the lender at closing. However, the fund manager will want to negotiate for

limitations on the lender exercising all of the fund manager’s rights against a defaulting investor. For example, a fund manager will normally want to maintain control of the sales process of a defaulting investor’s interest).

Enforcement by the Lender Against the Investors

It is common to have investors in a fund organized and/or located in multiple jurisdictions, including foreign jurisdictions. It is important for a lender, after an event of default occurs, to be able to seek the capital contributions from the investors, but this can be a complicated process when a reluctant foreign investor is involved. The lender would likely have to obtain a judgment against such investor from a court located in the jurisdiction designated for disputes under the partnership agreement, and then the lender will be required to have such judgment recognized and enforced in the jurisdiction where the investor is located. Advice from counsel in the subject jurisdictions is important on these issues.

Due Diligence Matters

From a lender’s perspective, it will have to conduct adequate due diligence on each investor, including financial and legal due diligence. The fund’s organizational documents, the partnership agreement, each subscription agreement and all side letters will have to be reviewed to ensure there are no limitations on the fund entering into the capital loan arrangements and pledging the unfunded capital commitments and the related pledged assets. Sometimes a fund’s organizational documents restrict the fund’s ability to borrow except for bridge financing (such as a capital loans program). In such cases, the fund’s organizational documents may also limit the amount that can be so borrowed, such as not more than 15-25% of aggregate capital commitments. In addition, a lender will need to confirm that there are no set-off rights or counterclaims or defenses to the capital calls or any circumstances under which an investor will have a right not to fund its capital commitment at a time when the lender exercises its remedies under the loan documents. For example, one or more investors may have contractual rights under the fund’s organizational documents or side letters to be excused from their capital contribution obligations for investments in certain types of industries or investments which raise certain tax issues (e.g., unrelated business taxable income in case of tax-exempt investors) or potential ERISA issues (e.g., a prohibited transaction in case of private pension plans). Such rights could affect the borrowing base.

Advance Planning for Capital Loans

The time for a fund manager to plan for a capital loan program is **before**, not after, the formation of the fund. For example, the fund manager in consultation with legal counsel in the jurisdiction in which the fund is organized should determine whether the fund has inherent authority under applicable law, or it is necessary to include authorizing provisions in the organizational documents (or in subscription agreements executed by the investors), to do the following:

- borrow;
- pledge the unfunded capital commitments and the right of the fund manager to make capital calls;
- disclose financial and know your customer information about the investor;
- provide copies to the lender of subscription agreements and side letters executed by the investors; and
- guarantee the obligations of the fund's subsidiaries, if a subsidiary of the fund will be the borrower and the fund will be required to guarantee the subsidiary's obligations.

Specific provisions may be required to meet certain lender contractual requirements, such as the investors agreeing to provide supplementary and/or periodic updates on their financial condition and/or acknowledging to the lender that a security interest in their capital commitments has been granted to the lender.

Consultation with counsel and one or two lenders in advance of finalizing the fund documentation as to what provisions to incorporate in the fund documents and what related disclosures need to be made to the investors will facilitate the entering into of these loan arrangements.

Conclusion

As evidenced by their growth in popularity, capital loan programs can be a useful financing technique for private equity funds. Planning for them as part of the fund formation process — rather than after all the fund documents are set in stone — can facilitate implementing a program with the best terms. ©

ARE YOU PAYING TOO MUCH? HOW SMART COMPANIES USE FCPA AND UK BRIBERY ACT DUE DILIGENCE TO ENSURE THEIR DEALS ARE VALUED CORRECTLY

By M. Scott Peeler and Erin Callahan

There is a global focus on corruption that shows no signs of abating and in fact, is intensifying. Beginning with the adoption of the Sarbanes-Oxley Act in 2002, we have seen an increase in regulation designed to put the brakes on clever accounting and even cleverer “innovative” banking products. Society – and in response government – wants its pound of flesh for the practices of the large corporates like Enron and large financial institutions like Lehman Brothers. Punishment is exacted in the form of increasingly large penalties, occasional jail sentences and ubiquitous demands for ever stricter corporate governance and compliance programs. The most common and effective tools for exacting punishment are the U.S. Foreign Corrupt Practices Act (“FCPA”) and its souped-up sidekick – the UK Bribery Act.

The Foreign Corrupt Practices Act

In 1977, in the wake of the Watergate scandal, the U.S. Congress enacted the FCPA to halt the bribery and corruption of foreign officials. In addition, it was hoped that the FCPA would lead to more integrity and accountability in business and more efficient and equitable distribution of economic resources. The FCPA created criminal and civil penalties for payments, or the promise of anything of value, by U.S. corporations or U.S. nationals to foreign officials for the purpose of gaining an improper advantage or obtaining or retaining business. The FCPA also applies to foreigners who take part in furthering such bribes while in the United States.

The U.S. Department of Justice (“DOJ”) has made prosecuting violations of the FCPA one of its top priorities in recent years. FCPA enforcement is now viewed as a national security issue. The DOJ is focusing its efforts on “industry sweeps” of those sectors it considers to be at high risk of corruption, including energy, mining, banking, insurance, telecommunications, pharmaceuticals, gaming and manufacturing. From 2004 through 2009, the DOJ brought more FCPA prosecutions than in all of the previous 26 years combined since the act was passed. In 2010 alone, the DOJ resolved more than

50 FCPA enforcement actions, with 35 defendants currently awaiting trial on FCPA charges. In November 2011, the DOJ secured a 15-year prison sentence in an FCPA case – the longest ever imposed.

Foreign companies are increasingly a target of FCPA enforcement actions, as the United States attempts to pressure foreign governments into being more proactive in the anti-corruption arena. Under the theory of “correspondent bank account” jurisdiction, the DOJ need only establish a tenuous connection to the United States in order to bring a prosecution under the FCPA. It is enough for U.S. dollar funds to have cleared overnight in the U.S. branch of a bank with no other connection to the United States. Eight of the 10 largest FCPA actions of all time were against foreign corporations, and in 2010 the six largest actions, accounting for 80% of the fines, were against foreign companies.

The UK Bribery Act

As of July 1, 2011, companies with any tie to the United Kingdom’s stream of commerce — and not just those with share listings in London — are subject to the tough new UK Bribery Act. Its scope is similar to the FCPA, with three important

distinguishing features. First, accepting a bribe from or paying a bribe to any individual is prohibited, no matter where it occurs. For instance, a bribe paid to an employee of a private company is illegal. This is a much broader prohibition than the FCPA, which makes it illegal to offer anything of value only to foreign government officials and employees of international public organizations. Second, a company can be held strictly liable for bribery if the company fails to put in place procedures to prevent corruption. Third, there is no limit on the size of fines, and the potential prison sentences are longer than under the FCPA. Unlike the FCPA, the UK Bribery Act does not have an exception for facilitation payments, such as those used to speed up the process for obtaining a building permit or import license.

Impact on Deal Price

When you mention the word “compliance” to almost anyone working in capital markets, be they bankers, lawyers or accountants, you almost immediately lose your audience. Compliance is just a cost center, right? Just another hurdle in the way of getting deals done efficiently and cost-effectively, right? Wrong! In the new era of compliance-hungry regulators, who are fighting corruption Clark Kent style, it pays to put these issues at the forefront of every deal.

FCPA and UK Bribery Act investigations can have an immediate impact on share price. For example, on March 1, 2011, the Las Vegas Sands Corporation announced that the Securities and Exchange Commission (“SEC”) and the DOJ were investigating its FCPA compliance. By the end of the trading day, its share price had dropped 6.3%, which represented a shrink in market capitalization of \$1.67 billion in a single day. Examples of this kind, showing a marked drop in

share price and value in response to announcements of alleged corruption, are prevalent among the small- to mid-cap companies. The large-cap companies tend to be hit less hard and to rebound more quickly. Among the possible reasons for this phenomenon are the stronger reputation in the market of many large cap companies and the less significant impact any ultimate fine will have on the market capitalization of such companies.

FCPA fines are steep and are on the increase. In 2010, companies paid in penalties an average of \$2.14 per U.S. dollar gained from FCPA violations. This is an 1800% increase from penalties of just \$0.11 per dollar in 2007. In 2010, corporate fines and disgorgements for FCPA violations amounted to over \$1.7 billion, which exceeded all previous years. And, the six largest actions in 2010 accounted for \$1.36 billion of this total.

There are also significant “downstream effects” that can far surpass the cost to companies of FCPA fines and drops in share price. These include securities class actions, disbarment from foreign government contracts and restrictions on the ability to import or export goods and services. Corruption has a big impact on the cost and sometimes even the ultimate viability of a deal.

The discovery of FCPA and UK Bribery Act violations can unravel potential merger discussions. In 2003, Titan Corporation entered into merger discussions with Lockheed Martin for \$1.8 billion. Titan represented in the merger agreement that neither it nor any of its subsidiaries had taken any actions to violate the FCPA. When it was later revealed that Titan had funneled more than \$2 million through an agent in Benin toward the election of that country’s president, the merger with Lockheed Martin collapsed.

“Successor Liability” Approach to Enforcement

Increasingly, the U.S. government has wielded the enforcement powers of the FCPA in a manner that casts the specter of “successor liability” on acquirers for historical violations of acquired companies, even when the acquirer played no role in the pre-acquisition conduct. This approach to successor liability is frequently invoked when the acquirer is seen to have failed to undertake adequate due diligence to inform itself about the violations and allows the prohibited conduct to continue post-acquisition after the acquired business has been consolidated with that of the acquirer. For example, in September 1998, Halliburton, through a series of corporate transactions, acquired KBR. It was later revealed that from 1994, prior to its acquisition by Halliburton, and continuing

Top Ten Regulatory Settlements

	FCPA Fines (\$M)	Home Country
1.	800	Germany
2.	579	United States
3.	400	United Kingdom
4.	365	The Netherlands/Italy
5.	338	France
6.	218.8	Japan
7.	185	Germany
8.	137	France
9.	81.8	Switzerland
10.	70	United States

through 2004, KBR and its partners in the TSKJ joint venture had paid bribes to a wide range of government officials in order to obtain contracts worth more than \$6 billion to build the Bonny Island liquefied natural gas facility in Nigeria. The SEC subsequently accused KBR of violating the anti-bribery provisions of the FCPA and aiding and abetting Halliburton's violations and accused Halliburton of conducting insufficient due diligence and failing to design and maintain adequate internal controls when it consolidated KBR's false financial statements into its own. In enforcing the books and records violations against Halliburton, the SEC used those alleged failures, along with Halliburton's own lack of post-acquisition vigilance and alleged misconduct, to force a sizable penalty. Halliburton and KBR agreed to pay \$177 million in disgorgement to settle the SEC's charges. KBR also agreed to pay \$402 million to settle the DOJ's parallel criminal charges, \$382 million of which was paid by Halliburton under contractual indemnification arrangements with KBR as part of KBR's spin off as a separate public company in 2006. In addition, as part of the resolution of the SEC investigation, Halliburton agreed to retain an independent consultant to perform a review of its internal controls and record-keeping policies and to adopt any necessary improvements.

The idea of successor liability is troubling to many legal practitioners, particularly those practicing in jurisdictions outside of the United States. For instance, in the UK, successor liability is limited to certain torts, such as product liability and environmental breaches, situations involving express or implied assumptions of liability, de facto mergers where the successor is a continuation of the predecessor, or mergers done as a pretext to defraud creditors. In contrast, the U.S. government's approach to successor liability has become a primary enforcement feature of the FCPA in any type of acquisition, and because the vast majority of cases settle, its legality has not yet been challenged in a court of law.

Prophylactic measures

To avoid a loss in deal value, an acquirer must conduct careful anticorruption due diligence that is specifically tailored to the company being acquired. First, however, the level of risk should be assessed through a series of key questions. These questions include:

- 1.** Are any employees, owners, or principals current or former government employees or closely affiliated with one?
- 2.** What practices and safeguards are there regarding gifts, entertainment, hospitalities, charitable contributions, sponsorships, donations and other benefits?

- 3.** What is the target's relationship with intermediaries (distributors, agents, consultants, etc.)?
- 4.** Have there been any past investigations/violations?
- 5.** Does the target operate in a high-risk industry/high-risk country?
- 6.** What is the target's association with foreign governments? Does it provide them with goods and services? Is it government owned or controlled? Does it rely on government-issued licenses or permits?
- 7.** Does the target have clear policies and procedures in place to detect, report and manage FCPA and UK Bribery Act violations?
- 8.** Is there any suspicion of FCPA or UK Bribery Act violations in the target?
- 9.** What does the Transparency International Corruption Perception Index reveal about the target?

Second, the target's systems and controls should be evaluated in the following areas:

- 1.** Use of agents and outside consultants
- 2.** Expense claims, payments and petty cash disbursements
- 3.** Contracting/contact points with government bodies
- 4.** Fraud response procedures/mechanisms
- 5.** Entertainment and gift practices
- 6.** Record-keeping practices and accuracy of books and records
- 7.** Relationships with state-owned enterprises

Coordination with accountants and auditors in conducting pre-merger anticorruption due diligence is vital. Cash is the most prevalent form of bribery worldwide, particularly disbursements to sales people, and so these professionals have a critical role to play in their review of books and records. They should report back regularly to the legal experts, who can make an informed decision on the likelihood of FCPA violations based on what is unearthed by the accountants. In the United States, it is sometimes possible to extend attorney-client privilege to an accountant's findings, if the accountant is acting as an agent for the attorney or is retained directly by the attorney to provide services to the attorney's client. This would, of course, be the best possible outcome.

In order to reduce the risk of potential FCPA and UK Bribery Act liability, every acquirer should consider (1) encouraging the target to undertake a compliance investigation prior to any potential investment; (2) insisting on the right to audit the books and records of the target; (3) insisting on

anticorruption and compliance representations and warranties; and (4) requiring execution of FCPA and UK Bribery Act compliance certifications.

If the due diligence reveals FCPA or UK Bribery Act issues, a buyer has several options available, including (1) negotiating specific indemnification provisions; (2) self-reporting to the DOJ or SEC; (3) adjusting the deal price or walking away from the transaction; and (4) allocating potential fees and fines in the merger agreement.

If there is not time to conduct adequate anticorruption due diligence prior to closing, then the acquirer could consider requesting an advisory opinion from the DOJ. Halliburton did this in connection with its recent proposed acquisition of a British company operating in the oil and gas industry in more than 50 countries, some of which were high risk, to ensure that it would not incur any FCPA liability. The target was accepting closed bids with a very limited amount of due diligence allowed in accordance with London Stock Exchange rules. The DOJ advised Halliburton that the transaction itself would not create any FCPA liability and that it would not be prosecuted for any of the target's pre-acquisition conduct, provided that it disclosed any questionable conduct discovered during a 180-day post-closing period, and that it completed a detailed post-closing due diligence plan.

If, on the other hand, due diligence is conducted but potential issues do not arise until after the merger, then the acquirer should seek thoughtful and expert legal advice as to whether to make a voluntary disclosure of its findings to the DOJ. In addition, if a company agrees to develop evidence against others and provide it to the DOJ and SEC, as many have done, this can mitigate liability. This so-called "cooperation credit" can be very expensive, because it requires a comprehensive internal investigation and then full remediation.

There are also significant "downstream effects" that can far surpass the cost to companies of FCPA fines and drops in share price.

Compliance Programs

Because of the significant risk corruption poses to the success and cost of a deal, it is prudent for companies to establish a "best practices" compliance program to mitigate potential damage from hidden corruption. The UK Bribery Act contains an affirmative defense that allows a company to avoid strict liability only if it can demonstrate that it had in place "adequate procedures" designed to prevent bribery. Although the FCPA does not contain an analogous provision, the United States considers good compliance programs to be an important mitigating factor. In fact, recent amendments to the U.S. Sentencing Guidelines include "monitoring and auditing to detect criminal conduct" and "evaluat[ing] periodically the effectiveness of the organization's compliance and ethics program" as essential elements of an effective compliance program.

Conclusion

There can be no doubt: corruption is expensive, it damages corporate and individual reputations, and it can seriously impair – if not kill – a deal. Smart companies, however, turn those negatives to their advantage. They recognize that by performing meaningful anticorruption due diligence they can protect themselves from overpaying for key acquisitions; avoid costly diminutions of share value; and mitigate the risk of successor liability that surely follows a post-acquisition discovery of corruption. These companies put into practice the sage and oft-quoted advice that "the best defense is a good offense," and by so doing, position themselves to reap the benefits of their best practices compliance efforts for years to come. ©

MINORITY INVESTMENTS IN U.S. INSURANCE COMPANIES — REBUTTING THE PRESUMPTION OF “CONTROL”

By Daniel A. Rabinowitz

Current developments in insurance law may significantly alter the way in which acquirors making a minority investment in U.S. insurance companies report their prospective ownership to state insurance regulators. This article will examine the technique of “disclaiming” control over an insurer and how recent changes to a model state law, currently making its way through various state legislators, could change the technique’s utility and affect deal execution.

Like almost all other aspects of insurance law in this country, corporate control over an insurance company is a matter of state law, enforced at the administrative level by state insurance regulators. The National Association of Insurance Commissioners (“NAIC”), the umbrella organization of these insurance regulators, issues model statutes and regulations and disseminates other resources intended to promote uniformity across states in regulating insurers. One key model law, the Insurance Holding Company System Regulatory Act (Holding Company Act or “HCA”)¹, governs relationships between insurers and their affiliates and is motivated by the public policy of preventing holding companies from looting insurance company surplus or otherwise abusing a subsidiary insurer to the detriment of policyholders.

Under the HCA generally, an insurer “controlled” by another entity must register as such in the insurer’s domiciliary state, and any person seeking to acquire control over an insurer must file a detailed application (known in many states as a “Form A”) with, and receive approval from, the insurance

regulator of the domiciliary state prior to completing such acquisition.² The Form A process frequently involves a public administrative hearing on the fitness of the acquiring company as well as background checks on its officers and directors. The HCA contains other restrictions on holding company conduct as well, including standards governing transactions between insurers and their affiliates.³ Some version of the HCA or substantially similar statutes and regulations are in effect in virtually every state.

The HCA currently in effect in the respective states is in the process of being amended on a state-by-state basis in response to the 2008 financial crisis. The state-by-state amendment process, which could take years to complete, was prompted by amendments to the model HCA adopted by the NAIC in December 2010.⁴ These significant amendments shift the model law’s focus from regulating holding companies and affiliate relationships as such to overseeing an insurer and all its affiliates holistically as a group. The amendments’ most notable feature is the introduction of the concept of “enterprise risk,” which denotes risks present in an affiliate that can have a collateral effect on the insurer, regardless of a specific transaction between the two.⁵ In states adopting the amended HCA, insurers and their holding companies will for the first time be required to identify such group-wide risks to solvency and report these to the lead domiciliary regulator. These and similar requirements of the amended HCA sparked much controversy among industry observers and other commentators during the NAIC legislative process. As of this writing the amended HCA has

The Insurance Holding Company Act currently in effect in the respective states is in the process of being amended on a state-by-state basis in response to the 2008 financial crisis.

been adopted (with some variations) in Texas, West Virginia and Rhode Island,⁶ and has been introduced in the legislatures of a number of other states.

Another HCA reform, which was less contentious, changes the process of determining “control” in the first place. Under the HCA, in provisions largely unchanged by the 2010 amendments, control is defined as

the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or nonmanagement services, or otherwise, . . . Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, *ten percent (10%) or more of the voting securities* of any other person. This presumption may be rebutted by a showing made in the manner provided by Section 4K that control does not exist in fact.⁷

(emphasis supplied). In other words, control is presumed to exist at 10% direct or indirect ownership of voting securities, but can be “disclaimed” (*i.e.*, the presumption can be rebutted) by a person meeting such threshold that nevertheless can show that it does not “control” the subject company. Disclaiming control thus is essentially a declaration that despite the presence of indicia of control, control does not actually exist, and therefore the requirements of the HCA should not apply.

As indicated by the definition of “control,” the procedure for disclaiming control is set forth in Section 4(K) of the Act. Prior to the 2010 amendments, the provision read as follows:

Any person may file with the commissioner a disclaimer of affiliation with any authorized insurer or a disclaimer may be filed by the insurer or any member of an insurance holding company system. The disclaimer shall fully disclose all material relationships and bases for affiliation between the person and the insurer as well as the basis for disclaiming the affiliation. After a disclaimer has been filed, the insurer shall be relieved of any duty to register or report under this section which may arise out of the insurer’s relationship with the person unless and until the commissioner disallows the disclaimer.

Under the prior model Act, a party could “disclaim” control over an insurer, but as a practical matter this remedy might not be available in a transactional context where a minority investment was being made.

The commissioner shall disallow a disclaimer only after furnishing all parties in interest with notice and opportunity to be heard and after making specific findings of fact to support the disallowance.⁸

The 2010 amendments effected the following marked changes to the disclaimer provision:

Any person may file with the commissioner a disclaimer of affiliation with any authorized insurer or a disclaimer may be filed by the insurer or any member of an insurance holding company system. The disclaimer shall fully disclose all material relationships and bases for affiliation between the person and the insurer as well as the basis for disclaiming the affiliation. After a disclaimer has been filed, the insurer shall be relieved of any duty to register or report under this section which may arise out of the insurer’s relationship with the person unless and until the commissioner disallows the disclaimer. The commissioner shall disallow a disclaimer only after furnishing all parties in interest with notice and opportunity to be heard and after making specific findings of fact to support the disallowance: insurer as well as the basis for disclaiming the affiliation. A disclaimer of affiliation shall be deemed to have been granted unless the commissioner, within thirty (30) days following receipt of a complete disclaimer, notifies the filing party the disclaimer is disallowed. In the event of disallowance, the disclaiming party may request an administrative hearing, which shall be granted. The disclaiming party shall be relieved of its duty to register under this section

if approval of the disclaimer has been granted by the commissioner, or if the disclaimer is deemed to have been approved.⁹

Historically, in acquisitions in which an entity proposed to acquire 10% or more of an insurer's voting stock, but less than 100%, the parties would have to form a view on whether the resulting relationship would be one of "control." If the parties concluded that it was reasonable to argue non-control (e.g., because the acquiror would not have any right to board representation or because of the presence of another, majority shareholder), the acquiror might file a disclaimer prospectively with the relevant state prior to closing. Such disclaimer would argue that, although acquiror A proposed to acquire X% of insurer Y's voting stock (where $X \geq 10$), A would not acquire actual control over Y by virtue of the investment because of factors J, K and L. The acquisition agreement would provide as a condition to closing that all required regulatory approvals be obtained, either specifically identifying the disclaimer as a required approval or including it by inference.

As illustrated above, the disclaimer provision pre-2010 ostensibly made a disclaimer effective upon filing. In theory, a disclaimer could be filed immediately prior to closing without awaiting a response from the regulator. However, in most transactional contexts involving minority investors, this practice would not have been considered prudent, for one or more of four reasons set forth below.

1. The prospect of a future rejection of the disclaimer would typically constitute more regulatory risk than the acquiror would be willing to bear. To illustrate, assume that an acquiror files a disclaimer in respect of a pending minority investment and then closes the investment transaction on the theory that control has been disclaimed, and the disclaimer is valid upon filing. Under the language of the statute, at any time in the future the regulator could, subject to the due process protections therein, reject the disclaimer, resulting potentially in an inadvertent breach by the acquiror of the HCA because control will have been acquired without proper clearance. This leads most acquirors to seek affirmative relief from the regulator prior to closing.
2. However, some regulators historically have taken the view that the pre-2010 disclaimer statute does not empower a regulator to expressly "accept" a disclaimer. A

disclaimer can be rejected after the fact in accordance with the procedure set forth in the statute, but nowhere does pre-2010 Section 4K authorize acceptance.

3. Regulators sometimes take the view that while they might have authority to accept a disclaimer, they cannot do so prospectively. In other words, the regulator would not rule on a disclaimer prior to the existence of the relationship to which it relates (*i.e.*, the minority investment). This position makes it impossible to achieve satisfaction of conditions precedent to closing.
4. Many regulators take the view (often as a corollary to the above points) that in such a minority investment, the acquiror's proper remedy prior to closing is not a disclaimer at all, but rather an exemption from Form

The NAIC has provided some clarity around the use of disclaimers, but uncertainties remain.

A requirements under Section 3(E)(2) of the HCA. Such provision states that a Form A need not be filed, and approval need not be obtained, in the case of an acquisition "which the commissioner by order shall exempt as not having been made or entered into for the purpose and not having the effect of changing or influencing the control of a domestic insurer, or as otherwise not comprehended within the purposes of this section."¹⁰

The exemption provision explicitly authorizes the regulator to act prospectively. However, the key drawback of the exemption is that mere exemption from Form A requirements – without a specific finding that control will not exist – will not relieve the insurer from the registration and other requirements of the HCA post-investment. That is, the means of *acquiring* control may have been exempted from formal approval requirements, but this does not per se equate to a finding of non-control.¹¹

As a result of these factors, the disclaimer option was often unavailable as a practical matter to transaction participants. However, the amended HCA improves the disclaimer procedure by alleviating some of the above concerns.

First, the statute now provides for a 30-day period in which the regulator must act, failing which the disclaimer is “deemed to have been granted.” This “deemer” provision adds some teeth to the disclaimer process and is more precise than the previous formulation (“[a]fter a disclaimer has been filed, the insurer shall be relieved . . .”). The new wording provides textual support for the view that relief is granted automatically upon the expiration of the 30-day period, foreclosing regulatory action after that point.

Furthermore, the last sentence of the statute clearly eliminates any doubt as to whether a disclaimer can be “granted” by the regulator; indeed, a disclaimer must be either “granted” or “deemed granted” in order to be effective.

Finally, the old statute suggested that a regulator could at any time disallow a disclaimer upon a proper showing of control. This construction led to the peculiar result in some states that a regulator could not grant affirmative relief but could challenge a disclaimer at any time in the future, leaving uncertainty around whether the investment constituted “control” in the eyes of the regulator. With the amendments, the regulator has 30 days post-filing in which to act. After that, the disclaimer carries the imprimatur of regulatory approval, which is more meaningful than the “may be relied upon” status and the prospect of future disapproval.

While the amended disclaimer statute does resolve some of the uncertainties surrounding this procedure, it is by no means certain that transactions will be directly affected in states in which the amendments are adopted. The main question will be whether the “deemer” provision can be relied upon for purposes of satisfying closing conditions and completing transactions with a minimum of regulatory risk. In other contexts of insurance regulation, “deemer” and similar timing provisions are sometimes disregarded by regulators, who claim the right to “start the clock” when the filing is complete in their discretion. Such practices can effectively vitiate the deemer concept itself.¹² This result could very well be the case in some states that adopt the amended HCA; one idea to address this risk is for the acquiror to specify in the acquisition agreement’s regulatory closing condition that affirmative approval be received, not merely deemed approval. Similarly, a regulator could continue to take the view in an acquisition context that the Form A exemption is the proper remedy because the amended disclaimer statute still does not expressly permit prospective approval. Nevertheless, in refining disclaimer procedures, the NAIC has provided much-needed clarity around the scope of the regulator’s

exemptive authority in this area. This has the potential to significantly improve the regulatory process relating to minority investments in insurers. ☺

¹ NAIC Model Laws, Regulations and Guidelines 440-1.

² *Id.*, § 3(A)(1).

³ See, e.g., *Id.*, § 5.

⁴ News release, Dec. 17, 2010, “NAIC Adopts Key Health Care Provisions, Budget, Other Regulatory Issues — Special Session Finalizes Many Pending 2010 Regulatory Issues.”

⁵ HCA § 1(F).

⁶ See 2011 Texas S.B. 1431; 2011 West Va. S.B. 253; 2011 R.I. H.B. 5730.

⁷ *Id.*, § 1(C).

⁸ HCA pre-Dec. 16, 2010, § 4(K). It should be noted that New York, despite having a “controlled insurer” statute largely similar to the NAIC model HCA, does not follow the NAIC model in the area of disclaiming control. New York’s analogous statute (NY Ins. Law § 1501(c)) empowers the state insurance regulator to grant a determination that a person does not control another person, but the technical procedure for and consequences of such a determination are slightly different from those prescribed in the NAIC model.

⁹ HCA § 4(K).

¹⁰ HCA § 3(E)(2). This provision is commonly used in internal legal entity restructurings in which the immediate parent of an insurer may change, constituting a nominal change of control, but ultimate control remains with a top-tier holding company.

¹¹ Under the HCA, the regulator does have the discretion to exempt an insurer from the registration requirements of the statute. See HCA § 4(J). Here too, however, regulators have been reluctant to use this provision prospectively and may view it as irrelevant in the context of a minority investment undergoing regulatory review.

¹² Some regulators, most notably the California Insurance Commissioner, have in the past even required applicants to waive the relevant deemer provision as a predicate for reviewing their filings.

2011 CASE NUGGETS

By Charles E. Hord, III and Thomas H. Watson

Delaware and New York state and federal courts issued a number of important opinions during 2011, dealing with business combinations, corporate governance and materiality determinations, among other things. This article briefly recaps some of the cases readers may want to remember in thinking about future transactions.

I. Business Combinations

Breach of Fiduciary Duty

In re Del Monte Foods Company S'holder Litigation, Consol. C.A. No. 6027-VCL (Del. Ch. Feb. 14, 2011). The Court of Chancery preliminarily enjoined Del Monte Foods Company from proceeding with a stockholder vote on its merger with private equity buyers and enjoined the enforcement of certain deal protections pending the vote due to alleged misconduct by Del Monte's banker. The Court found that Del Monte's banker provided buy-side financing before a price was set while failing to disclose its intention to provide such financing from the beginning of the process and concealing for several months its pairing of two buyers in violation of existing confidentiality agreements.

In re Smurfit-Stone Container Corp. S'holder Litigation, C.A. No. 6164-VCP (Del. Ch. May 20, 2011). On a motion for a preliminary injunction to enjoin Rock-Tenn Company's acquisition of Smurfit-Stone Container Corp., the Court found that the plaintiff Smurfit-Stone shareholders would likely prevail on their argument that Revlon's enhanced scrutiny would apply to their challenge of the merger in which they would receive consideration consisting of 50% cash and 50% Rock-Tenn stock. (Previously, Delaware courts have ruled that 33% cash consideration did not trigger *Revlon* scrutiny and 60% or greater cash consideration did). The Court ultimately denied the motion for a preliminary injunction due to a lack of probability of success on the claim that the directors breached fiduciary duties.

In re Massey Energy Company Derivative and Class Action Litigation, C.A. No. 5430-VCS (Del. Ch. May 31, 2011). The Court of Chancery declined to preliminarily enjoin a merger between Massey Energy Co. and Alpha Natural Resources,

Inc. after refusing to apply the entire fairness standard because it found that the Massey directors had negotiated in good faith. Massey's stockholders had argued that the merger was unfair because the Massey directors did not properly consider derivative claims relating to a mine explosion when valuing the company.

In re Southern Peru Copper Corp. S'holder Derivative Litigation, C.A. No. 961-CS (Del. Ch. Oct. 14, 2011). The Court of Chancery awarded \$1.263 billion in damages in a derivative action challenging Southern Peru Copper Corporation's acquisition of Minera Mexico, S.A. de C.V., a corporation controlled by Southern Peru's controlling stockholder, Grupo Mexico, S.A.B. de C.V. Because Grupo Mexico was on both sides of the transaction, the Court analyzed the transaction under the entire fairness standard and ultimately found that the transaction was not entirely fair due primarily to the strained financial analysis used to show that the transaction was fair to Southern Peru. The awarded damages reflected the Court's view of the true value of the transaction versus the consideration offered in the agreement for Minera Mexico.

Deal Protection Devices

In re Orchid Cellmark Inc. S'holder Litigation, C.A. No. 6373-VCN (Del. Ch. May 12, 2011). The Court of Chancery declined to preliminarily enjoin a tender offer by Laboratory Corporation of America Holdings, Inc. for the stock of Orchid Cellmark Inc. that was protected by a top-up option, a no-shop clause, match rights, informational match rights, a termination fee and Orchid's agreement to pull its rights plan with respect to LabCorp. The Court determined that the deal protections were reasonable, but acknowledged that there could be some point at which deal protection devices become so burdensome and costly as to render a fiduciary out illusory.

In re OPENLANE, Inc. S'holder Litigation, C.A. No. 6849-VCN (Del. Ch. Sept. 30, 2011). The Court of Chancery declined to preliminarily enjoin the merger between OPENLANE, Inc. and KAR Auction Services, Inc., despite the fact that the merger agreement had a no solicitation covenant but did not include a fiduciary out. The Court rejected the plaintiff's claims that the transaction ran afoul of *Omnicare* and said that courts should not automatically enjoin a merger that does not have a fiduciary out provision if no superior offer has emerged because doing so may deny stockholders their only opportunity to accept a transaction.

Disclosures

In re Atheros Communications, Inc. S'holder Litigation, Consol. C.A. No. 6124-VCN (Del. Ch. Mar. 4, 2011). The Court of Chancery preliminarily enjoined Atheros Communications, Inc. from holding a meeting of its stockholders to vote on a merger with Qualcomm Incorporated, pending appropriate distribution of curative proxy disclosures relating to contingency fees for Atheros' financial advisor and the potential post-merger employment of its CEO by Qualcomm.

Two-Step Merger Transactions

Olson v. ev3, Inc., et al., C.A. No. 5583-VCL (Del. Ch. Feb. 21, 2011). In the first meaningful challenge to the use of a top-up option, the Court of Chancery upheld the use of the top-up option and provided guidance for practitioners' future use of the structure. However, the Court awarded plaintiff's counsel the full amount of attorneys' fees and expenses requested because the particular top-up option failed to comply with statutory formalities relating to the issuance of capital stock. The parties eventually amended the merger agreement to correct the statutory defects. In awarding the attorneys' fees for forcing the amendments to the merger agreement, the Court reaffirmed Delaware's requirement of strict statutory compliance with respect to matters involving a corporation's capital structure and emphasized that a board of directors' mere knowledge of the generalities of a transaction is not sufficient to satisfy the requirements.

Merger Agreement Consideration

In re John Q. Hammons Hotels, Inc. S'holder Litigation, C.A. No. 758-CC (Del. Ch. Jan. 14, 2011). The Court of Chancery held that the third-party purchase of a corporation, which had a controlling stockholder who received consideration different from the minority, was entirely fair. It further found that the controlling stockholder did not breach any fiduciary

duties, particularly because he took less per-share consideration than the minority.

Merger as Implicating Anti-Assignment Agreement

Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH, C.A. No. 5589-VCP (Del. Ch. Apr. 8, 2011). The Court of Chancery considered, as an issue of first impression under Delaware law, whether a reverse triangular merger would result in an assignment of the target corporation's contracts by operation of law. It declined to resolve the question at the motion to dismiss stage and allowed the suit to proceed after finding that the parties presented two competing, reasonable interpretations as to whether the merger resulted in a breach of an anti-assignment clause.

Sale of Substantially All Assets

Bank of New York Mellon Trust Co. v. Liberty Media Corp., No. 284, 2011 (Del. Sept. 21, 2011). The Delaware Supreme Court affirmed the Court of Chancery's conclusion that Liberty Media Corporation's series of four spin-off and split-off transactions over a seven-year period should not be aggregated such that, taken together, they constituted the transfer of "substantially all" of its assets in violation of successor obligor provisions in its bond indenture. It found the transactions were independently motivated by business considerations, separated by significant periods of time and showed no intent to evade bondholder claims. The Supreme Court, however, declined to endorse the "step-transaction test" adopted by the Court of Chancery.

Barasch v. Williams Real Estate Co., Inc., 600053/09, NYLJ 1202532609945 (Sup., NY, Nov. 3, 2011). The Supreme Court, New York County granted plaintiff's appraisal motion after finding that the series of asset transfers and mergers of affiliates constituted a disposition of "all or substantially all" of defendant's assets, thereby triggering appraisal rights. The Court determined that the transactions were not made in the regular course of business and effectively constituted the transfer of substantially all of the company's assets and thus required stockholder approval.

Independence and Good Faith of the Special Committee

S. Muoio & Co. LLC v. Hallmark Entertainment Investments Co., C.A. No. 4729-CC (Del. Ch. Mar. 9, 2011). The Court of Chancery held that a recapitalization of Crown Media Holdings, Inc. by its controlling stockholder and primary debtholder, Hallmark Cards, Inc. was entirely fair. It determined that

the process used by Crown's board of directors to approve the recapitalization was proper, that the special committee was independent and negotiated at arm's length and that at the time of the recapitalization, Crown could not pay its debts and therefore had only two other options—default or bankruptcy.

Krieger v. Wesco Financial Corp., C.A. No. 6176-VCL (Del. Ch. May 10, 2011). The Court of Chancery declined to preliminarily enjoin the acquisition of Wesco Financial Corporation by its 80.1% stockholder, Berkshire Hathaway. The Court analyzed the transaction under the business judgment rule, which presumptively applies where a transaction is (i) negotiated and approved by a special committee of independent directors and (ii) conditioned on the affirmative vote of a majority of the unaffiliated stockholders.

New Jersey Carpenters Pension Fund v. infoGROUP, Inc., C.A. No. 5334-VCN (Del. Ch. Sept. 30, 2011). The Court of Chancery refused to dismiss a fiduciary duties claim where the plaintiff had adequately pled that the largest stockholder and founder of infoGROUP, Inc. dominated its board of directors and forced it to approve a sale of the company for an inadequate price. The Court found that the allegations of a pattern of threats by the founder aimed at directors combined with the evidence of the founder's need for and a lack of liquidity to adequately plead that the founder was interested in the merger and controlled the board.

Krieger v. Wesco Financial Corp., C.A. No. 6176-VCL (Del. Ch. October 13, 2011). The Court of Chancery granted defendants' motion for partial summary judgment, finding that Wesco's stockholders were not entitled to appraisal rights because the merger agreement did not require them to accept appraisal-triggering consideration under Section 262 of the DGCL.

In re Alloy Inc. S'holder Litigation, C.A. No. 5626-VCP (Del. Ch. Oct. 13, 2011). The Court of Chancery dismissed fiduciary duties claims for money damages challenging a going-private transaction. Plaintiffs alleged that two of Alloy Inc.'s directors were disloyal because they retained senior management positions and received equity in the post-merger company. They also alleged that the other directors, who served on the special committee, breached their duty of loyalty and disclosure. The Court rejected the damages claims based primarily

on Alloy's Section 102(b)(7) provision and the fact that the transaction was approved by a majority of disinterested and independent directors and that there was proper disclosure to stockholders.

Stockholder Rights Plans

Air Products & Chemicals, Inc. v. Airgas, Inc., C.A. No. 5249-CC (Del. Ch. Feb. 15, 2011). The Court of Chancery found that Airgas Inc.'s board of directors did not breach its fiduciary duties in refusing to redeem Airgas' poison pill because it had met its burden under *Unocal* to articulate a legally cognizable threat—Air Products & Chemicals, Inc.'s allegedly inadequate offer, coupled with the fact that a majority of Airgas stockholders would likely tender into that inadequate offer—and had taken defensive measures that fell with a range of reasonableness proportionate to the threat posed.

Yucaipa American Alliance Fund II, L.P. v. Riggio, No. 565, 2010 (Del. Mar. 3, 2011). The Delaware Supreme Court affirmed the Court of Chancery's conclusion that Barnes & Noble's rights plan, which it implemented to halt the advances by Ronald Burkle's Yucaipa entity, was a valid anti-takeover mechanism. The Court upheld the plan under *Unocal*, noting that it did not have a preclusive effect on Yucaipa's ability to conduct a proxy contest.

II. Stockholder and Creditor Litigation

Preferred Stock Issues

Fletcher International, Ltd. v. ION Geophysical Corp., C.A. No. 5109-VCS (Del. Ch. Mar. 29, 2011). The Court of Chancery refused to block a joint venture between ION Geophysical Corp. and China National Petroleum Corporation by reaffirming the primacy of contract principles when interpreting the rights of preferred stockholders under Delaware law. The Court refused to expand the rights of Fletcher International, Ltd. as a preferred stockholder of ION beyond the clear and unambiguous terms of ION's certificate of incorporation. The Court rejected Fletcher's argument that ION's sale of 51% of the equity in one of its wholly-owned subsidiaries to China National triggered its consent rights and noted that it was immaterial whether ION purposefully structured the transaction to avoid triggering the rights because Fletcher was a sophisticated contracting party and could have bargained for the rights it claimed, but did not.

Derivative Actions and Claims

Kahn v. Kohlberg Kravis Roberts & Co., L.P., 23 A.3d 831 (Del. 2011). The Delaware Supreme Court held that a plaintiff may state a derivative claim for insider trading under Delaware law (a *Brophy* claim) without making a showing of actual harm to the corporation. The Supreme Court based its finding on *Brophy's* policy of “preventing unjust enrichment based on the misuse of confidential corporate information.”

CML V, LLC v. Bax, 2011 WL 3863132 (Del. Sept. 2, 2011). The Delaware Supreme Court held that creditors of a Delaware limited liability company have no standing to assert derivative claims on behalf of an LLC, even if the LLC is insolvent, based on the plain language of Section 18-1002 of the Delaware Limited Liability Company Act, which expressly provides that only members and assignees of an LLC interest have standing to bring derivative claims.

III. Corporate Governance Issues

Annual Meetings and Meeting Procedures

Goggin v. Vermillion, Inc., C.A. No. 6465-VCN (Del. Ch. June 3, 2011). The Court of Chancery declined to enjoin the 2011 annual meeting of Vermillion, Inc., which was scheduled to occur six months after its 2010 meeting. Plaintiff sought to have the meeting delayed, citing a recent Delaware Supreme Court opinion in the *Airgas, Inc. v. Air Products and Chemicals* litigation in which the Court invalidated a stockholder bylaw that advanced an annual meeting with the effect of “so extremely truncat[ing] the directors’ term as to constitute a *de facto* removal....” The Court found that the scheduling of the 2011 meeting was consistent with Delaware law, Vermillion’s charter and bylaws and did not run afoul of *Airgas*.

IV. Securities Law

Materiality

Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309 (Mar. 22, 2011). The Supreme Court of the United States declined to adopt a bright-line rule that would base the materiality of reports of adverse drug events solely on whether the reports reveal a statistically significant increased risk of such adverse events due to use of the drug. In doing so, the Court reaffirmed the materiality standard in *Basic v.*

Levinson—under which materiality depends upon whether a reasonable investor would have viewed the undisclosed information as having significantly altered the total mix of available information.

Litwin v. Blackstone Group L.P., 634 F.3d 706 (2d Cir. 2011).

The Court of Appeals for the Second Circuit vacated the dismissal of claims alleging misstatements and omissions in IPO disclosures relating to the impact of adverse developments and market trends on particular investments in Blackstone’s private equity and real estate business segments. It declined to find immaterial as a matter of law omissions concerning known adverse trends in investments that alone constituted relatively small portions of the firm’s total assets under management, but were significant to the firm’s private equity and real estate segments, which were significant portions of the firm’s total AUM.

Fait v. Regions Financial Corp., No. 10-2311-cv (2d Cir. Aug. 23, 2011).

The Court of Appeals for the Second Circuit affirmed the dismissal of a putative class action, finding that defendants’ alleged failure to write down goodwill in a timely manner and to increase loan loss reserves sufficiently during the financial crisis were not actionable misstatements and omissions under the Securities Act of 1933 because they were based on matters of managerial judgment, rather than strictly objective criteria. As matters of opinion and not fact, the plaintiffs had to allege that the defendants did not believe the statements were true at the time they were made.

In re Washington Mutual, Inc., No. 08-12229 (MFW), 2011

WL 4090757 (Bankr. D. Del. Sept. 13, 2011). Arising out of the Washington Mutual, Inc. bankruptcy proceedings, the Bankruptcy Court for the District of Delaware reaffirmed the Supreme Court’s rejection of an “agreement-in-principle” standard for materiality in *Basic v. Levinson*. At issue was whether hedge funds that held large amounts of Washington Mutual notes could trade on that debt when in possession of information about settlement negotiations between Washington Mutual and JP Morgan Chase. The hedge funds had argued that any information about the settlements that they did possess was not material because no agreement-in-principle had been reached. ©

RECENT TRENDS IN FINANCING & STRUCTURING GREEN ENERGY M&A DEALS

The financial turmoil that started in the summer of 2011, particularly in Europe, raises concerns regarding the availability of financing in 2012. Is access to financing still available? What have been the main sources of acquisition financing? What deal structure trends have emerged?

The following is an edited excerpt of the transcript from a panel discussion, moderated by Jonathan Melmed, a Chadbourne M&A partner, at the Infocast green energy M&A conference in California in November 2011. The panelists are Scott Mackin, Co-President and Managing Partner of Denham Capital, Frank Napolitano, Managing Director and Group Head of U.S. Power & Utilities at RBC Capital Markets, Anastasia Pozdniakova, Managing Director of Fieldstone Private Capital Group, and Partho Sanyal, Managing Director of the Global Energy and Power Group at Bank of America Merrill Lynch.

Access to Financing

MR. MELMED: Frank, could you talk a little about what you are seeing in terms of public markets as well as acquisition financing for more traditional clean technology or utility M&A activity?

MR. NAPOLITANO: Sure, there has been reference to the markets being open, which I concur with. Let us talk about why the markets are open, and what is a market. Partho earlier talked about a coupon for investment-grade utility at 4%. With a 10-year treasury at 2% and a 30-year UK treasury at 3%, that sets the overall cost of capital for many different people to think about how many multiples of those risk-free rates they need to make for a given modicum of risk, whether it be that risk in debt, in mezzanine or in a cash-flowing renewable project in the form of equity (or at HoldCo equity).

A good amount of money is moving around the system. Private equity funds are well funded. Pension funds are well funded and their portfolios have remained intact. Institutional investors who buy fixed-income debt are well funded and they are chasing yield. So it all comes back to cash flow values. How much is the cash flow at the base project? How much cash flow can I attribute on a risk-adjusted basis to a HoldCo that might contain a development portfolio as a series of nested options? How do I capitalize that series of cash flows in some mixture of simple debt and equity?

On the debt side, thinking about it from the bottom up, the banks that are in business are still in business, and the banks that are not in business are probably not in business for a reason. Maturities that favored issuers, which were, for a renewable project, a construction period of around 1 to 3 years plus the term-out period, which, at the peak of the debt markets and the commercial bank project finance markets, appear to have been 18 years. So C + 18, which really equates to 20-year bank debt. That is hard to come by anywhere but in the mortgage market here in the U.S. It is really hard for anybody to get 20 year bank debt. That sounds more like an institutional product, more like a bond, or a private placement note of some kind. And if one looked at the cost of capital of those deals, which again, favored issuers, so issuers are supposed to take it when it is on offer if it is money good, versus those bonds, the negative arbitrages of the banks lending the money at that term versus where it ordinarily should have priced out at an appropriate cost of capital in the bond market, was material. In effect, you could say that those banks spent themselves out of business.

Who gave them the subsidy to do that? Subsidies in our space were not just all of the direct subsidies that were talked about in all of the panels to date, which is a form of tax or other revenue benefit, whether it be feed-in tariffs or mandated contracts due to RPS. It truly was a global cost-of-capital subsidy, in this case thank you to the European Union. It seemed like everyone was lined up to subsidize the U.S. renewables space. Now not everyone is lined up to do that any longer. I think we are in an M&A cycle simply out of necessity to allow projects that should be funded to get their funding and companies that should be funded to get their funding in what seems to be a pressure-shrinking, addressable market based on the macro points that have been raised earlier. The commercial banks that are still in business and lending commercial bank capital are hanging together in club form and are willing to do deals, not necessarily at negative arbitrages

that get bankers fired, but at an appropriate risk-reward for the risk that is being taken on.

MEMBER OF AUDIENCE: 2012 looks to be a huge year for construction for wind, and banks are rationalizing how much, and the terms under which, capital is going to be available. I have heard a lot of people say there is debt for good projects, which we generally agree with, but is this coming build cycle going to run into problems in access to capital, both debt and equity, for projects?

MR. SANYAL: My sense is that there will be enough debt capital, notwithstanding \$16 billion of government financing having disappeared post-1705 [DOE Loan Guarantee Program], which will have an impact on the private debt market. I think the tax equity market will be the tail wagging the dog a little bit. The amount of tax equity available that could be closed before these projects have to be in operation, which is the end of 2012, will determine how many of these projects get built. It typically takes 3 to 4 months to put a tax equity deal together if you do it the old-fashioned way. There is just not enough time to go out and launch a deal today, get tax equity all lined up, and then finish construction by the end of 2012. So, it will be a mad race to the finish to get projects built.

MR. NAPOLITANO: In simple terms, I think the bank market will be there, but I think it will be at shorter tenors than construction period +18 years. The bond market will be there as well. I think there will be some hybrids between bank and private placement issuers who will get together to help finance projects, with a mixture of fixed and floating rate instruments. The private placement market is wide open for business on the debt side. I agree with Partho that the tax equity market will be the tail wagging the dog. In fact, we have heard that some entrepreneurial financial institution groups, who are now actively prospecting amongst the banks who bought tax equity in the 2006 through current period, are looking to sort of cycle their vintages, because they think in 2012 they are going to be able to pound the

The majority of recent green energy deals have been financed with cash, but debt capital is available for projects that are coming to market.

table and get whatever it is they want because they have the market trapped, at least under the current rules.

I think tax equity definitely has the premium seat and true equity is going to have to look for very long-dated situations in terms of ownership to get paid. The wind regime is another interesting one where there is a debate between whether to take the grant or whether to take the production tax credit. Folks are looking at the consulting reports about bigger machines and higher hub heights, but tell me about the wind debt that ever got upgraded since issuance from 2006. That has been a challenge that I think is on the minds of institutional investors. They are there to do deals but I do not think they are going to materially widen out the spread to do those deals. However, they are definitely going to do their diligence because there is more data since 2006 on where the wind has been and how various turbines have performed in a variety of wind regimes versus the base cases that were originally projected.

Sources of Financing

MR. MELMED: In terms of sources of financing, what have been the main sources of acquisition financing in 2011? Stated another way, what have been the main types of buyers? What is your sense of the outlook for next year in this regard?

MR. SANYAL: The majority of financings in 2011 across clean energy and clean tech globally have been cash financings — strategics using their balance sheet. Cash has been an important driver. The exceptions have been Iberdrola's purchase of Iberdrola Renovables and EDF's purchase of EDF Energies Nouvelles — they were catering to a similar investor base so they took stock of the parent company. Given where stock valuations are, people are likely skeptical about the value of what they are getting if they are getting paper, whereas if they are getting cash, they can do what they please with it. If you have a liquid stock, in theory, you can sell it and do what you please with it, but much of the consideration in the deals we are seeing has been in cash.

Going forward, it is hard to think about the whole sector in a general sense; it is region-specific, I would think, but my sense is that people will buy these depressed companies at these low valuations if there is strategic value. I do not expect failing companies to be somewhat re-engineered and strategic buyers magically finding value out of such companies. They have fallen for a reason; they have fallen because their technologies either are no longer working in a competitive sense or they are being subjected to demand/supply

inequities. One reason solar valuations have depressed is that there is 40 gigawatts of supply and 23 gigawatts of demand, and that 17 gigawatts is being shipped out at depressed valuations. The market capitalization of the top ten solar companies in the world about four years ago was about \$100 billion. Today that number is \$15 billion. There have been drastic shifts in value for some of these publicly-traded stocks, so it is hard to see how somebody would accept stock as a currency for M&A.

MS. POZDNIAKOVA: In terms of what I have seen in the market, there are strategics, infrastructure funds and private equity funds that have all been active. It often depends on the underlying project value. For example, we worked on offshore wind projects in New Jersey that had great development risk that should be, in theory, attractive to private equity funds, but private equity funds would not take that risk because the underlying projects could only be approved by the government issuing RFPs at levels that are attractive to strategic investors. Only somebody with a balance sheet who can look at low, unlevered returns would be interested in these opportunities. As the underlying project value continues to drop, the more opportunity for strategics to jump in.

MR. MELMED: As we see less and less government assistance in this industry, what is your view of the viability of other sources of capital in the U.S.?

MR. NAPOLITANO: I will try to marry a couple of concepts together. Without the subsidies, what is the industry? If there are those who believe in the industry for non-economic reasons, then there will be that segment of the industry that will continue to live. If the segment is purely dependent upon cash-flow returns and appropriate risk adjusted returns for whatever piece of the capital structure is required and the industry cannot support those, I think that segment will come out in the wash, which will likely lead to a series of M&A events because the strong could likely mate up with each other to create critical mass and be more financeable and be more diverse and possibly have a different series of fuel-types in the mix. If you look at U.S. publicly-traded companies in the independent power space, which is what these projects are really an amalgamation of, there are core thermal companies looking to migrate into renewables where it makes sense for them, because the return on money makes sense, but you do not see many pure renewable generating companies out there.

MR. MELMED: I hear often that there does not seem to be much capital at the venture growth or early private equity stage; in other words, revenue positive companies not quite

ready for a U.S. listing or a sizable M&A deal. Do you see that space filling up?

MR. MACKIN: I think the market is somewhat rate-of-return constricted in the U.S. This general market — growth equity for development — is where private equity should

The use by private equity buyers of management teams and a milestone approach to equity commitments has become a common deal structuring option.

play well. If you have a great management team and proven technology, and if you have a playing field where there is a PPA market or feed-in tariff or the like, it is fertile territory to invest. But, it is difficult because in the U.S. you have all of the development pitfalls that you face elsewhere, but then you make less money at the end. We are working in the U.S. and want to do more in the U.S., but we have spent most of our focus right now elsewhere, for example, with a play in South Africa that just put bids in on wind and solar. Construction is going to be a bit more expensive there because they do not have the infrastructure quite yet, but returns are more commensurate with taking a lot of early development risk. And, particularly with the ever-changing nature of solar, most people are trying to look for the next window of opportunity for better returns. We have seen good windows of opportunity in the past in Italy, and now in India and South Africa. Those are the places that we and a lot of others may try to invest when we can because the returns are higher.

MS. POZDNIAKOVA: There is definitely a gap between venture capital and private equity funding that gives rise to the phenomenon we often refer to as the “valley of death.” We had an experience working this year with a company that is in the residential solar space. As it turned out, the company was not of interest to venture capital because it did not have any proprietary technological components, but private equity was also telling us that it was too late because the market was already saturated due to successful models that have already been proven here in California.

Deal Structuring

MR. MELMED: One trend that I am seeing in terms of deal structures is the teaming up of private equity. Often the merchant banking arms of major banks are teaming up with solar and other alternative energy developers, sometimes under the guise of getting in at the holding company level, where there is a significant minority or even a majority level investment with an equity percentage that ratchets upwards or downwards based on project financing milestones at the project company levels below. Scott, are you seeing that from a private equity perspective?

MR. MACKIN: For private equity-type returns, we think you generally have to take some development risks in this field. The old-fashioned private equity LBO model does not really work so much because the market is better defined by growth and not many mature, distressed companies that

you can get in and shake things up. So, generally, what we and some others have done is to get in at the corporate level. And, at the corporate level, you can structure equity ownership to be linked to ultimate returns.

Private equity is constantly arbitraging the market — trying to figure out whether you can bring in cheaper equity and whether that is ultimately going to be accretive for an exit. As a growth equity provider, if you have not provided value, which generally translates to a high life cycle rate of return for the assets that you created, then why are you in there? ☺

SEC 2011 ROUNDUP

By Sey-Hyo Lee and Coleman C. Miller

During 2011, the Securities and Exchange Commission (“SEC”) stepped up its enforcement efforts on insider trading and Foreign Corrupt Practices Act violations and brought charges against a number of high-profile individuals and corporations. The SEC also continued its rulemaking under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”), which contains over 90 provisions requiring SEC rulemaking and dozens of other provisions that give the SEC discretionary rulemaking authority.

Securities Litigation

10b-5 Liability: The U.S. Supreme Court, in *Janus Capital, Inc. v. First Derivative Traders*, held that an investment advisor is not liable for securities fraud under Rule 10b-5 for allegedly misleading statements contained in prospectuses issued by mutual funds that the advisor managed and administered. The Court ruled that only a person or entity who actually issued a prospectus could “make any untrue statement of a material fact” in the prospectus in violation of Rule 10b-5, despite the especially close relationship of the advisor to the issuer and its intimate involvement in the drafting of the disclosure. While the case involved a fraud claim against an investment advisor, its protection likely extends to all persons who participate in drafting or preparing securities disclosure documents, including investment bankers, accountants and lawyers.

Materiality: The U.S. Supreme Court, in *Matrixx Initiatives Inc. v. Siracusano*, rejected a bright-line materiality standard for securities fraud claims under Rule 10b-5. Instead, the Court reaffirmed the fact specific approach to materiality determinations under the *Basic v. Levinson* standard which looks to whether the misstatement or omitted fact could be viewed by a reasonable investor as having significantly altered the “total mix” of information made available.

Estimates: The Second Circuit, in *Fait v. Regions Financial Corp.*, affirmed the dismissal of fraud claims under the Securities Act based on statements regarding goodwill and loan loss reserves because the statements were matters of opinion rather than fact. As such, the plaintiffs would have to allege that the defendant’s opinions were both false and

not honestly believed when they were made in order to state a claim.

Insider Trading

The SEC’s Division of Enforcement filed a number of civil insider trading complaints in 2011. The predominant number of cases featured company insiders (executives, directors, or employees) allegedly either trading on confidential company information themselves, or sharing that information with friends, family members and business associates, who would trade on the confidential information and then share the illicit profits with the insider.

In 2011, the SEC continued its focus on expert networks and insider trading schemes by hedge funds and their portfolio managers and analysts that used technology company employees moonlighting as expert network consultants.

The SEC also continued its pursuit of insider trading by the Galleon hedge funds and their founder and manager, Raj Rajaratnam. In criminal actions, Mr. Rajaratnam was convicted and sentenced to 11 years in prison, and on November 8, 2011 he was assessed a civil penalty of almost \$93 million. On March 1, the SEC announced it had charged Rajat Gupta, a friend and business associate of Mr. Rajaratnam’s, in an administrative proceeding for allegedly sharing confidential information Mr. Gupta obtained while serving on the boards of Goldman Sachs and Procter & Gamble. The administrative proceeding stumbled, however, when Mr. Gupta countersued the SEC, and the two sides agreed to withdraw their complaints. On October 26, federal prosecutors indicted Mr. Gupta for five counts of criminal securities fraud and one count of conspiracy in connection with his tipping of Rajaratnam with confidential information about Goldman Sachs and Procter & Gamble.

Foreign Corrupt Practices Act Enforcement

The SEC's Division of Enforcement was also busy in 2011 prosecuting Foreign Corrupt Practices Act (FCPA) violations. Generally speaking, the FCPA forbids any U.S. company or individual to make any illicit payment to a foreign official to obtain or retain business for the company. The year's more traditional FCPA cases included allegations of bribes paid to Iraqi and Chinese government officials, or to U.N. bureaucrats. The more unique cases, however, featured companies like Tyson Foods, Inc. and Johnson & Johnson paying bribes to veterinarians and doctors, respectively, whose responsibility it is to ensure the companies' products are safe for their domestic markets. Overall, the SEC recovered over \$66 million in settling these cases.

Corporate Governance and Executive Compensation

Say-on-Pay: The SEC adopted rules to implement the Dodd-Frank "say-on-pay" provisions. These rules require companies to hold a nonbinding shareholder advisory vote on the company's named executive officers' compensation at least once every three calendar years, and a nonbinding shareholder advisory vote on the frequency of its "say-on-pay" vote (every one, two or three years) at least once every six years. The rules also require a nonbinding shareholder advisory vote on "golden parachute" compensation arrangements in connection with votes on M&A transactions.

Compensation Committee Independence: The SEC proposed rules under the Dodd-Frank Act to require the national securities exchanges to amend their listing rules to require that a company's compensation committee be comprised of independent directors and has the authority and financial resources to retain outside compensation advisers. These requirements are substantially similar to existing requirements for audit committees. Although the comment period on these proposed rules has expired, the SEC has yet to issue a final rule.

Proxy Access: The SEC's amendments to Rule 14a-8 allowing shareholder proposals regarding proxy access procedures for director nominations became effective, but the SEC's proposed rule mandating proxy access for director nominations to any shareholder or group of shareholders holding at least 3% of a company's voting stock for at least three years was vacated by court order.

Securities Regulation

Interactive Data Files (XBRL): The SEC staff issued a no-action letter stating that it will not require foreign private issuers who use IFRS as issued by the IASB to prepare their financial statements to submit interactive data files in XBRL format to the SEC or post these files on their websites until the SEC specifies a classification system for preparing such files. The SEC has yet to specify such a classification system.

Reverse Mergers:

- The SEC issued an Investor Bulletin detailing the risks inherent in investing in "reverse merger" companies; that is, operating companies (usually foreign) that gain access to the U.S. capital markets by merging with a shell company whose securities are publicly traded in the United States. The SEC's principal concern with such companies seems to be that the companies, when preparing their public filings to the SEC, often rely on smaller auditing firms that cannot read or understand the financial statements of the companies as presented in the style of their home country. This has resulted in number of instances where the SEC has suspended trading of reverse merger companies' securities due to questions about the accuracy and completeness of their public filings.
- In September, the SEC staff also issued guidance on a number of deficiencies in disclosure observed by the staff in their review of Forms 8-K filed to report reverse merger transactions.
- Most recently in November, the SEC approved new rules for the three major United States exchanges (NYSE, NASDAQ and NYSE Amex) which require reverse merger companies to meet stricter listing standards before being eligible to list on one of the exchanges. The additional requirements include a one-year "seasoning period" of trading on a United States OTC market or other regulated United States or foreign market post-reverse merger and filing all required reports with the SEC and maintaining a minimum share price for a sustained period and for at least 30 of the 60 trading days preceding both the listing application and the listing approval.

Short-Form Registration Eligibility: The SEC adopted rules under the Dodd-Frank Act revising the eligibility criteria for registering primary offerings of nonconvertible securities. These revisions replace the "investment grade ratings" with

four alternative standards similar to the standards for determining well-known seasoned issuer (WKSII) status.

Whistleblowers: The SEC's whistleblower rules became effective. Under the new rules, the SEC will reward individuals who voluntarily provide the SEC with original information that leads to successful enforcement actions in which the SEC obtains monetary sanctions totaling more than \$1 million. Recently, whistleblowers helping the SEC investigate whether Bank of New York Mellon and State Street Corp. improperly charged customers for currency trades filed the first reward claims under the new rules to the SEC's new Office of the Whistleblower, which opened on August 12, 2011.

Cybersecurity Risk: The SEC staff issued guidance regarding the proper level of disclosure companies should make regarding cybersecurity risk. The guidance suggests that companies evaluate known and potential threats to the security of their digital systems and disclose such threats to potential investors in the same way the company would disclose a more traditional risk factor that could materially affect its results of operations. Additionally, the guidance noted the potential impact a cybersecurity breach could have on the accuracy and efficacy of a company's periodic reports as another reason to comprehensively address cybersecurity risks proactively.

Revised Definition of "Accredited Investor": The SEC adopted amendments to the \$1 million net worth standard for determining the "accredited investor" status of natural persons to exclude as an asset the person's primary residence, and also to exclude as a liability the mortgage on the person's residence, except to the extent the mortgage exceeds the fair market value of the residence. This change was required by the Dodd-Frank Act.

Implementing Other Dodd-Frank Act Provisions

The SEC adopted several other rules and policies pursuant to its authority under the Dodd-Frank Act. Among the most significant:

- The SEC began to exercise the regulatory authority over security-based swaps. Specifically, it proposed rules for the acknowledgement and verification of swap transactions, and proposed specific definitions of the terms "swap," "security-based swap," and "security-based swap agreement." Additionally, the SEC published guidance for participants in the security-based swap market as to which of its

regulatory provisions would apply to swap transactions, and granted temporary relief to market participants from compliance with certain of these provisions.

- The SEC adopted a variety of amendments to the Investment Advisers Act as required by the Dodd-Frank Act. Most significantly, the amendments require that hedge funds and other private funds register with the SEC, subject to certain exemptions for entities such as "family offices" (which the SEC defined for the first time in 2011). SEC also delegated some of its regulatory responsibility to the various states by creating a new category of advisers called "mid-sized advisers," who until the changes would have registered with and reported to the SEC but must now register with and report to the appropriate state authority.
- The SEC adopted rules designed to revitalize the asset-backed securities market by encouraging better disclosure for investors, particularly by increasing the requirement for the quality of the securities when issued pursuant to a shelf registration.
- The SEC, jointly with the FDIC, the Federal Reserve Board and the Office of the Comptroller of the Currency, proposed a rule implementing the prohibition against proprietary trading contained in the Volcker Rule portion of the Dodd-Frank Act. Under the proposed rule, a banking entity may not engage in short-term proprietary trading of any security, derivative or certain other financial instruments on its own account. The proposed rule contains substantial exceptions to this general prohibition, including exemptions for trading in United States, state, or local government obligations and for market making, underwriting, and risk-mitigating hedging activities. The comment period on these proposed rules has been extended to February 13, 2012. ©

ISS PROXY SEASON 2011 REVIEW & 2012 FORECAST

In October 2011, Chadbourne hosted its annual presentation with Institutional Shareholder Services (“ISS”), to review the 2011 U.S. proxy season and provide a look ahead to 2012. The following is an edited excerpt of the transcript. The speakers are Marc Goldstein, Head of Engagement at ISS, and Bimal Patel, Head of ISS Global Policy Steering Committee. Also participating are Marc Alpert, Sey-Hyo Lee and Kevin Smith, Chadbourne corporate partners in New York.

Say-on-pay Dominates 2011 Proxy Season

ISS: Say-on-pay was the biggest issue in the 2011 proxy season, and the biggest change from earlier years. This was the first year of universal say-on-pay.

C&P: Do you think say-on-pay generally improved the approach that public companies took to their executive compensation not only in terms of enhanced disclosure but in terms of actual steps to make changes in how they structure their performance based compensation?

ISS: Yes, absolutely. We see greater use of performance linked compensation, especially equity awards, for example, incentive awards that are more closely tied to performance. We’re also seeing companies get rid of their remaining tax gross ups and some of the more headline grabbing perks as well and we’ll get into that a little bit more later on.

ISS: Only 38 companies have seen their say-on-pay proposals actually voted down but there were certainly a number that would have had them voted down had they not taken last minute steps to improve their pay practices.

C&P: With all the hoopla over say-on-pay, isn’t it kind of remarkable that there has been such a small proportion of companies that have had any, you know, real negative feedback?

ISS: We weren’t expecting too many more than this I think. Some people actually predicted fewer than this would fail. Again it’s clear that a greater number would have failed had it not been for last minute actions taken, either frantic lobbying or substantive changes to pay programs.

AUDIENCE: You referred to the fact that a number of issuers made last minute changes to avert a negative vote. Can you comment on the process with ISS in terms of changing your recommendation on a vote as a result of those changes and how does that work? What’s the dialogue process?

ISS: In some cases we have had discussions with them. We can’t design their compensation programs for them, we can’t tell them this is what you have to do to get a favorable vote but we can certainly explain our policy and explain the reasons for a negative recommendation and then in some cases the issuers will take steps.

They’re also talking to their shareholders, not just to us but to their investors and hearing hopefully a consistent message from them as to what needs to be done. And very often the reason is a pay-for-performance disconnect as we’ll see later on. So the solution generally is to link pay and performance more tightly by imposing performance conditions on some of the equity awards that companies are making.

We can and do change vote recommendations in response to new information as long as it is publicly available in time for us to make a change. If the change is made the day before the meeting, our clients aren’t going to be able to react to it — they have already cast their votes and they can’t make a change at that point. But as long as there is sufficient time we do sometimes change our recommendations and it certainly is a possibility.

Say-When-on-Pay

ISS: Say when on pay, that’s the other big new agenda item for 2011. You know, we and our clients are going to be doing the work, doing the analysis anyway regardless of whether say-on-pay is on the ballot so it’s just a question of how do you use that analysis. Do you use it in making a recommendation, making a vote on the say-on-pay proposal or on the compensation committee members?

So our clients tend to prefer overwhelmingly an annual vote as do we and issuers sort of came to realize over the

course of the year that it's definitely in their interest. It's better to have a safety valve, have a nonbinding say-on-pay vote rather than what's increasingly a binding vote on the directors because of course more and more companies have majority voting not plurality.

C&P: How does that work with companies who have adopted something other than annual?

ISS: If there is a biannual or triannual vote, then in the off years we will look at compensation committee members. We'll do the same analysis. Are there problematic pay practices, is there pay for performance disconnect, and so on.

C&P: So companies likely prefer the annual vote so that you're focusing on say-on-pay rather than compensation committee members.

ISS: Exactly.

Strong Stockholder Support for Say-on-Pay Votes

ISS: Say-on-pay proposals are getting supported overwhelmingly by shareholders. Nearly three-fourths of proposals are supported 90% or higher. And through the end of June, first half of the year only 1.62% of companies in the Russell 3000, or 37 companies, failed to win majority support.

Now does that mean that every company where say-on-pay gets a majority is safe? Well not really. Our clients told us in the policy survey that it's not enough to win a majority support if a company is getting substantial opposition *i.e.*, 20%, 30%, 40% opposition even though the proposal is deemed to have passed. It's a nonbinding proposal but even if it may have been deemed to have passed our clients are still going to be looking to the company to acknowledge the high degree of discontent and respond in some way. Now what that response should be is going to depend a lot on the company's circumstances, what has driven the vote. There is no simple answer to that question but it's something that we are going to have a policy on and that our clients are going to have to have policies on.

C&P: I know it's the first year of seeing this and there have been so few negative votes, but are there any things that we can draw from the negative votes and even the companies that received just kind of high opposition, not outright negative? In other words are there any industries or types of pay practices that you can drill down on that people should be aware of?

ISS: I don't think there is much of a pattern in terms of industries. I mean, we've seen failed votes at all kinds of different companies of different sizes, going all the way up to HP. Pay for performance tends to be the overwhelming driver.

But among the other factors, problematic pay practices such as excise tax gross ups, especially when they're in new contracts, those are clearly driving some of the negative votes.

Say-on-pay was the biggest issue in the 2011 proxy season, and the biggest change from earlier years. This was the first year of universal say-on-pay.

High Voting Support for Directors in 2011

ISS: Say-on-pay votes are something of a safety valve. Some would say that say-on-pay on the ballot gave investors a way of protesting what they saw as problematic compensation practices or a pay for performance disconnect without having to go against members of the compensation committee which had been shareholders' only real option in the past.

And so as a result of that we saw among S&P 500 companies the average vote for director nominees was 96%. In 2011 through June 30, in Russell 3000 companies it was 95%. So we're really talking overwhelming support for most nominees and increasing levels of support compared to past years.

As for directors who failed to get at least 50% support, through June 30 there were a grand total of 43 of them. Now that's down sharply from 2010, it's down by about half roughly from 2010. And again we attribute that in large part to say-on-pay but also there were fewer proxy contests and that had an impact as well.

Shareholder Proposals on Board Issues

ISS: Votes to declassify boards of directors have been a perennial favorite. These statistics are for the first half of the year but actually going up to the end of September even into early October there have now been 41 of these proposals that have gone to a vote. The most recent one is at Smithfield Foods which again got over 70% support. Among all companies where these proposals have come to a vote the average rate of support has been about 71% and it rises to nearly 80% at S&P 500 companies. So it is now clear that a significant majority of S&P 500 companies have declassified their boards and gone to annual election for directors.

C&P: It seems like there are a fair number of management proposed declassification proposals. ISS generally recommends for these votes, correct?

ISS: Yes, almost across the board. I can't think of a case where we wouldn't have. It's clear that shareholders are so overwhelmingly in support of this that I think a lot of management teams, rather than seeing a shareholder proposal get majority support, are deciding to just declassify. And those few remaining companies in the S&P 500 that haven't done that are likely to continue to be targeted with shareholder declassification proposals until they come around.

ISS: Majority voting for directors as opposed to plurality voting is of course another proposal that tends to get very strong support from our clients and that we always support as well. And so those proposals averaged 58% support through the first half of 2011.

Independent chair proposals have never done as well as majority voting and declassification but the support rate is increasing from 2010 to 2011. And obviously those are going to be case by case for a lot of shareholders. Many of our clients support an independent chair at least in theory.

They like the concept but when it comes to actually voting at a particular company they're going to look at that company's track record, they're going to look at that company's board leadership *i.e.*, is there an independent lead director whose responsibilities are clearly defined and robust.

A Look Ahead to 2012

ISS: So I'm going to turn now to look ahead to 2012. One of the biggest challenges or tasks for us at ISS is developing a policy for companies that have either had failed say-on-pay votes or have gotten a substantial degree of opposition even if the proposal squeaked by.

We aren't quite ready to announce what the new policy is going to be. It's going to be going out for comment shortly. Stay tuned, watch our website. But clearly it's something that all shareholders are going to have to think about going into 2012. [The ISS has issued its 2012 Policy Updates — For a summary, see our update on page 34]

Another issue they're going to have to think about is what happens in the — and it's admittedly going to be a very small number of cases — where a board disregards the shareholder preference on the frequency of the vote.

And there are really two situations there. It's possible to have a situation where none of the three choices gets a majority and so the board disregards the plurality but is that the same as disregarding the majority?

If an annual vote gets majority support and the board implements triannual that seems to us a pretty clear case of disregard for shareholders' views. On the other hand if

it's merely a plurality, for example 40, 35, 25, the case is not quite as strong. So yes the plurality of shareholders may have favored an annual vote but a majority favored something other than annual. So that's a different situation and we're trying to distinguish those two.

Say-on-pay Lawsuits

ISS: We want to mention say-on-pay lawsuits, kind of alluded to those earlier. But I think a lot of observers felt that these were a nuisance that were really intended to get companies to settle and they weren't going to go very far. But we did see at Cincinnati Bell the case survived a motion to dismiss and is moving forward at least for now. So we're likely to see more of those lawsuits.

AUDIENCE: If that's the case, does the fact that a significant negative say-on-pay vote is a likelihood or possibility of prompting an expensive derivative lawsuit inform how you approach that issue with your clients?

ISS: The answer is if it turns out that Cincinnati Bell is not a one-off, if it turns out that the lawsuit really does advance, it's still fairly early on, then it might inform our approach.

AUDIENCE: If you have large institutional shareholders as clients and if we're seeing a trend that negative say-on-pay votes prompt private litigation, does that go into your policy calculus?

ISS: You know, I don't think it did in 2011. That might change in 2012 and again this is an issue for the policy board to debate, to discuss. You know, we're not interested in inflating costs to companies and therefore their shareholders for no reason. But at the same time say-on-pay is an important issue and we don't want to pull our punches based on the possibility that there might be some litigation expenses. We don't want to end up saying well, you know, we really think this is a disconnect between pay and performance, we think the company's pay practices are outrageous but because they might be subject to a lawsuit over them we're not going to recommend against say-on-pay.

AUDIENCE: I think you can expect the issuer community to be very vocal about that and, you know, make institutional investors aware of that fact.

ISS: I think that's probably true.

Proxy Access

ISS: So proxy access, as we discussed earlier a lot of observers were anticipating that proxy access would in fact go through if not for 2011 then for 2012, but with the litigation and the ultimate judgment by the DC circuit that's now off the table.

But as probably you've heard the SEC has decided to allow shareholder proposals on the topic; going back to private ordering.

We do anticipate seeing those in 2012. We don't think that the activist institutions, the labor funds for example or public employee funds will sponsor large numbers of these. We're expecting a small number, hopefully well targeted at companies that have serious governance issues, responsiveness issues. But the retail activists are a big question mark. We don't know what they are going to do. It's possible that they will target whatever companies are in their portfolios whether or not there are concerns about the board.

I can say though that the message we're hearing from mainstream asset managers is that they're going to be cautious on these shareholder proposals. They're unlikely to support them if the ownership requirements and holding period requirements are substantially lower than what the SEC had been proposing, 3% for 3 years.

Also, as a result of the defeat of the SEC's proposal and the fact that there isn't going to be proxy access universally available to shareholders, we do kind of expect a renewed push for other means of holding boards accountable such as majority voting and board declassification so we're expecting more shareholder proposals on those issues in 2012. And it's also possible we'll see more proxy contests now that it's clear to the activists that that's the only way to go about changing the board.

State End Runs

ISS: Finally, I'd like to spend just a minute talking about what we consider to be end runs around shareholder proposals. In three states recently we have seen state legislatures amend their state corporate law to mandate classified boards.

In Indiana, companies were given the option of opting out if they wanted to maintain an annually elected board. In Oklahoma, companies didn't even have the option of opting out until 2015 so it mandated classified boards even for companies that were very happy to have an annually elected board. Iowa is the most recent example.

C&P: Do you see that expanding to certain other areas, for example possibly proxy access? Because, you know, one of the things that you can use to prevent a 14a-8 shareholder proposal is if it would violate state law.

ISS: It's quite possible. You know, I'm not expecting it in Delaware of course but there are quite a few states that have corporations that are major employers, major donors, major participants in the political process and are shown a degree of deference by state legislators for one reason or another. And it's quite possible that we will see similar types of end-runs around other shareholder proposals. ©

2012 ISS SHAREHOLDER VOTING POLICY UPDATES

In November 2011, ISS updated its Corporate Governance Policy effective for shareholder meetings held on or after February 1, 2012. Below is a summary of the significant changes.

Pay-for-Performance Evaluation

ISS revised its methodology for determining pay-for-performance alignment to consider the following factors:

- **Peer Group Alignment:** (i) the degree of alignment between the company's Total Shareholder Return ("TSR") rank and CEO's total pay rank within a peer group, as measured over one-year (weighted 40%) and three-year (weighted 60%) periods; and (ii) the multiple of the CEO's total pay relative to the peer group median.
- **Absolute Alignment:** The absolute alignment between the trend in CEO pay and company TSR over the prior five fiscal years.

If the tests show a weak alignment, ISS will consider additional factors, such as (i) the ratio of performance to non-performance-based compensation, (ii) grant practices, (iii) the rigor of performance programs and (iv) special circumstances such as the impact of a new CEO.

Board Response to Say-on-Pay Votes

- If a company's 2011 SOP proposal received less than 70% shareholder support, ISS will recommend on a case-by-case basis on the reelection of compensation committee members and the company's 2012 SOP proposal, considering additional factors such as the company's response to the low level of shareholder support, the company's ownership structure, whether the compensation issues

raised are one-time versus recurring, and whether the level of shareholder support was less than 50%.

- If a company's 2011 SOP proposal did not receive significant support, ISS will look for substantive disclosures on the company's response.

Board Response to Say-When-on-Pay Results

- ISS will recommend a vote against or withhold from all incumbent directors if the company implements SOP votes less frequently than the frequency that received a majority of the votes cast by shareholders.
- If the company implements SOP votes less frequently than the frequency that received a plurality, but not the majority, of the votes cast by shareholders, ISS will take a case-by-case approach on director elections, considering additional factors.

Proxy Access Proposals

ISS will continue to take a case-by-case approach in evaluating proxy access proposals, but refined the factors considered and will apply the policy to management proposals also. Company-specific factors and proposal-specific factors considered will include (i) the percentage and duration of ownership proposed; (ii) the maximum proportion of directors that shareholders may nominate each year; (iii) the method of determining which nominations should appear on the ballot if multiple shareholders submit nominations; and (iv) any other factors ISS deems relevant. ©

THE NEXT SAY ON SAY-ON-PAY: LITIGATION

By Edward P. Smith and Tae Sang Yoo

Negative say-on-pay advisory votes were received by more than 40 companies during 2011, the first year for these votes under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

In the wake of the negative say-on-pay votes, shareholders have brought derivative lawsuits alleging that the directors have breached their fiduciary duties by pursuing executive compensation plans disapproved by the shareholders. Among these actions, two that were initiated in 2010 have been settled, one is pending settlement, two have been dismissed (one of which is under final review) and four are currently in progress.

The allegations in the complaints are based on a common pattern: (i) a company discloses, typically in the proxy statement, a pay-for-performance philosophy; (ii) the company experienced poor financial performance; (iii) the board approved an increase in executive compensation notwithstanding the decrease in financial performance; (iv) the advisory vote on say-on-pay is negative; and (v) the board nevertheless goes forward with the increase in executive compensation.

In addition to alleging breach of fiduciary duty by the directors, the complaints typically allege that the company’s compensation consultants have aided and abetted that breach, that the officers have been unjustly enriched and that the company’s pay-for-performance philosophy has been misrepresented. Approximately the same five law firms have brought these cases.

The defendants have responded by stating that (i) plaintiffs had failed to make a pre-suit demand that the board evaluate the claim; (ii) the directors’ determination is protected by the business judgment rule which generally holds that directors will not be personally liable for errors in judgment regarding business matters, absent a showing that the directors acted in bad faith, with a conflict of interest or in a fraudulent or grossly negligent manner when making the determination; and (iii) Section 951 of the Dodd-Frank Act states that the advisory say-on-pay vote shall not be binding on the board or create any change in its fiduciary duties. Section 951 even provides that a company’s board of directors is not required to change the executive compensation program based on the outcome of a say-on-pay vote. Nevertheless, the plaintiffs have sought to use the negative say-on-pay vote results as evidence for rebutting the business judgment

presumption and for supporting the finding of a breach of fiduciary duties.

Cincinnati Bell (*NECA-IBEW Pension Fund v. Cox Teamsters Local 237*), Beazer (*Additional Security Benefit Fund v. McCarthy*), and Umpqua (*Plumbers Local No. 137 Pension Fund v. Davis*) Cases

The cases that offer a glimpse of the courts’ approach to the negative say-on-pay litigation are the actions brought against Cincinnati Bell, Beazer and Umpqua. In these actions, the plaintiffs have cited poor financial results and alleged that the directors acted unreasonably and breached their fiduciary duties by increasing executive compensation. In addition, the plaintiffs argued that the negative say-on-pay vote reflects the shareholders’ determination that increasing executive compensation was not in the best interest of the shareholders and that such determination rebutted the presumption that the directors validly exercised business judgment. In response, the defendants filed motions to dismiss arguing that their actions were protected under the business judgment rule.

The Courts in Cincinnati Bell and Beazer have reached opposite conclusions in reviewing the motions to dismiss. The U.S. District Court for the Southern District of Ohio denied the motion in Cincinnati Bell. The Court ruled that the plaintiff provided enough factual allegations that raise a plausible claim to survive a motion to dismiss. The Court supported its ruling by reasoning that a plaintiff only needs to state a plausible claim in the motion to dismiss stage since Ohio’s “business judgment rule imposes a burden of proof, not a burden of pleading” and federal procedural rules did not require the plaintiff to “plead the exception with particularity.”

The Court, at least for purposes of evaluating the adequacy of the pleadings, also appeared to adopt the plaintiff's position that the negative say-on-pay vote result was "direct and probative evidence that the 2010 executive compensation was not in the best interest of the Cincinnati Bell shareholders." The Court also concluded that plaintiff was excused from bringing a pre-suit demand.

In direct contrast to Cincinnati Bell, the Georgia Superior Court of Fulton County granted the motion to dismiss in *Beazer*. In addition to finding that the plaintiffs lacked standing and failed in applying Delaware law to properly allege a legal excuse for not making a pre-suit demand, the Court determined that the plaintiffs failed to state a claim upon which relief may be granted. In making such determination, the Court cited the Dodd-Frank Act and explicitly rejected the plaintiffs' claim that the result of a negative say-on-pay vote alone is sufficient to rebut the presumption of the business judgment rule. The Court instead found that the plaintiffs failed to allege particularized facts rebutting the business judgment rule's presumption and therefore lacked a basis for imposing liability on the directors.

In *Umpqua*, the Magistrate Judge of the U.S. District Court for the District of Oregon also recently recommended dismissing the say-on-pay litigation brought against Umpqua's board of directors and executives. The Magistrate

expressly declined to follow the Cincinnati Bell case and rejected the plaintiffs' argument that the pre-suit demand requirement should be excused if the shareholders showed that board members faced substantial likelihood of breach-of-duty liability. Furthermore, the Magistrate also held that directors of Umpqua are protected under the Delaware business judgment rule and reaffirmed that the Dodd-Frank Act does not create or alter the fiduciary duties of directors. This Umpqua ruling has been referred to the District Judge and objections are to be filed by January 25, 2012.

Conclusion

The impact of the say-on-pay litigation is yet to be determined. The three cases discussed above, with their similar underlying facts and allegations but different results, give little guidance on how most courts will rule in the ongoing say-on-pay litigation. While Cincinnati Bell has since been questioned for procedural reasons, we will have to wait for the final outcome of the remaining cases to fully understand how negative say-on-pay votes impact the business judgment rule and fiduciary duties of directors. The question of whether shareholders of other companies with negative say-on-pay votes will be encouraged to bring actions may also depend on the final outcomes of these cases. ☺

SEC STAFF CONTINUES TO FOCUS ON LITIGATION CONTINGENCY DISCLOSURE

By Kevin C. Smith, Alison H. Kronstadt and Tae Sang Yoo

In 2011, the staff of the Securities and Exchange Commission (“SEC”) zeroed in on public company disclosure surrounding litigation contingencies, most notably through staff comment letters issued in connection with the review of annual and quarterly reports filed with the SEC, as well as through staff statements made in speeches and at conferences. While its initial focus in this area was directed at large financial institutions, based on our review of over 250 SEC comment letters made public in 2011, it is now clear that the SEC has extended its focus to companies outside of the financial services sector.

Background

Financial Accounting Standards Board (“FASB”) ASC 450-20¹ (formerly known as FAS 5) (ASC 450) requires companies to record an accrual of loss contingency amounts when a loss is deemed both “probable and estimable” and provide related disclosure. Where accrual is not required but a loss is “reasonably possible,” disclosure should indicate the nature of the contingency and provide “an estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.” Similarly, even when an accrual is required, companies are required to disclose any “reasonably possible” loss in excess of the amount accrued. Most of the SEC’s recent focus has been to urge companies to provide estimates of “reasonably possible” losses or ranges of “reasonably possible” losses for litigation matters where no accrual has been recorded or for which there may be exposure beyond the recorded accrual, or either to disclose that such “reasonably possible” losses are not material or to explain why estimates of “reasonably possible” losses cannot be made. The objective of the disclosure is not necessarily to address what is accrued on the balance sheet but what is not accrued for which it is “reasonably possible” that there is a loss so as not to make the balance sheet potentially misleading.²

SEC Hot Buttons

We reviewed over 250 SEC comment letters made public in 2011 in which the SEC staff issued a comment regarding a company’s litigation contingency disclosure. We also have reviewed speeches and presentations made in 2011

by senior staff members of the SEC’s Division of Corporation Finance. Based on this review, it is apparent that there are certain aspects of litigation contingency disclosure that have become hot buttons for the SEC staff and may result in a staff comment in connection with the SEC’s review of a company’s periodic reports filed with the SEC.

Silence May Result in Comment. When companies include disclosure relating to litigation matters, but do not address whether “reasonably possible” losses in excess of any accrual may exist, the SEC has been issuing a generic comment along the lines of the following:

- *If there is at least a reasonable possibility that a loss exceeding amounts already recognized may have been incurred, you must either disclose an estimate of the additional loss or range of loss, or state that such an estimate cannot be made or, if true, state that the estimate is immaterial with respect to your financial statements as a whole.*

If an Estimate Cannot be Made, the SEC May Ask Why. In response to requests from the SEC staff to disclose an amount or a range of “reasonably possible” losses in connection with litigation contingencies, many companies have stated that they cannot estimate such an amount or range. While this disclosure is permitted under ASC 450, companies should be prepared to explain to the staff why such disclosure is appropriate under the circumstances. When a com-

pany states that it is not “reasonably possible” to estimate the possible loss or range of loss, the SEC has inquired about the procedures the company performs to attempt to provide an estimate with comments like the following:

- *For any matters for which you cannot estimate a range of reasonably possible losses, please supplementally provide the following:*
 - *An explanation of the procedures you undertake on a quarterly basis to attempt to develop a range of reasonably possible loss for disclosure;*
 - *Please explain, in sufficient detail for each specific matter, why you are unable to estimate a range; and*
 - *The name of any case in which the plaintiff has requested in public filings a quantified amount of relief and the amount of such relief. For each of these filings, please explain why a range of reasonably possible loss cannot be determined.*

The SEC staff may also request that companies describe the specific factors that limited their ability to reasonably estimate the loss or range of loss.

SEC May Allow You to Aggregate Estimates. In an effort to mitigate companies’ concerns that providing too much quantitative information may be detrimental to litigation efforts or settlement strategies, the SEC has indicated that separate disclosure for each individual matter is not necessarily required. The staff stated at the June 2010 Center for Audit Quality SEC Regulations Committee Joint Meeting with the SEC Staff that “disclosure can be aggregated in a logical manner vs. separate disclosure for each asserted claim.” The SEC has given the following comment in connection with a company’s ability to provide amounts in the aggregate:

- *Please revise your disclosure to either provide the reasonably possible loss or range of possible losses, which may be aggregated for the matters in which estimation is possible, or provide explicit disclosure for each matter that you are unable to estimate the loss or range of possible loss and the reasons why you are unable to provide an estimate.*

SEC Wants to See Proper Terminology. As discussed above, the standard for evaluating litigation contingency disclosure consists of “probable” and “reasonably possible.” The SEC has issued comments questioning the use of terms inconsistent with ASC 450, such as “possible losses,” and has given the following comment in response to the use of such terminology:

- *Please revise your disclosures in future filings to refer to “probable” and/or “reasonably possible” losses instead of “possible losses” to be consistent with terminology of ASC 450. In this regard, please note that your use of the term “possible” is confusing as it appears to imply a fourth criteria in ASC 450 that does not exist in the range of probable, reasonably possible or remote.*

Certainty is Not Required in Order to Provide an Estimate. When a company asserts that it cannot predict “with certainty,” “with confidence” or “with precision” the loss or range of loss related to litigation matters, the SEC has commented that this is not the required standard for disclosure:

- *We note your disclosure on page [x] regarding your belief that the Company cannot predict “with certainty” the loss or range of loss, if any, related to the Company’s litigation matters. It appears your threshold for disclosure is whether you can estimate “with certainty” what the eventual outcome of the pending matters will be. We do not believe that this criteria is consistent with the guidance in ASC 450. ASC 450 indicates that if an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure must be made regarding the nature of the contingency and an estimate of the possible loss or range of possible loss or state that such an estimate cannot be made. Please revise your disclosures beginning in your Form 10-Q for the [x] quarter to include all of the disclosures required by paragraphs 3-5 of ASC 450-20-50. To the extent that you cannot estimate the possible loss or range of possible losses, please consider providing additional disclosure that could allow a reader to evaluate the potential magnitude of the claim.*

SEC is Looking for Timely Litigation Disclosure Updates.

The staff expects management to diligently review its litigation contingency disclosures in each reporting period and update such disclosures in response to changes in relevant facts and circumstances. Such changes could result in the accrual of a loss that is now probable, new disclosures in connection with a “reasonably possible” loss that could not be estimated in a prior period or revised disclosures about an estimated loss. The SEC has noted that disclosures should contain more quantitative information as a litigation contingency evolves over time and nears resolution. Disclosure of a material settlement of a case where prior disclosures gave no indication of “reasonably possible” losses may trigger a comment. For example, when a company’s disclosure indicated that it settled a lawsuit during the quarter, the SEC had the following comment:

- *We note that you have settled a lawsuit on [date] and have accrued \$[x] million related to the settlement. Please provide to us a chronological analysis supporting management’s compliance with ASC 450 regarding this lawsuit. Please ensure that you address each of the reporting periods affected, the timing of the accrual and the disclosure provided.*

SEC Distinguishes S-K 103 Disclosure from ASC 450

Disclosure. The staff has pointed out the different disclosure requirements and objectives set forth in ASC 450 and Regulation S-K, Item 103. The staff stated at the September 2010 Center for Audit Quality SEC Regulations Committee Joint Meeting with the SEC Staff that “attempts to satisfy both objectives through an integrated set of disclosure often result in lengthy factual recitations rather than focusing on the underlying loss contingency, the related exposure and the likelihood of a loss.” Companies are reminded that Regulation S-K, Item 103 sets forth disclosure requirements outside of the financial statements which are related to legal proceedings.

Conclusion

The extent of SEC comments in this area suggest that companies should carefully assess their disclosures surrounding litigation matters on an ongoing basis to ensure compliance with ASC 450. When drafting and revising these disclosures, companies should be mindful of the areas of frequent SEC staff comment described above. ©

¹ FASB Accounting Standards Codification Topic 450, *Contingencies*.

² The Financial Accounting Standards Board (FASB) proposed new standards in July 2010 that would require enhanced disclosure regarding loss contingencies. The FASB received many comments on the draft standards and has subsequently postponed the adoption of new standards.

BOILERPLATE MATTERS: GIVING NOTICE

By the time most people get to the last article in a contract the inclination is often to think that it is just the “boilerplate” and therefore there is no reason to read it closely, if it gets read at all. Unfortunately for that reader, the boilerplate can have a real impact on how the contract will be interpreted and how the parties operate after signing.

Given that every party to an agreement has its own objectives, and the circumstances surrounding each agreement are different, it is not realistic to say that there is a correct approach to take for the boilerplate provisions. However, there are some common situations of which the reader should be conscious. We will be including a practical discussion about various boilerplate provisions in each issue of the *Corporate Practice NewsWire*. First up — notice provisions.

Notice provisions appear in nearly all contracts and are a staple of contract boilerplate. Despite their prevalence, notice clauses are often offered a fleeting glance, and lawyers tend to groan when prompted to negotiate their terms. Nonetheless, the form, content, timing or even delivery method for notice can determine whether, for instance, a party properly declared a default, exercised an option, or claimed a force majeure event. As such, the importance of a properly given notice demonstrates the need for a discussion on this provision — not to mention the still all-too-common references to telex (when was the last time you sent or received a telex?).

Towards this end, this article will focus on providing practical advice on drafting notice provisions and will conclude with a checklist of items to consider when drafting such provisions.

Why do agreements contain notice provisions? Generally speaking, notice provisions perform two key functions. First, they govern the mechanics of how parties to an agreement communicate with one another. Second, they set a standard to determine whether notice was effectively and timely given.

Most contracts contain two kinds of notice provisions, sometimes called “generic” and “specific.” A generic notice provision usually appears in the boilerplate section of a contract and describes the mechanics of giving notice under the contract. Generic notice sets forth the general proce-

dures that govern all communication made pursuant to the agreement.

In contrast, “specific” notice provisions are generally scattered throughout a contract and relate to giving notice in connection with agreement-specific matters. For instance, a specific notice provision can (i) require a party to deliver quarterly financial statements according to a recurring deadline, (ii) permit a party to notify the other of an event of default or (iii) extend the term of an agreement by giving notice within a certain number of days prior to the expiry of the agreement.

The generic notice provision should be drafted broadly to ensure that it covers all possible communication under the agreement (*i.e.*, the provision should cover requests, demands or other communications made under the agreement). Moreover, the generic notice provision should require notices to be in writing and should create an obligation for the parties to comply with this requirement. A writing serves two purposes; first, it demonstrates the authenticity of the message and second, it provides evidence that a message was communicated.

As a drafting point, drafting the generic provision as a covenant (*i.e.*, “each party shall give any notice or other communication under this agreement in writing”) is preferable to stating that “all notices under this agreement shall be in writing. The latter approach may leave open the question of whether the parties are obligated to send notices in writing or whether the writing serves as a condition precedent to effectiveness. The former approach, however, unambiguously requires the sender to give notice in writing, and also permits the recipient to sue for breach if the sender fails to comply.

In addition, notice provisions should enumerate the various permitted methods of delivery and state that each of these constitutes a “writing.” This, for instance, may avoid any debate about whether e-mail or other means of

electronic communication is considered a writing under the agreement.

One of the most important functions of a generic notice provision is to set forth when a notice is deemed effective. Historically, notice provisions operated with a presumption of delivery and thus allocated the risk of nondelivery to the recipient (*i.e.*, the “mailbox rule,” you may recall, permitted an offeree, after receiving an offer in the mail, to form a contract simply by depositing an acceptance in the mail). However, in modern generic notice provisions, the effectiveness of notice often hinges on receipt.

Parties should expressly state how effectiveness of notice can be determined for each of the enumerated methods of delivery. Most agreements contain language to this effect, however, inconsistencies sometimes exist between the permitted types of delivery and the language describing when notices are deemed effective. For example, an agreement may provide that all notices shall be delivered by hand, certified mail or overnight carrier (without any mention of e-mail or fax) and then go on to state that notice is deemed effective when confirmation of e-mail or fax is received by the sender. This discrepancy raises the question whether notice delivered by e-mail or fax is indeed valid under the agreement.

Consider also who should receive the notice. Did you really intend that notices be sent to “John Smith” or were you intending that the notices go to “Chief Financial Officer” (which was the officer position John Smith was holding at the time the contract was prepared). The difference can be important. You can easily have a situation where John Smith has left the company but his email address is still active but not being closely monitored and the counterparty sends a time-sensitive notice to this address. One possible way to deal with the departing contact person and email issue is to provide a group email address for notices under the agreement. For example, an address could be established as ProjectAlpha@xyz.com that provides for multiple persons at the company to receive the email when sent to that address.

In addition, it is imperative that specific notice provisions work in conjunction with a contract’s generic notice provision to ensure there is no conflict or confusion as to the mechanics on providing notice. For example, a specific notice provision may hinge on the “sending” of notice whereas the generic notice provision focuses on when notice is deemed “received” by a party. This distinction can be of critical importance — imagine you seek to exercise a warrant on the last day of the exercise period, would you be comfortable dropping your exercise form in the mail on that last day based on

the concept of “sending” when the generic notice provision deems notice effective when received?

Generally speaking, notice provisions perform two key functions. First, they govern the mechanics of how parties to an agreement communicate with one another. Second, they set a standard to determine whether notice was effectively and timely given.

The following is a list of items that you may consider when reviewing notice provisions in a contract:

- Is notice drafted broadly to include all of the methods of communication that the parties intend to permit under the agreement?
- Are addresses provided for each permitted method of delivery of notice (*i.e.*, mailing address, courier address, email address, fax number, etc.)?
- Is there a standard to determine the effectiveness of notice delivered under each of these methods of delivery?
- Under each of these methods of delivery, is notice deemed effective upon sending, receipt, or some other formulation (e.g., X days after being sent)?
- When is notice deemed effective if sent after business hours via e-mail or fax?
- Do the specific notice provisions work in tandem with the generic notice provision?
- Who is receiving the Notice — a specific person or a position?

Given the substantial risk that may accompany the failure to give proper notice, as well as the common pitfalls that to this day plague notice provisions, wise attorneys will pay close attention to such provisions. ☺

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