2020 Insights

Skadden

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Special thanks to former partner **Thomas H. Kennedy**, whose efforts as the global head of Skadden's Knowledge Management has helped set the standard for our annual compendium of forward-looking thought leadership.

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Stay Calm and Carry On: Strong 2019 US M&A Market Supports Optimism for 2020, Though Headwinds Persist

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M&A professionals greeted 2019 with a note of caution. Following a strong year for M&A in 2018, optimism was tempered by concerns over increased market volatility, trade disputes, rising interest rates and global political uncertainties. As it turned out, we saw significant turbulence in a number of areas in 2019, including trade relations, domestic politics in the U.S. and Europe, and regional flare-ups in the Middle East and Persian Gulf. Notwithstanding this turmoil, deal activity remained resilient, particularly in the United States, facilitated by relatively stable equity markets and available financing. While global transaction volume of approximately $3.3 trillion in 2019 was down slightly from 2018, it nonetheless represents the fourth-largest annual volume on record; and U.S. volume of approximately $1.6 trillion was up slightly from the prior year, according to data from Mergermarket. Companies announced a number of significant deals at the end of the year, and a robust pipeline supports continued, if cautious, optimism for 2020.

Large transactions drove market statistics for 2019. The number of deals valued at greater than $10 billion was up compared to 2018 and represented close to one-third of global activity and approximately 10% of U.S. activity. Average deal size increased to $389 million globally, the second-highest on record, and a record $768 million in the U.S. At the same time, the total number of deals fell both globally (down approximately 5% from 2018) and in the U.S. (down approximately 10%) for the second consecutive year.

Activity in 2019 was again fueled in large part by strategic transactions, as corporations continued to make substantial investments in response to the imperatives of increasing earnings and enhancing competitive platforms and scale. Deal activity was strong across multiple industries, including industrials, pharma/biotech, energy/resources, technology and financial services. Notably, the three leading sectors — industrials, pharma/biotech and energy/resources — accounted for almost half of global deal volume. Private equity activity was again at a healthy level, following a strong 2018, though elevated equity prices and strategic competition for attractive assets tempered the impact of record levels of available capital.

Selected 2019 Trends

Strength of US Activity and Decline in Cross-Border Activity. As the M&A market softened in many geographies, the U.S. stood out as an attractive destination, with activity representing approximately 47% of global M&A — the highest proportion since 2001 — owing to a relatively strong economy and a number of large domestic transactions. Mergers of U.S. corporations represented 15 of the 20 largest deals in 2019. Cross-border activity decreased approximately 6% globally compared to 2018, and consistent with generally strong U.S. activity in 2019, the U.S. accounted for 20% of all cross-border acquirers and 25% of all cross-border targets.

Regulatory Developments. Over the past several years, national security regulatory concerns have negatively impacted cross-border M&A activity, particularly in the United States with respect to investment in certain industries by Chinese companies and state-controlled investors. The jurisdiction of the Committee on Foreign Investment in the United States was expanded in 2018, and final regulations were adopted in early 2020 requiring mandatory filings for certain foreign investments in businesses involving critical technology, infrastructure or sensitive personal information. These rules, in addition to other factors, have contributed to the chilling effect on Chinese investments, particularly in the U.S. tech sector. At the same time, ongoing tensions in the U.S.-China relationship have continued to limit U.S. companies' appetite for transactions involving significant Chinese assets. Concerns over Chinese investment, again focused on technology and other sensitive industries, also have been exhibited by the U.K. and other European countries. (See "CFIUS' First Full Year Under FIRRMA" and "Conservative Party Win Paves Way for Reforms to UK National Security Reviews.")

On the antitrust front, the Federal Trade Commission (FTC) and Department of Justice (DOJ) continued to pursue vigorous enforcement in 2019, including scrutiny of vertical mergers and transactions where large companies are perceived to be acquiring nascent competitors, especially in the technology industry. This regulatory focus on large tech companies, which is consistent with increased regulatory scrutiny in Europe and the U.K., is in line with growing political focus on the behavior of large technology and health care companies. Consistent with their renewed interest in vertical merger enforcement, in January 2020, the DOJ and FTC jointly issued for comment a draft set of updated Vertical Merger Guidelines, which would provide an updated articulation of the government's current analytic approach to these transactions. The FTC also has shown continued interest in investigating consummated transactions and conducting merger retrospectives to guide future policy. (See "Antitrust Enforcement Centers on Technology Industry.")

While the impact of regulatory developments on overall transaction activity can be difficult to predict given the *sui generis* nature of specific deals, navigating the regulatory and political scrutiny of significant transactions has become more complicated and time-consuming.

Private Capital. Financial sponsors continue to play an active role in U.S. and global M&A, with a healthy level of activity in 2019. While global private equity activity was down slightly from 2018, sponsor buyouts represented over one-quarter of total deal activity. In the U.S., buyout levels reached a post-2007 peak, representing almost 15% of U.S. transaction value, according to Mergermarket. Private equity firms face mounting competition from other sources of private capital, including sovereign wealth funds, Canadian pension funds and family offices, which may have different return criteria and longer investment horizons than PE funds. However, private equity activity is poised to remain strong and may benefit if perceived economic headwinds start to affect asset prices.

Separation Transactions. Corporations have put substantial effort into optimizing their business models, adding technological, platform and geographic capacity to service their customers. At the same time, both corporations and investors have continued to focus on corporate clarity and fit, with companies separating non-core businesses that may have greater value to others or which may trade with different multiples or other characteristics in the public market. One manifestation of this latter trend is the number of significant spin-offs and reverse Morris trust transactions (involving an agreed acquisition of a distributing or distributed company following a spin-off) in recent years, which was again a notable trend in 2019, with $13.4 billion in volume for spin-off transactions in the U.S., according to Bloomberg Global.

Activism. Activist funds continued to have a meaningful impact on corporate strategic activity. Assets under management at activist funds remain high, at approximately $170 billion, according to *Activist Insight*, and increasing professionalization and sophistication, particularly at the larger activist hedge funds, have permitted those firms to have disproportionately loud voices compared to actual share ownership at even the largest companies. Corporate groups (such as Business Roundtable), certain institutional investors and politicians have provided substantial commentary regarding the importance of companies pursuing long-term corporate strategies focused on the needs of employees, communities and other constituencies in addition to shareholders. However, the practical effects of this shifting zeitgeist are unclear, and event-driven activism continues to attract significant shareholder support. The number of activist campaigns in 2019 was down from 2018, by over 10% globally and somewhat less than 10% in North America, according to *Activist Insight*, but there was no dearth of high-profile situations, many of which generated or impacted deal activity. Numerous public campaigns and private engagement efforts sought to pressure corporations to pursue strategic changes, most frequently including board refreshment and M&A initiatives, such as the sale of the company or the sale or spin-off of businesses. Many of these campaigns targeted large companies, with over 20% of activist demands directed at companies with market caps of $10 billion or greater. "Announced deal" activism, in which activist funds seek to renegotiate price or stop a transaction altogether, was pursued at both targets and acquirers.

Looking Ahead

Notwithstanding the strength of M&A activity at the conclusion of 2019, cautionary signs remain. Significant economic and political uncertainties continue to confront the global community, and at some point the headwinds they generate will likely slow the corporate appetite for merger activity. Apprehension remains over the duration of the economic cycle, trade and tariffs, increased equity market volatility, the direction of interest rates and potential tightening of borrowing conditions. The decline in the number of transactions in 2019 compared with 2017 and 2018 is a concerning sign of the overall strength of the M&A market.

As political criticism of large companies mounts amid growing populist sentiment in many Western nations, and regulatory scrutiny of transactions causes increasing uncertainty as to the timing (and in some cases the ultimate execution) of deals, the perception of political and regulatory risk may restrain the pursuit of some transactions. This may become a cause of particular concern in the U.S., where the 2020 election campaign has featured candidates highlighting proposed changes to antitrust and regulatory policies potentially impacting the financial services, health care and technology sectors. Combined with high asset prices, activist challenges to transactions at both the target and acquirer levels, and concern over timing of the business cycle and a potential recession, transaction parties may tread cautiously.

At the same time, several factors suggest significant M&A activity will continue in the coming year. Most importantly, the strategic need of corporations to grow earnings and optimize business platforms has not abated. Corporate buying power remains high, with access to significant balance sheet cash and the debt financing markets, as well as the ability to use stock as consideration in appropriate circumstances. Finally, private equity buyers and other private capital sources remain anxious to deploy substantial capital and are poised to jump in if asset prices come down. Absent meaningful deterioration in fundamental economic conditions or sustained disruption of access to deal financing, these drivers should continue to support significant transaction levels in the coming year.

Optimism for UK M&A and IPOs as New Decade Begins

Partner

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As we enter the 2020s, we begin the new decade with greater optimism than we had at the start of the previous one. In the U.K., December 2009 ended with negative growth; the government as the owner of the remains of Northern Rock and Bradford & Bingley, the majority shareholder of the Royal Bank of Scotland and the largest shareholder of Lloyds Banking Group; the employment rate at 70%; and the *Financial Times* Stock Exchange 100 down to 5,400. Ten years later, economic growth is a subdued but positive 1%, the employment rate is up to 76%, the financial sector has been almost entirely returned to private ownership and the FTSE 100 is at 7,500.

While a positive outlook for deal activity is not a certainty, market participants have several reasons to be confident.

First, following the U.K. general election in December 2019, the political situation looks to be stabilizing after a long period of turbulence. The U.K. business community has responded with hopefulness: The *Financial Times* reported that "UK Stocks Jump as Easing Political Angst Unleashes Bulls," and the City A.M. front page led with "City Looks Forward to Bojo Boom." While many in the European Union (and in the U.K.) regret the end of any last chance to avoid Brexit, the election results mean the end of the U.K.'s 10-year experiment with coalitions and minority governments and a return to an executive and legislature dominated by a single political party that will hold power for at least four years. Meanwhile, under its new leadership team of Ursula von der Leyen at the European Commission and Christine Lagarde at the European Central Bank, the EU can get on with its own priorities. Outside Europe, signs suggest that the trade war between China and the U.S. may be approaching resolution.

Second, political stability has the potential to bring with it significant structural change in the U.K. economy over the next decade, as it pivots away from the EU and toward North America, potentially driving deal growth. Although claims that the U.K. can complete comprehensive trade deals with the EU and U.S. within the next 12 months are probably overly optimistic, these deals are likely to be concluded in the medium term. The U.S. and U.K. economies already have similar emphases: The services sector accounts for 70% of U.S. output and 80% of U.K. output, and the U.S. and U.K. are the world's biggest earners from services and income, together accounting for 24% of world exports in 2017, according to *The Economist*. Previously, companies in the services sector in the U.K. might have looked to Europe for growth opportunities; however, as trade barriers between the U.K. and U.S. fall — and those between the U.K. and the EU are more likely to increase, as any trade deal is likely to be more restrictive than actual membership in the EU — trans-Atlantic acquisitions seem likely to increase.

Third, market data suggests increasing demand in the mergers and acquisitions and initial public offerings markets in 2020. After a slow start in 2019, European M&A ended the year well. Following a quiet first six months, Mergermarket reported 1,545 deals with an aggregate value of US$166.5 billion in the third quarter and a final year figure of US$770.5 billion, an overall decrease from 2018's total of US$986.4 billion. However, European outbound M&A in 2019 was much more robust, with deals

reaching an aggregate value of US$272.1 billion, an increase of 28.3% over the previous year. Those figures support the view expressed by some market participants toward the end of the year that it was "time to just get on with doing deals." The number of IPOs in 2019 was low, with only 69 completed in Europe by the end of the third quarter, compared with 154 in the same period in 2018. Rising markets and greater investor optimism may cause companies that paused IPOs in 2019 to dust off plans as market sentiment recovers in 2020.

Fourth, a significant volume of capital remains to be deployed. U.S. corporations, particularly in the technology space, continue to hold significant cash reserves. Private equity funds also continue to have significant capital, reportedly raising new funds of more than US$342.9 billion in Europe in 2019, adding further to the large amounts already raised. Funds will want to put that capital to work. Moreover, significant opportunities exist to leverage equity funds with debt. Direct-lending funds have increasingly replaced banks as providers of finance for transactions, structurally changing the European debt markets over the past decade. While these funds were previously focused on small-to-mid-market deals, increasingly, they are willing to fund larger transactions, either funding deals that banks may not have been willing to finance or providing competitive pricing that makes deals more viable. And for the largest deals, the collateralized loan obligation market remains very active.

Finally, the U.K. remains one of most open jurisdictions for M&A in the world. Though it includes some elements that overseas bidders may find frustrating, the regime of the City Code on Takeovers and Mergers and English company law continues to prioritize shareholder value. Accordingly, if a bidder's price is fair, directors are obliged to put the offer to shareholders, and most offers result in completed transactions. Acquisitions in specialist sectors, such as defense, will continue to be regulated, and it seems likely that additional legislation will be passed to increase the level of review of sales of businesses with a national security dimension. (See "Conservative Party Win Paves Way for Reforms to UK National Security Reviews.") Signs also suggest that the U.K. antitrust authorities are becoming more hawkish. That said, the U.K. has not adopted a more general foreign investment review process for "strategic assets" beyond the national security sector, thus increasing the U.K.'s attractiveness as a source for overseas investment. Even if new processes are introduced, the Johnson administration looks likely to exercise its review powers pragmatically; one of its first acts was to approve the acquisition of the U.K. defense company Cobham by a U.S. private equity buyer.

Conclusion

The new decade begins with: (i) more stable politics; (ii) a changing economy that will create opportunities; (iii) rising M&A and IPO markets; (iv) buyers with cash to deploy; and (v) an open M&A regime. Though we won't know for another 10 years whether the 2020s will prove to be a roaring decade for doing deals, as we look forward from here all the fundamentals appear to be in place.

Private, Pre-IPO Investments Continue To Gain Influence for Companies Looking To Go Public

Partner

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The continued growth and power of private financing alternatives have changed the dynamic of initial public offerings over time. Historically, an IPO was the ultimate goal for a company and its founders after raising initial venture capital and developing a story to sell to the public markets, and investors eagerly sought allocations in highly anticipated offerings. In recent years, however, the focus has shifted to late-stage private capital-raising, sometimes referred to as the "private IPO round" or the "final private offering," through which companies can attract significant funding from a broader group of investors in advance of or in conjunction with a traditional IPO. These private financings can have significant influence on a company's subsequent IPO, and, if properly structured and planned, can provide a strategic benefit for both issuers and investors.

IPO Market Developments

Many companies today are waiting longer to go public and have completed more, and larger, private financing rounds prior to their IPOs. In 1999, the average age of a newly public technology company reached a low of 4.5 years, which since has been creeping up. From 2017 through 2019, the median age of technology companies going public was more than 12 years old. (Data according to research published by Prof. Jay Ritter in *Initial Public Offerings: Updated Statistics*.)

In a speech at the Economic Club of New York in September 2019, Securities and Exchange Commission Chairman Jay Clayton said, "Twenty-five years ago, the public markets dominated the private markets in virtually every measure. Today, in many measures, the private markets outpace the public markets, including in aggregate size." In its most recent analysis, the SEC's Division of Economic and Risk Analysis reported that in 2017 registered offerings accounted for $1.5 trillion of new capital, compared to more than $3 trillion reported raised through all private channels.

A number of dramatic IPOs in 2019, including the highly anticipated offerings of Beyond Meat, Fiverr, Lyft, Pinterest, SmileDirect, Uber and XP, reflect the range of potential outcomes when pursuing financing in the public markets: Some of these offerings were great successes, while others experienced significant post-IPO stock price declines. Against this backdrop, a number of companies chose to delay or withdraw potential transactions.

The volatility in the 2019 IPO market highlighted the perceived misalignment between what may be valued by investors in private, pre-IPO rounds of financing and what public investors want to see post-IPO. Historically, many pre-IPO companies have successfully attracted private capital based on innovative or disruptive ideas, powerful mission statements, brand recognition and rapid growth, and the vision and reputation of charismatic leaders, even without profitability. On the other hand, public market investors increasingly are demanding a clearer path to profitability, fundamentals of long-term value and growth at a reasonable price.

Combining IPOs and Private Financings

IPOs and private financings, however, need not be mutually exclusive. Properly structured and planned with a view toward a future or concurrent IPO, late-stage private rounds can provide a strategic benefit for both issuers and investors, from valuation, marketing and financing perspectives.

By staying private longer and having access to larger sources of private capital, companies have the opportunity to grow and mature beyond the venture capital stage and better prepare for an IPO. Prior to launching public offerings, companies can develop a track record with products, services and technology and show actual profitability and cash flow, or at least a specific path to deliver earnings to public investors. Increased flexibility to raise capital in either the private or public markets allows companies to determine which strategy and timing work best for them, irrespective of what competitors may be doing. A notable comparison of strategies is that of Impossible Foods, which to date has chosen to remain private, and its competitor Beyond Meat, which completed a successful IPO in 2019. Impossible Foods has raised a total of $777 million in private financings since 2011; Beyond Meat raised a total of approximately $193 million in the private markets, completed a $240 million IPO at $25 per share in May 2019 and two months later completed a subsequent follow-on public offering at $160 per share. (Data according to PitchBook.)

In addition, the number and types of investors willing to participate in private financings has increased over time. For example, large mutual funds and "crossover" investors, which have traditionally focused on public markets, are participating increasingly in pre-IPO private placements. Other key investors include hedge funds, family offices, sovereign wealth funds and special purpose vehicles through which sophisticated individuals invest. Also, the Securities and Exchange Commission has articulated parallel goals of enhancing the attractiveness of the public capital markets while also increasing the types and quality of opportunities for retail investors in private markets.

In particular, late-stage private financings by crossover or strategic investors, sometimes referred to as the "crossover round" before the public offering, can be a strategic step shortly before, or concurrent with, a company's public offering. These private placements can allow companies to raise additional capital to strengthen balance sheets or simplify capital structures before going public; they frequently offer common stock but can include debt securities or convertible securities as well. A company also may desire, as part of its IPO marketing or business strategy, to bring in strategic partners or anchor investors that make an actual investment instead of just providing a nonbinding indication of interest in participating in the IPO.

This structure has been common for some time in life sciences IPOs and has been expanding to other IPOs more generally. Recent examples include PayPal's purchase of $500 million of Uber shares in a private placement concurrent with Uber's IPO, as well as the extension of PayPal and Uber's global partnership arrangement; and the additional $100 million investment by affiliates of Technology Crossover Ventures, an existing Peloton stockholder, concurrent with Peloton's IPO. Having a well-known investor purchase shares in the company as part of a crossover round, particularly if the purchase is made at the public offering price, can help show confidence in the company, its business and its valuation. Private investors will require detailed information about a company and its management and perform significant due diligence before investing in it. In return, these investors have the opportunity to invest in an IPO-ready company and acquire a potentially larger stake than they would receive in an allocation in the IPO.

Planning for a Late-Stage Private Financing

Following the ups and downs of the 2019 IPO market, pre-IPO investors and companies may look more closely at what drives valuations in private funding rounds and how those valuations relate to the expected pricing if and when the company seeks to go public, whether through a traditional IPO or a direct listing. The "private IPO round," "crossover round" or "final private offering" before the initial public offering can provide strategic valuation, marketing and financing benefits to both investors and issuers. A company considering a late-stage private placement before, or concurrently with, its public offering should consult with counsel and the other parties in the offering process well in advance to ensure that both the public offering and the private placement are structured in accordance with applicable legal requirements and in a manner to successfully achieve the parties' objectives.

Strong Finish to 2019 Offers Promising 2020 for US and European High-Yield Markets

In 2019, a wave of bond-to-bond refinancings, as well as significant bank and term loan-to-bond refinancings, punctuated a strong year for debt financings after a slow first quarter. Throughout last year, debt investors balanced the confidence they gained from solid fundamentals with the ongoing uncertainty over Brexit, global economic unease and trade wars. Companies with strong balance sheets and well-known credits reaped the rewards of lower yields and flexible covenants, as interest rates hit — as described by Bank of America Merrill Lynch's head of global research — "5,000-year lows."

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A year-to-year reduction in the number of issuances driven by mergers and acquisitions kept the high-yield market from reaching record highs and resulted in refinancings leading the market. In the United States, year-to-date issuances as of the end of November amounted to over $235 billion, an increase of 41% over 2018. Of that amount, new issuances accounted for 41% of overall issuances (for a total of $97 billion), down from 53% in 2018 (for a total of $90 billion). The European high-yield market edged higher as well, ending 2019 with more than €70 billion in high-yield and more than 150 issuances, up from €63.5 billion and 125 issuances in 2018, finishing stronger in the last quarter, with the highest level of issuances since the fourth quarter of 2017. (Sources: Debtwire, S&P Capital IQ and Xtract Research.)

A number of key trends dominated both U.S. and European markets:

Reverse Yankee Bonds. U.S. issuers generally shied away from European markets during the first three quarters of 2019, with reverse Yankee issuances (*i.e.*, bonds issued by U.S. companies outside the U.S., in non-U.S. currencies) down more than 50% from record highs in 2017 and 2018. The decline was driven in part by U.S. issuers preferring the depth of the U.S. markets and finding superior overall pricing by issuing directly in dollars rather than in euros and then swapping into dollars. The fourth quarter of 2019, however, was the busiest for reverse Yankee issuances since the first quarter of 2018, suggesting that 2020 may be promising for U.S. issuers looking to Europe.

Libor. Although market participants have known of the impending end of the London Interbank Offered Rate (Libor) since 2017, solutions have been slow to develop, and the lack of a settled approach has continued to weigh on the market. The European markets gradually developed several variations for alternatives in 2018 and 2019 in the event of the unavailability of Libor — so-called "fallback" language for the European Interbank Offered Rate (Euribor) — although consensus has not been reached. Sterling high-yield issuances saw their lowest volume of the decade, and floating-rate issuances have been limited in recent years, but two floating-rate high-yield issuances came to market in Europe in 2019. The U.S. markets experienced greater stability as market participants began to warm to the Alternative Reference Rates Committee's (ARRC) suggested fallback language. As the end of Libor draws closer, the markets will need to continue to align on the appropriate fallback provisions for new issuances.

Leverage-Based Flexibility. Increasingly, issuers face fewer covenant restrictions when they achieve a particular leverage ratio (typically, debt or net debt to earnings before interest, tax, depreciation and amortization, or EBITDA). For example, since the start of the 2010s, many indentures have provided that limits

on “restricted payments” (including dividends, loans and investments) no longer apply once a leverage test is met. More recently, indentures have given issuers the option to incur unsecured debt upon meeting either a fixed-charge coverage-ratio test (the ratio of interest and similar expenses to EBITDA) or a leverage-ratio test. Similarly, 2019 saw issuers include a leverage-based asset sale step-down clause (as documented by covenant review services) more frequently. These clauses allow the issuer to lower (or “step down”) the proportion of proceeds from an asset sale that it must apply to repay senior debt or for other permitted applications in accordance with the asset sale covenant if it meets a leverage test.

Finally, a growing number of bond issuances permit unlimited investments, provided that a leverage test is met. The relaxation of covenant restrictions has typically been conditioned upon some improvement post-issuance — *i.e.*, the ratio that an issuer had to meet to benefit from the covenant relief required improving its leverage ratio. However, the leverage ratios that must be met are, more and more frequently, closer to the leverage of an issuer at the time of issuance, enabling issuers to benefit from additional flexibility through more relaxed covenants by only maintaining or modestly improving leverage.

Anti-Net Short. In 2019, high-yield issuers also were focused on crafting innovative solutions to protect themselves from the recent wave of “net-short debt activism.” Issuers have become concerned that bondholders who held short positions in issuers’ derivative instruments had found ways to assert covenant defaults to put issuers into default. Different approaches have been explored for dealing with such “net-short” bondholders, including changes in provisions relating to voting mechanics, instructions for amendments, waivers, and actions upon defaults or events of defaults. However, the market has not adopted a single approach to net-short bondholders. Issuers are trying to balance these new and necessary protections with their impacts on investors and the marketability of their bonds; many investors have resisted the addition of any such protections, which they perceive as disenfranchising investors.

Changes in Lease Accounting in IFRS. On January 1, 2019, International Financial Reporting Standard (IFRS) 16 (Leases) came into effect, changing the accounting treatment for leases. Previously, leases had been accounted for as either operating leases or finance leases, but IFRS 16 abolished that distinction, leading to an asset being recorded on the balance sheet at the beginning of the lease and then depreciating over the life of the lease. The impact of this change has varied depending on the industry, but it has affected bond covenants in a number of areas, including net income, which influences capacity for dividends and other restricted payments, and EBITDA, which impacts various line items and therefore borrowing capacity, as well as certain other financial measures used in covenants.

Issuers have taken different approaches to dealing with the impact of IFRS 16 on bond documentation, with some “freezing” accounting standards to a date prior to the adoption of IFRS 16 and others not making any adjustments (and accepting the impact of IFRS on covenant calculations). Some issuers have provided a detailed reconciliation on a pre- and post-IFRS basis in bond offering documentation to show the impact to investors. The U.S. Financial Accounting Standards Board opted not to make a similar change to Accounting Standards Committee 842, despite adopting other changes to the lease accounting rules that became effective in 2019.

Outlook

The market in 2019 ended on a high note, and global bond issuances are expected to increase going into 2020 on account of low interest rates. An influx in M&A supply and strong fundamentals have generated optimism for the high-yield markets next year.

Hong Kong Stock Exchange Poised To List New Economy Companies Trading Abroad

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Leading Chinese e-commerce company Alibaba, which has a primary listing on the New York Stock Exchange, made its long-awaited Hong Kong Stock Exchange (HKEx) debut in November 2019. This marked the first secondary listing in Hong Kong under a new regime for China-based issuers.

The HKEx revamped its rules in April 2018 to facilitate the secondary listing of China-based companies that operate in innovative, new economy sectors. (Biotech companies are excluded since they were the subject of separate listing reforms; see our June 18, 2019, client alert "HKEx Reforms Attract High-Profile Technology and Biotech Listings.") The new rules enable these companies to dispense with the myriad prospectus disclosure requirements, mandatory shareholder protection standards in corporate constitutional documents and post-listing compliance obligations that are applicable to companies conducting a primary listing in Hong Kong. Importantly, the HKEx retains the discretion to determine whether a company is "suitable" for listing under the new rules (including whether it is sufficiently "innovative"). Companies must have either (i) a market capitalization in excess of HK$4 billion (US$513 million) or (ii) a market capitalization in excess of HK$10 billion (US$1.28 billion) with revenues in excess of HK$1 billion (US$128 million) in the most recent financial year — ensuring that the number of companies potentially benefitting from the rules remains relatively constrained.

The new rules divide Chinese companies that are listed abroad into two categories depending on whether they were listed before (grandfathered) or after (non-grandfathered) December 15, 2017, with grandfathered issuers having significantly fewer listing requirements. In addition to the various waivers applicable to grandfathered companies, Alibaba received additional waivers from the HKEx for a variety of listing and post-listing obligations not provided for under the rules. A recurring argument Alibaba made in support of the waivers was that it already was subject to commensurate, albeit different, disclosure obligations and regulatory oversight under U.S. securities laws. The result paved the way for Alibaba's listing, simplified its disclosure requirements and reduced its ongoing compliance burden.

To complement the new issuer-friendly secondary listing rules, the HKEx and two mainland bourses, the Shanghai Stock Exchange and the Shenzhen Stock Exchange, recently agreed to allow secondary issuers in Hong Kong to participate in the Shanghai and Shenzhen Stock Connect programs. These programs enable mainland China-based investors to trade directly in certain HKEx-listed securities (southbound trading) and Hong Kong-based investors to trade directly in certain Shanghai and Shenzhen Stock Exchange-listed securities (northbound trading). The Stock Connect programs previously excluded the securities of Hong Kong-listed companies with weighted voting rights (WVRs). That exclusion was officially lifted in October 2019 when the Shanghai and Shenzhen Stock Exchanges promulgated new rules to allow companies structured with WVRs to participate in the Stock Connect programs, provided they are constituent securities of the Hang Seng Composite Index (an index that covers almost 500 stocks representing approximately 95% of total market capitalization) and meet certain thresholds for market capitalization, liquidity and trading period. In the same month, Xiaomi Corporation, a leading Chinese technology company, and Meituan-Dianping, a leading Chinese e-commerce platform for services, were among the first companies with WVR structures to be admitted to the Stock Connect programs.

For major U.S.-listed Chinese companies, the ability to access mainland Chinese markets via the Stock Connect programs without the regulatory burden of a Hong Kong primary listing is a potentially attractive proposition. According to the HKEx's data, the total value of southbound trading in 2019 amounted to HK$2.3 trillion (US$300.1 billion), with an average of 202,990 daily trades. Mainland China-based investors held HK$999.5 billion (US$127.8 billion) worth of Hong Kong-listed shares through the Stock Connect programs as of the end of October 2019, up from HK$13.1 billion (US$1.7 billion) at the end of 2014.

Alibaba, Xiaomi Corporation and Meituan-Dianping, despite being members of the 400-constituent Hang Seng Composite Index, are not qualified to be admitted into the 50-member benchmark Hang Seng Index (HSI) or Hang Seng China Enterprises Index under the current admission rules, because only companies with a primary listing and without a WVR structure are eligible. Companies often covet membership in the benchmark HSI because it is the most widely quoted gauge of the Hong Kong stock market, potentially resulting in significant inflows for companies from the funds that track it. HSI inclusion for secondary-listed issuers and issuers with a WVR structure is therefore likely to be the next major step for Hong Kong to take to enhance its capital markets platform.

Hang Seng Indexes Company Limited, the entity responsible for managing the family of Hang Seng indexes, recently announced its plan to conduct a market consultation for expanding the constituent eligibility of the HSI in the first quarter of 2020, with the results expected to be published in May 2020. Market participants and U.S.-listed Chinese technology companies contemplating a Hong Kong secondary listing will be interested to see if an HSI inclusion will be introduced.

Conclusion

Against the backdrop of a prolonged series of large-scale anti-government protests, the successful completion of the Alibaba deal under the new secondary listing regime could spark a new wave of secondary listings in Hong Kong of Chinese new economy companies. For well-known technology giants, the potential to penetrate the mainland Chinese markets via the Shanghai and Shenzhen Stock Connect programs will be a powerful incentive to pursue a secondary listing in Hong Kong. A move to amend the rules of admission into the HSI to render issuers with a secondary listing or a WVR structure eligible for index inclusion will further boost that attraction.

US Corporate Governance: From the Frying Pan Into the Fire?

Partner

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Three significant trends mark the last decade in corporate governance, and they have only accelerated over time: (i) the dismantling of structural provisions that some shareholders believe insulate directors from accountability; (ii) a more searching inquiry by shareholders into board composition; and (iii) an increased focus on environmental, social and governance (ESG) matters.

Although the reasons behind these trends and the mechanisms employed to further them are varied, some quarters place the blame, at least in part, on the shareholder proposal process and proxy advisory firms. They view the potential adoption of recently proposed SEC rules relating to these two areas as a welcome rebalancing of a system out of equilibrium. In contrast, others believe the adoption of the proposed rules would muffle a critical voice — that of shareholders — in a governance ecosystem in which they play an important part. Regardless of one's perspective, the rulemaking process and its aftermath may portend a period in which directors' positions are more precarious than ever.

Structural Changes Relating to Director Accountability to Shareholders

The structural-change trends are not new. For companies in the S&P 500 index, the vast majority of boards of directors are subject to election on an annual basis, rather than on staggered terms, and directors in uncontested elections are required to submit their resignations if they fail to receive a majority of votes cast. A substantial majority of S&P 500 companies provide shareholders with a proxy access right, to date virtually unused, that allows shareholders to have a limited number of competing board nominees appear in the company's proxy materials. In addition, a substantial majority of those companies provide shareholders the right to call a special meeting, and at many companies the ownership thresholds required to exercise that right have been lowered over time.

These changes have been achieved through "private ordering" — the notion that private parties are best-positioned to order their affairs — rather than by SEC mandate or stock exchange rule. However, the shareholder proposal process played a significant role in building momentum. In many cases, once trends become well-established and investor voting policies and patterns become clear, the shareholder proposal process becomes secondary. At that point, with the outcome of a vote fairly predictable, investor-engagement or letter-writing campaigns, sometimes with the implicit threat of a shareholder proposal, can achieve the same outcome.

Also contributing to these structural trends are proxy advisory firm voting policies that recommend against directors at newly public companies that have disfavored governance provisions, such as classified boards or supermajority voting requirements for shareholders to approve charter or bylaw amendments. In addition, the threat of being labeled by proxy advisory firms as "unresponsive" to a majority-supported shareholder proposal, with the related risk of a recommendation against directors' reelection, gives "teeth" to what are otherwise nonbinding votes. Accordingly, it is difficult to envision the structural changes occurring to the same degree and at the same pace as has occurred in the absence of the shareholder proposal process and proxy advisory firm voting recommendations.

Focus on Board Composition

Investors have become keenly focused on whether companies have the "right" directors in the boardroom, paying particular attention to director skills and experiences, diversity, tenure and overboarding (*i.e.*, serving on an excessive number of public company boards). The focus on director skills has taken the form of an emphasis on disclosure, including a campaign by the New York City Comptroller, launched in 2017, calling for the disclosure of a skills matrix to more easily understand the skills represented in the boardroom and identify gaps. According to one survey, 75% of *Fortune* 100 companies included a skills matrix in their 2019 proxy statements. Many large institutional investors have been vocal advocates for increasing board diversity and, as of July 2019, no S&P 500 companies have all-male boards. In addition, the New York City Comptroller recently launched a campaign for boards to adopt a "Rooney Rule" policy requiring that the initial lists of candidates considered to fill board seats or identify external CEO candidates include qualified female and racially/ethnically diverse candidates. Average director tenure and the mix of tenures on a board have become common proxy disclosures and discussion points with investors who believe that "lengthy" director tenure may compromise board independence, represent stale skill sets and impede increasing board diversity. Finally, the adoption of limits on the number of public company board seats a director may hold — as part of proxy advisory firm voting guidelines and the voting policies of large asset managers and other investors, as well as by companies themselves — has reduced the number of boards on which many directors serve, resulting in public companies needing to expand the pool of potential directors.

In contrast to the structural changes described above, the shareholder proposal process and proxy advisory firm voting recommendations have played a less prominent role in bringing about these changes. Although shareholder proposals have addressed these matters, particularly on disclosing a skills matrix and increasing board diversity, the vast majority of these proposals have been withdrawn following company engagement with the shareholders and company adoption of enhanced disclosures or policies. Proxy advisory firm policies on director diversity and overboarding arguably have been less impactful than — and in some cases have lagged behind — voting policies and engagement on these matters by large asset managers such as BlackRock, State Street and Vanguard.

Environmental, Social and Governance

The level of ESG-focused investment continues to grow, and ESG funds continue to form. ESG investing takes a variety of approaches, such as making investments in companies viewed as positively addressing environmental or social issues, choosing to exclude from portfolios companies in certain industry sectors viewed as problematic, or integrating ESG data into an assessment of risk-adjusted returns to make investment decisions. The growth of ESG investing has caused a proliferation of ESG ratings and scores, which are often based on incomplete or incorrect information and employ a wide variety of methodologies. Due to investor demand and a need for companies to tell their own ESG stories, 86% of S&P 500 companies have chosen to publish sustainability or ESG reports, according to the U.S. Chamber of Commerce.

On the shareholder proposal front, for the third year in a row, environmental and social proposals represented the largest category of proposals submitted, many of which were withdrawn following company engagement with the proponents. Median shareholder voting support for these proposals continues to increase, with approximately two dozen receiving majority support over the last two years. These majority-supported proposals span a wide range of topics, including climate change and other environmental issues, political and lobbying expenditures, workforce diversity, gun safety and opioids.

A related debate has been taking place among companies, investors, politicians, academics and others concerning whether corporations have a responsibility to stakeholders other than shareholders. The Business Roundtable issued its "Statement on the Purpose of a Corporation," in which the signatory CEOs committed to delivering value to all stakeholders, including customers, employees, suppliers, communities and investors. Some interpreted the statement as a way to avoid accountability to shareholders, while others viewed it as simply a statement of good business practices and a reflection of what companies were already doing. As we have previously written, the shareholder primacy rule applicable to Delaware corporations has sufficient flexibility for directors to consider nonshareholder stakeholder interests so long as the board, in its business judgment, determines that the action being taken has a sufficient nexus to shareholder welfare. (See "Social Responsibility and Enlightened Shareholder Primacy: Views From the Courtroom and Boardroom" and "Putting to Rest the Debate Between Corporate Social Responsibility and Current Corporate Law.") In light of the upcoming presidential election, expect the debate about the role of business in addressing societal issues to continue. In 2018, for example, presidential candidate Sen. Elizabeth Warren introduced the Accountable Capitalism Act, which would require companies with more than $1 billion in revenue to obtain a federal charter stating the company's "purpose of creating a general public benefit," defined as "a material positive impact on society resulting from the business and operations" of the company.

In the case of environmental and social (E&S) matters, the shareholder proposal process has played a clear role in increasing company-shareholder engagement on these topics, as evidenced by the withdrawal of a significant number of proposals and the increasing number of proposals that achieve majority support. Proxy advisory firm voting recommendations may have some impact on the margins. Nevertheless, the primary driver of change in this area stems from the significant growth in ESG-based investing, and that growth is expected to continue for the foreseeable future, as upcoming generations of investors appear to have a greater interest in socially responsible investing.

In fact, these trends may accelerate rapidly following BlackRock's January 2020 announcements relating to ESG and sustainability. In his annual letter to CEOs, titled "A Fundamental Reshaping of Finance," BlackRock's CEO Larry Fink stated that BlackRock's "investment conviction is that sustainability- and climate-integrated portfolios can provide better risk-adjusted returns to investors." In a companion letter to clients, BlackRock stated its belief that "sustainability should be [BlackRock's] new standard for investing" and that it would be significantly expanding its sustainable investing client offerings and further integrating sustainability into its investment processes.

SEC Proposals, Investor Reaction and Possible Impact

In November 2019, the SEC proposed rules relating to the shareholder proposal process and to proxy advisory voting recommendations. (See "SEC Proposes Amendments to the Proxy Rules Regarding Shareholder Proposals and Proxy Voting Advice.") The period for public comment on the proposals extends into February 2020. Some business groups, such as the U.S. Chamber of Commerce, have voiced support for the SEC's proposals, while investor groups, such as the Council of Institutional Investors, have been critical.

Although it may be difficult to predict the precise impact or unintended consequences of these proposals, if adopted, two things are clear: Both the shareholder proposal process and proxy advisory firm voting recommendations will remain part of the governance landscape. On the margins, some proponents may become ineligible to submit proposals and some proposals may not achieve enough voting support to be eligible for resubmission. Perhaps shifts will occur with regard to the particular shareholders submitting proposals and the particular companies receiving them. In addition, although some of the largest asset managers have expanded their internal governance analytical teams, investor demand for proxy voting advice will remain. Proxy advisory firms may have to enhance their procedures and incur more costs, which likely will be passed on to investors, but they will continue to offer voting advice, which will continue to not always align with companies' recommendations.

Nevertheless, the impact may be that some shareholder concerns no longer make it onto the company ballot with an opportunity for shareholders to express their views. How will shareholders react if, in fact, they feel stifled? Arguably, providing investors with an ability to voice concerns at the ballot box has proven beneficial in another instance — when investors were given the chance to express their displeasure regarding executive compensation issues with say-on-pay votes, negative votes against members of compensation committees decreased. If investors are displeased with a company's record on an issue that might otherwise have been expressed through a shareholder proposal vote, they may simply choose to vote against directors more frequently.

In fact, if investors have fewer opportunities to raise concerns via the shareholder proposal process, those concerns may take the shape of "vote no" campaigns against directors. Furthermore, as investor focus on ESG continues to evolve, "vote no" campaigns may revolve around ESG issues. For example, in 2017, the New York City Comptroller launched a "vote no" campaign against a director at an energy company that had publicly embraced reducing greenhouse gas emissions because the director allegedly had a history of climate change denial. Although that example presented an unusual fact pattern, investors might launch similar campaigns based on a company's ESG record rather than advocate for ESG changes through submission of a shareholder proposal.

Moreover, having achieved proxy access rights at a substantial majority of S&P 500 companies, investors might simply nominate a candidate with stronger ESG credentials. When announcing his campaign advocating for disclosure of a skills matrix, the New York City Comptroller tied the information to informing investors' use of proxy access. Although that phenomenon has not yet been seen, perhaps changes to the shareholder proposal process could increase the risks of proxy access nominations.

Directors face challenges navigating the business landscape of disruption, artificial intelligence, cybersecurity and trade wars, among other issues. Understanding what ESG matters are material to a company's business and how to address them in a way that creates long-term value is an additional challenge. Potentially entering a phase where those ESG questions play a heightened role in director elections, and maybe even in proxy contests, will only make those challenges more difficult and directors' positions more precarious.

As Shareholder Activism Grows in Japan, New Amendment Places Limits on Foreign Investors

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Investors in Japanese-listed companies have traditionally taken a passive approach to their investments, in part because Japanese business culture have long held an unfavorable view toward investors making demands or voicing strong opinions to companies. In recent years, however, the Japanese market has become increasingly receptive to direct and open engagement between market participants and listed companies. This change may be due in part to the gradual recognition by the public that investors, particularly foreign investors, exerting pressure on management teams and boards of directors can add corporate value. The dominant catalyst, however, has been the Japanese government's efforts to improve the corporate governance practices of listed companies, as reflected by the introduction of the Stewardship Code in 2017 and the Corporate Governance Code in 2018, which require Japanese-listed companies to actively engage in dialogue with their shareholders to enhance value.

In this climate, Japan is experiencing unprecedented growth of shareholder activism, and listed companies can no longer disregard the demands of activist investors. In June 2019, when the majority of Japanese-listed companies held their annual general meetings, a record 54 companies received shareholder proposals, on issues ranging from suboptimal balance sheets to management transparency. Notably, a few of the proposals were either approved or nearly approved — both of which are unusual outcomes in Japan. While the large number of shareholder proposals may reflect investor frustration with substandard corporate governance or the sluggish pace of change at listed companies, it also shows that active engagement, from private discussions to public proposals, is taking place between investors and companies.

However, despite the rise of shareholder activism, Japanese-listed companies still are not very sophisticated when dealing with activist investors. For example, most Japanese-listed companies lack any planned communication protocols or the experience necessary for active and constructive engagement with activist investors. The amendment of the Foreign Exchange and Foreign Trade Act (FEFTA) appears to be intended to help these companies avoid becoming targets of foreign activist investor campaigns.

Foreign Exchange and Foreign Trade Act

FEFTA has long regulated foreign investments in Japanese businesses by requiring certain prior notification processes, preclosing approvals from the Japanese government and/or post-closing reporting when acquisitions of significant minority equity stakes of listed companies are made, depending on the industry of the target company. The act subjects a broad range of industries related to national security to these requirements. In addition, other laws regulate specific industries, such as the Banking Act and the Insurance Business Act. A key requirement under FEFTA is a prior approval process that is triggered by an equity investment, representing 10% or more of voting rights, into a Japanese-listed company engaged in

sensitive business important to national security. In most cases, companies receive prior approval within 30 calendar days; however, approval may take more time if the investment is for a controlling interest and the target company operates in a highly regulated industry or controls businesses determined to be important to national security, such as military, defense, nuclear power and aviation.

Japan will be tightening certain reporting requirements under the act pursuant to a recent amendment that was passed by the Japanese legislature in November 2019 and is expected to become law by May 2020.

Key Changes to the Act

Under the amendment:

- Foreign investors seeking a 1% voting interest in Japanese-listed companies engaged in sensitive businesses will be required to undergo a prior notification process and obtain preclosing approval with the Japanese government. The ownership threshold of listed companies in nondesignated sectors remains at 10%; coverage of designated sectors is subject to ongoing review by the relevant authorities.
- A new provision will require foreign investors to undergo a prior notification process before making certain changes to management of a target company engaged in a sensitive business, such as the nomination of new board members or proposals of transfers or dispositions of important business units of the target company.

The Exemption

Some foreign activist investors consider the amendment a reflection of Japan becoming less hospitable to foreign investors and believe their campaigns to improve shareholder returns will be more difficult. These investors contend that the amendment will make it practically impossible to increase their stakes in certain investments quietly. They also believe that a subtle intent of the amendment was to establish a monitoring mechanism on activist activities.

In response to such concerns, and as part of the Japanese government's efforts to mitigate the negative impacts in corporate governance practice and the M&A market in general, the amendment also includes an exemption from the prior notification process and preclosing requirement for passive investments, such as stock acquisitions made through portfolio investments by an asset manager and certain other safe harbors. However, it is clear that foreign activist investors will no longer be able to amass a voting interest equal to or greater than 1% while avoiding the scrutiny of the Japanese government.

The Ministry of Finance also explained that, in order to improve clarity as to whether a notification process is necessary for a given situation, it will categorize all listed companies into one of the following three groups:

- Companies subject to post-investment reporting only;
- Companies for which prior investment notification is required but exemption is applicable; or
- Companies for which prior investment notification is required and exemption is not applicable.

Requirements for the Exemption

In order to be eligible for exemption from the prior notification process and preclosing requirement, the following criteria must be met:

- Neither the investor nor a closely related person of the investor may become an officer or a member of the board of directors of the target company;
- The investor shall not propose to transfer or dispose of an important business unit of the target company at any annual general meeting; and
- The investor shall not have access to nonpublic information about the target company's technology that is important to national security.

The exemption is not available for (i) state-owned enterprises; (ii) companies that have previously violated relevant regulations of the act; or (iii) companies that are in the business of manufacturing weapons or producing/providing nuclear power, electricity or telecommunications services/technology.

Until the amendment is promulgated and further administrative proceedings take place, a degree of uncertainty will remain as to how the exemption applies to various situations. For example, how a shareholder proposal to elect an independent director would be treated remains unclear.

Relationship to CFIUS

While the amendment does not result in the Japanese government explicitly targeting a particular country or class/type of investor under the revised reporting rules, the change may enable closer monitoring of foreign inbound investments. This political move by the Japanese government is in line with a similar step taken by the United States through the enactment of the Foreign Investment Risk Review Modernization Act (FIRRMA), which strengthened the powers of the Committee on Foreign Investment in the United States (CFIUS) and allowed enhanced scrutiny of ownership in sensitive industries critical to national security by foreign investors. We believe that the primary purpose of the amendment is to prevent the transfer of technology from Japan to China and certain other countries — as Japan often aligns with U.S. policy in this area — and that the Japanese government seems unlikely to intervene in inbound investments from companies from the U.S., Europe or other close allies. According to the Ministry of Finance, the 1% threshold for advance screening will be the second lowest (after

the United States) among the G7 countries, and with respect to post-investment reform, the amendment still falls short of the regimes in the U.S., the U.K., Germany and Canada, all of which cover all business sectors and are not limited to those important to national interests.

Adopting a CFIUS-type regulatory regime regarding foreign investments may strengthen Japan's monitoring capability, safeguarding its national interests and preventing the leaking of information about critical technology. Additionally, it also may help support the argument that, by establishing robust regulatory measures that facilitate coordination with the U.S. on matters relating to investment security, Japan appears more likely to be recognized as an "excepted foreign state" under CFIUS, benefiting Japanese companies by narrowing the CFIUS process for investments in U.S. businesses. For this reason, the short-term incremental impact of the FEFTA amendment on the M&A market may actually be positive from an outbound M&A perspective.

Looking Ahead

While the potential impact of the FEFTA amendment may be significant for foreign activist investors and certain institutional investors, in particular Chinese state-backed institutions, we expect the overall impact on corporate governance and deal activity in Japan to be relatively limited. The amendment, according to the Ministry of Finance, does not impose direct restrictions on the FEFTA proposal rights of minority shareholders or their ability to engage with companies pursuant to the Companies Act, as long as such actions (or campaigns) do not relate to the amendment's objective, *i.e.*, protecting against the leakage or transfer of sensitive technology. A short-term dip in investments by foreign activists, whether in the form of passive investments or full-fledged campaigns, is possible, but the long-term impact of the amendment is likely to be mitigated as the Ministry of Finance provides detailed guidance in due course.

It is likely that the amendment primarily reflects the Japanese government's geopolitical motivations and is intended to be used as a tool to implement foreign policy, not to counter efforts the government recently has made to improve corporate governance practices and promote investments. The Japanese M&A market has grown significantly in the past few years, especially since 2012, when the Liberal Democratic Party under the leadership of Shinzo Abe implemented its new economic policy and pushed for corporate governance reform. In addition, the markets understand that Japan's opening to foreign investors has benefited the stock market, and the Japanese government is unlikely to reverse this direction and force foreign investors to leave the overseas investor-dependent market. The limited intent of the amendment is to put in place necessary safeguards so that critical technology and information are not transferred in a manner that is inconsistent with Japan's national interests.

A Look at 2019 Court Decisions That May Shape Restructuring Issues in the Year Ahead

A series of decisions over the past year — on issues such as make-whole premiums, intercreditor agreements, backstops for rights offerings and nonconsensual third-party releases — will likely have a significant impact in 2020 on parties involved in bankruptcy proceedings.

Fifth Circuit Reverses Course on the Enforceability of Make-Whole Premiums in Chapter 11

On November 26, 2019, the U.S. Court of Appeals for the Fifth Circuit withdrew an opinion it issued earlier in the year in which it signaled that make-whole (or prepayment) premiums owed to unsecured or undersecured creditors are, as a matter of law, disallowed under the Bankruptcy Code. In its newly issued opinion, *In re Ultra Petroleum Corp.*, the Fifth Circuit removed the discussion of this issue while leaving intact its previous holding that a claim is impaired under the Bankruptcy Code only if the Chapter 11 plan itself — as opposed to the Bankruptcy Code — alters a claimant's legal, equitable or contractual rights.

Background

The debtor in this case, Ultra Petroleum Corporation and its affiliates (Ultra), is an oil and gas exploration and production company that filed for Chapter 11 in 2016 after a precipitous decline in oil prices. As of the bankruptcy filing, Ultra owed $1.46 billion under a note purchase agreement and $999 million under a revolving credit facility (the holders thereof, Funded Debt Creditors).

During the pending bankruptcy, oil prices rebounded to such a degree that Ultra became solvent. Consequently, Ultra's plan purported to leave the Funded Debt Creditors unimpaired and thus unable to vote on its plan. Specifically, Ultra proposed to pay them the "outstanding principal owed on those obligations, pre-petition interest at a rate of 0.1%, and post-petition interest at the federal judgment rate." The Funded Debt Creditors objected, arguing that they were impaired because the plan did not provide for payment of the make-whole premium that was triggered by the bankruptcy filing and post-petition interest at the contractual default rate.

The bankruptcy court disagreed with Ultra that the Funded Debt Creditors were unimpaired. According to the court, to be unimpaired, they must be paid everything they are owed under state law, even if such payments are otherwise disallowed by the Bankruptcy Code. Ultra sought, and was granted, a direct appeal to the Fifth Circuit.

Fifth Circuit's Holding

The Fifth Circuit reversed the bankruptcy court, holding that disallowance of a claim due to the application of the Bankruptcy Code does not render such claim impaired. Relying on the Third Circuit's decision in *In re PPI Enterprises (U.S.)*, the Fifth Circuit observed that "'a creditor's claim outside of bankruptcy is not the relevant barometer for impairment,'" and held that the court must examine whether the plan itself limits a creditor's rights. The Fifth Circuit interpreted Section 1124(1) — which provides that a claim is unimpaired where the plan "leaves unaltered the [holder's] legal, equitable, and contractual rights" — to mean that the Chapter 11 plan, not the Bankruptcy Code, must do the altering in order for a claim to be impaired.

Because the bankruptcy court had not ruled on whether the Bankruptcy Code disallows the make-whole premium and default post-petition interest, the Fifth Circuit remanded these questions to the bankruptcy court to answer in the first instance.

Fifth Circuit Changes Its Thinking on Make-Whole Premiums

Notably, in the Fifth Circuit's initial opinion, without ruling on the issue, it strongly telegraphed that make-whole premiums are unenforceable under the Bankruptcy Code. In that opinion, the court observed that (i) make-whole premiums constitute unmatured interest, (ii) Bankruptcy Code Section 502(b)(2) should be construed to bar such interest and (iii) the debtor-solvent exception (which, if applicable, would require payment of a make-whole premium) likely did not exist. The Fifth Circuit's newly issued opinion removed the discussion relating to the first two observations, and with respect to the debtor-solvent exception, reversed course, noting that "[o]ur review of the record reveals no reason why the solvent-debtor exception could not apply."

Implications

While the Fifth Circuit removed the controversial portions from its initial decision, the newly issued *Ultra* opinion remains noteworthy because it is only the second court of appeals decision to explicitly adopt a plan-impairment approach to Bankruptcy Code Section 1124. As a creditor's ability to vote for or against a Chapter 11 plan depends on whether its claim is impaired, the *Ultra* decision provides critical guidance to parties involved in a Chapter 11 case. In the Fifth Circuit, a creditor will be unimpaired and therefore cannot vote on a Chapter 11 plan where a debtor pays, subject to the Bankruptcy Code's disallowance provision, all that is owed under state law. The lasting impact of the decision, however, remains to be seen, as the bankruptcy court must now answer whether the Bankruptcy Code disallows the make-whole premium and default post-petition interest.

"Fifth Circuit Reverses Course on the Enforceability of Make-Whole Premiums in Chapter 11" was adapted from an article authored by Lisa Laukitis and Cameron Fee in the June 2019 *ABI Journal*.

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Delaware District Court's Decision Highlights Potential Pitfall for Intercreditor Agreements

As the enforcement of intercreditor agreements (ICAs) between secured creditors plays an increasingly prominent role in bankruptcy cases, a recent ruling by the U.S. District Court for the District of Delaware suggests that the terms utilized in these agreements can have a significant impact on competing creditors' rights.

In September 2019, in *In re La Paloma Generating Company*, the U.S. District Court for the District of Delaware affirmed a Delaware bankruptcy court's interpretation and enforcement of an ICA. The case involved a dispute between a first-lien creditor and second-lien creditors over Chapter 11 plan distributions, which the collateral agent was holding in reserve to be distributed in accordance with the ICA. The ICA set forth the creditors' rights with respect to the "Collateral," which included substantially all of the debtors' assets.

The bankruptcy court granted the first-lien creditor's motion, finding that the ICA required the subject funds to be paid to the first-lien creditor. The bankruptcy court interpreted the ICA to require the second-lien creditors to return to the collateral agent any "Collateral or proceeds thereof" if four conditions were met: (i) the distribution is "Collateral or proceeds thereof"; (ii) the distribution is received "in connection with the exercise of any right or remedy" by the second-lien creditors; (iii) any such exercise of a right or remedy "relat[es] to the Collateral"; and (iv) the exercise of such right or remedy is in contravention of the ICA.

The district court affirmed the bankruptcy court's conclusion that all four elements of the turnover provision were satisfied. Notably, in analyzing the second element, the court found that the second-lien creditors' filing of a proof of a claim was an exercise of remedies, largely because the right to file a proof of claim was an action permitted in the exercise-of-remedies section of the ICA. (Interestingly, the bankruptcy court distinguished a prior Delaware case, *In re Energy Future Holdings, et al.*, which concluded that filing a proof of claim was not an exercise of remedies because, unlike the *La Paloma* ICA, the exercise-of-remedies section of that ICA did not include a safe harbor permitting the junior creditors to file a proof of claim.) Once the bankruptcy court determined that the elements of the turnover provision were satisfied, it applied the ICA's waterfall provisions and concluded that the first-lien lender should be paid in full prior to the second-lien creditors receiving a distribution.

The *La Paloma* decision is noteworthy in two respects: First, the district court affirmed that the junior creditors' filing of a proof of claim against the debtors, an action permitted under the ICA, constituted an "exercise of remedies" with respect to "Collateral." Second, the court affirmed, at least on the facts before it, that the lien subordination and turnover provisions provided for the "functional equivalent" of claim subordination. In short, the second-lien lenders' recoveries on account of their proof of claim were subject to the ICA's turnover provisions.

The district court further agreed with the first-lien lender that, having found that the plan distribution in question constituted proceeds of "Collateral," the distinction between claim and lien subordination was "nothing more than semantics." Specifically, the lien subordination and turnover provisions in the ICA were the "functional equivalent" of claim subordination given the bankruptcy court's finding that all remaining distributable assets constituted Collateral.

As the *La Paloma* decision makes clear, however, the terms used in ICAs can have a significant impact on a creditor's rights. Parties should carefully examine their ICAs with counsel, including to determine whether seemingly ordinary actions, such as filing a proof of claim, may be considered an "exercise of remedies" and therefore implicate turnover provisions of the ICA. The *La Paloma* decision is currently being appealed to the U.S. Court of Appeals for the Third Circuit, but the language of the current opinion could prove beneficial to first-lien creditors in future disputes and serves as a reminder to secured creditors to carefully review and understand their ICAs.

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Backstop Agreements Remain Common Source of Contention in Large Corporate Bankruptcies

In recent years, backstop agreements for rights offerings have emerged as an area of dispute in a number of large bankruptcy cases, and the trend appears likely to continue in 2020 and beyond.

A rights offering is a vehicle that allows debtors to raise money by offering debt or equity securities for sale, usually for a discounted price. Backstop agreements almost always accompany rights offerings in large bankruptcy cases. The creditors who agree to a backstop commit to purchase any remaining securities if the rights offering is undersubscribed. This ensures the debtor raises a specific amount of money. In exchange for this backstop commitment, the purchaser is paid a premium, usually in cash or additional securities.

In recent years, backstops have been attacked for allowing some creditors to receive higher recoveries than others with the same priority claims (in some cases even resulting in different recoveries for different holders of the same bonds). Objectors have tried to argue, among other things, that this disparate treatment violates the equal treatment requirements of Section 1123(a)(4) of the Bankruptcy Code.

Courts generally have taken a dim view of these objections. As long as the consideration received is for "new value" (*i.e.*, the backstop commitment), courts have repeatedly rejected the argument that a backstop premium paid to certain creditors violates the Bankruptcy Code. This was the approach in several large bankruptcies in recent years, including CHC Group, SunEdison and BreitBurn Energy Partners.

In August 2019, the U.S. Court of Appeals for the Eighth Circuit issued the strongest decision yet in support of paying a premium to existing creditors in exchange for a backstop commitment. In *In re Peabody Energy Corp.*, a group of creditors received significant consideration to backstop a $750 million rights offering and a $750 million private placement. Another group of creditors objected, arguing the lucrative backstop consideration for some creditors and not others resulted in unequal treatment. The Eighth Circuit soundly rejected this argument. Focusing on the high degree of volatility in coal prices, the Eighth Circuit agreed with both the bankruptcy court and the district court that (i) a backstop was necessary to ensure the debtors raised enough capital to fund their exit from bankruptcy and (ii) the consideration received by backstopping creditors was on account of the valuable backstop commitment and not the creditors' claims.

While the Eighth Circuit decision is likely a boon for creditors looking to improve their recoveries by participating in a backstop, a much less-noticed bench ruling by Judge Michael Wiles of the U.S. Bankruptcy Court for the Southern District of New York could provide a roadmap for those looking to successfully object to backstop agreements in the future. In *In re Pacific Drilling S.A.*, decided at the end of 2018, Judge Wiles approved a backstop agreement, but he did so with "a great deal of misgivings" and laid out a lengthy and articulate critique of backstop premiums. While Judge Wiles' ruling deserves to be read in full, a key takeaway is that debtors need to carefully explore all opportunities to raise capital and submit convincing evidence that a backstop commitment is (i) necessary, (ii) the best available alternative, and (iii) consistent with precedent transactions (both in and out of bankruptcy).

In a world flush with cash and with limited distressed investment opportunities, creditors will continue to push for aggressive and lucrative backstop agreements as a way to improve their recoveries. In that environment, even with the favorable ruling from the Eighth Circuit in the *Peabody* case, expect continued attacks on these lucrative arrangements, and don't be surprised if Judge Wiles' reasoning is used in support of future objections.

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Nonconsensual Third-Party Releases Remain an Option in the Third Circuit

In December 2019, the U.S. Court of Appeals for the Third Circuit issued its long-awaited decision in *In re Millennium Lab Holdings II, LLC*, affirming Delaware district court and bankruptcy court rulings that approved a Chapter 11 plan with nonconsensual third-party releases, which had been challenged at the confirmation hearing. The ruling should provide parties litigating bankruptcy plan confirmations in the Third Circuit confidence regarding the availability of nonconsensual releases.

The contested plan provisions in *Millennium* released claims against the debtors' former shareholders, who had received a $1.3 billion special dividend from the debtors approximately 18 months prior to the commencement of the bankruptcy proceedings. The released shareholders contributed $325 million to fund the debtors' Chapter 11 plan. The funds were utilized, in part, to pay for the debtors' $256 million settlement with several governmental agencies that were investigating the debtors and had threatened to revoke Medicare billing privileges that were essential to their business. A detailed evidentiary record established that the debtors could not afford to make the settlement payment without the shareholders' contribution and that, absent the government settlement, "liquidation, not reorganization, would have been Millennium's sole option."

The primary legal issue before the Third Circuit was whether the bankruptcy court, as a non-Article III court operating as a unit of the federal district court, had the requisite constitutional authority to confirm a Chapter 11 plan containing nonconsensual third-party releases and injunctions. Analyzing U.S. Supreme Court precedent, including the 2011 decision in *Stern v. Marshal*, the Third Circuit held that on "the specific exceptional facts of [the case,] the Bankruptcy Court was permitted to confirm the plan because the existence of the releases and injunctions was 'integral to the restructuring of the debtor-creditor relationship.'" The phrase "integral to the restructuring of the debtor-creditor relationship" appears likely to remain a critical focus, in the Third Circuit and beyond, of future decisions analyzing the boundaries of a bankruptcy court's authority under the Constitution.

In addition to establishing that the bankruptcy court has the authority necessary to approve these types of Chapter 11 plans, the *Millennium* decision also confirms that nonconsensual third-party releases are, indeed, acceptable to courts and available to debtors in the Third Circuit under appropriate circumstances. While the majority view in the Third Circuit has supported the availability of nonconsensual third-party releases ever since the court's seminal decision in *In re Continental Airlines, Inc.* in 2000, some litigants (and at least one lower court in the Third Circuit) have argued that *Continental* left the question unanswered.

In *Millennium*, the Third Circuit discusses *Continental* and another of its past rulings implicating plan injunctions, its 2011 decision in *In re Global Industrial Technologies, Inc.*, in a manner that should leave no doubt about the current state of Third Circuit law. The court's decision confirms that nonconsensual third-party releases remain a potential option. Distressed companies and their management teams, shareholders, lenders and other key stakeholders involved in complex restructuring efforts should be confident that bankruptcy courts in the Third Circuit, including the District of Delaware, offer the full array of tools and options often required to achieve and implement a truly global restructuring.

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Restructuring Market Trends

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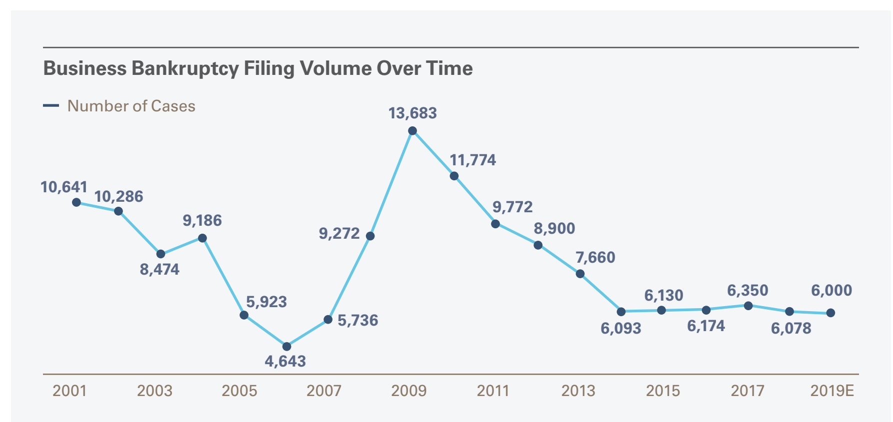
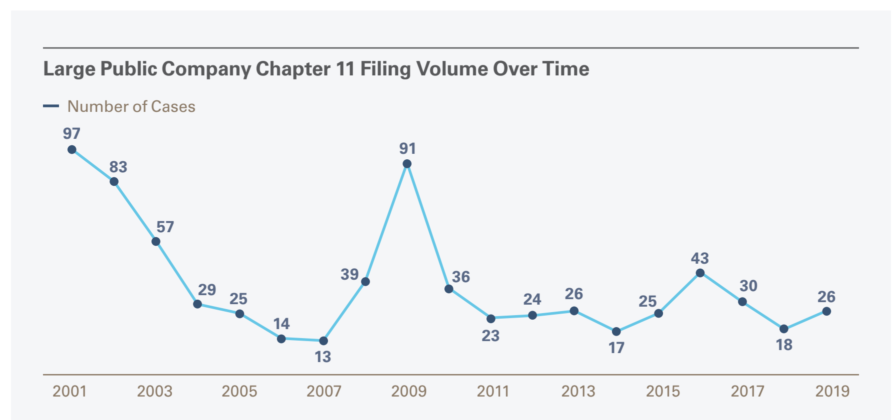
The number of corporate Chapter 11 filings in the United States remained relatively low in 2019. An estimated 6,000 business bankruptcies were filed (based on the data available at the time of writing), which, if it holds up as the data is finalized, is essentially flat from 2018 and down 56% from the peak reached in 2009, following the Great Recession. The chart immediately below depicts corporate Chapter 11 filing volume over time.



Based on statistics compiled by the Administrative Office of the United States Courts.

Large public company Chapter 11 filings (*i.e.*, public companies with assets greater than $300 million) follow similar trends. Only 26 large public companies filed for Chapter 11 in 2019, up from 18 filings in 2018, but well below the more than 90 filings of large companies in 2001 and 2009. The chart immediately below shows the volume of large public company Chapter 11 cases over time.



Data derived from the UCLA-LoPucki Bankruptcy Research Database.

Companies from the energy (primarily oil and gas), retail and health care industries have accounted for nearly half the Chapter 11 cases filed annually since 2016. While each of these sectors has benefited in recent years from a strong U.S. economy, they remain a focus of restructuring activity and are particularly vulnerable as economic growth slows. Unsurprisingly, most of the year's high-profile filings are in these industries.

2020 Outlook

After years of record growth, the U.S. economy appears to be cooling, and some economists believe a recession is looming. The U.S. Bureau of Economic Analysis estimates that U.S. economic growth slowed to 2.1% in Q3 2019. (Q4 2019 results have not been released at the time of writing.) The slowdown is attributable to several factors, including the escalating trade war between the United States and China, the uncertainty associated with Britain's exit from the European Union and fluctuating energy prices. Should a slowdown in the U.S. economy occur, the level of Chapter 11 filings may increase.

The government has made efforts to combat the weak economic growth by lowering interest rates. The federal funds rate was lowered to 1.75% in October 2019 after starting the year at 2.5%, and last month the Federal Reserve indicated that it intends to hold rates steady with no action likely in 2020 amid low inflation. Low interest rates mean that many distressed companies will be able to obtain financing on favorable terms, potentially permitting them to avoid comprehensive restructurings. Nonetheless, signs exist that the next cycle of financial restructurings may be approaching.

The United States' record-high corporate debt levels have been news for several years now, yet the amount of corporate debt only continues to rise. Large companies in the U.S. owe approximately $10 trillion in corporate debt, which is 47% of the country's GDP (the highest ratio of corporate debt to GDP in U.S. history). This represents a rise of 52% from its last peak in 2008, when corporate debt was at $6.6 trillion, approximately 44% of GDP. Approximately $5 trillion of this corporate debt will become due in the next five years. Even though many companies have taken advantage of low interest rates to refinance their debt, this amount of leverage poses a potential challenge if the economy weakens. Corporate debt as a percentage of GDP, a closely watched measure for distress, has risen sharply before each of the last three economic downturns.

Another possible sign of future financial distress is the trend in recent years toward weakened borrower covenants in debt securities and instruments. Historically, financial covenants have provided lenders with early warning signs of a borrower's distress, enabling them to engage in restructuring negotiations with the borrower before its business deteriorates. Covenant quality improved slightly in Q1 2019 but remained weak overall, with a rating of 3.9 out of 5, where 1 means covenants are extremely strong (in favor of lenders), and 5 means they are extremely weak (in favor of borrowers). While companies have been successful in negotiating "covenant-lite" borrowing terms from investors, the prevalence of "cov-lite" loans and non-investment grade bonds may reflect that lenders are under-pricing risk, which could result in a wave of borrower defaults without advance covenant breaches when economic conditions change. If these trends continue, an uptick in restructuring activity in the coming year is possible.

New Trends Emerge for 'Consensual' Third-Party Releases in the Southern District of New York and District of Delaware

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A survey of recent rulings by judges from the bankruptcy courts for the Southern District of New York and the District of Delaware suggests that judges in these districts have very different views about the nature and extent of "consensual" third-party releases that may be approved in a given case. The data also indicates that their thinking on this issue continues to evolve as they confront new arguments.

The Bankruptcy Code allows a debtor to obtain a discharge of its debts upon confirmation of a Chapter 11 plan. The discharge does not affect the liabilities of third parties; however, Chapter 11 plans often contain releases for these third parties. Third-party release provisions, which are typically limited to claims related to the debtor, its business and/or the restructuring, are important currency and negotiating tools in Chapter 11 cases ensuring participation by other parties necessary for carrying out the plan.

The nondebtor parties involved in a restructuring want comfort that other third parties cannot bring certain claims against them. For example, debtor-in-possession and exit lenders typically insist upon third-party releases under a plan of reorganization. Similarly, officers, directors, creditors and other parties that provide a substantial contribution to a debtor's restructuring often seek third-party releases in exchange for those contributions. Third-party releases also apply to related parties of releasees, such as affiliates, subsidiaries, officers, directors, attorneys, advisers and representatives.

Chapter 11 plans containing third-party releases were routinely approved in the past with little or no scrutiny unless challenged by an economic stakeholder in the case. More recently, however, the bankruptcy courts for the Southern District of New York and the District of Delaware have taken a closer look at such provisions. In general, these courts agree that third-party releases are binding to the extent that the creditors have consented to the releases (by, for example, voting to accept a plan including its releases or affirmatively opting to grant such releases). Accordingly, much of the debate has centered around what constitutes "consent" for purposes of granting third-party releases.

Recent decisions indicate that the judges in these districts have differing views on what constitutes "consent." On the one hand, several judges have ruled that creditors or equity holders have consented to third-party releases if they do not "opt out." In these instances, a creditor or equity holder typically receives a ballot, or a notice of nonvoting status in lieu of a ballot, which provides the opportunity to opt out. Those who do not check an opt-out election box and return the ballot or notice are considered to have granted consent for a third-party release. These judges reason that clear and conspicuous directions on the solicitation materials about how to opt out and the consequences of not doing so indicate that parties that do not take these steps have manifested their consent to the release. These judges also have looked at other factors when considering whether the releases are "consensual," such as the importance of the releases to the restructuring; stakeholder support for the plan and the absence of objections; support by major parties in interest, including the official committee of unsecured creditors; the level of sophistication of the affected parties (*e.g.*, whether they are institutional investors or general unsecured creditors); and how much the affected creditors were receiving under the plan.

On the other hand, some judges require stakeholders to affirmatively "opt in" to the third-party releases. These judges reason that inaction cannot be a sufficient manifestation of consent, especially since many creditors and equity holders receive little or no recoveries under the plan and may not appreciate that bankruptcy papers from a debtor could result in their release of claims against third parties.

The following table provides an overview of how each judge has addressed the issue of what constitutes consent to a third-party release, to the extent that the judge has issued a ruling, whether published or orally from the bench. Some judges have indicated that what they may have approved in the past may no longer be justified in this constantly changing area of the law. In addition, most judges state that their rulings depend on the facts and circumstances of a particular case. Therefore, the characterizations set forth herein only provide general guidance on how a particular judge might rule when asked to approve third-party releases as consensual. (Notably, the table does not include orders approving third-party releases these judges may have entered without litigation or discussion of the issue because these provide less guidance on how a particular judge views consensual third-party releases.)

The table suggests that as judges take a fresh look at third-party releases, there will be a lack of certainty for parties regarding this key issue.

Former associate Bryan Kotliar contributed to this article.

Creditors[1] Deemed To 'Consent' to the Third-Party Release					
Judge	**Creditors Not Entitled To Vote**		**Creditors Entitled To Vote**		
SDNY	**Unimpaired** (Deemed To Accept)	**Impaired** (Deemed To Reject)	**Vote To Accept**	**Abstain**	**Vote To Reject**
Judge Michael Wiles	No These parties' rights cannot be affected by the plan (*Chassix*)	Yes, if creditor checked the box to opt in to the release (*Chassix*)	Yes Voting to accept is deemed consent (*Chassix*)	Yes, if voter checked the box to opt in to the release (*Chassix*)	Yes, if voter checked the box to opt in to the release (*Chassix*)
Judge Sean Lane[2]	Yes, if creditor checked the box to opt in to the release (*Trident*)	Yes, if creditor checked the box to opt in to the release (*Trident*; *Aeropostale*)	Yes Voting to accept is deemed consent (*Trident*)	Yes, if voter checked the box to opt in to the release (*Trident*)	Yes, if voter checked the box to opt in to the release (*Trident*)
Judge Stuart Bernstein	N/A[3] Rulings indicate would likely require an opt in (*SunEdison*)	N/A Rulings indicate would likely require an opt in (*SunEdison*)	Yes Voting to accept is deemed consent (*SunEdison*)	Yes, if voter checked the box to opt in to the release (*SunEdison*)	N/A
Judge James Garrity	N/A	N/A	Yes Voting to accept is deemed consent (*Ditech*)	Yes, if voter failed to check the box to opt out of the release (*Ditech*)	Yes, if voter failed to check the box to opt out of the release (*Ditech*)

[1] For purposes of this chart, references to creditors also include holders of equity interests.

[2] After previously approving some Chapter 11 plans that provided for an opt-out mechanism, Judge Lane subsequently reversed course and recently indicated that he requires a greater manifestation of consent than that provided by an opt-out.

[3] "N/A" indicates that the judge has not ruled on this issue.

Creditors[1] Deemed To 'Consent' to the Third-Party Release					
Judge	**Creditors Not Entitled To Vote**		**Creditors Entitled To Vote**		
SDNY	**Unimpaired** (Deemed To Accept)	**Impaired** (Deemed To Reject)	**Vote To Accept**	**Abstain**	**Vote To Reject**
Judge Robert Drain	Yes, if creditor failed to check the box to opt out of the release, although some rulings suggest unimpaired creditors cannot have their rights affected (*Deluxe*; *Cenveo*)	Yes, if creditor failed to check the box to opt out of the release (*Tops*)	Yes Voting to accept is deemed consent (*Tops*)	Yes, if voter failed to check the box to opt out of the release (*Tops*)	Yes, if voter failed to check the box to opt out of the release (*Tops*)
Judge Shelley Chapman	Yes, if creditor failed to check the box to opt out of the release (*Cumulus*; *Nine West*)	Yes, if creditor failed to check the box to opt out of the release (*Cumulus*; *Nine West*)	Yes Voting to accept is deemed consent (*Stearns*; *Cumulus*; *Nine West*)	Yes, if voter failed to check the box to opt out of the release (*Stearns*; *Cumulus*; *Nine West*)	Yes, if voter failed to check the box to opt out of the release (*Stearns*; *Cumulus*; *Nine West*)
Delaware	**Unimpaired** (Deemed To Accept)	**Impaired** (Deemed To Reject)	**Vote To Accept**	**Abstain**	**Vote To Reject**
Judge Christopher Sontchi[4]	Yes, if creditor does not object (*Gibson*; *True Religion*)	Yes, if creditor failed to check the box to opt out of the release (*Molycorp*)	Yes Voting to accept is deemed consent (*Molycorp*; *Gibson*; *True Religion*)	Yes, if voter does not object (*Gibson*; *True Religion*)	Yes, if voter failed to check the box to opt out of the release (*Molycorp*; *Gibson*; *True Religion*)
Judge Brendan Shannon	Yes (*Indianapolis Downs*; *Remington*)	N/A[5]	Yes Voting to accept is deemed consent (*Indianapolis Downs*; *Remington*)	Yes, if voter failed to check the box to opt out of the release (*Indianapolis Downs*; *Remington*)	Yes, if voter failed to check the box to opt out of the release (*Indianapolis Downs*; *Remington*)
Judge Mary Walrath[6]	Yes, if creditor does not object (*Southeastern Grocers*)	No Did not consider opt in (*Washington Mutual*)[7]	Yes, if voter failed to check the box to opt out of the release (*Washington Mutual*)	No (*Washington Mutual*)	No (*Washington Mutual*)

[4] In *Molycorp*, Judge Sontchi broadly approved the use of an opt-out mechanism for all voting and non-voting parties. Subsequently, in *Gibson* and *True Religion*, the judge clarified his position with respect to creditors that are unimpaired and deemed to accept the plan or receive a ballot and abstain from voting. For both of these creditors, Judge Sontchi has said that no opt-out mechanism is necessary, and it is a consensual third-party release if they are provided notice and do not object.

[5] To date, Judge Shannon has not considered whether an opt-in or opt-out mechanism for parties deemed to reject would be sufficient. In all of the cases with rulings on the release issue, the plans did not attempt to release claims of parties deemed to reject.

[6] Judge Walrath's decision in *Washington Mutual* is often cited to say that parties that abstain from voting cannot be deemed to consent to the third-party release. In *Southeastern Grocers*, Judge Walrath appears to have clarified this position by permitting a consensual third-party release by parties that receive notice and an opportunity to object to the plan and fail to do so. In that case, the parties were unimpaired creditors that were deemed to accept the plan; Judge Walrath has not considered this construct for unimpaired, deemed-to-reject creditors after *Washington Mutual*.

[7] To date, Judge Walrath has not considered whether an opt-in mechanism for deemed-to-accept or deemed-to-reject parties would be sufficient.

Creditors[1] Deemed To 'Consent' to the Third-Party Release					
Judge	**Creditors Not Entitled To Vote**		**Creditors Entitled To Vote**		
Delaware	**Unimpaired** (Deemed To Accept)	**Impaired** (Deemed To Reject)	**Vote To Accept**	**Abstain**	**Vote To Reject**
Judge Kevin Gross[8]	Yes, if creditor does not object (*Orchard Acquisition*)	Yes, if creditor checked the box to opt in to the release (*Cloud Peak*)	Yes (*Orchard Acquisition*)	Yes, if voter failed to check the box to opt out of the release (*Orchard Acquisition*)	Yes, if voter failed to check the box to opt out of the release (*Orchard Acquisition*)
Judge Karen Owens	N/A	Ruling indicates would likely require an opt in (*Emerge Energy*)	N/A	Ruling indicates would likely require an opt in (*Emerge Energy*)	N/A
Judge Laurie Silverstein	Yes, if creditor does not object (*Millennium Health*)	N/A	N/A	N/A	N/A

To date, SDNY Judges Martin Glenn, Cecelia Morris and Mary Kay Vyskocil and Delaware Judge John Dorsey have not ruled on this issue.

[8] In *Orchard Acquisition*, Judge Gross said that his thinking on consensual third-party releases had "evolved" since his prior orders confirming plans with these provisions but nevertheless approved the proposed third-party release in that case as consensual. To date, Judge Gross has not considered whether an opt-in or opt-out mechanism would suffice for deemed-to-accept or deemed-to-reject parties.

Valuation Challenges for Fintechs Highlight Legal Considerations in 'Down Rounds'

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In recent years, fintech has been an attractive sector for growth capital, as evidenced by robust investment and M&A valuations in the sector. While interest remained high in 2019, deal volumes began to level off early in the year, followed by a second-half decline. Investor enthusiasm also has moderated within the tech space more generally, and the valuations of some tech "unicorns" have fallen. Companies and their investors are now considering the possibility that new equity might need to be raised at valuations below the company valuations used in prior financing rounds, potentially resulting in the dilution of early round investors — a so-called "down round." Companies and investors, new and old, should consider a number of issues in light of a possible or approaching down round.

Existing Holders and Dilution

Early stage fintech companies generally have two types of underlying equity interests: common and preferred stock. Management and employees generally hold common stock (either directly or in the form of options or restricted stock units), which has economic and voting rights but rarely other protections for their holders. Outside investors generally hold preferred stock, which typically entitles the holder to a preferred liquidation preference right, along with various prenegotiated rights and protections not afforded to holders of common stock (some of which are discussed below). Preferred stock is often convertible at a rate, based on a predetermined formula, into common stock, giving holders of preferred stock the opportunity to participate in future growth of the company along with holders of common stock.

Preferred shareholders may also benefit from other governance and/or consent rights that might restrict a company's ability to raise new equity funding, including if a company does not have sufficient authorized stock to issue preferred stock or to reserve additional common stock for issuance upon conversion of newly issued preferred stock. While discussion of these rights is outside the scope of this article, it is important for boards and investors to understand them and how they impact the relative bargaining power of different stakeholders in connection with a possible new financing round.

Anti-Dilution Protections

Anti-dilution protections have the effect of increasing the conversion rate for shares, thus entitling the holder to obtain a greater percentage of the company for the same underlying conversion price. (These protections are, of course, waivable, and companies and their existing investors may see new investors demand such waivers where a company has a critical need for immediate new capital.) Often, preferred shares have an anti-dilution right that automatically adjusts their exchange ratio upon a subsequent equity financing at a valuation below the level at which the preferred shares were issued. Unless waived, anti-dilution rights of preferred holders further compound the dilution of common holders, who generally have no similar right, in a down round. This anti-dilution adjustment usually occurs on either a "full-ratchet" or "weighted average" basis, with the latter

being more typical and the former being more advantageous for implicated holders of preferred shares.

Full-ratchet. The conversion rate of the preferred shares is adjusted such that they become convertible into an amount of common stock equal to the price per share in the prior investment divided by the price per share in the down round.

Weighted-average. The conversion rate of the preferred shares is adjusted based on the weighted average of the current and prior financing and related per-share prices and down-round conversion rate. The larger the investment size and the lower the associated per-share price in the down round, the larger the adjustment. This adjustment of the preferred conversion ratio also takes into account the existing common shares (including options and warrants).

In both examples above, holders of common stock do not receive a protective adjustment and are more heavily diluted than they would be if no anti-dilution adjustment protections existed.

Employee Alternatives

Because the equity interests held by management and company employees often do not enjoy the same anti-dilution and other protections as preferred shareholders, equity interests held by management and company employees may be greatly diminished in value, or underwater in the case of options, following a down round. To align these individuals' incentives with investors, promote retention and improve morale, the boards of companies undergoing a new investment round should consider adjustments to options and other incentives. Typical adjustments and incentives include (i) granting additional equity awards that reflect post-down-round valuation, (ii) exchanging or repricing underwater options for new at-the-money options and (iii) creating or increasing an employee cash bonus pool.

Other Considerations

A direct investment in exchange for equity in a company must be approved by the company's board. The transaction and the associated board approval may be challenged by shareholders on various grounds, the most common of which is that the company's directors did not fulfill their fiduciary duties when they approved the transaction. Due to the large dilutive effect on shares in a down round, shareholders are more likely to challenge a down round and prior rounds that included anti-dilution protections. While most board decisions regarding equity raises will be subject to the business judgment rule, down rounds involving existing members of management, directors or investors may be challengeable under less deferential entire fairness review. Therefore, companies and their advisers must consider potential conflicts of interest before negotiating the terms of a down round with new investors and, if necessary, should implement procedural safeguards (including those that have been applied in Delaware as the "*MFW* standard") in order to ensure that board decisions will continue to be reviewed under the business judgment rule notwithstanding potential conflicts of interest.

A company also may consider retaining a financial advisor to perform a valuation analysis and provide an opinion to the board about the fairness of the consideration received in the down round. State laws generally allow directors to rely in good faith on information, opinions, reports and statements presented by an outside financial or legal adviser on matters that the directors reasonably believe are within such person's professional or expert competence, so long as the adviser has been selected with reasonable care.

The board should thoroughly document all steps taken in connection with the transaction. Evidence of meetings, considerations and the process can help establish that the board fulfilled its fiduciary duties and will also be an important source material for disclosure to shareholders if any portion of the down-round transaction is subject to stockholder approval.

Conclusion

Because the need for additional capital and a resulting down round may be urgent, companies and investors should become well-versed in common issues that arise in such circumstances. It is essential to understand the rights parties have under existing agreements, so that potential financing options can be quickly and clearly outlined and implemented when needed.

Litigation / Controversy

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2019-20 Supreme Court Update

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The U.S. Supreme Court's 2019-20 term is receiving substantial attention for cases involving signature initiatives of President Donald Trump's administration. But the Court also maintains an extensive docket directly relevant to the business community, including important disputes concerning workplace discrimination, challenges to agency enforcement, copyright law and stock-drop litigation.

Discrimination in the Workplace

In one of the most anticipated decisions this term, the Supreme Court will decide whether discriminating against an individual for being gay, lesbian, bisexual or transgender violates Title VII of the Civil Rights Act, which prohibits discrimination "because of sex."

Counsel for gay, lesbian and bisexual employees argue that, as the *en banc* U.S. Court of Appeals for the Second Circuit held in *Zarda v. Altitude Express*, firing someone for being attracted to a person of the same sex is a decision motivated, at least in part, by sex. By contrast, in *Bostock v. Clayton County, Georgia*, the U.S. Court of Appeals for Eleventh Circuit adopted the employers' position that Congress did not intend to include sexual orientation within the meaning of "sex" when it passed the Civil Rights Act in 1964. The U.S. Court of Appeals for the Sixth Circuit grappled with the statute's application to transgender employees in *EEOC v. R.G. & G.R. Harris Funeral Homes*, finding in favor of the employee.

Based on oral arguments, which took place on October 8, 2019, the cases remain too close to call. The Court's decision could materially affect employers in states that do not already outlaw workplace discrimination based on LGBTQ status.

Challenges to Agency Enforcement: Separation of Powers

Following the 2008 financial crisis, Congress established the Consumer Financial Protection Bureau (CFPB) to regulate consumer financial products and services, and structured it as an "independent bureau" headed by a single director, who can be removed by the president only for cause. In *Seila Law LLC v. CFPB*, the Supreme Court will consider whether this structure violates the separation of powers, and, if so, whether the statutory provision limiting the president's removal power can be severed without invalidating the provisions establishing the CFPB.

The petitioner, a California law firm that provides "debt-relief services," received a civil investigative demand from the CFPB requesting documents about its business structure and practices. It asked the CFPB to set aside the demand because a panel of the U.S. Court of Appeals for the District of Columbia Circuit had held (in an opinion authored by then-Judge Brett Kavanaugh) that the CFPB's structure was an unconstitutional impediment to the president's power. The *en banc* D.C. Circuit ultimately reversed the panel's holding, concluding — as later did the U.S. Court of Appeals for the Ninth Circuit in the instant case — that the CFPB's structure did not violate the separation of powers.

Both the petitioner and the Trump administration argued that the Supreme Court should grant *certiorari* and that the CFPB's structure (established by statute during the Obama administration) is unconstitutional — they disagree only on the severability question. This unusual alignment prompted the Court to appoint counsel to defend the Ninth Circuit's judgment.

Whether the CFPB's structure violates the separation of powers likely will depend on the Court's willingness to distinguish a single-director independent agency from independent agencies headed by tenure-protected boards or multimember commissions (for example, the Securities and Exchange Commission or the Federal Trade Commission), whose constitutionality has appeared settled since the New Deal. As for severability, the Court will analyze whether Congress expressed a preference for a CFPB with a director who is removable at will over no CFPB at all. Oral argument is scheduled for March 3, 2020.

Securities Law: Disgorgement

The SEC may seek only three types of remedies in civil actions to enforce federal securities laws: injunctive relief, equitable relief and civil monetary penalties. For decades, courts have accepted the SEC's authority to seek disgorgement of ill-gotten gains as a form of "equitable relief." That authority came into question in 2017 when the Supreme Court unanimously held in *Kokesh v. SEC* that disgorgement claims are subject to a five-year statute of limitations because disgorgement represents a penalty, not a remedial sanction. The Court explicitly declined to decide whether the SEC may seek disgorgement in enforcement actions at all. The question is now before the Court in *Liu v. SEC*. (See "SEC Enters Election Year Focused on Key Initiatives.")

Petitioners contend that the SEC lacks authority to seek disgorgement because, unlike equitable relief, which aims to restore the status quo and compensate victims, disgorgement seeks to punish violators and deter future violations. The SEC argues, among other things, that disgorgement can qualify as an equitable remedy even though it also might be considered a penalty in some contexts.

The Supreme Court's decision could significantly limit the funds the SEC may seek in future enforcement actions and affect its position in settlement negotiations. Oral argument is scheduled for March 3, 2020.

Copyright Law

Java is one of the world's most popular programming languages. To aid developers in creating programs, Java released a library of shortcuts to implement functions with fewer lines of code. Google wanted to tap into developers' familiarity with Java's shortcuts when it created its mobile platform and included some of those shortcuts in its new implementing code. This term, the Court will consider whether shortcuts that function to access other lines of code are copyrightable and, if so, whether Google's actions qualified as fair use. In two opinions, the U.S. Court of Appeals for the Federal Circuit decided against Google, holding that the shortcuts were subject to copyright law and that the fair use doctrine did not apply.

The Court's decision could have broad implications for the software industry. Java's shortcuts are part of an application-program interface that allow for the interoperability of programs across multiple platforms, and, as *amicus* Red Hat, Inc. contends, "[v]irtually all software and consumer product developers depend on interoperability." Indeed, *amici* R Street Institute and Public Knowledge contend that "nearly every technical standard in use" for the interoperation of programs across platforms "includes one or more software interfaces that must be implemented in the same way that Google implemented the Java interface in the present case." Therefore, the Court's resolution of the software copyright issues will be of interest to the broader business community. Oral argument remains to be scheduled.

International Arbitration

In *GE Energy Power Conversion France SAS v. Outokumpu Stainless USA LLC*, the Supreme Court will consider whether a party can compel arbitration by enforcing an arbitration agreement it did not sign. In this case, an arbitration agreement existed between a buyer (Outokumpu) and a seller. When the buyer sued the seller's subcontractor (GE Energy), the subcontractor moved to compel arbitration under the arbitration agreement.

Extensive case law, rooted in contract principles, addresses the enforcement of agreements by and against nonsignatories. Some of that case law involves the doctrine of equitable estoppel, which prevents parties from relying on contractual terms as the basis for a suit while simultaneously denying the applicability of other terms in the same contract. The Supreme Court has applied this doctrine to domestic arbitration agreements under the Federal Arbitration Act (FAA). Here, the question is whether the doctrine also applies to international arbitration agreements under the New York Convention, even though the convention, unlike the FAA, defines agreements as those "signed by the parties."

Outokumpu argued that, under a plain reading of the New York Convention, GE Energy could not compel arbitration because it did not sign the arbitration agreement. The Eleventh Circuit agreed. GE Energy sought the Supreme Court's review, arguing that, because equitable estoppel does not conflict with the terms of the convention, the doctrine should apply to international arbitration agreements.

The Court's decision should be closely watched by businesses engaged in cross-border commercial transactions in which nonsignatories affect performance of a contract. Oral argument is scheduled for January 21, 2020.

ERISA Stock-Drop Suits

The interaction between the federal securities laws and the Employee Retirement Income Security Act of 1974 (ERISA) will remain an open question — at least this term. In *Fifth Third Bancorp v. Dudenhoffer*, the Supreme Court held that, in cases where plaintiffs allege that an employee stock ownership plan (ESOP) fiduciary violated ERISA for failing to disclose that the company's stock was overvalued, courts must determine whether a prudent fiduciary could not have concluded that disclosure would do more harm than good and that the disclosure would have been consistent with federal securities law.

In *Retirement Plans Committee of IBM v. Jander*, the Supreme Court was poised to consider whether the *Dudenhoffer* standard could be satisfied by plaintiffs' generalized allegations that disclosure of the artificial inflation is inevitable and that the earlier the disclosure, the less the harm. In a three-page *per curiam* opinion, however, the Court vacated the judgment and remanded the case to the Second Circuit because petitioners and the federal government had focused on the consistency between the securities laws and ERISA, arguments the Second Circuit never had the chance to address. (See "Securities Class Action Filings Continue Record Pace.") The Court, however, left open the possibility it may hear the case once the Second Circuit decides the issue. Some of the justices hinted at their views in short concurrences, with Justices Ruth Bader Ginsburg and Elena Kagan inclined toward the plaintiffs' position and Justice Neil Gorsuch toward the fiduciary's.

Administrative Law and Immigration

In another case of intense public interest, *Department of Homeland Security v. Regents of the University of California*, the Court will consider the fate of the Deferred Action for Childhood Arrivals (DACA) program. Established in 2012 by the Obama administration, DACA gives undocumented immigrants brought to the United States as children the opportunity to postpone deportation and receive work permits. The Trump administration rescinded the program in 2017, calling it "an unconstitutional exercise of authority by the Executive Branch." Litigation ensued, with plaintiffs arguing that DACA's rescission was arbitrary and violated the Administrative Procedure Act (APA).

The Trump administration contends that the rescission was adequately justified and that, in any event, the rescission is not reviewable by courts because it involves a matter "committed to agency discretion by law." Courts around the country weighed in, with most siding against the Trump administration. The Supreme Court is now poised to determine both the rescission's reviewability and its legality under the APA. Oral argument occurred on November 12, 2019. Justices Elena Kagan, Stephen Breyer, Ruth Bader Ginsburg and Sonia Sotomayor were critical of the government's justifications for winding down DACA. The other justices appeared more accepting of the government's rationale, although Chief Justice John Roberts and Justices Neil Gorsuch and Brett Kavanaugh each questioned whether the administration adequately explained the reliance interests involved.

Defense Preclusion in Serial Litigation

If a defendant raises a defense and chooses not to pursue it, is raising that same defense barred in a later proceeding between the same parties over a different claim? In August 2018, the Second Circuit held that district courts have the discretion to bar the defense in appropriate circumstances — a decision in tension with those of the Ninth, Eleventh and Federal Circuits.

In *Lucky Brand Dungarees v. Marcel Fashion Group*, the Supreme Court will take up the principles of claim and issue preclusion for defendants in serial litigation with another party — not an uncommon occurrence, particularly in the intellectual property space. As a leading treatise notes, lower courts "have had difficulty in articulating the rules of defendant preclusion," reflecting "deeper problems in defining the proper scope of preclusion." At oral argument on January 13, 2020, several Justices questioned whether the Court's precedent sent conflicting signals on this issue.

Securities Class Action Filings Continue Record Pace

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Several securities litigation trends over recent years show no signs of abating in 2020. Federal securities class action filings seem likely to remain at elevated levels. Last year, for the third consecutive year, more than 400 securities class actions were filed in federal court. Given the high volume of filings and the fact that the number of publicly listed companies has decreased by nearly two-thirds since 2000, the chance of a public company being named in a securities class action has grown exponentially.

Although filings in 2019 reflected a moderate drop in the number of federal merger objection suits, this decline was offset by an increase in more traditional class action cases — *i.e.*, those seeking relief under Section 10(b) of the Securities Exchange Act of 1934 or Section 11 of the Securities Act of 1933. These statistics also do not account for the increased number of Securities Act suits filed in state court due to the Supreme Court's decision in *Cyan Inc. v. Beaver County Employees Retirement Fund*, which held that Securities Act cases were not removable to federal court. Technology and health care/life sciences companies continued to be targeted as a result of their more volatile stock price performance, a trait unlikely to change in 2020.

Against this backdrop, the impact of several recently decided cases and one pending U.S. Supreme Court case will become clearer in 2020. Companies should understand the potential impact these and other trends are likely to have on the securities litigation landscape.

Event-Driven Cases Are Likely To Remain a Focus

We expect plaintiffs firms will continue to gravitate toward so-called event-driven litigations — cases where the catalyst is the disclosure or occurrence of a significant event. These triggering events tend to reflect general risks that cut across multiple industries, such as data breaches or other cybersecurity incidents; environmental accidents; natural disasters; allegations of sexual harassment; and alleged regulatory violations, such as those arising under the Foreign Corrupt Practices Act. With numerous cases at the pleading stage, we may soon get more insight into how likely event-driven lawsuits are to survive motions to dismiss and thus gain traction at the district court level.

This decisional law, as it develops, will shed light on the viability of different allegations and theories of recovery. One typical pleading tactic, for example, is to claim on the heels of an alleged regulatory violation that the company misled investors regarding its compliance with an internal code of conduct or governing law. For instance, the U.S. Court of Appeals for the Second Circuit in *Singh v. Cigna Corp.* affirmed the lower court's dismissal of a putative class action, holding that alleged violations of generic statements included in Cigna's code of ethics could not support a claim for alleged securities fraud. The *Cigna* decision, however, did not prevent claims from moving forward against Signet Jewelers Ltd., where, following public reports of alleged sexual harassment, the plaintiffs alleged that the company violated its internal corporate policies prohibiting such behavior. Taken together, these cases suggest that courts will not hesitate to dismiss claims premised on vague or generic corporate statements but will permit them to move forward if plaintiffs provide strong and detailed factual allegations.

Supreme Court Decision in *Cyan* Will Continue To Shape Securities Litigation

The U.S. Supreme Court's 2018 decision in *Cyan* is expected to continue to impact Securities Act litigation, as plaintiffs' firms have increased the number of Securities Act filings in both federal and state courts, requiring the courts to wrestle with several thorny issues relating to stays, transfer and coordination. In *Cyan*, the Supreme Court held that the Securities Litigation Uniform Standards Act of 1998 did not authorize federal courts to remove cases brought solely under the Securities Act, and that state courts may exercise jurisdiction over such cases.

In the immediate aftermath of the ruling, we predicted that plaintiffs' firms, emboldened by the decision, would file cases in state courts with greater frequency — including in jurisdictions, such as New York, that previously refused to hear these suits. (See "Supreme Court Holds That Class Actions Brought Under Securities Act in State Court Are Not Removable.") Last year, more Section 11 cases were filed in state court than in 2018, with a substantial number landing in New York state court. According to data compiled by the Professional Liability Underwriting Society, more than 75% of these post-*Cyan* suits were filed in state court alone or in both state and federal court. Conversely, less than 25% of Section 11 cases were filed in federal court alone. By way of comparison, in the three years before *Cyan* — roughly seven out of every 10 Section 11 cases (or 67%) were brought in federal court on a stand-alone basis, making it possible for defense counsel to consolidate or coordinate parallel filings through the Judicial Panel on Multidistrict Litigation, motions to transfer or otherwise.

The post-*Cyan* migration of cases to state court, by contrast, has complicated case management efforts. For example, in 2019, nearly half (48%) of all new Securities Act matters included parallel state and federal filings (as compared to 16% in the three years before *Cyan*). Because no procedural mechanism exists for consolidating — or even coordinating — these overlapping suits, corporate defendants have been forced to seek discretionary stays and other alternative forms of relief. These efforts have led to several inconsistent rulings at the state court level. For instance, on two occasions in 2019, the Commercial Division of the New York Supreme Court denied a stay even though the federal cases included Exchange Act claims that could only have been brought in federal court. In contrast, at least one Massachusetts state court, several in California and even one New York court granted stays in favor of federal cases. One factor that appears to have favored stays is whether the federal case was filed first. State courts also have disagreed as to whether the automatic discovery stay provisions of the Private Securities Litigation Reform Act of 1995 apply to Securities Act claims brought in state court.

As these examples suggest, the law surrounding Cyan remains unsettled. With multiple Securities Act cases pending in New York, California and elsewhere, the new year may provide more clarity as to how state courts are resolving these procedural issues. Equally important, we hope to learn more in 2020 about how different state courts are applying the substantive elements of Securities Act claims at the motion to dismiss stage. In 2019, defendants won several important victories in this regard. Rulings this year may provide more insight into whether trends are developing within or among states.

Supreme Court May Address Whether Plaintiffs Can Use ERISA Stock-Drop Suits To Plead Around the Securities Laws

In *Retirement Plans Committee of IBM v. Jander*, the U.S. Supreme Court remanded to the Second Circuit a closely watched case regarding whether plaintiffs can effectively use ERISA to plead around the federal securities laws. In *Jander*, the plaintiffs accused plan administrators, all of whom were company insiders, of violating ERISA by failing to disclose allegedly negative information about IBM's microelectronics business. The plaintiffs claimed that during the relevant time period, plan administrators should have understood that the disclosure of this nonpublic information (along with a corresponding drop in the price of IBM stock) was inevitable. As a result, the plaintiffs alleged, any prudent fiduciary would have concluded that silence — that is, waiting to reveal the adverse information — would do more harm than good. In reversing the dismissal of the plaintiffs' complaint, the Second Circuit largely agreed with this framing of the "more harm than good" standard first enunciated by the Supreme Court in *Fifth Third Bancorp v. Dudenhoeffer*.

Before the Supreme Court, the IBM fiduciaries argued, in a position supported by the U.S. solicitor general, that when ERISA fiduciaries learn of inside information that may negatively affect the company's stock price, courts must evaluate a duty to disclose that information by looking solely to the federal securities laws. Reasoning from this premise, IBM has claimed that the Second Circuit's "inevitable disclosure" standard sweeps far more broadly — and is appreciably more lenient from a pleading perspective — than *Dudenhoeffer* permits. Indeed, IBM argued that the Second Circuit's test could, in some cases, require disclosure in situations where the federal securities laws do not. (See "2019-20 Supreme Court Update.")

The Supreme Court's decision leaves the issue unsettled as the case goes back to the Second Circuit for further proceedings because petitioners and the federal government had focused on the consistency between the securities laws and ERISA, arguments the Second Circuit never had

the chance to address. (See “Supreme Court Declines To Rule on ERISA Breach of Fiduciary Duty Pleading Standard for ESOP Cases.”)

Other Issues To Look for in 2020

District and appellate courts likely will have an opportunity to consider two of the Supreme Court’s more notable securities rulings from 2019: *Lorenzo v. SEC* and *Emulex Corp. v. Varjabedian*. In *Lorenzo*, the Court held that Francis Lorenzo, an investment banker, was liable under Subsections (a) and (b) of Rule 10b-5 for emailing clients a false and misleading investment solicitation that had been prepared by Mr. Lorenzo’s boss. The Court’s decision meant, in practical terms, that Mr. Lorenzo could be held responsible as a primary violator of Section 10(b) despite not having “made” the underlying statement. In 2020, *Lorenzo* may lead to an increase in private securities claims against disseminators who themselves did not make false and misleading statements, based on the theory that these defendants participated in a scheme to defraud investors.

We also will be tracking any fallout from *Emulex Corp. vs. Varjabedian*, a merger objection suit that was dismissed by the Court after oral argument and, crucially, before any decision was issued. The complaint had asserted violations of Section 14(e) of the Exchange Act, a provision that is routinely invoked by private plaintiffs in challenging the accuracy of tender offer materials. However, this long-recognized private right of action, may be in jeopardy: During oral argument, several justices questioned whether it was even appropriate for a private plaintiff to proceed under Section 14(e). Taking their cues from the Supreme Court, defendants in Section 14(e) suits are likely to challenge the very right of private investors to sue under this section of the Exchange Act. If one of these cases survives long enough, it may well serve as a vehicle for the Court to revisit whether a private right of action exists under Section 14(e).

This year will mark the 25th anniversary of the enactment of the Private Securities Litigation Reform Act of 1995, which was intended to curtail securities class action filings. Despite those intentions, we anticipate another year of record or near-record filing levels and will be closely watching a number of potential decisions that will continue to shape the securities litigation landscape.

DOJ Emphasizes Transparency and Encourages Cooperation

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In 2019, the Criminal Division of the U.S. Department of Justice (DOJ) continued its efforts, begun a few years prior, to enhance transparency with respect to the DOJ's prosecutorial decision-making. In public statements, DOJ leadership has expressed the view that increased transparency ensures consistency and predictability in charging decisions and incentivizes good corporate conduct. The DOJ is plainly confident that institutions will make greater efforts to prevent misconduct in order to avoid investigations or increase the likelihood the DOJ will decline prosecution. Furthermore, because the department's policies favor companies that voluntarily self-report misconduct, internally investigate, cooperate with its investigation and remediate as necessary, the DOJ presumably expects that its transparency may increase the likelihood that institutions will self-report misconduct they identify.

Ironically, increased transparency — and the increased cooperation that the DOJ seeks as a result — can also create risk for the DOJ when it prosecutes individuals with information obtained by a cooperating institution. Arguments made by defendants in recent cases, with some success, indicate potential pitfalls when the DOJ relies too heavily on cooperating institutions. While the DOJ is expected to continue to encourage robust cooperation, it may be more cautious in future cases about the nature and extent of its collaboration with these institutions in order to avoid jeopardizing individual prosecutions.

DOJ's Guidance Concerning Prosecutorial Decision-Making

Assistant Attorney General Brian Benczkowski emphasized in an October 2019 speech that the "best way to deter white-collar crime is to provide proper incentives for law-abiding businesses to prevent misconduct before it occurs and foster the type of ethical corporate behavior that benefits all of us." Assistant AG Benczkowski further indicated that by publicly stating the standards that should guide prosecutorial decision-making, the DOJ "helps to ensure consistency and predictability in how those standards are applied within the Department." While the standards are not new, written public guidance provides a "window into the Department's thinking" that previously was unavailable publicly and eschews the "black box approach around the principles and policies that guide [DOJ] decisions," as Assistant AG Benczkowski stated in his December 2019 remarks at the ACI Conference on the Foreign Corrupt Practices Act (FCPA).

For example, in October 2019, the DOJ issued public guidance concerning the factors the DOJ will consider in evaluating a company's "inability to pay claims." These same factors have shaped prior evaluations, but the DOJ previously had not identified them publicly — or committed to applying them. Additionally, in April 2019, the DOJ released guidance concerning its assessment of corporate compliance programs. The existence and effectiveness of a corporate compliance program have long been key factors in the DOJ's corporate charging and penalty determinations, but the department had not explained previously, at this level of detail, how it evaluates effectiveness or what specific components the DOJ expects a robust compliance program to include.

Also in 2019, the DOJ announced changes to the FCPA Corporate Enforcement Policy to further incentivize cooperation. Designed to encourage self-disclosure and/or full cooperation, the policy makes clear the credit available to companies for doing so, and the changes relax, to some extent, the requirements a company must meet in order to receive credit.

For example, in March, the DOJ no longer required a company to prohibit the use of ephemeral messaging apps (such as WhatsApp and WeChat) to receive full cooperation, requiring only appropriate guidance and controls to ensure the retention of business records created via use of these apps. In November, the DOJ modified disclosure language to clarify that companies can disclose misconduct before knowing all relevant facts if they share all facts known at the time and inform the DOJ that the investigation will continue. The DOJ also stated that disclosure should relate to any individual who played a substantial part in the "misconduct at issue," as opposed to a "violation of law," such that companies can divulge without having determined that a legal violation occurred.

In 2019, the DOJ continued, as in past years, to make publicly available its decisions not to prosecute companies that voluntarily self-disclosed and/or cooperated. Most recently, the DOJ highlighted its decision to decline to prosecute a publicly traded *Fortune 200* company and to charge the former chief legal officer and chief executive officer with FCPA violations. While the misconduct allegedly reached the company's senior levels, the DOJ declined to prosecute the company because it voluntarily self-disclosed within two weeks of the board's learning of the misconduct, permitting the DOJ to identify and prosecute culpable executives.

Corporate Cooperation Impacting Individual Prosecutions

As noted above, increased corporate cooperation can pose risks to individual prosecutions that are based substantially on the information provided by cooperating institutions. In 2015, with the publication of the Yates memorandum, the DOJ stated formally and publicly that individual prosecutions were a priority. Since then — as in prior years — the DOJ has worked closely with companies conducting internal investigations and simultaneously cooperating with the DOJ. Corporate cooperation typically involves responding to DOJ requests for documents and information and regularly updating the DOJ on the nature and status of the company's internal investigation. The DOJ may request that companies focus on specific issues and make factual and legal presentations of their investigative findings. These findings can be based on numerous sources, including key documents, employee interviews and expert analysis. Over the past few years, the DOJ has in some cases requested that company counsel inform the department of any anticipated interviews of employees or that it refrain from conducting such interviews so the DOJ may go first.

This regular contact may facilitate a DOJ determination that a company has fully cooperated and may aid the department in its efforts to prosecute culpable individuals, but if not carefully handled, it also can implicate the constitutional rights of employees who are future criminal defendants. This may potentially jeopardize the DOJ's prosecutions and convictions and subject the company to broad discovery of its internal investigative files. For example, in *United States v. Connolly*, former derivatives trader Gavin Black was convicted by a jury of wire fraud and conspiracy related to manipulating LIBOR, a global financial benchmark. In May 2019, Chief Judge Colleen McMahon of the U.S. District Court for the Southern District of New York held that the DOJ and other agencies had effectively outsourced their investigation of Mr. Black to his former employer and its outside counsel, and that Mr. Black's interview by outside counsel — under threat of termination — was compelled within the meaning of the Fifth Amendment. But the court rejected the defense counsel's motion to dismiss the indictment, finding that prosecutors did not use Mr. Black's compelled statements in any meaningful way to obtain his indictment and conviction.

Connolly followed another criminal case in the U.S. District Court for the District of New Jersey, *United States v. Blumberg*, in which the defendant made a similar argument, claiming that his Fifth Amendment rights were violated when the government outsourced its investigative work to his former employer, but failed to search the employer's files for exculpatory materials. The case was resolved in 2018 with a plea following a hearing on the extent of "outsourcing" of the government's investigation to the company, but without a decision on that issue. Had the court found that the company acted on the government's behalf, effectively conducting a joint investigation in which the government had access to the company's files, those files could have been subject to discovery on the theory that the government had "constructive possession" of them.

In March 2019, following the *Blumberg* resolution and the *Connolly* motion to dismiss the indictment post-trial, the DOJ took steps to ensure its independence in future investigations, updating the FCPA corporate enforcement policy with respect to avoiding conflicts. The policy defines full cooperation to include, where

"requested and appropriate," deconfliction of witness interviews and other investigative steps that a company intends to take as part of its internal investigation — that is, making efforts to ensure that the company's investigation does not interfere with the DOJ's investigation. A footnote added in March 2019 clarifies that "although the Department may, where appropriate, request that a company refrain from taking a specific action for a limited period of time for de-confliction purposes, the Department will not take any steps to affirmatively direct a company's internal investigation efforts."

Courts have yet to elaborate how the DOJ and a corporation can facilitate appropriate cooperation while maintaining the independence of their respective investigations. But the DOJ and cooperating institutions are expected to be sensitive to this issue going forward, and both are expected to tailor their interactions accordingly.

Key Developments in Delaware Corporation Law

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Consistent with trends in recent years, in 2019 Delaware corporation law largely was shaped by post-closing suits for money damages against directors who had approved mergers and acquisitions. Two Delaware Supreme Court decisions — *Kahn v. M & F Worldwide Corporation* (*MFW*) and *Corwin v. KKR Financial Holdings LLC* (*Corwin*) — and their progeny dominated those lawsuits.

Beyond the transactional context, the Delaware courts provided valuable insight to directors charged with monitoring risk and illuminated the standards by which director independence will be measured. Finally, stockholder inspection rights continued to evolve under Section 220 of the Delaware General Corporation Law (DGCL).

Directors and other transaction participants should take note of these developments and their impact on transaction structure, corporate disclosures, oversight responsibility, independence and companies' obligations to produce books and records.

Deal Litigation Developments Under *MFW*

Transactions involving controlling stockholders were a major target by plaintiffs in 2019. As a result, important rulings applied the Delaware Supreme Court's 2014 seminal decision in *MFW*. Under *MFW*, a transaction involving a controlling stockholder will be reviewed under the deferential business judgment rule (as opposed to the far more stringent entire fairness standard) if it is conditioned "*ab initio*" (from the beginning) on the "dual protections" of approval by both a well-functioning committee of independent and disinterested directors and a majority of the minority stockholders in an uncoerced, fully informed vote.

In *Olenik v. Lodzinski*, the Delaware Supreme Court clarified the meaning of *ab initio*. According to the court, the dual protections must be expressly put in place before "substantive economic negotiation[s]" begin, and *MFW* is satisfied only if a controlling stockholder has agreed that a transaction will not go forward without "the special committee and disinterested stockholder approval early in the process and before there has been any economic horse trading." Court rulings in 2020 likely will further illuminate the contours of the *ab initio* requirement and provide additional clarity as to the other requirements of *MFW*, such as director independence and committee effectiveness.

In *Tornetta v. Musk*, the Court of Chancery expanded *MFW*'s scope beyond "transformational" transactions to apply to other corporate decisions involving controlling stockholders, explaining that non-extraordinary transactions such as compensation decisions could be subject to business judgment review by following the procedures set forth in *MFW*. According to the ruling, where *MFW* is employed, "[T]he Court's suspicions regarding the controller's influence would [be] assuaged and deference to the Board and stockholder decisions would [be] justified."

Transaction participants should consider this valuable guidance when structuring transactions in 2020.

Deal Litigation Developments Under *Corwin*

The Delaware Supreme Court's 2015 decision in *Corwin* also remained a focus of recent cases. Under *Corwin*, in the absence of a conflicted stockholder, the fully informed vote of disinterested, uncoerced stockholders will extinguish

breach of fiduciary duty claims, leaving only claims for waste. Two notable 2019 cases addressed — with differing outcomes — whether disclosures created a fully informed vote.

In *English v. Narang*, the Court of Chancery applied the *Corwin* doctrine to dismiss a fiduciary challenge to a merger following what the court ultimately held to be a fully informed stockholder vote. The court rejected a plethora of disclosure challenges concerning the company's financial outlook, discussions of post-merger employment and financial advisor conflicts, holding that the disclosure claims failed as a matter of law, and defendants met their burden to show that the vote was fully informed. By contrast, in *Chester County Employees' Retirement Fund v. KCG Holdings, Inc.*, the Court of Chancery denied motions to dismiss, holding that the defendants were not protected by *Corwin* because the plaintiffs had identified "significant deficiencies" in the proxy statement — including omitted details about an alleged financial advisor conflict, the CEO's role in negotiating a management compensation and retention pool, and revised projections late in the process — that rendered the stockholder vote uninformed.

In 2020, Delaware disclosure law may develop further in the context of the *Corwin* doctrine and less common disclosure-based requests for injunctive relief.

Caremark and Director Independence in Derivative Litigation

The Delaware courts provided valuable guidance outside the transactional context in 2019 as well. For example, in *Marchand v. Barnhill*, the Delaware Supreme Court reversed the Court of Chancery's dismissal of so-called *Caremark* duty of oversight claims arising out of the alleged failure by the directors of Blue Bell Creamery USA Inc. to adequately monitor whether its ice cream was safe to eat. The case arose after a listeria outbreak in Blue Bell's ice cream that sickened many consumers, caused three deaths and resulted in a total product recall. The court explained that "[w]hen a plaintiff can plead an inference that a board has undertaken no efforts to make sure it is informed of a compliance issue intrinsically critical to the company's business operation, then that supports an inference that the board has not made the good faith effort that *Caremark* requires."

A few months later, the Court of Chancery relied on the *Marchand* ruling to deny a similar *Caremark* claim in *In re Clovis Oncology, Inc. Derivative Litigation*. In that case, stockholders of Clovis Oncology, Inc., a clinical-stage biopharmaceutical company, alleged that the board ignored red flags that the company was not adhering to clinical trial protocols in developing its "most promising" drug, which, once disclosed, allegedly resulted in a 70% decline in the company's stock price. The court explained that "when a company operates in an environment where externally imposed regulations govern its 'mission critical' operations, the board's oversight function must be more rigorously exercised." It remains to be seen in 2020 whether these decisions lead to an increase in duty of oversight litigation.

The *Marchand* decision also provided valuable insight into the sufficiency of allegations challenging director independence in derivative litigation. In *Marchand*, the Delaware Supreme Court held that the complaint adequately alleged that a majority of the members of the board of directors were interested and/or lacked independence for purposes of a demand futility analysis. The Supreme Court's ruling hinged on whether the complaint adequately alleged that one outside director, who previously was employed by the company, was conflicted. The court held that although the director was retired, a "longstanding business affiliation and personal relationship" between the director and the family of the company's CEO, as well as charitable donations made by the family on the director's behalf, were sufficient to plead "very warm and thick ties of personal loyalty and affection" between the director and the CEO.

Following *Marchand*, the Court of Chancery denied motions to dismiss derivative claims in *In re BGC Partners, Inc. Derivative Litigation*, concluding that stockholder plaintiffs adequately pleaded that members of a special committee lacked independence from an alleged controller due to, among other things, director fees they had earned from companies affiliated with the controller, the directors' attendance at social events where the controller was present and the controller's donations to charities affiliated with the directors.

In the coming year, the court's approach to these types of independence analyses will be of significance to companies and their directors, as stockholder plaintiffs continue to expand the manner in which they plead personal relationships and charitable connections, such as with the use of social media postings and other types of prelitigation discovery.

Trends in Books and Records Litigation

This past year stockholders increasingly implemented Section 220 of the DGCL to obtain corporate documents before commencing litigation. Section 220 permits stockholders of Delaware corporations to inspect books and records where they have identified a "proper purpose" for doing so. Traditionally, Section 220 was utilized by plaintiffs to draft and file detailed derivative complaints. Given the recent decrease in M&A injunction requests, and the corresponding decrease in discovery records created for that purpose, stockholder plaintiffs turned to Section 220 to access documents and communications that might assist them in similarly crafting a post-closing class action complaint that could survive *MFW* or *Corwin*. In addition, stockholder plaintiffs continue to expand the scope of documents they

seek under Section 220, frequently requesting not only board-level materials, such as minutes and presentations, but also electronic documents, such as personal emails and text messages. In 2019, Delaware courts helped clarify when such electronic documents should be made available to a stockholder in a Section 220 demand.

For example, in *Schnatter v. Papa John's International, Inc*., the Court of Chancery ordered the production of correspondence from personal email accounts and text messages from personal devices, rejecting a bright-line rule that such electronic communications are not subject to production under Section 220. Weeks later, in *KT4 Partners LLC v. Palantir Technologies Inc*., the Delaware Supreme Court ordered the production of electronic communications because the plaintiff had presented sufficient evidence that the company did not honor traditional corporate formalities and instead acted informally through email rather than at formal board meetings, in connection with the alleged wrongdoing that the plaintiff sought to investigate. In so ruling, the court explained that a corporation should not be required to produce electronic communications if other materials, such as board meeting minutes, exist and would accomplish the petitioner's proper purpose. In 2020, practitioners and Delaware courts may continue to grapple with whether and in what circumstances requests for electronic communications are proper under Section 220.

In *High River Limited Partnership v. Occidental Petroleum Corporation*, the Court of Chancery refused to permit affiliates of activist investor Carl Icahn to inspect corporate documents for use in a proxy contest to replace members of Occidental's board. The court declined to "recognize a new rule entitling stockholders to inspect documents under Section 220 if they can show a credible basis that the information sought would be material in the prosecution of a proxy contest," as opposed to another proper purpose, such as the investigation of corporate wrongdoing or mismanagement. The decision is currently on appeal, and the Delaware Supreme Court is likely to provide clarity in this area, which the Court of Chancery described as "murky" in its *Occidental* decision.

2020 Class Action Outlook

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Several pending rulings at the circuit court level have the potential to significantly influence class action law in 2020. Of greatest note, the U.S. Court of Appeals for the Sixth Circuit may determine the future of "negotiation" class actions, and pending decisions in the U.S. Courts of Appeals for the Seventh and D.C. Circuits will address nationwide class actions in the wake of the U.S. Supreme Court's ruling in *Bristol-Myers Squibb Co. v. Superior Court of California* (*BMS*). Additionally, district court developments in deceptive labeling consumer fraud class actions make certain types of claims in this area more likely.

"Negotiation" class actions. The Sixth Circuit recently granted a petition in *In re: National Prescription Opiate Litigation* to appeal the certification of an unprecedented "negotiation" class action. The negotiation approach was first detailed in a June 2019 paper titled "The Negotiation Class: A Cooperative Approach to Class Actions Involving Large Stakeholders" authored by Duke University School of Law professor Francis McGovern and Harvard Law School professor William Rubenstein. Under this framework, putative class members generate a "negotiating bloc" before settlement discussions with the defendant and are then bound to any settlement decision by a supermajority vote of the class, creating what the authors believe to be a simplified negotiation process. Plaintiffs favor negotiation classes because they create more pressure on defendants to settle and strengthen the bargaining power of individual plaintiffs.

The defense bar, by contrast, disfavors negotiation classes and has argued that they violate Federal Rule of Civil Procedure 23 and the Rules Enabling Act. Rule 23 on its face clearly contemplates certification of classes as a litigation tool for "suing" another party, not as a negotiation mechanism. Moreover, judicially expanding the class action device to achieve policy goals — *i.e.*, global settlements of controversies — would effectively transform Rule 23, which is intended to be merely procedural, into a private attorney general statute. This would contravene the Rules Enabling Act, which states that federal procedural rules cannot be used to substantively change the law because they are simply promulgated by judges — they are not enacted into law by Congress. The Sixth Circuit is likely to address these and other thorny issues in its much-anticipated ruling, the outcome of which could determine whether this burgeoning concept spreads to other courts.

Nationwide class actions in the wake of *BMS*. Panels of the Seventh and D.C. Circuits are poised to decide whether federal courts can exercise personal jurisdiction over nonresident defendants, even where unnamed putative class members base their claims solely on events that occurred outside the forum jurisdiction. In *Molock v. Whole Foods Market Group, Inc.*, a federal judge in the U.S. District Court for the District of Columbia refused to dismiss nationwide class allegations asserted on behalf of out-of-state grocery store employees for alleged violations of state common and statutory law. In *Mussat v. IQVIA, Inc.*, a federal judge in Illinois struck a class definition encompassing out-of-state class members allegedly injured by junk faxes under the Telephone Consumer Protection Act. Both cases aim to resolve a question left open by the landmark

ruling in *BMS*, in which the Supreme Court held that state courts (including those presiding over sprawling mass tort proceedings) cannot exercise personal jurisdiction over out-of-state defendants when the plaintiffs' claims arise outside the forum state. In the wake of that decision, district courts have struggled to determine whether the holding in *BMS* applies to unnamed, absent class members. The district court in *Molock* held that the claims of unnamed, out-of-state class members were not barred by *BMS*, while the district court in *Mussat* reached the opposite conclusion.

Based on the tenor of oral argument, it appears that both the Seventh and D.C. Circuits will hold that *BMS* does not apply to absent class members. Such a ruling will undermine the Supreme Court's reasoning in *BMS* because personal jurisdiction principles should apply with at least equal force to nationwide class actions. After all, each class member, named or unnamed, must bring his or her claims in a court that has personal jurisdiction over the defendant. Decisions in both cases are likely to be rendered in the first half of 2020, potentially setting the stage for Supreme Court intervention regarding a critical issue implicating personal jurisdiction and class action principles.

Deceptive labeling class actions. If the past year is any indication, the volume of false labeling class actions seems likely to rise in 2020. In these putative class actions, a plaintiff or handful of plaintiffs allege that a beverage, food, medication or other consumer product is deceptively labeled — for example, it allegedly misrepresents the product as "all natural." These cases have become increasingly attractive to plaintiffs' lawyers because they tend to survive motions to dismiss (and are harder to defeat at class certification than other consumer fraud lawsuits). As a result, defendants often feel pressured to settle, even if the claims are substantively meritless. With respect to class certification in particular, plaintiffs' lawyers have successfully argued that cases involving a single allegedly deceptive label involve fewer individualized questions than traditional consumer fraud class actions, which typically have varying representations and disparate consumer experiences. Plaintiffs' lawyers also have touted these cases as prime candidates for so-called "issues" class certification, in which a single purportedly common issue (*e.g.*, whether the label is deceptive) is certified, leaving remaining individualized questions of causation and injury to separate follow-on proceedings. While some courts have recognized that these purportedly simple cases are in fact fraught with highly individualized questions (*e.g.*, whether consumers interpreted the statement the same way and whether it affected purchasing decisions differently), these low-investment class actions remain appealing to plaintiffs' lawyers, and we likely will see many more in 2020.

Enforcing International Arbitration Awards: US Courts Achieve Prompt and Efficient Enforcement, With Safeguards

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Recent U.S. court decisions demonstrate that international arbitration remains a widely used and potentially attractive method for resolving international business disputes, largely due to the relative ease of enforcing awards under the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. U.S. courts, however, are sensitive to cases where a purported foreign "award" was not genuine and will refuse enforcement where serious questions exist.

Companies entering into cross-border transactions often include a clause in their contracts providing for international arbitration of disputes that may arise. These clauses typically provide for arbitration before a three-person tribunal in a neutral seat (*e.g.*, New York, London, Singapore or Hong Kong), conducted under the rules of a major international arbitral institution, such as the International Chamber of Commerce (ICC), the International Centre for Dispute Resolution of the American Arbitration Association or the London Court of International Arbitration.

Companies often choose international arbitration because awards granted by an international arbitral tribunal may be enforced worldwide through the New York Convention. This treaty, which has been ratified by 158 countries, including the major trading nations, rests on two key principles: (i) a written "agreement to arbitrate," including as contained in a contractual arbitration clause, is generally enforceable; and (ii) subject to certain narrow exceptions, an arbitral award may be recognized and enforced as a final judgment in each contracting country. In the United States, the New York Convention has been enshrined in federal law through the Federal Arbitration Act (FAA).

To enforce a foreign commercial arbitral award in the U.S. courts (assuming the losing party is subject to the jurisdiction of the U.S. courts), an award holder need only present an authentic copy of the award to the court, at which point it will be recognized and enforced unless the losing party can establish a basis for nonrecognition under Article V of the New York Convention. Article V allows recognition to be declined if (i) the arbitration agreement was invalid; (ii) the losing party was not properly notified of the arbitral proceedings; (iii) the award "deals with a difference not contemplated by or not falling within the terms of the submission to arbitration, or it contains decisions on matters beyond the scope of the submission to arbitration"; (iv) the tribunal composition was improper; (v) the award "has been set aside or suspended by a competent authority of the country in which, or under the law of which, that award was made;" (vi) the "subject matter" of the dispute is not "capable of settlement by arbitration" under that country's law; or (vii) award enforcement would be contrary to "public policy."

Recent Cases

Federal case law makes clear that the enumerated grounds in Article V are to be read narrowly. As a result, the U.S. courts frequently reject attempts by losing parties to resist enforcement of foreign arbitral awards. Two recent examples include:

KG Schifffahrtsgesellschaft MS Pacific Winter MBH & CO. v. Safesea Transport, Inc., U.S. District Court for the District of New Jersey: A German ship owner obtained a $122,367.86 award against a U.S. company for breach of a charter party agreement and sought enforcement in the United States. The losing party argued that the award should be denied as being contrary to "public policy," claiming that the arbitrator ignored a time bar applicable under

maritime law. Rejecting this argument, the court noted that "courts have strictly applied the Article V defenses and generally view them narrowly," and held that "the Convention does not sanction the second guessing of an arbitrator's interpretation of the parties' agreement as this type of judicial review frustrates the basic purpose of arbitration."

De Rendon v. Ventura, U.S. District Court for the Southern District of Florida: Various parties entered into a settlement agreement concerning the share ownership in a Colombian pharmaceutical company, which provided for arbitration of disputes before an ICC tribunal in Bogota, Colombia. After a dispute arose, one of the parties obtained an arbitral award of $900,000 for breach of the agreement's confidentiality provisions. The losing party opposed enforcement of the award on a variety of grounds under Article V of the New York Convention, including that the arbitration clause, as applied, had become "invalid" because the ICC had improperly treated the case as an international (rather than domestic) arbitration. These and other challenges were rejected, with the court emphasizing "its 'extremely limited' review of arbitral awards" and "the powerful presumption that the arbitral body acted within its powers."

The limits of the courts' pro-arbitration policy, however, were demonstrated in 2019 in *Al-Qarqani v. Chevron Corporation* in the U.S. District Court for the Northern District of California. Saudi Arabian nationals brought a petition to recognize and enforce a purported arbitral award of approximately $18 billion that had been rendered against numerous individuals and companies under the auspices of the International Arbitration Centre in Cairo, Egypt. The case involved unique facts and myriad questions regarding the source of the award and the conduct of the purported arbitration in Egypt. In response to the petition, the U.S. respondents (two Chevron affiliates) argued that:

> [T]he Award was the product of sham proceedings engineered to produce an award in Petitioners' favor, that there was never an agreement to arbitrate between the Petitioners and Respondents, that the arbitral proceedings violated the plain terms of the arbitration agreement the tribunal purported to rely upon, that the claims fell outside the arbitral agreement, and that the arbitral process was riddled with gross irregularities and criminal misconduct.

The court focused on whether there was an arbitration clause between the Saudi individuals and the U.S. companies, noting that the sole basis for arbitration had been a 1933 concession agreement between the government of Saudi Arabia and a Standard Oil affiliate. The Saudi claimants, however, had never been parties to the 1933 concession and, therefore, could not invoke the arbitration clause against Chevron. With no agreement to arbitrate, the court dismissed for lack of jurisdiction.

The court added that had there been an agreement between the parties to arbitrate, recognition still would have been denied, on the grounds that the tribunal's composition had not been "in accordance with the agreement," and that the arbitral tribunal had decided matters outside the scope of the arbitration agreement.

Cases like this may prompt some to rethink whether their disputes clauses should instead specify litigation in an agreed forum, rather than arbitration. Indeed, for decades, efforts have been made to enact a treaty that will facilitate enforcement of court judgments in a similar manner as arbitration awards are subject to enforcement under the New York Convention. A multilateral treaty, the 2015 Hague Convention on Choice of Court Agreements allows for recognition and enforcement of litigation forum selection clauses, and has been ratified by five countries plus the European Union. A more comprehensive mutual judgment recognition treaty, the 2019 Convention on the Recognition and Enforcement of Foreign Judgments in Civil or Commercial Matters, was opened for signature in July 2019 at the Hague Conference on Private International Law. Neither treaty, however, has gained widespread adherence.

Because of the unique facts involved, *Al-Qarqani* does not signal a trend against enforcement of commercial awards generally. Nevertheless, the case illustrates the basic threshold requirements that must be met in order to enforce a foreign arbitration award, including that the award must arise from a genuine arbitration agreement. Where there are questions about the integrity of the foreign arbitral proceeding, U.S. courts may decline to enforce the resulting award.

Proposed Rule Could Substantially Affect 'Disparate Impact' Claims Under the Fair Housing Act

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In August 2019, the U.S. Department of Housing and Urban Development (HUD) proposed rulemaking that potentially would make it harder to bring disparate impact discrimination claims under the Fair Housing Act. The proposed rule, which HUD likely will finalize in 2020, would impose on plaintiffs a new five-part pleading requirement and create several new defenses. The proposal also would clarify a number of issues with HUD's current disparate impact standard, promulgated in 2013. The proposed rule has the potential to significantly affect mortgage and housing cases under the Fair Housing Act, and it may likewise affect non-mortgage credit, such as auto or student loans, as regulators and courts will likely draw on HUD's standard for guidance in interpreting the Equal Credit Opportunity Act.

Background — The Disparate Impact Theory

As a general matter, parties can be liable under certain anti-discrimination laws not only for intentional discrimination but also for practices that have an adverse impact on the basis of race, ethnicity or other protected classes. In particular, in the 2015 decision in *Texas Department of Housing and Community Affairs v. Inclusive Communities Project, Inc*., the U.S. Supreme Court upheld the finding that disparate impact is a valid theory of liability under the Fair Housing Act, though limits exist on its application. Specifically, the Court held that a plaintiff must demonstrate a "robust" causal connection between the challenged practice and alleged disparities. HUD's proposed rule was a direct response to the *Inclusive Communities* decision and seeks to conform the showing that plaintiffs must make to be consistent with the disparate impact limitations articulated by the Supreme Court.

Plaintiff's *Prima Facie* Burden

The proposed rule requires plaintiffs to allege that a "specific, identifiable policy or practice has a discriminatory effect" and to "plausibly allege" the following:

- The challenged policy or practice is arbitrary, artificial and unnecessary to achieve a valid interest or legitimate objective;
- A robust causal link exists between the challenged policy or practice and a disparate impact on members of a protected class that shows the specific practice is the direct cause of the discriminatory effect;
- The alleged disparity caused by the policy or practice has a significant adverse effect on members of a protected class; and
- A direct link exists between the disparate impact and the complaining party's alleged injury.

New Defenses

The proposed rulemaking also includes two categories of new defenses.

Models. One new defense will permit a defendant to provide the "material factors" for quantitative models or algorithms used in its business (*e.g.*, underwriting or pricing models) and show that the factors are not "substitutes or close proxies for protected classes" and that the model is predictive of risk. Likewise, lenders can

show that a model from a third party meets "industry standards" and is used only for its intended purposes. Creditors also will be able to demonstrate that a model has been validated by a neutral third party, which has determined that it is empirically derived and based on a demonstrably and statistically sound algorithm that accurately predicts risk, with none of the factors relying on substitutes or close proxies for protected classes.

With the advancement of artificial intelligence and "big data," and the widespread use of models and algorithms across the consumer finance industry for loan underwriting, pricing and other decisions, the availability of this new defense could prove significant.

External limits on discretion. Another proposed defense would apply when the defendant's "discretion is materially limited by a third party," such as through a law or a "binding or controlling court, arbitral, regulatory, administrative order, or administrative requirement." If a lender could show, for example, that a challenged practice was necessary to promote compliance with regulations requiring a creditor to evaluate a customer's ability to repay a debt, the lender might be able to rely on this defense.

Less Discriminatory Alternative and Business Justification Standards

The proposed rule also would modify the less discriminatory alternative and business justification standards.

"Equally effective" less discriminatory alternative. Under the proposed rule, as well as current law, if the defendant shows that a valid interest for the challenged practice exists, the burden shifts to the plaintiff to show that an alternative practice with less discriminatory impact would serve the defendant's interest. HUD's proposal, however, clarifies that a plaintiff's less discriminatory alternative must serve the defendant's interest "in an equally effective manner" and without "imposing material greater costs" or "creating other material burdens" for the defendant.

Possible easing of business justification standard. The proposed rule states that a "valid interest" for a challenged policy can include "a practical business, profit, policy consideration, or requirement of law." The proposal also allows the defendant to rebut the plaintiff's *prima facie* case by showing that the challenged policy "advances" a "valid" interest.

Looking Ahead

Questions as to when and whether the rule will be finalized in its current form aside, the changes proposed by HUD would significantly affect the litigation of disparate impact cases under the Fair Housing Act and may influence non-mortgage fair lending cases brought under the Equal Credit Opportunity Act or state laws, insofar as regulators or courts look to the new HUD standards for guidance. Under the proposed standards, plaintiffs would have a higher burden to proceed with disparate impact claims, and lenders would have an additional incentive to use quantitative models that meet the standards for the new defenses set forth in the proposal.

The State of Congressional Investigations Heading Into 2020

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When members of the U.S. House of Representatives and Senate were sworn into office in January 2019, Democrats took control of the House and its oversight agenda for the first time in eight years, 235-200 seats, and Republicans maintained a majority in the Senate, 53-45 (with two Independents). In April 2019, the House Oversight and Reform Committee — the House's principal oversight body — issued a 248-page report detailing each of the House standing committees' plans to address those priorities, including health care; wages, jobs and economic prosperity; climate change; and investigations into the Trump administration. Over the course of 2019, House committees have initiated numerous investigations that have significantly affected the private sector.

While Republicans typically are viewed as being less aggressive toward the private sector, the Senate also has been active in carrying out its oversight responsibilities, and the work of many of its committees has overlapped significantly with Democratic priorities. This is particularly evident with consumer protection issues, drug pricing, the e-cigarette industry, data privacy and antitrust enforcement.

2019 Committee Investigations Overview

In January 2019, the House Oversight and Reform Committee launched a broad investigation into the drug industry, focusing on the prescription drugs that have increased the most in price over the last five years. The committee also requested documents and convened hearings with respect to the e-cigarette industry, PFAS (also known as "forever chemicals" because they don't easily break down and can exist in the environment for decades) and a number of consumer protection issues. The committee likely will continue to prioritize drug pricing and e-cigarettes regulation in 2020.

At the start of 2019, Rep. Maxine Waters, chair of the House Financial Services Committee, pledged that the committee would hold many hearings under her leadership, and she has followed through. The committee has focused on private equity firms and their acquisitions of hospitals, nursing homes, emergency service companies, retail companies and residential real estate. The committee also has focused on emerging digital currencies and cryptocurrencies, diversity and inclusion efforts within the financial services industry, and data breaches and cybersecurity policies of industries under the committee's jurisdiction.

Rep. Frank Pallone, chair of the House Energy and Commerce Committee, has prioritized antitrust issues, robocalls, the e-cigarette industry, PFAS chemicals, "surprise billing," drug pricing and short-term, limited-duration insurance plans.

The House Intelligence Committee, which has focused on the impeachment inquiry and claims surrounding Russia's interference in the 2016 election, is now likely to shift its attention to the private sector. It recently held a hearing signaling its focus on deepfakes — fake videos or audio clips that appear to be real — and other forms of manipulated media.

The House Judiciary Committee chaired by Rep. Jerrold Nadler has held hearings on antitrust concerns in the telecommunications, technology and health care industries. Given the mounting scrutiny the technology industry is facing from

state and federal officials, the committee's investigation into the sector likely will continue in 2020.

Data privacy and cybersecurity have been the focal points for numerous Senate committees, including the Senate Permanent Subcommittee on Investigations, the Senate Judiciary Committee and the Senate Commerce Committee, which has not yet targeted particular companies but has held several hearings on data breaches and data misuse.

Similar to several House committees, the Senate Finance Committee has scrutinized prescription drug pricing, holding three hearings on the issue with witnesses from the pharmaceutical industry; and the Senate Judiciary Committee has addressed how drug patent reform can promote the committee's interest in increasing competition in the drug industry without discouraging innovation.

The Senate Health, Education, Labor and Pensions Committee has conducted oversight of the e-cigarette industry and the cosmetic industry, the latter in particular for products sold to children and teenagers that may contain asbestos.

Congressional Subpoenas

A number of lawsuits have challenged the enforcement of congressional subpoenas in 2019, largely stemming from investigations into President Donald Trump and his administration.

The U.S. Supreme Court has long emphasized the vast scope of Congress' power to investigate and issue subpoenas to obtain information. In its 1975 ruling in *Eastland v. United States Servicemen's Fund*, the Court explained that "the scope of the power of inquiry ... is as penetrating and far-reaching as the potential power to enact and appropriate under the Constitution." Recent decisions have reinforced this principle.

For example, in early December 2019, in *Trump v. Deutsche Bank AG*, the U.S. Court of Appeals for the Second Circuit upheld a congressional subpoena issued to two banks for documents related to President Trump's finances. The court highlighted the breadth of congressional investigative authority and explained that although "disclosure of the financial records sought by the Committees will subject Appellants' private business affairs to the Committees' scrutiny," "inquiry into private affairs is not always beyond the investigative power of Congress."

Additionally, in *Trump v. Mazars USA, LLP*, the U.S. Court of Appeals for the D.C. Circuit recently upheld a congressional subpoena issued to President Trump's accounting firm seeking records related to work performed for President Trump and several related business entities before and after he took office. In that ruling, the D.C. Circuit emphasized that "a legislative inquiry may be as broad, as searching, and as exhaustive as is necessary to make effective the constitutional powers of Congress." These and other decisions in 2019 likely will give additional momentum to oversight and investigatory activity. On December 13, 2019, however, the Supreme Court granted *certiorari* in *Mazars* and *Deutsche Bank*. Oral arguments for both cases are scheduled for March 2020, with decisions likely to come at the end of June 2020. These decisions likely will further define the scope of Congress' authority to issue subpoenas.

2020 Predictions

Companies can expect House and Senate committees to launch investigations closely aligned with priorities and issues of their respective majority parties and presidential nominees. As stated above, we already have seen this with the House in terms of consumer protection, drug pricing, the e-cigarette industry, data privacy and antitrust enforcement, some of which have been highlighted by Democratic presidential election front-runners for 2020.

U.S. Government Accountability Office reports, which often are requested in an effort to launch a more thorough investigation or hearing into an issue, will be useful in assessing potential investigative priorities in the upcoming year. In 2019, Democratic committee members have requested reports on data privacy, e-cigarettes, insurance companies, diversity and inclusion, hospital and nursing home facilities, climate change and drug pricing, many of which were subject to investigations last year.

The investigations and enforcement actions of state attorneys general also may be useful in predicting the potential investigative priorities of the House and Senate in 2020. State attorneys general often play a crucial role in bringing new issues to the forefront of committees and committee members. In July 2019, 22 state attorneys general sent a collective letter to Congress urging its members to address PFAS chemicals, which likely played a role in Congress' decision to investigate them. A coalition of state attorneys general also called on Congress to ban asbestos. Letter requests from state attorneys general aimed at prompting legislative action have resulted in oversight and investigations. Other issues and industries that state attorneys general have pursued include data privacy, cybersecurity, robocalls, generic pharmaceuticals, e-cigarettes and opioids. Although this is not an exhaustive list, there is tremendous overlap in oversight between Congress and state attorneys general.

Conclusion

As we saw in 2019, even when issues such as the various investigations into President Trump and his administration take center stage, congressional committees still expend significant attention and resources on oversight agendas that affect the private sector. Companies that are within industries that have been or are likely to be subject to congressional scrutiny in 2020, as described above, should assess whether to take proactive measures, such as modifying internal policies, halting certain practices or understanding certain risks posed by mergers and acquisitions.

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Antitrust enforcers in the United States and European Union (EU) remained active in 2019, and recent developments at the Department of Justice (DOJ), Federal Trade Commission (FTC), state attorneys general (AG) offices and EU agencies signal even greater levels of activity in 2020. The common theme is increased attention to high-tech industries and digital markets, which are expected to face heightened scrutiny.

United States

Focus on the Technology Industry

The DOJ and the FTC pursued active enforcement agendas in 2019. Grabbing the most headlines was the agencies' shared emphasis on alleged anticompetitive conduct in the technology industry. The FTC announced its Technology Task Force in February 2019 to "monitor competition and investigate potential anticompetitive conduct in markets in which digital technology is an important dimension of competition." This mandate includes scrutiny of allegedly anticompetitive practices and merger activity within technology-related industries, and the FTC has stated that multiple investigations are underway. For its part, the DOJ announced in July 2019 that it is investigating "whether and how market-leading online platforms have achieved market power and are engaging in practices that have reduced competition, stifled innovation, or otherwise harmed consumers." Similar to the FTC, the DOJ has stated that it is investigating conduct and merger activity, and media reports have suggested that its investigations are similarly wide-ranging.

While the exact scope of these investigations is not known, leaders at both agencies have indicated that they are specifically looking at the use of big data to exclude competitors, the leveraging of two-sided platforms (*e.g.*, leveraging significant membership base to extract higher payments from advertisers) and "killer acquisitions" (in which a large company acquires a smaller competitor to stifle innovation or eliminate competition) — issues that historically have not been the basis for enforcement actions. With respect to merger reviews, both agencies are focused on prospective and consummated transactions. Companies considering acquisitions in technology-related sectors in 2020 face greater risk of prolonged investigations and, possibly, enforcement actions based on novel theories that would not have been anticipated in the past.

State Attorneys General Are Increasingly Active

State AGs also significantly increased their enforcement activity in 2019. For many years, state AGs generally were content to follow the lead of the DOJ or FTC when it came to merger reviews, but nine states and the District of Columbia broke that mold in June 2019 when they filed suit to block T-Mobile's proposed acquisition of Sprint, despite the DOJ's decision to clear the deal subject to a divestiture. Eight more states joined that lawsuit (although four states have now withdrawn). A two-week bench trial was held in December 2019. The suit raises complex issues related to the interplay of federal and state antitrust enforcement authority. The outcome carries significant implications for the T-Mobile/Sprint merger and potentially could embolden individual states to more actively police mergers on their own, regardless of the outcome of DOJ or FTC review.

Increased activity by state AGs is not limited to mergers, as many states have announced that they are opening their own investigations into technology firms that could mirror the DOJ and FTC investigations. Both agencies have signaled that

they are coordinating to some degree with state AGs as they conduct these parallel investigations, indicating that the possibility of federal and state antitrust enforcers working together, when possible, still exists.

Expect Continued Vigorous Enforcement

Although we have yet to see results of recent antitrust investigations, DOJ and FTC leaders have suggested that those will come as soon as 2020. In addition, companies should be cognizant of the heightened risk of independent — and perhaps divergent — state AG investigations. Finally, both Democratic and Republican candidates in the 2020 elections have stated that vigorous antitrust enforcement is a key part of their agendas. Given that all signs point to continued vigorous enforcement, companies should have a firm grasp of the possible antitrust risks associated with their business decisions and have a strong game plan to avoid any antitrust pitfalls.

European Union

On November 27, 2019, the EU Parliament approved the new composition of the European Commission (EC), the EU's executive arm, for a five-year term. Margrethe Vestager will serve a second term as the commissioner in charge of the competition department (DG COMP). In a rare dual role for a commissioner, she also will coordinate the EC's digital agenda, which involves working on the Digital Services Act and a European approach to artificial intelligence. Digital markets are a priority area for DG COMP, but Brussels will not monopolize the debate, as regulators in EU member states are expected to remain prevalent. Companies can expect to face novel theories of harm and speedier interventions from regulators.

Digital Markets

In April 2019, an expert panel appointed by Commissioner Vestager issued a report on competition policy for the digital era, the findings of which will influence the EC's enforcement activities. The report's key conclusions include a number of novel approaches, indicating, for example, that the EC may:

- view a company's access to data as a reflection of its market power;
- define market power more broadly than the traditional market definition;
- prohibit potentially anticompetitive conduct absent a showing of pro-competitiveness; and
- assess acquisitions of fast-growing startups to be part of an anticompetitive strategy to make up for the acquirer's own user defections.

Additionally, the EC is concerned about companies regulating their own platforms if those platforms are used by other businesses. Given these developments, increased enforcement intervention is likely; however, as no sweeping legislative changes are expected, it remains to be seen whether the EU courts will support these novel approaches.

Assertive Local Authorities

Companies doing business in the EU also may face member state authorities that have their own agendas. Some of the highest-profile cases of 2019 originated in the member states, including investigations into use of personal data, online advertisement practices, digital payment methods and e-commerce/logistics activities. It is uncertain whether all these investigations will result in enforcement decisions but they demonstrate that national competition authorities are willing to take on global players and business practices, even if the EC is conducting parallel investigations.

In the area of merger control, expect increased intervention by national regulators as well, most notably in the U.K., where deals in the digital industry receive intense scrutiny. The German legislature is working on revisions to the German competition law with a particular focus on digital markets and platforms, allowing for early intervention against digital platform companies leveraging their market power.

Interim Measures

For the first time in almost two decades, the EC imposed interim measures in an ongoing investigation. The decision is appealed, but Commissioner Vestager has indicated that she will use interim measures again if necessary. This desire for swift intervention, especially in tipping markets, is echoed by national authorities. In the U.K., a 2019 expert report has called for increased use of interim measures, and the Belgian, Dutch and Luxembourg competition authorities have expressed the need for an ex ante intervention mechanism against gatekeepers to online ecosystems, *e.g.*, dominant companies that control a platform.

Expect Intrusive Enforcement Actions

We predict vigorous antitrust enforcement across the EU in 2020, notably in the digital space. Authorities in many EU capitals may feel the need to deliver on their promises, as well as the competitive pressures from fellow authorities. The EC may demonstrate less patience for long-running investigations and open-ended remedies, and an increased desire to fix perceived issues quickly and comprehensively.

Blockchain Trends and Enforcement Surrounding the New Technology

In 2019, regulators continued to consider whether and how to regulate blockchain technology. After the two previous years that included a high number of initial coin offerings (ICOs), many of which involved allegedly fraudulent conduct, 2019 was marked by the growth of "stablecoins" (*i.e.*, coins that are stabilized through a computer algorithm or by being backed by a reserve asset). Many regulators and policymakers have turned their attention to the potential impact of stablecoins on monetary policy since, if successful, such nonvolatile coins could become a true medium of exchange to complement fiat currencies.

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The fact that regulators have started to consider the possibility of these coins becoming an accepted means of global payment is a testament to the growth of the technology and the number of projects seeking to develop a useable virtual currency. Despite that shift, the U.S. Securities and Exchange Commission (SEC) continued to bring enforcement actions throughout 2019. These efforts likely will continue in 2020, increasing the probability that the courts may be called upon to provide some clarity around token sale activity that occurred in 2017 and 2018.

Regulatory advancements in a number of countries also highlighted that companies looking to monetize blockchain technology cannot have a U.S.-centric view.

SEC Enforcement Activity

The SEC brought a series of enforcement actions in 2019 and entered into a number of settlements with entities that engaged in ICOs, as well as others that allegedly took part in fraudulent activity.

For example, the SEC settled charges against SimplyVital Health, Inc., a New England-based blockchain company that had raised $6.3 million for a blockchain-based health care protocol using Simple Agreement for Future Tokens (SAFT) purchase agreements, under which SimplyVital would create tokens and deliver them to investors. The SAFTs were not offered pursuant to a registration statement, and many agreements were with individuals whom SimplyVital had failed to verify were accredited investors. The settlement included no civil penalty in part because SimplyVital had scrapped its token program and returned "substantially all" of the funds to those who had participated in the SAFTs presale. SimplyVital also agreed to a cease-and-desist order preventing it from "committing or causing any violations and any future violations of Section 5(a) and (c) of the Securities Act," without admitting or denying the SEC's findings.

Also in 2019, the SEC announced that it had settled charges against Bitqyck, Inc. and its founders in connection with their operation of a digital asset exchange, TradeBQ, which allowed the trading of a single security, Bitqy, one of two digital assets the SEC alleged Bitqyck fraudulently offered to investors. The SEC asserted, in part, that Bitqyck persuaded investors to purchase Bitqy by falsely claiming that it provided an interest in a cryptocurrency mining facility powered by below-market-rate electricity. As part of the settlement, Bitqyck agreed to injunctive relief, without admitting or denying the SEC's findings. The company also agreed to pay over $8 million in disgorgement, interest and penalties; and its founders each agreed to pay over $850,000 in disgorgement, interest and penalties.

In December 2019, the SEC settled charges with Blockchain of Things, Inc. (BCOT), which had conducted a "presale" and "public sale" through which it offered and sold BCOT tokens. Without admitting or denying liability, BCOT agreed, among other things, to register the BCOT tokens as a class of securities under Section 12(g) of the Securities Exchange Act of 1934, and to inform BCOT purchasers of their ability to recover any consideration paid for such tokens.

Also in 2019, the SEC's Strategic Hub for Innovation and Financial Technology (FinHub) issued its second no-action letter in the blockchain industry to Pocketful of Quarters (PoQ) regarding a token for video games on what is largely a closed, permissioned platform. Similar to FinHub's first no-action letter — a 2018 letter to TurnKey Jet, Inc. regarding tokens to be used on a private, permissioned blockchain platform to purchase charter jet services from the company — the PoQ letter dealt with a narrow use case that does not provide substantial guidance for other decentralized blockchain projects.

Finally, in 2019, the SEC brought high-profile enforcement actions in federal court against two digital asset developers, Kik and Telegram.[1] Notably, neither action involves fraud allegations, but assert violations of the Securities Act of 1933 based on the developers' alleged failure to register their offerings under the federal securities laws. Both cases are being watched closely, as the rulings may provide much-anticipated judicial guidance in this new area of the law.

New York BitLicense 2.0

In 2015, seeking to regulate the growing cryptocurrency industry, the New York State Department of Financial Services (NYDFS) began requiring companies engaged in "virtual currency business activity" to obtain a license (BitLicense). The BitLicense has come under fire for having onerous requirements and a lengthy procurement time, with some saying this has caused cryptocurrency companies to leave New York. Acknowledging these issues, in 2019 NYDFS Superintendent Linda Lacewell established a new Research and Innovation Division to consider, among other matters, whether the BitLicense process could be improved while still protecting consumers. To that end, in December 2019, the NYDFS proposed two new measures to enhance the BitLicense: (i) a public list of coins that are permitted for virtual currency business activities without the NYDFS' prior approval, and (ii) a model framework for creating a self-certification process for virtual currency businesses. Although in its early stages, these proposals reflect that regulators are seeking to strike a balance between fostering innovation and protecting consumers.

Report on GDPR and the Need for Regulatory Guidance

Since the European Union's General Data Protection Regulation (GDPR) went into effect in May 2018, many have questioned how the regulation can be applied to blockchain applications given the technology's highly decentralized and immutable structure. A lengthy July 2019 report commissioned by the European Parliament Panel for the Future of Science and Technology (the STOA Report) provides the most comprehensive and thorough analysis to date of these issues. Not surprisingly, the STOA Report concludes developers need to consider GDPR requirements and cannot simply determine that the law is incompatible with the technology. However, the STOA Report is also a call to action to European data protection regulators, noting that various GDPR provisions do not work in blockchain-based systems and further regulatory guidance is required. As the STOA Report states, attempts to draft the GDPR to be technology-agnostic have created ambiguities requiring further clarification. Whether such guidance emerges, and whether it resolves these ambiguities, remains to be seen, but the STOA Report was significant in acknowledging that regulatory openness is required in order for blockchain technology to achieve its potential.

Stablecoin Reports

In 2019, stablecoins drew the attention of regulators and financial sector policymakers. For example, in October 2019, the Financial Stability Board (FSB), which coordinates the national financial authorities and international standard-setting bodies to develop effective financial sector policies and regulation, issued its own report on stablecoins. The FSB acknowledged that the financial system could benefit from stablecoins by providing lower costs in cross-border transactions and facilitating financial inclusion given the widespread use of smartphones. The report notes the need for regulators to determine how existing country-specific and international standards and principles can support stablecoins. Similarly, in December 2019, the Council of the European Union and the Commission on Stablecoins issued a joint statement on stablecoins, in which they highlighted the opportunities stablecoins present in terms of cheap and fast payments but also the challenges and risks they pose. The council and commission concluded that no global stablecoin arrangement should begin operating in the European Union until "the legal, regulatory and oversight challenges and risks have been adequately identified and addressed."

2020 Outlook

In 2020, we anticipate that regulators and policymakers will continue to search for a balance between fostering a technology that could have significant positive impacts on financial services and other industries with existing laws and regulations. We also anticipate greater cross-border cooperation in addressing these issues.

[1] Skadden is counsel of record for Telegram in its proceedings.

CFIUS' First Full Year Under FIRRMA

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The achievement of legislative consensus in 2018 around a preferred approach to safeguarding U.S. technology and information from national security threats via foreign investment resulted in passage of the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA). Following the legislation and the associated adoption of two sets of rules by the Committee on Foreign Investment in the United States (CFIUS) to begin implementing the legislative vision, the focus shifted from the legislators to the activity of CFIUS itself.

In its first full year under FIRRMA, CFIUS has learned what works and does not work under its interim rules, clarified its increased jurisdiction and focus on transactions involving critical technology and infrastructure and sensitive personal data, and demonstrated a growing appetite for reviewing non-notified transactions (*i.e.*, transactions that are not voluntarily filed with the Committee) and enforcing mitigation agreements. In 2020, we expect general continuity of CFIUS practices, with an increased focus on China-related non-notified transactions; implementation of the final FIRRMA regulations (effective February 13, 2020) that will fill some regulatory gaps, including civil penalties, use of voluntary declarations and white-listed countries; and, likely most significantly, expanded mandatory CFIUS coverage via continuing export control reform.

Although CFIUS is a crucial and often-used tool in the U.S. government's broader efforts to protect U.S. technology, information, infrastructure and security from foreign actors, it is far from the only tool available. More specifically, as the U.S. government has pursued a "decoupling" of the U.S. and China — particularly as it relates to sensitive U.S. technology — Congress and the executive branch have pursued numerous related but distinct initiatives. Export control reform, greater scrutiny of export control licenses, executive orders related to specific Chinese actors and broader review of foreign technology in U.S. information and communications technology, limits on the U.S. government's use of technology from certain foreign providers and aggressive use of more traditional trade instruments all combine to significantly complicate cross-border business, investments and supply chains. In this light, CFIUS and other developing initiatives likely will remain central to investors and businesses through 2020 and beyond.

Safeguarding Critical Technology: FIRRMA's Pilot Program and Mandatory Filings

In October 2018, CFIUS implemented FIRRMA's Pilot Program for critical technology transactions, which effectuated both the Committee's expanded jurisdiction to review certain noncontrolling investments that involve information rights for minority investors and its new authority to direct that certain filings — for the first time ever — be mandatory. (See "US Finalizes CFIUS Reform: What It Means for Dealmakers and Foreign Investment" and "CFIUS Pilot Program Expands Jurisdiction to Certain Noncontrolling Investments, Requires Mandatory Declarations for Some Critical Technology Investments.") With the release of the final regulations, CFIUS clarified that the Pilot Program in its current form remains in effect through February 12, 2020. Beginning February 13, 2020, the Pilot Program will, in substance, remain in effect, but will be fully integrated within the CFIUS final regulations. Thus, mandatory filings for controlling and certain noncontrolling investments in critical technology remain,

and they have in fact been expanded to certain foreign government-related transactions in businesses involving critical infrastructure and sensitive data. What remains uncertain — although CFIUS' general intent is clear — is exactly how CFIUS will modify the current NAICS-code based mandatory filing requirements and implement a filing requirement based solely on export control considerations. (According to the preamble to the final rule, Treasury anticipates issuing a separate notice of proposed rulemaking that would effectively eliminate the association between "critical technologies" and the 27 industries previously identified as sensitive. Rather, the mandatory filing requirement would be triggered by export licensing requirements alone.)

Thus far, the mandatory filing requirement has impacted both deal diligence and timing for many implicated transactions. In particular, technology-focused funds and early-stage investors have confronted a disconnect between a fast-moving investment environment in the early-stage technology sector and the delays inherent to a CFIUS review. CFIUS sought to address delays by creating a short-form declaration and providing alternative results to approve or block a transaction, but investors encountered mixed results in terms of both timing and certainty. CFIUS has yet to publish statistics on the declaration process but has made informal comments to the effect that, although a significant number of declarations have been submitted, they often do not provide investors with the "safe harbor" that results from formal CFIUS approval of a transaction. In other cases, filing a short-form declaration has resulted in CFIUS requesting that the parties file a full notice, extending the length of the CFIUS process. Accordingly, parties should consider filing a full notice for a Pilot Program transaction at the outset, in lieu of a short-form declaration, or should carefully structure the transaction (*e.g.*, by limiting governance or information rights) such that a mandatory filing is not required. In 2020, short-form declarations may prove much more helpful once CFIUS implements rules permitting parties to use them for voluntary filings for less sensitive transactions, and not just for mandatory critical technology filings.

Emerging and Foundational Technologies: Ongoing Reform Means Continued Uncertainty

The Pilot Program compelled U.S. companies to pay closer attention to, and often to become more educated about, the export control classifications of their products, services and technology — a task made more difficult by ongoing export control reform. (See "Tightened Restrictions on Technology Transfer Under the Export Control Reform Act.") In November 2018, the Department of Commerce (Commerce)

Key Takeaways for 2020 and Beyond

- The vast majority of CFIUS filings will remain voluntary, and important considerations remain for voluntarily filing, including CFIUS' expanded jurisdiction and increased attention to non-notified transactions.
- CFIUS' jurisdiction and sensitivity will remain aligned with export control laws, and both foreign investors and U.S. companies considering business combinations should develop or maintain fundamental competency in the subject area.
- CFIUS is expected to have greater resources and appetite for enforcing mitigation agreements; therefore, companies must prioritize understanding and complying with both new and existing agreements.
- CFIUS' increasing interest in companies that collect U.S. citizen information is likely to result in increased mitigation to shield foreign investors from accessing that information.
- Parties contemplating covered transactions in the information and communications technology sector should expect more focus on supply chain restrictions and vendor review in potential mitigation agreements.
- The Committee remains primarily concerned with the national security threats posed by China, and thus both Chinese investors and non-Chinese investors with significant Chinese connections are likely to be subject to increased scrutiny.
- The majority of CFIUS' requirements will continue to apply to "excepted investors" from "excepted countries" even if CFIUS establishes, as expected, a "white list" of such investors and countries.

published an advance notice of proposed rulemaking to solicit comments on the criteria it will use to identify "emerging" technologies. Emerging technologies fall into representative categories that include artificial intelligence and machine learning, quantum computing, robotics, nanotechnology and biotechnology, among others. Commerce has yet to publish specific proposed rules for emerging technologies — newly developed technologies such as artificial intelligence, machine learning, autonomous vehicle technology or robotics that are not already captured by existing export controls — or an advanced notice of proposed rulemaking regarding "foundational" technologies — meaning technologies currently subject to existing export controls that are only controlled for anti-terrorism reasons, and which are therefore generally freely exportable to all but U.S.-embargoed destinations. However, we expect gradual rulemaking on this front throughout 2020. (See "Commerce Department Will Move Forward With More Stringent Export Controls for Certain Emerging Technologies" for additional insight into the proposed emerging technologies rules.) Both technologies are explicitly included in CFIUS' definition of "critical technology" and thus potentially implicate mandatory filing requirements and impact CFIUS' view of the risk associated with affected transactions.

Non-Notified Transactions: Increasing Scrutiny

Before FIRRMA, CFIUS had the authority to review non-notified transactions; however, its resources were limited. The number of voluntarily filed transaction notices continues to increase, with over 200 filed in 2017, over 230 in 2018 and over 240 in 2019 (not including additional short-form declarations filed in the past year). FIRRMA granted CFIUS increased hiring authority, permitting it to build up its capacity and allowing certain staff members to spend more time strictly focused on non-notified transactions. Over the past year CFIUS demonstrated an increased emphasis on this category, which tends to generate dramatic outcomes, including its authority to unwind transactions. This was demonstrated in Beijing Kunlun Wanwei Technology's acquisition of a stake in Grindr — a company that collects personal user data including sexual orientation, HIV status and photos — in which CFIUS initiated and ultimately ordered Kunlun to divest its interest; and PatientsLikeMe's acquisition by iCarbonX — a Chinese digital health company — in which CFIUS similarly forced iCarbonX to divest its interest. These divestments demonstrate both CFIUS' willingness to review completed transactions and force divestiture when it finds a national security concern and its increasing focus on deals that involve sensitive data about U.S. persons, such as health, genetic and other general information. Given CFIUS' increased focus on non-notified transactions, and its willingness to force divestitures of completed transactions to address its concerns, companies should carefully weigh the effects a voluntary filing will have on deal certainty and timing against the sensitivity of the transaction and the likelihood CFIUS may take an interest. This becomes most important when investments have a nexus — either direct or indirect — to China or Russia, or involve especially sensitive technology or information. As both above-cited cases illustrate, CFIUS' definition of what makes a transaction sensitive goes far beyond traditional government-related technologies and information.

National Security Agreements: Evolving CFIUS Practices

FIRRMA granted CFIUS broader powers to mitigate threats to national security. For example, CFIUS can suspend a transaction during its review or call for interim mitigation before completing review, and CFIUS may unilaterally open a review for any breach — even if unintentional — of a mitigation agreement. In April 2019, for the first time ever, CFIUS imposed a $1 million civil penalty for repeated breaches of a 2016 CFIUS mitigation agreement, citing its "commitment to enforcement." Later in 2019, CFIUS imposed a $750,000 civil penalty for violations of a CFIUS interim order related to data access and monitoring. CFIUS' increased hiring authority is likely to correspond to greater attention to negotiating and enforcing mitigation agreements in 2020; such agreements may involve — among other measures — limitations on governance and information rights, supply chain assurances, cyber and data security requirements, supply assurances to the U.S. government, security monitoring and annual audits. Given CFIUS' growing appetite for enforcement, companies must carefully consider their future ability to comply when entering into a new agreement. Companies operating under mitigation should consider allocating resources to prioritize and ensure ongoing compliance.

China-Related Investments: No Relief in Sight

Despite tense ongoing trade negotiations, most notably with China, the U.S. government has strictly maintained that the country remains open to foreign investment — a sentiment CFIUS representatives have echoed publicly. But CFIUS and a number of federal agencies also have continued to articulate strong concerns about both the legal and illegal transfer of U.S. technology and data to China — a worry that was the principal motivating factor behind FIRRMA's enactment. A number of recent public enforcement actions have targeted Chinese companies, such as CFIUS' forced divestments of Grindr and PatientsLikeMe, and in other contexts, such as with the $1 billion fine ZTE was required to pay under its

settlement agreement in connection with export violations. Although CFIUS approved some deals involving China in 2019, the harsh scrutiny and increased likelihood of either heavily mitigated or blocked transactions coincided with a noticeable downturn in Chinese foreign direct investment. CFIUS' concerns about China extend to joint ventures as well. Even before FIRRMA, CFIUS had the jurisdiction to review technology transfers to China through joint ventures, and CFIUS' focus on and skepticism of these arrangements has continued. Accordingly, non-Chinese investors should continue to carefully consider the terms of their existing joint venture agreements, as well as the ultimate sources of any co-investment funds they may use when entering into a transaction.

Final Rules: Greater Definitiveness and Possible Changes in 2020

In September 2019, CFIUS issued two sets of proposed regulations seeking to further implement FIRRMA, and, on January 13, 2020, CFIUS issued final FIRRMA regulations effective February 13, 2020. (See "Draft CFIUS Regulations Portend Evolution, Not Revolution.") Among other things, these rules codified CFIUS' expanded jurisdiction over noncontrolling investments in, and increasing attention to, businesses involving critical technology, infrastructure or bulk U.S. personal data — "TID U.S. Businesses." The final rules address most of FIRRMA's mandated changes, including the following key highlights:

- **Technology U.S. Businesses.** As noted above, the final rules clarify that CFIUS will maintain the mandatory filing regime for entities in this category. The most significant changes yet to come in this realm will be Commerce's release of defined "emerging and foundational technologies" and future rulemaking to replace the industry-based filing criteria with one focused on export control licensing requirements.
- **Infrastructure U.S. Businesses.** The final rules clarify CFIUS' focus on Infrastructure U.S. Businesses, which will be defined through the functions a U.S. business performs in relation to critical infrastructure. For example, covered critical infrastructure includes telecommunications services, a particular focus of the U.S. government over the past year, and the final rules implicate U.S. businesses that supply or service telecommunications infrastructure. (See "Commerce Department Takes Steps To Thwart Use of Information and Communications Technology and Services Associated With Foreign Adversaries.") Parties contemplating covered transactions in the telecommunications industry should expect more focus on supply chain restrictions and vendor review in potential mitigation agreements.
- **Data U.S. Businesses.** Motivated by concerns that foreign governments may influence foreign parent companies to directly access U.S. personal data, the final regulations define Data U.S. Businesses in a way that affects a wide range of companies that likely would not have considered themselves to be of interest to CFIUS. This is in part because CFIUS has prospectively defined personally "identifiable data" to include all data that "can be used to distinguish or trace an individual's identity" when it is not aggregated or otherwise anonymized. While CFIUS has limited the definition to apply to businesses that have collected or maintained data on over 1 million individuals (or have demonstrated an objective to do so), in practice this requirement does little to narrow CFIUS' scope. Examples added to the final regulations confirm CFIUS' expansive scope, for example, stating that the time period for demonstrating a business objective to maintain or collect sensitive data from 1 million individuals could extend out to at least two years. Foreign investors will want to expand their diligence regarding how a U.S. business collects, stores and protects its U.S. personal data when considering a new transaction. Conversely, sellers will be interested in a potential purchaser's history of data-related compliance and practices. Importantly, CFIUS has shown an interest in all data, not just identifiable data that meets the definition for a TID U.S. Business, and this sensitivity to data can provide a hook for jurisdiction where CFIUS may have other concerns about a foreign investor.
- In addition to the primary set of rules that addresses TID U.S. Businesses, CFIUS issued a second set of rules to codify its expanded jurisdiction over real estate. Under FIRRMA, the Committee's jurisdiction includes certain stand-alone real estate deals that would not traditionally have been covered transactions. The final regulations focus primarily on real estate transactions that could provide a foreign person with proximity to airports and maritime ports or to military installations or other sensitive facilities or properties of the U.S. government. Like with Infrastructure U.S. Businesses, the final rules lack specificity, and investors will be looking to see how CFIUS asserts its jurisdiction in practice once the rules are published. The Committee anticipates providing a web-based tool for the public to better understand the geographic coverage of the final regulations. Investors should remain cognizant, however, that CFIUS' expanded jurisdiction over real estate transactions does not preclude the Committee from exercising jurisdiction over transactions that involve could result in foreign control or certain non-controlling investments by a foreign person in an entity engaged in interstate commerce that also owns or leases real estate.

CFIUS 'White List'

One of the more widely anticipated changes under the final rules was clarification of whether and how CFIUS would establish the "white list" to exempt certain foreign investors from filing requirements for their noncontrolling investments in TID U.S. businesses. Under FIRRMA, CFIUS was directed to specify criteria to limit its application of expanded jurisdiction to certain categories of foreign persons. In its final rules, CFIUS addressed this by creating a set of "excepted foreign states" to receive special treatment; excepted investors, in turn, must be from "excepted foreign states." CFIUS' initial list includes Australia, Canada and the United Kingdom — three countries that share extremely close intelligence and foreign investment review relationships with the United States.

Perhaps most importantly, the expected benefit to these "excepted investors" is likely to be small because the white list will not exempt foreign investors from CFIUS' jurisdiction in controlling transactions. In essence, meeting the "excepted investor" criteria exempts certain Australian, Canadian and U.K. investors from CFIUS' expanded jurisdiction, but does nothing to remove their investments from the Committee's traditional jurisdiction over transactions in which the foreign person obtains a controlling interest in a U.S. business. Further, although inclusion as an excepted investor can suggest that CFIUS views a foreign investor as a relatively lower-threat acquirer, a filing may be warranted if the acquired asset is particularly sensitive to U.S. national security. Given these limitations, we expect the white list likely will have limited practical effect for investors.

Conservative Party Win Paves Way for Reforms to UK National Security Reviews

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The Conservative Party's conclusive win in the U.K.'s recent general election paves the way for long-anticipated and decisive reforms to the country's national security screening regime. The government first outlined its proposals for a wide-ranging national security screening regime for inward investments in a white paper published in mid-2018. (See "Foreign Investment Control Reforms in Europe.") With Brexit leaving little political bandwidth in the U.K. and the prior government's lack of a majority in Parliament making the successful passage of legislation very uncertain, those reforms have not yet been enacted. However, now armed with an 80-seat majority, the government is well-positioned to ensure the successful implementation of its legislative agenda, and the proposed reforms are likely to be implemented in the near future.

Recent government interventions in high-profile transactions with national security implications highlight the increased focus on national security concerns, provide useful lessons for navigating the future regime and act as a reminder that the existing regime is not without teeth.

Existing Enterprise Act 2002 Regime

The Enterprise Act 2002 allows the U.K. government to intervene in transactions that raise national security concerns, including by attaching a public interest intervention mechanism to both the U.K. and the European Union (EU) antitrust merger control regimes. In 2018, as a stop-gap measure prior to implementing the proposed new national security screening regime, merger control thresholds were lowered to a £1 million turnover or a 25% share of the supply (either buyer or target) for businesses that are active in (i) military or dual-use goods subject to export control, (ii) computer processing units and (iii) quantum technology. No threshold applies for designated U.K. military suppliers, giving the government an ability to intervene in smaller direct suppliers and nascent businesses with national security implications.

After the government issues an intervention notice, the U.K.'s Competition and Markets Authority (CMA) must report on the potential transaction, and the relevant secretary of state must determine whether a more detailed and protracted "Phase 2" review by the CMA is needed. A Phase 2 review can include blocking the transaction in its entirety. The relevant secretary of state generally has allowed transactions to proceed without a Phase 2 referral, subject to the parties to the transaction agreeing to legally binding undertakings to address national security concerns.

The Enterprise Act regime is supplemented by existing nonstatutory measures, including U.K. government-owned "golden shares" in a limited number of U.K. companies considered strategically important, which provide the government with certain governance rights over the company, including the right to restrict shareholdings in the company to 15%. Further, U.K. government departments, in particular the Ministry of Defence, routinely require companies to obtain their consent for proposed changes of control of important suppliers.

Recent Developments

From 2002-2018, the U.K. government brought eight public interest interventions on national security grounds under the Enterprise Act regime. In seven of those cases, the government accepted undertakings and allowed the transactions to proceed; in one case, it did not identify any national security concerns.

Consistent with the increasing focus on national security issues, the U.K. government issued intervention notices in four transactions in 2019 and accepted undertakings from the bidders to address national security concerns in two cases (two are still in the initial review stage).

Notably, one case involved the U.K. government issuing an injunctive order in relation to an acquisition that had not been formally notified: the proposed acquisition of Mettis Aerospace by Aerostar, a fund established in China. This was the first time that the U.K. government issued an injunctive order to prevent completion based on national security grounds.

Advent's Proposed Acquisition of Cobham plc

On July 25, 2019, defense contractor Cobham and funds managed by U.S. private equity firm Advent International agreed to Advent's approximately £4 billion cash acquisition of Cobham.

The U.K. Ministry of Defence identified Cobham as a supplier and subcontractor of products and services of particular importance to national security. On September 17, 2019, U.K. Secretary of State for Business, Energy and Industrial Strategy (BEIS) Andrea Leadsom announced that she would intervene in the transaction. Following a CMA report, engagement with relevant government agencies, including the U.K. Ministry of Defence, and a public consultation process, the secretary of state announced on December 20, 2019, that she would accept Advent's proposed undertakings to address national security concerns.

The legally binding undertakings are intended to:

- ensure that Cobham's existing security arrangements protecting sensitive U.K. government information will be continued and strengthened, and that, in addition to existing boards, new board structures implemented under the ownership of Advent will comply with national requirements;
- require Cobham's new owners to honor the terms of existing contracts, notify the U.K. Ministry of Defence in advance if a material change would impact Cobham's ability to supply key services, and refrain from withdrawing from any specified service for a set period; and
- require Cobham's new owners to give the Ministry of Defence prior notice of plans to sell all or parts of Cobham's business in order to inform the exercise of Enterprise Act powers designed to protect national security interests in future transactions.

Acquisition of Inmarsat plc

A consortium of private equity firms, including Apax Partners and Warburg Pincus, launched a $3.4 billion takeover bid on March 19, 2019, for Inmarsat, a British satellite telecommunications company.

On July 23, 2019, then-Secretary of State for Digital, Culture, Media and Sport Jeremy Wright issued a public interest intervention notice on national security grounds under the Enterprise Act. Following a review and public consultation, the secretary of state accepted undertakings intended to require the bidder and Inmarsat to:

- maintain existing security measures and implement enhanced controls to protect sensitive information and technology from unauthorized access, including a high standard of physical security, information technology systems security and personnel security; and
- continue to provide certain capabilities and maintain a U.K.-registered company to ensure that relevant services remain under U.K. jurisdiction.

The undertakings provide rights of access to premises and information and other provisions to enable the U.K. Ministry of Defence and other government agencies to audit compliance with the security measures and undertakings.

Lessons Drawn From the Cobham and Inmarsat Transactions

The outcomes of both the Cobham and Inmarsat transactions highlight particular areas of focus for the U.K. defense establishment in assessing all transactions, in particular, the importance of:

- maintaining strategic capabilities in the U.K., including continuity of development and/or supply of goods and services provided by U.K. companies for military programs;
- retaining the U.K.'s capability to develop, operate and maintain equipment, platforms and technologies independent of other countries so as to preserve the operational capabilities of the U.K. Armed Forces, particularly in the event that the U.K. stands alone in any particular conflict;
- ensuring that the target's capabilities continue to be made available and maintained in the U.K.;
- protecting classified information, including ensuring that military programs and security within the U.K. be maintained in line with U.K. National Security Regulations;

- protecting sensitive information and technology, and keeping confidential and limiting intellectual property use;
- protecting and retaining "U.K. Eyes Only" for classified information; and
- retaining a majority of U.K. security-cleared British citizens on target company boards.

Companies facing a national security review may also find it helpful to emphasize aspects of the proposed deal that would diversify and enhance the U.K.'s supply chain, promote exports from the U.K. target to other markets and close current and future (post-Brexit) capability gaps.

In addition to the Cobham and Inmarsat transactions, the U.K. government recently intervened in two additional transactions on national security grounds.

Proposed Acquisition of Impcross Limited

On December 6, 2019, the CMA announced that it was investigating the anticipated acquisition by Chinese-owned aircraft parts supplier Gardner Aerospace Holdings Limited of aerospace player Impcross Limited after an intervention notice was issued. The CMA is expected to report early in March 2020.

Proposed Acquisition of Mettis Aerospace

On December 20, 2019, Andrea Leadsom, the U.K. secretary of state for BEIS, announced that she had issued a public intervention notice in relation to the proposed acquisition of Mettis Aerospace, an aircraft parts manufacturer, by Aerostar, a fund established in China.

The secretary of state also issued an injunctive order preventing Mettis Aerospace from taking any actions that might raise national security concerns. This was intended to prevent both the completion of the transaction and the transfer of information know-how or documents to Aerostar. The order also imposes obligations in relation to Mettis' business operations, safeguarding of assets and reporting. This first use of an injunctive order to prevent a completion on national security grounds demonstrates the U.K. government's increased readiness to use its powers to stop deals pending national security review.

The CMA is expected to report in the second half of March 2020, after which the secretary of state will decide whether to clear the merger, including by accepting undertakings to address any national security concerns, or refer the merger to a Phase 2 review by the CMA.

This transaction highlights the importance of a proactive approach to national security screening for businesses active in sensitive sectors even in advance of the introduction of the proposed reforms, particularly for potential acquirers based in jurisdictions where the U.K. government's perceptions of potential risks to national security appear to be heightened.

The New Regime

The new government's legislative agenda, as laid out in the recent Queen's Speech, proposes a National Security and Investment Bill, which appears to be consistent with the proposals set out in the 2018 white paper, although the precise details of the proposed legislation, and the timing of its introduction, remain to be seen.

An Illusory Promise or Real Change? Transition at CFTC Brings Hope for Dodd-Frank Act Revisions

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Over the past five years, the Commodity Futures Trading Commission (CFTC) has settled 20 enforcement actions against financial institutions for violations of various Dodd-Frank Act regulatory requirements (*i.e.*, rules other than prohibitions on fraud, manipulation and spoofing). The resulting civil monetary penalties — for actions involving record keeping, know-your-customer, diligent supervision, swap data reporting, real-time price reporting and daily swap position reporting — exceed $45 million. Notably, almost half of these cases settled in 2019, indicating an acceleration of the trend in the last 12 months.

This uptick has occurred despite recent efforts to reduce regulatory obligations in the space. The Trump administration has sought, through executive order, to alleviate burdens in the over-the-counter (OTC) derivatives market, and the CFTC's 2017 "Project KISS" was intended to make the agency's rules, regulations and practices simpler, less burdensome and less costly. However, the strict liability standard and highly technical rules stemming from extensive regulatory requirements implemented in 2012 have created a difficult landscape within which market participants operate.

The trend also comes at a time of transition at the CFTC. In July 2019, a new chairman took the reins of the agency and has since appointed new directors for three of the agency's four operating divisions. Recent proposals from the new Division of Swap Dealer and Intermediary Oversight (DSIO) are a potentially promising indication that progress lies ahead. DSIO Director Joshua Sterling has voiced some welcome messages, supporting streamlining data use, limiting one-off no-action letter relief in favor of broadly applicable guidance and evaluating potential amendments to existing rules. At the same time, Director Sterling stated in remarks before the D.C. Bar in September 2019 that he is "strengthening [DSIO's] relationship with the Division of Enforcement with a more focused approach to referrals … ."

Background

New Year's Eve 2012 marked the beginning of the implementation of the Wall Street Transparency and Accountability Act of 2010, better known as Title VII of the Dodd-Frank Act. In the two years leading to the December 31, 2012, compliance date, the CFTC proposed and adopted nearly 40 comprehensive regulations comprising more than 150 new rules and scores of additional requirements. More than 3,600 pages were added to the Federal Register. The pace of rule-writing was unprecedented for the agency.

The rapid adoption of rules left little doubt that the CFTC would need to make future adjustments. Prior to 2012, the OTC swap market had been unregulated, opaque and dominated by customized transactions. Commissioner Jill Sommers highlighted some of the early challenges in her opening remarks at a 2011 CFTC open meeting: "There was often insufficient time to fully consider the implications of all aspects of some proposals, particularly when we were getting revisions the night before a vote, and sometimes the morning of a vote. [As a result,] we have issued a number of proposals in which at least three Commissioners have voiced concerns regarding the possibility of unintended consequences."

The extent of these unintended consequences is difficult to quantify, but one indicator is the dramatic increase

in CFTC staff no-action letters issued between 2012 and 2014. The agency did not have the time or resources to revise each rule, as more and more issues were identified in the run-up to the initial compliance date. Instead, as a stop-gap approach to plug many of the holes in the new and complex regulatory regime, the CFTC leaned on the no-action process, in which the staff issues a nonbinding notice that it will not recommend an enforcement action for failure to comply under specific circumstances. From 2012 to 2014, the staff issued 327 no-action letters, up from just nine in 2011. The relief in the no-action letters was often time-limited, sometimes for as little as a few months. Many of these had to be renewed perpetually. Others expired, yet the problems with the rules remained unresolved. This patchwork of no-action letters remains in place today, and the CFTC has done little to incorporate the staff's relief into its regulations.

Good Faith Compliance

In response to concerns from market participants during this timeframe, the CFTC often issued temporary relief. For example, on the Friday before Christmas 2012 — just 10 days before the compliance date — the CFTC adopted a time-limited exemptive order for cross-border swap activities through the first half of 2013. The order's preamble included what was thought by the industry to be the Commission's statement of a policy to refrain from bringing enforcement actions for technical noncompliance with Title VII swap rules when market participants attempted in good faith to comply.

The late Commissioner Bart Chilton touted the 2012 exemptive order and highlighted its language describing the Commission's policy to permit market participants to "avoid a Dodd-Frank compliance-related enforcement action by working to comply [with the new rules] reasonably and in good faith." Republican and Democratic Commissioners alike reiterated their commitment in congressional oversight hearings to the principle of "good faith compliance" as a basis for the CFTC to forgo enforcement action during the initial period of unprecedented implementation. Nevertheless, to date 80% of the Commission's enforcement actions for Dodd-Frank regulatory rule violations cite conduct from 2013.

Notably, most regulatory requirements under the Dodd-Frank Act do not require intent as an element of a violation. In other words, the Title VII Dodd-Frank regulatory regime essentially imposes strict liability. Market participants not surprisingly question whether this is the right fit for a previously unregulated market that recently became subject to numerous new and complex regulatory requirements.

Looking Ahead

Market participants have been waiting for the better part of a decade to see substantive steps taken to address many of the challenges and issues that resulted from the rushed implementation of Title VII. With the recent additions of a number of new senior staff and a new chairman, the Commission has a fresh opportunity to make significant reforms in this area.

The DSIO/Enforcement connection will be an area to watch closely. On one hand, the new Commission and staff have an opportunity to make meaningful improvements to the regulatory framework. On the other, increased referrals from DSIO to Enforcement may well simply contribute to the upward trend in enforcement actions for regulatory violations on a strict liability basis and provide very little in the way of meaningful regulatory reform.

Growing State Anti-Discrimination and Anti-Harassment Protections Create Patchwork of Regulations for Employers

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The #MeToo Movement, now in its third year, continued its evolution from grassroots activism to legislative change in 2019, with new laws addressing discrimination and harassment emerging from state governments and resulting in significant protections for employees. Employers face a patchwork of rules as they balance compliance with various state laws while also maintaining consistency in their workplace policies, procedures and trainings. Significant legislation in California, Illinois, New York state and New York City alone will affect tens of millions of employees, and employers can expect more states to follow the lead of these jurisdictions in the months and years to come.

Meanwhile, at the federal level, the trend of deregulation and lack of action continued. Long-awaited enforcement guidance on unlawful harassment from the Equal Employment Opportunity Commission (EEOC) remains in limbo, awaiting approval by the Office of Management and Budget, after first being proposed in January 2017. Additionally, the EEOC announced in September 2019 that it will stop collecting wage data for years after 2018. That move came after wage data collection requirements — which are meant to reduce pay inequality — were reinstated by the courts for 2017 and 2018.

Confidentiality Limits for Settlements and Employment Agreements

In California, newly enacted Section 1001 of the Code of Civil Procedure invalidates any provision in a settlement agreement that prevents an employee from disclosing the facts underlying a charge or complaint of workplace sexual harassment or sex discrimination. The law applies to any settlement on or after January 1, 2019. Additionally, Section 12964.5 of the California Government Code forbids employers from requiring their employees to sign a release of claims or a nondisclosure agreement related to sexual harassment or other illegal conduct as a condition of employment.

In Illinois, the Workplace Transparency Act, effective January 1, 2020, applies to certain settlements and employment agreements entered into or modified on or after that date. The Act drastically limits an employer's ability to require a provision in a settlement or termination agreement that prohibits an employee or former employee from making truthful statements of fact regarding unlawful workplace conduct. This type of confidentiality clause may be included only if it is the employee's stated preference, and an employer must give consideration in exchange for confidentiality. The Workplace Transparency Act also forbids any employment agreement or waiver that prevents an employee from disclosing illegal workplace conduct, including sexual harassment, to government authorities.

In June 2019, the New York State Legislature expanded its prohibition on confidentiality provisions in settlements. Agreements that resolve discrimination complaints may only prevent an employee from disclosing the facts and circumstances underlying the complaint if such nondisclosure is the employee's preference. This confidentiality prohibition previously applied only to settlements related to sexual harassment. Similar to Illinois law, a confidentiality provision may be included if it is the employee's preference. Additionally, any employment

agreements "that prevent the disclosure of factual information related to any future claim of discrimination" are unenforceable unless the agreements notify employees that they may discuss claims with government authorities and their own attorneys.

Mandatory Anti-Harassment Training

A new anti-harassment training mandate in California applies to employers with five or more employees, down from a 50-employee threshold prior to 2019. Where training was required only for supervisors, now all employees must receive anti-harassment training by January 1, 2021, and every two years thereafter. The statute specifies the required content and process for administration, for instance, the training must be interactive and must include instruction on bystander intervention.

Illinois' anti-sexual harassment training mandate applies to all entities, regardless of size, with employees in the state. Employees in Illinois must receive training annually starting January 1, 2020. Additional, industry-specific trainings must be provided to restaurant and bar employees. Penalties for noncompliant employers start at $500 for a first offense, rising to $3,000 for a third or subsequent offense.

New York employers faced their first anti-harassment training mandate deadline on October 9, 2019. All employees working in New York state for any portion of their employment must receive annual, interactive anti-harassment training. Additionally, New York City employers with 15 or more employees must administer annual anti-harassment training with more comprehensive content than the state-required training — though an employee who receives city-mandated training also will satisfy the state requirement.

Lower Standards of Proof Under Anti-Harassment and Anti-Discrimination Laws

Under federal anti-discrimination laws, a plaintiff alleging sexual harassment must prove that the harassing conduct was so severe or pervasive as to create an abusive, hostile or intimidating workplace. Until October 2019, the severe and pervasive standard also applied to sexual harassment suits brought under the New York State Human Rights Law. Now, to succeed on such a claim, a plaintiff need only prove the harassment caused inferior terms, conditions or privileges of employment. The new legislation also provides that the New York Human Rights Law must be construed liberally regardless of the manner in which similar federal civil rights laws are interpreted. The changes bring the state Human Rights Law in line with the New York City Human Rights Law, which has had a lower standard of proof since the 2009 state court ruling in *Williams v. New York City Housing Authority*.

Restrictions on Predispute Arbitration

California, Illinois and New York recently enacted laws aimed at curtailing mandatory arbitration for employment disputes. Under new revisions to California's Government and Labor Codes and under the Illinois Workplace Transparency Act, in both states an employer may not require an employee to sign an arbitration agreement as a condition of employment after January 1, 2020. In a June 2019 decision in *Latif v. Morgan Stanley & Co. LLC*, the United States District Court for the Southern District of New York struck down a New York state law that purported to invalidate mandatory arbitration agreements for discrimination claims, holding that the law is inconsistent with the Federal Arbitration Act. Similarly, a temporary restraining order preventing the California arbitration limits from going into effect was issued on December 29, 2019, by the United States District Court for the Eastern District of California in *Chamber of Commerce of the U.S. v. Becerra*.

The 2020 Landscape

Under the Federal Arbitration Act, state limits on arbitration are likely preempted. However, the wide variety of other state reforms enacted recently are probably here to stay and will very likely be emulated in other jurisdictions — albeit with some differences. Employers also must account for other stakeholders — such as applicants, employees, shareholders and customers — who will press for policies more comprehensive than what state or federal laws require. For instance, students at top law schools, including Harvard Law School, recently targeted law firms that have mandatory arbitration agreements for their employees, prompting a number of firms to drop those agreements. Similarly, several Silicon Valley entities have done away with mandatory arbitration for discrimination claims as a result of pressure from employees and activists. These examples demonstrate that employers must stay informed of current trends and demands for reform, even where their practices are lawful.

Following the lead of California, Illinois and New York, new laws in Nevada, New Jersey, Oregon and Vermont now restrict the use of confidentiality provisions in sexual harassment and discrimination settlements. Likewise, nondisclosure agreements that limit an employee's right to report allegations of discrimination and sexual harassment recently have been prohibited in New Jersey, Oregon, Vermont and Washington. In addition, the legislatures in New Jersey, Vermont and Washington recently have enacted bills limiting the use of arbitration to resolve charges of workplace harassment

and discrimination. In the coming year, employers can reasonably expect that additional states may enact legislation in this area.

Employers should prepare for increasingly fragmented state-by-state regulation, with each new law imposing unique requirements, by:

- reviewing employment agreements, separation agreements and settlements for compliance with the new laws;
- drafting a confidentiality provision in light of applicable state and federal laws, in particular by allowing parties to make factual disclosures to authorities;
- instituting thorough and comprehensive anti-harassment training for all employees;
- monitoring deadlines for required trainings and providing those trainings early in the employment relationship — preferably as part of the onboarding process;
- educating employees about workplace conduct in light of new legal standards applicable in harassment cases;
- reviewing and rewriting anti-harassment policies to be consistent with laws, new trainings and best practices;
- examining legislative and regulatory developments in other states, even where an employer does not currently operate; and
- supporting diversity and inclusion initiatives for employees.

Drug Pricing Concerns Drive Continued DOJ Focus on Life Sciences Companies

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In 2019, U.S. Department of Justice (DOJ) enforcement activity targeting drug and device manufacturers jumped sharply over the prior year, reflecting an increased focus on fraud and abuse in the life sciences sector. More than two-thirds of settlements involved Anti-Kickback Statute (AKS) violations, highlighting the DOJ's scrutiny of the financial relationships between drug and device manufacturers and those who purchase, prescribe or pay for their products. We expect attention on kickbacks and financial fraud to continue in 2020 as the DOJ targets the activities it believes contribute to high drug and medical device prices.

Although Congress and the Food and Drug Administration (FDA) took steps to reduce health care costs in 2019, the year ended without significant legislation. While it is unlikely in an election year that Congress will send a drug pricing bill to the president, we expect the Trump administration to continue its push to lower drug prices through price transparency requirements, faster FDA approval of generic and biosimilar products, and enforcement actions against manufacturers involving practices that the DOJ believes are unlawful and contribute to higher drug costs, particularly for specialty products. We also anticipate that various states will continue to enact bills aimed at lowering drug prices, although the impact on prices of such state initiatives has been modest to date.

DOJ Enforcement Trends: The Perils Persist

Pharmaceutical and device makers faced tough scrutiny in 2019 from DOJ prosecutors concerned about high drug costs and allegations of improper relationships with prescribers and users of their products, as well as promotional activities that encourage use of products for medically unnecessary indications. Speaker programs continued to face withering scrutiny, as did company interactions with physicians and insurance companies regarding coverage and reimbursement issues. Patient privacy concerns also appeared to motivate DOJ enforcement activities, with the DOJ increasingly utilizing the Health Insurance Portability and Accountability Act as an enforcement weapon. To address the greatest areas of risk, many companies are modernizing their compliance programs to include controls around patient and provider support activities that are becoming more central to the commercial success of many newer products, such as restricting access to protected health information through data privacy programs, auditing patient support services, outsourcing services related to financial or patient-reimbursement matters and building a firewall between patient-facing activities and marketing, to name a few.

The DOJ's interest in kickbacks and financial fraud rather than advertising and promotion reflects two important trends: (i) the evolving life sciences industry business model (which generally includes a more significant percentage of higher-cost therapies with smaller patient populations; greater interactions with payers, specialty pharmacies, reimbursement hubs and patient advocacy organizations; and more complex financial and reimbursement flows), and (ii) successful court challenges to DOJ actions premised on companies' provisions of truthful, non-misleading information about their products. As companies have increasingly developed and commercialized higher-cost specialty

products, the DOJ has scrutinized activity it believes facilitates those higher costs, including improper donations to independent charitable copay foundations and fraud involving reimbursement information provided by manufacturers to insurers. Although the DOJ does not technically have authority to regulate drug prices, it nevertheless has used a variety of statutes to target programs that it believes inappropriately support expensive prices.

The most common theory of liability in 2019 continued to be allegations of kickbacks paid to physicians. Nine of the 14 kickback-related settlements involved alleged (or admitted) kickbacks to physicians, most commonly in the form of payments to physicians to educate and train health care providers about the benefits, risks and appropriate uses of prescription drugs for patients. The DOJ continues to take a granular approach to its review, critiquing the number of program attendees, the need for the information provided, the number of programs attended by the same person (so-called “frequent flyers”) and even low-dollar activities, such as the provision of in-office meals or snacks, where it believes inadequate evidence exists that the items were incidental to the provision of legitimate product.

The settlements also reflect the DOJ’s pursuit of what some prosecutors have called a “refined” approach to off-label enforcement. In particular, several recent settlements resolved allegations that the company’s promotion of off-label uses caused the submission of claims for medically unnecessary uses in violation of the False Claims Act. Thus, while resolutions premised solely on off-label promotion appear to be a thing of the past, the DOJ seems poised to use its enforcement tools against promotional conduct that causes claims to be submitted for medically unnecessary procedures or nonmedically accepted therapies. We expect that the DOJ’s enforcement priorities on kickbacks and other forms of financial fraud will continue in 2020 and the years ahead.

Drug Pricing: The Debate Rages On

Though much debate in 2019 surrounded rising health care costs, including drug prices, the year came to a close without the enactment of any major drug pricing legislation. In December 2019, the House of Representatives passed Speaker Nancy Pelosi’s drug pricing bill, known as the Lower Drug Costs Now Act, which would allow the U.S. government to negotiate lower drug prices on the costliest drugs each year. However, those who oppose the legislation argue that it would stifle medical innovation, result in fewer lifesaving medicines and curtail investment in small biotech companies. Senate Finance Committee Chair Chuck Grassley and Ranking Member Ron Wyden introduced a competing bipartisan health care bill, known as the Prescription Drug Pricing Reduction Act of 2019, which is viewed as a more moderate alternative. The bill would reduce Medicare Part D beneficiaries’ out-of-pocket costs and cap annual out-of-pocket spending in Medicare Part D. Although there is clear bipartisan interest in lowering prescription drug costs, the challenge for lawmakers is doing something meaningful about drug prices that will not hurt innovation or the development of new products.

While drug pricing legislation was not passed in 2019, the FDA took notable regulatory actions toward delivering lower prices and more access to prescription drugs. The agency announced an all-time record of 1,171 generic drug approvals in fiscal year 2019, following record-setting approvals in FY 2018 (971) and FY 2017 (937). In the U.S., nine out of 10 prescriptions filled are for generic drugs, and increased generic approvals should continue to facilitate access to even more affordable alternatives. In December 2019, the FDA also updated its List of Off-Patent, Off-Exclusivity Drugs Without an Approved Generic to improve transparency and encourage the development and submission of applications for drugs with limited competition. The FDA does not consider the cost of drugs when making drug approval decisions (unlike authorities in other countries) but encourages competition and has publicly recognized that it can help reduce drug prices and improve access to medicines.

Most recently, in December 2019, the Trump administration, along with the United States Department of Health and Human Services and the FDA, took a historic step in proposing a new rule that could allow certain prescription drugs to be imported from Canada to help reduce drug prices and improve access. Under the proposed rule, states, wholesalers or pharmacists could submit proposals to the FDA for the importation of certain prescription drugs that are approved in Canada and meet the conditions in an FDA-approved drug application. Eligible prescription drugs would have to be relabeled prior to importation and undergo testing for authenticity, quality, purity and potency. Notably, the proposals would have to demonstrate significant cost reductions to the American consumer in order to gain approval. Also, in December 2019, the FDA issued a draft guidance for the industry that describes procedures drug manufacturers can follow to import less expensive versions of their FDA-approved products that are manufactured abroad and authorized for sale outside the United States. Both the proposed rule and draft guidance are open for public comment, and interested parties should submit comments prior to the deadlines.

Even though federal prescription drug pricing legislation is uncertain for 2020, states are continuing to move forward to rein in drug prices and expand access. As of September 2019, 33 states had enacted a record 51 laws, according to the National Academy for State Health Policy. State drug pricing legislation primarily relates to (i) limiting "gag" rules by pharmacy benefit managers to prevent pharmacists from discussing pricing with customers; (ii) allowing importation of less expensive foreign prescription drugs; (iii) creating drug affordability boards; and (iv) increasing price transparency. We expect federal lawmakers will be watching state initiatives to discern where legislative compromise may lie.

The affordability of prescription drugs is a high priority among voters, lawmakers and the industry, and vigorous public debate is likely to remain unabated throughout 2020. We expect the executive branch to continue to advance programs that address rising health care costs and for Congress to look for areas for bipartisan compromise. Finally, the complexity of prescription drug pricing calls for clarity, creativity and education, especially with regard to the connections between drug pricing and innovation, the connection between high-priced specialty pharmaceuticals (such as gene and cellular therapies designed for small populations) and the potential for overall health care savings for patients and payers.

SEC Enters Election Year Focused on Key Initiatives

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As Chairman Jay Clayton's tenure at the Securities and Exchange Commission (SEC) likely enters its final year — regardless of the outcome of the next presidential election — the SEC remains focused on priorities such as protecting the long-term interests of Main Street investors and responding to technological developments that affect how capital markets behave. Chairman Clayton indicated in recent congressional testimony that, to help achieve those goals, the SEC added approximately 140 new employees in the past year, after lifting the hiring freeze that had been in place since late 2016 due to budget constraints.

The SEC welcomed its newest commissioner in 2019, Allison Herren Lee. Commissioner Lee previously spent more than a decade in different roles at the SEC, including as senior counsel in the Enforcement Division's Complex Financial Instruments Unit. Lee, a Democrat, has publicly expressed opposition to certain high-profile proposals taken up by the Commission in the past year, including those that would expand the definition of "accredited investor" and amend the proxy voting regime. Commissioner Lee's appointment filled the only vacant seat on the Commission; however, Commissioner Robert Jackson, the other Democratic commissioner, recently announced his intention to leave the SEC.

Beyond changes in leadership, the SEC has faced heightened scrutiny from Congress and the press over its handling of personnel matters at the Public Company Accounting Oversight Board (PCAOB). Critics argue that prolonged vacancies in senior staff positions at the PCAOB are contributing to low morale and a decline in productivity. These critics, who believe the PCAOB should be nonpartisan, also take issue with Chairman Clayton's recent decision to install officials perceived to be administration-friendly in top PCAOB positions. In light of these concerns, members of Congress and others have called for greater transparency into the board's dealings.

As is customary in election years, activity at the SEC is expected to slow as the general election nears. Thus, the SEC faces a truncated timeline for accomplishing its 2020 goals. Observers expect a heightened level of activity in the first part of the year as Chairman Clayton seeks to shape his legacy and certain high-profile proposals become ripe for consideration.

Regulatory Modernization

The SEC has taken a number of steps recently to modernize its regulatory framework and likely will continue this focus in 2020. Chairman Clayton has acknowledged that the dynamic nature of securities markets — including changes in investor behavior and advances in communications technology — requires the SEC to regularly take a fresh look at its rules and regulations in order to align them with current market realities.

In 2019, the SEC adopted rules to modernize and simplify certain of its key annual disclosure requirements and to tweak its auditor independence rules to clarify lending relationships with audit clients that could impact independence. The SEC also adopted a rule to allow any issuer (not only emerging growth companies) to use "testing-the-waters" communications with qualified institutional buyers and institutional accredited investors for the purpose of evaluating the viability of a contemplated registered public offering before the filing of a

registration statement. Further, the SEC adopted Regulation Best Interest to prohibit broker-dealers from putting their own financial interests first when recommending an investment strategy or securities transaction.

Regulating proxy advisers. In response to concerns raised about the lack of oversight of proxy advisory firms, the SEC issued an interpretation in August 2019 clarifying that it believes the meaning of "solicit" in the U.S. proxy rules covers the activities of entities that make proxy voting recommendations to institutional investors. As a result of this interpretation, the SEC publicly weighed in on the debate as to whether proxy advisory firms are subject to liability under the U.S. proxy rules. The leading proxy advisory firm, Institutional Shareholder Services (ISS), challenged this interpretation in a lawsuit alleging that the SEC exceeded its statutory authority and failed to satisfy notice-and-comment procedures required by the Administrative Procedure Act. The case is pending before Judge Amit Mehta in the U.S. District Court for the District of Columbia.

Meanwhile, the SEC proposed changes to its rules in November 2019 that would, among other things, codify its solicitation interpretation into the proxy rules, require proxy advisory firms to provide specific disclosures of material conflicts of interest when rendering proxy voting advice, and give companies the opportunity to review recommendations and provide feedback to advisory firms before the firms disseminate the advice. Despite the fact that these proposals, which have been under consideration for decades, set off a fierce public debate, the SEC likely will attempt to finalize the rules before the end of 2020.

Shareholder proposal process. The SEC also recommended changes to its shareholder proposal rules in November 2019 that it is likely to adopt before Chairman Clayton departs. These proposals, like those regulating proxy advisers, were under consideration for some time, and although the changes were fairly limited in scope, they were met with pushback from certain institutional investors and investor advocates, such as the AFL-CIO and the Council of Institutional Investors. Specifically, the proposed changes would, among others things, replace the current ownership requirements to make a shareholder proposal with a tiered approach that combines the number of shares owned and the length of ownership, raise the levels of support that a proposal must receive to be resubmitted at future shareholder meetings and add a new provision that would allow companies to exclude resubmitted proposals that have experienced declining shareholder support.

Participation in private capital markets. In December 2019, the SEC proposed amendments to its definition of "accredited investor," *i.e.*, a subset of investors who meet certain criteria, such as net worth or annual income thresholds, and may participate in private securities transactions. The proposals would, among other changes, add new categories of natural persons who may qualify as accredited investors based on certain professional certifications or designations or other credentials, as well as allow family offices and family clients to more easily satisfy the definition. If adopted, the proposals would likely increase the number of investors that are eligible to participate in certain private capital transactions, creating more flexibility for private companies looking to raise capital. It remains to be seen, however, whether the SEC will attempt to adopt these changes in 2020.

Enforcement Priorities

Despite being limited by a month-long government shutdown that halted most enforcement activity, the SEC's Enforcement Division brought 862 actions in Fiscal Year (FY) 2019, a 7% increase over FY 2018 totals. The Division's priorities for 2020 — continuing its focus on accelerating the pace of investigations, encouraging self-reporting of violations and promoting transparency around how cooperation credit is assessed — seem likely to encourage a similar or even higher number of actions in the year ahead.

An area that will likely continue to drive growth in the number of enforcement actions is the Share Class Selection Disclosure Initiative. The initiative incentivizes investment advisers to self-report any failure to disclose conflicts of interest associated with their selection of fee-paying mutual fund share classes over lower-cost alternatives. In FY 2019, 95 investment advisory firms that chose to self-report in exchange for favorable settlement terms returned more than $135 million to clients.

The Enforcement Division will seek to continue to accelerate the pace of its investigations in 2020 by encouraging greater cooperation. In FY 2019, the average investigation lasted approximately 24 months before the filing of an enforcement action. The Division maintains that it is striving to reduce that number and points to the 17-month timeline achieved in its investigation of PPG Industries, Inc. as an example of how extensive cooperation can shorten an investigation. To that end, the Division is considering ways to provide greater transparency into how it weighs cooperation credit so that more companies are willing to follow PPG's lead.

The Enforcement Division also is likely to carry its recent focus on accounting and disclosure cases into 2020. In FY 2019, the SEC brought actions against public companies for violations involving deficient disclosure controls, misleading risk factor disclosures, misleading presentation of non-GAAP metrics and false disclosures regarding executive compensation. Notably, the SEC brought a case against Nissan Motor Co., Ltd. — a company that does not file financial

reports in the United States — for filing false financial disclosures obscuring $140 million that would be paid to the company's CEO in retirement. The Nissan action could signal a bolder approach toward disclosure violations made by foreign issuers despite some uncertainty surrounding the extent of the SEC's ability to enforce U.S. securities laws against non-U.S. issuers.

Finally, the SEC will likely pay close attention to Congress and the Supreme Court in 2020 as questions about the scope of its enforcement power are decided. These questions arise out of the Supreme Court's 2017 ruling in *Kokesh v. SEC*, which held that the SEC's authority to seek disgorgement is subject to a five-year statute of limitations. Since *Kokesh*, the SEC estimates that it has foregone an estimated $1.1 billion in disgorgement. Enforcement authority could be curtailed even further once the Supreme Court hears *Liu v. SEC*, a case set to be argued in March 2020 that challenges the SEC's authority to seek disgorgement as a remedy. (See "2019-20 Supreme Court Update.") Though *Kokesh* and *Liu* present challenges to the SEC's enforcement power, recent bipartisan action on Capitol Hill suggests that Congress is prepared to step in to protect the SEC's ability to seek disgorgement and even extend the statute of limitations period for the SEC to obtain disgorgement in enforcement actions.

The SEC is expected to pursue a busy agenda in the first part of 2020, before activity slows in advance of the presidential election. Issuers and regulated entities, therefore, should continue to pay close attention to the ever-shifting regulatory landscape and the SEC's ongoing efforts to bring actions consistent with its stated enforcement priorities.

The Tax Cuts and Jobs Act's Impact on Cross-Border Transactions

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Two years after the enactment of the Tax Cuts and Jobs Act (TCJA), the most significant tax reform enacted in a generation, taxpayers continue to encounter substantial uncertainty arising from interpretations of new statutory provisions, reinforcing calls for administrative guidance to provide more clarity.

The TCJA introduced comprehensive international tax reforms that have profoundly impacted multinational companies and cross-border transactions. The sweeping reform was intended to encourage multinational companies to remain or become U.S.-headquartered and to locate business operations in the United States through a variety of incentives. The TCJA reduced the U.S. corporate income tax rate from 35% to 21% and provided, as part of its participation exemption system, a 100% dividends-received deduction (DRD) for certain offshore dividends paid by 10%-or-more-owned foreign subsidiaries. The TCJA, however, also established the global intangible low-tax income (GILTI) and base erosion anti-avoidance regimes, which effectively impose minimum taxes on certain foreign income and deductible payments made to related foreign parties, and enacted various penalties on newly inverted companies and obstacles to post-inversion tax planning. The TCJA, coupled with ongoing global tax reforms (with both bilateral changes under the OECD framework and unilateral changes from individual countries) and potential challenges from supranational regulators (such as the World Trade Organization) will continue to contribute to uncertainties in structuring cross-border transactions and post-transaction restructurings.

Determining CFC Status

Whether an entity qualifies as a controlled foreign corporation (CFC) — a foreign corporation that is at least 50% owned, directly or via certain attribution rules, by 10%-or-greater U.S. shareholders — can significantly impact the U.S. tax consequences of a cross-border sale for both the buyer and the seller. This determination has been complicated by the TCJA's repeal of a long-standing provision that had previously limited the application of "downward attribution" so that a U.S. subsidiary would not be deemed to own stock held by its foreign parent. Legislative history suggests that the expansion of downward attribution was intended to deter taxpayers from entering into transactions in order to minimize the taxation of domestic owners of the CFC (so-called "de-control" transactions). However, the TCJA's wholesale repeal of this provision is much broader and has resulted in unintended consequences, with many more foreign corporations unexpectedly qualifying as CFCs, thereby triggering GILTI and/or Subpart F income inclusions, significant information reporting requirements and even disqualification from the portfolio interest exemption.

Structuring Acquisitions and Dispositions of CFCs

Asset Sales

The GILTI regime encourages U.S. acquirers to structure purchases of CFCs as taxable asset transactions in order to reduce the amount of their GILTI inclusions going forward. While an actual asset acquisition often is not possible for non-tax reasons, acquirers can make a so-called "Section 338(g) election" to treat what is in form a stock deal as an asset acquisition with similar consequences for U.S. tax purposes.

For both U.S. buyers and sellers, the TCJA has introduced additional variables that they need to take into account when determining whether a Section 338(g) election would be permitted on the disposition of CFC stock. From the buyer's perspective, a Section 338(g) election may reduce its post-acquisition GILTI

inclusion amount as a result of a basis step-up that can be written off in computing the amount of the GILTI inclusion for post-acquisition years. The election closes the taxable year of the acquired CFC at the time of the acquisition, allowing the buyer to avoid accounting for any pre-acquisition GILTI and/or Subpart F income. However, the election also eliminates the acquired CFC's earnings and profits (E&P), potentially limiting the buyer's ability to pay out tax-free dividends in later years.

From the seller's perspective, a Section 338(g) election results in potential GILTI and/or Subpart F income, which may be offset, in whole or in part, by foreign tax credits. Generally, U.S. corporate shareholders are currently entitled to a 50% deduction on GILTI (reducing the tax rate from 21% to 10.5%) and an 80% deemed-paid foreign tax credit with respect to GILTI inclusions. This 10.5% effective rate may in some instances make GILTI income arising from a Section 338(g) election preferable to gain from the sale of stock. The basis of the CFC stock increases by the amount of any GILTI and/or Subpart F income inclusions in the transaction year, such as those arising from the deemed asset sale. Furthermore, any gain the seller derives from the sale of CFC stock is recharacterized as a deemed dividend to the extent of the CFC's untaxed E&P (which includes non-GILTI and/or Subpart F income derived from the sale). For a U.S. corporate seller, this generally qualifies, subject to certain holding and other requirements, for the DRD.

Stock Sales

In the absence of a Section 338(g) election, gains derived by a U.S. seller from the sale of CFC stock are recharacterized as a deemed dividend up to an amount equal to the CFC's untaxed E&P and are generally eligible, subject to certain holding and other requirements, for the DRD. The interaction of the DRD with pre-TCJA law has enabled parties in certain CFC stock sales to eliminate tax on a portion, if not all, of pre-acquisition GILTI and/or Subpart F income. In a sale to a U.S. acquirer, any GILTI and/or Subpart F income of the CFC in the year of the sale would be taxable to the acquirer because any such income inclusion applies only to a U.S. shareholder of the company on the last day of its taxable year that it is a CFC (in this case, the acquirer and not the seller). Under pre-TCJA law, any such income inclusion is generally reduced by the current-year actual or deemed dividends paid to the seller (including the deemed dividend resulting from the sale) as long as such dividends do not exceed the pre-acquisition GILTI and/or Subpart F income. Given that these dividends generally qualify for the DRD, the portion of the CFC's pre-acquisition GILTI and/or Subpart F income that is offset by such dividends would no longer be subject to any tax under post-TCJA law.

Similarly, if the CFC remains a CFC after a sale to a foreign acquirer (due, for example, to downward attribution of the CFC's stock to a domestic subsidiary of the foreign acquirer), neither the seller nor the acquirer would bear the burden of any GILTI and/or Subpart F income in the year of sale because they would not be treated as U.S. shareholders of the CFC on the last day of such year. Furthermore, although any gain arising from the sale is treated as a deemed dividend to the seller to the extent of the seller's untaxed E&P, it generally qualifies for the DRD. Consequently, the seller has avoided taxation on all of the pre-acquisition GILTI and/or Subpart F income under post-TCJA law.

In contrast, if the company ceases to be a CFC following the sale to a foreign acquirer, the seller would be taxable on its pro rata share of any GILTI and/or Subpart F income from the year of the sale, as the U.S. shareholder of the company on the last day of such taxable year of the company that it is a CFC (which occurred on the closing date). Such pro rata share generally would be computed by looking at the seller's holding period compared to the entire taxable year, and multiplying such fraction by items of GILTI and Subpart F income for the entirety of such year (whether before or after the sale). Therefore, the seller may consider negotiating terms to minimize the generation of post-acquisition GILTI and/or Subpart F income, such as covenants limiting the acquirer's post-closing activities, or an indemnity right for inclusions attributable to post-closing income. Taxpayers would achieve similar economic results if the stock of a second-tier CFC (whose status as a CFC may cease if sold to a foreign acquirer as described above) is sold indirectly through a first-tier CFC (whose status as a CFC does not change as a result of the sale). The U.S. Department of Treasury issued temporary regulations to address planning opportunities arising from the application of the DRD to transactions discussed above. See "Challenging Tax Cuts and Jobs Act Regulations and IRS Guidance" for a more detailed summary and discussion of the validity of such regulations.

Joint Ventures

In the joint venture context, if a seller divests CFC stock held indirectly through a U.S. partnership, the tax consequences are further complicated under post-TCJA law. While U.S. and foreign partnerships are now treated as aggregates of their individual partners for GILTI and/or Subpart F purposes, this treatment does not apply in the context of deemed dividends attributable to gains from the sale of CFC stock, sometimes creating anomalous results for both U.S. and non-U.S. shareholders when they divest their interests in a U.S. partnership holding a CFC or when that partnership sells its interests in a CFC. Specifically, if the partnership sells CFC stock, U.S. shareholder partners (those

indirectly owning 10% or more of a CFC through a domestic partnership) generally would have direct GILTI and/or Subpart F income inclusions for current CFC income under recent administrative guidance and would recognize their distributive share of deemed dividends arising from the sale, which generally would be eligible for the DRD for corporate partners. In contrast, U.S. taxpayers that are not 10% indirect owners holding a CFC through a domestic partnership generally would not have any GILTI and/or Subpart F inclusions for current CFC income but would recognize their distributive share of deemed dividends arising from the sale, which would not qualify for the DRD.

In addition, when U.S. and non-U.S. shareholder partners sell their interests in the partnership, any gain would be recharacterized as ordinary income to the extent the partnership would have a deemed dividend if the partnership sells the CFC stock for fair market value. Because ordinary income is not treated as a deemed dividend for tax purposes, the DRD would arguably not be available to such corporate partners with respect to that gain (which also cannot be offset by any foreign tax credits), even though the DRD would have offset any such gain if the partnership had sold the CFC directly.

As the preceding examples illustrate, cross-border buyers and sellers should continue to monitor developments. Further guidance relating to the TCJA may be issued, finalized and (potentially) challenged during the coming year, all of which may impact the U.S. federal income tax treatment of these sales.

Challenging Tax Cuts and Jobs Act Regulations and IRS Guidance

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The Tax Cuts and Jobs Act (TCJA) brought sweeping changes to the U.S. international tax system. Along with those changes came substantial taxpayer uncertainty as to how the TCJA's rules apply to their unique circumstances. That uncertainty continues to affect current tax return filings and may significantly impact a company's financial reporting, potentially requiring taxpayers to establish reserves and make public disclosures regarding issues created by the TCJA.

The U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) have raced to issue a series of regulations, notices and other administrative guidance regarding the TCJA's implementation; however, the guidance often has left taxpayers with more questions than answers. Among other issues, key components of post-TCJA guidance may be invalid and subject to challenge by taxpayers.

This uncertainty could be readily resolved in non-tax administrative areas, in which regulated companies can seek immediate judicial review of newly issued regulations (and, in some cases, obtain temporary injunctive relief), potentially limiting their financial exposure and invalidating regulations. The Anti-Injunction Act, however, significantly limits taxpayers' ability to seek immediate judicial review of a tax regulation or other IRS guidance. Thus, they could be forced to carry financial exposure, and potentially financial accounting reserves, for 10 years or more before their case is finally resolved.

Given the significant and far-reaching consequences of continuing ambiguity, companies affected by uncertain post-TCJA rulemaking should explore creative procedural options for accelerating their cases, which could allow them to obtain clarity and resolve their issues far more quickly.

Problematic IRS and Treasury Rulemaking

In the months after the TCJA was enacted, Treasury identified more than 60 priority issues for which additional guidance was needed. Treasury and the IRS have released much of that planned guidance, creating further uncertainty at times.

Some of the guidance issued by the IRS and Treasury appears to be inconsistent with or goes beyond the scope of controlling statutes. As one example, Treasury issued regulations under Section 78 that it claimed were designed to prevent an unintended benefit.

The language of the TCJA, as originally passed, permits some U.S. shareholders of foreign corporations to claim both a foreign tax credit and a deduction for foreign taxes paid by the foreign corporation. Section 960 allows U.S. shareholders of foreign corporations to claim a foreign tax credit for foreign taxes paid by the foreign corporation. The TCJA added Section 245A, which permits U.S. shareholders to deduct dividends received from a foreign corporation. Under Section 78, amounts deemed received under Section 78 that represent taxes paid by the foreign corporation generally are treated as dividends. Thus, some U.S. shareholders of foreign corporations could be eligible for both a foreign tax credit under Section 960 and a deduction for those same taxes under Section 245A.

As part of the TCJA, Congress amended Section 78 to provide that amounts representing foreign taxes are not eligible for the Section 245A deduction. However, Congress established different effective dates for Section 245A and for the changes to Section 78. Thus, U.S. shareholders of non-calendar-year foreign corporations still may be able to claim both credits and deductions for the same foreign taxes. Treasury sought to prevent that result through regulations purporting to change the statutory effective date for the new Section 78. Case law strongly suggests, however, that Treasury cannot unilaterally change a statutory effective date. Taxpayers thus face uncertainty, because Treasury's attempt to alter the effective date of the new Section 78 may be invalid.

Over the next few years, taxpayers likely will challenge this and other examples of TCJA-related guidance that seemingly overstep or create further uncertainty.

Procedures for Challenging IRS and Treasury Guidance

Taxpayers seeking to challenge IRS and Treasury guidance face unique procedural hurdles. For challenges to non-tax administrative guidance issued by other agencies, the Administrative Procedure Act generally permits a party to file a lawsuit that simply asks the court to rule on the validity of the guidance being challenged. When the guidance relates to the collection of a tax, however, the Anti-Injunction Act may prevent review until the IRS enforces the guidance and applies it to the taxpayer. Thus, challenges to tax guidance generally are brought after the IRS completes its audit of a tax year and assesses an additional tax liability based on the guidance, and courts have frequently rejected recent taxpayer attempts to challenge tax regulations and other guidance prior to enforcement of those rules by the IRS.

Waiting for the IRS to complete its audit, however, means years of continuing uncertainty that affects current tax positions, future tax planning and public financial reporting. An audit of a taxpayer's 2018 tax year may not conclude until 2024. If the IRS makes an adjustment based on a position taken with respect to the TCJA and the taxpayer seeks judicial review, that process could take another three years, reaching final resolution in 2027. Thus, taxpayers may consider options to accelerate their dispute with the IRS rather than waiting for the IRS to complete its audit. In particular, taxpayers may pay the tax that would be owed under the guidance, then immediately file a claim for refund seeking to recover that tax. In so doing, taxpayers may challenge IRS and Treasury guidance much more quickly, accelerating judicial review by a number of years and potentially limiting any financial statement impact.

Taxpayers already have taken an accelerated approach to challenging aspects of the TCJA. In September 2019, in *Moore v. United States*, a couple filed a lawsuit in the U.S. District Court for the Western District of Washington seeking a refund of the TCJA transition tax on offshore earnings and asserting that such tax is unconstitutional. Although the taxpayers were individuals and did not have the financial statement concerns discussed above, they sought an expedited review. Thus, they paid the transition tax owed, then filed an amended return seeking a refund. That allowed them to file a refund suit for their 2017 tax year in September 2019 — six months after submitting their amended return — rather than waiting several years for the completion of an IRS audit.

Paying the tax and immediately seeking a refund, however, may be costly and raises other challenges: What happens to the IRS audit of those years? Will the IRS seek to stay the litigation pending its examination? How should a taxpayer deal with rollover or rollback items to the tax year that is now in litigation? All of these questions must be carefully considered before proceeding to court.

Lessons From 2019: Impact of BEPS on Cross-Border Transactions

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In 2019, a number of common themes emerged from cross-border transactions that have continued to demonstrate the impact of the 2014 Base Erosion and Profit Shifting (BEPS) actions. These themes, which we anticipate will gain even more traction in the coming years, impact all stages of a transaction, including due diligence, structuring and valuation, integration, reporting and ongoing operation of group structures.

Shift to Substance

Increasingly, multinational groups face a marked structural shift toward aligning jurisdictions in which tax outcomes are realized and reported with the jurisdictions in which the people who contribute to those outcomes are located. This has manifested prevalently through revenue authorities feeling empowered by BEPS to deploy two-sided, function-driven transfer pricing approaches (looking at the entire value chain rather than just the tested transaction), coupled with unilateral measures such as diverted profits taxes. Advisers anticipate that the introduction of the principal purpose test in determining eligibility under tax treaties (which means taxing authorities will deny the benefit of a covered treaty if the principal purpose of the structure is to obtain treaty benefits) will require business and commercial considerations to be at the center of multinational group structuring. This shift toward substance — which oversimplified, implies real people working in a real business — may mean reduced flexibility in operating models and holding structures. Many transactions, both internal and external, already have reshaped economic flows in a way that ensures substance is more fully recognized, including by transferring intangible assets onshore.

Financing and Its Impact on Deal Costs

BEPS outcomes have perhaps been shown in their starkest light in the context of financing transactions, with changes including (i) interest restrictions based on a proportion of earnings before interest, tax, depreciation and amortization (EBITDA) or a similar metric, (ii) rules neutering advantages from hybrid structures (double deductions or deduction/no inclusion scenarios) and (iii) stricter requirements to qualify for reduced withholding rates under tax treaties. Each of these changes can be relevant in both internal and external financing transactions and potentially has a noticeable, immediate and direct effect on a group's effective tax rate.

Multinational groups will aim to maximize their use of allowable debt capacity under these new rules but will need to train themselves to reliably predict future EBITDA by jurisdiction. There also now will be an increased incentive to ensure that each jurisdiction within a group takes on a suitable share of any debt, bringing internal on-lending, "push-down" and similar structures to the fore again. However, whether utilizing debt capacity within a jurisdiction will be perceived by tax authorities as an acceptable reason to introduce debt remains to be seen.

Additional Reporting Requirements

In addition to substantive tax rules, the BEPS outcomes also introduced a new form of aggregated information sharing for large, multinational companies: country-by-country reports (CbCR). In addition to local tax returns, multinationals within the scope of CbCR must maintain and share with tax authorities on an annual basis a form identifying numerous relatively rigid data points. Because of the format, CbCR can never tell the whole story accurately and inevitably require a good deal of translation for tax authorities or prospective buyers who access CbCR

through diligence. Currently, CbCR are confidential, but political pressure exists from some parties, especially in the European Union, to make them publicly available. Additional reporting considerations and the systems required to support and enable CbCR are already increasing compliance costs.

Coping With Uncertainty

Though many rules deriving from BEPS are in force, they remain largely untested. Scoping a diligence exercise to capture the ever-shifting global tax frameworks is becoming an art. Though some of the rules may be formulaic, it is unclear whether any group operating in a multinational environment will ever be fully "BEPS compliant."

Prudent transaction valuations may start to build in a buffer for the potential impact of some of the rules, as modelling for the future is equally critical and uncertain. More than ever, forecasting teams will require a full understanding of projected revenue streams, the jurisdiction(s) in which revenues arise, and jurisdiction-by-jurisdiction details of the implementation of and timetable for the BEPS proposals. One effect is that different market participants may have greater variance in their perceptions of deal value and synergies and, therefore, in pricing.

Each of the factors mentioned above suggests that tax will remain an area of high focus in managing cross-border transactions. The proper integration, upkeep and refreshing of structures must not be ignored, including ongoing assessments as to whether the operations follow the assumptions made in diligence or modelling. In addition to managing transactional downside risk, flexible tax and legal teams also may realize opportunities in the changing international landscape.