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Stapled Financing in the Aftermath of Delaware's *Del Monte* Decision

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In the *Del Monte*[1] shareholder lawsuit, the Delaware Court of Chancery took the extraordinary step of preliminarily enjoining a stockholder vote on a proposed $5.3 billion leveraged buyout of Del Monte Foods by a group of private equity bidders. Based on its highly fact-driven analysis, the Court of Chancery found that the stapled financing involved in the transaction had created an actionable conflict of interest and that the plaintiffs had established a reasonable probability of being able to prove that the directors of the Del Monte board had breached their fiduciary duties by failing to properly supervise the sale process of the company. The Court of Chancery enjoined the deal for 20 days to allow a topping bid to emerge and also enjoined the enforcement of the no-solicitation, matching-rights and termination fee provisions in the merger agreement pending the stockholder vote.

This shareholder lawsuit, which settled for $89.4 million last fall, shed light on the harsh consequences that may await participants in a stapled financing gone awry. In the settlement's aftermath, the question remains as to whether the case effectively sounded a death knell for the use of such financing packages. In the context of private company sales and sales of subsidiaries and divisions by public companies, where the risk of shareholder litigation is significantly lower than in public company sales, the answer appears to be no. Nonetheless, *Del Monte* provided the Delaware courts an opportunity to revisit — and drive home — a fundamental lesson of Delaware corporate fiduciary duty law, *i.e.*, that in the event of a sale of the company, the board must stay actively involved throughout the sale process. *Del Monte* also provided numerous takeaways for financial advisors that are considering offering, and bidders that are considering participating in, stapled financing.

Background on Stapled Financing

"Stapled financing" traditionally refers to a prearranged financing package that a target's financial advisor offers to potential bidders, although the term has come to be applied broadly to any financing offered to a bidder by the target's financial advisor. A perceived potential conflict of interest underlying the financing structure is rooted in the position of the target's investment bank financial advisor: While the M&A advisory department of the bank acts as the sell-side advisor, the same bank's financing department acts as the lender to the buy-side bidders. This structure may be perceived to incentivize the target's financial advisor to steer an auction or sale to those bidders that will use the stapled financing, even if those bidders may not be offering the highest price, so that the financial advisor can collect fees on both the sell side and the buy side. Given the potential conflicts, a stapled financing in the context of a public company sale is bound to receive significant scrutiny from a Delaware court in the event of litigation.[2]

Takeaways From Del Monte

The *Del Monte* decision is a reminder for boards of public targets that they should play an "active and direct role in the sale process." Specifically, in the stapled

[1] *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813 (Del. Ch. Feb. 14, 2011).

[2] Other recent cases also demonstrate the Delaware courts' concern with the potential for investment banker conflicts of interest. *See In re Atheros Commc'ns, Inc. S'holder Litig.*, C.A. No. 6124-VCN (Del. Ch. Mar. 4, 2011); *In re Art Tech. Grp., Inc. S'holders Litig.*, C.A. No. 5955-VCL (Del. Ch. Dec. 20, 2010).

> "[I]n the stapled financing context, the board must decide, as a threshold matter, whether the benefits of the staple would outweigh the potential risks of conflicts."

financing context, the board must decide, as a threshold matter, whether the benefits of the staple would outweigh the potential risks of conflicts. To make such a determination, the board typically will evaluate any prior or existing relationships that the financial advisor has with actual or potential bidders and determine whether any potential conflicts of interest are likely to develop, in each case carefully reflecting such consideration in its board minutes. In addition, the board must clearly demonstrate the benefits that would result from the staple, which may include (i) confidentiality (by reducing the need for the bidder to contact outside financing sources, the risk of leaks is reduced), (ii) speed (with financing in place, the bidder need not obtain its own financing) and (iii) deal certainty (by having made committed debt financing available to qualified potential bidders on specified terms, the seller increases the likelihood that the transaction can be financed at an acceptable sale price).[3] Another relevant consideration is the general availability in the market of financing to bidders.

Common Practices of Targets

After careful deliberation, if the board determines that the benefits justify the potential risks, it should actively pursue measures that minimize the possibility of such risks. Examples of ways a board can do this include:

- Clearly articulating to the financial advisor from the outset that the board will have the right to tell the advisor whether, and when, the advisor will be able to offer financing in the transaction;
- Obtaining representations from the financial advisor in an engagement letter or otherwise that the advisor has (i) disclosed to the target all communications that it has had with prospective buyers concerning the target prior to the date of the engagement letter and (ii) described any known conflicts;
- Considering hiring a second financial advisor to be involved in the sale process, including running any "go-shop" process and providing a second fairness opinion; and
- Considering a reduction in the fees payable to the investment bank providing buy-side financing to offset fees of the second financial advisor that may be required as a result of a conflict.

Implications for Financial Advisors

Del Monte also has implications for financial advisors that are considering offering stapled financing. First, a financial advisor should clearly disclose up front any potential conflicts of interest, including any relationship it has with prospective buyers, as well as any intention of providing buy-side financing to a client. Second, a financial advisor should establish structural devices to minimize potential conflicts, including imposing a strict ethical wall between the buy-side and sell-side advisors within the bank. Third, a financial advisor should consider providing buy-side financing as

[3] Whether the seller has thereby indicated the price it is ultimately prepared to accept — in effect, setting a ceiling price, subject to the dynamics of an active auction if one develops — is an interesting potential adverse consequence, which should be considered as well.

part of a syndicate of lenders, as opposed to on its own. Overall, financial advisors desiring to provide stapled financing should follow the basic principle illustrated by *Del Monte*: Financial advisors should strictly follow the letter and spirit of their clients' instructions.

Lessons for Bidders

Finally, *Del Monte* demonstrates that bidders could be exposed to potential liability for aiding and abetting a breach of duty by the target board. In light of the facts in *Del Monte*, a bidder generally should avoid any conduct that could be viewed as interfering with the target board's ability to fulfill its duties, such as engaging in discussions with the target's financial advisor or other potential bidders on matters bearing on the financial advisor's own economic interests. In the event that a bidder wants to engage in discussions relating to providing acquisition financing or other fee-generating services, it generally should consider obtaining advance written consent from the target prior to approaching any third parties, including the target's financial advisor.

* * *

After *Del Monte*, we anticipate fewer stapled financings in the public context due to increased scrutiny and the high risk of shareholder litigation. In the private context, however, staples are likely to continue, albeit with all participants proceeding with caution to clearly demonstrate that the benefits outweigh the potential risks of conflict.

The Practical Impact of Basel III and Dodd-Frank on Loan Agreements

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When entering into credit agreements, lenders anticipate a certain rate of return based on an agreed-upon interest margin over their respective cost of funds. In the event that a lender's costs for a loan increase due to a change of law after the credit agreement is entered into, thereby decreasing its expected rate of return, a lender will expect to be able to pass on the cost to the borrower. Upon implementation, certain provisions of Basel III and the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) will compel banks and certain other financial institutions to raise and maintain additional capital to satisfy more stringent capital requirements, which may increase a lender's costs of funding loans or reduce its rate of return in lending transactions.

Who will bear the costs arising from these impending regulations? The answer seems to lie in a trend found in recent credit facilities toward protecting banks from having to bear the additional costs of funds.

The Basel Committee on Banking Supervision issued on December 16, 2010 (and revised on June 1, 2011) its final text of significant updates to the 2004 Basel II Accord (such updated requirements are collectively known as Basel III). Basel III increases Common Equity Tier 1 capital requirements; imposes additional and more stringent capital requirements to risk-weighted assets, liquidity and leverage ratios on banks; and requires available Tier 1 capital and capital ratios to be calculated after numerous material regulatory deductions and other adjustments

(rather than prior to such deductions). The U.S. has agreed to adopt Basel III, and the new rules are scheduled to be implemented through national regulations starting in January 2013.

Section 171 of the Dodd-Frank Act directs federal banking regulators to establish minimum leverage and risk-based capital requirements for depository institutions, holding companies and certain systemically significant nonbank financial institutions supervised by the board of governors of the Federal Reserve System (the Federal Reserve). These new capital requirements are to be no lower than the leverage and risk-based capital requirements that were in effect for insured depository institutions at the date of enactment of the Dodd-Frank Act. The Federal Reserve issued a final rule implementing these requirements for "the largest, internationally active banking organizations" on June 14, 2011, and regulations implementing Section 171 with respect to other organizations are expected in the first quarter of 2012. The section also has the effect of changing the components includable in Tier 1 capital to exclude certain hybrid debt and equity instruments, thereby requiring banks to raise common stock as additional capital; such Tier 1 capital-related changes will be phased in beginning in 2013.

Loan agreements traditionally have enabled lenders to pass on increased costs arising as a result of a change in law enacted after the closing of the transaction. Such provisions may well cover the future implementation of the Dodd-Frank Act and Basel III. However, given the passage of the Dodd-Frank Act and adoption of Basel III prior to implementation, most recent credit agreements now explicitly provide for, and are expected to provide for in the future, an explicit inclusion of (i) the Dodd-Frank Act and any rules, regulations, guidelines or directives issued under it; and (ii) all requests, rules, guidelines or directives concerning capital or liquidity adequacy, reserve requirements or similar requirements enacted by the Basel Committee or U.S. financial regulatory authorities (in each case pursuant to Basel III). These express inclusions are (and will be) provided, regardless of the date enacted in credit agreement definitions of "applicable law," "change in law," "regulatory change" or such similar defined terms.

The practical effect of these definitional changes is to ensure that lenders are protected from, and compensated for:

- Any costs, conditions or expenses on or affecting such lender, the result of which is to increase the costs to the lender of agreeing to make or maintain loans or reduce any amount received or receivable by such lender; and
- The adoption, effectiveness, phase-in or applicability of laws regarding capital or liquidity adequacy, reserve requirements or similar requirements that have or would have the effect of reducing the rate of return on the capital allocated to such lender's loan, loan commitment or loan participation that could have been achieved but for such adoption, effectiveness, phase-in or applicability.

Certain credit agreements limit increased costs-compensation provisions such that the borrower is not obligated to pay unless the lender at that time is generally assessing such amounts on a nondiscriminatory basis against borrowers under its other loan agreements that have similar increased costs provisions. A further

limitation in some agreements is that the additional costs shall not exceed any individual borrower's *pro rata* share of costs attributable to all loans, advances or commitments to all borrowers by such lender that collectively result in the consequences for which the lender is to be compensated.

As Basel III and the Dodd-Frank Act are further implemented — and as borrowers react to these changes — loan agreements will no doubt continue to evolve as well.

Borrower-Friendly Provisions Remain a Strong Leveraged Finance Trend

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The credit boom of 2005 to 2007 gave rise to numerous borrower-friendly features in bank financings for private equity-led leveraged acquisitions, including incurrence-based covenants (the ability to incur debt and engage in other restricted transactions based on an incurrence ratio rather than a fixed-dollar amount, including accordions permitting such debt to be incurred as new tranches in the applicable loan agreement), "available amount" baskets (provisions permitting the use of cumulative unswept excess cash flow, equity proceeds and certain other sources of funds for investments, junior debt payments and dividends above and beyond those otherwise permitted by the covenants) and "equity cures" (provisions permitting borrowers to count infused equity as EBITDA for purposes of calculating compliance with financial performance covenants).

The turmoil in the credit markets that followed spawned additional sponsor- and borrower-favorable features in leveraged credit agreements such as sponsor and borrower loan buyback provisions (express provisions permitting the equity sponsor and/or borrower to purchase loans from lenders on a non-*pro rata* basis, purchases generally done below par), amend-and-extend clauses (provisions permitting individual consenting lenders to extend maturity dates — and be compensated therefor — without the consent of the enitre lending group), and the inclusion of "refinancing facilities" (provisions that permit borrowers to refinance loans under a credit agreement with either additional tranches of loans under the same credit agreement or with debt incurred under a separate credit agreement, with such debt sharing in the collateral securing the loans under the credit agreement). As the credit markets normalized in 2010, many wondered whether and to what extent these borrower-friendly provisions would reemerge or survive. Would they ebb and flow with market conditions? Or would they become relatively permanent fixtures in leveraged credit agreements going forward? The volatile credit markets of 2011 seem to have provided the answer — these provisions are here to stay, in good markets and bad.

After a strong first half of the year, the credit markets fell off precipitously in the third quarter of 2011, especially following Standard & Poor's downgrade of the U.S. credit rating and the related equity market selloff in August. The economic terms of post-August acquisition financings reflected this — spreads (and flex) widened, call protection increased and the minimum equity capitalization required to obtain financing effectively doubled. Compare, for instance, the 26 percent equity capitalization required in July for the financing of the acquisition of Kinetic Concepts to the nearly 50 percent required for the post-August underwritings for the acquisitions of Pharmaceutical Product Development, Inc. (PPDI), 99 Cents Only Stores and Capital Safety Group. But noneconomic terms like the ones described

above consistently bridged the gap, especially in larger transactions for major private equity sponsors, without much resistance from underwriters or the market.[4] That they could survive such a challenging market period intact is telling. It now seems safe to assume that the borrower- and sponsor-friendly provisions born in the credit boom and its aftermath are a permanent part of the leveraged finance landscape.

Proposed Regulatory and Legislative Initiatives May Affect Privately Held Companies and Publicly Traded Small and Emerging Businesses

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Recent regulatory and legislative initiatives relating to capital formation and public reporting requirements, if implemented, would have a significant effect on privately held companies and publicly traded small and emerging businesses. Although the ultimate outcomes and timing of these initiatives are unknown, we expect at least some of them to be adopted in 2012. Because the proposals could materially impact the timing of when a company decides to go public, how it attracts, retains and pays employees, and the manner in which issuers and investment banks conduct offerings, issuers and their advisors should closely monitor developments related to these initiatives.

Prompted by a series of letters in the spring of 2011 between Rep. Darrell E. Issa (R-CA), Chairman of the House Committee on Oversight and Government Reform, and Mary L. Schapiro, Chairman of the Securities and Exchange Commission (SEC), in which Chairman Issa criticized perceived regulatory impediments to capital formation, the staff of the Division of Corporation Finance of the SEC (the Division) has committed to undertake a review of certain regulatory provisions, including:

- The shareholder threshold that triggers public company registration and reporting;
- The restriction on general solicitation and advertising applicable to private offerings;
- A potential increase in the offering amount permitted under the Regulation A safe harbor covering small securities offerings; and
- "Crowdfunding" capital-raising strategies.

It is unclear what actions the SEC ultimately will take as a result of the review of its rules. The Division has stated that it is preparing a concept release for consideration by the SEC on the general solicitation and advertising limitations under the Securities Act of 1933, as amended (the Securities Act). In addition, the SEC's Advisory Committee on Small and Emerging Companies recently approved a recommendation regarding relaxing or modifying the general solitication and advertising limitations, as discussed below, and will provide the SEC and the Division with preliminary recommendations about other regulations that affect privately held and publicly traded small and emerging businesses in coming weeks.

Certain members of Congress also have introduced bills that would amend the securities laws in a number of the foregoing areas. Several of these bills, as well

[4] One important exception to this is so-called "covenant lite" financings — senior secured financings done without financial performance covenants. Covenant lite financings, which became commonplace in 2006 and the first half of 2007, do seem to reemerge only during particularly strong market conditions or for very well-received borrowers. For example, PPDI, which launched to the market with a financial covenant, was able to strip this covenant prior to closing in light of high demand for the debt by the market in November (in part caused by the absence of other large transactions then competing for market demand).

as the Division's initiatives, are discussed below. In addition, certain members of Congress have introduced bills that would permit certain emerging growth companies to delay compliance with particular regulatory requirements that involve high costs.

Shareholder Threshold for Public Reporting

Section 12(g) of the Securities Exchange Act of 1934, as Amended (the Exchange Act). Section 12(g) and its related rules require a company with more than $10 million in assets to register any class of its equity securities that, as of the end of a company's fiscal year, is "held of record" by more than 500 persons. The definition of "held of record" counts as record holders only those persons identified as holders in the records maintained by the company or on its behalf, including the participants in the Depository Trust Company (DTC) (the principal U.S. securities depositary) listed as holding the securities on the company's DTC security position listing. Since enactment of Exchange Act Section 12(g) and the adoption of the definition of "held of record," the securities markets have changed substantially. Most securities of publicly traded companies are held in nominee or "street name" instead of directly in the name of the beneficial owner. Accordingly, for most publicly traded companies, many shareholders are not individually counted under the definition of "held of record," but rather their brokerage firm, which has a DTC account that may be holding securities for numerous accounts, will be counted as one holder. However, shareholders of most private companies usually hold their shares directly and are, therefore, counted as "holders of record."

Deregistration of a class of equity securities under Section 12(g) is permissible when such class of equity securities is held of record by fewer than 300 persons, or by fewer than 500 persons under limited circumstances.

Exchange Act Rule 12h-1 exempts certain classes of securities from Section 12(g) registration. For instance, in 2007, the SEC adopted Rule 12h-1(f), which exempted certain classes of stock options issued to employees as compensation; however, this exemption does not apply to all classes of securities that are used as compensation. Restricted stock units, for example, are not covered by the exemption.[5]

SEC Action. The Division is reviewing the triggers for Exchange Act registration, which necessarily will determine which companies are subject to public reporting obligations. According to written testimony presented to a Senate committee by the director and deputy director of the Division on December 1, 2011, the Division is undertaking a study to:

> determine whether the current thresholds and standards effectively implement the Exchange Act registration and reporting requirements and what it means to be a "public" company such that an issuer should be required to register its securities and file [annual, quarterly and current reports] with the Commission. The

[5] However, in response to the increased use of restricted stock units as compensation for employees, the staff of the Division provided no action relief initially to Facebook, Inc. and then to Zynga Inc. and Twitter, Inc. from the registration requirements of Exchange Act Section 12(g) for classes of restricted stock units issued under certain circumstances.

> staff has begun a detailed analysis of public company information — including numbers of record and beneficial owners, total assets and public float — to assess the characteristics of public companies. The study also will seek to obtain and consider private company information to assess current reporting thresholds.

In an April 6, 2011, letter to Chairman Issa, Chairman Schapiro also indicated that any review would evaluate the recent trend of using special purpose vehicles (SPVs), formed either by the issuer and a sponsor or by firms unaffiliated with the issuer, to hold private company securities and the important policy issues raised by these structures:

> For example, should our rules count the holders of the SPV in determining whether registration under Section 12(g) should be required? Should that be the case only if the issuer is involved in forming the SPV? If SPV investors are not counted, does this approach undermine the goals of Section 12(g)? Should our rules under Section 12(g) be amended to address these questions, whether to provide additional certainty or to require registration without regard to the purpose of the SPV? On the other hand, does the formation of these SPVs and investors' interest in them suggest underlying problems with our rules that should be addressed? If the SPVs are traded on private markets, should some level of information be required? These are important questions that I look forward to considering.[6]

Congressional Action. Bills have been proposed in both the House and the Senate to raise the shareholder threshold for registering under Section 12(g) and address related matters. For instance, on June 14, 2011, Rep. David Schweikert (R-AZ) introduced the "Private Company Flexibility and Growth Act" (H.R. 2167) in the House. The legislation seeks to amend Section 12(g) to:

- Raise the current 500-shareholder threshold to 1,000 shareholders; and
- Exempt shares held by persons who received their shares pursuant to exempt transactions under an employee compensation plan from counting toward the new, 1,000-shareholder threshold.

The legislation also would require that the SEC adopt safe harbor provisions that issuers could use to determine whether holders of their securities received the securities pursuant to an employee compensation plan in a qualifying exempt transaction.

The House Financial Services Committee approved the Schweikert legislation on October 5, 2011, as amended. Further consideration of the legislation by the House has not yet been scheduled.

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[6] The investment in Facebook by The Goldman Sachs Group, Inc. (Goldman) in January 2011 highlighted the issues surrounding Section 12(g). Goldman used a special purpose vehicle to raise and invest funds in Facebook. In practice, such an SPV, even though it may represent hundreds or thousands of individuals, potentially could be considered a single-record holder for purposes of Section 12(g).

On November 8, 2011, Sen. Pat Toomey (R-PA) introduced a companion measure to the bill pending in the House. The Toomey legislation, also entitled the "Private Company Flexibility and Growth Act" (S. 1824), would amend Section 12(g) to:

- Raise the current 500-shareholder threshold to 2,000 shareholders; and
- Exempt shares held by persons who received their shares pursuant to exempt transactions under an employee compensation plan from counting toward the new 2,000-shareholder threshold.

The legislation contains a safe harbor provision similar to the one set forth in H.R. 2167. In addition, S. 1824 would liberalize the provisions related to exiting the Exchange Act reporting system by amending Exchange Act Sections 12(g)(4) and 15(d) to raise the current 300-shareholder threshold to 1,200 in the case of a bank or bank holding company. This legislation was referred to the Committee on Banking, Housing and Urban Affairs on November 8, 2011, and was the subject of a committee hearing on December 1, 2011, and a subcommittee hearing on December 14, 2011. Other than as noted above, the House and Senate bills propose no additional changes to the definition of "held of record."

> "Raising the shareholder threshold for Exchange Act registration would benefit private companies."

Other bills seeking amendments to Section 12(g) and related provisions have been introduced in Congress. (See, for example, S. 1600 (which would raise the 500-shareholder threshold in Section 12(g) to 2,000 shareholders for banks and bank holding companies and raise the 300-shareholder exit thresholds in Sections 12(g)(4) and 15(d) to 1,700 shareholders in the case of banks and bank holding companies); and S. 556 and H.R. 1965 (each dividing the shareholder threshold that requires registration under Section 12(g) into (i) 2,000 shareholders of record if the issuer is a bank or bank holding company and (ii) 500 shareholders of record if the issuer is neither, and requiring termination of a security registration in the case of a bank or bank holding company if the number of shareholders of record is reduced to fewer than 1,200). The House overwhelmingly approved H.R. 1965 on November 2, 2011, and referred it to the Senate where no further action has occurred.)

Raising the shareholder threshold for Exchange Act registration would benefit private companies by precluding application of the Exchange Act registration and reporting provisions on a schedule that may be inconsistent with the companies' goals and priorities. Furthermore, the exemption for shares held by persons who received such shares pursuant to exempt transactions under an employee compensation plan could affect how a company attracts, retains and pays its employees.

The changes to the registration and deregistration thresholds may be further impacted by the rise of secondary-market trading platforms for securities of private companies. These platforms, primarily SecondMarket, Inc. and SharesPost, Inc., are intermediaries that match buyers and sellers of private company securities. Some of the platforms, such as SharesPost, act only as bulletin boards where buyers and sellers can meet and may charge users a fee for the service. Other platforms, such as SecondMarket, are broker-dealers registered with the SEC and the Financial Industry Regulatory Authority (FINRA); these platforms facilitate the trades, provide transaction documents and charge a commission on each trade. Secondary trading in private company securities has become increasingly popular

and enables founders, employees, venture capitalists and other early investors to exit an investment in a private company during the increasingly longer period before the company goes public or is acquired. In addition, secondary trading may enable companies to delay going public and incurring the attendant costs and burdens (including those imposed by the Sarbanes-Oxley Act) by providing some measure of liquidity in their securities. Active trading on the secondary trading platforms, however, has the potential to increase the number of shareholders in private companies, causing challenges for some private companies to stay below the 500-shareholder threshold for Exchange Act registration.[7]

In her April 6, 2011, letter to Chairman Issa, Chairman Schapiro noted the Division's focus on secondary trading activity:

> [t]he staff also is currently monitoring the secondary trading activity on a variety of online trading platforms, many of which are facilitating the trading of securities of private companies. Trading that develops on online trading platforms can be beneficial in that it can provide much desired liquidity to investors, which can assist in attracting investors to smaller private companies. This benefit, however, must be balanced with investor protection concerns that can be raised when there is a lack of information available to investors about these private companies. Trading markets, including these online platforms, can operate more efficiently where adequate information is available to investors. In the absence of an informed market, concerns can be raised that pricing of securities may be influenced by conflicted market participants who may be buying and selling for their own account as well as facilitating transactions for other buyers and sellers.

The Exchange Act registration and reporting provisions are designed to protect and inform investors in the secondary public trading markets. While the asset threshold under Section 12(g) has been raised a number of times over the years, the shareholder threshold has not been similarly revised upward. Given the substantial changes in the securities markets since the enactment of Section 12(g) in 1964, we believe that revising the thresholds under Section 12(g) with a view to more properly balancing the costs and benefits to issuers and investors is appropriate at this time.

The Restriction on General Solicitation and Advertising in Private Offerings

Section 4(2) and Rule 506 Under the Securities Act and the Restriction on General Solicitation and Advertising. Offers and sales of private company stock, like all offers and sales of securities, must be either registered or exempt from registration under the Securities Act. Section 4(2) of the Securities Act, a commonly used exemption, exempts "transactions by an issuer not involving any public offering." In 1962, the SEC stated in Securities Act Release No. 4552, the "Nonpublic Offering Exemption," that whether a transaction involves a public or

[7] SecondMarket, Inc. generally has modified its practices to help private companies manage Section 12(g)-related issues.

private offering is essentially a question of fact and necessitates consideration of all surrounding circumstances, including such factors as the relationship between the offerees and the issuer and the nature, scope, size, type and manner of the offering. The SEC further noted that public advertising of an offering is incompatible with a claim of a private offering.

Rule 506 of Regulation D under the Securities Act is a nonexclusive safe harbor that guarantees the availability of the private offering exemption set forth in Section 4(2). Rule 502(c) of Regulation D prohibits general solicitation or advertising of the unregistered offering by the issuer or any person acting on its behalf. This prohibition extends to advertisements, articles, notices or other publication in any U.S. newspaper, magazine or similar media (including the Internet); broadcasts over U.S. television or radio (also including the Internet); and any seminar or meeting in the U.S. to which attendees have been invited by any general solicitation or advertisement. One important factor in analyzing whether a general solicitation has occurred is whether the investors had a preexisting, substantive business relationship with the issuer or broker-dealer involved. Some commentators cite the ban on general solicitation and advertising as a significant impediment to capital formation.

SEC Action. The Division is reviewing the restrictions the SEC's rules impose on communications in private offerings, in particular those on general solicitation and advertising. In analyzing whether to recommend changes to the restriction, as noted above, the Division is preparing a concept release for the SEC's consideration and eventually will seek public comment on the costs and benefits of retaining or relaxing the restrictions on general solicitation and advertising. The testimony by the division director and deputy director noted above stated, "[t]he Commission could seek views from all interested parties on a number of issues related to the restriction on general solicitation, including specific protections that could be considered if the restriction is relaxed and the types of investors who would be most vulnerable if it is relaxed. Of course, in considering whether to recommend that the Commission make changes to the rules restricting general solicitation, we will remain cognizant of our investor protection mandate."

On January 6, 2012, the SEC's Advisory Committee on Small and Emerging Companies approved a recommendation that the SEC "take immediate action to relax or modify the restrictions on general solicitation and general advertising to permit general solitication and general advertising in private offerings of securities under Rule 506 where securities are sold only to accredited investors."

Congressional Action. Bills have been proposed in both the House and Senate with respect to elimination of the ban on general solicitation and advertising in private offerings. On September 15, 2011, Rep. Kevin McCarthy (R-CA) introduced the "Access to Capital for Job Creators Act" (H.R. 2940) in the House that seeks to:

- Amend Section 4(2) to exempt transactions by an issuer not involving any public offering, "whether or not such transactions involve general solicitation or general advertising;" and
- Direct the SEC to revise its rules to provide that the prohibition against general solicitation or advertising contained in Regulation D shall not apply to offers and

sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors.

The House overwhelmingly approved H.R. 2940 on November 3, 2011, and the bill was referred to the Senate, where no additional action has occurred.

On November 9, 2011, Sen. John Thune (R-SD) introduced a companion measure to the House bill that also is entitled the "Access to Capital for Job Creators Act" (S. 1831). The legislation, identical to H.R. 2940, was referred to the Committee on Banking, Housing and Urban Affairs on November 9, 2011, and was the subject of a committee hearing on December 1, 2011, and a subcommittee hearing on December 14, 2011.

Eliminating or modifying the ban on general solicitation and advertising in connection with private placements is hardly a new concept and has been considered by the SEC previously. Whether a transaction qualifies for an exemption from the Securities Act registration requirements should depend on the status of the purchasers, rather than on the number or status of offerees or the method by which an issuer locates potential offerees and purchasers. An offering in which the ultimate purchasers are accredited or "sophisticated" investors should qualify for a Securities Act exemption, regardless of the means by which such purchasers were located. The focus should be on the protection of actual purchasers. An offeree does not suffer actual loss merely by virtue of having been offered securities unless he or she becomes a purchaser. As a result, from a policy point of view, offerees do not require the protection of the Securities Act. Purchasers, however, either do or do not need the protection of Securities Act registration, based on their financial wherewithal, investment sophistication, relationship to the issuer, institutional status and access to information.

In view of technological advances, including the Internet, it may be both unnecessary and unrealistic to retain any restrictions on "offers" and "general solicitation and advertising" with respect to securities being sold in private offerings. The rationale for continuing to condition private offering exemptions on the absence of general solicitation and advertising is undermined by the public availability of information about private offerings released by third parties. For example, the Internet has made information concerning private offerings, including secondary price quotes, securities ratings, rating agency offering reports and analyst research reports, immediately and widely accessible. Use of today's technologies to permit broader access to information in connection with private offerings should not hinder the SEC's ultimate goal of investor protection and would permit smaller companies to reach more potential investors at a lower cost. Of course, if general solicitation and advertising is deemed permissible, it also could impact more mature companies that engage in Rule 144A offerings.

Potential Increase in the Offering Amount Permitted Under Regulation A

Regulation A. Regulation A under the Securities Act provides an exemption from the registration requirements for offerings of up to $5 million per year by nonreporting issuers. Although an offering document must be filed with the SEC, the

information requirements are simpler than those in registered offerings. Issuers also may "test the waters" for interest before committing to an offering. In addition, Regulation A does not require that the offering be made to a certain type of investor, and securities offered and sold are not transfer-restricted. Regulation A, however, is not used widely, primarily because of the $5 million annual cap, the filing requirement (including potential review) and the lack of preemption from state registration under Securities Act Section 18.

SEC Action. The Division is considering recommending that the SEC increase the offering amount permitted under Regulation A.

Congressional Action. Bills have been proposed in both the House and Senate that would require the SEC to create a new exemption from registration under the Securities Act, similar to Regulation A, but with additional conditions and an increased offering amount. On March 14, 2011, Rep. David Schweikert (R-AZ) introduced the "Small Company Capital Formation Act of 2011" (H.R. 1070) that seeks to:

- Raise the cap in the exemption for small issuances under Section 3(b) of the Securities Act from $5 million to $50 million in any 12-month period;
- Add a clearly specified litigation remedy (Section 12(a)(2) of the Securities Act);
- Mandate that the SEC require the issuer to file audited financial statements with the SEC annually;
- Authorize the SEC (i) to require an issuer that has made an exempt offer to make periodic disclosures available to investors regarding the issuer, its business operations, its financial condition and its use of investor funds; and (ii) to provide conditions for the suspension and termination of such a requirement with respect to that issuer;[8] and
- Require the SEC (i) to review and increase biennially such offering amount limitation, as appropriate, and (ii) to report to certain congressional committees on its reasons for not increasing the amount if it determines not to do so.

> "Regulation A … is not used widely, primarily because of the $5 million annual cap, the filing requirement … and the lack of preemption from state registration under Securities Act Section 18."

The House overwhelmingly approved H.R. 1070 on November 2, 2011, and the bill has been referred to the Senate for consideration.

On September 12, 2011, Sen. Jon Tester (D-MT) introduced a companion measure to the House bill that also is entitled the "Small Company Capital Formation Act of 2011" (S. 1544). The bill is identical to H.R. 1070 and was referred to the Committee on Banking, Housing and Urban Affairs on September 12, 2011. The committee conducted a hearing on the legislation on December 1, 2011, but has taken no further action.

H.R. 1070 and S. 1544 may be helpful in that they raise the cap for issuances under the exemption, while adding additional investor protections, such as a

[8] Although the bill does not explicitly make a company that conducts an offering under this exemption subject to the Exchange Act registration and reporting requirements, any such company would be required to file audited financial statements with the SEC annually, and other periodic disclosure would be required to the extent that the SEC directs.

litigation remedy under Section 12(a)(2) for false or misleading statements or omissions set forth in the offering document or oral communications involved in the offer or sale of securities, as well as access to annual audited financial statements of the issuer. In addition, Regulation A offerings may be marketed to an unlimited number of retail investors (the bills do not appear to change this). However, the fact that an issuer may still have to file an offering document subject to staff review may continue to limit use of such an exemption in the future. (Under the bills, the SEC will be able to decide whether or not to require the filing of an offering document.) Pursuing an offering under Rule 506 of Regulation D (which has no cap on the amount that may be offered, does not require staff review and is not subject to Section 12(a)(2) liability) may be more attractive to issuers.

Crowdfunding

Background. "Crowdfunding" describes a capital-raising strategy whereby groups of people pool money, composed of small individual contributions, to support accomplishment of a particular goal. Crowdfunding initially was developed to fund projects such as charitable endeavors, films, books and music recordings. The persons providing such funding were more like contributors than "investors" because they were persons donating money without the right to participate in any profits. Because these crowdfunding efforts did not involve the offer and sale of a security, they did not raise issues under the federal securities laws. Today, there is increasing interest in crowdfunding as a means of offering investors an ownership interest in an early-stage or small company.

SEC Action. The Division is reviewing the regulatory questions posed by new capital-raising strategies and, according to the Senate testimony of the director and deputy director, "has been discussing crowdfunding, among other capital raising strategies, with business owners, representatives of small business industry organizations, and state regulators." Some of the questions under consideration include:

- What limits should govern the amount of funds that may be raised by an entity and invested by an individual;
- What information should be required to be made available to investors;
- How, and to what extent, should there be regulatory oversight with respect to the websites that facilitate crowdfunding investing;
- What restrictions should be placed on participation by those that have been involved with prior securities fraud;
- Should an SEC filing or notice be required; and
- Whether securities purchased in a crowdfunding transaction should be freely tradeable.

Congressional Action. Bills have been proposed in both the House and Senate that would exempt from the Securities Act registration requirements certain crowdfunding transactions. On September 14, 2011, Rep. Patrick T. McHenry (R-NC) introduced the "Entrepreneur Access to Capital Act" (H.R. 2930) that seeks to:

> "[W]e believe broker-dealer registration of the crowdfunding intermediary should be considered as well as reasonable limitations on the intermediary's solicitation activities."

- Create a new registration exemption for an offering amount up to $2 million ($1 million if the company does not have audited financial statements) within any 12-month period, with a maximum investment per investor of the lesser of $10,000 or 10 percent of the investor's annual income within any 12-month period;
- Treat securities offered as "covered securities," thereby preempting state authority to register the securities;
- Amend Section 12(g)(5) to exclude holders of crowdfunded securities from the definition of "held of record" with respect to mandatory registration of securities;
- Provide for an exemption for intermediaries from broker-dealer registration under the Exchange Act; and
- Restrict transfer of securities issued and sold under such exemption for one year (unless the securities are sold to the issuer or an accredited investor).

The House overwhelmingly approved H.R. 2930 on November 3, 2011, and the bill was referred to the Senate. The Committee on Banking, Housing and Urban Affairs conducted a hearing on the bill on December 1, 2011.

On November 2, 2011, Sen. Scott P. Brown (R-MA) introduced the "Democratizing Access to Capital Act of 2011" (S. 1791). The bill differs from H.R. 2930 in a few important respects, including:

- Individual investments would be limited to $1,000 per person per year, with an aggregate offering cap of $1 million during any 12-month period; and
- The entity raising the money must be incorporated under and subject to state law, and a "crowdfunding intermediary" must be used.

On November 2, 2011, the bill was referred to the Committee on Banking, Housing and Urban Affairs, which conducted a hearing on the bill on December 1, 2011.

Presumably, the exemption provided for by these bills would be used by early stage issuers seeking many small investors. Issuers could solicit retail investors through the Internet, with no requirement to provide a meaningful disclosure document and no prior SEC review. Not only do the bills provide for an exemption from Securities Act registration, they also provide an exemption from broker-dealer registration under the Exchange Act. The latter exemption may provide significant opportunities for fraudulent sales activities, including so-called "boiler room" scams. At a minimum, we believe broker-dealer registration of the crowdfunding intermediary should be considered as well as reasonable limitations on the intermediary's solicitation activities. In addition, the bills do not address integration. Use of the crowdfunding exemptions, as drafted, may prevent the issuer from utilizing other exemptions for six months.

Some have criticized these measures, such as:

> [o]ne million dollars is a low ceiling, and Rule 504 already permits a similar level of sales to unsophisticated retail investors. The only difference is that under Rule 504, an issuer cannot make a general solicitation without providing a disclosure document that satisfies state "Blue Sky" law requirements. Under proposed Section 4(6), state law would be preempted (and the retail shareholders who acquire these securities would not count toward the Section 12(g) threshold for "reporting" company status). Possibly, this provision would be used by some small companies because it freely permits general solicitation, but a ceiling set at the lesser of $10,000 or 10 percent of annual income is confining, and would in my judgment make most fly-by-night issuers still prefer Rule 504.[9]

* * *

The foregoing regulatory and legislative initiatives seek to encourage economic growth by more efficiently facilitating capital formation at a time when smaller companies are struggling to raise funds amid regulatory and economic pressures. As noted above, although the ultimate outcomes and timing of these initiatives are currently unknown, we expect at least some of them to be adopted in 2012. As the proposed bills move forward, it is possible that amendments will be introduced that attempt to synthesize the efforts of the SEC and Congress.

[9] http://www.sec.gov/info/smallbus/sbforum111711-materials-coffee.pdf.

IRS Expansion of Qualifying Asset Classes Broadens Range of REIT Opportunities; Proposed FIRPTA Legislation to Increase Foreign Investment in U.S. Real Property; and Mortgage REIT Developments

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REITs: Not Just for Real Estate Operators Anymore

As the REIT industry matures and nontraditional real estate operators consider whether REITs might be suitable vehicles for their investments, the U.S. Internal Revenue Service (IRS) has continued the inexorable march to expand the classes of assets and sources of income that satisfy the qualification tests for real estate investment trusts.

The process began with timber. Prior to the first IRS rulings stating that timberlands constituted an interest in real property and gains from sales of harvested timber would be treated as gains from sales of real property, REITs were not considered viable investment vehicles for timber companies. Today they are the preferred structure for timber investors, including non-U.S. persons and tax-exempt organizations, because of their tax-efficiency. The IRS continues to evaluate new income and asset classes in this area, ruling in 2011 that a timber REIT's income from agreements to sell carbon dioxide offset credits is good REIT income and carbon emissions units allocated to a REIT by a foreign government qualify as good REIT assets.

The IRS similarly opened the door to new, and continuously evolving, classes of REITs when it confirmed that transmission towers and cell towers could qualify as good REIT assets. The IRS's ongoing exploration of what types of assets constitute good REIT assets has facilitated the expansion of REITs into varied infrastructure projects, such as power distribution systems, total energy systems, and oil and gas pipelines, transmission and distribution assets. We anticipate that this area will continue to evolve, particularly with respect to the types of infrastructure that qualify for purposes of the REIT asset tests. In light of this growth pattern, we expect that REITs may soon be used to own and finance alternative energy projects, such as wind farms and nuclear power plants.

We expect that operating companies with significant property holdings will continue to evaluate the feasibility of restructuring their businesses so as to more efficiently hold their real estate through REITs. For example, health care providers with substantial real estate will continue the trend of restructuring into property-owning REITs and separate operating companies. In light of this development in health care, the IRS continues to issue rulings that clarify what types of properties constitute "health care facilities," as more senior living facilities move into REIT structures. The guidelines governing this investment structure should receive additional attention and refinement.

Keying off the success of the property/operations split employed in health care REITs (and in hotel REITs before them), we anticipate companies in a number of other industries will consider ways in which they can separate their real property holdings from their operations in order to employ REITs in their structure. Such "PropCo/Opco" splits have been pushed by some investors, who argue that this structure provides property owners with continued control over their real property while improving access to credit and capital.

Growth in the REIT arena has not been limited to consideration of the types of physical real property suitable for investment. The IRS continues to consider the

increasing use of REITs for investment in sophisticated financial products and provision of financial services, recently ruling that excess mortgage servicing rights constitute good REIT assets and produce good income. We expect to see REITs pursuing new types of investments and potential income streams in the coming year, with ongoing dialogue with the IRS as to the qualification of various mortgage-type investments under the REIT rules.

As these exciting trends continue, there will be ever-expanding opportunities for REITs to invest in new assets and income sources, and for new industries to look to REITs as a means of structuring their holdings in a more tax-efficient manner.

FIRPTA: Proposed Legislation Will Increase Foreign Investment in U.S. Real Property

In September 2011, bills were introduced in both the House and Senate proposing a significant modification to the Foreign Investment in Real Property Tax Act (FIRPTA) provisions applicable to REITs. The bills represent substantive FIRPTA reform that will generate sizeable foreign investment in U.S. REITs, providing REITs with the equity necessary to refinance looming debt maturities, upgrade and renovate properties, revitalize neighborhoods and create jobs.[10]

Under current law, foreign shareholders owning 5 percent or less of publicly traded companies are not subject to FIRPTA upon a sale of stock or, if the company is a REIT, receipt of a capital gain distribution. The House and Senate bills extend these exemptions to shareholders owning 10 percent or less of a publicly traded REIT. Increasing this exemption will allow foreign investors to dramatically increase their investments in publicly traded REITs without being subjected to FIRPTA.

The bills also provide that liquidating distributions from, or redemptions by, REITs are to be treated as sales of stock. This provision rectifies the confusion created in the foreign investment community when the IRS issued Notice 2007-55, revoking existing authority and concluding that, solely for foreign shareholders, REIT liquidating distributions and redemptions should be treated as capital gain distributions subject to FIRPTA. This simple clarification will provide significant incentive to foreign investors considering investing in private REITs and present added flexibility to private equity and other funds structuring investments in U.S. real estate.

In addition, the bills provide a mechanism for publicly traded REITs to, for the first time, confidently rely on the domestically controlled exception to FIRPTA. The bills provide that a publicly traded REIT may presume all "small" shareholders are U.S. persons, except where the REIT has actual knowledge to the contrary. The bills further provide that stock in a REIT held by another REIT will be treated as held by a foreign person unless the shareholder REIT is itself domestically controlled. Should the bills be enacted, a publicly traded REIT will be able to inform potential foreign investors of its domestic status, thereby allowing foreign investors to confidently assess the expected U.S. tax burden of investing in the REIT.

[10] For the past two years, Skadden has worked closely with one of our clients in this legislative process.

Mortgage REIT Developments

Mortgage REITs are generally excluded from regulation as an "investment company" by the Investment Company Act of 1940 (the 1940 Act). The 1940 Act excludes any company that is "primarily engaged in the business" of "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate," provided that the company does not issue redeemable securities or certain other types of securities historically associated with investment companies. On August 31, 2011, the SEC issued a concept release and requested comments regarding this exclusion. In practice, this means the SEC will consider whether the exclusion as currently applied is consistent with congressional intent in enacting it and is administered in a manner consistent with the purposes and policies underlying the 1940 Act — *i.e.*, whether mortgage REITs are operating in a manner too similar to investment companies and should be subject to additional regulation. While we anticipate that the review process initiated by the release will take some time, it is not clear at this point what impact the release will have on the formation and growth of mortgage REITs.

The Effect of a Eurozone Breakup on Euro-Denominated Corporate Bonds and Loans

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The recent sovereign debt crisis that erupted in Greece and other European countries has roiled world markets and forced many to contemplate what was unthinkable only a few months ago — the possibility of one or more eurozone members leaving the Economic and Monetary Union (EMU or eurozone) or even a total breakup of the currency union. Although members of the eurozone have taken actions to stabilize their monetary union, considerable questions remain about its future. While many commentators still believe the scenario of a limited or a total breakup is unlikely due to the economic costs and the numerous legal, political, practical and procedural barriers, the possibility has led many companies (not only banks and other financial companies) and investors to begin preparing contingency plans. Several European central banks already have started preparing for the possibility that the currency union could break apart entirely. One of the many questions being asked is what the effect would be on the obligation to make payments in euros for euro-denominated loans and bonds if one or more member countries left the eurozone.

Any analysis of the implications of a limited or a total breakup of the eurozone must start with an understanding of the possible scenarios for the manner and nature of a breakup. Currently, there are no provisions in the relevant European Union treaties for the withdrawal of a country from the eurozone. Also, there are no mechanisms in the relevant treaties for the expulsion of a country from the eurozone. However, the members are sovereign states and, as such, they can repudiate their treaties and unilaterally withdraw. As a result, numerous possible permutations for a breakup exist. This article focuses on what might happen to a corporate bond or loan denominated in euros in two possible breakup scenarios: (i) a limited breakup of the eurozone, either via a nonconsensual unilateral withdrawal or a negotiated withdrawal of one or more countries, with the euro remaining in existence; and (ii) a complete breakup of the eurozone, where the euro would cease to exist.

In both scenarios, one must begin with a review of the specific terms of the relevant debt agreement. It is possible that the agreement explicitly provides for the replacement of the euro by a successor monetary unit; however, most agreements do not. If the agreement is silent, determining what happens to corporate bonds and loans denominated in euros will depend on a number of factors, including the governing law of the agreement, whether the parties have submitted to the exclusive jurisdiction of the courts in a particular country, how the agreement defines the currency in which payments must be made and the place of payment provided for in the agreement.

Limited Breakup of the Eurozone: Unilateral Withdrawal or Negotiated Withdrawal

Two principal concerns for bond and loan market participants that would arise from a partial or complete dissolution of the eurozone are (i) the continuity of contracts — whether an agreement to make payments denominated in euros will remain valid and binding and (ii) redenomination risk — the risk that the payment obligations will be redenominated from euros to a new currency, which, depending on the relative strength of the currencies, could have an adverse effect on either the creditor or the debtor. In addition, many commentators believe that if the eurozone fractures, Europe would spiral into an economic depression and the rest of the world would enter a severe recession, causing a significant adverse effect on the ability of debtors to pay.

> "[M]any commentators believe that if the eurozone fractures, Europe would spiral into an economic depression and the rest of the world would enter a severe recession."

Corporate bonds and loans governed by the local law of a country withdrawing from the eurozone would be exposed to redenomination risk because the withdrawing country will need to introduce a new currency. In all likelihood, the withdrawing country also will enact redenomination legislation which, for the sake of simplicity, we assume will provide that all debts payable by its nationals in euros are automatically redenominated into and payable in the new currency. Courts, including English and New York courts, would in most cases give effect to the redenomination legislation and hold that loans and bonds governed by the laws of a withdrawing country would become payable by its nationals in the new currency because sovereign countries have the right to determine their legal currency. However, if the bonds or loans are governed by and under the jurisdiction of English or New York law (the most frequently chosen law to govern international corporate bond and loan agreements), English and New York courts are unlikely to recognize the unilateral redenomination by a withdrawing country and would likely hold that such loans or bonds remain denominated in euros. A country withdrawing from the eurozone does not appear to have a legally enforceable right to redenominate a corporate loan or bond governed by English or New York law and under the jurisdiction of the English or New York courts.

If the breakup was a unilateral (nonnegotiated) withdrawal, the English courts could determine that because the United Kingdom is a signatory to the EU treaties that a unilateral withdrawal would breach, a withdrawing country's redenomination legislation is contrary to English public policy and should not be recognized. However, it is unlikely that there would be a public policy concern in a negotiated breakup: a country withdrawing from the eurozone under a multilaterally negotiated framework likely

will exit with supporting monetary legislation from the EU — and the cooperation of other member states in its transition to a new currency. It is unlikely that New York courts would have public policy concerns with either a unilateral or negotiated withdrawal.

If the debt agreement provides that the sole place of payment is within a departing state, commentators have expressed the view that this creates a presumption that the parties intended for the currency to be the currency of the departing member, and that this presumption can be rebutted by the other terms of the contract, the intention of the parties and the relevant surrounding circumstances.

Complete Eurozone Breakup

If there is a complete eurozone breakup and the euro ceases to exist, payment obligations under euro-denominated debt agreements would need to be redenominated into new currencies (which could be national currencies or a currency unit that is a basket of currencies, similar to the European Currency Unit (ECU) used for the introduction of the euro); otherwise, questions arise as to whether performance of the debt agreement is "impracticable," "impossible" or "frustrated" because the euro no longer exists. The legal doctrine of impracticability or impossibility involves the inability to perform as promised due to intervening events beyond the control of the obligor. The legal doctrine of frustration provides that if, due to an unforeseen event, the obligations under a contract are so different from what the parties to the contract originally contemplated, the contract should be terminated. If such arguments were successful, it would allow borrowers to discharge payment obligations under their debt agreements and pose a serious threat to the continuity of debt-payment contracts.

Given the severity of such a result, we think it's likely that legislatures will act to head off any questions about the validity of euro-denominated debt obligations. Our belief that the legislatures will act is based in part on the history of the introduction of the euro. When the euro was introduced, the EU issued directives addressing the continuity of contracts. These regulations stated that the conversion to the euro does not allow for a party to unilaterally escape from its contractual obligations, unless the parties have otherwise agreed to it. In addition, the New York legislature took similar actions to provide for the continuity of contracts under Section 5-1601 *et seq.* of the NY General Obligations Law when the euro was introduced. This New York legislation provided that if the form of payment for a contract, security or instrument is a currency that had been replaced by the euro, including the ECU, the euro will be a commercially reasonable substitute and substantial equivalent, and may be used in determining the value of the currency, or tendered, in each case at the conversion rate specified by the regulations adopted by the Council of the European Union. The New York legislation further provided that the introduction of the euro would not excuse performance under any contract or give a party the right to unilaterally alter or terminate any contract. Most important, this legislation was given retroactive effect and applied to contracts entered into prior to the enactment of the legislation. If, in connection with any breakup of the eurozone, similar laws are enacted by the legislatures of the jurisdictions whose laws are the

chosen laws governing the debt agreement, questions of whether performance of a contract is "impracticable," "impossible" or "frustrated" because the euro no longer exists would largely be eliminated.

In the unlikely event that legislatures fail to act, it is not anticipated that many contracts governed by New York or English law will be discharged because the legal criteria to show impracticability, impossibility or frustration are extremely difficult to satisfy. Given the serious market disruption of such a result, it is unlikely that New York or English courts applying New York or English law will accept a borrower's argument that payment under a debt obligation is excused because the euro no longer exists. In such a circumstance, courts likely would seek to impose some sort of equitable remedy to the creditor in the absence of legislation.

* * *

This is a general discussion of some of the issues that parties to debt agreements might consider in connection with the euro crisis and potential breakup of the eurozone. There likely will be much more nuanced and complex questions and concerns, and it is difficult to predict with any degree of certainty what a potential breakup would look like.

Potential Implications of the UK's Enhanced Disclosure Requirements on Debt Financing of Takeover Bids

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Increased disclosure was a key factor behind the UK Panel on Takeovers and Mergers (the Panel) implementing amendments to its regulations in the City Code on Takeovers and Mergers (the UK Code) on September 19, 2011. These amendments are meant to put all interested stakeholders and, in particular, the target board, shareholders and employees in a better position to judge the merits of an offer.

Enhanced disclosure requirements are likely to have significant implications for the debt financing of takeover bids. Financial institutions and potential bidders need to be aware of these requirements in terms of both their potential financial impact and reputational aspects.

A Move Toward Greater Disclosure

Prior to the amendments, the UK Code required disclosure of the key terms of any debt facility financing a takeover. However, disclosure was limited to a brief description of the key terms of the debt facility in the offer document and to placing a copy of the credit agreement on public display for inspection. There was no requirement under the UK Code to display ancillary documents relating to the financing, such as fee letters, or to disclose the parameters, or existence of, any market flex provisions or the amount of any financing fees.

However, Kraft Foods' 2010 acquisition of Cadbury, following a protracted takeover bid, was the subject of considerable criticism by the Panel because of certain statements Kraft made during the course of the takeover concerning the retention of one of Cadbury's existing manufacturing facilities. After the takeover was declared unconditional, Kraft announced it would close the facility. The Panel concluded that certain aspects of the UK Code, specifically those relating to disclosure, should be

reviewed. A consultation process was launched in May 2010, with the resulting amendments taking effect last September.[11] (See "Global M&A/European Union: The UK-Continental Europe Debate on Takeover Regulation.")

These amendments are meant to bring about increased disclosure of any information that could affect relevant stakeholders in relation to an offer. The categories of relevant stakeholders are now considered to include employees and former employees in addition to shareholders. Where an all-cash offer is made, shareholders' interests generally are limited to matters affecting the price, whereas if part of the consideration is equity, shareholders will continue to have an interest in matters affecting the target, as its strength may affect the value of the (consideration) shares in its new owner. Employees and former employees are interested, as the continued existence and performance of the target will be material to their employment terms and pension entitlement.

New Disclosure Requirements in Relation to Debt Financing

The new disclosure requirements under the UK Code include an obligation on the potential acquirer to put all documents relating to the debt financing on display (including any side letters such as syndication letters dealing with flex provisions) and to give full disclosure of any financing fees.

Disclosure of this information is now required to be posted on either the bidder's website or, if it does not have a website, a third-party website such as the financial advisor's. While this makes it easier for relevant stakeholders to access the information, it also makes the detailed terms of any financing readily available to other parties, such as advisory firms and rival financial institutions, whose interest may not be specific to the takeover offer itself but to the terms of the financing generally.

Financing Fees

Regulations always have required a copy of the credit agreement to be put on display, and its terms were therefore always capable of becoming public. However, the new regulations require disclosure of the amount of the financing fees as well. This new requirement is controversial given that, historically, the level of financing fees paid to the arranging bank has been confidential and was not disclosed even to the wider debt syndicate.

The UK Code now requires all documents relating to the financing to be put on display. Although the Panel seems likely to acknowledge that the level of disclosure required extends only to documents that are likely to be material to relevant stakeholders, how the Panel deals with this remains to be seen: It is clear that disclosure of sensitive commercial points such as fees can no longer be avoided by the use of side letters.

[11] Along with other interested parties, Skadden participated in the consultation process.

Market-Flex Provisions

The new UK Code rules mandating wider disclosure of financing documents would currently be applied by the Panel to oblige a bidder to disclose any ability of the arranging banks to require amendments to the terms of the credit agreement, typically referred to as market-flex provisions.

Before 2008, market-flex provisions in European debt financings were generally limited to the arranging banks having the ability to require small increases in the pricing of the debt facilities, typically capped at an additional 0.25-0.50 percent increase in the interest payable or an equivalent increase in the amount of the upfront arrangement fee. If these market-flex rights were invoked, the potential impact was minimal, and the existence and terms of any market-flex rights was therefore generally not considered material or disclosed.

Given the continuing uncertainty in the financial markets, market-flex provisions are now more extensive, and it is not unusual for the arranging bank to negotiate wide-ranging rights to increase the interest rate on the debt or the amount of any upfront arrangement fees. It also is not unusual for the arranging bank to sell the loans at a discount, retranche the facilities and have the right to require amendments to any other terms to the extent necessary to achieve a successful syndication.

Market-flex provisions are highly sensitive, of course, as their public disclosure is likely to result in an increase in the cost of the financing for the takeover. This impacts the bidder in terms of an increased financing cost, but potentially also impacts the employees and former employees of the target company and the exiting shareholders if the consideration for any offer is made partially with equity, as any increased cost will reduce the funds available to the combined group.

* * *

The amendments to the UK Code are likely to have significant implications for the debt financing of takeover bids as a result of the enhanced disclosure requirements.[12] The long commitment period required (generally four to six months) for the offer process already presents challenges in a volatile market, and anything that materially impacts the ability of arranging banks to syndicate will inevitably make financing of takeovers more expensive.

It also seems likely that the requirement to disclose the terms of any market-flex provisions will be challenged, and the Panel will need to reconsider the scope of the disclosure required in order to achieve a balance between protecting stakeholders and preserving an efficient financing market.

[12] Skadden recently advised on the first takeover to occur since the UK Code amendments were implemented.

As Market for Bonds Denominated and Settled in Offshore Chinese Renminbi ('Dim Sum Bonds') Grows, European and U.S. Investors Demand Bondholder Protections

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Dim sum bonds emerged in 2007 when China began its experiment to internationalize the national currency by permitting foreign companies and certain Chinese financial institutions to issue debt denominated and settled in offshore Chinese renminbi (CNH) — a currency effectively different from onshore renminbi (CNY) and primarily traded and cleared in Hong Kong. Since then, more than 70 companies have issued offshore renminbi (RMB) bonds in Hong Kong. Dim sum bonds, like the popular bite-sized Chinese food from which their name originates, often have been doled out in relatively small sizes, with some deals raising as little as RMB 200 million (US$30 million). However, the market for these bonds has been growing rapidly, with the largest dim sum bond issuance to date being the RMB 3.6 billion (US$564 million) issuance by Baosteel Group in November 2011.

In the first six months of 2011, 22 issuers raised an aggregate of more than RMB 19 billion (US$2.9 billion) through dim sum bond sales. The majority of these issuers were Hong Kong-based companies (including Chinese businesses owned by offshore companies whose shares are publicly traded on the Hong Kong Stock Exchange). International players (typically those with meaningful China operations) such as McDonald's, Caterpillar, Unilever, Tesco and L'Air Liquide also are developing an appetite for this new debt class. A recent policy change by the People's Bank of China allows Chinese state-owned companies to issue offshore RMB bonds, up to a quota of RMB 50 billion. The first issuance of such bonds by a Chinese state-owned company took place in November 2011, when Baosteel issued its debut dim sum bond.

Dim Sum Bond Terms and the Changing Nature of Dim Sum Bond Issuers

Prior to mid-2010, virtually all of the dim sum bond issuers were People's Republic of China sovereign bodies and financial institutions. A slight change occurred in mid-2010 when a number of private investment-grade corporations and supranational institutions, such as the World Bank, International Financial Corporation and Caterpillar, came to the market. However, beginning with a December 2010 issuance by Macau gaming operator Galaxy Entertainment, an increasing number of high-yield issuers — including those that either previously had issued U.S. dollar high-yield bonds or had U.S. dollar high-yield bonds outstanding — have accessed this market.

Speculation that the RMB will strengthen, as well as the large deposit of RMB with banks based in Hong Kong, have fueled demand for dim sum bonds in Hong Kong and the region. The demand for dim sum bonds by investors has been so high that many of the deals that were done prior to early 2011 contained only limited bond covenants, even though the issuers were not investment-grade companies. In some cases, the bond terms do not contain covenants that restrict debt incurrence (such as a fixed-charge coverage test or a maximum debt-to-equity ratio). According to Bloomberg, only four non-financial companies in the HSBC Offshore Renminbi Bond Index contain this level of protection. Investors bought these bonds with reliance on negative pledge provisions, which typically prevent the issuer from using its assets as security for new debt unless holders of the dim sum bonds will get to share such security or get alternative security of the

same value. Other safeguards include relying on cross-default clauses in the bond instruments; if the issuer is in default of another bond or loan with a set minimum principal amount, it will trigger the dim sum bonds to be repayable immediately.

Additional differences between typical dim sum bond terms and China-related U.S.-dollar high-yield bond terms include the following:

Secured vs. Unsecured. It is common for China-related U.S. dollar high-yield bonds to be secured by shares of the non-China subsidiaries. It is very rare for dim sum bonds to be secured.

Structural Subordination. It is common for China-related U.S. dollar high-yield bonds to be guaranteed by the issuer's non-China subsidiaries. The advantage is that it reduces structural subordination, as investors are able to have direct causes of action against the guaranteeing subsidiaries. It is very rare for dim sum bonds to be guaranteed.

High-Yield Covenants. China-related U.S. dollar high-yield bonds often contain a suite of typical high-yield covenants, including limitations on indebtedness, restricted payments, asset sales, transactions with shareholders and affiliates, dividend and payment restrictions affecting subsidiaries, and sale and leaseback transactions, among others. Except for a handful of recent deals, most dim sum bonds do not contain typical high-yield covenants. At times, the decision on whether to employ high-yield covenants may determine the success of a bond issuance. A tighter covenant package helped the automobile dealership ZhongSheng Group successfully issue its RMB 1.25 billion 4.75 percent dim sum bonds in early 2011. This issue's bond terms included standard incurrence tests, as well as asset sale and payment restrictions. Recently, some real estate companies have failed to put through deals using light covenant packages.

As demand has outpaced supply, the dim sum market has, until very recently, been essentially an "issuer's market" — where the balance of power regarding the proposed terms of the bonds is generally in favor of the issuer during negotiations with the offering's investment banks. Hong Kong banks and investment funds, faced with burgeoning RMB deposit accumulation and limited same-currency, fixed-income investment options, are the main purchasers of dim sum bonds. Other investors include high-net-worth individuals in the Asia-Pacific region. As of May 2011, more than RMB 500 billion was deposited in Hong Kong, while only RMB 131 billion in dim sum bonds was outstanding as of June 2011. Participation from other investors has been fueled by, among other things, expectations that the RMB will appreciate.

A review of the more recently completed dim sum bond terms suggests that some issuers are now including selected high-yield covenants in their bond terms to facilitate marketing. For example, the RMB 1 billion dim sum bonds issued by Shougang Corporation in November 2011 include a leverage covenant and an asset sales covenant.

What Is the Future for the Dim Sum Bond Market?

The recent volatility in global currency and financial markets, along with the publicity surrounding the alleged inaccuracy of disclosure in some recent securities offerings by People's Republic of China-related issuers, have made it more difficult for issuers and investment banks to market dim sum bonds. This has led to the repackaging of bond terms by tightening the covenants in a number of deals. Market requirements may further tighten for issuers as alternative RMB-denominated investment products become available.

With more than 70 dim sum bonds having been issued, investor demand in Asia for this type of product may gradually reduce. European and U.S. investors entering the dim sum bond market have in the past demanded, and likely will continue to demand, bondholder protections similar to those contained in typical Asia-based U.S. dollar high-yield bonds. Furthermore, as expectations for RMB appreciation decline, there may be less demand for dim sum bonds. As a result — and as this market continues to mature — we expect offering structures and covenant packages in dim sum bond issues to correlate more closely with the credit quality of the issues.