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Communications: Emerging Wireline, Media Ownership and Wireless Challenges

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The Federal Communications Commission (FCC) has spent much of the last 12 months concluding several key regulatory proceedings, including actions to restructure the federal universal service fund (USF), revise intercarrier compensation regulations and issue updated media ownership guidelines. While the conclusion of these highly controversial proceedings may reduce the FCC's near-term level of activity, any respite will be short-lived as marketplace developments — especially in the wireless sector — will force the FCC to focus on a new and possibly more contentious set of issues. Indeed, the intense regulatory fight over AT&T's proposed but terminated acquisition of T-Mobile USA serves as a harbinger of these upcoming battles, which will shape a variety of related industry sectors for years to come.

Wireline – USF/Intercarrier Compensation

In an action affecting nearly every aspect of the telecommunications sector, the FCC voted unanimously in late October to substantially overhaul the decades-old mechanisms by which it allocates USF subsidies to certain carrier segments and the intercarrier compensation and payment systems through which carriers recover their network costs.

The FCC's reform of its USF mechanisms will redirect existing subsidies that support only legacy voice services to a new Connect America Fund (CAF), which will support the deployment of broadband facilities and services to previously underserved areas. Of particular importance, the CAF, with an annual budget limit of $4.5 billion, will support the extension of both wireline and wireless broadband networks in underserved areas. With respect to the multibillion-dollar intercarrier compensation system, the FCC adopted a bill-and-keep approach under which carriers eventually will recover their network costs resulting from the exchange of traffic from their own customers before imposing per-minute charges on other carriers. While certain carriers may experience a loss of revenue from the transition to a bill-and-keep system, these carriers will be permitted to recoup part of the lost revenue through higher per-line charges.

Media – Ownership Regulations

Culminating a two-and-one-half-year process, the FCC is poised to release a limited proposal to change regulations governing media ownership. FCC rules long have prohibited common ownership between newspapers and broadcasters in the same market, while also restricting the number of broadcast outlets a single company can own in a market. By statute, the FCC must reevaluate the rules quadrennially; the on-the-verge-of-release proposal attempts to finally conclude the 2010 review.

Published reports indicate that while the FCC might allow some common ownership between newspapers and broadcasters, permission would be available only in the largest markets. Even there, the FCC is considering barring combinations of newspapers with network-affiliated television stations. Because these affiliates are most likely to broadcast newscasts, they also are the most promising candidates for transactions. The FCC proposal would continue to make it nearly impossible for these combinations to go forward.

The proposal ignores the substantial marketplace impact wrought by new media, such as the Internet. Retention of current limits likely will further dampen the transactional market. Whatever rules ultimately are adopted, they almost certainly will be appealed in court again — leaving the industry with continued uncertainty.

Wireless – AT&T/T-Mobile[1]

The insatiable consumer appetite for wireless services — especially data and broadband — is driving a fundamental restructuring of the wireless sector. During 2011, wireless carriers proposed a variety of large-scale acquisitions positioned as efforts to acquire the spectrum necessary to meet an ever-increasing demand for wireless broadband services. Most notably, AT&T portrayed its proposed acquisition of T-Mobile USA as vital to its efforts to deploy 4G LTE wireless services throughout the country. AT&T's arguments regarding its need for additional spectrum met with stiff resistance from industry participants and staff of the U.S. Department of Justice and the FCC, which both rejected the carrier's purported claims and moved to block the transaction. Each agency was particularly concerned with the adverse impact that AT&T's proposed acquisition could have on existing and future competition in the wireless marketplace. In light of the government's objections, AT&T eventually decided to abandon its bid to acquire T-Mobile in late December.

The regulatory reviews associated with other proposed spectrum acquisitions (including Verizon Wireless' recent announcement that it intends to acquire the sizeable spectrum holdings of a consortium of cable operators) likely will continue the FCC's trend of promulgating policy decisions in the context of deal-specific reviews. For instance, in its January 2011 order approving Comcast's acquisition of NBC Universal, the FCC mandated that, for up to seven years, the merged companies adhere to the network neutrality rules adopted by the FCC in December 2010, even if the regulations ultimately are vacated or otherwise overturned as a result of a court challenge.

> "The regulatory reviews associated with other proposed spectrum acquisitions … likely will continue the FCC's trend of promulgating policy decisions in the context of deal-specific reviews."

Policy issues raised by the rejection of the AT&T/T-Mobile transaction and the regulatory reviews associated with other pending acquisitions (regardless of their ultimate outcomes) involve the permissible amount of spectrum that a company can control in specific geographic markets (the spectrum "screen") and whether that amount is sufficient for carriers to offer robust wireless broadband services. The ultimate decisions on these and other issues will help shape the upcoming fierce battles over the availability of additional spectrum for wireless services. In these debates, the resolution of questions surrounding the sources and recipients of new spectrum will be particularly difficult. These legislative and regulatory proceedings will pit wireless carriers against broadcasters, which will vociferously fight any efforts that would force them to surrender their existing spectrum holdings. Regulators also will face challenges in balancing the somewhat conflicting goals of deploying a sufficient amount of spectrum to offer nearly ubiquitous wireless broadband services with the need to ensure that spectrum is deployed to enough carriers to foster a competitive marketplace.

[1] Skadden represented Sprint Corporation in its opposition to AT&T's acquisition of T-Mobile.

Congressional Investigations: Anticipated Areas of Focus

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- In a presidential election year, we expect U.S. congressional oversight committees to turn their attention to oversight and investigation of the Obama administration and, in particular, the adjustment of special loan guarantees and other programs that were included in the administration's stimulus package.
- Several congressional committees will continue their investigations of the Department of Energy loan guarantee program.
- A number of high-profile incidents of cyber attacks have drawn considerable attention from congressional committees. Recently, House intelligence committees announced an investigation into cyber threats and the security of U.S. communications networks. As we previously discussed in *Insights*,[2] we expect that Congress will come under increasing pressure to produce bipartisan legislation.
- Financial institutions will continue to be the target of congressional investigations, as the TARP bailouts continue to draw scrutiny, the home foreclosure process remains politicized (in particular as it relates to servicemembers under the Servicemembers Civil Relief Act and urban homeowners under a variety of fair housing initiatives), and executive compensation and bonuses remain a major subject of discourse.
- Over the last several years, a number of Senate and House committees have launched investigations into online marketing and promotional activity. We expect the committees to continue to be active in this area with an eye toward emailing new consumer protection legislation. We also expect that the committees will continue to work closely with the FTC to address consumer complaints reflecting online marketing.

[2] *See* "Cybersecurity: What to Expect From Proposed Legislation" (Sept. 22, 2011), *available at* http://skadden.com/newsletters/Cybersecurity_What_to_Expect_From_Proposed_Legislation.pdf. (Also see "Regulatory/Privacy and Data Security: Changing the Corporate Mindset.")

Environmental: The Potential Impact of EPA Regulatory Developments on Electricity Generation

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In 2011, the U.S. Environmental Protection Agency (EPA) promulgated final or proposed air and water regulations, with more to come in 2012. These regulations will impose significant retrofit requirements on existing electric generating units and new obligations on new or modified units. While several bills have been introduced that attempt to rescind the EPA's authority to issue these regulations or to delay their implementation, there is little reason to believe that such legislation will become law in the current congressional session. Generators, regulators and the environmental community are debating the potential impact of these rules on electric reliability and the future of coal-fired generation.

Clean Air Act

Cross-State Air Pollution Rule. The EPA issued the Cross-State Air Pollution Rule (CSAPR) in July 2011. Twenty-seven states in the East, South and Midwest will be required to comply with state budgets for sulfur dioxide and annual nitrogen oxide emissions (to address interference with the fine particulate matter national ambient air quality standards) and/or ozone season nitrogen oxide emissions (to address interference with the national ambient air quality ozone standard). On December 15, 2011, the EPA finalized a supplemental rule that expands the ozone season nitrogen oxide emission limits to five additional states (four of which already are subject to annual sulfur dioxide and nitrogen oxide limits). Although EPA also found that emissions from Kansas contribute significantly to nonattainment or interference with maintenance of the 1997 ozone standard, the EPA determined that it did not have legal authority to subject Kansas to the ozone season limitations in 2012. Phase I of CSAPR was supposed to go into effect in 2012 (but see below), and Phase II of CSAPR (reducing sulfur dioxide emission budgets in 16 states) becomes effective in 2014.

CSAPR is an allowance-based emissions regulatory program issued pursuant to Section 110(a)(2)(D) of the Clean Air Act (the "good neighbor" provision). Currently, the only emissions sources subject to CSAPR are fossil-fuel-fired electrical generating units (EGUs). CSAPR imposes limitations on the interstate trading of emissions allowances in order to "assure" that each upwind state subject to the rule eliminates the emissions that are "contributing significantly" to air quality problems in downwind states. However, EPA issued a proposed amendment to CSAPR on October 14, 2011, to delay the assurance penalty provisions for two years in order to promote the development of allowance market liquidity during the first phase of the rule.

Not unexpectedly, substantial disputes exist among both utilities subject to the regulation and state governments, based on the methodologies used by the EPA to develop state emissions budgets and to allocate allowances to individual generating units. Another source of controversy arises because of the EPA's decision to require compliance beginning in 2012 pursuant to federal implementation plans, rather than allowing states time to develop their own implementation plans to satisfy the requirements of the regulation. Some operators have alleged that the combination of insufficient or invalid allowance allocations and the 2012 commencement of the program will require them to shut down units or substantially reduce their operations because of the inability to install necessary pollution controls before they must comply with the regulation.

Petitions challenging CSAPR are pending. On December 30, 2011, a panel of the U.S. Court of Appeals for the District of Columbia Circuit granted motions to stay the rule and ordered that the parties submit a proposed schedule allowing the challenges to the rule to be heard by April 2012. The order indicated that the EPA is expected to continue to administer the current Clean Air Interstate Rule, applicable in most of the states subject to CSAPR, pending the resolution of the petitions for review. Although the order does not explain the basis for the court's ruling, it does mean that, at the least, the court has found that the petitioners made a substantial case on the merits. Even if the EPA prevails in this case, one result of the stay is that CSAPR is not likely to take effect until 2013 at the earliest.

Hazardous Air Pollutants. In March 2011, the EPA issued its proposed regulation pursuant to Section 112 of the Clean Air Act limiting emissions of hazardous air pollutants (HAPs) from coal- and oil-fired EGUs. EPA Administrator Lisa Jackson signed the final rule on December 16, 2011.

The HAPs rule applies to those EGUs capable of combusting more than 73 megawatt-electric (MWe) heat input. For coal-fired EGUs, the regulation establishes numerical emission limits for mercury, particulate matter (as a surrogate for toxic non-mercury metals) and hydrochloric acid (as a surrogate for toxic acid gases), although the rule also provides alternative standards for certain subcategories (for example, limits on SO_2 as an alternate to hydrochloric acid). For oil-fired EGUs, the regulation establishes numerical limits on total metals, hydrogen chloride and hydrogen fluoride. The final regulation relies on work practice standards, rather than numerical emission limits, to control the emission of organic acid gases such as dioxin/furan and to control emissions during startup and shutdown. The rule also allows for emissions-averaging among existing electrical generating units at a facility so long as the units are classified in the same subcategory.

The most controversial aspects of the rule involve the EPA's method for establishing standards and the timing for compliance. With respect to the former, the regulated community has expressed concern that the EPA developed the emission limits by separately identifying the EGUs with the lowest emissions for each HAP, rather than basing such limits on the actual performance of the best-performing units. With respect to timing, the EPA indicated in the preamble to the final rule that although it believed that controls could be installed at most nonretiring generating units within three years of the effective date of the regulation, the EPA believed that permitting authorities (typically, state environmental agencies) would have significant freedom to grant extensions for up to one year on a case-by-case basis, as authorized by the Clean Air Act. In addition, the EPA's Office of Enforcement and Compliance Assurance issued a memorandum on December 16, 2011, setting forth a policy governing the issuance of administrative orders that would authorize generating units that are critical for electrical reliability to operate for an additional, fifth year before said facilities achieve compliance with the regulation.

GHG Permitting Requirements / New Source Performance Standards. The EPA is continuing to roll out regulations relating to greenhouse gases (GHGs) following the Supreme Court's 2007 decision in *Massachusetts v. EPA*, which

declared that GHGs were air pollutants subject to the Clean Air Act. Since this decision, the EPA (in conjunction with the National Highway Traffic Safety Administration) has promulgated regulations imposing GHG standards on passenger cars and light-duty vehicles, beginning with model years 2012-2016 (and has just proposed standards for model years 2017-2025). This regulation in turn led to GHGs becoming pollutants subject to the Prevention of Significant Deterioration (PSD) preconstruction permit program. The EPA's regulations relating to the application of the PSD permit program to GHG emissions are the subject of a number of legal petitions. These relate not only to the underlying substance of the regulations, but also (in cases filed by Texas and Wyoming) to the EPA's takeover of GHG permitting in Texas and the EPA December 2010 rule requiring certain states to update their regulations to account for GHG permitting. Oral argument is scheduled on the consolidated petitions (other than the Texas and Wyoming challenges) in February 2012, and a decision by the D.C. Circuit is expected later in 2012.

Since January 1, 2011, several states have issued PSD permits with GHG emissions standards or are processing such applications. In November 2011, the EPA issued its first PSD permit for GHG emissions, in connection with the construction of a natural gas combined-cycle power plant by the Lower Colorado River Authority (LCRA) in Texas. To date, permits issued with GHG limits have focused on efficiency and have not required permittees to modify their projects or to capture and sequester carbon. However, in the LCRA permit and in its comments on state-issued permits, the EPA requires project applicants to evaluate whether carbon capture and sequestration qualifies as "best available control technology" (or BACT), the applicable control standard for pollutants subject to a PSD permit review.

The EPA is now preparing to issue New Source Performance Standards (NSPS) pursuant to Section 111 of the Clean Air Act with respect to GHG emissions from several sectors, with power plants up first. The EPA sent a draft of a proposed rule to the White House Office of Management and Budget (OMB) in November 2011 and has stated that the proposed rule will be released for public comment this year. Section 111(a)(1) of the Clean Air Act requires that standards of performance issued pursuant to that authority reflect "the best system of emission reduction," taking into account the cost of achieving such reduction and other non-air environmental, health and energy impacts that have been "adequately demonstrated." A recent report claims that the proposed rule submitted to OMB contains fuel efficiency limits that are so stringent that only natural gas plants (or coal plants that are designed to capture and sequester carbon) could be built. Even if this report is accurate, it is questionable whether such standards would survive OMB's review.

Pursuant to Section 111(d) of the Clean Air Act, once the EPA promulgates an NSPS for new, modified or reconstructed emissions sources, the EPA is required to establish guidelines requiring states to develop GHG emission standards for existing sources of the same category, provided that the air pollutant at issue is not a regulated HAP or a pollutant as to which a national ambient air quality standard has been issued. Thus, while existing power plants will not be subject to direct GHG regulation pursuant to the NSPS to be issued in 2012 (or 2013), GHG emissions standards for existing power plants are not far off.

Clean Water Act

Cooling Water Intake Structures. In March 2011, the EPA issued its proposed rule regulating cooling water intake structures (CWIS) for existing electrical generating and manufacturing facilities. EPA is required to issue the final regulation by July 27, 2012.

Section 316(b) of the Clean Water Act requires the EPA to ensure that the location, design, construction and capacity of cooling water intake structures (CWIS) reflect the best technology available (BTA) for minimizing adverse environmental impacts. The EPA's proposed rule is applicable to facilities that withdraw at least 2 million gallons per day of cooling water, with at least 25 percent of the water being used for cooling water purposes. The timing for compliance with the requirements will be determined by permitting authorities when subject facilities renew their wastewater discharge (NPDES) permits.

The proposed rule would establish maximum monthly and annual limits on fish mortality due to the "impingement" of fish on intake screens, provided that subject facilities also could comply with the regulation by limiting intake velocity to 0.5 feet per second. With respect to "entrainment" of organisms that are drawn into the facility, the EPA will continue to allow BTA controls to be established on a case-by-case basis; however, facilities that withdraw greater than 125 million gallons per day will be required to conduct more extensive studies to determine appropriate controls. Finally, new units at existing facilities would be required to reduce intake flow to a level similar to a closed-cycle recirculation system.

> "[T]he proposed [cooling water] regulation provides more flexibility to the regulated community than had been expected."

Although the industries subject to the proposed rule have commented on the performance and design limits for impingement, the proposed regulation provides more flexibility to the regulated community than had been expected. Conversely, members of the environmental community have submitted comments reiterating their belief that the EPA should require existing facilities to be retrofitted with closed-loop systems. In the preamble to the proposed rule, the EPA stated that it did not mandate closed-cycle systems for existing facilities based on a number of factors, including potential impacts on system reliability, air emission impacts, land availability and the useful life of plants. However, permitting authorities may still require closed-cycle systems such as cooling towers, based on the relevant factors associated with a particular power plant or manufacturing facility.

Effluent Limitations Guidelines. The EPA continues to work on revising its technology-based limitations for pollutant discharges from steam electrical generating units, last revised in 1982. The updated regulations are expected to address, among other things, wastewater pollutants arising from the operation of ash ponds and flue gas desulfurization air pollution controls, the use of which are expected to expand as a result of the air pollution control regulations discussed above. In November 2010, the EPA entered into a consent decree with the Sierra Club and Defenders of Wildlife that requires the EPA to propose regulations by July 2012 and complete action on the regulations by January 2014.

Resource Conservation and Recovery Act

Coal Combustion Residuals. As we reported in last year's *Insights*,[3] the EPA issued a proposal in May 2010 to regulate coal combustion residuals (CCR) generated by the combustion of coal at electrical generating facilities. The EPA is still evaluating data and comments received on this rule proposal, and we anticipate they will issue final regulations in late 2012 or 2013.

The 2010 proposal included two alternatives. Under either proposal, most beneficial reuse of CCR would continue to be exempt from regulation, although the use of CCR as fill in operations such as sand and gravel pits and quarries would not be considered beneficial reuse:

- **Alternative One.** CCR would be regulated as "special wastes" that would, with certain modifications, subject the storage, transport, treatment and disposal of such wastes to hazardous waste regulation. It is likely that surface impoundments handling "wet" CCR would not be retrofitted and would therefore need to be closed no later than five years after the effective date of the regulation.
- **Alternative Two.** CCR would continue to be exempt from hazardous waste regulation but would be subject to minimum criteria governing its disposal and would otherwise be subject to state regulation. The EPA has requested comments as to whether surface impoundments would need to be retrofitted (and therefore likely to be closed) or be allowed to operate for the remainder of their useful life.

Besides the technical standards, key issues in this rulemaking include the extent to which identifying CCR as "special waste" will stigmatize the beneficial use of such materials and the adequacy of state regulatory programs relating to CCR disposal.

[3] *See* Skadden 2011 *Insights*, "Regulatory," *available at* http://skadden.com/Index.cfm?contentID=51&itemID=2326.

Government Affairs and Government Procurement Compliance

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Ensuring compliance with laws regulating government affairs and government procurement activities will continue to be a challenge for every industry in 2012. Corporations and other organizations engaged in these activities face pay-to-play laws at the federal, state and local levels. Transparency in corporate political spending continues to garner attention in the boardrooms of the nation's largest corporations. In addition, new trends are emerging with regard to laws requiring lobbyist registration and reporting by investment advisers and other firms that historically have not been covered under these laws.

A Continued Wave of Pay-to-Play Laws

An increased interest in pay-to-play laws by enforcement agencies and legislatures continues as a result of various scandals involving public officials. The landscape has become even more treacherous with a second wave of pay-to-play laws that are sweeping the country.

Pay-to-play laws apply to virtually every company that has government contracts or sells products or services to a government entity. These laws automatically ban such companies from entering into or having government contracts if certain executives or members of the board of directors (including their spouses and dependent children) make or solicit a political contribution. In some cases, there also may be personal liability for the executive or director. Even a small contribution by a covered executive or family member can cause a company to lose millions of dollars in contracts.

Pay-to-play Rule 206(4)-5, promulgated by the SEC under the Investment Advisers of 1940 for investment advisers in 2010, continues to present challenges for companies by way of implementation, including giving to PACs and party committees, developing look-back features for new covered associates and implementing a compensation ban once an inadvertent contribution has been made. Additional federal pay-to-play rules also are on the horizon. The CFTC is expected to finalize its proposed pay-to-play Rule 23.451 covering swap dealers and major swap participants. In June 2011, the SEC issued its counterpart proposed pay-to-play Rule 15Fh-6 under the Exchange Act, which applies to firms engaging in security-based swap transactions with municipal entities.

In addition, municipal advisors are required to register with both the SEC and the Municipal Securities Rulemaking Board (MSRB). In September 2011, the MSRB announced it was withdrawing its municipal advisor proposals pending with the SEC, including Proposed Rule G-42, the pay-to-play rule for municipal advisors, and that it would not resubmit the proposals until the SEC finalizes its municipal advisor definition.

Corporations with government contracts should be vigilant in monitoring the progress of these new rules and establishing procedures to ensure that problematic contributions are not made.

A Spike in Shareholder Activism

Major corporations continue to grapple with inquiries and proxy proposals submitted by the Center for Political Accountability regarding transparency in corporate political spending and lobbying activities. Such inquiries have increased, as has shareholder activism, as a result of the U.S. Supreme Court's 2010 decision in *Citizens United v. FEC*. In addition, several major public pension funds have adopted rules requiring disclosure of charitable and corporate political spending of public companies in which they are shareholders.

Given the variety of shareholder proposals we have seen and the technical issues that arise under political law, it is recommended that corporations consult political law counsel and work with their internal government affairs team before responding to or trying to negotiate with respect to such proposals.

"In October 2010, legislation (AB 1743) was enacted in California that requires lobbyist registration for placement agents of investment advisers."

Increased Applicability of State and Local Lobbying Laws to Investment Advisers

An increasing number of states and localities are enacting laws classifying certain activities of investment advisers and placement agents as requiring lobbyist registration and reporting. In October 2010, legislation (AB 1743) was enacted in California that requires lobbyist registration for placement agents of investment advisers. This law was significant in that, for the first time, placement agents are required to register as lobbyists as a result of doing business with state or local public retirement systems/pension funds. In the last two months, both New York state and New York City have been especially vigilant in applying their lobbying laws to the activities of investment advisers.

Companies should survey their businesses to ensure they are properly registered with New York City and other jurisdictions that have similar procurement lobbying laws. Moreover, companies should establish comprehensive policies and procedures to deal with these laws.

Health Care: Will a Supreme Court Decision and the Presidential Election Reshape the Industry? (A Discussion of the Implementation of the Health Care Reform Law, Enforcement Activity and Health Care M&A Activity)

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The health care industry will face a turbulent mix of legal and business opportunities and risks in 2012. Powerful demographic trends — including U.S. population growth and the percentage of the elderly within that population — will increase the need for goods and services, and advances in technology and health care delivery systems hold the promise of improved health outcomes. However, the slow economy and looming budget cuts will put downward pressure on costs in every sector of the industry.

Implementation of Sweeping Health Care Reform Law Continues Despite Legal and Political Uncertainties

The Obama administration's 2010 health care reform law, the Affordable Care Act (ACA), called for sweeping changes in who would receive health care, how such care would be delivered and who would pay for it. The ACA called for a major overhaul of the health insurance industry to cover more than 30 million additional Americans and establish new service delivery and care models to increase quality and decrease costs. While the ACA has been extremely controversial — contributing to the historic 2010 midterm congressional elections and triggering numerous legal challenges to the ACA's constitutionality that now have reached the Supreme Court (see "Global Litigation/U.S. Supreme Court Cases to Watch") — federal agencies and most states continue to issue regulations and other guidance to implement the law. The regulatory agenda for 2012 includes, among dozens of other items:

- **Accountable Care Organizations (ACOs).** In October 2011, the Centers for Medicare and Medicaid Services (CMS) issued its final rule for health care providers to become accountable care organizations, which will allow providers and others to share in expected savings from improved care coordination. The final rule eased some requirements for ACOs in response to concerns that overly restrictive regulations will discourage the creation of ACOs. While the regulations are "final," many issues will be fleshed out by CMS in subregulatory guidance documents in 2012 and beyond. While it still is unclear whether providers and others will embrace the ACO model, many providers are hedging their bets by taking initial steps to welcome this new approach.

- **Health Benefit Exchanges.** Exchanges in each state are to be in place by 2014, with all participants offering four standard benefits packages. Many federal and state regulatory issues still need to be decided, and 2012 will be a crucial year in formulating the regulatory structures for these exchanges, which will serve approximately 30 million Americans who will account for $200 billion in premiums.

- **Medical Loss Ratios (MLRs).** In December 2011, the Department of Health and Human Services finalized its MLR for health plans, making only modest changes from the prior draft. If unable to meet the MLR requirements (*i.e.*, 80 percent of premiums spent on patient care for small and medium plans and 85 percent for large plans), plans must refund a portion of premium dollars to members. Many individual and small-market plans currently are not meeting the new required MLRs. Doing so will require revamped cost structures, which is likely to be a continuing area of controversy between insurers and regulators in 2012.

- **Hospital Value-Based Purchasing (VBP) Model.** CMS issued the final VBP rule in April 2011, which applies beginning in FY 2013 to payments for discharges occurring on or after October 1, 2012. Under the program, CMS will make value-based incentive payments to acute-care hospitals, based either on how well the hospitals perform by certain quality measures or how much the hospitals' performances improve by certain quality measures from their performances during a baseline period.

Despite the Obama administration's efforts to create regulatory momentum to implement the ACA, the Supreme Court's decision to schedule a historic five-and-one-half hours of oral arguments for challenges creates a substantial legal overhang for the ACA in a presidential election year — and continuing uncertainty for health care companies. Among the many options available to the Court: remand the case to lower courts for further argument, rule narrowly on the constitutionality of the "individual mandate" while leaving intact the remaining provisions of the law or strike down the law entirely. The Court's ruling to hear the challenges also included an issue not directly raised in the many lower court appeals — namely, the extent of congressional authority to condition federal funds on state acceptance of onerous and costly mandates, in this case the dramatic expansions of Medicaid eligibility in the ACA.

Trend Toward More Aggressive Enforcement Continues, Though Legal and Legislative Proposals Offer Glimmer of Hope

As discussed in last year's Skadden *Insights*,[4] health care enforcement was a major challenge for every industry sector. Health care companies accounted for nine of the top 10 False Claims Act (FCA) settlements in the first 10 months of 2011, and health care cases accounted for more than 75 percent of the $3 billion in FCA settlements during this year — more than enough to make 2011 the second-largest year in health care fraud settlements. Of the top 10 health care-related FCA cases in FY 2011, eight involved pharmaceutical or medical device companies and two involved health care providers. Six of these settlements exceeded $100 million.

Pharmaceutical companies and, to a lesser but growing extent, medical device makers continue to face a particularly harsh enforcement climate with prosecutors targeting companies, their executives and employees with criminal charges and massive civil penalties for unlawful sales, marketing and related practices. In the first 10 months of 2011 alone, more than a dozen pharmaceutical companies settled civil or criminal charges, paying in excess of $2 billion in criminal and civil fines, penalties and damages. As senior officials have warned, the DOJ has pursued the prosecution of individuals aggressively, most vividly demonstrated in the *Synthes* case.[5] A federal district court recently sentenced four executives to prison terms of six to nine months following their guilty pleas to misdemeanor

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[4] *See* Skadden's *2011 Insights*: "Regulatory" (Jan. 10, 2011), *available at* http://www.skadden.com/Index.cfm?contentID=51&itemID=2326.

[5] *See* DOJ press release, "Former Executives of International Medical Device Maker Sentenced to Prison in Unlawful Clinical Trials Case" (Nov. 21, 2011), *available at* http://www.justice.gov/usao/pae/News/2011/Nov/synthesexecs_release.pdf.

strict liability violations of the Federal Food, Drug, and Cosmetic Act (FDCA) and ordered a 30-day sentence for the prior chairman and CEO of KV Pharmaceuticals following a similar plea for manufacturing violations of the FDCA.

Ominously, the DOJ and the Department of Health and Human Services' Office of Inspector General (OIG) have pledged to utilize new remedies against health care companies engaged in misconduct. In late 2010, the OIG issued new guidance for stepped-up use of its authority to exclude officers and managers of companies convicted of certain health care fraud-related offenses (*i.e.*, "(b)(15)" authority). In November 2011, a senior DOJ official warned that it may pursue additional post-conviction remedies — such as court-imposed supervision or civil injunctive relief — to prevent misconduct at companies that have been found guilty of wrongdoing.

"The bottom line is that, in 2012, health care companies and their executives will face an unprecedented array of enforcement risks."

The bottom line is that, in 2012, health care companies and their executives will face an unprecedented array of enforcement risks — including criminal prosecution, massive civil penalties, post-conviction supervision and monitoring, and exclusion and other collateral administrative actions — and an environment in which prosecutors are willing, and often eager, to use such tools more aggressively and in more cases than ever before.

Health Care M&A Will Remain at or Near Record Levels in 2012 as Health Care Reform Law Is Implemented

The merger and acquisition market in the health care industry was relatively robust in 2011 given the anemic U.S. and global economies and the business and regulatory uncertainty stemming from political gridlock in Washington, D.C. Through the first nine months of 2011, there were more than 700 health care transactions totaling approximately $150 billion. Medical device was the most active sector in both deal and dollar volume, with 130 deals worth $58.8 billion — 18 percent and 32 percent, respectively, of total health care M&A deals and dollars. Some of the notable deals in 2011 include:[6]

- **Express Scripts**' proposed $29.1 billion acquisition of competitor **Medco Health Solutions**;
- **Gilead**'s $11 billion proposed acquisition of **Pharmasset, Inc.** Pharmasset has three product candidates in clinical testing for the treatment of the chronic hepatitis C virus;
- **Cigna Corporation**'s proposed $3.8 billion acquisition of **HealthSpring, Inc.**, the largest managed care acquisition in a number of years;
- **Carlyle Group** and **Hellman & Friedman LP**'s joint $3.9 billion bid for **Pharmaceutical Product Development**. This was the largest privatization of a contract research organization in history; and
- **Johnson & Johnson**'s $21.3 billion bid for **Synthes**, a Switzerland-based maker of orthopedic devices.

[6] Skadden represented Express Scripts, Gilead, HealthSpring and Pharmaceutical Product Development in these matters.

The forces driving deal activity vary by sector. If health care reform survives its political and legal challenges, the industry faces a simultaneous influx of more than 30 million people, and many hospitals and health systems are scrambling to gather the necessary resources to meet future clinical needs. At the same time, heightened requirements for health care quality, information technology and enhanced compliance program obligations will be a challenge for small- and medium-sized hospitals, health systems and health plans. Along with downward pressure on reimbursement rates, further consolidation across all sectors of the health care system seems likely for the foreseeable future. In the pharmaceutical sector, the long-predicted patent cliff is now a reality for many larger companies, and despite high valuations on smaller companies with promising products or pipelines, M&A activity is likely to continue at high levels. This will include traditional acquisitions and mergers, as well as "virtual" M&A activity such as joint ventures, co-promote agreements, and novel partnerships and alliances. More pharmaceutical companies are expected to consider spin-offs and divestitures to unlock value.

Companies active in health care are paying more and more attention to pre- and post-acquisition diligence, particularly for exposure to U.S. and foreign government enforcement actions. Many companies in the health care space have made acquisitions and subsequently become subject to federal and state health care fraud investigations based on the conduct of the acquired company. Such investigations can be costly, distract senior management and, depending on what the acquirer knew or should have known about the potential misconduct at the time of acquisition and/or how it responded to any identified misconduct, lead to settlements involving substantial sums as well as impose compliance and remedial requirements on the acquirer on a going-forward basis. Some leading practices in this area include: (1) creation of dedicated diligence teams with relevant expertise using preestablished protocols and documentation, (2) routine post-deal audits and reviews to promptly identify potential compliance problems, (3) management commitment to remediate problems promptly so improper activity is confined to legacy issues and (4) stronger contractual provisions, including, in private company acquisitions, stronger indemnification provisions, representations and warranties, and escrows and holdbacks.

Labor and Employment: Employee Use of Social Media

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Use of Facebook, Twitter, LinkedIn and myriad other social media sites by employees has exploded in recent years. Confronted with potential liability under anti-harassment and discrimination laws as well as damage to their business reputations, employers cannot ignore employee social media activity. However, before making disciplinary decisions, employers must consider whether an employee's particular social media postings are protected by law.

In particular, the National Labor Relations Act (NLRA) protects the rights of employees (unionized or nonunionized) to engage in "concerted activities," which include conferring regarding terms and conditions of employment. Throughout 2011, the National Labor Relations Board, through its general counsel's office, has been very active in attempting to enforce these rights with respect to employees' use of social media. In August, the board's acting general counsel issued a report on recent cases,[7] which describes various Facebook postings that constituted protected activity under the NLRA. These include employees complaining to each other (with expletives) about their employer's tax withholding practices; a commission-paid employee posting pictures and sarcastic commentary criticizing the inexpensive manner in which his employer conducted a sales event; an employee posting negative comments about a supervisor who was investigating a customer complaint against the employee; and multiple employees posting comments criticizing the work performance of their co-workers and staffing-level problems. Several commonalities worth noting exist among these cases. First, they all involved employees who criticized specific employment practices or work conditions. Additionally, these employees engaged in online discussions after work hours, on their own computers and off work property. Most importantly, every case involved online discussions among multiple employees.

These factors may prove critical in determining whether such social media postings are protected activities. By way of comparison, the U.S. Court of Appeals for the Ninth Circuit recently decided that the whistleblower provisions of the Sarbanes-Oxley Act — which prohibit retaliation by publicly held companies against employees who disclose evidence of fraud to federal or law enforcement agencies, members of Congress or supervisors — did not protect employees who leaked information to the news media about their employer's alleged auditing deficiencies.[8] Thus, conduct which may be protected in one forum can go unprotected in another.

It is difficult to predict whether the National Labor Relations Board in 2012 will further develop and expand social media cases. Following the expiration of board member Craig Becker's recess appointment on December 31, 2011, President Obama restored a quorum on the five-seat board with three new recess appointments (without Senate confirmation) to join chairman Mark Pearce and member Brian Hayes. However, these recess appointments will likely be challenged, and, if they are found to be impermissible, the two-member board would not have the authority to decide unfair labor practice cases. That said, the board already

[7] *See* National Labor Relations Board Memorandum OM 11-74, *available at* http://mynlrb.nlrb.gov/link/document.aspx/09031d458056e743.

[8] *Tides v. The Boeing Co.*, 644 F.3d 809 (9th Cir. 2011).

significantly expanded the scope of protected concerted activity in cases outside the social media context during 2011. For example, in one case the board held that even when an employee had not engaged in concerted activity, but instead made an individual complaint to her employer about a perceived wage disparity, the employer violated the NLRA by discharging the employee to prevent the possibility that she might engage in concerted activity in the future (a so-called preemptive strike).[9] In another case, the board held that an employee who voiced an individual complaint about working conditions, but did so in a group setting, was engaged in protected concerted activity.[10] If the board maintains a quorum in 2012, these expanded concepts of protected concerted activity may be applied in the social media context.

[9] *Parexel International, LLC*, 356 NLRB No. 82 (Jan. 28, 2011).

[10] *Worldmark by Wyndham*, 356 NLRB No. 104 (Mar. 2, 2011).

Privacy and Data Security: Changing the Corporate Mindset

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As 2010 wound to a close, many expected to see significant movement toward federal data privacy and information security legislation. The FTC had just issued its long-awaited preliminary staff report — *Protecting Consumer Privacy in an Era of Rapid Change* — and the Department of Commerce (DOC) Internet Policy Task Force had released its own green paper, setting forth the department's views on data privacy. In addition, two House bills on privacy were being debated, and the Obama administration had formed an executive branch task force on privacy.

One year later, little progress has been made toward legislative enactment, and many feel that little will be accomplished until after the 2012 presidential election, even given the fact that the Obama administration plans to release a white paper on online privacy during the first quarter of 2012. Nonetheless, companies need to change their mindset about data privacy.

Information security breaches can no longer be viewed as an obscure "what if" possibility. The number of data breach incidents in 2011 has caused many in the security industry to argue that it is not a question of whether a company will be the target of such an attack, but rather when. In addition, the cost of addressing such breaches has been rising steadily, and many studies place the average cost of responding to a data breach at $5 million to $10 million per incident. These figures do not take into account the adverse publicity that a company may face, resulting in intangible costs. Given the growing prevalence of such breaches, and the high cost to address them when they occur, there is a growing viewpoint that companies have an affirmative duty to implement data security measures, even absent a specific legislative mandate to do so.

There are numerous regulations that would seem to impose a positive duty on companies to implement and monitor data security plans. For example, under Sections 302 and 404 of Sarbanes-Oxley, management is required to establish and maintain adequate internal controls over a company's financial reporting. While it is likely that information security was not a major concern when these requirements were initially developed, one can easily construct an argument that management can vouch for the accuracy of its financial information only if it knows that such information has not been compromised. Similarly, while the FTC does not impose minimum information security requirements, the agency has brought actions against companies for misrepresenting to consumers the adequacy of their information security practices. And, in today's environment, a failure to implement adequate information security protocols could expose a company to a shareholders' suit in the event of a security breach.

The challenge companies face is there are no laws enumerating the specific information security controls a company must implement. Even those laws addressing information security, such as The Gramm-Leach-Bliley Act or the Massachusetts Data Privacy Law, do not provide companies with specific security steps to implement, undoubtedly out of concerns of being seen as supporting a specific technology solution. Nonetheless, the laws that do exist, coupled with evolving industry practice, provide companies with important guidance on how they should be thinking about data privacy and information security.

First, companies must view information security as a legal issue as well as a technology issue. Companies that do not involve their legal department in the design, monitoring and implementation of an information security program are likely to find that the programs they create fall short of the duty of care companies must implement.

Second, companies need to view information security as an ongoing process, not a one-time action. As technologies evolve, a company's data use changes or business processes are reorganized, and information security protocols must be reevaluated and modified as necessary. Even if a company has not undergone any changes in how it operates its business, its risk profile may have changed, necessitating a new approach to information security.

Third, companies need to customize their information security protocols so they align with the companies' risk exposure, taking into account the amount and type of data they hold and how they use that data. All too often, companies simply want to model their data security procedures based on what other companies are doing without taking their own profile into account. Such an approach is risky and may not withstand duty of care scrutiny. As part of this customization, companies should consider whether any third-party vendors have access to data held by the company and whether such vendors provide adequate information-security protections.

Finally, once a company crafts a robust information security policy, it must implement and maintain it. A robust information security program includes ongoing education and training, as well as efforts to make information security part of a company's culture. Disciplinary measures for failures to adhere to the policy also should be considered.

The intersection between security and corporate governance is likely to increase in 2012 and beyond. As just one example, companies increasingly are relying on cloud computing solutions to distribute board packets, make corporate filings and store company financial records. While such solutions offer many advantages, they also bring an added level of security concerns. Involving the corporate legal department in the company's information security program and viewing such a program as an ongoing process will help mitigate such risks.

Tax: Toward a Territorial Tax System?

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As recent events have demonstrated, uncertainty dominates the tax landscape, with the discussion being driven by deficit reduction (including the debate over revenue increases versus entitlement cuts) and the looming 2012 presidential election. All parties concede that tax reform is needed, but they disagree on whether it should be revenue-neutral or raise revenue and, in either case, how the revenue should even be calculated. The failed supercommittee process demonstrates how difficult any reform efforts will be.

To date, the discussions have focused on two major proposed reforms: (i) reduction of the corporate income tax rate (with the resulting revenue loss offset by eliminating tax expenditures), and (ii) a move to a territorial tax system in order to increase the competitiveness of U.S. companies internationally. Most tax policy staff, however, have had difficulty in drawing the line at corporations and raising sufficient revenue to permit a reduction in rates large enough to attract broad-based support.

In a potentially significant step toward achieving these two goals, House Ways & Means Committee Chairman Dave Camp (R-MI) released on October 26 a discussion draft of legislative language that would reduce the maximum corporate income tax rate to 25 percent and implement a territorial tax system. Committee staff have emphasized that this rate and other parameters in the discussion draft remain subject to change. The committee intends for the international reforms to be revenue-neutral, and for the corporate income tax rate reduction to be financed entirely by tax-base broadening. Given the limited base-broadening options within the corporate tax system and the aforementioned political difficulty of financing corporate tax reform outside the corporate income tax, we believe a corporate rate of 28 percent or higher is a likelier outcome than reduction to 25 percent.

The proposal achieves territoriality by allowing U.S. corporations to enjoy a 95 percent dividends-received deduction (DRD) with respect to foreign-source dividends from controlled foreign corporations (CFCs), effectively reducing the U.S. tax rate on repatriated earnings to 1.25 percent (at a 25 percent corporate rate). Foreign branches of U.S. corporations would be treated as CFCs for this and all other purposes of the Code, and 10-percent-owned foreign corporations (10/50 companies) could be so treated by election.

Chairman Camp's proposed implementation of a territorial tax system would further address the issue of "locked-out" foreign earnings by effectively ending deferral of U.S. tax with respect to those earnings. To address concerns about increased incentives to transfer intangibles and associated income to low-tax jurisdictions, the discussion draft presents three options that would expand Subpart F to subject U.S. corporations to current U.S. tax on certain income of their CFCs subject to a low foreign effective tax rate. Two of those options would apply to intangible income only; the second of those two options also would adopt a "patent box" regime variant that would reduce the U.S. tax rate on foreign intangible income. A third option would apply to low-tax income more generally. Because rules regarding previously taxed income would be repealed, income subject to tax under Subpart F would nonetheless be included in a U.S. shareholder's income again when repatriated, subject to the 95 percent DRD. A foreign tax credit would be available — subject to a relaxed foreign tax credit limitation — for income included under Subpart F but not for income eligible for the DRD. Together with the 95 percent DRD, which

would significantly increase a U.S. corporation's incentive to repatriate foreign earnings, any of these options would result in current taxation of a much larger share of income from foreign operations than under current law.

To finance the anticipated revenue loss from a territorial system, the Committee has proposed a one-time transition tax on U.S. corporations' *pro rata* share of all previously untaxed earnings of their CFCs and 10/50 companies. The corporations would be required to include all such earnings in gross income in the year before implementation of the territorial system but would be eligible for an 85 percent DRD with respect to those earnings, bringing the effective U.S. tax rate to 5.25 percent (at a 25 percent corporate rate). Those earnings also would be included in the U.S. shareholder's income when actually repatriated, subject to the 95 percent DRD, and thus would bear an additional 1.25 percent tax. As currently drafted, the transition tax would apply to all previously untaxed foreign earnings and profits, including amounts invested in operations, and not merely to cash and cash equivalents held offshore. Additionally, as a revenue-raising and base-protection measure, the committee proposes denying interest deductions where a U.S. corporation is excessively domestically leveraged and has net interest expense exceeding a percent-of-income threshold (not yet specified).

In offering this detailed but flexible territorial proposal, Chairman Camp has advanced the international tax reform discussion in a way that significantly increases the prospects for U.S. adoption of a territorial system over the next two to three years. Expressing the proposal in legislative language naturally shifts discussion from whether to implement a territorial system to the appropriate means of doing so and invites taxpayers and others to play a role in that discussion. The discussion draft's options for low-taxed foreign earnings and excessive domestic leverage, in particular, address common criticisms of a territorial system and lay a foundation for bipartisan agreement.

"Looking ahead to 2012, Congress will have to address the expiration of the Bush tax cuts (including dividend and capital gains rate reductions and the reduced estate tax (and increased exemption amounts)) by the end of the year."

Even as the debate over these major tax reforms continues, smaller "revenue measures" continue to garner attention, including changes to the tax treatment of carried interests and changes to tax incentives for oil and gas. In addition, the administration has continued to push its proposal to limit itemized deductions for high-income individuals, and members of Congress have proposed a millionaires' surtax as an offset for various bills. Expiring business tax provisions face even greater uncertainty than usual given the pressure not to increase the deficit.

Looking ahead to 2012, Congress will have to address the expiration of the Bush tax cuts (including dividend and capital gains rate reductions and the reduced estate tax (and increased exemption amounts)) by the end of the year. In an election year, it is difficult to see how significant tax legislation can be enacted, but it is equally difficult to see how Congress can put off needed changes.

Given the uncertainty regarding the direction of tax reform, now is a good time for businesses to be modeling how they would win or lose under various reform concepts (*e.g.*, how they would be affected by a move to a territorial tax system, such as the one proposed by Chairman Camp, or by the elimination of tax expenditures versus a rate reduction). We will continue to monitor the status of tax reforms and provide updates as significant developments occur.