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Corporate Practice NewsWire is dedicated to in-depth analysis of current legal issues and trends affecting domestic and international business transactions. Increased regulatory oversight and enforcement, as well as heightened focus on corporate governance practices, are consistent themes affecting companies and corporate practices globally in 2013, and these themes flow through this issue’s featured articles. Our Funds lawyers take an in-depth look at private equity enforcement concerns, with a focus on the SEC’s increased scrutiny of this sector and best practices that PE firms should be implementing. Corporate governance is a global issue, and in this issue we have contributions from our U.S., Brazilian and English lawyers providing perspectives on how corporate governance practices and related regulations and industry standards are affecting the way companies are doing business and directors and officers are doing their jobs. Dodd-Frank continues to affect the financial industry in many ways. Our finance lawyers explain how the new swap rules work and offer recommendations on how to reflect these new rules in loan documentation. Our M&A and insurance lawyers have teamed up to provide a comprehensive and practical overview of a technique that deal participants increasingly consider to reallocate deal risk: representation and warranty insurance. Finally, our Telecom, Media & Technology lawyers provide insight on how the Obama administration is combating theft of U.S. trade secrets and why private companies should be paying attention.
PRIVATE EQUITY ENFORCEMENT CONCERNS – REFLECTING ON RECENT ACTIONS AND GUIDANCE

Scott W. Naidech and Garrett Lynam

Recent remarks by Bruce Karpati, Chief of the Asset Management Unit of the Securities and Exchange Commission (the “SEC”), at the Private Equity International Conference on January 23, 2013 in New York, as well as recent enforcement cases by the SEC, demonstrate an increased focus on the private equity sector. In particular, they denote a focus on aggressive fundraising disclosures, transparency, asset valuations, conflicts of interest, misappropriation of fund opportunities and “zombie funds.”

The SEC’s Division of Enforcement is organized into five specialized units: the Asset Management Unit; the Market Abuse Unit; the Structured and New Products Unit; the Foreign Corrupt Practices Unit; and the Municipal Securities and Public Pensions Unit. The Asset Management Unit is the largest of these units. It investigates securities law violations in the asset management industry, focusing on alternative investments and private funds and hedge funds, as well as their investment advisors and asset managers. It is national in scope with approximately 75 staff members across 11 offices, including former experienced industry professionals from private equity funds, hedge funds, mutual funds and due diligence firms.

By understanding the SEC’s enforcement priorities and trends, alternative asset managers can better tailor their practices, compliance policies and procedures, and fund terms in a manner that protects investors and demonstrates a commitment to best industry practices.

Increased Scrutiny on Private Equity Firms

Historically, the SEC’s Division of Enforcement focused its enforcement efforts on hedge fund managers that breached their fiduciary duties to clients or engaged in other types of fraudulent conduct. Since 2010, it has brought over 100 cases against hedge fund managers, with a majority of these cases involving conflicts of interest, valuation, performance, and compliance and controls.

At the Private Equity International Conference, Mr. Karpati recognized the growth of private equity as a rapidly maturing industry—in terms of assets under management, it is equivalent to or potentially larger than the hedge fund industry. New registration and reporting rules under Dodd-Frank’s amendments to the Investment Advisers Act of 1940 (the “Advisers Act”) required many private equity managers to register with the SEC as investment advisers or as exempt reporting advisers. Mr. Karpati noted that the number of enforcement actions involving private equity could potentially increase and highlighted potential areas of focus.

Fundraising and Capital Overhang

Fundraising pressures on managers can lead to aggressive fund marketing and, in some cases, misleading disclosures and inappropriate behavior. Over the last ten years, the private equity industry has experienced a rapid growth in assets under management and in the number of managers raising funds and competing for capital. Over the last few years, the industry has also experienced a contraction in the amount of capital available to new funds. Fundraising difficulties can pressure managers to overstate returns, increase valuations and downplay (or omit) material disclosures.

Valuations

Valuations take on greater significance during the period of fund marketing. The SEC is focused on managers that may exaggerate the performance or quality of illiquid or unrealized holdings during the fundraising period. While the true measure of value is a realization event, data from older, realized investments may not be relevant to a decision to commit
capital to a new fund, and interim valuations may be the best data available to investors at any particular time.

Conflicts of Interest
Conflicts of interest are a major area of SEC scrutiny, including:

- **Profitability of the Manager vs. the Best Interests of Investors:** This conflict exists at all firms, but may be particularly acute at firms that have publicly listed their management company shares. These managers may feel additional pressure from their public shareholders to generate short-term results.

- **Allocation of Expenses:** Managers should focus on whether certain expenses are properly borne by the manager, its funds, or the funds’ portfolio companies. Mr. Karpati noted circumstances in which expenses were misallocated in a manner benefiting the manager or a select group of preferred investors.

- **Managing Multiple Funds and Clients:** Conflicts can arise when multiple clients, funds, investors and products are managed under the same umbrella. Mr. Karpati noted several examples of troubling behavior:
  - Broken deal expenses rolled into future transactions, where they will ultimately be borne by other clients. This can include a situation where certain preferred clients incur no (or limited) broken deal expenses, which are all absorbed by a core co-mingled fund.
  - Improper shifting of organizational expenses, where co-mingled vehicles bear organizational expenses for preferred clients or their investment vehicles.
  - Complementary products supporting each other, such as a primary fund vehicle being utilized to create deal flow for a more profitable co-investment vehicle.
  - Conflicts with a manager’s other businesses or activities that incentivize managers to usurp investment opportunities or enter into related-party transactions at the expense of investors.

Zombies
“Zombie funds” can result at the end of the life of a fund. The term generally refers to a fund that holds a few remaining, highly illiquid assets at the end of its term — the fund will continue to charge investors fees for managing these assets, and investors may be left with little recourse if they are unable to force a liquidation of the fund. It is important to note that most funds at the end of their respective terms are not “zombies,” and often there are legitimate business reasons for holding onto assets to maximize value. However, managers who are unable to raise new capital into successor funds may be incentivized to generate revenue by delaying the realization of remaining assets under management. Mr. Karpati noted that, given the large amount of capital raised in 2006 and 2007, this can potentially become a significant issue where funds near the end of their vintage and sponsors are unable to raise fresh capital into successor funds.

Other Areas of Increased Scrutiny
In addition, in a recent speech on hedge fund enforcement priorities at the Regulatory Compliance Association on December 18, 2012, Mr. Karpati noted certain behaviors by hedge fund managers receiving increased scrutiny. They demonstrate the kinds of factors that, from the SEC’s perspective, might indicate a heightened risk profile warranting further investigation:

- **Lack of Transparency:** A lack of transparency into investment strategies and operations may occur for legitimate business reasons. However, there exists the potential for substantial abuse when practices and investment objectives are opaque.

- **Retail Investors as an Investor Class:** An emerging class of retail investors is being exposed to private funds and hedge funds as direct investors and indirectly via pensions, endowments, foundations and retirement plans, all of which are increasing their stakes in private equity. In addition, the forthcoming elimination of the prohibition on general solicitation and general advertising as a result of the JOBS Act will expand the potential audience for private fund offerings. The SEC is concerned that funds may be offered to prospective investors who, despite being qualified to invest as “accredited investors,” are not financially sophisticated or otherwise able to properly evaluate the investment product. Mr. Karpati’s remarks may indicate increased SEC focus on investment vehicles funded primarily by retail investors (directly or indirectly).

- **Unregistered Advisers:** Smaller asset managers with less than $150 million in assets under management are generally not required under Dodd-Frank to register as investment advisers with the SEC. Unregistered advisers may not have effective compliance programs and procedures to monitor
and prevent fraud and other violations, are not subject to inspection by the exam staff, and need not comply with the SEC’s rules on advertising which generally apply only to registered advisers.

From an examination perspective, exempt reporting advisers remain subject to SEC examinations under the anti-fraud provisions, although the SEC does not anticipate conducting examinations of them on a routine basis. SEC examinations of exempt reporting advisers are likely to occur where there is an indication of wrongdoing prompted by a tip, complaint, or notification from another agency. In addition, exempt reporting advisers, unlike registered investment advisers, are not subject to similar rules on record keeping, compliance programs or custody of client funds. Exempt reporting advisers are nevertheless subject to the SEC’s antifraud rules, and should therefore adopt internal controls sufficient to monitor activities and ensure compliance with these rules (such as reviewing disclosures provided to investors, marketing materials, allocation of investments and expenses).

**Examination Priorities**

On February 21, 2013, the SEC’s Office of Compliance Inspections and Examinations, which monitors compliance of investment advisers and registered investment companies with the SEC’s rules through the Investment Adviser-Investment Company Program (the “IA-IC Program”) of the National Examination Program (the “NEP”), announced its updated examination priorities. The updated examination policies seek to present issues and business practices of registrants that are perceived by the staff to present the highest risks to investors and the integrity of the market. These ongoing and emerging risks include the following:

- **Safety of Assets:** Recent examinations of registered investment advisers have found a high frequency of issues regarding the custody and safety of client assets under the Advisers Act. Consequently, compliance with the Advisers Act’s custody rules will be a key concern of the IA-IC Program going forward.

- **Conflicts of Interest Related to Compensation Arrangements:** When conducting an investigation, the IA-IC Program intends to closely investigate whether compensation arrangements that present a material conflict of interest are properly disclosed to clients.

- **Marketing/Performance:** Marketing materials should contain proper disclosure regarding performance. The IA-IC Program will focus on the accuracy of advertised performance, including hypothetical and back-tested performance, the assumptions or methodology used in calculations, and related disclosures and compliance with record keeping requirements.

- **Conflicts of Interest Related to the Allocation of Investment Opportunities:** The IA-IC Program will focus on examining advisers who manage accounts that do not pay performance fees (such as most mutual funds) alongside accounts that pay performance-based fees (such as hedge funds), especially if the manager is responsible for investment decisions of both types of accounts.

- **Fund Governance:** The IA-IC Program will assess whether advisers are making full and accurate disclosures to fund boards and investment committees, and whether fund directors are conducting reasonable reviews of such information in connection with their fiduciary obligations. The IA-IC Program notes that the “tone at the top” will play an increasingly important role in its assessment of risk.

- **Compliance with the “Pay to Play” Rule:** The IA-IC Program will review compliance with the SEC’s recently adopted and amended “Pay to Play” rule, which seeks to prevent advisers from obtaining business from government entities in return for political contributions.

In addition, the IA-IC Program intends to focus on the roughly 2,000 newly-registered investment advisers who have never been registered, regulated, or examined by the SEC. The IA-IC Program’s initiative in this regard is expected to run for approximately two years and result in the examination of a “substantial percentage of the new registrants.” Additionally,
dually registered investment advisers and broker-dealers will be scrutinized closely, as well as managers of “alternative” and hedge fund strategies in open-end funds, exchange-traded funds and variable annuity structures.

Recent Enforcement Actions
The Division has recently brought a number of private equity cases, as well as hedge fund and registered fund cases with private equity-like issues. These include cases involving employee misconduct, misallocation of expenses, and misrepresentations regarding valuations and performance, among others.

- **Fraudulent Conduct; Conflicts of Interest:** In the matter of Matthew Crisp (In re Crisp, Adm. Proc. File No. 3-14520, instituted Aug. 30, 2012), the SEC brought an action against Mr. Crisp, a partner of Adams Street Partners, LLC, for misappropriating and redirecting investment opportunities away from Adams Street to a personal vehicle that he co-managed. The scheme was concealed from Adams Street in violation of his fiduciary duties and Adam Street’s policies.

- **Misappropriation; Material Misrepresentations:** In the matter of Robert Pinkas (In re Pinkas, Adm. Proc. File No. 3-14759, instituted Feb. 15, 2012), Mr. Pinkas, the principal of private equity manager Brantley Capital, was charged with misappropriation and misrepresentation (among other things) by using fund assets to satisfy personal expenses he had incurred in defending himself from other SEC actions (in connection with his management of another Brantley Capital entity). The charges indicate that Mr. Pinkas made material misrepresentations to his fund investors about the misappropriation, and breached his fund’s operating agreement by using fund assets to satisfy his personal expenses and legal fees relating to non-fund matters.

- **Material Misrepresentations; Failure to Supervise:** In the matter of Advanced Equities (In re Advanced Equities, Inc., Adm. Proc. File No. 3-15031, instituted Sept. 18, 2012), a principal of Advanced Equities, Inc., a registered broker-dealer and investment adviser, made material misstatements to investors in connection with the offering of private equity securities. When raising capital on behalf of the target company, principals of Advanced Equities made a number of significant and willful misrepresentations regarding the company’s finances and performance. The SEC also charged the manager with failure to properly supervise employees with a view toward preventing securities violations.

- **Ponzi Scheme:** In the matter of Resources Planning Group (SEC v. Resources Planning Group, Inc., No. 12-cv-9509, N.D. Ill. filed Nov. 23, 2012), the SEC charged a private equity principal with improperly using newly raised capital to pay off notes (which were guaranteed by the principals) issued to previous investors. The SEC complaint alleges that the principal misrepresented his fund as a viable entity and misappropriated investor funds to repay loans from other investors and reduce his personal liability under the notes.

- **Fraud:** In the matter of Onyx Capital Advisors (SEC v. Onyx Capital Advisors, LLC, No. 10-cv-11633, E.D. Mich. filed April 22, 2010), the SEC charged Onyx Capital and its founders with misappropriating over $2 million from a private fund through a variety of measures and false statements. A number of public pension funds had invested in the fund.

- **Insider Trading:** In the matter of Gowrish (SEC v. Gowrish, No. 09-cv-5883, N.D. Cal. filed Dec. 16, 2009), the SEC charged a number of individuals with stealing confidential merger and acquisition information from their employers, TPG Capital and Lazard Frères & Co., and selling that information to friends who made nearly $500,000 in illicit trading profits.

- **Inflated Valuations; Material Misrepresentations:** In the matter of Yorkville Advisors (SEC v. Yorkville Advisors, No. 12 Civ. 7728, S.D.N.Y. filed Oct. 17, 2012), the SEC charged a hedge fund manager and its principals with inflating the value of illiquid assets in order to hide losses and increase fee collections from investors, and tout positive returns to raise additional capital. The SEC alleged that the manager failed to adhere to the fund’s stated valuation policies (as

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described in its PPM and due diligence questionnaire) and misled investors about the liquidity of the funds, the value of investments, and the fund’s use of a third-party valuation firm, among other things. Similarly, in the matter of KCAP (In re KCAP Financial, Inc., Adm. Proc. File No. 3-15109, instituted Nov. 28, 2012), a publicly traded business development company, in its financial statements, materially overstated the value of its debt securities and collateralized loan obligations held in an investment portfolio by over 25%.

Best Practices

What can a private equity COO or CFO do to reduce the risk of inquiry by the Division of Enforcement? The Advisers Act imposes broad fiduciary duties on investment managers to act in the best interest of their clients. As a fiduciary, a private equity manager must guard against conscious and unconscious incentives that might cause him or her to provide less than disinterested advice, since an investment adviser may be faulted even when he or she does not intend to injure a client or even if a client does not suffer a monetary loss.

COOs and CFOs, who are charged with overseeing the business of the investment manager, are often best positioned to detect and correct conduct that may not comply with the fiduciary duty standard. This job is especially important in private equity, where long-held industry practices may sometimes be viewed as putting the manager’s interest ahead of the interests of investors. For instance, Mr. Karpati has noted that managers who offer co-investment opportunities only to certain favored clients potentially may be viewed as violating their fiduciary duty to other clients who may also be interested in such opportunities.

Firms may find that implementing appropriate policies and procedures, in addition to promoting best practices, will help attract and retain sophisticated, institutional investors. Potential best practices, as noted recently by Mr. Karpati, may include the following:

Integrated Decision Processes

COOs, CFOs and CCOs should be part of the firm’s important decision making processes and should act as investor advocates. The SEC has often referred to this as setting a “culture of compliance,” with robust supervision of employees and internal controls to monitor potential conflicts and potential abuses. For instance, if a COO, CFO or CCO is a member of the investment committee, they can monitor that the firm executes transactions at arm’s length and in accordance with the firm’s stated strategy. They can also learn about the operation of the firm’s portfolio and use that knowledge to ensure that valuations are fairly represented and that investors are accurately informed of the status of their investment.

Utilizing LP Advisory Committees

Regularly utilizing a fund’s LP Advisory Committee is a prudent choice. Disclosing and, in some cases, clearing conflicts with an LP Advisory Committee can demonstrate a firm’s commitment to best practices, minimizing potential conflicts and demonstrating good faith.

Compliance Policies

Regularly updated compliance policies and programs of the firm are very important. Policies and procedures should be tailored to the risks and investment strategies of the firm, and designed to proactively spot and correct situations where conflicts of interest may arise. Specific persons should be assigned responsibility for maintaining and testing compliance procedures. Given the transactional nature of private equity funds, experienced deal professionals should help review and implement these procedures.

Be Prepared

All investment advisers should be alert and prepare for exam inquiries. It is important to be cooperative with exam staff when an examination takes place, and to implement corrective steps if the SEC identifies violations or potential violations. This will result in a more efficient examination process and reduce the likelihood of more formal inquiries by the SEC’s Division of Enforcement.

Substantive changes in U.S. securities regulations, regulatory actions, and remarks by SEC staff members demonstrate a clear focus on private equity industry practices and structures. Fund sponsors that tailor their institutional policies and procedures and adopt appropriate internal controls will be better able to meet their fiduciary duties as investment advisers. Moreover, a commitment to best practices can only serve to enhance a manager’s longevity and fundraising success.
As M&A practitioners well know, the availability to a buyer of a remedy for a seller’s breach of representations and warranties (“R&W”) is a critical component of deal structuring, documentation and execution. A seller of a business (where there is a seller that survives closing) typically is required to provide some contractual indemnity with respect to such breaches as well as with respect to violations of covenants. In a situation where the buyer questions the seller’s credit, the indemnity may be accompanied by an escrow of part of the purchase price. However, escrows often do not provide full protection to the buyer, either because the funds in escrow are insufficient or may require litigation to obtain. Likewise, sellers often resist escrows because they tie up funds for extensive periods of time.

One technique to reallocate the risk associated with breaches of R&W is provided by the insurance industry. Increasingly being offered by a wide variety of carriers, R&W insurance covers the buyer against the seller’s breaches of R&W (in the nature of first-party coverage) or, alternatively, the seller against losses recovered from it by the buyer resulting from such breaches (third-party coverage). The remainder of this article will focus on some of the key uses and features of this specialized coverage, including a discussion of the impact that R&W insurance can have on the dynamics of a particular transaction.

**Purpose and Role in the Transaction**

Because the R&W policy provides protection from an independent third party to either the seller or buyer, it can enable the protected party to be more flexible in the sale agreement provisions, including the scope of representations and warranties, the applicable deductibles and caps under the indemnification provisions, applicable contractual survival periods for asserting claims and whether, and the extent to which, the seller is required to place a portion of the purchase price in escrow to support the indemnity obligations. Thus, R&W insurance can help narrow gaps in the parties’ negotiating positions, can provide the seller greater and quicker access to the full amount of sales proceeds by reducing or eliminating escrow requirements and can give a buyer who is trying to win a bid a competitive advantage.

**Types of Policies: Buyer-Side vs. Seller-Side**

Policies can be tailored to meet the specific objectives of the buyer or the seller. Thus, policy coverage decisions (all representations and warranties in the sale agreement or only particular representations and warranties), policy duration, policy limits and other economic terms can be fashioned in light of the sale agreement and the risks the insured is most concerned about.

Buyers and sellers have distinct motivations for obtaining R&W coverage. Fundamentally, the seller is seeking to reduce or eliminate its exposure under the sale agreement resulting from a breach of the seller’s representations and warranties. The buyer, on the other hand, is seeking to obtain protection from loss caused by a breach of seller’s representations and warranties, regardless of whether such loss is not covered or only partially covered by the applicable indemnity provisions, without being exposed to the risk of the seller’s inability to pay an indemnity claim.

Consequently, although seller-side and buyer-side R&W policies share many common characteristics, they can differ in key respects. For example, while all such policies are
claims-made (i.e., a claim with respect to a breach of an R&W must be asserted during the policy period in order to be valid), the R&W policy periods are typically different for seller-side and buyer-side policies. The policy period for the seller-side policies is typically coextensive with the applicable survival periods in the sale agreement (or slightly longer to provide time to furnish notice). If this were not the case in a given context, a seller could be exposed to the risk of having to satisfy an indemnity with respect to a breach as to which the policy term has expired. By the same token, the policy period where the buyer is the insured may extend well beyond the survival period provided in the sale agreement (but generally not for more than six years) if the buyer desires coverage regardless of whether the loss is covered by the contractual indemnity.

Likewise, the policy limit in the seller-side policy might be no greater than the indemnity cap under the sale agreement (plus some additional amount to cover seller’s defense costs), while a buyer might want coverage in excess of the indemnity cap and would also take into account the seller’s indemnity in fashioning any retention amount.

There are also coverage differences. A seller may not be able to insure against its own fraud, but the buyer-side policy would cover a seller’s fraud. On the other hand, a buyer-side policy will not cover seller’s representations breaches known by the buyer even if the sale agreement contains a pro-sandbagging clause, but the seller-side policy would cover the buyer’s claim in such situation.

**Pricing**

Pricing varies of course based on a number of factors, including an assessment of the risks, the scope and nature of the risks insured, the amount of the retention, applicable time periods and other terms. However, typically the range we have seen in recent years is from 2% to 4% of policy limits. The premium charged typically includes the commission payable to the insurance broker, but this should always be confirmed.

In addition, insurance companies often require the proposed insured to agree to pay the insurance company a fixed amount for the insurance company’s due diligence expenses. However, the insurance company will often agree to waive such fee if the policy is ultimately purchased.

Who bears the cost of the policy premium can be part of a negotiation between the buyer and the seller. For example, the seller can reduce the sales price in return for a buyer agreeing to reduce or eliminate escrow arrangements and obtain an R&W policy instead.

**Key Policy Terms**

In addition to those described above, policy provisions should be carefully reviewed and refined in any M&A deal context to reflect the objectives of the parties. Among the provisions that can be the most meaningful in achieving the appropriate level of insurance protection are the following:

**Definition of “Insured”**

Any of the buyer, the seller or the target itself or the seller can be the named insured under the policy, i.e., the principal insured identified in the policy that is usually entitled to exercise remedies in the event of a claim or a dispute with the carrier. Others (such as corporate affiliates) may be “additional insureds” depending on the specific provision. In fashioning this provision, parties should identify the universe of persons and legal entities for which coverage is sought. These distinctions can be meaningful and can also be sensitive to nuances in terms such as “subsidiary”, “control” and “affiliate”, which are generally not terms of art unless defined in a specific context. The practitioner will want to exercise care in fashioning the “named insured”, “additional insured” and related definitional provisions to make sure that the desired universe of related parties are covered. This could be particularly relevant, for instance, in a fund context where “control” over portfolio companies or companies in “silos” or parallel funds can be a matter of (sometimes purposeful) ambiguity.

**Definition of “Loss”**

The definition of “loss” in R&W policies, while typically straightforward and similar to such definitions in similar contexts, does sometimes involve important details that can make a difference in resolving disputes and recovering awards. Consider the following definitions of “Loss” and policies can be tailored to meet the specific objectives of the buyer or the seller.
certain related provisions from two buyer-side R&W policies we have recently seen:

1. “Loss” means the amount to which the Insureds are contractually entitled in respect of a Breach pursuant to the terms of the Acquisition Agreement . . . Other Insurance Coverage. The Insureds shall, or, if applicable, to the extent possible shall cause their respective Affiliates to, maintain or purchase insurance coverage for the acquired business in a commercially reasonable manner. The coverage provided under this Policy shall be excess coverage . . .

2. “Loss” means the net sum of the following amounts sustained as a proximate result of a Breach: Net Provable Damages plus Defense Costs less Adjustments; . . . “Adjustment” means . . . all amounts recovered by the Insured or the Acquired Company under applicable insurance policies other than this Policy; . . . any reserves established in the books and records of the Insured or the Acquired Company as of the Closing Date, prepared as of the date on which the Closing Date Balance Sheet is finalized; and . . . any right of set off, or any other gain or benefit that will be realized by the Acquired Company or the Insured arising from the matter(s) giving rise to the Breach other than the right to indemnification under the Agreement.

These definitions raise potential interpretive issues. The latter “Loss” definition may have the effect of reducing the buyer’s recovery by amounts reserved on the balance sheet of either the target or acquirer (implicitly this must refer to reserves established in respect of the particular contingency), unlike, arguably, the first one. Another textual difference that bears mentioning relates to the status of other insurance coverages that may be available. The second policy quoted above uses the word “recovered” in specifying what amounts may be netted out of a claim. The first policy quoted above provides that it constitutes “excess” cover, a term that has been litigated numerous times. Whether these two phrasings could result in a difference in what a policyholder may recover relative to another policy is open to question.

Claims and Dispute Resolution
We have seen R&W policies providing for judicial resolution of claims disputes, but these are the exception, with most requiring arbitration. Arbitration is a common forum for insurance and (especially) reinsurance disputes between sophisticated parties; seasoned arbitrators in this space are well-versed in the interpretive canons associated with insurance contracts. However, in R&W policies, the validity of the claim may rest not only on interpretive issues arising out of the policy but also on the proper construction of provisions in the underlying acquisition contract. In other words, whether a “loss” has occurred in a given instance may hinge on the meaning of a particular representation in the acquisition contract. Deal participants may want to consider whether they would feel comfortable relying on an arbitrator for interpretive resolution in such a situation or if, instead, they would prefer a court.

In any event, the insured party should notify the carrier as promptly as possible when it becomes aware of possible grounds for a claim under the policy. Failure to give prompt notice may give rise to a basis to deny a claim, particularly where such delay can be shown to have caused a detriment to the insurer (as contemplated in many states’ insurance codes).

Issues from Insurer’s Perspective – Due Diligence and Underwriting
The underwriting process varies from transaction to transaction, but insurance companies have attempted to minimize the inconvenience sometimes associated with the application process in order to make their product more appealing. As a general matter, the insurer typically will review various transaction-related documents and have discussions with the insured (buyer or seller) and their advisors to understand the business being sold, how key business and legal issues have been analyzed and addressed and how the disclosure and due diligence process was structured. The perceived thoroughness of a seller’s disclosure process or a buyer’s due diligence process will be important factors in the underwriting decision (both in general or with respect to specific representations and warranties) and the pricing of the insurance.

Document review may include, among other things, the sale agreement and disclosure schedules, legal and financial due diligence reports, financial statements and other financial information and some or all documents contained in a data
room. Insurers (or an outside underwriting firm engaged to perform such services) may use not only chartered underwriters but also lawyers and actuaries in conducting such review, which may also entail a review of key contracts that are incidental to the target business such as financing documents with banks or other lenders, major contracts with customers, supply contracts and vendor contracts. In the sale of an entire business, the insurer may focus on the target’s existing risk assessment techniques such as the use of Enterprise Risk Management or similar techniques and programs.

The proposed insured will want to discuss at an early stage with the insurer the process to be followed to confirm that it will meet the timing and other objectives of the buyer and seller.

Issues from Perspective of Deal Participants
Policy Exclusions
Certain categories are often excluded from coverage, subject to specific negotiations with the insurance company. Depending on the particular objectives and needs of the buyer insured or the seller insured, such exclusions may obviate the need for, or reduce the appeal of, an R&W policy. Typical proposed exclusions include:

- Environmental liabilities. However, coverage for these might be obtained by means of a separate pollution liability policy.
- Federal Corrupt Practices Act (FCPA) violations. However, coverage for this may be obtainable if the insured is able to demonstrate a strong compliance and internal controls program.
- Certain tax representations, in particular taxes in certain foreign jurisdictions.
- Certain securities law violations in respect of the target’s publicly-traded securities. However, certain coverage for these might be available from existing D&O policies.
- Misrepresentations known by the seller (in the case of a seller-side policy) or by the buyer (in the case of a buyer-side policy). However, these exceptions can be narrowed through careful drafting, such as restricting knowledge to specified individuals on the “deal team.”

Credit Risk and Regulation of the Insurer
The degree of regulatory oversight over an insurer may be of interest to a prospective policyholder considering R&W coverage insofar as such policyholder will be exposed, after all, to the credit risk associated with that insurer. In this context it is worth noting that, while all U.S. insurers are generally subject to some solvency regulation, the extent to which a given policy and its related premium rates have been subject to regulatory oversight can vary. Much R&W coverage is written in the so-called excess and surplus lines, meaning that such coverage is less subject to “rate and form” regulation (that is, policy wording and cost of coverage) than typical retail policies. Among other things, insurers have more freedom over the premium rates and policy wordings associated with such policies, and such coverage may not entitle the policyholder to coverage under the state “guaranty funds” (state-organized bodies, funded by the insurance industry, that provide partial payments to policyholders when a carrier becomes insolvent). Carriers organized outside the U.S., in addition, may be subject to regulatory standards that differ even further. For all these reasons, an M&A participant may want to consider the regulatory posture not only of a given insurer (in terms of its financial condition) but also of the particular coverage and rates being proposed.

Conclusion
R&W insurance can be an effective tool in helping the seller or buyer (or both) address critical issues in allocating risk, providing protections and resolving impediments to completing the negotiation of a transaction. Careful review and negotiation of the specific terms of the R&W insurance policy (ideally with the assistance of knowledgeable insurance counsel) are required in order to make sure the objectives of the proposed policyholder are satisfied by the final policy.

However, the utilization of R&W insurance will only be effective if obtained in a time-efficient manner. The process should start early by the proposed insured contacting an insurance broker to confirm that one or more insurers will be interested in providing the proposed coverage, and then proceeding to work out an acceptable and timely due diligence process by the insurer while negotiating the terms of the policy.
Low corporate governance standards have been a traditional concern for investors in Brazil. In recent years, Brazil seems to have woken up to this issue. In an effort to gain the confidence of international and domestic investors, the country has been promoting improved corporate governance practices.

Alongside legal reform and a consolidation of institutions, self-regulatory initiatives have promoted a real improvement in corporate governance practices in Brazil. Such factors have also led to the creation of a more diffuse control of capital in Brazilian companies and the increased participation of active minority investors demanding professional, independent and transparent management bodies.

Recognizing that a high proportion of Brazilian corporations have concentrated capital — i.e., they are controlled and managed by families — IBGC recommends the use of Conselhos de Família (Family Committees) aimed at ensuring that family interests are discussed separately from management meetings and that the interests of the controlling families do not conflict with those of the company.

The Brazilian Securities Commission (Comissão de Valores Mobiliários, or CVM) has gained autonomy as a market regulator under the corporate law reform and has been playing an important role in improving corporate governance standards in the country. CVM has issued a Cartilha de Recomendações sobre Governança Corporativa, which creates a set of guidelines on corporate governance practices (CVM Guidelines).

In line with the spirit of the corporate law reform, CVM Guidelines and the IBGC Code focus on the protection of shareholders with no voting rights (i.e., holders of ações preferenciais, or preferred shares). CVM Guidelines establish that all shareholders — regardless of the type of shares they hold — should be called to vote on important company decisions, such as those involving: (i) the approval of an asset valuation integrating the capital of the company; (ii) changes to the object of the company; (iii) a reduction of compulsory dividend distributions; and (iv) M&A transactions.

CVM Guidelines and the IBGC Code recommend the use of mediation and arbitration to resolve disputes between shareholders. Such provisions should be added to the company by-laws or agreed by separate contract.

Brazilian state-owned companies have also sought to improve corporate governance standards. In this respect, the Council for the Protection of State Capital (Conselho de
Defesa dos Capitais do Estado, or CODEC) has issued a manual on corporate governance principles for state-owned companies. Brazilian state-owned/controlled companies have also been adhering voluntarily to higher corporate governance standards by opting to list on segments of the Brazilian capital markets that require higher corporate governance standards, such as Novo Mercado, Nível 1 and Nível 2, which are discussed below.

Corporate Law Reform
Over the years important modifications have been introduced to corporate law in Brazil aimed at offering greater protection to minority shareholders, increasing transparency in the management of corporations and allowing CVM to operate as a market regulator. The clear intention has been to promote a greater participation by smaller investors and institutional investors in the Brazilian securities market.

One of the main targets of corporate law reform has been those Brazilian companies where the capital is highly concentrated (i.e., companies controlled and managed by families and thus lacking independent management boards). Previous Brazilian corporate law allowed corporations to issue up to two-thirds of its shares with no voting rights. Current legislation, however, prohibits newly incorporated companies from issuing more than 50% of shares without voting rights. Companies established before October 31, 2001 and with provisions in their bylaws enabling them to issue up to two-thirds of non-voting preferred shares are entitled to keep such proportions in place. Nonetheless, CVM Guidelines recommend that companies — irrespective of the date of their establishment and the provisions of their bylaws — should not issue preferred shares representing more than 50% of the total capital of the company.

If companies intend to trade their preferred shares (either with no voting rights or with restricted voting rights) in the securities market, corporate law requires that such shares must confer their holders with a minimum of one of the following benefits: (i) a payment of dividends equal to a minimum of 25% of average profits at year-end; (ii) a payment of dividends at least 10% higher than the dividends paid to common shares (which confer voting rights to their holders); or (iii) the right to “tag-along” the preferred shares in a public offer for disposal of control and receive dividends at least equal to the dividends paid for common shares.

Current Brazilian corporate law establishes that holders of common shares which are not part of the controlling block have the right to tag these shares along for disposal of control and receive at least 80% of the price paid for controlling shares. Both CVM Guidelines and the IBGC Code recommend that this right be extended to minority holders of all types of shares, including preferred shares.

Special Listings
The creation by BM&FBOVESPA (the São Paulo Stock Exchange) of new special listing levels for companies with high corporate governance standards (Nível 1, Nível 2, Novo Mercado and BOVESPA Mais) is arguably the measure that has had the greatest impact in terms of enhancing corporate governance standards in Brazil. It has also been central in improving investor confidence and promoting the growth of capital markets in Brazil.

Each special listing segment has its own listing requirements. A company intending to list shares in one of these segments must enter into an agreement with BM&FBOVESPA and adhere voluntarily to corporate governance standards that are higher than those required under current Brazilian corporate law.

Novo Mercado has become the most popular special listing segment in Brazil, chosen by the vast majority of issuers that went public in recent years. Companies seeking new listings on Nível 1 and Nível 2 tend to be those subjected to specific regulation and, particularly, certain regulatory provisions regarding their capital structure with preferred non-voting shares. Examples of such companies include financial institutions and airlines.

The Brazilian Financial and Capital Markets Association (Associação Brasileira das Entidades dos Mercados Financeiro e
The creation by BM&FBOVESPA (the São Paulo Stock Exchange) of new special listing levels for companies with high corporate governance standards (Nível 1, Nível 2, Novo Mercado and BOVESPA Mais) is arguably the measure that has had the greatest impact in terms of enhancing corporate governance standards in Brazil.

**Novo Mercado Listings**
The main requirements include:

- 100% of the capital stock must be divided into voting shares (i.e. common shares, as opposed to preferred shares with no voting rights);
- a minimum of 25% of the shares of the capital stock must float in the market;
- tag-along rights offering the same price paid per share for the controlling block, where a sale of corporate control occurs;
- a minimum of 20% of the board members must be independent from the company and from the controlling shareholders (the definition of “independence” is included in the Novo Mercado Listing Requirements);
- mandatory tender offers in the case of a delisting from Novo Mercado, a delisting from BM&FBOVESPA and a deregistration from CVM, for fair value, as determined by an independent, specialist firm with certain qualifications and experience, appointed by the board and approved by the shareholders; and
- any disputes arising between shareholders and the company must be resolved by arbitration conducted by the Câmara de Arbitragem do Mercado.

**Nível 2 Listings**
The main requirements applicable to listing under Nível 2 include:

- capital stock can be divided into common and preferred shares;
- preferred shares are entitled to certain voting and tag-along rights (despite the fact that current corporate law only entitles common shares to tag-along rights).
Voting rights must be granted in the bylaws of the company in the following circumstances:

  a. when choosing a firm to issue a valuation report for the shares in connection with any capital contribution or with the tender offer for delisting the shares from Nível 2;
  b. on any transaction with related parties, when such transaction requires a shareholders’ vote;
  c. on any proposed change of the voting rights of preferred shares; and
  d. on the delisting of the company from Nível 2;
- a minimum of 25% of the shares of the capital stock must float in the market;
- tag-along rights offering the same price paid per share for the controlling block, where a sale of corporate control occurs;
- a minimum of 20% of the board members must be independent from the company and from the controlling shareholders (the definition of “independence” is included in the Nível 2 Listing Requirements);
- mandatory tender offers in the case of a delisting from Nível 2, a delisting from BM&FBOVESPA and a deregistration from CVM, for fair value, as determined by an independent, specialist firm with certain qualifications and experience, appointed by the board and approved by the shareholders; and
- any disputes arising between shareholders and the company must be resolved by arbitration conducted by the Câmara de Arbitragem do Mercado.
Nível 1 Listings

Nível 1 requirements include:

• capital stock can be divided into common and preferred shares;

• a minimum of 25% of the shares of the capital stock must float in the market;

• annual financial statements have to be produced in accordance with international standards (i.e., U.S. GAAP or IFRS);

• mandatory tender offers in the case of a delisting from Nível 1, a delisting from BM&FBOVESPA and a deregistration from CVM, for fair value, as determined by an independent, specialist firm with certain qualifications and experience, appointed by the board and approved by the shareholders; and

• any disputes arising between shareholders and the company must be resolved by arbitration conducted by the Câmara de Arbitragem do Mercado.

BOVESPA Mais Listings

The BOVESPA Mais is aimed at “SMEs” (small and medium-sized enterprises) seeking a less regulated market. Requirements for such listings include:

• capital stock must be divided into common shares. Companies that already had preferred shares before listing on BOVESPA Mais may keep them but cannot issue additional preferred shares after the listing;

• a minimum of 25% of the shares of the capital stock must float in the market, with a grace period of seven years should the company not comply with this requirement at the time of the listing;

• mandatory tender offers in the case of a delisting from BOVESPA Mais, a delisting from BM&FBOVESPA and a deregistration from CVM, for fair value, as determined by an independent, specialist firm with certain qualifications and experience, appointed by the board and approved by the shareholders; and

• any disputes arising between shareholders and the company must be resolved by arbitration conducted by the Câmara de Arbitragem do Mercado.

This type of special listing has not been widely used, which suggests that Brazilian SMEs are still not familiar with the use of funding from capital markets and that many Brazilian SMEs still have difficulties in complying with regulatory requirements. ★
Our clients from time to time are asked to consider joining the board of directors of a company listed on the London Stock Exchange as a Non Executive Director (“NED”). This may be an exciting opportunity but one which should not be undertaken lightly. The term Non Executive Director is not defined in legislation under English law – it refers to a director who is not a full or part-time employee or holder of an executive office of a company but who devotes part of his time to the affairs of the company as an adviser/director. Recent guidance issued in January 2013 by the Institute of Chartered Secretaries and Administrators on the roles and responsibilities of NEDs is a strong reminder that prospective NEDs should think carefully about the liability that they will be exposing themselves to by virtue of their appointment and the role that they will be expected to play on the Board. Before and after joining the Board, NEDs should take steps to ensure that they will be effective in their roles and not expose themselves to liability by virtue of their actions or inactions.

The UK Corporate Governance Code (the “Code”) applies to all companies with a premium listing on the London Stock Exchange irrespective of where the companies are incorporated. Companies admitted to trading on AIM, London Stock Exchange’s junior stock market for smaller growing companies, although not required to comply with the Code, generally strive to comply with the Code insofar as it is appropriate given their size and stage of development.

The Code provides that the purpose of corporate governance is “to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company.” Corporate governance is what the Board of a company oversees and the Code provides a guide to a number of key components of effective board practice including the systems and processes for ensuring proper accountability, openness and probity. The role of the NED is crucial for effective Board behavior and in summary the NED is a check and balance and should “constructively challenge and help develop proposals on strategy.” Under the Code principles, NEDs should scrutinize the performance of management in meeting agreed objectives and monitor the reporting of their performance. They should be satisfied with the integrity of company financial information and that the financial controls and systems of risk management in place are robust and defensible. They are responsible for the remuneration of executive directors as well as removing such directors if this is required.

An important point to note is that as a matter of English law there is no distinction between the duties and obligations owed by an NED and an executive director. Under English law, a director’s duty is to exercise the care, skill and diligence that would be exercised by a reasonably diligent person with: (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by that director in relation to the company; and (b) the general knowledge, skill and experience that the director has. Accordingly, whether the duty has been satisfied comprises both an objective and subjective test, with the result that more is expected of a director with specific skills and expertise, e.g. skills in finance or law.

The Institute of Chartered Secretaries and Administrators (“ICSA”) issued a guidance note in January 2013 on liability of NEDs: care, skill and diligence. The guidance suggests the
steps NEDs can take that would help them demonstrate to a regulator, or to a court, that they had exercised care, skill and diligence in the execution of their roles and responsibilities. It is not reasonable to expect an NED to have the same detailed knowledge and experience of a company as an executive director. According to the guidance, when deciding whether an NED has breached his director’s duties, “a court would consider the steps a reasonably diligent non-executive director in the same position would have taken to familiarize themselves with the company’s business and operations.”

ICSA recommends that prior to joining a Board, prospective NEDs should:

1. carry out their own due diligence on the company. In a separate ICSA guidance note issued in May 2011, guidance was given on sample questions to ask during this exercise. The questions should cover matters such as the business, the governance procedures in place, the composition of the Board (to ensure that it is suitably balanced between executives and NEDs, is diverse and has the necessary skills), boardroom behaviors (to ensure that constructive challenge from NEDs is welcome) and how the Board operates (e.g. how often the Board meets, the quality of advance information provided and whether the Board rigorously evaluated to ensure its effectiveness). A prospective NED should diligently review the company’s website and annual financial reports and all other public information that has been announced to the market. Although public information is unlikely to disclose any wrongdoing, if there is a lack of transparency then this may be a warning signal. Before accepting an appointment, the prospective NED should meet in person with as many Board members as possible and at the very least with the Chairman of the Board, CEO and CFO. The prospective NED should be mindful that due to various insider trading and market abuse rules, there is certain price-sensitive information which will not be disclosed to him before joining the Board;

2. ascertain what skills and experience the company is seeking from them to complement the existing Board and ensure that they have or can acquire the skills needed to serve that Board and they should devote time to developing and refreshing their skills;

3. during the discussions held with members of the Board, ask questions and make a judgment on the culture, values and behavior of the Board;

4. review their letter of appointment and ensure that it states the minimum time expected to be devoted to the role. A prospective NED should be satisfied that he can devote the time necessary to discharge his responsibilities on the Board and any committees of the Board and be mindful that at certain times of the year he may be required to devote additional time. A prospective NED should ascertain what Directors and Officers insurance cover is in place for legal action against the directors; and

5. understand the various laws, rules and regulations (including of the London Stock Exchange) that they will be subject to on appointment. It may be helpful to meet with the company’s various advisers (lawyers, brokers and accountants) to discuss these various duties and obligations.

Upon joining a Board, new NEDs should have input into their induction program and take responsibility for their ongoing training and continuous development. An NED should keep up to date with developments in the company, its sector and changes in any laws and rules under which the company operates, and request training if he feels that it is required. The NED should insist on receiving high quality information in advance of all Board meetings which is accurate and up to date. Decisions made by the NED should be objective and in the
interests of the company and the NED must avoid any conflicts of interest. The NED must provide independent oversight and be prepared to constructively challenge the executive team as and when required, which is not necessarily always welcome or easy to do.

In recent years the role of the NED has increased significantly. It is not a rubber-stamping exercise and requires the active participation of the director concerned if he is to avoid breaches of directors’ duties, or other applicable laws or regulations or indeed public censure in the media if corporate governance standards are not met.

The NED must provide independent oversight and be prepared to constructively challenge the executive team as and when required, which is not necessarily always welcome or easy to do.
NEW DODD-FRANK SWAP RULES HAVE IMPLICATIONS FOR LOAN GUARANTEES AND SECURITY DOCUMENTS

Andrew C. Coronios and Monika B. Szymanski

New swap rules issued under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which became fully effective on April 1, 2013, have significant implications for borrowers and lenders in credit facilities where guarantees and security documents cover swap obligations. Borrowers are often required to maintain certain hedges for interest or currency risk and the loan documentation is often structured so that the guarantee and security documents cover not only the loan obligations but also the swap obligations. Under the new rules, if a guarantor or grantor of security is not an “eligible contract participant”, the entire guarantee or security document may be unenforceable, even where the direct counterparty to the swap itself is an eligible contract participant. This is an issue that can often arise in financings where a parent borrower qualifies as an eligible contract participant but its obligations are guaranteed or secured by its subsidiaries.

Under Section 2(e) of the Commodity Exchange Act, as amended by the Dodd-Frank Act (the “CEA”), unless a swap is entered into on, or subject to the rules of, a board of trade designated as a contract market by the U.S. Commodity Futures Trading Commission (the “CFTC”), the swap must be entered into by an entity that is an “eligible contract participant”, as defined under the CEA. The CFTC has interpreted “swap” to include a guarantee of a swap. The Office of General Counsel of the CFTC, in an October 12, 2012 no-action letter no. 12-17 (the “CFTC 12-17 Letter”) provided that guarantors of swap obligations generally must be eligible contract participants and that entities that are not eligible contract participants may not be jointly and severally liable for swap obligations. The CFTC 12-17 Letter provides that it covers guarantees only and does not address other credit support arrangements (such as pledge and security agreements or mortgages) and noted that the CFTC may address such issues in the future. Although the application to security documents is not clear, parties are generally interpreting the new rules to apply to security agreements and other provisions of collateral as well as guarantees.

It is important that borrowers and lenders promptly and carefully consider the implications of the new swap rules and take steps to address them in loan documentation.

Eligible Contract Participant

Section 1a(18) of the CEA sets forth the definition of “eligible contract participant”, which includes, among others, a corporation, partnership, proprietorship, organization, trust, or other entity (i) that has total assets exceeding $10,000,000, (ii) the obligations of which are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement by an entity that has total assets exceeding $10,000,000 or (iii) that has a net worth exceeding $1,000,000 and is hedging its commercial risk. Many borrower entities have sufficient assets to reach the dollar threshold or otherwise satisfy one or more of the clauses of the definition; however, a borrower’s subsidiaries, which are often guarantors and grantors of security in credit facilities, may not.

In situations where a swap is hedging commercial risk, it is not clear whether a subsidiary guarantor or grantor would qualify as an eligible contract participant under clause (iii) because the commercial risk would not be its own risk but rather that of the swap counterparty entity (the borrower).
As a result, parties are generally seeking to qualify guarantors and grantors as eligible contract participants under clause (i) or (ii).

**Implications**

If the guarantor or grantor with respect to swap obligations is not an eligible contract participant, then the guarantee or security documents would be unenforceable and illegal. Because guarantees and security documents usually do not contain a severability provision, the entire guarantee or security document could be unenforceable, including the guarantee or security provided (i) to secure loan obligations and (ii) by co-guarantors or grantors that are eligible contract participants. Such a result would trigger default provisions in the loan documents and the swap documents, which could in turn trigger cross-default provisions in other agreements.

In addition, since under the CEA it is unlawful for a person to enter into a swap if it is not an eligible contract participant, unless the swap is entered into or subject to a designated contract market, an entity that is not an eligible contract participant may be subject to an enforcement action by the CFTC.

The rules with respect to swap guarantors apply not only to new loan documents but also to existing loan documents in certain circumstances. Eligible contract participant status is determined at the time a swap is entered into, so the new rules apply to existing loan documents where the swap documentation or guarantee or security documents covering the swap obligation are entered into or after the effectiveness of the rules, including a guarantee joinder agreement entered into by a new subsidiary. In addition, the new rules apply to amendments to loan documents where the amendments would constitute entering into a swap.

**Recommendations**

There are several recommendations for additional loan documentation provisions to address the implications of the new swap rules on guarantees and security documents covering swap obligations:

- Loan documentation and related guarantee and security documents covering swap obligations should contain appropriate provisions so that guaranteed and secured obligations exclude obligations of a guarantor or grantor that is not an eligible contract participant.
- Parties should also consider adding severability provisions in guarantees and security documents covering swap obligations so that if part of the guarantee or security is provided by an entity that is not an eligible contract participant, the guarantee or security granted by eligible contract participants would still be enforceable.
- Provisions in loan documents dealing with waterfall and sharing among lenders and swap counterparties (including intercreditor arrangements) should be examined and drafted to provide that swap counterparties would not get the benefit of proceeds from guarantees made by entities that are not eligible contract participants.
- Additional termination event provisions in the swap documentation with respect to guarantee, waterfall and sharing provisions should also be carefully reviewed and drafted so as to not trigger early termination.
- “Keepwell” and other support arrangements should be included in guarantees or in separate parent support agreements where necessary in order for entities that would not otherwise be an eligible contract participant to qualify as an eligible contract participant.
- Parties should consider adding an eligible contract participant representation in the credit agreement, which representation would be made by the guarantors or grantors each time a guarantee or security document is entered into, as well as at the time each secured swap is entered into. Swap documents already usually include an eligible contract participant representation; however, it is usually made only with respect to the direct swap counterparty entity (the borrower), not its guarantors or grantors, and only at specific times. Credit agreements have not typically contained such a representation with respect to the borrower or its guarantors or grantors.

**It is important that borrowers and lenders promptly and carefully consider the implications of the new swap rules and take steps to address them in loan documentation.**
• On February 15, 2013, the Loan Syndications and Trading Association (the “LSTA”) published a market advisory which includes recommended definitions for use in guarantees and security documents, including definitions of “Excluded Swap Obligation” and “Swap Obligation,” to carve out swap obligations of a guarantor or grantor that is not an eligible contract participant from guaranteed or secured obligations. The market advisory also includes a recommended “keepwell” provision among joint and several guarantors. Because LSTA model credit agreement provisions are included in most syndicated loan documentation, these provisions are being added to new loan documents as well as amendments to existing loan documents.

If the guarantor or grantor with respect to swap obligations is not an eligible contract participant, then the guarantee or security documents would be unenforceable and illegal.
A DISCUSSION WITH ISS ON PROXY SEASON TRENDS AND HIGHLIGHTS

In January 2013, Chadbourne hosted its annual presentation with Institutional Shareholder Services (“ISS”) to review the 2012 U.S. proxy season and provide a look ahead to 2013. The following is an edited excerpt of the transcript. The speakers are Marc Goldstein, Head of Engagement at ISS, and Bimal Patel, Head of ISS Global Policy Steering Committee. Also participating are Marc Alpert, Sey-Hyo Lee and Kevin Smith, Chadbourne corporate partners in New York.

Proxy Season Trends

ISS: It is not a surprise that executive compensation continues to be the top area of focus around the globe. Investor respondents again cited compensation as the perennial top governance topic similar to what we saw in the survey result last year. Issuer respondents also cited compensation as their top concern in North America and Europe.

C&P: What were some of the other top issues during the proxy season?

ISS: On a global basis, investors also focused on board competence, director qualifications and board independence. Across every region, board competence and independence were identified among the top three most important governance topics by investors. For issuers, board competence was the third most commonly cited topic across every region. Specifically, board independence and competence seems to resonate with both investors and issuers in the developing markets and Asia Pacific region where board issues may not be as evolved as in some of the more developed markets.

Majority Supported Shareholder Proposals

ISS: With respect to the U.S. market, one of the survey questions we have asked was on the issue of board responsiveness to majority supported shareholder proposals. The marketplace has been clearly evolving in this area both in terms of institutional investor expectations and in terms of the actual responsiveness by issuers.

According to our survey results, 86% of investor respondents expect that boards should implement a shareholder proposal that receives support from majority of shares in the previous year. That is not too surprising to us. But what is surprising was that 47% of issuer respondents agreed with that view as well. Issuers have been increasingly responding to shareholder proposals that received only one year of majority of votes cast.

C&P: Did you also get any feedback from the issuers as to why they would not be implementing such majority supported shareholder proposals?

ISS: Yes, we certainly did. It was interesting because based on the survey results, 46% of issuers agreed with this approach. However we got a different message during the comment period. Some of the issuers or issuer-related organizations indicated that such a policy forces directors to abdicate their fiduciary duties and it could potentially reduce engagement with shareholders.

Overall, the issuers indicated that a case-by-case approach in looking at the board’s responsiveness and the actions they have taken is more appropriate or that a transition period should be provided for the policy to take effect.

C&P: What is the ISS position regarding boards failing to implement majority supported shareholder proposals or implementing alternative measures?

ISS: Generally speaking, we expect majority supported shareholder proposals to get implemented. There may be circumstances in which we will be flexible but it is going to be on a highly case-by-case and coverage-specific basis.

Under the current policy in the U.S. market, ISS recommends to vote against or withhold from the entire board except new nominees if the board failed to act on a shareholders proposal that received the support of a majority of shares
Generally speaking, we expect majority supported shareholder proposals to get implemented. There may be circumstances in which we will be flexible but it is going to be on a highly case-by-case and coverage-specific basis.

outstanding in the last year, or a majority of shares cast in the last year and one of the two previous years.

This year we have transitioned to using a majority of shares cast in one year as a trigger to evaluate a company’s response to proposals appearing on ballots in 2013. Some of the other changes include flexibility to recommend against members as deemed appropriate and not necessarily the full board. We are also going to include more guidance on our case-by-case examination of the sufficiency of the company’s action in response to a majority-supported proposal.

However we are not retroactively applying this policy and we will not be taking action against directors this year on the basis for proposals in 2012. So the clock starts next year with respect to these proposals.

C&P: Would ISS recommend against the directors in instances where the board attempts but fails to implement the majority supported shareholder proposal? For example, a proposal to declassify the board would require the amendment of the charter through a supermajority approval. Even if the board listens to the shareholders and proposes to amend the charter to declassify at the next year’s meeting, the board would not be able to implement the proposal on its own without the supermajority approval by the shareholders.

ISS: We certainly don’t want to go against the board as long as the board is making an effort. However, if they try only once and it fails to receive the supermajority of the shareholders, we might not consider that to be sufficient effort. Again, this is going to be a case-by-case scenario but we certainly would expect the board to keep trying and not just give up after one attempt. We would expect the board to keep trying if not every year then at least every few years as the shareholder base will change over time. There has to be a robust solicitation effort from the board to try to solicit the shareholders.

Stock Pledges as Collateral for Marginal Loans

ISS: The practice of executives or directors pledging stock as collateral for margin loans has recently received more attention. Based on the results of this year’s policy survey, close to half of investors and 45% of issuers essentially have a zero tolerance policy on pledging. In fact, 80% of issuers and 87% of investors think that significant pledging is a concern; very few think it’s never a concern. Therefore we’ve decided to update our policy on pledging as well.

We view pledging as a risk oversight issue rather than a compensation issue. There is a very real risk to shareholders if pledged shares need to be sold in a hurry, as such sale would negatively impact the company’s stock price. Therefore we have amended our policies to include significant pledging as one of the material failures of governance, stewardship, risk oversight, or fiduciary responsibilities, which can result in recommendations against the directors.

C&P: What level of pledging would be considered “significant”?

ISS: There is no magic number because it’s going to differ from company to company. We’ll examine the number of shares outstanding, average daily turnover, percentage of shares pledged and, if there are multiple executives or directors who have shares pledged, we would look at that as well.

C&P: How should issuers with existing significant pledges respond to this policy update?

ISS: We would like to see boards adopt policies against future pledging and hopefully work on ways to unwind existing pledges responsibly over time. Obviously if companies are required to take such measures immediately, it would have the same impact as a margin call. Therefore we don’t expect companies to do that overnight. However we do expect to see some progress made over time in getting rid of pledges.

Peer Groups

ISS: Peer groups have been another perennial hot topic. Our approach has historically been to use the Global Industry Classification Standard (“GICS”) group starting with eight digits and expanding to six, four, and if necessary, two digits. We recognize that this is imperfect but our investor clients use GICS to measure the performance of their portfolio companies to make investment decisions. Furthermore, everyone agrees that the size range of the company is important and that compensation correlates very heavily with the size of the company. Therefore you don’t want companies that are widely different in size being compared to each other.
That being said, issuers tend to ask or prefer that we use the peer groups that they choose, in part because their business activities often aren’t limited to one GICS group. Sometimes business characteristics change over time and GICS doesn’t get updated even though the business has changed. Also, some companies are conglomerates or at least have more than one line of business and so they have peers that straddle GICS groups.

For 2013 and beyond, we will start with the company’s eight-digit GICS group but also look at the subject company’s chosen peers and see if those companies are in industries that make sense. If the industry makes sense but perhaps the company that the subject company has chosen is the wrong size, we may pick a company in the same eight-digit GICS group as the company’s peer, but that’s closer in size to the subject company.

C&P: How do you get the information from the issuers? Is that something you would actively request from them?

ISS: Yes, to the extent that the peers stay the same from year to year, we start with what was in the last proxy. However we know that companies make changes year over year and we asked companies this past fall whether they made any changes in 2012 and asked them to send the changes to us so that we can get started on the process of using those for comparison purposes.

C&P: Issuers are going to be very interested in how ISS comes out in their peer group determinations and how they may differ from what the issuers are doing. Will ISS be disclosing its peer group designations to issuers and allow issuers to comment or have any say in the final determination?

ISS: At least for this year, we don’t have plans to disclose in advance as we are planning to make our final determination while we’re doing the analysis after the proxy is out. However, we’re expecting that the methodology will result in a lot more overlap between our peer group and the subject company’s peer group.

**Realizable Total Compensation**

ISS: Companies are providing a diverse set of realizable total compensation to show how executive pay has been affected by performance. While grant date pay in the summary compensation table showed the intent behind the pay decisions made by the compensation committee, it doesn’t necessarily reflect the final payouts of performance-based awards or changes in the value due to gains and losses in the company’s stock price. Therefore we changed the way we examine realizable pay based on the responses from the market.

As of 2013, we are going to be more systematic in calculating a realizable value for grants made during a performance measurement period of three years and then compare that value to the grant date value of the same pay and awards in order to provide a more explicit indication of the strength of the pay-for-performance linkage in a company’s compensation programs. Specifically, realizable pay includes all non-incentive compensation amounts paid over the measurement period. To that we add the value of equity or long-term cash incentive awards made during the period and either earned or, if their award remains ongoing, revalued at the target level as of the end of the measurement period.

This realizable pay component is being added for large-cap companies only for this year. We are focusing on the S&P 500 companies since these companies have the most complex compensation programs. In addition, these companies are increasingly using performance-conditioned awards that could be forfeited if the goals are not met. Finally since current disclosure rules don’t provide a standardized picture of realizable pay, we wanted to start with a subset of companies to ensure that we are using the most meaningful definition and getting it right.

**Shareholder Proposals and Proxy Access**

ISS: Proxy access was not entirely new but it was, for all intents and purposes, a new proposal in 2012 and therefore got a lot of attention at ISS. We saw several flavors of these proposals depending on the identity of the proponent, and there

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*It is not a surprise that executive compensation continues to be the top area of focus around the globe. Investor respondents again cited compensation as the perennial top governance topic similar to what we saw in the survey result last year. Issuer respondents also cited compensation as their top concern in North America and Europe.*
was a clear bifurcation. The proposal sponsored by the U.S. Proxy Exchange and some of the retail proponents tended to get fairly low levels of support. However, proposals submitted by institutional investors and some of the public funds and labor funds in the U.S. received much higher levels of support from investors in 2012.

C&P: Given the longstanding excitement regarding proxy access from the SEC and many shareholder activists, are you surprised by the generally underwhelming support by shareholders?

ISS: Well, not really. If you back out the retail investors’ proposals, which we did not support because we found the ownership thresholds to be too low, and focus on the proposals coming from institutions, the average rate of support was actually quite high considering this was effectively a first year proposal.

Ownership Thresholds for Proxy Access

ISS: Many of the proxy access proposals in 2012 were largely similarly to the defunct SEC Rule 14a-11, which would have permitted shareholders or shareholder groups who owned not less than 3% in voting power for at least three years to include their nominees in the company’s proxy materials for up to 25% of the board.

C&P: Is the SEC’s formulation by far the majority preference for your client base?

ISS: Yes. I don’t know about majority but certainly a number of our clients have indicated fairly strongly that they support this approach as they don’t want to see proxy access used as a substitute for a proxy contest to take over a company. Specifically, our survey indicates that investors indicated support for the 3% ownership threshold on a three-year holding period and the 25% cap on board seats. And those proposals got reasonably high support, that is, somewhere over 30%. In contrast, the retail proposals allowing 50 or 100 investors with $2,000 worth of shares to aggregate their holdings got no traction at all.

Say-on-Pay Votes and Compensation Committees

ISS: The overall support for say-on-pay was down very slightly in 2012 from 2011 but we’re talking about 90.8% on average versus 91.7%. The median level of support in the Russell 3000 was 96.2%. However, 58 companies or 2.5% of companies in the Russell 3000 that had votes this year, failed to get majority support. This is somewhat higher than 2011, where 40 companies or about 1.6% failed to get majority support. About 8% of the Russell 3000 had opposition greater than 30% to their say-on-pay proposal.

The negative votes were mainly due to the perceived disconnect between pay and performance. While shareholders don’t like issues like excise tax gross ups, those issues are largely going away, so the negative votes are being driven more by pay for performance than by anything else.

When say-on-pay first was introduced, we were hearing from a lot of investors that they would take a yellow card, red card approach. If they see a compensation problem, they’ll vote against the say-on-pay proposal in the first year. In the second year, they’ll consider going against the compensation committee if the underlying issue hasn’t been addressed. But what we saw in 2012 is that shareholders in fact were willing to vote against say-on-pay two years in a row but they haven’t been willing in large numbers to escalate to the red card of coming against the compensation committee.

In fact, the major factor in reducing negative votes on directors is say-on-pay. If shareholders have a compensation-related concern, they vote against say-on-pay instead of voting against the compensation committee. We also know that engagement, especially engagement with directors, has increased over prior years. That’s also largely driven by the say-on-pay votes as well. Therefore, compensation committee members are under less pressure than we had anticipated and we do not expect a lot of directors and compensation committee members to actually get voted out over pay concerns.

A Look Ahead to 2013

ISS: So turning to the 2013 preview, we have already identified a few big themes for the year including private ordering and proxy access. However the U.S. Proxy Exchange itself is no longer in existence and we think there are likely to be fewer access proposals from retail investors in 2013. Of course they are not going to disappear altogether but given the lack of success they had in 2012, we just don’t think that we’re going to see a massive push across the entire universe of companies for proxy access.

In terms of shareholder proposal topics, we don’t expect there will be a lot of new ones. The perennial favorites such as board declassification, elimination of super majority voting requirements, independent chair and so forth will not go away.

Some of the hot button governance issues in 2013 are largely the same as in 2012 and 2011. There are perennial, such as annual election of directors and independent chairs. We expect an increase in support among the shareholders for proposals on independent chairs but it hasn’t reached the levels yet of proposals for declassifying a board or implement-
ing majority voting for directors. So we’re going to see a lot of shareholder proposals on this topic but not quite at the level of those other two.

In terms of annual election of directors, our clients overwhelmingly support it. Investors want the ability to vote on directors every year but that doesn’t necessarily mean they’re willing to throw them all out. According to our own statistics, only 61 nominees out of over 17,000 in the Russell 3000 failed to get majority support. Therefore we expect to see pretty much the entire S&P 500 move to annual elections within a few years.

We’re also expecting to see more proposals for majority voting moving down to the next tier of companies after the S&P 500. We’re going to see continuing activity on special meetings and written consents where companies already have the right to call a special meeting but the threshold for doing so is high. We expect to see shareholder proposals calling for that to be lowered. We may see companies try to preempt that by lowering their own thresholds but not as much as shareholders want. And again, this is a continuation of a trend already seen in 2012.

Say-on-pay hasn’t completely done away with shareholder proposals on compensation-related topics and we expect to see a number of those in 2013. Shareholder proposals on recoupment or clawbacks tend to go beyond the requirements of Dodd-Frank and Sarbanes-Oxle, and seek recoupment even where there isn’t a formal restatement.

We will see proposals on holding periods for equity awards, retention ratios and bonus banking. In other words, make sure that the metrics for the pay are sustainably achieved before the bonus gets paid out.

We also expect to see at least one and probably more proposals specifically related to peer group benchmarking, especially targeted at companies that target their CEO compensation at the 75th percentile of their peer group.

Environment and sustainability issues such as labor and human rights issues throughout the supply chain are also expected to come up in 2013. Again, we’ve seen this in the past couple of years and that’s going to continue in 2013.

Finally, board diversity and especially gender diversity is going to be another focus. This issue will possibly be addressed through shareholder proposals or through dialogue and engagement. We don’t know how many shareholder proposals we’re going to see but we know that it’s an issue that is of concern to a lot of investors and that they are going to be talking to companies about it.
Over the last fifteen years the recognized importance of intellectual property to international commerce has skyrocketed. The focus has been on code and patents and the willingness of strategic and financial investors to invest in both — and to litigate once rights have been acquired. In that context, a focus on trade secrets has seemed outdated. But from another point of view, overlooking trade secrets has simply been a market failure. Trade secrets are protectable as formal IP, and arguably more powerful, because a trade secret does not need to be registered, and it can represent a broad right.

The Obama Administration is taking a novel course. As set out in a new strategy announced in February 2013, it is invoking the enforcement of trade secrets under U.S. and international law as a tool of statecraft to combat industrial espionage. Private companies would be well served to pay attention to this development. The Obama Administration is signaling that it thinks this tool has been overlooked, and can play an important role in protecting U.S. commercial interests. We will have to see whether private companies agree. Below we lay out some of the background relevant to this development.

One additional comment: the focus on trade secrets has an embedded risk. It requires that companies enforce their trade secrets. Failure to take action to do so will mean that private companies may be handing their opponents a strong defense to a claim that IP rights have been violated.

Existing Law
Trade secrets are generally defined as information that is not generally known to the public; that confers some sort of economic benefit on its holder which derives specifically from its not being generally known; and that is the subject of reasonable efforts by its owner to maintain its secrecy.

Enforcement of trade secret rights between private parties is largely the province of state law. However, the Economic Espionage Act of 1996, 18 U.S.C. §§ 1831-29 (the EEA), criminalizes some forms of trade secret theft and also empowers the government to initiate civil enforcement proceedings. Section 1831 of the EEA makes it a felony to knowingly steal or misappropriate a trade secret to benefit any foreign government or agency thereof. Section 1832 makes it a crime to knowingly steal or misappropriate a trade secret to the economic benefit of anyone but its owner if the accused party intends to injure the owner.

The Threat
Recent years have seen an alarming growth in state-sponsored industrial espionage and criminal theft of trade secrets. The criminal activities involve efforts to acquire trade secrets both through the recruitment of current and former employees, and through cyber intrusion against electronic repositories of trade secret information. This is illustrated by a summary of the related criminal proceedings that have occurred since January 2009 published by the Department of Justice, which identifies 20 significant cases including the following examples:

- In November 2012, a former General Motors engineer and her husband were convicted of stealing GM trade secrets relating to hybrid vehicle technology worth $40 million. The defendants copied more than 16,000 GM files,

Recent years have seen an alarming growth in state-sponsored industrial espionage and criminal theft of trade secrets.
including trade secret documents, to an external computer hard drive, and then tried to pass the trade secrets to a Chinese automaker.

• In October 2012, South Korea-based Kolon Industries and several of its executives and employees were indicted for allegedly engaging in a multi-year campaign to steal trade secrets related to DuPont’s Kevlar® fiber and Teijin Limited’s Twaran® fiber. The indictment seeks forfeiture of at least $225 million in proceeds from the alleged theft of trade secrets from Kolon’s competitors, and charges Kolon with multiple related criminal counts. According to the indictment, Kolon allegedly sought to improve its product by targeting current and former employees at DuPont and Teijin and hiring them to serve as consultants, then asking them to reveal confidential and proprietary information.

• In September 2012, a former senior software engineer for Chicago-based CME Group pleaded guilty to theft of trade secrets for stealing source code and other proprietary information while at the same time pursuing plans to improve an electronic trading exchange in China and admitted to downloading more than 10,000 files containing CME computer source code that made up a substantial part of the operating systems for CME’s Globex electronic trading platform. The government maintained that the potential loss was between $50 million and $100 million.

• In April 2011, a former Ford employee was sentenced to 70 months in federal prison for theft of trade secrets and economic espionage. The employee resigned to work at a Chinese automotive company. He copied 4,000 Ford documents onto an external hard drive, which he took to China. Ford valued the loss of the trade secrets at $50 million.

Administration Response
In response to these threats, on February 20, 2013, the Obama Administration announced a new “Strategy on Mitigating the Theft of U.S. Trade Secrets,” which summarizes the problem as follows:

“Emerging trends indicate that the pace of economic espionage and trade secret theft against U.S. corporations is accelerating. . . . Additionally, there are indications that U.S. companies . . . are experiencing cyber intrusion activity against electronic repositories containing trade secret information. Trade secret theft threatens American businesses, undermines national security, and places the security of the U.S. economy in jeopardy.”

The Obama Administration . . . is invoking the enforcement of trade secrets under U.S. and international law as a tool of statecraft to combat industrial espionage.

With the Strategy, the Administration proposed a multifaceted approach to address the situation, consisting of the following principal elements:

1. Focus diplomatic efforts to protect trade secrets overseas. The Strategy seeks to respond to the international aspects of the problem through a coordinated effort by the Departments of Commerce, Defense, Justice, Homeland Security, State, Treasury and the U.S. Trade Representative. Significantly, the Strategy commits the Administration to continue to apply diplomatic pressure on foreign governments where there are regular incidents of trade secret theft. In addition, the Administration will utilize trade policy tools to increase enforcement against trade secret theft; seek international law enforcement cooperation; build international training capacity; and work with global organizations to strengthen international enforcement efforts.

2. Promote voluntary best practices by private industry to protect trade secrets. The Strategy calls on industries and trade associations — consistent with antitrust laws — to develop best practices to protect trade secrets. These include developing policies relating to research and development compartmentalization, information and physical security and human resources practices. The U.S. Intellectual Property Enforcement Coordinator, in concert with other government agencies, will help to facilitate these activities.

3. Enhance domestic law enforcement operations. The Strategy directs the Department of Justice and FBI to continue to prioritize the enforcement of the EEA. The Office of the Director of National Intelligence will coordinate efforts within the intelligence community to
inform the private sector how best to combat trade secret theft, and will share threat warning and awareness information with the private sector.

4. Improve domestic legislation. The Strategy indicates the Administration’s intent to continue to ensure that U.S. laws in this area are as effective as possible. To this end, the Administration directed federal agencies to review relevant existing federal intellectual property laws in March 2011. This led to recommendations that the maximum sentence for economic espionage be increased from 15 to 20 years, and that the U.S. Sentencing Commission also increase the guideline ranges for economic espionage.

5. Promote public awareness and stakeholder outreach. Acting through the Department of Commerce, the Patent and Trademark Office, the International Trade Administration and the FBI, the Administration will encourage all stakeholders to be aware of the potential adverse effects of trade secret misappropriation and to take appropriate actions to combat it. ☞