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Delaware Court of Chancery Upholds the Facial Validity of Organic Exclusive Forum Provisions, But Future "As-Applied" Challenges Could be a Different Matter

In June 2013 Chancellor Strine of the Delaware Court of Chancery (Delaware Chancery Court), in *Boilermakers Local 154 Retirement Fund v. Chevron Corporation* and *IClub Investment Partnership v. FedEx Corporation*[1], significantly advanced the ball in an effort to combat the burgeoning costs, company distraction and potentially inconsistent judicial outcomes when Delaware corporations are forced to defend lawsuits commenced in multiple jurisdictions arising out of the same set of facts, circumstances and transactions. These multi-forum actions typically involve redundant allegations and theories of law, and often seek duplicative forms of legal and equitable relief.

In his judgment on the pleadings, Chancellor Strine, on both a statutory and contractual basis, upheld the facial validity of exclusive forum selection bylaws ("EFBs") adopted unilaterally by the respective Boards of Chevron Corporation ("Chevron") and FedEx Corporation ("FedEx"). In doing so, he likened the authority of Delaware directors to adopt EFBs to the well-settled authority of Delaware directors to unilaterally adopt a stockholder rights plan ("poison pill") as a reasonable and proportionate response to a validly perceived threat to corporate policy and effectiveness. The

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threats in this context instead being the adverse consequences and potential damage to a Delaware corporation of defending redundant litigation (the costs of which ultimately are borne by the corporation's stockholders) and the possibility that a non-Delaware court may misconstrue or improperly apply Delaware statutory and common law to achieve an unfair or inequitable judicial result for the corporation.

The instances of multi-forum litigation promptly following the public announcement of an extraordinary corporate transaction (such as a merger, business combination, recapitalization or corporate restructuring transaction) have increased substantially in recent years. These parallel actions can be rather difficult to "stay" and it can take considerable time to consolidate the action brought outside the jurisdiction of incorporation with the "home court" action (especially if the home court action was not commenced first-in-time). Moreover, strike suits brought in non-Delaware courts against Delaware corporations have surged in the wake of the Dodd-Frank Act alleging breach of fiduciary duty and materially misleading (proxy statement) disclosure in connection with say-on-pay advisory votes and proposed amendments to equity compensation and option plans for which stockholder approval is sought at an annual meeting. In response to these litigation trends, various iterations of EFBs (and to a lesser extent, exclusive forum charter provisions) have been adopted to date by many S&P 500 and Russell 2000 corporations.

The EFBs adopted by Chevron and FedEx designated Delaware (their jurisdiction of incorporation) as the exclusive forum for stockholder derivative lawsuits, fiduciary duty lawsuits, lawsuits involving interpretations of the Delaware General Corporation Law ("DGCL"), and lawsuits implicating Delaware's internal affairs doctrine.

In response to plaintiffs' challenge to the statutory validity of Chevron's and FedEx's EFBs, Chancellor Strine concluded that the Boards' unilateral adoption thereof was well within the directors' statutory authority. He noted that for the plaintiffs' statutory challenge to have merit, the EFBs would need to fall outside the ambit of Section 109(b) of the DGCL and constitute an improper subject matter for a corporation's bylaws. Chancellor Strine cited to the text of Section 109(b), which expressly provides that the bylaws of a Delaware corporation may "contain any provision, not inconsistent with law or with the [corporation's] certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." He especially noted that the EFBs were procedural in nature and addressed only - - "where" - - certain enumerated types of litigation must be brought, not - - "whether" - - the enumerated categories of litigation (or, for that matter, any other type of litigation) can be brought. Chevron's and FedEx's EFB's did not seek to limit the nature of the claims or theories of law that can be asserted or the remedies available in any such litigation.

Chancellor Strine was not persuaded by plaintiffs' "lack of privity" argument that, as a contractual matter, the EFBs should not be enforceable against stockholders who did not have an opportunity to affirmatively vote for their adoption and that the stockholders acquired a preexisting, vested interest in the bylaws that were in effect at the time of their investment. He noted that EFBs are analogous to the forum selection covenants of other contracts and that, consistent with Section 109(b) of the DGCL, Chevron's and FedEx's certificate of incorporation expressly authorized the Board of each corporation to adopt bylaws unilaterally (i.e., without stockholder approval). Therefore, he reasoned that whenever a stockholder invests in a corporation whose certificate of incorporation permits the Board to adopt bylaws unilaterally, such stockholder has been put on notice that the bylaws can be amended by the Board at any time and from time to time without advance notice and without first seeking stockholder approval.

Of course, unlike a charter amendment (which requires both Board approval and subsequent stockholder adoption), bylaw provisions are subject to repeal or amendment by unilateral stockholder action.

The Chevron and FedEx decisions do not preclude, and will not necessarily deter, future litigation (in Delaware and elsewhere) alleging that the adoption, use or application of EFBs in a particular circumstance is unreasonable, unfair or inequitable. It is entirely possible that the application of EFB's in a particular context could constitute a breach of the directors' fiduciary duty. Indeed, Chancellor Strine cautioned that his decision addressed only the facial validity of the EFBs and that the enforceability thereof in any future action or dispute would be subject to judicial review on a case-by-case basis, under the reasonableness standard applicable to "choice of forum" clauses announced by the U.S. Supreme Court in *The Bremen v. Zapata Off-Shore Co*.[2]

It is not entirely certain how the Delaware Supreme Court may rule if and when it addresses a challenge to either the statutory or contractual validity, or the application, of EFBs similar to those adopted by Chevron and FedEx. An appeal taken by the plaintiffs in the Chevron and FedEx litigations was voluntarily withdrawn in October 2013, ultimately depriving the Delaware Supreme Court of an opportunity to address the Delaware Chancery Court's decision. However, Chancellor Strine's decision and analyses was likely drawn sufficiently narrow (i.e., facial validity) to be affirmed by the Delaware Supreme Court and the plaintiffs presumably decided not to risk an adverse precedent (affirmation) of the Delaware Supreme Court that could be more difficult to sidestep in a future challenge to the EFBs brought by the plaintiffs in a non-Delaware forum. Notwithstanding the overwhelming national respect for decisions of the Delaware Chancery Court, a ruling on this subject by the Delaware Supreme Court - - the ultimate arbiter of Delaware law - - could likely have a more powerful res judicata impact. It is also possible (although, to date, there has been no announced legislative initiative) that the Delaware General Assembly could pick up the pen and weigh in on the subject in the future.

Most recently, in *Edgen Group Inc. v. Genoud, C.A.* No. 9055-VCL (Del. Ch. Nov. 5, 2013), Vice Chancellor Laster (in a transcript decision on plaintiff's motions for a temporary restraining order (TRO) and expedited proceedings) declined to grant Edgen's application to temporarily enjoin a breach of fiduciary duty lawsuit commenced in a Louisiana state court against Edgen and its directors. Edgen previously had adopted at the time of its IPO, in its certificate of incorporation, an exclusive forum provision for actions involving breach of fiduciary duty, derivative actions, interpretations of the DGCL and Delaware's internal affairs doctrine. Edgen, a Delaware corporation headquartered in Louisiana, recently had announced that it entered into an agreement to sell Edgen to Sumitomo Corporation of America in an all-cash merger transaction and plaintiff-Genoud challenged the transaction in Louisiana. After Edgen filed a motion requesting the Louisiana state court to dismiss or stay the action (but before the Louisiana court ruled on Edgen's motion), Edgen petitioned the Delaware Chancery Court to temporarily restrain the Louisiana action on the basis that such litigation was precluded by Edgen's charter provision. Edgen argued, among other things, that it would suffer irreparable harm if it were forced to litigate the validity of the exclusive forum provision outside of Delaware.

At an expedited hearing on Edgen's motion for a TRO, Vice Chancellor Laster found that there was a reasonable probability that Edgen would successfully establish on the merits that plaintiff-Genoud breached Edgen's exclusive forum provision and that Edgen would indeed suffer irreparable harm if the validity and enforceability thereof was not enforced by the Louisiana state court. Nevertheless, the Vice Chancellor declined to grant Edgen's application for the TRO because (citing principles of interstate comity) because he believed it was more appropriate for the Louisiana state court to first rule on the enforceability of Edgen's charter provision than for the Delaware Chancery Court to intervene in an anti-

suit injunction action at that stage of the pending Louisiana litigation. In addition, Vice Chancellor Laster observed that, although not necessarily dispositive of whether the Delaware Chancery Court had personal jurisdiction over Genoud, there was a triable issue as to whether such jurisdiction existed due to the absence of an express "consent to personal jurisdiction" clause in Edgen's exclusive forum charter provision. The Vice Chancellor referenced the fact that Edgen's charter provision itself illuminated this issue by expressly stating that the exclusive forum provision was "subject to [the Delaware Chancery Court] having personal jurisdiction over the indispensable parties named as defendants." It nonetheless remains unclear after the Edgen decision whether the inclusion of an express consent to jurisdiction clause is an important practical requirement when bringing an anti-suit injunction case (or alternative action) in the Delaware Chancery Court. Accordingly, the Vice Chancellor concluded that the "balance of the equities" (one of the three tests, together with the aforementioned "irreparable harm" and substantial likelihood of success" tests, used by the Delaware courts when determining whether an injunction should be issued) did not weigh in favor of granting Edgen's motion for a TRO.

While Vice Chancellor Laster's decision in Edgen certainly reinforces Chancellor Strine's decisions in Chevron and FedEx that properly tailored exclusive forum charter or bylaw provisions are facially valid (as a statutory and contractual matter), the Vice Chancellor suggested that as a procedural matter Edgen should have first waited for the Louisiana state court to rule on Edgen's motion to dismiss or stay Genoud's breach of fiduciary duty action before requesting the Delaware Chancery Court to intervene and hear Edgen's application for an anti-suit TRO. As of this writing the Louisiana state court has scheduled a hearing on Edgen's motion to dismiss in mid-December 2013.

The Vice Chancellor specifically noted that Edgen's anti-suit injunction strategy was the most aggressive procedural path to take (vis a vis other procedural options available to Edgen) and that Edgen's approach raised significant issues of interstate comity and judicial deference. In dicta, he offered (without detailing a precise roadmap) that, alternatively, Edgen might have sought to obtain a default judgment in the Delaware Chancery Court (to the extent Genoud failed to appear in the selected Delaware forum) and have that judgment entered by the Louisiana state court on principles of res judicata. Vice Chancellor Laster did note, however, that there nevertheless may be circumstances in a future case where it would be appropriate to file, in the first instance, a motion for an anti-suit injunction in the Delaware Chancery Court. Perhaps, a future decision of the Delaware Chancery Court might further clarify the procedural alternatives available to a Delaware corporation when seeking enforcement in the Delaware Chancery Court of an organic exclusive forum provision.

As is evident from the Chevron, FedEx and Edgen decisions, the adoption by Delaware corporations and the facial validity of organic exclusive forum provisions by no means puts to bed all of the issues that may arise with respect to the willingness of litigants and of non-Delaware courts to respect the facial validity of such provisions, or whether the use of such provisions in a particular context ultimately would be upheld as fair, reasonable and equitable in an "as-applied" challenge brought in a Delaware or non-Delaware court.

Indeed, much like the aforementioned analogy drawn by the Delaware Chancery Court to the validity of the adoption of a poison pill, a challenge outside of Delaware to the facial validity of a properly drafted exclusive forum provision may present less of an issue than actions challenging the use thereof in a particular set of fact and circumstances. In the latter context plaintiffs almost certainly would challenge the enforceability and use of such provisions by alleging a breach of the directors' fiduciary duty and by seeking to engage the court in a substantive review of the directors' duties of care and loyalty, in addition to a determination of the overall reasonableness and fairness of such provisions and of whether the

provisions were applied equitably in a fact-specific setting. The fiduciary analyses could be more fact-intensive where the exclusive forum clause is permissive or elective -- where the provision expressly permits the corporation to consent in writing to the selection of an alternate, non-designated forum -- as opposed to a mandatory (more self-executing) exclusive forum provision.

To be sure, the adoption of an organic exclusive forum provision (of the type facially validated, to date, by the Delaware Chancery Court) is not a "one-size-fits-all" exercise for every Delaware corporation. As with all significant corporate decisions, and especially those involving organic change, corporate governance policy and extraordinary transactions, context is key and the decision should be made by the Board on a well-informed basis (with the best available information requested and reviewed by the directors and with a well-documented record of the Board's deliberative process) in light of all prevailing facts and circumstances. To determine whether the adoption of an organic exclusive forum provision is fair to and in the best interests of the corporation and its stockholders, directors should, at a minimum, carefully examine with management and legal counsel the relative corporate merits and risks involved, and pay particular attention to the corporation's past history with multi-forum fiduciary duty and derivative actions (and litigation involving Delaware internal affairs matters), the composition and institutional concentration of the corporation's stockholder base (and the corporation's relationship with significant investors), the corporation's governance scorecard, and whether the corporation has principal offices and significant operations in jurisdictions outside of Delaware (to help assess whether there is a real world probability of future multi-forum or non-Delaware litigation).

As part of any Board decision on these matters it is also important to take the temperature and review the historical voting patterns and, if available, published investment guidelines of the corporation's institutional stockholders. A fair number of the largest institutional investors (e.g., traditional asset managers, index funds and non-activist funds) may tend to understand the cost- efficiencies and other advantages of exclusive forum requirements, whereas other institutional investors may perceive such requirements as an attempt to disenfranchise stockholders and eliminate substantive rights. Institutional Shareholder Services ("ISS") announced earlier this year a case-by-case review policy with respect to exclusive forum proposals, taking into account whether the corporation has suffered past material harm in a litigation outside the corporation's jurisdiction of incorporation and whether the corporation follows good corporate governance practices (i.e., according to ISS: no classified Board, no "poison pill" in effect that was not approved by stockholders, and a majority voting standard for the election of directors). Glass-Lewis & Co. also has announced a case-by-review policy, but noted it will recommend that stockholders vote against any proposal to adopt an organic exclusive forum requirement unless the corporation provides a compelling argument why such requirement would directly benefit stockholders, the corporation maintains a strong record of good corporate governance practices, and the corporation provides evidence that it has been subject to an abusive legal process in litigation outside the corporation' state of incorporation.

In view of the foregoing, we continue to recommend that Delaware corporations should carefully consider the appropriateness of adopting organic exclusive forum selection provisions to mitigate the threat of having to concurrently defend against parallel litigation in multiple jurisdictions and to increase the likelihood that only a Delaware court will adjudicate future breach of fiduciary duty disputes, derivative actions, litigation implicating Delaware's internal affairs doctrine and actions involving the interpretation of Delaware statutory and common law as it relates to the corporation. If deemed fair to and in the best interests of the corporation and its stockholders under all of the circumstances, adoption by means of bylaw amendment can be implemented exclusively by the Board, subject to the repeal and

amendment thereof by subsequent stockholder action. Implementation by means of charter amendment would require both Board approval and subsequent adoption by the requisite vote of the corporation's stockholders. Interestingly (although stockholder approval would be required in the first instance), it would seem that the charter method ultimately is the less stockholder-friendly (less flexible) approach because a subsequent stockholder proposal to amend or repeal the charter provision would merely be precatory (i.e., advisory and not binding) in nature. As a practical matter, when used, the charter method is overwhelmingly used at the time of a corporation's formation or initial public offering.

We are continuing to monitor the adoption and use of organic exclusive forum provisions in jurisdictions outside of Delaware. Such non-Delaware activity has been less robust (depending in part on the corporation law statutes of the state in question and whether the courts of the relevant state review and find persuasive decisions of the Delaware Chancery Court), but to date a number of significant Maryland corporations and corporations in other non-Delaware jurisdictions have adopted various iterations of Chevron's and FedEx's EFBs.

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[1] C.A. No. 7220-CS (Del. Ch. June 25, 2013); C.A. No. 7238-CS (Del. Ch. June 25, 2013).
[2] 407 U.S. 1 (1972).

Maintaining Attorney-Client Privilege in a Merger in the *Wake of Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP*

On November 15, 2013, the Delaware Court of Chancery held that the surviving corporation in a merger owns and controls the seller's attorney-client privilege, including pre-merger attorney-client communications regarding the negotiation of the merger, absent an express carve-out in the merger agreement.[1]

The plaintiffs (the Buyers) in *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP* (*Great Hill*) acquired Plimus, Inc., a California corporation (Plimus), in September 2011 through a merger in which Plimus was the surviving corporation. A year later the Buyers brought suit in the Delaware Court of Chancery against the former stockholders and representatives of Plimus (the Sellers), alleging that the Buyers were fraudulently induced to acquire Plimus.

After bringing the suit, the Buyers notified the Sellers that among the files on Plimus' computer systems that the Buyers had obtained in the merger were communications between the Sellers and Plimus' former legal counsel regarding the merger. The Sellers "asserted the attorney-client privilege over those communications on the ground that [they], and not the surviving corporation, retained control of the attorney-client privilege that belonged to Plimus for communications regarding the negotiation of the merger agreement."[2] Specifically, the Sellers argued that "all privileges" as used in Section 259 of the General Corporation Law of the State of Delaware (the DGCL) did not encompass the attorney-client privilege, which privilege was maintained by the Sellers.[3]

In response, the Buyers argued that Section 259 of the DGCL – which provides that upon a merger, "all property, rights, privileges, powers and franchises, and all and every other interest shall be thereafter as effectually the property of the surviving or resulting corporation" – controlled and caused Plimus' attorney-client privilege to pass to the surviving corporation.[4] Applying well established rules of statutory construction, the Court agreed. According to the Court, Section 259 of the DGCL "uses the broadest possible terms to make sure that 'all' assets of any kind belong to the surviving corporation after a merger,"[5] such that "*all* means *all*" and includes the attorney-client privilege.

Express Contractual Carve-Out

The Court indicated that sellers wishing to avoid transferring the attorney-client privilege along with all of their other assets in a merger "can – and have – negotiated special contractual agreements to protect themselves…."[6] According to the Court, "the answer to any parties worried about facing this predicament in the future is to use their contractual freedom in the manner shown in prior deals to exclude from the transferred assets the attorney-client communications they wish to retain as their own."[7] "Absent such an express carve out, [however], the privilege over all pre-merger communications – including those relating to the negotiation of the merger itself – passe[s] to the surviving corporation in the merger, by plain operation of clear Delaware statutory law under § 259 of the DGCL."[8]

Waiver of the Attorney-Client Privilege

An express provision of the merger agreement carving out the seller's attorney-client privilege from the assets of the seller transferred in the merger is an important first step in retaining the seller's attorney-client privilege. Including a carve-out in the merger agreement, however, may not be enough to preserve

the attorney-client privilege. Having decided that the attorney-client privilege transferred to the surviving corporation in the merger, the Court in *Great Hill* did not reach the question of whether the Sellers waived the attorney-client privilege by failing to remove the privileged communications from Plimus' computer systems prior to the merger. The Court hinted, however, that the Sellers may encounter difficulty in arguing that they had not waived the privilege, "through [their] lengthy [(a full year after the merger)] failure to take any reasonable steps to ensure the Buyer did not have access to the allegedly privileged communications."[9]

As a practical matter, preserving the attorney-client privilege can be difficult in the context of a merger. E-mail communications often intensify in the days leading up to both the execution of the merger agreement and the closing of the merger. As deadlines approach and last-minute issues arise, hasty e-mails are too often typed on cell phones and PDA's and dispersed to a wide "working group." *Great Hill* stands as an important reminder of the discipline and care required, not just in drafting the relevant provisions of the merger agreement, but in protecting the seller's attorney-client privilege throughout the merger process.

There are several steps that parties can take to help avoid waiving the attorney-client privilege. For example, counsel should consider who the client is – the company or certain principal stockholders – and therefore to whom the attorney-client privilege belongs, and make sure that an engagement letter is entered into with the correct party or parties and that communications counsel intends to be given the protection of the attorney-client privilege are made only with the "client."[10] Principal stockholders who have their own counsel and who also serve as directors, officers or employees of the seller, should consider setting up personal e-mail accounts to communicate with their counsel on the merger or sale negotiations rather than using company e-mail accounts.[11]

Stop - Think - Send

There are usually dozens of issues to consider during the course of a merger or other sale process. Nevertheless, parties to a merger or other sale process should remain aware of the risks to the attorney-client privilege, including negotiating the relevant provisions in the agreement and segregating and/or removing the privileged e-mails and files from the seller's computer systems. Before clicking "send" (or potentially even worse "send all") the seller and its counsel are well advised to take a moment to stop and re-read each e-mail and check its recipients for possible attorney-client privilege issues.

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[1] *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP*, __ A.2d __, 2013 WL 6037329 (Del. Ch. Nov. 15, 2013).
[2] Id. at *1.
[3] Id. at *1.
[4] The merger agreement in *Great Hill* stated that "[t]he Merger shall have the effects set forth in this Agreement and in the applicable provisions of the DGCL and the [California General Corporation Law ('CGCL'))." Id. at *1 n. 1. Although Plimus was a California corporation and the buyer was a Delaware corporation, the merger agreement stated that "[a]ll disputes, controversies, issues and questions concerning the construction, validity, interpretation and enforceability of this Agreement … shall be governed by and construed in accordance with the Laws of the State of Delaware …." Id. The Buyer represented to the Court that the CGCL "effectively follows" the DGCL, and the Sellers failed to argue otherwise. Id.
[5] Id. at *1.
[6] Id. at *3. In this regard, the Court cited to *Postorivo v. AG Paintball Holdings, Inc.,* 2008 WL 343856 (Del. Ch. Feb. 7, 2008), in which a New York law governed asset purchase agreement expressly excluded from the assets transferred to the buyer, "all rights of the Seller under th[e] [Asset Purchase] Agreement and all other documentation relating to the transactions contemplated [t]hereby." *Great Hill*, at *3 n. 27.
[7] Id. at *4.
[8] Id.
[9] Id. at *4.
[10] *Ryan v. Gifford*, 2007 WL 4259557 (Del. Ch. Nov. 30, 2007) (finding that the special committee's attorney-client privilege was waived by the presentment of its report to the full board of directors, which included individual directors accused of wrong-doing and their counsel); see also *Ryan v. Gifford*, 2008 WL 43699, *5 (Del. Ch. Jan. 2, 2008) (refusing an interlocutory appeal on the November 30, 2007 decision of the Court).
[11] See In *re Information Management Services, Inc*., 2013 WL 4772670 (Del. Ch. Sept. 5, 2013) (finding that senior executives waived the attorney-client privilege with respect to communications with their personal attorneys made through their work emails).

Amendments to Delaware Limited Liability Company Act Confirm that Managing Members and Managers of Delaware Limited Liability Companies Owe Default Fiduciary Duties

Amendments to the Delaware Limited Liability Company Act (the LLC Act) confirming that managing members and managers of Delaware limited liability companies owe default fiduciary duties took effect in August. These amendments came on the heels of several court decisions examining whether a managing member or a manager of a Delaware limited liability company owes default fiduciary duties to the company's members, absent clear contractual provisions defining applicable fiduciary standards or adequately eliminating these duties.

Prior to the amendments, according to the Delaware Supreme Court, the LLC Act did not expressly address whether the fiduciary duties of loyalty and care imposed on corporate directors applied to managing members or managers of Delaware limited liability companies. Two recent Delaware Court of Chancery decisions, *Auriga Capital Corporation v. Gatz Properties, LLC*[1] *(Auriga)* and *Feeley v. NHAOGC, LLC*[2], reviewed the applicable historical case law and the LLC Act and found that default fiduciary duties applied to managing members and managers of limited liability companies. As discussed in the last edition of the GT M&A Report, in the appellate decision in the *Auriga* case, however, the Delaware Supreme Court refused to express any view on whether default fiduciary duties applied.[3] The Supreme Court made clear, however, that it viewed it as an open issue about which reasonable minds could differ and urged the "organs of the Bar" and the Delaware General Assembly to resolve the statutory ambiguity.[4]

The changes to the LLC Act enacted in August responded to the Supreme Court's call for greater statutory clarity by amending Section 18-1104 of the LLC Act to insert the underlined text below:

"In any case not provided for in this chapter, the rules of law and equity, including <u>the rules of law and equity relating to fiduciary duties and</u> the law merchant, shall govern."

The commentary accompanying the amendments confirmed that "in some circumstances fiduciary duties not explicitly provided for in the limited liability company agreement apply. For example, a manager of a manager-managed limited liability company would ordinarily have fiduciary duties even in the absence of a provision in the limited liability company agreement establishing such duties."

Managing members of Delaware limited liability companies have the same default fiduciary duties. Nevertheless, Section 18-1101(c) of the LLC Act still provides that fiduciary duties may be expanded, restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing. Through careful drafting of a limited liability company agreement, parties are still free to define their own fiduciary relationships or eliminate fiduciary duties altogether, subject to the foregoing.

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[1] *Auriga Capital Corporation v. Gatz Properties, LLC*, Del. Ch., C.A. 4390-CS, Strine, C. (January 27, 2012).
[2] *Feeley v. NHAOGC, LLC*, Del. Ch., C.A. 7304-VCL, Laster, V.C. (November 28, 2012).
[3] *Gatz Properties, LLC v. Auriga Capital Corporation*, Del. Supr., No. 148, 2012, Steele, C.J. (November 7, 2012), at 26.
[4] *Id.*, at 27.

Bilateral PRC/US Investment - Is 2014 the Year?

A New Year – A New Direction

The Paltry Purse

Why China buys United States Treasury bonds and not United States companies has befuddled deal-makers ever since China crossed the trillion dollar mark in foreign exchange reserves. One would expect that the world's largest economy and the world's second largest economy would each be major investors in the other. In 2010, however, when China's foreign investment abroad jumped by 20%, the United States ranked 7th as a destination for China's investment dollars. Admittedly the top three countries, Hong Kong, the British Virgin Islands and the Cayman Islands, may serve as a half-way point for outbound funds and so disguise the ultimate destination of the investment; but since none of these countries has a tax treaty with the United States, it is unlikely that they serve as pass-through corporate vehicles for investment in America. And while the United States might make excuses for coming behind these three former or existing British colonies, the United States also ranked in 2010 behind Luxembourg, Australia, and Sweden, and was only slightly ahead of Canada.[1]

Times are changing, however. There has been a rapid increase in the amount and rate of investment by Chinese companies in the United States in the last three years. At the end of the second quarter of 2013, the United States with cumulative investment from China of $57.8 billion ranked only behind Australia with $59.2 billion.[2] With the September 2013 closing of the Shuanghui International acquisition of pork producer, Smithfield, for $7.1 billion and several large real estate investments, the United States took the lead as the preferred destination for China investment.[3] Included within the United States numbers during the first nine months of the year is $12.2 billion invested in 55 Greenfield projects and acquisitions in the United States.[4]

Investment flows in the opposite direction, that is, from the United States to China, are at a disappointing, though historically consistent, low level and do not appear to have experienced the bounce that Chinese investment incurred so recently. The United States only managed to rank 6th as an investor in 2011, the most recent year for which official figures are available; a position it also enjoys on a cumulative basis for all investment in China in the past decade.[5]

The Year of the Horse

The year of the horse is supposed to represent the steadfastness and diligence of the Chinese people in overcoming obstacles. The recent rise in Chinese investment in the United States may indicate that Chinese investors have now learned how to overcome the difficult bureaucracy that limits their outbound investment. Also, China's promised reforms to come out of the Third Plenum to be held in November 2014 may again open the door to American companies to invest in China. If so, the Year of the Horse may be the first time for substantial Chinese investment in the United States and a renewed investment appetite for American companies to go to China.

It is quite possible that there is already substantially more investment in the United States than is reported in the official statistics. For small scale investments, Chinese entrepreneurs seem to simply ignore China's rules about obtaining permission to invest abroad and so their investment may not be picked up by the Bureau of Statistics. And since the acquisition company is most likely a newly

incorporated United States company owned by one or more individuals, which then receives acquisition funding from a corporation in Hong Kong or the BVI, the Department of Commerce may not have statistics on the purchase.

Indicative of the fact that Chinese acquisitions may be greater than the statistics report is the success of the Detroit Chinese Business Association (DCBA). The DCBA started in 1998 as a small business club, and now has more than 1,500 members and a wide range of partnerships with local government agencies, business associations and other community organizations.[6] Many of its members are suppliers to the automobile industry, who purchased small factories in the Midwest and are now allocating production between factories in China and those in the United States.

Another indication that investment in the United States by Chinese nationals may be greater than the statistics is the number of advertisements for EB-5 visa program lawyers and consultants in Mainland Chinese newspapers. The EB-5 program, known as the "investor visa program", grants to investors that create more than 10 jobs in the United States, a permanent resident visa for each member of the investor's family. It is unlikely that the Bureau of Statistics in China would know of such investors, since the required amount of the investment is only one million dollars (or $500,000 in depressed areas), well below national reporting requirements. Moreover, since each Chinese individual may outwardly remit $50,000 without government scrutiny or approval, groups of friends are formed each year to wire the full amount to Hong Kong, where it is combined into the investor's account, and then invested to obtain the visa. The following year, another friend benefits. And while the Department of Homeland Security's Citizen and Immigration Services estimates that the program, which was created by Congress in 1990, as of June 30, 2011 has resulted in more than $1.5 billion in capital investments and created at least 34,000 jobs, there is no breakdown by applicant nationality. The number of investor applications, however, has doubled in the past three years and much of this increased interest in the program seems to be from China.[7]

Continuing Quandary

Even though the statistics may be incomplete, nevertheless the two-way exchange of investment is clearly less than one would expect for the world's two largest economies.

Why is the money missing? While there may be many reasons for the poor state of bilateral China-U.S. investments, three of the contributing factors are the law, the attitudes, and the politics.

The Law as to Outbound Investments

China's Outbound Foreign Investment Regime

With foreign exchange reserves of more than $3.66 trillion as of the end of September 2013,[8] China should be acquiring the rest of the world; instead, companies engaging in outbound investment have appeared hesitant, confused, and amateurish.

There have been several well-publicized success stories, such as Lenovo's acquisition of IBM's notebook business, Zhejiang Geely's acquisition in 2010 of Ford Motor Company's Volvo brand, and Pacific Century's acquisition of the Saginaw division of General Motors Corporation. There also have been equally well-publicized failures, such as CNOOC's aborted attempt to acquire Unocal Oil Company in 2005

and Sichuan Tengzhong Heavy Industrial Machinery Co., Ltd.'s failed attempt to acquire General Motors' Hummer brand in 2010.

One reason that the world's largest holder of foreign exchange reserves seems incapable of making significant foreign acquisitions stems from China's own system of regulating foreign merger and acquisition activity. While some unsuccessful cases are the result of political opposition in the target country, such as the Huawei proposed acquisition of 3Com, both the scarcity of acquisition attempts and the limited number of success stories is due largely to the domestic throttle being held tightly in the closed position. The "Go Abroad" program exists in name and propaganda, but until quite recently it should have been re-labeled as the "Go Abroad with Our Permission" program.

One of the striking features of the recent increase in China acquisitions in the United States is that private or semi-private Chinese companies are leading the way, while large State-owned enterprises are no longer the principal investors. The Shuanghui-Smithfield acquisition makes private concerns the largest investors in 2013 and last year, private firms for the first time accounted for more than half of the total deal value, largely due to Wanda's acquisition of AMC theaters. According to a study by the Rhodium Group, during the first nine months of 2013, private firms were the acquirers in 84% of the deals and the total investment of such private deals was 74% of the total.

Regulating the World

It would not profit the objective of this article or please the reader's patience to provide an overly dense description of China's regulation of outbound foreign investment. China regulates investment abroad in much the same manner that it regulates inbound investment. The National Development and Reform Commission (NDRC), the former State Planning Commission, or its local provincial affiliates must review and approve outbound investments. Formerly any resource investment above $30 million and any non-resource investment above $10 million had to go to the national level NDRC for approval. Although the respective amounts were raised in 2011 to $300 million for resource projects and $100 million for non-resource projects, an approval from the planning authorities is still required both before the Chinese buyer begins serious substantive negotiations and after the buyer has completed those negotiations and wishes to implement the acquisition.[9]

While the NDRC applies 'state planners' perspective to the outbound foreign investment approval process, MOFCOM, in coordination with the Ministry of Foreign Affairs, reviews and must approve the documents as to legal content and for compliance with China's foreign affairs policies.[10]

Finally, since China's currency is not freely convertible, the State Administration of Foreign Exchange (SAFE) needs to register outbound investment projects so that required conversions of currency may be made when capital crosses the border.[11]

For those familiar with China's inbound investment regime, the outbound system will seem familiar. All outgoing investment, just as all incoming investment, requires multiple government approvals. And while, just as with the inbound investment program, China has recently raised the approval levels of the provincial planning and foreign investment authorities, the relaxation is not a lifting of controls, but an attempt to makes those controls more efficient.

Does It Work?

It is probably too early to say whether China's system for regulating outbound investment works. It may well be that the complicated bureaucracy for major outbound investments avoids major mistakes and losses. The general impression to date, however, is that Chinese companies entering into international merger and acquisition activities are unsure of themselves, slow to react, and unlikely to conclude the deal. This general impression is due in part to the fact that the approval system hamstrings the Chinese negotiator. He must learn about the target company in sufficient detail to file the preliminary application with the NDRC, but is not supposed to sign a confidentiality agreement or other substantive document without the required NDRC Confirmation Letter.

China's strict, watch-dog approach to inbound investment projects has been successful, since everyone wanting to enter the Gates of the Forbidden City must pass through the emperor's guard. But when Chinese companies go abroad and compete in free markets for acquisitions, there is seldom enough time to report home and allow the state planning approval process to work. One explanation for why private companies are becoming the investors in America, as opposed to State-owned enterprises, is that the private entrepreneur is more attuned to making the China State Planning system and the American free market work together. Where investment negotiations tend to be government to government, such as Russia, South America, Sub-Sahara Africa, and the Arab World, the State-owned enterprise continues to dominate.

Must It Be This Way?

Since the problem is obvious, why not fix it by allowing companies with capital to invest abroad as they see fit? To do so would effectively mean that China had given up its capital controls and made the Renminbi a capital account convertible currency. When China is willing to float the RMB, Chinese buyers will swamp the M&A markets. Until that time, and so long as other competitive bidders are in the market, it is likely that China acquisitions will focus on those businesses with direct and immediate connections to the China market such as resource transactions and the purchase of brand names where the goods are now made in China. Private companies, which are used to avoiding or skirting foreign exchange controls, will be the principal investors in the United States.

The Law as to Inbound Investments

Investing in China has always been about getting the necessary required approvals. And, although this process is very time consuming, since it applies to everyone, an investor either accepts the process or does not invest. The attractiveness of the Chinese market has brought a great many investors to the doors of the approval authorities. In recent years, however, as China has modernized its legal system, it has also made the investment process far more cumbersome.

While there are many examples of the increased complexity of investing in China, there are two recent ones of considerable importance: the Anti-Monopoly Law and the National Security Review system. Since all investments have been subject to an approval regime and no reason needed to be given for a refusal, the complexity of the new laws seems unwarranted. If China were to reform its foreign direct investment regime to provide that all investors have a legal right to invest so long as they abide with certain specified

laws, then the new complexity would be justified, since an open door to investment should have protections for monopolistic conduct and national security.

The Anti-Monopoly Law

There are a number of open questions about the Anti-Monopoly Law.[12] First, is it a law that only applies to foreigners? The curious language of Article 7 of the law, which exempts the State-owned sector from the law's prohibitions, appears to create not only an uneven playing field, but two separate fields:

> With respect to the industries which are under the control of by the State-owned economic sector and have a bearing on the lifeline of the national economy or national security and the industries which exercise monopoly over the production and sale of certain commodities according to law, the State shall protect the lawful business operations of undertakings in these industries, and shall, in accordance with law, supervise and regulate their business operations and the prices of the commodities and services provided by them, in order to protect the consumers' interests and facilitate technological advance. The undertakings mentioned in the preceding paragraph shall do business according to law, be honest, faithful and strictly self-disciplined, and subject themselves to public supervision, and they shall not harm the consumers' interests by taking advantage of their position of control or their monopolistic production and sale of certain commodities. [13]

Apparently the State will protect the public against State-owned enterprises, while the NDRC, SAIC, and MOFCOM, which are the three departments that jointly compose the Anti-Monopoly Enforcement Authority, will protect China against the foreigner. To date, only foreign related acquisitions have been subject to MOFCOM review as to whether such a concentration would reduce competition. While far more domestic acquisitions take place, domestic companies do not file reports and data on their merger, and proceed without any MOFCOM interference.

While clearly all acquisitions or concentrations should be subject to rules preventing a decrease in competition, the Anti-Monopoly Law appears to be having the effect of enhancing an offer from a domestic buyer over a foreign one. If only the foreign investor need submit the detailed documentation required to establish either that its proposed acquisition does not fall under the law's purview or, if it does, that competition will not be harmed, then clearly the acquisition target will be able to sell itself to a domestic buyer much faster than to a foreign one.

Just as China's outbound approval process makes Chinese bidders in America slower than their American competitors when faced with a competitive purchase situation, the application of the Anti-Monopoly Law to all acquisitions of domestic enterprises by foreign companies, assuming the applicable thresholds are met, favors the domestic buyer over the foreign buyer.

National Security Review

Article 31 of the Anti-Monopoly Law provides that for those acquisitions of domestic enterprises by foreign investors where national security is involved, national security investigations shall be conducted pursuant to relevant national regulations. Neither national security nor the relevant national regulations were specified in the Anti-Monopoly Law.

This confused state existed until March of 2011 when the State Council issued a notice launching the security review system.[14] The Security Review Procedure defines most forms of foreign investment where an interest owned by a domestic enterprise is transferred to a foreign company, including when the percentage of foreign ownership is simply increased, as being included in the merger and acquisition activities subject to review.[15] Where the investor establishes a WFOE with no acquisition of Chinese assets or equity, the national security review is not required. It is also required that the foreign investor take control of the domestic entity, although the definition of control includes “actual” or “indirect” control.[16] The national security review is supposed to occur whenever any merger or acquisition involves:

> foreign investors' merger or acquisition of military industrial enterprises or military industry related supporting enterprises, enterprises located near key and sensitive military facilities, and other entities relating to national defense; foreign investors' M&As of key domestic enterprises in areas such as agriculture, energy and resources, infrastructure, transport, technology, assembly manufacturing, etc., whereby the foreign investors might acquire the actual controlling right thereof.[17]

The Security Review Procedure is much more than a way to prevent the acquisition of military technology by foreigners, since not only are enterprises owned by the military or supplying weapons included, key domestic enterprises in areas such as agriculture, energy, resources, infrastructure, transport, technology, and major equipment manufacturing are also to be protected.

In the review process, the reviewing body is supposed to consider the following factors:

1. Impact of the transaction on the national security, including the domestic product manufacturing capacity, domestic service provision capacity, and relevant equipment and facilities needed for the national security;

2. Impact of the transactions on the stable operation of national economy;

3. Impact of the transaction on the basic living of the people; and

4. Impact of the transaction on the research and development capacity for key technologies related to the national security.[18]

The problem with this very broad description of what constitutes “national security” related acquisitions is that almost every acquisition might fall under the heading.

In order to provide a procedure for potential acquirers of domestic enterprises that may be required to go through the Security Review Procedure, MOFCOM issued provisions on the implementation of the Security Review System Notice.[19] The MOFCOM Security Review Procedures require that whether considering an acquisition under the Domestic Acquisition Regulations or reviewing a transfer of equity in an existing FIE, the local commerce department shall not accept the application if the deal falls under the scope of security review, unless the applicant has successfully applied to MOFCOM for a security review.[20] A potential foreign acquirer may approach MOFCOM in advance of filing a required application.[21]

The approval of foreign acquisition activity in China has been delegated down to the provincial level if the amount involved is less than $300 million, but the new Security Review Procedure re-inserts the national government into any transaction that may have a security component. Because the definition of what constitutes national security includes matters such as the “stable operation of the national economy” or

the "effect on the research and development capabilities of key national security technologies," many transactions may be subject to central government review. In any ambiguous case, it is quite unlikely that provincial authorities will proceed with consideration of an acquisition that might somehow – no matter how vaguely – affect national security.

It is difficult to understand what is being protected by this national security review system. Have foreign investors been stealing Chinese military technology? Has Iran tried to purchase the State Nuclear Power Technology Corporation? As with the Anti-Monopoly Law, it would seem simply another way to give the Central Government power to vet inbound investment.

The Attitudes

Discussing attitudes is highly subjective and so a proper warning must be given: the opinions below may be only those of the author, not held by anyone else, and possibly quite incorrect.

China Inbound Investment

China's comparative success in handling the economic downturn of 2008-2010 has given it a new confidence in itself. Foreign experts no longer appear quite so expert. The vast accumulation of foreign exchange reserves means that a foreign investor's money is of little importance and, unless the investor is willing to fully disclose its technology, there is little interest in establishing a partnership. Moreover, there is now a labor shortage in China for skilled workers, so providing jobs is not enough.

For these reasons, the approval authorities in China are considerably more stringent in their application of the relevant laws to foreign investors. Projects that the Catalogue on Foreign Investment permit to be developed by wholly foreign owned enterprises are not being approved (as a matter of internal policy) only if done in a joint venture format with an open sharing of technology.

China Outbound Investment

The Chinese entrepreneur's attitude toward outbound investment is extremely enthusiastic. Without the bureaucratic controls on the outbound foreign investment system, the average Chinese with money would no doubt be an investor outside of China.

The government, however, is divided on the wisdom of buying companies abroad. The acquisition of necessary raw materials and natural resources is supported, but when Chinese companies wish to acquire foreign companies for technology, manufacturing capabilities or foreign distribution, there is a definite division among the leadership. Some believe that such acquisitions are necessary if China is to assume its rightful position as a world-class industrial leader. Others believe that Chinese companies will be the big losers in international M&A activity and over time give back the precious foreign exchange treasure trove that China has earned through its export of low priced goods.

The American Attitude toward Investment in China

Although almost all companies recognize that China is a large and attractive market, the recent recession reduced the amount of new investment available to penetrate the market. Companies like Coca-Cola, General Motors, Wal-Mart and Yum Brands that earn large profits in China have continued to invest those domestic profits in developing the market, but the number of new entrants appears to have

lessened. Private equity funds that have money, but not technology to license or products to make and sell, have experienced definite difficulties in acquiring businesses in China and many are frustrated with the roadblocks they encounter. Service companies have become interested in China, but except for franchising restaurants, have found the entry of pure service businesses to be difficult.

While once the foreign investor could do no wrong, today it seems he can do no right. Under the prior tax law, all foreign investors received a two year tax holiday and three years at half tax, and many were granted especially low tax rates due to their high technology. Now, everyone pays the same tax rate and most of the tax preferences seem to go to domestic enterprises, through arcane rules requiring domestic innovation or ownership of core technology. Moreover, recent administrative prosecutions under the Anti-Monopoly Law against foreign-owned milk powder and pharmaceutical companies appear to be politically motivated, rather than an attempt to protect the Chinese consumer.

The Politics of Cross Border Investment

American Politics

American politicians have long prospered from badgering American companies about exporting jobs to China and China for manipulating its currency. As with any sound bite, there is some truth in the criticism. In almost all cases, however, the politicians making the comments have no intention of either preventing American companies from producing their goods wherever they choose, or imposing countervailing duties on China as a currency manipulator. Instead, the politics of the sound bite is to put one’s name forward during the 6:00 news.

The harmful effect of such sound bite rhetoric, however, is that it encourages Chinese officials to make their system less open to United States investors and to tilt the playing field even further against American companies.

Chinese Politics

The Security Review system established by China in 2011 is a good example of the harmful effect of political sound bite wisdom from America. Prior to the introduction of the Security Review system, China had delegated the approval power down to the provincial level for all investments below $100 million (and has now raised that limit to $300 million). Local approval is generally must faster, more open, and less political than consideration of an investment at the national level.

The Security Review system, however, re-centralizes in MOFCOM the approval power for any acquisition or investment that might possibly have some national security element, including an effect on the national economy. But since the Security Review regime is closely modeled on the Committee on Foreign Investment in the United States (CFIUS) and there has been considerable propaganda in China how the CFIUS system is used to prevent Chinese companies from investing in the United States, it is primarily a tool designed for tit for tat retribution against American companies when the United States government does something that displeases Beijing. It is hard to imagine a company from another foreign country that will be prevented from buying a Chinese company due to security concerns.

Since all foreign investments into China must be approved by the government, China has always been able to stop any unwanted investment, particularly if it would impact national security. But since

American politicians like to intervene in CFIUS like decisions, such as CNOOC's acquisition of Unocal or Huawei's acquisition of 3Com, China now has a retaliatory tool to use to disrupt American investment in China. The new tool will be used and will likely have nothing to do with security.

The Negative List

The Shanghai Pilot Free Trade Zone announced in September of this year may open the door to a new round of reform. One of the unique aspects of the Zone is its "negative list," which was first published in October.[22] The negative list reverses China's foreign investment system, since anything that does not appear on the negative list may be established without review or approval. The foreign investment approval process only applies to those specific items listed on the negative list. Such a system, if extended to all of China, would greatly increase foreign investment by decreasing bureaucratic uncertainty.

Likelihood of Two-Way Investment in 2014

Bilateral investment between the United States and China would be good for both countries. It is hoped that the recent increase in Chinese investment in the United States and the new experimentation in China, such as the Pilot Free Trade Zone in Shanghai, are leading indicators that the Year of the Horse will see galloping bilateral investment.

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A View from Amsterdam: Recent Developments in Implementing the Alternate Investment Fund Manager's Directive

Overview

The European Commission's Alternative Investment Fund Managers Directive (AIFMD), which went into effect on July 22, 2013, was designed to establish a unified framework throughout the EU for regulating previously unregulated Alternative Investment Funds (Funds).

The AIFMD applies to: (1) managers that are themselves established in the EU; (2) managers that are not established in an EU country, but that manage and market Funds established in the EU; or (3) non-EU managers that market Funds that are not established in an EU jurisdiction. Thus, the AIFMD may be broadly applicable to managers and funds within and without the EU.

As is the case with any EU directive, EU member states (Member States) must transpose the AIFMD into their national laws for it to be enforceable on individuals. As the AIFMD represents the minimum EU regulatory requirements, Member States have significant flexibility in designing a regulatory framework for implementing the AIFMD.

Prior to the AIFMD's implementation, shares in funds were placed exclusively through private placement. The AIFMD's provisions will eventually phase out private placement, however, the AIFMD's full regime will be implemented gradually. Member States have the option of maintaining a private placement regime for non-EU Alternate Investment Fund Managers (Managers) for several more years.

Although July 22, 2013 marked the transposition deadline, by that date only a handful of member states had implemented their national AIFMD statues. Moreover, of those that met the July 22nd deadline, most did not have the full AIFMD mechanisms in place. In particular, few, if any, member states had worked out the full notice, and regulatory regime applicable to non-EU managers continuing to use the Member States' available private placement regimes. Thus, the last few months since July 22nd have seen member states' piecemeal implementation of the appropriate AIFMD registration and notice requirements.

After describing the AIFMD's main regulatory framework, the following review will address the recent developments in the Member States' transposition of the AIFMD private placement requirements.

Regulatory Target—AIF Managers

The AIFMD seeks to regulate a set of previously unregulated funds, namely, "all collective investment undertakings that are not regulated under the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive." These include hedge funds, private equity funds, commodity funds, and real estate funds, among others.

Rather than directly regulating funds, however, the AIFMD regulates managers—that is, entities providing either risk or portfolio management to a fund. According to the AIFMD, each fund may only have a single entity as its manager.

Under the AIFMD, the manager for regulatory purposes may not be the entity colloquially considered the manager. A manager that is a shell entity (which the AIFMD terms a letter-box entity) is not considered the true manager for regulatory purposes.

Broadly speaking, a manager that does not retain the core management functions of risk management, investment decision-making, or investment management is deemed by the AIFMD to be a shell entity. For regulatory purposes, this shell manager will be looked through to the true manager that retains the core management functions.

Exemption—Small Managers

Pursuant to the AIFMD, whereas managers with assets under management (AUM) of more than € 100 million (if leveraged), or € 500 million (if unleveraged) are subject to the AIFMD's full regulatory regime, managers with AUM less than € 100 million (if leveraged) or € 500 million (if unleveraged) are subject to a lighter AIFMD regulatory regime.

For regulatory purposes, a manager's AUM is the total amount that the manager manages through all of its managed funds, including assets that the manager both directly and indirectly controls.

Marketing—Definition

As previously discussed, the AIFMD applies to non-EU managers marketing non-EU funds in one or more Member States.

The AIFMD defines marketing as "a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the Union." This marketing definition does not include reverse solicitation, where the investor initiates the investment, and the investment is not at the manager's direct or indirect initiative.

Thus, for example, if an EU investor initiated an investment in a U.S. fund, managed by a U.S. manager, the U.S. manager and fund would remain unaffected by the AIFMD. Only if the U.S. manager solicited investment in the U.S. fund in a Member State would the AIFMD apply.

Regulating Non-EU Managers—National Private Placement Regimes

The AIFMD is designed to phase out national private placement regimes, creating a unified regulatory regime throughout the EU. However, the AIFMD is scheduled to come into force in stages.

Between July 22, 2013, and 2018 (at the earliest), Member States may continue to permit non-EU managers to market their non-EU funds in Member States subject to the applicable national private placement regimes. However, Member States may abolish their national private placement regimes prior to the AIFMD's 2018 date. (Indeed, Germany, with limited exception, has already abolished its private placement regime.)

Regulating Non-EU Managers—Additional AIFMD Requirements

As explained, through 2018, the AIFMD will largely permit non-EU managers to market non-EU funds subject to the private placement regime in the relevant Member State (if available).

However, the AIFMD does include three additional requirements for a non-EU manager to be able to take advantage of a Member State's private placement regime. These include, specific disclosure and reporting requirements, cooperation agreements, and exclusion of managers and funds established in certain countries. Each of these will be discussed in turn.

Applicable AIFMD Reporting Requirements

By its terms, the AIFMD will require even non-EU managers marketing non-EU funds pursuant to national private placement regimes to comply with certain AIFMD provisions concerning annual reports, disclosures to investors, periodic reporting to regulators, and acquisition of control over EU companies.

Cooperation Agreements

For non-EU managers to be able to market their non-EU funds in a Member State, the AIFMD requires that there be cooperation agreements in place between the regulator in the relevant Member State, and those in the home jurisdictions of the non-EU manager, and the non-EU fund.

ESMA has negotiated memoranda of understanding (MOU) with 34 regulators in a variety of jurisdictions. These MOUs, however, are insufficient to permit non-EU managers to market their non-EU funds in any EU jurisdiction. Rather, the Member State must sign a separate cooperation agreement with the regulators in the non-EU manager's and non-EU fund's home jurisdictions.

Thus, for example, for a U.S. manager to be able to market its Jersey-based fund in the UK, the UK's Financial Conduct Authority must have a cooperation agreement with the United States' regulator, as well as the Jersey regulator.

The Member States are signing these cooperation agreements at different rates. For example, the Netherlands, the UK, and Luxembourg have signed cooperation agreements with all 34 countries with which ESMA negotiated MOUs. Whereas Germany has signed cooperation agreements with only half of these jurisdictions, and only plans to sign cooperation agreements with the countries doing business with Germany.

Exclusion of Non-Cooperative Country or Territory

Finally, pursuant to the AIFMD, to be able to market based on a Member State's private placement regime, neither the non-EU manager's nor the non-EU fund's home jurisdiction may be considered a "Non-Cooperative Country or Territory," by the Financial Action Task Force on anti-money laundering, and terrorist financing.

Recent Developments—The Netherlands

Member States that have preserved their private placement regimes through 2018, have, since July 22, 2013, begun to issue AIFMD-compliant procedures for managers' licensing or registration. The Netherlands is among these Member States.

At present, the Netherlands Authority for Financial Markets (AFM) has issues two separate regimes for managers, including: (1) a licensing regime for managers with AUM over the € 100 million / € 500 million threshold; and (2) a registration regime for managers with AUM below the € 100 million / € 500 million threshold.

For managers with AUM over the € 100 million / € 500 million threshold, the AFM has issues a full licensing regime which takes 13 weeks to process. To obtain a license, the manager must submit extensive information regarding the manager, and its funds, including: the investment plans; control structure; solvency and liquidity information; and conflict of interest policies, among others.

If, however, the manager's AUM are under the € 100 million / € 500 million threshold, and the fund is only being marketed to professional investors, then the notification procedure is free, and consists of sending the AFM general information regarding the manager and the relevant fund. The registration information includes: the manager's and the fund's AUM; a description of the fund; the fund's leverage; and the means of ensuring that the fund is marketed only to professional investors.

The AFM has issued applicable registration forms for Dutch managers, and for managers from "Designated Third Countries," which include Switzerland, the United States, and Australia. Registration of managers from other non-EU countries is effectuated by sending the required registration information to the AFM via email.

Forecast

If the last few months since the AIFMD's 22 July implementation date are in any way indicative of the future, the AIFMD will eventually be fully implemented throughout the EU. However, because Member States seem to be implementing their AIFMD regimes piecemeal, it may be some time before there is any semblance of EU-wide AIFMD order.

By Wietse de Jong and Ilana Haramati.

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A View from China: New Announcement Regarding the Individual Income Tax of Investors and MOFCOM Approved Glencore's Acquisition of Xstrata with Restrictive Conditions

New Announcement Regarding the Individual Income Tax of Investors

《国家税务总局关于个人投资者收购企业股权后将原盈余积累转增股本个人所得税问题的公告》(07/05/2013)

For the purpose of further implementing the Individual Income Tax Law and other related rules, the State Administration of Taxation released the Announcement on Certain Issues Regarding the Individual Income Tax on the Increase of Share Capital Converted from the Original Accumulated Surplus after Acquisition of the Enterprise Equity by Individual Investors (Income Tax Announcement) on May 7, 2013, which took effect on June 7, 2013.

a) Where one or more individual investors (new shareholders) purchase 100% equity from an enterprise and then would like to use the accumulated surplus to increase share capital after the acquisition, given that the book value of the accumulated surplus (including capital reserve, surplus reserve and undistributed profits) of the acquiree, instead of being converted to the share capital before the acquisition, has been included in the equity transfer price with related income tax paid at the time of transaction, the individual income tax should be subject to the following principles:

- If the transaction price of the equity acquisition is not less than the value of net assets of the acquired enterprise, and has included the original accumulated surplus, then no individual income tax will be levied on the increased portion of the capital share converted from the accumulated surplus.
- If the transaction price of the equity acquisition is less than the value of net assets of the acquired enterprise, for the increased portion of the capital share converted from the accumulated surplus that has been included in the transaction price, no individual income tax will be levied; however, for the increased portion of the capital share converted from the accumulated surplus that has not been included in the transaction price, individual income tax will be levied as "interests, dividends and bonuses."

According to the Income Tax Announcement, new shareholders are required to convert the taxable part of the accumulated surplus into share capital before converting the tax exempt part, if the transaction price of the equity acquisition is less than the value of net assets of the acquired enterprise.

b) When new shareholders transfer these newly acquired entities, the value of the equity share shall be the combination of the transaction price and related taxes they have actually paid during the acquisition.

c) After the equity transaction and increase of share capital, the enterprise shall report relevant matters to competent tax authorities within 15 days of the following month since the conversion, including the changes in shareholders and equities, the accumulated surplus prior to the equity transaction, and the increase in share capital converted from the previous accumulated surplus, as well as the tax collection status.

- Announcement of the State Administration of Taxation on Certain Issues Regarding the Individual Income Tax of Investors where the Share Capital is Increased with the Original Accumulated Surplus after the Acquisition of Enterprise Equity by Individual Investors
- 《国家税务总局关于个人投资者收购企业股权后将原盈余积累转增股本个人所得税问题的公告》
- Issuing Authority: the State Administration of Taxation
- Date of Issuance: May 07, 2013 / Effective date: June 07, 2013

MOFCOM Approved Glencore's Acquisition of Xstrata with Restrictive Conditions

商务部附加限制性条件批准嘉能可收购斯特拉塔 (16/04/2013)

Glenore International plc (Glencore) is the world's largest supplier for non-ferrous metals and minerals. Glencore owns seven entities engaged in trade and warehousing business in China. Xstrata plc (Xstrata) is the fifth largest mining group and metal company as well as the fourth copper producer in the world. Xstrata sells coking coal, thermal coal, iron alloy, refined copper and owns a stainless steel production joint venture and two entities engaged in trade operations in China. Glencore currently holds 33.65% and will hold 100% of Xstrata's shares after the acquisition.

Based on the examination on concentration of undertakings, MOFCOM concluded that the acquisition will eliminate Xstrata's presence in the Chinese market, who is a significant competitor of Glencore, significantly increase the mineral resources controllable by Glencore, strengthen Glencore's integration over related industries and enhance Glencore's control over the market. As a result, MOFCOM approved Glencore's acquisition of Xstrata with restrictive conditions including:

a) Copper Concentrate Market

- Divestiture of the copper concentrate assets: Glencore shall divest all the interests Xstrata holds in a Peru copper project after completion of the acquisition.
- Keeping the trading conditions for copper concentrate unchanged: Glencore shall provide the Chinese clients with offers for long-term copper concentrate contracts no less than the agreed minimum volume from 2013 to 2020.

b) Zinc Concentrate and Lead Concentrate Market: Glencore shall continue to provide the Chinese clients with offers for long-term and spot zinc concentrate and lead concentrate contracts. The offer conditions shall be fair and reasonable.

By George Qi and Dawn (Dan) Zhang.

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A View from Italy: New Threshold to Trigger Mandatory Tender Offers

Current Rules for Mandatory Tender Offers

Tender offer rules are set forth by Articles 102-112 of the Legislative Decree No. 58 of February 24, 1998 (the Consolidated Financial Code) and CONSOB[1] Regulation No. 11971 of May 14, 1999 (so called 'issuers regulation'). The Italian law system aims at ensuring equal treatment of shareholders of target companies, providing for a specific set of rules governing mandatory tender offers, in addition to rules governing voluntary tender offers.

In general terms, whenever a shareholder has acquired control of an Italian publicly listed company, the controlling shareholder is required to launch a mandatory tender offer for all of the outstanding shares of the company at the highest price the controlling shareholder has paid for the company's shares in the preceding 12-month period. In the absence of other shareholders having a majority of outstanding shares, such control is deemed achieved whenever the controlling shareholder acquires more than 30 percent of the outstanding shares.

In addition, a mandatory tender offer is triggered whenever a shareholder holding more than 30 percent of the voting shares of an Italian publicly listed company acquires for consideration, subscribes to, or converts securities into more than five percent of the voting shares of such company within a 12-month period. Such rule is aimed at frustrating silent stake building.

Italian law also provides for certain exemptions from the obligation to launch a mandatory tender offer.

Telefonica and Telecom Italia Transaction

Reaction to a recent transaction involving one of Italy's principal telecommunications companies has prompted legislative developments in the Italian mandatory tender offer rules. The Spanish telecom company Telefonica S.A., Europe's largest telecommunication group based on revenues, is currently negotiating a transaction to acquire control of Telecom Italia S.p.A.

In October, Telefonica reached an agreement with certain Italian institutional shareholders of Telco S.p.A.[2], an investment vehicle holding a 22.4 percent controlling stake of Telecom Italia, with the aim of gradually taking over Telco S.p.A. Specifically, Telefonica agreed to increase its stake in Telco from 46 percent to 100 percent through various steps starting from next year.

Given the fact that Telco is the main shareholder of Telecom Italia and has de-facto control of the company, appointing a majority of the members of the Telecom Italia board, by acquiring the control of Telco, Telefonica would take over Telecom Italia without triggering the 30 percent threshold for mandatory tender offers.

New Proposal for Italian Takeovers

Concerns have been raised regarding the Telefonica – Telco transaction because the minority shareholders of Telcom Italia are not receiving any premium. As a consequence, the Senate has proposed a new bill regulating control of listed companies that would introduce a second threshold triggering a mandatory tender offer in addition to the existing 30 percent threshold (Mandate to the Government on the control of listed companies and opposition to the so called phenomenon of the "Chinese boxes", the "Bill"). However, the Italian Parliament has not yet approved the Bill, which if approved would delegate to the Government authority to proceed with the reform.

The measure proposed by the Senate would mainly strengthen the role of CONSOB in the context of mandatory tender offers and force a full takeover bid if the purchase of a stake ensures effective control over the issuer. Specifically, the proposal would grant CONSOB the power to ascertain whether there is de-facto control by a shareholder or multiple shareholders acting in concert and introduce a second threshold for mandatory tender offers based on the ascertained de-facto control (irrespective of the 30 percent ceiling).

According to the Bill, the Government should, as a matter of urgency, use its best effort to implement amendments to Articles 106 and 109 of the Consolidated Financial Code, summarized below. With respect to listed companies on regulated markets, the new provision will impose an obligation to launch a mandatory tender offer for all the outstanding shares of the listed company on:

- Anyone who comes to hold a stake higher than 30 percent as a result of an acquisition for consideration;
- Anyone who comes to hold a controlling stake through two or more companies belonging to the same company chain, as a result of an acquisition for consideration; and
- Anyone, although holding a stake lower than 30 percent, that presumably acts in concert with other shareholders holding, in the aggregate, a stake higher than the 30 percent threshold.

Furthermore, the Government will grant CONSOB the powers (a) to indicate, by its own regulation, a threshold lower than 30 percent but no lower than 15 percent for issuers having high capitalization and particularly widespread common stock and (b) to verify the existence of the conditions listed in (ii) and (iii) above, through an independent board of experts supervising the transfers of stakes or controlling stakes, mergers and acquisitions.

In case of a public tender offer or transfer of a stake greater than 15 percent, CONSOB will be able to set limits on the issuer's indebtedness for up to three years upon the request of shareholders representing at least 2 percent of the corporate capital.

The new provisions, if adopted, will also change the rules relating to the voting system in the shareholders' meeting and controlling chains, granting CONSOB powers to apply sanctions in case of major misconduct by directors.

Finally, the Government would be required to amend the fiscal regime applicable to listed companies in order to discourage long controlling chains and favor transparency and efficiency of the regulated markets.

Effects of the Proposal on the Telecom Italia Takeover by Telefonica

The Bill is still a simple proposal. If passed, however, the new law would significantly complicate the takeover of Telecom Italia by Telefonica. If the new legislation is implemented before Telefonica takes control of Telco, Telefonica could be forced to launch a mandatory tender offer to purchase all the shares of Telecom Italia for around 13 billion euro, which represents about 18 billion U.S. dollars.

As a result, a takeover bid for Telecom Italia might prove an expensive move for Telefonica and could also trigger antitrust issues in Latin America, where the two European companies are direct competitors.

By Mario Santa Maria and Ada Villa.

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[1]Commissione Nazionale per la Società e la Borsa (CONSOB) is the Italian Securities and Exchange Authority.

[2]The corporate capital of Telco S.p.A. is held by Generali Group (19.32%), Intesa SanPaolo (7.34%), Mediobanca (7.34%) and Telefonica (29.17% B shares, 36.83% C shares).

A View from London: The UK Takeover Code - Recent Changes

Introduction

In the UK, the conduct of public takeovers and certain private transactions is governed by the City Code on Takeovers and Mergers (the Code). The Code is a set of statutory rules and general principles which have at their heart the objective of ensuring fair treatment for all shareholders in takeover bids and avoiding the creation of false markets. The Code is issued and administered by the Panel on Takeovers and Mergers (the Panel), an independent body comprised of investors, practitioners and members of major financial and business institutions.

With effect from 30 September 2013, the Code was amended and as a result now has application to a wider category of companies and transactions. The Code now applies to all public companies that are incorporated in the United Kingdom, the Isle of Man and the Channel Islands and whose shares are traded on a regulated market in the United Kingdom, any stock exchange in the Isle of Man or the Channel Islands or any multilateral trading facility in the United Kingdom, *irrespective of where these companies are managed and controlled*, thereby implementing the partial removal of the so-called "residency test".

The position under the Code prior to 30 September 2013

Prior to 30 September 2013, the Code applied to all companies incorporated in the UK, the Isle of Man or the Channel Islands whose shares were traded on a regulated market in the United Kingdom (i.e. the London Stock Exchange's main market for listed securities) or on a stock exchange in the Isle of Man or the Channel Islands. In addition, if a company did not have its shares admitted to trading on such a market but was a public limited company or a private company whose securities had been admitted to trading in the previous 10 years, it would be subject to the Code if it satisfied the residency test (i.e. its place of management and control was within the UK, the Isle of Man or the Channel Islands). In applying the residency test, the Panel has taken into consideration factors such as the place of residence of the majority of a company's board of directors.

What exactly is changing?

The changes to the Code go to the very essence of the Code, namely which companies and transactions are subject to it. The residency test has now been removed for companies incorporated in the UK, the Isle of Man or the Channel Islands whose shares are traded on multilateral trading facilities (such as AIM or the ISDX Growth Market).

It was sometimes complex to identify whether or not a company listed on a UK stock market was subject to the auspices of the Code because, for example an AIM company whose management was based outside of the UK (even if it had a registered office in the UK, the Isle of Man or the Channel Islands) fell outside the jurisdiction of the Panel. Shareholders could not simply look to the place of incorporation of the relevant company, but would need to look beyond to the question of place of management/ residence of directors, which was not always clear. This led to concern and uncertainty on the part of holders of shares in AIM companies who expected to automatically benefit from the protections afforded by the provisions of the Code, but were denied because of the application of the residency test.

The changes bring the Panel's approach to companies listed on AIM or the ISDX Growth Market in line with companies whose shares are listed on the London Stock Exchange's main market for listed securities. By the Panel's estimation, there are approximately 200 additional listed companies which will now fall within the Code's jurisdiction as a result of these changes. It will be interesting to see whether any overseas-managed companies seeking to join AIM will attempt to avoid being brought within the jurisdiction of the Code by listing a non-UK top company instead. The Code will continue to not apply to open-ended investment companies.

Who is the residency test being retained for?

The residency test remains in place for non-traded public companies, private companies that potentially may be subject to the Code because they have had securities admitted to trading within the preceding 10 years or public companies whose shares are admitted to trading on a public market that is not a regulated market (either in the UK or, for UK companies only, in another EEA member state) or a multilateral trading facility in the UK or a stock exchange in the Channel Islands or Isle of Man. This means that the Code only applies to UK, Isle of Man and Channel Islands companies with shares admitted to trading outside the EEA where such companies satisfy the residency test. AIM-listed companies which are incorporated in jurisdictions such as the Cayman Islands are still not subject to the Code even if they would like the Code to apply to them.

The table set out below illustrates which companies are now subject to the Code:

	Company	Will the Code apply?
1	UK, Isle of Man or Channel Islands incorporated company with securities admitted to trading on a multilateral trading facility in the UK such as AIM.	The Code will apply to these companies without reference to the residency test.
2	Company with securities admitted to trading on a regulated market in the UK such as the main market of the London Stock Exchange or Channel Island or Isle of Man stock exchange.	The Code will continue to apply to these companies without reference to any residency test.
3	Company with securities admitted to trading on an EEA regulated market (but not a UK regulated market).	This is subject to the rules on shared jurisdiction and the residency test is not relevant.
4	Company with securities admitted to trading on a public market other than company referred to in 1, 2 or 3 above such as the NYSE.	The residency test will continue to be relevant for these companies - the Code will apply if the residency test is satisfied.
5	Public company whose securities are not admitted to trading on a public market.	The residency test will continue to be relevant for these companies – the Code will apply if the residency test is satisfied.
6	Private company.	The residency test will continue to be relevant for these companies, and the Code will apply if: • The residency test; and • The "10 year rule" referred to above are satisfied.

What are the practical implications of these changes for companies becoming subject to the Code?

A number of companies may have provisions in their articles of association which seek to replicate certain provisions of the Code. If this is the case, these provisions may have ceased to be relevant or may conflict with the Code from 30 September 2013 onwards. If there is a direct conflict between a company's articles of association and the Code, or the relevant clauses of the articles of association become obsolete, because they are, for example, expressed to apply only in instances where the Code does not apply, the relevant clauses will need to be removed by shareholder resolution at the next available opportunity.

Directors of companies that are now subject to the Code will need to familiarise themselves with the provisions of the Code, particularly in the context of potential offers for their shares. The Code stresses the vital importance of secrecy, particularly in relation to confidential and price-sensitive information, before an announcement is made and also the need for all parties to act in such a way so as to reduce the possibility of any accidental leakage of information. The Code also sets out very detailed rules as to when announcements are required to be made. Announcements will be required when, following an approach by or on behalf of a potential offeror, there is an untoward movement in the share price of the offeree or the offeree company is the subject of press speculation.

Investors in companies that fall within the auspices of the Code will now be unable to increase their shareholdings over the threshold of 30% or, if they already hold between 30% and 50% of a company's shares, they will be unable to increase their shareholding at all without being obliged to make a mandatory bid for the remaining share capital in the company, unless they manage to obtain a waiver from the Panel and the consent of the independent shareholders of the company. If a company has convertible securities in issue, the exercise of these could also trigger a mandatory offer under the Code.

Code amendments to profit forecasts, material changes in information and quantified financial benefits statements

Amendments to the Code relating to profit forecasts, material changes in information and quantified financial benefits statements also came into effect on 30 September 2013.

The amendments to the Code are intended to provide greater clarity for offerees and offerors that publish profit forecasts before an offer is made and during the offer period. The rationale behind the new provisions appears to be to apply more proportionate requirements in respect of profit forecasts, therefore encouraging a greater degree of communication with the market and with a company's shareholders and to ensure a greater degree of consistency with the existing reporting framework that applies to profit forecasts, namely the Prospectus Rules published by the Financial Conduct Authority.

Key amendments

- The concept of a "quantified financial benefits statement" has been introduced to Rule 28 of the Code replacing the previous concept of a "merger benefits statement". The Financial Reporting Council intends to publish a new reporting standard on quantified financial benefits statements and their "proper compilation" in due course.

- A new directors' confirmation regime will apply to profit forecasts published by parties following the first active consideration of an offer and prior to an approach to the offeree company.
- Dispensations from the requirements of Rule 28 may be available where the application of the rule would be inappropriate or disproportionate; for example, where consideration securities will not represent a material proportion of the offeror's enlarged share capital or a material proportion of the value of the offer.
- The new Rule 27 contains a new obligation on parties to announce "material new information" that they would have been required to include in the offer documentation, had such information been known when the relevant documentation was published.

By Henrietta Walker and Adam Cain.

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