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Now is the Time to Revisit the Advancement and Indemnification Provisions of Delaware LLC Agreements

By Kenneth A. Gerasimovich and Jennifer Brady

Imagine setting off on an exciting venture with a new business partner. You have a great business plan and have formed a new Delaware limited liability company. Your lawyer circulates the draft limited liability company agreement that will govern your relationship with your partner and the operation of the business. You flip immediately to the relevant sections. You are named as a "manager," you are entitled to the agreed percentage of the profits that are soon to be rolling in and your name is correctly spelled on the schedule of members. Everything looks great. You sign on the dotted line and get to work.

Fast forward a few years. Things have not worked out so well. Your business partner has dumped you and you are being sued for mismanagement by the company you helped build. You feel that ultimately you will prevail against these claims, but how will you afford to defend yourself? Are you entitled to any advancement or reimbursement from the company for your legal fees?

Look no further than the limited liability company agreement for the answer to these questions. Somewhere in the agreement between the part enumerating the powers of the managers and the seemingly never-ending tax sections, there should be a provision on "indemnification." If you did not pay close attention to this section when you

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negotiated the limited liability company agreement, you may find yourself out of luck and out-of-pocket.

The Delaware Limited Liability Company Act (the Delaware LLC Act) gives parties wide latitude to set their own terms for the indemnification of managers, members, employees and other parties, and the advancement of litigation expenses. Delaware courts have made clear that they will honor the parties' agreement on these issues and will give effect to the plain meaning of the relevant provisions in limited liability company agreements. This point was reiterated by the Delaware Court of Chancery in August in a transcript ruling granting a motion for summary judgment requiring advancement of expenses in *John E. Harrison v. Quivus Systems, LLC (Harrison v. Quivus)*.[1]

Harrison v. Quivus involved a claim for advancement of expenses arising from a lawsuit brought by Quivus Systems, LLC (Quivus) against its former CEO, John Harrison (Harrison), alleging mismanagement, incompetence and corporate malfeasance. Harrison demanded that Quivus advance funds to pay for certain expenses that he incurred and would continue to incur in defending the actions against him and pursuing counterclaims that he had brought against Quivus.[2]

Quivus was a joint venture between Harrison's company, Quivus Holdings, and Soroof International, a corporation organized under the laws of the Kingdom of Saudi Arabia and owned by His Highness Prince Bander Bin Adbulla Bin Mohammed Al-Saud. Soroof International owned 55 percent of Quivus and Harrison's Quivus Holdings owned the remaining 45 percent. Harrison served as CEO of Quivus from 2007 until 2014 when he was removed as CEO by Soroof International after the business relationship between Harrison and Soroof International deteriorated.

In the ruling, the Delaware Court of Chancery (the Court) notes that "[c]laims for advancement of attorneys' fees are particularly well-suited for resolution by way of a motion for summary judgment because the relevant question turns on the application of the terms of the corporate instruments setting forth the purported right to advancement and the pleadings in the proceedings for which advancement is sought."[3] The Court highlights a distinction between advancement claims involving limited liability companies and those involving corporations. As the Court pointed out, indemnification and advancement of expenses provisions of corporate charters and bylaws tend to track Section 145 of the Delaware General Corporation Law (DGCL) and often condition the right to advancement on whether a corporate officer is being sued by reason of the fact that he took action in his official corporate capacity.

The Delaware LLC Act is more permissive than the DGCL with respect to indemnification and advancement. Section 108 of the Delaware LLC Act provides that subject to the standards and restrictions, if any, set forth in its limited liability company agreement, "a limited liability company may, and shall have the power to, indemnify and hold harmless any member or manager or other person from and against any and all claims and demands whatsoever." As noted in *Harrison v. Quivus*, "Delaware courts have made clear that Section 108 defers completely to the contracting parties to create and to limit rights and obligations with respect to indemnification and advancement."[4]

The indemnification and advancement provision in the Quivus limited liability company agreement provided that, subject to any limitations in the Delaware LLC Act, Quivus was required to "indemnify and advance expenses to each present and future Member or Manager of the Company (and, in either case,

his heirs, estate, personal representatives or administrators) to the full extent allowed by the laws of the State of Delaware, both as now in effect and as hereafter adopted."[5]

Soroof International tried to argue that, under the provision, only "present and future managers" were eligible for indemnification and advancement of expenses and given that Harrison was now a *former* manager, Harrison was not entitled to advancement for actions taken when he was a manager. The Court likens Soroof International's complicated interpretation of "present" and "future" and the introduction of the word "former" to a scene from the Mel Brooks movie *Spaceballs,* where a character uses new technology to watch the entire film while it is still being made, only to become disoriented when he sees himself at that very moment watching the film. As the Court humorously recounted, his comrade tells him, "'You're looking at now, sir. Everything that happens now is happening now,' and explains that they passed then just now, they're at 'now' now, and they can't go back to then because they missed it, but then will be now soon."[6]

Similarly, according to Soroof International, "Harrison was a present manager in the past, not the present. Instead, in the present, where everything that happens now is happening now, Harrison is a former manager, or at least became one just now, but we can't go back to then -- when Harrison was a present manager -- because we missed it."[7]

The Court offers a different interpretation of the agreement that it describes as reasonable, unambiguous, and uncontroversial. According to the Court, when "the parties adopted the LLC agreement, Quivus became bound to provide each then-present member or manager of the company with mandatory indemnification and advancement. Quivus also became bound to provide mandatory indemnification and advancement to anyone who became a member or manager of the company sometime thereafter -- that is, in the future."[8]

The Court recognized the public policy for advancement and indemnification rights, which is "to encourage capable men and women to serve as corporate directors, secure in the knowledge that expenses incurred by them in upholding their honesty and integrity as directors will be borne by the corporation they serve."[9] The Court noted, however, that the Delaware LLC Act is "less paternalistic" than the DGCL and requires parties to expressly contract for indemnification and advancement. According to the court, where the parties have exercised their contractual freedom to provide for expansive and mandatory indemnification, such as in the Quivus limited liability company agreement, the plain terms of the agreement will be enforced as written.

One of the most noteworthy facts of this case, as highlighted by the Court, was that the Quivus limited liability company agreement went through several rounds of comprehensive revisions during a period of approximately five weeks of negotiation, but the indemnification provision did not change at all from the first draft of the agreement circulated by Harrison's counsel to the final version executed by the parties. Delaware courts have reiterated in many different contexts that limited liability companies are creatures of contract. This provides parties with tremendous flexibility, but imposes on the parties and their counsel responsibility for exploring and evaluating their options with respect to each provision of the limited liability company agreement. By glossing over provisions on indemnification and advancement, parties may miss out on an opportunity to tailor these provisions to their specific needs.

Some of the issues that the parties may consider addressing in indemnification and advancement provisions of their Delaware limited liability company agreements are the type of expenses covered, the procedures for requesting advancement of expenses, the timing for payment of expenses, and insurance coverage to ensure funds are available for indemnification and advancement. The parties may also consider specifying the conditions and procedures for return of amounts advanced if it is ultimately determined that the claimant is not entitled to. Further, the parties also may wish to specify how future changes in law or amendments to the agreement will affect indemnification and advancement rights set forth in the limited liability company agreement.

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[1] *John E. Harrison v. Quivus Systems, LLC*, Del. Ch. C.A. No. 12084-VCMR, Montgomery-Reeves, V.C. (Aug. 5, 2016)(Transcript).
[2] *Id.* at 7-9.
[3] *Id.* at 10.
[4] *Id.* at 11.
[5] *Id.* at 12.
[6] *Id.* at 17.
[7] *Id.*
[8] *Id.* at 18-19.
[9] *Id.* at 21.

DOJ and FTC's Antitrust Division Issue Hiring and Compensation Guidance for Human Resource Professionals

By James I. Serota

On Oct. 20, 2016, the United States Department of Justice, Antitrust Division and the Federal Trade Commission issued antitrust guides for human resource professionals. The guides are intended to alert human resource professionals and others involved in hiring and compensation decisions to potential violations of the antitrust laws. In connection with this guidance the Federal Enforcement Agencies issued the following "red flags for employment practices":

- agreeing with another company about one or more employees salaries or other terms of compensation;
- agreeing with another company to refuse to solicit or hire another company's employees;
- agreeing with another company about employee benefits;
- agreeing with another company on terms of employment;
- discouraging competitors from competing too aggressively to recruit employees;
- exchanging company-specific information about employee compensation or terms of employment with another company;
- participating at a meeting such as a trade association, where the above topics are discussed;
- discussing the above topics with colleagues at other companies, including during social events;
- receiving documents that contain another company's internal data about its employee compensation.

These guidelines and red flags were intended to be a warning to human resources professionals that "naked wage-fixing or no poach agreements among employees whether entered into directly or with their party intermediary are per se illegal under the antitrust laws." As such, conduct in violation of the guidelines would evidence a knowing intention to violate the law, allowing the Department of Justice to pursue criminal sanctions against anyone who engages in such conduct. The need for these warnings arose out of three civil actions brought against various technology companies that entered into "no poach" agreements with competitors. In those cases many of the defendants argued that the agreements occurred in the context of joint ventures or other legitimate collaborative activity. As the government successfully noted in response, what began as legitimate collaborative activity "morphed" into companywide agreements not to hire or not to "cold call" each other's employees under any circumstances.

These warnings and guidelines are particularly significant for professionals engaging in mergers and acquisitions. Even if participants in an information exchange are parties to a proposed merger acquisition, there is antitrust risk if the shared information is about terms and conditions of employment. In view of this guidance and red flags, parties engaging in merger discussions, drafting of letters of intent, or due diligence activities should use particular care in sharing information regarding employment data, as the government has explicitly warned that the sharing of information (particularly where it is not

specifically limited to what is necessary to complete the merger and acquisition discussion or acquisition) may be subject to criminal prosecution.

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The Attorney-Client Privilege Post-Merger

By Kenneth A. Gerasimovich and Sheran Sharafi

Attorneys should keep in mind the importance of preserving the attorney-client privilege during the course of an M&A transaction and understand (and cause the client to understand) which communications regarding the transaction are protected by the attorney-client privilege and what actions may waive the privilege. To the extent feasible, attorneys may also wish to discuss with the client which party will control the attorney-client privilege post-merger. Specifically, if the client is the seller (or a controlling shareholder), depending on the jurisdiction governing the merger agreement, specific steps may need to be taken to ensure that the client will continue to control pre-merger attorney-client privileged communications, and that the privilege does not pass to the surviving entity (and, therefore, to the acquiror).

Who Controls the Attorney-Client Privilege Once the Merger Has Closed

As a general rule, a corporation's management retains the right to waive the attorney-client privilege regarding certain communications made to counsel and relating to the corporation's business.[1] The U.S. Supreme Court has held that post-merger transfer of the attorney-client privilege depends on the "practical consequences" of the merger, and not on the "formalities of the particular transaction."[2] These "practical consequences" rest on whether the merger results in a change of control of the target corporation. If it does, privilege passes to the surviving corporation with the new management holding the right to assert or waive privilege.[3] This is to ensure that the management of the surviving corporation has all the information necessary to continue the operations of the corporation and properly defend any claims against it.

However, transfer of the attorney-client privilege is not always clear. Post-merger litigation regarding the acquisition transaction is common, and oftentimes the surviving corporation may request access to (or be entitled to receive under the terms of the transportation documents) privileged pre-closing communications between the seller (or a former controlling shareholder) and its attorneys relating to the merger or its negotiation. The answer to the question of who controls pre-closing, privileged communications relating to the transaction when the surviving corporation demands access to such communication post-closing depends on the jurisdiction. The two leading jurisdictions are New York and Delaware, with most other states following the rule established by one of these jurisdictions.

Generally, New York law provides that privileged pre-closing communications concerning the target corporation's general business operations will pass to the surviving corporation's management when the surviving corporation continues the business operations of the pre-merger entity.[4] However, privileged pre-closing communications relating to the merger negotiations do not transfer to the surviving corporation following the merger.[5] New York courts reason that granting the new corporation "control over the attorney-client privilege as to communications concerning the merger would thwart, rather than promote, the purposes underlying the privilege."[6] If a seller would have to concern itself with whether a buyer would be able to use pre-merger privileged communications against the seller in post-merger

litigation by the buyer, the concern would likely chill attorney-client communication during the transaction.

In considering who may assert the attorney-client privilege post-closing, Delaware courts look first to the Delaware General Corporate Law Section 259, which provides that, after 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 as they were of the several and respective constituent corporations.”[7] According to the plain meaning of Section 259, *all* privileges are transferred to the surviving corporation, including communications relating to the merger itself.[8] Delaware courts, however, have held that parties to a Delaware law transaction may negotiate contractual provisions to prevent certain aspects of the privilege, such as privilege regarding any pre-merger communications or communications relating to the negotiation of the merger, from being transferred to the surviving corporation in a merger.[9]

Merger Communications Protected Under Attorney-Client Privilege

Knowing what happens to pre-merger attorney-client privileged communications relating to the transaction post-merger is only half the battle. M&A attorneys and their clients should also understand what communications are protected by the privilege, and in what circumstances the privilege may be waived. Generally, disclosing privileged communications to a third party will waive the attorney-client privilege. Just like the rules governing post-merger transfer of the attorney-client privilege, the rules governing whether attorney-client communications made in connection with an M&A transaction will remain privileged under the so-called “common interest” doctrine differ from jurisdiction to jurisdiction.

New York’s interpretation of the common interest doctrine requires that, in order to be protected by the attorney-client privilege, communications between clients and their attorneys made in the presence of a third party must be related to pending or reasonably anticipated litigation. Therefore, in the M&A context, the presence of a third party assisting in executing a transaction, such an investment banker or accountant, while clients and attorneys are discussing what would otherwise be considered privileged communications, automatically waives the privilege. It does not matter if the third party was assisting in pursuing a common legal interest (*i.e.*, the merger).

Delaware, on the other hand, sanctions the application of the attorney-client privilege to communications involving the company’s financial advisor in the transactional context.[10] Further, where the parties have a “common interest,” the common interest doctrine may prevent the attorney-client privilege from being waived. For parties to have the necessary “common interest,” the “’interest must involve primarily legal issues, rather than relate to a common interest in a commercial venture’” and the disclosure must have been made “’to facilitate the rendition of legal services.’”[11]

What to Keep in Mind

Attorneys should consider the implications of the rules governing the attorney-client privilege for their deals and their impact on the choices they have to make in protecting communications with clients. In transactions where there is an identifiable client seller (or controlling shareholder) in addition to a target

company, attorneys should remember the seller's (or controlling shareholder's) perspective, and if communications are important, remember the seller (or controlling shareholder), not the target company, should be treated as the client.

Attorneys should keep in mind the numerous privilege issues that arise both before and after the closing of a merger transaction. It is important to understand the different ways in which privilege could be transferred or waived during the course of the negotiations or after the transaction closes. Attorneys should clearly identify who their client is and should advise and protect the client from third-party access to privileged communications and, in the case of a seller client, from the surviving company's access to the communications. This can include ensuring that the client takes precautions in keeping attorney communications secured and, in the merger context, separate from all other documents and assets that are transferred to the surviving corporation at the closing.

The attorney should keep in mind that if the target corporation that is privy to attorney-client communications is a Delaware corporation, the surviving entity will gain access to all privileged communication regarding the merger once it has been completed. In order to prevent that, specific carve-out provisions can be placed in the merger agreement that clearly specify that the seller (or controlling shareholder), not the target corporation, is entitled to control the privileged communications post-merger.

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[1] *Commodity Futures Trading Commission v. Weintraub*, 471 U.S. 343 (1985).
[2] *Id*. at 348.
[3] *Id.* at 349.
[4] *Tekni-Plex, inc. v. Meyner & Landis*, 89 N.Y.2d 123, 136 (1996).
[5] *Id*.
[6] *Id*. at 138.
[7] DGCL § 259(a) (emphasis added).
[8] *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLP*, 80 A.3d 155, 158 (Del. Ch. 2013).
[9] *Id*. at 161.
[10] *3COM Corp. v. Diamond II Holdings, Inc., 2010 WL 2280734, at *4 (Del. Ch. May 31, 2010). But See Town of Georgetown v. David A. Bramble, Inc.*, 2016 WL 27771125 (D. Del. May 13, 2016) (construing *3COM* as "involve[ing] third-party professionals hired specifically to prepare for litigation.").
[11] *In re Lululemon Athletica Inc. 220 Litig.*, 2015 WL 1957196(April 30, 2015) (quoting *In re Quest Software Inc. S'holders Litig*, 2013 WL 3356034, at *4 (Del. Ch. July 3, 2013).

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A View from Amsterdam: Continuing Renewal of Dutch Corporate Law

By Thédoor Melchers , Martijn W.S. Hermus, and Paul Westhoff

Cross Border Migration

As part of a continuing effort of the Dutch government to modify the existing corporate legislation in the Netherlands to address today's needs, a legislative proposal has been published that facilitates the cross-border migration of Dutch BVs and NVs to another EU member state.

The underlying proposal on cross-border migration aims to codify the possibility for BVs and NVs – Dutch companies with limited liability most commonly used in international structures involving the Netherlands – to migrate their statutory seat to another EU member state, changing the applicable law of such company without the company ceasing to exist.

Because the company does not cease to exist, a cross-border migration is different from a cross-border merger. A cross-border merger, codified in Dutch corporate law in 2008, allows a national company to merge, resulting in the transfer of all its assets under a universal transfer of title to a foreign company (or vice versa). Whether or not the transferring company ceases to exist under a cross-border merger may have substantial tax consequences and should be thoroughly analyzed in advance.

Cross-border migrations are not entirely new to the Dutch legal system. Currently, a cross-border migration is possible under codified Dutch law in exceptional circumstances such as war or revolution. Furthermore, cross-border migration is possible for entities of European origin, such as the SE (*Societas Europaea*) and the SCE (*Societas Cooperative Europaea*), for which the possibility of a cross-border migration is set out in the respective European directives.

Despite the lack of codification, cross-border migrations of Dutch BVs and NVs have already been taking place for quite some time. Based on decisions of the European Court of Justice in the *Sevic* case, the *Cartesio* case and the *Vale* case, it has become increasingly common since 2009 for the Dutch legal practice to facilitate cross-border migrations, even without a codified legal basis. Such migrations include both inbound migrations (to the Netherlands from abroad) and outbound migrations (from the Netherlands to abroad).

The legislative proposal that was published refers only to BVs and NVs. Although these are the most commonly used entities in the Netherlands, legal scholars have already taken the position on the basis of existing case law that cross-border migration should also be available to other Dutch legal entities, such as the association (*vereniging*), cooperation (*coöperatie*), mutual insurance company (*onderlinge waarborgmaatschappij*), and foundation (*stichting*).

The process of a cross-border migration under Dutch corporate law can be briefly summarized as follows. In short, the process requires the involvement of a Dutch civil law notary, like many corporate structuring actions. The civil law notary is commonly involved in the drafting of a migration proposal. The migration

proposal must be filed at the Dutch trade register as well as at the office of the migrating company. Furthermore, the legislative proposal provides for certain measures of protection of the rights of shareholders, employees, and creditors:

- *Shareholders* who vote against the migration have a right to have their shares purchased by the migrating entity; this measure aims to protect minority shareholders that may find a shareholding in a foreign entity (in a foreign country) burdensome. The migration proposal must set a price for which the company will purchase such shares and the Dutch enterprise court has jurisdiction over disputes;

- *Employees* of a company whose articles of association provide employees the right to appoint one out of three supervisory board directors are granted protection.

- *Creditors* are granted a two month period during which they can oppose (*verzet instellen*) a migration at the district court of the corporate seat of the migrating company. In such a court proceeding the creditor can request surety or bail to ensure that its claim will be paid.

Most cross-border migrations that currently take place involve companies from Luxembourg and Spain. This can likely be explained by the freedom granted by Luxembourg and Spanish law to facilitate cross-border migrations to and from countries outside the European Economic Area.

The date that the proposal will be codified into Dutch corporate law is not yet determined, but this legislative proposal is just one of many measures proposed by the Dutch government to continuously work on an updated, flexible, yet reliable system of corporate law.

Thédoor Melchers advises corporates, private equity and funds in transactions, investments and the setting up of structures. He specializes in public and private M&A, funds, joint ventures, venture capital, restructurings and corporate governance. Thédoor has particular experience in cross border work and setting up international joint ventures for large multinationals.

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A View from China: China Simplifies its Foreign Direct Investment Regulatory System

By George Qi, Dawn Zhang, and Calvin Ding

On Sept. 3, 2016, the Standing Committee of the National People's Congress issued its decision to amend the four statutes regarding enterprises funded by foreigners and Taiwanese investors, namely, the *Foreign-Invested Enterprise Law*, the *Foreign-Sino Equity Joint Venture Law*, the *Foreign-Sino Contractual Joint Venture Law*, and the *Investment Protection Law for Taiwanese Compatriots*. The amendment, taking effect from Oct. 1, 2016, will formally replace the existing approval regime with a filing system in respect to the establishment, certain changes and dissolution of foreign-invested enterprises (FIE). Also on Sept. 3, to enforce the proposed filing system, the Ministry of Commerce (MOFCOM) published its for-comment draft of the Interim Administrative Measures on Filing of Establishment and Change of Foreign-Invested Enterprises (the Draft Measures). Comments on the Draft Measures were accepted by MOFCOM until Sept. 22, 2016. A few key points of the Draft Measures are highlighted below.

> Reduced Paperwork and Shortened Time for Filing

Under the existing approval regime, foreign investors must obtain approval from MOFCOM in advance of obtaining a business license from the Administration of Industry and Commerce (AIC). At this time MOFCOM reviews and approves various paper documents submitted by the investors, including joint venture contracts and the articles of association of the FIE. The whole process may take up to a few months. In contrast, under the proposed filing system, investors are permitted to complete the filing either before obtaining a business license from AIC, or within 30 days after obtaining the business license from AIC, and the filing can be done through an online system. According to the Draft Measures, MOFCOM shall complete the filing within 3 business days. In the past three years, a trial filing system was already in place for both foreign investors investing within the "free trade zones" of Shanghai, Tianjin, and the Guangdong and Fujian provinces, and for Hong Kong investors investing in the Guangdong province. The trial programs, according to a MOFCOM representative during a news conference shortly after the release of the Draft Measures, has saved 90 percent of paper materials and shaved more than two weeks off the process for the benefit of foreign investors.

> Scope of the Filing System and the Proposed Negative Sheet

The proposed filing system will apply to the establishment of any corporations wholly or partially owned by foreign investors, as long as the investment does not fall within the Special Administrative Measures for Market Access, *i.e.*, the "negative sheet" to be published by the State Council. Investment projects falling under the scope of the "negative sheet" will nevertheless be subject to MOFCOM's examination and approval. However, no such negative sheet has been published in association with the amendment or Draft Measures, and it is speculated that the "negative sheet" contemplated under the Draft Measures will duplicate or resemble the list published by the State Council in April 2015, applicable to the "free trade zones" (FTZ Negative Sheet). The FTZ Negative Sheet sets out 49 specific industries under which

foreign interest is prohibited, restricted to the form of joint ventures with Chinese investors, or is limited to a certain percentage.

Filing System Applicable to FIE Changes

The Draft Measures further require an FIE to file with MOFCOM changes to the following within 30 days after such change has occurred:

i. The FIE's basic information, including its name, address, registered capital, composition of constituent institutions;
ii. The investor's basic information, including its name and nationality, way and time of capital contribution, change or pledge of equity interest or shares, merger, acquisition, and termination;
iii. Transfer or pledge of corporate assets;
iv. Earlier retrieval of investment by investors from contractual joint ventures; and
v. Entrusted management of contractual joint ventures.

It is noteworthy that the Draft Measures mandate investors to disclose the "ultimate controller" of an FIE and file with MOFCOM any change thereof. However, the Draft Measures do not provide a definition or guideline to identify such "ultimate controllers."

Enforcement of Filing System and Punishment

MOFCOM promised to enhance post-filing supervision of FIEs. The Draft Measures authorize MOFCOM to randomly select FIEs through a lottery system for inspection, which can include requesting and examining related materials of the FIEs. The FIEs who fail to comply with the filing requirements will be compelled to complete the filing, or in cases of repeated contraventions or other extreme scenarios, will be subject to a monetary fine of no more than RMB 30,000. The FIEs who violate the restrictive and prohibitive provisions under the negative sheet will be subject to a fine of no more than RMB 30,000 and the prohibited/restricted activity will be discontinued.

Despite the simplification, the amendment and the Draft Measures leave many other issues unanswered, such as whether the filing system will apply to a foreign investor's acquisition of existing domestic corporations, whether the *Catalogue of Industries for Guiding Foreign Investment* will be repealed, and how to define and identify the "ultimate controller" of an FIE. To answer such questions, MOFCOM is expected to promulgate new regulations and alter, and even repeal, certain existing regulations concerning the FIE regulatory system in the near future.

- Decision of the Standing Committee of the National People's Congress to Amend the Four Statutes including the Foreign Invested Enterprise Law of the People's Republic of China
- 全国人民代表大会常务委员会关于修改《中华人民共和国外资企业法》等四部法律的决定
- Issuing Authority: the Standing Committee of the National People's Congress
- Date of Issuance: September 3, 2016 / Effective Date: October 1, 2016
- Interim Administrative Measures on Filing of Establishment and Change of Foreign-Invested Enterprises (Draft for Comment)
- 外商投资企业设立及变更备案管理暂行办法（征求意见稿）
- Issuing Authority: Ministry of Commerce
- Date of Issuance: Sept. 3, 2016 / Deadline for Comment: Sept. 22, 2016

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A View from Israel: Of Sand Castles and Sandbagging

By Aaron R. Katz

When I was a summer associate at Greenberg Traurig in Chicago, I took part in the firm's annual corporate mock deal for its summer associates. Our summer class split into two teams that were involved in a fictional transaction involving the sale of a diamond business and its property, with one team representing the buyer and one team representing the seller. We were guided by shareholders and associates who served as our mentors, and at the end of the summer we had to present the various positions that we had taken in the transaction documents to a group of seasoned GT attorneys. During our presentation, my co-counsel and I answered many of the questions that the attorneys peppered us with, including a number of the toughest ones that came from David Schoenberg, a highly-regarded and longtime M&A practitioner who unfortunately died last year. The zinger came when David asked us whether we had inserted a sandbagging provision in the purchase agreement. After a long pause, I mustered enough strength to respond that we actually were quite sure that there were no environmental liabilities with the property that the store sits on and it was nowhere near the beach, and thus no sandbagging to protect the building from floods or rain were necessary. Let's just say that even David was amused by that answer!

Now what exactly is "sandbagging" and how does it appear in transaction documents? The term sandbagging refers to a situation in which the buyer knows that a certain representation and warranty made by the seller in a purchase agreement might in fact be untrue, yet the buyer still closes the transaction despite having knowledge of such breach. Post-closing, the buyer then seeks to hold the seller liable for such breach (*i.e.*, the buyer, knowing that the building had a leak, still proceeded to close on the leaky purchase, but following the closing then demands to be indemnified by the seller for the leak).

A sandbagging or "pro-sandbagging" clause will protect the buyer in such a scenario, and a typical clause reads as follows: "The right to payment, reimbursement, or other remedy based upon any such representation, warrant, covenant, or obligation will not be affected by any knowledge acquired by the Buyer, at any time, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy or inaccuracy of, or compliance with, such representation, warranty, covenant, or obligation." According to Charles Whitehead in his article "Sandbagging: Default Rules and Acquisition Agreements," the term of sandbagging itself appears to have originated from the use of a bag of sand as a weapon, often in a surprise attack. Thus by inserting a sandbagging provision, the Buyer has fortified his position. The sandbagging clause commonly appears in purchase agreements of all kinds, including stock purchase agreements, asset purchase agreements, merger agreements and real estate acquisition agreements.

However, as with Newton's laws, for every pro-clause, there always comes an equal but opposite anti-clause, and sandbagging is no different. Indeed many sellers try to include an anti-sandbagging clause which prohibits the buyer from seeking indemnification in respect of any matter as to which the buyer has knowledge of prior to the closing. Interestingly, according to the American Bar Association's Deal Points Study, which reviewed 117 acquisition agreements of private targets that were acquired by public

companies in 2014, while 35 percent of deals had a pro-sandbagging clause, only 9 percent of deals had an anti-sandbag clause.

So what about the remaining 56 percent? They took the silent approach by leaving out a pro or anti clause. The question is what occurs in the absence of a clause?

For the most part, the default position when the agreement is silent regarding sandbagging is that the buyer must have justifiably relied on the accuracy of a representation and warranty in order to recover any claims. Thus, this would mean that a buyer should not be able to bring post-closing claims for a breach of a representation and warranty that the buyer was aware of, because in such circumstance the buyer will not be able to demonstrate reliance on the breached representation.

However, the law is not completely settled on this matter and there are differences among various jurisdictions. Notably, Delaware and New York are generally seen as pro-sandbagging jurisdictions, while California generally is seen as an anti-sandbagging state. It is important to realize that there are still differences between Delaware and New York courts. In Delaware, when the contract is silent as to express provisions permitting sandbagging, buyer's pre-closing knowledge of a breach will generally not preclude it from claiming a breach post-closing. In New York, however, the case law is less clear and generally a buyer can bring a claim for a breach if it's pre-closing knowledge comes from a source other than the seller (*i.e.*, a third party or public information), but not if the information comes from the seller itself.

Conclusion

As shown by the sandbagging example, the drafting and review of U.S. commercial agreements is highly dependent on market practices and the specific jurisdiction governing the agreement. With offices across the United States, and specifically in Delaware, New York, and California–all states with highly sophisticated and oft-invoked commercial laws–Greenberg Traurig is uniquely situated to offer high value legal services to our Israeli clients.

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A View from London: The Impact of Brexit on UK Mergers & Acquisitions

By Alex Gest and Fiona Adams

On 23 June 2016, the United Kingdom voted to leave the European Union. Although the English High Court decided on 3 November 2016 that the UK Government must obtain the approval of the UK Parliament before it can trigger the Brexit process governed by Article 50 of the EU Treaty, the Prime Minister, Theresa May, continues to target the end of March 2017 as the date by which the UK will notify the European Council of its intention to leave the EU and officially start the Brexit process.

While the ultimate shape of the UK's relationship with the EU following Brexit remains unclear, it is clear is that UK mergers and acquisitions (M&A) activity will be, and, in some respects, already has been, affected by the ramifications of the referendum result. What is not clear at this stage is when the changes to the legal landscape will take place and in what form.

From a purely legal perspective, as UK M&A is subject to limited amounts of EU-derived law and regulation, M&A laws and regulations, both in terms of private and public M&A, are unlikely to be materially affected by Brexit or change significantly in the short term. From a commercial perspective, however, Brexit presents both risks and opportunities, with its effect varying between companies and industries, in some cases stirring activity, in others encouraging caution.

The general uncertainty introduced by Brexit has created many additional considerations which need to be taken into account both prior to embarking on an M&A transaction in the UK and also during the transaction. Sellers and buyers, for example, will need to consider the possibility that the nature and value of certain types of assets to be sold or acquired as part of a transaction may change once the UK exits the EU, inevitably impacting valuation. For example, pan-European intellectual property rights, such as registered and unregistered community designs and EU trade marks may lose some of their value by virtue of no longer having effect in the UK post-Brexit.

Conditionality

One of the ways to potentially protect against such risks is to introduce conditionality provisions tied to Brexit. In respect of transactions expected to close after Brexit has occurred, overseas buyers may try to obtain general economic material adverse change protection when there may be a reasonably long period between signing and closing to counteract major currency fluctuations and making express reference to Brexit. Buyers generally will want to provide themselves with increased flexibility, given the various potential outcomes of the UK's exit negotiations.

Another way would be to specify post-closing obligations which shall only apply up to and until the UK actually withdraws from the EU. Finally, the parties could provide for modified arrangements after the UK leaves the EU; for instance, a licensing agreement could be specified to cover the entire EU including the UK until Brexit, and be limited to the EU excluding the UK post-Brexit.

Due Diligence

Brexit will also naturally affect the commercial and legal assessment of a potential M&A opportunity, with additional emphasis being placed on the due diligence stage of a transaction. Buyers may need to consider new areas of focus when looking at diligence issues including, but not limited to, the definition of geographical scopes of key commercial contracts such as agency, distribution, supply, and licensing agreements, and supplier/customer dependency. Existing material adverse effect/change provisions in key contracts will receive enhanced scrutiny as the UK's exit from the EU may trigger such provisions, in turn allowing a counterparty to terminate or vary the relevant contract.

Brexit will also result in new challenges for target businesses which may include, but are not limited to: (a) potential tariffs being imposed on goods exported to, or imported from, the EU; (b) difficulties in moving EU staff to and from the UK (including administrative burdens associated with visas); and (c) the fate of EU grants/loans, particularly where the eligibility criteria limit the availability of the funds to recipients within the EU.

It is expected that warranty and indemnity provisions contained in the sale and purchase documentation for pre-Brexit transactions will be tailored to take into account the UK's exit from the EU. As a whole, there is no doubt that Brexit due diligence will also inform and affect deal valuation, deal-specific tax considerations, corporate restructurings, and overall transaction structures.

Regulatory Considerations

Brexit will also have an impact on various M&A regulatory considerations, such as takeover rules and merger control. While withdrawal from the EU is unlikely to have a significant effect on the substance of the rules applying to public takeovers (primarily because the EU Takeovers Directive implemented by the UK Takeover Code was heavily modeled on the UK Code in the first place), the same cannot be said for merger control considerations.

Currently, large transactions that impact the UK may be filed with the European Commission – under the one-stop-shop principle of the EU merger control regime there is no need for them to also be reviewed in the UK by the Competition and Markets Authority (CMA). Post-Brexit, an EU clearance will not cover the potential effects on the UK market, and this in turn will be likely to lead to an increase in the number of deals reviewed by the CMA under the UK's voluntary merger regime. Of the 337 notifications made to the EU in 2015, it is estimated that 50-75 would have been notifiable to the CMA in a post-Brexit world. Given that in the financial year 2014/15 the CMA reviewed 82 mergers, this would double its workload. One is also likely to see parallel notifications to the CMA and EU Commission which, in turn, will increase the cost, regulatory burden, and uncertainty inherent in M&A activity.

Finally, there is also a risk that the UK merger control process may become more politicised (stemming from recent comments by Theresa May which suggest an appetite for using the UK's merger control regime for more general industrial policy reasons), which could, in turn, impact deal clearance certainty and necessitate the use of political avenues to secure clearances.

Market Reaction and Outlook for the Future

As expected, the markets initially reacted negatively to the news of Brexit.

The U.S. $2.1 trillion decline in the value of global equity markets on the day after Britain voted to leave the EU was the biggest daily loss ever. The International Monetary Fund also downgraded the UK's economic growth forecasts for 2016 and 2017 by 0.2 and 0.9 percentage points, respectively—the largest reduction of all the advanced economies.

The longer-term outlook very much depends on getting greater clarity on the ultimate Brexit terms. Until there is more clarity on the nature of the UK's relationship with the EU post-withdrawal, many potential purchasers will continue to adopt a wait-and-see approach while continuing to assess potential buying opportunities as they emerge.

Some commentators, however, agree that the decrease in the value of sterling against other currencies and some falls in share prices is likely to result in an increased interest in companies that are based in the UK but generate a large portion of their revenues in currencies other than sterling. Some commentators also believe that the UK's stable financial, regulatory, and legal systems, in addition to the appealing corporate tax rates, have contributed to historical M&A activity and are not likely to change significantly post-Brexit. In other words, the markets will inevitably adjust to a post-Brexit world.

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