CLEARY GOTTLIEB

ALERT MEMORANDUM

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Selected Issues for Boards of Directors in 2015

As expected, 2014 proved to be a challenging year for boards. The legal and economic environments continued to grow more complex, and directors faced increasing scrutiny from investors and governmental authorities in the forms of market reaction, shareholder activism, litigation and enforcement and regulatory activity. We expect these trends to continue, and boards will need to remain extremely proactive in their oversight and involvement in 2015.

In the coming year, it will be crucial for boards to maintain a clear and current strategic vision. Throughout 2014, activist shareholders presented a significant challenge for all types of companies, and we expect the activity and influence of activists to further increase. Proactive risk management also will be necessary in 2015. Boards and management will be required to devote substantial attention to issues of cybersecurity, shareholder litigation, regulatory enforcement and other company-specific and systemic risks.

As these and other tasks grow ever more complex, directors must be actively engaged with management and outside advisors so that the concerns of shareholders and the challenges of the evolving business and legal environments are monitored and rapidly addressed. And boards must ensure that the company is communicating effectively with its shareholders and the market. In 2015, the ability of a board and its management to communicate their vision and explain the measures being taken to put that vision into effect will be critical for success.

In light of these pressures and concerns, this memorandum reviews the following issues:

- the risks presented by hedge fund activism, and measures to reduce vulnerability and respond to an activist challenge should it arise;
- the ability of companies to exclude proxy access proposals in favor of their own proposals;
- the continued threat of cyber attacks and strategies for prevention and response;
- the SEC's increasingly active approach to enforcement;
- changes in accounting and disclosure standards;
- the opportunity to amend bylaws to mitigate the costs and logistical burdens of shareholder litigation;
- developments with respect to the attorney-client privilege and their impact on the conduct of corporate business and internal investigations; and

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- the future for inversion transactions.

1. Shareholder Activism

In 2015, boards must be prepared to navigate the risks and opportunities presented by increasing and more aggressive hedge fund activism.

The State of Activism in 2015

The amount of money committed to activist hedge funds has grown over 20% per year in each of the last four years to exceed $110 billion, and the number of activist campaigns has risen to the range of 140 to 160 per trailing 12 months up from approximately 120 four years ago. Returns generally have been sufficient to justify expectations that these trends will continue in 2015.

Activists also are enjoying broad shareholder support. A board cannot rest easy simply because its shareholder profile does not show any aggressive activists. Traditional institutional shareholders, such as T. Rowe Price and Fidelity, may never run a proxy contest but will not necessarily be shy about communicating with and supporting activist hedge funds with respect to corporations in their portfolio they believe need shaking up. Non-activist hedge funds, pension funds and sovereign wealth funds may similarly support activist funds going forward.

Vulnerabilities and Foci

A company with steady cash flow and a healthy balance sheet is not immune from an activist campaign, and some recent studies have indicated that these characteristics may in fact make a company more likely to draw interest from activists. In general, activists have been focusing on the following:

- Return of cash through special dividends and share buybacks, often coupled with increased leverage. As long as cash balances at corporations remain high and interest rates remain low, we expect these financial engineering campaigns to continue.

- Value extraction through a split-off, spin-off or divesture due to perceived hidden or unrealized value of a unit within a larger company.

- Improvement of operations; change of management; and exploration of a sale of the company. Even if the "operational activist" lacks managerial expertise and its ideas on how to run the business are based on fluff, campaigns to replace senior management or to put the company in play, and their citation to underperformance relative to peers, can be very effective.

Activist Tactics

We expect that the 2015 activist playbook typically will entail the following:

- First, the activist confidentially accumulates a significant equity position. These "under the radar" accumulations take advantage of HSR exemptions (e.g., using options) and the fact that a public statement of ownership on Schedule 13D need not be filed until 10 days after crossing the 5% beneficial ownership threshold.

- The activist will then use social and traditional media, as well as filings on Schedule 13D, to distribute aggressive letters and white papers, which in the case of the largest funds have become increasingly sophisticated, smoothly composed and well-researched.

- The next step is to leverage tacit and overt support from other investors and proxy advisory firms. The relationships between the largest hedge funds and these actors are now well-established.

- Finally comes the threat of the proxy contest. Activists are no longer necessarily waiting until the annual meeting; they are taking steps to call special meetings and threatening to act by consent in lieu of a meeting where permitted by the charter and bylaws. As recently as a few years ago, almost all activists sought only minority board representation; now, however, activists are becoming increasingly emboldened to nominate replacements for every board member.

In addition to the more typical activist approach, as the war chests, market power and agility of activist funds increase, we may see more direct roles for activists in M&A activities. This could take the form of takeover proposals on their own or in tandem with partners as diverse as sovereign wealth funds and strategic operating companies; support for third-party hostile takeovers through accumulations of large equity positions and making public statements and running or threatening proxy contests; and tender offers (subject to the limits of poison pill rights plans) to increase dramatically their control at mid- and small-cap companies and put those companies into play.

Preparation and Response.

In 2015, boards must be proactive in preparing for and responding to hedge fund activism.

- *Engage in More Intensive and Focused Strategic Planning.* Directors must participate, at least annually, in comprehensive strategic planning to ensure that there is consensus and confidence in the corporation's direction. Topics to consider include:
    - Operational direction and reform, including thorough understanding of performance relative to peers and performance goals and targets (Which companies are our peers? Why are we underperforming or outperforming? What are our long-term targets for key operating metrics and how will we get there?);
    - Balance sheet management, including plans for dividends, share buybacks and leverage (Should we be incurring more debt? Should we be dedicating more excess cash to capital expenditures or M&A? Should we be returning more value to shareholders directly?);
    - Sum of the parts analyses (What are the costs and benefits of a spin-off or sale of a business unit?); and
    - Strategic alternatives analyses (Why is the stand-alone plan in the best interests of stockholders?).

- *Take Investor Relations to the Next Level*. Just as important as a well-formulated strategic plan is for the board to be involved and have confidence in how the plan will be communicated to investors. Too many corporations fail to engage with stockholders sufficiently to obtain buy-in to the corporation's approach to the issues most likely to be raised by hedge fund activists. A corporation should consider annual investor days, one-on-one meetings with major shareholders (including the participation of top executives and, at times, the lead director), presentations that explain the strategic plan for achieving long-term objectives and an overall approach to IR that goes beyond the earnings guidance game.

- *Consider Vulnerabilities*. Boards should understand their vulnerabilities from a governance perspective. Hot button issues that can attract negative attention from pension funds and proxy advisory firms, and thereby create volatility that an activist hedge fund can leverage, include: lengthy tenure of directors; lack of board diversity; lack of industry expertise among the directors; over-boarded directors; directors with poor attendance records; unnecessary related party transactions; executive compensation plan characteristics that will result in poor levels of support in the corporation's "say on pay" vote; and staggered board structures.

- *Upgrade the Bylaws*. Bylaws should guarantee that the board is fully informed about the efforts of any activist shareholder, including advance notice and related provisions that require the activist, when nominating directors or making a shareholder proposal, to be transparent about the material relationships and interests that the fund and its board nominees have (including requiring disclosure of derivative holdings, "golden leashes" and interests in and relationships with competitors). However, it is worthwhile to review these bylaws regularly to ensure that they are not written in a way that would cause a court to be reluctant to enforce them due to overly burdensome disclosure requirements (see, e.g., Chancellor Bouchard's remarks about Allergan's "horse choker of a bylaw").

- *Consider the Costs, Limitations and Rationale for a Poison Pill Rights Plan.* There is no doubt that a shareholder rights plan (i.e., poison pill) is justifiable and defensible when an activist files a Schedule 13D indicating that it may acquire more shares or engage in change-in-control transactions. But the board still needs to consider the costs and limitations of a rights plan. Glass Lewis has recommended withhold votes against governance committee directors even when a board adopts a rights plan with a term of only one year. ISS regularly recommends withhold votes against incumbent directors once a plan's term is extended beyond 12 months absent a prior stockholder approval. And more importantly, the rights plan may be of limited effectiveness against activism. At mega-caps, where not even the most wealthy hedge funds can afford to exceed the 3% ownership threshold, activist campaigns still regularly result in board seats and implementation of financial engineering and spin-offs. For somewhat smaller companies, a rights plan can give the board some space to deliberate and protect against accumulations beyond the 10% or 15% threshold. However, while the rights plan will discourage additional activists from explicitly collaborating for fear of exceeding the beneficial ownership threshold, it won't stop additional hedge funds from simply jumping on the bandwagon.

- *Foster Constructive Relationships*. Constructive relationships with hedge fund activists and their board designees are feasible, and boards should seek opportunities to leverage these relationships into support for the corporation's strategic plan. Directors and board counsel should not assume that reaching an amicable settlement with an activist will lead to disruption. Indeed, having an activist "under the tent" is often more constructive than engaging reciprocally in disparaging public statements or the necessarily awkward meetings where the activist, less informed than the representatives of the board, explains its perspective on the company, while the representatives of the board are not in a position to say much in response due to the constraints of Regulation FD and the reluctance of activists to enter into long-term non-disclosure agreements (often activists will only sign a non-disclosure agreement that requires the corporation to make public within a short timeframe any material non-public information disclosed to the activist).

- *Obtain Appropriate Protections and Concessions in Settlements*. As part of any settlement with an activist that involves addition of directors, the board should consider obtaining a standstill from the activist, as well as appropriate undertakings relating to use of confidential information by the director and the fund. In addition, the board should ensure that it has done background checks on the new nominees and that it is aware of any "golden leash" arrangements that would create an incentive for an activist director to pursue a strategic direction divergent from the interests of the public shareholders. Replacement of "golden leashes" with alternative fee arrangements that do not misalign incentives (e.g., flat fees from the hedge fund for service on the board) are reasonable to require as part of any settlement that results in board seats for the hedge fund.

- *Risks of Withhold Votes on All but the Activist Directors*. Boards should be conscious of the risks that arise from withhold vote recommendations when there is an activist on the board. For example, one board recently extended its rights plan beyond one year despite the activist directors on the board voting against the extension. As a result, the proxy advisory firms recommended withhold votes on the directors who voted against the rights plan (other than one new director), resulting in majority withhold votes for all directors other than the activist directors and the new director. If the company had had a majority vote policy, depending on its mechanics, the entire board (other than the new director and the activist directors) may have had to resign or, just as awkwardly, submit their resignations subject to the decision of the new director and the activist directors as to whether the resignations should be accepted.

2. Shareholder Proxy Access Proposals

In 2010, the SEC adopted a rule for "universal proxy access" at all public companies, which allowed a shareholder or group of shareholders who have beneficially owned at least 3% of a company's stock continuously for a period of three years to include director candidates in the company's annual proxy statement for up to a quarter of the current board seats. That rule was struck down in 2011 by the U.S. Court of Appeals for the D.C. Circuit, but the court left intact the ability for shareholders to submit proposals asking companies to adopt proxy access bylaws. A small number of such proposals were submitted in 2012 and 2013, often incorporating lower ownership thresholds (e.g., 1% of stock held for one year). None of those proposals received majority support from shareholders.

In 2014, shareholders began submitting proxy access proposals using the same 3%/3-year thresholds as the 2010 SEC rule. The voting guidelines of the proxy advisory firms ISS and Glass Lewis state that in determining whether to support proxy access proposals, they consider the ownership and holding requirements of the proposal as well as certain "good governance" characteristics of the underlying companies, but in each of the 2014 cases they recommended that shareholders support the 3%/3-year proposals, and, in six of nine cases, the proposals received majority support from shareholders. A handful of companies adopted their own proxy access bylaw amendments in 2014, either independent from shareholder proposals or in response to a failed shareholder proxy access vote.

Over 100 companies have already received proxy access proposals for the 2015 proxy season, including 75 submitted by the New York City Comptroller as part of its "Boardroom Accountability Project." ISS and Glass Lewis have not made any changes to their proxy access proposal policies for the 2015 proxy season, so we assume they will continue to recommend support for 3%/3-year proposals. Many large institutional shareholders have also indicated their support for 3%/3-year proposals.

Exclusion of Shareholder Proxy Access Proposals

Under Rule 14a-8(i)(9) of the Securities Exchange Act of 1934, a company may exclude a shareholder proposal if it directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting. Whole Foods Market, Inc. recently received no-action relief from the SEC relating to its exclusion of a shareholder proxy access proposal on the basis of a directly conflicting management proposal, where the two proposals had very different terms. The shareholder proposal would have permitted a shareholder or a group of shareholders holding at least 3% of the company's shares for at least 3 years to include in the company's proxy statement nominees for up to 20% of the company's entire board or at least two members. The management proposal would permit a single shareholder (not a group) holding at least 9% of the company's shares for at least five years to include the greater of one nominee or 10% of the entire board in the company's proxy statement. The SEC granted no-action relief to Whole Foods on the basis that the two proposals were in direct conflict; the shareholder proponent of the Whole Foods proxy access proposal has requested that the SEC staff refer the question to the full Commission, but this relief is rarely granted. Whole Foods filed a preliminary proxy statement on December 31, 2014, and it reduced the required ownership to 5% from 9%.

Since the SEC granted relief to Whole Foods on December 1, 2014, five more companies have filed no-action requests seeking permission to exclude shareholder proxy access proposals on similar grounds. In each case, the shareholder proposal included a 3%/3-year threshold for a single shareholder or a group, and would have permitted nominees for 25% of board seats. Each of the companies seeking no-action relief described management proposals that would establish more limited proxy access rights than the proposal offered by shareholders, but that were not as restrictive as the Whole Foods proposal. The SEC has not yet acted on these requests, but no-action relief would be consistent with the Whole Foods precedent, as well as the SEC's approach to similar management-shareholder proposal conflicts (e.g., in the context of proposals regarding shareholders' rights to call special meetings). Neither the proxy advisory firms nor the large institutional shareholders have yet expressed their views on proxy access proposals with ownership threshold and holding period requirements exceeding the 3%/3-year proposals that they supported during the 2014 proxy season.

Offering a Conflicting Proxy Access Proposal

If a Board wishes to exclude a proposal from its 2015 annual proxy statement, it may offer a conflicting management proposal for shareholder vote. Based on the no-action relief granted to Whole Foods, it is likely that even a company proposal containing materially different terms from the shareholder proposal (including a different ownership threshold, holding period, individual or group allowance, and number of directors that may be nominated) would provide sufficient basis for a company to exclude the shareholder proposal.

- *Ownership Threshold.* Although each of the proxy access proposals voted on by shareholders in 2014 included a 3% ownership threshold, all five of the companies offering conflicting management proposals so far for 2015 included a higher stock ownership threshold, typically 5%. However, since none of the proxy access proposals from the 2014 proxy season included an ownership threshold above 3%, it is unclear how institutional investors and proxy advisory firms will respond to higher requirements.

- *Holding Period.* As with the ownership threshold requirement, all of the proxy access proposals on which votes were held last year contemplated a holding period of three years, so it is unclear how a longer holding period would be viewed by the proxy advisory firms and institutional investors. Management proposals for 2015 adopt a variety of different holding periods, but several have lengthened this period to five years.

- *Individual or Group.* While most of the proxy access proposals voted on during 2014 would have permitted nominations by either individuals or groups of shareholders who met the ownership and holding period thresholds, the conflicting management proposals submitted this year more often require an individual shareholder to meet the threshold, which may be particularly limiting when the proposal also includes a high ownership threshold. Several of the proxy access proposals offered by management in 2014 and in 2015 took an alternative approach by limiting the number of shareholders who may comprise a group to up to ten or twenty. In a case where a company has a relatively large number of significant shareholders, limiting the proxy access right to individuals or to groups made up of a limited number of shareholders may be one way to avoid multiple nominations from a large number of groups, while still providing proxy access to its significant shareholders.

- *Number of Directors.* In proxy access proposals voted on during the 2014 proxy season, the number of directors that a qualified shareholder or group of shareholders would be permitted to nominate was either 20% or 25% of the entire board. Several of the management proposals offered for 2015 limit that number to the greater of 10% or 1 director. Since none of the proposals voted on in 2014 so limited the nominations, it is unclear how institutional shareholders and the proxy advisory firms will view this type of limitation.

While shareholder proxy access is a significant topic in corporate governance for the 2015 proxy season, the proxy access votes from 2014 offer little guidance in terms of what alternative proposals may be satisfactory to shareholders. Companies may wish to engage directly with the shareholder making a proposal, as well as other significant shareholders, to determine their reactions to a company proposal with a higher ownership threshold and holding period, and potentially a lower number of permitted nominations. The Whole Foods no-action relief may provide flexibility to offer a different proposal with terms that are more restrictive or more closely tailored to a company's particular circumstances (market capitalization,

shareholder concentration, or board size). However, a company making a particularly restrictive proposal may provoke adverse publicity and possibly investor dissatisfaction, and it could face a new shareholder proposal with less restrictive terms in a later year.

3. Cybersecurity

High profile cyber breaches continued in 2014, with significant attacks on businesses of all types, including major retailers, financial services firms, healthcare providers and media and entertainment companies. These breaches resulted in significant harm to the hacked companies, including financial burdens, reputational issues, litigation and enforcement actions, the loss of customer and patient information and the theft of valuable intellectual property, strategic information and other assets. In this environment, management and boards should focus on developing and reviewing their company's strategy for averting, and perhaps more importantly mitigating, the damage caused by a potential cyber breach.

This requires a multidisciplinary approach tailored to the company's risk level, taking into account the nature of its operations, industry and key vulnerable assets. Although several standards have emerged, including the National Institute of Standards and Technology's Framework for Improving Critical Infrastructure Cybersecurity (the "NIST Framework") and several industry-specific guidelines, there is no one-size-fits-all approach, and we expect these standards will evolve as market practice and assessment of risk profiles continue to develop.

We believe that companies should focus on the following key cyber priorities in 2015:

- *Regularly assessing cyber vulnerabilities.* Even the most robust cybersecurity program cannot prevent all breaches. However, a company can reduce (but likely not eliminate) the risk of a cyber breach and any damage resulting from a breach. In order to determine the areas of greatest risk, companies should regularly assess the nature and extent of any intellectual property, strategic information and other valuable assets as well as any personal information (including any financial and healthcare information) that is stored on their externally accessible systems or through cloud providers. Companies should review their policies and procedures for collecting and storing information and ensure that they have taken appropriate steps to protect these assets, including, if feasible, by encrypting the information, restricting access to it or storing it on segregated servers. Companies also should consider whether to involve outside experts in this exercise.

- *Assembling a multidisciplinary team.* Recent attacks have made clear that the most effective responses to a cyber breach involve a coordinated multidisciplinary team that brings together senior management, members of the company's business units, and representatives from IT, legal, human resources, and investor relations. Companies should also have the right external advisors, including cybersecurity experts who can help analyze and remediate the cyber intrusion; external legal counsel who can assist with the legal implications of the breach, including the sensitive, real-time disclosure issues, issues under state data breach statutes and international privacy laws and any related litigation or enforcement action; and public relations advisors who can help manage reputational concerns. Identifying a team before a breach occurs and involving the team in regular cyber vulnerability assessments will result in a more robust assessment as well as a more effective response if a breach occurs. In addition, companies should consider proactively establishing a relationship with the appropriate

law enforcement authorities to facilitate a rapid response to any attack, subject to relevant privilege concerns that should be analyzed with legal counsel.

- *Developing an incident response plan*. Recent data suggests that cyber breaches are often not discovered by the targeted company but rather by law enforcement or bloggers, and that, by the time they are uncovered, the hackers have been present on the company's system for an extended period of time. In these instances, the targeted company will be under significant pressure to make disclosure and reassure the market, even though it is still in the process of gathering the relevant facts. Companies, therefore, will benefit from a robust response plan that takes into consideration any relevant frameworks (including the NIST Framework) and applicable industry-specific guidelines, and also permits sufficient flexibility to make real-time decisions depending on the nature of the cyber breach. Any incident response plan should include: (i) a strategy to investigate and remediate the breach; (ii) the preparation of draft disclosures for regulatory filings, press releases, websites, FAQs and similar documents; (iii) a plan for complying with applicable state data breach statutes and international privacy obligations; (iv) a strategy for monitoring the company's trading window and determining whether to impose a special blackout; and (v) a clear allocation of responsibilities for the above.

- *Reviewing arrangements with third-party vendors.* Some of the most high profile cyber breaches over the last few years occurred, in part, as a result of weaknesses in third-party vendors' cyber protocols. Although companies should insist on appropriate representations and warranties as well as indemnification provisions in their arrangements with their third-party vendors, they also should conduct careful diligence to understand, evaluate and monitor their vendors' cyber protocols. A company should refuse access to its systems if the results of this diligence exercise are unsatisfactory.

- *Reviewing existing cyber disclosures*. Given the large number of recent high profile attacks, companies should carefully review their existing cyber disclosures and reflect any necessary updates in the upcoming annual reporting season. Companies should continue to refer to the SEC's Division of Corporation Finance 2011 guidance in determining the extent of cybersecurity disclosure required in their SEC filings and consider the SEC staff's subsequent guidance (generally in comment letters) urging companies to tailor disclosures to their specific risks and history (including requiring disclosure of whether the company has suffered a material cyber breach). At the same time, as companies review the effectiveness of their disclosure controls and internal controls, they should carefully focus on the role of cybersecurity within those controls.

- *Considering strategy for handling any shareholder cyber proposals.* We expect the number of shareholder cyber proposals for inclusion in proxy statements to increase. So far, such proposals have primarily requested information and reports on how companies oversee privacy and data security risks. Companies should consider what steps they can take to prepare to best address any such proposals.

- *Considering cybersecurity insurance*. Cybersecurity insurance generally is designed to mitigate losses from a variety of cyber incidents, including data breaches, business interruption, and network damage. While cybersecurity insurance is unlikely ever to be sufficient to cover all losses arising from a cyber breach (particularly when considering reputational implications), companies should nonetheless carefully review any existing

coverage and consider the added benefits from obtaining specific or additional insurance.

- *Involving the board in the cyber effort*. The importance of consistent board involvement in cybersecurity efforts was highlighted by an October 2014 decision by a U.S. District Court in New Jersey.[1] In dismissing a shareholder derivative suit against directors and officers of Wyndham Worldwide Corp. for cyber breaches, the court noted, among other things, that (i) the Wyndham board discussed cyber issues (including the recent cyber attacks, Wyndham's security policies and proposed security enhancements) at fourteen meetings (both before and after the breach); (ii) the Wyndham audit committee reviewed the same matters in at least sixteen meetings during the same period; and (iii) Wyndham hired technology firms to investigate each breach and had begun implementing recommendations made by those firms.

  We recommend the following procedures with respect to board involvement:

  - Boards should affirmatively determine whether the full board should be tasked with cybersecurity oversight or whether it should primarily be the responsibility of a specific committee. The size of the company, the company's level of risk and developments in market practice by peer companies will influence this decision.

  - If a committee is tasked with primary oversight responsibility, which committee will depend on the individual circumstances and board composition of the particular company, and regular reports should still be made to the full board. Some companies may choose to allocate oversight of cybersecurity matters to the audit committee given its role in reviewing risk; others may assign this responsibility (particularly given the significant responsibilities already falling to most companies' audit committees) to an existing risk or IT committee; and still others may allocate this responsibility to a special cyber committee.

  - The board (either as a whole or through the designated committee) should focus on having a clear understanding of developments in the company's industry and in the market more generally so that it can evaluate the company's vulnerabilities and preparedness against evolving best practices. To that end, the board should require regular updates on the status of the company's incident response team and plan, with a particular focus on any deficiencies and means of remediation. It should also ensure that it receives regular briefings on industry and market developments regarding cyber attacks, response strategies, legal and regulatory developments, litigation and enforcement activity (and related settlements or decisions) and disclosure trends. Of course, if the company has suffered a significant breach, the board should be involved immediately, and should receive frequent updates on status as the investigation and response progresses.

[1] *Palkon v. Holmes*, No. 14-CV-01234 (SRC), 2014 U.S. Dist. LEXIS 148799 (D.N.J. Oct. 20, 2014).

4. SEC Enforcement Trends

The past year was an active one for the SEC's Enforcement Division, which had a number of successes across a broad range of the Division's areas of responsibility. Although the total number of actions filed can be a misleading statistic, by that measure 2014 was a record year; the Enforcement Division brought 755 actions and obtained orders resulting in $4.16 billion in monetary sanctions (which is itself a record amount).

As the remaining cases relating to the financial crisis wound down, the SEC continued to press forward with its long-standing focus on insider trading and violations of the Foreign Corrupt Practices Act (FCPA), while expanding its efforts in other areas. For example, the SEC has renewed its focus on financial reporting and disclosure cases, in part through the creation of the Financial Report and Audit Task Force (FRATF). This led to several enforcement actions regarding the preparation of financial statements and disclosure issues, and the SEC has promised more in 2015. We expect the SEC will continue to use its other data analysis tools to identify possible disclosure and reporting issues as well. Last year also saw the continued growth of the SEC's whistleblower program, which received 3,620 tips (up from 3,238 the prior year) and made $35 million in payments to whistleblowers. And the SEC brought its first case charging violations of the whistleblower anti-retaliation provisions against a hedge fund that allegedly retaliated against an employee who reported prohibited trading activity to the SEC.

While issues like growth of the FRATF, use of data analytics to identify and bring cases, and the growth in the whistleblower program are all issues to watch, the following issues are likely to be of particular interest to directors in 2015.

Continued Focus on "Gatekeepers"

The SEC has stepped up its efforts to punish so-called "gatekeepers" – such as directors, lawyers, and accountants, who are supposed to protect the company and its investors – for failing to take steps to prevent fraud and other misconduct. In a speech last year to the Stanford Directors' College, SEC Chair Mary Jo White called directors a company's "most important gatekeepers." White expressed her view that it was the responsibility of directors and senior management to set an appropriate "tone at the top" with respect to corporate governance and "rigorous compliance." She also reminded directors that they must "ask the difficult questions, particularly if you see something suspicious or problematic" and that they must "never ignore red flags."

The danger for directors of not fulfilling that gatekeeper role has been vividly illustrated in several cases the SEC brought last year. For example, the SEC brought an enforcement action against AgFeed Industries and a number of its executives relating to an accounting fraud. The action included the company's audit committee chair, who was allegedly advised of the misconduct (that there was "not just smoke but fire") and received a recommendation to hire outside counsel and investigators to investigate, but did not take action.[2] In another action, the SEC brought proceedings against the chair of the audit committee for a coal company, L&L Energy, for allegedly signing, as a director, a filing containing a certification (required by Sarbanes-Oxley) falsely stating that any fraud, whether or not material, involving management had been brought to the attention of the company's auditors and Audit Committee.[3] In that

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[2] "SEC Charges Animal Feed Company and Top Executives in China and U.S. With Accounting Fraud," available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541102314#.VK1lSPkRBhc.

[3] *In re Kiang*, available at https://www.sec.gov/litigation/admin/2014/34-71824.pdf.

case, the chair of the audit committee had been advised that the company and its CEO were allegedly misrepresenting the identity of L&L's purported acting CFO in public filing but did not share it and then signed the filing containing the false Sarbanes-Oxley certification.

Pursuing violations of the securities laws by gatekeepers is an announced priority of the SEC for 2015. While the AgFeed and L&L cases are obviously extreme examples, they make clear that directors can sometimes find themselves in difficult situations involving wrongdoing at their company. When that happens, as part of their responsibility as directors, they should take steps to ask questions, ensure that an appropriate (and if necessary independent) internal investigation is conducted to identify the nature and scope of that misconduct, and, where relevant, oversee remediation efforts to prevent the misconduct from happening again.

The "Broken Windows" Debate

In October 2013, SEC Chair White announced a new enforcement strategy as part of an effort to "strive to be everywhere." In short, the SEC would pursue even the smallest infractions, because "minor violations that are overlooked or ignored can feed bigger ones, and, perhaps more importantly, can foster a culture where laws are increasingly treated as toothless guidelines." Chair White likened this approach to the "broken windows" strategy used by New York City Police in the 1990s to prosecute even minor violations so that wrongdoers realized there was a cost to violating the law, which, in turn, would help prevent further, more serious violations of law.

The Enforcement Division followed through on this announced strategy in 2014. In September 2014, the SEC announced charges against 28 officers and directors of companies (as well as six public companies) with failing to file required reports about their holdings and transactions in company stock under Sections 13(d), 13(g) or 16(a) of the Exchange Act. Almost all of the defendants settled the charges, paying fines of between $25,000 and $150,000 (two parties charged with more serious violations paid higher fines). In announcing these actions, Andrew Ceresney, the SEC's Director of Enforcement, noted that the SEC had used data analytics tools to identify and target individuals who had repeated filing deficiencies. But Ceresney also took the opportunity to relate the charges back to the "broken windows" strategy, noting that inadvertence was not a defense to a failure to comply with these filing obligations and that the SEC would police these types of violations vigorously.

Notwithstanding the SEC's announced efforts to step up its policing of such violations, the policy has not been without controversy. Following these September 2014 charges, SEC Commissioner Michael Piwowar appeared to take issue with the approach in a speech at the Securities Enforcement Forum (where White had discussed the policy a year earlier). Piwowar challenged the underlying premise of the approach, noting that "If every rule is a priority, then no rule is a priority. If you create an environment in which regulatory compliance is the most important objective for market participants, then we will have lost sight of the underlying purpose for having regulation in the first place." Ceresney, on a panel after Piwowar's speech, however, defended the strategy, stating that the goal was not to make every violation into an enforcement action, but instead to bring a culture of compliance to specific areas of regulation.

Whatever the outcome of this debate in 2015, the September 2014 actions sent a clear message from the Enforcement Division that it will focus on even technical violations of law and regulation (such as late filings) and that it will use data analysis to identify those violations in the first instance. For directors and significant shareholders of companies who have to comply with these types of filing and notice requirements, it is important to ensure compliance with all of

them, and to confirm that the company has appropriate policies and practices addressing such compliance. More broadly, these actions reinforce (yet again) the need for companies to have an appropriate compliance and control framework that addresses relevant laws and regulations, even with respect to those areas that may previously have been deemed less of a risk because they have not been vigorously enforced.

New Insider Trading Decision

On December 10, 2014, the U.S. Court of Appeals for the Second Circuit issued an important and much-anticipated decision that clarified certain aspects of insider trading law, especially with regard to tippees. For reasons discussed below, however, this decision is unlikely to have a significant impact on how companies (and directors) should approach insider trading and material non-public information.

In United States v. Newman and Chiasson,[4] the Second Circuit addressed the appropriate standard for sustaining an insider trading conviction against a tippee. The defendants were remote tippees, meaning that they received material non-public information from an intermediary tippee, the recipient of the insider information, who ultimately received it from the tipper, a company insider. The Court held that in order to sustain an insider trading conviction against a tippee, the prosecution must prove that the tippee knew that a company insider had disclosed confidential information *and* that the insider did so in exchange for a personal benefit in violation of the insider's fiduciary duty. The Court then went on to hold that the evidence against the defendants was insufficient in two respects. First, the evidence of personal benefit provided to the company insiders – "career advice" and "family friendship" – were each insufficient as a matter of law to establish the required personal benefit. If these were "personal benefits" for purposes of insider trading liability, the Court noted, then "practically anything would qualify." In short, the personal benefit must be "of some consequence." Second, the Court found that the prosecution had failed to prove that the defendants knew that they were trading on information obtained from an insider in breach of the insider's fiduciary duty. The Court noted that the defendants were several steps removed from the insiders, knew next to nothing about them, and knew little about what, if any, personal benefits they received.

The Second Circuit's decision will no doubt make it more difficult to secure insider trading convictions against tippees, particularly remote ones. From a company's perspective, however, the decision is likely to have little practical impact. Notwithstanding this decision, the SEC and the Department of Justice will continue to make insider trading prosecutions a priority, even if certain kinds of cases may be more difficult to make. Moreover, a public company "insider" is often the individual who is acting as the tipper, and, in the financial industry in particular, certain employees may have a financial motivation to obtain material nonpublic information to use improperly for trading purposes. As a result, maintaining robust policies and training around the handling and improper use of material non-public information will continue to be important, not only from a legal and regulatory perspective, but for business and reputational purposes as well.

5. Accounting and Disclosure Matters

The new "global" standard on revenue recognition, issued jointly by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), comprehensively overhauls existing revenue recognition rules. It is more principles-based than

[4] *United States v. Newman*, Nos. 13-1837, 13-1917 (2d Cir. Dec. 10, 2014).

the existing U.S. GAAP standard and will require U.S. companies to make more estimates and judgment calls than under current guidance. The new standard is currently scheduled to take effect for reporting periods beginning after December 15, 2016 for U.S. public companies (with retrospective adoption requiring three years of comparative financial statements) and for reporting periods beginning on or after January 1, 2017 for companies that use International Financial Reporting Standards (IFRS) (with two years of financial statements for retrospective adoption). The FASB is currently researching several implementation issues that may delay implementation for U.S. companies by an additional year. Boards and audit committees should ensure that management carefully evaluates the new guidance and implements appropriate changes to accounting systems and controls.

The new revenue recognition standard reflects efforts by the FASB and the SEC staff to work with the IASB to develop converged "global" accounting standards. A similar overhaul to lease accounting is currently underway at the FASB and IASB, with a similar principles-based approach, but will likely still take some time to finalize. Accounting for insurance companies is also in the works, but there is currently considerable divergence between the IASB and FASB proposals. Further, true IFRS convergence still seems a long way off for U.S. companies. Recent comments by James Schnurr, Chief Accountant of the SEC, suggested that in his view market participants may not generally support full movement to IFRS, optional or otherwise, for U.S. companies. Accordingly, he indicated that the SEC may consider, among other things, permitting inclusion of supplemental IFRS information alongside U.S. GAAP financial statements (and possibly changing the non-GAAP rules to make that easier). Further consideration at the SEC should take place over the next few months.

Another accounting and auditing matter that boards should consider in the coming year is the new framework for internal control over financial reporting (the 2013 COSO framework, replacing the 1992 framework). Some companies have already adopted the new framework, but for those companies with a December 31 year-end that have not already done so, adoption of the new framework should be in its final stages, and boards and audit committees should expect to hear a comprehensive review of this process along with the usual year-end evaluation of controls. The PCAOB continues to be focused on how the auditing process can be improved, and Chief Accountant Schnurr indicated in December 2014 that the SEC is encouraging the PCAOB to move more quickly to update auditing and quality control standards.

Chief Accountant Schnurr also indicated that the SEC may consider proposing changes in audit committee disclosure requirements and encouraged audit committees to evaluate how their disclosures might be enhanced in advance of any such changes. That statement mirrors the SEC's recent recommendations with respect to disclosure more generally. In October 2014, Keith Higgins, Director of the SEC Division of Corporation Finance, provided details of the Staff's disclosure effectiveness project, in which the Staff is evaluating the SEC disclosure rules – principally Regulation S-K and Regulation S-X (and business and financial disclosures in particular, rather than compensation or governance disclosures) – to develop proposals to update and modernize disclosure requirements, eliminate duplicative disclosures and continue to provide material information to investors. With respect to financial disclosures, Director Higgins stated that the SEC is discussing joint efforts with the FASB to eliminate overlapping requirements. He indicated that the SEC is also considering whether the technology and approach for delivery of company disclosure could be changed (e.g., a "company file" approach rather than submission of stand-alone reports through EDGAR). Any such far-reaching change in approach is unlikely to occur in the near term, however, and would likely take the form of a concept release in the first instance; changes to individual disclosure requirements seem more feasible in the short term.

Director Higgins further recommended that companies consider how they can enhance their disclosure in advance of any rule proposals, encouraging companies to experiment with presentation, reduce duplication and eliminate stale or immaterial information. He indicated that the Staff is willing to talk to companies about these efforts, although they won't pre-clear specific disclosures. Accordingly, boards and audit committees should at least be open to efforts by management to enhance company disclosure in annual disclosure documents and should ensure that management is focused on a clear and effective presentation of material information.

6. Litigation-Related Bylaws

In 2014, courts displayed increasing comfort with boards adopting litigation-related bylaws. These decisions serve as a reminder that corporate bylaws may be powerful tools for implementing innovative mechanics addressing corporate litigation, including for resolving disputes between stockholders and fiduciaries.

Exclusive Forum

Bylaws selecting an exclusive forum for resolving disputes raising internal corporate matters – such as claims made by stockholders against directors and officers – are now well accepted. In 2013, then-Chancellor Strine of the Delaware Court of Chancery held in *Chevron* that bylaws unilaterally adopted by a board (where permitted by the charter, as is common) can validly designate an exclusive forum for resolving internal corporate disputes and bind all stockholders, including those who acquired shares before the bylaw was adopted.[5] In the 18 months since *Chevron* was issued, courts in California, Illinois, Louisiana, New York, Ohio and Texas have enforced bylaws that, in each case, selected the courts of Delaware to hear disputes brought by stockholders against fiduciaries of Delaware companies. In an important decision extending *Chevron*, Chancellor Bouchard held in *First Citizens*[6] that a bylaw could select a forum outside Delaware as the exclusive place to hear internal affairs disputes (there, a Delaware corporation selected the courts within the state of its headquarters as the exclusive forum), *and* that the exclusive forum bylaw could be adopted on a so-called "cloudy" day (there, the bylaw was adopted on the same day the board also adopted a merger agreement, that it presciently believed would be the subject of later stockholder litigation). In December 2014, the Supreme Court of Delaware affirmed the power of boards to adopt forum selection bylaws (and to condition DGCL § 220 books and records document productions on adherence to them), noting that they reflect a corporation's interest in rationalizing stockholder litigation, and endorsed board-adopted bylaws as valid and enforceable against stockholders who purchased shares before adoption.[7]

As of December 1, 2014, over 400 corporations had adopted forum selection clauses. The vast majority were adopted unilaterally by boards of directors; fewer than 20 corporations adopted the forum selection clause via a charter amendment, which requires a stockholder vote. Despite the clear benefits to the corporation that forum selection clauses provide, the leading proxy advisory firms generally have viewed them skeptically. Although ISS and Glass Lewis recommended against adoption of the forum selection clauses that were put to stockholder votes in 2014, each passed, with support ranging from 56% to 90% of the votes cast.

[5] *Boilermakers Local 154 Ret. Fund v. Chevron*, 73 A.3d 934 (Del. Ch. 2013).

[6] *City of Providence v. First Citizens BancShares, Inc.*, 99 A.3d 229 (Del. Ch. 2014).

[7] *United Technologies Corp. v. Treppel*, No. 127, 2014 (Del. Dec. 23, 2014) (en banc).

Furthermore, stockholders do not appear to have adversely reacted to directors (by casting withhold or against votes) based on their unilateral adoption of a forum selection clause. Thus, we expect exclusive forum clauses to continue to be widely adopted. Our memorandum of November 19, 2013 includes model bylaw language.

Mandatory Arbitration

It remains to be seen whether mandatory arbitration bylaws receive as favorable treatment from courts as exclusive forum bylaws (at least for individual claims, if not for class actions). The U.S. Supreme Court has upheld mandatory arbitration clauses in commercial contracts,[8] but the legal precedent enforcing mandatory arbitration bylaws is limited to REITs chartered under Maryland law, and no Delaware court has yet considered the issue.[9] It is not clear whether courts addressing the issue in the context of stock corporations will agree with the REIT decisions, even though those decisions rely on the *Chevron* analysis that upheld exclusive forum bylaws. Proxy advisors and institutional investors generally oppose proposals to adopt mandatory arbitration provisions, as does the SEC staff, which has declined to accelerate the registration statements of companies with such provisions in their organizing documents. It is unclear whether and how the SEC will react to arbitration bylaws adopted by corporations that are already public.

Even if permitted, whether arbitration should be selected as the exclusive forum for resolving internal affairs disputes is debatable. Arbitration offers the benefits (among others) of confidentiality, limited discovery costs and often – though not always – swift resolution. But arbitration is not well-suited to class actions, the structure through which many internal affairs claims are brought, and corporations may prefer a single proceeding where all claims can be resolved rather than a multitude of arbitrations. In addition, arbitration offers virtually no appellate rights, and rarely do arbitrators dismiss actions prior to a full testimonial hearing.

Fee Shifting

Another topic recently generating a great deal of discussion is whether corporations can adopt "fee-shifting provisions," which allow a corporation to recover legal expenses from an unsuccessful plaintiff in an intra-corporate dispute. In 2014, the Delaware Supreme Court upheld the facial validity of a fee-shifting bylaw of a non-stock Delaware corporation in *ATP Tour*.[10] The Court said that, in the abstract, such bylaws "may be enforceable if adopted by the appropriate corporate procedures and for a proper corporate purpose." Whether a fee-shifting bylaw is enforceable in any specific case will depend on the manner in which it was adopted and the circumstances under which it was invoked. Importantly, *ATP Tour* noted that "the intent to deter litigation . . . is not invariably an improper purpose."

Delaware courts have not yet reached the merits of any case calling into question the adoption of a fee-shifting bylaw by a stock corporation, but there are cases that are briefing the issue now. And, in a recent lecture, Vice Chancellor Laster of the Delaware Court of Chancery suggested that, due to the structural limitations of the Delaware General Corporation Law, fee-shifting provisions may be invalid unless they are adopted in a charter.

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[8] *American Express v. Italian Colors Rest.*, 133 S. Ct. 2304 (2013); *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740 (2011).

[9] *Delaware Cnty. Emps. Ret. Fund v. Portnoy*, 2014 WL 1271528 (D. Mass. Mar. 26, 2014); *Katz v. Commonwealth REIT*, No. 24–C13–001299 (Md. Cir. Ct. Feb. 19, 2014).

[10] *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A. 3d 554 (Del. 2014).

Legislation addressing the validity of fee-shifting provisions is expected. A bill limiting fee-shifting provisions to non-stock corporations was expected to be proposed by the Delaware General Assembly last summer, but given the strong opposition from the U.S. Chamber of Commerce and others, consideration of the legislation was postponed until 2015. The Oklahoma State Legislature amended the Oklahoma General Corporation Act to require fee-shifting for all derivative suits brought in Oklahoma (including those brought against non-Oklahoma corporations). Other states are also considering fee-shifting legislation.

The SEC has not yet taken a position on fee-shifting bylaws, but Senator Richard Blumenthal (D-Conn.) has asked it to take action to respond to these provisions. In recent testimony to the SEC's Investor Advisory Committee, Professor John Coffee suggested that unless a fee-shifting bylaw explicitly excludes cases involving federal securities laws, it should be considered contrary to the public interest. Professor Coffee also suggested that the SEC should refuse to accelerate the registration statements of companies with fee-shifting provisions in their organizing documents, as it has with mandatory arbitration provisions.

As of November 19, 2014, more than 40 public companies (including some with active disputes) had adopted fee-shifting provisions in their bylaws or charters. Some, including Alibaba Group Holding Ltd. (a Cayman Islands company), Smart & Final Stores, Inc. and ATD Corp., went public with a fee-shifting provision in place. No large, well-known U.S. corporation has adopted a fee-shifting bylaw yet. Proxy advisors and institutional investors remain strongly opposed to these provisions.

Because of the uncertainty about whether and in what circumstances fee-shifting provisions will be upheld, corporations should continue to exercise caution when considering adoption.

7. Attorney-Client Privilege

Over the past year, there have been several important developments in the law of attorney-client privilege that are relevant to the work boards do, particularly with respect to internal investigations and corporate transactions. Three notable decisions reaffirmed existing principles or clarified previously unsettled areas of the law on privilege, which should give companies more certainty about its protections and limitations moving forward.

Two of these cases dealt with plaintiffs seeking to obtain documents related to internal investigations. In In re Kellogg Brown & Root, Inc.,[11] the U.S. Court of Appeals for the District of Columbia reaffirmed the long-standing rule that communications relating to internal investigations carried out by counsel, including notes of interviews of company employees, are privileged against disclosure in a suit against the company. Importantly, the court maintained that the privilege applies whether or not the investigation is carried out by in-house or external counsel, and that it protects notes and memoranda of interviews even if performed by non-attorneys, provided the interviews were conducted as part of an investigation supervised by counsel. Perhaps most significantly, the court clarified that the attorney-client privilege applies as long as *one* significant purpose of the investigation is to provide or obtain legal advice, even if the inquiry is carried out for other purposes as well, including where it is required by regulation or a company's compliance program. This decision provides comfort to companies that they will not lose the protections of the attorney-client privilege simply because regulations or corporate

[11] *In re Kellogg Brown & Root, Inc.*, 2014 WL 2895939, No. 1:05-cv-1276 (D.C. Cir. June 27, 2014).

policy require the investigation, or where it is handled by internal counsel or even non-lawyers under counsel supervision.

While the Kellogg Brown decision strengthens the attorney-client privilege, the Supreme Court of Delaware arguably limited its protections. In Wal-mart Stores, Inc. v. Indiana Electrical Workers Pension Trust Fund IBEW,[12] a case involving allegations of bribery by a Wal-mart subsidiary in Mexico, Delaware's highest court held for the first time that where stockholders can make a showing of "good cause," they may be able to gain access to otherwise privileged material to support a claim for breaches of fiduciary duties. In adopting this so-called Garner exception — first announced in 1970 by the U.S. Fifth Circuit Court of Appeals — the Delaware court explained that in order to find "good cause," a court must consider several case-specific factors. Notably, the case involved a stockholder request to inspect books and records, and the court held that the exception applies to these types of actions as well as to ordinary merits proceedings. However, the court stressed that in a books and records proceeding, before a court considers whether the exception to the privilege applies, the stockholders must first meet a separate test of establishing that the materials are necessary and essential to a proper stockholder purpose. While the Delaware Supreme Court's adoption of this exception is significant, lower courts in Delaware had already applied the exception on several occasions, and the Supreme Court had signaled previously that it might follow suit.

Finally, in Ambac Assurance Corp. v. Countrywide Home Loans, Inc.,[13] the First Department of the Appellate Division in New York significantly expanded the scope of the protections afforded by the common-interest privilege — a privilege closely related to the attorney-client privilege. While the general rule is that the attorney-client privilege is waived if the contents of the communication are disclosed to a third party, the common-interest privilege allows disclosure to a third party without destroying the privilege if the communication is made for the purpose of receiving legal advice and if it will further a legal interest common to the client and third party. In New York, however, courts had previously imposed a third requirement that the legal advice also relate to reasonably anticipated litigation. The recent First Department ruling dispenses with this additional requirement, acknowledging that in today's business environment corporations often need common legal advice to deal with complex legal and regulatory requirements, and holds that the common-interest privilege applies regardless of whether there is reasonably anticipated litigation. This is the first New York state appellate court to so rule, and it is not yet the law in New York outside the First Department (which includes Manhattan). Still, we expect the change ultimately to be followed throughout the state, which will bring New York law in line with the law of Delaware and most federal courts. In any event, as a matter of best practice, parties with a common legal interest seeking to protect shared privileged information should enter into an agreement setting out the scope of the common interest and requiring confidentiality, which should provide protection from disclosure.

Together, these three decisions reflect a move toward greater uniformity across jurisdictions in the area of attorney-client privilege. However, it is important to note that there are still substantial variations in the law of privilege in different jurisdictions, and you should be sure to discuss any specific privilege questions or issues with counsel.

[12] *Wal-Mart Stores, Inc. v. Indiana Electrical Workers Pension Trust Fund IBEW*, No. 13-614 (Del. July 23, 2014).

[13] *Ambac Assurance Corp. v. Countrywide Home Loans, Inc.*, 2014 NY Slip Op 08510 (App. Div. 1st Dep't Dec. 4, 2014).

8. Inversions

Corporate inversions — transactions in which U.S. corporate groups reduce their overall U.S. tax burden through combinations with foreign corporate groups — represented a significant portion of M&A activity in 2013 and 2014. Although the transactions were structured to comply with the current tax laws addressing inversions, the large number of announced inversions in 2014 sparked intense criticism from the Obama administration amid concerns about erosion of the U.S. corporate tax base.

In the absence of any realistic near-term prospect of a comprehensive legislative solution, the IRS and Treasury Department issued a Notice in September 2014 announcing their intention to use regulatory authority to curtail a specific subset of tax benefits conferred by inversions. Although the regulations would not eliminate all potential tax benefits conferred by inversions, the Notice has had a clear chilling effect on proposed inversions and may change the considerations for boards and management contemplating business combinations with foreign entities.

In an inversion transaction, a U.S. corporation (typically, although not exclusively, the U.S. parent company of a multinational group) becomes the subsidiary of a holding company located in a lower-tax, non-U.S. jurisdiction. After the inversion, the U.S. corporation continues to own the same assets and businesses as before and continues to pay U.S. tax on its U.S. business activities. However, to the degree the U.S. corporation has foreign subsidiaries with earnings trapped overseas, inversions appeared to allow the new foreign parent to access those earnings without first subjecting them to U.S. taxation. For example, at least prior to the Notice, the U.S. corporation's foreign subsidiaries could loan money directly to the new foreign parent (a so-called "hopscotch loan"). In addition, the inversion may offer opportunities to use leverage to reduce the U.S. corporation's U.S. tax burden, and may allow the new corporate group to develop future business opportunities in non-U.S. companies that are not under a U.S. parent.

Although Congress enacted "anti-inversion" legislation in 2004, that legislation generally is limited to transactions in which the shareholders of the U.S. target retain at least 60% of the equity of the acquiring foreign entity, and reserves the worst consequences for transactions in which the shareholders of the U.S. target retain at least 80%. Specifically, where the 60% threshold is crossed, tax attributes such as credits and net operating losses are not available to offset taxable gains realized by the U.S. target from the inversion and certain other types of income realized by the target during the ten years following the inversion. Where the 80% threshold is crossed, however, the foreign corporation will be treated as if it were a U.S. corporation and thus will be subject to U.S. tax on its worldwide income like a U.S. corporation would be. In the recently announced inversion transactions, the original shareholders of the U.S. targets typically would retain control, but hold less than 80%, and in some cases less than 60%, of the equity of the inverted corporate group.

The recent wave of inversion transactions has prompted calls for legislative and administrative action. Most recently, Democrats in Congress proposed legislation to replace the 80% threshold with a 50% threshold, retroactive to May 8, 2014. Republicans, however, have not been supportive of retroactive legislation (or any other material legislation targeting inversions), and the recent election has presumably reduced the likelihood of retroactive legislation being passed. Any future legislative proposals to expand the tax rules on inversions could be enacted independently, or as part of comprehensive tax reform, and any legislation could apply retroactively. Potential non-tax risks include further limitations on government contracts with inverted entities.

The September 2014 Treasury and IRS Notice and the regulations to be issued thereunder would generally apply to inversion transactions in which the U.S. corporation's shareholders meet the 60% ownership test, and would apply to transactions closing on or after September 22, 2014. There is no grandfathering provision for signed contracts for transactions that have not yet closed.

- The Notice would impose a tax on "hopscotch loans" from subsidiaries of the U.S. company to the new foreign parent or its foreign affiliates. Any such loans, or other credit support, would be treated as deemed dividends to the U.S. corporation. This reduces the ability of the U.S. company to access its own trapped cash to finance the inversion transaction.

- The Notice would prevent some "out from under" planning designed to transfer control of foreign subsidiaries from a U.S. corporation to a foreign parent. This may impede the ability to grow businesses out from under the U.S. tax net.

- The Notice strengthens the 80% ownership test by adding additional presumptions and includes a provision disregarding transactions during the three years prior to an inversion that had the effect of "skinnying down" the U.S. corporation (*i.e.*, reducing the value of the U.S. corporation and consequently the percentage of equity held by target shareholders in the new parent following the inversion).

Treasury has signaled that it intends to issue additional guidance, and is specifically considering guidance to address "earnings stripping" transactions in which the U.S. corporation increases its debt levels to benefit from increased interest deductions. Treasury has also suggested that it is considering changes to current U.S. policy on tax treaties. Some taxpayers and commentators believe that Treasury did not have the authority to issue portions of the guidance in the Notice. Challenging the legality of the Notice, however, likely would be impractical.

Boards should consider the following when considering an inversion as an opportunity to minimize taxes or otherwise.

- Does an inversion transaction make sense, both from a commercial sense and from a tax perspective?

- How "solid" are the potential tax synergies, and what is the likelihood that they might not be available due to changes in relevant law?

- What contractual protections can be built into a transaction to protect against the risk of changes in law that would prevent an inversion or significantly reduce potential tax benefits (e.g., termination rights or closing conditions, ability to change recommendation, MAE definitions)?

- Boards should also be aware of the potential tax consequences for a corporation's shareholders, officers and directors.

    - An outbound reorganization (where U.S. shareholders exchange their shares in a U.S. corporation for shares in a foreign corporation) is treated as a taxable sale by the U.S. shareholders of their shares, if the U.S.

shareholders own over 50% of the foreign company after the transaction. This could become an investor relations issue for the company and its board.

- o Directors and officers of an inverting corporation (or any U.S. affiliate) are subject to a 15% excise tax on the value of their equity-based compensation, unless (i) the substantial business activities exception applies or (ii) no shareholder-level tax is imposed on the transaction. Substantially all corporations have grossed up their insiders for this cost, or accelerated vesting of equity-based compensation in advance of the closing so as to allow the tax to be avoided.

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Please call any of your regular contacts at the firm or any of the partners and counsel listed under Capital Markets, Corporate Governance, Executive Compensation, Litigation, Mergers and Acquisitions or Tax in the Practices section of our website (www.cgsh.com) if you have any questions.

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