
By Daniel Smith

On 30 March 2011, the UK Ministry of Justice (MoJ) published guidance on procedures which commercial organizations can put in place to prevent bribery (the MoJ Guidance).

The MoJ Guidance steers commercial organizations towards the only defense available to the offense under the Bribery Act 2010 (the Act) of failure to prevent bribery, although it provides no safe harbors. It also sets out the MoJ’s view on the proper interpretation of various aspects of the Act, although the final arbiter on this will be the English Courts and cases will depend on what the prosecutors choose to prosecute. Both of the courts and prosecutors might disagree with the MoJ. We also now know that the Act will come into force on 1 July 2011.

Prosecution guidance has also been published setting out factors which the prosecutors, principally the Serious Fraud Office (SFO), will take into account in deciding whether or not to exercise their discretion to prosecute offenses. Importantly, it is not entirely in line with the MoJ Guidance.

Key Points

- Combating bribery risks is largely about common sense and the core principle for procedures is proportionality.
- The six principles in the MoJ’s draft guidance remain largely intact.
- The MoJ sees the section 7 offense of failing to prevent bribery applying only to those with a “demonstrable business presence” in the UK, and suggests that mere listing would not be enough. The Prosecution Guidance is silent on this.
• The MoJ Guidance recognises that companies might have limited control over bribery by contractors, joint ventures or (potentially) subsidiaries.
• Facilitation payments will remain illegal under English law.
• Reasonable and proportionate expenditure on corporate hospitality is unlikely to be prohibited or prosecuted.
• Existing published SFO guidance on corporate prosecutions will continue to apply. The SFO will continue to prosecute only where (a) there is sufficient evidence, and (b) prosecution is in the public interest.
• The SFO continues to promote “self-reporting” and remedial action, both of which may tend against a prosecution.

Context
The Bribery Act will make bribery easier to prosecute and will extend its territorial reach. It also creates a novel and potentially far-reaching criminal offense of failing to prevent bribery, committed by a commercial organization merely where a third party who performs services for an organization commits bribery to win business for the organization. It applies to all commercial organizations which carry on “part of a business” in the UK. The only defense to this is to have “adequate procedures” in place, and this is the subject matter of the MoJ Guidance.

According to the MoJ Guidance the Act is “directed at making life difficult for the mavericks responsible for corruption, not unduly burdening the vast majority of decent, law-abiding firms”. Its objective “is not to bring the full force of the criminal law to bear upon well run commercial organizations that experience an isolated incident of bribery on their behalf”. The Prosecution Guidance echoes this sentiment, but notes that prosecution of wrongdoing will be the SFO’s default position.

The Six Principles
The MoJ Guidance sets out six non-prescriptive principles which should “inform” the procedures that organizations put in place to prevent bribery (commonly referred to as the “adequate procedures guidance”).

Principle 1 — Proportionate Procedures:
“A commercial organization’s procedures to prevent bribery by persons associated with it are proportionate to the bribery risks it faces and to the nature, scale and complexity of the commercial organization’s activities. They are also clear, practical, accessible, effectively implemented and enforced.”

Principle 2 — Top Level Commitment: “The top level management of a commercial organization (be it a board of directors, the owners or any other equivalent body or person) are committed to preventing bribery by persons associated with it. They foster a culture within the organization in which bribery is never acceptable.”
Principle 3 — Risk Assessment: “The commercial organization assesses the nature and extent of its exposure to potential external and internal risks of bribery on its behalf by persons associated with it. The assessment is periodic, informed and documented.”

Principle 4 — Due Diligence: “The commercial organization applies due diligence procedures, taking a proportionate and risk based approach, in respect of persons who perform services for or on behalf of the organization, in order to mitigate identified bribery risks.”

Principle 5 — Communication (including training): “The commercial organization seeks to ensure that its bribery prevention policies and procedures are embedded and understood throughout the organization through internal and external communication, including training, that is proportionate to the risks it faces.”

Principle 6 — Monitoring and Review: “The commercial organization monitors and reviews procedures designed to prevent bribery by persons associated with it and makes improvements where necessary.”

Prosecution Guidance

The Prosecution Guidance confirms that existing guidance on corporate prosecutions and overseas corruption will apply. These, taken together, set out factors tending for and against the exercise of the SFO’s discretion to bring a prosecution. The SFO will be looking in particular for a good corporate anti-bribery culture, and also evidence that the corporate reacted to suspected incidents of wrongdoing, investigated the incident (potentially with external advisers), and took appropriate remedial steps. The Prosecution Guidance also promotes “self-reporting” wrongdoing to the SFO, indicating that a failure to do so might increase the risk of prosecution and higher fines. The effects of these regulations on their structures and internal policies and recordkeeping and reporting procedures.

Specific Issues

The MoJ Guidance also sets out the MoJ’s view on the application of the Act to a number of situations of interest to commercial organizations (although this view might not be shared by the SFO or the courts):

- Reasonable and proportionate hospitality is acceptable; lavish hospitality might indicate an intention to bribe
- A “demonstrable business presence” in the UK would be necessary for the section 7 offense to apply, and listing alone would not be sufficient
- A section 7 offense might not be triggered where the organization does not control the third party, for example in some cases of joint ventures and supply chains
- Unlike the US Foreign Corrupt Practices Act, there is no exemption under the Act for facilitation payments, i.e. payments to secure a routine governmental or administrative task

Case Studies

The MoJ appends 11 case studies to the MoJ Guidance which are helpful to some extent, but provide little in the way of substantive guidance.

Next Steps

The MoJ Guidance is a vital large-scale roadmap for commercial organizations worldwide, but it will not get them all the way home. Organizations will need to carefully review their own bribery risks to determine what they could do to reduce their bribery risks, and also reduce the risks of investigation or prosecution under the Act.
The chief objective of the proposed changes is to redress the perceived “tactical advantages” to bidders over target companies, to the detriment of the target company and its shareholders, in hostile takeover situations (Kraft’s offer for Cadbury was initially hostile). The issues raised were that: (i) it is too easy for ‘hostile bidders’ to succeed; and (ii) short-term investors have too much influence over the outcome of offers, particularly hostile ones. The proposed changes fall into four categories.

Increasing Protection for Target Companies Against Protracted ‘Virtual Bid’ Periods

The amendments to the Code will require potential bidders to clarify their position (so called “put-up-or-shut-up”) within 28 days of being publicly identified, limiting the virtual bid period to which a target company may be subject. This will avoid the growing tendency of bidders to announce a possible offer without any commitment to make an actual offer. The Code will be amended so that the potential bidder’s name is made known in the announcement commencing the offer period, regardless of which party makes the announcement, and that within 28 days of the start of the offer period the potential bidder must either: (i) announce a firm intention to make an offer; (ii) announce that it will not make an offer (in which case the Rule 2.8 restrictions apply); or (iii) make a joint application with the target company board to extend the 28 day deadline.

The requirement to name the bidder and the fixed 28 day period to put up or shut up will not extend to auction sales initiated by a target. It will also not apply where a bidder announces a firm intention to make an offer for a target.

The changes are intended to ensure that a target company cannot be put under siege for unlimited periods by a bidder that has not been identified or which is not under any obligation to make an offer. The changes will also impact the strategy of bidders’ approaches and when to make an announcement, particularly where a bidder will require third party financing to effect an acquisition.

Strengthening the Position of the Target Company

PCP 2011/1 provides that deal protection measures, including inducement fees, are generally prohibited because of concerns that such measures deter, and reduce the competitiveness of, competing offers. The Panel may consent to inducement fees in the case of auction sales initiated by a target company or in order to incentivise a white knight bidder where the target is the subject of a hostile bid.

The prohibition on deal protection measures is broad and extends to any "offer-related arrangement" with a bidder, thereby including implementation agreements between target and bidder. The prohibition...
will also prevent bidders from providing finance to, or purchasing assets from, the target during an offer period or when an offer is reasonably in contemplation, except in the ordinary course of business.

The prohibition will not apply to undertakings with respect to confidentiality, non-solicitation and the provision of information to the bidder which is necessary for the bidder to satisfy conditions to the offer or to obtain regulatory approval.

These changes will impact bidders’ strategies, given that they may need to commit resources to a bid without being able to impose any protections on the deal and absent any cost recompense.

**Increasing Transparency and Improving the Quality of Disclosure**

The Code will also be amended to provide that, whilst offer-related fees are not prohibited, the minimum and maximum amounts payable should be disclosed. The relevant parties will be required to disclose: (i) estimated aggregate fees; (ii) estimated advisers’ fees (broken down by category of adviser, including amounts of any incentive-based fees); and (iii) fees in respect of any financing received.

**Providing Greater Recognition of the Interests of Target Company Employees**

The Code will be amended to further facilitate the provision of information to employee representatives and employees. Consequently, in addition to statements required under Rule 24.1 (which require a bidder to disclose details of its intentions regarding the future business of the target company and the effect that this will have on employees), it is proposed that a bidder be required to make a negative statement where it has no plans in relation to the points covered by Rule 24.1. Furthermore, Rule 24.1 statements made by the bidder will be expected to hold true for at least one year from the unconditional date.

**Summary**

The proposed changes seek to redress the perceived imbalance in the operation of the Code, which the Code Committee currently sees as favouring bidders, particularly in the context of hostile takeovers. There is, however, also a risk that these revisions will deter bidders unnecessarily.

Without the deal protection measures that bidders have come to rely on, concerns have been raised that bidders will be reluctant to commit money to diligence and financing during an offer period, as such costs may not be recouped if the takeover is unsuccessful. Private equity firms, in particular, will be affected given the high financing costs they incur on bids.

It has been suggested that auction sales could become more common as a result of the changes, as the proposals allow the Takeover Panel to grant an exemption from the revised “put up or shut up” rules, as well as the prohibition on deal protection measures, for auction processes. However, as auction sales may in themselves deter potential bidders given the purchase price uncertainties and the risk of being out-bid, it is not certain whether the advantages under the revised Code would remain sufficiently attractive to bidders.

The consultation period ran until 27 May 2011 and the expectation is that the changes to the Code will be implemented in the autumn of 2011, largely unchanged from the proposals in PCP 2011/1.

“The chief objective of the proposed changes is to redress perceived ‘tactical advantages’ of offerors over offerees to the detriment of the offeree and its shareholders in hostile takeover situations.”
Emerging Trends From 2010 Upstream Oil and Gas M&A

By Michael Dillard and Michael Chambers

According to market research, global upstream oil and gas M&A (upstream M&A activity) in 2010 totaled a record US$211 billion. That amount was 42 per cent greater than 2009 and 85 per cent greater than 2008.

Industry experts project that upstream M&A activity in 2011 will continue 2010’s record-setting momentum as current market conditions present a wealth of opportunities for buyers and sellers to exploit. In this article, we will identify two trends that emerged in upstream M&A activity in 2010.

Shift from Unconventional Natural Gas to Unconventional Liquids

In 2010, US onshore oil production increased over the previous year, reversing a 30 year trend of declining oil production. The increase was largely attributed to oil and natural gas liquids production from complex geological shale-rock formations (unconventional liquids) as contrasted with previous production cycles which focused on production from cheaper and easier to produce conventional oilfields. As recently as 10 years ago, unconventional liquids were viewed by industry experts as too difficult to develop.

Industry experts project that unconventional liquids production can reach 1.5 million barrels a day by 2015 from less than 500,000 barrels today. That amount is comparable to the amount of oil currently produced offshore in the Gulf of Mexico and is roughly equal to 30 per cent of current US production. The unconventional liquids boom is the product of two factors — advanced drilling technology and high oil prices.

Horizontal drilling and hydraulic fracturing technology allow producers to retrieve oil and natural gas liquids trapped in complex shale-rock formations by breaking open the rocks at specific points and collecting the hydrocarbons contained inside. These technologies have become popular over the last five years among production companies to retrieve natural gas trapped in complex shale-rock formations (unconventional natural gas). In 2010, 17 per cent of the US’s natural gas production came from shale-rock, up from 1 per cent in 2000, and is projected to rise to 35 per cent in 2020.

In early March 2011, North American crude traded over US$100 a barrel. According to industry experts, many leading unconventional liquids projects are profitable at prices under US$50, so many unconventional liquids projects will now provide high rates of return.

In 2010 Latham & Watkins advised a number of companies and financial advisers on unconventional liquids transactions, including:

- Enduring Resources in its sale of Eagle Ford shale in South Texas to Talisman Energy, Inc. and Statoil ASA
- Talon Oil & Gas LLC in its sale of oil and natural gas property in the Barnett Shale in North Texas to EnerVest, Ltd.

**Aggressive Purchasing by National Oil Companies in the Americas**

As recently as 2007, national oil companies (NOCs) — such as CNOOC, Petrochina and Sinopec in China, the Korean National Oil Co. and KOGAS in South Korea, Petronas in Malaysia, Reliance Industries and ONGC in India, and Mitsubishi, Mitsui and Sumitomo in Japan — were small players in the upstream M&A market accounting for only 1 percent of upstream M&A activity. However, NOC upstream M&A activity has grown every year over the last six years. Today, NOCs have emerged as market major players.

In 2010, NOCs, primarily Chinese NOCs, had upstream M&A activity that totaled $40 billion or 19 percent of the world total. South America and Canada were the main targets of NOC upstream M&A activity in 2010. In South America, the second biggest upstream M&A market in 2010, Chinese NOCs accounted for four of the top five deals in 2010. Industry experts predict that aggressive NOC acquisitions will remain a key theme in upstream M&A in 2011. Industry experts speculate that the catalysts for increased Chinese NOC acquisitions are: (1) energy security; (2) hedge against inflation; (3) a desire to diversify away from cash to hard assets; and (4) Chinese NOCs’ desire to behave like international supermajor oil companies by increasing oil and gas reserves and production and increasing shareholder value. Additional factors for NOC acquisitions include their focus on long-term central planning for future needs and their desire to learn horizontal drilling and hydraulic fracturing technologies.

Major upstream acquisitions by NOCs in 2010 in the Americas included:

- Sinopec buying a 40% per cent stake in Repsol Brazil for US$7.1 billion and gaining access to Brazilian offshore pre-salt reserve assets
- Bridas Corp. (50 per cent owned by CNOOC) buying a 60 per cent stake in Pan American Energy, the second biggest oil and gas producer in Argentina for US$7 billion
- Sinopec buying a 9 per cent stake in Syncrude Canada, a major producer in the Canadian oilsands for US$4.65 billion
- Sinopec buying Occidental Petroleum Corp.’s Argentinean upstream assets for US$2.5 billion
- CNOOC buying a 33 per cent stake in Chesapeake Energy Corp.’s US Eagle Ford Shale assets for US$1.08 billion in cash and US$1.08 billion in drilling carries through 2012

During 2010, Latham advised a number of companies and financial advisers on various acquisitions in the upstream market involving NOCs, including Sinopec’s acquisition of a stake in Repsol Brazil and CNOOC’s purchase of a stake in Chesapeake Energy Corp.’s US Eagle Ford Shale assets. Additionally, Latham is acting for Vedanta Resources Holdings Ltd on its proposed US$9.6 billion acquisition of Cairn India Ltd.

This 2010 deal list highlights the ongoing success of Latham & Watkins’ expanded oil and gas offering allied with its newly established oil and gas group.

**Conclusion**

The year 2010 was an exciting year for upstream oil and gas M&A. The potential for another record-setting year in 2011 remains high and the market promises to remain vibrant as both PLS, Inc. and Wood Mackenzie predict that upstream M&A activity in 2011 will continue 2010’s strong pace. In 2011, upstream M&A activity will likely continue shifting from unconventional natural gas to unconventional liquids as US natural gas prices remain depressed, North American oil prices remain high, and unconventional liquids projects provide higher rates of return. In 2011, NOC upstream acquisitions will likely continue at 2010’s aggressive pace as NOC acquisitions will be driven by several factors, all of which indicate that oil and gas assets at current prices are attractive.
Takeover Bids in Italy: The New CONSOB Rules

By Maria Cristina Storchi and Isabella Porchia

In recent years, the Italian law rules (set forth in Legislative Decree 58/1998 and its implementing regulations) governing takeover bids have undergone several changes affecting, inter alia, passivity rule, concerted conducts and derivative instruments in the context of takeover transactions.

On April 5, 2011, after two rounds of public consultation with the market participants carried out in October 2010 and February 2011 respectively, Consob (the Italian Financial Regulator) approved Resolution no. 17731 (the Resolution) that contains several provisions which amend the provisions on takeover bids set forth in CONSOB regulation 11971/99 (Regulation 11971) and complete the implementation in Italy of the EU Takeover Directive (Directive 2004/25/EC) started in 2007. The new provisions came into force on May 2, 2011 except for certain provisions which came into force on April 9, 2011.

The new regulatory framework on takeover bids as amended by the Resolution aims at strengthening minority shareholders’ protection and transparency as well as simplifying requirements and procedures in cases of takeover bids and ensuring equal treatment to foreign and domestic investors. Among the most significant amendments resulting from the Resolution we emphasize the following.

• Concerted Action. With a view to reducing uncertainty as to whether a specific conduct may trigger the joint obligation to launch mandatory takeover bids, the Resolution clarifies the definition of acting in concert. On the one hand, the new provisions contemplated by the Resolution amending the Regulation 11971 identify certain situations which are deemed to constitute concerted action subject to rebuttal. These situations include the existence of family relations or of financial consultancy relations among the persons involved. On the other hand, with the aim to support shareholder activism, the new provisions of the Regulation 11971 introduced by the Resolution expressly exclude from the definition of acting in concert certain situations, such as the cooperation among shareholders for the exercise of minority rights and active participation to governance.

• Equal Treatment to Foreign and Domestic Investors. Certain provisions set forth in Regulation 11971, as amended by the Resolution, simplify the procedures applicable to cross border tender offers of debt instruments by introducing new exemptions from the application of tender offer rules and regulating recognition procedures of offering documents approved by the competent authorities of EU Member States and non-EU states. This aims to align the Italian rules to international practices on liability management and applying the Prospectus Directive rules to exchange public offers of debt instruments, thus reducing transactions costs.

• Derivatives. With a view to reducing the risk of indirect violation of takeover rules, purchases of listed shares carried out through equity derivatives granting a long position over listed shares (including cash
settled ones) are to be disclosed and counted towards the thresholds (30 percent and 5 percent) triggering mandatory takeover bids and the relevant offer price. Moreover, the rules on disclosure and fairness to be complied with during the offer period are extended to transactions in equity derivatives granting long positions on the shares of the target.

• **Remedies to Pressure to Tender.** Where the offer is made by insiders (such as, inter alia, shareholders holding at least 30 percent of the voting capital, directors of the listed company and persons acting in concert with the above mentioned insiders) the new provisions of Regulation 11971 introduced by the Resolution state that in case of success of the offer, the offer period must be re-opened for an additional 5 trading days, thus allowing shareholders who initially decided not to tender their securities to the offer to adhere to such offer. Further, under the new rules, the issuer’s statement on the convenience of the offer shall include separate advice by the independent directors not related to the bidder providing shareholders with an objective evaluation of the offer.

• **Protection of Minority Shareholders.** The new provisions of Regulation 11971, introduced by the Resolution, better specify the circumstances when a restructuring plan for a distressed company is exempted from the obligation to launch a mandatory tender and also provides for the possibility to benefit from the exemption if such specific circumstances do not occur (subject to approval by shareholders approved without the contrary vote of a majority of minority shareholders).

• **Best Price Rule.** The best price rule (i.e. the obligation to pay to all shareholders the highest price paid or offered from the announcement relating to the offer launched at a lower price) is extended to the six-month period following the end of the offer should the purchase of the financial instruments which are the subject of the tender offer exceed 0.1 percent of such outstanding financial instruments. The best price rule is also extended to equity derivatives.

• **Enhancing the Market for Corporate Control.** The minimum period during which a voluntary tender offer aimed at acquiring control shall be open has been reduced (from 25 days to 15 days) in order to mitigate the disadvantage of the initial bidder, who bears all the costs connected to the launch of the tender offer. In connection with competing bids, the new provisions of Regulation 11971, as amended by the Resolution, introduce an obligation on the target to disclose to all bidders, upon their request, the same information that it has provided to any one of them, so as to reduce information asymmetries. Constraints on the requirements for the launch of competing bids have also been loosened, by removing the obligation to offer a consideration higher than that of the original offer.

• **Price Determination.** Eventually, certain new provisions of Regulation 11971, introduced by the Resolution, provide for detailed and specific procedures to determine the offer price, distinguishing cases where the price can be either reduced or increased and restricting Consob’s discretion in amending the price of a mandatory takeover bid and in determining the price in sell-out and squeeze-out procedures.
**Carry Arrangements**

As private equity firms establish operations in multiple jurisdictions, the tax rules to which they are subject become substantially more complex. Among the issues such firms must deal with is the manner in which their principals are taxed on their share of a fund’s carried interest. How this issue is managed can affect the rate at which a principal’s share of carry is taxed, and in some cases, the time at which it is taxed. This article will discuss how home country tax rules affect proceedings as a typical US private equity fund adds principals in the UK, France and Germany.

Our hypothetical US fund (the Fund), is a limited partnership, with an LLC as its GP. The carry consists of a special interest of the GP in the Fund, representing a right to receive 20 percent of its profits once the investor's capital contributions have been returned, and any preferred return has been paid on that capital. The principals' share of the carry is represented by an ownership interest in the GP.

**United States**

In the US, compensation of individuals is subject to federal income tax at a maximum rate that is around 20 percentage points higher than the rate applicable to capital gains of individuals. Both limited partnerships and LLCs are generally fiscally transparent. Under current law, a US principal will generally not be taxed on receipt of the interest in the GP that represents the carry, if that interest is received at a time when the value of the Fund’s portfolio is not greater than the preferences of its investors.

The Fund’s income and gains will flow through to the principal, so their share attributed to the carry will have the same character, and will be realized at the same time, as the underlying income and gains of the Fund. Thus, if the Fund realizes capital gains or other income taxed at a favorable rate, the principal’s share attributable to the carry will also qualify for favorable treatment.

Congress may change US rules so that carry is taxed at the same rate as compensation income. However, it would still be necessary to be mindful of the consequences to non-US principals of the structure of the Fund, the GP and the carry.

**United Kingdom**

Realizations of carry in the UK are typically liable to capital gains tax of 28 percent. This assumes the carry vehicle is treated as transparent. If this is the case, carry will have the same character and be realized at the same time as the underlying income and gains of the Fund.

However, for UK tax purposes, an LLC is treated as “opaque” rather than transparent, and holders of interests are typically treated as holding interests (or equivalents) in a stock corporation. Therefore, distributions (even of capital proceeds) are likely to be treated as dividend income and taxed at higher income rates. UK-based principals may therefore be disadvantaged by holding their carry through an LLC. Alternative structures may need to be explored, such as using a limited partnership, as a GP.

Principals with carried interest will not fall within the scope of entrepreneurs' relief — which would otherwise result in the taxation of up to £5 million (£5.7 million) of gain at an effective rate of 10 percent — as the scope of this relief is too narrow to encompass carry. In addition, the acquisition of a carry right is regarded as the acquisition of securities for the purposes of the UK employment securities legislation. However, in practice this becomes problematic only if principals do not acquire their rights at the outset of the Fund, or do not fall within the so-called “safe harbor” rules agreed between HMRC and the BVCA.
France

Under current French law, foreign limited partnerships or LLCs are not generally treated as fiscally transparent. As a result, French resident principals’ realizations of carry in the Fund will typically be regarded as foreign securities income and taxed at progressive rates up to around 50 percent. In certain circumstances, they may also be subject to social security contributions if regarded as compensation income.

However, a favorable tax treatment exists for carry derived from investment entities located in the EU, Iceland or Norway (qualified jurisdictions). Under that regime, subject to certain conditions, a capital gains tax rate of 30.1 percent applies to a principal’s share of distributions of capital gains realized by qualifying investment entities.

Alternative structures could thus be explored to optimize tax treatment, such as using an entity located in a qualified jurisdiction as a parallel vehicle. The vehicle would need to qualify as an investment entity and thus include other investors in addition to French principals. This would require a rather complex structure, and may also raise tax issues in other jurisdictions where the investors are resident.

Germany

Under the US/UK fund structure, German tax resident principals would be taxed at their personal rate of up to 45 percent, as the carry would be deemed to be income from services rendered to the Fund. A more favorable treatment may be obtained by adding a managing LP and complying with the requirements of a ruling issued by German tax authorities in 2003, which would give the principals a 40 percent tax exemption on carry. The applicable tax rate then would equal the rate on capital gains of a German individual. This treatment depends on the overall structure and requires complete tax transparency of the Fund and any other entities between the Fund and the principals, which may limit its flexibility regarding other jurisdictions.

Conclusion

When dealing with the structuring of carry arrangements, it is important to remember that a typical US arrangement will not always be advantageous to non-US principals. It is likely to be necessary to consider local tax rules and alternative arrangements.
Extension of French Thin Capitalization Rules to Third Party Loans Guaranteed by Related Entities

By Olivia Rauch-Ravisé

The French Finance Bill for 2011, passed in late December 2010, extends the scope of French thin capitalization rules to loans granted by third-party lenders when such loans are secured by a company related to the French borrower.

Current French Thin Capitalization Rules

Article 212 of the French Tax Code (FTC) limits the tax deductibility of interest borne in connection with "related-party" loans. In this respect, two companies are said to be "related" where (i) a company holds, directly or through intermediate entities, a majority of the share capital of the other company, or actually exercises the power of decision-making in such company or (ii) both companies are under the control — within the same meaning as under (i) above — of a third company.

In summary, interest borne in respect of a related-party loan is deductible if, for a given fiscal year:

- The borrowing company complies with a 1.5/1 debt-to-equity ratio computed by comparing its net equity (including share premium and retained earnings) with the average amount of its related-party debts during the said fiscal year. The maximum amount of deductible interest under this test is determined pursuant to the following formula: interest borne in respect of related-party lenders x (1.5 net equity of the borrower / average amount of related-party loans)
- The interest paid on related-party loans by the borrowing company does not exceed 25 percent of the borrowing company’s operating profit before tax, increased in particular by the said interest and by the depreciation allowances booked during the relevant fiscal year
- The interest paid on related-party loans by the borrowing company does not exceed the interest it receives itself from related parties

If the three limits above are simultaneously exceeded in a given fiscal year, the portion of interest which is in excess of the highest of those three limits is disallowed. It remains potentially deductible in a subsequent fiscal year, though subject to significant restrictions and limits and with a decrease of its amount by 5 percent for each year after the second year.

Note that the thin capitalization provisions do not apply if the borrowing company can demonstrate that the overall debt-to-equity ratio of its economic group is higher than its own debt-to-equity ratio in respect of the fiscal year concerned. Specific rules also apply in tax consolidated groups.

Extension of the Scope of French Thin Capitalization Rules to Third Party Loans Guaranteed by Related Entities

Under previous rules, third-party financings did not qualify as "related-party loans" for the purposes of thin-capitalization rules even when they were secured by parties related to the borrower, which French tax authorities regarded as a loophole.
Under the new legislation, loans granted to a French entity by third-party lenders now fall within the scope of thin capitalization rules if they are guaranteed (i) by a company related to the French borrower or (ii) by a third party whose commitment is secured by a company related to the French borrower.

The following loans however remain outside the scope of the new rules:

- A safe harbor clause is provided for a public offering of bonds. This exception further extends to bonds issued in accordance with a foreign legislation equivalent to the provisions of Article L 411-1 of the French Monetary and Financial Code.

Conversely, financings giving rise to private placements will fall within the scope of the new rules. As an example, capital markets debt, such as high yield bonds, privately placed under Rule 144 A and Regulation S within a French/EU public offer exemption and listed on an unregulated market, will not be considered as offered to the public for purposes of this particular exception and thus will not be exempted.

- A guarantee granted by the related party exclusively consists of (i) a pledge over the shares of the borrowing company or over receivables held over the borrowing company or (ii) a pledge over the shares of an intermediate company which directly or indirectly holds the shares of the borrowing company. However, this latter exception only applies if the holder of the pledged shares and the borrowing company are members of the same French tax consolidated group so that “double LuxCo structures” set up in most recent LBO transactions will not be exempted.

- Finally, loans contracted for the purposes of refinancing an existing debt for which reimbursement has become mandatory as a result of a change of control of the borrower. The refinancing loan is exempt up to the principal amount of the existing debt which is being reimbursed and any interest falling due.

The new legislation is effective for fiscal years closed as from December 31, 2010. However, it contains a grandfathering provision that covers loans contracted before January 1, 2011 for the financing or refinancing of an acquisition of shares. Financial structures of past LBOs should not therefore be impacted by the new rules, contrary to corporate loans.
Latin America Market Update:

Post-Crisis Trends and Deal Flow

By Tony Del Pino

These are promising times in Latin America. Despite expectations of a profound and prolonged recession following from the global economic crisis — as the popular saying goes, “when the US sneezes, Mexico catches a cold” — this time around, the region has weathered the global storm better than most and has seemingly emerged stronger than ever.

General Growth Trends

During the early stages of the economic crisis in 2007/2008, “decoupling” became a popular theme. Although the effects were not immediate, the region was eventually affected by the crisis, as country after country fell into recession, in particular Mexico, which suffered greatly as a result of the US economic crisis. That said, the recovery has been dramatic in the last year. According to United Nations ECLAC statistics, the region’s GDP grew at a pace of roughly 6 percent in 2010, with some countries such as Peru at 8.6 percent and Brazil leading the charge at 7.7 percent. This represents the strongest performance for the region in the last decade. Many leading economists are predicting more positive growth in 2011.

Deal Flow/Trends

Much of Latin America has undergone an unprecedented period of democracy and sound macroeconomic policies, which has had a direct correlation to investment and growth in the region. Not surprisingly, 2010 was a banner year for Latin American M&A and private equity. As a firm, Latham & Watkins saw a substantial increase in M&A activity with almost US$20 billion dollars worth of deals in the year, including four deals that each exceeded a US$1 billion. According to Dealogic, Latin America had the highest volume of M&A deals on record and the largest percentage it has ever had of global M&A deals.

We have noticed a number of interesting trends in the deal flow. The first is the diversity of the buyers and investors. For example, last year we worked on one of the largest M&A deals in the region, representing Repsol in a US$7.1 billion sale of a significant interest in its Brazilian operations to Sinopec from China, forming the second largest oil and gas company in the region with a total capitalization of over US$17 billion. It’s no secret that Chinese companies have become one of the largest investors in the region, surpassing the US as Brazil’s largest trading partner. Chinese companies are mainly focused on natural resources, which are abundant in the region. Latham also represented Norsk Hydro ASA in its US$5.2 billion acquisition of Vale’s aluminium business in Brazil. We expect investments in natural resources to continue to be a driver in Latin American M&A in 2011 and the years to come and have made it one of the primary focuses of our regional strategy.

That’s not the only interesting trend. Two other trends evidenced by deals from last year are the rise of (1) the “multi-latinas” (Latin American companies expanding outside of their borders) and (2) private equity. In 2010, we saw Colombia’s Grupo Aval make one of the largest ever acquisitions by a Colombian group outside of its borders when it bought BAC-Credomatic, a prestigious financial institution operating across Central America, from Latham client GE Global Banking for US$1.9 billion. This deal was signed in July and closed by the first week of December after obtaining regulatory approvals in eight countries.

Historically, the private equity business has been very challenging in Latin America. The last private equity boom in Latin America occurred around the turn of the millennium (late 90s through early 2000s) and investor returns were mixed as a whole. Those that were successful are still in the business
and raising new funds. There has been a relatively quiet boom in Latin American private equity business over the last couple of years with new funds reaching unprecedented sizes — Advent and Southern Cross both raised new funds last year of reportedly $1.6 and $1.7 billion respectively.

There are many reasons for this new increase in fund raising for the region. For starters, we have seen a number of new funds over the last few years successfully exit their investments and show positive results. In addition to the traditional strategic buyers, private equity funds now have the possibility of exiting through capital markets, particularly in Brazil which boasts one of the largest stock exchanges in the world, the Bovespa. The convergence of the Bovespa with other stock exchanges should increase the liquidity of investors in Brazil. As noted above, there are also more potential buyers interested in Latin American assets including the “multi-latinas” and those from different regions such as Asia expanding the possibilities for exits. The availability of financing for deals will be a big contributor to this trend.

Another important development for private equity fund raising has been the availability of local pension fund money. In the past few years, a number of countries (including Brazil, Chile, Colombia, Mexico and Peru) have facilitated pension fund investment in private equity. This is still a developing story and some fund managers have shied away from local pension fund money because of some of the conditions tied to it, particularly in Brazil and Mexico. However, for the first time we have seen even large US private equity managers such as Blackstone and Carlyle fund raising in the region.

**Final Thoughts**

There are still a number of challenges to doing deals in the region. There are local, legal and political risks that need to be considered carefully in any investment. A recent problematic trend is that a number of countries have taken measures (mainly by imposing taxes or requiring reserves for cross-border financings, and taxing in-bound investments) in order to try to curtail the appreciation of local currencies against the dollar, which in some cases have increased close to 40 percent in the last couple of years. These restrictions will likely make financing large deals more expensive. However, by and large, most countries in the region have been successful in creating a much improved environment to encourage investment and stimulate growth, and we expect that trend to continue.

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**BAC Credomatic GECF Inc**
Representing BAC Credomatic GECF Inc. and GE Capital Global Banking in the sale of 100% of the equity of BAC Credomatic GECF Inc., a Central American banking firm, to Grupo Aval.

$1,900,000,000

**Repsol Brasil, S.A.**
Representing Repsol YPF and Repsol Brasil, S.A. in the sale of a significant interest in Repsol Brasil, S.A., an oil and gas exploration company based in Brazil, to and joint venture with China Petrochemical Corporation (Sinopec Corporation).

$17,800,000,000

**Vale S.A.**
Representing Norsk Hydro ASA on its acquisition of Vale SA’s aluminium business and issuance of shares to Vale S.A.

$5,270,000,000

**Linzor Capital Partners and Mercantil Group**
Representing Linzor Capital Partners in the acquisition of Citi Colfondos, a Colombian pension fund administrator, from Citigroup.

Confidential

**Volaris**
Representing Indigo Partners LLC in the acquisition, together with a group of Mexican investors, of an interest in Volaris, a Mexican airline held by Grupo Inbursa and Grupo Televisa.

$160,000,000

**Iberdrola, S.A.**
Representing Spain’s Iberdrola on its acquisition of a Brazilian electric utility.

$2,400,000,000
Russian Legislation Update

By Oksana Uberwolf

Federal law No. 224-FZ “On Prevention of Illegitimate Use of Insider Information and Market Manipulation and on Amendments to Certain Laws of the Russian Federation” (the Law on Insider Information) entered into force on 27 January 2011 (with the exception of certain provisions, which are due to come into force by 30 July 2013).

The Law on Insider Information creates an express prohibition on insider trading in Russian financial and commodities markets, thereby plugging a gap in the existing legal regime. By bringing Russian regulation more in line with European and US standards of regulation, it is hoped that the Law on Insider Information will strengthen the protection of investors’ interests and solidify public confidence in Russian markets.

The adoption of the Law on Insider Information may also encourage Russia to become a full signatory to the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and Exchange of Information (the MMoU) of the International Organization of Securities Commissions (IOSCO). Signing the MMoU shows a statement of commitment at the state level with regard to mutual assistance and the exchange of information for the purpose of enforcing and securing compliance with the laws and regulations of the relevant signatories and increase the investment attractiveness of Russia.

The Law on Insider Information establishes definitions of “insider information” and “insider.” The definition of “insider information” replaces the previous definition, which, set out in the Code of Corporate Conduct, was of a purely advisory (non-mandatory) nature.

“Insider information” is defined as accurate and precise information (including any commercial, official, bank, postal or other secrets protected by law), which have not been disclosed and if disclosed could materially affect the price of financial instruments, foreign currency and/or commodities, and which relates to the category(ies) of insider information mentioned in the law, in the list of insider information to be adopted by the Russian Federal Service for Financial Markets (the FSFM) or by relevant insiders, as specified in the Law on Insider Information.

The Law on Insider Information also provides a broad definition of “insiders,” which captures the following categories of persons:

1. Issuers and management companies
2. Legal entities holding a dominant position in any particular market
3. Exchanges, clearing companies, depositories and credit institutions which effect settlements of transactions performed on exchanges
4. Professional participants in the securities market, (together with those listed in items (1)–(3) above, the Insider Parties)
5. Persons having access to insider information of any Insider Party pursuant to any agreement concluded with them (including auditors, appraisers, professional participants of the securities market, banks and insurance companies)
6. Persons entitled to cast 25 percent or more of the total votes in the supreme governing body of any Insider Party
7. Persons who, through the ownership of stock or participation interests in the stock capital of any Insider Party, have access to insider information pursuant to a foundation document of such Insider Party or any corporate law

8. Members of the boards of directors, management boards, CEOs (management company, manager or temporary CEO) and members of audit commissions of companies falling within items (1)–(7), (9), (11) and (12) herein

9. Persons having access to information concerning voluntary, mandatory or competitive offers for the acquisition of shares in a joint stock company made in accordance with Russian legislation

10. Federal and local governmental bodies, local administrations and other bodies or organizations that perform similar functions, managing bodies of State off-budget funds in certain cases and the Central Bank of Russia

11. Information agencies providing information disclosure services to Insider Parties or persons falling within item (10)

12. Ratings agencies providing ratings services to any Insider Party

13. Employees and/or contractors of entities falling with items (1)–(12) and certain officials falling with item (9) who have access to insider information

The Law on Insider Information also introduces a new definition of “market manipulation” which will replace the current definition of “price manipulation” set out in the Securities Market Law.

The Law on Insider Information prohibits the use of insider information:

- For carrying out operations with financial instruments, foreign currency and/or commodities which such insider information relates to
- By way of its transfer to third parties
- For recommending, obliging or motivating third parties to acquire or dispose of financial instruments, foreign currency and/or commodities

In cases described above, the law provides for certain exceptions where the use of insider information is allowed.

Any person who illegally uses insider information and/or carries out market manipulation bears liability in accordance with Russian law.

The FSFM will be the main competent authority responsible for the regulation of insider trading and market manipulation. The persons falling within items (1)–(12) above must maintain a list of insiders. The insiders must also disclose insider information in a manner to be stipulated by the FSFM.

The Law on Insider Information provides for the right of a person to claim damages for any loss, if such loss was caused by the illegal use of insider information and/or market manipulation. However, illegal use of insider information and/or market manipulation while carrying out operations cannot be grounds for the challenge.

The Law on Insider Information also amends the Code on Administrative Offences and the Criminal Code of the Russian Federation in order to introduce administrative and criminal liability for insider trading, and amends and clarifies administrative and criminal liability for market manipulation. In particular, the administrative liability for illegal use of insider information or market manipulation is (i) a fine of up to RUB5,000 (approximately US$176) for individuals; (ii) either a fine of up to RUB50,000 (approximately US$1,760) or disqualification for up to two years for officers and (iii) a fine of up to RUB700,000 (approximately US$24,600) for legal entities. The criminal liability for the mentioned offenses may be in the form of a fine or imprisonment and certain forms of ancillary punishment. The relevant amendments creating criminal liability for insider trading will enter into force in 2013.

Amendments to the Securities Market Law, which came into force in 2010, introduces new definitions of the terms “financial instrument” and “derivative instrument” and amends the definition of “repo transaction.”

The Definitions. A “financial instrument” is defined as a security or a “derivative instrument.” A “derivative instrument,” in turn, is defined as an agreement providing for: (i) an obligation of a party or parties to make a single payment or periodic payments (including upon request of the other party) that is/are dependent on changes in prices for commodities, securities, FX or interest rates, level of inflation, statistical and environmental data, failure to perform an obligation by a legal entity, state or municipality as well as on any other facts
as specified in a federal law or a regulation of the FSFM, the occurrence or non-occurrence of which is not known, or on a combination of any of the above — i.e., swap transactions; (ii) an obligation to sell or purchase, upon request of the other party, securities, currency or commodities or to enter into a derivative (i.e., physically-settled options) — i.e., option transactions and (iii) an obligation to deliver securities, currency or commodities on a longer than T+3 settlement basis provided that the agreement specifies that it shall constitute a derivative instrument — i.e., forward transactions.

A new definition of “repo transaction” replaces the previous definition set out in the Tax Code. Currently, repo transactions are specifically excluded from the definition of a “derivative.” The new definition of “repo transaction” should reduce the risk of transaction re-characterisation which existed prior to 2010; however, it is not entirely clear how the courts will apply the new definition to repo transactions, the terms of which are materially different from the definition.

Foreign Financial Instruments. The amended Securities Market Law does not clearly define the term “foreign financial instrument” and does not explicitly state whether the new definition of “financial instrument” captures all, or only domestic, financial instruments. It is therefore unclear which foreign instruments would fall within the scope of the law. The current market consensus, however, seems to be that any derivative offered by a foreign institution shall constitute a “foreign financial instrument.”

“Foreign financial instruments” can only be offered to qualified investors (each, a QI). Currently, the Securities Market Law provides for two types of QI: (a) persons or entities that are QIs as a result of the operation of law, including Russian licensed brokers, dealers and managers; Russian “credit organizations;” joint stock investment funds; private pension funds; managers of investment funds, mutual funds; insurance companies; the Central Bank of Russia and certain other state agencies and international financial organizations (a QI by Operation of Law); and (b) persons or entities, other than a person or entity that is a QI by Operation of Law, that satisfy certain eligibility criteria and are recognized as QIs by a licensed broker, an investment company of a mutual fund or other authorised entity (a QI by Recognition). A QI by Operation of Law can trade in foreign financial instruments directly, whereas a QI by Recognition, by contrast, can only enter into transactions involving a foreign financial instrument through a broker (although it is not clear whether only the QI by Recognition, or all other parties to the transaction need to act through a broker). However, exceptions to this restriction may be granted by the FSFM.

Disclosure and Distribution of Information. Amendments were also made to the provisions relating to disclosure and distribution of information (which enter into force in April 2011, with certain limited exceptions). The amendments significantly expand the scope of information that must be disclosed by issuers that have registered prospectuses, including through: (i) the quarterly reports of the issuer of securities; (ii) the consolidated financial statements of the issuer and (iii) notices of any material facts. The recent amendments provide for an expanded list of material facts that should be disclosed and have expanded the definition of ‘material fact’ itself to include information that in the case of disclosure could “materially affect the price or quotations of the issuer’s securities.”

The amended Securities Market Law establishes that persons that sign the quarterly reports of an issuer and auditors that prepare auditors’ reports for an issuer included in the quarterly report of the latter can be held to be secondarily liable for losses of investors and/or shareholders suffered as a result of any quarterly report of an issuer being incomplete, misleading or misrepresenting information.

Article 30.1 of the Securities Market Law (which entered into force on 1 January 2011) establishes certain exemptions from the mandatory disclosure requirements otherwise applicable to issuers under the Securities Market Law. In order to qualify for the exemption, the issuer’s shareholders must pass a resolution to send an application for exemption from disclosure to the FSFM. The FSFM will only grant an exemption if the issuer complies with certain conditions stipulated by law, including a condition that the issuer has no more than 500 shareholders and its securities are not listed on a stock exchange.
Latham & Watkins Opens Office in Boston, Massachusetts

Latham & Watkins is pleased to announce the opening of our newest office in Boston, Massachusetts. The firm is committed to serving the technology, clean technology and life sciences industries, and our new presence in Boston affirms this.

Boston is a market that is rich in public and private companies focused on evolving technologies, along with the venture capital firms and investment banks that fuel and support their growth. The city is also home to one of the most dynamic private equity markets in the United States. Our experience in helping emerging companies grow and thrive, particularly with our strong presence in the technology markets of Silicon Valley and Southern California, and our global reach and substantial depth in private equity, capital markets and mergers and acquisitions, are perfectly complemented and enhanced by our presence in Boston.

Seven leading corporate lawyers have joined the Boston office including partners John Chory, Peter Handrinos, Susan Mazur, Phil Rossetti, Alex Temel and Hans Brigham and counsel Julie Scallen.

Latham & Watkins’ M&A and Private Equity Practices Rank in Top Tier in Industry League Tables

Latham & Watkins’ M&A and Private Equity practices ranked among the top tier in global, US and European year-end industry league tables. Reflecting Latham’s global strength, the firm was ranked #5 for global M&A and #3 for US M&A by value by Bloomberg and mergermarket, respectively. Latham also ranked in the Top 10 for Asia Pacific (excluding-Japan) and European M&A by value by Bloomberg.

Latham’s strength in private equity is reflected in its Top 3 rankings from mergermarket including: #2 for global Private Equity Buyouts by value; #3 for US Private Equity Buyouts by value and #3 for European Private Equity Buyouts by value.

Latham & Watkins adds Corporate Partner in Moscow

Latham & Watkins is pleased to announce that Mikhail Turetsky has joined the firm’s Moscow office as a partner in the Corporate Department. His practice focuses on advising companies and Russian and international banks on domestic, intra-region and cross-border matters with an emphasis on capital markets, finance and restructuring.

Mr. Turetsky has worked on a number of high profile transactions in Russia and more broadly the CIS, with particularly deep expertise advising on debt and equity capital markets, bank lending and restructuring matters. His practice spans numerous sectors, including financial services, energy, industrial, media and communications, among others.

Mr. Turetsky is a Russian-qualified lawyer and a graduate of the Novosibirsk State University. He also holds an LLM from the University of East Anglia.
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