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The Wild East: Managing Compliance Risk in China

By Darin Bifani

Protecting the interests of clients in China requires a flexible compliance approach focusing on ethically preserving business value in the face of complicated operating realities.

Due to increasing foreign investment in China, more and more lawyers even outside of China will be required to directly or indirectly manage China-related legal compliance risk. This is extremely difficult, even for experts who are fluent in Chinese and have worked in China for years. For the non-China specialist, even with the support of local experts, helping to ensure that a client's investments are executed in accordance with internal compliance policies and relevant laws in a rapidly changing country thousands of miles away with a different culture, government, and legal system will pose significant challenges.

The economic, reputational, and personal costs of non-compliance when doing business in China can be extremely high. In a highly publicized case in March, four Rio Tinto mining executives were convicted by a Shanghai court of bribery and theft of commercial secrets and received lengthy prison sentences. While various forms of bribery have been widespread in China for a long time, corruption is punishable by death. In July of this year the former director of the Chongqing Justice Bureau was executed on corruption related charges. Adding further regulatory risks, U.S. officials have indicated that they will step up enforcement of the Foreign Corrupt Practices Act, which includes penalties of fines and imprisonment.

Apart from corruption, there have been many cases in China of doctored products, substandard construction practices, and employee strikes, acts that in the United States would expose a firm to substantial legal liability and reputational risk.

Also, and what may pose a greater risk to a firm's China operations, are less sensational failures to follow politically driven interpretations of local regulations or practice requirements that result in increased operating costs and delays or lost local government support. Over time, these costs can have a significant impact on, if not wipe out, the profitability of a China business venture.

Given the risk, it is important to have a well-thought-out compliance and risk management strategy that combines a client's economic objectives and compliance imperatives with a hardheaded view of on-the-ground China realities. As comforting as the wisdom in the Chinese classic the *Dao De Jing* that states "*wei wu wei, ze wu bu zhi*" ("everything will be put in order if nothing is done") may be, practically minded attorneys should keep in mind the famous statement of the more likely client view that "history is the sum total of things that could have been avoided."

Challenges of Emerging Legal System Compliance

Legal compliance in the United States is often thought of as the relatively narrow task of following existing laws, regulations, and rules. This is because for most lawyers working in developed legal systems, there is a working analytical assumption that the law is reasonably clear, reasonably stable, and interlocks in a reasonably coherent way with individual rules and regulations. In a developing legal system like China's, however, which is struggling to rapidly adapt to tremendous internal changes and a flood of incoming investment, laws can be highly ambiguous or even contradictory.

Dr. Lutz-Christian Wolff, a China scholar, has stated that in China "legal practice may not necessarily follow applicable laws and regulations and may even differ between two adjacent districts of one municipality."

There are also many uncertainties in China's judicial process. Due in part to cultural reasons which favor collective problem solving, litigation is viewed as an absolute last resort where the best that usually can be hoped for is some degree of defeat. While it has continued to improve, the Chinese judiciary suffers from deficiencies in professionalism, resources, and perhaps most importantly, independence.

As a consequence, government officials can be involved in the legal process in a number of ways which affect the outcome

of legal disputes.

Managing the "government variable" for compliance planning purposes in China is extremely complicated. There are multiple levels of government in China which have wide authority to interpret national policies or rules in a way that best suit their particular regional or local interests. These levels of government operate against a backdrop of complicated relationships with various government officials and committees. Far from guaranteeing a coherent regulatory picture for the foreign company, this creates ambiguities far in excess of what would ordinarily be encountered in the United States.

An insight into these operating realities is captured in the Chinese expression "*shang you zhengce, xia you duice*," which means "the higher authority has policies and the lower authority has countermeasures." Adding to these tensions is the fact that the officials responsible for approving a project or providing ongoing support can change over time, causing a change in official views as to how project related issues should be handled.

The enforcement stage of legal disputes can also be highly uncertain. Courts struggle to keep up with changing laws and are highly conscious of the political impact of their decisions. Due to lack of resources or political factors, decisions may also simply not be enforced at all. It therefore can be very difficult to understand what the law to be complied with actually is.

Foreign investors often opt for arbitration as a way to avoid the ambiguities or biases of China's legal system, but arbitration awards often must be enforced on Chinese soil, which can effectively place the dispute back in the hands of the Chinese judiciary.

Rather than thinking of China as a place where there is a fixed set of laws that can be condensed to a tick-the-box checklist, the better approach is to view China as a sea of conflicting and incomplete rules and regulations set against a backdrop of moving political realities and interests. This forces the compliance objective to become, rather than closely following a clear set of directions, an attempt to keep the transaction moving in a straight a line as possible toward the hoped for commercial outcome. This is best done through an iterative approach where a continuing dialogue develops between the China team, local advisers, and government officials to address where the safe harbors, grey zones, and likely legal violations are regarding a given project.

Viewing Legal Compliance in Business Value Terms

Due to the uncertainties in China's legal environment, a second building block for a sound compliance plan is to view a compliance breach as not merely a violation of a specific law which leads to traditional penalties for regulatory violations, but more broadly as a result of government officials' actions or failures to act which result in a project or investment not being approved or completed as scheduled. In other words, compliance should not merely be viewed as a stand-alone legal requirement which is removed from core business activities and results, but a key driver of project completion and therefore investment returns.

While investments in China may be made with a primary focus on gaining a long-term strategic foothold rather than short term profit, most China business ventures are undertaken based on an assumed future investment return based on cash flows received over a defined period of time. Each additional cost, compliance or otherwise, and each delay due to non-compliance which causes the project not to be completed on time, lowers the effective investment return. These compliance related setbacks are typically not caused by outright legal violations and government investigations but rather delays in receiving required approvals on the much less tangible ground that what is contemplated is somehow inconsistent with local practice or the locality's view of national policy.

Many attorneys might assume that this risk can be mitigated through U.S.-style legal actions, but the exact source of political or administrative roadblocks can be difficult to pinpoint, and the people you complain to can often be more closely related to the people you are complaining about than might be initially apparent. Even if offending parties can be identified, due to judicial review and enforcement uncertainties, legal actions or damages provisions cannot be viewed as an economically reliable backstop for business losses.

As specific compliance issues and applicable regulations can vary widely on a case-by-case basis, for planning purposes it can be helpful for strategic purposes to divide these issues into several categories: (1) actions which cause a project not to be approved or, worse yet, for approval to be withdrawn after a substantial amount of money has already been sunk into the project; (2) internal operating issues, including labor law breaches, misappropriation of firm intellectual property, and failure to make required filings; (3) external operating issues, including untoward acts in furtherance of the business such as bribes, and breaches of applicable contracts or regulations; and (4) issues related to investment exit, including capital repatriation. Depending on the project, these issues can be further ranked based on potential impact on project economics or timing.

Accordingly, the compliance plan objective should not merely be to avoid violating isolated laws, but more broadly to keep the project operating within a set of moving legal and political boundaries which is necessary to stay as close to original cost and timing assumptions as possible to preserve business value.

Avoiding the Profit Shangri-La Syndrome

While the natural inclination when building a compliance platform is to consider foreign operating realities and local counterparties as the key risk drivers, a substantial amount of compliance risk can in fact come from one's own client's business objectives.

The reason is that many investors arrive in China with profit expectations that simply are not realistic. While there are tremendous investment opportunities in China, Chinese companies are bound by the same economic laws of supply, demand, and profit margin sustainability that

exist elsewhere. If China counterparties promise, or are pushed to agree in writing to provide unrealistic returns, when economic realities begin to set it this can increase the likelihood that the Chinese firm will resort to innovative attempts to cut costs or generate profits and create compliance risk for the foreign investor. To guard against this risk, compliance officers should not merely be a post-closing safety net but rather a vital part of reviewing the underlying business strategy from the start.

A second element of the business objective that also must be carefully taken into consideration is time expectations. Optimistic schedule predictions should be tested with careful due diligence and healthy skepticism. Additionally, key business model assumptions that work in other markets may not work in China for reasons beyond an investment counterparty's control. For example, an investment return based on asset sale assumptions that would be reasonable in a developed market may drastically understate time frames in China, especially in smaller markets with thin or highly volatile demand. From a compliance perspective it is therefore helpful to have a timeline for all significant business steps and related compliance risks to make sure that if the project realities start deviating from business team assumptions they can be detected as soon as possible.

Beyond Compliance Rule Export Strategies

A natural tendency for firms starting to do business in China is to adopt a top down strategy of "exporting" their compliance rules, which amounts to taking their compliance policies and procedures, translating them into Chinese, and sending them abroad with the expectation that they will be followed to the letter.

This is an understandable approach but it is worth remembering that even for firms with outstanding compliance records in the United States, compliance is often more due to a complicated combination of values, firm culture, and individual judgment rather than mechanical application of compliance manual provisions. A firm's compliance culture is built on many years on cultural understanding and business experience in the United States which in many cases do not have direct parallels in China.

Further, it would be extremely difficult, and certainly not cost effective, to draft a compliance manual that covers every potential compliance problem or scenario. Even policies and procedures comprised of hundreds of pages contain numerous gaps, and it is precisely in these gaps where actual business realities and tough decisions collide and make the difference between walking the path that helps the business or harms it.

Rather than relying solely on written documents, a better approach is to create a compliance *process* that includes a reasonably digestible set of written guidelines, but more importantly, provides an ongoing forum for collectively analyzing situations, determining whether compliance issues exist, and resolving those issues. This takes a tremendous amount of time, but it is an area where there are no easy shortcuts and the natural frictions that will arise in the course of these discussions will provide important insights into how the overall compliance strategy should be shaped and adjusted.

It is also wise for U.S. lawyers to view the on-the-ground China team not merely as a compliance risk but as a vital part of compliance strategy offense. The China-based team will always be in the best position to see compliance related risks coming and to suggest practical and culturally realistic ways that these risks can be managed. If these people are alienated through a heavy handed, top down approach, a key component of the overall compliance team will be lost.

Assembling the Advisory Team

Another key element for compliance success is assembling the right on-the-ground advisory team. China compliance risk is a moving target and the farther in the distance the problem can be seen the better. Rather than merely contacting advisors once the problem arrives, it is better to have a relationship with firms where the advisory arrangement contemplates a long distance issue spotting component tied to a thorough understanding of the business objective. These arrangements can include client alerts on key issues affecting the project, periodic meetings with government officials, and even external audits of client internal legal teams. With a little creativity, a lot of preventive legal maintenance can be done at surprisingly low cost, and certainly at a fraction of the cost that can be incurred in an emergency situation.

Another smart move is to keep the core deal team in contact throughout the life of the transaction. It is common in the United States for both practical and cost reasons that after the deal closes the deal team is dissolved and a specific outside advisor might be contacted on an as-needed basis. However, this is not the best strategy in China, where neither problems, nor more importantly, solutions typically fall within narrow advisory boundaries. It requires relatively minimal expenditure to have the core team meet on some limited basis, even once a quarter, to evaluate if the commercial objectives are on track and to discuss market or other changes which may have an impact on the underlying project assumptions and timelines.

Facing a Crisis Situation

If careful due diligence was done prior to launching a project or making an investment, the risk of a compliance catastrophe should be low, as appropriate control mechanisms are built in to the investment vehicle operating documents and an ongoing compliance oversight plan is put in place and managed with appropriate local advisers. However, as in all markets, there is a risk of partner or asset disappearance, disruptive government interference, and other extreme events which can wipe out investment capital or cause extreme reputational risk.

As with other elements of a compliance plan, crisis management also requires sensitivity to China realities. Due to the combination in the United States of the availability of different types of injunctive relief, a system of determining aggrieved party rights which generally favors speed, and a reasonable expectation of rights enforcement, there is a tendency to take

immediate, drastic action against the offending party when extreme breaches occur. In China, however, which does not have a developed preliminary injunction system and where there are numerous uncertainties in the contract litigation and enforcement process, narrow, aggressive litigation strategies can cause further loss of value.

Further, if local government officials have not been brought into, or tactfully made aware of the removal strategy, it becomes very easy for the local partner to paint the foreign party as somehow at fault. This severely limits the foreign investor's exit and restitution options. To reduce this risk, by maintaining ongoing relationships with government officials involved in the project, it is more likely that the government will form a more objective view of who is at fault when investment problems occur.

Even in a situation of total investment loss, it is important to salvage future opportunity value. If a longer-term China strategy is contemplated, it is necessary to remember that how an investment is exited can have significant ramifications for investment opportunities in the future.

It is important to design an exit strategy where some semblance of "face" can be saved for the relevant persons involved, particularly the relevant government officials. Very little in China is accomplished without *guanxi*, or relationships, and this means that when you do business you are in reality contracting with a far wider set of people than appears in the contract. If the investment does not go well, it will negatively affect the relationships of many people who were involved in supporting the investment, indirectly or directly, and this will add tremendous barriers to any future contemplated commercial arrangements where these people or their offices are involved.

Conclusion

Due to China's continuing ascent as an economic powerhouse, managing or considering China risk will become an increasingly important task even for attorneys who are based outside of China. There can be no denying that, due to economic, cultural, and legal differences between China and the United States, this will be a challenging hurdle to a successful China business strategy. However the business legal track record in China for foreign firms does not necessarily need to be a painful history of "things that could have been avoided." By taking a broad view of compliance and conceptualizing compliance issues as a vital part of business performance, it is possible to formulate a working compliance strategy which substantially increases the likelihood, that not only will costly pitfalls be sidestepped, but that short- and long-term business value can be created.

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Recent Trends in Acquisition Financings

By J. Christian Nahr and Viktor Okasmaa

As credit markets continued to improve in 2010, private equity sponsors and borrowers have been able to obtain and implement increasingly favorable financing terms and deal structures. Original issue discounts are tightening, sponsors have been able to effect dividend recapitalizations, and borrowers have been able to negotiate loan provisions allowing discounted buy-backs or the purchase of loans by the private equity sponsor. The credit crisis, however, continues to exert an influence on the debt markets: asset-based loans have become increasingly popular, arrangers remain conservative about committed financings, and certain economic terms such as "soft-call" premiums and LIBOR floors have become standard.

The Popularity of Asset-Based Lending

Continuing a trend that started in 2009, asset-based loans (also known as ABLs) are an increasingly popular source of financing. According to the Commercial Finance Association, new credit commitments of asset-based lenders increased by 49 percent in the second quarter of 2010 compared to the first quarter of 2010.

Asset-based loans are revolving loans secured by specified borrower assets such as accounts receivable, inventory, or equipment. The amount that can be borrowed under the facility depends on a percentage (typically between 65 percent and 80 percent depending on the asset class) of the value of the collateral. This percentage is known as the "advance rate."

ABLs are attractive to borrowers and sponsors because they typically feature more favorable pricing than cash flow loans. Further, with the primary collateral being limited to specified assets, the borrower can often preserve significant flexibility to incur other secured indebtedness. In addition, because asset-based lenders are more focused on collateral provided by the borrower than on cash flow, ABLs usually contain less stringent negative covenants than traditional cash-flow revolving loans. Most notably, ABLs typically do not provide for any financial maintenance covenants other than a fixed-charge coverage ratio, which is usually only applicable if "excess availability" (i.e., the amount by which the lesser of the borrowing base or the commitment of the lenders exceeds amounts outstanding under the facility) falls below a specified threshold. Finally, negative covenants in ABLs are generally inapplicable if there is sufficient excess availability and, if applicable, typically provide for larger baskets than in cash-flow loans.

Because lenders under ABL loans focus on the collateral against which the loans are made, asset-based loans contain more rigorous information and inspection covenants than in cash-flow loans. In particular, ABLs require:

- delivery of monthly or more frequent (weekly or even daily) borrowing base certificates providing a calculation of the borrowing base,
- regular appraisals of the borrower's inventory, and
- field examinations of collateral.

Field examinations and appraisals, which are conducted by third parties, typically take place two or three times per year. Accordingly, an ABL borrower must have requisite reporting and financial systems in place prior to entering into an ABL facility in order to comply with such requirements. In addition, if excess availability or other triggers occur, the collateral agent has the right to take control of the borrower's cash. This so-called "cash dominion" is triggered at a much earlier point in ABL loans than in cash-flow loans where lenders do not usually have the right to exercise control over bank accounts until an event of default has occurred.

Asset-based loans are not only used to provide working capital but also to finance acquisitions. The assets of the acquired company can be used as part of the borrowing base to obtain leverage on the closing date. However, the use of asset-based loans to finance acquisitions presents certain risks. Because the amount that may be borrowed under an asset-based loan facility varies with the borrowing base, using an ABL for an acquisition may present the risk of not having sufficient funds available at closing. As a result, drawings under an ABL facility typically are used to finance only a small part of the acquisition (e.g., backstopping letters of credit and funding additional closing fees due if the lenders exercise their rights

to "flex" in syndication) and are coupled with borrowings under a term loan facility, bridge loans, or the issuance of high yield notes.

Yield Protection

In the current sinking interest rate environment, lenders are seeking to protect their yields by imposing "soft-call" provisions on borrowers in the case of a refinancing or repricing of loans under a term loan facility. On the other hand, borrowers and sponsors are resisting the inclusion of such "soft-call" provisions to limit the cost of a refinancing in connection with a change of control. These "soft-call" provisions are ultimately part of the pricing terms and have in some situations necessary to achieve a successful syndication of certain loan facilities.

The refinancing or repricing may be implemented by the incurrence of incremental terms loans under the existing facility at a lower interest rate, by the incurrence of new term loans under a new facility or by amending the existing facility to reduce the applicable interest rate. Such "soft-call" provisions typically impose a 1 percent prepayment premium within the first year of the loan only if the refinancing or repricing has the effect of reducing the effective interest rate or weighted average yield (which includes any upfront or closing fees or original issue discount) on the debt of the borrower.

The Disappearing Swingline Facility

Several banks acting as administrative agent under credit agreements have stopped offering swingline facilities to borrowers. Swingline facilities are part of a revolving facility and are provided by one swingline lender. Swingline facility loans are available upon same-day notice by the borrower.

Some administrative agents are shying away from this type of facility because, acting as swingline lender, the administrative agent advances the full amount of the swingline loan and is concerned about other lenders defaulting on their obligations to fund their portion of the swingline facility.

As an alternative for borrowers seeking to be able to access their revolving facility on a same-day basis, base rate loans that were traditionally only available to be borrowed upon one-day notice are now more frequently accessible upon same-day notice.

Continued Focus on Conditionality

Arrangers and lenders continue to focus on their ability to syndicate deals to a comfortable hold level (i.e., the proportion of the loan retained by the lead arranger). In light of this trend, "club deals" (in which with several banks team-up to each provide part of the commitment to the borrower) remain a regular fixture of the syndicated loan market. Further, while "flex" terms which allow lenders to modify the terms of a loan to achieve a successful syndication remain limited to a list of certain provisions, they continue to permit lenders fairly expansive discretion. In particular, pricing flex is much broader than experienced prior to the financial crisis and there lenders are focused on being able to add more stringent terms (such as the soft-call provisions described below) or modify and curtail borrower-friendly provisions such as equity cures, the percentage of excess cash flow eligible to be swept to prepay debt, reinvestment periods for proceeds of asset sales, or the size of the incremental facility.

Finally, lenders continue to focus on conditionality. In particular, lenders will review and comment on the material adverse change provisions in the acquisition agreement before agreeing that the related condition in the financing documents will mirror that in the acquisition agreement. Financing sources also are reviewing acquisition agreements in more detail (and earlier in the transaction) than in the past and may require the principals to make certain modifications before delivering a commitment letter (such as requiring that lenders have third-party beneficiary rights to the assistance with financing covenant or the choice of law provisions).

Where are the Credit Markets Headed?

Current trends are encouraging and suggest a return to normality making financing more accessible and cheaper for corporate borrowers and private equity sponsors. Financing sources are competing for deals again, which has resulted, and should continue to result, in more advantageous terms for borrowers. That being said, lenders and lead arrangers continue to focus on the fundamentals, and at least for now it appears unlikely that credit markets are headed for the next bubble.

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The Birth of a New Financial Services Regulator

By Michael A. Benoit

The new Bureau of Consumer Financial Protection is a massive new regulator with largely subjective standards.

On July 21, 2010, President Obama signed into law the Wall Street Reform and Consumer Protection Act of 2010 (Act), the most far-reaching financial reform legislation since the Depression. Title X of the Act establishes the new Bureau of Consumer Financial Protection (BCFP or Bureau), a division of the Federal Reserve Board (FRB) that effectively will be an independent agency overseeing all aspects of consumer protection with respect to financial products and services.

Purpose and Objectives

Section 1021 of the Act requires the BCFP "to implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services" and that such markets are fair, transparent, and competitive.

It will take over as the primary enforcement authority for federal consumer financial law (discussed below) for the purposes of ensuring that:

- consumers are provided with timely and understandable information to make responsible decisions about financial transactions;
- consumers are protected from unfair, deceptive, or abusive acts and practices and from discrimination;
- outdated, unnecessary, or unduly burdensome regulations are regularly identified and addressed in order to reduce unwarranted regulatory burdens;
- federal consumer financial law is enforced consistently, without regard to the status of a person as a depository institution, in order to promote fair competition; and
- markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation.

Much of the Act goes into effect on the "designated transfer date" (DTD), which as of this writing is July 21, 2011. The Treasury secretary may extend the DTD for an additional six months if he transmits to appropriate committees of Congress:

- a written determination that orderly implementation of Title X of the Act cannot be feasible accomplished by July 21, 2011;
- an explanation of why an extension is necessary for the orderly implementation of Title X; and
- a description of the steps that will be taken to effect an orderly and timely implementation of Title X within the extended time period.

Governance and Funding

One striking aspect of the BCFP is the near-total lack of oversight to which it can be subjected. The first example of that is its governance structure. The BCFP will be headed by a single director who will serve for five years and who may only be removed from office by the President, and then, only for cause. This is a departure from other independent agency governance, where a commission is in charge and no more than 3 (assuming a five person commission) can be from the same political party.

Until the director is confirmed, Treasury has interim authority to do all that the director could. While the President has yet to appoint a director, he has appointed Professor Elizabeth Warren from Harvard, a noted consumer advocate, as a special assistant to the president in charge of getting the BCFP off the ground until a permanent director is confirmed. Given that the BCFP is Professor Warren's brainchild, we can assume that she will be intimately involved in its activities during the Obama administration.

Second, the BCFP will not have to endure the appropriations process; the primary means Congress uses to keep independent agencies in check. Instead, the director may request, and the FRB must provide, up to 10 percent of its annual operating budget in the first year, rising to 12 percent over the next two years, and then adjusted thereafter for inflation. In year

one, the maximum amount the BCFP can obtain is estimated to be approximately $550 million. To put that into perspective, the Federal Trade Commission budget is $314 million; a budget that applies not only to its consumer protection mission, but all of its other activities (e.g., competition) as well.

Should the director determine that its portion of the FRB budget is insufficient for its operational needs, it may still avail itself of the appropriations process and obtain an additional $200 million per year. Together, this could represent a budget of $750 million in year one—more than enough for the BCFP to get its mission off the ground.

Jurisdictional Authority

The BCFP has jurisdictional authority primarily over "covered persons" and "service providers."

In general, a "covered person" is "any person engaged in offering or providing a consumer financial product or service." "Consumer products and services" can include extending credit, data services, real estate services, stored value cards, deposit taking activities, etc., but does not include insurance activities or "electronic conduit" activities. While much of the focus has been on traditional financial institutions and nonbank mortgage lenders, the BCFP is mandated to define by rule classes of "non-depository covered persons" that will be subject to full BCFP authority. In other words, Congress has delegated authority to the BCFP to determine what sectors of the financial services industry it wants to regulate.

A "service provider" is "any person that provides a 'material service' to a covered person in connection with the offering or provision by such covered person of a consumer financial product or service." With such a subjective definition at its disposal, the BCFP will have significant reach into the financial services industry's vendor ranks.

Unfair, Deceptive, or Abusive Acts

The BCFP may take any action authorized under the Act to "prevent a covered person or service provider from committing or engaging in an unfair, deceptive, or abusive act or practice under Federal law in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service."

While we have years of jurisprudence from which providers may glean what acts or practices may be unfair or deceptive, the standard for "abusive" practices is new and untested. Specifically, an act or practice is abusive if it:

- materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
- takes unreasonable advantage of
  - a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
  - the inability of the consumer to protect his or her interests in selecting or using a consumer financial product or service; or
  - the reasonable reliance by the consumer on a covered person to act in the consumer's interests.

To provide some certainty and understanding to consumer financial services providers, clear regulatory guidance from the BCFP defining abusive acts and practices with more clarity will be necessary. Absent clear guidance, it would not be surprising to see providers somewhat reluctant to offer products and services directed to none but the least sophisticated consumers. On the other hand, history has shown the financial services industry to be adaptive to the environments imposed on it, and the same is likely to occur in this instance.

There is, however, a new twist to this standard that has not been seen before. That is, this "abusive" standard includes a fiduciary element unprecedented in the consumer lending industry, i.e., taking unreasonable advantage of the "reasonable reliance by the consumer on a covered person to act in the consumer's interests." In virtually all instances, the relationship of a borrower to a lender is adversarial throughout the duration of the relationship. It is relatively easy to disclose to borrowers at application that they should not rely on the lender to act in their interests, and no borrower should ever assume that a lender has any obligation to do so. Each is looking to get the best deal possible for themselves at origination; query whether a borrower who needs a disclosure to understand this is competent to contract for financial services in the first instance?

It gets more complicated during the life of a loan. Lenders looking to enforce the contract at various points during the term may need to tread carefully. Those lenders who try to work with their borrowers who are experiencing difficulties making their payments may be less willing to do anything other than strictly enforce the contract terms if not doing so could make it difficult to enforce the contract when all efforts to help the consumer fail. Of course, they could disclose to the borrower in each interaction that they should not rely on the lender to act in their interest, but query how helpful that sounds to the borrower?

Supervision

As of the DTD, the BCFP has will have exclusive rulemaking authority with regard its powers granted under the Act and the "enumerated" federal consumer financial laws (Enumerated Laws), e.g., the Truth in Lending Act and Regulation Z, the Consumer Leasing Act and Regulation M, the Equal Credit Opportunity Act and Regulation B, etc. The list of Enumerated Laws is long and comprehensive and can be found in § 1002(12) of the Act.

With some exception, the BCFP has exclusive examination authority and primary enforcement authority over any rules it promulgates, and will have the same authority with respect to the Enumerated Laws as of the DTD. It will also have the authority to collect information and the power to exempt classes of providers from the full reach of its authority.

In addition to depository institutions, the BCFP will supervise:

- all mortgage-related non-depository in-

stitutions (lenders, servicers, mortgage brokers, etc.);
- private student lenders;
- pay day lenders;
- service providers to non-depository institutions subject to the Bureau's supervision.

The BCFP may also exercise supervisory authority over "larger participants" of the market for other consumer financial products or services. Within one year after the DTD, it must issue a rule in consultation with the Federal Trade Commission (FTC) to define "larger participants." Finally, it may supervise other covered persons when it has "reasonable cause to determine that the covered person's offering or provision of consumer financial products or services conduct poses risks to consumers."

The BCFP will require reports from covered persons and conduct periodic compliance examinations. Its supervision will be risk-based, i.e., it will focus its resources on those providers or classes of providers whose products and service represent the greatest risk to consumers. Many of these providers will be state-regulated; the BCFP is required to coordinate its supervisory activities with the state agencies. Additionally, the BCFP may require specific record-keeping, as well as impose a requirement for background checks or other appropriate financial requirements as it sees fit.

Enforcement and Remedies

Except for FTC, the BCFP will have exclusive enforcement authority for all transferred and newly promulgated rules. It must coordinate its enforcement with the FTC and negotiate protocol with FTC for initiation and notice of enforcement actions.

With respect to its power to prohibit unfair, deceptive, and abusive practices, the BCFP may bring investigations, and issue Civil Investigative Demands (CIDs) in connection with those investigations. It may conduct cease-and-desist administrative proceedings, and it may bring enforcement actions in U.S. district court.

A court, or the BCFP in the case of an administrative proceeding, may "grant any appropriate legal or equitable relief with respect to a violation of Federal consumer financial law," including a violation of a rule or order under a federal consumer financial law. Such relief may include, without limitation,

- rescission or reformation of contracts;
- refund of moneys or return of real property, restitution;
- disgorgement or compensation for unjust enrichment;
- payment of damages or other monetary relief;
- public notification regarding the violation, including the costs of notification;
- limits on the activities or functions of the person; and
- civil money penalties.

State attorneys general are authorized under section 1042 of the Act to bring court and/or administrative actions to enforce the Act and any regulations promulgated thereunder. Existing limitations on states' enforcement activities with respect to the Enumerated Laws remain intact. However, if the Bureau, a state attorney general, or any state regulator is the prevailing party in an action to enforce any federal consumer financial law, it may recover its costs in connection with prosecuting such action.

Final Thoughts

There is far more to the BCFP that may be covered in a simple column, and we will be learning new things about it every day. The BCFP is the new reality for both financial services providers and consumers.

Its primary goal is to protect consumers in financial transactions while keeping markets open and transparent, and ensuring that access to services and innovation is preserved. No doubt, achieving this goal will be no small feat. Achieving this goal without significantly increasing the costs of financial products and services for consumers is, more than likely, a statistical improbability.

All indications seem to be that the BCFP is interested in having an open dialogue with industry and consumers. Building any new organization of this scope is a monumental task, one made easier by developing a clear understanding of the facts and realities affecting its mission. It would be easy enough for the regulatory pendulum to swing too far one way or the other, and there are plenty of reasons (e.g., economic stability, access to credit, etc.) to try to forge a middle path.

In an effective regulatory environment, balance and cost controls are the key components. Regulations should protect those whom they are meant to protect, while at the same time imposing as little burden as possible on those being regulated. Congress, in its efforts to ensure it addressed every financial woe possible, has created a massive new regulator with no track record and provided it with largely subjective standards to enforce while at the same time eliminating much of its own ability to oversee it effectively. So query: What will drive the balance and regulatory cost controls at the BCFP?

Michael Benoit is a partner in the Washington, D.C., office of Hudson Cook LLP. *Nothing in this article is intended to be legal advice and should not be taken as such. All legal questions should be addressed to competent counsel.*

BUSINESS LAW TODAY
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Keeping Current: Securities

Redefining "Swap" under Dodd-Frank

By J. Paul Forrester

Title VII of the Dodd Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), titled "Wall Street Transparency and Accountability Act," contains significant reforms of the over-the-counter derivatives markets. The actual extent of many of these reforms may turn on the extent of regulatory reach under Title VII, which in turn will be determined by the meaning to be given to certain key terms used in Title VII. Importantly, section 712(d) of the Dodd-Frank Act requires that the Commodities and Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC), in consultation with the Federal Reserve Board, jointly further define these key terms.

Not surprisingly, one of the first actions taken by the CFTC and the SEC under the Dodd-Frank Act was to solicit comments regarding so-called "key definitions" of Title VII, including the terms "swap," "swap dealer," and "major swap participant" in their joint Advance Notice of Proposed Rulemaking (ANPR).

This article will focus on the term "swap" and the potential breadth thereof unless the Dodd-Frank Act's definition (included in pertinent part below in *Appendix I*) is limited by rulemaking. While the joint rulemaking by the CFTC and SEC required under Dodd-Frank section 712(d) is still pending, there were 70 related comments made to the SEC and 83 related comments and presentations made to, and meetings held with the CFTC regarding the ANPR. Only a few comment letters raised any significant issue with the potential breadth of the definition of "swap" under the Dodd-Frank Act.

Much of the current attention to this definition (at least as inferred from the comments submitted to the CFTC and SEC) concerns: the extent of the exclusion in the Commodity Exchange Act (7 U.S.C 1a) section 2(a)(47)(B)(ii); the scope of the so-called "end-user" exclusion; and the level of systemic risk and substantial position in swaps that will trigger "swap dealer" and "major swap participant" (or the corresponding "security-based swap dealer" and "major security-based swap participant") status. However, only the occasional comment (e.g., the comments of the American Council of Life Insurers) raises serious question regarding the breadth of the definition of the term "swap" in the Dodd-Frank Act. The definition of "swap" contained in the Dodd-Frank Act can be reasonably read to apply to many ordinary transactions that are not widely regarded as swaps, including the following examples:

- Certain insurance and reinsurance contracts, particularly non-traditional contracts such as industry-loss warranties or contracts with embedded derivatives (e.g., variable annuity policies and policies with guaranteed income and similar features).
- Credit agreements, bonds or other debt instruments that provide for a fluctuating interest rate that is based on a variable interest rate or index or on the borrower's financial condition or specified financial metrics.
- Loan participations (discussed in further detail below).
- Post-closing purchase price adjustments for changes in working capital or other specified economic or financial event or contingency in business acquisition or combination agreements.
- Earn-out and similar provisions where payments vary based on specified economic or financial performance in business acquisition or combination agreements.
- Lotteries and other gaming contracts.
- Catastrophe bonds.
- Provisions in leases, employment and other agreements that index payments for inflation or other specified economic or financial event or contingency.
- Provisions for collateral or a guaranty to be provided or some other change in contractual relations upon a specified economic or financial event or contingency.
- Provisions requiring a notice of default or other economic or financial event or contingency.

There are undoubtedly many other examples of transactions that could not have been intended by anyone, including Congress, to be deemed swaps subject to

potential regulation under the Dodd-Frank Act.

Loan participations illustrate some of the difficulties that lie in the interpretation of swap under the Dodd-Frank Act. U.S.-style loan participations still appear "caught" by CEA section 1a(47)(A)(ii), even if—as is usually the case with the U.S.-style loan participation agreement—they convey a beneficial interest in the underlying loan or loans and would thereby escape section 1a(47)(A)(iii). In contrast, the Loan Market Association's participation agreement forms often used in Europe do not convey any interest in the underlying loan and, as a result, appear to fall within CEA sections 1a(47)(A)(ii) and (iii). The swap analysis for loan participations does not end here, however, as section 725(g)(2) of the Dodd-Frank Act excludes "identified banking products" as swaps. Identified banking products are defined in section 206 of the Gramm-Leach-Bliley Act to include:

> (5) a participation in a loan which the bank or an affiliate of the bank (other than a broker or dealer) funds, participates in, or owns that is sold—
> (A) to qualified investors; or
> (B) (to other persons that—
> (i) have the opportunity to review and assess any material information, including information regarding the borrower's creditworthiness; and
> (ii) based on such factors as financial sophistication, net worth, and knowledge and experience in financial matters, have the capability to evaluate the information available, as determined under generally applicable banking standards or guidelines.

The term "qualified investor" is defined in section 3(a)(54) of the Securities Exchange Act as follows:

> 54. Qualified investor
> (A) Definition
> Except as provided in subparagraph (B), for purposes of this title, the term 'qualified investor' means
> (i) any investment company registered with the Commission under section 8 of the Investment Company Act of 1940;
> (ii) any issuer eligible for an exclusion from the definition of investment company pursuant to section 3(c)(7) of the Investment Company Act of 1940;
> (iii) any bank (as defined in paragraph (6) of this subsection), savings association (as defined in section 1813(b) of Title 12), broker, dealer, insurance company (as defined in section 2(a)(13)) of the Securities Act of 1933, or business development company (as defined in section 2(a)(48) of the Investment Company Act of 1940);
> (iv) any small business investment company licensed by the United States Small Business Administration under section 681(c) or (d) of this title;
> (v) any State sponsored employee benefit plan, or any other employee benefit plan, within the meaning of the Employee Retirement Income Security Act of 1974, other than an individual retirement account, if the investment decisions are made by a plan fiduciary, as defined in section 1002(21) of Title 29, which is either a bank, savings and loan association, insurance company, or registered investment adviser;
> (vi) any trust whose purchases of securities are directed by a person described in clauses (i) through (v) of this subparagraph;
> (vii) any market intermediary exempt under section 3(c)(2) of the Investment Company Act of 1940;
> (viii) any associated person of a broker or dealer other than a natural person;
> (ix) any foreign bank (as defined in section 3101(b)(7) of Title 12);
> (x) the government of any foreign country;
> (xi) any corporation, company, or partnership that owns and invests on a discretionary basis, not less than $25,000,000 in investments;
> (xii) any natural person who owns and invests on a discretionary basis, not less than $25,000,000 in investments;
> (xiii) any government or political subdivision, agency, or instrumentality of a government who owns and invests on a discretionary basis not less than $50,000,000 in investments; or
> (xiv) any multinational or supranational entity or any agency or instrumentality thereof.
> (B) Altered thresholds for asset-backed securities and loan participations
> For purposes of subsection (a)(5)(C)(iii) of this section and section 206(a)(5) of the Gramm-Leach-Bliley Act [15 U.S.C.A. § 78c note], the term 'qualified investor' has the meaning given such term by subparagraph (A) of this paragraph except that clauses (xi) and (xii) shall be applied by substituting '$10,000,000' for '$25,000,000'.
> (C) Additional authority
> The Commission may, by rule or order, define a "qualified investor" as any other person, taking into consideration such factors as the financial sophistication of the person, net worth, and knowledge and experience in financial matters.

Confused? So are experienced legal practitioners, who are finding it difficult to explain to clients the inconsistent results of this statutory and definitional interplay, leaving aside the basic incongruity that substantially similar transactions (e.g., loan credit default swaps) are potentially treated in a very dissimilar manner.

Accordingly, there is a real risk of inadvertent/unintentional regulatory treatment for swaps that are not thought of as such. And, while this may be mostly limited to some possible reporting and other "minor" inconvenience, there remains a further risk of significant adverse consequences if an entity has substantial swap exposure so as to possibly trigger "swap dealer" or

"major swap participant" (or the corresponding "security-based swap dealer" or "major security-based swap participant) status and related registration, business conduct and other more onerous Dodd-Frank Act compliance requirements.

It is unclear at this time whether the CFTC or the SEC would agree with the suggested "unintended" swaps or regarding the potential exclusion thereof (if applicable). Interested parties will have to wait for the CFTC and SEC proposed rules for the opportunity to comment thereon; however, if the CFTC and/or the SEC take the view that these transactions are appropriately treated as "swaps" it will likely be more difficult to persuade them otherwise in connection with the related rulemaking.

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APPENDIX I

The Dodd-Frank Act defines "swap" in section 721(a)(21) and adds to section 1a of the Commodity Exchange Act (7 U.S.C 1a) the following (**emphasis added**):

(47) Swap.

(A) In general.—Except as provided in subparagraph (B), the term 'swap' means any agreement, contract, or transaction—

(i) That is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind;

(ii) That provides for **any purchase, sale, payment, or delivery** (other than a dividend on an equity security) that is **dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence**;

(iii) That provides on an executory basis for the **exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more** interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, **quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof**, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level **without also conveying a current or future direct or indirect ownership interest in an asset** (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred, **including any agreement, contract, or transaction commonly known as—**

(I) An interest rate swap;
(II) A rate floor;
(III) A rate cap;
(IV) A rate collar;
(V) A cross-currency rate swap;
(VI) A basis swap;
(VII) A currency swap;
(VIII) A foreign exchange swap;
(IX) A total return swap;
(X) An equity index swap;
(XI) An equity swap;
(XII) A debt index swap;
(XIII) A debt swap;
(XIV) A credit spread;
(XV) A credit default swap;
(XVI) A credit swap;
(XVII) A weather swap;
(XVIII) An energy swap;
(XIX) A metal swap;
(XX) An agricultural swap;
(XXI) An emissions swap; and
(XXII) A commodity swap;

(iv) That is an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap;

(v) Including any security-based swap agreement which meets the definition of 'swap agreement' as defined in section 206A of the Gramm-Leach-Bliley Act (15 U.S.C. 78c note) of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein; or

(vi) That is any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v).

(B) Exclusions.—The term 'swap' does not include—

(i) Any contract of sale of a **commodity for future delivery** (or option on such a contract), leverage contract authorized under section 9, security futures product, or agreement, contract, or transaction described in section 2(c)(2)(C)(i) or section 2(c)(2)(D)(i);

(ii) Any **sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled;**

(iii) Any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities, including any interest therein or based on the value thereof, that is subject to—

(I) The Securities Act of 1933 (15 U.S.C. 77a *et seq.*); and
(II) The Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*);

(iv) Any put, call, straddle, option, or privilege relating to a foreign currency entered into on a national securities exchange registered pursuant to section 6(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(a));

(v) Any agreement, contract, or transaction providing for the purchase or sale of 1 or more securities on a fixed basis that is subject to—

(I) The Securities Act of 1933 (15 U.S.C.77a et seq.); and
(II) The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.);

(vi) Any agreement, contract, or transaction providing for the purchase or sale of 1 or more securities on a contingent basis that is subject to the Securities Act of 1933 (15 U.S.C. 77a et seq.) and the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), unless the agreement, contract, or transaction predicates the purchase or sale on the occurrence of a bona fide contingency that might reasonably be expected to affect or be affected by the creditworthiness of a party other than a party to the agreement, contract, or transaction;

(vii) Any note, bond, or evidence of indebtedness that is a security, as defined in section 2(a)(1) of the Securities Act of 1933 (15 U.S.C. 77b(a)(1));

(viii) Any agreement, contract, or transaction that is—

(I) Based on a security; and

(II) Entered into directly or through an underwriter (as defined in section 2(a)(11) of the Securities Act of 1933 (15 U.S.C. 77b(a)(11)) by the issuer of such security for the purposes of raising capital, unless the agreement, contract, or transaction is entered into to manage a risk associated with capital raising;

(ix) Any agreement, contract, or transaction a counterparty of which is a Federal Reserve bank, the Federal Government, or a Federal agency that is expressly backed by the full faith and credit of the United States; and

(x) Any security-based swap, other than a security-based swap as described in subparagraph (D).

(C) Rule of Construction regarding master agreements.—

(i) In general.—Except as provided in clause (ii), the term 'swap' includes a master agreement that provides for an agreement, contract, or transaction that is a swap under subparagraph (A), together with each supplement to any master agreement, without regard to whether the master agreement contains an agreement, contract, or transaction that is not a swap pursuant to subparagraph (A).

(ii) Exception.—For purposes of clause (i), the master agreement shall be considered to be a swap only with respect to each agreement, contract, or transaction covered by the master agreement that is a swap pursuant to subparagraph (A).

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Focusing on Pro Bono

Bankruptcy Assistance: Creative Strategies

By Allyn O'Connor

As unemployment rates soar and the weakened economy stresses individual finances, more consumers are turning to the bankruptcy process for protection from creditors. According to the National Bankruptcy Research Center, consumer bankruptcy filings between April 2009 and April 2010 rose 15 percent. In some states, filing rates are even higher. Filings in Arizona and California, for example, are up 40 percent or more from the prior year. A recent *USA Today* headline reads "Only a Fraction of Those in Need File for Bankruptcy." The author cites a lack of affordable legal assistance as a primary reason why most debtors don't file for bankruptcy.

More concerning, however, are the number of debtors who attempt to file pro se. A recent study comparing Chapter 7 pro se filings made during 2007 to those made during 2001 found a significant increase in the number of pro se filings. Furthermore, in 2007, 20 percent of the Chapter 7 cases filed pro se were dismissed or converted to a Chapter 13 case whereas in 2001, only 2 percent of the Chapter 7 cases filed by an unrepresented debtor were dismissed or converted.

Bankruptcy courts, legal services organizations, and pro bono programs have all noticed the dramatic increase in the need for bankruptcy legal assistance as well as most pro se filers' lack of success. Often working together, these groups have devised creative and effective ways to help consumers by maximizing scarce volunteer resources. The most successful of these involve the collaboration of all stakeholders: bankruptcy judges and court staff, members of the state, local and bankruptcy bars, legal services agencies, and volunteer lawyer programs.

Bankruptcy experts agree the best form of debtor assistance is full representation by an experienced consumer bankruptcy practitioner through the entire bankruptcy process. Dedicated volunteers continue to make this possible in many instances, through programs such as the Rutgers University School of Law–Camden Bankruptcy Pro Bono Project, which pairs volunteer lawyers with law students to provide debtors with full bankruptcy representation. The ABA Business Law Section's *How to Begin a Pro Bono Program in Your Bankruptcy Court* remains one of the most downloaded pro bono publications offered by the ABA.

Many bankruptcy pro bono programs, however, have faced a shortage of volunteers for the last few years. In part, this is due to the myriad of changes to the bankruptcy process imposed by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. In addition, the current economy has meant a booming business for consumer bankruptcy attorneys, who may not have the time to take on pro bono matters. As a result, many pro bono programs are exploring alternative ways to help debtors.

Low Bono Representation

Maryland debtors have access to a Debtor Assistance Project (DAP). Bankruptcy court personnel coordinate the DAP, though which a debtor may seek pro bono representation. If a debtor is not financially eligible for pro bono representation, he or she may seek reduced-fee, or "Low Bono" services from a volunteer bankruptcy attorney.

The Low Bono portion of the DAP is a list of attorneys developed from those who have completed an on-line DAP volunteer information form. In order to be included on the Low Bono list, attorneys must already serve the DAP in some other capacity, either by staffing the DAP office (help desk) periodically or by completing a bankruptcy pro bono case through the Maryland Volunteer Lawyers Service's Pro Bono Panel. If a lawyer signs up for Low Bono representation, his or her name is included on a list made available to the debtors who have first come to a DAP clinic. Lawyers on the list agree to take on cases at reduced fees. There is no established reduced-fee structure, but Low Bono lawyers have copies of area legal aid and pro bono program client qualification guidelines. Low Bono lawyers have agreed to negotiate a reduced fee with the client consistent with the client's financial situation. The DAP does not match lawyers with debtors. Rather, a debtor has access to the Low Bono list and is invited to contact a lawyer and negotiate a lower fee.

Clinics / Consultations

Many times, debtors seek to file bankruptcy without first understanding the process or the implications of filing. A number of organizations sponsor clinics in which volunteer lawyers provide general education about the bankruptcy process or meet with the unrepresented debtors one-on-one to answer questions and explain all aspects of the bankruptcy process. The DAP, mentioned above, uses volunteer bankruptcy lawyers to meet with debtors individually. The Legal Aid Center of Southern Nevada, on the other hand, partners with the William S. Boyd School of Law to conduct a community legal education class on bankruptcy. They provide an accompanying manual and have made a video of the class available online. Legal Aid Services of Oregon works with volunteers for the Debtor-Creditor Section of the Oregon State Bar both to hold regular bankruptcy education classes and to follow each class with individual consultations with a volunteer lawyer.

Pro Se Help Desks

On a minimal budget, business bankruptcy lawyers in the Eastern District of Wisconsin (Milwaukee) staff a help desk for a few hours each week, answering debtors' questions and providing them with a handful of sample documents for their use. The desk is located in the courthouse, and volunteers have a good relationship with the court, the clerk's office, and filing desk personnel.

A similar program is the bankruptcy assistance desk in the Northern District of Illinois. The desk is staffed by an employee of the Legal Assistance Foundation of Metropolitan Chicago, who is available during the morning hours on any day the court is open. The project was funded indirectly with moneys remaining from a Chapter 11 case resulting in the debtor's liquidation. The court made a cy pres grant of the funds to the Chicago Bar Foundation, intending to support the bankruptcy assistance desk. The person staffing the desk answers questions, directs petitioners to forms and schedules, provides explanations, and unofficially reviews prepared documents.

In Phoenix, the local bankruptcy bar has been instrumental in setting up a walk-in Self Help Center at the courthouse. There, debtors can find on-line and printed information about how the bankruptcy process works in Arizona. The Self Help Center is open daily, with volunteer law students assisting debtors with basic questions, and volunteer bankruptcy lawyers available for individual consultations.

Pro Se Filing Preparation

In some locations, legal services organizations have determined the most effective use of resources is to assist pro se filers with the preparation of bankruptcy petitions and schedules. Legal Services NYC's Bankruptcy Assistance Project (BAP) utilizes staff and volunteers to provide basic bankruptcy education and to prepare filings. The staff conducts a final review of petitions and schedules and then facilitates the filing of the petition with the bankruptcy court. And while recruiting volunteer lawyers from certain law firms would ordinarily be problematic due to conflicts, the BAP relies on an ethics opinion issued by the Bar of the City of New York setting out the circumstances under which volunteers may assist pro se filers without raising conflict issues.

Reaffirmation Clinics

Chapter 7 debtors quite often owe balances on items such as car loans. The bankruptcy process offers them the opportunity to agree to repay, or reaffirm, the debt. Many debtors agree to do this in order to retain possession of the property. A car, for example, may be a consumer's only form of transportation and may make the difference between a paycheck and unemployment. In many instances, however, consumers reaffirm these debts when it may not necessarily be in their best economic interest.

Legal services programs and volunteer lawyers have been joining in the effort to educate Chapter 7 debtors on the reaffirmation process. They work with bankruptcy courts to consolidate reaffirmation hearings, and then schedule reaffirmation education clinics beforehand to prepare debtors. Volunteer lawyers and legal services attorneys develop reaffirmation information packets for debtors and take the time to go over the reaffirmation process and explain the benefits and disadvantages of reaffirming a debt.

Hundreds of consumers have been helped this way in clinics across the country. In Los Angeles, Public Counsel's Debtor Assistance and Consumer Law Projects have been counseling consumers on reaffirmations for over 10 years. In Atlanta, volunteer lawyer John Mills replicated the Los Angeles model in the United States Bankruptcy Court for the Northern District of Georgia.

Adversary Representation

There are circumstances in which a pro se filer's case has not yet been dismissed, but a creditor has raised an issue in an adversary proceeding. Some organizations have created projects where bankruptcy attorneys volunteer to represent the debtor through the adversary proceeding. In Denver, Faculty of Federal Advocates Bankruptcy Pro Bono Program volunteers furnish free legal services to debtors in pending bankruptcy cases. In Minnesota, the Minnesota State Bar Association Bankruptcy Section, partnering with the U.S. Bankruptcy Court for the District of Minnesota and the Volunteer Lawyers Network in Minneapolis, created a project to represent indigent defendants in adversary proceedings.

Funding

Some traditional, IOLTA-funded sources are strained at this time and may not have funds for new debtor assistance programs. A state or local bankruptcy bar or the bankruptcy section of a state or local bar, may be able to provide some monetary assistance. In addition, the American College of Bankruptcy (ACB) may be a source of funding. The ACB has a well-funded grant program and generously distributes funds each year to facilitate the growth of bankruptcy pro bono programs. Finally, if members of an area business bankruptcy bar are involved in Chapter 11 cases that result in liquidation, unclaimed funds may be available for the court to make cy pres awards to fund bankruptcy assistance programs.

Conclusion

This article briefly presents just a few of the many new ideas legal services organizations and pro bono programs are using to help the greatest number of debtors possible with scarce resources. Staff creativity is resulting in extensive unbundling within the bankruptcy process, as well increased use of volunteers for limited-scope tasks. The bankruptcy community as a whole is committed to an open, accessible, bankruptcy system, and the future promises even more innovation in the delivery of justice for consumer debtors.

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Keeping Current: Securities

Delaware Supreme Court affirms Use of NOL Poison Pills

By Diane Holt Frankle and Michael J. Stein

The Delaware Supreme Court, in Versata Enterprises, Inc. and Trilogy, Inc. v. Selectica, Inc., No. 193, 2010 (Del. Oct. 4, 2010), acting en banc, has affirmed a prior Delaware Chancery Court ruling and upheld the use of what is known as a section 382 poison pill (or, more commonly, a net operating loss, or NOL, pill).

An NOL pill is designed to protect the company's net operating loss carryforwards, which can be used to offset future tax liability to the extent that the company (or an acquiror) has such tax liability in the future. Section 382 of the Internal Revenue Code limits the amount of NOLs that can be used following certain changes in ownership. Generally, a section 382 ownership change occurs if, on any testing date, the 5 percent shareholders of a company have increased their aggregate percentage ownership of the company by more than 50 percentage points over their respective lowest levels of percentage ownership during the three years prior to the testing date. Therefore, NOL pills generally contain 5 percent thresholds which seek to prevent a person who is not a 5 percent shareholder from becoming one, subject to certain exemptions, and also place strict limits on acquisition of additional shares by incumbent greater than 5 percent shareholders.

Through its October 4 ruling, the Delaware courts again confirmed the legality of the use of rights plans as a takeover defense under Delaware law and expressly acknowledged the validity of an NOL rights plan.

Prior to the Chancery Court's ruling in *Selectica* and the Supreme Court's subsequent *en banc* affirmation of that ruling, Delaware courts had only examined the appropriateness of poison pills in the context of hostile change-of-control transactions. The Chancery Court upheld the validity of Selectica's NOL pill, the adopted replacement NOL pill, and the exchange. Trilogy subsequently appealed.

The Delaware Supreme Court upheld the validity of Selectica's NOL pill, the adopted replacement NOL pill, and the exchange under Delaware's *Unocal* standard, which is used to address defensive actions taken by a board in connection with a possible change of control, such as the adoption of a poison pill. Under *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946 (Del. 1985), in order to be afforded the protections of the business judgment rule, a company's board must show it had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and demonstrate that the defense response was reasonable in relation to the specific threat. Delaware courts have stated that a response is not reasonable if it is either coercive or preclusive.

Addressing the first prong of *Unocal*, the Supreme Court found that Selectica's board had reasonable grounds for concluding that a threat existed. Justice Holland noted that Selectica's board met often and that the record supports a factual finding that Selectica's board "acted in good faith reliance on the advice of experts," which included receiving advice from legal counsel and an investment banker and conducting a thorough review of a financial expert's analyses of the NOLs in November 2006 and again in each of March 2007, June 2007, and July 2008. The court concluded that Selectica's board followed a "logical deductive reasoning process" and reasonably determined that "[its] NOLs were worth preserving and Trilogy's actions represented a serious threat of [Selectica's NOL's] impairment."

Similarly, the Supreme Court found that the decision of the board to act promptly to reduce the trigger on the rights plan from 15 percent to 4.99 percent was reasonable on the record, noting that the change in ownership calculation under Section 382 stood at approximately 40 percent, Trilogy's ownership had climbed to over 5 percent in just over a month and that Trilogy intended to buy more stock. Not only was there nothing to prevent Trilogy from continuing to buy Selectica stock, but the board understood that once the section 382 limitation was tripped, it could not be undone. The Supreme Court also noted the creation of the Review Committee with a "mandate to conduct a periodic review of the continuing appropriateness of the NOL Poison Pill." The Supreme Court upheld the Chancery

Court's findings and held that the Selectica directors had showed that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership."

The Supreme Court also determined that Selectica's NOL pill was not preclusive. The court stated that a defensive measure is preclusive where it "makes a bidder's ability to wage a successful proxy contest and gain control either 'mathematically impossible' or 'realistically unattainable'" given the specific factual context. The Supreme Court held that there is really only one test of preclusivity: that it is "realistically unattainable." Further, based on expert testimony, the Supreme Court concluded Selectica's NOL pill and the newly adopted replacement pill were *not* preclusive. The Supreme Court was clear that the "fact that a combination of defensive measures makes it more difficult for an acquirer to obtain control of a board does not make such measures realistically unattainable, i.e., preclusive." In addition, the Supreme Court unambiguously held that "the combination of a classified board and a rights plan do not constitute a preclusive defense."

The court then evaluated the NOL rights plan under the standard of reasonableness and noted that the exchange of the rights employed by Selectica's board of directors was a more proportionate response than the flip-in mechanism provided in the rights plan, and, therefore, Trilogy experienced less dilution than it would have had the flip-in mechanism been permitted to operate. The court found that after three failed attempts to negotiate with Trilogy, it was reasonable for Selectica's board to determine there was no other option than to implement the NOL pill. The court also determined that it was reasonable for Selectica's board to adopt the reloaded pill based on the board's ultimate findings that the NOLs were a corporate asset worth protecting and the fact that a threat still existed under section 382 with respect to the loss of the NOLs.

The Supreme Court was careful to point out, however, that the reasonableness of a board's response to a "specific threat" is determined in relation to that threat "at the time it was identified." The Supreme Court cautioned that the adoption of a rights plan is not absolute and noted that the court had "upheld the adoption of rights plans in specific defensive circumstances while simultaneously holding that it may be inappropriate for a rights plan to remain in place when those specific circumstances change dramatically." The Supreme Court explained that "[i]f and when Selectica "is faced with a tender offer and a request to redeem the reloaded pill, they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism."

The Supreme Court thus provided significant and welcome guidance to boards of directors that are considering a rights plan. It upheld the use of a rights plan, including an NOL pill such as that adopted by Selectica, in cases where the board of directors has reasonably determined that it is a reasonable response to a threat reasonably perceived. The court also reminded directors that the reasonableness of a board's decision with respect to antitakeover measures will be judged in context at the time the directors make the determination to implement or continue the measure under challenge.

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