BUSINESS LAW **TODAY**

The ABA Business Law Section's Online Resource

Return of the Earnout: An Important Tool for Acquisitions in Today's Economy

By Kevin Levy, Angelo Bonvino, and Prem Amarnani

Purchase price is arguably the most important issue for both the buyer and the seller in an acquisition transaction. Without an agreement on price there is no deal. Each party uses different assumptions and adjustments in determining the value of a business. Inevitably, this results in a difference of opinion on pricing. Lately, this disconnect seems to arise from a disagreement on the target's projected earnings. Such disagreements over valuation have become increasingly commonplace after the recent economic downturn where many businesses' earnings were drastically reduced. As a result, buyers and sellers in private transactions are once again turning to earnouts in order to reach a consensus on purchase price.

An earnout is a contingent portion of the purchase price that is paid after closing to the seller upon the target business achieving certain agreed financial or non-financial benchmarks within a specified period of time. Utilizing an earnout limits the buyer's risk that it is overpaying for an underperforming asset, while also providing the seller with what it considers appropriate deal consideration if the target business' projected performance is achieved. A properly crafted earnout has the potential to lead to a win-win situation—the seller realizes a higher purchase price by capturing value from the future growth of the target and the buyer gets what it paid for. Particularly in today's recovering economy, a carefully drafted

earnout can serve as an important tool to help consummate a transaction that might otherwise be dead on arrival.

Recent Trends

Anecdotal evidence suggests that a major factor influencing the existence and use of earnouts is the health of the M&A and debt financing markets and the economy as a whole. This fact was evident during the "seller's market" from 2005 through 2007. Increasing prices during this time led to increased competition among potential buyers. As a result, many buyers were hesitant to incorporate earnouts as part of the purchase price because there was a meaningful risk that another buyer could win the deal by offering the full amount of the purchase price upfront. Additionally, inexpensive financing was readily available, which provided buyers with both a means and a justification for paying what may in hindsight have been inflated

As most people who are reading this article are well aware, not too long after the peak of the M&A market, the economy took an unprecedented turn for the worse and many companies suffered significantly reduced revenues and earnings as a result. In addition, many buyers (both financial and strategic) stayed on the sidelines as debt financing became sparse, and for a while non-existent. As the general economy and the M&A and debt financing markets began to improve

in the last quarter of 2009, the issue of purchase price was front and center in the eyes of both sellers and buyers. The typical argument expressed by sellers for their expected valuation was that the reduced revenue and earnings suffered during the downturn was only temporary and performance would return to normal when the economy recovered. They emphasized that the target's business was fundamentally sound and value should not be discounted because of timing. However, buyers and their debt financing sources were wary of overpaying for a business that might never fully recover. In this valuation tug-of-war, sellers, in an effort to get a price closer to what they believe the target is worth in a better economic climate, and buyers, in an effort to acquire a promising business at a fair price, have each become increasingly amenable to using earnouts. As a result, the use of earnouts has steadily increased in acquisition transactions involving businesses that have suffered during the economic downturn.

Choosing the Benchmark

The benchmark is perhaps the most critical component of the earnout and should be custom tailored to the target's business. Benchmarks can be financial, non-financial, or a combination of the two, and can relate to the entire business or a specific division or product line. Because there is a significant potential for future disputes regarding whether the benchmark was met,

it must be easily measurable and as clearly and comprehensively defined as possible.

Financial benchmarks typically relate to gross revenue, EBITDA (earnings before interest, taxes, depreciation, and amortization), and net income. Gross revenue is the easiest benchmark to determine because it is not affected by costs and expenses of the target. However, gross revenue benchmarks are rarely used because businesses are typically valued based on an EBITDA basis. Yet financial benchmarks other than gross revenues are more prone to manipulation because of the many inputs involved.

EBITDA is generally the default benchmark as it is consistent with the valuation methodology used by buyers. EBITDA is preferred over gross revenue by the buyer because it reflects the cost of goods and services, selling expenses, and general and administrative expenses. Although the items that are included in the definition of EBITDA vary from deal to deal, the calculation commonly excludes "extraordinary items" of gain or loss as defined in United States generally accepted accounting principles (GAAP), gains or losses resulting from non-ordinary course sales of assets, management fees and other intercompany charges, and transaction fees arising out of the acquisition itself. Other adjustments are often included, such as to the purchase and sale prices of goods and services in non-arm's length transactions, which are adjusted to reflect amounts realized or paid as if dealing with an independent party in an arm's length transaction. Such adjustments "normalize" EBITDA and arguably make it the most fair financial benchmark for both the buyer and the seller.

Non-financial benchmarks are varied and are typically used in acquisitions of development stage companies and those that operate in heavily regulated industries, such as those in the biotech and pharmaceutical industries. Examples of non-financial benchmarks include obtaining regulatory approvals, expanding sales presence to certain markets and obtaining a specified number of unique visitors to a website. Although the determination of whether a non-financial benchmark has

been met may seem binary in nature, it can be just as complicated as that of a financial benchmark. The parties should anticipate the variables that surround such a determination and the impact they may have on the seller's ability to achieve the earnout.

Post-Closing Operations

The likelihood that the earnout will be achieved generally depends entirely on the operation of the target business following the closing. The buyer will likely have total control over the business following the closing unless the seller can negotiate contractual protections. Formulating a mutually acceptable set of protections is usually as difficult as formulating a clearly defined benchmark. The parties often have diverging interests during the earnout period. The seller will likely want the target to maximize the short-term performance of the business in order to achieve the earnout. The buyer might take the opposite approach and cause the company to eliminate low margin items or to make significant investments during the earnout period in order to maximize long-term growth.

Sellers typically try to negotiate for negative covenants to provide them with veto protection for major business decisions, such as incurring additional debt, expanding operations, cutting products or product lines, and hiring and firing key employees. Additionally, the seller will usually request a generic covenant that the target's business will be operated in a manner consistent with past practice. Not surprisingly, buyers are generally opposed to any restrictions on their ability to run the business they just paid for. Buyers typically argue that they should have complete discretion to run the company and that the buyer's interests are aligned with those of the seller because each wants the business to succeed. Unfortunately for buyers, some courts have recently implied that absent specific contractual language to the contrary, the covenant of good faith and fair dealing requires the buyer to operate the target's business so as to maximize the likelihood of an earnout payment. (See, e.g., Airborne Health, Inc.

and Weil, Gotshal & Manges LLP v. Squid Soap, LP, C.A. No. 4410-VCL (Del. Ch. Nov. 23, 2009); Sonoran Scanners, Inc. v. Perkinelmer, Inc., No. 09-1089 (1st Cir. Oct. 29, 2009).) Accordingly, buyers might seek to include specific contractual language in the acquisition agreement that negates any obligation of the buyer to operate the target's business in a certain manner, such as an acknowledgement that the buyer has the right to operate the target's business as it sees fit and that it is under no obligation to cause the earnout to be achieved. One potential compromise may be for the buyer to agree to a provision that it will not take any action or omit to take any action with the sole intent of reducing or eliminating the earnout payment. Under this approach, the buyer has the discretion to run its business so long as it is not intentionally taking actions to avoid making earn-out payments to the

Other Considerations

In addition to issues relating to postclosing control and determination of the relevant benchmark, there are a host of other considerations that the buyer and the seller should keep in mind while negotiating an earnout. At a minimum, the parties should carefully consider issues relating to: measurement of the target's performance relative to the benchmark; structuring the earnout payment (i.e., whether it should be a linear or an "all or nothing" equation), the method of payment of the earnout (i.e., whether it should consist of cash, equity, debt, or a combination); the appropriate length of the earnout period; whether one or multiple earnout payments should be made; the effect of acquisition financing on the earnout, including subordination of the earnout payment to lenders; the effect of future acquisitions and sales by the buyer, including a sale of the target during the earnout period; and dispute resolution mechanisms, including negotiation of the buyer's right to "buy out" the earnout by paying a specified sum regardless of the target's performance.

Conclusion

In light of the frequent debates between

buyers and sellers regarding valuation of businesses that have suffered lack-luster performance during the economic downturn, earnouts are playing a more prevalent role in helping parties reach agreement on purchase price in private transactions. Despite the complexity and possibility of future disputes, a carefully thought out and clearly drafted earnout has the potential to create a win-win situation for both buyers and sellers.

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Do's and Don'ts When Using Independent Contractors

By Robert W. Wood

Business lawyers must be flexible and advise their clients on a plethora of legal issues. Clients expect them to not only provide accurate legal advice, but to also provide it in a practical and digestible form. Often, particularly given the fast pace of business today, business lawyers are in the unenviable position of being forced to give a kind of template for how a situation should be resolved.

This is understandable, because their clients must make many decisions. It is not always possible to stop the flow of business and to seek legal advice on every point. Yet actions the client may take can have enormous implications for overall liability, as well as particular employment law and tax implications both immediately and for many years into the future.

The decision whether to hire a worker as an employee or an independent contractor is a significant one with fingers in a large number of pies, with regulations from the IRS, the Department of Labor and employment statutes, and state unemployment insurance authorities. In fact, it is hard to think of a more consequential business decision. Yet paradoxically, the question whether to hire someone in one capacity or the other may garner little attention from business people.

Because of the potential for staggering tax and other liabilities such decisions can trigger, business lawyers must be vigilant. Far from being a one-time or immediate problem, the issue has significant legal implications down the road. When a business client hires workers in any capacity, they understandably focus on business objectives. Whether or not the arrangement works out well, clients tend not to revisit fundamental questions such as whether the workers should be independent contractors or employees.

Businesses can avoid major landmines if they consider these topics from time to time. Business lawyers can serve a key function in this regard. Business lawyers should encourage their clients do so when additional workers are brought on, when the tenure and nature of the relationship changes, when the tasks expected of the worker expand or contract, or when other terms and conditions of the work change. The worker's role may morph into something quite different from what it was at the inception of the relationship. That can impact the status of the worker as an employee or independent contractor.

Here are the top 10 mistakes I see committed by companies in using workers the company may believe are safely independent contractors but who may actually turn out to be reclassified as employees.

1. Not Having a Written Contract

Failing to have *any* written agreement for independent contractors is a recipe for disaster. If you hire a plumber for a one-time toilet fix and pay out \$200, I would not worry that he or she is an employee. Yet it is surprising how

many businesses have regular and long-term workers—on their premises or off—paid month after month and year after year as independent contractors without a written contract.

As a business lawyer, if you become aware of such a situation, take steps to warn your client. Without a written contract, your client is virtually doomed to fail in any dispute over the status of the worker, no matter how strong the client's independent-contractor facts may be.

The taxing, labor and employment, and insurance authorities expect a written contract that states that the worker is an independent contractor and will be paid as such with no tax withholding, no benefits, etc. *See Illinois Tri-Seal Prods., Inc. v. United States*, 353 F.2d 216, 218 (1965). Plainly, such a contract does not by itself mean the worker is really an independent contractor, but the lack of a written contract will make employee status much more likely.

Furthermore, your client may even have a dispute with the worker directly. If the worker later claims that he or she considered him or herself to be an employee, to what will your client point as a contrary indication?

2. Treating Similar Workers DifferentlyMany businesses have some employees and some independent contractors, and

there is nothing improper in so doing. However, it is inappropriate to have to have one worker selling shoes on an independent-contractor basis and another similarly situated worker doing the same thing as an employee. The same can be said for having some employee messengers and some independent-contractor messengers (or sales people, computer programmers, or what have you).

The risk of treating similarly situated workers differently is that the workers you are trying to treat as independent contractors may be reclassified as employees. For example, in Institute for Resource Management Inc. v. United States, 22 Cl. Ct. 114 (1990), no safe harbor was available for employment tax treatment of any worker who was treated as an independent contractor if the business treated any worker holding a substantially similar position as an employee for employment tax purposes. In other words, you set yourself up for trouble by having the two differently classified workers for ready comparison by the IRS, state tax authorities, labor or employment agency, or other authority. They all look for this tell-tale sign.

Advising a client in this area requires that you help the client to make significant distinctions between the two types of workers. Some companies are able to have two groups of workers do essentially the same type of work—such as independent-contractor sales agents and employee sales agents. However, business lawyers need to be very careful in helping clients navigate these waters.

3. Providing Tools and Supplies

One of the hallmarks of independent contractors is that they are required to supply their own tools, equipment, and supplies. Rev. Rul. 71-524, 1971-2 C.B. 346 ruled that a trucker working for a trucking company that leased vehicles (and provided maintenance) was an employee. *See also* Rev. Rul. 87-41 1987-1 C.B. 296, point 14. As

with just about everything else in the contractor versus employee characterization realm, this is not dispositive by itself. However, it is certainly something reviewed in making a thumbs-up or thumbs-down decision.

After all, independent contractors are classically independent business people or professionals. It makes sense that they would bring their own ladder, shovel, or paint brush. A company that purports to have independent contractors but that supplies a desk, chair, computer, software, and telephoneeverything they need—may not be very convincing in a worker status dispute. As this example suggests, this problem may be most common with office work. Still, it can arise in virtually any setting. In this age of high technology, it is not easy to determine exactly what will be regarded as tools, supplies, and equipment. The safest bet may be to make sure you don't provide anything. But that can be impractical. (For possible ways around this conundrum, see No. 5 "Paying By the Hour" below.) As a lawyer advising in this area, get as many facts from your client as you can, and try to be creative.

4. Reimbursing Expenses

Another red flag is the extent to which your client reimburses workers for their business expenses. *See* Rev. Rul. 55-144, 1955-1 C.B.483, where an individual had his business expenses recouped by his auto dealership employer and was deemed to be an employee. *See also* Rev. Rul. 87-41, 1987-1 C.B. 296, point 13. If workers work late, does your client pay for their dinner or a taxi? If they need special paper for the report they are producing, does your client provide it or reimburse them?

There is no bright line saying one can't cover the expenses of an independent contractor, but doing so can suggest the worker is an employee. Classically, all such items are supposed to be factored into the price you are paying the independent contractor for a finished

product. As a result, reimbursements and reimbursement policies are likely to be reviewed if your client becomes involved in a worker classification dispute.

Lawyers should point out these risks to clients. Your clients might think they are being magnanimous to cover such items. The reality is that the clients may be blurring the line between the employees and independent contractors.

5. Paying By the Hour

How a business pays someone is about a fundamental a work-variable as one can get. And it can be one of the most fundamental indicators of whether a worker is an employee or an independent contractor. *See* Rev. Rul. 87-41, 1987-1 C.B. 296, point 12. Classically, one pays a contractor for a job, like putting a pool in your backyard, repairing your computer system, or putting in a break room at your office. In contrast, one classically pays employees by the hour or by the week.

Yet it is surprising how many businesses don't think about this issue, much less explore ways to package it. There is no rule saying that one cannot pay an independent contractor by the hour. After all, that is how most lawyers bill time to their numerous clients.

But when one has alternatives, paying by the hour can be unwise. Consider whether you can come up with a payment regimen that fairly covers all the elements going into the work and yet that is independent contractor-like in scope. Ideally, a project fee or success fee is more consistent with independent-contractor status than an hourly rate. Help your clients to be creative in considering compensation alternatives.

Furthermore, you may be able to help your client to address any tool, equipment, and supply issues, and even expense reimbursements, as part of the payment formula you devise. As the discussion of those topics noted (*see* No. 3 "Providing Tools and Supplies"

and No. 4 "Reimbursing Expenses" above), you don't want to provide items that are employee-indicators. Yet if an independent-contractor worker arrives at the job site with no hammer, understandably, you may want to provide one.

The answer may be to do so but to have the business charge back the worker for the item provided. The worker could have the charge subtracted from his invoice at the end of the week. As a lawyer, you may find that a little creative thinking with independent contractors will help your clients to remain in the same place economically but with a vastly better appearance, viz., the likelihood independent-contractor treatment will be upheld.

6. Failing to Have Consistent Forms and Documents

The fact that your client calls someone an independent contractor does not make it so. An "employee lounge" sign in an office does not mean only employees can go there. The fact that one pays a worker based on a time card and then issues a check and paystub does not make him or her an employee. But all these things add up.

Sometimes, after all, something is what you call it. So help your clients consider whether they should have an "employee file" for each employee and use a different name for independent contractors. Ask your clients to consider if independent contractors should turn in an "invoice," not a time card. Ask your clients to consider whether independent-contractor discipline should be handled in exactly the same way as employee discipline. Usually, changes in terminology or substance can be made that may not impact your client's business but that may help your client materially to bolster independent-contractor treatment.

7. Over-Supervising

With an independent contractor, one is paying for a product or result. With an employee, one is paying for him or

her to do what is asked, whatever that might be. With employees, one controls not only the nature of the work, but the method, manner, and means by which they do it. In *Alford v. United States*, 116 F.3d 334 (8th Cir. 1997), for example, a church pastor was ruled at the district court level to be an employee, but the ruling was reversed by the Eighth Circuit based on the lack of institutional control the national and regional churches had over the operation of his church.

This control factor is the most overarching point in this area. It is also the most over-arching way in which clients can end up in trouble with workers they believe are independent contractors but who might be ruled otherwise. How much does your client check in with workers, monitor what they are doing, or make suggestions? How frequently must the workers check in with your client and report how and what they are doing?

Urge your clients to be very careful with supervision and control. The mere fact that an independent contractor must provide a weekly progress report on how the installation of the new laundry room in your house is going does not mean the builder is an employee. But if the report involves constant tweaking and redirecting of the effort, it might be otherwise. *See* Rev. Rul. 70-309, 1970-1 C.B. 199; Rev. Rul. 68-248, 1968-1 C.B. 431; Rev. Rul. 87-41, 1987-1 C.B. 296.

Note that the important inquiry is not merely whether the business is exercising control over the method, manner, and means by which the worker is doing the job. It can even be fatal if your client has the legal right to do thi—even if the client fails to exercise it. Treasury Regulation Sections 31.3121(d)-1(c)(1) and 31.3401 make clear that the common law right-to-control standard is generally controlling in these matters. For that reason, urge your clients to be careful what their contracts and other documents say about reports, supervision, and the like.

8. Requiring Set Hours

One of the classic signs of employee status is a time clock or set office hours. In contrast, with independent contractors, one should normally pay for the result, not exactly when or how the worker does it. *See* Rev. Rul. 87-41, 1987-1 C.B. 296, points 7–8. That does not mean an employer cannot have some control over the hours an independent contractor works.

For example, the fact that you tell your building contractor not to work on your kitchen remodel past 7:00 p.m. does not make him or her an employee. Nevertheless, it is surprising how many businesses fail to consider which workers need to be on a set schedule and which workers do not. Lawyers can be good issue spotters, and should help the client to consider whether certain workers can be allowed to complete work on their own schedule as long as they meet applicable deadlines. Such flexibility can help to show that the workers involved are independent contractors. Conversely, it can be telling if your client dictates a 9 to 5 and fulltime schedule.

9. Prohibiting Competition

Many businesses using independent contractors require full-time work, prohibit competition, or both. Neither of these points alone is likely to be dispositive of an independent contractor versus employee characterization battle. They are merely factors in the determination. For example, an anesthesiologist who entered into contracts with hospitals guaranteeing to have anesthesia services available at any time (a marker of employee status) was deemed to be an independent contractor (see Rev. Rul. 57-380, 1957-2 C.B. 634, Rev. Rul. 87-41, 1987-1 C.B. 296, point 17).

For that reason, lawyers should urge business clients to consider whether the business needs such rules and why. Optimally, if your client is paying for a particular result—such as selling a minimum dollar volume of goods each

month—the client should stick to that target. Point out to the client that it may be inappropriate to focus on how long the worker may take to do it or where else they may work during the same period. Those details are arguably irrelevant.

Since requiring full-time work and/ or no competition will be viewed as more employee-like in nature, ask your clients to consider whether it is a good idea to dictate these terms. Always bear in mind the paradigm case: an independent contractor like a lawyer or plumber serving many clients or customers. If your clients are worried about the worker giving away the company's business methods or intellectual property to a competitor, make those concerns explicit. Focus on prohibiting the worker from disclosing the company's property. That may accomplish the client's major goal and may be cosmetically much more pleasing.

10. Attempting the Impossible

As a lawyer, it is never easy to be the bearer of bad news. Yet failing to point out obviously flaws in the client's operations or documents can be a mistake and can even result in malpractice liability. If your clients cannot possibly keep their influence and direction over workers to a minimum, cannot possibly let them come and go as they please, cannot allow them to work part-time and for other companies, and can't abide the thought that they may make some of their own decisions, is it realistic for your clients to even try to treat them as independent contractors?

Probably not. In that situation, even if you urge your clients to apply some of the points noted here, the clients may be asking for trouble—either immediately or down the road—if they do not admit face facts.

That may mean simply treating the workers as employees. Sometimes cutting corners ends up costing the business considerably more money in the long run than if appropriate actions were taken in the first place. This oc-

curs over and over with independentcontractor issues. Lawyers are uniquely qualified to offer such perspectives.

As an alternative to a wholesale reclassification, the business could apply this principle in stages, such as by focusing on particular types of workers or even time periods. Lawyers can help business clients engage in a kind of triage to help limit their exposure. Plainly, it is technically wrong to suggest that all short-term workers are independent contractors.

However, a business could try independent-contractor status for short-term workers and those it is trying to evaluate. If the business tries working with someone on an independent-contractor basis for three months as a kind of evaluation period, that might keep them out of company health plans, payroll processing and employment tax returns, and even worker's compensation and unemployment insurance rolls.

If the worker settles in well, the company could bite the bullet and treat them as employees. If the worker fails, the company could assume that even if the person is later recharacterized as an employee, the company's financial exposure should be fairly limited. For example, if your client "fires" such a worker after two months, will he qualify for unemployment benefits?

The object of this kind of approach is to limit the business client's exposure. At least the big picture would be better because the company's long-term workers would be employees. Even if the company ends up losing a worker-status dispute later, the employment tax or other liabilities for short-term workers should be fairly limited. In contrast, if the company is aggressive with widespread independent-contractor treatment and fails to take some of the steps I advocate here, the company could have staggering liabilities.

Conclusion

Business lawyers must often wear mul-

tiple hats, and this may particularly be true in such fundamental legal issues as worker status. Yet the role of the lawyer in helping clients through these circumstances should not be underestimated. Help your clients to evaluate what you are trying to do, what is realistic to expect, and whether your clients are being reasonable.

Moreover, urge your clients not to make this a static or one-time process. Like an annual medical checkup or annual visit with an estate planning lawyer over the terms of a will, companies and their counsel should periodically evaluate workers, their status, duties, and treatment. The more frequently companies do it the less likely it will be that they have major problems to address. As a lawyer, you should be suggesting these evaluations even if your clients are not volunteering. The optimum time for evaluations and for addressing these worker status issues is before there is a lawsuit, audit, or investigation. Don't wait.

Robert W. Wood practices law with Wood & Porter in San Francisco and is the author of Taxation of Damage Awards and Settlement Payments (4th Ed. 2009), Qualified Settlement Funds and Section 468B (2009), and Legal Guide to Independent Contractor Status (5th Ed. 2010), available at www.taxinstitute.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

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Chapter 9 Municipal Bankruptcy:

The New "New Thing"? Part II

By Henry C. Kevane

This is the second part of our overview on municipal bankruptcies, building on last month's article.

The U.S. Constitution authorizes Congress to enact uniform laws on the subject of bankruptcies. But the Constitution also establishes a limit on the scope of federal judicial power over the states. Municipal bankruptcies under Chapter 9 are thus carefully calibrated to both respect state sovereign control over municipal debtors and limit federal court interference with municipal affairs, property, and operations. As a result, the Bankruptcy Court in a Chapter 9 case has only a few key functions—to determine the eligibility of the municipality to file at the beginning of the case, and to consider the confirmation of a plan of adjustment at the end.

In between, the court's role is mainly confined to approving the assumption or rejection of agreements, adjudicating avoidance actions (except against bondor note-holders, who are immune in a Chapter 9 case from preference actions), and considering the possible dismissal of the case if it has languished or if confirmation of a plan has been denied or refused. In addition, the court has certain duties under various provisions of the Bankruptcy Code that are specifically incorporated into Chapter 9. For example, if the municipality is also a health care business (common in California, with 72 local health care districts, 46 of which operate

hospitals), section 333 of the Bankruptcy Code contemplates the court's appointment of an ombudsman to monitor the quality of the municipality's patient care.

Types of Municipal Debt

Once it passes the eligibility gauntlet, the municipality must then turn its attention to its exit strategy. The most common forms of debt in a municipal bankruptcy are, naturally, bond debt and public employee obligations. Municipalities will, of course, also have ordinary trade and vendor liabilities but these are generally limited in amount. Unlike long-term bond debt, other municipal liabilities are often subject to state debt limitation provisions. Generally speaking, these provisions restrict the ability of municipal entities (1) to incur, without a popular vote, indebtedness that exceeds anticipated fiscal year revenues, or a percentage thereof, or (2) to satisfy, without a popular vote, indebtedness incurred in one fiscal year from the revenues of a future fiscal year. The provisions operate as a form of balanced-budget, "pay-as-you-go" rule for municipalities, generally requiring that each fiscal year's obligations be paid out of the income and revenue attributable to that year. In some jurisdictions debts incurred in excess of the borrowing limitations may be unenforceable. In many cases, therefore, outstanding trade obligations are not a significant portion of a municipality's total pre-petition claims pool.

Thus, bond debt and public employee obligations are typically perceived as the principal moving parts in a municipality's restructuring effort. Approximately \$2.8 trillion of state and local bond debt is currently outstanding in the U.S.; the aggregate amount of unfunded pension and other public employee benefits is similarly projected to be in the trillions. On the other hand, annual state and local tax revenues have declined dramatically during the Great Recession, in some instances by more than 10 percent on a year over year basis. Despite the growing gap between tax receipts and public debt, there have been only about 20 Chapter 9 filings over the past four years.

Although a Chapter 9 bankruptcy can provide the necessary "breathing spell" to recover from an unanticipated fiscal emergency, it cannot itself resolve longterm structural imbalances. Just as the Bankruptcy Court may not interfere with the municipality's governmental powers or revenues, the municipality must correspondingly comply with any regulatory or electoral approval necessary to carry out a plan of adjustment. A Chapter 9 debtor will thus continue to be buffeted by the same political forces and community dynamics that exist outside of bankruptcy. Consequently, cultivating taxpayer, union, and bondholder consensus over the terms of a plan can take time which, in turn, will increase the expenses of a Chapter 9 case.

Like a corporate debtor under Chapter 11, a municipal debtor must also pay all accrued administrative expenses in full as of the effective date of the plan.

Bond Debt

Moreover, certain common forms of municipal bond debt are mostly unaffected by a Chapter 9 filing. First, the legislative history to Chapter 9 clarifies that industrial revenue bonds, issued by municipalities purely as conduits for private entities, are excluded from Chapter 9. 121 Cong. Rec. H39412 (daily ed. Dec. 9, 1975). In other words, according to the legislative history, claims that arise under tax-exempt industrial revenue bonds, nominally issued by a municipality to finance corporate infrastructure projects but actually sold on the basis of the corporation's private credit (not tax receipts or other municipal revenues), are not claims that are subject to adjustment by the municipal debtor in the Chapter 9 case. Nor, correspondingly, are the amounts paid by the corporation to the holders of the bonds (via the municipal conduit), included among the assets of the municipality. The municipality is strictly a vehicle for the issuance of such bonds and they are neither debts nor property of the debtor.

Second, bonds secured by *statutory* liens on tax revenues remain secured following the commencement of the case. Under state law, a secured party may obtain a security interest (i.e., a lien created by agreement) in after-acquired property of the debtor. Section 552 of the Bankruptcy Code, however, operates to terminate the reach of such a security interest in post-petition property, unless such property constitutes proceeds of the pre-petition collateral. Generally speaking, thus, a secured creditor's recovery will be dependent upon the value of pre-petition collateral and the proceeds thereof, not any property acquired by the debtor's estate after the commencement of the bankruptcy case. Although section 552 of the Bankruptcy Code applies in a Chapter 9 case, by its terms it only truncates a lien created under a security agreement, not a lien that arises by operation of law, "without consent or negotiation as to its terms or nature." In many cases, the liens securing bonds issued pursuant to municipal financing schemes are created automatically by statute, rather than by contract. In re County of Orange, 189 B.R. 499 (C.D. Cal. 1995) (reversing bankruptcy court: pledge of tax revenues was a statutory lien). In those instances, post-petition tax receipts will continue to serve as collateral for the bondholders and may not be freely diverted for the general purposes of the debtor. As a result, notwithstanding the intervening Chapter 9 case, the bondholder will continue to enjoy the rights of a secured creditor in after-acquired taxes.

Third, and more importantly, the Bankruptcy Code confers unique protections on the holders of revenue bonds. By some recent estimates, revenue bonds account for approximately two-thirds of average annual municipal debt issuance. Unlike general obligation bonds, secured by the full faith, credit, and taxing power of the issuer, a revenue bond is secured solely by income generated by the project or facility financed with the proceeds of the bond. Ordinarily, a revenue bond might be deemed a riskier investment than a general obligation bond because the holder of the revenue bond faces the risk of project failure and lacks recourse to municipal receipts other than the specific revenue stream dedicated by the issuer. (Moreover, as a public facility, bondholders generally lack the ability to foreclose on the physical asset itself.) Changes to the Bankruptcy Code in 1988, however, rendered the rights of a revenue bondholder in Chapter 9 comparatively more favorable than the rights of a general obligation bondholder.

If the revenue bond qualifies as a "special revenue" obligation under section 902(2) of the Bankruptcy Code, then (a) the scope of any accompanying lien will survive the commencement of the case notwithstanding section 552, (b) the indebtedness will continue to be serviced notwithstanding the automatic stay under section 362, and (c) any prepetition payments will be immune from preference recovery (as noted, this protection applies to all bonds and notes in a Chapter 9 case not just special revenue bonds). Of course,

the risk of project failure will still affect the bondholder's ultimate recovery—if, however, the special revenues are adequate and ongoing, the bondholder need not be unduly concerned with the state of the municipality's general finances. The special revenues generated by the project will, however, remain subject to the project's necessary operating expenses and the bondholder will have no recourse against the municipality or its general taxing power in the event of a revenue shortfall (neither of which should come as a surprise to a bondholder since these conditions are generally consistent with the disclosures made in the offering statements for revenue bonds).

There are five categories of special revenues listed in section 902(2) of the Bankruptcy Code. Congress intended to "define special revenues to include the revenues derived from a project or from a specific tax levy, where such revenues are meant to serve as security to the bondholders." H.R. Rep. No. 100-1011, at 6-7 (1988). Although Congress specified discrete categories of special revenues, the categories are susceptible to some flexibility. See In re Heffernan Memorial Hospital District, 202 B.R. 147 (Bankr. S.D. Cal. 1996) (general tax receipts restricted in use to a specified financing project might qualify as special revenues). There is little applicable case law on the subject and the only guidance is contained in the legislative history which contains some general examples of various special revenues, including: (a) receipts from the operation of water, sewage, waste or electric systems, (b) highway or bridge tolls, (c) user fees, (d) special excise taxes, including hotel/motel taxes, alcoholic beverage taxes, meal taxes and license fees, and (e) proceeds from project financing.

Financing Leases

Financing arrangements based on lease transactions also enjoy certain protections under Chapter 9. Like debtors under the reorganization provisions of the Bankruptcy Code, a municipality in Chapter 9 can also wield the potent options to reject, assume, and assign unexpired leases under section 365 of the Bankruptcy Code. Generally speaking, an unexpired lease includes any

lease that has not terminated by the expiration of its stated term either prior to or during the commencement of the bankruptcy case. The Bankruptcy Code establishes a 120-day deadline to assume or reject a nonresidential real property lease, and also caps any claim for damages following the rejection of a lease. Municipal financing leases, however, are unique instruments. For purposes of state law limitations on the issuance of debt, such instruments are usually considered true leases, subject to periodic rental payments and the potential for surrender of the leased property in the event of non-use by the municipality. In some states, the leases are not considered debt because of their contingent or installment nature, meaning that each periodic payment is in exchange for a corresponding, contemporaneous right of occupancy. In other states, financing leases may escape characterization as long-term indebtedness because they bear the risks of "abatement" or "non-appropriation."

The world of municipal finance, on the other hand, typically views such lease instruments as debt obligations, bearing traditional attributes of governmental safety and liquidity and usually enjoying favorable tax treatment. For this reason (as with the exclusion of conduit financing from the reach of Chapter 9), a special rule of construction has been added to Chapter 9 to prevent the potential treatment of municipal financing leases as true leases subject to potential assumption or rejection under section 365. Section 929 provides that "a lease to a municipality shall not be treated as an executory contract or unexpired lease for the purposes of section 365 or 502(b)(6) of this title solely by reason of its being subject to termination in the event the debtor fails to appropriate rent." This rule will override the assumption or rejection deadlines and rental claim limitations under the Bankruptcy Code and thereby preserve, for the "lender/lessor," the right to seek full recovery on the outstanding amount of the debt.

Public Employee Wages, Pensions, and Benefits

If traditional municipal bond debt is

largely off limits in a Chapter 9 case, what other restructuring options does the municipality have during times of flagging tax receipts and diminished federal funding? By some measures, the largest component of municipal budgets is public employee wages, pensions, and benefits. Recent headlines in several states hint at looming battles between public employees and budget-sensitive local officials. Is Chapter 9 a possible tool to re-balance the sources and uses of government revenues?

The recent experience of the City of Vallejo suggests that Chapter 9 can be used to re-calibrate public employee benefits. Shortly after filing its Chapter 9 petition, the city sought to reject its collective bargaining agreements with certain public employee unions pursuant to section 365 of the Bankruptcy Code (which is expressly incorporated into Chapter 9). The unions opposed the rejection on the grounds that sections 903 and 904 (the cornerstones to the constitutionality of Chapter 9), elevated state labor laws as an obstacle to rejection. These state laws would impose certain procedural and substantive requirements on the mid-term modification or termination of public employment contracts.

The Bankruptcy Court and the appellate court each rejected this contention, finding that California's broad statutory permission to file a Chapter 9 case necessarily entailed an acknowledgement that section 365 might be used to assume or reject executory contracts. In re City of Vallejo, 432 B.R. 262 (E.D. Cal. 2010). Hence, by specifically consenting to Chapter 9 relief for its cities, counties, and districts, the state also consented to the subordination of those state laws and policies in conflict with the benefits of federal bankruptcy protection. This decision is consistent with the legislative history to Chapter 9— Congress noted that collective bargaining agreements "may be rejected despite contrary State laws. . . . It is intended that the power to reject collective bargaining agreements will preempt state termination provisions but not state collective bargaining laws." S. Rep. No. 95-989, at 111 (1978). Section 1113 is not incorporated into Chapter 9, however—hence, the standards articulated by the Supreme Court in *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513 (1984), govern the balancing of the equities that is required in order to reject a collective bargaining agreement. Since there is no "estate" created upon the commencement of a Chapter 9 case, the municipality must show that continued performance under the agreement impairs its ability to formulate a plan of adjustment.

Plan of Adjustment Requirements

Of course, the rejection of a collective bargaining agreement, or other unilateral changes to employee benefits or pensions, might trigger claims for damages, which would then be subject to adjustment under a plan. Although many of the statutory requirements to confirm a Chapter 9 plan of adjustment are borrowed directly from Chapter 11, the feasibility, "best interests of creditors," and "fair and equitable" requirements have unique meanings under Chapter 9 (since there are no shareholders of a municipality, nor may its assets be liquidated). See H.R. Rep. No. 95-595, at 263 (1977) ("[A] municipality is generally not a business enterprise operating for profit, and there are no stockholders. These differences dictate some modifications of the standards governing the proposal and confirmation of a plan.").

Under Chapter 11, the feasibility requirement is intended to test a debtor's ability to meet the obligations created by the plan (i.e., make distributions to creditors), without an ensuing liquidation or the need for further financial reorganization. The feasibility requirement under Chapter 9 is similar, although the debtor's ability to make the payments contemplated by the plan is measured with reference to the municipality's contemporaneous ability to sustain its ongoing governmental functions, not avoid a subsequent bankruptcy. In other words, can the municipality both distribute the plan consideration and meet its governmental functions?

The "best interests of creditors" and "fair and equitable" requirements are intended to protect, respectively, dissenting creditors and dissenting classes of creditors. In Chapter 11, the best interests

test provides a floor for payments under a plan, ensuring that creditors will receive at least as much under the plan as they would realize in a Chapter 7 liquidation. A Chapter 9 case, however, may not be converted to Chapter 7 nor may the assets of a municipal debtor be involuntarily liquidated. Hence, under Chapter 9, the best interests test has been construed to mean that the plan offers a better alternative than dismissal of the bankruptcy case. If plan recoveries are superior to state law creditor remedies then the plan is generally considered in the "best interests of creditors."

The "fair and equitable" requirement, naturally, only comes into play if a class of creditors rejects the plan. Under Chapter 11, the requirement embodies the absolute priority rule, ensuring that any senior class that has rejected the plan is paid in full before a junior class may receive or retain property under the plan. There are, however, no holders of equity interests in a municipality and, hence, strict application of the "fair and equitable" test to a dissenting class of unsecured creditors (who are senior to shareholders in a corporate context) is not practicable under Chapter 9. Although there are varying interpretations, the legislative history to Chapter 9 suggests that, in order to be fair and equitable, a plan of adjustment must provide creditors with the "going concern" value of their claims—this standard entails a comparison of the reasonably expected revenues, expenditures, and taxing powers of the municipal entity.

Conclusion

Although Chapter 9 has seemingly re-entered the mainstream, there are still many aspects of Chapter 9 that may preserve its reputation as the remedy of last resort. The eligibility requirements are daunting, several common categories of municipal debt are largely immune from restructuring, and the modification of public employee wages, benefits, and other obligations may create and accelerate claims that would then require treatment and voting under a plan. Chapter 9 was born out of the extraordinary hardships of the Great Depression; it remains to be seen whether

the Great Recession will generate situations of similar distress.

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BUSINESS LAW TODAY

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Keeping Current: Anti-Corruption

The Bribery Act 2010 Guidance: Countdown to Implementation

By Robert F. Amaee and John P. Rupp

The UK Ministry of Justice's publication on March 31, 2011, of guidance on the UK Bribery Act 2010 (Bribery Act) marked the start of a 90-day countdown to implementation of the Bribery Act, which will be brought into force on July 1, 2011.

Many U.S. companies are, of course, carrying on business or part of their business in the UK, which is only one of the bases for the assertion by the Serious Fraud Office (SFO) in the UK of jurisdiction over conduct violating the Bribery Act. Companies and individuals subject to the Bribery Act also need to be aware that the SFO has adopted an aggressive posture toward enforcement of the UK statutes that will be replaced by the Bribery Act, a stance that is likely to carry over to the SFO's enforcement of the expanded jurisdictional and substantive mandates contained in the Bribery Act.

The imminent entry into force of the Bribery Act in the UK is only one of the many reasons that U.S. companies and their legal counsel need to be mindful of their expanding responsibilities under the many bribery statutes that have been enacted outside the United States over the past few years.

The Scope of the Bribery Act

The Bribery Act runs to just 17 pages and contains only four substantive offenses. The scope of two of those offenses in particular prompted business leaders to voice concerns to ministers and others. The section 6 (Bribery of Foreign Public

Officials) and section 7 (Failure of Commercial Organisations to Prevent Bribery) offenses have been criticized as being too widely drawn, introducing novel and undefined concepts and giving undue discretion to officials at the SFO.

The comments by the Minister of Justice, Ken Clarke QC MP, and the guidance itself aim to reassure companies that the Bribery Act will be enforced with common sense and pragmatism, as previously signaled by the SFO. The minister ushered in the guidance by saying that "[t] he ultimate aim of [the Bribery Act] is to make life difficult for the minority of organisations responsible for corruption, not to burden the vast majority of decent and law-abiding businesses."

The Bribery Act is not a mirror image of the U.S. Foreign Corrupt Practices Act (FCPA). Unlike the FCPA, the Bribery Act covers bribes paid in both the private and the public sectors. In addition, the Bribery Act—again, unlike the FCPA—makes no allowances for so-called "facilitation payments." In addition, the tests for violations of the Bribery Act are phrased differently than the tests found in the FCPA. Finally, the Bribery Act provides for penalties that are, in several respects, even more severe than those found in the FCPA.

For the foregoing reasons, among others, simple compliance with the FCPA will not necessarily ensure compliance with the Bribery Act. Neither will compliance with Sarbanes-Oxley, the much maligned U.S. statute, ensure compliance with the

Bribery Act. A focused analysis of the Bribery Act provisions and assessment of the policies and procedures that the particular company has developed and implemented are required.

Six High-Level Principles

The guidance, as expected, focuses on six high-level principles with which companies will need to familiarize themselves. The high-level principles are supported by 11 case studies illustrating the application of the principles for businesses of all sizes. The guidance stipulates that the principles are not "prescriptive" but "flexible and outcomes focused," being designed to assist both small and large organizations create "robust and effective anti-bribery procedures" that are "proportionate to risk."

The principles are:

1. Proportionate Procedures

A company's procedures should be proportionate to the bribery risks it faces and to the nature, scale, and complexity of its activities. The procedures should be clear, practical, accessible, and effectively implemented and enforced.

2. Top-Level Commitment

The "top-level" management of a company must be committed to preventing bribery by persons associated with the company and must foster a culture within the company in which bribery is never acceptable.

3. Risk Assessment

There is an expectation that the company will assess the nature and extent of its exposure to potential external and internal risks of bribery on its behalf by associated persons. The risk assessment is to be "informed" and "documented" and is to be conducted "periodically."

4. Due Diligence

Companies should apply a proportionate and risk-based approach to due diligence of those performing services on the company's behalf.

5. Communication

The aim is that the company's bribery prevention policies and procedures must be "embedded and understood throughout the organisation." This is to be achieved by internal and external communication, including training, which is proportionate to the risks a company faces.

6. Monitoring and Review

Policies and procedures should be reviewed periodically by internal or external experts, with improvements being made on an as-needed basis.

Tangible Assistance?

The guidance sets out the UK government's policy in relation to the section 7 corporate offense, stating that "[t]he objective of the [Bribery] Act is not to bring the full force of the criminal law to bear upon well run commercial organisations that experience an isolated incident of bribery on their behalf." The guidance recognizes that "no bribery prevention regime will be capable of preventing bribery at all times."

Organizations such as the International Chamber of Commerce (UK) and the Confederation of British Industry have welcomed the guidance but others, including Transparency International (UK), have described certain aspects of the guidance as being "deplorable" and have complained that "[p]arts of it read more like a guide on how to evade the Act than how to develop company procedures that will uphold it."

We discuss below the guidance as it

relates to some of the act's thorniest issues such as the UK's jurisdiction over non-UK registered companies, the extent of liability for the actions of third parties, and the boundary between acceptable corporate hospitality and a prosecutable bribe, particularly when foreign officials are concerned.

A Question of Jurisdiction

The guidance makes it clear that "the courts will be the final arbiter as to whether an organisation 'carries on a business' in the UK taking into account the particular facts in individual cases" and sets out the government's "intention" in relation to the phrase "carries on a business, or part of a business, in the [UK]."

The guidance states that "the Government anticipates that applying a common sense approach would mean that organisations that do not have a demonstrable business presence in the United Kingdom would not be caught." It also states that the government "would not expect" a mere listing on the London Stock Exchange or the presence of a subsidiary in the UK automatically to bring a company within the reach of UK courts.

Companies should be mindful though that, in the appropriate case, prosecutors are likely to take a broad approach to the powers conferred by the Bribery Act. The director of the SFO has stated, for example, that he will be taking a "wide view of jurisdiction" and will not be impressed with "overly technical interpretations" of the act crafted to evade the UK's jurisdiction.

Third Party Liability—Associated Persons

A company will be liable for the actions of associated persons—those performing services for or on its behalf—only if a bribe is paid by the associated person with the intention of obtaining or retaining business or a business advantage for the company. The guidance states that a bribe that is paid by an employee or agent of a subsidiary "will not automatically involve liability on the part of its parent company . . . if it cannot be shown the employee or agent intended to obtain or retain business

or a business advantage for the parent company. . . . "

The guidance also seeks to provide comfort to companies in relation to potential liability for the actions of its "suppliers." It makes clear that, in the government's view, when the supplier is "simply acting as the seller of goods," it is unlikely to qualify as an "associated person."

When considering the potential liability of a company by virtue of its involvement in a joint venture, the guidance makes a distinction between a joint venture that is a "separate legal entity" and one that is "conducted through a contractual arrangement." In relation to the former, the guidance stipulates that the existence of the joint venture "will not of itself mean that it is 'associated' with any of its members" and that "a bribe paid on behalf of the joint venture entity . . . will therefore not trigger liability for members of the joint venture simply by virtue of them benefiting indirectly from the bribe through their investment in or ownership of the joint venture."

In relation to the case of a "contractual" joint venture, the guidance introduces the concept of "level of control"—a concept that does not appear in the Bribery Act—as one of the "relevant circumstances" that would be taken into account when seeking to determine whether a person who paid a bribe on behalf of the joint venture business can be said to be performing services on behalf of the participants in the joint venture.

The guidance states that "[t]he question of adequacy of bribery prevention procedures will depend in the final analysis on the facts of each case, including matters such as the level of control over the activities of the associated person and the degree of risk that requires mitigation."

Foreign Public Officials

The guidance states that bribing a foreign public official could be prosecuted under section 1 of the Bribery Act but that evidential difficulties in proving that a bribe was paid to a foreign public official with the intention to induce him or her to perform his or her role "improperly"—something the guidance calls "a mischief"—

means that prosecutors often would seek to rely on the section 6 offense, which requires no such proof. The guidance goes on to state that "it is not the Government's intention to criminalise behaviour where no such mischief occurs. . . ."

In other words, it appears that the guidance may be advocating that the concept of "improper performance" be read into section 6. That would in effect introduce a higher threshold for prosecution than the Bribery Act explicitly envisages. While this may be a welcome statement for those who routinely interact with foreign government officials, companies will be mindful that prosecutors are unlikely to apply anything but the letter of the law when faced with a case that they consider to be in the public interest to prosecute.

Corporate Hospitality and Other Business Expenditures

In addressing the topic of corporate hospitality and other business expenditures, the guidance adopts a permissive tone.

The guidance codifies the comments the minister of justice had made in the run-up to publication of the guidance, stating that "[b]ona fide hospitality and promotional or other business expenditure which seeks to improve the image of a commercial organisation, better to present products and services, or establish cordial relations, is recognised as an established and important part of doing business. . . . " The guidance goes on to state that "it is not the intention of the [Bribery] Act to criminalise such behaviour. . . . " The foreword to the guidance invites companies to "[r]est assured" as "no one wants to stop firms getting to know their clients by taking them to events like Wimbledon or the Grand Prix."

The guidance endorses "reasonable" and "proportionate" hospitality and business expenditures. In determining what is reasonable and proportionate, the guidance proposes taking into account "all of the surrounding circumstances," which include matters such as "the type and level of advantage offered, the manner and form in which the advantage is provided, and the level of influence the particular foreign public official has over awarding busi-

ness." It states that "the more lavish the hospitality or the higher the expenditure in relation to travel, accommodation or other similar business expenditures provided to a foreign public official, then, generally, the greater the inference that it is intended to influence the official to grant business or a business advantage in return."

Much of this already is part of the compliance mantra but the guidance also appears to sanction certain interactions with foreign public officials that would today be closely and critically scrutinized by those responsible for compliance. As an example, the guidance envisages that the provision of flights, airport to hotel transfers, hotel accommodation, fine dining, and tickets to an event for a foreign public official as well as his or her spouse are "unlikely to raise the necessary inference" to engage section 6 so long as there is a business rationale for the trip.

Facilitation Payments

While the government has recognized the problems faced by commercial organizations in some parts of the world and in certain sectors, the guidance reiterates that there is no exemption for facilitation payments. It sets out the OECD position that such payments are corrosive and that exemptions create artificial distinctions that are "difficult to enforce, undermine corporate anti-bribery procedures, confuse anti-bribery communication with employees and other associated persons, perpetuate an existing 'culture' of bribery and have the potential to be abused."

When a company or individual has no alternative but to make a facilitation payment to "protect against loss of life, limb or liberty," the guidance states that "the common law defence of duress is very likely to be available." It stresses that it is a matter for prosecutorial discretion whether to prosecute an offense and defers to the Joint Prosecution Guidance when it comes to the "prosecution of facilitation payments."

Conclusions

Companies that already have reviewed and updated their anti-bribery procedures will need to study the new guidance to see what, if any, further amendments may be required. Those who have yet to complete the process of updating their procedures to ensure compliance no doubt will draw a modicum of comfort from the fact that they have some 90 days in which to digest and absorb the guidance and implement the required policies and procedures.

Companies will be pleased, of course, to have more guidance than they previously had on aspects of the Bribery Act. They will look in that connection to draw as much comfort as they can from the rather "permissive" tone of the Ministry of Justice guidance. At the same time, however, companies with a global footprint cannot afford to look at their UK exposure in isolation. It will be of little comfort if a company is able to avoid prosecution in the UK but face prosecution in the United States, for example, for what the U.S. prosecutors may regard as corporate hospitality that stepped over the line into prohibited bribery under the FCPA.

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BUSINESS LAW TODAY

The ABA Business Law Section's Online Resource

Keeping Current: FCPA

Central District of California Rejects Argument that State-Owned Corporations
Can Never Be "Instrumentalities" of Foreign Governments

By Iris E. Bennett, Jessie K. Liu, and Sean J. Hartigan

As the Department of Justice and the Securities and Exchange Commission have stepped up enforcement of the Foreign Corrupt Practices Act, these agencies also have increased prosecution of cases involving improper payments to employees of state-owned and state-controlled entities. DOJ and SEC consider such entities to be foreign government "instrumentalities" within the meaning of the FCPA and, therefore, their employees to be "foreign officials" under the statute. The breadth of such an interpretation has led many companies and their employees to question the act's reach. Indeed, the U.S. Chamber of Commerce has spearheaded an effort to reform the FCPA by, among other things, clarifying the term "foreign official" to achieve fairer and more predictable results.

A recent judicial decision has now addressed, in part, the government's interpretation and provided some guidance for how to assess whether a state-owned or state-controlled company can be considered an "instrumentality" of a foreign government and thus whether such a company's employees are "foreign officials." In a rare FCPA case that has gone to trial against a company and individuals, the U.S. District Court for the Central District of California issued on April 20 a written opinion in *United States v. Noriega et al.*, 2:10-cr-01031 (the *Noriega* Opinion),

addressing the issue of whether a stateowned entity is always outside the FCPA's reach. Because of the posture of the defense motion, the court was not asked to address when such an entity actually is within the definition of "instrumentality," but only if there was no conceivable set of factual circumstances in which that could be proved. The court found:

- That a foreign state-owned or state-controlled corporation can be a government "instrumentality" within the meaning of the FCPA, and therefore that an employee of such a corporation can be a foreign official within the meaning of the statute:
- That the following characteristics can be considered in determining whether any particular state-owned or state-controlled corporation is a foreign government "instrumentality" under the FCPA: o Whether the entity provides a service
 - to the citizens of the jurisdiction; o Whether key officers and directors are, or are appointed by, government

officials;

- o Whether and to what extent the entity is financed through government appropriations;
- o Whether the entity is vested with and exercises exclusive or controlling power to administer its designated functions; and
- o Whether the entity is widely perceived

and understood to be performing official (i.e., governmental) functions.

Factual Background and the Parties' Arguments

The American defendants in the *Noriega* case—Lindsey Manufacturing Company and several of its officers—are accused of violating the FCPA by funneling bribes to an electric utility company allegedly wholly-owned by the Mexican government (the Comisión Federal de Electricidad, or CFE), through payments to a Mexican sales representative.

In a motion to dismiss the indictment, the defendants argued that the alleged bribes could not violate the FCPA as a matter of law because "under no circumstances can a state-owned corporation be a department, agency, or instrumentality of a foreign government." Therefore, the defendants asserted, an employee of a state-owned corporation never can be a foreign official under the FCPA.

The Plain Language of the Statute

Under the FCPA, a "foreign official" is any "officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality, or for or

on behalf of any such public international organization." 15 U.S.C. § 78dd-1(f) (1), 78dd-2(h)(2), and 78dd-3(f)(2). Because CFE clearly is not a "department" or "agency" of a foreign government, both parties and the court focused on whether it was a foreign government "instrumentality," a term that the FCPA does not define. Defendants argued that "instrumentality" should be read to include only those entities that share qualities with both agencies and departments. The government asserted that state-owned or state-controlled corporations share at least some qualities with agencies and departments (e.g., they exist at the pleasure of the government and are oriented to public policy), such that at least some such corporations could be considered "instrumentalities" under the law.

The court agreed with the government and set out the "non-exclusive list" of "defining" agency and department characteristics that would render a state-owned or state-controlled entity a government instrumentality, as noted above. The court concluded that CFE exhibits all of the enumerated characteristics.

The Structure, Object, and Policy of the FCPA

Each party also asserted that its position was most consistent with the FCPA's structure and policy objectives. Thus, the government argued that the term "instrumentalities" should be construed broadly because the 1998 amendments to the FCPA were expressly enacted to ensure that the statute comported with the 1997 Organization for Economic Co-operation and Development Convention on Combating Bribery of Foreign Officials in International Business Transactions (the OECD Convention). The OECD Convention in turn includes "public enterprises" among the list of entities for which foreign officials may work. Defendants countered that Congress' failure to amend the FCPA in 1998 to include employees of "public enterprises," and the fact that the FCPA and its amendments always have been intended to address attempts to influence governmental, not corporate, action, support a narrower definition of the term

"instrumentality." The court agreed with the government, but also concluded that even under the defendants' proposed definition of "instrumentality," CFE clearly falls within the scope of the statute as a matter of statutory text.

Conclusion

Although the court rejected the broad assertion that state-owned corporations are never, as a matter of law, "instrumentalities" of foreign governments under the FCPA, it left open the possibility that some state-owned or state-controlled corporations and their employees may be beyond the FCPA's reach. The list of characteristics of government agencies and departments that the court articulated provides a framework for evaluating whether a state-owned or state-controlled corporation is such an entity.

Presumably those entities that look most like private-sector corporations—those in which the government's ownership stake is small, government funding is minimal, and which compete in an open marketplace against privately-held competitors—would have the best case for not being considered an "instrumentality" of a foreign government. That would be consistent with the OECD Convention, which states that an enterprise that "operates on a normal commercial basis in the relevant market . . . without preferential subsidies or other privileges," is not to be deemed a public enterprise within the cognizance of the OECD Convention. That said, it is the rare state-owned or state-controlled entity that will meet this test

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BUSINESS LAW **TODAY**

Focusing on Pro Bono

Pro Bono for Business Lawyers: Is it Always Transactional?

By Allyn O'Connor

Ask a business lawyer about pro bono, and generally he or she will tell you about working with nonprofits. The truly committed business lawyers seek out nonprofits that serve low-income communities or individuals. They volunteer to address one or more of the organization's legal needs. They may help obtain tax-exempt status, review and negotiate contracts, handle real estate transactions, and take care of intellectual property matters. They may handle these matters discretely or volunteer as general counsel. Some business lawyers prefer to volunteer in a for-profit context, handling the legal needs of low-wealth entrepreneurs and very small businesses.

Most business lawyers, however, have one thing in common: an inability to find enough pro bono opportunities to match their skills and experience.

Or do they?

Business lawyers possess a useful and unique skill set. They are resourceful. They frequently deal with large, layered bureaucracies. They understand not just a client's motivations, but also those of the party on the opposite side of the table. They are advocates for their clients every day . . . not in court, but in the private sector or in front of government agencies. And above everything, business lawyers are good negotiators and very, very good listeners.

It turns out these skills are ideal to assist individual clients who are overwhelmed navigating the processes and systems that have become a part of daily life for the poor. A homeless Chicago day laborer, for instance, may have no idea how to go about collecting his or her past-due wages. A business lawyer is the ideal person to locate the Illinois Department of Labor wage claim application, help the client complete and submit it, and to explain the wage claim process.

Business lawyers are intuitive. They pick up on issues quickly and are experienced at identifying areas of a matter ripe for compromise. They know and understand the language and responses that resonate with other parties.

In San Francisco, business lawyers have worked well as volunteers for the Courthouse Landlord/Tenant Project organized by the San Francisco Bar Association's Volunteer Legal Services Program. The project is a limited scope representation program providing free legal services to pro per litigants facing detainer settlement conferences. VLSP Supervising Attorney Cary Gold describes business lawyers as ideally positioned to help. "They know the client's objectives and what the other side will go for," she says. Gold supports the volunteers with information about the law behind a forcible detainer action. Business lawyers are results-oriented problemsolvers, reflects Gold. Lawyers from firms and in-house settings have been ideal volunteers.

Business lawyers also have been very effective on the most sensitive matters.

Many large law firm attorneys have volunteered to help Bet Tzedek Legal Services assist survivors of Nazi forced labor schemes during World War II. Elderly clients eligible for pensions, reparations, or other benefits from Germany or other European countries frequently need help completing applications and preparing appeals. Business lawyers have made excellent volunteers. They are gifted with a quiet, clear, and non-confrontational communication style. They ask open-ended questions and listen patiently as clients recount a painful and traumatic period in their lives.

Jeffrey Katz, a Boston lawyer who sits on the board the Lawyers Clearinghouse on Affordable Housing and Homelessness says, "Instead of scouring the earth for transactional pro bono projects, we're trying to educate corporate attorneys to take on non-litigation pro bono matters even if they don't fit within a particular view of corporate work. There's a lot out there. There's a lot that they can do."

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