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Transfer Restrictions in the Indirect Holding System: Is Alienability in the Form of Holding?

By [E. Perry Hicks](#)

Assets such as limited partnership interests, limited liability company interests, shares of closely-held corporations and life insurance policies are commonly subject to broad transfer restrictions. How these restrictions limit transfers (including grants of security) is well understood when such assets are held directly, but when these assets are held in the indirect holding system, the legal analysis of the transfer differs.

A transfer of an asset in the indirect holding system is not simply an “indirect transfer” of the underlying asset. It is a transfer of a new and particular set of rights created under Article 8 of the Uniform Commercial Code. Failing to distinguish these rights from direct rights in the underlying asset denies core principles of the modern indirect holding system.

Hedge Funds: Illustrative Transactions

One subset of transactions involving transfer restricted assets that exemplifies these issues is secured financings for hedge funds known as “funds of funds.” A fund of funds is simply a hedge fund that invests in other hedge funds. In the United States hedge funds are typically organized as limited partnerships or limited liability companies. Accordingly, the concepts applicable to fund of funds transactions are illustrative for the broader group of transfer restricted assets.

Like other alternative entity assets, hedge

funds are often subject to broad transfer restrictions. Hedge funds utilize transfer restrictions to avoid being regulated under certain securities laws, such as the Investment Company Act of 1940. Without this exemption, a hedge fund that offers or sells its interests in the United States would typically qualify as an “investment company” under the Investment Company Act and would be required to comply with the obligations thereof, which could (1) create potentially significant administrative burdens for the fund, (2) limit the fund’s ability to utilize leverage, and (3) limit its use of certain investment strategies (such as short selling). Hedge funds rely on their transfer restrictions to maintain eligibility for these exemptions.

Additionally, funds of funds have an appetite for credit to manage liquidity and leverage needs. On the liquidity side, funds of funds use credit to facilitate portfolio management. If a fund is invested in illiquid assets and becomes obligated to return investor capital (typically through an investor request called a redemption), the fund can readily draw on its liquidity line to meet the applicable redemption deadlines or to avoid liquidating specific assets in a down market. On the leverage side, funds use credit to magnify returns to investors, which strategy also magnifies losses.

To minimize credit risk, fund of funds lending transactions are usually secured. To secure obligations to a creditor, a fund of funds commonly pledges an investment ac-

count as collateral. This account is generally established and maintained as a “securities account” under Article 8 of the Uniform Commercial Code. All of the fund’s investments (or a specified group thereof) are credited to this account. The fund grants a security interest in the account and that interest is typically perfected through a control agreement. These fund of funds transactions provide a useful model for the application of the concepts addressed in this article.

The Controversy

The controversy for transfer restricted assets in the indirect holding system is whether the transfer restrictions that limit transfers in the direct holding system also limit transfers of such assets once they are credited into the indirect holding system. In the case of a fund of funds transaction, if the pledge of a fund’s securities account is analyzed as a pledge of direct rights in the underlying hedge funds, the pledge will likely be viewed as breaching the transfer restrictions incorporated into such interests. The breach of these transfer restrictions can trigger penalties and other negative consequences that diminish the value of the collateral. Additionally, a breach of these restrictions may raise concerns about the fund’s compliance with certain representations and covenants incorporated into financing documents and may present issues for the law firm that prepares a legal opinion with respect the pledge of the securities account in such a

transaction.

This controversy generates market inefficiencies. The specter of transfer restrictions can sideline assets that might otherwise be available as collateral to secure obligations of indebtedness. These idled assets are significant. In 2011, assets under management in the hedge fund industry alone reportedly exceeded \$2.02 trillion dollars—a historical high-water mark. Additionally, analysis by approximation to the direct holding system obscures relevant risks that ought to be highlighted to parties engaged in these transactions.

The resolution of this controversy resides in the core principles of the modern indirect holding system. Article 8 of the Uniform Commercial Code acknowledges that the form of holding is an essential consideration in analyzing transfers. The official comments to section 8-104 provide that “[w]here an item of property can be held in different ways, the rules on how one deals with it, including how one transfers it or how one grants a security interest in it, differ depending on the form of holding.” This article identifies key distinctions in the direct and indirect holding systems and addresses how those differences impact the legal analysis of transfers of assets subject to transfer restrictions.

The Systems of Holding

The direct holding system (Direct Holding System) is a system in which rights originate from an issuer of a security (or similar asset). This is the traditional form of holding a security. A holder of rights in the Direct Holding System (Direct Holder) includes a person that holds a certificated “security” in its own name or is the registered owner of an uncertificated “security” on the books of the issuer. For purposes of this paper, a Direct Holder also includes a person that holds a security or similar asset through another entity, where that entity is not a “securities intermediary.” For example, if shares of a corporation (Corp. A) are held by single member limited liability company (LLC A), the individual that holds the membership interests of LLC A would still be a deemed Direct Holder with respect to the Corp. A shares. As used herein, the

indirect holding system (Indirect Holding System) refers to the holding system described under Part 5 of Article 8 of the Uniform Commercial Code as modified by the 1994 revisions thereto (1994 Revisions) and an indirect holder (Indirect Holder) is a holder of rights arising in the Indirect Holding System. Assets credited to the Indirect Holding System are referred to as “financial assets.” Under the definition of “financial assets” in section 8-102 of Article 8, parties are free to agree to treat any asset as a financial asset, unless such asset is excluded as a “financial asset” under section 8-103 of Article 8 (such as “commodity contracts”).

The key to determining the applicable holding system is the source of the relevant rights at issue. If the rights at issue are directly traceable to an underlying issuer of a security (or similar asset), the rules of the Direct Holding System apply. If the rights at issue are directly traceable to a “securities intermediary” (as defined in Article 8), the rules of the Indirect Holding System apply. Applying this framework, where the sole member of LLC A transfers all of its interests in LLC A to another party, the transfer (with respect to the Corp. A shares) would be analyzed under the Direct Holding System because the rights at issue are directly traceable to Corp. A (as the issuer of the corporate shares), not a securities intermediary.

The Modern Paradigm: A Brief Overview

The 1994 revisions to Article 8 fundamentally changed the rights of a person holding a security in the Indirect Holding System. Prior to such revision, whether a person held a security directly or indirectly, the person was deemed to be the owner of that security. This framework changed, however, when the 1994 Revisions created a distinction between the rights of Direct Holders and Indirect Holders. To implement this conceptual change, the 1994 Revisions created a new section in Article 8 – Part 5, entitled “Security Entitlements,” which describes the primary rights and duties of parties in the Indirect Holding System.

Security entitlements are the keystone of the Indirect Holding System. A security entitlement is both a package of personal rights against a securities intermediary and a property interest in the assets held by the securities intermediary. A person that holds an asset through a securities intermediary pursuant to Article 8 has a “security entitlement.” The property interest that comprises that security entitlement is described in the official comments of Article 8 as a “sui generis property interest.” Article 8 provides that the incidents of such property interest “are established by the rules of Article 8, not by common law property concepts.” The 1994 Revisions created a clear distinction between the two holding systems. The rights of an Indirect Holder are new rights and separate from the rights of Direct Holders. Consistent with this paradigm, the 1994 Revisions incorporated new and separate substantive rules for the two systems.

Separate Substantive Rules

The 1994 Revisions introduced separate substantive rules to be applied in the Direct and Indirect systems, including rules on (1) property interest remedies, (2) governing law, and (3) warranties upon transfer. These different substantive rules reinforce the unique nature of the rights arising under the two systems.

Limitations on Remedies

The remedies with respect to property interests arising in the Indirect Holding System are limited under section 8-503 of Article 8. While the securities intermediary is solvent, the entitlement holder must look to the intermediary to satisfy its claims. The entitlement holder cannot assert its property interest directly against other parties, except in extremely unusual circumstances. This remedial limitation is intended to promote the sound and efficient operation of the securities holding and settlement system by eliminating the need for purchasers to investigate whether a securities intermediary acted wrongfully in transferring a financial asset. This limitation also promotes an understanding that the property interest of an entitlement holder is a unique right, which originates from its securities intermediary, not the issuer.

Different Governing Law

Similarly, the rules for identifying the applicable governing law support the distinction of the rights in both systems. In the Direct Holding System, pursuant to 8-110(a), the local law of the issuer's jurisdiction governs concepts such as: (1) the validity of a security and (2) the rights and duties of the issuer with respect to registration of transfer. In the Indirect Holding System, pursuant to 8-110(b), the local law of the securities intermediary's jurisdiction governs analogous concepts such as: (1) the acquisition of a security entitlement from the securities intermediary, and (2) the rights and duties of a securities intermediary and entitlement holder arising out of a security entitlement. Under these provisions, the governing law is determined by reference to the originator of the relevant rights. In the Direct Holding System the originator is the issuer. In the Indirect Holding System, the originator is the securities intermediary. Where the nature of the rights held in the different systems is determined by reference to different governing laws, the rights themselves must be understood to be separate rights.

Separate Warranties

Additionally, the warranties to be provided upon a transfer of rights in the two systems differ with respect to violations of transfer restrictions. Under sections 8-108(a), (b), and (c), a person transferring or effecting a transfer of a directly held "security" provides, among other warranties, a warranty that the transfer "does not violate any restriction on transfer." This warranty is appropriate under section 8-108 because transfers of securities in the Direct Holding System may violate issuer transfer restrictions.

This warranty is also appropriate for transfers that occur at the interface of the Direct Holding System and the Indirect Holding System because such transfers may also result in the violation of issuer transfer restrictions. Such transfers occur, for example, when (1) a person delivers an asset to a securities intermediary to be credited to a securities account or (2) a securities intermediary causes its entitlement holder to be registered as the owner of an uncertificated security. In both of

these transfers, the Direct Holder changes. Because these transfers involve rights in the Direct Holding System, the issuer's transfer restrictions apply and potentially limit such transfers. Accordingly, the package of warranties provided for such transfers, under sections 8-109(b) and (c) for these interface transfers, include a warranty that such transfers do not violate any restriction on transfer.

In contrast, no such warranty is required in connection with instructions to effect transfers occurring entirely within the Indirect Holding System. Because the rights in the Indirect Holding System originate from the securities intermediary, not the issuer, it is appropriate that transfers occurring entirely within the Indirect Holding System should not be constrained by issuer-originated transfer restrictions. Consistent with this view, the package of warranties provided for such transfers under section 8-109(a), does not include a warranty that the transfer does not violate any restriction on transfer. Unlike the Direct Holding System, rights arising under the Indirect Holding System are not expected to be subject to transfer restrictions.

Understanding the two systems as separate regimes permits the isolation of certain commercial law issues in a manner consistent with the core principles of the modern Indirect Holding System. The 1994 Revisions to Article 8 distinguished the Direct Holding regime from the Indirect Holding regime. Accordingly, the grant of a security interest in rights of an Indirect Holder does not breach transfer restrictions originated by an issuer of the underlying asset because the rights being granted originated from the securities intermediary. This simplifies the analysis of transactions involving the transfer of transfer restricted assets, such as fund of funds transactions. Such simplification, however, is useful only if it can be reconciled with other law that may find an issuer's transfer restrictions to be lawful and enforceable.

Preserving the Expectations of Issuers: The Intermediary as Legal Owner

Issuers rely on the effectiveness of transfer restrictions to limit transfers by holders

of their interests for a variety of reasons. To be effective, these restrictions may need to exclude certain parties from being both legal and beneficial owners. Deeming issuer transfer restrictions to be imported into the Indirect Holding System, however, is not the appropriate mechanic to give effect to such restrictions because such approach is inconsistent with the core principles of Article 8. To understand how Article 8 reconciles the expectations of issuers with the structure of the Indirect Holding System we need to review (1) a hedge fund's need to restrict transfers, (2) the relevant securities intermediary's awareness of such transfer restrictions, and (3) the provisions of Article 8 that enable the securities intermediary to preserve these expectations.

As noted previously, one common reason why a hedge fund seeks to restrict transfers is to comply with certain exemptions to federal securities laws, such as the Investment Company Act of 1940. Eligibility for such exemptions can be contingent on the identity of legal and beneficial owners of an issuer's interests. In the case of the Investment Company Act, such exemptions can require that the number of "beneficial owners" be limited to not more than 100 persons or that "owners" be "qualified purchasers." If an underlying hedge fund's transfer restrictions are not effective to stop the transfers of its "beneficial owners," the hedge fund's compliance with such exemptions could be threatened, potentially subjecting the fund to registration requirements under the Investment Company Act.

In typical fund of funds transaction, a securities intermediary is able to give effect to issuer transfer restrictions, without having to import such restrictions into the Indirect Holding System. In such transactions, the fund of funds, as the entitlement holder, becomes the beneficial owner. The securities intermediary becomes the legal owner of each hedge fund in which the fund invests by completing each hedge fund's subscription documents. In the subscription process, the securities intermediary identifies and agrees to comply with the transfer restrictions of the hedge fund. Additionally, the securities interme-

diary (as legal owner) commonly affirms representations, on behalf of itself and the beneficial owner, that both parties meet the criteria to hold the hedge fund's interest (i.e., both parties qualify as "qualified purchasers"). To avoid breaching these representations and related obligations owed to the hedge funds, a securities intermediary must be able to limit transfers by the beneficial owners. Fortunately, the securities intermediary is able to do so because entitlement holders cannot effect outright transfer of security entitlements without the involvement of the relevant securities intermediary.

The Concept of Eligibility

While a securities intermediary is obligated to comply with "effective" entitlement orders of specified persons under section 8-507, this obligation is not unconditional. Where a securities intermediary receives an effective instruction to transfer a security entitlement to a third party and that third party does not satisfy the beneficial owner criteria of the underlying hedge fund or such instruction is not consistent with the intermediary's obligations as the Direct Holder, the intermediary might deem such transferee not "eligible," as permitted under section 8-508 or deem such instruction inconsistent with its obligations, under section 8-509. In either case, the preservation of the issuer's expectations is effected through the securities intermediary, consistent with the securities intermediary being a Direct Holder of the underlying asset. This approach avoids the need to import issuer transfer restrictions into the Indirect Holding System.

Consistent with the preservation of issuers' expectations, pledges of rights arising in the Indirect Holding System can be implemented without effecting a transfer of the legal or beneficial owner. Where a fund of funds pledges its securities account to a creditor and the creditor perfects that security interest by entering a control agreement consistent with section 8-106(d)(2) of Article 8, there is no transfer of the security entitlement and the fund remains the beneficial owner.

Redemption as an Adequate Remedy

Where a perfected secured creditor with "control" (as defined in Article 8) seeks to enforce its interest in a debtor's securities account by directing the intermediary to deliver the financial assets to a new securities account (either its own or that of a third party), the beneficial owner of the underlying hedge fund interest would change. To the extent such change is inconsistent with the obligations the securities intermediaries undertook with respect to the underlying hedge fund, or if the hedge fund is unwilling to permit such a transfer upon request by the securities intermediary, the secured creditor may not be able to effect its transfer. This limitation on enforcement may exist notwithstanding the secured creditor's perfected security interest in the securities account and may significantly diminish the value of the collateral in the judgment of the creditor. In a fund of funds transaction, however, the creditor has the option of redemption, which provides an avenue of enforcement.

The benefit of redemption is that it does not require any transfer of legal or beneficial ownership of the security entitlement. Consequently, where a perfected secured creditor enforces on the collateral in the typical fund of fund transaction, it will be able to instruct the securities intermediary to redeem the hedge fund interests that have been credited to the securities account. The securities intermediary will be obligated (pursuant to the relevant control agreement and applicable provisions of Article 8) to request a redemption of the hedge fund interest from the underlying hedge fund. The hedge fund, under its subscription documents, will be obligated to redeem the hedge fund interest (subject to the terms of its subscription documents, which may include gating limits or other restrictions). Accordingly, the secured creditor has a means of exchanging the collateral for value that is not contingent on the cooperation of the securities intermediary or the issuer (other than their cooperation to comply with their respective obligations under Article 8 and the relevant subscription documents).

Conclusion

When an asset is held in the Direct Holding System, issuer transfer restrictions provide a direct restraint on a holder's right to transfer such asset. This direct restraint is not applicable to the same asset held in the Indirect Holding System because the source of the rights and the law governing those rights is different. In the Direct Holding System, the source of the rights is the issuer. In the Indirect Holding System, the source of rights is the securities intermediary. Importing issuer-originated transfer restrictions into the Indirect Holding System is inconsistent with the modern Indirect Holding System.

Where a secured creditor has the option of redemption and such option provides adequate value to the creditor (in its own judgment), the Indirect Holding System may afford holders of assets subject to transfer restrictions a means of using such capital to secure obligations that is not available in the Direct Holding System. This conclusion gives effect to the core principles of Article 8 without rendering issuer transfer restrictions ineffective. This conclusion also simplifies the commercial law analysis of pledges of transfer restricted assets held in the Indirect Holding System, which promotes efficiencies in the market and, potentially, the broader use of such capital as collateral for secured financings.

E. Perry Hicks is a Finance partner at Mayer Brown LLP in Charlotte and member of the Uniform Commercial Code and Commercial Finance committees of the Business Law Section of the ABA.

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States Prepare to Bet the House on Online Gaming

By [Laura A. D'Angelo](#) and [Kerry O. Irwin](#)

In recent years, cash-strapped states have begun to seek alternative means of generating revenue and boosting state coffers—including exploring expanded gaming. For some states, this meant the legalization of casinos, once considered the exclusive territory of Nevada, Atlantic City, and the tribal authorities. However, the frontier of expanded gaming stretches well beyond casinos and slot machines. In particular, the online gaming, or iGaming, industry is booming. According to the American Gaming Association's (AGA) white paper: *Online Gambling Five Years After UIGEA*, global online gambling revenue in 2010 was nearly \$30 billion, with roughly \$4 billion originating in the United States.

Recently, the United States Department of Justice issued a legal opinion indicating it may be reversing its long-standing opposition to online gaming under the Wire Act, causing several states to move to seize new gaming territory—and the considerable tax revenue that it could generate.

Regulation of Online Gaming

Most iGaming operators are licensed and regulated in their home jurisdictions and operate legally in many countries around the world. According to the AGA's white paper, roughly 85 countries, including Canada, have legalized—and regulated—online gaming. A 2010 survey conducted by Spectrum Gaming for the AGA found 2,679 Internet gambling sites worldwide,

owned by 665 companies. While iGaming is legal and regulated in the UK and several European countries, the largest online gaming operators are predominately licensed in off-shore island nations such as Gibraltar, Malta, the Isle of Man, and Alderney. These jurisdictions tend to offer low taxes, ease of formation, and sometimes, less regulatory oversight. Until recently, many of these jurisdictions have essentially taken the position that U.S. law only bans online wagering on sports betting, and have therefore allowed licensees to accept bets from U.S. residents on non-sports wagers, such as poker. However, while the gaming companies' overseas operations have made it difficult for federal authorities to monitor or prosecute their activities within U.S. borders, the U.S. Department of Justice nonetheless has a history of using federal and state laws to target iGaming operators.

Congress has not enacted legislation that expressly prohibits wagering online, but certain federal statutes provide ammunition for the Justice Department's attacks on iGaming. As an example, the Illegal Gambling Business Act, 18 U.S.C. § 1955, prohibits illegal gambling businesses, which are defined by the act as businesses that: (1) violate state law; (2) are operated by five or more persons; and (3) receive at least \$2,000 a day in revenue. The 2006 Unlawful Internet Gambling Enforcement Act of 2006 (UIGEA), 31 U.S.C. § 5361 *et seq.*, provides criminal and civil liability

for financial transactions related to unlawful Internet gambling, rather than expressly targeting online wagering activity. The UIGEA defines "unlawful Internet gambling" as "plac[ing], receiv[ing], or otherwise knowingly transmit[ing] a bet or wager by any means which involves the use, at least in part, of the Internet where such bet or wager is unlawful under any applicable Federal or State law in the State or Tribal lands in which the bet or wager is initiated, received, or otherwise made." Thus, the UIGEA and the Illegal Gambling Business Act, rather than expressly prohibiting certain types of wagering, allow other state or federal laws to define what is legal or illegal Internet gambling.

Only a limited number have states have enacted legislation that expressly prohibits Internet gaming, but these laws can be effective in the prosecution of iGaming operators when used in combination with federal statutes. In February 2012, online sports wagering company Bodog Entertainment Group and its founder, Calvin Ayre, were indicted by the U.S. district court in Maryland for violations of the Illegal Gambling Business Act, based on violations of Maryland's prohibition of online sports wagering. With respect to federal gambling laws, the federal Wire Act, 18 U.S.C. § 1084, prohibits at least some forms of interstate online gaming. However, because the Wire Act was passed in 1961, and has not been amended since the advent of the Internet, the act has

been open to interpretation with respect to its application to iGaming—namely, whether it prohibits all forms of online interstate wagering, or only online interstate sports wagering.

The exception to the general, if ambiguous, federal prohibition on interstate Internet wagering is telephone and Internet wagering on horse racing, which was expressly authorized by a 2000 amendment to the Interstate Horseracing Act of 1978 (IHA), 15 U.S.C. § 3001 *et seq.* Nevertheless, in line with the department's long-held position that the Wire Act prohibits interstate Internet wagering, the department of Justice has taken the position that the 2000 amendment to the IHA did not supersede the prior existing federal criminal gambling statutes, and that pari-mutuel wagering on horse racing over the Internet is, therefore, illegal under federal law.

The Wire Act

The Wire Act, which was passed in 1961 in response to organized crime and book-making, essentially prohibits the placing of certain interstate wagers by wire transmission. More specifically, the relevant provision of the Wire Act, 18 U.S.C. § 1084(a), contains two broad clauses. First, the Wire Act prohibits anyone who engages in the business of betting or wagering from knowingly using a wire communication facility to transmit interstate bets or wagers, or information assisting in the placing of bets or wagers, on any sporting event or contest. Second, the act prohibits using a wire communication facility to transmit communications that entitle the recipient to receive money or credit either as a result of bets or wagers, or for information assisting in the placing of bets or wagers. These two clauses have resulted in considerable ambiguity with respect to whether the Wire Act, as a whole, applies only to betting on sporting events or contests, or whether it prohibits all interstate wagering wire transmissions—including online gaming, such as Internet poker. The Department of Justice has traditionally taken the position that the act prohibits all Internet wagering—including, and perhaps especially, poker.

A 2002 case addressing the applicability of the Wire Act to iGaming was *In re*

Mastercard International Inc. Internet Gambling Litigation, 313 F.3d 257 (5th Cir. 2002), in which the plaintiff debtors, who had been gambling at Internet casinos, alleged that credit card companies violated the Wire Act and other statutes, and that, therefore, their gambling debts were unenforceable under state law. The Fifth Circuit agreed with the district court's conclusion that the Wire Act concerns gambling on sporting events or contests, and that the plaintiffs failed to allege that the defendants had engaged in Internet sports gambling. The district court found that a plain reading of the Wire Act clearly required that the object of gambling be a sporting event or contest. Other courts have disagreed, however, lending uncertainty to the application of the Wire Act.

Perhaps because of this uncertainty, the recent indictment of several Internet poker companies in, *United States v. Sheinberg, et al.*, filed in the Southern District of New York, was based not on the Wire Act, but on the UIGEA, the Illegal Gambling Business Act, state gambling laws, and federal money laundering and wire fraud statutes. On April 15, 2011, the federal government announced that a New York grand jury had indicted the founders of the three largest Internet poker operations that were accepting bets from U.S. residents—PokerStars, Full Tilt Poker, and Absolute Poker/Ultimate Bet. The indictment focused on the processing of payments to and from the companies' customers, alleging that those transactions involved bank fraud, money laundering, and the maintenance of illegal gambling businesses. The Justice Department filed a parallel civil complaint demanding forfeiture of the Internet domains used by those operators. Five weeks later, a second wave of indictments against online poker and sports betting companies was handed down; these charges also involved the Illegal Gambling Business Act and money laundering statutes, rather than the Wire Act. While the indicted companies took measures to stop wagering by U.S. residents, the AGA's white paper indicates that approximately 300 off-shore gambling operators continue to operate in

the U.S. market through more than 1,000 online gaming websites. However, these off-shore operators may soon face domestic competition in light of the recent legal opinion from the Justice Department.

The 2011 Department of Justice Wire Act Opinion

The underlying ambiguity of the Wire Act in its application to iGaming has clearly resulted in uncertainty as to the legality of any Internet gaming—including intrastate, non-sports wagering. This uncertainty led policy makers from New York and Illinois to formally request opinions from the Justice Department's Office of Legal Counsel as to the legality of the sale of lottery tickets over the Internet. In late December, 2011, the Justice Department released a memorandum opinion (Opinion), written by Deputy Attorney General Virginia Seitz for the Office of Legal Counsel, which not only confirmed the legality of intrastate online lotteries under the federal Wire Act, but, in the view of some regulators, also opened the door to other forms of intrastate online gaming, including poker, by stating that the Wire Act applies only to sport betting. Ironically, this does not put to rest the tension between the Department of Justice and horse racing.

The question before the Justice Department was the same as the question before the court in *In re Mastercard* and its ilk: whether both of the relevant clauses of 18 U.S.C. § 1084(a) apply only to betting on sporting events or contests, or whether the second provision effects a broad prohibition of all gambling transactions by wire. Reversing its previous interpretation, the Justice Department in the December Opinion found that, even though the phrase "on any sporting event or contest" does not appear in the second clause, "the references to 'bets or wagers' in the second clause are best read as shorthand references to the 'bets or wagers on any sporting event or contest' described in the first clause." Thus, the Wire Act only prohibits certain interstate wagers on sporting events or contests—and wagers that are outside of this category fall beyond the scope of the Wire Act's prohibitions. Therefore, because the New York and Illinois online

lottery sales are intrastate and do not relate to a “sporting event or contest,” the Wire Act does not prohibit them.

The Justice Department relied heavily on legislative history and the congressional testimony contemporary with the passage of the Wire Act in 1961. The primary focus of the act was to stop the use of wire communications for sports gambling. “This focus on sports-related betting makes sense,” Seitz wrote, because “the record before Congress indicated that sports bookmaking was the principal gambling activity for which crime syndicates were using wire communications at the time.”

Implications

The Justice Department did not address other forms of Internet wagering, but states that are eyeing expanded gaming as a way to boost revenue are looking to seize the moment and pass legislation that will allow them to regulate—and thus tax—online gaming companies that wish to operate within their borders. Nevada recently enacted regulations legalizing limited intrastate Internet gambling, and California, Iowa, Mississippi, and New Jersey also took steps to legalize intrastate online gaming. The D.C. City Council legalized online gaming in 2010 and repealed it in 2012, but Councilman Michael Brown plans to reintroduce a bill to legalize Internet poker and slots. According to the *New York Times*, Steven Grossman, Massachusetts state treasurer and chairman of the New York Lottery Commission, believes the Justice Department’s Opinion is a “turbocharged opportunity to engage new markets,” and that it “will put additional pressure on Congress and others to allow online poker and other Internet gambling.” Coupled with significant improvements in online gaming technology, both for play and for integrity, and increased acceptance of gaming, states are realizing that it is practicable to tax and regulate online gaming both for revenue reasons and to protect consumers.

However, the Justice Department’s Opinion, in deciding such a narrow issue, does not indicate that iGaming companies are now free to accept wagers from U.S. customers without reservation. In fact,

gaming industry groups, such as the American Gaming Association, are lobbying for federal legislation to regulate Internet gaming, in order to establish consistent regulatory standards and to prevent fraud and money laundering. In the February 2012 issue of *Global Gaming Business*, Frank Fahrenkopf, CEO of the AGA, wrote that “the [Justice Department’s] opinion further illustrates the urgent need for federal legislation to prevent a patchwork quilt of rules and regulations governing domestic online gambling and the continued proliferation of unlicensed and unregulated foreign gambling websites targeting the millions of Americans playing online[.]”

Federal legislation could provide a mechanism for regulating and taxing foreign operators in order to protect players; it would also clear up lingering ambiguities as to the application of the Wire Act and other federal laws to online gaming. Even casino companies like Caesars Entertainment Corp., wary of possible competition with Internet casinos, are lobbying for federal regulation of Internet gaming. Another possible avenue for regulation is by interstate compacts similar to those currently used in horse racing. These compacts permit larger pools—and larger payoffs—for customers. Interstate compacts are not a complete bypass of federal regulation, however, as Congress may take the position that it has to approve any proposed compact.

Ultimately, the Justice Department’s Opinion clarified two points of law: that the Wire Act only applies to interstate wire transmissions related to bets or wagers on sporting events or contests; and that the Wire Act does not prohibit intrastate online lotteries. Despite the rush by several states to bet the house on iGaming tax revenue, regulators are well-advised to acknowledge potential conflicts with other federal laws and to stay well within the narrow bounds of the 2011 Opinion.

Laura A. D’Angelo is a partner in the Lexington office of Dinsmore & Shohl LLP. Kerry O. Irwin is an associate in the Lexington office. Both practice in the Corporate, Gaming, and Equine Practice Groups of the firm.

BUSINESS LAW TODAY

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Delaware Insider:

Running a Proper Independent Committee Process: Practice Tips from Recent Delaware Cases

By [Jeffrey R. Wolters](#)

A board of directors faced with a conflict transaction—such as a transaction with a controlling stockholder or, in many cases, an acquisition by a financial buyer where management will be retained and will receive equity in the post-acquisition entity—will usually form an independent committee of directors to consider the transaction. The required attributes of an independent committee process are by now fairly clear under Delaware law. However, recent cases have pointed out a few remaining uncertainties in the Delaware law governing committees, particularly as regards the scope of authority that must be given to a committee and the legal standards that a reviewing court will apply in assessing a committee process. Perhaps more importantly from a practitioner's standpoint, recent cases also highlight certain recurring fact patterns that have undermined committee processes. This article briefly reviews the legal uncertainties, and then turns to these recurring facts patterns and suggests ways that counsel could deal with them.

Settled Law and Remaining Uncertainties

Under Delaware law (as generally outlined in *In re So. Peru Copper Corp. S'holder Derivative Litig.*, 2011 WL 6440761 (Del. Ch. 2011)), a transaction with a controlling stockholder, or a transaction in which a majority of the board otherwise has a conflict, will be reviewed

under the entire fairness standard. This means that the defendants will bear the burden of proving that the transaction was entirely fair, both in terms of “fair process” and “fair price.” If the defendants cannot satisfy this standard, they may be personally liable for damages.

However, the proper use of an independent committee can provide significant protection for directors by changing how these legal standards are applied, either by changing the standard of review, shifting the burden of proof, or providing evidence of fairness. In a transaction with a controlling stockholder, use of an independent committee can shift the burden of proof under the entire fairness standard back to the plaintiff. In a transaction not involving a controlling stockholder, it can change the standard of review from the entire fairness standard to the business judgment rule. In either case, whether or not there is a change in the standard of review or burden shift, the committee process can itself be important evidence of fairness.

Within this relatively settled framework, recent cases have pointed out three open questions.

Scope of Authority

The first question relates to the scope of authority that must be granted to or exercised by the committee. It is not clear that a committee will result in the benefits discussed above, particularly the benefits relating to burden of proof and standard

of review, unless the committee is granted broad authority. This could include not only the standard “power to say no” to any given transaction, and the power to retain independent advisors, but also the power to consider alternative transactions (even in response to an offer from a controlling stockholder who could potentially veto other deals) and to take defensive measures to protect stockholders. *In re CNX Gas Corp. Shareholders Litigation*, 2010 WL 2705147, *10 (Del. Ch. 2010); *In re So. Peru Copper Corp. S'holder Derivative Litig.*, 2011 WL 6440761, *23 (Del. Ch. 2011).

Standard of Review

The second open question relates to standard of review in a transaction with a controlling stockholder. The Chancery Court has suggested that the use of an independent committee, if combined with a “majority of the minority” stockholder vote, should result in the full protection of the business judgment rule, rather than simply a shift in the burden of proof under the entire fairness standard. At the same time, the Chancery Court has laid down stringent requirements for committees in this context, including, generally, that the committee's authority match that of an independent board as much as possible. *In re CNX Gas Corp. Shareholders Litigation*, 2010 WL 2705147 (Del. Ch. 2010). The Delaware Supreme Court has yet to rule whether it will adopt the Chancery

Court's suggested approach as the law of Delaware.

Shift in Burden of Proof

The third open question relates to when a court will determine whether a committee process has the effect of shifting the burden of proof in a control stockholder transaction. Chancellor Strine recently concluded in *In re Southern Peru Copper Corp. S'holder Derivative Litig.*, 2011 WL 6440761, *23 (Del. Ch. 2011), that the precedents dictate that this cannot be determined until after the trial court has reviewed the factual record to decide whether the committee functioned properly. He also candidly noted that if a court cannot determine who bears the burden of proof until after reviewing all the facts, it calls into question the relevance of a "burden shift" as a practical matter.

Recurring Fact Patterns to Address

Even in the midst of some uncertainty concerning the legal rules applicable to committees, lawyers who advise committees can help ensure the maximum effectiveness of a committee process by being alert to certain recurring fact patterns that have troubled the courts in recent cases.

Scope of Authority Granted to the Committee

The courts have clearly signaled that because a primary purpose of an independent committee process is to replicate the process that an independent board would go through in a transaction with a third party, the committee should have powers that are generally comparable to the powers of a board in such a situation. The courts have focused recently on whether a committee must be given the power to consider alternatives, including in response to a proposal made by a controlling stockholder. Delaware law is fairly settled that if a controlling stockholder has stated that it will vote its shares against other transactions, then a board generally does not have a duty to pursue the "futile act" of shopping for alternative deals. It might therefore be argued that a committee need not be empowered to consider alternatives if the controlling stockholder has made

such a "veto statement." On the other hand, arguably the decision whether or not to believe the veto statement, and what to do in response to it, is a decision that should be left to the committee. A decision "not to shop" may be perfectly defensible if made by the independent committee, but subject to attack if foreordained by the board as a whole. An important role for committee counsel in this context is to make sure the committee understands the scope of the authority granted to it, and to discuss with the committee whether it could be advisable to seek to expand that authority.

Committee Member Conflicts

A court may not respect a committee process if it is not fully convinced that the committee members are in fact independent in relation to any conflicted parties and the transaction in question. Recent cases have focused on the need for liquidity as a potential conflict. In the *Southern Peru* case, for example, a committee was established to consider a transaction proposed by a majority stockholder. One committee member was affiliated with another large stockholder that wanted to liquidate its stake, but could not do so unless its stock was registered—a decision which the court found was controlled by the majority stockholder (through its control of a majority of the board). The court concluded that this "liquidity conflict," although different from a "classic self-dealing interest," nonetheless called into question the independence of the committee member.

Another example of a liquidity conflict arose in the Chancery Court's recent decision in *N.J. Carpenters Pension Fund v. infoGROUP, Inc.*, 2011 WL 482588, *10 (Del. Ch. 2011). There it was alleged that the CEO had pushed for a sale of the company because he needed liquidity to fund another venture of his own and to cover certain personal liabilities. The company was being sold to an unrelated third party and therefore the sale itself did not raise conflict issues. However, the court found that the CEO's liquidity needs compromised his independence, and in turn infected the sale process as a whole given

his central role in negotiating the deal and leading the board.

An important role for counsel can be to flush out any actual or potential conflicts of interest at the outset of a committee process. This might be done by interviewing the committee members or providing them with a detailed questionnaire. If a conflict or potential conflict is discovered, it is not necessarily disqualifying for the committee member. It may be crucial, however, that the matter be disclosed to and discussed by the committee as a whole, so that the record can reflect the committee's knowledge of the matter and its collective judgment whether to take any action. This point was highlighted in another recent decision of the Delaware Chancery Court, *In re El Paso Corp. S'holder Litig.*, 2012 WL 653845, *8 (Del. Ch. 2012), where both the CEO and the board's investment banker were found to have had conflicts of interest that were not disclosed to the board. The court stated that "[w]hen anyone conceals his self-interest . . . it is far harder to credit that person's assertion that self-interest did not influence his actions." Committee counsel can often play an important role in flushing out such conflicts at the outset, rather than waiting for them to surface in litigation, when they are likely to cause far more damage.

Committee Control of Management

Another recurring "bad fact pattern" is where management rather than the committee appears to be leading the process, but management has a conflict of interest. Such a conflict often arises in connection with a sale of the company to a financial buyer which plans to retain management and provide management with new equity (i.e., a rollover). The Delaware courts have emphasized repeatedly that in this context, it is important for the record to reflect that the committee actively directed the process rather than ceding control to management. In litigation challenging the buyout of J. Crew, for example, (*In re J. Crew Group, Inc. Shareholders Litigation*, C.A. No. 6043 at 66 (Del. Ch. Dec. 14, 2011)), the court commended the committee for implementing management guidelines that

restricted management's ability to discuss retention or equity participation with bidders, unless authorized by the committee. Damage had already been done, however, because the CEO had brought in the winning bidder, and discussed his own retention and rollover package with that bidder, before the board as a whole was made aware of the potential sale and was able to establish the independent committee. Chancellor Strine criticized boards in general for not having in place policies to prevent CEOs from front-running sale processes in this manner:

I really don't understand why it is not expected of all public company boards that they have protocols in place to deal with the [not] unusual circumstance of whether the CEO decides that the best strategic option for the company might be a sale. It is, in my view, outrageous for a board to be the last to know when the CEO changes the fundamental strategic direction in his own mind . . .

I believe that there are deals tainted by CEOs messing around early, boards not having policies in place. It's inexcusable for companies to be doing this. I don't get why all boards don't have policies to say, when the CEO changes in his own mind that it's a viable option [to sell the company], the board hears first. The company's advisors belong to the company. You don't talk to employees. You don't share confidential information. You don't make promises to work for anybody else, or anything like that, without talking to us. And there are many defense lawyers and people who advise boards in the room, and it's really not excusable [that they fail to implement such policies].

In re J. Crew Group, Inc. Shareholders Litigation, C.A. No. 6043 at 66, 69–70 (Del. Ch. Dec. 14, 2011) (Transcript).

Committees should expect similar criticism if they do not move forcefully to control management's role in a sale process in which management may have a conflict of interest. This does not mean that it is necessarily required to exclude management from the process, and it will typically be neither feasible nor advisable to do so. But the committee and its

counsel should develop a clear record that they actively dealt with the issue and implemented rules to mitigate the potential for any management conflict to affect the process to the detriment of stockholders as a whole.

Financial Advisor Conflicts

An independent board or committee process may also be undermined by conflicts of interest on the part of the directors' financial advisor. The Delaware Chancery Court has repeatedly emphasized the importance of vetting and disclosing "banker conflicts," and the serious risk that such conflicts may pose to a sale process:

Because of the central role played by investment banks in the evaluation, exploration, selection, and implementation of strategic alternatives, this Court has required full disclosure of investment banker compensation and potential conflicts. This Court has not stopped at disclosure, but rather has examined banker conflicts closely to determine whether they tainted the directors' process.

In re Del Monte Foods Company Shareholders Litigation, 25 A.3d 813, 831–832 (Del. Ch. 2011) (citations omitted).

In addition, as noted in the *El Paso* case, the concealment of such conflicts magnifies the substantive problem. Thus in the *Del Monte* case, the court enjoined a merger primarily because of the undisclosed actions of a conflicted banker, notwithstanding that the board of directors itself was independent and the sale was to a third party. The banker's actions included arranging to provide financing to the buyer before a final deal price was struck.

The conflict created when a target financial advisor also provides buy-side debt financing—so-called stapled financing—was again considered by the court in the *El Paso* case. There, interestingly, Chancellor Strine took care at the hearing to note that such financing was not necessarily a problem if an independent committee controlled the process and could show a benefit to the company, such as luring more bidders or a potentially higher price.

Conclusion

In summary, regardless of where a conflict originates or what course of action is chosen, the key issue in a committee process will often be whether the record reflects that the committee was proactive, in control and made an informed judgment on the matter, or whether the committee instead appeared to be a passive victim of the conflicted party (whether a banker, management, a conflicted committee colleague, the board as a whole, or a controlling stockholder).

Jeffrey R. Wolters is a member of the Delaware Corporate Law Counseling Group at Morris, Nichols, Arsht & Tunnell LLP in Wilmington, Delaware.

BUSINESS LAW TODAY

The ABA Business Law Section's Online Resource

Inside Business Law

April 2012

Recognizing the Efforts of the ABA and BLS Leaders to Preserve the Independence of the Legal Profession

Over the past several years, the ABA has [fought vigorously](#) to preserve the independence of the legal profession by successfully blocking or modifying numerous key legislative and regulatory proposals that would have undermined traditional state court regulation of lawyers, interfered with the confidential client-lawyer relationship, or otherwise imposed excessive regulations on lawyers engaged in the practice of law. The Business Law Section has been a vital part of this overall ABA effort, with our business lawyers leading the way in numerous key areas, including:

- Martin Lybecker (Chair-Elect of the ABA Business Law Section and a member of the ABA Task Force on Financial Markets Regulatory Reform) and other Task Force members played a leading role in crafting a new ABA policy opposing provisions in the Dodd-Frank Act that would have granted the Consumer Financial Protection Bureau sweeping new powers to regulate practicing lawyers and their law firms. Marty also joined the ABA Governmental Affairs Office (GAO) in [helping persuade](#) key congressional leaders to include a strong practice-of-law exclusion in the final version of the Dodd-Frank Act. This exclusion effectively exempts practicing lawyers and their employees from the expanded regulatory powers of the new Consumer Financial Protection Bureau created by the legislation.
- Terry Franzen, Chair of the ABA Business Law Section's Consumer Financial Services Committee, worked with the GAO to craft detailed comments forwarded to the FTC, [urging the Commission](#) to include a broad practice of law exemption in the final "Mortgage Assistance Relief Services" Rule. The exemption spares the vast majority of practicing lawyers who help consumer clients to renegotiate their mortgages or avoid foreclosure from all of the burdensome federal regulations in the rule.
- Donald Lampe of the ABA Business Law Section Council and Andrew Smith of the Section provided valuable assistance to the GAO that eventually led to the enactment of P.L. 111-319, [effectively exempting](#) practicing lawyers from the FTC's Red Flags Rule that requires "creditors" to develop costly programs identifying, detecting, and responding to the warning signs of identity theft.
- William H. Clark, Jr., Chair of the ABA Business Law Section's Anti-Money Laundering and Anti-Terrorism Initiatives Committee, Martin Lybecker, and other members of the ABA Task Force on Gatekeeper Regulation and the Profession, [helped to develop several new ABA policies](#) opposing federal anti-money laundering legislation or regulations that would undermine the attorney-client privilege or the confidential lawyer-client relationship. They also helped to develop the "[Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing](#)" and to disseminate the Guidance to state bars, state courts, and the legal community in general.
- For a full summary of significant recent efforts by the ABA and the Business Law Section to preserve the independence of the legal profession, be sure to check [here](#).

Small and Midsize Companies Securities Law Update

Recent federal securities law initiatives promise to greatly simplify the raising of capital for small and midsize companies. The Business Law Section has been a national leader in both promulgating and analyzing such initiatives, with our contributions paying off in the form of President Obama's recent approval of the Jumpstart Our Business Startups Act (the JOBS Act). Securities law reforms for small and midsize companies were understandably a hot topic at the Business Law Section's Spring Meeting held this past March, and

while the Spring Meeting occurred prior to the president's approval of the JOBS Act, you won't want to miss the meeting's informative presentations and articles covering these emerging issues, provided [here \(audio\)](#) and [here \(audio\)](#).

Ethical Issues in Negotiating and Drafting Business Contracts

Good transactional lawyers always strive to negotiate and draft contracts that best achieve client goals, but what happens when ethical considerations conflict with achieving those goals? This is an issue most busy transactional lawyers will inevitably face, and the Business Law Education Committee provides us with an invaluable opportunity to learn how to deal with such issues in this [hypothetical-based presentation \(audio\)](#) from the Business Law Section's 2012 Spring Meeting.

Annual Reviews of Legal and Business Developments

One of the most important functions of the Business Law Section is to track current legal and business developments that directly impact the day-to-day practice of the business lawyer, and to compile those developments in the form of annual reviews. Many of these reviews are published in connection with the Business Law Section's annual Spring Meeting, and 2012 is no exception. You will want to print these important reviews and keep them near your desk for ready reference:

- The LLCs, Partnerships and Unincorporated Entities Committee released its 2012 edition of "[The 2012 Annual Review of LLC Case Law and Recent Developments](#)," ([Audio link](#).) This document is an essential compendium of current case law in this dynamic field.
 - "[The 2012 Annual Review of Developments in Business and Corporate Litigation](#)" ([audio link](#)) from the Business and Corporate Litigation Committee provides comprehensive case law analyses in functional areas including director and officer liability insurance, corporate law, business torts, class action law, and employ-
- ment law, as well as a multi-state review of recent developments in the use of business courts.
- The Business Financing Committee published its "[30th Annual Review of Developments in Business Financing](#)" ([audio link](#)), with a strong focus on how market and regulatory conditions have influenced IPOs, private equity financings and venture capital investments over the past year.

BUSINESS LAW TODAY

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Keeping Current:

When Judges Attack: A Cautionary Tale of Lawyer Error In Two Cases

By [Arthur F. Fergenson](#)

Two recent Seventh Circuit decisions, both written by its chief judge, illustrate how courts react to lawyer error. The usual course, followed in one case, is to forgive and forget. But a court is less likely to be in a forgiving mood, as demonstrated in the other case, when (1) as a result of attorney error, the court itself may never have had the power to hear the case, (2) the court had to do the work to extricate itself and the parties from the problem, and (3) the attorneys for the prevailing party disregarded the local and federal rules when seeking sanctions because the lawsuit was meritless. Err once and all is well. Rely on the court to find and fix the problem of its own jurisdiction, and you are less likely to get a pass. But compound those errors with a further error when asking the court to exercise its discretion in your client's favor, and you invite judicial ire. By putting the two cases together, litigators can gain a deeper appreciation of what courts care about when deciding how to treat lawyer error.

Courts follow an unwritten rule of lenity when dealing with attorney error. But there are limits, as successful defendant's counsel discovered on February 7, 2012, when Chief Judge Easterbrook of the United States Court of Appeals for the Seventh Circuit wrote a unanimous opinion exonerating by name a law firm and connecting the court's refusal to grant sanctions with serious errors of practice committed by the firm. *Heinen v. Northrop Grumman Corp.*

(February 7, 2012, No. 10-3408). Why this court acted with such ferocity should act as a cautionary tale for practitioners, especially in light of Judge Easterbrook's more forgiving treatment of successful defense counsel in *Dixon v. ATI Ladish LLC* (January 26, 2012, No. 11-1976). Heinen filed in Illinois state court alleging a breach of employment contract with the defendant company, for which Heinen worked for about six months in 2006. The defendant removed the case to the United States District Court for the Northern District of Illinois. The removal notice, and the jurisdictional allegation in the brief before the Seventh Circuit, stated that Heinen was a "resident of Massachusetts" and *therefore* a "citizen" of Massachusetts, allowing the federal courts to exercise power to decide the controversy pursuant to the constitutional, under Article III, and congressional, under 28 U.S.C. § 1332, grant of diversity jurisdiction. Yet, diversity jurisdiction depends on the domicile of the parties, not residence. That Heinen was a resident of Massachusetts may have been evidence of citizenship, but it was not the same, especially because Heinen agreed to take a job with the defendant in Illinois while he was living in California, and defendant is a Delaware corporation with its principal place of business in California. Not only did the plaintiff live in California when he agreed to take the Illinois job, but his family remained in California and a lender foreclosed on his California house in 2008.

Judge Easterbrook stated that "both sides were surprised" to learn that the law required domicile, not residence, when the issue was presented at oral argument. The panel directed an amended notice of removal. The removal notice was re-drafted to state that plaintiff and his family had a home in Massachusetts, he was registered to vote there, and he had a Massachusetts driver's license. That was enough for citizenship, and subject matter jurisdiction was established.

But the damage was done to the judicial process, and the court made plain the costs: the court's time was wasted, as well as the client's money, "by postponing essential inquiries until after the case reached the court of appeals." More was to come, including the implicit charge that the lawyers failed in their "professional obligation to analyze subject-matter jurisdiction before judges need to question the allegations."

That was bad enough, but the punishment to be meted out to the lawyers was compounded by the court's further determinations. The court held that on the merits it was proper for the trial court to dismiss the claim because it was subject to an arbitration clause. The merits were so obviously in favor of the defendant company that the circuit court held that the appeal was frivolous. The court then went out of its way to blame defendant's lawyers for the refusal of the court to grant sanctions. The lawyers put a request

for sanctions in its appellate brief, instead of following Fed. R. App. P. 38 and filing a motion. The lawyers filed a motion two weeks after oral argument. The circuit court stated bluntly that it “is not inclined to award sanctions in favor of a party that cannot be bothered to follow the rules itself,” citing to both Rule 38, and “be[ing] able to tell the difference between residence and domicile”

The consequences of the lawyers’ failure, as identified in the opinion, will cost the law firm in the fees that it spent preparing and filing the notice of removal, and, most likely, in all the fees that could have been recovered by the motion for sanctions, and in intangible costs, in terms of its relationship with its client and the law firm’s reputation. It is hard to argue with the court’s own logic: but for the multiple errors by defendant’s counsel, sanctions would have been awarded.

The *Heinen* case was argued on January 12 and decided February 7. Six weeks before, on December 1, 2011, the *Dixon* case was argued, and it was decided on January 26, while the *Heinen* appeal was pending. Judge Easterbrook also wrote the opinion in *Dixon*, and cited to two merits arguments that defense counsel could have made but did not. One was pre-emption under the Securities Litigation Uniform Standards Act of 1998 (SLUSA). In what turned out to be a preview of a distinction that turned out to be crucial in *Heinen*, Judge Easterbrook wrote that “[p]reemption under SLUSA is a defense rather than a limit on subject-matter jurisdiction.” While stating that the failure to raise the defense forfeits any use of the statute, the court stated that a carve out “appears to preserve” plaintiff’s claim. The court thus observed the general practice of educating counsel rather than excoriating them. At issue on the merits of the appeal was the applicability of the business judgment rule in defending against plaintiff’s claims. The applicable state statute was not cited by defendants until their appellate brief, but the issue had been raised generally below. The court ruled that “a litigant does not forfeit a position just by neglecting to cite its best authority; it suffices to make the substantive argument.” Nowhere in the

opinion did the court identify the lawyers who failed to identify the critically-important statute before the trial court.

Why the difference in the way Judge Easterbrook treated successful defending counsel? Two reasons immediately suggest themselves. First, in *Heinen* the issue at stake was subject-matter jurisdiction. Without subject-matter jurisdiction, which cannot be waived, the federal court is bereft of power to adjudicate the controversy. For federal courts that take jurisdiction seriously, and Judge Easterbrook does, this is a sin of a high order. The courts may be, in Professor Bickel’s adoption of Alexander Hamilton’s term, the “least dangerous branch,” but the ability to exercise those powers it legitimately possesses must be preserved by refusing to act beyond the constitutional limits of its authority. Lawfulness for courts starts at home, as the Supreme Court held in the landmark assertion of authority through negative action in *Marbury v. Madison*, 5 U.S. (1 Cranch) 137 (1803). Second, the *Heinen* court was certainly influenced by the utter basics of the legal proposition that the lawyers failed to understand. Contrast that with the failure in *Dixon* to allege SLUSA, a far more esoteric area of the law. A close reading of *Heinen* suggests a further reason for the court’s ire. In *Heinen*, the court was compelled to do all the work, a task that it was compelled to undertake because subject-matter jurisdiction is a baseline inquiry that courts must make whenever it is spotted, even by the courts. The panel received no help from anyone. In *Dixon*, at least on appeal the statutory argument was fully briefed by defendants; the court did not have to do the work of the lawyers. In *Heinen* the defendants also requested sanctions, and then failed to follow the rules in seeking sanctions. Unfortunately, mistakes happen. In litigation, mistakes happen all the time. One of the author’s mentors, a seasoned federal narcotics prosecutor and then criminal defense attorney, was fond of quoting Bobby Knight’s observation that college basketball was a game of mistakes; so, too, is litigation. But there are limits, and those limits were transgressed in *Heinen*, in ways that implicated the

federal courts in a possible constitutional violation of judicial power. It was, ultimately, too much for Judge Easterbrook. He and his fellow panel members had had enough, and silence and forgiveness were not enough. Let us all stand warned and remain wary.

Arthur F. Fergenson is of counsel at the Ellicott City, Maryland, office of Ansa Assuncao LLP.

BUSINESS LAW TODAY

The ABA Business Law Section's Online Resource

Keeping Current: Fines by UK's Financial Services Authority Show the Importance of Anti-Bribery Policies

By [Raymond L. Sweigart](#)

Much has been written about the UK Bribery Act's new strict liability corporate offense of failure to prevent bribery and the advisability of having in place a comprehensive anti-bribery policy adopted and enforced by senior company management as the only recognized defense available against the specter of criminal prosecution and potentially unlimited fines. However, it is not just the criminal prosecutors at the Serious Fraud Office (SFO) but the regulators of the financial services industry in the UK at the Financial Services Authority (FSA) who will be reviewing the adoption and implementation of adequate internal management procedures to combat corporate corruption.

In the UK, anti-bribery issues are not only a matter for the prosecutors, but also fall within the FSA's regulatory objectives of reducing financial crime and bribery in the financial services industry. The fines that the FSA imposed on two well-known international insurance brokers, Aon and Willis, underscore that anti-corruption remains a strategic priority of that agency. It levied a £5.25 million fine against Aon for breaching Principle 3 of the FSA's Principles for Businesses ("A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.") with respect to failings in its anti-bribery systems and controls. The FSA found that Aon failed to assess the risks involved in its dealings with overseas third parties

and failed to implement effective controls to mitigate those risks. The FSA also fined Willis £6.895 million for breaching Principle 3 and Rule 3.2.6 of FSA's Senior Management Arrangements, Systems and Controls ("A firm must take reasonable care to establish and maintain effective systems and controls for compliance with applicable requirements and standards under the regulatory system and for countering the risk that the firm might be used to further financial crime.") as a result of management failings similar to those found at Aon.

What should not escape notice is that the FSA in its role of regulatory prevention and not criminal prosecution has a significantly lower burden than do the SFO and the Crown Prosecution Service. The FSA in levying fines does not even need to prove that any bribes have actually been paid, but merely that a company's systems and controls do not properly protect against the risk of such payments.

In December 2011, the FSA published a policy statement, *Financial Crime: A Guide for Firms*. This guidance on combating bribery and corruption makes clear that, in the FSA's collective mind, senior company management plays a key role in the anti-corruption process. More specifically, the FSA guidance states that senior management should take "clear responsibility" for managing financial crime risks in the same manner as other risks faced by the business, and that the FSA would look

for "evidence that senior management are actively engaged in the firm's approach to addressing the risks." The FSA makes it clear that it expects to find evidence as to

- senior management, the board or appropriate sub-committees' timely consideration of financial crime issues and actions following discussions;
- senior management's keeping up-to-date on financial crime issues, such as receiving regular reports on the firm's performance in this area, as well as ad hoc briefings on individual cases or emerging threats;
- the motivating factors and rationale behind the firm's efforts on financial crime issues and the outcomes it seeks to achieve;
- senior management's setting the right tone and demonstrating leadership on financial crime issues;
- proactive, rather than reactive steps to prevent criminals from taking advantage of the firm's services; and
- a strategy for self-improvement in policing financial crime.

In both the Willis and Aon cases, the FSA was quite critical of the type and timeliness of management information provided to the board and relevant upper management committees. However, the FSA also appears to have taken the following mitigating factors into account in

setting the fines and allowing a 30 percent early settlement discount:

- The issues, when recognized, were promptly self-reported to the SFO and to the FSA.
- Dedicated internal management committees were established and outside accountants were appointed with overall responsibility for monitoring the systems and controls relating to anti-bribery and anti-corruption.
- Appropriate disciplinary action was taken against employees.
- Outside law firms were engaged to carry out detailed investigations into potentially improper payments.
- New and enhanced systems and controls in relation to anti-corruption and anti-bribery were introduced, including enhanced reporting of relevant management information and better evidence of board and committee involvement and oversight.
- Provision was made for additional training and guidance of employees.

Nevertheless, in addition to fairly substantial monetary penalties, both Willis and Aon clearly incurred considerable additional costs in addressing these issues, both in the expense of outside attorneys and accountants as well as internal management time and distraction from other business. The fines imposed by the FSA demonstrate that it takes quite seriously the requirements for firms to have in place satisfactory management systems and controls and for senior management to ensure that those systems and controls are adequately implemented and monitored at the highest levels. Even for companies in industries other than financial services, the Aon and Willis cases are instructive as to just what anti-corruption procedures may be considered by UK regulators as adequate and expected in well-managed firms.

Raymond L. Sweigart is a partner at Pillsbury Winthrop Shaw Pittman LLP in Washington, D.C.

BUSINESS LAW TODAY

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Injunction Junction, Not Our Function: Court of Chancery Grapples with Enjoining Stockholder Votes on Troubled Transactions

By [Stephen B. Brauerman](#)

While more than 90% of publicly announced mergers face lawsuits from dissatisfied stockholders, obtaining a preliminary injunction to enjoin such transactions remains a tall order. Within the span of one week in February, three different members of the Delaware Court of Chancery each considered expedited challenges to proposed mergers (*In re El Paso Corporation Shareholders Litigation*, C.A. No. 6949-CS (Feb. 29, 2012), *In re Micromet, Inc., Shareholders Litigation*, C.A. No. 7197-VCP (Feb. 29, 2012), and *In re Delphi Financial Group Shareholder Litigation*, C.A. No. 7144-VCG (Mar. 6, 2012)) and—despite facts that led the court to conclude in two cases that serious breaches of fiduciary duty may exist—declined to enjoin the contemplated transaction. Instead, in each instance, the court chose to respect the shareholder franchise and allowed the stockholders to decide for themselves whether to approve the merger. Secure that the combination of monetary damages and appraisal rights would adequately, albeit imperfectly, protect dissenting shareholders, the Court of Chancery refused to enjoin shareholder votes on transactions that offered substantial premiums over pre-announcement market price where no alternative bidders were readily apparent—even in the face of disappointing, if not defective, negotiation processes. Even when faced with troubling circumstances, the Court of Chan-

cery's prompt denial of each of these preliminary injunction motions demonstrates its respect for the shareholder franchise and unwillingness to deprive stockholders of the ability to think for themselves.

As with most equitable remedies, the Court of Chancery has substantial discretion to enjoin a challenged merger. Nevertheless, in order to obtain a preliminary injunction (as set out in the *Micromet* decision), a plaintiff must demonstrate “(1) a reasonable probability of success on the merits at a final hearing; (2) an imminent threat of irreparable injury; and (3) a balance of the equities that tips in favor of issuance of the requested relief.” While a plaintiff must prove each element, “there is no steadfast formula for the relative weight each deserves. Accordingly, a strong demonstration as to one element may serve to overcome a marginal demonstration of another.” *Canter Fitzgerald, L.P. v. Cantor*, 724 A.2d 571, 579 (Del. Ch. 1998). The adequacy of money damages makes it difficult for a stockholder plaintiff to demonstrate the requisite irreparable harm.

El Paso

In considering whether to enjoin the transaction, the Court of Chancery colorfully noted several facts that made the El Paso Corporation board's otherwise “reasonably debatable choices” subject to greater skepticism. First, El Paso's chief

executive officer and primary negotiator did not disclose his interest in leading a post-merger management buyout of one of El Paso's businesses from Kinder Morgan, Inc. In the court's view, “when El Paso's CEO was supposed to be getting the maximum price from Kinder Morgan, he actually had an interest in not doing that.” Second, the El Paso board received conflicted advice from Goldman Sachs, Inc. (which owned 19% of Kinder Morgan and designated two of its directors), and then inadequately cabined the conflict by incentivizing Morgan Stanley, “the conflict-cleansing bank,” to approve the merger since Morgan Stanley would only get paid if El Paso sold to Kinder Morgan. Third, the El Paso board employed a “less than aggressive negotiating strategy” in allowing Kinder Morgan to reduce its bid after threatening a hostile takeover and failed to subject the offer even to a soft-market check. These facts convinced the court, on a preliminary record, that plaintiffs had “a reasonable likelihood of success in proving that the Merger was tainted by disloyalty.”

The court next considered whether El Paso stockholders would suffer irreparable harm if the Kinder Morgan transaction were to proceed. Chancellor Strine first found that the exculpatory provisions in El Paso's charter would make it difficult to recover money damages from El Paso's independent directors, who justifiably

relied on management and the company's financial advisors in making their decisions, and then concluded that El Paso's wealthy CEO could not satisfy estimated post-trial damages in excess of \$500 million. In view of these facts, the court was "willing to accept that the plaintiffs have shown that there is a likelihood of irreparable injury if the merger is not enjoined."

With the first two elements necessary for a preliminary injunction satisfied, the *El Paso* court turned to the "real question"—"whether the court should intervene when the El Paso stockholders have a chance to turn down the Merger at the ballot box." Two factors weighed heavily on the court's mind. First, the Kinder Morgan transaction presented a 37% premium over El Paso's pre-announcement trading price and no rival bid for the company existed. Second (and perhaps in recognition of this fact), the stockholder plaintiffs did not seek a traditional injunction enjoining the shareholder vote. Rather they sought a quasi-injunction that would allow El Paso to shop the transaction, unburdened by any of the deal protection devices in the merger agreement (no-shop, matching rights, and a termination fee of 3.1% of equity value) while retaining the ability to force Kinder Morgan to close at the end of the injunction period if El Paso could not find a better deal. The court observed that the plaintiffs' creative remedy "illustrates that they share the concern I have, which is that an injunction could pose more harm than good" and then held that "[g]iven that the El Paso stockholders are well positioned to turn down the Kinder Morgan price if they do not like it, I am not persuaded that I should deprive them of the chance to make that decision for themselves."

Micromet

Decided on the same day as *El Paso*, Vice Chancellor Parson's decision in *Micromet* exemplifies the court's reluctance to enjoin a shareholder vote and (notwithstanding *El Paso* and *Delphi*) demonstrates that showing a likelihood of success on the merits is a tall order. Micromet, Inc. is an early stage pharmaceutical research and

development company that partners with larger pharmaceutical companies to commercialize and distribute the drugs in its pipeline. To develop one of its products, Micromet entered into a confidentiality agreement with Amgen, Inc., the largest independent biotechnology medicines company in the world. As a result of this partnership, Amgen expressed an interest in acquiring Micromet and, in July, 2011, offered to acquire Micromet for \$9 per share. Micromet's board rejected the offer as inadequate and continued its efforts to partner with pharmaceutical companies to develop its products. In September 2011, Amgen reiterated its \$9 offer, which Micromet again rebutted as inadequate. Amgen raised its offer at the end of October to \$9 per share plus contingent payouts that could net an additional \$3 per share. The Micromet board also rejected this offer as inadequate. On December 21, 2011, Amgen increased its offer to \$10.75 per share. Micromet negotiated this offer and the parties ultimately agreed on a price of \$11 per share—a 37% premium over the one-month volume weighted average stock price for the company. Before signing the merger agreement, Micromet conducted a market check with several pharmaceutical companies, but none of those companies expressed interest in an acquisition.

With the market check complete, Micromet and Amgen entered into a merger agreement that contained several protection devices including a no-solicitation provision, information and matching rights, a termination fee of 4.9% of enterprise value and an amendment to Micromet's rights agreement to exclude Amgen from the company's poison pill, but otherwise leaving the pill in place. Following the merger announcement, six different plaintiffs groups sought to enjoin the transaction. Specifically, plaintiffs' claim that the Micromet board breached its fiduciary duties by favoring Amgen as a bidder, waiting too long to complete any meaningful market check, and agreeing to deal protections that unreasonably shortened the tender offer period and precluded competing bids. The Court of Chancery found that plaintiffs were not likely to succeed on the merits because the scope of the market check was "adequate and consistent with

the Board's well-informed understanding of the industry and Micromet's needs," and the deal protections were not, "at least collectively," preclusive.

Since the stockholder plaintiffs were not likely to succeed on the merits, the court also found that they were not likely to suffer irreparable harm. With the first two preliminary injunction factors absent, the court could have ended its inquiry, but it proceeded to balance the equities, finding they weighed against enjoining the Amgen merger. The court emphasized that the "proposed transaction offers Micromet's shareholders a significant premium over the pre-announcement price of Micromet's stock . . . [and b]ecause no other bidder has emerged during what I have found to be a reasonable sales process, the proposed transaction may represent the shareholders' only and best opportunity to receive a substantial premium for their shares." As a result, the court allowed the stockholders to decide for themselves whether to tender their shares to Amgen.

Delphi

Six days later, Vice Chancellor Glasscock considered a motion to enjoin Tokio Marine Holdings, Inc.'s (THM) acquisition of Delphi Financial Group, Inc. Following its initial public offering, Delphi had two classes of stock: Class A, entitled to one vote per share and held by public stockholders and Class B, entitled to 10 votes per share and held by the company's founder and chief executive officer, Robert Rosencrantz and his affiliates. Although Rosencrantz owned less than 13% of the company's outstanding equity, he controlled approximately 49.9% of the voting power of the company. In connection with the IPO, Rosencrantz agreed to amend the company's charter to require the conversion, upon a sale of the company, of Class B stock to Class A stock, so that Rosencrantz's Class B stock would receive the same consideration upon a merger as would the company's Class A stock. This essentially gave Rosencrantz a non-transferable veto right over any action requiring stockholder approval. Prior to the IPO and during the entire course of its existence, Delphi purchased investment advisory ser-

vices from certain entities owned by Rosencrantz (the Management Contracts). The Management Contracts were terminable by either party upon 30-days notice and were fully disclosed at all relevant times.

TMH, through its investment banker, approached Rosenkranz about acquiring Delphi. Although Rosenkranz expressed his belief that Delphi was not for sale, he agreed to report TMH's interest to Delphi's board. The board discussed TMH's interest and Rosencrantz suggested that a deal at \$45 to \$60 per share might be attractive to stockholders. Notwithstanding the charter's prohibition of disparate consideration for Class B stockholders, Rosencrantz began discussing with Delphi management how he could maneuver around the charter provision and obtain a control premium for his Class B stock. Rosenkranz did not advise the board of these discussions until the middle of September.

On September 7, 2011, TMH offered to acquire Delphi at a price between \$33 and \$35 per share (then a 50% to 59% premium over Delphi's market price). Rosenkranz expressed disappointment with this range and suggested a range of \$45 to \$60 per share might work, even though Rosenkranz was unwilling to sell his Class B stock for \$45 per share. In response, TMH raised its offer to \$45 per share (a 106% premium). Rosenkranz presented this offer to the board, advising that as a controlling stockholder he viewed it as inadequate and was unlikely to approve it. Rosenkranz suggested that the board form a special committee to evaluate the TMH proposal and direct negotiations. The special committee retained its own legal and financial advisors and created a sub-special committee to discuss Rosenkranz's demand for disparate consideration to approve the merger.

After determining that Rosenkranz would torpedo the deal if he did not receive a control premium for his Class B stock, the sub-special committee negotiated vigorously to obtain the best deal on disparate consideration. Ultimately, the sub-special committee succeeded in convincing Rosenkranz to accept \$53.875 for each share of Class B stock (down from \$59 per share) and \$44.875 for each share

of Class A stock. During these negotiations, Delphi continued to negotiate with TMH, ultimately extracting a one dollar pre-closing dividend, which effectively raised the merger consideration to \$46 per share. To avoid disrupting the momentum with TMH, the special committee decided to leave Rosenkranz as the company's primary negotiator, albeit with close supervision from the special committee's financial advisor. With the price set, the parties agreed to condition the merger on stockholder approval of a charter amendment that would allow Rosenkranz to receive the disparate consideration.

In an effort to extract more value from the deal, Rosenkranz attempted to sell to TMH the entities providing services under the Management Contracts for \$57 million. In the end, he convinced TMH to agree to keep the Management Contracts in place for five years. Upon learning of this side-deal the sub-special committee convinced TMH and Rosenkranz to repudiate their side-deal and obtained representations that no other agreements between Rosenkranz and TMH existed, other than those set forth in the transaction documents.

In spite of the more than 100% premium offered by the transaction, plaintiffs sought to enjoin the stockholder vote on the merger because the board and Rosenkranz breached their fiduciary duties in approving differential consideration for the Class B stockholders, allowing Rosenkranz to dominate the negotiation process, and allowing Rosenkranz to funnel money to himself through the Management Contracts, which depressed Delphi's stock. The plaintiffs also challenged the process that the special committee and sub-special committee used to reach the disparate merger price with Rosenkranz.

Although the court recognized troubling aspects of Rosenkranz's conflicting roles and the side agreement with TMH, it found plaintiffs would not likely succeed in their challenge to the process by or price at which the TMH transaction would occur or to the side deal relating to the Management Contracts on the basis of disparate consideration for Rosenkranz. The court was, however, persuaded that plaintiffs would succeed on their claim

that "despite a contrary provision in the Delphi Charter, Rosenkranz in breach of his contractual and fiduciary duties, sought and obtained a control premium for his shares, an effort that was facilitated by the Executive and Director Defendants." The court observed that "though Rosenkranz retained voting control [following the IPO], he sold his right to a control premium to the Class A stockholders via the Charter. The Charter provision, which prevents disparate consideration, exists so that if a merger is proposed, Rosenkranz cannot extract a *second* control premium for himself at the expense of the Class A stockholders." (Emphasis in original.)

The court next considered whether these breaches would expose plaintiffs to irreparable injury, concluding that Rosenkranz's breaches of fiduciary and contractual duties could easily be remedied by an award of money damages, enforceable through disgorgement of proceeds received from the transaction. The court also found that the balance of the equities counseled against an injunction. Citing *El Paso*, Vice-Chancellor Glasscock concluded that the opportunity to obtain a substantial premium through a single-bidder merger was too great to deprive the stockholders of a vote, notwithstanding Rosenkranz's questionable behavior. As the court explained, "[t]he price offered by TMH for the Class A shares, even though less than what Rosenkranz will receive in the Merger, is 76% above Delphi's stock price on the day before the Merger was announced. No party has suggested that another suitor is in the wings or is likely to be developed at a greater, or even equal price."

Conclusion

The *El Paso*, *Mircomet*, and *Delphi* decisions each demonstrate the Court of Chancery's reluctance to deprive stockholders of the chance to vote themselves on a cash-out transaction that represents a substantial premium to each company's pre-transaction trading price—even where the court has serious concerns (at least in *El Paso* and *Delphi*) about the process that led to the transaction. The court expressed confidence in the availability of money damages and the appraisal statute to

adequately protect stockholders, making injunctive relief unnecessary. Most importantly, these cases demonstrate the court's reluctance to deprive stockholders, even at their own request, of the opportunity to sell at a substantial premium where no alternative transactions or even competing bidders appeared likely to emerge. Stockholders (and not the court) should decide at the ballot box whether to approve an economically intriguing, but procedurally flawed transaction, that but for fiduciary misconduct (potentially remedied by a post-merger award of money damages), might have yielded an even higher return for stockholders.

Stephen B. Brauerman is an attorney at Bayard P.A. in Wilmington, Delaware specializing in corporate and intellectual property litigation. The views expressed herein are the author's own, and do not necessarily represent the views of Bayard P.A. or its clients.

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Ashley N. Wicks

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awicks@joneswalker.com

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Editor

John Palmer

ABA Publishing Periodicals
American Bar Association
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