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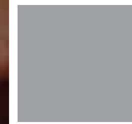

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In This Issue

Welcome to the first issue of *International News* for 2011. The focus for this issue is international restructuring.

We start with a look at how asset-based lending could be a suitable alternative to restructuring for some companies. Asset-based lenders impose rigorous collateral reporting requirements but require fewer financial covenants than commercial banks, making them a potentially attractive option.

Many tax jurisdictions do not have detailed internal regulations or other internal rules concerning transfer pricing and how it applies to business restructurings. Instead, countries rely upon the Transfer Pricing Guidelines for Multi-National Enterprises and Tax Administrations published by the Organisation for Economic Co-Operation and Development (OECD). On 22 July 2010, the OECD amended its Guidelines to adopt, for the first time, rules applicable to business restructurings. We review the Guidelines and their implications.

Despite the existence of carefully constructed intercreditor agreements, in a default situation, junior debt classes are increasingly instigating a dispute by challenging the established order in the capital structure. We examine how this is possible and the reaction of the US courts.

There have been developments in the application of Chapter 15 of the US Bankruptcy Code that affect the ability of debtors subject to foreign insolvency proceedings to receive assistance to protect and administer their property located in the United States. If a recent US court decision is upheld, it will re-open the door for Chapter 15 filings for funds and other offshore investment vehicles. Staying with the subject of aid, in the European Union, State subsidies may only be granted under strict conditions, but, despite its limitations, the State aid regime offers opportunities for the company, investors and competitors to profit from State subsidies and to emerge from the restructuring stronger than before.

In Italy, the enactment of Legislative Decree No. 78, dated 31 May 2010, has had the effect of shielding restructuring agreements and related financing from the negative consequences of bankruptcy. This has made the Italian restructuring market more attractive not only to Italian and international investors but for cross-border restructurings in general.

In Germany, the restructuring of companies or groups in financial crisis is subject to significant tax risks. We examine those risks and suggest that a debt-mezzanine-swap may not trigger negative tax consequences. In addition, in our online version of *International News* we include an examination of reforms to the German Insolvency Code. These will provide an excellent environment to acquire and restructure a business via the equity and/or the debt side.

Finally, poor communication with employees, the community, suppliers and customers can generate criticism and misinformation that in turn foster resistance, undermine commitment and jeopardise the entire restructuring plan. We outline methods for communicating efficiently with key stakeholders.

In our features section we highlight the European Commission's draft regulation establishing transitional arrangements for bilateral investment treaties (BITs) between EU Member States and third countries. We examine how the potential regulation will affect existing BITs and the management of disputes relating to them.

On 12 February 2011, the Office of the State Council of China announced the formation of a state-level investment body to review China-based mergers and acquisitions deals that involve non-Chinese firms. Many now question whether the Chinese Government will be as aggressive in prohibiting non-Chinese investors as the US Government has been in its treatment of Chinese investors.

We then review some key issues relating to tax. Non-US businesses often assume mistakenly that state tax consequences are the same as the federal income tax consequences. There are, however, key differences between state and federal income taxation of non-US corporations, so non-US businesses should consider carefully the potential state income tax consequences of any US business operations.

Finally, after more than five years of speculation, consultation and legislation, the UK Government has published details of interim reforms to the controlled foreign company rules that it intends to enact in 2011. We take a look at the reforms and their possible impact.

If you have any comments on this issue or would like to contribute to *International News*, please contact me at hnineham@mwe.com.

Hugh Nineham
Partner & London Office Head

Asset-Based Lending: An Alternative to Restructuring

By **Gary Rosenbaum** and **Adam Spiegel**

The turmoil that rocked many commercial banks during the most recent recession should serve as a warning sign to savvy borrowers that they must be proactive and explore new financing opportunities, not only to address their own credit issues, but also to avoid potential problems with their existing lenders.

As profitability suffers and the headroom under financial covenants tightens, many companies are realising that the asset-based lending paradigm provides access to credit at a time when it may no longer be available from their existing lenders and other traditional commercial bank sources. The results of the Commercial Finance Association's Quarterly Asset-Based Lending Index shows that new credit commitments among asset-based lenders increased by 13.2 per cent in the fourth quarter of 2010. The recent growth in commitments issued by asset-based lenders demonstrates not only that lenders are loosening their purse strings, but that many leveraged borrowers have identified asset-based loans as a viable alternative and are availing themselves of these opportunities. The inertia of remaining with an existing bank relationship may be hard for a borrower to overcome, but the risk of being reluctant to switch lenders may be that the borrower finds itself without any options other than a bankruptcy or other means of liquidation.

> "New credit commitments among asset-based lenders increased by 13.2 per cent in the fourth quarter of 2010."

Historically, commercial banks regularly took advantage of pending defaults to transfer borrowers to their workout groups and used actual defaults as an excuse to charge additional fees or terminate their relationships with existing borrowers. Today, as commercial banks are faced with greater regulatory oversight and stricter internal underwriting policies, there is increased pressure to take speedy action against non-performing borrowers.

Asset-based loans provide private equity sponsors and companies with an alternative to traditional commercial bank lending, serving borrowers with risk characteristics that typically fall outside a commercial bank's comfort level. An asset-based lender makes a loan with the goal of ensuring that the assets of its borrower, measured at a percentage of their liquidation value, will be sufficient to repay that loan regardless of that borrower's profitability. Therefore, asset-based lenders make loans based primarily on the value of their borrowers' assets, as opposed to their borrowers' financial condition. While commercial banks look first to the borrowers' cash flow for repayment and then to the

borrowers' assets, asset-based lenders will look primarily to the assets. As a result, asset-based lenders require fewer financial covenants but impose more rigorous collateral reporting requirements.

> Asset-based lenders require fewer financial covenants but impose more rigorous collateral reporting requirements.

The structure of an asset-based loan begins with the grant by a borrower of a security interest in all of its assets or, in some cases, solely in its accounts receivable or inventory as collateral for the loan. The asset-based lender will construct a borrowing base for the borrower corresponding to the lender's analysis of its likely recovery on the receivables and inventory. As receivables are paid, the borrower turns the cash over to the lender to pay down the outstanding loan balance. When the borrower needs additional working capital to make payments to its employees, vendors or other parties, the borrower requests an advance from the lender. The principal advantage of the asset-based loan for the borrower is that it is able to accelerate its cash flow to support its immediate working capital needs. The borrower does not have to wait for inventory to be sold to create an account receivable and then for the account receivable to be paid.

Asset-Based Loans

A typical asset-based loan will include a borrowing base formula, collateral reporting and collection control.

Borrowing Base

A borrowing base is a formula generally composed of a percentage of a borrower's eligible accounts receivable and inventory. The borrowing base provides the lender with the comfort of knowing that the outstanding loan balance correlates directly to, and at no time will exceed, the value of the collateral for the credit facility. For a borrower that is dealing with fluctuations in operating results during the sluggish economic recovery (or as a result of its natural business model) but owns a steady flow of current assets (*i.e.*, accounts and inventory), an asset-based loan will be attractive because the lender is likely to require a less onerous financial covenant package because of its strong position with respect to the borrower's collateral. The amount of borrowing capacity under the asset-based line of credit will be limited by the maximum amount of the line and the company's current borrowing base calculation.

In determining a borrower's advance rate against eligible accounts receivable, the lender will take into account the historical dilution of the company's accounts receivable. In this context dilution covers all of the factors that might reduce the value of the receivables, including discounts, advertising allowances, credits and return items. The asset-based lender applies the accounts receivable advance rate against the amount of the company's eligible accounts receivable.

While the liquidation of accounts receivable generally produces a yield that is fairly close to their face value, the results of a liquidation of inventory are more difficult to predict. A lender's realisation in a liquidation of inventory is based on the stage of the inventory (*i.e.*, raw materials, work in progress (WIP) or finished goods) and the type of inventory (*e.g.*, one would not expect VCR machines to have an advance rate as high as DVR machines). Most asset-based lenders evaluate the type of inventory collateral on which they are being asked to make advances and, in most instances, engage an appraiser to estimate the liquidation value in order to ascertain the appropriate advance rates for raw material, WIP and finished goods inventory, and to adjust the categories of ineligible inventory on a deal-by-deal basis.

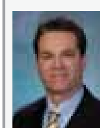
Collateral Reporting

As a result of the asset-based lender's focus on the value of the assets of its borrower, any company that intends to enter into an asset-based loan facility should expect to provide its lender with detailed information about its accounts receivable and inventory as well as its overall operations and performance. The intensive reporting requirements of asset-based lenders buttress the lenders' belief in the quality of their collateral and enable them to make available larger credit facilities to their borrowers.

Collection Control

Asset-based lending relies on a cash management system that manages the flow of collections as a means of paying down the outstanding loan balance on a regular basis. The lender looks to the cash management system to minimise the outstanding loan risk and to perfect its security interest in the borrower's deposit accounts and the funds on deposit in those accounts. In an asset-based financing, the borrower trades the loss of its ability to control cash collections for the benefit of a system that reduces idle cash and interest expense.

The recent recession has highlighted how tenuous the relationship can be between a non-performing borrower and its commercial bank lender. But before the relationship devolves into a bankruptcy or liquidation, borrowers should consider the asset-based loan, not as a panacea, but as an initial step in its restructuring strategy. Make no mistake, the increased collateral reporting requirements and full dominion of a borrower's cash flow by the asset-based lender are likely to surprise the company that is used to complete freedom in managing its business. However, the alternative for a non-performing borrower may be even less attractive.



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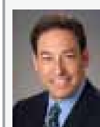

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New OECD Tax Guidelines Applicable to Business Restructurings

By **Steven Hannes**

Tax authorities have perceived recently that international corporate groups are going through internal business restructurings in large part or in whole to achieve income tax savings. Authorities believe that the restructurings are intended to justify changes in how much one affiliate charges the other for goods, services or intangibles and thereby reduce taxes. In reality, the restructurings can be motivated by a desire to maximise synergies or economies of scale, to achieve greater efficiencies, or to protect profitability or limit business losses.

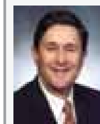
At the same time, multinational corporations do take into account income tax savings in restructuring their operations or their intercompany transactions and, in some cases, the savings are achieved by way of changes in transfer pricing. There is, however, nothing inappropriate in this behaviour as long as there is substance to the transactions and certain other requirements are met.

Many tax jurisdictions do not have detailed internal regulations or other internal rules concerning transfer pricing generally or how it applies to business restructurings. Instead, it is common for countries to rely upon the Transfer Pricing Guidelines for Multi-National Enterprises and Tax Administrations published by the Organisation for Economic Co-Operation and Development (OECD). On 22 July 2010, the OECD published a report on the transfer pricing aspects of business restructurings and amended its Transfer Pricing Guidelines to adopt, for the first time, rules applicable to business restructurings. Many countries will now rely upon these business restructuring rules. Among the targets of the new rules are circumstances where intangibles or risks are reallocated among affiliates such as manufacturers or distributors. The downsizing or closing of operations can also be considered a restructuring within the scope of the new Guidelines.

> "Many countries will now rely upon these business restructuring rules."

While the Guidelines acknowledge that taxpayers have the right to organise their business affairs, they advise tax authorities to look closely at a number of factors in restructurings. The tax authorities may argue for an unexpected triggering of income, the loss of deductions or other adverse tax consequences. Among the factors the tax authorities may examine is whether the conduct of the affiliates conforms to the provisions of their intercompany contracts. Thus, it is important for corporate groups to choose the right business and tax strategy, have a contract with supporting terms and conditions, and implement these strategies in a manner consistent with what the contract provides. In examining whether two affiliates have moved intangibles or allocated risks in an acceptable fashion, these Guidelines focus on matters such as whether the allocation is one that might be expected to have been agreed upon between totally independent entities in similar circumstances. The Guidelines ask whether one party or the other has greater control over the risks or intangibles, and whether the party to which risks are allocated has the financial capacity to assume them.

With these amendments to the Guidelines, the business community and tax authorities in many countries have been given, for the first time, rules addressing when there might be and when there should not be income tax benefits or difficulties associated with their business restructurings. With the new Guidelines in place, taxpayers have been given insights into how to address their intra-group changes in ways that will achieve their intended business and tax objectives. Although the new rules may cause certain governments to increase their scrutiny of the income tax ramifications of business restructurings, well-advised taxpayers should be able to go forward with their business restructurings and achieve the intended tax outcomes.



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Imposing Hierarchy in Intercreditor Relations

By **Nathan Coco**

It has become common in financings for companies to utilise a capital structure with multiple layers or tranches of debt. Sitting atop the creditor hierarchy is the senior secured debt. Below, there may be one or more layers of junior subordinated debt, such as second lien, mezzanine or convertible debt. The multiple tranches of debt serve the purpose of dividing and allocating risk, and the allocation of that risk drives the financing terms and expected rate of return for the various debt holders.

The creditor hierarchy is most often effected through an intercreditor or subordination agreement. The agreement is typically one of the most carefully and thoroughly negotiated documents in a financing transaction and is intended to eliminate intercreditor disputes in the event of financial distress. Despite the agreement, in a default situation, junior debt classes are increasingly instigating a dispute by challenging the established order in the capital structure.

> "The multiple tranches of debt serve the purpose of dividing and allocating risk."

Intercreditor Agreements and Claim and Lien Subordination

An intercreditor agreement can provide for either claim subordination or lien subordination. Claim subordination generally requires senior debt to be satisfied in full before junior debt holders receive payment and requires junior debt holders to turn over to the senior debt holders any payments received from the borrower in the event of a default. Lien subordination subordinates the rights of junior creditors only with respect to collateral that is shared with the senior debt.

Standard claim subordination and lien subordination arrangements between senior debt holders and junior debt holders are enforceable under Section 510(a) of the US Bankruptcy Code: "[a] subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law." However, intercreditor agreements in complex financing structures often include provisions that purport to waive various bankruptcy-related rights and protections of junior debt holders. For example, junior debt holders may assign to the senior debt holders their right to vote on any Chapter 11 plan or, amongst other things, may waive the following rights:

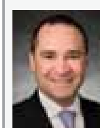
- To challenge the validity or priority of the senior debt holders' liens or claims
- To object to the terms of any debtor-in-possession financing provided by the senior debt holders to the borrower in bankruptcy
- To object to the debtor's use of cash collateral if the senior debt holders consent to such use
- To object to any adequate protection sought by the senior debt holders and waive the right to seek adequate protection themselves
- To seek the reimbursement of administrative expenses from the debtor
- To contest any motion by the senior debt holders to seek relief from the automatic stay to proceed against the senior debt holders' collateral
- To object to the sale of collateral if the senior debt holders consent to such sale
- To seek conversion of dismissal of the bankruptcy case or a conversion of the bankruptcy case from a Chapter 11 reorganisation to a Chapter 7 liquidation

The Courts' Response

Some bankruptcy courts hold that a subordination agreement may govern priority and distribution but not otherwise supersede fundamental bankruptcy rights. Others have upheld certain waivers of bankruptcy rights and protections in intercreditor agreements—including the right to vote on a Chapter 11 plan—to the extent that they are otherwise enforceable under applicable nonbankruptcy law (*i.e.*, state contract law).

> "Intercreditor agreements have come under attack in US bankruptcy cases."

The conflict in the reported case law authorities has created some uncertainty and has perhaps encouraged some junior debt holders to challenge intercreditor waivers and restrictions in bankruptcy. However, the recent trend among courts adjudicating such disputes has been to enforce intercreditor agreements, consistent with the parties' expectations at the outset of the financing transactions.



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Chapter 15 Recognition in the United States: Recent Developments

By **Geoffrey Raicht** and **Nava Hazan**

Chapter 15 of the US Bankruptcy Code enables debtors that are already subject to a foreign insolvency proceeding to receive assistance from US courts in order to protect and administer their property located in the United States. Whether a foreign debtor is eligible to receive all, some or none of the ancillary assistance provided for under Chapter 15 turns on the bankruptcy court's legal and factual determination of whether the foreign insolvency proceeding is a "foreign main" or "foreign non-main" proceeding.

This issue requires the bankruptcy court to determine where the foreign debtor has its centre of main interest (COMI). If the debtor has its COMI in the country where the foreign insolvency proceeding is pending, the matter qualifies as a "foreign main" proceeding, which triggers certain beneficial and automatic protections for assets located in the United States. If the debtor's COMI is not in the country where the foreign insolvency proceeding is pending, but the debtor has an "establishment" in that country because it conducts non-transitory economic activity there, the proceeding may qualify as a "foreign non-main" proceeding. This would permit the bankruptcy court to grant the debtor—on a discretionary basis—many of the same protections granted to a debtor in a foreign main proceeding. If a debtor's underlying insolvency case is determined to be neither a foreign main nor foreign non-main proceeding, the debtor may be denied access to the protections of Chapter 15.

> "The bankruptcy court granted the petition because the debtors' COMI had shifted to the BVI."

Such was the case for Bear Stearns' offshore feeder funds when they sought the protections of Chapter 15 in 2007. In a controversial decision, the US Bankruptcy Court for the Southern District

of New York determined that Bear Stearns' Cayman Island insolvency proceedings (which commenced on the same day as the liquidators filed their petition for Chapter 15 recognition) could not qualify as either a foreign main or foreign non-main proceeding. The bankruptcy court found that the funds' COMI was located in the United States because the funds had no employees in the Cayman Islands, all of the funds' assets were located in the United States, and the funds' asset manager was located in the United States. For an offshore investment vehicle, these facts are common and the decision questioned whether any similarly structured fund could ever be eligible for Chapter 15.

Testing Availability

Until the recent global financial crisis, few funds had been willing to re-test the availability of Chapter 15 to offshore funds. However, at least one such fund has recently attempted to gain access to Chapter 15 under the theory that—prior to filing any petition for Chapter 15 in the United States—the foreign debtor's COMI had shifted from its traditional location to the jurisdiction where the liquidator was conducting a court-supervised wind up. In *In re Fairfield Sentry Ltd.*, the US Bankruptcy Court for the Southern District of New York held specifically that a foreign debtor's COMI could shift to the country where the foreign insolvency proceeding was located.

> At least one such fund has recently attempted to gain access to Chapter 15.

The debtors in *Fairfield* invested in Bernard L. Madoff Investment Securities LLC for clients who were non-US persons or certain tax-exempt entities. The debtors were organised as an International Business Company under the laws of the British Virgin Islands (BVI) but were managed by a New York-based management company and held assets in the United States.

In December 2008, the debtors learned of the fraud committed by Madoff and discontinued the transfer of funds to New York to be invested by their manager. The board of directors of the debtors' management company resigned shortly thereafter and the debtors subsequently terminated their contract with the management company in 2009. During this period, the debtors were managed by an independent committee composed of non-US directors and held meetings by telephone from the BVI.

> Offshore investment funds may finally be permitted to access courts in order to protect their assets.

In July 2009, liquidation proceedings were initiated against the debtors before the Commercial Division of the High Court of Justice of the British Virgin Islands, and liquidators were appointed to administer the debtors' assets. The liquidators controlled the winding down of the debtors' affairs from the BVI, relocated the debtors' books and records to the BVI, had resident employees and offices in the BVI, and collected assets in the BVI.

In June 2010, 11 months after the commencement of the BVI liquidation, the liquidators filed a petition for Chapter 15 recognition as a foreign main proceeding. The bankruptcy court granted the petition because the debtors' COMI had shifted to the BVI as a result of the actions taken by the liquidators in administering the BVI Liquidation.

Although this decision is on appeal, if upheld, offshore investment funds may finally be permitted to access courts in order to protect their assets located within the jurisdiction of the United States.

Questions Raised

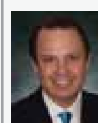
The *Fairfield* decision raises several questions that may be answered by appellate courts or by other funds seeking the relief provided by a Chapter 15 filing.

First, will courts develop a "bright line rule" as to when a COMI shifts after the initiation of foreign insolvency proceedings? If not, what steps will foreign liquidators need to take in order to determine that COMI has in fact shifted and whether it is in the best interests of their stakeholders to seek Chapter 15 relief?

Second, if the COMI can shift, what types of acts will bear a greater risk that such a shift is interpreted to have been made in bad faith or was orchestrated to intentionally obtain Chapter 15 recognition (a strategy the *Fairfield* court clearly condemned)?

While these and other questions must be addressed over time, there is little doubt that the *Fairfield* decision, which recognised that a fund's COMI may shift as a result of the activities of its court-appointed liquidator, will, if upheld, re-open the door for Chapter 15 filings for funds and other offshore investment vehicles.

The authors would like to thank Jared Zajac for his assistance in preparing this article.



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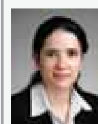

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State Aid Regime for Restructuring Companies in Europe: Limits and Opportunities

By Martina Maier and Philipp Werner

In the European Union, State interventions in the market in the form of subsidies or other economic advantages are generally prohibited, but companies can receive aid from Member States if the aid is approved by the European Commission. State subsidies may only be approved under strict conditions. In fact, for firms in difficulties, the only available form of aid is "rescue and restructuring aid". Companies must close unprofitable operations, bear up to 50 per cent of the restructuring costs and divest important parts of their business in order to be eligible for restructuring aid.

Despite its limitations, the State aid regime offers opportunities for the restructuring company, investors and competitors to profit from State subsidies and to emerge from the restructuring stronger than before.

The EU Framework

In its Rescue and Restructuring Guidelines, the European Commission has indicated under which conditions it would approve such aid. While rescue aid allows the short-term survival of a company, restructuring aid should ensure sound mid- and long-term endurance. A company must fulfil certain criteria in order to be eligible for restructuring aid:

- It must be a firm in difficulties.
- It must implement a restructuring plan.
- It must take compensatory measures in order to ensure that the restructuring aid does not lead to undue distortions of competition.
- It must make its own contribution to the restructuring costs.

Individuals running or investing in a firm in difficulty should familiarise themselves with these guidelines. The Rescue and Restructuring Guidelines seem rigid and lay down very harsh conditions compared to other jurisdictions where States may grant subsidies. However, restructuring aid will be the last resort, so a firm in difficulty must apply the Commission's guidelines. For competitors, potential market entrants and investors, the system provides the chance for takeovers and, possibly, rewarding investment opportunities.

> "The State aid regime offers opportunities for the restructuring company, investors and competitors."

Firm in Difficulty

In order to qualify for restructuring aid, the beneficiary business must be a "firm in difficulty". This means that the firm must be unable—whether through

its own resources or with the funds it is able to obtain from its owners, shareholders or creditors—to stem the losses that would condemn the firm to leaving the market in the short or medium term. Applying for public money must be its last resort.

A firm is regarded as being in difficulty if one of the following "hard criteria" is fulfilled: more than half of its capital has gone and more than one quarter of the capital has been lost over the preceding 12 months, or the company fulfils the insolvency criteria under the law of the Member State where it is registered. In addition, a firm may also be considered a firm in difficulty if the "usual signs", such as increasing losses, diminishing turnovers or a decline in cash flow, are present. New firms, *i.e.*, firms that have been in business in the relevant field for less than three years, are not eligible for restructuring aid.

Firms that are part of a group are only eligible for restructuring aid if the difficulties are intrinsic (not the result of an arbitrary allocation of costs within one group) and if the difficulties are too serious to be dealt with by the group itself. Restructuring aid may not be granted if the shareholders of the group are in a position to keep the company in business.

> "A firm in difficulties may only receive rescue and restructuring aid."

Whether or not a company is a firm in difficulties has dramatic consequences for the type of State subsidies it may receive under EU law. A firm in difficulties may only receive rescue and restructuring aid. No other subsidies may be approved and the company may not benefit from any aid scheme, even if the European Commission has already approved the scheme.

Restructuring Plan

The first step is to work out a sound restructuring plan, as this lies at the heart of the restructuring and must be endorsed by the Commission. The plan must describe the circumstances that led to the difficulties and set out how the firm's long-term viability will be restored. The restructuring must be achieved by internal measures that are sustainable.

Normally, the restructuring must include the abandonment of activities that would remain structurally loss-making even after the restructuring. The company must be able to cover all its costs and have an expected return in capital to enable the restructured firm to compete on the market on its own merits. This may be very painful for the company, but it is a necessary, albeit not sufficient, part of the restructuring. The success of the restructuring must be established by a simulation of the future development of the market in which the firm is active. It is important not to protract the restructuring period, as the European Commission would not approve this.

Own Contribution

The amount and intensity of the restructuring aid must be limited to the minimum of the costs that are necessary to enable the restructuring to go ahead. The company must also make a significant contribution to the restructuring plan from its own resources. The own contribution requirement can be up to 50 per cent, depending on the size of the firm. The own contribution must be entirely aid-free, *i.e.*, it may not be financed through other subsidies.

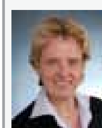
This is of particular interest to potential investors in firms that face difficulties. Financial investments by private investors may be considered as "own contribution" and are seen as evidence by the Commission that the market believes in the return of the firm. In return, investors can obtain the firm's or its shareholders' assets as securities for the investment. When investing in a firm in difficulty, investors may at the same time implement a restructuring plan and receive State subsidies for the firm. Overall, this may be a beneficial investment for an investor.

Compensatory Measures

State aid is seen in the European Union as distorting competition, and restructuring aid in particular must be compensated adequately to minimise the distortion. Although cases are assessed on an individual basis, compensatory measures are compulsory. There are three possible forms of such measures: reductions in the firm's capacity or market presence, divestment of assets, or reduction of entry barriers on the market concerned.

The necessary compensatory measures may be considerable. For example, when approving the restructuring of banks after the recent financial crisis, the European Commission required some banks to divest up to 50 per cent of their balance sheet or to divest a profitable business unit. The restructuring company must carefully consider its options and offer the right compensatory measures that will secure the Commission's approval and will still allow it to prosper in the medium and long term.

The acquisition of assets divested by a restructuring company as a compensatory measure can thus be a chance for competitors to expand their business, or an opening for companies that would like to enter the market.



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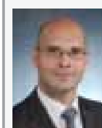

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The Development of Restructuring in Italy

By **Filippo Mazza**

Since 2005, pushed by the insolvencies and rescues of large Italian corporations such as Parmalat, Cirio and Alitalia, the Italian legislature has introduced effective tools aimed at preserving the debtor's assets and ensuring the successful reorganisation of a debtor's business to the benefit of all the parties involved. The enactment of Legislative Decree No. 78, dated 31 May 2010, has strengthened this approach even more by making the Italian restructuring market more attractive not only to Italian and international investors but for cross-border restructurings in general.

These newly reformed restructuring procedures are preventative composition with creditors and restructuring agreements pursuant to Article 182-*bis* of the Bankruptcy Law. In addition, more private out-of-court restructurings are being implemented through Article 67(3)(d) of the Bankruptcy Law (Article 67).

Common Features of Italian Restructuring Procedures

Certain features are common to all Italian restructurings, including debtor's control over the business under the court's supervision and prevention of claw-back actions against transactions performed in compliance with the approved plan. Other features, such as stay of third-party actions upon filing, apply only to court-based restructuring procedures (the preventative composition with creditors and procedure under Article 182-*bis*).

> If the court finds the debtor's restructuring plan unfeasible, the court may reject it.

Pursuant to article 48 of Decree 78/2010, restructuring agreements provide an additional shield to lenders willing to provide rescue or interim financing to a distressed Italian company:

- Financing from banks and intermediaries granted in the implementation of the plan of restructuring (including those granted to meet the requirements set for the above-mentioned procedures) will be paid off fully.
- Shareholder loans and intra-group loans granted for the implementation of the same plan will also be paid off up to 80 per cent.
- The stay of all creditors' motions for injunctions or foreclosures against the debtor can now be extended to the phase of negotiation if the debtor files a proper motion in compliance with Article 182-*bis*.

The New Preventative Composition with Creditors

The court-supervised regulation provided for the preventative composition with creditors procedure has elements in common with the United States' Chapter 11 reorganisation process. As in the United States, the process in Italy commences with the debtor filing a restructuring proposal with the court. The court then examines the proposal alongside an expert opinion as to the feasibility of the debtor's plan. The outcome of the procedure depends on the acceptance of the plan by the creditors holding the majority of the debt. Importantly, this approval binds all creditors, including those that rejected the plan. The supervisory powers of the court relate to any transaction outside of ordinary course of business, any major settlement and any payment of any pre-petition claim.

If, upon filing the proposal, the court finds the debtor's restructuring plan unfeasible, the court may reject it, even if the majority

of creditors voted in its favour. In this case the court, following a motion from the debtor, a creditor or the public prosecutor, may, if the requirements are met, declare the debtor bankrupt. This causes, *inter alia*, the debtor to lose control over the company and liquidate all assets to creditors according to priority.

The debtor may split creditors into different classes and then differentiate the economic treatment for each class. However, the classification of creditors cannot alter the priority treatment provided by law, and the court must supervise the lawfulness of any classification.

Secured creditors cannot vote on the plan unless the proposal provides for a partial payment of their secured liabilities. In this case, they could vote for the portion of such liabilities that will not be paid.

Similar to the US "cram-down" procedure, the court may approve the plan even if the majority in one or more classes of creditors have rejected it, provided that the majority of the classes overall accepted the plan and the court finds that the dissenting creditors would receive an amount not less than the amount they would receive under any other practicable alternative.

Restructuring Agreements Under Article 182-*bis*

Article 182-*bis* provides that the company may negotiate and execute out-of-court plans of reorganisation with creditors holding not less than 60 per cent of claims (including intra-group loans). Once agreed, the plan can be filed with the Companies' Register and with the bankruptcy court. The filing must include a report by an independent expert (appointed by the company) to certify the feasibility of the agreement to ensure the regular payment of those creditors that did not adhere to or were not parties to the plan.

Upon filing in the Companies' Register and for as long as 60 days, Article 182-*bis* shelters the debtor from any third-party action, whereas creditors have 30 days to file an opposition with respect to the debtor's plan. After the filing, the court examines the proposed plan. If approved, the debtor files the court-approved plan with the Companies' Register.

Article 182-*bis* is generally used by companies with a small number of creditors holding a significant piece of its debt. The limited number of creditors helps the negotiation with each creditor.

This procedure became more appealing in 2009, after *Risanamento*. Risanamento, an Italian real estate company, filed a restructuring agreement under Article 182-*bis* during an already initiated (though not yet concluded) bankruptcy procedure. The court held that the filing under Article 182-*bis* cannot prevent or stop, *per se*, a bankruptcy petition. However, even though a petition for bankruptcy was already filed, the court held that parties must await the outcome of the Article 182-*bis* procedure, favouring Article 182-*bis* over the other bankruptcy proceedings.

The Out-of-Court Procedure Under Article 67

Article 67 allows for an out-of-court settlement and agreement with creditors.

Creditors are often cautious about dealing with companies on the verge of insolvency because of the risk that any payments they receive might be "clawed back" by the debtor after a formal insolvency process is commenced. Pursuant to Article 67, any transactions, payments and issuances of securities relating to a company's assets cannot be subject to claw-back actions, if compliant with a restructuring plan approved by an independent expert. However, the company cannot prevent the filing of other bankruptcy petitions or claims by interested parties.

Generally, because of its private nature, an agreement is reached only with the company's financial creditors, whereas employees and unsecured creditors are usually paid in full. As a mere claw-back shelter, the settlements will not abide by any mandatory priority scheme imposed by law.

Impact on the Italian Restructuring Market

The reform of the Italian restructuring rules has proved to be very useful. All sound restructuring agreements as well as all related financing are now considered shielded from the negative consequences of a bankruptcy procedure.

The preventative composition with creditors has proved to be more useful when the financial distress is more serious, the main reasons being the immediate stay of the executive actions, the debt-discharge against all company creditors and the absence of a duty to pay off a certain percentage of claims.

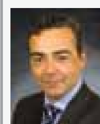
"All sound restructuring agreements are now shielded from the negative consequences of a bankruptcy."

The debtor's general use of Article 182-*bis* agreements has been determined by these factors:

- The out-of-court resolution, which also offers the legal certainty of the financial recovery provided by the court's involvement
- As witnessed by *Risanamento*, the courts' further recognition of a stay over the other bankruptcy proceedings until the conclusion of the process provided by Article 182-*bis*

While the attractiveness of these new restructuring procedures has already proved significant for Italian and international investors, their true impact is yet to be seen.

The author would like to thank Leonardo Pinta for his assistance in preparing this article.



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The Major Tax Obstacles to Restructuring in Germany

By **Gero Burwitz** and **Annette Keller**

In Germany, the restructuring of companies or groups in financial crisis is subject to significant tax risks. The two most important tax restrictions are the taxation of restructuring gains and the decline of tax losses.

Taxation of Restructuring Gains

Restructuring measures, such as the cancellation of debt by waiver or a debt-equity-swap, generally create a taxable profit. Although German tax law does not provide for a specific tax exemption of the profit gained by a cancellation of debt in restructuring cases, the German Federal Finance Ministry (*Bundesfinanzministerium*) has issued the so-called restructuring administrative decree (the *Sanierungserlass*). At the German revenue office's discretion, a tax deferral (*Stundung*) or tax abatement (*Erlass*) is granted upon application, provided the company is in need of, capable of and eligible for restructuring, and the creditors grant the cancellation of debt with the intention of restructuring. In general, if these requirements are fulfilled, the revenue offices grant the tax deferral or abatement.

After two contradictory rulings by the fiscal courts in Munich and Cologne, the maintenance of the taxpayer-friendly application of the *Sanierungserlass* was in doubt. However, the German Supreme Tax Court (*Bundesfinanzhof*) gave a degree of reassurance in July 2010, which confirmed the legitimacy of the revenue offices' practice to grant tax relief for cancellation of debt income based on the fulfilment of the requirements under the restructuring decree.

There are a number of unresolved questions and problems in connection with the tax deferral or abatement of cancellation of debt income, however. For example, the revenue office is not entitled to grant a tax relief for trade tax purposes. As the trade tax is imposed by municipalities, each municipality in which the company runs a permanent establishment is entitled to decide whether or not it grants a tax deferral or abatement.

Decline of Tax Losses

The German legislature implemented the German restructuring exemption clause (*Sanierungsklausel*) in order to eliminate the negative impact of restructurings on German tax losses for cases in which the shares in a corporation are acquired with the intent to rescue the company through financial restructuring.

The restructuring exemption clause was intended to ease the consequences of a German rule on the usability of tax losses. This rule constitutes an obstacle to the restructuring of corporations or groups in financial crisis. Under the general rule, tax losses are completely lost if more than 50 per cent of the shares are transferred directly or indirectly to an acquirer within a period of five years. Tax losses are declined on a *pro rata* basis if more than 25 per cent of the shares are transferred on this basis. Consequently, share transfers to investors willing to support the company in financial crisis, or the change of the shareholding quota because of debt-equity-swaps, may trigger the loss of tax losses.

In January 2011, the European Commission determined that the *Sanierungsklausel* distorted competition, was therefore illegal State aid, and that any tax benefit granted since 1 January 2008 under this clause needed to be reclaimed.

Restructuring Alternative: Debt-Mezzanine-Swap

When carefully tailored, a debt-mezzanine-swap may be used to avoid insolvency or excess indebtedness without triggering negative tax consequences. This is the case if the debt-mezzanine-swap leads to equity on the commercial balance sheet while maintaining debt on the tax balance sheet. No taxable restructuring gain is triggered and the swap is generally not considered a harmful share transfer.

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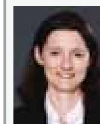

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What They Don't Know Will Hurt You

By **Eileen O'Connor**

One thing companies often overlook in a restructuring plan is the role of communications. Lack of information for employees, the community and customers can generate criticism and misinformation that in turn foster resistance, undermine commitment and jeopardise the entire plan.

Internal Communications

The biggest potential losers in any restructuring are the employees, yet they are also the chief asset that a company must keep in order to emerge successfully. Effective internal communications are therefore a necessity when restructuring a business.

> E-mails and videoconferences are not enough.

First, communicate the "how" and "why" of your plan and any developments regularly and without delays. Employees should not find out what is happening in the company through the media. An information vacuum is usually filled with speculation, fuelling misinformation and lowering morale. People fear the unknown, and while anxiety cannot be completely eliminated, knowledge can lessen that fear.

Second, share the positive vision of the future plan and how it can be successful. Employees are less likely to stay if you don't present a vision of success after restructuring.

Third, be honest about the uncertainty. When you don't know the answer to a question, say so. You can usually provide some comfort by describing the process that you are undertaking so employees know that you are gathering facts and exploring all options.

Fourth, listen to employees and be empathetic to their concerns. Management must be seen to recognise employees' anxiety and to demonstrate a humane process for dealing with redundancies and closures.

Fifth, act quickly, decisively and with emotional intelligence when making redundancy announcements. Give appropriate attention to employees who are leaving, even organising leaving parties. It is smart to be generous to those leaving, as it shows good faith to those staying and it is good for morale to recognise the achievements and careers of those departing.

Sixth, talk face-to-face throughout. E-mails and videoconferences are not enough. Management must be visible during the process, hosting meetings in groups as small as possible.

External Communications

In addition to effective internal communications with employees, it is important to remember the impact of your plan on the world outside the company and its investors.

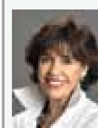
Your company and your employees are part of the wider social community, and redundancies will have a profound economic impact on the local community. Major manufacturing plant closures may also require environmental clean-ups or significant dismantling, with necessary regulatory approvals.

Early communication with stakeholders can lower the risk of misinformation and potential opposition to the plan from the media, politicians, local community leaders and regulatory bodies that have the power to seriously alter the course of your plan. Inviting stakeholders to share in the process, but not control it, can create buy-in that will be essential to success.

If all they know is that you are in difficulty, customers and suppliers may go looking for other sources of products or other customers, leaving you unsupported and under-resourced when you emerge from the restructuring. Send regular updates on your progress in order to maintain productive relationships.

> Redundancies will have a profound economic impact on the local community.

Restructuring is a worrying process for all stakeholders. The old adage "what they don't know won't hurt them" is definitely not true, and it is the company's restructuring plan that could be hurt the most.



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New Perspectives and Opportunities for Turnaround Investors in Germany

By **Uwe Goetker** and **Thomas Ammermann**

The German Government has introduced a reform of the German Insolvency Code (*Insolvenzordnung–InsO*) in order to further facilitate business restructurings in Germany. Once implemented, the Bill to the Law Regarding the Further Facilitation of the Restructuring of Businesses (*Regierungsentwurf zum Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen*) will open new perspectives and opportunities for turnaround investors in Germany by making insolvency proceedings more predictable and facilitating the implementation of "loan to own" strategies. As a result, German insolvency law will provide an excellent environment to acquire and restructure a business via the equity and/or the debt side.

Self-Administration

At present, "self-administration"—comparable to the "debtor in possession"—is the exception rather than the rule under German law. Under the Bill, this situation will reverse. The debtor's application for self-administration can only be rejected if there is reason to believe that the self-administration may lead to disadvantages for the creditors. Therefore, the debtor has the chance to implement a restructuring that utilises the efficient tools of German insolvency law without losing control over the business and the restructuring process.

Preparatory Insolvency Proceedings

Moreover, as long as the debtor is neither illiquid nor over-indebted, and the pursued restructuring is not obviously hopeless, the Bill entitles the debtor to apply for a protection period of up to three months, which allows for preparation of an insolvency plan for the restructuring of the business. In this case, the management can even propose a preliminary trustee (*Sachwalter*) who can only be rejected by the relevant insolvency court if the proposed candidate is not qualified to hold office. However, the preparatory proceedings do not provide for a mandatory moratorium, and they will be terminated by the court once the debtor is not able to satisfy its debts when due.

> "The preliminary proceedings are a decisive stage."

Preliminary Creditors' Committee

The German unemployment authorities must pay the net salaries of the workforce for up to three months prior to the opening

of the actual insolvency proceedings. As a result, German insolvency proceedings regularly start with preliminary proceedings of up to three months during which the business can be continued at a lower cost. The preliminary proceedings are a decisive stage; the fate of the business is regularly determined during this first phase.

Until now, the creditors have not been represented officially at this stage. The Bill provides for the establishment of a preliminary creditors' committee (*vorläufiger Gläubigerausschuss*), which will represent the creditors during the preliminary insolvency proceedings. For example, the preliminary creditors' committee will be involved by the court in connection with the application for self-administration and the selection of the preliminary insolvency administrator. A preliminary creditors' committee will be established for active businesses that satisfy two of the following criteria: assets with a value of at least EUR2 million, a turnover of at least EUR2 million in the last 12 months or an annual average of 10 employees. The preliminary creditors' committee is therefore applicable to the vast majority of businesses in Germany.

Selection of Insolvency Administrator

Unless the debtor applies for self-administration, the appointment of the (preliminary) insolvency administrator is one of the most important decisions for the success of a business restructuring in insolvency proceedings. Until now, the (preliminary) insolvency administrators were appointed by the insolvency court without the debtor and the creditors being entitled to influence this decision, and, indeed, many insolvency courts would reject a proposal because it was made by the debtor or the creditors. The Bill will change this. A proposal agreed upon by the preliminary creditors' committee will be binding for the court, unless the proposed party is not capable of holding office. Consequently, creditors will be able to choose an insolvency administrator who is competent and qualified for the specific needs of the situation. In addition, the debtor could propose a preliminary insolvency administrator without the proposal being binding for the court. However, the Bill clarifies that persons who were proposed by the debtor, who advised the debtor in general form on insolvency proceedings and their consequences, or who created an insolvency plan for the debtor and the creditors shall not be excluded for these reasons.

Facilitation of Insolvency Plans

A key tool for restructurings of insolvent companies under German insolvency law is the "insolvency plan", which is comparable to US Chapter 11 proceedings, but which can also be applied in very small restructuring cases. The insolvency plan is a flexible and efficient restructuring tool, and allows for a settlement of the creditors' insolvency claims in deviation from the settlement procedure by law. An insolvency plan may be initiated either by an insolvency administrator upon the creditors' request or by the debtor. The insolvency plan remains subject to (i) the approval of the creditors who convene for a discussion and voting meeting docketed by the insolvency court, and (ii) the final confirmation of the plan by the insolvency court.

"The insolvency plan is a flexible and efficient restructuring tool."

The Bill will eliminate certain obstacles and clarify some uncertainties regarding insolvency plans which previously impeded insolvency plan proceedings. One such impediment is the fact that insolvency proceedings currently do not affect shareholders' rights. As a result, any change to the registered share capital (including debt/equity swaps) requires approval from at least 75 per cent of the shareholders. The necessary consent of the majority currently bears the risk of shareholders demanding compensation for their consent (hold-out value). The Bill now provides for a conversion of debt into equity, capital measures that include a contribution in kind, the exclusion of pre-emptive rights and the payment of compensation to exiting shareholders in an insolvency plan.

The insolvency plan requires confirmation only by the insolvency court and is subject to approval of the various groups of "participants to the proceedings" (*Beteiligte*), as creditors and shareholders are referred to collectively. Each group of participants approves the plan autonomously. The shareholders' potential to obstruct the plan is reduced, as only a majority of the registered share capital, rather than a minority of 25 per cent, can reject the capital measures agreed to in the insolvency plan. Furthermore, even the rejection of the insolvency plan by the majority of a group of creditors or of the shareholders is deemed as approval under qualified circumstances, such as the approval of the majority of participants' groups and the shareholders being in a better position with the insolvency plan than without it.

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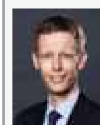

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Bilateral Investment Treaties After the Lisbon Treaty

By **Gary Moss** and **James McNamara**

The 2009 Lisbon Treaty amended the European Union's governing treaties. In doing so, it expanded the EU common commercial policy to include "foreign direct investment". One of the governing treaties, the Treaty on the Functioning of the European Union (TFEU), grants the European Union exclusive competence for certain areas, including the common commercial policy. It provides that where the European Union has exclusive competence, only it can legislate or adopt legally binding acts; Member States may only do these things if authorised. Because bilateral investment treaties (BITs) between Member States and third countries fall within "foreign direct investment", the TFEU transfers the power to make BITs from Member States to the European Union.

In July 2010, the European Commission released a draft regulation establishing transitional arrangements for BITs between EU Member States and third countries. There are currently more than 1,000 BITs between Member States and third countries, which retain force under public international law. The draft regulation proposes a transitional regime for the harmonisation of the existing international legal norms with the centralisation of investment treaty-making power in the European Union. The regulation aims to retain investor certainty without undermining EU authority. This is achieved by conditionally authorising all current BITs (and providing for the re-negotiation of existing BITs and entry into new BITs), but re-establishing them within the ambit of EU power.

The Proposed New Framework

Under the proposed regulation, Member States will notify the Commission of existing BITs that they wish to maintain in force (Article 2) and Article 3 provides for their conditional authorisation. The Commission will review all notified BITs to determine whether they conflict with EU laws, overlap with EU agreements with the third country, or obstruct EU investment policies, particularly the common commercial policy (Article 5). If they do, the Commission can revoke the BITs' authorisation (Article 6).

> "From opening negotiations through to the BIT's operation, the Commission retains control."

Article 7 sets out how Member States may be authorised to negotiate with third countries to amend an existing BIT or conclude a new BIT. The Member State must notify the Commission of the intention to negotiate and provide all relevant documentation and information (Article 8). The Commission can withhold authorisation if the negotiations would conflict with EU law, undermine current or intended negotiations between the European Union and the third country, or obstruct EU investment policies (Article 9). Article 9 empowers the Commission to require Member States to include particular clauses in BITs, and Article 10 provides that the Commission must be kept informed of the progress and results of the negotiations, and may even participate in them.

Article 11 requires Member States to give the Commission the text of the proposed treaty. Before authorising the treaty's signing, the Commission will determine whether the treaty conflicts with EU law, undermines current or intended negotiations between the European Union and the third party, obstructs EU investment policy or fails to include any clause prescribed by the Commission.

Even if the BIT is authorised, the Commission remains involved: The Member State must keep the Commission informed of meetings that take place pursuant to the BIT and take a particular position at these meetings if the Commission requires it (Article 13(1)). From opening negotiations through to the BIT's operation, the Commission retains control.

BIT Arbitration Under the Proposed Regulation

Under the proposed regulation, the Commission controls BIT arbitration between Member States and third parties. The "Member State shall … immediately inform the Commission of any request for [BIT] dispute settlement" and "fully cooperate" with the Commission. Where necessary, the Commission will participate in the arbitration (Article 13(2)). The Communication accompanying the draft regulation clarifies that the European Union would likely be, if not the defendant, then at least the co-defendant in any relevant BIT arbitration. Member States also lose the capacity to initiate or not initiate arbitrations under BITs: the proposed regulation provides that they "shall seek the agreement of the Commission before activating any relevant mechanisms for dispute settlement . . . and

shall, where requested by the Commission, activate such mechanisms". This includes informal "consultations" between the BIT counterparties.

Additionally, a new species of international arbitration is proposed by the draft regulation. The accompanying Communication states: "the Union should build on Member State practices to arrive at state-of-the-art investor state dispute settlement mechanisms". The European Union would likely move to employ a standardised dispute resolution provision in any new or renegotiated treaty made by Member States under the draft regulation, guided by the following principles:

- Transparency in investor-state disputes, including open hearings, and the publication of requests for arbitration, submissions, *amicus curiae* briefs and awards
- The use of quasi-permanent arbitrators and provision for appeals

The alternative suggestion is that the International Centre for Settlement of Investment Disputes Convention (ICSID) should be amended to allow EU participation.

The 2010 Rapporteur's Report

After an International Trade Commission of the European Parliament hearing in November 2010, Rapporteur Carl Schlyter MEP issued a draft report on the draft regulation. The report suggests amendments to the regulation that would further increase the Commission's power over BITs and BIT arbitration. As relevant to international investment treaty arbitration, the proposed amendments fall into three broad groups.

Additional emphasis that the preservation of Member States' BITs is "temporary"

The report sets an expiry date of eight years for the regulation (extendable by a further five, per Amendments 7 and 26) and suggests that by "this time, all existing bilateral agreements of Member States with third countries should be replaced by an agreement of the Union concerning investment" (Amendment 6).

Increased Commission power over BITs

Whereas the draft regulation provides that Article 3 authorisation to keep BITs on foot "*may* be withdrawn" (authors' emphasis) in certain enumerated circumstances, Amendment 16 shifts the burden to oblige Member States to renegotiate or terminate a BIT where it is incompatible with specified EU laws or policies.

Increased Commission participation in BIT arbitrations

Amendment 13 extends the Commission's power of review over Member States' BITs to include review for provisions that would impede EU entities (and the public) from accessing dispute resolution documents. Further, Amendment 8 proposes a new clause which provides that "The Member States and Commission should take all necessary measures to ensure that the Commission is allowed to participate to the broadest possible extent in any dispute settlement procedures initiated under a bilateral investment agreement of a Member State."

As is evident, the power of the Commission *vis-à-vis* Member States proposed by the draft regulation would be extended considerably by the Rapporteur's suggested amendments.

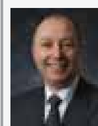
> "Member States will be unable to institute arbitrations without the Commission's permission."

Comment

The Lisbon Treaty in several crucial aspects centralises power in a federal structure that contains certain elements attributed traditionally to the nation state. Specifically, the Treaty, effected by the proposed regulation, moves current and future Member State BITs ultimately under the Commission's control. If the draft regulation is adopted, the way third party investors deal with counterparty Member States will change.

Crucially, it will also change how BIT arbitration occurs. Third party states will likely face the European Union as a defendant or co-defendant. Member States will be unable to institute arbitrations without the Commission's permission, and the Commission may also compel Member States to commence arbitrations.

Just as significantly, the Communication potentially heralds a new standardised dispute resolution procedure, which is at odds with many traditional attributes of arbitration. Conversely, the proposed new dispute resolution mechanism—and the requirement for Commission review before proceedings are entered into—will contribute to an international arbitral jurisprudence of greater certainty. The Rapporteur's proposed amendments would have the effect of extending the Commission's control of the BIT and international BIT arbitration process even further. Whether these will be accepted by the European Parliament is another matter.



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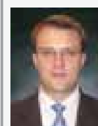

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National Security Review: Is It a Game of Tit for Tat?

By **Henry Chen**, **Michael Socarras** and **Michael Xu**

On 12 February 2011, the Office of the State Council of China issued a circular announcing the formation of a state-level investment body to review China-based mergers and acquisitions (M&A) deals which involve non-Chinese firms and which might endanger China's "national security". Many speculate whether this review mechanism could become a political tool wielded by the Chinese Government to block deals unrelated to national security but opposed by the Chinese Government. Questions remain on how assiduously the Chinese Government will enforce the review mechanism. For example, will the Chinese Government be as aggressive in prohibiting non-Chinese investors as the US Government has been in its treatment of Chinese investors?

China: Inter-Ministry Roundtable Conference

The investment review body is an inter-ministry roundtable conference that involves primarily the National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM). Other ministries will participate when their relevant industry sector is involved in the M&A deal.

> "Will the Chinese Government be as aggressive . . . as the US Government has been?"

A review will commence if the non-Chinese investor takes *de facto* control of the Chinese enterprise and the Chinese enterprise is either a military-related enterprise (an enterprise surrounding a key or sensitive military infrastructure, or a unit otherwise related to the military), or a national-security-related enterprise (relating to an important agricultural product, energy resource, element of infrastructure, transportation system, technological business or equipment manufacturing).

The factors that the conference will take into account include the impact of the M&A deal on national defence (including the capacity for manufacturing domestic products, providing domestic services, or providing the relevant facilities and equipment that relate to national defence), the stable operation of China's economy and basic social life, or the research and development of key technology related to national security.

The conference will ask MOFCOM and the relevant government agency to prohibit the M&A deal if the transaction has affected or may affect national security. Alternatively, the conference can order the parties to divest certain equity interests or assets, or adopt some other effective measures to remove the existing or potential effect.

The United States: Committee on Foreign Investment in the United States

The counterpart of the conference in the United States is the Committee on Foreign Investment in the United States (CFIUS). CFIUS is a high-level government committee that advises the US President. It is chaired by the Secretary of the Treasury and includes representatives from

several US departments and agencies—including State, Defence, Commerce and Homeland Security—and works closely with the Director of National Intelligence. CFIUS's legal authority is to review "covered transactions", which are defined as deals that could result in control of a US business by a foreign person or entity. CFIUS defines its legal authority broadly, but its authority is applied only to determine the effect of covered transactions on national security.

CFIUS has significant legal powers to stop a covered transaction and even unwind a closed deal. The parties to a merger, acquisition or takeover must notify CFIUS, which then has 30 days to review the deal. During the initial 30-day review, the Director of National Intelligence is required to conduct a complete 20-day analysis of any threat to US national security, even though he or she is not a voting member of CFIUS.

> "CFIUS has significant legal powers to stop a covered transaction and even unwind a closed deal."

If during this review period even one member of CFIUS believes that the deal requires an investigation, a 45-day rigorous investigation may begin. The President is then legally permitted to conduct a national security investigation of a covered transaction if only a single member of CFIUS requests it. However, if a foreign-state-owned company is involved, the Secretary of the Treasury may exempt the deal from review.

The Impact of CFIUS on China

China National Offshore Oil Corp (CNOOC) suffered failure in its attempted acquisition of Union Oil Company of California (UNOCAL). There was wide political and public opposition to this deal within the United States. The main concerns revolved around CNOOC's special status as a Chinese state-owned company and the potential national security concerns relating to oil stock and military use of UNOCAL's technology. It is not clear what role CFIUS played in the failure of the CNOOC/UNOCAL deal, but it has been speculated that UNOCAL's board rejected CNOOC's offer in favour of a lower bidder on the basis of concerns regarding the likely negative outcome from a CFIUS review.

In the technology sector, Huawei's (relatively tiny) US$2 million bid for 3Leaf, a US server company, was withdrawn after CFIUS recommended against the purchase.

Even in successful deals there have been serious compromises. When Lenovo acquired IBM's personal computer and laptop unit, IBM made various promises to CFIUS such as making its research labs off limits to Lenovo before the deal was approved.

The main concerns for CFIUS are the Chinese companies' state-owned background and the security sensitivities involving China. These factors are unavoidable; most Chinese companies capable of making acquisitions in the United States are state-owned or at least well connected with the Chinese Government. Maybe in the post-financial-crisis era, when the United States is eager for foreign investment, the political climate will be more conducive to Chinese investment. However, the failed Huawei acquisition of 3Leaf has shown that any acquisition of US assets by Chinese state-affiliated companies, especially in the technology sector and even slightly relating to security, will continue to face the most stringent of reviews.

Challenging and Lobbying

It is almost certain that the Chinese courts would be reluctant to adjudicate cases against the conference. Similarly, US courts are generally reluctant to decide cases involving national security. It would be as difficult for a non-Chinese investor to litigate a case against the conference as it is for a non-US entity to litigate against CFIUS, because the evidence could easily be classified as a state secret.

Ultimately, for prominent purchases of Chinese assets by corporations from countries such as the United States, regulatory approval depends on the political climate and equal, reciprocal treatment of Chinese corporations abroad. It remains to be seen for foreign corporations and lawyers whether or not the member agencies of the conference could be lobbied or influenced similarly to CFIUS. While there is no lobbying law in China, it is crucial for commercial entities to explore thoroughly the regulatory and compliance issues in order to avoid any unpleasant regulatory surprises.

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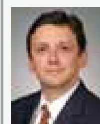

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Demystifying US State Income Taxation of Non-US Corporations

By Arthur Rosen and Lindsay LaCava

In the expanding global economy, non-US corporations are increasingly transacting business in the United States. While non-US businesses may consider the federal income tax consequences of conducting business in the United States, they often overlook the potential state income tax consequences of those activities, or assume mistakenly that the federal income tax consequences dictate the state income tax consequences. There are, however, key differences between state and federal income taxation of non-US corporations.

Jurisdiction to Impose Tax

Non-US corporations are often surprised to learn that a state may have jurisdiction to impose state income tax or an alternate business activity tax (such as Ohio's commercial activity tax, which is based on gross receipts) on a corporation that is not subject to federal income tax. For a state to impose income or other business activity tax on a non-US corporation, the corporation must have sufficient contact, or "substantial nexus," with the state. The issue of whether a non-US corporation has substantial nexus with a state must be analysed independently from the issue of whether the corporation is subject to federal income tax.

It is well accepted that a corporation will have substantial nexus with a state if it has a physical presence there, either through the presence of its own employees or property, or through the presence of a third party (including an independent agent) that is conducting activities that are associated significantly with the corporation's ability to establish and maintain a market in the state. In recent years, however, states have asserted that a corporation can also have substantial nexus with a state for income tax purposes if it has merely an economic presence in a state—for example, if it has customers in that state. Some states have adopted economic nexus standards by statute, and many of these utilise a quantitative test under which a corporation will have substantial nexus if its gross receipts from the state exceed a certain threshold (for example, US$500,000). The validity of this so-called "economic nexus" argument has been litigated and upheld by a number of state courts, but the Supreme Court of the United States has repeatedly declined to address the issue.

Largely because of this economic nexus concept, there is a disconnect between the types of activities that will subject a non-US corporation to state tax and the activities that will subject a non-US corporation to federal net income tax. Non-US corporations

are generally subject to federal income tax only if the corporation is engaged in a US trade or business. While there is no comprehensive definition of a US trade or business, federal case law and administrative rulings indicate that a physical presence in the United States is generally required. Moreover, if an income tax treaty applies, a non-US corporation will be protected from federal income taxation unless its presence in the United States rises to the level of a "permanent establishment," which generally requires a fixed place of business in the United States through which its business is conducted either directly, or through a dependent agent.

"States are not bound by federal tax laws or by income tax treaties."

States are not bound by federal tax laws or by income tax treaties. Therefore, while states may elect to refrain from asserting income tax jurisdiction over non-US corporations that are not subject to federal income tax, they are not obligated to do so. Federal legislation known as the Business Activity Tax Simplification Act has been proposed in Congress over the past several years and would require corporations (whether foreign or domestic) to have a physical presence in a state to be subject to income or other business activity taxes there, more closely aligning state and federal tax jurisdictional standards.

Computation of Tax

If a state has jurisdiction to impose an income tax on a non-US corporation, the corporation's state tax base may vary significantly from its federal income tax base, if any.

The precise method for computing state income tax liability varies by state. Typically, states use federal taxable income, with certain modifications, as the starting point for computing a corporation's state tax base, and then allocate or apportion that tax base to the state using an apportionment formula consisting of one or more factors, namely, the percentage of the corporation's gross receipts, payroll and/or property within the state.

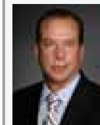
Because states use federal taxable income as the starting point for computing state taxable income, a corporation that has no federal taxable income (for example, because it does not have a permanent establishment under an applicable treaty) may consequently have no state taxable income. However, several states explicitly require corporations to include in their state tax base income that is not otherwise included in their federal income tax base. For example, a non-US corporation that does not have a permanent establishment under an applicable treaty may be required to include in its state tax base all of its worldwide income, or any income that it would have been required to include for federal income tax purposes if it were not protected by a treaty.

Similarly, a non-US corporation that is subject to federal income tax may be required to include in its state tax base additional items of worldwide income that may not have been included in its federal income tax base. For federal income tax purposes, a non-US corporation is only subject to net income tax on income that is "effectively connected" to the corporation's US trade or business. In sum, the non-US corporation must account separately for the income and deductions connected to its US trade or business and pay tax only on that net income. States, on the other hand, have generally rejected separate accounting in favour of formulary apportionment. Thus, a non-US corporation may be subject to state income tax on an apportioned share of its worldwide income, even though that corporation may only be subject to federal income tax on its "effectively connected" income.

"A non-US corporation may be subject to state income tax on an apportioned share of its worldwide income."

In addition, states may require corporations to file returns on a unitary or combined basis with other related corporations. This means that a corporation with substantial nexus in a state may be required to compute its income or business activity tax liability based on the combined incomes (after intercompany eliminations) and combined apportionment factors of all affiliated entities with which it is conducting a unitary business. This requirement applies regardless of corporate formalities and regardless of whether those other entities also have substantial nexus with the state. The determination of a "unitary" business is a factual issue, but generally includes business activities that experience a flow of value as evidenced by functional integration, centralisation of management and economies of scale. While some states limit the entities included in the combined report group to entities located in the United States (*i.e.*, a "water's edge" combined report), others require the inclusion of all worldwide affiliates.

Because of the significant differences between state and federal taxation of non-US corporations, non-US businesses should consider carefully the potential state income tax consequences of any US business operations.



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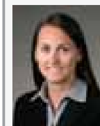

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International Tax Reform in the United Kingdom: The Latest Chapter

By James Ross

After more than five years of speculation, consultation and legislation, the long-term shape of the United Kingdom's regime for the taxation of foreign profits is finally becoming clear. The Government has published details of interim reforms to the controlled foreign company (CFC) rules that it intends to enact in 2011, together with an exemption for the profits of foreign branches. It has also set out its proposals for a definitive overhaul of the CFC rules in 2012.

The interim reforms provide a new exemption for CFCs carrying on trading activities with limited UK connection. This exemption is aimed mainly at those carrying on transactions with other group companies, which are generally unable to avail themselves of the existing "exempt activities" exemption for trading companies. Additionally, the "period of grace" exemption that applies on acquisitions of foreign companies will be extended from one year to three years so that UK companies have an extended period to restructure the operations they have acquired in order to avoid the potential imposition of a CFC charge.

> The interim reforms provide a new exemption for CFCs carrying on trading activities with limited UK connection.

A potentially complex exemption will also be introduced for companies exploiting intellectual property (IP) with a limited connection to the United Kingdom through an overseas business establishment. This exemption will apply only if the IP has not been owned by a UK resident within the last 10 years and is not created, maintained or enhanced in the United Kingdom by a person related to its owner. It will not apply if the relevant company is substantially equity-funded by the United Kingdom, or if its revenues derive substantially from the United Kingdom.

It appears that this provision will form the basis of the permanent IP rules that are to be introduced in 2012. A further test will be introduced to determine whether entities that do not benefit from the temporary exemption outlined above are receiving "excess profits", determined by reference to the substance of the entity.

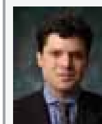
Where a CFC holds IP offshore as an investment, the Government proposes to apply a "thick capitalisation" test from 2012; it also intends to apply this approach to foreign finance companies. This test will be based on a minimum debt to equity ratio of 1:2, effectively excluding two-thirds of the income of such a subsidiary from a CFC charge, equating to an effective 8 per cent rate of tax when the main rate of corporation tax falls to 24 per cent in 2014.

Draft legislation has also been published providing for an elective exemption regime for foreign branch profits. Companies will be able to elect that the profits (and losses) of their foreign branches will be exempt from corporation tax, subject to a claw-back for losses previously allowed. Any election will be irrevocable and will apply to all the company's branches. Anti-diversion rules similar to the CFC rules will prevent the artificial allocation of profits to exempt branches.

The Government also reaffirmed its desire to introduce a patent box regime from 2013, whereby income attributable to patents will be taxed at 10 per cent.

> The Government also reaffirmed its desire to introduce a patent box regime from 2013.

Will these reforms make the United Kingdom a more attractive head office location? It certainly improves its competitiveness as far as potential inward investors are concerned, relative to a number of other jurisdictions. It remains to be seen whether it dissuades multinationals already headquartered in the United Kingdom from migrating or inverting their structure. Except in relation to patents, the proposals seem to offer no great incentive to such companies to bring their foreign IP into the country. And where the IP in question has a link to the United Kingdom, companies may still consider adopting foreign holding companies in order to avoid the complex new IP proposals.



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