

# BUSINESS LAW TODAY

The ABA Business Law Section's Online Resource

## Chapter 9 Municipal Bankruptcy: The New “New Thing”? Part I

By Henry C. Kevane

Chapter 9 has entered the conversation again—municipal bond funds have swooned, Congress is considering whether to permit states to seek federal bankruptcy protection, and public employee wages, pensions, and benefits are in the cross-hairs. The City of Harrisburg publicly flirted with a Chapter 9 filing and Boise County, Idaho, filed a Chapter 9 case on March 1, 2011, after suffering a \$4 million judgment under the Fair Housing Act. Jefferson County in Alabama is also navigating murky waters after using complex derivatives to hedge interest rate risks on sewer revenue bonds. And Indiana is considering new legislation to permit its municipalities to seek bankruptcy protection. It is perhaps only a matter of time before residents and taxpayers begin to follow the fiscal travails of their cities on Twitter and Facebook.

For years, Chapter 9 was considered the option of last resort, triggered mainly by true emergencies (such as Orange County, in 1994), or when municipalities emulate businesses that are otherwise troubled (such as health care districts in rural or underprivileged areas). Indeed, over the past 77 years since the enactment of Chapter 9 in 1934 there have been only about 600 Chapter 9 filings. Now, Chapter 9 is back in vogue as a potential solution to long-term structural imbalances caused by ballooning public employee benefits and flattened revenues.

### The Role of the Bankruptcy Court

Unlike private sector bankruptcies under Chapters 7 and 11 of the Bankruptcy Code, the bankruptcy case of a public agency under Chapter 9 is largely conducted without significant court involvement. Indeed, the term “bankruptcy” is really a misnomer for a Chapter 9 case. Bankruptcy courts do not hear and determine the various operating disputes common to corporate cases; rather, the principal functions of the Bankruptcy Court are to oversee the entry (by determining eligibility) and exit (by confirming a plan) of a municipality from federal bankruptcy protection. Otherwise, the court is mostly a bystander to the daily affairs of the Chapter 9 municipal debtor. By contrast, in a Chapter 11 case, the court and other parties in interest will review virtually every transaction outside the ordinary course of business. The U.S. Trustee, likewise, has only one function in a Chapter 9 case—to appoint a creditor’s committee. (Actually, the legislative history suggests that since “Chapter 9 does not provide for involvement of the U.S. Trustee in the administration of municipal bankruptcies, in Chapter 9 cases, the court will be responsible for the appointment of members of creditor committees.” S. Rep. No. 100-506, at 12 (1988)).

These limitations arise because of the interplay in a Chapter 9 case between two constitutional mandates. On the one hand, as instrumentalities of a state, Chapter

9 municipal debtors necessarily enjoy substantial freedom from federal interference. This freedom derives from the Tenth Amendment to the Constitution, which provides that “[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.” According to the Supreme Court, the Tenth Amendment determines the boundary between state and federal authority and was designed to be declaratory of the relationship between the national and state governments. As the Court stated in *New York v. United States*, 112 S. Ct. 2408, 2418–19 (1992), the “Tenth Amendment itself is essentially a tautology. . . . In the end, just as a cup may be half empty or half full, it makes no difference whether one views the question at issue . . . as one of ascertaining the limits of the power delegated to the Federal Government under the affirmative provisions of the Constitution or one of discerning the core of sovereignty retained by the States under the Tenth Amendment. Either way, . . . we must determine the boundary between federal and state authority.”

On the other hand, only federal law can overcome the constitutional prohibition on the impairment by states of the obligation of contracts (U.S. Const., art. I, § 10, cl. 1), or otherwise override contrary state law. U.S. Const., art. I, § 8, cl. 4 (uniform laws on bankruptcies); and art. VI, cl. 2 (Supremacy Clause). Thus, the powerful debt restructuring tools under the Bank-

ruptcy Code—such as the automatic stay, the avoidance of preferential transfers, the rejection of contracts, the disallowance of claims and the confirmation of plans through binding majority vote—are available exclusively in federal court.

### Balancing State and Federal Powers

As a result of the tension between these two constitutional imperatives, Chapter 9 was carefully crafted by Congress to accommodate both the reserved sovereign rights of the states and the debt adjustment powers of federal law. This accommodation is reflected both in certain unique provisions of Chapter 9 and in the omission of selected bankruptcy provisions from Chapter 9. According to the legislative history, the 1978 amendments to Chapter 9 were drafted in deference to developing ideas of Federalism.

First, the eligibility of a municipality to seek federal relief is committed to the exclusive control of each state. In 1994, Congress amended the Bankruptcy Code to require that municipalities be “specifically authorized” under state law to file a petition under Chapter 9. Previously, a municipality was eligible if it was “generally authorized” to file. Moreover, under *In re County of Orange*, 183 B.R. 594, 604-05 (Bankr. C.D. Cal. 1995), courts may “no longer find the requisite authorization for the filing by implication. The amendment requires that the state give the municipality express authority to file . . . . Since a state acts by statute, the authorization obviously would be recorded in writing. It also must be exact, plain, and direct with well-defined limits so that nothing is left to inference or implication.” A prior legislative act is not strictly necessary, however—authorization to file may also derive from a governmental officer otherwise empowered by state law to permit a particular entity to commence a Chapter 9 case. *In re New York City Off-Track Betting Corp.*, 27 B.R. 256 (Bankr. S.D.N.Y. 2010).

By amending the eligibility statute, Congress expressly invited each state to revisit the types of local agencies that may seek federal relief. Although many states currently permit Chapter 9 cases, some

with detailed pre-conditions or prior consent, almost half the states either prohibit or do not expressly permit the bankruptcy option. Various states currently use a gatekeeper to regulate entry to Chapter 9. Connecticut requires the prior written consent of the governor and New Jersey requires the prior approval of a municipal finance commission. Kentucky requires the pre-approval of a proposed plan by certain state officers before a county may file; Louisiana requires the pre-approval of the bankruptcy petition by the governor and the attorney general; and Pennsylvania has a detailed list of bankruptcy triggers. Given the extraordinary proliferation of local agencies in California (according to some estimates, California has over 7,000 local government agencies), certain special or limited purpose entities are expressly barred from access to federal bankruptcy courts. For example, the California Earthquake Authority “is not and shall never be authorized to become a debtor in a case under the United States Bankruptcy Code.”

Second, Chapter 9 is designed to permit, if not encourage, active state involvement in the post-bankruptcy affairs of the municipality. Section 903 of the Bankruptcy Code, for example, provides that (with certain limited exceptions) the provisions of Chapter 9 do not “limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise.” Bankruptcy Rule 2018 also permits the state to freely intervene in any Chapter 9 case “with respect to matters specified by the court.” And section 943(b)(6) prohibits confirmation of a plan of adjustment unless the debtor has obtained any electoral approval necessary to carry out the plan.

It is a fundamental precept of municipal law that local agencies, created by the state, exist principally as instrumentalities for the orderly and convenient exercise of state powers and the delivery of state services. According to the California Constitution, for example (Cal. Const. art. XI, § 1(b)), the “Legislature shall provide

for county powers.” Local agencies, thus, are creatures of only limited and enumerated powers. As put forth in 121 Cong. Rec. H39412 (daily ed. Dec. 9, 1975), “the municipality is a creature of State law, and operates by virtue of the delegation of power from the State.” Based on this precept, it seems indisputable that the state may, at its pleasure, modify or withdraw any delegated powers and exercise them directly. During the Orange County Chapter 9 case, this principle, in conjunction with section 903, was used to pass legislation authorizing the appointment of a trustee over both the county and its creditors in order to promote a consensual plan.

The Orange County statute specified the conditions for the appointment of a trustee by the governor and further provided that, in that event, “all powers granted to the county board of supervisors shall be withdrawn and delegated to the trustee.” Cal. Gov’t Code §§ 30402(a). The trustee was specifically empowered to oversee the Chapter 9 case and file a plan of adjustment. In recognition of the fact that the county’s day-to-day affairs were likely beyond the scope of a trustee’s expertise, the statute authorized the trustee to retain or re-delegate specified powers to the board of supervisors, as necessary or appropriate to the “most effective action for resolving the pending case.” Further, and most importantly, the trustee was authorized to assume and exercise certain powers of the (over 200) local agencies asserting claims against the county based on losses stemming from the failure of its investment pool. Specifically, the trustee would have the ability to vote, on behalf of the affected local agencies, to accept or reject the county’s plan of adjustment and subordinate or otherwise restructure the claims against the county. Although seemingly broad, these powers were limited to those actions necessary and proper to achieve the timely confirmation of the county’s plan. Ultimately, no trustee was appointed and the county confirmed a consensual plan—the potential, however, for the state to accelerate the plan process by essentially agreeing with itself was probably helpful.

Third, other provisions of Chapter 9 render certain municipal decisions largely immune from court review or creditor scrutiny. A Chapter 9 case may neither be commenced involuntarily by creditors nor converted to another case under the Bankruptcy Code. Section 904 prohibits the Bankruptcy Court from interfering, “unless the debtor consents or the plan so provides,” with any of the debtor’s political or governmental powers, property or revenues, or use or enjoyment of income producing property. In addition, section 363 of the Bankruptcy Code, concerning the use or sale of property, is omitted from Chapter 9, as are sections 327 and 330 (concerning the employment and compensation of professionals), and section 1107 (concerning reporting duties). Hence, a Chapter 9 debtor has significant latitude to pay pre-petition claims on a current basis or to defer payment until the effective date of the plan. The Bankruptcy Court may not appoint a trustee to manage or control the debtor (except in very limited circumstances to pursue avoidance actions) or compel a liquidation of municipal assets. Nor can the Bankruptcy Court appoint a receiver in a Chapter 9 case (or in any other case for that matter—11 U.S.C. § 105(b)). Moreover, only the municipality can propose a plan of adjustment; creditor plans are not permitted. The sole effective remedy for disgruntled creditors is dismissal of the case.

### Commencing a Chapter 9 Case

Section 904 presents a formidable constraint on creditors’ remedies. In the Orange County case, for example, although the county often sought court approval for certain actions taken in the case, it seldom missed an opportunity to remind potential objecting parties that, under section 904, it likely could proceed with the planned action absent court approval. And section 904, coupled with the absence of section 331 from Chapter 9, was the basis for the Bankruptcy Court’s early opinion that it lacked the power to compel interim payments to professionals without the County’s consent. *In re County of Orange*, 179 B.R. 195 (Bankr. C.D. Cal. 1995). In another opinion in the Orange County

case, however, 179 B.R. 185, 190 (Bankr. C.D. Cal. 1995), the Bankruptcy Court concluded that it had the power to order the County to provide adequate protection without “unduly encroaching on the county’s ability to conduct its affairs free from court interference.”

A Chapter 9 debtor, thus, has the virtually unfettered right (1) to determine whether and when a bankruptcy case will be filed, (2) to manage its own affairs and property during the pendency of the case, and (3) to file a plan of adjustment during a virtually perpetual exclusive period. Although a municipality controls its decision to commence a case, an order for relief does not follow automatically from the filing of a petition, like other chapters of the Bankruptcy Code, but is subject to creditor review and court ratification.

An entity must meet fairly stringent eligibility requirements in order to commence a Chapter 9 case, and must file its petition in good faith. If the entity is not eligible to file, the Chapter 9 petition must be dismissed. The eligibility requirements are set forth in a 5-prong test under section 109(c) of the Bankruptcy Code: (1) the debtor must qualify as a municipality (a political subdivision or public agency or instrumentality of a state that, generally speaking, exhibits the traditional attributes of sovereignty, such as the police power, the power to tax, or the right of eminent domain), (2) the debtor must be specifically authorized by state law to file, (3) the debtor must be insolvent, (4) the debtor must genuinely seek to effect a plan, not merely frustrate or delay creditors; and (5) the debtor must have first tried to avoid filing for bankruptcy (by negotiating with creditors, unless impractical or infeasible).

Recently, in 2008, the City of Vallejo filed a Chapter 9 petition that was vigorously contested by certain of its public employee unions. After a trial, the Bankruptcy Court determined that the city was eligible to be a debtor under Chapter 9—the unions appealed on the principal ground that Vallejo was not insolvent. For a municipality, the insolvency test focuses on the debtor’s failure or inability to pay its debts as they become due, a rather fact-intensive, totality-of-the-circum-

stances inquiry. The unions claimed that, through a combination of budget cuts, wage compromises and contract modifications, the city could have operated for at least another year or possibly longer and, hence, was not definitively insolvent as of the petition date. The Bankruptcy Court and the appellate panel each rejected this “stopgap” approach to solvency, taking a prospective, long term view that a municipality is not required to run out of funds and actually default before it is deemed insolvent. *In re City of Vallejo*, 408 B.R. 280 (B.A.P. 9th Cir. 2009).

### Creating an Exit Plan

Once it passes the eligibility gauntlet, the municipality must then turn its attention to its exit strategy. Despite the recent dire prediction by a prominent financial analyst of a wave of municipal defaults totaling “hundreds of billions of dollars,” it remains unclear whether Chapter 9 is an effective tool to comprehensively restructure municipal bond debt. Several common forms of bond debt are largely insulated from the impact of a Chapter 9 filing. Moreover, the ability to restructure public employee obligations, while possible under Chapter 9, would likely entail the acceleration of claims that would then require treatment under a plan, and be subject to a vote by the same public employees whose obligations were modified. These topics will be further explored in Part II of this article.

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## Foreign Investment Review in Canada: Be Careful What You Wish For

By Lawson A. W. Hunter and Susan M. Hutton

In February, 2011, a Canadian Parliamentary committee began reviewing the Investment Canada Act (ICA) with a view to recommending measures to increase the transparency and effectiveness of the statute. The review was terminated by the federal election called in late-March, but may well recommence in the next Parliament. This article examines recent events leading to the statutory review as well as the various decision-making models under consideration and asks: "Will reforms be of 'net benefit' to Canada?"

The ICA applies to the acquisition of control of existing Canadian businesses and to the commencement of new Canadian businesses by non-Canadians. In the case of most such transactions, the foreign purchaser or investor is merely required to file a short notification within 30 days following completion of the transaction, and there is no discretion on the part of the Canadian government to block the deal from closing or to re-visit it after the fact to impose conditions. Acquisitions of control of large Canadian businesses, however, by persons controlled in WTO-member states (and smaller acquisitions if the business has a "cultural" aspect or neither party is controlled in a WTO-member state) generally require the approval of the minister of industry on the grounds that he or she is satisfied that the transaction is likely to be of "net benefit" to Canada, according to a prescribed set of criteria.

The Standing Committee on Industry,

Science, and Technology of the House of Commons (the Industry Committee) commenced a review of the ICA in February, 2011, considering the pros and cons of proposals for increased transparency and predictability of the ICA review process. Proposals under consideration range from public hearings for all reviewable transactions, to publication of the undertakings upon which ministerial approval is conditioned, to amendments to the "net benefit" test, to the publication of case summaries and guidelines to help investors gain insight into what is currently perceived by some to be a "black box" of bureaucratic and ministerial discretion.

For much of its history, the ICA had been seen as a bit of a rubber stamp—a nuisance for foreign investors who wished to acquire control of Canadian businesses, but at the end of the day, not a serious obstacle to doing so nor a serious impediment to conducting business post-closing.

The ICA has slowly been growing teeth however, as globalization has seen the acquisition in recent years of several iconic Canadian companies by foreign investors (including, for example, Inco, Falconbridge, Alcan, and Stelco), and the serious recession of 2008/2009 inevitably led to the rise of protectionist and nationalist sentiments in many countries, including Canada. The increased role of sovereign wealth funds and other state-owned investors has given rise to concerns over political interference in Canada's economy and

resulted in the issuance of special rules for review of investments by state-owned enterprises (SOEs) under the ICA. The need for a national security screen post-9/11 also led in 2009 to entirely new powers granted to the federal cabinet, to review a broad range of investments in Canada for potential national security risks.

The decision by the minister of industry on November 3, 2010, to block the hostile bid by BHP Billiton Ltd. (BHP) for Potash Corporation of Saskatchewan, Inc. (PotashCorp), amid unprecedented public and media attention, ultimately led to the review of the statute that is currently underway. Federal opposition parties, while applauding the decision, decried the confidential nature of the discussions, and complained that the test and the manner in which it is applied are vague and unspecified, therefore defying accountability on the part of the minister and his staff. The minister's rejection of the BHP bid for PotashCorp also led to speculation as to whether Canada is still open to foreign investment, or whether politics (and the uncertainties associated with it) are now to play a more prominent role.

The bid for PotashCorp was just the second time that a proposed foreign acquisition has been turned down by the Canadian government (other than when a "cultural business" was involved). The first such rejection involved Alliant Techsystems Inc.'s bid for the information systems division of MacDonald

Dettwiler and Associates Ltd. which, in light of the military use of some of the technology involved, seems to have been understood by the investment community as having been based on national security grounds. The friendly “merger of equals” which was recently proposed between the Toronto Stock Exchange and the London Stock Exchange will, in some sense, be more important for Canada’s reputation as a relatively free-market jurisdiction as investors ask: “Was BHP/PotashCorp an anomaly or is it part of a trend?”

Recent cases and the current calls for reform should be viewed in the context of two conflicting trends. On the one hand, there has been a trend toward a higher public profile for the ICA, and the chief lesson investors can learn from the failed BHP bid is that they and their advisors ignore local politics at their peril. On the other hand, there has been a longer-term trend toward deregulation of the Canadian economy, resulting in higher thresholds for review and the removal of Canadian control restrictions in a number of industries. The circumstances of PotashCorp and of the BHP bid were unique, and are not likely to recur very often. More significant for the future of foreign investment in Canada will be the outcome of calls for reform.

All but the most drastic reforms are unlikely to significantly affect the vast majority of reviewable transactions. Convincing the minister of industry that a proposed investment is likely to be of “net benefit” to Canada will still be fairly easy in the vast majority of cases. Canada needs and welcomes foreign investment and, as significant investors abroad, Canadians need reciprocal access to foreign markets. Canada is and will remain a small, open economy, and more or less unfettered access to global capital markets is critical for continued growth. It is therefore only very high-profile transactions that would—or should—be affected by reform of the ICA review process.

A blue-ribbon panel appointed to study Canada’s regulatory regime with a view to increasing Canadian competitiveness (the Competition Policy Review Panel led by Red Wilson issued its report, *Compete to*

*Win*, in 2008) recommended drastically increasing thresholds for the size of review of foreign acquisitions (from the current \$312 million based on the book value of assets, to \$600 million and eventually \$1 billion based on the enterprise value of the Canadian business). It also recommended changing the onus from the investor having to prove “net benefit” to the minister having to prove “net harm,” and removing foreign investment restrictions on sectors such as telecommunications and airlines. As noted, these changes are part of a long-term trend in Canada toward deregulation generally, and the encouragement of the free flow of capital internationally.

The proposals being considered by the Industry Committee would, if implemented, result in the Canadian government being held more publicly accountable for its administration of the ICA and for ensuring that foreign acquisitions indeed are of “net benefit” (or at least not of “net harm”) to Canada. Whether increased transparency is good or bad for Canada, however, will depend on how it is achieved. To understand the pros and cons of current reform proposals, one must understand the nature of the current “net benefit” test, as well as the institutional decision-making models under consideration. Finally, an examination of recent trends under the act assists in understanding the relative benefits of the reform proposals.

### How ICA Reviews are Currently Conducted

The purpose of the ICA is to “encourage investment in Canada by Canadians and non-Canadians that contributes to economic growth and employment opportunities and to provide for the review of significant investments in Canada by non-Canadians in order to ensure such benefit to Canada.” These goals are sought to be achieved by reviewing the acquisition of large Canadian businesses with reference to a list of largely economic criteria, to ensure that, on balance, such acquisitions are likely to be of “net benefit” to Canada.

The factors required to be considered by the minister are:

- the effect of the investment on the level and nature of economic activity in

Canada (employment; resource processing; utilization of Canadian parts, components, and services; exports; capital expenditure, *etc.*);

- the degree and significance of participation by Canadians in the Canadian business;
- the effect of the investment on productivity, industrial efficiency, technological development, product innovation, and product variety in Canada;
- the effect of the investment on competition within any industry in Canada;
- the compatibility of the investment with national industrial, economic, and cultural policies, taking into account policies enunciated by the federal government or by provinces likely to be directly affected; and
- the contribution of the investment to Canada’s ability to compete on world markets.

The minister of industry (and/or of Heritage Canada in the case of “cultural” businesses) is responsible for making the decision which, given the disparate factors involved, can be highly subjective. The “net benefit” test is similar to the “public interest” test as applied by Canadian sectoral regulators to review of mergers in industries such as broadcasting and energy. The list of factors required to be taken into account under the ICA does serve to define the nature of the inquiry (other than the compatibility with cultural policies, they all relate to the short- or long-term economic impact of the foreign acquisition), just as the list of objectives of the Broadcasting Act or of the Competition Act shapes decisions under those statutes. That said, several of the factors listed in the ICA do not provide objective standards against which proposed investments can be measured, and leave the minister with a great deal of discretion.

One question the Industry Committee needs to ask is whether objective standards, and reigning in the minister’s discretion, are in fact desirable? With certainty comes rigidity. Arguably, given the significant range of facts and circumstances applicable to investment in a sophisticated economy such as Canada’s, flexibil-

ity is required if meritorious investment is not to be arbitrarily blocked. For example, many mergers and acquisitions, whether by domestic or foreign nationals, result in a change in management and a house-cleaning of sorts. Particularly if the Canadian business has not been faring well, such a house-cleaning, while resulting in the short term in decreased employment, may well be required for the long-term good of the company and therefore will benefit the long-term level and nature of economic activity in Canada. Leaving the minister the flexibility to determine that certain negative effects can be outweighed by positives in other areas (decreased employment might be offset for example by an increased ability to compete) may well result in the rejection of fewer investments than would a more rigid set of criteria—and may well be better for Canada.

Another feature of the current system which maximizes flexibility is the identity of the decision-maker. Currently, the ICA operates under political leadership, with the minister personally responsible for the decision, based on his or her own weighing of the various factors.

Alternatives will entail, in varying degrees, more of a “law enforcement” approach, such as that used for the review of mergers under the Competition Act. An independent agency investigates and, for practical purposes, decides the fate of most mergers (very few contested mergers are litigated in Canada—they are largely settled or withdrawn). The test for mergers, “substantial lessening or prevention of competition” is, although couched in economic terms, nonetheless justiciable. Particularly with the publication of guidelines and case summaries, a fair degree of predictability has evolved in the application of that standard to particular facts. Even within the Competition Bureau, procedures have been developed which ensure that parties are presented with the case against them and given an opportunity to respond, and have the right to “appeal” internally to the commissioner of competition if they are at odds with bureau officials. Clearly, the Competition Act merger review process was designed with accountability and predictability in

mind. The question is, do we want that, or something similar, for reviews of foreign investment under the ICA?

Arguably, any attempt to quantify the “net benefit” test and to make it independent of politics and politicians would result in the rejection of a far greater number of investments than just two in 25 years. The more rigid the test, the more likely that the long-term benefits of the free flow of investment itself would be forgotten or underweighted when compared to any short-term pains caused by a foreign acquisition.

One might be able to overcome the rigidity to some extent by reversing the burden of proof. Rather than having investors convince the minister of likely “net benefit,” as is currently the case, the act could require the minister to act only if he thinks the investment is likely to result in “net harm” (as noted, this reform was suggested in the Wilson Report *Compete to Win*, but has not yet been taken up by the government). One might even go further, and (taking into account the inherent benefit of the free flow of capital) state that investments are to be approved unless the decision-maker is of the opinion that they will cause “significant net harm” to Canada, based on the enumerated criteria in the act.

Public hearings, of course, would enable not just directly-affected parties, but the press and all stakeholders to follow the details of cases. While greatly enhancing public insight into the administration of the act and investors’ plans in individual cases, and therefore increasing accountability, public hearings might impede the ability of the minister (or an independent decision-maker) to make compromises in order to let investments proceed. In addition, investors may shy away from making reviewable investments if public opinion would be stirred up by such proceedings. If hearings were combined with reversing the burden of proof by moving to a “no net harm” test, the ultimate outcome in terms of the impact on decisions would be difficult to determine. What is certain is that public hearings would significantly increase costs to investors of being reviewed, as well as lengthen the time

required for such reviews, and in all likelihood increase the uncertainty associated with reviews.

All of these reform proposals, moreover, must be examined in light of the changes in investment flows which themselves have already given rise to some of the increased public profile of the act described earlier. Whether in these changing times Canada would be better off with more of a “law enforcement” approach to foreign investment review, or with the current flexible, political but largely discretionary model, or some combination thereof, is presumably what the Industry Committee will address.

### The Changing Face of Foreign Investment

One trend noted above has been the apparent drift in recent years toward more stringent enforcement of the act. More—and more detailed—undertakings are being required of foreign investors in ICA reviews. The U.S. Steel acquisition of Stelco, for example, was conditioned on over 30 separate undertakings by U.S. Steel in regard to its future conduct of the Canadian steelmaker. The reasons for this “undertaking creep” are not entirely clear, but may relate in part to the need for Industry Canada officials to measure their own work product. There is more to it than that, however, as at the political level, Canada has had several years of successive minority governments, which can be voted out of office at any time. Such governments are sometimes of necessity more sensitive to criticism than are majority governments who need not face the polls for several years. Undertakings, being binding, show that the government is serious about ensuring foreign investment is beneficial, and thus help protect Ministers from nationalist criticism, even while permitting foreign investment to proceed relatively unfettered.

With respect to enforcement actions themselves, although there has been a lot of publicity concerning the government’s court case against U.S. Steel for breach of several of those commitments (U.S. Steel shut down its Canadian plants in the aftermath of the 2008/2009 recession in

favor of production at US. plants, thereby allegedly breaching its undertakings concerning Canadian production and employment), this is, after all, the first time in over 20 years that the government has sought to punish an investor for breach of its undertakings. Many other investors over the years, facing events beyond their control, have been able to demonstrate their good faith in doing their best to comply with the spirit, if not the letter of their commitments. Seen in this light, it is remarkable that there has only been the one court case to enforce undertakings under the act.

The reform proposals must also be seen in the light of the successive waves of mergers which have accompanied globalization of many industries. Industries which were clearly national or continental in scope when the act was passed in the mid-1980s have since become continental or global. Along with the increased geographic scope of markets comes international consolidation, and along with such consolidation comes cross-border investment. Particularly with high commodities prices spurring investment in natural resource extraction, the pace of foreign investment in Canada has never been higher. Enforcement actions of some sort were inevitable. The fact they were deemed necessary at all does not, however, support the notion that the statute is not tough enough.

Reformers must also be mindful of the reciprocal nature of cross-border investment. Outgoing Canadian investment abroad has increased even more than incoming investment, with total foreign investments in Canada recently falling behind the stock owned by Canadians abroad. Arguably, the free flow of capital out of Canada is even more important than the free flow of capital into Canada. Impediments to cross-border investment flows clearly should be very carefully considered.

Another factor which affects the need for a flexible approach to decision-making under the ICA is the rise of sovereign wealth funds and other state-owned enterprises (SOEs) in the international invest-

ment community. Greater participation by entities owned by foreign governments, as opposed to private business concerns, raises a potential concern about political interference in the Canadian economy. As Dubai sought to invest in American ports, and China sought to acquire a Canadian natural resources company (Noranda) a few years ago, it became apparent that an articulated, coherent strategy toward investment by SOEs was required.

The federal government therefore issued guidelines for the review of investments by SOEs under the “net benefit” test. The guidelines state that as part of the net benefit test, SOE investors will be scrutinized to ensure that the investor adheres to Canadian standards of transparency and governance, and that the Canadian business maintains the ability to make economic decisions, such as the location of processing of raw materials, on a commercial basis. A basic premise of a capital market economy is that the greatest good will be achieved overall if each investor acts in its own economic best interests. If a government that is not answerable to shareholders but to voters in other countries (or, in some cases, only to itself), is instead controlling the Canadian business, a benign approach to foreign investment may not be warranted. The SOE guidelines, accordingly, ensure that investment in Canada by SOEs is screened on the same basis as other investors, and that xenophobic reactions against some governments are not part of the equation.

Similarly, the enactment of the national security review provisions in 2009 can be seen as a necessary response by Canada to rising threats from global terrorism and uncertain political and economic times. Under these provisions, the federal cabinet is permitted to review a foreign investment (of just about any kind—it need not amount to an acquisition of control) if it fears the investment may be injurious to Canada’s national security. Despite the lack of a definition of “national security,” given that a review cannot be held other than at the request of the federal cabinet, and that a review must be ordered within 45 days after the minister of industry is

first notified of the transaction, there are not likely to be many national security reviews. The fact that the sell-off of Nortel proceeded without a national security review, despite very vocal public demands to do so by some Canadian bidders, is testimony to the non-interventionist approach of Canada toward foreign investment and capital markets generally. Again, however, in the face of changing sources of investment and uncertain political and economic times, the Industry Committee needs to consider whether moving away from a model of political discretion toward a more “law enforcement” approach is wise.

### Where Do We Go From Here?

It is in the context of these conflicting trends—generally toward a more hands-off approach toward economic regulation on the one hand, with increasing limits for the review of foreign investment and the removal of restrictions on foreign control of key sectors—and on the other hand that of “undertaking creep” and greater public profile of the act amid changing investment flows and diverse sources of funds—that we examine the current proposals for greater accountability, transparency and effectiveness in the ICA review process.

Recent calls for greater accountability in the ICA process could serve to smooth the path for foreign investors by lessening uncertainty surrounding the ICA review process. The publication of guidelines and of after-the-fact case summaries including details of undertakings, for example, would permit the development of a body of non-binding precedent and could be beneficial to the investing community. Investors could see what kinds of undertakings had been required in various circumstances, and the breadth of mechanisms through which “net benefit” has been shown.

Care would need to be taken not to reveal confidential business information, but the need for confidentiality in individual cases has not prevented the publication of very detailed court decisions in other contexts (e.g., Competition Tribunal merger decisions). We see no reason why case

summaries along the lines of the “back-grounders” which the Competition Bureau sometimes publishes in merger cases could not be produced. Over time, they would form a useful body of precedent upon which both Industry Canada and the business community could draw.

Indeed, if guidelines and case summaries are useful for merger review under the Competition Act, where the Competition Bureau’s discretion is ultimately subject to adjudication by the Competition Tribunal, they should prove all the more useful for foreign investment review under the ICA, where the minister alone is responsible and there is effectively (barring extraneous considerations or malfeasance) no avenue of appeal.

When debating the merits of guidelines and case summaries, however, one must also recognize that with increased accountability comes a loss of flexibility on the part of the minister, with a potential cost.

In this context, the Industry Committee should question, if it truly desires increased accountability, does it really

want foreign investors to have to prove “net benefit”? Or should the minister have to prove, as recommended by the Wilson Report *Compete to Win*, that the investment will not be of “net harm” to Canada? Is that not in reality how the test has typically been applied in the past?

Public hearings before an independent adjudicator would make decision makers more accountable, but would considerably lengthen the process, increase the cost for investors, and introduce a much more significant degree of publicity and uncertainty into the process. One possible compromise might be for Industry Canada to develop its processes such that well prior to making a public announcement on a merger, staff would present the case against the investment and request further input from the investors. Just as is currently the case with merger review at the Competition Bureau, the minister might hold him/herself above the fray until the end, thus ensuring a sort of “informal” appeal right. Again, however, such quasi-judicialization of the internal process will come at a cost in terms of time and

flexibility.

In order to get the right institutional and legislative design for review of foreign investment under the Investment Canada Act, the next Industry Committee needs to carefully consider the implications of the various decision-making models under consideration. Recent trends have increased the public profile of the statute, thereby resulting in nationalistic calls for reform. With outflows of investment from Canada now greater than inflows, however, and globalization leading of necessity to increased cross-border investment flows generally, Canada should seriously question whether reforms will be of “net benefit” to Canada.

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# BUSINESS LAW TODAY

The ABA Business Law Section's Online Resource

## Negotiating the Loan Agreement: The Borrower's Perspective, Part II

By John N. Oest

One hallmark of an expanding economy is increased lending to businesses. As more capital becomes available, borrowers need to know how best to negotiate the terms and conditions under which they acquire it.

In a [prior issue](#) of this magazine, this author proposed strategies a borrower might adopt when negotiating a commercial loan commitment. While reasonable minds will differ on what points should be raised at that early stage, a number of matters inevitably remain for negotiation in the loan agreement itself. This article will examine a typical asset-based loan agreement and outline practical steps the borrower's counsel should take in order to insure that the closing proceeds smoothly and on time.

### Satisfying Conditions Precedent

The loan agreement will list a number of items the borrower must deliver as a precondition to funding. Pay close attention to these items from the outset, particularly ones that will require performance by third parties. These parties might include:

*Title companies.* A lender taking real estate collateral will require an ALTA Standard Loan Policy insuring the validity and priority of its mortgage lien. Engage your title insurer at once and provide it with the list of the lender's required endorsements. Unexpected difficulties often arise during title clearance and the careful borrower's counsel will leave herself the maximum

time to get it accomplished.

*Surveyors.* Most real estate lenders require a new survey. The surveyor must be hired and provided a list of the lender's requirements as well as copies of existing title evidence. Engaging the surveyor quickly is particularly critical in "year-end" transactions where surveyors often have more fieldwork than they can timely perform.

*Landlords.* Some states afford landlords a statutory security interest in personal property of the tenant located on the leased premises in order to secure rental obligations. A lender advancing against inventory and equipment stored on such sites will frequently ask all (or major) lessors to waive or subordinate their landlords' liens. The borrower should not assume that these negotiations will be painless (or even successful) and must forward the draft letters to the landlords quickly.

Try to obtain the lender's agreement that you need not obtain letters from all lessors but only from some lesser percentage, such as 75 percent. Do not be surprised however, if the lender insists that acceptable waiver letters be delivered for all sites deemed crucial to the borrower's business operations.

*Auditors.* When a loan closes sometime after the close of a company's most recent fiscal year, lenders may ask for an audit of the "stub period" from the date of the last audited statements to an agreed-upon

date prior to closing. If the lender cannot be dissuaded, the auditor must begin work at once.

*Local Counsel.* Local counsel must frequently be engaged in multistate transactions for any number of reasons. Negotiations over their opinions are often more protracted than anyone would wish, which is why the borrower should put the lender's proposed form of legal opinion into local counsel's hands as early as possible. Far too many transactions find the lender and local counsel still arguing over opinions on the day of closing.

Many provisions are common to loan agreements. The borrower's ability to revise them will depend not only on its financial strength but also on market terms generally. Nonetheless, the borrower's counsel should keep certain ideas in mind.

### Loan Administration

Establish whether the borrower's receipts must be paid directly into a lockbox controlled by the lender. If so, determine whether it can be a "soft" lockbox (where the borrower may withdraw funds from the account prior to an event of default without lender approval) or must be a "hard" lockbox (where withdrawals must be consented to, or pre-approved, throughout the life of the loan). In most cases, a soft lockbox is all that will be required although the lender will always be granted the right to debit the account for regular debt service.

## Representations and Warranties

All loan agreements require the borrower to recite certain facts as true and to acknowledge that the lender is relying on the truth of those recitations. There are two schools of thought about representations and warranties. Many view the terms interchangeably.

But others distinguish between them based on whether knowledge is implied. In this view, a representation is the borrower's statement that a fact is true but implies knowledge or at minimum an absence of knowledge that the statement is untrue. A warranty would be much broader: a statement that a fact is true without regard to the borrower's knowledge. Warranties can also be extended to future events whereas representations cannot meaningfully be so extended. An automobile manufacturer, for example, does not know whether an engine will run properly six months from the date its car leaves the lot, but warrants nonetheless to take certain actions if that statement proves untrue.

No matter which view an attorney adopts, breaches of representations and warranties always have adverse consequences for borrowers, so wherever possible, statements of fact should be expressly limited as being "to the borrower's knowledge." Lenders will resist, arguing that the representation and warranty section is simply a risk-shifting device and that, should a given fact prove untrue, the borrower should suffer the consequences without the lender needing to prove the borrower knew the statement was untrue.

A borrower may still succeed in inserting a knowledge limitation on at least two fronts. While it must stand ready to remedy any environmental defect, the borrower should not be in default if an environmental condition arises that was unknown to it. If the Phase I report overlooked something, the borrower should not face acceleration so long as it is actively attempting to remedy the problem.

The borrower should also qualify its representation and warranty about compliance with laws. Most borrowers view themselves as law-abiding, and in popular parlance they are. But on deeper reflection

most realize they cannot possibly warrant compliance with all building codes, zoning laws and ordinances, ERISA rules, labor standards, and more. No one can. It should seek to represent only that it neither knows of a violation nor has received a notice of such from a governmental entity.

If a borrower does succeed in obtaining a "best of knowledge" limitation, it must then define that term. What does it mean for a corporate entity to "know" something? Does it have knowledge if anyone in the organization knew it? If anyone should have known it? The borrower's ideal provision looks something like this:

For purposes hereof, "the Borrower's best knowledge" shall mean the actual knowledge of [X and Y] as of the date hereof, with no duty of inquiry, which duty has been disclaimed.

In the above clause, X and Y would be two individuals reasonably expected to know of the important facts that are the subject of the representation and warranty section.

## Affirmative Covenants

All loan agreements require borrowers to perform a host of acts, such as maintaining its corporate existence, most of which should be unobjectionable. Three covenants in particular warrant close attention.

### Maintaining Insurance

Consult an insurance broker or expert as early as possible. Lenders are known for far-reaching and expensive insurance requirements. Quite often the amounts inserted by the lender in the documents are boilerplate without regard to this particular business. The lender might be talked out of some coverage altogether or limit the terms of other requirements such as the length of time one must covered by business interruption insurance.

Even attorneys well-versed in insurance provisions lack the expertise to assess the reasonableness of the amounts of required coverage or permitted deductibles, particularly under liability policies. These determinations require knowledge

of insurance market conditions as well as experience with the types, frequencies and amounts of exposures this particular borrower's business is likely to face.

### Financial Reporting Requirements

The loan agreement will invariably require quarterly unaudited income statements and balance sheets together with annual audited statements. There are at least two issues to discuss: (1) does the due date for interim statements afford the chief financial officer time enough to prepare them? and (2) what level of audit review will ultimately be required?

There are three levels of financial statement review. The least expensive, a compilation, consists of the accountant simply arranging the borrower's financial information in the format of a financial statement. The accountant states only that the statements are in proper form and free of obviously material errors. No comfort is given that the statements were prepared in accordance with Generally Accepted Accounting Principles (GAAP). Compilations are typically prepared only for the internal use of small companies and lenders virtually never accept them.

Far more common is a review. The accountant performs a certain amount of due diligence on financial information provided by the company, makes limited inquiry of the company, then applies procedures sufficient to form a reasonable basis for giving a limited assurance that no material changes are required for the statements to conform with GAAP. This may be acceptable to some lenders, particularly if the borrower is a small start-up of some sort.

The most expensive, and the one most lenders want, is the audit. The accountant performs all tests required to determine that the statements conform to GAAP. The accountant then issues an opinion that is either "clean" (unqualified), "qualified," or "adverse." Lenders will require a clean opinion—that the financial statements "present fairly the financial position" of the borrower. A qualified opinion might be issued if there were agreed upon limitations in the engagement or other uncertainties surrounding the audit. Adverse

opinions state that the financial statements do not accord with GAAP and are always unacceptable to the lender.

Some loan agreements require the auditor to certify annually that it has reviewed the financial covenants in the loan document and that there are no defaults thereunder. If so, the borrower must determine at once whether its auditor gives such an opinion. Auditors routinely resist them because they often form the basis of actions against them by lenders.

#### *Compliance with Laws*

At most the borrower should agree that it will be in material compliance with laws or alternatively that it will comply with laws so long as the effect of noncompliance does not materially adversely affect the borrower.

#### **Negative Covenants**

Several of the more important negative covenants (such as due-on-sale and due-on-encumbrance clauses) were discussed in the [previous article](#) on loan commitments. Some additional issues that arise during loan agreement negotiations include:

#### *Mergers and Consolidations*

No lender will permit its borrower to be merged or consolidated out of existence, so the borrower's goal is simply to narrow the scope of the clause by excluding: (a) mergers of subsidiaries into the borrower; (b) mergers of subsidiaries into one another, or (c) mergers where the borrower is the surviving entity. Exceptions (a) and (c) may be difficult to obtain because, although they will typically satisfy the lender's concern about consistent management and control, they nevertheless expose the lender to the risk that the surviving entity could have a lower net worth than the pre-existing borrower (if the acquired company has a weak balance sheet). An approach acceptable to some lenders is to permit mergers or consolidations where the borrower is the surviving entity and its net worth does not decrease as a result of the merger or consolidation. A careful lender will also insist that certain designated individuals

remain in day-to-day control of company decisions.

#### *Dividends*

Smaller borrowers frequently express surprise at dividend prohibitions but the lender's view is always the same: debt gets paid before equity. The lender will take great interest in salaries being paid out by the company and can be expected to limit them. Nonetheless, certain carve-outs from the dividend proscription are generally available. These include exceptions for: (1) dividends paid solely in shares of common stock; (2) pre-existing contractual obligations to pay dividends on preferred stock; and (3) distributions to equity holders (of pass-through entities) in amounts sufficient to pay their allocated share of company income. Members of a limited liability company for example must pay income taxes on their aliquot share of company taxable income whether or not received. The members will want to receive dividends sufficient for them to meet those tax obligations. As a practical matter, the lender will be asked to assume that each distributee is in the highest marginal tax bracket for purposes of these computations, as will often be the case.

#### **Materiality and Reasonableness**

Borrowers often attempt to insert materiality limitations on covenants and representations (e.g., "The borrower will advise the lender of any *material* threatened litigation."). The author's view however is that time spent negotiating the many places where materiality limitations could be inserted is largely wasted. The common law requires materiality as a precondition to default in performance of any contract and a loan agreement is no exception. Nor do lenders look to seize upon immaterial defaults as a reason to accelerate. Lenders do not want to run the borrower's business nor incur the expense of liquidation absent a compelling reason to do so. Lenders take action only when there is a significant problem, no matter what the documents say.

"Reasonableness" on the other hand is something worth fighting for, such as obtaining the lender's agreement that its

consent shall never be "unreasonably withheld, conditioned, or delayed." A lender will be bound by implied or statutory covenants of good faith and fair dealing, but there is no overarching obligation to act "reasonably" in all contracts nor as to any particular decision. This concession can be difficult to obtain however, particularly in tight credit markets. It is never available in any section dealing with loan defaults.

#### **Events of Default**

No section is more apt to capture the borrower's attention than the one detailing events of default. But most lenders will not countenance extensive discussion of this topic and will be quick to wonder aloud why the borrower is spending so much time on it if the borrower never intends to default. The most effective approach is to press for one or two simple things then let the rest go. These include:

#### *Notice and Cure for Monetary Defaults*

Borrowers routinely request a right to receive notice of, and then cure, a default before a lender accelerates the loan. The ideal borrower clause might read as follows:

Any failure of the borrower to pay principal or interest within five (5) days after notice of same from the Lender.

Lenders grant this concession far less frequently than in the past, arguing that the borrower knows full when payments are due and should be making them on time. The borrower should recognize that the lender has a legitimate interest in not being burdened with sending repeated default notices to chronically delinquent parties and try to address that concern. One way is by agreeing that the lender need send such notices no more than twice a year.

A different approach, little used but effective, is to insist that a notice of default should always precede the momentous step of acceleration, but to offer instead that the borrower pay escalating late payments each time the lender is forced to

give such a notice. Increasing payments quickly attract the borrower's attention and will deal with the lender's worry about chronic delinquency. Parties can and do agree to "reset" the late payments if the borrower is in compliance for an agreed period of time.

#### *Notice and Cure for Nonmonetary Defaults*

The borrower has a more compelling request here. While the borrower should know its payment schedule, how is it to know if its lender believes the borrower is not maintaining proper insurance unless it receives notice from its lender? A borrower can often obtain up to a 30-day cure period for non-monetary defaults.

For defaults not capable of being cured within 30 days, borrowers will request a "continuing cure" right such as the following:

Provided however that if the nature of the default is such that it is not capable of being cured within 30 days, then so long as the borrower is actively and continuously attempting to cure such default, the borrower shall not be deemed in default for such breach.

Even if the lender accedes to this request, the borrower should be prepared to accept an outside cut-off date by which the breach must be cured no matter the circumstances. Ninety days is a great result; 60 should be acceptable.

#### *Cross-default Provisions*

Pay close attention to cross-default provisions. It may well be that the loan facility under negotiation is not the first or only loan the borrower has with this lender. While the borrower may well view the two loans on a stand-alone basis, the lender often sees it differently. Cross-default provisions should be resisted wherever possible but can prove difficult to fend off.

#### *Material Adverse Change*

Although Article 1-309 of the Uniform Commercial Code permits "general insecurity clauses" so long as the lender

exercises them in good faith, the borrower should vigorously contest any such provision. The borrower argues that such a provision affords the lender far too much control and, further, that the standards for acceptable financial performance have already been spelled out in the financial covenants. Many lenders will delete this clause but, if unwilling, may be persuaded to move to objective tests rather than subjective ones (e.g., an X percent decline in net operating income for two consecutive quarters or a Y percent decrease in the net worth of the borrower as reflected on the audited financial statements).

#### **Remedies**

Beyond the suggestions outlined above, most experienced borrowers' attorneys spend little time on the remedies section. By the time a lender has finally decided to accelerate the loan, it is difficult to argue there should be further contractual impediments to its exercise of remedies. Most lenders summarily dismiss such requests arguing that the borrower's best course of action is to repay the loan as agreed.

In loans with substantial personal property as collateral, however, parties will often negotiate the standards for a "commercially reasonable sale"—as contemplated by section 9-603 of the UCC. Borrowers may seek to obtain as long as 21 days prior notice of an Article 9 disposition, but 10 days is a realistic expectancy.

In a syndicated (multi-lender) loan, it is important to resist provisions providing contractual rights of setoff. Generally the law permits setoff only if there is mutuality (i.e., the same two parties owe each other money) and both obligations are fully mature. But in a syndication with participations, only the lead lender is in contractual privity with the borrower. No participants have a right of setoff *unless* the borrower contractually grants them one. Borrowers often do not know the identity of all (or any) of the loan participants so should not risk discovering that an account has been set off because one of its depository banks was an unknown participant. Contrast this situation with a "co-lending" agreement in which each of

the co-lenders is in direct privity with the borrower. It will be futile to resist setoff rights here.

#### **Conclusion**

Even after the major deal points have been finalized in the loan commitment, the loan agreement itself remains to be negotiated. While large portions will always remain off limits, the borrower must still choose its battles wisely and attempt to pare down the most objectionable portions of the document.

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# BUSINESS LAW TODAY

The ABA Business Law Section's Online Resource

## Keeping Current: Antitrust

### California Antitrust Case Demonstrates Need to Be Cognizant of State Laws

By Marvin R. Lange, Daniel E. Hemli, and Jacqueline R. Java

Businesses that market products or services in multiple jurisdictions are aware that laws differ from place to place. This is true in the area of antitrust, where all of the states have enacted legislation. While there is a great deal of similarity among state antitrust laws, individual statutes and their interpretations by state courts and regulators do vary somewhat from state to state. Additionally, while state antitrust statutes generally are modeled after the federal antitrust laws, differences do exist. These divergences between and among federal and state laws can have important practical consequences for businesses. A recent consent decree between the State of California and a manufacturer of beauty care products illustrates one difficulty that can confront companies operating interstate, particularly in the Internet age—specifically in the context of setting resale prices for products or services.

The attorney general of the State of California sued Bioelements, Inc., contending that contracts with its distributors and retailers prescribing the minimum prices at which they could sell Bioelements products online constituted per se violations of California's state antitrust law, the Cartwright Act. *California v. Bioelements, Inc.*, Case No. 10011659 (Cal. Super. Ct., Riverside Co. Jan. 11, 2011). (A government enforcer or a private claimant can establish a per se antitrust violation merely by proving that particular acts occurred. It is not neces-

sary to show an impact on competition.) Rather than proceed to trial, earlier this year Bioelements agreed to refrain in the future from controlling the prices at which distributors and retailers could resell its products, to inform the existing distributors and retailers that they were no longer bound by the price control provisions in their contracts, and to pay \$51,000 in civil penalties and attorney fees.

This case would have been unremarkable a few years ago. The practice in question—known as “vertical price-fixing,” or “minimum resale price maintenance” (RPM)—was held to be illegal per se under the federal antitrust laws in 1911. In 2007, however, in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007), the United States Supreme Court, recognizing that RPM can be procompetitive (for example, by stimulating competition between different brands), overruled that long-standing doctrine. Now, RPM is not per se illegal under the federal antitrust laws, but its legality is judged under the “rule of reason” standard. A rule of reason case requires analysis of the competitive effects of challenged conduct, a far more in-depth and complicated inquiry than in a per se case. As a result, a practice long held to be illegal under federal law is now likely to be challenged less frequently and held illegal even less often.

Individual states, however, are free to enact and enforce their own antitrust laws,

and to apply their own standards, within limits. The precise scope of application of those laws to conduct occurring in other states can present difficult legal issues, but it is clear that the states may regulate conduct that occurs within their borders and some out-of-state conduct that affects their residents. (Here, Bioelements' president worked in California, many of Bioelements' distributors were located in California, and the products were sold to consumers in California.)

Application of a state's antitrust laws to conduct that takes place in, or affects, that state can create difficulties for companies that seek some control over the prices at which their products are sold. Imagine a manufacturer that, like Bioelements, sells to the public through distributors that sell online. The manufacturer wishes to maintain the prices of its products above a certain point—perhaps to maintain the image of the products as quality products; perhaps to prevent prospective customers from obtaining information about the products at conventional brick-and-mortar stores and then buying more inexpensively online. Under federal law, in most cases, this would no longer be illegal. But if the manufacturer sells to distributors/retailers in California, or in another state that still regards RPM as illegal per se, or if such distributors/retailers sell to customers in California or in such other state, such restrictions might be impermissible as a matter of state law.

The Internet, of course, does not respect state boundaries. Online distributors and retailers in California may sell to consumers in Kansas through the same websites from which California residents make purchases. And if distributors can price at whatever levels they choose in California, those same prices will appear on computers in Kansas. The manufacturer's efforts to maintain its desired price levels in Kansas will thus be undermined by lower prices that originate in California but are equally available to consumers all over the country.

The manufacturer may be able to avoid this result, but the methods available to it may be costly, imperfect, or even counterproductive. For example, under most circumstances, the manufacturer can legally agree with the California distribu-

tor that the distributor will sell only to California residents, but in order to ensure that residents of other states not view the lower California prices—for which they don't qualify—on their computer screens, the distributor would have to incur the trouble and expense of partitioning its website content by geography, something not all distributors might be willing to do. Or, the manufacturer might refrain entirely from selling to distributors in California, but even if the manufacturer sold only to out-of-state distributors, California might nevertheless argue that those distributors' online sales to California residents at prices set by the manufacturer violated California law. A manufacturer faced with this dilemma could reasonably conclude that its best choice is to refrain altogether from including price maintenance provi-

sions in its distribution contracts.

There is still vigorous debate among lawyers and economists regarding when RPM is anti-competitive and when it can have salutary effects. Courts and legislatures in different jurisdictions have reached different conclusions on this issue. The *Bioelements* case presents a timely reminder that, unless and until state and federal laws conform—in RPM and in other areas in which they currently diverge—companies must continue to be mindful of the laws of all applicable jurisdictions.

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# BUSINESS LAW TODAY

The ABA Business Law Section's Online Resource

## Training for Tomorrow

### Ten Tips for a Successful Transition from Law School to Law Practice

By Miriam R. Albert

Every fall, lawyers eagerly wait to see if their newly-hired colleagues have passed the bar, and my law professor colleagues and I restart our annual pontification on whether we have (or even whether we should have) prepared these poor graduates sufficiently for the bar exam. What's the role of law school, we ponder. Should we teach them the law? Or should we teach them how to think like lawyers? Or should we teach them how to be lawyers? Do we "teach to the bar" or instead ground them in theory and policy and let the bar review courses drill them on the rule against perpetuities?

Reasonable minds can and do differ on all these questions, but one thing all of us reasonable minds can likely agree on, whether we are in practice or teaching, is that there is a noticeable gap between the skill set one has upon graduating from law school and the skill set one needs to effectively engage in the practice of law. I certainly felt this myself—I was a December graduate, and returned to the firm where I had been a summer associate. So I put on my cap and gown, moved my tassel to the left and joined the same firm where I had summered, this time as a first-year associate. I was a lawyer. It felt like returning home. For about five minutes. Suddenly, the partners were expecting me to practice law. "But wait," I wanted to say, "remember this summer when I just took it all in and went with you to parties and ball games and a few meetings and listened to

your war stories? Now suddenly I am supposed to draft shareholder agreements? By myself? And what's a shareholder agreement, anyway?" I wanted to ask.

I figured out quickly that I had better figure out how to become a lawyer, and quickly. So I did. But the road from law school graduate to useful member of a deal team was a bumpy one for me, as it was for many of my colleagues. In an effort to make other lawyers' transitions from law school graduate to lawyer a bit smoother, I now offer my list of 10 things lawyers wish they had known on the first day of practice. In the spirit of full disclosure, I am a transactional lawyer by training, and now teach business law and skills classes, so much of the list is geared toward transactional lawyers. That said, easy conversions exist, I suspect, to modify the list as needed for my litigating brethren.

In the spirit of still more full disclosure, I note that many of the topics lend themselves equally to my other project—parenting (and by that I mean refereeing the various combinations and permutations of disputes between and among my three kids). I will leave the philosophical question of why this significant overlap between lawyering and parenting exists to others to explore—perhaps we really did learn all we needed to know to be good lawyers in elementary school, but have since forgotten it all.

So here goes—the top 10 things law

graduates need to figure out before becoming a useful transactional lawyer.

#### 1. Be a Good Listener

Good lawyers need to know when to ask questions, and equally importantly, how to ask questions and who to ask them of. One key to successful questioning is good listening and proper timing. So for our newly-minted lawyers, try to ascertain as much as you can about the task at hand from the assigning lawyer, and then get to work. This may not, and probably does not, mean that you start writing. First, find good precedents and forms to use as the basis of your document. See if any of your fellow associates have worked for this partner, and see if they have relevant forms, particularly forms this partner has used; odds are what worked for this partner in the past may well work for this partner now.

It would be surprising and perhaps even concerning if you had no questions at this point in your career, so make your list of questions. Check it twice. Then work on answering them yourself with old fashioned or Internet research. Seek out the help of the law librarian, or other junior colleagues. This is a great way to begin to build a mentoring relationship—respectfully tap into the body of experience that your colleagues possess. For now, you primarily take from that body of experience, with the hope that someday soon you will be able to replenish and even expand it.

When it comes to reaching out to the partner, ask questions when and if they are really needed, and choose your timing carefully. This skill seems woefully absent in some of today's law students. My experience and that of my colleagues at other law schools seems to support the idea that a noticeable percentage of law students seem to have no idea about what constitutes a good question. I had a 3L in my office just weeks before her graduation, and she was struggling with a corporate law concept. She was a good student, on law review, and generally prepared for class.

That said, this young lady made a few strategic mistakes. First, she blew into my office about 30 minutes before class time, which is typically not a good time for me to chat. I gave her very clear non-verbal signals, by not looking up right away when she popped in, and when she said, "I have a question," I responded by saying "only if it's a quick one—I am getting organized for class." She said, "Well, it may not be that quick." And sat down. Curious choice. She continued, "I am just not understanding piercing the corporate veil and reverse piercing. What I need," she continued "is for you to walk me through the concept, so I can fully grasp it. Then I'll need about five to seven hypotheticals on this topic for me to work through, and then we can go over them together." She took my stunned silence for acquiescence, I fear, since she continued: "I'll need them by the end of the week, as the last draft of my law review note is due the following week and my time will be very tight." And she smiled at me, expectantly.

Suffice it to say, I had already taught the class the concept of piercing the corporate veil and reverse piercing, with hypotheticals. The bottom line here was that she asked the wrong question, in the wrong way, at the wrong time. Whether or not she was a good listener in class, she was not a good listener in my office, and further, she came to me at the wrong time.

How does that translate into the world of practice? It's a direct leap. This young lady was months away from practice at a pretty fancy law firm. She was very bright and very personable, but she simply did not understand why I would not drop

everything to make up new fact patterns for her, on her individual time frame.

Query whether she would have a different attitude at her firm? I hope so, but am not so sure. Perhaps she views her professors as her employees, which although not necessarily how I view things, makes her demand somewhat less unreasonable.

Project forward four months. She has passed the bar and now let's say she goes to work for you. Her partner gives her an agreement to draft. In the absence of some self-reflection on her part, this doesn't seem to end well. My guess is that she will not be the lawyer who approaches the partner at a mutually convenient time, and succinctly explains what she has done so far and asks reasonable questions; rather, I fear she will be the one who busts in, on or near the day the project is due, explaining that she couldn't find any viable precedents or that she was too busy to get to the project. And she will smile at the partner, expectantly.

What's the take away on this one? Figure out what questions are appropriate, figure out when to ask them, and who to ask them of—and figure it out soon. One rule of thumb: don't ask a question until you are sure you absolutely can't answer it yourself, with the myriad tools, electronic and otherwise, at your disposal. E-mailing questions can ease some of the timing concerns, as the reader can read the e-mail on his or her own timeframe; but e-mail is not a panacea. E-mail is devoid of tone and expression, and may change the impact of the question. Also, close proofreading is required, especially if your word processing program has an auto correct feature which "helps" you by substituting its choices from your misspellings, with sometimes hilarious and sometimes horrifying results.

## 2. Be an Active Participant in Your Career

The most successful law students are active and engaged in their academic careers. Some are involved in journals and moot court, others in student organizations, or combinations thereof. But they are moving their career forward, and being truly present in their law school

education. Does that mean that these students never checked their e-mail in class, or did some planting on Farmville during a public lecture? Of course not. But they show up, and not just physically. They are connected to their law school, to their classes, to their classmates.

Treat your career with the same degree of care. In this economy, many new lawyers have not landed their dream jobs, but instead have landed their dream of getting any job. Stay connected with your career. Do a good job at what you are doing, but keep your eye on your goal—how does your current job help you move toward the job you think you really want? What contacts and connections can you make, while faithfully discharging your responsibilities, that will enable you to move toward your goal?

Law students need to shed their roles from law school and grow into their roles as lawyers. Carry yourself as a lawyer, a counselor, a trusted advisor, and you will start to believe it yourself. And remain committed to your success and stay active in your career. Network, join bar association committees, do pro bono work. Decide to get involved. A mid-level associate once told me that the last decision he remembered truly making was the decision to take the LSAT. He got into law school with a scholarship, and he said he felt like he jumped on a speeding train, and now here he was, five years into practice, wondering how he got here. More tragically, he felt it was too late for him to get off that train.

## 3. Understand the Time Value of Money

All lawyers need a handle on at least the basic concepts of finance. To work on a messy partnership dissolution or practically any deal, you must have an understanding about the business issues that underlie your work. If you don't, you will never progress beyond the role of scribe. Scribes can make money, in some cases, lots of money; but scribes typically don't make partner. You need to add value either to your firm or to your deals or both to get the nod for partnership. So educate yourself on basic finance concepts: the time

value of money and basic valuation skills.

With the trend toward skills training taking firm root in our law schools, today's students have many more options to pick up the skills needed to add value from the start. One available option is the education through professional organizations like the ABA. The ABA Business Law Section Committee on Legal Education co-sponsored a program at the 2011 Spring Meeting in Boston called "1, 2, 3's of Finance" in which panel members provided an overview of financial concepts that every business lawyer should know, such as the time value of money, valuation concepts, national market system, and the roles of intermediaries and financial advisors. This kind of program is perfect for junior lawyers who plan to practice in areas of law that in some way deal with money. In other words, all areas.

#### 4. Understand the Money Value of Time

Your time is now worth something. A lot, in fact. And with the race for billable hours on, you need to free yourself up to do what only you can do. So use your support staff and paraprofessionals wisely and effectively. Don't give them something to do that will take you longer to explain to them than it would to do it yourself.

Know what the billable hours expectations are for you, and stay on pace to get there. You need to get a sense from the partner of how long he or she thinks the assignment will take, and try to work within that estimate. Don't shy away from hard work but don't be a martyr. If you need help, or you need more time, approach the partner in a smart and thoughtful way. Please see Tip No. 1.

#### 5. Don't Try to be the Smartest Person in Every Room

Many of us were raised to believe we were the smartest person in the room. In every room. That works for many of us until we get to law school and then the room suddenly became a lot smarter. Your law degree gets you to the starting line of a very different race than you have ever run before. Suddenly, your group of colleagues may include pillars of the legal

community, scholars, judges, and attorneys with more time in practice than you have been alive. No one is looking for you to run the meeting, or close the deal on day one. Figure out what your role is as a junior associate and embrace it and excel in it.

Let me be clear—you may in fact, still be the smartest person in the room, but what will clinch this title for you is the fact that you don't feel the need to make that point clear to everyone in the room.

#### 6. Comport Yourself in a Professional Manner

Law school is not the real world, God knows, but it is a graduate school that in some significant way, prepares the lawyers of tomorrow. One of these lawyers of tomorrow was sitting in my class last week, chewing gum and blowing bubbles. Yes, blowing bubbles. Again, I am hopeful that the change of venue from the lecture room to the conference room will involve a stop at the trash to spit out the gum, but I am not confident of that.

Do you address partners by their first names? What about clients? How do you need to dress for a Saturday in the office? Can you take your shoes off at 8:00 P.M. on a weeknight? Can you bring your dog to work on a Sunday afternoon? The answer to all these questions is, of course, "it depends." It depends on the partner and on the client. It depends on the firm and the size of the dog. You need to feel out your surroundings and see what others who are succeeding there are doing with these issues. When in doubt, err on the side of professionalism—imagine yourself wearing cutoffs and a tank top in the office on a Saturday when a partner strolls by with a group of clients. Roll the tape back and put on some nice business casual clothes, just to be sure.

#### 7. Write More and Write Less

Whether you wind up in litigation or deal work, it will be helpful to have ever-improving researching and writing experience. So write more. Equally important though is to write less. In all writing, especially lawyerly writing, clarity is key, a good sense of audience is essential, and

delivery may make a difference that wins and loses cases, kills or seals deals.

The current trend in legal education from the Carnegie Report and other sources is to increase our students' competencies and offer them opportunities for skills training. Hopefully, law graduates will soon have many more skills in their tool kit than I had when I graduated 10 those many years ago, but what of our current graduates, on the cusp of this shift in legal education? Lawyer, educate thyself. Get a good book on drafting. Take a CLE. Audit a drafting course at a local law school. And learn on the job. Go through the file and figure out how those who have come before you have mastered this task.

#### 8. Treat Every E-mail as if it will be in the New York Times

Don't put in an e-mail what you wouldn't say to someone's face. Don't e-mail in anger or frustration. Write your thoughts and save them in a Word document. And be careful with the bells and whistles on your e-mail system. We all know the story of the sad sack who hit "reply" instead of "forward," and included an unvarnished evaluation of the sender. Okay, that was me. And you too, I am guessing.

The same rules apply for Twitter and Facebook. Cyberspace lives forever, so don't put it out there if you think you might ever regret it. And remember you can't soften your remarks with your jovial tone in a message. Creepy emoticons can only go so far in helping the reader interpret your meaning.

#### 9. When You're Done, You're Done

This was billed as a list of 10, but it seems we're done at nine. Adding on another item just to get to 10 will not further our discussion substantively, and in fact may detract from the nine good points raised. Enough said.

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# BUSINESS LAW TODAY

The ABA Business Law Section's Online Resource

## Speaking Volumes

The Fund Industry: How Your Money is Managed

By Robert Pozen and Theresa Hamacher, Wiley Finance

2011, 526 pages, \$75.00 (hardcover list price)

ISBN: 978-0-470-63425-7

Reviewed by Robert A. Robertson

Approximately 87 million Americans invest in mutual funds, either directly or through retirement accounts. These investors likely include 90 percent of households with an ABA member. With the importance of these investments and the growth of the fund industry, Robert Pozen and Theresa Hamacher's insightful book on fund operations—*The Fund Industry: How Your Money Is Managed*—is a must-read.

Pozen and Hamacher are veterans of the mutual fund business. Pozen is chairman emeritus of MFS Investment Management, as well as a senior lecturer at the Harvard Business School and a senior fellow at the Brookings Institute. Prior to MFS, he was an executive for many years with Fidelity Investments. Hamacher is president of the National Investment Company Service Association, and the former chief investment officer for Pioneer Investment Management USA. Contributors to the book include other industry luminaries, such as Deborah Miller, director of equity quantitative research at MFS, and Eric Roiter, lecturer in law at Boston University and former general counsel with Fidelity.

The authors examine the fund industry from a unique perspective, from the basics to complex concepts and, equally important, they do so in plain English. Unlike

numerous other books that attempt to help investors decide where to put their money, *The Fund Industry* explains how the \$12 trillion mutual business operates.

"Mutual funds are unique because their investors don't go to a stock exchange to buy and sell their shares, they go directly to the fund itself. As a result, a fund's share price isn't established by traders . . . rather, it's equal to the fund's net asset value . . ." From this foundation, the book takes the reader through the fund portfolio management process and the role of portfolio managers. "Active management seeks to beat the return of an index through insightful securities selection. Industry insiders often call this *generating positive alpha*," with alpha representing the difference between the market return and the return on an investment portfolio.

New to the book's second edition is a chapter devoted to money market funds. The chapter addresses the money fund investment process and the role of money funds in the U.S. financial system, particularly during the 2008 credit crisis. "It wasn't until the Reserve Primary Fund broke the buck that the government took direct action." "The federal government stepped in with a series of programs to reduce fund redemptions and stabilize the markets," including implementing the U.S. Treasury's temporary guarantee

program.

Also new to the second edition are discussions of other types of fund products, such as the operation of exchange traded funds (ETFs) and hedge funds. "Let's explore how ETFs operate from day-to-day. We'll look at how ETFs create and redeem shares and how they manage subsequent market trading of their shares, focusing on investment company ETFs." The hedge fund section explains common hedge fund strategies, including equity long-short, relative value, distressed, and leveraged strategies.

Several chapters are dedicated to international funds: "Cross-Border Investing," "Cross-Border Asset Gathering," and "The Market for Investment Funds: Beyond the United States and Europe." "Investing overseas also raises a host of operational issues . . . [M]ost mutual funds buy securities locally and entrust them to local custodian banks—called sub-custodians—for safekeeping." After U.S. funds that invest abroad, the book reviews European retail funds called UCITS, an acronym for the awkward phrase "Undertakings for Collective Investment in Transferable Securities."

In addition to being a resource for investors, *The Fund Industry* contains career track vignettes for persons who are considering a career in the fund busi-

ness. Over the past 12 years, fund industry employment in the U.S. has grown 38 percent to 157,000 workers in 2009, according to the Investment Company Institute. Twenty-eight percent of the industry's workforce was employed by a fund's investment adviser or third-party service provider in support of the portfolio management function, such as investment research, trading and securities settlement, and information systems. Jobs related to fund administration, such as accounting and compliance, represented 11 percent of industry employment. *The Fund Industry's* career track vignettes include:

- Stock Analyst: "Interested in becoming a stock analyst?"
- Bond Portfolio Manager: "Wonder what it's like to be a bond portfolio manager?"
- Money Market Credit Analyst: "Inter-

ested in becoming money market credit analyst?"

- Fund Accountant: "What does it take to be a fund accountant?"
- Hedge Fund Manager: "What's involved in running a hedge fund?"

For those interested in these areas, including lawyers who practice in the fund business, the vignettes provide true operational insight. Also for lawyers, you should consider other books that do a workmanlike job of providing a business and legal framework for mutual funds. These books include: Tamar Frankel and Clifford Kirsch, *Investment Management Regulation* (Fathom Publishing, 3rd ed. 2005) and Matthew Fink, *The Rise of Mutual Funds: An Insider's View* (Oxford University Press, 2nd ed. 2011).

Plain English and insightful depth are the hallmarks of *The Fund Industry's* more

than 500 pages. The book is accessible to the investor and investment professional who are new to the marketplace, and it serves as an excellent reference for the more seasoned. The book has a broader perspective, but makes a nice companion book to Lee Gremillion's work, *Mutual Fund Industry Handbook: A Comprehensive Guide for Investment Professionals* (John Wiley & Sons 2005). *The Fund Industry* succeeds in assembling the various segments of the fund business into a coherent and complete picture. Pozen and Hamacher should be commended for their tremendous effort.

*Robert A. Robertson is a partner in the Financial Service Group of Dechert LLP. He is the author of Fund Governance: Duties of Investment Company Directors (Law Journal Press 2011, originally published in 2001).*