



## Quarterly State Compliance Review

By Sandra Feldman

This edition of the Quarterly State Compliance Review looks at some legislation of interest to corporate lawyers that went into effect from May 1 through July 1, 2010. It also looks at recent decisions of interest from the courts of Delaware, New York and California.

### IN THE STATE LEGISLATURES

This has been a busy quarter for those who track changes to state business entity statutes, as a significant number of amendments went into effect. Below are some of the legislative highlights from around the country.

In Iowa, House File 2111, effective July 1, directed the Secretary of State to notify the Department of Workforce Development when a corporation or LLC applies for reinstatement after a dissolution, and directed the Department to report the entity's tax status to the Secretary of State. In Kansas, Senate Bill 132, effective July 1, enacted the Entity Transaction Act, which will govern mergers, conversions, interest exchanges and domestications involving all types of business entities.

In Maryland, Senate Bill 784, effective June 1, required foreign statutory trusts to register with the state before doing business there and imposed penalties for failure to do so. In Mississippi, Senate Bill 2003, effective July 1, allowed

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## Risk Retention: Throwing the Baby Out with The Bathwater

By David Galainena, Patrick Hardiman, Ronald Jacobson and Michael Mullins

There is significant, ongoing debate in Congress, as well as among the industry's regulators, as to the direction and scope of financial reform measures designed to address the problems that were perceived to be the cause of the current economic crisis. Some form of risk retention in any final legislation and rules are to be expected and perhaps are inevitable. But it is important to understand at this still formative stage of the legislative process that the public outcry driving financial reform may unwittingly create risk retention levels in securitization transactions that will ultimately affect Main Street's credit costs, and severely limit access to credit.

The key, we believe, is to resist the temptation to adopt broad-based reforms that do not really address the underlying causes of the global financial meltdown but that, in the process, harm a market that significantly contributed to the growth of our economy over the last few decades. For instance, an exclusion from whatever rules are adopted could be carved out for various aspects of the commercial loan industry. Also, risk retention might not be applied where investment sponsors are required to be more transparent about the risks or conflicts involved in their products.

Perhaps a brief summary on how we got to where we are — and how we might be able to avoid a similar situation in the future — is worthwhile.

### A BIT OF HISTORY

Before the subprime mortgage crisis developed in July 2007, consumer credit and corporate leverage availability were at record levels. The availability of mortgage loans to homeowners was not a result of the misplaced generosity of mortgage lenders willing to loan money at low interest rates with little or no down payment. Similarly, the ability of businesses to obtain inexpensive money with loose repayment terms and limited contractual protections was not necessarily due to the sterling credit histories and performances of the businesses receiving such credit. Rather, the high level of credit availability was driven, to a

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## Risk Retention

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large extent, by sophisticated investors that were willing to take the risks of the related consumer and corporate loans off of the balance sheets of banks and finance companies that originated such loans, and that then sold them through rated securitization transactions. With less risk (in theory, as it turned out) on bank and finance company balance sheets, and the ability to easily transfer the related credit risk, banks and finance companies were able to extend substantially greater amounts of credit at lower rates.

The growth and efficiency of the securitization market over the last 30 years resulted in financial institutions moving away from the “loan and hold” business model. No longer were financial institutions content with loaning money and waiting for the borrower to pay interest and principal over the life of a loan, as fees became a larger component of bank and finance company profits and growth. Under the securitization model, yield could be generated from, among other things, the origination and sale of the mortgages and other consumer and commercial loans, the structuring and underwriting fees associated with the securities backed by such loans, the derivative/hedging trades relating to the transactions and fees relating to the managing of the securitized financial assets.

Securitization has had a tremendous impact on credit availability. It has helped fuel the growth of banks and finance companies and

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corporate profits, and helped increase home values and the availability of consumer and corporate credit generally. The securitization market has been vital to the growth of the world economy and is widely considered to be a linchpin for the sustainability of that growth. As a result of recent financial and economic developments, securitization and its impact, or perceived impact, as the creator of bank and investor losses has made this financing technique a particular focus of Congress and other financial regulators. The perceived role of securitization and the sale of asset-backed and mortgage-backed securities (collectively, “ABS”) as precipitators of the recent financial crisis has resulted in concerns regarding the securitization market generally. One area of particular focus has been “risk retention” (colloquially referred to as “skin in the game”), whereby sponsors of securitization transactions would be required to retain a certain portion of the credit risk associated with the assets being securitized in order to better align investors' and originators' interests. In effect, risk retention is a subset of the traditional “loan and hold” model.

### RECENT CONGRESSIONAL AND REGULATORY ‘SKIN IN THE GAME’ PROPOSALS

There are presently no “risk retention” requirements in the securitization markets, but there are currently four such proposals in various contexts being considered by various U.S. regulatory and legislative bodies. A primary objective under each proposal is to align the interests of sponsors/securitizers of securitized products with those of investors. In late 2009, both the House and the Senate proposed “financial regulatory reform” legislation that includes mandatory “risk retention” standards intended to address concerns in the securitization markets. In its current form, the Senate legislation requires a “securitizer” (the sponsor of a securitization) or “originator” (one who transfers assets to

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# Health Care Reform

## *Prepare for the Changes Already Approved, and Stay Tuned*

By Joseph Hugg  
and E. Fredrick Preis, Jr.

After months of proposals, bills, votes, more bills, and reconciliation bills, the President signed into law the Patient Protection and Affordable Care Act ("PPACA") on March 23, 2010, followed on March 30, 2010 by his signing into law the Health Care and Education Tax Credit Reconciliation Act, also known as "the Reconciliation Bill." These laws make fundamental changes to the current U.S. health care system, some of which become effective immediately or by Sept. 24, 2010, and others that do not take effect until 2018. Despite their length and complexity, these laws leave many unanswered questions that will need to be sorted out by Congress and applicable agencies (some of which may not yet be in existence) in the coming months and years. Employers need to be aware of the various effective dates and deadlines and track the most current developments in order to form and implement policies that will comply with the laws as they become effective and evolve. This article provides a brief description of the changes of which employers should be aware.

### **WHAT ARE THE MOST IMPORTANT PROVISIONS TO EMPLOYERS AND WHEN DO THEY BECOME EFFECTIVE?**

#### ***Immediately***

The Reinsurance Program for Early Retirees provides \$5 billion in temporary financial help for employer plans to provide coverage to

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retirees between the ages of 55 and 64 who are neither active employees nor eligible for Medicare. The program subsidizes 80% of an eligible retiree's costs between \$15,000 and \$90,000. The program became effective June 21, 2010, but payments are retroactive for one year, allowing employers to begin subsidizing retirees' medical costs immediately. This program is temporary, however, and will end after 2013. If your company is considering providing health care benefits for early retirees, you may want to consider taking advantage of this program.

### ***Certain small businesses will be eligible for a tax credit from 2010 through 2013 to offset the additional expenses ...***

Certain small businesses will be eligible for a tax credit from 2010 through 2013 to offset the additional expenses associated with providing health care coverage to its employees. An employer with fewer than 25 full-time employees whose average annual wages are less than \$50,000 per full-time employee are eligible, but they must pay premiums under a "qualifying arrangement." The maximum credit is 35% of a qualifying employer's contribution from 2010-2013, but the ceiling increases after 2013 for a maximum of two years up to 50% of the employer's contribution for coverage purchased through one of the new state health care Exchanges (see below). Be sure to consider the many details of this tax credit if your workforce meets these requirements.

Also effective as of June 2010 is a program providing affordable coverage to uninsured Americans with pre-existing conditions. Though significant for many individuals, this provision should have little effect on an employer's benefits policies.

#### ***Sept. 24, 2010***

Several provisions of the health care reform laws will become effective

on Sept. 24, 2010, six months after the President signed the PPACA. One such provision prohibits the imposition of lifetime dollar limits on coverage for "essential benefits," such as ambulance services, emergency care, hospitalization, maternity/newborn care, mental health and substance abuse treatment, prescriptions, rehabilitation and devices, laboratory work, preventive treatment, wellness and disease management, and pediatric care including oral and vision.

Also beginning in September 2010, employers will be required to provide during the first year after the birth of a female employee's child reasonable break time for nursing and a place other than a bathroom that is shielded from view and free from intrusion from co-workers and the public. However, employers with less than 50 employees are exempt if compliance would impose an undue hardship.

Other provisions taking effect on Sept. 24, 2010 prohibit policies from excluding dependent children of plan participants under the age of 19 because of pre-existing conditions, rescinding or "dropping" coverage absent fraud or misrepresentation by the plan participant, or discriminating in favor of highly compensated employees. Also, after Sept. 24, 2010, policies cannot exclude adult children until they are 26-years-old regardless of marital or student status, unless eligible under another employer's plan, and they must cover most preventive care without cost sharing or co-pays, as well as certain emergency services. Examples of preventive care that must be covered include immunizations, annual check-ups, healthy-child visits, and breast cancer screening for women. Finally, policies must provide a certain appeals process in the event coverage is denied.

#### ***Jan. 1, 2011***

Beginning Jan. 1, 2011, employers will need to update their payroll systems in order to comply with a requirement that they report on every employee's W-2 the full premium

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## Health Care Reform

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value of his or her health coverage. The information to be reported includes, but is not limited to, the value of prescription drug plans and employee assistance programs.

Also starting on Jan. 1, the tax on distributions from a health savings account (“HSA”) and an Archer medical savings account (“MSA”) that are not used for qualified medical expenses is increased to 20%. Further, unless prescribed by a doctor, over-the-counter drugs other than insulin will no longer qualify for reimbursement under an HSA, MSA, health reimbursement account, or flexible savings account (FSA).

### **Jan. 1, 2012**

Beginning in January 2012, employers and insurers will have to comply with new requirements relating to disclosures describing health care benefit plans. For example, employers will have to comply with rules that standardize the summaries of benefit disclosures. These rules have not yet been implemented, so employers will have to stay tuned for the details. Further, employers will be required to give 60 days’ notice of any “material” changes to their health care plans; however, “material” changes is also not defined, so the details of this provisions will have to be addressed in the future as well.

### **Jan. 1, 2013**

Several other substantial reforms will become effective beginning in January 2013. For example, the Medicare portion of employees’ FICA will increase from 1.45% to 2.35% for earnings that exceed \$200,000. Also, employers with more than 200 employees must automatically enroll their employees in a health care plan and must notify employees of their rights under the plan. Employees may opt out of course, and an employer-mandated waiting period may still apply. Yearly contributions to FSAs will be capped at \$2,500 (subject to inflation) beginning in 2013. Finally, employers will be required to pay \$2 per year per participant to fund a “Patient-Centered Outcomes

Research Fund,” which will establish a non-profit organization to advance research regarding the quality and effectiveness of medical treatment.

### **Jan. 1, 2014**

The most significant and controversial reforms in both laws become effective in 2014. First, the provision requiring all individuals to have minimum health care coverage, commonly referred to as the “individual mandate,” goes into effect on Jan. 1, 2014. Individuals that fail to obtain coverage will be required to pay a penalty equal to \$695 or 2.5% of their income, whichever is higher.

Second, at the same time, the provision requiring employers to provide health care coverage to their employees, also known as the “Pay or Play” mandate, goes into effect. In sum, the employer mandate requires employers with 50 or more full-time employees to offer their full-time (30 hours or more per week) employees and their dependents minimum essential health benefits, as that term is defined by the bill. Employers that do not offer minimum coverage will be required to pay \$2,000 per full-time employee if at least one of their employees qualifies for the federal tax credit for those without sufficient coverage. Those employers that provide minimum coverage that is not “affordable” will be required to pay \$3,000 per employee. These penalties are not tax deductible.

Third, the American Health Benefits Exchange takes effect in January 2014. This provision requires states to establish “Exchanges,” which are collections of approved insurance plans intended to cover those individuals who might not have access to affordable health care because, for example, they are unemployed, self-employed, or employed by a small business. This provision also requires states to make available a Small Business Health Options Program (“SHOP Exchange”) to assist small employers in enrolling their employees in qualified health plans.

Fourth, starting in 2014, every employer that offers and contributes to the cost of “minimum essential” cov-

erage (an “offering employer”) must provide a “Free Choice Voucher” to every qualifying low-income employee. A qualifying employee is one: 1) whose premium is between 8% and 9.8% of the employee’s household income; 2) whose income is below 400% of the federal poverty level; and 3) who enrolls in Exchange coverage. An employee will use this voucher to purchase (presumably less expensive) coverage through an Exchange. The voucher is equal to the employer’s highest potential contribution for employer-provided coverage and would allow the employer to avoid the “Pay or Play” penalty.

### **Other Provisions in 2014**

Other provisions that become effective in 2014 include the prohibition of employer-imposed “waiting periods” that exceed 90 days after an employee starts work full-time, annual limits on essential benefits (which are already subject to restrictions in 2011), and all exclusions from coverage based on pre-existing conditions. Plans will also have to cover costs associated with certain clinical trials in which employees participate. Finally, an employer will be required to file an annual report providing the following facts: whether it provided minimum essential coverage to its full-time employees; a description of all applicable waiting periods for coverage; the number of full-time employees covered by its plan; and its financial contributions to its employees’ coverage.

### **Jan. 1, 2018**

Beginning Jan. 1, 2018, the 40% excise tax on so-called “Cadillac” health care plans, which are plans exceeding \$10,200 for individuals and \$27,500 for families, will go into effect. This provision sets forth higher limits for certain “high-risk” occupations and early retirees (age 55-64), and it excludes dental-only and vision-only plans. Keep in mind that the insurer

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# The Changing Role of The General Counsel

By Bryan Hughes

There is no doubt that the global recession has had a lasting impact on the legal sector across the world. Although it was quite clear from the outset that law firms would be far from immune from the economic crisis, the long-term impact has been more pronounced than anyone anticipated. The headlines may be capturing cost-cutting exercises and reduced headcount for many in the sector, but one of the major changes of the recession is how the boundaries of the client-lawyer relationship has been redrawn — the power now firmly lies with the client as the status of general counsel within their own organization continues to grow.

The growing status of the in-house lawyer was a key trend that emerged from our latest report — “Law Firm of the 21st Century: The Clients’ Revolution” — that canvassed the opinions of both general counsel and law firm partners. In fact, it was seen as the factor that is set to have the most transformative effect on the global legal profession by 35% of all respondents, just behind the top factor, globalization.

But is it a short-term shift or long-term change? Will the sector revert back to the pre-recession supplier-led market as soon as the economy stabilizes?

The report indicates that this shift is set to be long-term — of the 76% of clients and 75% of partners who thought that the balance of power now lay in-house, the majority thought this change would be permanent. Arguably, this is something that should have happened sooner, but for many law firms, this will require a significant change in mindset.

## THE POST-RECESSION

### ROLE OF GENERAL COUNSEL

It means that today’s law firm, and general counsel, have essentially

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seen their job descriptions change. The in-house lawyer has squeezed spend on external law firm suppliers — no doubt this is in part due to internal pressure from finance directors. Ninety percent of clients surveyed said they were under pressure to demonstrate better value, efficiency and cost reductions — 60% have reduced their overall legal expenditures. But it is also due to in-house teams increasing their own capability — 55% of clients said their in-house departments would grow over the next five years and over half (52%) are actively reducing the amount of work they send to external law firms.

This reversal in position now means that the general counsel has now become a focal point in the structure of a business. The remit of in-house lawyers in business has broadened as the status of the general counsel has risen. For example, in October 2009, Mark Harding, the general counsel for Barclays Bank, was appointed to the Executive Committee — a relative rarity in the legal market. This is indicative of the growing importance of General Counsel as a strategic partner to business.

### WHAT DOES THE INCREASED ROLE OF THE GENERAL COUNSEL LOOK LIKE?

Increased responsibility has seen general counsel occupy an expanded job role, with 74% saying they now occupied a far more senior commercial advisory role compared with before the recession. In some cases, job descriptions had dramatically altered after the credit crisis and, as mentioned previously, the in-house legal department is now seen as more of a business unit than a support unit. Just over half (55%) said they have assumed more responsibility for corporate governance and many have taken on more functions and new responsibilities in business.

For example, the financial crisis has reshaped the attitude of business to risk. The “back-to-basics” approach is making a return and the in-house lawyer has a crucial role to play in setting the balance of risk for their organizations. Seventy-three percent of

in-house lawyers said their organizations’ approach to risk had changed as a result of the crisis. Added to this, a third (33%) also said that there was a new dimension to their roles as ethics champions in business.

So what does mean for today’s law firms and the future of the client/lawyer relationship? The boundaries are being redrawn — it is the general counsel who is more likely to occupy the role of trusted adviser to the business. Although law firms still aspire to this role, they are seen by the in-house lawyer as service providers and, at best, close collaborators. This dynamic is demonstrated by a reduction in loyalty among general counsel — 73% admitted to either changing or reducing the number of their external legal advisers as a result of the recession and over half said that as their in-house capabilities increased, they would only look to external lawyers as a source of highly specialized advice.

In short, in the post-recession world, law firms will need to focus on quality and innovation, while demonstrating efficiency in order to maintain solid ongoing, collaborative client relationships.

### MAINTAIN QUALITY, BUT SHOW EFFICIENCY

General counsel are either demanding lower fee rates or are looking at value-added services. These could include free-of-charge secondees or complimentary access to knowledge management resources. The majority of clients in the report — 87% — said that these value-added services are a crucial factor when it comes to instructing an external law firm.

Demand for high-quality legal services will remain and simply cutting costs is not enough as this will inevitably result in a decline in this quality. The challenge for law firms will be able to provide quality, value-for-money services in the most efficient way. For many clients, technology has emerged as a way to achieve this — and they expect their law firms to invest in new ways of working to increase efficiency.

At Eversheds, many of our clients are multinational companies and  
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## General Counsel

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businesses with branches and interests in many different jurisdictions. To address their needs and provide a seamless service across all of our international offices, we have looked at how technology helps in managing these relationships more effectively and efficiently. The result is our online global account management system (GAMS), which we began to use with clients in 2007. This has since evolved to GAMS II, which is an advanced management tool, designed for in-house legal teams to measure success against key performance indicators. The key outcomes for the client with GAMS II are:

- **Cost control** — the system ensures that the firm will not process an invoice that exceeds the costs estimate, allowing the client to predict costs extremely accurately.
- **Transparency** — the client can identify on his computer screen at the touch of a button how many ongoing matters there are on a global level, what costs have been accrued for each one and how much more there is to be spent on that matter.
- **Strategic analysis** — the client now has access to invaluable management information, allowing the legal team to forecast, for example, cost of litigation over the next 12 months. The client can also pull off a report at any time to see legal expenditures, or trends in the expenditures, by practice area, lawyer, case, country or business unit.
- **Risk Management** — managing risk has never been as important as during the economic downturn. GAMS II enables the client to better coordinate and manage international risk.
- **KPIs** — we work with each client to develop a predetermined set of Key Performance Indicators. The use of KPIs is still relatively new in the legal world, so we pride ourselves in helping our clients meet their own internal objectives.

- **Measurement** — we obtain pre-approval for the number of hours we spend on a piece of work, so the client knows exactly what needs to be done. We have a number global clients using GAMS II. The control and predictability of spend has resulted in many General Counsel receiving very positive acclaim within their own business as they can demonstrate how they have effectively managed budgets.

### **COLLABORATIVE RELATIONSHIPS**

While the roles of the GC and law firm have changed, a good collaborative working relationship between the two is still important. Law firms need to be able to advise on business, as well as legal risk. The best results are achieved where GCs and their law firms find new ways of working together that recognize a reduced legal expenditures. That can include a better allocation of work between in-house and external, jointly running workshops on reducing spend by changing working practices, greater use of technology and standardization and making sure the right work is sent to the right external firm. This type of joint problem-solving can generate bigger and more sustainable savings than just reducing traditional hourly rates. A good case in point is how we currently work with global manufacturing giant, Tyco. In November 2009, we signed a third groundbreaking contract with Tyco on its legal needs across Europe, Middle East and Africa. The contract extends the relationship, first signed in 2006 when Tyco reduced its panel of 250 law firms to one overnight, by a further two years. The contract sees Eversheds advise Tyco on legal matters across 80 jurisdictions. This ongoing partnership, first signed over three years ago, has set a new standard for the provision of legal services and client relationship excellence across international jurisdictions, that to date, no other law firm has been able to equal. The focus of the relationship is delivery of a high quality consistent international service but uniquely coupled

with a drive to achieve the greatest cost control and efficiencies for the client, both in terms of legal spend reduction and also how the work is managed. To do this, collaboration and innovation between both parties has been key to ensure total satisfaction for both client and law firm. The contract has resulted in a 27% reduction in fees for Tyco and the number of Tyco's litigation cases fell by 60%. At the same time, the proportion of high-quality work we service for the client increased by over 300%, including M&A and IP work, achieving one of the objectives of the relationship, to deliver an improved and sustainable return on investment for the law firm — the findings in the "Law Firm of the 21st Century: The Clients' Revolution" supports this.

### **THE CRITICS WEIGH IN**

But the arrangement was not without its detractors, the traditionalists in the legal sector believed that the consolidation of law firms and the project management approach was risky, and that, given the choice, most clients did not want to work in this way. We felt then, and still do, that the combination of quality, control, value, efficiency and transparency were what clients were increasingly demanding and that law firms had to innovate if they were to survive.

### **HOW THE CONTRACT HAS CHANGED**

The Tyco contract has evolved since it was first signed, with both parties committed to constant innovation and simplification. Working with Tyco for so long means that we have accumulated a wealth of knowledge about the client and its sector around the world. This is only beneficial to a client if it translates into benefits such as economies of scale and lower overall spend. New deputy general counsel EMEA, David Symonds, worked with us to review how the relationship had evolved and whether the all the mechanisms in the original contract were still relevant. As a result, much of the original contract's demands have been changed to recognize this evolution. It has

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# Managing Data And Anticipating Litigation

## *Planning Now Reduces Later Expense*

By Michele C.S. Lange and  
George M. May, Jr.

In today's digital world, corporations must manage data in a manner that mitigates legal risk and reduces the likelihood of sanctions for failure to safeguard and preserve electronically stored information (ESI) that is potentially relevant to a legal or regulatory proceeding. Approximately 40% of all e-discovery cases in 2009 involved claims for sanctions against parties that allegedly failed to comply with discovery obligations. Of the sanctions cases, 67% addressed an alleged failure to properly preserve ESI. See Kroll Ontrack's 2009 Year in Review Report, available at [www.krollontrack.com/news-releases/?getPressRelease=61396](http://www.krollontrack.com/news-releases/?getPressRelease=61396). This growing body of statutory and common law regarding electronic discovery instructs litigants that the best defense against sanctions is to take proactive measures to fully comply with future discovery obligations. Ignorance or lack of preparation are no longer tolerated, and there is decreasing protection for preservation mistakes, oversights or intentional destruction activities.

### **FACING THE RISKS**

Corporations that are heavily regulated and targeted in litigation face increasingly significant risks that are inextricably tied to information management and data storage. The tendency to over-preserve electronic data leaves organizations with mountainous volumes of ESI and an

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attendant increase in risk and cost, while inadequate policies, processes and tools often lead to wrongful destruction and possible spoliation sanctions. Meanwhile, some corporations spend considerable sums on one-off tools that can identify and "hold" content, while failing to address the policies and risks associated with the native systems where the content actually lives. Corporations that fail to leverage enterprise-wide technology to manage data or invest in tools that over-promise and under-deliver bear the burden of inflated costs and increased risk associated with responding to litigation or regulatory inquiries.

### **CORPORATE DATA MANAGEMENT PRACTICES TODAY**

In February 2010, Kroll Ontrack surveyed 170 law firm attorneys, corporate counsel, IT administrators and legal support professionals on the showroom floor of LegalTech® New York to better understand how corporations are managing data in preparation for litigation and/or regulatory inquiries. See the results of Kroll Ontrack's recent survey conducted at LegalTech® New York 2010, available at [www.krollontrack.com/news-releases/?getPressRelease=61435](http://www.krollontrack.com/news-releases/?getPressRelease=61435). Nearly 63% of corporate legal, compliance and IT professionals claimed that inadequate technology was one of the biggest barriers to managing electronically stored information (ESI). And, one-third of respondents confirmed they either do not have or do not know if they have the appropriate technology tools or an archiving platform to manage the storage and destruction of ESI. These results are staggering when considering the legal risks and inflated costs that flow from a failure to manage data in a manner that contemplates legal requests for production of ESI. The bottom line is this: In today's digital world corporations must implement sound data retention and disposal protocols, ensuring compliance with legal hold obligations while also disposing of material in native systems when it is prudent to do so. Through implementing the right

technology solution, organizations can proactively minimize the burdens associated with responding to legal requests for ESI.

### **THE DUTY TO PRESERVE**

Despite the growing body of case law on the topic, knowing when the duty to preserve arises is a key issue that continues to plague corporations. Once a lawsuit, audit or investigation begins, corporations are considered to have been provided actual notice and are subject to a duty to preserve potentially relevant paper documents and ESI. This duty is clear and uncontroverted. However, following *Zubulake v. UBS Warburg LLC*, it is well-established that the duty to preserve arises upon reasonable anticipation of litigation. Under this standard, more often than not, the duty to preserve arises well in advance of commencement of litigation or an investigation.

Although pertinent case law does provide corporations useful guidance in determining when the duty to preserve is triggered, each determination is inherently fact-based and highly dependent upon individualized circumstances. It is the duty of individual entities and respective corporate counsel to discern when preservation is required and to issue proper written legal holds in response. When litigation appears to be on the horizon, prudent corporations act conservatively and quickly implement written legal holds. (In fact, respondents at LegalTech® New York cited a technology's ability to effectively implement litigation holds as a key factor when making an enterprise-wide information management purchasing decision.) However, before the duty to preserve is triggered corporations can avoid preservation missteps and resulting sanctions by thoughtfully and proactively managing data in

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## Managing Data

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a manner that contemplates a swift and effective litigation response. To accomplish this, corporations should consider incorporating the following data management best practice tips into their records management protocol.

### KNOW WHERE YOUR DATA LIVES

An organization must know where its data is stored before it can effectively manage that data in a manner that contemplates and prepares for future litigation. Many organizations catalog and keep track of data through creating and maintaining an application inventory and data map. An application and inventory map diagrams IT environments to help corporations and outside counsel quickly identify relevant data sources and custodians that are key to an investigation or litigation, and prevents the need to search for information throughout every storage system within the organization's IT environment. An application inventory and data map should include a record of past and present operating systems and application software, document retention and back-up rotation procedures and schedules, contact information for a designated point-person in each business department, and notes regarding accessibility difficulties issues that may support an argument of undue burden and/or expense.

Once the application inventory and data map is in place, it must be regularly updated to stay current with the constant evolution of a corporation's technology environment. The updates should intertwine with technology asset management processes, storage planning, information security assessments and other processes that touch the IT environment. When applications or systems are retired, information should be included as to where the final set of data is kept and what process will be required to restore if necessary. Maintaining the current and comprehensive nature of this information will save time, effort and cost down the road. This will also strengthen

defensibility arguments if the opposing party moves for spoliation sanctions in the event data is lost or otherwise does not get preserved.

### INSTITUTE A DEFENSIBLE DOCUMENT RETENTION AND DISPOSAL POLICY

As legal requirements become more stringent, it is increasingly important for organizations to arm themselves with the proper tools to defend against the many risks presented by the mountains of data created and maintained in the course of business. A key component of sound data and records management is the implementation of a repeatable, defensible document retention policy. A defensible retention policy will classify records per a records retention schedule that dictates how long each record classification should be kept, and contain citations of any applicable document retention regulations in order to ensure compliance with regulatory bodies and industry standards.

Once an organization has comprehensively determined the universe of records to be maintained, decisions may be made with regard to the method of maintenance and necessary document destruction policies. A defensible document retention policy will detail where data is to be stored, in what format electronic documents should be retained, and when, if at all documents and records should be converted to alternative formats.

### ARCHIVE YOUR DATA

Implementation of an archiving system is an integral part of a sound document retention policy and data management solution. Organizations facing tighter budgets and decreased resources may question why archiving is an important investment. Archiving allows corporations to maintain records in a way that optimizes storage efficiency, reduces expenses and complies with legal and regulatory requirements. More specifically, archiving can actually help control electronic discovery costs, which is often the largest unbudgeted annual corporate expense. Maintaining data in an archive will also

allow corporate litigants meet short timelines to preserve, collect, process, review and produce data, while delivering electronic information in a form conducive to cost-effective document review. This will prevent the expense of searching through unorganized data that is often scattered across various mediums within an organization when litigation or an investigation is apparent.

Another critical function of an archiving solution is the ability to administer legal holds. Incorporating legal hold technology within an overarching data archiving system allows users to search throughout an IT enterprise to identify and immediately preserve potentially relevant ESI, minimizing risks of potential failure to preserve claims. As demonstrated by opinions in cases such *Pension Committee of the University of Montreal Pension Plan v. Banc of America Securities, LLC*, the standards of acceptable discovery conduct in regards to implementing legal holds has been raised. Following this recent, authoritative opinion, the failure to issue timely, written legal holds is deemed to be grossly negligent behavior and may subject litigants to terminating sanctions.

Although some jurisdictions still require evidence of intentional misconduct to warrant the imposition of terminating sanctions, the message of recent opinions is clear. Ignorance in the arena of preservation obligations, including the issuance of legal holds, is no longer an acceptable excuse. This, coupled with the difficulty of determining the precise moments when a corporations duty to preserve attaches, demands corporations to be cognizant of the way they manage data in conjunction with issuing legal holds.

### CONCLUSION

As data stores continue to increase and courts tolerances of failures to

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## Compliance Review

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business entities to voluntarily register fictitious business names with the Secretary of State for renewable five-year terms.

In New Jersey, Senate Bill 895, effective May 6, eliminated the 10-day waiting period for effectiveness of actions other than mergers that are taken without a meeting upon consent of less than all shareholders. In South Dakota, House Bill 1109, effective July 1, authorized LLCs to enter into conversions and domestications.

In Tennessee, House Bill 3643, effective July 1, required that documents being filed to dissolve, terminate, or withdraw a corporation, LLC or LLP be accompanied by a tax clearance certificate. In Utah, Senate Bill 179, effective May 11, provided that a shareholder of a corporation, when acting solely in the capacity of a shareholder, has no fiduciary duty to any other shareholder.

In Virginia, Senate Bill 100, effective July 1, permitted bylaws requiring that if the corporation solicits proxies or consents with respect to an election of directors, the corporation include shareholder nominees, and requiring that the corporation reimburse the expenses incurred by a shareholder in soliciting proxies or consents in connection with an election of directors.

In Washington, House Bill 2657, effective June 10, provided that in winding up, an LLC may voluntarily file a certificate of dissolution to provide notice that it is dissolved and that an LLC that has filed a certificate of dissolution may dispose of known claims by following a specified procedure.

In West Virginia, Senate Bills 624 and 696, effective June 11, changed the due date for filing the Annual Report of an LLC and an LLP from April 1 to July 1. And in Wyoming, Senate

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Bill 18, effective July 1, enacted the Uniform Limited Liability Company Act, which provides default and mandatory provisions governing LLCs.

### IN THE STATE COURTS DE CHANCERY COURT HOLDS THAT LP ACT PERMITS ARBITRATION OF BOOKS AND RECORDS ACTION

In *Aris Multi-Strategy Fund, LP v. Southridge Partners, LP*, C.A. No. 5422, decided May 21, 2010, a limited partner filed an action in the Delaware Chancery Court under Sec. 17-305 of the Delaware LP Act, seeking access to a Delaware LP's books and records. The partnership agreement contained a clause stating that any claim or controversy arising among or between the parties pertaining to the LP shall be settled by arbitration. The LP moved to dismiss in favor of arbitration.

The Chancery Court, noting that this dispute pertained to the LP and that the arbitration provision clearly evinced an intent to submit such disputes to arbitration, granted the motion to dismiss. The plaintiff contended that inspection rights under Sec. 17-305 could not be determined by an arbitrator because the statute grants exclusive jurisdiction to the Chancery Court. However, the Chancery Court stated that this was incorrect. According to the court, Sec. 17-109 allows limited partners to waive their right to bring actions relating to the LP's internal affairs in the Delaware courts so long as they do so by agreeing to arbitrate such actions. And, according to the court, that was exactly what happened here. The court also noted that permitting limited partners to contractually agree to arbitrate their statutory rights is consistent with the manner in which Delaware courts have treated this issue in the context of corporations and LLCs.

### DE CHANCERY COURT: SEEKING TO ESTABLISH DEMAND FUTILITY IN A PREVIOUSLY FILED DERIVATIVE SUIT IS NOT A PROPER PURPOSE

In *King v. Verifone Holdings, Inc.*, C.A. 5047, decided May 12, 2010, the plaintiff sought to inspect books and records of a Delaware corporation. Several lawsuits were filed against the corporation after it an-

nounced that it was restating its financial statements. The plaintiff was the first to file a derivative suit and was named the lead plaintiff when the suits were consolidated in a California federal court. The plaintiff's counsel admitted to rapidly filing the derivative suit in order to become lead plaintiff.

The defendants moved to dismiss the derivative suit for failure to plead that demand was excused. The plaintiff did not seek discovery because federal precedent holds that a derivative plaintiff cannot obtain discovery until it meets its pleading burden to show grounds for excusal. Instead, the plaintiff filed this complaint in the Delaware Chancery Court seeking an inspection pursuant to Sec. 220 of the General Corporation Law.

The Chancery Court dismissed the complaint on the grounds that the plaintiff failed to state a proper purpose for the inspection. The plaintiff's stated purpose was to seek information to show that making a demand on the board of directors would have been futile. That purpose was improper for several public policy reasons.

First, according to the court, the plaintiff was doing a costly, inefficient end run around the federal discovery rule applicable to derivative suits. Second, filing a Sec. 220 action seeking discovery in a case pending in another court conflicts with the policies against subjecting defendants to simultaneous suits in separate forums. Third, the court stated that allowing a plaintiff to use Sec. 220 in an after-the-fact manner to bolster his derivative complaint would exacerbate the perverse incentives motivating some representative plaintiffs' unseemly and inefficient race to the courthouse.

### NY APPELLATE COURT RULES THAT 'HOLDER CLAIM' VIOLATED OUT-OF-POCKET RULE

In *The Starr Foundation v. American International Group, Inc.*, 2010 N.Y. Slip Op. 4526 (A.D. 1st Dept.), decided May 17, 2010, the plaintiff's main asset was nearly 50 million shares of AIG stock. It sought to divest itself of the stock and set a floor

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## Compliance Review

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price of \$65 per share for the sale of the stock. According to the plaintiff, it was induced to maintain that floor price by misstatements made by the defendants minimizing the degree of risk attached to AIG's credit default swap. The plaintiff claimed that if not for those misstatements it would have lowered the floor price and sold all of its remaining AIG stock. Instead, it held over 15 million shares when the value declined substantially. The plaintiff brought an action for fraud, which the trial court dismissed.

The New York Supreme Court, Appellate Division affirmed the dismissal, holding that the plaintiff's claim violated New York's out-of-pocket rule governing damages recoverable for fraud. The court noted that under that rule, the loss of an alternative contractual bargain cannot serve as a basis for fraud damages because the loss of the bargain was undeterminable and speculative. Here, the plaintiff sought to recover the value it might have realized from selling its shares during a period when it chose to hold, under hypothetical market

conditions for AIG stock that never existed. According to the court, a bargain more undeterminable and speculative would be hard to imagine.

### CA APPELLATE COURT HOLDS THAT IN-HOUSE COUNSEL WHO ARE ALSO OFFICERS ARE NOT EXEMPT FROM STATUTE

In *Gutierrez v. G & M Oil Company, Inc.*, G042041 (C.A. 4th Dist.), decided May 7, 2010, a class action suit was filed against a corporation. The corporation's general counsel was also a Vice President. The general counsel decided to handle the case himself. He did not tell anyone else at the company about the lawsuit. He also failed to respond to the amended complaint and took almost no steps to defend the case. A \$4 million default judgment was taken against the corporation.

The trial court vacated the default judgment pursuant to Sec. 473 of the California Code of Civil Procedure. Sec. 473 provides mandatory relief where the application is accompanied by an attorney's sworn affidavit that it was his or her neglect or mistake that resulted in the default judgment. The plaintiff appealed, arguing that because the attorney was

also a corporate officer his actions had to be imputed to the corporation, meaning that the corporation was at fault.

The California Court of Appeal held that Sec. 473 applied. The court noted that the text of Sec. 473 does not differentiate between outside and in-house attorneys, or between in-house attorneys who are corporate officers and those who are not, and that there was nothing in the language or structure of the section to require an implied differentiation.

In addition, the court noted that a corporation must be represented in court by an attorney and that the very corporate form then, in the context of litigation, treats in-house attorneys, whether they are officers or not, as agents separate from the corporation itself. Furthermore, case law distinguishes between corporate counsel who perform "strictly legal services" to a corporation and services of a "nonlegal business nature." And, as the court noted, some defalcation on an attorney's part leading to a default judgment clearly falls on the legal services side of the legal services-business services dichotomy.



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## Risk Retention

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a securitizer) of a securitized portfolio of financial assets to retain, on an un-hedged basis, at least 5% of the credit risk associated with each pool of financial assets. The House legislation requires that any "creditor" that makes a loan retain, on an un-hedged basis, an economic interest in at least 5% of each loan that such creditor transfers, including for purposes of securitizing a pool of financial assets.

The Federal Deposit Insurance Corporation ("FDIC") also issued proposed rules that would require a bank sponsoring a securitization to retain at least 5% of the un-hedged credit risk of the assets transferred to the securitization entity. The retained risk would be required to be either in the form of an interest in each tranche of the ABS or in a represen-

tative sample of the transferred assets equal to at least 5% of the principal amount of the assets transferred.

More recently, in April 2010, the Securities and Exchange Commission ("SEC") proposed new rules to regulate the offerings of ABS. Not only do these proposed rules dramatically expand the scope of regulation of securitization through increased disclosure, but they also look to impose on securitization sponsors seeking "shelf registration" of an ABS a mandate to acquire and maintain on an ongoing basis a 5% un-hedged position in each tranche of the securitized pool (*i.e.*, a vertical slice of the deal) of such ABS. The SEC believes that risk retention requirements for shelf eligibility distinguish the quality of assets supporting the ABS that are of a higher quality and character "while avoiding the possibility of undue reliance on ratings." It should be noted that sponsors may still of-

fer securities publicly (or privately) without risk retention (but with additional prescribed disclosures); these offerings would not be eligible for delayed shelf registration and would, in the case of a public offering, require a substantially longer time period to bring to the market. The proposed additional disclosures would also be applicable to private transactions under both Rule 144A market and Regulation D, if the investors request such information.

### HOW COULD RISK RETENTION AFFECT SECURITIZATION?

Mandatory risk retention will likely require financial institutions to hold more equity against the required retained securitization tranches. The corresponding charges for bank regulatory capital purposes will probably weigh on the consumers' cost of funds, as it is reasonable

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## Risk Retention

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to believe that those charges will ultimately be passed through, in one form or another, to borrowers. Moreover, any increase in interest rates is likely to drive home prices down due to the decreased purchasing power of home buyers. As has been experienced during the current economic crises, sustained low home prices are likely to continue to have adverse effects on economic recovery. Only the best capitalized financial institutions will have sufficient capital to hold the required retention amounts and be able to access the securitization market as a securitization participant. Additionally, the cost of capital related to the retention requirement will ultimately limit access to the securitization market for start-up/entrepreneurial finance companies which have traditionally provided financing to the middle markets.

Risk retention in the context of securitized commercial loan funds (or CLOs), which hold a significant percentage of the outstanding commercial loans today, could significantly impair credit availability for many U.S. businesses. Existing CLOs are one category of the primary buyers of loans in the secondary market, but cannot hold significant portions of any one loan due to contractual limitations imposed by investors and rating agencies. Additionally, existing CLOs only have limited amounts of funding availability through their available reinvestment periods. Because CLO issuance has been negligible during the past two and one-half years and reinvestment amounts available under existing CLOs are limited, risk retention minimums applied to any CLO “securitizer” (e.g., the manager or sponsor) would further hamper the formation of new CLOs available to buy loans. Many CLO managers and sponsors are simply not in the position to make such large investments in the CLO tranches as required by risk retention proposed rules. Applying risk retention standards to commercial loans of

this type could significantly limit the number of CLO lenders available to make and participate in newly originated commercial loans and provide financing for the estimated trillions in dollars of commercial loans that are scheduled to mature between 2012 and 2014. It is unclear in, for example, the CLO context, which entity would be considered the “sponsor” of the transaction. It is possible it could be the manager (who does not typically own any of the loans) or the underwriter/placement agent (who may or may not have an interest in a portion of the loans). The SEC’s proposing release acknowledges that originators of loans may not have the resources to retain risks.

### ‘CHEAP MONEY’

It is not necessarily a negative that certain businesses and consumers who previously had access to “cheap money” with loose terms will no longer have access on as favorable terms. Moreover, risk retention will slow transaction pace which will provide professionals greater time to more appropriately disclose transactional risks (and for investors to understand them), and avoid the sloppiness which comes from an overheated market. However, careful consideration should be given so as not to shift the pendulum too far in the other direction. More extensive due diligence with respect to both structure and assets in the subprime securitization and CDO market investors should have occurred — ultimately, investors must do their job and not rely solely on ratings as they did when the securitization market was frothy. The reality is that many sponsors of securitizations (or their affiliates) have historically retained a portion of the credit risk of the securitized pool, either through retention of the first loss position or the more senior tranches that do not yield sufficient returns for investors.

Another possible effect of mandatory risk retention is the impact on financial reporting. Recently issued Statements of Financial Accounting Standards Nos. 166 and 167 modified the accounting treatment for

transfers of financial assets and the consolidation of variable interest entities (“VIEs”) — most securitization vehicles are VIEs. While the risk retention proposals are not likely to have an impact on the legal isolation analysis necessary to obtain “true sale” legal opinion comfort, they will require a more thorough analysis by outside accountants and management when analyzing whether the sponsor of a securitization has a controlling financial interest in a VIE through the retention of economic risks and benefits.

### CONCLUSION

Financial institutions as well as consumers require and benefit from the liquidity and risk transfer mechanisms that are available from an efficient securitization market. It is better for the financial system as a whole to permit the diversification that securitization provides which ultimately reduces systemic risk inherent in concentrated loan holdings as well as provides investors alternative investment opportunities. Without an efficient securitization market, access to capital for consumers and businesses will decline while the cost of available capital will rise. Imposing further restrictions on a primary component of capital availability and liquidity could provide a damaging blow to the slowly stabilizing economy.

One potential solution as it relates to commercial loans is to have loan funds and loan managers expressly excluded from the risk retention proposals. CLOs were designed, in part, to allow a diverse group of sophisticated investors to obtain exposure to the commercial loan market. Requiring risk retention in the context of the commercial loan market would make CLOs, in their current form, unpalatable for all but the largest financial institutions and loan managers and would inhibit the very risk diversification that syndicated loan transactions were designed to accomplish.

Another solution would be to not mandate risk retention, but instead require sponsors to prominently and

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## Risk Retention

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specifically disclose the amount and form of the risks that are retained as well as disclose conflicts and other related facts. Indeed, the SEC acknowledges this approach as a viable alternative in its discussion of risk retention and shelf eligibility standards. If risk retention simply becomes a cost of securitizing, will a sponsor's forced risk retention really mean that the quality and characteristics of a pool of assets are of higher quality? The sponsor would still be selling up to 95% of the credit risk.

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## Health Care Reform

*continued from page 4*

is liable to pay this tax if the Cadillac plan is an insurance policy, but the employer is required to pay if the plan is self-funded.

### HOW DO THESE REFORMS AFFECT EXISTING HEALTH CARE PLANS?

A Grandfathered Health Plan ("GHP") is one in which an individual was enrolled on March 23, 2010, the date the PPACA was enacted. Significantly, GHPs are exempt from many — but not all — of the

ABS investors are characteristically sophisticated institutions and, when appropriately engaged, should be able to understand the risks of the sponsor not having any "skin in the game." With the proper disclosure, the investors can decide which transactions are worthy of their dollars.

While the legislative and regulatory efforts are only proposals at this stage, the intense pressure on legislators and regulators to fix the problems that were perceived to be the cause of the current economic crises will almost certainly result in the adoption of some form of risk retention in the final legislation and

new mandates. Additionally, collectively-bargained plans must comply with some but not all of the new requirements until the termination of the collective bargaining agreements. Having a GHP gives employers some breathing room with respect to some of the laws' mandates, but it is not a carte blanche because even GHPs cannot impose lifetime dollar limits on the provision of "essential benefits," exclude children under the age of 19 because of pre-existing conditions, drop coverage absent fraud or misrepresentation,

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### THE FUTURE

The "Law Firm of the 21st Century: the Clients' Revolution" report has shown that clients now have the power to not only demand value for money from law firms but to be able to demonstrate that value too. For

must ensure that data that is necessary to the business or potentially relevant to a legal or regulatory proceeding is safeguarded. Conversely, data that is not business-essential or not relevant to a legal proceeding should be systematically disposed of. Technological solutions such as archiving platforms with legal hold

rules. Who is covered and what exceptions there will be to those rules will be key issues. Ultimately, the CDOs and subprime transactions which should never have been done (but were done solely on a ratings based model founded on misplaced assumptions) and purchased without appropriate investor diligence of available information created the financial contagion. Ironically, the resulting public outcry may create risk retention levels that will ultimately affect main street's credit costs and credit availability.



or exclude adult children until they are 26-years-old regardless of marital or student status.

### CONCLUSION

Compliance with the new health care reform bill should include not only reviewing thoroughly your company's existing health-care benefits plans and consulting your benefits experts and employment counsel, but also remaining up-to-date on the changes to and evolution of the health care reform laws, which are far from complete.



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## General Counsel

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been simplified to revolve around a fixed fee for all litigation and non litigation work but leaving behind some of the previous bonus structures built in to reward certain outcomes like a reduction in litigation cases, but the bonuses are now embedded in the culture of the relationship.

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## Managing Data

*continued from page 8*

preserve decline, it is more important than ever for corporate counsel to advocate for the investment in proactive, comprehensive corporate information management systems. Information management platforms

law firms, this means developing collaborative relationships that focus on achieving efficiencies without compromising quality. With the power resting with general counsel for some time to come, and with their role as trusted adviser within business set to grow, what they want (and need) will dictate how the global legal market develops.



functionality will not only help ensure that business continuity objectives are being met, but help legal, IT and compliance teams to appropriately preserve, manage, locate and produce relevant ESI in a legal or investigatory proceeding.



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