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An Update on UK Tax Disputes Including the New UK Corporate Criminal Offense: What Is It and What Should You Do About It?

Introduction

Across the world, tax authorities are becoming more aggressive and have sharpened their focus on corporates and multinationals. As a result, tax audits, investigations and disputes have increased significantly, both at the domestic and cross-border levels. Tax authorities are also now introducing offenses targeted at corporates and partnerships that fail to prevent tax evasion.

From September 30, 2017, the UK tax authority HR Revenue & Customs ("HMRC") will begin to enforce a new corporate criminal offense aimed at corporates that fail to prevent staff, agents and certain service providers from deliberately facilitating tax evasion. This offense under the *Criminal Finances Act 2017* targets both UK and off-shore tax evasion by any company or partnership with a link to the UK. The only defense is for corporates to show that they have "reasonable prevention procedures" in place aimed at preventing the facilitation of tax evasion. Companies or partnerships that breach the new corporate offence may be punished upon conviction by unlimited fines. By taking simple preventative steps, corporates can minimize the risk of exposure to this new offense.

In addition, tax disputes around the world are expanding beyond the usual tax tribunal and tax court domains with increased tax-related disputes under development agreements or tax treaties, whether double tax treaties or bilateral investment treaties. This has become necessary in various jurisdictions, for example in various African countries, where corporates rely increasingly on remedies in development agreements or treaties to defend aggressive and unlawful actions by tax authorities or their governments. As a result, tax in the context of arbitration proceedings has become a significant growth area.

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Melissa Baily Named to *Daily Journal*'s Top 40 Under 40

Melissa Baily has been named one of the most outstanding 40 lawyers in California under the age of 40 for 2017. This annual list recognizes outstanding lawyers under the age of 40 who have distinguished themselves in their respective practice areas. Melissa has achieved several victories for companies like Google and GoPro, and she is currently representing Waymo against Uber in high-profile trade secret litigation. This award follows Melissa's previous listing as a top IP lawyer under 40 by *Law360*.

Peter Calamari and Stephen Broome Honored in *The New York Law Journal*'s 2017 "Professional Excellence" Awards

Peter Calamari and Stephen Broome have been selected as honorees by the *New York Law Journal* for its "Professional Excellence" awards. Peter has been named a 2017 Distinguished Leader while Stephen has been named a *NYLJ* 2017 Rising Star. The "Distinguished Leadership" award honors attorneys in leadership roles who achieved impressive results in the past year. Peter was recognized for his principal engagement in the firm's ResCap cases and for his work with American Electric Power, alongside his role as Managing Partner of the firm's New York Office. He is among only 22 lawyers on this list. The *New York Law Journal*'s Rising Stars project recognizes the region's most promising lawyers who are 40 years old or younger and are "innovators, developing unique practice niches…demonstrating strong leadership qualities." Stephen was recognized for his work on *Sessions v. Morales-Santana*, which resulted in a landmark decision by the Supreme Court. He is one of only 30 lawyers selected.

Tax: From Local to Global

The publication of the Panama Papers in 2015 was a watershed moment for tax authorities around the world. Millions of documents were leaked, which detailed the financial and legal affairs of thousands of off-shore entities and revealed a level of tax evasion and fraud that had previously been undetected.

Since that time, and in order to become more effective, tax authorities have enhanced their powers to enable them to prosecute tax evasion and, in addition, to prosecute the facilitation of such tax evasion. Tax authorities are increasingly extending their global reach and cooperation. It has been reported that, over the past five years, the HMRC has nearly doubled its requests for help from foreign governments. The number of inquiries by the HMRC to foreign authorities surged seven per cent (7%) in 2016 alone (Financial Times, *UK Tax Evasion Investigations Increasingly Going Global*, 5 July 2017). A recent example of cross-border cooperation in tax enforcement occurred in March 2017, when the HMRC announced that it had launched an investigation into an unnamed "global financial institution" for suspected tax evasion and money laundering, in partnership with the tax authorities of the Netherlands, Australia, Germany and France. It has since been revealed that the financial institution in question is Credit Suisse (Financial Times Advisor, *Credit Suisse Faces International Tax Probe*, 3 April 2017). Such multi-jurisdictional co-operation is likely going to increase significantly.

The New Offense: Failure to Prevent the Facilitation of Tax Evasion

Under UK law, the Crown Prosecution Service (the "CPS") can prosecute tax evasion (either under statute or under the common law) where a person or company has acted knowingly, dishonestly and has had actual involvement in the non-payment of tax. The CPS may also prosecute the facilitation of tax evasion where a person or company deliberately and dishonestly facilitates (i.e. encourages or assists) tax evasion by another. The HMRC has powers to conduct investigations into these offenses and works closely with the CPS to bring such prosecutions. Adding to these powers, the new statute permits tax authorities to go one step further and target corporates that fail to prevent the facilitation of tax evasion. The new corporate offense criminalizes the failure of a corporate to prevent the facilitation of tax evasion by a person who performs services for, or on behalf of, that corporate when acting in that capacity. This means that any corporation or partnership, not just banks and financial services providers, can be held responsible where a staff member, contractor or other agent facilitates tax evasion either in the UK or overseas in the course of business. This is a drastic development and places a significant burden on corporates to take steps necessary to avoid criminal liability.

What Is It?

The *Criminal Finances Act 2017* became law in the United Kingdom on 27 April 2017. The Act creates two new corporate offenses of failing to prevent facilitation of UK and foreign tax evasion. These offenses will become effective as of 30 September 2017. A company or partnership will be held criminally liable for the actions of its employees, agents or other "associated persons" unless it can demonstrate that it had "reasonable prevention procedures" in place. This is a similar mechanism to section 7 of the Bribery Act 2010. There are slightly different requirements for the offenses dealing with UK and foreign tax evasion.

Potential Costs of Non-Compliance

Corporates that fail to comply with the two new corporate offences are at risk of potential investigation costs, and if convicted for breach, potentially unlimited fines. Aside from the risk of reputational damage, a conviction could also make it more difficult for the corporate to operate in certain regulated jurisdictions. It is therefore vital that corporates with links to the UK start putting in place prevention procedures immediately, in order to mitigate these risks (see "What Is the Defense?" below).

Who Can Be Convicted?

- The "relevant body" for the UK tax offense is a body corporate or partnership, wherever incorporated.
- The "relevant body" for the foreign tax offense is either:
  - incorporated under UK law;
  - carrying on a business or part of a business in the UK; or
  - outside the UK but its "associated person" is located in the UK at the time they commit the criminal act of facilitating foreign tax evasion.

Each offense can be broken down into three stages which must be met for the offense to apply:

- Stage 1 (tax evasion): a taxpayer (either an individual or company) criminally evades tax under existing law. This must be deliberate but there does not need to be a conviction.
- Stage 2 (facilitation): an "associated person" of the relevant body criminally facilitates this tax

evasion by the tax payer when acting in that capacity. This also must be deliberate.
    - An "associated person" is defined very broadly as a person who is an employee, agent or other person who performs services *for or on behalf of* the relevant body.
    - The associated person must be *acting in their capacity* as an employee/ agent/ person performing services for or on behalf of the relevant body, when they commit the crime of facilitating tax evasion.
- Stage 3 (failure to prevent facilitation): the relevant body fails to prevent the associated person from committing the criminal facilitation. If the offenses in Stages 1 and 2 are committed, then the relevant body will have committed the new corporate offense *unless it can make out the defense.*

The legal assessment of the above three stages involves looking at different laws, depending on whether one is assessing the UK tax offense or the foreign tax offense.

What Is the Defense?

The relevant body has a defense where it can show that, at the time the facilitation of tax evasion was committed, it has reasonable prevention procedures in place (or it is unreasonable to expect such procedures).

The term "prevention procedures" refers to (i) formal policies adopted by the relevant body to prevent the criminal facilitation of tax evasion by its representatives, and (ii) practical steps taken to implement these policies, enforcement of compliance and monitoring of effectiveness.

The HMRC has issued draft guidance on the new corporate offense, which sets out the following six guiding principles for implementing reasonable prevention procedures:

- Risk assessment
- Proportionality of risk-based prevention procedures
- Top-level commitment
- Due diligence
- Communication (including training)
- Monitoring and review

Corporates are not expected to undertake burdensome procedures to eradicate all risk. Procedures should be bespoke to that corporate and proportionate to the risk the corporate is facing. In practice, the reasonableness of a corporate's procedures will depend on, amongst other things, the level of control and supervision that it can exercise over its representatives, the nature, scale and complexity of its activities, and the resources available to it.

Recent Trends That Narrow Privilege Complicate Matters

Due to recent case law in the UK, corporates should be particularly alert to how they are producing and retaining documents during the risk assessment and monitoring procedures listed above. The HMRC has wide powers that it can exercise in order to build the case for prosecution, including the power to compel production of documents or to seize them with a judicially-issued warrant. The HMRC's power to demand or seize documents does not extend to documents that are protected under legal professional privilege (as governed by UK law) (*see, eg, P*olice and Criminal Evidence Act 1984, section 10). However, two recent landmark cases in the UK – *The RBS Rights Issue Litigation* [2016] EWHC 3161 (Ch) and *SFO v ENRC* [2017] EWHC 1017 (QB) – evidence a trend toward narrowing the scope of that privilege. In *The RBS Rights Issue Litigation*, the Court held that notes of interviews will only be protected where legal advice is incorporated within those notes. In *SFO v ENRC*, the Court held that documents made in contemplation of legal proceedings will only be privileged where the corporate's internal investigations have uncovered evidence of the suspected offense. These and similar decisions could arguably be interpreted to permit the HMRC to access documents generated during an internal investigation phase (e.g. the risk assessment phase above), in which case corporates would need to think carefully about the manner in which they conduct and document risk assessments.

What Should Corporates Do?

Given that enforcement of the new corporate offense is due to begin imminently, corporates should <u>immediately</u> be taking the following steps as a minimum:

- Adopt tax policy (or amend existing tax policy to include new corporate offense) and ensure top level endorsement by way of a board resolution;
- Appoint a "contact person" who will be responsible for monitoring compliance with the new offense going forward;
- Update document retention procedures and policies;
- Identify risk areas (including internal and external risks) as part of an initial risk assessment, including review of KYC (Know

Your Client) requirements and due diligence procedures;
- Corporates should also:
- Review risk areas identified during the initial assessment results and consider mitigation measures;
- Start rolling out training on the new corporate offense, and the related offenses of tax evasion and facilitation of tax evasion; and
- Ensure ongoing monitoring of high risk areas and ensure implementation of mitigation measures.

The content of the steps listed above will depend on each company's individual circumstances. If your company has a connection to the UK, and you have not already implemented policies and procedures with respect to this new corporate offense, we would recommend seeking legal advice immediately.

Tax Update: Tax Crackdown in Africa

In parallel with the UK and continental Europe's recent moves to increase pressure on tax offenders, we have seen a similar crackdown on multinationals by African tax authorities. The approach by African tax authorities, however, has been much broader and arguably less predictable than the approach in the UK and continental Europe.

Raising "Tax Assessments"

Under most local rules in Africa, tax authorities can raise "tax assessments" against an entity, including multinational corporations. Such tax assessments can be raised for withholding tax, corporation tax, income tax, VAT and/or stamp duty on local transactions or, in the case of disposals, the seller's capital gains tax. Even where the tax assessment has been objected to by a taxpayer, the taxpayer must pay the tax (in whole or in part) pending an appeal against the assessment. This gives the tax authorities a substantial cash flow advantage. In general, any objections to the advance tax payment are dealt with by the local tax authorities at their discretion. Such objections must be made within strict time limits and if the payment is not made on time, penalties and interest can be imposed.

Who Is Being Targeted?

Multinationals with local operations in Africa are the main target, particularly where operations are conducted through separate local operating entities. These measures should be of specific concern to multinationals with the following profiles: those involved in mining, energy and infrastructure (particularly where the multinational has significant local cash flows); those which distribute dividends regularly; those with substantial profits; and those which enter into transactions in the local jurisdiction from time to time.

Why Unpredictable?

Tax authorities in Africa have relied on various grounds to raise tax assessments. Tax authorities will be looking for a link to the local jurisdiction, and we have seen cases where such assessments have been based on an incorrect or flawed understanding of the multinational's operations or of the local tax legislation. It is therefore advisable to seek legal advice where your corporation has had a tax assessment raised against it, or where a risk of such a tax assessment exists due to the corporation fitting one of the profiles described above.

Update in Nigeria—the Voluntary Assets and Income Declaration Scheme

In accordance with the general trend in tax crackdowns, Nigeria has recently implemented its Voluntary Assets and Income Declaration Scheme ("VAIDS") in July 2017 (see PwC, *Voluntary Assets and Income Declaration Scheme (VAIDS) Has Been Launched*, 29 June 2017). The scheme encourages voluntary disclosure of previously undisclosed assets and income, and offers a limited waiver as an incentive for those who come forward. While the VAIDS applies to all individuals resident in, and all companies operating in, Nigeria, the key targets are multinationals and high net worth individuals.

Any taxpayers who fail to embrace the voluntary scheme will be investigated and, if sufficient evidence of tax evasion is found, may be prosecuted.

Similar to the UK tax authority's increase in cooperation with overseas jurisdictions, with this new scheme, Nigeria aims to collaborate with foreign governments in order to clamp down on perceived tax evasion by multinationals (see PwC, *Voluntary Assets and Income Declaration Scheme (VAIDS)*, March 2017).

Tax Update: Arbitration

Tax arbitration is becoming increasingly important in the international sphere and corporates should give serious consideration to adopting arbitration as a method of resolving tax disputes.

On June 7, 2017, sixty-nine (69) countries signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "BEPS Multilateral Convention"), which adds new anti-base erosion and profit shifting provisions to tax treaties internationally. As part of the BEPS Multilateral Convention, countries could opt-

in to providing mandatory binding arbitration for its bilateral tax agreements (see Part VI). Only twenty-five (25) territories committed to this measure, including Australia, Belgium, Canada, France, Germany, Singapore, Switzerland and the United Kingdom.

The International Chamber of Commerce ("ICC") has urged more countries to adopt mandatory binding arbitration, particularly to better resolve double tax disputes. In light of the clear trend, discussed above, of increased activity by tax authorities around the world, the ICC has emphasized the need for countries to adhere to more robust dispute resolution mechanisms with mandatory agreements "*to mitigate anticipated international tax disputes in the coming years*" (Tax-News, *Countries Urged to Sign up to Mandatory Binding Arbitration*, 19 June 2017).

While disputes under tax treaties are between sovereigns, such disputes typically arise at the request of an affected party (most frequently corporates). Adopting arbitration, as opposed to bilateral consultations for example, promotes certainty and could potentially create more space for the affected party to contribute to the resolution of the question affecting it.

NOTED WITH INTEREST

U.S. Supreme Court Holds That *American Pipe* "Tolling" Does Not Apply to Statute of Repose for Securities Act Claims

In *California Public Employees' Retirement System v. ANZ Securities, Inc.*, 137 S. Ct. 2042 (2017) ("*CalPERS*"), the Supreme Court resolved a longstanding circuit split by holding that the class action "tolling" principle set forth in *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974) does not apply to the three-year statute of repose under the Securities Act of 1933. The five-to-four decision in *CalPERS* has significant implications for investors, underwriters, and issuers of securities, as well as for other litigants whose claims may be subject to repose periods.

American Pipe held that "the commencement of a class action suspends the applicable statute of limitations as to all asserted members of the class." 414 U.S. at 554. The *American Pipe* doctrine gives putative class members the option to wait to see how the class action plays out to decide whether to pursue their claims independently. Absent protection, doing so would risk the opt-out claims being deemed untimely. In 2000, the Tenth Circuit held that *American Pipe* applies not only to limitations periods, but also to the three-year "repose" period in the Securities Act of 1933. *See Joseph v. Wiles*, 223 F.3d 1155, 1167-68 (10th Cir. 2000) ("*Wiles*"). The court in *Wiles* observed that "in a sense, application of the *American Pipe* tolling doctrine . . . does not involve tolling at all" because the plaintiff "has effectively been a party to" a class action lawsuit that already includes their claims. *Id.*

The Second, Sixth, and Eleventh Circuits disagreed, holding that the *American Pipe* rule does not apply to Securities Act claims because the three-year statute of repose is a creation of Congress that is absolute and cannot be extended by "equitable tolling" principles. *See Police & Fire Ret. Sys. of the City of Detroit v. IndyMac MBS, Inc.*, 721 F.3d 95 (2d Cir. 2013) ("*IndyMac*"); *Stein v. Regions Morgan Keegan Select High Income Fund*, 821 F.3d 780 (6th Cir. 2016); *Dusek v. JPMorgan Chase & Co.*, 832 F.3d 1243 (11th Cir. 2016). The Second Circuit applied its own *IndyMac* decision in more recent cases to again conclude the *American Pipe* rule does not reach statutes of repose. *See In re Lehman Bros. Sec. and ERISA Litig. (California Public Employees' Ret. Sys. v. Moody Investors Serv.)*, 655 Fed. Appx. 13 (2d Cir. 2016); *SRM Global Master Fund Ltd. P'ship v. Bear Stearns Cos.*, 829 F.3d 173 (2d Cir. 2016). The *CalPERS* plaintiffs petitioned for writ of certiorari on that issue, which the Supreme Court granted in January 2017.

In June 2017, Justice Kennedy delivered the majority opinion in *CalPERS*, which affirmed the Second Circuit's rulings. The Court held that the three-year limit in the Securities Act is a statute of repose that was intended by Congress to be "an absolute bar on a defendant's temporal liability," and therefore cannot be extended by any "tolling" rule, including *American Pipe*. 137 S. Ct. at 2049. The Court elaborated that "the purpose of a statute of repose [] to give the defendant full protection after a certain time" trumps the "equitable balancing powers" of the courts to consider the rights of plaintiffs, and that any concerns about an influx of protective filings resulting from its decision "likely are overstated." *Id.* at 2053-54. The majority made clear that its holding was limited to statutes of repose, as statutes of limitations

still "may be tolled by equitable considerations." *Id.* at 2050, 2053.

The dissent in *CalPERS*, which was authored by Justice Ginsburg, argued that the *American Pipe* rule is at bottom a recognition of the fact that the filing of a class action itself "commenced the action for all members of the class." *Id.* at 2056-57. By opting out, a putative class member "simply [takes] control of the piece of the action that had always belonged to it," and thus should not lose the benefit of the period that its claim was timely brought as part of the class. *Id.* The majority answered by focusing on the dictionary definition of "the action;" because a class action complaint is a separate judicial proceeding from an opt-out complaint, the filing of the former does not "stop the clock" for the latter. *Id.* at 2054-55.

For investors with Securities Act claims, the impact of *CalPERS* is immediate. Investors with significant holdings can no longer rely on class actions to stop the clock running on their opt-out claims, but rather now must presume that any direct action must be filed within three years of the offering, or else be time-barred. This is an important restriction because, as noted by the minority opinion in *CalPERS*, securities class actions often take over three years just to reach a class certification decision. *Id.* at 2057-58. This means that even investors who had hoped to participate in a favorable class-wide recovery can no longer sit on the sidelines without risking receiving little or no recovery if class certification is denied or proves to be problematic. On the other hand, underwriters and issuers of securities stand to benefit from the decision in *CalPERS*. Those defendants will often be able to determine, at a much earlier stage in the proceedings, "the number and identity of individual suits, where they may be filed, and the litigation strategies they will use," and to thus "calculate [] potential liability or set [] plans for litigation with [more] precision." *Id.* at 2053.

Although the *CalPERS* decision specifically concerned only Securities Act claims, the Court's general reasoning suggests that the *American Pipe* rule does not apply to any repose period, unless the particular statute of repose "itself contains an express exception." *Id.* at 2050; *see also id.* at 2050 ("In light of the purpose of a statute of repose, the provision is in general not subject to tolling."), 2051 ("statutes of repose are not subject to equitable tolling"), 2055 ("Because § 13's 3-year time bar is a statute of repose, it displaces the traditional power of courts to modify statutory time limits in the name of equity."). Thus, litigants in other subject areas that include statutes of repose should carefully consider the potential impact of *CalPERS* on their claims and defenses.

The *CalPERS* reading of *American Pipe* is also important to keep in mind when considering other areas where the scope of the *American Pipe* rule remains unsettled. For instance, most (if not all) courts recognize that *American Pipe* cannot just impact the timing analysis for the specific causes of action brought by class plaintiffs, but also other causes of action arising out of the same factual predicate. *See, e.g.*, *In re Libor-Based Financial Instruments Antitrust Litig.*, 2015 WL 6243526, at *147-48 (S.D.N.Y. Oct. 20, 2015) ("*Libor IV*") (collecting cases). The logic is that "limiting American Pipe tolling to the identical causes of action asserted in the initial class action would encourage and require absent class members to file protective motions to intervene and assert their new legal theories prior to class certification, thereby producing . . . court congestion, wasted paperwork and expense." *Id.* (citing *Cullen v. Margiotta*, 811 F.2d 698, 721 (2d Cir. 1987)). Other than in the general sense that *CalPERS* was a 'narrowing' decision which could thus be read by defendants to give license to question everything touching *American Pipe*, this application does not seem directly threatened by *CalPERS*.

However, use of that doctrine does often give rise to another disputed area. Specifically, parties often dispute what happens when a class member opts out of a federal class action and in the same opt-out complaint tries to assert state-law claims. Using the fact-pattern of *CalPERS*, an example would be an opt-out plaintiff choosing to also assert common law fraud claims arising out of the same allegedly false statements. When this happens, some courts take the approach that because the timeliness of a state-law claim is judged by state law, they must assess whether the relevant state would itself decide whether to "toll" the clock for its claims based on the filing of a related federal class-action. *See, e.g.*, *Libor IV*, 2015 WL 6243526, at *138-47. As state laws often differ, that approach creates a patchwork of considerations for otherwise similarly situated class members. An argument against the need to do so was that, under the logic of *Wiles*, it was a mistake to look to each state's approach to "tolling" because the filing of a class action represented the bringing of an "action" for all purposes, directly fulfilling the timeliness requirements of all states. As the majority in *CalPERS* took a technical view of *American Pipe* as a "tolling" doctrine, it seems likely that courts and class members will instead continue to be forced to continue to grapple with questions of so-called "cross-jurisdictional tolling" whenever an opt-out claim would include a cause of action arising out of state law.

Insurance Litigation Update

Insurer Bad Faith: Recent Trends. With increasing frequency, it seems, courts issue decisions that have the effect of imposing extra-contractual liability upon insurance companies for "bad faith" in the handling of claims. These decisions often lead to jury awards that impose millions of dollars in liability upon insurance companies on the thinnest of bases. Recently, for example, in *Madrigal v. Allstate Indemnity Co.*, --- F. App'x ----, 2017 WL 2590771 (9th Cir. June 15, 2017), the Ninth Circuit refused to overturn a jury award against Allstate for $14 million in bad faith damages. Allstate incurred this multi-million dollar exposure even though its claims handler agreed to pay a policy limits demand of $100,000, withdrew the offer for a few days upon receipt of conflicting information about the responsible party, then reiterated that the limits were available for settlement. The Ninth Circuit refused to reverse the jury award, finding that the question of whether Allstate's conduct was reasonable was properly before the jury.

The Tenth Circuit's decision in *Home Loan Investment Co. v. St. Paul Mercury Insurance Co.*, 827 F.3d 1256 (10th Cir. 2016), provides a chilling example of this trend. The jury heard extensive testimony that the policyholder may not have had a sufficient interest in the home that was the subject of the fire claim, but nonetheless found in favor of the policyholder on a statutory bad faith claim. On appeal, the Tenth Circuit affirmed the jury's verdict, reading the Colorado bad faith statutes expansively and holding that even where coverage is fairly debatable, an insurer could be found to have acted in bad faith.

Even in cases where courts find no coverage, bad faith claims can still find their way to a jury. In *Travelers Property Casualty Co. of America v. Federal Recovery Services, Inc.*, 156 F. Supp. 3d 1330 (D. Utah 2016), for example, the court determined that the insurer had no duty to defend the policyholder against a suit that alleged willful and malicious conduct. Despite that there was no coverage for such claims, the court refused to dismiss the bad claim, allowing the jury to determine whether the insurer's investigation and its communications with the policyholder were reasonable.

The trend is a troubling one for insurers as it has led policyholder counsel to market their ability to obtain huge jury verdicts against insurers on even fairly disputed claims. However, the federal court decisions in *Sinclair Wyoming Refining Co. v. Infrassure Ltd.*, 2017 WL 3123461 (D. Wyo. Mar. 10, 2017), and 2017 WL 3187597 (D. Wyo. May 25, 2017), demonstrate that bad faith claims can be defeated when vigorously litigated. In that case (handled by Quinn Emanuel) the policyholder cited a parade of alleged bad faith acts committed by the insurer with regard to its claims investigation, its communications with the insured, its run off status, and its participation in a subrogation action. On summary judgment, the court reviewed the record of the investigation and claims process and then precisely addressed each of the allegations raised by the policyholder about the insurer's handling of the claim. Because the files were carefully documented, the court found the record to be undisputed and concluded that the amount of the claim was "fairly debatable," that the insurer had conducted a reasonable investigation and communicated appropriately with the policyholder. On reconsideration, the court then grated summary judgment dismissing the bad faith claim altogether finding that the policyholder had failed to demonstrate injury independent from its contractual damages.

As the *Sinclair* case demonstrates, the surest way to avoid bad faith liability is for the insurer to carefully document its file and hire experienced coverage counsel to assist it in avoiding the bad faith minefield created by the law in many states.

EU Litigation Update

Germany: Expanding Liability for Patent Infringement to Extra-Territorial Acts. In a recent decision, the German Supreme Court ("Bundesgerichtshof") expanded the liability for patent infringement of a foreign company selling infringing goods to its customers outside of Germany (judgment of May 16, 2017, case no. X ZR 120/15 – Abdichtsystem).

Prior German Case Law. It had been established in the case law of the Supreme Court that deliveries from a foreign company to a customer in Germany may constitute patent infringement *in Germany* (Decision of 26th February 2002, X ZR 36/01 – Funkuhr I). In this context, it does not matter where the German customer takes possession of the products (i.e. in Germany or abroad) or whether another foreign company acts in between the first and the German customer, as long as the first foreign company knows that the products end up in Germany at the end (judgment of February 3, 2015, case no. X ZR 69/13 – Audiosignalcodierung). As a result, a foreign company will be liable for patent infringement in Germany if it has *positive knowledge* that its deliveries of patent infringing products end up in Germany.

The Present Case. The defendant in the case decided this May did not sell the majority of its products in Germany itself, but mainly delivered them

to customers who were based outside of Germany. However, some of these customers then sold these products in Germany.

The plaintiff had won before the Court of First Instance (Landgericht Mannheim) based on the *defendant's own deliveries* to Germany, with the relief including an order to recall the products from the German market. The defendant appealed and the plaintiff cross-appealed to extend the case to the defendant's deliveries to *third-parties outside of Germany* who then sell the infringing products in Germany. The Court of Appeals (Oberlandesgericht Karlsruhe) dismissed the defendant's appeal and the cross-appeal, holding—in line with the earlier Supreme Court decisions—that the defendant could only be liable for its customer's acts in Germany if the defendant had *positive knowledge* of these customers selling the products in Germany. However, it found that at most, the defendant could have considered such further deliveries to Germany possible, which was not sufficient for positive knowledge.

The Supreme Court's Decision. Reversing the Court of Appeals and remanding the case, the Supreme Court went further and held that *not only positive knowledge* of further deliveries to Germany gives rise to liability. In addition, the supplier may also be liable for patent infringement if there are *sufficiently specific facts that make it seem likely* that its customers will further deliver the infringing products to Germany. The supplier is not generally obliged to investigate or control the further use of the products by its customers. It is obliged, however, to investigate the circumstances of the case if there are specific reasons to believe that its customer's further use may result in patent infringement by delivering the products to Germany. The mere abstract possibility of the customer delivering the goods to Germany, however, is not sufficient; concrete facts indicating that this is actually the case are required. This is the case, for instance, if the amount of products delivered is so huge that it can hardly be distributed only within markets where there is no patent protection. Under such circumstances, the supplier can no longer have confidence in its customer not infringing patent rights in Germany. In fact, the supplier is obliged to ask the customer about deliveries and offers in Germany and, as a precautionary measure, to point out potential patent infringement. If the customer does not provide a satisfactory response, the supplier—by continuing to deliver the products to its customer—will be deemed an infringer in addition to the customer's subsequent patent infringement in Germany even though the delivery of products takes place outside of Germany.

In the matter to be decided there was a significant discrepancy between the total number of products delivered to Germany and the number of products delivered directly to Germany by the defendant itself. In the first instance, the defendant had also stated that an injunction would have a devastating impact on its business within Germany. As it turned out, its actual business with German costumers directly was negligible. The German Supreme Court deduced from this statement that the products must have been put on the German market on a large scale by the defendant's customers and that the defendant must have been aware of these facts. As a result, the Court held that "it could hardly be denied that there were specific facts for deliveries to Germany."

With that ruling the case was remanded to the Court of Appeal in order to investigate the relevant facts, including whether there were specific enough reasons for the defendant to believe that its customers would further deliver the goods to Germany. The Court of Appeal will also have to investigate whether the defendant's customers actually infringed the patent by delivering the goods to Germany or—at least—whether there was a risk of a first-time infringement. The Supreme Court also held that if that was the case, the defendant would need to render account about all sales to these customers, including those that did not end up in Germany, so that plaintiff is put into a position to evaluate and verify the defendant's numbers. Finally, the Supreme Court tasked the Court of Appeals with taking into account this special situation when tailoring its injunction, though without providing much guidance on what that might entail.

Conclusion. The decision shows that the liability of a foreign company for patent infringement in Germany does not require that the foreign company acts in Germany itself and directly. It does not even have to have positive knowledge of the behavior of customers based outside of Germany. Circumstances indicating that the company's customers may infringe the patent by delivering the products to Germany can be sufficient to give rise to liability of the company. Thus, it is essential for the company to *actively investigate the circumstances* and *inform its customers about possible patent infringements* as soon as the company becomes aware of facts indicating infringing activities of its customers in Germany.

Bankruptcy & Restructuring Litigation Update

Ninth Circuit Holds That a Shareholder Can Be Liable for an Actual Fraudulent Transfer When Its Wholly-Owned Corporation Transfers Assets

Even Absent a Showing of Alter Ego. On July 11, 2017, the Ninth Circuit in *DZ Bank AG Deutsche Zentral-Genossenschaft Bank v. Meyer*, No. 15-35086, 2017 WL 2954611 (9th Cir. Jul. 11, 2017), issued a short but nonetheless important decision concerning shareholder liability for fraudulent transfers when wholly-owned subsidiaries transfer assets. The decision not only finds liability at the shareholder level, but also holds that a shareholder can be liable even without a showing of alter ego or the shareholder holding legal title to the assets. *DZ Bank* will likely embolden creditors and bankruptcy estates to challenge a wider array of fraudulent transfers and should give pause to companies (and their directors and officers) facing insolvency on structuring asset transfers at subsidiaries that they control.

In *DZ Bank*, two individuals (a husband and wife) owed a lender approximately $1.73 million evidenced by a promissory note. Prior to defaulting on the note, the individuals "executed an elaborate series of transfers and sales to place their assets beyond the reach of their creditors." 2017 WL 2954611 at *1. These transfers and sales all were undertaken by subsidiaries wholly-owned by one of the individuals. Specifically, a wholly-owned insurance company transferred assets, valued at $123,000, to another company the individual owned. That second company, which then held $385,000 in assets, transferred all of its assets to a third company under the individual's control, for no consideration. That third company then "agreed to pay the $385,000 back to Meyer, personally, over time." *Id.* The opinion does not identify any facts regarding this third company, including whether it had the ability to perform on the agreement to pay the $385,000 to the individual.
The individuals then filed for personal bankruptcy. The lender asserted that the $385,000 transferred out of the second company to the third company was actually fraudulent pursuant to the State of Washington's version of the Uniform Fraudulent Transfer Act and, as a result, the debt owed to the lender was not dischargeable under 11 U.S.C. § 523(a)(2)(A). *Id.*

The bankruptcy court found for the lender, but only to the extent of the $123,000 that was first transferred because that was the amount traceable to the lender's security interests. The district court affirmed, but on different grounds: that the lender could only avoid transfers of assets titled in the individual's name. Since the assets were legally titled in the second company's name, and the lender had not alleged alter ego, the lender could not recover the full amount transferred.

The Ninth Circuit reversed on all grounds, concluding that the entire $385,000 was subject to avoidance as an actual fraudulent transfer. The court stated: "If [the second company] had retained the $385,000 in assets, DZ Bank would have been able to enforce any judgment against the Meyers, prior to their filing for bankruptcy protection, by executing against Louis Meyer's 100% ownership interest in the [second company] to satisfy $385,000 of its claim." *Id.* at *2. The court continued, "His shares [in the second company] became worthless as a result of his actions as [the second company's] sole owner and shareholder, while, even after filing for bankruptcy, he continued to receive payments from [the third company]." *Id.*

DZ Bank stands for three important legal principles, at least one of which may go beyond any existing federal court precedent. First, a debtor makes a fraudulent transfer even if it does not transfer assets titled in the debtor's name, as long as the debtor indirectly owns the asset. *See id.*

Second, *DZ Bank* extended its first principle to the circumstance where a debtor's wholly-owned subsidiary is transferring the assets the subsidiary clearly owns, which may be the first circuit-level authority so holding. For support, the Ninth Circuit cited with favor three cases, *Wiand v. Lee*, 753 F.3d 1194 (11th Cir. 2014), *Reilly v. Antonello*, 852 N.W.2d 694 (Minn. App. Ct. 2014), and *In re Nickerson*, 2014 WL 6686524 (Bankr. D.S.D. Nov. 25, 2014). *Wiand* concerned a SEC receiver appointed for several corporations seeking to recover false profits an investor received in a Ponzi scheme; in *Wiand* the transfers were made by corporations to the Ponzi scheme orchestrator, who then made transfers to investors. The Eleventh Circuit held that the element of "a conveyance of property which could have been applicable to the payment of the debt due" was "established because the funds that Nadel controlled and transferred to investors could have been applied by him to pay the debt he owed to the receivership entities as a result of his use of funds to perpetrate a Ponzi scheme. With each transfer that Nadel made, Nadel became a debtor of the receivership entities because he diverted the funds from their lawful purpose in violation of his fiduciary duties and was thus obligated to return those same funds to the entities to be used for the benefit of the investors. Therefore, with each transfer, Nadel diverted property that he controlled and that could have been applicable to the debt due, namely, the very funds being transferred." *Wiand*, 753 F.3d at 1203.

Reilly and *Nickerson* involved a slightly different fact pattern—in each case, the debtor caused its wholly-owned subsidiary to issue more stock so as to dilute its ownership, *see DZ Bank*, 2017 WL 2954611 at *2, which is more closely connected to the debtor because of the debtor's clear ownership interest in the

(continued on page 11)

VICTORIES

Landmark Fintech Injunction Victory

The firm recently obtained a landmark preliminary injunction victory in the Southern District of New York, requiring defendant MarkitSERV to provide swap execution facility ("SEF") trueEX, LLC with access to MarkitSERV's post-trade processing platform while trueEX's case against MarkitSERV proceeds to trial.

The firm was retained by trueEX in May 2017. trueEX is a fintech startup SEF for the trading of interest rate swaps ("IRS"). In addition to executing IRS trades, trueEX provides some post-trade processing services that place it in direct competition with MarkitSERV, the IHS Markit subsidiary that dominates the market for IRS trade processing, with a market share of more than 90%. In particular, MarkitSERV has near-total control over the network for the "straight-through-processing" ("STP") of trade information to market participants' back-office books and records, which IRS dealers rely upon to ensure that their trading records always reflect their current risk exposures.

Because the vast majority of market participants rely on MarkitSERV to update their books and records, trueEX cannot process IRS trades without the ability to "drop" a copy (known as a "drop-copy") of each trade to MarkitSERV's network, which then sends the details of the trades downstream into end-users' books and records. If trueEX cannot send such drop-copies of trades, market participants will be unable to automatically update their books and records to account for such trades, and they will therefore stop using trueEX's platform.

In April 2017, after operating under a services agreement without any interruption for more than five years to provide drop-copy connectivity to trueEX, MarkitSERV moved to terminate the agreement. The firm quickly stepped in and filed a complaint against MarkitSERV asserting a monopolization claim under Section 2 of the Sherman Act based on MarkitSERV's unilateral refusal to deal with trueEX. In fact, at the precise time of the termination, trueEX's sister company, truePTS, was emerging as a direct competitor to MarkitSERV. By terminating the agreement and refusing to deal with trueEX and truePTS, the firm alleged that MarkitSERV's termination was an attempt to eliminate both trueEX and truePTS as competitors in the IRS trade processing market.

With less than 30 days before the termination became effective, the firm filed a preliminary injunction motion to block MarkitSERV from terminating the parties' services agreement pending determination of the action. The firm argued that MarkitSERV was a monopolist in the market for post-trade swap services and that, regardless of what the contract said, MarkitSERV could not terminate the agreement if its motive was to harm competition.

In a 40-plus page opinion, Judge Kaplan of the Southern District of New York agreed, and entered the preliminary injunction preventing MarkitSERV from barring trueEx's access to MarkitSERV's provision of drop-copy services. This victory is especially notable given the challenging landscape for Section 2 claims based on a defendant's unilateral refusal to deal with a rival following the U.S. Supreme Court's decision in *Verizon v. Trinko*. As MarkitSERV pointed out—no court since *Trinko* has issued an injunction compelling a defendant to cooperate with a competitor—that is, until trueEX's preliminary injunction was granted.

With this relief, trueEX and its 60 employees, can continue to provide competition and choice within the market for IRS trade processing. The firm is expected to try the case in March 2018.

Another S.D.N.Y. Motion to Dismiss Victory for E*TRADE in Class Action Challenging Best Execution

The firm won a significant victory for E*TRADE Securities and E*TRADE Financial when Judge Koeltl of the SDNY dismissed Section 10(b) and Section 20 putative class action claims against E*TRADE in *Schwab v. E*TRADE Financial Corporation*, 1:16-cv-5891 (SDNY). The decision is significant because it represents a rare instance of dismissal of a Section 10(b) claim for lack of reliance. The Court held that the *Affiliated Ute* presumption of reliance did not apply because plaintiff's second amended complaint alleged primarily affirmative misrepresentations and did not allege any omission with particularity. In the absence of a presumption of reliance, plaintiff must plead actual reliance, which he failed to do—the Court held that plaintiff's allegations of detrimental reliance were "entirely conclusory," and "fail to show with any sort of particularity . . . that the plaintiff was aware . . . of any of the challenged misstatements when he traded with E*TRADE." The Court's decision affirms that alleged omissions that are the mere "flip side" of alleged affirmative misrepresentations do not suffice to invoke the *Affiliated Ute* presumption of reliance. The Court also dismissed the complaint for failure to adequately plead scienter, holding that "[t]he pursuit of PFOF is the type of generic profit motive that is insufficient to establish scienter." The Court also confirmed that, in the Second Circuit, the "core operations" doctrine does not on its own suffice to plead scienter (though it may supplement other allegations of scienter).

This case is among a slew of cases brought against various retail brokers challenging their receipt of payment for order flow and order-routing practices. It represents a significant victory for E*TRADE in defending against the baseless allegation that it does not comply with its duty of best execution in routing its customers' orders to various market exchanges. TD Ameritrade unsuccessfully moved to dismiss a complaint brought against it in the United States District Court for the District of Nebraska bringing a Section 10(b) claim on the basis of similar allegations concerning TD Ameritrade's order routing practices and receipt of payment for order flow. *See Zola v. TD Ameritrade, Inc.*, 172 F. Supp. 3d 1055 (D. Neb. 2016).

This is the second victory Quinn Emanuel has obtained for E*TRADE in connection with its order routing practices: In April 2017, Judge Koeltl granted E*TRADE's motion to dismiss a putative class action making similar allegations as to E*TRADE's order routing practices, and bringing state law claims of breach of fiduciary duty and unjust enrichment. The Court was persuaded that that the complaint was precluded by the Securities Litigation Uniform Standards Act ("SLUSA") and dismissed all claims on that basis.

(Practice area updates continued from page 9)

existing stock. Thus, the Ninth Circuit arguably went further than the precedent it favorably cited to a more expansive universe of transfers. Instead of dilution of stock owned by a debtor, or transfers involving a Ponzi scheme, a subsidiary's transfers could be avoided as actually fraudulent solely because its sole shareholder directed it.

Third, though it did not provide any specific analysis, the *DZ Bank* opinion unambiguously holds that there was no requirement to prove alter ego in order to avoid as an actual fraudulent transfer a transfer that was not actually made by the debtor but rather was made "indirectly" by the debtor through a corporation wholly-owned by the debtor. *DZ Bank*, 2017 WL 2954611 at *1 (expressly disagreeing with the district court's holding that the UFTA required the lender to obtain a ruling that the subsidiary was the alter ego of the debtor).

DZ Bank may ultimately have limited application by covering only actual fraudulent transfer cases involving transfers by wholly-owned subsidiaries. Actual fraudulent transfers are far more difficult to establish than constructive fraudulent transfers. But the court's holdings arguably should apply with equal force to constructive fraudulent transfers, which are much more commonly pursued in bankruptcy cases. The UFTA does not treat differently what is a transfer solely because it is an actual fraudulent transfer. If *DZ Bank* does extend to constructive fraudulent transfer claims, such claims do not require a showing of intentional misconduct but a showing that the debtor (not the wholly-owned subsidiary) received less than reasonably equivalent value at a time that the debtor (not the wholly-owned subsidiary) was insolvent or had less than reasonable capital to operate. Even if *DZ Bank* is limited to actual fraudulent transfers, the elimination of a need to show alter ego will make it easier to challenge transfers by a wholly-owned subsidiary as actual fraudulent transfers. Finally, left unanswered is whether the rulings in *DZ Bank* apply in a circumstance where a debtor-shareholder controls the actions of a company, but is neither an alter ego nor its sole shareholder. No doubt this is fertile ground for additional litigation.

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business litigation report

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