Autumn/Winter 2014–2015

Weil

Perspectives:
A review of current legal issues
and trends and looking ahead to 2015

Contents

Introduction

Michael Francies
Managing Partner, London

Welcome to the third edition of *Perspectives* – a review of current legal issues and trends throughout 2014 and ahead to 2015 across competition, employment, intellectual property, pensions, real estate, tax and technology. For this issue, we are delighted to have Sue Tilstone, Head of the Fiscal Valuation Group at Deloitte, as author of our guest piece entitled *Taxing 'Leaver' Shares*. Thank you for your feedback on previous editions of Perspectives. Please do let us know if you have any comments on this issue or suggestions for future articles.

2014: the year so far

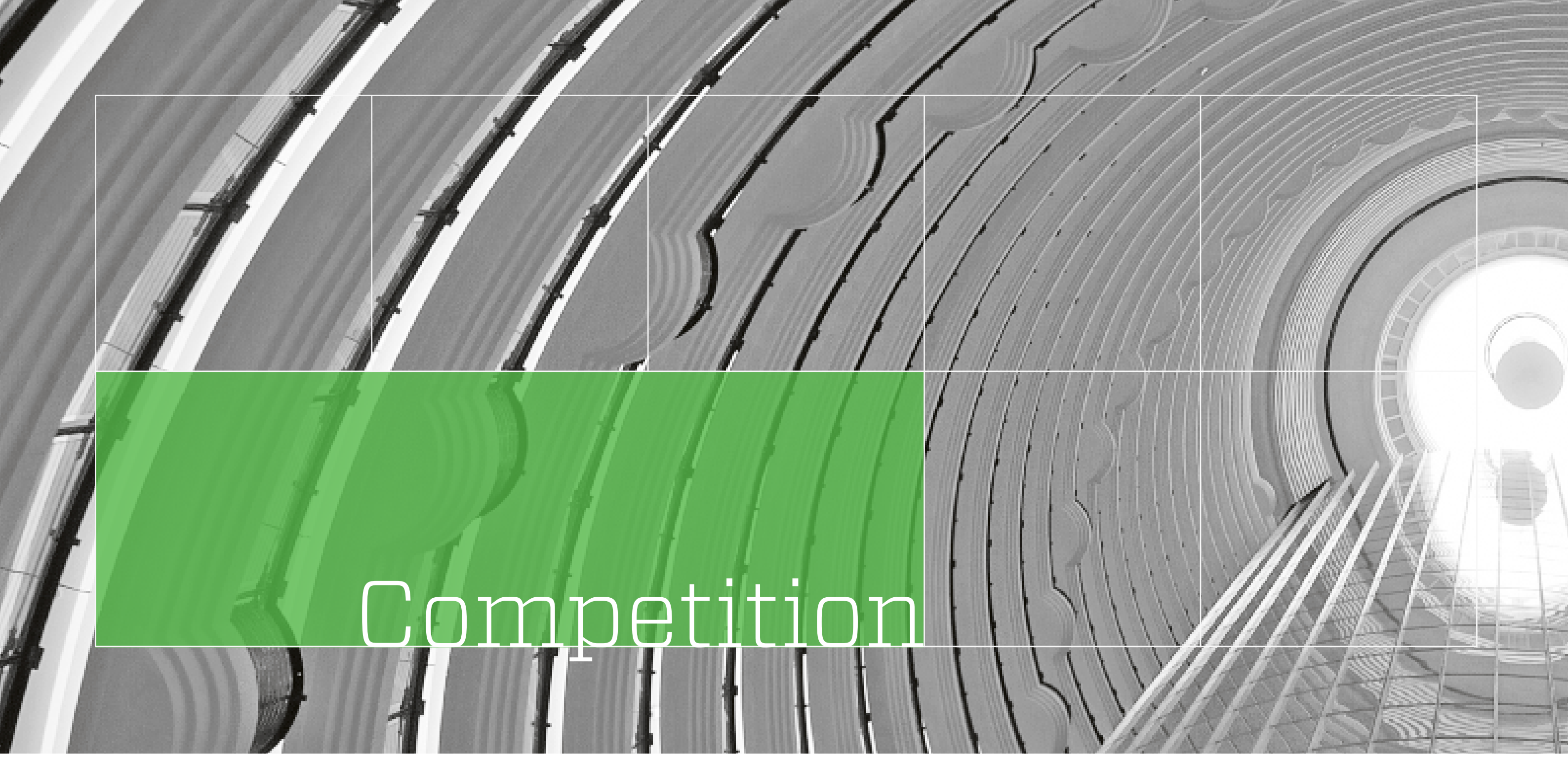
Market recognition

We have achieved noteworthy success across our practice areas in the first half of the year, with highlights including our global private equity team ranking number 1 for private equity deals globally in H1 2014 by Bloomberg, and our London restructuring team winning "Restructuring Team of the Year 2014" twice within six months at the Lawyer awards in June and in February at the Legal Business awards for our role on MF Global. External recognition such as this underlines the integral role that Weil's transaction specialists play in private equity and M&A deals, and on innovative, market-shaping mandates like MF Global. London Head of Real Estate, Rupert Jones, was also awarded the 2014 "Distinguished Service Award" by the City of London Law Society and the City of London Solicitor's Company for his outstanding service as Chairman of the Future of the Livery Working Party, where he was instrumental in producing a report mapping the Company's strategy and position for the next 20 years. The London office has also recently been ranked number 1 for employee satisfaction amongst global law firms in Legal Week's 2014 Employee Satisfaction Survey, for the second year running, and is also ranked as "Best Legal Employer 2014" in the survey. We are also one of a handful of firms have announced a 100% retention rate for the autumn 2014 newly qualified associate intake.

Recent matters

Throughout the first half of 2014 our transaction specialist team has advised a broad range of clients globally, including corporates, private equity houses and financial institutions, on some of their most significant mandates, including:

- Gores Group on its landmark Hovis joint venture agreement with Premier Foods.
- Principal shareholders of Grupo Corporativo Ono on its landmark €7.2 billion sale to Vodafone.
- UK manufacturer Volution Group on its initial public offering on the main market of the London Stock Exchange.
- Facebook on its acquisition of WhatsApp, in what was Facebook's largest acquisition at the time.
- RPC Group on its acquisition of Hong Kong headquartered ACE Corporation Holdings Limited.
- Working with our Paris office on one of the market's most high-profile deals of 2014, advising Alstom on GE's $16.9 billion bid to acquire Alstom's power and grid business, representing GE's biggest ever deal.
- Securing a £1.2 billion High Court victory for the Littlewoods group in its long-running dispute with HMRC concerning interest on overpaid VAT.
- Continuing to provide London-led global restructuring, pensions, litigation, structured finance, banking, corporate, employment, tax and IP advice on MF Global UK's ground-breaking and "historic" special administration, including the most recent milestone achievement advising in a landmark settlement of the MF Global group's pension liabilities.
- Continuing to act for Lehman Brothers in one of the most significant insolvency and pensions cases in recent years, including most recently on a landmark High Court settlement which will have significant implications for the extent of the Pensions Regulator's powers, in addition to wider application across the entire pensions industry.



Competition

Doug Nave
Antitrust/Competition

The Expanding Scope of Pre-merger Review

In recent months, several developments have placed in high relief the care companies must take in acquiring minority interests. First, the European Commission fined several companies for acquisitions that fell just shy of 50% and were deemed to constitute acquisitions of *de facto* control that should have been notified prior to completion. Second, the Commission has proposed various reforms that, among other things, would make some acquisitions of non-controlling interests subject to mandatory notification under the European Merger Regulation (EUMR) for the first time.

In July, the Commission imposed a fine of €20 million on Marine Harvest in connection with its acquisition of Morpol, a competing salmon farmer/processor. Marine Harvest acquired a stake of 48.5% roughly eight months before filing under the EUMR, apparently believing that its less-than-50% stake did not trigger prior notification. The Commission differed, noting that the stake was sufficient to confer *de facto* control over the outcome of shareholder votes, given the fragmentation of other ownership and attendance rates at shareholder meetings.

The Marine Harvest case follows another €20 million fine that the Commission imposed in 2009 on Electrabel SA for a similar offence in the energy sector. In July 2014, that fine was upheld by the European Court of Justice, even though the transaction itself was cleared unconditionally. These two cases, while applying concepts of *de facto* control that have existed for some time, represent more vigorous enforcement of the rules in “borderline” cases than was common in the past.

On a related front, the Commission took a major step forward in July on another key initiative, adopting a White Paper that moves closer to mandatory notification of some acquisitions of non-controlling interests in companies. While any final change in the rules is probably still at least a year away, this proposal represents a potentially very significant expansion of rules that previously required filing only for acquisitions of “controlling” interests.

Reform has been proposed because it is well established that some minority interests may appreciably reduce competition, for several reasons.

- **Information:** Minority shareholdings may provide a basis on which companies share (or, at minimum, the investor acquires from the target) confidential information that reduces strategic uncertainty for one or both of the companies and, consequently, the intensity of actual/potential competition between them.

- **Influence:** A minority investor may have the right, e.g. to veto important decisions like expansions in the scope of the target's business, major capital investments, corporate alliances, and the like. Where the two parties are actual/potential rivals, this can reduce the target's ability to compete effectively with the investor.
- **Inputs:** Where the investor is a supplier of important goods/services used by the target, the investor may curtail supplies to the target or its rivals in order to obtain a competitive advantage downstream.
- **Incentives:** Finally, even if none of these concerns exist, the formation of a relationship between two companies may well change their commercial incentives so that they compete less vigorously with each other or alter their terms of dealings with third parties.

In light of the foregoing, various regulators – including (in the EU) Austria, Germany and the UK – have laws under which they may challenge the acquisition of problematic minority stakes. The European Commission now has proposed a system whereby minority shareholdings also may be caught under the EUMR.

The Commission is proposing what it calls a "hybrid" system, representing a middle ground between the reporting of all minority investments at a set percentage (which could be unduly burdensome) and simple reliance on parties to self-assess the competitive significance of their investments (which is deemed somewhat unreliable).

The proposed approach would require notice of investments involving parties who meet the current EUMR turnover thresholds and stand in either a "horizontal" relationship (i.e. are actual/potential competitors of each other) or "vertical" (actual/potential customer-supplier) relationship. Where such a relationship exists, a filing obligation may arise for [i] acquisition of an interest of 20% or more, or [ii] acquisition of a 5-20% interest with additional rights that might be competitively significant (e.g. rights to block certain actions, a seat on the target's board, or access to competitively sensitive information).

Parties whose investments met these tests would be required to file a brief "Information Notice" and to suspend completion for roughly three weeks so that the Commission could decide whether to require full notification. If no notification was required, the parties would be free to complete the acquisition but the Commission would have another 4-6 months to investigate it if post-completion complaints or other concerns became evident. Given this latter possibility, parties also would have the option of voluntarily notifying the investment prior to completion, to eliminate the uncertainties/risks of later regulatory intervention.

This proposal (if adopted) may reach a limited number of transactions; the Commission has predicted that it would lead to 20-30 reviews per year. Nonetheless, it is one more indication (along with increased fines, reforms to ease private recovery for competition-law offences, and the like) that the regulators are focusing heavily on competition concerns, and that companies will be well advised to consider such issues early in any transaction planning.

Ivor Gwilliams
Employment

Rights of LLP Members

In the recent case of *Clyde & Co LLP and another v Bates van Winkelhof [2012] EWCA Civ 1207*, the UK Supreme Court held that LLP members can be 'workers' for the purpose of whistleblowing legislation. This means that LLP members (and not just employees) can now claim whistleblowing rights, in addition to certain other rights available to 'workers'. One important practical implication of this decision is that private equity and investment firms that engage their investment professionals as members of limited liability partnerships will now have to take more care when removing members but there may be other implications to consider as well.

Whistleblowing rights

If an employer subjects one of its workers to a detriment because the worker has made a protected disclosure, then that worker may be able to sue the employer for compensation which is not capped in the way that it is for, say, ordinary unfair dismissal. An LLP member will therefore be entitled to uncapped compensation based on their actual and future losses, if they are able to show at an Employment Tribunal that they have been subjected to detrimental treatment by their firm on the grounds of the member having blown the whistle on wrongdoing. Detriment could mean dismissal or something else that falls short of dismissal, e.g. a reduction in pay or demotion. In order for a disclosure to be 'protected', it must relate to one of the following: a criminal offence, a breach of a legal obligation, a miscarriage of justice, danger to health and safety of an individual, damage to the environment, or the deliberate concealment of information about any of the above.

It will be obvious to most employers that a complaint about, say, financial irregularities or unsafe working practices will be sufficient to give a worker protection under the whistleblowing legislation in the UK. However, a breach of any legal obligation, such as an alleged breach of the worker's own contract, could also be sufficient to give the worker such protection. All that the worker needs to do is show that (a) they had a reasonable belief that (i) the breach occurred (or is likely to occur) and (ii) the disclosure is in the public interest and (b) they were subject to a detriment because of the disclosure. Furthermore, departing workers have shown themselves creative in the way that they have tried to afford themselves of such protection. This can come as a nasty surprise to employers.

For private equity firms and other investment firms, this issue is most likely to occur in the context of acrimonious exit negotiations where a departing employee or LLP member tries to claim that they are being removed as a result of having 'blown the whistle', either because the individual genuinely believes this to be the case or as tactic to lever a better termination package.

Other rights

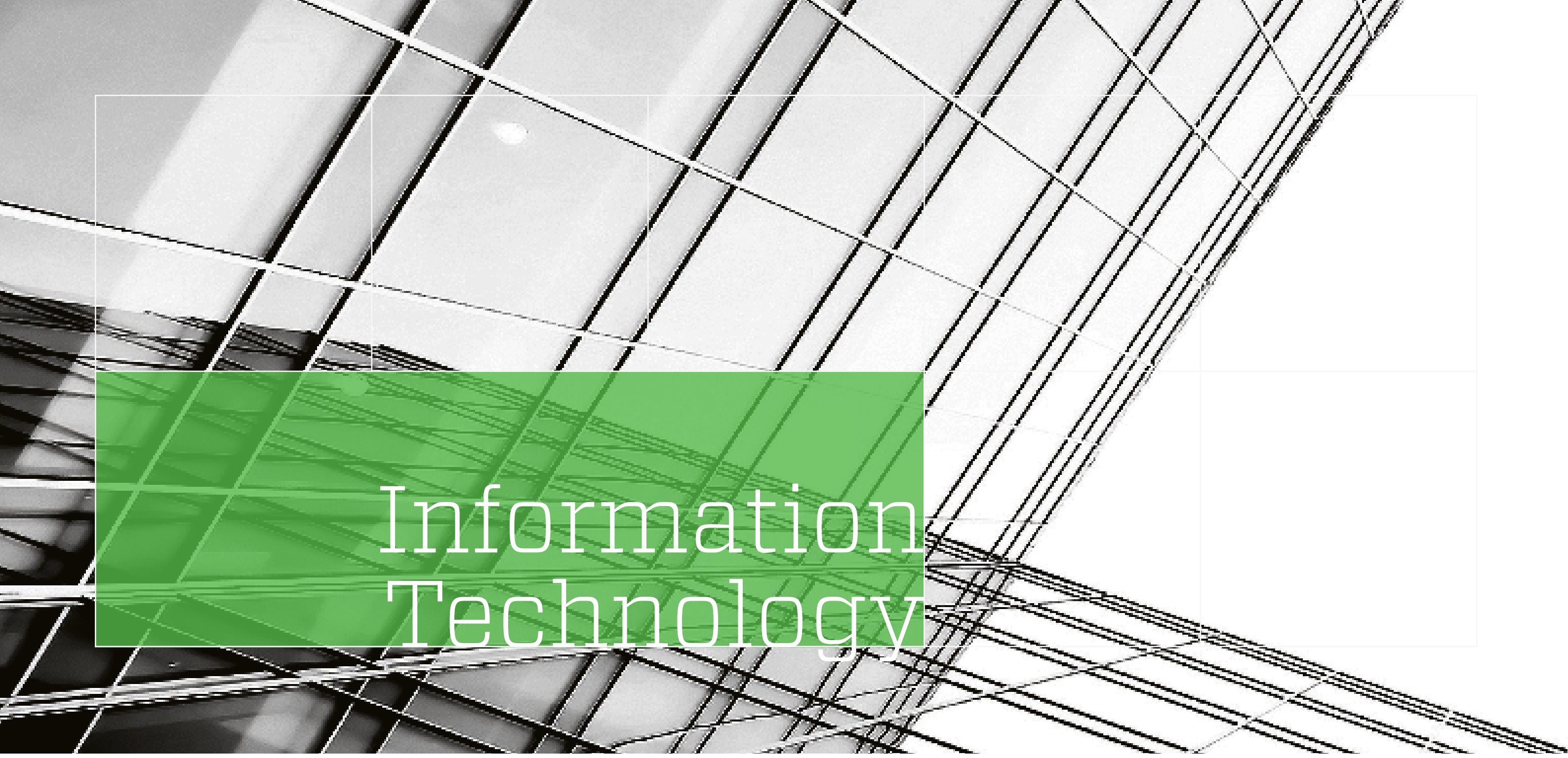
If an LLP member is a 'worker' for the purposes of the whistleblowing legislation, then they will also have certain other statutory rights enjoyed by workers. These include rights in relation to part-time status, the national minimum wage and working time and rights relating to unlawful deductions from pay.

There is a continuing debate as to whether LLP members will have to be enrolled automatically into a qualifying pension scheme with mandatory, minimum employer pension contributions, under the auto-enrolment regime. In order to determine this question, it would appear that one will need to decide first whether the LLP member is a 'worker' for these purposes and then whether the LLP member receives 'qualifying earnings' (i.e., salary, wages and commission but not genuine profit share). It remains to be seen whether any guidance on these points will be forthcoming from the UK Pensions Regulator.

What practical steps can LLPs take?

In response to the decision in the *Clyde & Co LLP* case, those who operate LLP structures should review their LLP agreements and related policies and practices in order to assess the impact on their businesses. In short, they should:

- ensure that there is a whistleblowing policy in place setting out procedures by which LLP members can report concerns about illegal, unethical or otherwise unacceptable conduct;
- ensure that they do not subject any LLP members to any detriment if they 'blow the whistle' (and consider taking legal advice before taking steps to remove an LLP member in order to establish whether the member might be able to bring a successful whistleblowing claim);
- carefully document genuine business reasons for any negative or otherwise detrimental actions taken against LLP members (e.g. compulsory retirement or reductions in profit share) so as to be able to show that the LLP has not taken any retaliatory action against LLP members for any alleged wrongdoing;
- ensure that they are in compliance with the Working Time Regulations (most notably regarding rest breaks and paid annual leave) and the regulations prohibiting less favourable treatment of part-timers in respect of their LLP members;
- ensure that the way that profits are drawn by LLP members and how this is drafted in the LLP agreement accords with national minimum wage legislation; and
- consider whether LLP members may need to be enrolled into a suitable occupational pension scheme under the auto-enrolment regime and, if necessary, plan for such enrolment.



Information Technology

Barry Fishley
IP/IT/TMT

Cyber Security 101

It seems as though almost every day there is a headline concerning a new cyber security attack. For example, in August, Russian cyber criminals committed the "largest data breach known to date", stealing 1.2 billion usernames and passwords from more than 420,000 websites. In September, a cloud storage breach was implicated in the embarrassing leak of compromising celebrity photographs. A UK Government survey showed that in 2013, 81% of large businesses and 60% of small business experienced a cyber attack.

With even the most sophisticated organisations falling victim to cyber-attacks, the importance of effective evaluation of cyber security risks when assessing a target within the context of an intended M&A transaction has never been more important. In this note we consider key cyber security issues for the potential acquirer of a business.

Impact

A cyber security failing can result in reputational risk, litigation, regulatory sanctions and loss of value. All of these will have a profound impact on a business' bottom line. The fall-out relating to the US retailer Target is a classic example of this. Hackers stole the login credentials from one of Target's contractors and installed software in the company's security and payments systems designed to steal every credit card used at the company's 1,797 US stores. As a result 40 million credit and debit card accounts and 70 million customers' addresses, phone numbers and other personal information were stolen. The ramifications were huge: loss of customer trust, the CEO resigned and reports estimate the costs were over $300 million.

Due Diligence and Transactional Issues

Even if the target is not an on-line business, cyber security risk should always be assessed, particularly where data and intellectual property assets are key value drivers.

Whilst awareness of cyber security issues has increased, we do not believe it has made its way into the checklist of issues which would-be buyers need to carefully consider within the context of M&A.

Areas of due diligence enquiry include:

- identifying historic data security breaches;
- understanding the level of organisational awareness of cyber security issues – is management fully engaged on the issue of cyber security?
- existence and content of IT policies and procedures (e.g. employee IT security policy) and understanding whether they are regularly reviewed and updated;
- existence and appropriateness of contingency plans in the event of a security breach;

- existence and frequency of penetration testing and results of historic testing;
- assessing the levels of security surrounding third party access, such as remote hosting:

  Many targets opt for a cloud-based IT solution with the effect that a significant proportion of data is held remotely and subject to third party security measures. As the September 2014 celebrity hack showed, cloud service providers are attractive targets for hackers. In addition to reviewing the contracts with such third parties, it would be prudent to ask the target, what (if any) due diligence was performed on third party providers including their cyber security arrangements, in order to determine whether they are adequate. In any event, assuming personal data is involved, from an EU data protection perspective the target is legally obliged to ensure that the third party's data security arrangements are appropriate.

- existence and quality of a response plan in case of a security breach;
- existence of insurance:

  Either basic policies covering third party claims resulting from data breach, or more comprehensive policies that cover other losses e.g. reimbursing cost of customer notifications, should be in place. Note of caution: the insurance will have required the target to disclose to the insurance company the details of any prior breaches. Accordingly, the information provided by the target in order to obtain the insurance will be a useful source of information, and would likewise be valuable to any hacker! Accordingly, the security arrangements of the broker/insurance company should also be investigated as part of the due diligence process. Even if the target has insurance, it is no substitute for a comprehensive security plan.

- legal and regulatory compliance and industry standards:

  Although compliance with laws demonstrates that data security is treated with appropriate seriousness, it does not provide a guarantee of preparedness for a cyber-attack. Various industry standards also exist which offer best practice for information security systems and an objective measure of commitment to cyber security, however they are not waterproof. For example, Target was PCI (payment card industry) compliant, yet that did not prevent a massive security breach. BSI ISO/IEC 27001 is an internationally-recognised security standard which is particularly useful on account of its risk-based approach.

  There is, as yet, no pan-European law which comprehensively relates to cyber security, but a draft directive on network and information security is currently passing through the European legislative bodies and seems set to be adopted. This law aims to achieve a common level of network and information security across Europe, although it applies only to operators of critical infrastructure and "market operators" such as cloud service providers.

Purchase Agreement

There are a number of ways of dealing with cyber security risks in the purchase agreement. Where the risk is identifiable, then it may be appropriate to seek an indemnity (for example, dealing with the consequences of third party claims against the target as a result of a cyber security breach). Similarly, warranty protection may be appropriate, even if it is primarily used as a mechanism to obtain further and better disclosure of the underlying issues.

Following from due diligence, there may be some pre-closing actions placed upon the target/seller which ought to be dealt with, (e.g. producing a cyber security response plan) and also should be included in the purchase agreement.

Post-acquisition

Post-acquisition, cyber security should be considered as part of any integration process. A cross-departmental team incorporating personnel from compliance, legal and IT functions should be tasked to reviewing the risk of integrating IT systems with those of the buyer or its other companies.

Key Takeaways

- Cyber-attack risk assessment should form part of any due diligence process.
- Raise probing questions of management to ascertain level of risk and engagement on the issues.
- Due diligence should also address any potential integration issues.
- Purchase agreement should help deal with allocation of responsibility for risk.
- Although it will be expensive, consider whether cyber insurance should be purchased to mitigate against cyber security risks and costs.

Pensions

Joanne Etherton
Pensions

Hidden Pensions Risk for Acquisitive Companies

At first glance, the pensions aspects of a UK shares acquisition may look straightforward where the only pension scheme in the target group is a defined contribution ("**DC**") group personal pension plan. However, before you strike pensions off your "material risks" list, be aware that a target group's pensions situation can be more complex than it seems and that there may be material defined benefit ("**DB**") risk lurking beneath a DC surface.

Get the questions right

Asking the following "starter" diligence questions should identify whether there is likely to be any such risk:

- Are there any historic DB schemes in the target group (including closed or "frozen" schemes or schemes in the process of wind-up)?
- Are there any current or historic DB schemes in the wider seller's group?
- Have there been any transfers into the target group under the Transfer of Undertakings (Protection of Employment) Regulations 2006 ("**TUPE**")?

If the answer to any of these questions is yes, further analysis and consideration will be needed to determine whether the issue is material in the context of the transaction and to ascertain whether SPA protections and/or a purchase price reduction would be commercially appropriate.

Risks relating to historic DB schemes in the Target Group

Possible issues which may arise in relation to DB schemes which are closed to accrual or frozen (but not fully wound-up) include:

- **Funding risk** Where historic DB schemes will be acquired with the target group analysis of all related funding obligations including under the scheme's schedule of contributions should be carried out to ascertain materiality. There may also be unpaid employer debts under sections 75/75A Pensions Act 1995 and, if the scheme is in wind-up, there could be wind-up costs.
- **Scheme closure risk** A significant High Court pensions case in April 2014 highlighted the possibility that a DB scheme closure exercise could be declared invalid. It was decided IBM's DB scheme closure to future accrual was inconsistent with the expectations IBM had given scheme members that the DB scheme would continue and that IBM had breached its duty of good faith to the members in closing the scheme. An ineffective past closure exercise could be costly for a purchaser.

- **“Moral hazard” risk** If a scheme is underfunded, the UK Pensions Regulator (“**TPR**”) could require the purchaser or members of its group to contribute towards or guarantee the obligations of the scheme’s employers by issuing them with a contribution notice (“**CN**”) or a financial support direction (“**FSD**”) even though they have no employees participating in the scheme. We have written in previous editions of Perspectives about the Pensions Regulator’s powers and would be delighted to advise readers on these issues in more detail if requested.

Seller’s group DB schemes

Both current and historic DB schemes in the wider seller’s group can create financial risk for a purchaser.

- If the scheme is/was underfunded, there will be TPR “moral hazard” risk for the target group that, broadly, will last for a six year period for CNs and a two year period for FSDs after closing. Risk may arise from a target company’s participation in the scheme before closing or to its pre-closing corporate connection with the seller’s group.
- If a target group company stopped participating in the scheme before closing or stops at closing, in each case while the scheme was underfunded, a debt from the company to the scheme will have been/will be triggered. Purchaser will want to ensure that seller bears the cost of meeting any unpaid debts to seller’s scheme.
- It will be necessary to ensure that if any target group company has provided a guarantee to the trustees of the seller’s scheme, such guarantee is released before closing.

Previous TUPE transfers into the target group

Previous TUPE transfers into or out of the target group may put a purchaser at risk of “Beckmann” early retirement liabilities. These arise where an employee’s right to take or to request an enhanced early retirement pension under a DB scheme has transferred under TUPE with that employee’s contract even though the scheme itself is retained by the relevant seller. Determining the existence and extent of any Beckmann liabilities can be tricky and time-consuming, but given the potential cost of meeting these liabilities, taking the time to identify and resolve these issues is usually time well spent.

Conclusion

As we have highlighted, no purchaser can afford to be blasé about hidden DB risk; a closed or frozen DB scheme (either in a target group or in the seller’s group) could result in pensions liabilities for the purchaser of thousands, hundreds of thousands, or even millions of pounds. Be DB aware first by asking the relevant “hidden DB risk” questions at the start of a diligence exercise and then, if necessary, take action to avoid or protect yourself against what could otherwise prove to be nasty post-closing pensions surprises.

Rupert Jones
Real Estate

Minimum Energy Efficiency Standards

The Energy Act 2011 is a product of the early days of the current coalition when the government wanted to demonstrate its "hug a husky" approach to environmental issues.

In the vast majority of cases, improving the energy performance of the nation's existing buildings is exceptionally cost-effective. One of the frustrations for the Department of Energy and Climate Change in championing such improvements is that, up to now, finance directors of UK PLC have not accepted or understood how cost-effective investment in improving energy efficiency can be. A key principle in current policy is that investment should be compliant with the "Golden Rule", i.e. the value of projected energy savings over the life of the measures is greater than the cost of financing the investment over that period.

But, for whatever reasons, there has been an apparent failure of the market to incentivise landlords to bear the costs of improving the energy efficiency of their buildings. In short, the carrot has not worked and there is the need for a stick.

Under the Energy Act the stick is that from April 2018 it will be unlawful to let properties that fail to meet a prescribed minimum energy efficiency standard ("**MEES**") until qualifying improvements had been carried out.

Since 2011 the Department of Energy and Climate Change has struggled with converting this policy into reality: the issue has been how to achieve this objective without destroying the property market; in particular how to apportion the capital costs of such improvements between the landlord and the tenant where the landlord has the economic interest in the building and the tenant receives the benefit of any resultant energy savings. The Department established working parties with experts from all parts of the real estate industry but they could not agree upon all the issues. A formal consultation was expected to be published in early 2014 but limped into the limelight in late July 2014. Many of the issues the Department has raised in such consultation simply request the views of the relevant stakeholders, i.e. the owners, investors and users of commercial property.

Energy Performance Certificates

Since 2008 Energy Performance Certificates ("**EPCs**") have been required whenever properties are sold or leased. An EPC rates the energy efficiency of a property between the maximum efficiency of A down to the worst performing G. The introduction of EPCs was intended to encourage voluntary improvement to energy performance on the basis that potential or actual buyers or tenants of properties would take into account energy efficiency when choosing between comparative sites to invest or to lease.

Whilst a perception is that the EPC regime is a bureaucratic interference originating out of European environmental directives, the policy intention is that an EPC is just one step on this journey of improving the energy performance of existing buildings in the UK. The Energy Act 2011 builds upon that programme.

Proposals

Whilst a number of the key issues dealt with in the consultation remain undecided, there is some general consensus on the basic policy.

The initial MEES will be an EPC rating of E: from April 2018 owners of properties with EPC ratings of F or G will, unless there are exceptional circumstances, no longer be able to let those properties until their energy efficiency has been addressed. Academic studies have identified that nearly 75,000 commercial premises having EPCs are rated F or G and represent 19% of all certified units. (A further 65,000 units have an E certificate.)

The key to understanding MEES is that the policy is not intended to prevent forever the letting of almost 20% of the commercial properties in the UK. Rather, the policy is intended to create the financial incentives so as to encourage an improvement in the energy efficiency of those buildings which are currently amongst the 20% worst performing from an energy perspective.

The policy, therefore, unlike the requirement to obtain EPCs themselves, will not apply to a sale but to most lettings and, in particular (although this is one of the areas where the issues become complex) will apply only on new lettings because then the landlord is able to refurbish the premises before the letting so as to increase the energy efficiency or to have an agreement with the incoming tenant under which the tenant improves energy efficiency.

Other exceptions include:

- Short term lettings (less than 6 months but will be caught if renewed more than once);
- Long leases (still unclear but consultation suggests more than 99 years);
- Where the Golden Rule would be broken, i.e. the cost of the necessary improvements exceed the expected energy savings; and
- Properties awaiting demolition.

Over time the MEES will be increased: so when planning your energy performance improvement, it may not be most cost effective to just scrape an E rating when within a few years you may have to scrap one set of improvements in order to achieve the revised (higher) standards on any reletting.

The actual regulations are expected to be issued in early 2015 and to become law before the general election.

Oliver Walker
Tax

"Corporate Tax Deserters" and "Economic Patriots": an Update on US Inversions

On 23 September 2014, the IRS published a Notice announcing new rules designed to restrict the availability of certain US tax benefits which are sometimes obtained by US companies that have undergone an "inversion" (see side-panel – "What is an Inversion?"). According to the US Treasury, the new rules "will significantly diminish the ability of inverted companies to escape US tax" and, more fundamentally, will mean that, for some companies, "inversions no longer make economic sense". The motivation behind the latest move is clear: according to the Joint Committee on Taxation (a non-partisan committee of the US Congress), the US could stand to lose around USD20 billion in tax revenues over the next decade if inversions are allowed to continue in their current form (see side-panel – "Why are inversions so popular in the US?"). Although the new rules are not retroactive, their impact on inversions which have yet to close may be significant; particularly where a material US tax saving is one of the key drivers of the transaction.

Recent Political Developments

The IRS Notice follows months of speculation around whether, and how, the US tax advantages often associated with inversions should be restricted. The rules were not passed by Congress: political stalemate meant that a legislative solution was always unlikely. Instead, the new rules represent unilateral action by the Treasury and IRS, and therefore do not necessarily carry universal support among US lawmakers.

Indeed, the choice of strategy for dealing with inversions has yet to be agreed within Congress, with some members favouring a more fundamental overhaul of the US tax system, and others preferring instead a more targeted anti-avoidance approach of the sort adopted by the IRS.

On 15 July, Jacob Lew, the US Secretary of the Treasury, wrote an open letter to the US House of Representatives in which he encouraged Congress to enact legislation immediately – retroactive to May 2014 – to "shut down" inversions. In doing so, Mr Lew invoked a "new sense of economic partriotism". On or around 30 July, Senator Richard Durbin championed a piece of anti-inversion legislation dubbed the "No Federal Contracts for Corporate Deserters Act". On 31 July 2014, Congressman Sander Levin released a discussion draft of legislation which was intended specifically to address the perceived tax benefits that might be obtained by US companies that engage in inversions.

What is an Inversion?

An inversion is a process in which a corporate group changes the jurisdiction of its parent company through the insertion of a new company (incorporated in a new jurisdiction), above its existing parent company. An inversion can occur in any jurisdiction, and is not a concept exclusive to the US, although there are tax reasons why it is particularly attractive for US companies to invert. Whilst a decision to relocate a parent company outside the US is likely to be influenced by various commercial reasons, one key factor is often to ensure that earnings arising to the new combined group from future growth outside the US remain outside the US tax system.

New Rules

The IRS Notice includes, among other things, the following anti-avoidance measures (noted here in broad summary form only):

- removal of certain tax advantages from "hopscotch" arrangements by which, post inversion, non-US subsidiaries make loans to new non-US affiliates thereby passing cash up the group while avoiding any US tax which would otherwise have arisen on the repatriation of the funds to the US;
- discouragement of any post-inversion dilution of the ownership by the former US parent of its non-US subsidiaries through the transfer or issuance of shares to the new non-US parent or its non-US affiliates, by treating the affected subsidiary as having made a dividend distribution, thus causing the US parent to recognise (US) taxable income; and
- widening of the scope of existing anti-avoidance rules which operate to treat, for US tax purposes, a non-US company as a US company for US tax purposes.

It should be noted that the rules announced by the Notice represent only an initial step in addressing inversions, and additional methods of reducing the tax advantages remain under consideration. The Notice specifically indicates that such additional methods could include additional regulatory guidance and a review of the US double tax treaty network.

One thing which the Notice does not contain is a rule dealing with "earnings stripping", another perceived tax avoidance method which has featured in some of the inversion-related commentary in recent weeks. Earnings stripping utilises the issue of intra-group debt resulting in deductions in the US and taxable receipts in the creditor's jurisdiction (the latter of which will likely fall to be taxed at a lower rate). However, the Notice warns that the IRS is considering guidance to address this concern which may be retroactive to 22 September 2014 to the extent it applies to inversions.

Effect on Current Inversions

Even before the Notice was published, the spectre of administrative intervention, as well as an awareness of potential public discontent, possibly influenced commercial decisions not to invert. For example, shortly after Walgreens agreed its non-inversionary takeover of Alliance Boots, it issued a statement in which it explained that it was "mindful of the ongoing public reaction to a potential inversion and Walgreens' unique role as an iconic American consumer retail company". Other companies, however, remained undeterred.

The measures contained in the Notice are stated only to apply to transactions which close on or after 22 September. In other words, inversions, such as the Liberty Global – Virgin Media tie-up, or the merger between Endo International and Canada's Paladin Labs, which completed before 22 September should be outside the scope of the new rules. However, companies that have agreed inversions that have yet to be completed (such as AbbVie in relation to its merger with Shire) will possibly be affected.

It is thought that some inversions were agreed subject to the ability of the US party to walk away from the deal should the US tax laws change, while others were agreed subject to contractual break fees.

The End of Inversions?

Many inversions are driven by commercial motivations and will likely remain valid, notwithstanding the recent changes to the US tax laws. Given the indications in the Notice that further measures are being considered, US companies planning an inversion for US tax reasons will need to tread carefully even if they are not discouraged by the new rules (although it is worth noting that, perhaps the key tax benefit arising from inversions – the resulting ability to ensure that future growth is kept outside the US tax system – cannot be addressed by any tax rule). Even if new legislation remains blocked by political stalemate, it is impossible to rule out further US Treasury action, particularly in relation to earnings stripping. If the frequency of inversions continues to increase, so too will the risk of further US Government action.

Why are inversions so popular in the US?

Most jurisdictions operate a territorial system of taxation which is based on the principle that taxes are charged in a given jurisdiction on profits generated in that jurisdiction. Under this type of system, if a parent company has subsidiaries in other jurisdictions, the profits of the subsidiaries earned in those other jurisdictions will generally not be subject to taxation in the parent's jurisdiction.

The US, on the other hand, operates a worldwide system of taxation. This means that a US company is subject to US tax on all its worldwide earnings, whether they are earned in the US or overseas.

A worldwide taxation system usually results in a group's total tax bill being set at the higher of the tax rate in the local jurisdiction(s) and the tax rate in the parent's home jurisdiction. That tax bill can be reduced in future years by moving the parent company of a multinational group from a worldwide taxation system into a territorial tax system with a comparatively low tax rate because then, once new businesses are acquired or developed outside the former parent's group, future profits are taxed in the various local profit-making jurisdictions at the prevailing rates (whatever they may be).

An inversion out of the US might not be worthwhile if the effective local tax rates in the underlying jurisdictions exceeded those applicable in the US. However, at around 40 per cent., the combined headline US federal and state corporate income tax rate is the highest in the G20, and one of the highest in the world.

Guest Article

Sue Tilstone
Deloitte

Taxing ‘Leaver’ Shares

Executives disposing of shares in their employer company generally expect to pay capital gains tax rather than income tax on the proceeds. Those who do so outside of a third party exit for the company could be in for a nasty surprise.

Most companies with employee share ownership make provision in their governing documents for the transfer of those shares in the event that the relevant employee leaves, retires or dies. Certain scenarios are often identified (for example ‘good leaver’ and ‘bad leaver’) which drive the terms of any required transfer of shares. We frequently encounter companies who consider that, because leavers have received the amount specified in the governing documents, any tax due will fall within the capital gains tax regime and will not be a matter for the company. This is not necessarily the case.

While an employee who leaves to join a competitor might, for instance, fall within the parameters for a bad leaver and therefore be required to return his shares for a nominal amount, departing employees or directors who benefit from more generous transfer provisions are at risk of an income tax charge, which their employing company is required to account for under PAYE.

Shares acquired by reason of employment (or directorship) are designated ‘employment-related securities’. Employment-related securities attract income tax in a number of scenarios. In particular, if someone sells employment-related securities for more than their ‘market value’ (as defined in the legislation), there is a charge to income tax on the excess, plus associated social security charges.

This potential income tax charge applies equally whether the executive sells their shares back to the company or to another shareholder.

A typical arrangement is for good leavers to be required to transfer their shares for an amount equivalent to ‘fair value’. Fair value is not the same as market value.

Market value is a very specific term which is defined by statute and supported by a wide body of case law. The assessment of market value is a complex exercise, but key points to remember are:

- Market value reflects only those rights and restrictions which attach to the shares. This means that, in general, the provisions of Shareholder Agreements will not be reflected in market value.

- Market value reflects only those rights and restrictions which attach to the shares in the hands of any shareholder. This means that, in general, the provisions of Articles of Association specifically relating to employee shares or employee shareholders will not be reflected in market value.
- The market value per share of small blocks of shares is generally considered (by the courts) to stand at a substantial discount to the 'per share' value of the whole company. Fair value would not normally stand at a discount and will therefore frequently be significantly higher than market value.

Therefore, any transfer provisions (such as a clause delivering fair value to good leavers) set out in a Shareholder Agreement rather than the company's Articles of Association will not be reflected in market value.

Similarly, any transfer provisions set out in a company's Articles of Association specifically for employee shares will not be reflected in market value.

What if there are beneficial provisions in the Articles of Association, attaching to all the shares in the company, for example a stipulation that any transfer of shares must take place at fair value? Surely then the payment of fair value to a departing employee cannot exceed market value, since that is an entitlement attaching to all the shares? HMRC are likely to disagree (and there is an entry in HMRC's Employment-Related Securities Manual addressing this very point). The market value of a share which is entitled to fair value on transfer will generally still reflect a discount to fair value, unless any holder of the share has the power to transfer it at will – something that is generally precluded in private companies, where directors usually have the right to refuse to register the transfer of shares. Even if there was no such right of refusal in the Articles of Association, the shareholder would have to know he could find an immediate buyer at the relevant price for no discount to fair value to be appropriate for market value.

What should companies with employees selling shares do?

- Consider whether HMRC would consider the price to be paid for the shares to be in excess of market value – remembering that market value has a very specific meaning in this context.
- Operate PAYE on the basis of a reasonable 'best estimate' of market value – and consider taking suitable professional advice to demonstrate that this has been done.
- Make an appropriate entry on Form 42, which should be filed by the 6 July following the transfer.

We are increasingly seeing transactions involving employee shares scrutinised as part of due diligence exercises. It is therefore important that companies can demonstrate that there is appropriate evidence to support the position taken.

The selling shareholder will also need to consider whether a disclosure should be made on his self-assessment tax return.

From April 2015 companies should routinely review any employee share repurchases in the year just ended 7 July so that they have an opportunity not just to catch up on missed PAYE but also to claw back the tax from the employee within 90 days of the tax year end and so avoid a S222 charge (whereby an additional income tax charge and employee's and employer's NIC arises because the employee is treated as having the tax paid on the employee's behalf). Having a standardised 90 reimbursement period offers a useful prompt for a compliance check by the employer.

What should companies about to implement employee share ownership do?

Before awarding employee shares, we recommend careful consideration not only of what any leaver terms should be, but also where they should be documented, how they should be drafted, and what the tax consequences are likely to be should they come into effect.

As ever, careful drafting, with a close eye on valuation, is absolutely key.

Weil Transaction Specialist Contacts

Peter King
Corporate
peter.king@weil.com
+44 20 7903 1011 tel

Peter is a Corporate partner in London. He has over 30 years of experience across a wide range of industries, transaction types and geographies, with a particular expertise advising boards of directors on corporate governance and related issues, including the UK Bribery Act 2010.

Peter is a regular speaker at conferences and seminars on matters such as the UK Takeover Code, London listing rules and anti-corruption programmes. He is co-chair of the firm's Pro Bono Committee, a trustee of several UK charities, a director of the Salvation Army International and was a founder, together with Archbishop Desmond Tutu, of the Tutu Foundation UK.

Peter is consistently highly ranked throughout the legal directories for Corporate/M&A and Equity Capital Markets. *Chambers UK* describes him as "able to talk about technical stuff in a highly practical and simple manner ... an experienced and highly respected transactional lawyer." Peter is also recognised as a "Leading Lawyer" for Equity Capital Markets in *IFLR 1000 UK* and ranked by Thomson Reuters as a "Super Lawyer" for M&A.

Recent experience includes advising:

- Multi-national companies, including the British Venture Capital and Private Equity Association, on developing procedures to comply with the UK Bribery Act and the FCPA (including businesses based outside the UK)
- Access Industries on its takeover offer for Perform Group plc
- Volution Group on its initial public offering and listing on the London Stock Exchange
- Edwards Group on its IPO and subsequent takeover by Atlas Copco
- Numerous UK clients on an ongoing basis on corporate governance issues

Doug Nave
Antitrust/Competition
doug.nave@weil.com
+44 20 7903 1288 tel

Doug is a partner and head of the EU Competition practice in London. Doug is a US-qualified practitioner who has advised companies on competition-law matters for over 30 years, including practicing in Europe for over 15 years. Doug has acted on a wide range of private equity and corporate/M&A transactions across a variety of sectors and has an impressive track record of winning unconditional clearances from both the European Commission (EC) and the UK's Office of Fair Trading (OFT). He also regularly advises clients on joint venture applications, competition-law rules on competitive conduct and customer-supplier relationships, issues arising from potential abuse of dominance, and the licensing and use of intellectual property.

Doug is consistently ranked in *Chambers UK* for Competition, where he is "applauded for his strong commercial capabilities and ability to provide an in-depth understanding of merger control and joint venture concerns". He is 'Recommended' for EU and Competition in *Legal 500 UK*, which praises him as being "valued for his succinct and targeted advice".

Recent experience includes advising:

- Hilton Worldwide in various EU Member State investigations of dealings between hotel operators and online travel agents
- Lenovo on EU and other regulatory reviews of its $2.9 billion acquisition of Motorola Mobility from Google
- Forest Laboratories on global pre-merger reviews of both its $25 billion merger with Actavis and its $2.9 billion acquisition of Aptalis
- Sanofi on restructuring and national regulatory reviews of its alliance with Bristol-Myers Squibb for global distribution of Plavix (the world's second best-selling prescription drug) and other cardiovascular pharmaceuticals
- Johnson & Johnson on the sale of its KY business in Europe

Weil Transaction Specialist Contacts

Ivor Gwilliams
Employment
ivor.gwilliams@weil.com
+44 20 7903 1423 tel

Ivor is Of Counsel and head of the Employment practice in London. He advises on the full range of employment law issues, both contentious and non-contentious, and has extensive experience advising on the employment aspects of a wide variety of private equity, M&A and outsourcing transactions, as well as restructuring schemes and IPOs.

Ivor is ranked for Employment in *Chambers UK* and is "commended for exhibiting sound judgement in highly sensitive situations. He is able to succinctly explain problems and outline different approaches, and is a noted expert in transactional employment concerns". Ivor is also ranked as a "Super Lawyer" for Employment Law in Thomson Reuters' *Super Lawyers*.

Recent experience includes advising:

- Gores Group on its joint venture agreement with Premier Foods in the Hovis business
- Eli Lilly on its acquisition of Novartis Animal Health
- Volution Group on its initial public offering and listing on the London Stock Exchange
- KPMG as joint administrators on the special administration of MFG UK
- Ongoing advice to various private equity and corporate clients

Barry Fishley
IP/IT/TMT
barry.fishley@weil.com
+44 20 7903 1410 tel

Barry is a partner and head of the Technology and IP practice in London. He specialises in intellectual property and technology, as well as data protection, commercial contract and social media. Barry has extensive experience advising major international companies and private equity funds on a range of issues including the IP and IT aspects of M&A transactions, complex international licensing arrangements, outsourcing, strategic alliances and general commercial matters.

Barry is 'Recommended' for Media and Entertainment in *Legal 500 UK*, which also describes his TMT practice as showing "cutting-edge knowledge and keen commercial sense."

Recent experience includes advising:

- Facebook on its acquisition of WhatsApp, in what was Facebook's largest acquisition at the time
- Gores Group on its joint venture agreement with Premier Foods in the Hovis business
- Montagu Private Equity on its $805 million acquisition of the Healthcare Devices and Prescription Retail divisions from Rexam in the UK
- eBay on the IP and IT aspects of its acquisition of Shutl Limited
- Yahoo Inc. on the IP, data privacy and IT aspects of its acquisition of Summly

Weil Transaction Specialist Contacts

Joanne Etherton
Pensions
joanne.etherton@weil.com
+44 20 7903 1307 tel

Joanne is a partner and head of the Pensions practice in London. Joanne is experienced in advising on the pensions aspects of high profile mergers, acquisitions, disposals, private equity transactions, joint ventures, IPOs, re-financings and insolvencies, as well as on market-leading pensions litigation. She has a particular expertise advising on strategy for employers in dealing with pension trustees and the Pensions Regulator both in the context of corporate transactions and also in issues relevant to the lifecycle of occupational pension schemes.

Joanne is ranked for Pensions in *Chambers UK*, where she is described as "tremendously good and a pleasure to work with." She is also 'Recommended' in *Legal 500 UK*, which highlights her as "outstanding … always reliable, highly efficient and very pleasant to work with." Joanne is a Fellow of the Pensions Management Institute, was awarded a Diploma in International Employee Benefits and is a member of the Association of Pension Lawyers.

Recent experience includes advising:

- Gores Group on its joint venture agreement with Premier Foods in the Hovis business
- Lehman Brothers Holdings Inc. on the UK pension and insolvency issues arising from Lehman Brothers bankruptcy proceedings, including the recent settlement of the UK pensions litigation
- The Joint Special Administrators to MF Global UK on the settlement of the Group's pension liabilities
- Alstom on GE's $16.9 billion bid to acquire Alstom's power and grid business, representing GE's biggest ever deal
- General Atlantic in its acquisition of MeteoGroup

Rupert Jones
Real Estate
rupert.jones@weil.com
+44 20 7903 1537 tel

Rupert is Of Counsel and head of the Real Estate practice in London. Rupert advises on the real estate aspects of private equity transactions encompassing due diligence of UK and pan-European portfolios, transitional service agreements, complex separation issues, post-completion asset transfers and provision of security. He has significant experience in providing day-to-day support on management issues relating to lease negotiations, lease renewals, break clauses and terminations and devising solutions to maximise the return on real estate assets through outsourcing, partnering Opco/Propco and other structures. Rupert also advises administrators and other insolvency practitioners on all aspects of real estate issues in restructurings and insolvency related transactions.

Rupert is Chairman of the City of London Law Society's (CLLS) Planning and Environmental Law Committee, and recipient of the 2014 CLLS and City of London Solicitor's Company "Distinguished Service Award" for outstanding service as Chairman of the Future of the Livery Working Party. Rupert has also been awarded "Property Lawyer of the Year" by *Legal Business*, and is 'Recommended' for Commercial Property in *Legal 50 UK*, which describes him as "responsive, and knows his stuff." He is also ranked as a "Super Lawyer" for Commercial Property in Thomson Reuters' *Super Lawyers*.

Recent experience includes advising:

- Gores Group on its joint venture agreement with Premier Foods in the Hovis business
- Barclays Bank in the £1.5 billion restructuring of General Healthcare Group, owner and operator of the BMI hospital chain
- KPMG as joint administrators on the special administration of MFG UK
- Ontario Teachers Pensions Plan Board on its acquisition of Busy Bees from Knowledge Universe
- Volution Group on its initial public offering and listing on the London Stock Exchange

Oliver Walker
Tax
oliver.walker@weil.com
+44 20 7903 1522 tel

Oliver is Of Counsel and leads the Corporate Tax practice in London. He focuses on providing tax and structuring advice in relation to private equity and general corporate M&A transactions and reorganisations; designing and advising on complex equity incentive arrangements; and providing VAT advice on structured finance transactions.

Oliver is also regularly involved in tax cases before the English and European Courts.

Recent experience includes advising:

- Littlewoods in a £1.2 billion High Court victory for the long-running dispute with HMRC concerning interest on overpaid VAT
- Providence Equity, CCMP, THLee and Quadrangle, as principal shareholders of Grupo Corporativo Ono, on its landmark €7.2 billion sale to Vodafone
- Gores Group on its joint venture agreement with Premier Foods in the Hovis business
- RPC Group in its acquisition of ACE Corporation Holdings Limited
- Volution Group on its initial public offering and listing on the London Stock Exchange

Training Offered

We offer a comprehensive range of training presentations and would be delighted to come and speak on any of the topics listed below. We could also arrange a bespoke training session if there is a particular issue of importance or interest to your team.

Back to the Future? Use of IPRs under the competition laws	Regulators worldwide have placed the licensing and use of intellectual property rights under greater competition-law scrutiny than they have done in decades. This presentation focuses on these trends and emerging rules, which must be borne in mind both in ongoing commercial operations and in evaluating potential acquisitions.
Competition law – basic rules and emerging trends	This presentation provides an overview of the basic rules on competition, as well as emerging regulatory emphases (such as on information exchanges) that will help companies to comply with their legal obligations, identify when competitors or business partners may not be doing so, and evaluate important regulatory considerations in possible joint ventures or acquisitions.
Social media – brand, reputational and governance issues	This presentation is focused on the benefits, but also the risks, of social media including its impact on brand reputation and therefore value. It also covers IP infringement, privacy, defamation and governance matters, together with looking at social media issues from an M&A perspective, both in terms of due diligence and warranty protection.
Brand licences – market trends	This presentation highlights key issues for a business when taking on a global brand or indeed, thinking of licencing its brand to a third party. We have been involved in licensing arrangements for major global brands such as Schweppes, so this is a helpful list of dos, don'ts and bewares.
Data protection/ privacy – what's on the horizon?	The EU Commission has published a draft regulation which will fundamentally change data protection laws in Europe. This will impact every organisation, particularly those which exploit and seek to monetise personal data. This presentation highlights these changes and the potential impact on businesses.
TUPE regulations – developments	The Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE) apply to protect employees in relation to business (asset) transfers as well as on service provision changes (e.g., outsourcings and insourcings). There have been a number of interesting decisions by the Employment Appeals Tribunal in the last few years, many of which shed light on issues relating to service provision changes. This presentation explores the main themes to emerge from these cases and to explain what they mean in practice for employers, as well as the Government's proposals for reforming TUPE.
Monitoring employee use of email and internet – the basics	Monitoring email and internet use of employees has always been a legal minefield. This presentation summarises the main rules whilst also exploring how employers are attempting to manage the risks posed by the use of social media by their employees.
Employment law – what's on the horizon?	This presentation includes a roundup of the most important recent changes to UK employment law. Topics covered will include reforms to the unfair dismissal regime (including the concept of protected conversations), tribunal reform, the TUPE Regulations, employee-shareholder contracts and pensions auto enrolment. We will also look at forthcoming changes to UK employment law, including shared parental leave, flexible working, mandatory early conciliation and changes in the calculation of statutory holiday pay.
Investor directors – issues to think about at different stages in a portfolio company's life cycle	Private equity houses appoint directors to the boards of companies on almost all of their investments. We consider the directors' duties and related issues which those individuals will have to consider through the life of an investment.

Training Offered

Trends in anti-corruption and anti-money laundering compliance	This presentation reviews developing practice in anti-corruption and anti-money laundering programmes adopted by businesses in response to increasingly aggressive enforcement by UK and other non-UK authorities (including the US in relation to FCPA enforcement). Trends in due diligence in this area are also discussed.
Preparing for an IPO	The equity markets are providing more opportunities for businesses to access capital and develop their public profile. This training reviews steps which companies can take at an early stage to ensure that they are prepared for an IPO on a recognised market in Europe or the US in the short to medium term.
UK Pensions – pitfalls to avoid in corporate and financing transactions	This talk looks at the risks of triggering significant cash payments to a UK pension plan either as a result of a deal structure or the powers of the UK Pensions Regulator. In addition, it considers the risk of significant unforeseen pension liabilities as a result of a proposed or previous TUPE transfer where employees have or used to have defined benefit pension rights and strategies to adopt in these situations.
UK Pensions – when is it necessary to involve the UK Pensions Regulator and/or the Pensions Trustees?	This presentation looks at the powers of the UK Pensions Regulator and the pension trustees to intervene in corporate transactions (including internal reorganisations, restructurings and refinancings or where there may not initially appear to be a UK angle), potentially demanding cash injections to the pension plan or otherwise impacting the deal's financial viability and possible strategies to adopt when navigating these issues.
Do Pension Trustees have a place at the table in public takeovers?	This presentation examines recent changes to the Takeover Panel rules in relation to the rights of pension trustees to be involved during takeover discussions and how these rights link to the Pensions Regulator's powers in the context of takeovers and suggests strategies for navigating these discussions.
Financial Support Directions and Contribution Notices – how significant a risk in practice?	This presentation examines the situations where the Pensions Regulator has exercised its moral hazard powers to date, lessons to learn from these cases, and the key uncertainties on the extent of the Regulator's powers.
End of lease term opportunities and liabilities	This presentation looks at the end of a lease from both a landlord and a tenant's perspective; how to negotiate better lease terms on a potential renewal or negotiating end-of-term liabilities, for example, dilapidations, where the tenant is vacating.
Commercial rent arrears recovery	April 2014 saw a revolution in the procedures relating to the recovery of commercial rent arrears. Traditional remedies, such as the landlord's right of distraint, are to be replaced by a set of remedies which are considerably more tenant friendly. This presentation explains the changes and considers possible impacts for affected parties such as landlords and insolvency practitioners.
Realising value from asset-rich real estate	Realising value from asset-rich real estate is the Holy Grail for private equity and similar investors who are attracted to financing structures which differentiate between capital-rich real estate, which many see as 'dead money', and leased operational real estate assets. This presentation looks at the evolution of the Propco/Opco type structures, the reasons for disenchantment with those structures and possibilities for the future.
Current tax issues in M&A transactions	This presentation will outline key tax issues tailored to the particular audience.

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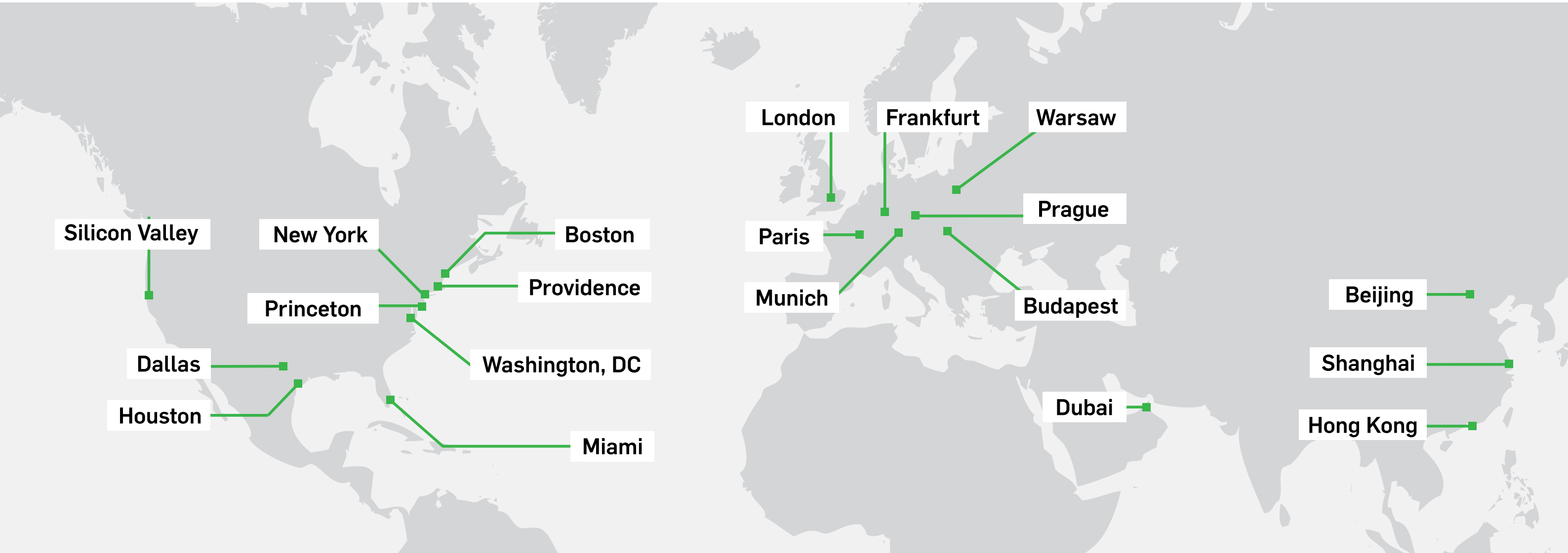

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