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## ■ Editorial Contact

If you have questions or comments about articles in the *ILR*, please contact any attorney in the firm's [International Practice Group](#) or the editors:

### **William T. O'Brien**

202.496.7107

### **Brett Ian Harris**

202.496.7343

## SPOTLIGHT

### ▶ Privatization of World's Largest Life Insurer May Level the Playing Field for U.S. and Other Foreign Insurers

As part of the largest financial sector reform in Japan's history, Prime Minister Koizumi's Council on Economic and Fiscal Policy (CEFP) issued on Sept. 10, 2004 a "Basic Policy" blueprint for privatizing the world's largest life insurer, Kampo. The document outlines the structure reformers hope to achieve for Japan Post (the government-owned parent of Kampo) as it transitions to four separate "privatized" entities. One of those entities will be a new Postal Insurance Corporation (the others will be a Postal Savings Bank, Postal Delivery Corporation and a Retail Services Corporation). For U.S. and other foreign insurers operating in Japan, privatization may finally mean achieving a "level competitive playing field" after attempting to compete for decades with Kampo's many government-provided advantages (e.g., it pays almost no tax, has unique government guarantees for its policies, operates under separate, less stringent regulations, and pays no premiums for policyholder protection). However, if the effort falters it could also result in a "partial" privatization that could actually promote the wider use by Kampo's successor of retained or new economic advantages.

For Prime Minister Koizumi, the stakes are extremely high. He has made privatization the focal point of his second, and likely last, term. He and many of his closest advisors see in Japan Post's massive financial services businesses an opportunity to redirect huge capital flows from a government pork-barrel "cash cow" investing billions in non-productive ventures, to the efficiencies of the private sector and a revitalization of a just recovering economy. The effort comes at a time when sales of Kampo's best selling traditional endowment life policies are declining as consumers look for new, more relevant "living benefits" coverage.

Under the new blueprint, which must be approved in statutory form by Japan's Diet, equity in the new Postal Insurance Corporation will be sold to private shareholders in increments so that it will be wholly privately owned by 2017. Given its sheer size—it

represents 40% of the second largest life insurance market in the world—private suppliers have a keen interest in ensuring that the transition to the new entity does not lead to severe market distortions. The issue is being followed closely by insurers and regulators around the world since other large government-owned financial intermediaries are being considered for similar transformation.

At issue is whether Kampo, as it moves to private status, will be permitted to market formerly restricted types of products that would compete with those of U.S. and other private insurers *before* it has shed the longstanding advantages it has retained for decades. In the fall of 2003, the government of Japan permitted sales by Kampo of a “hybrid” living benefits policy that U.S. insurers have said is virtually the same as those they sell and will draw existing customers away. Bilateral agreements with the U.S. and Japan signed in 1994 and 1996 attempted to require that such new policies be carefully reviewed by the Diet in order to avoid Kampo’s dominance in a market segment intended for foreign insurers. In a sign that Japan Post has urgent designs on what has become a \$35 billion market for U.S. insurers, the new Kampo policy was abruptly pushed through to approval in November, without Diet review, and over strong U.S. government objections.

Under WTO provisions and the General Agreement on Trade in Services (GATS), to which Japan is a signatory, services of foreign competitors are to be accorded treatment “no less favorable” than that accorded to the host nation’s own like services and like services suppliers. Since Japan did not reserve (exclude) its postal services from the GATS it is required to comply with this “national treatment” obligation. The GATS provides a backdrop to discussions that are ongoing between the U.S. and Japan over the course of privatization.

U.S. insurers have in recent months published analyses comparing the regulatory framework under which Kampo operates to internationally accepted standards and best practices. The International Association of Insurance Supervisors’ (IAIS) *Insurance Core Principles* are globally accepted benchmarks for insurance regulators in all jurisdictions. According to the industry analyses, the regulation of Kampo currently fails to meet these norms in a variety of ways:

- Its supervision is not independent or accountable in the exercise of its functions and powers – Kampo is supervised by the agency (Ministry of the Interior and Commerce-“MIC”) of which it was formerly a part; the agency is subject to political pressure and influence, and many exchanges of personnel of both entities occur routinely.
- Supervision is also not transparent. MIC does not disclose the basis for decisions it renders with respect to Kampo’s business activities, how its policy guarantees are financed, or, if so, at what cost.
- MIC does not have the duty or authority to regulate Kampo for solvency.
- Kampo fails to meet minimum requirements for consumer protection, including the prevention of fraud.

Some members of Prime Minister Koizumi’s own party, the LDP, are strongly opposed to continuing efforts to privatize Japan Post. There are strong political ties within all the political parties to the postmasters organization and other interests with ties to Japan Post. Not unlike military base closings in the U.S., it is apparent that if reforms are to be successful many redundant post offices will be shut down or converted to other uses. Japan Post’s 280,000 employees constitute a strong political force, as well. In the midst of this, President Bush recently made a public, and supportive, reference to the Prime Minister’s initiative. At the same time, senior

Administration officials have urged that steps be taken to maintain a “level playing field” as privatization proceeds.

The next several months are a critical period in that the “Basic Policy” is to be drafted into statutory language for Diet consideration as early as March of next year. Over 200 laws have to be amended or repealed. Traditionally, this process has been done within the Cabinet and has included private consultations with key majority party members of key Diet committees. However, because of the complexity and high profile of this privatization—it is the largest ever undertaken of a financial services sector—there is an expectation that there will be opportunity for the private sector of the industry to weigh in.

Our firm has been assisting the U.S. industry in this matter, both with regard to collaboration with a federal interagency group (made up of representatives from the U.S. Trade Representative’s Office, State, Commerce and Treasury Departments, National Economic Council and National Security Council) and in garnering support from Congress and the media, particularly in Japan.

The U.S. industry (represented in largest part by the American Council of Life Insurers-ACLI) has been joined in recent months by the Canadians, British, and Europeans in calling for an end to all postal insurance advantages and a “level playing field.” Even the traditionally reticent Life Insurance Association of Japan has become increasingly vocal in support of real reform. Insurers not operating in Japan are also watching the outcome, both for what it might hold for future investment in Japan and for its implications in other countries.

**Joseph K. Dowley**  
Washington, DC

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## TRANSACTIONS UPDATE

### ▶ **The Efficient Use of Outside Advisors in International Transactions**

**“We’re living in a global economy.”** More than a catchphrase, this saying aptly describes the environment in which virtually all U.S. businesses now operate. And among its benefits, the global economy creates additional, often compelling, transaction opportunities for U.S. companies. It is no surprise, then, that transactions with an international component increasingly are an important part of the growth strategy of U.S. companies.

However, pursuing that strategy involves additional risk, much of which might be described, to use a simple sports analogy, as the loss of “home field advantage.” To continue that analogy, when you, as a U.S. company, engage in an international transaction, not only are you playing on your opponent's home field, you're playing the game using different rules -- and at times, those rules may be so different that you feel like you might just be playing an entirely different *game*.

With careful planning and creative advice, though, you can avoid unnecessary surprises and manage international transactions in a way that not only neutralizes this dynamic, but creates value and helps realize the tremendous benefits that international deals can bring. This overview will touch on one important aspect of such an approach: the smart, efficient, and coordinated use of legal, tax, and

accounting advisors that, in our experience, goes a long way toward reaching these goals.

Start with the selection of local counsel. Simply put, you protect yourself, your deal, and your company when you select and engage qualified and experienced local counsel. While you may be familiar with and have confidence in an existing local counsel in a particular region, it is more typically the case that you will need to rely on recommendations from your U.S. outside legal counsel or business colleagues.

Once you have selected and engaged appropriate local counsel, don't make the mistake of confining them to performing one or two discrete tasks (such as due diligence, document translation, or responding to specific queries you may raise). Like any other advisor, local counsel are most useful and create the most value when you actively involve them with your U.S. deal counsel in considering and structuring the transaction as a whole and spotting and resolving the myriad issues that can (and invariably do) arise in international transactions. Just a few of the many areas that require special scrutiny with local counsel include:

- **Employee matters.** Unlike in the U.S., in some jurisdictions employees and trade unions play a critical role in the acquisition process, and failing to plan for this can delay or even kill the transaction. Further, there may be statutorily imposed obligations to inform and consult with employees prior to consummation of a deal, as well as rights afforded to employees displaced by acquisitions or outsourcing arrangements that U.S. dealmakers may not find intuitive (e.g., the Transfer of Undertakings (Protection of Employment) Regulations, or "TUPE," in the U.K.). Accordingly, understanding the implications and potential costs of any such features is important from the outset so that they can appropriately be considered and risks can be allocated.
- **Competition concerns.** Depending on the size and competitive impact of your deal, you may need to consider prenotification requirements (similar to Hart-Scott-Rodino in the U.S.) or broader competition filings or approvals (e.g., the Office of Fair Trading in the U.K.). In the European Union, for instance, there is a specialized body of law and principles regarding restrictive covenants and their enforceability that must be considered to the extent your transaction will involve non-competitions or non-solicitation covenants.
- **Foreign ownership issues.** Some countries mandate that some or all of the equity interests of entities incorporated in that country must be owned by residents of the home country. Similarly, in some instances countries may require that some portion of the entity's directors and/or officers be residents of the country.
- **Data protection.** U.S. dealmakers are sometimes surprised to find that statutory requirements relating to the protection and disclosure of confidential information, and in particular "personally identifiable information" (e.g., customer names and account numbers), are often more strenuous in jurisdictions outside the U.S. and may have a very real impact on the manner in which you operate a business once acquired.
- **Tax issues.** Inevitably, local, national, or supranational tax issues that are unique to the locality in which the transaction takes place will play a major role in structuring your transaction. In particular, the overlay of Value Added Tax, otherwise known as "VAT," is a feature of many European transactions that U.S. dealmakers may not be familiar with on the basis of domestic experience alone. Early engagement of local counsel and/or sophisticated tax advisers can help spot these issues and highlight ways to structure the transaction in an efficient manner.

- **“No binding agreement until we sign.”** Don't assume, as many U.S. companies do, that so long as you are acting in good faith, you have reasonably liberal rights to discontinue pursuit of a transaction at any time prior to signing a definitive agreement. While this principle is largely axiomatic in the U.S., it may be affected or altered by local law. For example, in the Netherlands, provisions of the Dutch Civil Code may have the effect of limiting (sometimes severely) the freedom of a party to terminate negotiations.
- **Legal opinions.** In some jurisdictions, opinion practice varies considerably from the U.S. For instance, in the U.K., outside counsel typically gives opinions to its own client, rather than to the party on the other side of the deal, if it gives any opinion at all.
- **Cultural differences.** While it may seem otherwise to the uninitiated, the importance of sensitivity to cultural differences cannot be overemphasized. This can manifest itself in several ways:
  - **Communication and Negotiating Styles.** Appreciate and be sensitive to this aspect of the negotiation. For example, the earnestness and directness that often characterize American negotiations in a genuine effort to quickly isolate and resolve issues may be perceived by some as brazen and aggressive. And while Americans often “cut to the chase” to speedily identify and quickly resolve problems, your international counterpart may need more time for reflection and consultation--one meeting or conference call may not be enough. Be prepared for this dynamic, and understand its constraining effect.
  - **Approach to disclosure.** While U.S. dealmakers are accustomed to a vigorous diligence process, where a buyer's failure to ferret out issues either through diligence or representations generally is the buyer's problem, this is not universally true in other jurisdictions. For example, the laws and codes of some countries impose upon sellers a much higher obligation to affirmatively disclose potential problems and issues.
  - **Work hours.** While the difference is not as pronounced as before, Americans still are regarded as tending to work longer hours and giving up evenings and weekends more readily than most. Similarly, seasonal vacations in some countries (e.g., July in Norway or August in France) are often longer and more widely embraced such that they can seriously impact transaction timetables.

In addition to the above issues, which are more legal in nature, don't forget tax and accounting. Relevant tax codes and provisions, together with a country's specific accounting conventions, can create real opportunity or hazard for the U.S. dealmaker. These considerations may fundamentally affect the financial model for a given transaction and often militate toward the early engagement of tax and accounting professionals.

If you work with a “Big Four” firm, it typically will have the means and resources available internationally to handle such tax, accounting, and potential structuring issues -- in concert with both your outside deal counsel and local counsel. Leverage this expertise, as well as any experience your accountants may have with other clients with multinational operations or transactions. For example, don't assume that the best way to fund a purchase price is by the purchasing entity merely wiring money -- in some instances, the most efficient structure may involve the creation of additional, extra-jurisdictional entities that, while adding to the complexity, pay off in measurable tax savings.

From reading the above, you might be under the impression that doing an

international transaction effectively means giving your advisors (including your local counsel and your tax and accounting professionals) free rein and tolerating the attendant fees that come with that approach. That is most assuredly not the case. Your advisors need to be managed carefully, particularly if their understanding of your business and your typical transaction requirements is not robust. In this regard, your regular outside deal counsel can add enormous value. In addition to playing their usual role in negotiating and documenting the deal, your primary outside counsel should play a true "project management" role -- managing and coordinating your external advisors, helping to identify issues and coalesce the input being received from various sources, and being attentive to the efficient, non-duplicative delivery of services from your entire team. Charge them with responsibility for coordinating the inputs and appreciating that a decision or course of conduct suggested in one area may invariably have a "ripple effect" in others.

Our experience demonstrates that this approach, and the resulting premium placed on a tight orchestration of your outside advisors, can help you navigate the complexities of international transactions effectively, and at a cost that won't eliminate the value that motivated you to pursue the international transaction in the first place.

**Richard R. Willis**  
**Brussels**

**Marc C. D'Annunzio**  
**Atlanta**

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## **CANADIAN UPDATE**

### **▶ Canadian Biopharma Industry and Government Partnerships Contribute to U.S. Biodefense Efforts**

While its conventional military investments have declined in recent years, Canada has excelled in its efforts to develop, apply and deploy new biopharmaceutical products and related technologies to respond to terrorist acts using chemical, biological, radiological, and nuclear (CBRN) materials. Since the first Iraq War, Canadian companies and government agencies have been working with U.S. government-led CBRN military and counter-terror programs, typically involving the U.S. Department of Defense, U.S. Department of Health and Human Services, or related agencies.

When President Bush signed the U.S. Project BioShield Act in July 2004, creating a US \$5.6 billion fund for the development and commercialization of medical countermeasures, Canada's substantial biopharma industry found itself well-positioned to contribute to this massive new U.S.-led initiative. Already, numerous Canadian companies, most of them marketing made-in-Canada technologies, are partnering successfully with the U.S. in its effort to secure the homeland and protect its military, allies, and civilian populations from CBRN terror attacks.

On November 8, the Canadian Defence Industry Association (CDIA) hosted its first-ever [CDIA Biodefence Luncheon](#), a unique program to examine the U.S. Project BioShield Act, the potential roles and opportunities for the Canadian government and Canadian biopharma industry in U.S. biodefense initiatives, and Canada's new

programs to enhance and promote chem-bio defense preparedness and response.

Frank Rapoport, head of McKenna Long & Aldridge's Biodefense Practice Group, provided the keynote presentation at the program, which included Canadian officials from the Canadian Department of National Defence (DND), Defence R&D Canada (DRDC), Public Health Agency of Canada, and Genome Canada. For more information or complimentary materials from this program, please call Scott Flukinger at 202-496-7352 or e-mail him at [sflukinger@mckennalong.com](mailto:sflukinger@mckennalong.com).

**Scott P. Flukinger**  
**Washington, DC**

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## **U.S. COMMERCE DEPARTMENT UPDATE**

### **▶ Bureau of Industry and Security Proposes Changes to Definition of “Knowledge” and “Red Flags” List**

Recently, the U.S. Department of Commerce’s Bureau of Industry and Security (“BIS”) proposed changes that would ease the agency’s efforts to impose civil penalties and denials of export privileges for negligent violations of the Export Administration Regulations (“EAR”). In a notice published in the Federal Register on October 13, 2004, the BIS proposed to amend the EAR by revising the regulatory definition of “knowledge” and adding to the list of circumstances expressly identified as presenting a “red flag” in particular export transactions. If finalized in their current form, these changes will significantly enhance BIS’ administrative enforcement capabilities by lowering the level of proof required for the imposition of civil penalties.

The current definition of “knowledge” found in the EAR is subjective, requiring “positive knowledge that the circumstance exists or is substantially certain to occur” as well as “an awareness of a high probability of its existence or future occurrence.” BIS proposes to add to this definition an objective, “reasonable person” standard in which culpable knowledge may be imputed to the actor “if a reasonable person in that party’s situation would conclude, upon consideration of the facts and circumstances, that the existence or future occurrence of the fact or circumstance in question is more likely than not.”

The notice also proposes significant updates to the “red flag” guidance currently contained in the EAR. BIS has proposed revised language for the existing examples and added eleven new ones. Among the revisions are the following:

- The address of the ultimate consignee, as listed on the airway bill or bill of lading, indicates that it is in a free trade zone.
- The customer uses an address that is inconsistent with standard business practices in the area (e.g., a P.O. Box address where street addresses are commonly used).
- The requested terms of sale, such as product specification and calibration, suggest a destination or end-use other than what is claimed (e.g., equipment that is calibrated for a specific altitude that differs from the altitude of the

claimed destination).

For a complete listing, see the attached PDF titled "BIS Proposed Red Flags Nov 2004", or [click here](#).

As a counterweight to the expansion of the "knowledge" definition and the "red flags" list, BIS is proposing the creation of a "safe harbor" from liability arising from violations of knowledge-based EAR requirements. Eligibility for this protection will require parties to demonstrate:

1. Absence of actual knowledge or actual awareness that the fact or circumstance at issue is more likely than not.
2. Compliance with item and/or destination-based license requirements and other notification or review requirements.
3. Determination that the parties to the transaction are not subject to a denial order, or to certain sanctions, that they do not appear on the Entity List or Unverified List, and that the transaction is not governed by a BIS General Order.
4. Identification and response to red flags.

Significantly, to be eligible for the safe harbor, the proposed regulation requires parties – in advance of the transaction – to file a report with BIS explaining its satisfaction of these requirements. In response, BIS will:

1. Concur with the party's judgment that it has adequately addressed the concerns raised by the red flags;
2. Not concur with the party's judgment that it has adequately resolve those concerns and describe additional information that would be necessary to resolve them adequately;
3. Issue an "is informed" notice advising the party of a license requirement under the EAR; or
4. State that more time is needed to review the submission.

BIS states that it expects to respond to most reports within 45 days of receipt. Given this significant time requirement, we expect that the proposed safe harbor program, if finalized, will likely be used by the exporting community only for the most sensitive shipments.

The regulatory changes proposed by BIS in this Federal Register notice are both technical and significant. Should you have any questions about the proposed changes, please do not hesitate to contact us.

**John R. Liebman**  
**Los Angeles**

**Brett Ian Harris**  
**Washington, DC**

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