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The International Comparative Legal Guide to:

Corporate Governance 2017

10th Edition

A practical cross-border insight into corporate governance

Published by Global Legal Group, with contributions from:

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Published by
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London SE1 3PL, UK
Tel: +44 20 7367 0720
Fax: +44 20 7407 5255
Email: info@glgroup.co.uk
URL: www.glgroup.co.uk

GLG Cover Design
F&F Studio Design

GLG Cover Image Source
iStockphoto

Printed by
Ashford Colour Press Ltd
June 2017

ISBN 978-1-911367-56-7
ISSN 1756-1035

Strategic Partners

MIX
Paper from responsible sources
FSC® C011748

Country Question and Answer Chapters:

Chapter 24

Puerto Rico

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1 Setting the Scene – Sources and Overview

1.1 What are the main corporate entities to be discussed?

This chapter will focus on privately held corporations ("Corporations") and limited liability companies ("LLC(s)"). The majority of Puerto Rican businesses are incorporated as Corporations, however, in recent years, LLCs have gained popularity among business owners and their counsel given the particular advantages that LLCs offer such as: (i) the freedom to structure management (i.e. member managed, manager managed, or centralised management structure such as board managed); (ii) they are not required to file financial statements with the Puerto Rico Department of State; (iii) streamlined corporate formalities; and (iv) the option to be taxed as a partnership or as a regular Corporation.

Please note that although there are publicly traded companies organised under the laws of Puerto Rico that trade in national stock markets (i.e. NYSE and AMEX) and over the counter markets (i.e. NASDAQ), we will not cover corporate governance requirements applicable to publicly traded companies under United States federal securities laws and regulations, and applicable securities exchanges rules and regulations.

1.2 What are the main legislative, regulatory and other corporate governance sources?

1. Legislative Sources: Puerto Rico Corporations and LLCs are subject to the requirements of the Puerto Rico General Corporations Act of 2009, as amended (the "Corporations Act") and case law from the Puerto Rico Supreme Court. It is important to note that the Corporations Act is modelled on the Delaware General Corporations Act (the "Delaware Corporations Act") and that the Puerto Rico Supreme Court has stated that judicial decisions from Delaware courts in connection with the interpretation of the Delaware Corporations Act shall be highly persuasive and illustrative before Puerto Rico courts. This principle of interpretation has not been expressly extended by the Puerto Rico Supreme Court to Delaware court decisions interpreting the Delaware Limited Liability Company Act (the "Delaware LLC Act"), however, it seems highly probable that the same principle would apply.

   Please note that Puerto Rican publicly traded companies registered with the Securities and Exchange Commission are subject to regulations promulgated under the Securities Act of 1933 and the Securities Exchange Act of 1934 and such other rules and other corporate governance requirements imposed by the exchanges in which their securities are traded. As previously indicated, we will not cover such rules and regulations in this chapter.

2. Organisational Documents: A Corporation's or LLC's organisational documents are an important source of corporate governance requirements. A Corporation's articles of incorporation, its by-laws and its shareholders' agreement may include particular provisions regarding voting requirements, meetings and shareholder rights, among others. Please note that although a shareholders' agreement is an important source of corporate governance for Corporations, the Corporations Act does not impose on a Corporation or its shareholders the obligation to adopt such document.

   Although the Corporations Act has default provisions applicable to LLCs, an LLC operating agreement is the principal source of corporate governance requirements. This is due to the fact that one of the LLC's principal benefits is the freedom provided to the members in determining the governance structure of the company, the formalities, if any, that shall be required, and ultimately how the company is managed. However, under Puerto Rico law, and contrary to Delaware law, the Corporations Act does not impose on the members of an LLC the obligation to adopt an operating agreement. If no operating agreement is adopted, the LLC will be subject to the default provisions contained in the Corporations Act. For the purpose of this Corporate Governance Guide, we will treat LLCs as if an operating agreement has been adopted.

1.3 What are the current topical issues, developments, trends and challenges in corporate governance?

The most recent development in corporate governance is the amendment of the Corporations Act in December 2015 to allow for the organisation, merger, and/or conversion of Public Benefit Corporations ("Benefit Corporations") in Puerto Rico. Benefit Corporations that are organised under the Corporations Act are required to file annual reports and social benefit reports, setting forth the public benefit provided by the Corporation. One of the advantages of organising a Benefit Corporation is that its directors, in making their determinations, are allowed to consider factors other than the best interests of its shareholders. For example, they are allowed to take into consideration, among others things, the general public benefit pursued, the best interests of its employees and the community at large. In addition, directors of Benefit Corporations shall not be liable for any damages caused due to decisions made in good faith and in pursuit of the general public benefit set forth in the Certificate of Incorporation.

A major challenge in Puerto Rico is that the majority of private companies in Puerto Rico are closely-held family businesses that

generally do not have the sophistication of larger businesses with regards to matters of corporate governance. Thus, given the nature of these companies, corporate governance formalities are not always strictly followed or enforced, and this may raise difficulties or problems when attempting to execute certain types of transactions, such as obtaining commercial financing or a merger and acquisition of an ongoing concern.

Another significant challenge for most closely-held family businesses is the adoption and successful implementation of an orderly plan of succession that will smoothly transfer the management of the business from one generation to the next. Often, these companies are founded and managed by one individual who may not take the time to nurture or identify another person or persons to succeed him after his retirement or death. The lack of a generation transition plan has resulted in the termination of many successful businesses in Puerto Rico.

2 Shareholders

2.1 What rights and powers do shareholders have in the operation and management of the corporate entity/entities?

One of the basics tenets of corporate law under the Corporations Act is that the business of a Corporation shall be managed by or under the direction of a board of directors. Thus, shareholders are generally not involved in the management of the Corporation. The principal exception to the foregoing occurs in the context of close corporations in which the shareholders are primarily responsible for the operation and management of the entities. Nonetheless, shareholders have the right and the power to elect the board of directors and they also have the right to vote on and approve extraordinary transactions such as: (i) any amendment to the certificate of incorporation or the by-laws; (ii) a merger or consolidation; (iii) the sale of all or a substantial amount of the assets of the Corporation; or (iv) a dissolution.

Contrary to Corporations, LLCs are regularly managed in a decentralised fashion by their members (similar to a partnership) and members actively participate in the operation and management of the LLC. The Corporations Act provides that unless otherwise established in the operating agreement, the LLC will be managed by the members owning more than fifty per cent (50%) of the equity interests in the LLC. Notwithstanding the foregoing, the members may choose to implement a centralised management structure, similar to that of a Corporation, including the election of a board of managers and the appointment of officers. If this were to be the case, the members need to specify in the LLC's operating agreement the particular requirements regarding the management structure, including what rights they wish to retain for themselves and not delegate to the LLC's board of managers and officers.

2.2 What responsibilities, if any, do shareholders have as regards the corporate governance of their corporate entity/entities?

Generally, except for certain extraordinary matters such as a merger or consolidation, the sale of all or substantially all of the assets or dissolution for which shareholder approval is required, shareholders do not have corporate governance responsibilities in Corporations. Notwithstanding the foregoing, the Corporations Act imposes upon the majority or controlling shareholders a duty of loyalty to the Corporation and to the other minority shareholders regarding corporate matters. In the case of LLCs, the Corporations Act establishes that members are bound by the same duty of loyalty to the LLC and to the other members of the same.

2.3 What shareholder meetings are commonly held and what rights do shareholders have as regards them?

The Corporations Act requires that Corporations hold an annual meeting of shareholders and allows the board of directors to convene special meetings of shareholders to discuss and take action on particular matters. The Corporations Act further provides that the notification period for annual or special meetings shall be no less than ten (10) days or more than sixty (60) days prior to such meeting. If the notification is for a special meeting, the purpose of said meeting must also be disclosed in the notification. In addition, the by-laws of the Corporation may establish additional rules regarding who may convene special shareholder meetings. For example, they could provide that the shareholders holding a majority of the voting rights may convene a special meeting. In annual and special meetings the shareholders have the right to vote (either in person or via proxy) on the matters brought before them.

Contrary to Corporations, LLCs are not statutorily required to hold annual or special member meetings, thus, the establishment of such meetings and the rules governing the same are subject to the discretion of its members or as otherwise stated in the operating agreement.

2.4 Can shareholders be liable for acts or omissions of the corporate entity/entities?

A basic tenant of corporate law and a principal advantage of organising a business as a Corporation or as an LLC is the concept of limitation of liability. This concept dictates that the liability of shareholders or members for the debts or other liabilities of the company is limited to those amounts invested in said Corporation or LLC by such shareholder or member. Notwithstanding the foregoing, a shareholder or member may be found responsible for the acts or omissions of the company pursuant to the doctrine of "piercing the corporate veil".

Puerto Rico courts have stated that the corporate veil shall be upheld unless such entity and the limited liability benefits afforded by it are used to: (i) defeat public policy; (ii) justify an inequality; (iii) commit fraud; or (iv) defend crime. Although a judicial action to pierce the corporate veil is very fact specific, the main factors considered by the Puerto Rico courts are: (i) when fraud is present and the corporate entity is used as a conduit to "legalise" illegal acts; and (ii) when the corporation is a mere instrument or alter-ego of the shareholders. Please note that the alter-ego factor is not, by itself, sufficient to pierce the corporate veil.

2.5 Can shareholders be disenfranchised?

It is important to note that a Corporation may not take away voting rights once they have been granted to shareholders. Notwithstanding the foregoing, there are certain situations in which shareholders may become "disfranchised". For example, disenfranchisement occurs in the context of "squeeze-out" mergers whereby pursuant to the vote of a majority shareholder, the minority shareholders are required to tender their shares in exchange for a cash payment and do not become shareholders of the surviving Corporation. Furthermore, in certain circumstances shareholder rights may be diluted by the issuance of additional shares or new classes of securities.

2.6 Can shareholders seek enforcement action against members of the management body?

Yes. Shareholders (and in certain situations creditors) may pursue direct or derivative actions against management. In a derivate

action, a shareholder or group of shareholders pursue a claim on behalf of the Corporation in the event that the directors or officers of the Corporation fail to do so or violate one or more of their fiduciary duties. This inaction in the part of management typically takes place if the directors or officers of the Corporation are responsible for the damages alleged under the derivative action. It is important to note that under a derivative action any relief or award granted by the courts shall be for the sole benefit of the Corporation and not for the shareholder(s) who initiated the action. On the other hand, a shareholder may also present a direct action against the Corporation and its management body alleging that he or she has suffered damages as an individual shareholder.

In the case of an LLC, the Corporations Act expressly states that only a current member of the LLC may file a derivative suit.

2.7 Are there any limitations on, and disclosures required, in relation to interests in securities held by shareholders in the corporate entity/entities?

The Corporations Act does not impose any limitations or require disclosure in relation to the ownership interest held by shareholders or members. Notwithstanding the foregoing, in the banking and insurance industry when a shareholder attains a certain level of ownership, disclosure to the appropriate regulators is required. Furthermore, it is common for local financial institutions or government agencies to request such information and disclosures pertaining to the ownership structure of an entity requesting financing from a financial institution, requesting that a licence be issued by a government agency, or entering into a contract with a government agency.

3 Management Body and Management

3.1 Who manages the corporate entity/entities and how?

As a general rule, Corporations are managed by or under the direction of a board of directors. Notwithstanding the foregoing, the certificate of incorporation could establish a different management structure, in which case the person or group of persons designated in the certificate of incorporation would assume all of the powers and responsibilities traditionally granted to the board of directors. Furthermore, the certificate of incorporation may grant to the board of directors the power to execute management agreements, provided, however, that the terms of such management agreement may not exceed three (3) years. It is important to note that the board of directors of a Corporation, generally, does not engage in or manage the daily operations of the Corporation; instead such responsibilities are delegated by the board of directors to the officers that it appoints.

Contrary to a Corporation, an LLC's default rule for management is member managed, however, the operating agreement may provide for a centralised management structure similar to that of a Corporation (i.e. a board of managers and officers). As the name implies, in a member-managed LLC the members are responsible for the day to day operations of the company. In certain instances, the members may decide to appoint a manager, who does not have to be a member, to oversee the day to day operations of the company. As mentioned in question 1.2, Delaware case law is highly persuasive in Puerto Rico. Although the Puerto Rico Supreme Court has yet to express itself on the following matter, it is important to note that the Delaware Chancery Court recently stated in *Obied v. Hogan*, WL 3356851 (2016) that the choice of management structure chosen by the members shall have consequences when drawing case law as an analogy in order to solve a controversy. For example, if the members adopted a board of managers structure, then corporate law may be applied by a court of law or if the members adopted a member managed structure, the general partnership law may be applied by analogy in deciding the particular controversy.

3.2 How are members of the management body appointed and removed?

The members of the board of directors of a Corporation are elected annually by a majority vote of the shareholders present at the annual meeting of shareholders, in person or via proxy, who have the right to vote at such meeting. It is important to note that the certificate of incorporation may provide for the creation of a staggered board with two or three groups of directors who may serve for a period of one to three years. In a staggered board only one group of directors will be elected at each annual meeting of shareholders.

In a non-staggered board of directors, any one director or the whole board of directors may be removed with or without cause by the holders of a majority of the shares entitled to vote for the election of directors. In a staggered board of directors, shareholders may only remove a director for just cause, unless otherwise provided in the certificate of incorporation. Furthermore, if the certificate of incorporation authorises cumulative voting, no director may be removed if the cumulative votes against his or her removal are sufficient to elect such director as a member of the board of directors.

In the event of a vacancy as a result of the removal, resignation or death of a director, the remaining members of the board of directors may designate a director without seeking the approval of the shareholders. A director designated to the board of directors in such a fashion shall serve for the remainder of the former director's term.

Unless otherwise specified in the certificate of incorporation or by-laws, the officers of a Corporation are appointed by the board of directors without the need to seek the consent of the shareholders. The board of directors has the exclusive power to appoint and remove corporate officers as they deem in the best interests of the Corporation.

The members of an LLC may choose to appoint a manager or a group of managers who will have the rights and responsibilities provided in the operating agreement. We note that the Corporations Act does not directly address the removal of the manager of an LLC but a manager may be removed by the members holding a majority interest in the LLC.

3.3 What are the main legislative, regulatory and other sources impacting on contracts and remuneration of members of the management body?

The Corporations Act does not impose any limitation on the compensation of directors. Unless otherwise specified in the certificate of incorporation or the by-laws, the board of directors has the authority to determine the compensation to be paid to the officers and directors of the Corporation. The Corporations Act does not specifically address this matter in connection with LLCs.

3.4 What are the limitations on, and what disclosure is required in relation to, interests in securities held by members of the management body in the corporate entity/entities?

The Corporations Act does not impose any requirement regarding share ownership disclosures and/or limitations. Unless otherwise provided in the company's organisational documents, the directors

and officers of Corporations and the managers of LLCs are not required to be shareholders/members in order to hold their respective offices.

3.5 What is the process for meetings of members of the management body?

The Corporations Act does not impose a statutory requirement to hold a minimum number of board of director meetings nor does it provide or establish specific guidelines as to how to conduct the order of business in a board meeting. The Corporations Act simply requires, unless otherwise stated in the certificate of incorporation or the bylaws, that the board of directors meeting may be held in person or by electronic means of communication (such as telephone or video conferences) provided that all members of the board of directors assisting such meeting are able to listen to each other simultaneously.

Furthermore, unless prohibited by the Corporation's bylaws, any action required or permitted to be taken at any meeting of the board of directors may be taken without a meeting, if all members of the board of directors consent thereto in writing, and such consents are filed with the minutes of the proceedings of the board of directors. Thus, any rules governing the meetings of the board of directors, such as minimum notification periods, frequency of meetings and quorum are most commonly specified in the Corporation's by-laws.

The Corporations Act does, however, expressly provide that meetings of the board of directors may be held in person or by means of electronic communication (such as telephone or video conferences) provided that all members of the board of directors assisting the meeting are able listen to each other simultaneously. Furthermore, unless prohibited by the Corporation's by-laws, any action required or permitted to be taken at any meeting of the board of directors may be taken without a meeting, if all the members of the board of directors consent thereto in writing, and the writing or writings are filed with the minutes of proceedings of the board of directors.

The Corporations Act does not govern the meetings of the members of an LLC nor does it provide or establish rules governing the structure or process for the meetings of the members or any governing body. Given the fact that the Corporations Act does not require that a meeting of the management body of an LLC be held, such requirements are generally established in the company's operating agreement.

3.6 What are the principal general legal duties and liabilities of members of the management body?

The directors and officers of a Corporation are bound by three (3) principal legal obligations: (i) to act pursuant to the objectives and purposes of the Corporation; (ii) to perform their duties with the care and attention that a reasonable and competent person would exercise under similar circumstances ("duty of care"); and (iii) to act in a just manner and exercise their powers with the utmost loyalty and in the best interest of the Corporation and its shareholders ("duty of loyalty").

The duty of care includes responsibilities such as: (i) the duty to monitor; and (ii) the duty to make enquiries. The duty of loyalty imposes upon directors and officers the obligation to act in the best interest of the Corporation and its shareholders, setting aside their own personal interests. In order to comply with this duty of loyalty, the directors and officers must avoid transactions that may result in a conflict of interest with the Corporation. The directors and officers of a Corporation should not engage in or become involved with businesses that compete with the Corporation. Nor should the directors and officers use material non-public information for their personal gain.

The Corporations Act expressly extends the duties set forth above to the members and managers of LLCs.

A director will be found to have violated his duty of care in the event that a plaintiff is able to prove that the actions of the director were grossly negligent. In order to establish that the director was grossly negligent the plaintiff must first overcome the presumption provided by the Business Judgment Rule. The Business Judgment Rule provides a presumption that in making a decision the director was informed and acted in good faith and in what he believed were the best interests of the Corporation. Furthermore, the Business Judgment Rule provides that the plaintiff must prove that a reasonable commercial basis for the director's decision did not exist. The underlying purpose of the Business Judgment Rule is to allow directors and officers to make reasonable business decisions without holding them responsible for the success or failure of each venture. In the event that the presumption established by the Business Judgment Rule is overcome, the implicated directors are subject to the Entire Fairness judicial standard of review. Under the Entire Fairness standard of review, a director must show that the decision was taken with the utmost good faith and that it was inherently fair to the shareholders.

Notwithstanding the forgoing, a Corporations Certificate of Incorporation may include a provision limiting or eliminating the personal responsibility of a director or officer for breaching his/her fiduciary duties, with the exception of the duty of loyalty and acts or omissions done in bad faith.

3.7 What are the main specific corporate governance responsibilities/functions of members of the management body and what are perceived to be the key, current challenges for the management body?

As mentioned in question 3.1 above, the Corporations Act states that the business of the Corporation will be managed by or under the supervision of a board of directors. The board of directors will be responsible for instituting the corporate strategy to be followed by the Corporation and they are also responsible for the appointment and supervision of the officers of the Corporation.

The corporate governance responsibilities of an LLC fall on the members of the LLC, unless the operating agreement appoints a manager to run the business, in which case the corporate governance structure will more closely resemble that of a Corporation.

Currently, the main challenges for management are related to the fact that the majority of private companies in Puerto Rico are closely-held family enterprises that may not have sophisticated corporate governance procedures, which in turn may present difficulties in the execution of certain transactions (such as a sale of the business or obtaining financing). In addition, another relevant challenge in the current environment is that the same closely-held family enterprises may face a generational change in ownership, and often these companies (which typically relied on the original founder(s)) do not have an ownership or management transition plan in place for the continuous operation of the business. The lack of a generation transition plan has resulted in the termination of many successful businesses in Puerto Rico.

3.8 What public disclosures concerning management body practices are required?

The Corporations Act does not contain any provisions that require

public disclosure by private Corporations or LLCs concerning the management practices of the board of directors, corporate officers or members. Please note that under applicable federal securities laws and regulations, publicly traded companies are subject to additional disclosure requirements.

3.9 Are indemnities, or insurance, permitted in relation to members of the management body and others?

Yes. The Corporations Act permits Corporations and LLCs to indemnify a person due to the fact that such person was a director, an officer, a manager, an employee or a member of the company. Such indemnification may include attorneys' fees, and any other fines or amounts paid as a result of a judgment or settlement. The indemnification will not proceed if the person is found liable to the company in connection with the cause of action for which such person is requesting the indemnification.

The Corporations Act further allows a Corporation or an LLC to buy insurance on behalf of its directors, officers, managers or employees.

4 Other Stakeholders

4.1 What, if any, is the role of employees in corporate governance?

Under the Corporations Act, there is no statutory provision regarding the involvement of employees in corporate governance. Nonetheless, a company may designate an officer to be in charge of corporate governance procedures and compliance.

4.2 What, if any, is the role of other stakeholders in corporate governance?

Under the Corporations Act, there is no statutory provision regarding the involvement of other stakeholders such as creditors, labour unions and employees in corporate governance.

4.3 What, if any, is the law, regulation and practice concerning corporate social responsibility?

Currently, there are no laws or regulations that specifically address corporate social responsibility. However, as previously mentioned in question 1.3, in December 2015, the Puerto Rico government enacted Act 233-2015 which amended the Corporations Act to allow the creation of Public Benefit Corporations. Public Benefit Corporations are required, among other things, to file annual reports and social benefit reports regarding: environmental matters (product cycle management, reduction of waste and residues, use of clean technologies, reduction of a negative environmental footprint, and responsible use of natural resources); corporate operations (information transparency, economic impact in the communities where the Corporation operates, and health and safety initiatives); and human capital (policies and practices against discrimination, elimination of work violence, and development of human capital). In addition, the reports must set out the public benefits that the entity brings to the community in which it operates.

In addition, a significant number of companies practise various levels of corporate social responsibility. Generally, Puerto Rico companies and business leaders are actively involved in an array of non-profit entities that provide a wide variety of services and benefits to local communities.

5 Transparency and Reporting

5.1 Who is responsible for disclosure and transparency?

The directors and officers of a Corporation are the parties responsible for disclosure and transparency. Under the Corporations Act, if an officer or director knowingly publishes false information regarding material aspects related to the Corporation's situation or business, such officer or director shall be responsible for any loss or damage resulting from the false information. Please note that the aforementioned provision applies to LLCs.

5.2 What corporate governance related disclosures are required?

Besides making the company's organisational documents, such as the certificate of incorporation and by-laws, in addition to the shareholders' agreement, if adopted, in the case of Corporations and the certificate of organisation and the operating agreement in the case of LLCs, available to the shareholders and members of the Corporation or LLC, there is no statutory requirement for private companies regarding corporate governance disclosures to private parties. However, the Corporations Act requires that all Corporations file an annual report to the Puerto Rico Department of State which, among other things, details the identity of at least two officers and/or directors of the Corporation. The Corporations Act does not require such disclosure for LLCs with the Puerto Rico Department of State.

5.3 What is the role of audit and auditors in such disclosures?

Under the Corporations Act, Corporations with an annual business volume in excess of $3 million are required to file with the Puerto Rico Department of State an audited balance sheet together with their annual report. LLCs are not required to file financial reports with the Puerto Rico Department of State.

5.4 What corporate governance information should be published on websites?

Currently, there is no statutory requirement for private companies to publish any corporate governance information on their websites.

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Mr. Rovira-Rullán is admitted to practise in Puerto Rico and New York. His principal areas of practice include mergers and acquisitions (local and cross-border experience), commercial lending, real estate, general corporate law, corporate governance and fiduciary duties, intellectual property, and tourism and hospitality.

Since 2010, Mr. Rovira-Rullán has been rated by *Chambers & Partners* in its *Global* and *Latin America* editions as a Leader in Corporate and Commercial areas of practice. He serves as an adjunct professor at the University of Puerto Rico School of Law, where for 15 years he has offered advanced corporate law courses such as Business Organisation and Mergers and Acquisitions.

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Mr. Lafontaine-Torres obtained his J.D. degree from the University of Puerto Rico School of Law. During his legal studies, Mr. Lafontaine-Torres was the Editor-in-Chief of the Third Volume of the University of Puerto Rico *Business Law Journal*.

Ferraiuoli LLC
Looking Forward

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Ferraiuoli LLC has received international recognition in the legal field from *Chambers & Partners*, a London-based legal directory firm that publishes, on an annual basis, the leading directories of the legal profession identifying the world's top lawyers and law firms. In its 2010–2016 *Latin America* and *Global* editions, Chambers & Partners ranked Ferraiuoli LLC as a leader in both Corporate and Intellectual Property, and several firm attorneys were named "Leaders in their Fields" by the publication. Ferraiuoli LLC has further been honoured as one of Puerto Rico's outstanding firms by *Chambers & Partners*, being shortlisted as one of the candidates for Puerto Rico's "Law Firm of the Year" for the years 2011–2016.

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