THOMPSON HINE

Business Law Update

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Corporate Governance Spotlight

The Rise of Majority Voting

By Stuart Welburn & Branwen Buckley

This is the first of two articles on the topic of majority voting by shareholders in the election of directors. It provides a brief overview of shareholder voting for directors and notes the movement away from plurality voting to majority voting in uncontested elections. The second article will review various design considerations that should be borne in mind by public companies that are contemplating the adoption of a majority vote provision in their charter documents.

The default rule under the corporation laws of most states is that directors are elected by a plurality of the votes cast. Under this voting model, there is no straight up or down vote for director nominees. Instead, the candidate who receives the highest number of "for" votes is elected, whether or not those votes constitute a majority of the votes cast. Although not particularly common in practice, the result of the plurality voting standard is that a nominee who receives more "withhold" votes than "for" votes, or who receives even a nominal number of votes in his or her favor, can still be elected to the board. The plurality voting model was once the prevailing standard and had long governed the election of directors at most public companies.

In recent times, however, many activist shareholders have advocated against the use of plurality voting. They argue that it can lead to unfair and unrepresentative election results in which the majority of a company's shareholders withhold the authority for their shares to be voted in favor of a director, but the director nominee is still elected to the board by virtue of receiving a plurality of the votes in his or her favor. These shareholders and groups advocating on their behalf have been very effective in their efforts to persuade large public companies to adopt a majority vote standard for the election of directors, prompting a rapid and widespread move away from plurality voting among large public companies. It is quite likely that this trend will continue into the middle market as investors expect smaller public companies to follow the lead of the major corporations and adopt what is being seen as a corporate governance best practice.

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For more details on any of the topics covered in this *Business Law Update*, please contact the authors via the links at the end of each article or Michael J. Hagan, editor-in-chief. For information on our Corporate Transactions & Securities practice, please contact Frank D. Chaiken, practice group leader.

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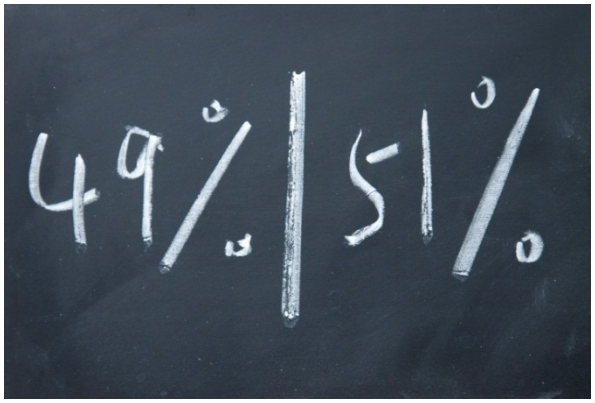
Some companies may wish to adopt a "plurality plus" voting model, in which the company retains a plurality threshold for the election of its directors, but voluntarily adopts a resignation policy that will only come into play when and if a director fails to receive a majority of votes cast in favor of his or her re-election. The resignation policy may require either all directors to submit an irrevocable resignation upon their election to the board or any directors who receive a majority of votes "withheld" to submit their resignation to the board within a specified timeframe of the relevant vote. Generally, under these policies the board retains the authority to decide whether such a resignation is ultimately accepted. In making its decision, the board has wide discretion, as the propriety of any such decision will, in most cases, be evaluated by the business judgment rule.

Activist shareholders have increasingly indicated their dissatisfaction with this approach. As an alternative, they have brought pressure on companies to amend their bylaws or certificates of incorporation to directly require that all directors be elected by a majority of votes cast, except in the case of contested elections. Some companies have chosen to do so voluntarily, while others have been forced into line after shareholders have brought and approved a shareholder proposal requiring an amendment as part of the annual meeting of shareholders.



When a company adopts a majority voting standard via an amendment to its charter documents, it is important that it also carefully consider the mechanics relating to the outcome of a director failing to receive a majority vote. These mechanics are particularly important in states like Delaware, where the company may find itself with a "holdover" director due to the phrasing of the state corporation law statute, which may provide that directors hold office until the director's successor is elected and qualified or until his or her earlier resignation or removal.

As it is likely that there will be a continued push by activist shareholders to replace plurality voting with the majority voting standard in uncontested director elections, middle market companies should be ready to address this topic with their boards and shareholders as the 2013 proxy season approaches. For companies to be able to respond to these developments, an understanding of the various alternatives and design considerations will be required. The second part of this article will review these matters in detail.

For more information on shareholder voting for directors, please contact Stuart Welburn or Branwen Buckley.

Mergers & Acquisitions

Representation & Warranty Insurance – Has Its Time Finally Arrived?

By Louis F. Solimine

As anyone who has been involved in the purchase or sale of a business knows well, the negotiations over the seller's representations and warranties, and the corresponding indemnity provisions that provide the means by which to enforce them, typically are among the most contentious aspects of the transaction. A seller understandably wants to limit and qualify its representations and warranties and its related indemnity obligations as much as possible. Conversely, the purchaser wants to preserve as much opportunity as possible to recover whatever losses it may incur should any of the seller's representations or warranties prove to be untrue.

The focus of these divergent interests typically centers on the length of time the seller's representations and warranties will survive after the closing as well as the deductibles, baskets, caps and other limitations that serve to limit the losses the purchaser is entitled to recover from the seller. Naturally, the seller wants to leave as little of the purchase price at risk as possible for the shortest feasible time. On the other hand, the purchaser wants to make certain that for a reasonable period of time there is a reliable source of funds, commensurate with the size of the transaction and the nature of the business, with which the seller can fund any indemnity claims.

The most common way by far in which sellers and buyers address the funding source is to create an escrow fund, which serves many useful purposes. Since escrow funds typically are held by large banks and are invested in short-term government obligations, the purchaser is assured that a safe and liquid source of funds will be available to satisfy indemnity claims. For the seller, particularly one with multiple owners, an escrow fund eliminates the need to call upon the owners to refund a portion of the purchase price, assuming the funds are still available, to satisfy an indemnity claim. At the same time, however, a seller obviously must endure lost opportunity costs for the duration of the escrow period, as escrow funds earn very little return.

In the late 1990s the ever-enterprising insurance industry created a new insurance product as a substitute for an escrow fund – representation and warranty insurance, also known as "transactional risk" insurance. Rather than ask the seller to set aside a portion of the purchase price in an escrow account, the insurance industry promoted the prospect of instead using an insurance policy to underwrite the risk that any of the seller's representations and warranties might prove to be untrue. According to the insurance industry, such a policy had much to offer since the policy premium would be only a fraction of the amount the parties otherwise would hold in escrow. For that reason, the seller could distribute a much larger share of the sale proceeds immediately following the closing and thereby minimize its lost opportunity costs. At the same time, it would provide at least the opportunity for the purchaser to negotiate for more generous indemnity provisions since, with an insurance policy in place to cover any losses, the seller presumably would be more willing to agree to terms more favorable to the purchaser.

The terms of a representation and warranty insurance policy will vary depending on the purpose the parties intend to serve. For instance, a policy might match precisely the seller's indemnity obligations including the relevant deductibles, baskets and caps. In that circumstance, the insurance policy will likely replace the escrow fund in its entirety. Even in instances where the purchaser for whatever reason prefers to use a conventional escrow fund, the seller may want to obtain a policy as a safety net against its own exposure, which may exceed the amount of the escrow fund depending on how the acquisition agreement is structured. On the other side of the table, the purchaser may want to obtain its own policy coverage to the extent the seller is unable or unwilling to indemnify the purchaser to the full degree the purchaser determines is necessary. In other words, a representation and warranty insurance policy is not a one-size-fits-all proposition and its coverage – and whether the seller or the purchaser is the insured – will depend on the risks one or both parties seek to insure.

Representation and warranty insurance is likely to be particularly useful in situations where the seller – such as an investment fund – wants to quickly distribute to its investors as much of the sale proceeds as possible. A seller also may need the sale proceeds to pay down debt and

cannot afford to sequester a substantial sum in an escrow fund for an extended period of time. A purchaser may find an insurance policy appealing where the amount of the escrow fund is smaller – as it often is – than the full extent of the seller's contingent indemnity obligations. A purchaser also would benefit from an insurance policy where the target is a public company whose representations and warranties commonly expire at the closing. Similarly, a purchaser may wish to insure the risk of acquiring a company in bankruptcy since debtors and bankruptcy trustees will offer only the bare minimum representations and warranties. Representation and warranty insurance also may have strategic value in connection with, for example, an auction process where a prospective purchaser could signal its willingness to rely on an insurance policy instead of an escrow fund and thereby distinguish its bid from competitors' bids. Conversely, depending on the circumstances, the insured may choose not to inform the other party about its procurement of insurance coverage.

Despite the efforts of the insurance industry, representation and warranty insurance has never really caught on. Investment bankers, lenders and lawyers often viewed the integration of an insurance policy – and the related negotiation with the insurer – as an expensive, cumbersome and time-consuming process that only would delay the closing. The recession in the early 2000s, the ensuing M&A boom and then the Great Recession, which especially damaged the balance sheets of many insurers, did not help. Depending on the time frame, many sellers and purchasers decided they either could not afford or did not need insurance protection. But now, with the financial industry slowly recovering along with the rest of the economy, representation and warranty insurance is once again being marketed in the M&A world. And market-savvy insurers are making special efforts to expedite their due diligence, to customize their policies to suit the insured's particular needs and to price the premium at financially attractive levels (currently in the range of about 2 to 4 percent of the coverage). Insurers also are increasingly willing to provide coverage for such formerly off-limits risks as tax, environmental, IP, fraudulent conveyance and successor liability indemnities.

If either the seller or purchaser is interested in a representation and warranty insurance policy, it generally is wise to bring a prospective insurer into the process sooner rather than later. The insurer will need time to conduct its own due diligence in order to assess and price the risk it is being asked to underwrite. It also will need to draft the policy and negotiate its terms with its insured (parties should expect to pay an up-front, non-refundable fee to cover the insurer's due diligence, the amount of which can range from $10,000 to $25,000 depending on the size and complexity of the transaction). If the parties delay the involvement of the insurer, this process almost surely will slow down the transaction and make it less appealing to the parties.

With insurers making a concerted effort to make representation and warranty insurance user-friendly and affordable, if nothing else, a seller or purchaser of a business may want to take a closer look at such a policy, either in place of, or in addition to a conventional escrow fund, particularly in those circumstances in which the use of a conventional escrow fund is problematic. Thompson Hine's M&A lawyers can help interested parties identify the insurers that are active in this market and, if appropriate, also help to negotiate the terms of the policy.

For more information about representation and warranty insurance and related issues, contact Louis F. Solimine.

Early Stage & Emerging Companies

Navigating the Complexities of LLC Profits Interests

By David J. Willbrand, Erin D. Borcherding & Nathan E. Holmes

Entrepreneurs often choose to form a limited liability company (LLC) when starting a business. While LLCs are often structured with many corporate characteristics, most entrepreneurs elect to have LLCs taxed as partnerships to take advantage of certain benefits (like "pass through" tax treatment and the personal use of losses). This combination of entity characteristics, while seamless and harmonious in most places, creates unique challenges in the area of equity compensation. LLCs often want to grant equity interests to key employees or service providers to motivate and reward them to grow the business. While the traditional corporate equity compensation method of incentive stock options is not available to an LLC, there are several avenues through which it may provide incentive compensation.

The basic forms of equity compensation an LLC will typically consider include a profits interest, a capital interest and an option to acquire a capital interest. A profits interest is an interest in the future profits and appreciation of an LLC, but is not an interest in any liquidating proceeds that would be distributed at the time the interest was granted. By contrast, a capital interest represents ownership in both the LLC's future profits and its current and future capital (i.e., net assets) upon liquidation. An LLC may also grant an option to acquire a capital interest.

Capital interests are substantively similar to stock in a corporation. Options for capital interests are fundamentally similar to options for stock in a corporation (of the "nonqualified," not the "incentive," variety). A profits interest does not have a corporate analogue. Consequently, the remainder of this article focuses on profits interests, because they can be very beneficial but may be less familiar than other forms of equity compensation. In addition, the tax consequences of profits interests require careful consideration.

Profits Interests

One of the benefits of a profits interest is that it may be structured similarly to a stock option but may be more attractive to the recipient because a profits interest grant, in some cases (at least under current law) can provide that all appreciation in value be taxed as long-term capital gains rather than ordinary income. Furthermore, unlike a stock option, the recipient does not have to pay to exercise the options to receive such favorable tax treatment. In addition, a profits interest allows the LLC to make the recipient a member of the LLC with rights equal to those of the other members with respect to future profits and future growth in the LLC, while allowing the original members to retain full right to the value of the LLC prior to the grant of the profits interest.

While the current federal tax treatment of profits interests is relatively clear, there are potential regulatory and legislative developments that might result in significant changes. As a result, tax treatment of profits interests requires careful consideration. A profits interest may be granted as a fully vested interest, or it may be unvested and subject to substantial risk of forfeiture based on continued service or the achievement of performance goals. A profits interest is considered vested if it is not subject to a substantial risk of forfeiture or is freely transferable. A profits interest is unvested if it is subject to a substantial risk of forfeiture because the recipient's right to the profits interest is conditioned on the future performance of services.

Vested Profits Interests

Based on current law, a vested profits interest may or may not be taxable depending on whether the safe harbor in Rev. Proc. 93-27 applies. Under Rev. Proc. 93-27, the IRS states that it would not treat the receipt of a profits interest in exchange for past or future services as a taxable event for the recipient or the LLC if the following conditions are met:

- The recipient must receive the profits interest in his or her capacity as a member, or in anticipation of becoming a member, in exchange for the

provision of services to or for the benefit of the LLC granting the interest.

- The interest must not relate to a substantially certain and predictable stream of income from LLC assets, such as income from high-quality debt securities or a high-quality net lease.

- The recipient must not dispose of the profits interest within two years of receipt.

- The profits interest must not be a limited partnership interest in a "publicly traded partnership" within the meaning of IRC 7704(b).

Unvested Profits Interests

While Rev. Proc. 93-27 clarified the tax treatment of a vested profits interest, the treatment of an unvested profits interest was unclear. Rev. Proc. 2001-43 provided that clarity and simplified the process of providing unvested profits interests to a service provider of a partnership or an LLC. Rev. Proc. 2001-43 provides that neither the granting of the profits interest nor the vesting of the profits interest will be treated as a taxable event. Essentially the grant of the profits interest is a tax realization event; however, the profits interest has no value, and therefore it does not give rise to any income to the recipient or to any deduction to the LLC. In order for the recipient to be treated as receiving the interest on the date of its grant under Rev. Proc. 2001-43, the following conditions must be satisfied:

- Both the LLC and the profits interest recipient must treat the recipient as a "real" member for tax purposes with respect to the entire profits interest granted beginning on the date of grant (meaning, among other things, that the LLC must provide the recipient with a Form K-1, and the recipient must pay his or her share of the taxes on the LLC's income).

- Neither the LLC nor the recipient may take any compensation deduction in connection with the profits interest.

- All of the requirements of Rev. Proc. 93-27 must be satisfied.

Rev. Proc. 2001-43 also specifically states that under these circumstances, no IRC Section 83(b) election need be made. In effect, the LLC and the recipient are treated as if an 83(b) election was made by the recipient and assessed the fair market value of the profits interest at zero. Rev. Proc. 2001-43 requires that the recipient and the LLC use consistent tax treatment allocating the LLC's gains and losses from the date of grant. *Despite this protection, it is still advisable to file an 83(b) election upon receipt of a profits interest. If any of the requirements of Rev. Proc. 93-27 are not satisfied (i.e., there is a disposition of the interest within two years), the protections of Rev. Proc. 2001-43 are lost and the recipient would not receive the tax treatment described above unless he or she timely filed an 83(b) election. Any downside to filing an 83(b) election is generally considered minimal.*

Proposed Regulations & Notice 2005-43

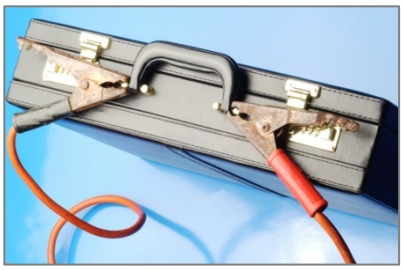
In 2005, the IRS issued Notice 2005-43, along with proposed regulations, which would provide additional guidance regarding the tax treatment of partnership (or LLC) interests issued as equity compensation. The proposed regulations would generally allow taxpayers to achieve the same results as are permitted under Rev. Procs. 93-27 and 2001-43, but would make important changes, including effectively requiring Section 83(b) elections to be made for unvested profits interests. Upon the finalization of the proposed revenue procedure found in Notice 2005-43, Rev. Procs. 93-27 and 2001-43 will become obsolete. Until that occurs, taxpayers may not rely on the safe harbor set forth in the proposed revenue procedure in Notice 2005-43, but may continue to rely upon current law, including Rev. Procs. 93-27 and 2001-43. The IRS has put this guidance on hold as it waits to see if there are any legislative developments in this area.

Future Legislation

There have been a number of legislative proposals in recent years dealing with so-called "carried interest." Some version of this legislation may resurface as the president and Congress attempt to address the "fiscal cliff" and potential tax reform, and, if so, the tax treatment of some or all profits interests might be fundamentally altered, including changes in the character of related income to ordinary, from capital gain.

For more information about LLCs and profits interests, please contact David J. Willbrand, Erin D. Borcherding or Nathan E. Holmes.

Securities Spotlight



Private Funds: The JOBS Act Revisited and Recent SEC & CFTC Developments; A Current State of Law

By Richard S. Heller

On April 5, 2012 President Obama signed the Jumpstart Our Business Startups (JOBS) Act. Among its proposed sweeping changes, it included IPO legislation for emerging growth companies (EGCs), companies with less than $1 billion in assets, to facilitate the IPO process, ease reporting requirements, make confidential SEC filings and add a "test the waters" mechanism. It lessened disclosure obligations relating to financial statements and executive compensation.

The act also introduced the concept of crowd funding, whereby private companies use electronic portals to access small investors who pool their money to fund these entities, subject to the adoption of SEC rules that have yet to be written.

There are other regulatory events in addition to the JOBS Act and Dodd-Frank that will impact private funds.

The Commodity Futures Trading Commission (CFTC) repealed a key exemption earlier this year upon which many hedge funds had relied. Set to expire at the end of the year, absent a *de minimus* exemption, private funds must now prepare to register with the CFTC (in addition to the Dodd-Frank requirement that they register as registered investment advisers (RIAs) with the SEC or the various states pursuant to Dodd-Frank).

Speaking to that issue, the SEC's Drew Bowden reported that approximately 1,400 new hedge funds registered as RIAs with the SEC as a result of Dodd-Frank, and on September 5, he announced that the SEC would initiate audits in January to promote compliance, prevent fraud and identify risk. Bowden stated that the SEC will begin onsite risk-based presence exams to look at what the SEC considers "high risk funds" and to examine a fund's marketing materials, separate accounts, conflict procedures and valuation – to name just a few items.

Thompson Hine has launched a program to assist funds in preparing for an SEC audit.

Returning to the JOBS Act, on August 29 the SEC released an interim rule regarding the general solicitation provision of the act. The act mandates that issuers can generally solicit pursuant to Regulation D as long as they ultimately sell securities to accredited investors. The SEC's release left vetting a sale to an accredited investor to each issuer. It stated that the issuer would need to take reasonable steps to determine if an investor is accredited but did not provide a safe harbor for issuers to rely upon. Instead, the interim rule called for another comment period, which expired October 5.

The SEC stated that issuers using general solicitation should take reasonable steps to verify that purchasers of securities are accredited investors. Whether the steps are reasonable would be an objective standard left to each issuer. The SEC further stated that issuers should consider a number of factors to verify that an investor is accredited. Some examples of the factors one might consider to determine accreditation might include:

1) The nature of the purchaser and type of accreditation an investor claims.

2) The amount and type of information the issuer has about the purchaser.

3) The nature of the manager: An offering conducted through a publicly available website or through social media would most likely require greater verification measures than would be required in an offering made to investors in a pre-screened database.

4) The terms of the offering and size of the investment. The SEC stated that a purchaser's ability to meet a high minimum investment amount could be relevant to the issuer's evaluation of the types of steps necessary to verify the purchaser's status as an accredited investor.

At present, it is expected that final rules will be promulgated by the SEC in the first quarter of 2013.

For more information about the JOBS Act, contact Richard S. Heller.

Post-Merger Rights & Obligations

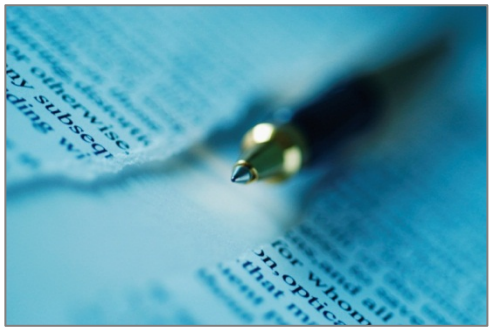
Ohio Supreme Court Reverses *Acordia* Decision

By Frank D. Chaiken & Todd M. Schild

On October 11, 2012, the Ohio Supreme Court reversed its decision in *Acordia of Ohio, LLC v. Fishel (Acordia I).* Acordia of Ohio, LLC filed a motion asking the court to reconsider its decision in *Acordia I* that a corporate merger triggered the termination provisions of certain noncompete agreements entered into by one of the constituent corporations in the merger (for details, see Thompson Hine's Summer 2012 *Business Law Update*). The court reconsidered and determined that portions of its *Acordia I* opinion were erroneous and remanded the case to the trial court for a determination of whether the noncompete agreements are still enforceable following the merger.

In May 2012, upon its first review of the case, the Ohio Supreme Court held that the merger of two companies terminated the existence of the acquired company, and that the language of noncompetition agreements entered into by the acquired company precluded the surviving company from enforcing the noncompetition agreements. The *Acordia I* decision seemed to run counter to corporate lawyers' established understanding of the operation of the Ohio merger statute.

In the most recent decision, *Acordia of Ohio, L.L.C. v. Fishel,* Slip Opinion No. 2012-Ohio-4648, the Ohio Supreme Court reemphasizes the continued validity of the Ohio merger statute, which provides that all assets and property (including, noted the court, employment contracts and agreements) of the constituent entities in a merger transfer by operation of law to the surviving company. According to the court, "Ohio merger law remains undisturbed, and employee and noncompete agreements transfer to the surviving company after a merger has been completed. . . ."



In reviewing its *Acordia I* decision, the Ohio Supreme Court concluded that the lead opinion in *Acordia I* misconstrued the *Morris* case, which formed the basis, in part, of the lead opinion in *Acordia I.* In the court's view, a correct reading of *Morris* supports the notion that a merged company becomes part of the resulting company following a merger and the surviving company has the ability to enforce noncompete agreements as if the surviving company has "stepped in to the shoes of the absorbed company."

Further, the court explains that the failure to include "successor and assigns" language in the noncompete agreements does not necessarily preclude the enforcement of the agreements by the surviving company. In fact, the court specifically notes that any language in *Acordia I* to the effect that the contracting company's rights to enforce the noncompete agreements did not automatically inure to the benefit of the surviving company, or that enforceability of the agreements was preconditioned on the inclusion of "successors and assigns" language in the contracts, was erroneous.

The Ohio Supreme Court's reversal in this case provides merging companies with a certain degree of comfort and certainty regarding their ability to enforce noncompete covenants with their employees. However, enforceability remains a key concern, and the court's holding should not be taken as a license for casual handling of these important contracts. In fact, the court explains that while noncompete agreements transfer by operation of law in a merger, the affected employees "may still challenge the continued validity of the noncompete agreements based on whether the agreements are reasonable . . ." in light of the changed circumstances brought on by the merger. To maximize the likelihood of future enforceability of noncompete agreements, both generally and in a post-merger scenario, transactional and employment lawyers should continue to carefully consider the factors affecting their use and construction.

For more information, please contact Frank D. Chaiken or Todd M. Schild.

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