THOMPSON HINE

Business Law Update

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# Corporate Governance Spotlight

## The Rise of Majority Voting; Part II: Design Considerations

***By Stuart Welburn & Branwen Buckley***

*This is the second of two articles on the topic of majority voting by shareholders in the election of directors. Part I of this article provided a brief overview of shareholder voting for directors and noted the movement away from plurality voting to majority voting in uncontested director elections. This second part reviews 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.*

As was noted in the first part of this article, 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, the candidate who receives the highest number of "for" votes is elected, whether or not those votes constitute a majority of the votes cast. Under a majority voting standard for the election of directors, all directors are to be elected by a majority of votes cast, except in the case of contested elections.

Companies contemplating the adoption of a majority voting standard, whether in anticipation of a shareholder proposal on the topic or otherwise, should consider a number of issues so the relevant charter provisions or governance guidelines are appropriately tailored to fit the company's needs. Among other things, the company will need to determine:

- How to address any potential holdover issues.
- When, under what circumstances and to whom a director's resignation should be tendered.
- Who will make any recommendation and final determination as to whether a director's resignation is ultimately accepted.
- The period of time that the deliberating directors will have to make this determination.



## New Climate Change Developments

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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.**

- Whether there will be an underlying presumption in favor of the director's resignation.
- What degree of public disclosure should follow the determination of the board.

When adopting a majority voting standard, it is important that a company carefully consider the consequences of a director failing to receive a majority vote. The 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 a director holds office until his or her successor is elected and qualified or until his or her earlier resignation or removal. In these states, a failure to receive a majority of "for" votes does not equate to the election and qualification of a successor, or the resignation or removal of the director, so the director will remain in his or her seat in a holdover capacity.

To avoid this situation, most companies that have adopted a majority voting standard have included language in their revised charter documents or corporate governance guidelines requiring any director not receiving a majority vote to submit a resignation.

Most companies that take this approach require a director to submit his or her resignation "promptly" following the certification of the vote. Others take a more definite approach by requiring that a resignation be submitted within a specified time frame, such as 10 business days from the date of the vote. A limited number of companies go even further by requiring that all director nominees submit an irrevocable resignation at the time of their nomination, which will be triggered upon a director's failure to receive a majority vote.

Given SEC and stock exchange listing rules and other corporate governance requirements to which public companies are subject, most companies that adopt a majority standard also opt to make a director's resignation conditional upon acceptance by the board, rather than automatic. In many instances, companies provide that director resignations will be tendered to the Nominating and Corporate Governance Committee of the board, or to a new committee made up of independent directors if a majority of the members of the Nominating and Corporate Governance Committee have been required to submit resignations. Once the relevant committee has come to a conclusion as to whether or not a resignation should be accepted, it will then make its recommendation to the board, which will make the final determination. Other companies have chosen to have resignations tendered directly to the full board or to all the independent directors of the full board. In any scenario, a director whose resignation is being considered should be excluded from the deliberations.

Generally, a board will have a substantial amount of discretion in deciding whether a resignation is ultimately accepted and its decision will be evaluated by the business judgment rule. Certain companies, however, most likely responding to shareholder demands, have chosen to limit the discretion of the board by including a presumption that any resignation will be accepted "absent a compelling reason" for the director to remain on the board.

In either instance, the board will have a limited amount of time to make its determination. The prevailing standard used by most companies is that a decision must be made within 90 days of the date of certification of the vote in question. Occasionally, a company will require that a decision be made within a shorter time period; however, it is important that a company allow at least enough time for the board to address any potential issues that may arise from removing and replacing any of its directors. Similarly, any significant increase in the amount of time allowed to the board will likely be met with mixed reactions from shareholders. Once a final determination has been made, most companies require that the decision be announced publicly and that the announcement include a general explanation of the reasons for the decision.

Careful consideration should be given to the above majority voting design elements before adopting a majority voting provision. As the tide continues to turn against the plurality voting model, those public companies that still maintain plurality voting should be familiar with these points so they are equipped to deal sensibly with any shareholder proposals to adopt to the majority voting standard.

For more information on this topic, please contact Stuart Welburn or Branwen Buckley.

## Questions a Potential Independent Director Should Ask About Directors & Officers Liability Insurance *Before* Joining the Board

***By Alan F. Berliner***

### Introduction

Directors and officers (D&O) liability insurance policies offer unique insurance coverage options and present a variety of atypical and sometimes unanticipated issues. Since a company purchases the D&O insurance, many directors do not realize what gaps may exist in the protections they expect to receive. This article explores many of the issues a potential director should consider with regard to a company's D&O insurance policy before joining its board of directors.

First, some basics. The primary concern of a potential director is whether the company's D&O insurance will cover not only his or her liability, if any, but also the legal defense costs if a claim is made against him or her. This is "Side A" coverage. "Side B" coverage refers to amounts the insurance carrier (hereinafter, "carrier") would pay to the company as reimbursement for indemnification paid by the company to its directors and officers. Lastly, "Side C" coverage protects the company for liability the company itself may have in the event of a claim.

A significant difference between D&O insurance and most other insurance policies is that defense fees and other costs covered by the D&O policy are charged against the policy limits. Legal expenses can, and often do, exceed policy limits, leaving the insureds to fund their additional defense fees and costs themselves, including any settlement costs.

Following are select questions a prospective director should consider asking before becoming a board member:

- The first question to ask is whether the company has D&O liability insurance. If not, you should reconsider taking the board position.

- If there is D&O liability insurance with Side A coverage, does the company have coverage for both reimbursement to the directors' and the company's own liability, i.e., Sides B and C coverages? This will help define if they are properly protected.

- Since defense costs can be substantial, even if there is no liability or significant risk of liability, how does the carrier pay defense costs? Unlike most liability insurance policies, a D&O policy does not require the carrier to provide a defense, even for covered claims; the carrier pays the cost of defense. Does the carrier advance the defense costs and expenses or only reimburse them? Similarly, if the corporate bylaws provide for indemnification, do they require the corporation to advance defense fees and costs to the director? Or do the bylaws only provide for reimbursement?

- Who selects the defense counsel? May the insureds choose counsel without the carrier's consent? Or will the insureds be required to use whomever the carrier chooses?

- What is the amount of coverage? What is the single limit for each claim and all claims in the aggregate? Are there separate sub-limits for some coverages? How likely is it that potential liability and defense costs will exceed the coverage amount in the event of a claim?

- D&O policies typically provide that the carrier will pay all loss for which the insureds become legally obligated to pay on account of a claim for a wrongful act. Are criminal, administrative and regulatory proceedings covered?

- The self-insured retention in a D&O liability policy is often a significant sum, for example, $50,000 or $100,000. Ask how much it is, and, if a claim is made, will the corporation pay

that retention before the D&O coverage kicks in?

- A D&O policy generally covers only claims made during the policy period unless expressly agreed otherwise. Have there been other claims that may use up part of the coverage? If so, will there be enough coverage left once those claims are resolved? How did the carrier handle the claim and the defense? Were they cooperative and helpful?

- Are you covered for claims made after the policy expires, and if so, for how long? Is there additional cost? Is it paid for in advance by the company? What about coverage after you leave the board?

- How are defense costs allocated among various insureds and/or sets of insureds? If there is Side C coverage and the company itself is insured for direct liability to a third party, is there any methodology specified for allocation of defense costs between the company and individual insureds?

- With regard to potential settlements, will all funds remaining in the policy, up to the unused limits, be utilized to settle a claim against one insured or one set of insureds to the exclusion of the others? This would leave some insureds uninsured.

- These policies generally provide that the carrier must consent to a settlement. Does the policy also require all insureds to consent to a settlement? Can consent by the carrier or the other insureds be withheld under any circumstances? Or is it limited to situations where consent cannot be unreasonably withheld?

- Is the carrier financially strong and highly rated by an agency such as A.M. Best? If there is an excess carrier and the primary carrier becomes insolvent, will the excess carrier pick up coverage?

- How are the indemnification provisions tied in with applicable law and the corporation's bylaws? What does the applicable state law provide for indemnification, and, if the bylaws are different, do they provide for maximum indemnification? If so, is it mandatory or discretionary?

- If there are misrepresentations in the policy application, does the carrier have the right to rescind the policy against all insureds, or only against the person who made the misrepresentations and/or the company itself? Similarly, if financial statements were in error and need to be restated, can coverage for all insureds be denied? Further, if there is a misrepresentation in the application and other insureds had knowledge that the representation was false, is there coverage for those insureds who did not have knowledge of the misrepresentation?

- These are just a few of the key, important questions you should ask prior to joining a board to ensure proper coverage. There are also questions regarding, for example, "Insured v. Insured" exclusions and other aspects to examine. Our lawyers have extensive experience in guiding and advising individuals on these complex issues to consider prior to joining a company's board of directors.

**Conclusion**

A prospective independent director should have a thorough understanding of the company's D&O insurance coverage before agreeing to serve. The time to look at these issues and ask questions is before joining a board of directors. Once a claim is made, the policy controls and directors may not be protected as they imagined or desired.

For more information about D&O liability insurance, contact Alan F. Berliner.

# Mergers & Acquisitions

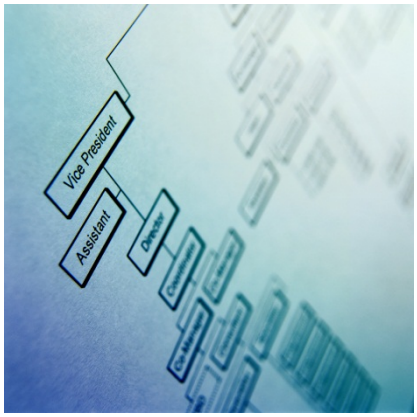
## Transition Services Agreements in M&A Transactions – Tips for Buyers

***By Corby J. Baumann***

Many acquisitions involve the seller and its affiliates providing services to the buyer and its affiliates for a limited period of time after the transaction closes in order to transition the business being acquired. These transition services arrangements vary greatly in scope and duration of services provided. For example, an acquisition of a business currently operated as a division of a larger entity may require fairly extensive transition services, while the acquisition of a stand-alone entity may not require any transition services.

The provision of transition services may directly impact the buyer's ability to properly run the acquired business post-closing. In the event the seller fails to provide services (or fails to provide a certain level of services), the buyer in an M&A transaction may be left with remedies that do not adequately address the impact of such a failure. For instance, many transition services agreements provide that an aggrieved party may seek to arbitrate a dispute or sue the other party. As transition services are intended to be temporary and often do not involve the payment of a substantial amount of fees, the buyer is not likely to want to arbitrate or sue to enforce its rights under a transition services agreement. This may leave the buyer with a significant amount of risk regarding the seller's services.

The buyer may be much more willing to accept this risk if it has internal resources to address any gaps in the services provided by the seller. In some instances, the buyer may wish to engage a third party to provide certain services (such as an IT consultant or accounting firm) rather than relying on the seller's services. However, the buyer may lack access to internal resources or timing may dictate that such services cannot be adequately provided without significant involvement by the seller. In deals requiring transition services, it is possible for the buyer to address some of the risk inherent in a transition services agreement through advanced planning and preparation prior to the closing of the transaction.




- ***Identify Scope of Services.*** The buyer should begin to identify the types and nature of transition services it will need while conducting due diligence on the business to be acquired. As part of due diligence, any intercompany or affiliate arrangements should be identified and the buyer should inquire as to what services (if any) the acquired business receives from affiliates. In addition, if the acquired business is a division, the buyer should request information from the seller regarding the resources of the overall enterprise that are allocated to the business that is to be acquired, including human resources, finance and accounting, information technology, logistics/purchasing and payroll services. Cost allocation information is also helpful in determining what to charge for transition services.

- ***Integration Planning.*** Transition services arrangements will be a key component in the buyer's integration planning. To ensure a smooth transition, begin planning early. Identify and appoint specific individuals to lead the transition efforts for each key area of services and identify the individuals at the seller who will be responsible for those areas. Regularly scheduled meetings or conference calls between the integration teams will allow for discussion of any issues and adequate closing preparation.

- ***Third Party Services.*** Services currently provided to the acquired business by a third party need to be identified, as these services may require additional time to transition. For example, if

the acquired business currently uses a third party payroll administrator, the administrator will need to be notified in advance of closing to ensure payroll processing occurs without interruption. The acquired business may also need to enter into new agreements with some third party providers if the services provided prior to the closing were under umbrella agreements covering multiple businesses, not just the acquired business.

- ***Contractual Limitations.*** The buyer should identify contractual limitations related to services provided to the acquired business. As noted above, certain services may have been provided under umbrella agreements and will need to be separated into different contracts. Contracts may allow for the provision of services to multiple parties while those parties are considered affiliates, but may not allow for multiple parties to use the services once there is no longer an affiliate relationship. Additionally, the buyer will want to identify any contracts that have restrictions on the use of third parties for services or any confidentiality restrictions that would prohibit a buyer from sharing with the seller information that is necessary to the provision of the services.

- ***Licensing Arrangements*.** The use of intellectual property may be covered by a licensing agreement rather than a transition services agreement. If the transition services required are not extensive and primarily relate to intellectual property, the parties should consider whether licensing or other arrangements may be put in place rather than negotiating a separate transition services agreement.

- ***Employee Matters*.** Special consideration should be given to employee-related matters as these items may require significant lead time. Employees may need to formally change employers as part of the transaction and may need to modify existing insurance or benefits arrangements or obtain new coverage. The full extent of employee matters that may be impacted is beyond the scope of this article; however, as part of its due diligence, the buyer should identify and begin to assess what changes may be necessary to transition the employees of the acquired business at closing.

Carefully identifying the scope and nature of services to be provided and planning in advance for the transition enable a buyer to assert more control over the integration process and recognize obstacles prior to closing. By thinking about transition services from the initial stages of due diligence, the buyer can better prepare to effectively transition the acquired business at closing and to continue operating the business in the same manner in which it operated prior to its acquisition.

For more information about transition services arrangements or M&A transactions, please contact Corby J. Baumann in Thompson Hine's New York office.

# Health Care Reform

## What CFOs Need to Know About Health Care Reform

***By Julia Ann Love***

The Supreme Court did not overturn the Patient Protection and Affordable Care Act, President Obama won re-election and the Mayan calendar did not accurately predict the end of the world, so health care reform is here to stay … and it's time to determine the impact on your organization.

**Pay or Play Mandate**

Beginning in 2014, all applicable large employers (generally employers with 50 or more full-time equivalent employees) must offer substantially all full-time employees and their dependent children group health plan coverage or risk being subject to a penalty for failure to offer coverage.

If an applicable large employer offers no group health plan coverage *and* any of the employer's full-time employees purchase insurance through a state exchange *and* receive a premium tax credit or cost-sharing subsidy, the employer is liable for a penalty in an amount equal to $2,000 times the employer's number of full-time employees, less 30.

If an applicable large employer offers group health plan coverage that is either unaffordable or fails to offer minimum value *and* any of the employer's full-time employees purchase insurance through a state exchange *and* receive a premium tax credit or cost-sharing subsidy, the employer is liable for a penalty in an amount equal to $3,000 times the number of full-time employees who purchase coverage through a state exchange and receive a premium tax credit or cost-sharing subsidy. This penalty is capped at the amount of the penalty the employer would be required to pay if the employer failed to offer any group health plan coverage ($2,000 times the number of the employer's full-time employees, less 30).

Employers subject to the pay or play mandate should already be evaluating the following options:

- Not offering group health plan benefits to employees. Of course, assessing the cost of ceasing to provide group health plan benefits when those benefits have been provided in the past (and may continue to be offered by other employers with whom the employer competes for talent) requires looking at more than the bottom line net result when the employer's cost of providing those benefits is eliminated in exchange for payment of the applicable penalty.

- Offering group health plan coverage that is both affordable for substantially all full-time employees and offers minimum value. If your group health benefits already meet the affordability and minimum value standards, there is no change in cost, but be sure to assess "affordability" and "minimum value" under the guidance issued to date (as well as future guidance).

- Offering group health plan coverage that either is not affordable for some or all full-time employees or does not provide minimum value. Determining the cost of this option will involve estimating the number of premium tax credit-eligible employees who will purchase health coverage through the exchange (an estimate that may not be easily calculated).

**Transitional Reinsurance Contributions**

Starting in 2014, sponsors of group health plans will also be on the hook for Transitional Reinsurance Contributions. Transitional Reinsurance Contributions are intended to stabilize the individual market during the first three years of operation of state health insurance exchanges by easing the burden of high-cost cases on exchange insurers that may result from adverse selection.

Transitional Reinsurance Contributions are expected to be in the neighborhood of $63 per covered life in 2014 and some lesser amount per covered life in 2015 and 2016, depending on the stability of the state exchanges in those years.

Transitional Reinsurance Contributions are paid by third party administrators (TPAs) of self-insured group health plans, but ultimately the plan sponsor is responsible for the contributions. For fully insured group health plans, the insurer is liable for Transitional Reinsurance Contributions. The contributions may be paid from plan assets and are tax deductible.

As set forth in proposed regulations, to determine a group health plan's liability for Transitional Reinsurance Contributions, the TPA or insurer must report the number of covered lives to HHS by November 15 of each year. HHS will then notify the TPA or insurer of the contribution amount by December 15, and the TPA or insurer must pay the Transitional Reinsurance Contribution within 30 days of the receipt of the notice from HHS.

The proposed regulations describe included and excluded group health plan benefits and provide various acceptable methodologies for determining covered lives for purposes of calculating this contribution.

**PCORI Fee**

In addition to the Transitional Reinsurance Contribution, sponsors of self-insured group health plans and insurers of fully insured group health plans are required to pay a Patient-Centered Outcomes Research Institute (PCORI) fee for the 2012 – 2018 plan years. This fee funds a trust to be established by the federal government to fund research to assist patients, clinicians, purchasers and policymakers in making informed health decisions. The fund will work to advance the quality and relevance of evidence concerning how diseases, disorders and other health conditions can effectively and appropriately be prevented, diagnosed, treated, monitored and managed.

The fee is equal to $1 per covered life in 2012, $2 per covered life in 2013 and $2 per covered life plus an adjustment for medical inflation for 2014 through 2018. The fee, paid via an IRS Form 720 filing, is due by July 31 of the calendar year following the plan year for which it is payable. Notably, unlike the Transitional Reinsurance Contribution, the fee may not be paid from plan assets and is not tax deductible.

Final regulations describe included and excluded group health plan benefits and various acceptable methodologies for determining covered lives. While this guidance is very similar to the guidance in the Transitional Reinsurance Contribution regulations, there are several distinctions that must be taken into account.

Each of these health care reform mandates comes at a cost for employers, both in the dollars spent on the fees, contributions and penalties and on the resources needed to determine the employer's obligations. Complicating the analysis is the fact that we are awaiting additional guidance, particularly with respect to the Transitional Reinsurance Contribution and the pay or play mandate, which could bring additional changes.

For more information about group health plan coverage and the Patient Protection and Affordable Care Act, contact Julia Ann Love or any of Thompson Hine's employee benefits attorneys.