



Counsel for
BOARD AND EXECUTIVES

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Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives. Acredula is available to clients and friends of the firm. It is not to be construed as legal advice or opinion.

The "Great Ham Theory" of Executive Compensation

Michael J. O'Sullivan, a Los Angeles attorney and author of the blog, ProvidedHowever.com, has advocated the "great ham theory" of executive compensation. O'Sullivan's Provided-However view is similar to the tongue-in-cheek humor of Will Rogers or Mark Twain that has an underlying message. The underlying message of the great ham theory is that compensation committees often reward executives who make themselves appear indispensable to the organization.

O'Sullivan derives his great ham theory from Warren Buffett who "supposedly once described a particular company's business as being so good that even a ham sandwich could run it." According to O'Sullivan, "[t]his suggests a different approach to executive compensation: the Great Ham Theory. Under this theory, we'd reward EGQu y j q" o c f g" v j g o u g n x g u" u w r g t f w q w u" c p f" punish those who persisted in making themselves essential." For his entire view, see <http://www.providedhowever.com/blog/2009/05/the-great-man-theory>.

In determining compensation, compensation committees should consider an executive's efforts in planning for his or her succession. Stewardship is one of the most important duties of any

executive, and encouraging stewardship is one of the most important duties of any governing board.

This brings us to the last of our series of articles on executive compensation. Although SERPs exist in a variety of forms for a variety of purposes, a SERP or supplemental retention or retirement plan can be a reward for stewardship. This issue's article on SERPs will hopefully serve as a guide for consideration of the correct form and purpose.

This issue also includes a timely article by Gordon Litt on recent remarks of the IRS Commissioner on the importance of involving boards of directors in overseeing corporate tax risks and strategies. Although the Commissioner warns he is only expressing his own view, we would not be surprised to see v j k u" x k g y" t g f g e v" g x g p v w c m n { " k p" V t g c u w t { " t g i w n c- v k q p u" c h h g e v k p i" u { u v g o k e" t k u m u" k p" v j g" L p c p e k c n" industry and the governance initiatives for tax-exempt organizations.

Finally, this issue includes an article by Kevin Kinross on a director's fiduciary duty on behalf of an Ohio corporation in the zone of insolvency.



EDITOR'S NOTE

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SERPs: Supplement Executive Retirement or Retention Plans

By
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NOTE: A glossary of the terms used in this and future articles on executive compensation are contained in the July 2009 issue of Acredula and are also available at <http://www.bricker.com/legalservices/practice/deferredcomp/glossary.aspx>.

A supplemental executive retirement plan or supplemental executive retention plan (SERP) is an arrangement providing retirement or retention or regular compensation to which the employee is otherwise entitled. The arrangement is typically limited to a select group of management or highly compensated employees (i.e., a “top-hat employee”).

SERPs exist in a variety of forms for a variety of purposes. The purpose of this article is to facilitate consideration of the relevant factors for the design of an appropriate SERP.

Retirement or Retention. They may be for purposes of retirement or retention for a period of time.

A *retirement SERP* supplements a top-hat employee remains in service until retirement (or another defined “triggering” severance such as normal retirement, death or disability). A “restorative” SERP is a common form of deferred compensation to a top-hat employee who is not entitled because of the limitations on highly-compensation SERPs may be a defined-benefit, defined-contribution, cash-balance or target-benefit arrangement as discussed below.

A *retention SERP* provides a cash award, typically in the form of a bonus, to a top-hat employee for remaining in service for a number

of years that is not based upon retirement. Most

Defined-Benefit, Defined-Contribution, Cash-Balance or Target-Benefit Arrangement. SERPs

typically, an amount based upon an employee’s compensation or a combination of compensation and years of service and for which the employer bears the investment risk. A common form upon retirement in the form of an annuity that, when added to the employee’s projected qualified pension will equal a percentage, such as 60 percent, of the employee’s projected pension.

A *retention SERP* provides for (i) an individual account for the employee and (ii) to the employee’s account and any income, expenses, gains and losses for which the employee bears the investment risk. A common form of *retention SERP* provides a contribution of periodic contributions, typically annually, to an individual account that is invested until the employee has a triggering severance (typically, normal retirement, death or disability), at which time the employee receives the account in lump sum.

A *ecuj dncpeg* SERP has characteristics of a cash credit, such as a percent of his or her compensation over the years of participation or other period, and an

included in the gross income and reported as wages of an employee for purposes of federal employment taxes, including Social Security and Medicare taxes, as of the later of when the underlying service is performed or when there is no substantial risk of forfeiture. Some SERPs are designed to require an advanced payment of employment taxes required to be withheld, and by the amount of the advanced payment.

Additional limitation applicable to SERPs of tax-exempt and government organizations.

Unlike employees of taxable organizations whose compensation of employees of tax-exempt and government organizations is includible for federal the compensation is not subject to a substantial risk of forfeiture. A SERP for an employee of a tax-exempt or government organization is typically designed to require the employee's service through the last day of the service period, for a retention SERP, or until retirement (or another triggering severance such as death or disability) for a retirement SERP. If the employee's service is terminated before the last day of such period or other than by a triggering severance, the employee typically

Limitation desired by some governance commentators. Some governance commentators dislike SERPs other than restorative arrangements the employee is not entitled because of the limita-

Internal Revenue Code on highly-compensated a policy of the Council for Institutional Investors is that a SERP should only be an extension of the retirement program covering other employees or, in other words, a restorative arrangement. Compensation committees should not be so limited as in determining total compensation and nothing excessive is hidden.

Limitation announced by Treasury and the Special Executive Compensation Master.

On October 22, 2009, Treasury and the Special Executive Compensation Master for companies receive TARP funds issues rulings requiring governing boards to (i) "ascertain the full amount of pay an executive will receive upon retirement," including performance to the extent that it provides more than employee is not entitled because of the limitations compensation employees.

A properly designed SERP can not only attract and retain a highly-compensated employee important to the organization but also can facilitate a transition by the employee after a period of service or upon retirement.

Hqt" swgukqpu" tgi ctfkpi" vjgug" vgtou." rncug" eqpvcev" Lqjp" R0" Dgcxgtu" cv" 836044904583" qt" cv" ldgcxgtu B dtkemgt0eqo0

What Happens When Your Organization is 'In the Zone?'

In a troubled economy where businesses are struggling to survive, it is no surprise that many insolvent. Directors of insolvent or nearly insolvent organizations are facing the question of to whom they owe their duty of loyalty, and whose best interest must they consider when making decisions. When in the zone of insolvency, directors still owe a duty to stakeholders to act in their best

interests. Judicial decisions in some jurisdictions, however, have suggested that when an organization is insolvent or in the "zone of insolvency," the organization's creditors as well.

Ohio courts have not decided whether directors of an insolvent or nearly insolvent corporation owe



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Federal courts applying Ohio law, however, have held that directors owe no such duty to creditors. The cases, discussed below, rely on Ohio Rev. Code § 1701.59 to reach their conclusions. Rev. Code § 1701.59(B) imposes a duty on a director to act in good faith and in a manner that he believes is in or not opposed to the best interests of the corporation. Section 1701.59(E) explains the factors a director may take into consideration when performing his duty:

(E) For purposes of this section, a director, in determining what the director reasonably believes to be in the best interests of the corporation, **shall consider the interests of the corporation’s shareholders** and, **in the director’s discretion, may consider** any of the following:

- (1) The interests of the corporation’s employees, suppliers, **creditors**, and customers

Ohio Rev. Code § 1701.59(E) (emphasis added). The most significant language is the distinction between the mandatory consideration (the interests of the shareholders) and the permissive considerations (which include the interests of the corporation’s creditors).

In *QhLekcn"Eqo okvvgg"qh"Wpugewtgf"Etgfkvqtu"qh"RJF."kpel"xl"Dcpm"Qpg*, the District Court for the Northern District of Ohio granted a director’s motion to dismiss and found that the director of an insolvent corporation *qygf"pq"Lfwekct{"fww{"vq"vjg"eqtrqtc-tion’s creditors*. The Committee argued that upon PHD’s insolvency, the director owed a duty of care to PHD’s unsecured creditors. The Committee further argued that he breached this duty by *hcknkpi"vq"hwLmn"jku"tgu"rpukdknkvgu"cu"cdirector*, failing to prevent others from making misrepresentations to PHD’s creditors, and failing to mitigate the effect of others’ misrepresentations to the creditors.

The court disagreed. It focused on the word “may” § 1701.59(E) and determined that there was no indication that the legislature intended that consideration of creditors’ interests was anything other than permissive. The court denied the motion for reconsideration as to the dismissal of the Com-
o kvvgou"enck o u"hqt"dtgcej"qh"Lfwekct{"fww{"qygf"

to the creditors. The court explained, “because *Qjkq"uvcvwwqt{"hc y"gzrnkekvn{"fgLpgu"vjg"fwkqu"qh"directors of a corporation, and because that explicit fgLpkvkqp"fggu"pqv"tgs wktg"fk tgevqtu"vq"eqpukfgt"vjg"interests of creditors, there is pq"Lfwekct{"fww{"owed by directors to creditors, regardless of the Lpcpekcn"uvcvg"qh"vjg"eqtrqtcvkqp."*

The court granted the motion for reconsideration as to dismissal of the Committee’s claims that the *fk tgevqtu" dtgcej" g" v jgt" Lfwekct {" fwwkqu" vq" the corporation* because none of the parties had moved to dismiss those claims, so the court’s dismissal of those claims was clear error. This distinction *enckLgu"vjg"eqwtvau"dgkngh"vjcv"wpfgt"Qjkq"hc y."gxgp"fwtkpi"kpukxgpe{"fktgevqtu"fq"pq"qyg"Lfwekct{"duties to a corporation’s creditors. However, the creditors of an insolvent corporation may bring a enck o "hqt"dtgcej"qh"Lfwekct {"fww{"vq"vjg"eqtrqtc-tion itself.*

In *Kp"tg"Coecw"kpfwuvtkn"Eqtr0*, the bankruptcy court took a similar approach and reached the same *eqpenwukqp."vjcv"qhLegtu"cpf"fk tgevqtu"fq"pq"qyg" c"Lfwekct {"fww{"vq" c"eqtrqtcvkqpau"etgfkvqtu"gxgp"if the corporation is insolvent or in the zone of insolvency. There, the court concluded:*

The plain language of Ohio Rev. Code È' 392307; *G+"enckLgu"vjcv" c" fktgevqt" jcu" discretion to consider many constituencies of the corporate enterprise, including creditors, when making corporate decisions. However, a director has no distinct legal obligation directly to creditors, separate from the corporate entity as a whole, even when a corporation has reached the point of insolvency.

Thus, the court found that Ohio law does not *k o rqug" c" Lfwekct {"fww {"qp"fk tgevqtu"vq" c"eqtrqtc-tion’s creditors* when the corporation is insolvent or nearly insolvent.

While not controlling on Ohio courts, *Dcpm"Qpg* and *Coecw" o c {"dg"kp l wgpvkn"qp"vjg"kuuwg"dgecwug"vjg {"tg l gev"tgcuqpcdn" c r rnkcevku"qh" Tgx0"Eqfg" § 1701.59(E).*

Ohio state courts have not determined the issue, but the Supreme Court of Delaware recently analyzed it in detail in *Pcvkqpcn"Cogtkecp"Ec vjqnke" Gfwecvkqpcn"Rtqi tco okpi" Hqwpfcvkqp."kpel" xl" Ijggycmc*. Because Ohio case law is silent on the subject, an Ohio court might consider a

Federal courts applying Ohio law, however, have held that directors owe no such duty to creditors.

Delaware business law case as persuasive authority. In *Ijggycmc*, the plaintiff was a creditor of Clearwire Holdings, Inc. The defendants were directors of Clearwire while it was either insolvent or in the zone of insolvency. The plaintiff alleged they owed to the plaintiff as a creditor.

Vjg"Uwrtg o g"Eqwv"chLt o g f"vjg"Ej cpegt {"Eqwv" fgekukqp"vq" fku o kuu"vjg"eq o rncpv"Kv"Łtuv"jgnf."öpq" fktgev"enck o" hqt"dtgcej"qh"Łfwekt {"fwvku" o c {"dg" asserted by the creditors of a solvent corporation that is operating in the zone of insolvency." The court reasoned that creditors, unlike shareholders,

have contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, commercial law, and other sources of creditor rights to protect them. It concluded that a corporation in the zone of insolvency is most in need of effective and proactive leadership and the ability to negotiate ykvj" etgfvkvtu=" c" fktgev" Łfwekt {"fwv {" cause of action for creditors likely would undermine these goals. Finally, when in the zone of insolvency, the court stated

that the focus for directors does not change; they must continue to exercise their business judgment in vjg"dguv"kpvtgguv"qh"vjg"eqt rqtcvkqp" hqt"vjg"dgpgŁv"qh" the shareholders. For all of these reasons, the court refused to allow creditors to bring direct claims for dtgcej"qh"Łfwekt {"fwv {"

Second, the Supreme Court held, "individual etgfvkvtu of an kpuvixgpv corporation have pq"tkij"vq" cuugt"v" fktgev" enck o u" hqt" dtgcej" qh" Łfwekt {"fwv {" against corporate directors." (emphasis by court). The court noted that when a corporation is insolvent, creditors take the place of shareholders as

dgpgŁekctkgu"qh"cp"kpetgcug"kp"xcnwg."uq"etgfvkvtu"qh" an insolvent corporation have standing to maintain fgtkxcvkg claims on behalf of the corporation for dtgcej"gu"qh"Łfwekt {"fwvku" J qy xgt."vq"Łpf"vjcv" fktgevvtu"qyg"Łfwekt {"fwvku" fktgevn {"vq"etgfvkvtu" "would create uncertainty for directors who have a Łfwekt {"fwv {"vq"gztekg"vjgkt"dwukpguu"lwf i o gpv" in the best interest of the insolvent corporation." Kv" cnuq" yqwnf" eqp lkev" ykvj"vjg" fktgevvtu"fwv {"vq" maximize the value of the insolvent corporation hqt"vjg"dgpgŁv"qh"cn"vjqug" ykvj"cp"kpvtgguv"kp"kv" Therefore, while creditors of an insolvent corporation may bring a fgtkxcvkg action against the fktgevvtu" hqt" dtgcej" qh" Łfwekt {"fwv {"vjg {"ecppqv" bring a direct action because the directors owe no Łfwekt {"fwv {"vq"vjg"etgfvkvtu

Given the vast experience of Delaware courts with business and corporate law matters, Ohio state courts may well see *Ijggycmc* as persuasive on the issue. Furthermore, as the federal courts explained in *Coecw* and *Dcpm"Qpg*, the plain language of Rev. Eqfg"È"392307; *G+uwv rqtvu" c"Łpfkpi"vjcv" fktgevvtu" fq"pqv"qyg" c"Łfwekt {"fwv {"vq"vjg"eqt rqtcvkqp" etgfvkvtu"tgictfnguu"qh"vjg"eqt rqtcvkqp"Łpcepekcn" state. This is especially true given that the statute expressly makes the consideration of shareholders' interests mandatory but makes consideration of creditors' interests permissive. Thus, we can say that Ohio law probably does not impose on eqt rqtcvg" fktgevvtu" c" Łfwekt {"fwv {"vq"vjg"eqt rqtcvkqp" tion's creditors when the corporation is insolvent or nearly insolvent. Still, with no Ohio case on point, it is impossible to conclude with certainty.

Kh" {qw" jcxg" cp {"swgukqpu." rncug" eqpvcev" Mgxp" O" Mkpqtqu" cv" 83604490) : 46"qt" mmkptqu B dtkemgt0 eqo

Ohio law probably does not impose on corporate directors a fiduciary duty to the corporation's creditors when the corporation is insolvent or nearly insolvent.

IRS Commissioner Addresses Corporate Governance Conference Regarding Managing Tax Risks

Internal Revenue Service (IRS) Commissioner Douglas H. Shulman addressed the 2009 National Association of Corporate Directors Conference on October 19, 2009. In his remarks, Commissioner Shulman discussed the importance of involving

boards of directors in overseeing corporate tax risks and strategies. His emphasis was to offer attendees a number of suggestions for managing task risks and FIN 48 compliance. (FIN 48 establishes vjg"Łpcepekcn"uvcvg o gpv"ceeqvpvki" hqt" wpegvckp"vcz"



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positions, including recognizing and measuring

Shulman suggests, as part of board members' ongoing corporate responsibilities, that boards of directors implement a mechanism to oversee tax risks. According to Shulman, boards should consider the following actions:

1. Position and review major tax positions.

2. Tax departments by engaging an independent the board of directors.

3. Contributions made in those jurisdictions.

In his speech, Shulman also discussed FIN 48 risk, liability and management in your company." He recommended that boards consider asking their tax director and external auditors the following questions relating to FIN 48 compliance:

4. Tax positions and how do you know all material

5. Quarterly tax exposure relating to each uncertain tax

6. Do you plan to litigate the issue if the IRS or tax advisor agree with the tax director's

7. Penalties, such as for underpayment of tax, what does this say about how aggressive the

Shulman emphasized that taxes are no different than any other large expense in that responsible management should try to control it, he stated. However, Shulman reminded the audience that, "In the case of taxes, controlling it can expose the company to challenge, which can result in reputational damage and perhaps large, unexpected expenses."

His recommendation is that boards need to have a close understanding of how their management has chosen to control the tax expense, and how aggressive they have decided to be. In addition, reporting must be effective. Shulman concludes by stating that as with any expense, "Manage it (taxes) too aggressively and there are bad consequences."

8. "Manage it (taxes) too aggressively and there are bad consequences."

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