



Counsel for  
BOARD AND EXECUTIVES

# Acredula®



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**A**credula 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.

## Independent Boards Help Businesses Avoid and Resolve Conflict

This issue of *Acredula* focuses on avoiding and, if unsuccessful, resolving business conflicts among owners of closely held businesses.

Although the article discusses several different mechanisms, the best way to avoid or resolve a conflict is governance by an independent governing board or, where appropriately structured, an advisory board.

One of my early clients tried this with his two sons. He formed a corporation, appropriately named "Push and Shove Corporation," and subjected both sons to

the overall authority of a statutory governing board composed of the two sons and the parents. Push and Shove was successful in avoiding unresolvable conflicts until the parents were no longer able to actively participate.

A better example is an architectural firm that has successfully succeeded through two generations of owners who were family members and a third and soon to be a fourth generation of owners who are non-family members. The architectural firm succeeded in avoiding unresolvable conflicts because it followed the corporate formalities of being directed by a governing board that had at least two independent members. Because of the presence of independent board members elected by the owners, the board met both of the tests for a mechanism to successfully avoid or resolve conflicts: The board appeared to favor no one over the other in any conflict, and there was a chilling effect of having any matter resolved by the board for reason that, because of the independence of the independent members, no one could predict the outcome.

Another example is a manufacturing firm that successfully succeeded through five genera-



### EDITOR'S NOTE

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tions of owners who were family members. The first generation of owners consisted of two brothers. The second generation consisted of the children of one of the brothers. The third, fourth and fifth generations were children of those children. The business succeeded through each genera-

tion because the owners also followed the corporate formalities of being directed by a governing board that had independent members. This included a cradle-to-grave life cycle from being managed by the family as the executive officers, to being managed by outside or professional managers, and finally to being sold to a publicly held corporation.

Although each of my examples involved a statutory governing board, a non-statutory or advisory board can accomplish the same result if the owners and the advisory board members agree at the outset that any conflict will be resolved by majority vote of the advisory board and that the owners will be bound by that resolution. An excellent resource for learning about or establishing an advisory board is *Business First's* Advisory Board Exchange. Information can be found at [www.advisoryboardexchange.com](http://www.advisoryboardexchange.com) or by calling 614.461.4040.

# Ways to Avoid and, if Unsuccessful, Resolve Conflicts with Your Business Partners

By  
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The surest reason for a failed partnership is lack of mutuality.

One of my areas of practice that occurred more by happenstance than by design is working with business partners at the beginning of their relationship to avoid and, if unsuccessful, to resolve business disputes.

When first beginning practice, my firm sent me to form a business partnership among three, first-generation Italians whose ages ranged from 50 to 60. The senior brother spoke on behalf of the others: “The most important provision in the partnership agreement is some event in which each of us has an equal chance of winning, but that can have a draconian result that forces us to agree.”

And they asked “Do you have any ideas?” When I gawked rather than responding with any idea, the senior brother continued:

In the old country we used a coin flip. If the loser doesn't accept the resolution, he has to sell at a predetermined discount. Business partners fight when they don't trust each other; brothers fight each other all the time. So we will disagree, and when we do we'll likely have three different opinions.

So we need something that forces us to agree. When you write this, remember you represent the family and not any one of us.

The provision can favor no one of us.

With their help, I drafted such a provision. The brothers argued; they fought; but none of them ever risked the coin flip.

Most importantly, I learned from that early meeting that:

- Most business disagreements occur because of a lack of trust. When business partners lack trust, they fight in the same way family members do when trust is abused; and
- For resolution of a conflict, (1) the method cannot favor one over the others and (2) the result has to include enough of a chilling or draconian effect to cause parties to agree rather than risk disagreement.

As I learned from my three clients, the Italian brothers, we can learn from business experiences of others. The following are some publicly reported failed business ventures from which we can learn.

## Lack of Mutuality

### Do all the business owners need each other?

The surest reason for a failed partnership is lack of mutuality. A reported example is Ford's and Volkswagen's partnership to manufacture, sell, and service luxury vans in Portugal. Having introduced economy vans in Spain through a French subsidiary, Ford decided that it could manufacture, sell, and service the vans directly through its French subsidiary without Volkswagen. Ford withdrew, leaving Volkswagen with virtually no return on its investment.

Due diligence by each party on the other is essential to any partnership. The Ford-Volkswagen partnership is an example where due diligence by Volkswagen to understand Ford's perspective for the business and the relation of that business with Ford's other business interests may have avoided a bad business deal on the part of Volkswagen.

In the partnership agreement between Ford and Volkswagen, some provisions that may have helped to avoid costly litigation include:

- **Window to withdraw provision.** The window to withdraw is typically from three to six months, within the first year or two of the organization during which either organization owner may withdraw. Most failures in mutuality become apparent to the organization owners rather quickly. If none of the organization owners elects to withdraw during the window, the term continues and there is a breakup fee or penalty to withdraw.
- **A put/call option provision.** This option is exercisable, typically after an initial period, by any organization owner's request that the other owner set a price at which the requesting owner has the option to either sell its interest or buy the other owner's interest. As long as the organization owners have the financial means to buy or sell, the put/call option generally encourages them to resolve disputes because the result of the option, if triggered, is never certain.
- **A break-up fee provision.** This fee is similar to break-up fees in mergers and acquisitions. It must be paid by the owner that elects to withdraw, within a defined period from the

beginning of the organization. The break-up fee is a form of liquidated damages to the other organization owner.

- **Coin flip provision.** In this provision, the owners agree to resolve disputes by a coin flip. The *in terrorem* affect of resolving any major decision by a coin flip typically causes reasonable business minds to avoid deadlocking disputes.

## Competing Interests

**Can competing interests between the organization and each of the organization owners be eliminated?**

An example is a partnership between IBM, Apple, and Motorola to create a new PC chip to compete with Intel and Microsoft. IBM was so embedded with Intel chips that the management of IBM's PC division viewed the organization as a competitor. IBM eventually withdrew.

Some provisions that may have avoided the withdrawal of IBM include:

- **Covenants protecting organization property.** These covenants provide that property developed or purchased by the organization belongs exclusively to the organization and may be used only for organization purposes. They also require that care be taken to protect the proprietary and confidential nature of all property that is proprietary or confidential to the company and all ideas claimed to be novel.
- **Covenants protecting organization opportunity.** These covenants prohibit competition with business activities of the organization; diversion of business away from the organization; and interference with the organization's relationships with employees, customers, or suppliers.

The more successful covenants do not give the injured owner the right to enjoin the competing interest, but instead allow the injured owner to terminate the organization and receive liquidated damages akin to a break-up fee from the owner with the competing interests. IBM may have avoided entering into the partnership with Apple and Motorola if the partnership arrangement had included a covenant giving Apple and Motorola, the injured owners, liquidated damages for IBM's withdrawal.

## Dedicating Resources

**Will resources be dedicated exclusively to the organization or be divided between the organization and the contributing organization owner?**

An example is Intel's and SAP's joint venture known as Pendescic. Sales for Pendescic were

supervised by managers of Intel and SAP who were simultaneously engaged in sales for Intel and SAP, respectively. Because these key resources were divided rather than dedicated to the joint venture, they focused on the sales of their own products instead of the joint venture's products.

In their joint venture arrangement, Intel and SAP should have considered having a requirement that both venturers, as owners with respect to their own businesses, are required to act in good faith in the best interest or not opposed to the best interest of the joint venture. Although most corporate and limited liability company law imposes a *duty of loyalty* on a corporation's directors and officers or an LLC's managers, owners typically are not subject to such a duty unless created contractually. Contractually providing duties of loyalty on the part of owners may produce a chilling effect on an owner that might otherwise be disloyal or may compensate the owner harmed by the disloyalty.

Any provision requiring a duty of loyalty of owners should also include remedies for breach of the duty. For this purpose, consider:

- Giving the injured owner the right to enjoin the disloyal act; and
- Allowing the injured owner to terminate the organization and receive liquidated damages akin to a break-up fee from the disloyal owner.

## Attending to Governance

**Can the organization owners agree upon a form of governance which the owners trust?**

Governance is especially important when one or more of the owners is to be passive in management. An example is the partnership between France Telecom, Deutsche Telekom, and Sprint, known as the Global One. The partnership was governed by layers of committees that resulted in slow and often inconsistent decisions. As a result, a frustrated Deutsche Telekom struck out on its own, acquiring Telecom Italia, a competitor of the partnership.

Although a lack of mutuality is the surest reason for conflict, a lack of attention when forming the organization's governance is the most frequent reason for conflict. Many successful organizations are governed by a governing board, akin to a statutory board of directors, with enough independence from the organization's day-to-day operations to provide independent oversight. Or, they are counseled by an advisory board with enough independence to provide objective guidance.

Although a lack of mutuality is the surest reason for conflict, a lack of attention when forming the organization's governance is the most frequent reason for conflict.

Whether for a statutory or advisory board, owners should consider complementary competencies in selecting their independent members.

This requires more than drafting. First, the partners or owners must select independent members for the board. These independent members should be disinterested in the personal or economic interests of each owner. Second, the partners or owners must consciously delegate decisions for directing the business to that board so that the independent members become familiar not only with the business, but also with the owners.

Owners can use an advisory board instead of a statutory board for this. However, the owners must agree in advance that the advisory board's decision will be binding upon all owners in the event of any deadlock.

Whether for a statutory or advisory board, owners should consider complementary competencies in selecting their independent members. The owners should first determine the competencies or skill sets that their business will need to achieve the business that the owners desires over the next two or three years. Then, after taking into consideration the competencies which the owners and others in the business already have, look for independent board members having the additional skill sets required.

### Summary

Consider the problems from these failed partnerships as red flags to avoid. Look for lack of mutuality, competing interests, and lack of dedicated resources. Most important, consider governance, especially a board with some independence upon which all partners or owners can rely.

Remember the advice of the senior brother of my Italian clients: Any method for avoiding or resolving a dispute must not appear to favor one over the others and the result has to include enough of a chilling or draconian effect to cause parties to agree rather than risk disagreement.

### Some Sample Provisions

Below are some samples of the provisions discussed in this article. These samples are for illustrative purposes only and are not intended as definitive legal drafting or advice.

#### Sample Put/Call Option

- (a) Right. Each Member (such Member is hereinafter referred to as the "Delivering Member") shall have the right to deliver to any other Member (such other Member is hereinafter referred to as the "Receiving Member") selected by the Delivering Member a put/call option exercisable by the

Receiving Member as provided in Section (c) to, at the election of the Receiving Member, either (1) buy all Membership Interests of the Delivering Member, or (2) sell all Membership Interests of the Receiving Member.

- (b) Offer. Any such put/call option shall be in writing and shall be irrevocable for a period of 60 days from the date of mailing thereof. The put/call option shall specify a price per Unit, payable in United States dollars, at which the Delivering Member is willing and able, and offers to, at the election of the Receiving Member as provided in Section (c), either (1) sell all Membership Interests of the Delivering Member, or (2) purchase all Membership Interest of the Receiving Member.
- (c) Acceptance. The Receiving Member shall within such 60-day period give written notice to the Delivering Member of the Receiving Member's election either to sell all Membership Interests of the Receiving Member or to buy all Membership Interests of the Delivering Member Edit accordingly: at the price per Unit stated in the put/call option. In absence of any notice in writing of an election to purchase all Membership Interests by the Receiving Member, the Receiving Member shall be deemed to have elected to sell all Membership Interests of the Receiving Member at the per Unit price stated in the put/call option.
- (d) Closing. The closing of any purchase and sale pursuant to the put/call option of this Section shall take place within 120 days after the date of mailing of the put/call option by the Delivering Member at principal place of business of the Company at such time (during reasonable business hours) and on such date (which shall be a business day) as designated by the purchaser.

#### Sample Coin-Flip Provision

Resolution of Deadlocks. Notwithstanding any provision to the contrary in this Agreement, if there is a deadlock in the management of the Corporation which cannot be resolved by vote of the holders of the Corporation's capital stock or if there is a deadlock among the Shareholders to this Agreement, then each issue in deadlock shall be resolved as among all Shareholders by plurality vote of the Shares and, if there are more than two alternative issues, the side or alternative receiving the greatest affirmative vote of the Shares shall prevail. If the vote on any issue or affirmative vote between two or more sides of an issue or two or more alternative issues is evenly divided, the Shareholders voting for each of the evenly divided sides shall designate one representative, and the deadlock shall be

resolved by these representatives as follows: each representative shall simultaneously flip a half-dollar or other United States' minted coin having a head on one side; the oldest-in-age of the representatives then flipping coins shall call, as such coins are being flipped, "heads" or "tails"; the side of an issue or alternative issue of each representative whose coin as flipped is not of the same side (heads or tails) as called shall be eliminated; this procedure shall be repeated until all but one side of the issue or one alternative issue has been eliminated, and the remaining side or alternative shall prevail. All Shares subject to this Agreement shall be voted in favor of the prevailing side or alternative as determined pursuant to this paragraph, and the representative of the prevailing side or alternative shall so vote such Shares as proxy of the Shareholders.

### Sample Break-Up Fee Provision

If any Owner terminates this Agreement pursuant to Section \_\_\_\_\_, then the terminating Owner shall pay to the Company an amount in cash equal to the other Owners' Formation Expenses (not in excess of the sum of \$ \_\_\_\_\_, plus any costs and expenses incurred by the Company or the other Owners to enforce their rights to receive the amounts due pursuant to this Section ("Collection Expenses")) and the Break-Up Fee. For purposes of this Agreement, the "Break-Up Fee" shall be an amount equal to \$1,000,000. For purposes of this Agreement, "Collection Expenses" shall mean an amount equal to all of Company's and each other Owner's out-of-pocket costs and expenses incurred in connection with this Agreement and the formation of the Company, including, without limitation, fees and disbursements of its outside legal counsel, accountants, consultants, and other professional service providers retained by or on behalf of the Company or the other Owners, together with all other out-of-pocket costs and expenses incurred in connection with negotiating the terms and conditions of this Agreement and any other agreements or other documents relating to the formation of the Company, arranging financing (including without limitation commitment fees), conducting due diligence, and other activities related to this Agreement and the formation of the Company.

### Sample Covenant Protecting an Organization's Property

#### 1. Ownership, Use, and Protection of Company Property.

- (a) Each Owner covenants and agrees that: (1) All Confidential Information, Equipment, Marks, Money, Proprietary Information, Trade Secrets, and other Company Property are and shall at all times remain, as between (A) the

Company, on one part, and (B) Owner and anyone claiming through the Owner, on the other part, the sole and exclusive property of the Company; (2) the Company considers its products known as \_\_\_\_\_ (the "Products") and its processes for producing the Products (the "Processes") that are part of Company Property to be novel as well as proprietary and confidential; and (3) all Company Property developed, produced, or enhanced by Owner or its employees, agents, and other representatives using the facilities or other resources of the Company are works of hire belonging to the Company.

- (b) Each Owner agrees that Owner will protect the proprietary and confidential nature of all Company Property, including technical information and description of processes, and the novelty of all Products and Processes using the same degree of care as Owner uses to protect Owner's own confidential materials and information, but in any event, not less than a reasonable degree of care and only with due care to protect their novel, proprietary, and confidential nature as provided herein, including but not limited to (1) not giving access to any Company Property to any person other than those who have a need to know any such property that is Confidential Company Property or to use or have access thereto for purpose of Company's business and who have an obligation to maintain the novel, proprietary, and confidential nature thereof; (2) not commercializing or otherwise profiting from any idea or concept generated from or described in any such Company Property, including any technical information or description of the Products or Processes except through his compensation as an employee of the Company; (3) not interfering with or otherwise impairing any relationship of the sharing party with any licensee, licensor, vendor, supplier, employee, customer, or other person that is identified in any of such Company Property; and (4) returning to the Company all Company Property, including and all documents, schedules, and other writings evidencing or embodying Company Property, including the Products or Processes or, if directed by the Company, destroying the same, upon termination of employment without retaining any copies – except for such disclosures as may be required under any applicable law, rule, or regulation or which may be relevant to any legal or regulatory proceeding to which Owner is subject. Each Owner agrees to provide the Company with immediate written notice of any regulatory

or legal proceeding to which Owner is subject in which there is the potential for disclosure of Proprietary Information.

- (c) In connection with the foregoing, at all times during and after the Owner's employment with the Company, each Owner:
- (1) Shall promptly execute and deliver such applications, assignments, descriptions, and other instruments as may be necessary or proper in the opinion of the Company to vest in the Company all of the Owner's right, title, and interest to Company Property and to enable it to obtain and maintain all of the Owner's right, title, and interest thereto throughout the world.
  - (2) Shall render to the Company at its expense all such assistance as it may require in the prosecution of applications for Company Property or reissues thereof, in the prosecution or defense of interferences which may be declared involving any of said applications or Company Property, and in any litigation in which the Company or its affiliates may be involved relating to Company Property.
  - (3) Agrees to, and does hereby, grant to the Company, all of the Owner's right, title, and interest to all copyrightable material first designed, produced, or composed in the course of or pursuant to the performance of work prior to the date of this Agreement on behalf of the Company or under this Agreement, which material shall be deemed "works made for hire" under Title 17, United States Code, section 101 of the Copyright Act of 1976.
  - (4) Agrees to, and does hereby, grant to the Company a royalty-free, non-exclusive, and irrevocable license to reproduce, translate, publish, use and dispose of, and to authorize others to reproduce, translate, publish, use and dispose of, any and all copyrighted or copyrightable material furnished prior to the date of this Agreement on behalf of the Company or as a result of work performed in the future under this Agreement but not first produced or composed by the Owner in the performance of this Agreement, provided that a license shall be granted pursuant to this section only to the extent that the Owner now has, or prior to the completion of work under this Agreement or under any later agreements with the Company relating to similar work may

acquire, the right to grant such licenses without the Company becoming liable to pay compensation to others solely because of such grant.

**Sample Covenant Protecting an Organization's Opportunity**

1. Protection of Company Opportunity. Each Owner acknowledges that the highly competitive nature of the segments of business in which the Company is engaged requires the Company to protect its business opportunity in order to avoid substantial and irreparable damage. Therefore, each Owner covenants and agrees that throughout the term of its ownership of any interest in the Company and for a period of one year thereafter the Owner shall not directly or indirectly:
  - (a) Be an agent or other representative of, directly or indirectly beneficially own any equity or similar interest in (except as the holder of not more than five percent of the stock of any publicly-traded corporation), or otherwise engage in, any business which is substantially similar to that engaged in by the Company in any state, territory, or possession of the United States or in any foreign jurisdiction in which the Company has conducted business or has property located during the term of this Agreement; or
  - (b) Interfere with or harm, or attempt to interfere with or harm, or assist any other person (including any entity or business) in interfering with or harming, or attempting to interfere with or harm, any relationship of the Company with any person who is, or with whom the Company during such period is negotiating to become, an employee (whether at will or for a determined period), customer, or supplier of the Company.

**Sample Contractual Duty of Loyalty for Owners**

1. Duty of Loyalty.
  - (a) General Rule. No Owner shall take any action regarding the Company, its operations or property, that in good faith the Owner knows or should reasonably know is opposed to the best interests of the Company.
  - (b) Definition. The meaning of what constitutes being "opposed to the best interests of the Company" with respect to an Owner under this Section shall be the same as the meaning with respect to a manager under Ohio Revised Code section 1705.29(B). In determining the "interests of the Company," an Owner shall be entitled to take into account all of the considerations that a director of a corporation may take into account in determining the interests of a

corporation under Ohio Revised Code section 1701.59(E). No action shall be deemed opposed to the best interests of the Company if:

- (1) The action, in light of the entire transaction under circumstances then existing, is fair to the Company; or
  - (2) The action is approved in advance, following disclosure concerning the material facts known to the Owner, (A) by disinterested members of the Company's Board of Managers, or (B) by majority vote of interests of disinterested Owners.
- (c) **Burden of Proof.** A party who challenges that an action taken is opposed to the best interests of the Company has the burden of proof, except that the Owner [director or executive] has the burden of proving that the action is fair to the Company to the extent relying on Section 2(b)(1) that the action is not opposed to best interests of the Company.
- (d) **Ratification.** A good faith, but defected disclosure of the facts concerning an action by an Owner may be cured if at any time (but no later than a reasonable time after suit is filed challenging the action as opposed to the best interests of the Company) the approval of the action by the Company is ratified, following the required disclosure, by the Board of Managers, the disinterested Owners (or the successors in office to such Managers or the assigns of such Owners) who initially approved the rejection of the Company opportunity.

**Sample Provision Delegating Authority to a Governing Board**

1. Authority.

- (a) **General Authority.** Subject to Section \_\_\_\_, the Board shall, as between the Board and any Owners, exclusively have:
  - (1) All right and authority to take all actions which it deems necessary, useful or appropriate for the management and conduct of the Company's business, and
  - (2) All powers of the Company to do all such lawful acts not prohibited by statute, the Act, the Articles or this Agreement.
- (b) **Specific Authority.** Subject to Section \_\_\_\_, the Board, on behalf of and in the name of the Company and in addition to, and not in limitation of, its general authority, shall have the following authority:
  - (1) **Asset Acquisition.** Purchase, lease as lessee, invest in, or otherwise acquire, or acquire title to, or an option for the purchase of, any real or personal property

of any kind or description appropriate for the Company business.

- (2) **Asset Disposition.** Sell, exchange, dispose of, transfer, lease as lessor or otherwise alienate, or convey title to or grant an option for the sale of all or any portion of the real or personal property of the Company.
- (3) **Bank Accounts.** Establish, maintain and draw upon checking and other accounts in the name of the Company in such financial institutions as from time to time selected.
- (4) **Contracts.** Negotiate, enter into, execute, deliver and perform any and all contracts appropriate for the Company business.
- (5) **Employees and Consultants.** Employ, discharge and determine the compensation and other terms of employment of, employees, agents, attorneys, accountants and other persons as may be reasonably necessary for the Company's business.
- (6) **Financing.** Borrow money and, as security therefor, mortgage or grant security interests in all or any part of any Company property or refinance, recast, increase, modify, consolidate, extend or prepay, in whole or in part, any mortgage or security interest affecting any Company property upon such terms, as is deemed proper.
- (7) **Governmental Reports.** Prepare and file all reports required to be filed with any governmental agency or authority.
- (8) **Litigation.** Commence, defend, settle, compromise, appeal, prosecute or otherwise deal with such legal proceedings, civil, criminal or otherwise, before any court or governmental agency.
- (9) **Reserves.** Set up and maintain all reserves permitted to be set up or maintained pursuant to this Agreement.
- (10) **Securities Filings.** Execute any notifications, statements, reports, returns and other filings that are necessary or desirable to be filed with any state or federal agency, commission or authority, including any state or federal securities commission.
- (11) **Security Certificates and Registry.** Determine the form and content of the security certificates evidencing the Units issued by the Company, including the signatures authorized to authenticate each such certificate; authorize maintenance of a registry of all Units issued by the

Company, the certificates evidencing such Units, and any transfers thereof in conformity with this Agreement and the express terms of such Units; authorize the employment or other retention of agents to keep such registry and to register and transfer Units and issue certificates evidencing the same; and authorize a process for replacing lost, stolen or destroyed certificates evidencing Units duly issued and outstanding.

- (12) Signatures. Execute, acknowledge, and deliver, or designate by name or title and delegate to representatives of the Company authority on behalf of the Company to execute, acknowledge and deliver, any and all instruments which are reasonably necessary to effectuate any of the foregoing and do all things permitted by law so long as consistent with the purposes stated in this Agreement.
- (13) Tax Elections. Make any tax elections available to the Company pursuant to the Code or the Regulations and any state and local tax laws, including classification of the Company as a partnership or a corporation, or pursuant to Section 7.6 any change in that classification, for purpose of federal income taxation (and applicable state income taxation resulting therefrom).

(14) Authority Not Otherwise Delegated. Except to the extent otherwise delegated pursuant to this Agreement, exercise all authority and rights of, or reserved to, the Company under this Agreement.

(c) Duties.

- (1) General Duties. The Board shall manage the affairs of the Company, subject to the provisions of this Agreement, in a prudent and businesslike manner and, in so doing, shall devote such part of its time to the Company affairs as is reasonably necessary for the conduct of such affairs.
- (2) Delegation. In performing its duties, the Board shall be entitled to delegate to and rely on information, opinions, reports, or statements of the following persons or groups unless the Board has actual knowledge concerning the matter in question that would cause such reliance to be unwarranted:
- (A) One or more employees or other agents of the Company whom the Board reasonably believes to be reliable and competent in the matters presented; or
- (B) Any attorney, public accountant or other person as to matters which the Board reasonably believes to be within such person's professional or expert competence.

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