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KMK Legal Update Seminar
Handouts & Resources

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Corporate Law Update: Features of Ohio Law Relating to Fiduciary Duties

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Selected Statutes from the Ohio General Corporation Law and the Ohio LLC Act

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O.R.C. § 1701.59 Authority of directors – bylaws; Standard of Care.

(A) Except where the law, the articles, or the regulations require action to be authorized or taken by shareholders, all of the authority of a corporation shall be exercised by or under the direction of its directors. For their own government, the directors may adopt bylaws that are not inconsistent with the articles or the regulations. The selection of a time frame for the achievement of corporate goals shall be the responsibility of the directors.

(B) ***A director shall perform the director's duties as a director***, including the duties as a member of any committee of the directors upon which the director may serve, [1] ***in <u>good faith</u>,*** [2] ***<u>in a manner the director reasonably believes to be in or not opposed to the best interests of the corporation</u>, and*** [3] ***<u>with the care that an ordinarily prudent person in a like position would use under similar circumstances</u>.*** A director serving on a committee of directors is acting as a director.

(C) In performing a director's duties, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, that are prepared or presented by any of the following:

(1) One or more directors, officers, or employees of the corporation who the director reasonably believes are reliable and competent in the matters prepared or presented;

(2) Counsel, public accountants, or other persons as to matters that the director reasonably believes are within the person's professional or expert competence;

(3) A committee of the directors upon which the director does not serve, duly established in accordance with a provision of the articles or the regulations, as to matters within its designated authority, which committee the director reasonably believes to merit confidence.

(D) *For purposes of <u>division (B)</u> of this section, the following apply*:

(1) A director shall not be found to have violated the director's duties under division (B) of this section unless it is proved by clear and convincing evidence that the director has not acted in good faith, in a manner the director reasonably believes to be in or not opposed to the best interests of the corporation, or with the care that an ordinarily

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prudent person in a like position would use under similar circumstances, in any action brought against a director, including actions involving or affecting any of the following:

(a) A change or potential change in control of the corporation, including a determination to resist a change or potential change in control made pursuant to division (F)(7) of section 1701.13 of the Revised Code;

(b) A termination or potential termination of the director's service to the corporation as a director;

(c) The director's service in any other position or relationship with the corporation.

(2) A director shall not be considered to be acting in good faith if the director has knowledge concerning the matter in question that would cause reliance on information, opinions, reports, or statements that are prepared or presented by the persons described in divisions (C)(1) to (3) of this section to be unwarranted.

(3) Nothing contained in this division limits relief available under section 1701.60 of the Revised Code.

(E) ***A director shall be liable in damages*** *for any action that the director takes or fails to take as a director* ***only*** *if it is proved by* ***clear and convincing evidence*** *in a court of competent jurisdiction that the director's action or failure to act involved an act or omission undertaken with* ***deliberate intent to cause injury to the corporation*** ***or*** *undertaken with* ***reckless disregard for the best interests of the corporation***. Nothing contained in this division affects the liability of directors under section 1701.95 of the Revised Code or limits relief available under section 1701.60 of the Revised Code. This division does not apply if, and only to the extent that, at the time of a director's act or omission that is the subject of complaint, the articles or the regulations of the corporation state by specific reference to this division that the provisions of this division do not apply to the corporation.

(F) ***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;

(2) The economy of the state and nation;

(3) Community and societal considerations;

(4) The long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation.

(G) Nothing contained in division (D) or (E) of this section affects the duties of either of the following:

(1) A director who acts in any capacity other than the director's capacity as a director;

(2) A director of a corporation that does not have issued and outstanding shares that are listed on a national securities exchange or are regularly quoted in an over-the-counter market by one or more members of a national or affiliated securities association, who votes for or assents to any action taken by the directors of the corporation that, in connection with a change in control of the corporation, directly results in the holder or holders of a majority of the outstanding shares of the corporation receiving a greater consideration for their shares than other shareholders.

Amended by 129th General Assembly File No.72, HB 48, §1, eff. 5/4/2012.

Effective Date: 03-17-2000.

O.R.C. § 1701.60 Contract, action or transaction not void or voidable.

(A) *Unless otherwise provided in the articles or the regulations*.

(1) No contract, action, or transaction shall be void or voidable with respect to a corporation for the reason that it is between or affects the corporation and one or more of its directors or officers, or between or affects the corporation and any other person in which one or more of its directors or officers are directors, trustees, or officers, or have a financial or personal interest, or for the reason that one or more interested directors or officers participate in or vote at the meeting of the directors or a committee of the directors that authorizes such contract, action, or transaction, *if in any such case any of the following apply*:

(a) The *material facts* as to his or their relationship or interest and as to the contract, action, or transaction *are disclosed or are known to the directors or the committee* ***and*** *the directors or committee*, *in good faith reasonably justified by such facts, authorizes the contract, action, or transaction by the* ***affirmative vote of a majority of the disinterested directors***, even though the disinterested directors constitute less than a quorum of the directors or the committee;

(b) The *material facts* as to his or their relationship or interest and as to the contract, action, or transaction *are disclosed or are known to the shareholders entitled to vote thereon* ***and*** *the contract, action, or transaction is specifically approved at a meeting of the shareholders held for such purpose by the affirmative vote of the holders of shares entitling them to exercise a majority of the voting power of the corporation held by persons* ***not*** *interested in the contract, action, or transaction*; **or**

(c) ***The contract, action, or transaction is fair as to the corporation as of the time it is authorized or approved by the directors, a committee of the directors, or the shareholders***;

(2) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the directors, or of a committee of the directors that authorizes the contract, action, or transaction;

(3) The directors, by the affirmative vote of a majority of those in office, and irrespective of any financial or personal interest of any of them, shall have authority to establish reasonable compensation, that may include pension, disability, and death benefits, for services to the corporation by directors and officers, or to delegate such authority to one or more officers or directors.

(B) Nothing contained in divisions (A)(1) and (2) of this section shall limit or otherwise affect the liability of directors under section 1701.95 of the Revised Code.

(C) For purposes of division (A) of this section, a director is not an interested director solely because the subject of the contract, action, or transaction may involve or affect a change in control of the corporation or his continuation in office as a director of that corporation.

(D) For purposes of this section, "action" means a resolution adopted by the directors or a committee of the directors of a corporation.

Effective Date: 03-17-2000.

O.R.C. § 1701.641 Fiduciary duties of officers.

(A) *Unless the articles, the regulations, or a written agreement with an officer establishes additional fiduciary duties*, ***the only fiduciary duties of an officer are the duties to the corporation set forth in division (B) of this section***.

(B) *An officer shall perform the officer's duties to the corporation* [1] *in good faith,* [2] *in a manner the officer reasonably believes to be in or not opposed to the best interests of the corporation, and* [3] *with the care that an ordinarily prudent person in a like position would use under similar circumstances.* In performing an officer's duties, an officer is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, that are prepared or presented by any of the following:

(1) One or more directors, officers, or employees of the corporation who the officer reasonably believes are reliable and competent in the matters prepared or presented;

(2) Counsel, public accountants, or other persons as to matters that the officer reasonably believes are within the person's professional or expert competence.

(C) *For purposes of this section, both of the following apply*:

(1) *In any action brought against an officer, the officer shall not be found to have violated the officer's duties under division (B) of this section unless it is proved by* ***clear and convincing evidence*** *that the officer has not acted in good faith, in a manner the officer reasonably believes to be in or not opposed to the best interests of the corporation, or with the care that an ordinarily prudent person in a like position would use under similar circumstances*.

(2) An officer shall *not* be considered to be acting *in good faith* if the officer has knowledge concerning the matter in question that would cause reliance on information, opinions, reports, or statements that are prepared or presented by any of the persons described in division (B)(1) or (2) of this section to be unwarranted.

(D) ***An officer shall be liable in damages*** *for a violation of the officer's duties under division (B) of this section* ***only if it is proved by clear and convincing evidence*** *in a court of competent jurisdiction that the officer's action or failure to act involved an act or omission undertaken with* ***deliberate intent to cause injury to the corporation*** ***or*** *undertaken with* ***reckless disregard for the best interests of the corporation***. This division does not apply if, and only to the extent that, at the time of an officer's act or omission that is the subject of the complaint, either of the following is true:

(1) The articles or the regulations of the corporation state by specific reference to division (D) of this section that the provisions of this division do not apply to the corporation.

(2) A written agreement between the officer and the corporation states by specific reference to division (D) of this section that the provisions of this division do not apply to the officer.

(E) *Nothing in this section affects the duties of an officer who acts in any capacity other than the officer's capacity as an officer. Nothing in this section affects any contractual obligations of an officer to the corporation.*

Added by 131st General Assembly File No. TBD, SB 181, §1, eff. 7/6/2016.

O.R.C. § 1705.081 Effect of operating agreement.

(A) Except as otherwise provided in divisions (B) and (C) of this section, an operating agreement governs relations among members and between members, any managers, and the limited liability company. A limited liability company is bound by the operating agreement of its member or members whether or not the limited liability company executes the operating agreement. To the extent the operating agreement does not otherwise provide, this chapter governs relations among the members and between the members, any managers, and the limited liability company.

(B) *Except as otherwise provided in division (C) of this section, the operating agreement may **not** do any of the following:*

(1) Vary the rights and duties under section 1705.04 of the Revised Code;

(2) Unreasonably restrict the right of access to books and records under section 1705.22 of the Revised Code;

(3) ***Eliminate the duty of loyalty under division (B) of section 1705.161 of the Revised Code or division (B) of section 1705.281 of the Revised Code****, but the operating agreement may identify activities that do not violate the duty of loyalty, and all of the members or a number or percentage of members specified in the operating agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty*;

(4) ***Eliminate the duty of care under division (B) of section 1705.161 of the Revised Code or division (C) of section 1705.281 of the Revised Code****, but the operating agreement may prescribe the standards by which the duty is to be measured*;

(5) ***Eliminate the obligation of good faith and fair dealing under division (D) of section 1705.281 of the Revised Code****, but the operating agreement may prescribe the standards by which the performance of the obligation is to be measured*;

(6) ***Eliminate the duties of a manager under division (B) of section 1705.29 of the Revised Code****, but the articles or the operating agreement may provide that a manager who is a member of the limited liability company or who is serving as the representative of a member owes to the limited liability company and the other members only the duties that would be owed by the member or may prescribe in writing the standards by which performance is to be measured or identify activities that do not violate the manager's duties*;

(7) ***Eliminate the duties of an officer under section <u>1705.292</u> of the Revised Code****, but the articles or the operating agreement may provide that an officer who is a member of the limited liability company or who is serving as the representative of a member owes to the limited liability company and the other members only the duties that would be owed by the member or may prescribe in writing the standards by which performance is to be measured or specify activities that do not violate the officer's duties*;

(8) Vary the requirement to wind up the limited liability company's business in cases specified in division (A) or (B) of section <u>1705.47</u> of the Revised Code;

(9) Restrict the rights of third parties under this chapter.

(C) ***<u>A written agreement, including a written operating agreement, that modifies, waives, or eliminates the duty of loyalty, the duty of care, or both for one or more members, managers, or officers shall be given effect</u>***.

(D) It is the policy of this chapter, subject to the limitations of divisions (B) and (C) of this section, to give maximum effect to the principle of freedom of contract and to the enforceability of operating agreements. Except as provided in divisions (B) and (C) of this section, the default rules relating to the rights and obligations between and among the members, managers, and officers of a limited liability company set forth in sections <u>1705.01</u> to <u>1705.52</u> and section <u>1705.61</u> of the Revised Code may be modified by the operating agreement or by the articles of organization.

Cite as R.C. § 1705.081

Amended by 131st General Assembly File No. TBD, SB 181, §1, eff. 7/6/2016.

Amended by 129th General AssemblyFile No.169, HB 247, §1, eff. 3/22/2013.

Added by 129th General AssemblyFile No.72, HB 48, §1, eff. 5/4/2012.

Note:

Committee Comment (2012)*

This new section states in division (A) the general principle that relations among or between the members, any managers and the limited liability company are to be governed by the operating agreement. Many provisions of Chapter 1705 set out a default rule that applies when there is no different rule stated in the articles or the operating agreement. That concept is reflected in numerous sections of Chapter 1705 that include language that states specifically that the provisions of that section may be altered by the articles or the operating agreement. This new section makes those words unnecessary even though they have not been removed from each of section of Chapter 1705.

Division (A) also clarifies that a limited liability company is bound by its agreement even if it has not executed the agreement

Division (B) identifies the provisions of Chapter 1705 that may not be altered and the limits that apply when the articles or the operating agreement alters certain other statutory provisions. If the section is not identified in division (B), it may be altered by the articles or the operating agreement. Both divisions (A) and (B) draw on similar provisions of Ohio's partnership law in § 1776.03. These provisions are consistent with the result in *McConnell v. Hunt Sports Enterprises*, 132 Ohio App.3d 657 (1999) in which the court recognized that a contract can limit the scope of fiduciary duties and held that the provision of an operating agreement permitting members' participation in ventures competitive with the company allowed the members to take actions that would otherwise have been a breach of fiduciary duty. Divisions (A) and (B) are also similar to provisions in Section 110 of the Revised Uniform Limited Liability Company Act (2006) ("RULLCA").

It is also important to recognize that Chapter 1705 defines by statute all the fiduciary duties owed by members and managers. *See*§§ 1705.281 and 1705.29 and the related *Committee Comments (2012)*. In contrast, RULLCA identifies what the drafters called "major" fiduciary duties, but does not purport to be an exhaustive or exclusive statement of fiduciary duties. *Prefatory Note* to RULLCA (2006).

*Comments on 129th General Assembly, HB 48, from the Ohio State Bar Association Corporation Law Committee

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O.R.C. § 1705.281 Members duties to LLC and other members.

(A) ***The only fiduciary duties a member owes to a limited liability company and the other members are the duty of loyalty and the duty of care set forth in divisions (B) and (C) of this section***.

(B) *A member's* ***duty of loyalty*** *to the limited liability company and the other members is* ***limited*** *to the following*:

(1) *To account to the limited liability company and hold as trustee for the limited liability company any property, profit, or benefit derived by the member in the conduct and winding up of the limited liability company's business or derived from a use by the member of the limited liability company's property, including the appropriation of a limited liability company opportunity*;

(2) *Either to satisfy the requirements of division (A) (1)(a), (b), or (c) of section 1705.31 of the Revised Code or else to refrain from dealing with the limited liability company in the conduct or winding up of the limited liability company's business as or on behalf of a party having an interest adverse to the limited liability company.*

(C) *A member's* ***duty of care*** *to the limited liability company in the conduct and winding up of the limited liability company's business is* ***limited*** *to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law*.

(D) *A member shall discharge duties to the limited liability company and the other members pursuant to this chapter or under the operating agreement and shall exercise any rights* ***consistent with the obligation of good faith and fair dealing***.

(E) A member does **not** violate a duty or obligation under this chapter or under the operating agreement merely because the member's conduct furthers the member's own interest.

(F) *If a member has satisfied the requirements of division (A)(1)(a), (b), or (c) of section 1705.31 of the Revised Code with respect to a contract, action, or transaction, the rights and obligations of the member with respect to that contract, action, or transaction are the same as those of a person who is not a member, subject to other applicable law.*

(G) This section applies to a person winding up the limited liability company's business as the personal or legal representative of the last surviving member as if the person were a member.

Cite as R.C. § 1705.281

Amended by 131st General Assembly File No. TBD, SB 181, §1, eff. 7/6/2016.

Added by 129th General AssemblyFile No.72, HB 48, §1, eff. 5/4/2012.

Note:

Committee Comment (2012)*

This section defines the fiduciary duties owed by members to each other and to the limited liability company. Unless the operating agreement or other agreement creates additional duties, this is a complete and exclusive statement of the fiduciary duties of members. Defining default fiduciary duties by statute is consistent with Ohio corporate and partnership law. The language of this section is based on the comparable provision of Ohio's partnership law, § 1776.44. Subject to the limits of § 1705.081(B), these duties may be modified. Modifications are not required to be in writing. *See Committee Comments (2012)* following Sections 1705.161 and 1705.282 ; *see also, Committee Comment (2012)* following Section 1705.29.

*Comments on 129th General Assembly, HB 48, from the Ohio State Bar Association Corporation Law Committee

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O.R.C. § 1705.161 Withdrawal of member.

(A) Upon a member's withdrawal from a limited liability company, the member's right to participate in the management and conduct of the limited liability company's business terminates.

(B) *Upon a member's withdrawal, a member's duty of loyalty under division (B) of section 1705.281 of the Revised Code and duty of care under division (C) of section 1705.281 of the Revised Code continue only with regard to matters arising and events occurring before the member's withdrawal.*

Cite as R.C. § 1705.161

Amended by 131st General Assembly File No. TBD, SB 181, §1, eff. 7/6/2016.

Added by 129th General AssemblyFile No.72, HB 48, §1, eff. 5/4/2012.

Note:

Committee Comment (2012)*

This new section is based on the comparable provision of Ohio's partnership law, § 1776.53(B). It defines the time when certain duties owed by a member will terminate and is part of a set of provisions that define, by statute, the fiduciary duties of members (and managers). *See*§§ 1705.281, 1705.282 ; *see also*§ 1705.29(B).

*Comments on 129th General Assembly, HB 48, from the Ohio State Bar Association Corporation Law Committee

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O.R.C. § 1705.29 Managers - powers and duties.

(A) If the operating agreement of a limited liability company provides for managers, then the business of the company shall be exercised by or under the direction of its managers, except to the extent applicable law or the operating agreement provides otherwise.

(B) *If a manager's duties are **not** governed by division (B) of section 1705.282 of the Revised Code,* ***then the only fiduciary duties a manager owes to the limited liability company are the duties to act [1] in good faith, [2] in a manner the manager reasonably believes to be in or not opposed to the best interests of the company, and [3] with the care that an ordinarily prudent person in a similar position would use under similar circumstances****.*

(C) *For purposes of division (B) of this section:*

(1) A manager of a limited liability company shall not be found to have violated division (B) of this section unless it is proved, by clear and convincing evidence, in any action brought against the manager, including, but not limited to, an action involving or affecting a termination or potential termination of service to the company as a manager or service in any other position or relationship with the company, that the manager has not acted in good faith, in a manner the manager reasonably believes to be in or not opposed to the best interests of the company, or with the care that an ordinarily prudent person in a similar position would use under similar circumstances.

(2) A manager shall not be considered to be acting in good faith if the manager has knowledge concerning a particular matter that would cause reliance on information, opinions, reports, or statements that are prepared or presented by the persons described in section 1705.30 of the Revised Code to be unwarranted.

(3) Nothing in division (C) of this section limits relief available under section 1705.31 of the Revised Code.

(D) ***A manager of a limited liability company is liable in damages*** *for any action that the manager takes or fails to take as a manager* ***only*** *if it is proved, by* ***clear and convincing evidence****, in a court with jurisdiction that the manager's action or failure to act involved an act or omission undertaken with* ***deliberate intent to cause injury to the company*** ***or*** *undertaken with* ***reckless disregard for the best interests of the company***. Nothing contained in this division limits the relief available under section 1705.31 of the Revised Code. This division does not apply if and only to the extent that, at the time of the act or omission of a manager that is the subject of complaint, the articles of organization or the operating agreement of the company state by specific reference to this division that its provisions do not apply to the company.

Cite as R.C. § 1705.29

Amended by 129th General AssemblyFile No.72, HB 48, §1, eff. 5/4/2012.

Effective Date: 07-01-1994 .

Note:

Committee Comment (2012)*

The modifications to Division (B) clarify that the only fiduciary duties of a manager who is not subject to § 1705.282(B) are the duties set forth in Division (B) of this section. The other modification is to be clear that the standard of § 1705.29(B) only applies when the manager is not subject to the standard of § 1705.282(B). This change makes this section part of a set of provisions that define, by statute, all the fiduciary duties owed by members and managers. *See*§§ 1705.281, 1705.282 . If done in writing, the duties of this section may be modified within the limits set out in § 1705.081(B).

*Comments on 129th General Assembly, HB 48, from the Ohio State Bar Association Corporation Law Committee

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O.R.C. § 1705.30 Relying on information.

In performing the duties to or exercising the authority on behalf of a limited liability company, a member , manager, or officer of a limited liability company is entitled to rely on information, opinions, reports, or statements, including, but not limited to, financial statements and other financial data, that are prepared or presented by any of the following persons:

(A) One or more members, managers, officers, or employees of the company who the member , manager, or officer reasonably believes are reliable and competent in the matters prepared or presented;

(B) Counsel, public accountants, or other persons as to matters that the member , manager, or officer reasonably believes are within the person's professional or expert competence.

Amended by 131st General Assembly File No. TBD, SB 181, §1, eff. 7/6/2016.

Effective Date: 07-01-1994 .

O.R.C. § 1705.282 Duties of member manager.

(A) A *manager* of a limited liability company *who was appointed in writing and has agreed in writing to serve as a manager* and *who is also a member* or who is serving as the representative of a member *owes to the limited liability company and the other members the duties of a manager*.

(B) ***Except as otherwise provided in division (A) of this section***, a *manager* of a limited liability company *who is a member* or who is serving as the representative of a member *owes to the limited liability company and the other members* ***only*** *the duties that would be owed by the member*.

Cite as R.C. § 1705.282

Added by 129th General AssemblyFile No.72, HB 48, §1, eff. 5/4/2012.

Note:

Committee Comment (2012)*

This section defines the default rules for the duties owed by a member or member's representative who is serving as a manager. It does not alter the duties owed by a member in the member's capacity as a member. This section determines whether the default rule for a particular manager will be found in § 1705.29 or § 1705.281 ; whichever section applies, its provisions will state all the fiduciary duties, subject only to modification as permitted by § 1705.081(B) or additional duties created by the articles or the operating agreement.

Division (A) establishes the rule that a member or a representative of a member who is appointed in writing and agrees in writing to serve as a manager owes the same duties as would be owed by any other manager. The general statement of those duties is in § 1705.29, but a manager's duties may be modified in writing within the limits set out in § 1705.081(B). When the writings required by division (A) of Section 1705.282 are not present, division (B) applies to set the default rule for the duties of the person serving as a manager. Under division (B), the default duties for a member or member's representative acting as a manager are the duties owed by the member. Those duties are set out in § 1705.281 but may be modified within the limits set out in § 1705.081(B). Variations of those duties are not required to be in writing.

*Comments on 129th General Assembly, HB 48, from the Ohio State Bar Association Corporation Law Committee

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O.R.C. § 1705.292 Fiduciary duties of officers.

(A) *Unless either a written operating agreement for the limited liability company or a written agreement with an officer establishes additional fiduciary duties or the duties of an officer have been modified, waived, or eliminated as contemplated by section 1705.081 of the Revised Code*, ***the only fiduciary duties of an officer to the limited liability company or its members are the following***:

(1) *If the individual is a member* of the limited liability company or serving as the representative of a member *and the individual is not a manager* of the limited liability company, *then the individual owes the duties that would be owed by a member*.

(2) *If the individual is a member* of the limited liability company or serving as the representative of a member *and the individual is a manager* of the limited liability company *and in that capacity owes the duties that would be owed by a member*, *then the individual owes the duties that would be owed by a member*.

(3) **If divisions (A)(1) and (2) of this section do not apply, the individual owes to the limited liability company the duties of an officer set forth in division (B) of this section.**

(B) *An officer of a limited liability company shall perform the officer's duties* [1] *in good faith*, [2] *in a manner the officer reasonably believes to be in or not opposed to the best interests of the limited liability company*, *and* [3] *with the care that an ordinarily prudent person in a like position would use under similar circumstances*.

(C) *For purposes of division (B) of this section, both of the following apply*:

(1) *An officer of a limited liability company shall not be found to have violated the officer's duties under this section unless it is proved by* ***clear and convincing evidence*** *in any action brought against the officer that the officer has not acted in good faith, in a manner the officer reasonably believes to be in or not opposed to the best interests of the limited liability company, or with the care that an ordinarily prudent person in a like position would use under similar circumstances*.

(2) An officer shall *not* be considered to be acting *in good faith* if the officer has knowledge concerning the matter in question that would cause reliance on information, opinions, reports, or statements that are prepared or presented by any of the persons described in section 1705.30 of the Revised Code to be unwarranted.

(D) ***An officer shall be liable in damages*** *for a violation of the officer's duties under division (B) of this section* ***only if it is proved by clear and convincing evidence*** *in a court of* *competent jurisdiction that the officer's action or failure to act involved an act or omission undertaken with* ***deliberate intent to cause injury to the limited liability company*** ***or*** *undertaken with* ***reckless disregard for the best interests of the company***. This division does not apply if, and only to the extent that, at the time of an officer's act or omission that is the subject of complaint, either of the following is true:

(1) The articles or the operating agreement of the limited liability company state by specific reference to division (D) of this section that the provisions of this division do not apply to the limited liability company.

(2) A written agreement between the officer and the limited liability company states by specific reference to division (D) of this section that the provisions of this division do not apply to the officer.

(E) *Nothing in this section affects the duties of an officer who acts in any capacity other than the officer's capacity as an officer*. *Nothing in this section affects any contractual obligations of an officer to the limited liability company*.

Cite as R.C. § 1705.292

Added by 131st General Assembly File No. TBD, SB 181, §1, eff. 7/6/2016.

O.R.C. § 1705.31 Contracts involving members, managers, or officers.

(A) *Unless otherwise provided in the operating agreement, the following apply:*

(1) No contract, action, or transaction is void or voidable with respect to a limited liability company because it is between or affects the company and one or more of its members, managers, or officers, or because it is between or affects the company and any other person in which one or more of its members, managers, or officers are members, managers, directors, trustees, or officers or have a financial or personal interest, or because one or more interested members, managers, or officers participate in or vote at the meeting that authorizes the contract, action, or transaction, *if any of the following applies*:

(a) The *material facts* as to his or their relationship or interest and as to the contract, action, or transaction *are disclosed or are known to the members or managers*, ***and*** *the members or managers, in good faith reasonably justified by those facts, authorize the contract, action, or transaction by the* ***affirmative vote of a majority of the disinterested members or managers***, even though the disinterested members or managers constitute less than a quorum of the members or managers.

(b) The *material facts* as to his or their relationship or interest and as to the contract, action, or transaction *are disclosed or are known to the members entitled to vote on the contract, action, or transaction*, ***and*** *the contract, action, or transaction is specifically approved at a meeting of the members held for that purpose by the affirmative vote of the members entitled to exercise a majority of the voting power of the company held by persons not interested in the contract, action, or transaction*.

(c) ***The contract, action, or transaction is fair to the company as of the time it is authorized or approved by the members or managers***.

(2) Common or interested managers may be counted in determining the presence of a quorum at a meeting of the managers that authorize a contract, action, or transaction.

(3) Irrespective of any financial or personal interest of any member or manager, the members of a limited liability company by the affirmative vote of a majority of the voting power of the company if the management of the company is reserved to the members, or the managers of a limited liability company by the affirmative vote of a majority of those in office if the management of the company is not reserved to its members, have authority to establish reasonable compensation for services rendered to

the company by its members, managers, and officers or may delegate that authority to one or more managers or officers. The reasonable compensation may include pension, disability, and death benefits.

(B) For purposes of this section:

(1) A member or manager is not an interested member or manager solely because the subject of a contract, action, or transaction may involve or affect a change in control of the limited liability company or his continuation as a member or manager of the limited company.

(2) "Action" means a resolution adopted by the members or managers of a limited liability company.

Effective Date: 07-01-1994 .

O.R.C. § 1705.61 Persons performing services to company or members.

(A) Absent an express agreement to the contrary, a person providing goods to or performing services for a limited liability company owes no duty to, incurs no liability or obligation to, and is not in privity with the members or creditors of the limited liability company by reason of providing goods to or performing services for the limited liability company.

(B) Absent an express agreement to the contrary, a person providing goods to or performing services for a member or group of members of a limited liability company owes no duty to, incurs no liability or obligation to, and is not in privity with the limited liability company, any other members of the limited liability company, or the creditors of the limited liability company by reason of providing goods to or performing services for the member or group of members of the limited liability company.

Amended by 129th General AssemblyFile No.72, HB 48, §1, eff. 5/4/2012.

Effective Date: 10-12-2006 .

Note:

Committee Comment (2012)*

Additional language in the last clause of division (B) is to clarify its meaning.

*Comments on 129th General Assembly, HB 48, from the Ohio State Bar Association Corporation Law Committee

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O.R.C. § 1701.13 Authority of corporation.

(A) A corporation may sue and be sued.

(B) A corporation may adopt and alter a corporate seal and use the same or a facsimile of the corporate seal, but failure to affix the corporate seal shall not affect the validity of any instrument.

(C) At the request or direction of the United States government or any agency of the United States government, a corporation may transact any lawful business in aid of national defense or in the prosecution of any war in which the nation is engaged.

(D) Unless otherwise provided in the articles, a corporation may take property of any description, or any interest in property, by gift, devise, or bequest, and may make donations for the public welfare or for charitable, scientific, or educational purposes.

(E)

(1) ***A corporation may indemnify or agree to indemnify*** *any person who was or is a party, or is threatened to be made a party, to any threatened, pending, or completed action, suit, or proceeding, whether civil, criminal, administrative, or investigative,* ***other than an action by or in the right of the corporation****, by reason of the fact that the person is or was a director, officer, employee, or agent of the corporation*, or is or was serving at the request of the corporation as a director, trustee, officer, employee, member, manager, or agent of another corporation, domestic or foreign, nonprofit or for profit, a limited liability company, or a partnership, joint venture, trust, or other enterprise, against expenses, including attorney's fees, judgments, fines, and amounts paid in settlement actually and reasonably incurred by the person in connection with such action, suit, or proceeding, ***if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, if the person had no reasonable cause to believe the person's conduct was unlawful***. The termination of any action, suit, or proceeding by judgment, order, settlement, or conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, the person had reasonable cause to believe that the person's conduct was unlawful.

(2) ***A corporation may indemnify or agree to indemnify*** *any person who was or is a party, or is threatened to be made a party, to any threatened, pending, or completed*

action or suit by or in the right of the corporation to procure a judgment in its favor*, by reason of the fact that the person is or was a director, officer, employee, or agent of the corporation, or is or was serving at the request of the corporation as a director, trustee, officer, employee, member, manager, or agent of another corporation*, domestic or foreign, nonprofit or for profit, a limited liability company, or a partnership, joint venture, trust, or other enterprise, against expenses, including attorney's fees, actually and reasonably incurred by the person in connection with the defense or settlement of such action or suit, ***if*** *the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation*, ***except that no indemnification shall be made in respect of any of the following***:

(a) *Any claim, issue, or matter as to which such person is adjudged to be liable for negligence or misconduct in the performance of the person's duty to the corporation* ***unless****, and only to the extent that, the court of common pleas or the court in which such action or suit was brought determines, upon application, that, despite the adjudication of liability, but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses as the court of common pleas or such other court shall deem proper*;

(b) *Any action or suit in which the only liability asserted against a director is pursuant to section 1701.95 of the Revised Code*.

(3) ***To the extent that a director, trustee, officer, employee, member, manager, or agent has been successful on the merits or otherwise in defense of any action, suit, or proceeding referred to in division (E)(1) or (2) of this section, or in defense of any claim, issue, or matter in the action, suit, or proceeding, the person shall be indemnified against expenses, including attorney's fees, actually and reasonably incurred by the person in connection with the action, suit, or proceeding***.

(4) *Any indemnification under division (E)(1) or (2) of this section, unless ordered by a court, shall be made by the corporation only as authorized in the specific case, upon a determination that indemnification of the director, trustee, officer, employee, member, manager, or agent is proper in the circumstances because the person has met the applicable standard of conduct set forth in division (E)(1) or (2) of this section*. ***Such determination shall be made as follows*****:**

(a) *By a majority vote of a quorum consisting of directors of the indemnifying corporation who were not and are* ***not*** *parties to or threatened with the action, suit, or proceeding referred to in division (E)(1) or (2) of this section*;

(b) *If* the quorum described in division (E)(4)(a) of this section is *not* obtainable or if a majority vote of a quorum of disinterested directors so directs, *in a written opinion by independent legal counsel other than an attorney, or a firm having associated with it an attorney, who has been retained by or who has performed services for the corporation or any person to be indemnified within the past five years*;

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(c) *By the shareholders*;

(d) *By the court of common pleas or the court in which the action, suit, or proceeding referred to in division (E)(1) or (2) of this section was brought*.

Any determination made by the disinterested directors under division (E)(4)(a) or by independent legal counsel under division (E)(4)(b) of this section shall be promptly communicated to the person who threatened or brought the action or suit by or in the right of the corporation under division (E)(2) of this section, and, *within ten days after receipt of that notification*, the person shall have the right to petition the court of common pleas or the court in which the action or suit was brought to review the reasonableness of that determination.

(5)

(a) <u>*Unless*</u> at the time of a director's act or omission that is the subject of an action, suit, or proceeding referred to in division (E)(1) or (2) of this section, *the articles or the regulations of a corporation state, by specific reference to this division, that the provisions of this division do <u>not</u> apply to the corporation* **<u>and</u>** *<u>unless</u> the only liability asserted against a director in an action, suit, or proceeding referred to in division (E)(1) or (2) of this section is pursuant to section <u>1701.95</u> of the Revised Code*, ***expenses, including attorney's fees, incurred by a director in defending the action, suit, or proceeding shall be paid by the corporation as they are incurred, in advance of the final disposition of the action, suit, or proceeding, <u>upon receipt of an undertaking by or on behalf of the director in which the director agrees to do both of the following</u>***:

(i) *Repay that amount* if it is proved by clear and convincing evidence in a court of competent jurisdiction that the director's action or failure to act involved an act or omission undertaken with deliberate intent to cause injury to the corporation or undertaken with reckless disregard for the best interests of the corporation;

(ii) *Reasonably cooperate* with the corporation concerning the action, suit, or proceeding.

(b) *Expenses, including attorney's fees, incurred by a director, trustee, officer, employee, member, manager, or agent in defending any action, suit, or proceeding referred to in division (E)(1) or (2) of this section, <u>may be paid</u> by the corporation as they are incurred, in advance of the final disposition of the action, suit, or proceeding, <u>as authorized by the directors in the specific case</u>, <u>upon receipt of an undertaking by or on behalf of the director, trustee, officer, employee, member, manager, or agent to **repay** that amount, **if** it ultimately is determined that the person is not entitled to be indemnified by the corporation</u>*.

(6) ***<u>The indemnification or advancement of expenses authorized by this section shall not be exclusive of, and shall be in addition to, any other rights granted to those</u>***

seeking indemnification or advancement of expenses under the articles, the regulations, any agreement, a vote of shareholders or disinterested directors, or otherwise*, *both as to action in their official capacities and as to action in another capacity while holding their offices or positions, and shall continue as to a person who has ceased to be a director, trustee, officer, employee, member, manager, or agent and shall inure to the benefit of the heirs, executors, and administrators of that person. A right to indemnification or to advancement of expenses arising under a provision of the articles or the regulations shall not be eliminated or impaired by an amendment to that provision after the occurrence of the act or omission that becomes the subject of the civil, criminal, administrative, or investigative action, suit, or proceeding for which the indemnification or advancement of expenses is sought, unless the provision in effect at the time of that act or omission explicitly authorizes that elimination or impairment after the act or omission has occurred.

(7) A corporation may purchase and maintain insurance or furnish similar protection, including, but not limited to, trust funds, letters of credit, or self-insurance, on behalf of or for any person who is or was a director, officer, employee, or agent of the corporation, or is or was serving at the request of the corporation as a director, trustee, officer, employee, member, manager, or agent of another corporation, domestic or foreign, nonprofit or for profit, a limited liability company, or a partnership, joint venture, trust, or other enterprise, against any liability asserted against the person and incurred by the person in any such capacity, or arising out of the person's status as such, whether or not the corporation would have the power to indemnify the person against that liability under this section. Insurance may be purchased from or maintained with a person in which the corporation has a financial interest.

(8) The authority of a corporation to indemnify persons pursuant to division (E)(1) or (2) of this section does not limit the payment of expenses as they are incurred, indemnification, insurance, or other protection that may be provided pursuant to divisions (E)(5), (6), and (7) of this section. Divisions (E)(1) and (2) of this section do not create any obligation to repay or return payments made by the corporation pursuant to division (E)(5), (6), or (7).

(9) As used in division (E) of this section, "corporation" includes all constituent entities in a consolidation or merger and the new or surviving corporation, so that any person who is or was a director, officer, employee, trustee, member, manager, or agent of such a constituent entity, or is or was serving at the request of such constituent entity as a director, trustee, officer, employee, member, manager, or agent of another corporation, domestic or foreign, nonprofit or for profit, a limited liability company, or a partnership, joint venture, trust, or other enterprise, shall stand in the same position under this section with respect to the new or surviving corporation as the person would if the person had served the new or surviving corporation in the same capacity.

(F) In carrying out the purposes stated in its articles and subject to limitations prescribed by law or in its articles, a corporation may:

(1) Purchase or otherwise acquire, lease as lessee, invest in, hold, use, lease as lessor, encumber, sell, exchange, transfer, and dispose of property of any description or any interest in such property;

(2) Make contracts;

(3) Form or acquire the control of other corporations, domestic or foreign, whether nonprofit or for profit;

(4) Be a partner, member, associate, or participant in other enterprises or ventures, whether profit or nonprofit;

(5) Conduct its affairs in this state and elsewhere;

(6) Borrow money, and issue, sell, and pledge its notes, bonds, and other evidences of indebtedness, and secure any of its obligations by mortgage, pledge, or deed of trust of all or any of its property, and guarantee or secure obligations of any person;

(7) Resist a change or potential change in control of the corporation if the directors by a majority vote of a quorum determine that the change or potential change is opposed to or not in the best interests of the corporation:

(a) Upon consideration of the interests of the corporation's shareholders and any of the matters set forth in division (F) of section 1701.59 of the Revised Code; or

(b) Because the amount or nature of the indebtedness and other obligations to which the corporation or any successor or the property of either may become subject in connection with the change or potential change in control provides reasonable grounds to believe that, within a reasonable period of time, any of the following would apply:

(i) The assets of the corporation or any successor would be or become less than its liabilities plus its stated capital, if any;

(ii) The corporation or any successor would be or become insolvent;

(iii) Any voluntary or involuntary proceeding under the federal bankruptcy laws concerning the corporation or any successor would be commenced by any person.

(8) Do all things permitted by law and exercise all authority within the purposes stated in its articles or incidental to its articles.

(G) Irrespective of the purposes stated in its articles, but subject to limitations stated in its articles, a corporation, in addition to the authority conferred by division (F) of this section, may invest its funds not currently needed in its business in any shares or other securities, to such extent that as a result of the investment the corporation shall not acquire control of another corporation, business, or undertaking the activities and operations of which are not incidental to the purposes stated in its articles.

(H) No lack of, or limitation upon, the authority of a corporation shall be asserted in any action except (1) by the state in an action by it against the corporation, (2) by or on behalf of the corporation against a director, an officer, or any shareholder as such, (3) by a shareholder as such or by or on behalf of the holders of shares of any class against the corporation, a director, an officer, or any shareholder as such, or (4) in an action involving an alleged overissue of shares. This division shall apply to any action brought in this state upon any contract made in this state by a foreign corporation.

Amended by 129th General AssemblyFile No.72, HB 48, §1, eff. 5/4/2012.

Effective Date: 07-01-1994 .

O.R.C. § 1705.32 Indemnifying manager, officer, employee, or agent.

(A) ***A limited liability company may indemnify or agree to indemnify*** any person who was or is a party, or who is threatened to be made a party, to any threatened, pending, or completed civil, criminal, administrative, or investigative action, suit, or proceeding, ***other than an action by or in the right of the company***, because he is or was a manager, member, partner, officer, employee, or agent of the company or is or was serving at the request of the company as a manager, director, trustee, officer, employee, or agent of another limited liability company, corporation, partnership, joint venture, trust, or other enterprise. ***The company may indemnify or agree to indemnify a person in that position against expenses, including attorney's fees, judgments, fines, and amounts paid in settlement*** *that actually and reasonably were incurred by him in connection with the action, suit, or proceeding* ***if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the company and, in connection with any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful***. The termination of any action, suit, or proceeding by judgment, order, settlement, or conviction or upon a plea of nolo contendere or its equivalent does not create of itself a presumption that the person did not act in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the company and, in connection with any criminal action or proceeding, a presumption that he had reasonable cause to believe that his conduct was unlawful.

(B) ***A limited liability company may indemnify or agree to indemnify*** any person who was or is a party or who is threatened to be made a party to any threatened, pending, or completed ***action or suit by or in the right of the company*** to procure a judgment in its favor, because he is or was a manager, officer, employee, or agent of the company or is or was serving at the request of the company as a manager, member, partner, director, trustee, officer, employee, or agent of another limited liability company, corporation, partnership, joint venture, trust, or other enterprise. ***The company may indemnify or agree to indemnify a person in that position against expenses, including attorney's fees, that were actually and reasonably incurred by him in connection with the defense or settlement of the action or suit if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the company, except that an indemnification shall not be made in respect of any claim, issue, or matter as to which the person is adjudged to be liable for negligence or misconduct in the performance of his duty to the company unless and only to the extent that the court of common pleas or the court in which the action or suit was brought determines, upon application, that, despite the adjudication of liability but in view of all the circumstances of the case, the person is fairly and reasonably entitled to indemnification for expenses that the court considers proper***.

(C) ***To the extent that a manager, officer, employee, or agent of a limited liability company has been successful on the merits or otherwise in defense of any action, suit, or***

proceeding referred to in division (A) or (B) of this section or has been successful in defense of any claim, issue, or matter in an action, suit, or proceeding referred to in those divisions, he shall be indemnified against expenses, including attorney's fees, that were actually and reasonably incurred by him in connection with the action, suit, or proceeding.

(D)

(1) Unless ordered by a court and subject to division (C) of this section, *any indemnification under division (A) or (B) of this section shall be made by the limited liability company* ***only as authorized in the specific case***, *upon a determination that indemnification of the manager, officer, employee, or agent is proper under the circumstances because he has met the applicable standard of conduct set forth in division (A) or (B) of this section. The determination shall be made in any of the following ways*:

(a) *By a majority vote of a quorum consisting of managers of the indemnifying company who were not and are* ***not*** *parties to or threatened to be made parties to the action, suit, or proceeding referred to in division (A) or (B) of this section*;

(b) Whether or not a quorum as described in division (D)(1)(a) of this section is obtainable and if a majority vote of a quorum of disinterested managers so directs, *in a written opinion by independent legal counsel* other than an attorney, or a firm having associated with it an attorney, who has been retained by or who has performed services for the company or any person to be indemnified within the past five years;

(c) *By the members*;

(d) *By the court of common pleas or the court in which the action, suit, or proceeding referred to in division (A) or (B) of this section was brought*.

(2) Any determination made by the disinterested managers under division (D)(1)(a) of this section or by independent legal counsel under division (D)(1)(b) of this section shall be promptly communicated to the person who threatened or brought an action or suit by or in the right of the limited liability company under division (B) of this section. *Within ten days after receipt of that notification*, the person has the right to petition the court of common pleas or the court in which the action or suit was brought to review the reasonableness of the determination.

(E) ***The indemnification authorized by this section is not exclusive of and shall be in addition to any other rights granted to those seeking indemnification under the operating agreement, any other agreement, a vote of members or disinterested managers of the limited liability company, or otherwise, both as to action in their official capacities and as to action in another capacity while holding their offices or positions. The indemnification shall continue as to a person who has ceased to be a manager, officer, employee, or agent of the company and shall inure to the benefit of his heirs, executors, and administrators***.

(F) A limited liability company may purchase and maintain insurance or furnish similar protection, including, but not limited to, trust funds, letters of credit, or self-insurance, for or on behalf of any person who is or was a manager, member, partner, officer, employee, or agent of the company or who is or was serving at the request of the company as a manager, director, trustee, officer, employee, or agent of another limited liability company, corporation, partnership, joint venture, trust, or other enterprise. The insurance or similar protection purchased or maintained for those persons may be for any liability asserted against them and incurred by them in any capacity described in this division or for any liability arising out of their status as described in this division, whether or not the company would have the power to indemnify them against that liability under this section. Insurance may be so purchased from or so maintained with a person in which the company has a financial interest.

(G) *The authority of a limited liability company to indemnify persons pursuant to division (A) or (B) of this section does not limit the payment of expenses as they are incurred, in advance of the final disposition of an action, suit, or proceeding, or the payment of indemnification, insurance, or other protection that may be provided pursuant to division (E) or (F) of this section. Divisions (A) and (B) of this section do not create any obligation to repay or return payments made by the company pursuant to division (E) or (F) of this section.*

(H) As used in this section, "limited liability company" includes all constituent limited liability companies in a consolidation or merger and the new or surviving entity. Any person who is or was a manager, officer, employee, or agent of a constituent limited liability company or who is or was a manager, officer, employee, or agent of a constituent limited liability company as a manager, director, trustee, officer, employee, or agent of another limited liability company, corporation, partnership, joint venture, trust, or other enterprise stands in the same position under this section with respect to the new or surviving entity as he would if he had served the new or surviving entity in the same capacity.

Effective Date: 07-01-1994 .

Cohen v. Dulay

Court of Appeals of Ohio, Ninth Appellate District, Summit County

July 26, 2017, Decided

C.A. No. 28071

Reporter

2017-Ohio-6973 *; 2017 Ohio App. LEXIS 3078 **; 2017 WL 3175781

ROBERT L. COHEN, As Receiver for PEI Liquidation, Inc., Appellant v. LAWRENCE J. DULAY, et al., Appellees

Prior History: [**1] APPEAL FROM JUDGMENT ENTERED IN THE COURT OF COMMON PLEAS, COUNTY OF SUMMIT, OHIO. CASE No. CV 2014-01-0009.

Disposition: Judgment affirmed in part, reversed in part, and cause remanded.

Counsel: JEFFREY M. LEVINSON, Attorney at Law, for Appellant.

RANDY J. HART, Attorney at Law, for Appellant.

RONALD S. KOPP, Attorney at Law, for Appellee.

ORVILLE L. REED, Attorney at Law, for Appellee.

MARVIN SICHERMAN, Attorney at Law, for Appellee.

F. DANIEL BALMERT, DAVID J. TOCCO, and HYUN YOON, Attorneys at Law, for Appellees.

Judges: JULIE A. SCHAFER, Judge. HENSAL, J. CONCURS. CARR, P. J. CONCURRING IN PART, AND DISSENTING IN PART.

Opinion by: JULIE A. SCHAFER

Opinion

DECISION AND JOURNAL ENTRY

SCHAFER, Judge.

[*P1] Plaintiff-Appellant, Robert L. Cohen, in his capacity as the court-appointed receiver for the dissolved corporation, PEI Liquidation, Inc. ("PEI"), appeals the judgment of the Summit County Court of Common Pleas granting summary judgment in favor of Defendants Appellees, Lawrence J. Dulay, Thomas W. Edger, Robert Schneider, Kenneth S. Sekley, Frederick Van Reames, Craig Cox, Jeffery Rohrs, Robert Zelinski, Mary Lee Pilla, and Kevin Dow (collectively, "Defendants").[1] For the reasons set forth below, we affirm in part, reverse in part, and remand. [**2]

I.

[*P2] This appeal arises out of the corporate dissolution proceeding for PEI and the related lawsuit that followed Cohen's investigation into the causes of the company's liquidation. PEI, formerly known as Patio Enclosures, Inc., was an Ohio for-profit corporation that was incorporated in 1966 and whose principal place of business was located in Macedonia, Ohio. PEI was in the business of manufacturing, distributing, and retailing sunrooms and other related products in both the residential and commercial markets. In 1967, Defendant Schneider, the son of one of the company's co-founders, entered the business and took over his father's interest. Schneider thereafter became PEI's longtime CEO and chairman of the board of directors.

[1] The Defendants were members of PEI's board of directors at some point between 2006 and 2010.

[*P3] In 1996, PEI established an employee stock ownership plan ("ESOP") with the goal of making the company entirely employee-owned by 2006. As part of the initial ESOP transaction, PEI divided its common stock into two classes, Class A and Class B. These two classes of common stock were equal in all respects except that the Class A shares had preferential dividend rights. The ESOP owned all of the outstanding Class A common shares, while Schneider controlled all of [**3] the outstanding Class B common shares. Starting in 1997, the ESOP gradually began purchasing shares of Schneider's stock until the ESOP eventually controlled 100% of the outstanding shares of PEI common stock. The final transaction occurred in 2006, when the ESOP purchased the remaining 30% of the company's common stock from Schneider for $6,494,850.00. The ESOP funded this final transaction of Schneider's remaining stock with a multi-million dollar legal judgment that PEI was awarded in 2004. *See Patio Enclosures, Inc. v. Four Seasons Marketing Corp.*, 9th Dist. Summit No. 22458, 2005-Ohio-4933. After purchasing the company's remaining stock from Schneider, PEI used the balance of the legal judgment to satisfy the debt of all of the company's secured creditors. Cohen's subsequent investigation into PEI's financials revealed that from 1996 to 2006, while the ESOP was actively purchasing Schneider's shares of common stock, PEI "consistently experienced declining operating profitability, ultimately resulting in net operating losses of $3.9 million in 2005 and $4.3 million in 2006."

[*P4] Schneider retired as CEO of PEI in late 2006 and resigned his position as chairman of the board of directors in May 2007. However, after successive years of net operating losses, PEI's board of directors [**4] entered into negotiations with Schneider to obtain financial assistance in an effort to provide the company with access to additional working capital. In 2009, Schneider proposed a loan guaranty to increase PEI's line of credit by up to six million dollars, but only if the board agreed to certain terms and conditions. The negotiations between Schneider and the board ultimately broke down and Schneider provided no additional funding or loan guarantees to PEI.

[*P5] Due to the company's inability to secure additional working capital, coupled with the collapse of the national housing market, PEI terminated all of its employees and its business operations on December 31, 2010. On January 20, 2011, PEI's board of directors adopted a resolution of dissolution to voluntarily dissolve the corporation under Ohio law. The corporation filed its complaint for judicial administration of its dissolution and the winding up of its corporate affairs on February 22, 2011. The trial court subsequently appointed Cohen as receiver to administer PEI's estate and its dissolution case.

[*P6] On January 2, 2014, following his investigation into PEI's affairs, Cohen filed suit against Defendants in the Summit County Court [**5] of Common Pleas, pleading the following five claims against the Defendants: (1) breach of fiduciary duty; (2) aiding, abetting, inducing, or participating in breach of fiduciary duty; (3) waste; (4) deepening insolvency and wrongful prolongation of corporate existence; and (5) breach of fiduciary duty owed to creditors. On March 14, 2014, all Defendants except Schneider filed a Civ.R. 12(B)(6) motion to dismiss Cohen's complaint for failure to state a claim upon which relief can be granted, arguing that Counts One and Five are time-barred by the applicable statute of limitations under R.C. 2305.09 and that Counts Two through Five are legally defective. On April 4, 2014, Schneider filed a Civ.R. 12(C) motion for judgment on the pleadings. The trial court denied Defendants' respective Civ.R. 12 motions. The trial court also denied Defendants' subsequent motions to reconsider the denial of their respective Civ.R. 12 motions. Defendants ultimately filed answers denying the allegations set forth in Cohen's complaint. The matter then proceeded through the discovery phase of the litigation.

[*P7] On September 10, 2015, Defendants filed motions for summary judgment. Cohen filed an omnibus brief in opposition to Defendants' motions for summary judgment, [**6] to which Defendants filed reply briefs in support of their respective summary judgment motions. On December 31, 2015, the trial court issued a judgment entry granting summary judgment in favor of Defendants. In so doing, the trial court specifically determined that Count One and Count Five contained within Cohen's complaint were time-barred by the statute of limitations set forth in R.C. 2305.09. The trial court also concluded that Count Two, Count Three, and Count Four contained in Cohen's complaint are not cognizable causes of action under Ohio Law.

[*P8] Cohen filed this timely appeal and raises one assignment of error for our review.

II.

Assignment of Error

> **The trial court erred in granting summary judgment in favor of the Board Members by (a) finding that there was no genuine issue of material fact and (b), after viewing the evidence most strongly in favor of the Receiver, concluding that the Board Members were entitled to judgment as a matter of law on the grounds that: (i) the Receiver's claims for breach of fiduciary duty are subject to the four (4) year statute of limitations set forth in R.C. [] 2305.09 and are not subject to the discovery rule; and (ii) the Receiver's claims for aiding and abetting** [**7] **breaches of fiduciary duty, waste and deepening insolvency (collectively, the "Additional Claims") are not cognizable causes of action under Ohio law**.

[*P9] In his sole assignment of error, Cohen argues that the trial court erred by granting summary judgment completely in favor of the Defendants.

A. Standard of Review

[*P10] We review an award of summary judgment de novo. *Grafton v. Ohio Edison Co.*, 77 Ohio St.3d 102, 105, 1996 Ohio 336, 671 N.E.2d 241 (1996). Summary judgment is only appropriate where (1) no genuine issue of material fact exists; (2) the movant is entitled to judgment as a matter of law; and (3) the evidence can only produce a finding that is contrary to the non-moving party. Civ.R. 56(C). Before making such a contrary finding, however, a court must view the facts in the light most favorable to the non-moving party and must resolve any doubt in favor of the non-moving party. *Murphy v. Reynoldsburg*, 65 Ohio St.3d 356, 358-359, 1992 Ohio 95, 604 N.E.2d 138 (1992).

[*P11] Summary judgment consists of a burden-shifting framework. To prevail on a motion for summary judgment, the party moving for summary judgment must first be able to point to evidentiary materials that demonstrate there is no genuine issue as to any material fact, and that the moving party is entitled to judgment as a matter of law. *Dresher v. Burt*, 75 Ohio St.3d 280, 293, 1996 Ohio 107, 662 N.E.2d 264 (1996). Once a moving party satisfies its burden of supporting its motion for summary [**8] judgment with sufficient and acceptable evidence pursuant to Civ.R. 56(C), Civ.R. 56(E) provides that the non-moving party may not rest upon the mere allegations or denials of the moving party's pleadings. Rather, the non-moving party has a reciprocal burden of responding by setting forth specific facts, demonstrating that a "genuine triable issue" exists to be litigated for trial. *State ex rel. Zimmerman v. Tompkins*, 75 Ohio St.3d 447, 449, 1996 Ohio 211, 663 N.E.2d 639 (1996).

B. Breach of Fiduciary Duty Claims

[*P12] Cohen asserts that the trial court erred by granting summary judgment in favor of the Defendants on the basis that his claims for breach of fiduciary duty and breach of fiduciary duty owed to creditors (Counts One and Five, respectively) are time-barred by the statute of limitations contained in R.C. 2305.09. Specifically, Cohen contends that since his breach of fiduciary duty claims are premised on allegations of fraud, the trial court erred by determining that the statute of limitations was not subject to "the discovery rule." In the alternative, Cohen argues that even if R.C. 2305.09's statute of limitations does apply to his breach of fiduciary duty claims, his claims are still not time-barred because the doctrines of equitable tolling and adverse domination apply.

[*P13] Neither party disputes that the four-year statute [**9] of limitations contained in R.C. 2305.09 governs Cohen's breach of fiduciary duty claims. *See Caghan v. Caghan*, 5th Dist. Stark No. 2014 CA 00094, 2015-Ohio-1787, ¶ 45-46 ("The statute of limitations for both a fraud action or a breach of fiduciary duty action is four years as set forth in R.C. []2305.09. * * * R.C. []2305.09(D) determines the statute of limitations for claims for breach of fiduciary duty."); *see also Cundall v. U.S. Bank*, 122 Ohio St.3d 188, 2009-Ohio-2523, ¶ 24, 909 N.E.2d 1244 ("Claims for fraud and breach of fiduciary duty based on fraud are governed by the four-year statute of limitations set forth in R.C. 2305.09, unless the claim is not discovered despite reasonable diligence."). Therefore, the issues raised in this portion of Cohen's argument are two-fold: (1) when did the four-year statute of limitations begin to accrue? and (2) did Cohen timely file his claims?

[*P14] Cohen asserts that since his breach of fiduciary duty claims are based on alleged fraudulent conduct committed by the Defendants, that the "discovery rule" is applicable to his breach of fiduciary duty claims. "The 'discovery rule' generally provides that a cause of action accrues for purposes of the governing statute of limitations at the time when the plaintiff discovers or, in the exercise of reasonable care, should have [**10] discovered the complained of injury." *Investors REIT One v. Jacobs*, 46 Ohio St.3d 176, 179, 546 N.E.2d 206 (1989), citing *Oliver v. Kaiser Community Health Found.*, 5 Ohio St.3d 111, 5 Ohio B. 247, 449 N.E.2d 438 (1983). Defendants, on the other hand, disagree and argue that the trial court correctly concluded that Cohen's breach of fiduciary duty claims did not properly plead claims for fraud and, as such, are not subject to the discovery rule. Accordingly, Defendants argue that the statute of limitations accrued when the alleged acts or omissions constituting the breach of fiduciary duties actually occurred. The resolution of this purely legal question necessarily dictates whether Cohen's claims are time-barred by R.C. 2305.09's four-year statute of limitation.

[*P15] "In determining the proper statute of limitations for a cause of action, the court must review the complaint to determine the essential character of the claim: '[I]n determining which limitation period will apply, courts must look to the actual nature or subject matter of the case, rather than to the form in which the action is pleaded. The grounds for bringing the action are the determinative factors, the form is immaterial.'" *Caghan* at ¶ 43, quoting *Love v. Port Clinton*, 37 Ohio St.3d 98, 99, 524 N.E.2d 166 (1988); *see also Doe v. First United Methodist Church*, 68 Ohio St.3d 531, 1994 Ohio 531, 629 N.E.2d 402 (1994). "[W]hen pleading fraud * * *, the circumstances constituting fraud * * * shall be pleaded with particularity." *Bear v. Bear*, 9th Dist. Summit No. 26810, 2014-Ohio-2919, ¶ 23, citing Civ.R. 9(B).

[*P16] In the present case, Cohen's [**11] complaint contains the following five counts: (1) breach of fiduciary duty; (2) aiding, abetting, inducing, or participating in breach of fiduciary duty; (3) waste; (4) deepening insolvency and wrongful prolongation of corporate existence; and (5) breach of fiduciary duty owed to creditors. Relevant to this portion of Cohen's argument, the trial court explicitly determined that counts 1 (breach of fiduciary duty) and 5 (breach of fiduciary duty owed to creditors) are not subject to the discovery rule.

[*P17] After a careful review of Cohen's complaint, we agree that Cohen failed to plead a cause of action for fraud with particularity as required by Civ.R. 9(B). Crucial to this determination is the fact that, upon thorough review of Cohen's 105-paragraph complaint, this Court simply cannot discern which of the Defendants' acts or omissions Cohen is alleging to be fraudulent. Additionally, although Cohen utilized headings within his complaint for each claim, Cohen failed to caption his breach of fiduciary duty claims with a heading indicating that those claims were based on fraudulent conduct. Lastly, although Cohen's complaint does assert that the Defendants' conduct constituting breaches of fiduciary [**12] duties "were either knowing, willful, intentional or fraudulent, or were grossly negligent, reckless or in bad faith, and without justification or excuse," we conclude that this sort of "catch-all" language fails to meet the heightened pleading requirements that Civ.R. 9(B) mandates. Accordingly, we determine that Cohen has failed to properly plead a cause of action for fraud in this matter. Thus, we conclude that the trial court did not err by determining that the discovery rule was inapplicable to Cohen's breach of fiduciary duty claims.

[*P18] However, our determination that the discovery rule does not apply to Cohen's breach of fiduciary duty claims does not end our analysis. Cohen argues on appeal that the trial court's decision that his claims are time-barred by the statute of limitations contained in R.C. 2305.09 violates the law of the case doctrine where the trial court previously rejected this exact argument in its denial of Defendants' respective Civ.R. 12 motions and in its denial of the subsequent motion for reconsideration.

[*P19] The law of the case doctrine provides that "the decision of a *reviewing court* in a case remains the law of that case on the legal questions involved for all subsequent proceedings in the [**13] case at both the trial and reviewing levels." (Emphasis added.) *Nolan v. Nolan*, 11 Ohio St.3d 1, 3, 11 Ohio B. 1, 462 N.E.2d 410 (1984). "[T]he law of the case doctrine does not mean that a trial court may not reconsider its prior rulings." *Creauro v. Duko*, 7th Dist. Columbiana No. 04 CO 1, 2005-Ohio-1342, ¶ 25, citing *Pitts v. Ohio Dept. of Transp.*, 67 Ohio St.2d 378, 380, fn. 1, 423 N.E.2d 1105 (1981) and *Poluse v. Youngstown*, 135 Ohio App.3d 720, 725, 735 N.E.2d 505 (7th Dist.1999). Indeed, Civ.R. 54(B) explicitly states that any order which is not a final appealable order "is subject to revision at any time before the entry of judgment adjudicating all the claims and the right and liabilities of all the parties." Accordingly, because the trial court's denial of the Defendants' respective Civ.R. 12 motions and subsequent motion for reconsideration were not final appealable orders, *see Sumskis v. Medina Cty. Bd. of Mental Retardation and Dev.*, 9th Dist. Medina Nos. 2886-M, 2887-M, 2000 Ohio App. LEXIS 283, 2000 WL 141078, *1 (Feb. 2, 2000), we determine that the trial court did not err by later revising its decision and concluding that Cohen's breach of fiduciary duty claims were time-barred. *See Creauro* at ¶ 26-28 (holding that the law of the case doctrine did not apply to appellees' motion for summary judgment since: (1) a motion to dismiss for failure to state a claim upon which relief can be granted and a motion for summary judgment involve different legal standards, and (2) the denial of a motion to dismiss is [**14] an interlocutory order). Accordingly, Cohen's argument on this point is without merit.

[*P20] Cohen also alleges on appeal that he is entitled to an equitable accounting "on account of the Board Members' breach of their fiduciary duty beginning in 2006 and continuing through 2009 up to the date of their resignation." Cohen contends that he is not time-barred from seeking an equitable accounting since R.C. 2305.14 "establishes a ten-year statute of limitations for equitable claims." We note, however, that Cohen failed to raise this argument in his omnibus brief in opposition to the Defendants' summary judgment motions. Accordingly, we decline to address this argument. *See Roberts v. Reyes*, 9th Dist. Lorain No. 10CA009821, 2011-Ohio-2608, ¶ 9 ("Although this Court conducts a *de novo* review of summary judgment, it is nonetheless a *review* that is confined to the trial court record. The parties are not given a second chance to raise arguments that they should have raised below."), quoting *Owens v. French Village Co.*, 9th Dist. Wayne No. 98CA0038, 1999 Ohio App. LEXIS 3789, 1999 WL 635722, *1 (Aug. 18, 1999).

[*P21] Cohen further alleged in his omnibus brief in opposition to Defendants' respective motions for summary judgment that even if R.C. 2305.09's statute of limitations does apply to his breach of fiduciary duty claims, his claims are still not time-barred because various "equitable tolling principles" and [**15] the doctrine of adverse domination apply. After a comprehensive review of the record, we note that the trial court did not explicitly rule upon the various doctrines raised in Cohen's opposition brief. Due to our role as a reviewing court, we cannot make a determination regarding the merits of an argument in the first instance. *Catalanotto v. Byrd*, 9th Dist. Summit No. 27824, 2016-Ohio-2815, ¶ 12. Rather, we must reverse the trial court's grant of summary judgment in favor of the Defendants. As such, we remand this matter for the trial court to address in the first instance the merits of the various tolling arguments that are raised in Cohen's omnibus brief in opposition to Defendants' motions for summary judgment. This Court takes no position on the merits of these arguments at this time.

[*P22] Lastly, Cohen argues that the Defendants breached their fiduciary duties by failing to take remedial action. Specifically, Cohen argued in his omnibus brief in opposition that "as PEI underwent its inevitable resulting failure, all Defendants continued in their failure to take subsequent corrective action with respect to the foregoing, resulting in a secured party foreclosure in January 2011[.]" Cohen contends that this portion of his breach of fiduciary duty claims [**16] is not barred by the statute of limitations, even without applying tolling principles. However, we again note that the trial court did not address this specific argument below. Accordingly, we also instruct the trial court to consider the merits of this argument in the first instance on remand. *See id.* Like Cohen's equitable tolling arguments, we take no position on the merits of this argument at this time.

C. Remaining Claims

[*P23] Additionally, Cohen argues that the trial court erred by granting summary judgment in favor of the Defendants on the basis that his remaining claims ("aiding, abetting, inducing, or participating in breaches of fiduciary duties," "waste," and "deepening insolvency and wrongful prolongation of corporate existence") are not cognizable causes of action under Ohio law. We disagree.

[*P24] "In determining which statute of limitations should be applied to a particular cause of action, * * * 'courts must look to the actual nature or subject matter of the case, rather than to the form in which the action is pleaded. The grounds for bringing the action are the determinative factors[;] the form is immaterial.'" *Bear*, 9th Dist. Summit No. 26810, 2014-Ohio-2919, at ¶ 18, quoting [**17] *Lawyers Cooperative Publishing Co. v. Muething*, 65 Ohio St.3d 273, 277-278, 603 N.E.2d 969 (1992), quoting *Hambleton v. R.G. Barry Corp.*, 12 Ohio St.3d 179, 183, 12 Ohio B. 246, 465 N.E.2d 1298 (1984).

[*P25] Our review of Cohen's remaining claims reveals that they are based upon the 2006 stock transaction and the Defendants' failure to secure a loan guaranty from Schneider in 2009. Cohen alleges that these two events constituted corporate waste, deepened PEI's insolvency, wrongfully prolonged PEI's corporate existence, and aided, abetted, induced, or participated in a breach of fiduciary duty and other misconduct. Although the respective headings utilized in Cohen's complaint on these claims are not independent causes of action under Ohio law, the nature of the waste and deepening insolvency claims, if true, may still constitute a breach of fiduciary duty. *See In re Gas Natural, Inc.*, N.D. Ohio No. 1:13 CV 02805, 2015 U.S. Dist. LEXIS 72538, 2015 WL 3557207, fn. 12 (June 4, 2015) ("Under Ohio law, corporate waste is a way in which a corporate director's fiduciary duty can be breached, not a separate cause of action independent of a fiduciary breach."), citing *In re Keithley Instruments, Inc.*, 599 F.Supp.2d 875, 903 (N.D. Ohio 2008); *see also In re National Century Financial Enterprises, Inc.*, 604 F.Supp.2d 1128, 1153 (S.D. Ohio 2009), citing *In re Amcast Indus. Corp.*, 365 B.R. 91, 115-117 (S.D. Ohio 2007) (recognizing that deepening insolvency is not an independent tort under Ohio law since it is "duplicative of a claim for breach of fiduciary duty.").

[*P26] However, as noted earlier in this opinion, Cohen clearly pled causes of action for breach of fiduciary duty stemming [**18] from the 2006 stock transaction and the Defendants' failure to secure a loan guaranty from Schneider in 2009. As such, due to the redundancy of Cohen's waste and deepening insolvency claims, we cannot say that it was improper for the trial court to dismiss those causes of action. *See In re Amcast* at 118 (dismissing plaintiff's redundant claim for deepening insolvency after determining that the claim was identical to the breach of fiduciary duty claim); *see also Cook Family Invests. v. Billings*, 9th Dist. Lorain Nos. 05CA008689, 05CA008691, 2006-Ohio-764, ¶ 19 ("[A]n appellate court shall affirm a trial court's judgment that is legally correct on other grounds, that is, one that achieves the right result for the wrong reason, because such an error is not prejudicial.").

[*P27] Lastly, with respect to Cohen's aiding, abetting, inducing or participating in breaches of fiduciary duties claim, we conclude that such a cause of action is not cognizable under Ohio law. *See Sacksteder v. Senney*, 2d Dist. Montgomery No. 24993, 2012-Ohio-4452, ¶ 73-76 (holding that Ohio courts have not recognized a cause of action for participation in a breach of fiduciary duty), citing *DeVries Dairy, L.L.C. v. White Eagle Coop. Assn., Inc.*, 132 Ohio St.3d 516, 2012-Ohio-3828, ¶ 2, 974 N.E.2d 1194 (holding that Ohio has never recognized a cause of action for tortious acts in concert under 4 Restatement (2d) of Torts, § 876 (1979)). Accordingly, we determine that the trial [**19] court did not err by dismissing Cohen's claim for aiding, abetting, inducing or participating in breaches of fiduciary duties.

[*P28] Cohen's assignment of error is sustained to the extent that the trial court erred by granting summary judgment in favor of the Defendants without first addressing Cohen's tolling arguments. The remainder of Cohen's assignment of error is overruled.

III.

[*P29] Cohen's sole assignment of error is sustained in part and overruled in part. The judgment of the Summit County Court of Common Pleas is affirmed in part, reversed in part, and the matter is remanded for further proceedings consistent with this opinion.

Judgment affirmed in part, reversed in part, and cause remanded.

There were reasonable grounds for this appeal.

We order that a special mandate issue out of this Court, directing the Court of Common Pleas, County of Summit, State of Ohio, to carry this judgment into execution. A certified copy of this journal entry shall constitute the mandate, pursuant to App.R. 27.

Immediately upon the filing hereof, this document shall constitute the journal entry of judgment, and it shall be file stamped by the Clerk of the Court of Appeals at which time the period for review shall begin [**20] to run. App.R. 22(C). The Clerk of the Court of Appeals is instructed to mail a notice of entry of this judgment to the parties and to make a notation of the mailing in the docket, pursuant to App.R. 30.

Costs taxed equally to both parties.

JULIE A. SCHAFER

FOR THE COURT

HENSAL, J.

CONCURS.

Concur by: CARR (In Part)

Dissent by: CARR (In Part)

Dissent

CARR, P. J.

CONCURRING IN PART, AND DISSENTING IN PART.

[*P30] Cohen has argued on appeal that the trial court erred in granting summary judgment to the Defendants because the discovery rule in R.C. 2305.09 applies to counts one and five of his complaint for breach of fiduciary duty based upon fraud. *See Cundall v. U.S. Bank*, 122 Ohio St.3d 188, 2009-Ohio-2523, ¶ 24, 909 N.E.2d 1244. Thus, he asserts that his litigation of those claims is not barred by the statute of limitations.

[*P31] The relevant portion of R.C. 2305.09 provides that, "[i]f the action is for trespassing under ground or injury to mines, or for the wrongful taking of personal property, the causes thereof shall not accrue until the wrongdoer is discovered; *nor, if it is for fraud, until the fraud is discovered*." (Emphasis added.) The trial court concluded that the discovery rule did not apply to counts one and five because Cohen failed to comply with Civ.R. 9(B) as he did not plead fraud with particularity. Cohen has argued that he demonstrated that "the Board [**21] Members committed fraud and thereby breached their duty[]" and that he complied with the requirements of Civ.R. 9(B). Cohen has not argued that the requirements of Civ.R. 9(B) do not apply to his claims and accordingly that issue is not before the Court. Assuming without deciding that the requirements of Civ.R. 9(B) do apply to these claims, the trial court did not err in concluding that he failed to satisfy those requirements.

[*P32] To the extent Cohen has argued that his claims include allegations that Board Members failed to take remedial action with respect to the 2006 transaction, and thus, that a portion of those claims would not be barred even absent application of the discovery rule, he did not make that specific argument below. While he did mention in his briefing below that certain Board Members failed to take remedial action, he did not reference that action in terms of how it would affect the statute of limitations. Therefore, I would not address that argument on appeal. *See Copen v. CRW, Inc.*, 9th Dist. Wayne No. 15AP0034, 2017-Ohio-349, ¶ 20.

[*P33] As to Cohen's remaining claims, I agree that aiding, abetting, inducing, or participating in breach of fiduciary duty is not a recognized cause of action in Ohio. *See DeVries Dairy, L.L.C., v. White Eagle Coop. Assn., Inc.*, 132 Ohio St.3d 516, 2012-Ohio-3828, 974 N.E.2d 1194. As to the claims [**22] for waste and deepening insolvency/wrongful prolongation of corporate existence, I would conclude that the trial court's statement that they were not cognizable under Ohio law is insufficient to allow this Court to properly review the issue. It is unclear if the trial court examined the allegations and determined that the substance of those two claims was not cognizable irrespective of how they were characterized, or if the trial court simply concluded that, as labeled, the causes of action were not cognizable and failed to consider whether the substance of the allegations was sufficient to state cognizable causes of action. In other words, did the trial court find the causes of action were not sufficiently pled or that Ohio does not recognize these causes of action under any set of facts. Further, the trial court offered no analysis as to why Ohio should not recognize the causes of action as labeled. Accordingly, I would remand the issue to the trial court for it to clarify its decision. *See Hunt v. Alderman*, 9th Dist. Summit No. 27416, 2015-Ohio-4667, ¶ 19, 50 N.E.3d 253.

End of Document

Crosby v. Beam

Supreme Court of Ohio

October 11, 1989, Submitted ; December 20, 1989, Decided

No. 88-1516

Reporter

47 Ohio St. 3d 105 *; 548 N.E.2d 217 **; 1989 Ohio LEXIS 316 ***

CROSBY ET AL., APPELLEES, v. BEAM ET AL., APPELLANTS

Prior History: [***1] APPEAL from the Court of Appeals for Lucas County, No. L-87-198.

On October 23, 1986, appellees, Howard F. (Dean) Crosby ("Crosby") and Christian Caring Center, The Church of Holy Light ("Church"), filed an amended complaint in the Court of Common Pleas of Lucas County. The record indicates that Seascape Building Company, Inc. ("Seascape") was, between April 30, 1977 and January 29, 1985, an Ohio corporation; that Crosby was a 26.214 percent shareholder in Seascape from April 30, 1977 until September 14, 1984; that in September 1984, Crosby transferred his shares of stock to the Church; that the Church held the shares in Seascape until January 29, 1985 when Seascape was voluntarily dissolved; and that upon dissolution, all corporate assets were transferred to the Crosby Properties Liquidating Trust ("the Trust") and each shareholder of Seascape stock became a beneficiary of the Trust in percentages identical to his interest in Seascape.

Appellees brought this action against appellants, Kenneth and Sally Beam and Gary and Sue Graves, who were the controlling shareholders, officers and directors of Seascape. Appellees alleged that appellants improperly expended corporate funds [***2] in that appellants: paid themselves unreasonable salaries (Count 1); caused Seascape to pay their personal expenses (Count 2); used Seascape's property for personal enterprise (Count 3); caused Seascape to purchase life insurance for their benefit (Count 4); and took improper, low-interest loans from Seascape, thereby depriving the corporation of interest income (Count 5). Count 6 alleged that the Church received less in Trust payments than the amount to which it was entitled. Appellees' final count, Count 7, alleged that all the foregoing acts of corporate wrongdoing were carried out pursuant to a conspiracy between the appellants. Appellees also claimed to have been deprived of $ 215,600 in distributions from the Trust and to have incurred more than $ 50,000 in attorney fees. Jointly, appellees sought $ 275,000 in compensatory damages and $ 200,000 in punitive damages.

Appellants filed a Civ. R. 12(B)(6) motion to dismiss the complaint for failure to state a claim. Appellants argued that appellees' action could only be brought as a Civ. R. 23.1 shareholder's derivative action. Appellants contended that appellees did not have standing to bring a shareholder's derivative action [***3] because Crosby did not own Seascape stock when this action was commenced and the Church could not assert claims which occurred prior to its acquisition of Seascape stock.

On May 13, 1987, the trial court granted the appellants' motion to dismiss Counts 1 through 5 and Count 7 of appellees' amended complaint. The trial court found that the claims of the appellees affected the corporation itself and that the shareholders were affected only in a general way. Hence, the appellees should have instituted a shareholder's derivative action since the appellees lacked standing to proceed individually. The trial court also noted that one shareholder, Toledo Trust, was not a party to the action and agreed with appellants that Crosby lacked standing to pursue a shareholder's derivative action since Crosby did not own any stock when the action was commenced and the Church could not assert any claims prior to obtaining the stock on September 14, 1984.

Furthermore, the trial court found no merit in the appellees' argument that they should be permitted to proceed individually against the appellants for breach of fiduciary duty owed by majority shareholders to minority shareholders. The trial court [***4] found that the alleged acts of appellants did not destroy the appellees' investment for the appellants' benefit. Also, the trial court found that appellants' alleged acts did not produce special damages peculiar to the appellees.

On July 8, 1988, the court of appeals, in reversing the common pleas court, held that the appellees were asserting their claims personally, so compliance with Civ. R. 23.1 was not required. The court of appeals found that appellees' complaint stated a cause of action and the trial court had improperly dismissed appellees' complaint.

The cause is now before this court pursuant to the allowance of a motion to certify the record.

Disposition: *Judgment affirmed.*

Syllabus

1. Typically, a close corporation is a corporation with a few shareholders and whose corporate shares are not generally traded on a securities market.

2. Where majority or controlling shareholders in a close corporation breach their heightened fiduciary duty to minority [***5] shareholders by utilizing their majority control of the corporation to their own advantage, without providing minority shareholders with an equal opportunity to benefit, such breach, absent any legitimate business purpose, is actionable.

3. Claims of breach of fiduciary duty alleged by minority shareholders against shareholders who control a majority of shares in a close corporation, and use their control to deprive minority shareholders of the benefits of their investment, may be brought as individual or direct actions and are not subject to the provisions of Civ. R. 23.1.

Counsel: *David R. Pheils, Jr. & Associates* and *David R. Pheils, Jr.*, for appellees.

Cooper, Straub, Walinski & Cramer, Keith A. Wilkowski and *John L. Straub*, for appellants.

Murray & Murray Co., L.P.A., Dennis S. Murray, Sr. and *Kirk J. Delli Bovi*, urging affirmance for *amicus curiae*, Terrence P. Morris.

Vorys, Sater, Seymour & Pease, Michael J. Canter and *John J. Kulewicz*, urging reversal for *amici curiae*, Dale W. Van Voorhis, Gasper C. Lococo and Funtime, Inc.

Judges: Douglas, J. Moyer, C.J., Sweeney, Holmes, H. Brown and Brogan, JJ., concur. Wright, J., concurs in part and dissents in [***6] part. James A. Brogan, J., of the Second Appellate District, sitting for Resnick, J.

Opinion by: DOUGLAS

Opinion

[*107] [**219] The issue before us is whether the appellees' cause of action may be maintained as an individual action or whether dismissal was proper because the suit was not instituted as a Civ. R. 23.1 shareholder's derivative suit.

A shareholder's derivative action is brought by a shareholder in the name of the corporation to enforce a corporate claim. [1] Such a suit is an exception to the usual rule that a corporation's board of directors manages or supervises the management of a corporation. A derivative action allows a shareholder to circumvent a board's refusal to bring a suit on a claim. On the other hand, if the complaining shareholder is injured in a way that is separate and distinct from an injury to the corporation, then the complaining shareholder has a direct action. 2 O'Neal & Thompson, O'Neal's Close Corporations (3 Ed. 1987) 119-121, Section 8.11.

[***7] Appellants contend that this case should have been brought as a derivative action because appellees' amended complaint alleges only that the appellants-majority shareholders misappropriated corporate funds. This misappropriation directly affected the corporation, appellants contend, and only indirectly harmed the appellees-minority shareholders. Thus, the appellants [**220] argue that the appellees could not maintain this cause as a direct action.

I

Close Corporation

Typically, a close corporation is a corporation with a few shareholders and whose corporate shares are not generally traded on a securities market. 1 O'Neal & Thompson, O'Neal's Close Corporations (3 Ed. 1986) 2-3, Section 1.02. See, also, R.C. 1701.591.

Close corporations bear a striking resemblance to a partnership. In essence, the ownership of a close corporation is limited to a small number of people who are dependent on each [*108] other for the enterprise to succeed. Just like a partnership, the relationship between the shareholders must be one of trust, confidence and loyalty if the close corporation is to thrive. While a close corporation provides the same benefits as do other corporations, such as limited liability [***8] and perpetuity, the close corporation structure also gives majority or controlling shareholders opportunities to oppress minority shareholders. For example, the majority or controlling shareholders may refuse to declare dividends, may grant majority shareholders-officers exorbitant salaries and bonuses, or pay high rent for property leased from the majority shareholders. [2] *Donahue* v. *Rodd Electrotype Co. of New England, Inc.* (1975), 367 Mass. 578, 588-589, 328 N.E. 2d 505, 513.

Minority shareholders in a close corporation, denied any share of the profits by the majority shareholder's action, will either suffer a loss or try to find a buyer for their stock. This situation is contrasted with an oppressed minority shareholder in a large publicly [***9] owned corporation who can more easily sell his shares in such a corporation. Generally, there is no ready or available market for the stock of a minority shareholder in a close corporation. This presents a plight for a minority shareholder in a close corporation who can become trapped in a disadvantageous situation from which he cannot be easily extricated. *Donahue, supra*, at 591-592, 328 N.E. 2d at 515.

II

[1] Civ. R. 23.1 states that:

"In a derivative action brought by one or more legal or equitable owners of shares to enforce a right of a corporation, the corporation having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege that the plaintiff was a shareholder at the time of the transaction of which he complains or that his share thereafter devolved on him by operation of law. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors and, if necessary, from the shareholders and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interest of the shareholders similarly situated in enforcing the right of the corporation. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders in such manner as the court directs."

[2] Whether this device is a freeze-out as stated in *Donahue, supra*, at 588-589, 328 N.E. 2d at 513, or a partial squeeze-out as identified in 1 O'Neal & Thompson, O'Neal's Oppression of Minority Shareholders (2 Ed. 1985) 1-2, Section 1:01, is not before us in this case.

Majority Shareholders' Fiduciary Duty in a Close Corporation

Generally, majority shareholders have a fiduciary duty to minority shareholders. *Jones* v. *H. F. Admanson & Co.* (1969), 1 Cal. 3d 93, 81 Cal. Rptr. 592, 460 P. 2d 464. Courts in sister states and Ohio appellate courts have found a heightened fiduciary duty between majority and minority shareholders in a close corporation. [3] This duty is similar to the duty that partners owe one another in a partnership because of the fundamental resemblance between the close corporation and a partnership. *Donahue, supra*, at 593, 328 N.E. 2d at 515, found the standard of a duty to be of the "'utmost good faith and loyalty.'"

[***10] Federal courts, applying what they found to be Ohio law, assumed the existence of a fiduciary duty between shareholders of a close corporation and particularly between majority and minority shareholders. In *United States* v. *Byrum* (1972), 408 U.S. 125, 137, the court stated in a case involving several Ohio close corporations that "[a] majority shareholder has a [*109] fiduciary duty not to misuse his power by promoting [**221] his personal interests at the expense of corporate interests."

Further, *Byrum, supra*, at 137-138, fn. 11, stated that:

"Such a fiduciary relationship would exist in almost every, if not every, State. Ohio, from which this case arises, is no exception: '[I]f the majority undertakes, either directly or indirectly, through the directors, to conduct, manage, or direct the corporation's affairs, they must do so in good faith, and with an eye single to the best interests of the corporation. It is clear that the interests of the majority are not always identical with the interests of all the shareholders. The obligation of the majority or of the dominant group of shareholders acting for, or through, the corporation is fiduciary in nature. A court of equity [***11] will grant appropriate relief where the majority or dominant group of shareholders act in their own interest or in the interest of others so as to oppress the minority or commit fraud upon their rights.' * * *" (Citation omitted.)

Majority or controlling shareholders breach such fiduciary duty to minority shareholders when control of the close corporation is utilized to prevent the minority from having an equal opportunity in the corporation. *Donahue, supra*, at 598, 328 N.E. 2d at 518, and *Tillis* v. *United Parts, Inc.* (Fla. App. 1981), 395 So. 2d 618. Control of the stock in a close corporation cannot be used to give the majority benefits which are not shared by the minority. *Alaska Plastics, Inc.* v. *Coppock* (Alaska 1980), 621 P. 2d 270. As an example, in *Wilkes* v. *Springside Nursing Home, Inc.* (1976), 370 Mass. 842, 353 N.E. 2d 657, majority shareholders breached their fiduciary duty to the minority by removing a minority shareholder from the payroll of a close corporation, which had never paid a dividend, and there was no legitimate business purpose for the removal.

Given the foregoing, if we require a minority shareholder in a close corporation, [***12] who alleges that the majority shareholders breached their fiduciary duty to him, to institute an action pursuant to Civ. R. 23.1, then any recovery would accrue to the corporation and remain under the control of the very parties who are defendants in the litigation. Thus, a derivative remedy is not an effective remedy because the wrongdoers would be the principal beneficiaries of the recovery. See, generally, 2 O'Neal's Close Corporations, *supra*, at 120-123, Section 8.11.

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[3] Cases in sister states include *Tillis* v. *United Parts, Inc.* (Fla. App. 1981), 395 So. 2d 618; *Alaska Plastics, Inc.* v. *Coppock* (Alaska 1980), 621 P. 2d 270; *Horizon House-Microwave, Inc.* v. *Bazzy* (1985), 21 Mass. App. 190, 486 N.E. 2d 70; and *Donahue* v. *Rodd Electrotype Co. of New England, Inc.* (1975), 367 Mass. 578, 328 N.E. 2d 505.

See, generally, the following Ohio appellate court cases: *Estate of Schroer* v. *Stamco Supply, Inc.* (1984), 19 Ohio App. 3d 34, 19 OBR 100, 482 N.E. 2d 975; *North* v. *Wick* (1957), 104 Ohio App. 332, 5 O.O. 2d 19, 144 N.E. 2d 132; and *Soulas* v. *Troy Donut Univ., Inc.* (1983), 9 Ohio App. 3d 339, 9 OBR 607, 460 N.E. 2d 310.

Where majority or controlling shareholders in a close corporation breach their heightened fiduciary duty to minority shareholders by utilizing their majority control of the corporation to their own advantage, without providing minority shareholders with an equal opportunity to benefit, such breach, absent a legitimate business purpose, is actionable. Where such a breach occurs, the minority shareholder is individually harmed. When such harm can be construed to be individual in nature, then a suit by a minority shareholder against the offending majority or controlling shareholders may proceed as a direct action. This was just the situation in *Steelman* v. *Mallory* (1986), 110 Idaho 510, 716 P. 2d 1282, [***13] where the court held that a breach by majority shareholders-directors of their fiduciary duty to a minority shareholder was actionable directly, as opposed to requiring a shareholder's derivative action.

Accordingly, we hold that claims of a breach of fiduciary duty alleged by minority shareholders against shareholders who control a majority of [*110] shares in a close corporation, and use their control to deprive minority shareholders of the benefits of their investment, may be brought as individual or direct actions and are not subject to the provisions of Civ. R. 23.1.

III

Plaintiffs-Appellees' Capacity to Sue

We must now determine if the complaint before us states an injury to the appellees upon an individual claim as distinguished from an injury which directly affects the corporation and only indirectly affects appellees. See *Adair* v. *Wozniak* [**222] (1986), 23 Ohio St. 3d 174, 23 OBR 339, 492 N.E. 2d 426.

Civ. R. 8(F) states that "[a]ll pleadings shall be so construed as to do substantial justice." The rule "* * * emphasizes the fact that pleadings shall be construed liberally * * *." Staff Notes to Civ. R. 8(F).

The complaint before us, in essence, alleges that the majority [***14] shareholders acted both separately and collectively to exclude the appellees from the corporation's profit. Seascape, the corporation, possessed characteristics consistent with an Ohio close corporation.

Arguably, Counts 1 through 5 of plaintiffs-appellees' amended complaint sound in the nature of claims that should be redressed through a derivative action and, therefore, appellees would be required to proceed in accordance with Civ. R. 23.1. Conversely, under a liberal construction, the matters pled in Counts 1 through 5 and clearly that matter pled in Count 7 can easily be construed as pleading claims that are not wholly derivative in nature. In effect, the claims are direct or individual claims for a breach of the fiduciary duty owed by the majority shareholders to the minority shareholders in close corporations. Liberally construing the pleadings, we find that appellees properly brought this action as a direct action rather than as a shareholder's derivative action.

Since we have decided that it was proper for appellees to bring this case as an individual action, it is not necessary to address the standing of appellees to institute a Civ. R. 23.1 suit. Furthermore, it is [***15] unnecessary to decide, as urged by appellees, whether there is an exception to the standing requirements of Civ. R. 23.1, which exception would allow a former minority shareholder, who parted with his shares unaware of misappropriations by the corporate directors, to recover the amount by which the misappropriations had reduced the value of his prior shareholdings. See *Watson* v. *Button* (C.A.9, 1956), 235 F. 2d 235.

For the above-mentioned reasons, the trial court erred when it dismissed this action for failure to state a claim. Appellees' complaint alleges a breach of fiduciary duty which may be brought as a direct action. Accordingly, the judgment of the court of appeals is affirmed.

Judgment affirmed.

Concur by: WRIGHT (In Part)

Dissent by: WRIGHT (In Part)

Dissent

WRIGHT, J., concurring in part and dissenting in part.

I heartily agree with the majority's discussion of the effects of stock ownership in a close corporation, as compared to equity ownership in a corporation with a large number of [*111] stockholders where the stock is publicly traded. Ofttimes the relationship between the shareholders in a close corporation is premised upon mutual confidence and trust. Ownership in a close corporation [***16] does indeed expose a minority stockholder to oppression by the majority. The trend of the law in this country is represented by *Donahue* v. *Rodd Electrotype Co. of New England, Inc.* (1975), 367 Mass. 578, 328 N.E. 2d 505. In that case the Massachusetts Supreme Court held that majority stockholders in a close corporation should be held to a strict standard of fiduciary duty when minority stockholders were, in effect, "frozen out" through exorbitant salaries, self-dealing and the like, and their ability to receive reasonable dividends was obviously undermined. There certainly is no ready market for the stock of a minority shareholder in a close corporation. The modern trend in the law has been to provide relief to a minority stockholder in a close corporation who is forced into an unfair situation from which he cannot extricate himself. *Donahue, supra*, at 591-592, 328 N.E. 2d at 514-515.

Accordingly, I accept the concept that in situations such as we may have here, we should impose upon majority shareholders a heightened fiduciary duty to minority [**223] shareholders in a close corporation and sanction a direct action against the alleged wrongdoers. Construing the pleadings [***17] in this case in the most liberal fashion, I believe Count 7 of plaintiff's complaint may state a cause of action for what amounts to a freeze-out. However, I am not prepared to accept the third paragraph of the syllabus announced by the majority outside the context of the facts alleged in this case. I am concerned that applying the third paragraph of the syllabus to a situation where there is no potential of demonstrating a freeze-out will amount to repeal of Civ. R. 23.1 as it relates to *all actions* by disgruntled minority shareholders in close corporations. To my mind this would be both unwise and outside our authority to, in effect, amend the Civil Rules in this manner. Thus, I would limit the syllabus law in this case to situations where the plaintiff can demonstrate an effort to "freeze him out" as a stockholder or where he is directly affected through loss of dividends, company employment or the like. Thus, I can concur only in paragraphs one and two of the syllabus in this case and in the judgment announced by the majority.

End of Document

Vontz v. Miller

Court of Appeals of Ohio, First Appellate District, Hamilton County

December 30, 2016, Date of Judgment Entry on Appeal

APPEAL NO. C-150693

Reporter
2016-Ohio-8477 *; 2016 Ohio App. LEXIS 5329 **

ALBERT W. VONTZ III, Plaintiff-Appellee, vs. VAIL K. MILLER, SR., CAROL V. MILLER, VAIL K. MILLER, JR., BROOKE MILLER HICE, ESQ., and MICHAEL W. MILLER, Defendants-Appellants, and DAYTON HEIDELBERG DISTRIBUTING CO., Nominal Defendant.

Subsequent History: Stay granted by Vontz v. Miller, 148 Ohio St. 3d 1436, 2017-Ohio-1267, 2017 Ohio LEXIS 581, 71 N.E.3d 1112 (Apr. 5, 2017)

Discretionary appeal not allowed by Vontz v. Miller, 2017-Ohio-8136, 2017 Ohio LEXIS 2077 (Ohio, Oct. 11, 2017)

Prior History: [**1] Civil Appeal From: Hamilton County Court of Common Pleas. TRIAL NO. A-1407093.

Disposition: Judgment Appealed From Is: Affirmed in Part, Reversed in Part, and Cause Remanded.

Syllabus

A 50 percent shareholder of a family-owned-and-operated close corporation was entitled to injunctive relief, as modified, against the other 50 percent shareholder, to enable the exercise of the oppressed shareholder's voting rights for the election of directors, when the evidence demonstrated that the controlling shareholder had purposely disenfranchised the other shareholder to maintain her control of the corporation, and in the process caused the corporation to violate its regulations and Ohio law related to the holding of annual shareholder meetings, in breach of her heightened fiduciary duty.

The members of a board of directors of a close corporation breached their fiduciary duty to a 50 percent shareholder, when the board in bad faith refused to schedule a mandatory annual shareholder meeting for the election of directors, in violation of the duty of loyalty. But this breach did not result [**2] in the irreparable harm necessary to support an injunctive order requiring the board to schedule the meeting because the shareholder as co-chairman of the board and as president was authorized to call a special meeting for the election of directors at which he could exercise his right to vote.

The trial court erred by entering judgment for a shareholder on a direct claim against general counsel based on the breach of a fiduciary duty because as general counsel her client was the corporation, and her duty and allegiance ran to the corporation, and not to the individual shareholder.

Counsel: Keating, Muething & Klekamp PLL, James E. Burke, Bryce J. Yoder, and Meaghan K. FitzGerald, for Plaintiff-Appellee.

Vorys, Sater, Seymour and Pease LLP, Daniel J. Buckley, J.B. Lind, and Elizabeth E.W. Weinewuth, for Defendant-Appellant Carol V. Miller.

Coolidge Wall Co., LPA, Terence L. Fague, and Jennifer R. Roberts, for Defendants Appellants Vail K. Miller, Sr., Carol V. Miller, Vail K. Miller, Jr., and Michael W. Miller, in their capacities as directors and officers of Dayton Heidelberg Distributing Co.

Katz Teller Brant & Hild, Robert A. Pitcairn, Jr., and Peter J. O'Shea, for Defendant Appellant Brooke Miller [**3] Hice.

Judges: CUNNINGHAM, Presiding Judge. DEWINE and MOCK, JJ., concur.

Opinion by: CUNNINGHAM

Opinion

CUNNINGHAM, Presiding Judge.

[*P1] This appeal is taken from the order of the Hamilton County Court of Common Pleas awarding injunctive relief to plaintiff-appellee Albert W. Vontz III in an action involving a dispute among the shareholders of nominal defendant Dayton Heidelberg Distributing Co., an Ohio family-owned-and-operated close corporation ("Heidelberg"), Heidelberg's six-member board of directors, and its officers.

[*P2] Vontz is the owner of 50 percent of the voting shares of Heidelberg, and its president and co-chairman of its board. He alleged, among other things, that his sister, defendant-appellant Carol V. Miller ("Miller"), the owner of the other 50 percent of the voting shares and also a board member, along with the other four defendants-appellants, all members of Miller's family, officers of the corporation, and board members under her control (with Miller, "the Miller family"), had purposely disenfranchised him to maintain their control of the corporation.

[*P3] Vontz requested equitable relief in the form of an injunction to allow him to exercise his voting rights and to redress what he alleged was a breach [**4] of fiduciary duties, a breach of contract, and a violation of corporate requirements by the Miller family. His request was granted as part of the injunctive relief afforded by the trial court after a trial of the matter. Of relevance to this appeal, the court ordered that (1) the board, with court monitoring, schedule the annual shareholder meeting for the election of directors that the Miller family board members had refused to schedule, (2) both Miller and Vontz attend the meeting, (3) Vontz be afforded "equal representation" on the board, with "[t]he parties to work out the current Board members to be displaced," (4) Miller's daughter, as general counsel for Heidelberg, "treat" Vontz and Miller "equally," and (5) the parties "pay their respective attorneys' fees." The appellants challenge the trial court's judgment on various grounds in multiple assignments of error.

[*P4] We hold that the record amply supports the trial court's conclusion that Miller had caused irreparable harm to Vontz by suppressing his voting rights, and that injunctive relief was warranted to prevent further oppression. But we sustain in part several assignments of errors and order that the trial court on remand modify [**5] the language of the injunction.

[*P5] Specifically, we order the trial court to (1) strike the language of the injunctive order requiring the board to schedule a shareholder meeting, (2) strike the language requiring Miller to attend the shareholder meeting, (3) modify the order to add that when a meeting for the election of directors is called—either by the board or by Vontz—the shareholders attending the meeting, in person or by proxy, and entitled to vote in an election of directors shall constitute a quorum for the purpose of electing directors, (4) to strike the language providing that Vontz "shall be allowed to have equal representation on the Board," directing "the parties to work out the current Board members to be replaced," and directing general counsel "to treat both shareholders equally." Our reasoning for these modifications, along with our treatment of the remainder of the trial court's order, is provided below.

I. Background Facts and Procedure

[*P6] In addition to Miller, the appellants here include the following: (1) Miller's husband, Vail K. Miller, Sr., ("Senior") who serves as Heidelberg's co-chairman of the board and its secretary; (2) Vail K. Miller, Jr., ("Junior") son of [**6] Miller and Senior, who serves as the chief executive officer of Heidelberg's Dayton operation, and who claims to be, over Vontz's objection, Heidelberg's chief executive officer; (3) Brooke M. Hice ("Hice"), daughter of Miller and Senior, who serves as the executive vice president and general counsel of Heidelberg; and (4) Michael W. Miller ("Michael Miller"), son of Miller and Senior, who serves as vice president of sales and marketing of Heidelberg.

[*P7] Heidelberg is an Ohio for-profit S-corporation, with a very large beer, wine, and spirits distribution business. The company was founded in 1938 by the grandfather of Vontz and Miller. Their father later took over the company and became its sole shareholder. He transferred some shares to his two children during his lifetime, and after he died in 2002, Vontz and Miller inherited the remainder of his shares, leaving them each with 50 percent of the voting shares of the company. As the trial court found, the record does not show that their father had intended other than an equitable division of the company with the two siblings working together.

[*P8] To ensure an equitable division, Vontz and Miller in 2009 entered into a shareholders' agreement [**7] providing that "[i]t is the intent of the parties that the 50%/50% division of Share ownership shall be preserved at all times as between the Miller Family and the Vontz Family." The agreement also preserves the cumulative voting rights of the shareholders.

[*P9] During the almost 50 years that Vontz and Miller's father controlled Heidelberg, the company operated informally. Director seats were "ceremonial" positions, awarded by Vontz and Miller's father. Junior and Hice were appointed to the board when they were only 18 years old. Vontz's only child was never named to the board, but he was only 12 years old at the time of his grandfather's death.

[*P10] Over the ten years preceding the filing of this action, the corporation had not held an annual shareholder meeting. The last informal election of board members that reflected the consensus of the voting shareholders and that was signed by Vontz as president occurred in 2007. That board was comprised of seven directors and included the mother of Vontz and Miller. After their mother died, that seat remained vacant, but Vontz, Miller, Senior, Junior, Hice, and Michael Miller remained on the board.

[*P11] The governance of the company was marked by consensus [**8] for many years, but began to change in 2010 after Vontz, who had loaned $17 million to the company, became concerned about the lack of proper corporate governance, the increased debt level of the company, and the Miller family's use of corporate assets and positions. As a result of these concerns, in 2011, Vontz began to informally suggest to the other board members that Ohio's general corporation law and the Heidelberg Code of Regulations mandated annual shareholder meetings for the election of directors as a matter of law.

[*P12] R.C. 1701.39 provides, in relevant part as follows:

> An annual meeting of shareholders for the election of directors * * * **shall be held** on a date designated by, or in the manner provided for, in the articles or in the regulations. In the absence of such designation, the annual meeting shall be held on the first Monday of the fourth month following the close of each fiscal year of the corporation. When the annual meeting is not held or directors are not elected thereat, they may be elected at a special meeting called for that purpose.

(Emphasis added.)

[*P13] With respect to the annual shareholder meeting, the regulations provided that "[t]he annual meeting of shareholders for the election [**9] of Directors * * * **shall be held** on such date as the Board of Directors may establish from time to time." (Emphasis added.) The regulations allowed for special shareholder meetings as called for by the chairman or president. And the regulations further provided that "[a]ny action required by the Ohio Revised Code to be taken at a meeting of the shareholders * * * may be taken without a meeting if a consent in writing, setting forth the action so taken, shall be signed by all of the shareholders entitled to vote at a meeting for such a purpose and filed with the Secretary of the Corporation." Finally, the regulations provided that the directors elected at the annual meeting would hold office for a one-year term or "until * * * his [or her] successor is elected and qualified."

[*P14] In 2013, Vontz sent a proposal to the other board members requesting that the board adhere to proper corporate governance and schedule annual shareholder meetings to elect new directors, three of whom he would be able to elect in accordance with his voting rights as a 50 percent voting shareholder. The seventh director seat would be deemed nonvoting and filled by the company's chief financial officer.

[*P15] While Miller by [**10] letter indicated that in theory she was open to observing more of the corporate formalities, she rejected Vontz's proposal with respect to the board, noting that the company was very successful and that "if it is not broke, don't fix it." None of the other directors acted on Vontz's suggestion. Hice, general counsel for the corporation, told Vontz at that time that she disagreed with his contention concerning the need for an annual shareholder meeting for the election of directors. But she acknowledged at trial that the relevant statutory and corporate provisions "unambiguously" required an annual shareholder meeting.

[*P16] After Vontz's unsuccessful attempts to have the board schedule an annual shareholder meeting, he informed the other board members that as co-chairman of the board he would notice a special shareholder meeting for the election of new directors. About this time, the relationship between Vontz and the Miller family had become so contentious that both sides submitted proposals for a separation and/or buy-out. However, the Miller family threatened to terminate all preliminary negotiations if Vontz followed through with noticing a special shareholder meeting for the election [**11] of directors. On December 5, 2014, after buyout negotiations fell apart, Vontz filed the action underlying this appeal.

[*P17] After filing his action, Vontz noticed special shareholder meetings for December 17, 2014, January 16, 2015, and July 3, 2015, for the express purpose of electing a new board, and he contemporaneously noticed his desire to vote cumulatively. Despite having received all notices, Miller, after discussing the matter with the other Miller family members, refused to attend. Miller took the position, as did the other parties, that under the company's regulations for the election of new directors, Miller's attendance as the other 50 percent voting shareholder was necessary to establish a quorum, without which no new directors could be elected.[1]

[*P18] Because Miller refused to attend, the quorum requirement in the regulations was not met. Thus, no directors could be elected. The composition of the board carried over, as intended by the Miller family. While Miller refused to attend the special shareholder meetings, the Miller family scheduled and attended a board meeting to approve increased compensation and bonuses to the Miller family officers and associates. The measures were [**12] approved over the objection of Vontz, who complained that he had not been provided the information sufficiently in advance to evaluate the increased compensation.

[*P19] Ultimately, the board did not schedule the annual shareholder meetings as requested by Vontz,

[1] This understanding of the "quorum requirement" was central to the parties' respective arguments during the trial and on appeal.

and Miller refused to attend the special shareholder meetings noticed by Vontz. As established at trial, the Miller family's intention was to prevent Vontz from exercising his voting rights in order to perpetuate Miller's control of the company and to keep the Miller family in five of the six voting seats on the board. And Miller made clear at trial that she would not attend any shareholder meetings unless ordered by the court.

[*P20] The trial court entered judgment for Vontz and granted injunctive relief. The basis of the trial court's judgment was articulated in a letter opinion that was sent to the parties and journalized. Subsequently, the trial court conditionally stayed the injunctive order pending this appeal.

II. Analysis

[*P21] Miller, as shareholder, and Hice, as director and general counsel, each filed separate appellate briefs in support of their challenge to the trial court's judgment. Senior, Junior, and Michael Miller, as directors [**13] and officers, filed a joint appellate brief, in which Miller, as director, joined.

[*P22] Miller raises three assignments of error that provide in essence that the trial court erred (1) by finding for Vontz on the breach-of-fiduciary-duty and breach-of-contract claims, and by ordering her to attend a shareholder meeting, (2) by ordering the board to be "equalized," and (3) by failing to dismiss Vontz's claim based on the violation of corporate requirements.

[*P23] Hice's seven assignments of error provide in essence that the trial court erred (1) by finding for Vontz on the claim that she had breached her fiduciary duty as director, (2) by finding for Vontz on the claim that she had beached her fiduciary duty as general counsel, (3) by ordering her, as general counsel, to treat both shareholders equally, (4) by ordering, in violation of Civ.R. 65(D)'s specificity requirement, that she treat both shareholders equally and "[t]hat the parties [] work out the current Board members to be displaced," (5) by finding for Vontz on the breach-of-contract claim, (6) by failing to dismiss Vontz's claim based on the violation of corporate requirements, and (7) by ordering the parties to pay their own attorney fees, if by this [**14] language the trial court intended to deny her the right to advancement and indemnification from the company.

[*P24] Miller, Senior, Junior, and Michael Miller as directors and/or officers ("the Miller Directors") raise four assignments of error. These assignments of error provide in essence that the trial court erred (1) by finding for Vontz on the breach-of-fiduciary-duty claim and by determining that the breach had resulted in irreparable harm, (2) by finding for Vontz on the breach-of-contract claim, (3) by finding for Vontz on the claim based on the violation of corporate requirements, and (4) by ordering the parties to pay their own attorney fees, if by this language the trial court intended to deny them the right to advancement and indemnification from the company.

[*P25] In sum, all appellants challenge both the trial court's determination that Vontz had established a right to injunctive relief and the terms of the injunctive relief ordered by the court. A permanent injunction is issued after the movant has demonstrated a right to relief under the applicable substantive law. *Procter & Gamble Co. v. Stoneham*, 140 Ohio App.3d 260, 267, 747 N.E.2d 268 (1st Dist.2000). A party seeking an injunction must show both that the injunction is necessary to prevent irreparable harm, and that [**15] the party does not have an adequate remedy at law. *Id.* We note also, as the trial court did, that Vontz was required to prove his case by clear and convincing evidence to be entitled to injunctive relief on any of his claims. *Id.* at 267-268.

[*P26] We review the trial court's decision to grant or deny an injunction under an abuse-of-discretion standard. *Id.* at 268. But we review de novo issues of law upon which the trial court based its decision, such as the sufficiency of the evidence to support a judgment and the interpretation of contract and statutory provisions. *Ceccarelli v. Levin*, 127 Ohio St.3d 231, 2010-Ohio-5681, 938 N.E.2d 342, ¶ 8; *Lehigh Gas-Ohio, LLC v. Cincy Oil Queen City, LLC*, 1st Dist. Hamilton No. C-130127, 2014-Ohio-2799, ¶ 43. And we review factual determinations under the deferential manifest-weight-of-the-evidence standard. *See Eastley v. Volkman*, 132 Ohio St.3d 328, 2012-Ohio-2179, 972 N.E.2d 517, ¶ 20-21.

[*P27] We begin by determining whether the trial court erred by finding against the appellants on the breach-of-fiduciary-duty claim.

A. Breach-of-Fiduciary-Duty Claim

[*P28] In support of its award of injunctive relief, the trial court determined that the appellants had breached fiduciary duties to Vontz in their refusal to allow him to exercise his voting rights, resulting in irreparable harm. The elements for a breach-of-fiduciary-duty claim are (1) the existence of a duty arising from a fiduciary relationship, (2) the failure to observe the duty, and [**16] (3) an injury proximately resulting. *Hickerson v. Hickerson*, 3d Dist. Hancock No. 5-10-08, 2010-Ohio-4070, ¶ 24.

[*P29] The appellants argue that the trial court's judgment on the breach-of-fiduciary-duty claim was erroneous for several reasons. We begin with Miller, who argues that she did not, as Vontz alleged, owe a heightened fiduciary duty to him as the other 50 percent shareholder. Miller also argues that if she owed a heightened fiduciary duty to him, she did not breach it when she failed to attend the special shareholder meetings. Finally, she argues that even if she did breach a fiduciary duty owed to him, that breach was not actionable because she had a legitimate business purpose for her tactics.

1. Fiduciary Duties of Shareholders in a Close Corporation

[*P30] It is undisputed that Heidelberg is a close corporation under Ohio law, even though the corporate documents do not reference R.C. 1701.591, which authorizes close-corporation agreements. A "close corporation" is generally characterized as a corporation with few shareholders who own shares that are not traded on a securities market. *Crosby v. Beam*, 47 Ohio St.3d 105, 107, 548 N.E.2d 217 (1989); *Estate of Schroer v. Stamco Supply, Inc.*, 19 Ohio App.3d 34, 36, 19 Ohio B. 100, 482 N.E.2d 975 (1st Dist.1984) (superseded by statute on other grounds.) Additionally, a close corporation is typically marked by "an identity of management and [**17] ownership, * * * by restrictions on the free alienability of shares, * * * and * * * by its unmistakable resemblance to the partnership form." *Stamco* at 36-37. The Heidelberg shareholder agreement makes it particularly onerous for a shareholder to sell shares.

[*P31] Because a close corporation resembles a partnership, albeit with "advantages" of limited liability, *see id.* at 37, "the relationship between the shareholders must be one of trust, confidence and loyalty to thrive." *Crosby* at 108. Generally, Ohio courts impose a heightened fiduciary duty on majority or controlling shareholders in those close corporations to protect against abuse and oppression of minority shareholders. *Id.* at 109-110. This abuse or oppression includes a "squeeze-out" or "freeze-out"—the "manipulative use of corporate control to eliminate minority shareholders, or to reduce their share of voting power or percentage of ownership assets, or otherwise unfairly deprive them of advantages or opportunities to which they are entitled." *Stamco* at 38; *see Crosby* at 109; 2 O'Neal and Thompson, *Oppression of Minority Shareholders and LLC Members* (2 Ed.1985, May 2016 update).

[*P32] The standard of duty owed by majority or controlling shareholders in a close corporation is the "'utmost good faith and loyalty.'" [**18] *Crosby* at 108, quoting *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 367 Mass. 578, 593, 328 N.E.2d 505 (1975). A breach of this heightened fiduciary duty is actionable, absent "any legitimate business purpose." *Crosby* at paragraph two of the syllabus, following *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 353 N.E.2d 657 (1976). Ultimately, a controlling shareholder in a close corporation may not "take[] action [she] is authorized to take which nevertheless operates to the disadvantage of the minority and was not taken in good faith and for a legitimate business purpose." *Busch v. Premier Integrated Med. Assocs., Ltd.*, 2d Dist. Montgomery No. 19364, 2003-Ohio-4709, ¶ 79, quoted in *Rhodes v. Paragon Molding, Ltd.*, 2d Dist. Montgomery No. 22491, 2011-Ohio-4295, ¶ 17.

[*P33] This duty of good faith in the context of a close corporation or partnership involves more than just honesty, as explained in *DiPasquale v. Costas*, 186 Ohio App.3d 121, 2010-Ohio-832, 926 N.E.2d 682 (2d Dist.):

> "A lack of good faith is the equivalent of bad faith, and bad faith, although not susceptible of concrete definition, embraces more than bad judgment or negligence. It imports a dishonest purpose, moral obliquity, conscious wrongdoing, breach of a known duty through some ulterior motive or ill will partaking of the nature of fraud. It also embraces actual intent to mislead or deceive another."

Id. at ¶ 127, quoting *Hoskins v. Aetna Life Ins. Co.*, 6 Ohio St.3d 272, 276, 6 Ohio B. 337, 452 N.E.2d 1315 (1983).

[*P34] Miller argues that because she owns only 50 percent of the voting shares, the trial court erred in determining that she owed a heightened fiduciary duty to Vontz. She argues that a 50 percent shareholder never owes a heightened [**19] fiduciary duty to the other 50 percent shareholder in a close corporation, citing *Herbert v. Porter*, 165 Ohio App.3d 217, 2006-Ohio-355, 845 N.E.2d 574, ¶ 13 (3d Dist.), and *Morgan v. Ramby*, 12th Dist. Warren No. CA2007-12-147, 2008-Ohio-6194, ¶ 21.

[*P35] But the Ohio Supreme Court in *Crosby* held that this heightened fiduciary duty applies to "majority or controlling" shareholders. *Crosby*, 47 Ohio St.3d 105, 548 N.E.2d 217, at paragraph two of the syllabus. And some appellate districts have interpreted this to mean that a heightened fiduciary duty applies when one shareholder exercises "control over the corporation to an extent that [the shareholder's] actions dominate[]," even though the shareholder is "not technically a majority owner." *McLaughlin v. Beeghly*, 84 Ohio App.3d 502, 506-507, 617 N.E.2d 703 (10th Dist.1992), cited in *Morrison v. Gugle*, 142 Ohio App. 3d 244, 245, 755 N.E.2d 404 (10th Dist.2001). *Accord Heaton v. Rohl*, 193 Ohio App.3d 770, 2011-Ohio-2090, 954 N.E.2d 165, ¶ 4, 54 (11th Dist.); *Citizens Fed. Bank v. Chateau Constr. Co., Inc.*, 2d Dist. Montgomery No. 13902, 1994 Ohio App. LEXIS 167 (Jan. 19, 1994).

[*P36] In this case, the trial court found that Miller owed a heightened fiduciary duty to Vontz. Although Miller argues that the record contains no evidence to support this finding, we disagree. The evidence shows that Miller exercised her influence and authority to such a degree that she in fact dominated Heidelberg's governing board. And Miller exerted her control by refusing to attend a shareholder meeting, thereby defeating the quorum requirement necessary for Vontz to exercise his right to vote for new directors. By doing so, Miller ensured that none of her family members would [**20] be replaced on the board, thus securing her continued control of the corporation.

[*P37] Because Miller so dominated the corporation that she was in control to the exclusion of Vontz, the unusual facts of this case demonstrated that Miller was the controlling shareholder, even though she owned only 50 percent of the voting shares. Miller's obligation to Vontz under this heightened fiduciary duty precluded her from "freez[ing]-out" Vontz from the "advantages [and] opportunities" to which he was entitled, including the power to vote. *Stamco*, 19 Ohio App.3d at 38, 482 N.E.2d 975.

[*P38] Next, Miller, citing to *Peter Schoenfeld Asset Mgmt. LLC v. Shaw*, Del. Ch. No. 20087-NC, 2003 Del. Ch. LEXIS 79 (July 10, 2003), argues that she could not have breached a heightened fiduciary duty because she had no statutory or contractual obligation to attend the shareholder meeting. But a fiduciary relationship may impose duties apart from statute or contract. *See Stone v. Davis*, 66 Ohio St.2d 74, 78, 419 N.E.2d 1094 (1981). Under her heightened duty of good faith and loyalty, she had an obligation of fairness to Vontz. Her duty required her to act for his benefit by protecting his right to vote for the election of new directors. She breached that duty because, as Vontz clearly demonstrated, he was unable to exercise his voting power due to a freeze-out by Miller.

[*P39] Finally, Miller argues that the trial court's decision cannot [**21] be sustained because the alleged breach was not actionable under the law when she acted with a "legitimate business purpose" in refusing to attend the special shareholder meetings noticed by Vontz. *See Crosby*, 47 Ohio St.3d 105, 548 N.E.2d 217, at paragraph two of the syllabus. But we do not believe the conduct here—disenfranchising a 50 percent shareholder to perpetuate one's own control and in the process causing the corporation to violate its own regulations and Ohio law relating to the holding of an annual meeting—is the kind of "legitimate business purpose" envisioned by the *Crosby* court.

[*P40] Thus, we hold that the trial court's determination that Miller breached her heightened fiduciary duty to Vontz is supported by the law and the facts. To the extent that Miller's first assignment of error challenges the propriety of the trial court's judgment on this basis, we overrule it.

2. Fiduciary Duties of Directors

[*P41] Next, we address the claim of the Miller Directors, as set forth in their first assignment of error, and in Hice's first assignment of error, that the court erred in determining that they had breached their fiduciary duty to Vontz as directors/ officers, resulting in shareholder oppression.

[*P42] Directors of a corporation [**22] are fiduciaries and are bound to exercise their power as directors in compliance with the duty of loyalty and the duty of care. These duties are codified in R.C. 1701.59(B). Thus, the duty of loyalty requires a director to "perform * * * in good faith, in a manner the director reasonably believes to be in or not opposed to the best interests of the corporation," while the duty of care requires a director to exercise "the care that an ordinarily prudent person in a like position would use under similar circumstances." R.C. 1701.59(B).

[*P43] Under Ohio law, the directors of a close corporation owe these duties to both the corporation and its shareholders. *See Thompson v. Cent. Ohio Cellular, Inc.*, 93 Ohio App.3d 530, 540, 639 N.E.2d 462 (8th Dist.1994); *Universal Real Estate Solutions, Inc. v. Snowden*, 2014-Ohio-5813, 26 N.E.3d 1272 (9th Dist.), ¶ 45. The plaintiff must prove a breach of duty by clear and convincing evidence. R.C. 1701.59(D)(1).

[*P44] Ohio courts heed the "business judgment rule" when analyzing a director's conduct. *Koos v. Cent. Ohio Cellular*, 94 Ohio App.3d 579, 589, 641 N.E.2d 265 (8th Dist.1994). Under the business-judgment rule, "directors carry the burden of showing a transaction is fair only after the plaintiff has made a prima facie case showing that the directors have acted in bad faith or without the requisite objectivity." *Radol v. Thomas*, 772 F.2d 244, 256 (6th Cir. 1985). In other words, the directors are presumed to have acted in good faith and in the best interests of the corporation. This "presumption" applies under Ohio law even [**23] for business decisions "affecting or involving a change in control or a termination of [a director's] services." 1986 Committee Comment interpreting former R.C. 1701.59(C), now codified as R.C. 1701.59(D).

[*P45] Although the trial court's letter opinion is not reflective of the exact analysis applied to this claim, the court did find that the appellants-directors had "refused" Vontz's request that, as directors, they schedule an annual shareholder meeting in accordance with the law, and that they had done so to prevent Vontz from exercising his right as a shareholder to elect directors. The court characterized the actions of the appellants-directors as "oppress[ive]."

[*P46] Initially, we note that under Ohio law and the relevant governing documents of the corporation, the corporation was to be governed by a board elected by the majority of the voting shareholders. It is undisputed in this case that the majority of the voting shareholders no longer supported the current board as evidenced by Vontz's filing of this action.

[*P47] The appellants-directors argue that the record contains no evidence to rebut the presumption that they had acted in good faith.[2] In support of this assertion, they point to the trial court's comment that "no party has [**24] questioned the basic honesty of the other party." We interpret this to mean that the trial court found the appellants-directors had been very open about their oppression of Vontz, but that it also concluded they had not acted in good faith, when they refused to hold a shareholder meeting in accordance with the regulations for the purpose of thwarting a shareholder vote for new directors.

[*P48] In the corporate-director context, a lack of good faith includes conduct involving the "intentional dereliction of a duty, a conscious disregard for one's responsibilities." *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 66-67 (Del.2006) (quoting the chancellor's opinion to explain that "'[a] failure to act in good faith may be shown * * * where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties'"). Moreover, the duty of loyalty requires those in control of corporate processes to refrain from unfairly manipulating those processes to keep control. *See Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del.1971).

[*P49] Not only did Vontz present sufficient [**25] evidence to rebut the presumption that the appellants-directors had acted in good faith, the appellants-directors failed to show that their decision to deny Vontz's request had been fair. The appellants-directors take the position that the trial court should have judged the fairness of their decision by whether Vontz was denied profits or whether other board members who were also officers had diverted company assets or the like, findings that the trial court did not make. But we conclude that their tactics to thwart corporate democracy were not fair to Vontz as a shareholder with 50 percent of the voting rights. Accordingly, we overrule the Miller Directors' first assignment of error and Hice's first assignment of error to the extent that they challenge the trial court's finding that the directors had breached their fiduciary duty to Vontz.

3. Claim against Hice as General Counsel

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[2] We note that Delaware courts would not apply the business-judgment rule under these circumstances, and would instead apply a less deferential "compelling justification standard of review," where a board of directors has refused to act for the reason of preventing a 50 percent shareholder from exercising his voting rights. *See MM Cos., Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1128 (Del.2003). As one court put it, "the ordinary considerations to which the business judgment rule originally responded are simply not present in the shareholder voting context." *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del.Ch.1998). Instead, "a decision by the Board to act for the primary purpose of preventing the effectiveness of a shareholder vote inevitably involves the question who, as between the principal and agent, has authority with respect to a matter of internal corporate governance. * * * Judicial review of such action involves a determination of legal and equitable obligations of an agent towards his principal. This is not * * * a question that a court may leave to the agent finally to decide so long as he does so honestly and competently; that is, it may not be left to the agent's business judgment." *Id.* at 660.

[*P50] In Hice's second, third, and fourth assignments of error, she challenges the trial court's judgment with respect to any judgment against her in the role as general counsel. Vontz alleged in his complaint that Hice had breached her fiduciary duty "to him" as general counsel. The trial court found for Vontz [**26] on this claim and ordered Hice to "treat both shareholders equally."[3]

[*P51] Hice contends that as general counsel, her client was the corporation, and her duty and allegiance ran to the corporation and not the shareholders. *See Maloof v. Benesch, Friedlander, Coplan & Aronoff*, 8th Dist. Cuyahoga No. 84006, 2004-Ohio-6285, ¶ 27. We agree.

[*P52] As general counsel, Hice owed a fiduciary duty to the corporation, but not to Vontz as an individual shareholder. Therefore, the trial court erred by finding for Vontz on his claim against Hice as general counsel. Accordingly, we reverse that part of the trial court's judgment and direct the trial court to strike from the injunctive order the mandate that "Hice * * * shall treat both shareholders equally henceforth." Accordingly, we sustain Hice's second, third, and fourth assignments of error.

B. Appropriateness of Injunctive Relief

[*P53] The question remains as to whether the injunctive relief awarded was warranted in light of the appellants' breach of fiduciary duties.

[*P54] "Injunction is an extraordinary remedy equitable in nature, and its issuance may not be demanded as a matter of strict right; the allowance of an injunction rests in the sound discretion of the court and depends on the facts and circumstances surrounding the particular case." *Perkins v. Quaker City*, 165 Ohio St. 120, 133 N.E.2d 595 (1956), syllabus. "Whether [**27] it will be granted depends largely on the character of the case, the peculiar facts involved and other pertinent factors, among which are those relating to public policy and convenience." *Id.* at 125.

[*P55] An abuse of discretion contemplates "an attitude" by the court "that is unreasonable, arbitrary or unconscionable." *AAAA Ents., Inc. v. River Place Community Urban Redev. Corp.*, 50 Ohio St.3d 157, 161, 553 N.E.2d 597 (1990). An unreasonable decision is one that is not supported by a "sound reasoning process." *Id.*

[*P56] In this case, the trial court found that Vontz's concerns were compelling, and that "[t]he implications for not [awarding injunctive relief] would be disastrous for the plaintiff in specific and Ohio law regarding closely held corporations in general." Essentially, the court found, based on the evidence, that the appellants would retain "perpetual control over the company." We hold that the trial court was within its discretion in determining that the equities weighed in favor of Vontz, and that some injunctive relief was warranted in this case. *See Crosby*, 47 Ohio St.3d at 108, 548 N.E.2d 217, quoting *United States v. Byrum*, 408 U.S. 125, 137-38, 92 S.Ct. 2382, 33 L.Ed.2d 238, fn. 11 (1972) ("'A court of equity will grant appropriate relief where the majority or dominant group of shareholders act in their own interest or in the interest of others so as to oppress the minority or commit fraud upon their rights.'") The terms of [**28] the court's order must be modified, however, as discussed below.

[*P57] It is well-settled that a party seeking equitable relief in the form of an injunction must show by clear and convincing evidence that the injunction is necessary to prevent a great or irreparable injury for which the party does not have an adequate remedy at law. *Dayton Metro. Hous. Auth. v. Dayton Human Relations Council*, 81 Ohio App.3d 436, 442, 611 N.E.2d 384 (2d Dist.1992), cited in *Stoneham*, 140 Ohio App.3d 260, 267-268, 747 N.E.2d 268; *see Hritz v. United Steel Workers of Am., AFL CIO*, 12th District Warren No. CA2002-10-108, 2003-Ohio-5284, ¶ 44.

[3] We do not read the complaint as stating a claim for breach of fiduciary duty against the other Miller family "officers."

[*P58] We first address the Miller Directors' argument that their conduct as directors could not have been the cause of any "irreparable harm" to Vontz. They contend that Vontz as co-chairman of the board and president was authorized to call—and did call—a special meeting for the election of directors at which he could exercise his right to vote. Furthermore, they emphasize that as directors they had no authority to require Miller's attendance at such a meeting.

[*P59] We are persuaded in part. Because Vontz can call the special shareholder meeting for the election of directors, Vontz failed to establish the irreparable harm necessary to support an injunctive order requiring the board to schedule the shareholder meeting. Therefore, the trial court must strike from its [**29] injunctive order the language and the related provisions requiring the board to schedule a shareholder meeting. Accordingly, we sustain the Miller Directors' first assignment of error to the extent that it presents this argument.

[*P60] Next, we address Miller's challenge to the trial court's order to the extent that it compels her to attend a shareholder meeting for the election of directors. Miller argues that the trial court cannot fashion a remedy where the Ohio General Assembly has not provided one. In other words, because she is not required by statute to attend a shareholder meeting, the court cannot order her to do so. Miller, quoting *Chomczynski v. Cinna Scientific, Inc.*, 1st Dist. Hamilton No. C 010170, 2002-Ohio-4605, ¶ 9, insists that a corporation as legal entity is a creature of statute and "can act in no other way than set forth by statute." While that is a correct statement of the law, Vontz, unlike the plaintiff in *Chomczynski*, invoked the equity jurisdiction of the trial court to enforce his rights as a shareholder. *See id.* at ¶ 19.

[*P61] Generally, corporate statutes do not displace all common-law equitable powers of the court. *See Danziger*, 103 Ohio St. 3d 337, 2004-Ohio-5227, 815 N.E.2d 658, syllabus (holding that "shareholders have a right at common law to inspect the records of a wholly owned subsidiary of the corporation [**30] in which they own stock when the parent corporation so controls and dominates the subsidiary that the separate corporate existence of the subsidiary should be disregarded"); Bahls, *Resolving Shareholder Dissension: Selection of the Appropriate Equitable Remedy*, 15 J.Corp.L., 285, 294 (1990) ("Modern corporate legislation is designed to provide courts with powers that supplement their inherent equitable powers, rather than diminish their historic powers.")

[*P62] Miller also argues that there is no precedent for requiring her to attend a shareholder meeting. The Ohio Supreme Court has held, however, that "'[p]recedents in equity are a guide to the principles of equity, but the absence of a precedent for the particular relief sought is no bar to action.'" *Civil Service Personnel Asso. v. Akron*, 48 Ohio St. 2d 25, 28, 356 N.E.2d 300 (1976), quoting McClintock on Equity, (2d Ed.1948), 77. But we are persuaded that the trial court erred by incorporating terms in its injunctive order that were not narrowly tailored to remedy the irreparable harm at issue here. *See Eastwood Mall v. Slanco*, 68 Ohio St.3d 221, 224, 1994 Ohio 433, 626 N.E.2d 59 (1994) ("Equity requires that an injunction should be narrowly tailored to prohibit only the complained of activities.") The trial court should have cured the irreparable harm resulting from Miller's manipulation of the regulations to suppress Vontz's voting rights without requiring Miller to attend an annual shareholder meeting.

[*P63] The parties, [**31] at trial and on appeal, argued that Regulation 2.07 of the Heidelberg Code of Regulations required the attendance of a majority of the voting shareholders to establish a quorum, without which no new directors could be elected at the shareholder meeting for the election of directors. Because of Miller's oppressive conduct, which resulted in irreparable harm to Vontz in that he could not exercise his voting rights, equity would require that the quorum requirement of Regulation 2.07 not apply when Vontz calls another special shareholder meeting for the election of directors. Instead, a quorum requirement should be applied that sets quorum at the number of voting shareholders who attend that meeting, and when quorum is met, the election of directors may then proceed as authorized under Regulation 2.07.

[*P64] Other states have enacted legislation to remedy the oppression of voting rights under similar circumstances. For example, a New York statute gives shareholders the right under specific circumstances to call a special meeting for the election of directors and provides that "[a]t * * * such a special meeting * * * the shareholders attending, in person or by proxy, and entitled to vote in an election [**32] of directors shall constitute a quorum for the purpose of electing directors, but not for the transaction of any other business." N.Y.Business Corporation Law 603. We direct the trial court on remand to incorporate similar language into its modified injunctive order. Thus, Miller may choose not to attend the shareholder meeting for the election of directors, but her failure to attend will not perpetuate the suppression of Vontz's shareholder rights.

[*P65] To the extent that Miller's first assignment of error challenges the injunctive order because it requires her to attend the shareholder meeting for the election of directors it is sustained. Thus, the trial court must modify the order accordingly.

[*P66] Miller also challenges the injunctive order because it requires the board to be "equalized." First, she argues that the board cannot be equalized because it consists of seven seats, and the parties will only be able to elect three directors each and will disagree on the seventh. The result, she claims, will be a failed election and the current board will carry over, in accordance with Ohio law and the corporate regulations. But Vontz takes the position, which is supported by our record,[4] that the election of six directors will [**33] be valid.

[*P67] Second, Miller argues, citing to *Humphrys v. Winous Co.*, 165 Ohio St. 45, 133 N.E.2d 780 (1956), that the requirement of equalization will give Vontz more power than Ohio law allows. In *Winous*, the court held that the right of cumulative voting "confers upon a minority shareholder only a right to vote cumulatively and does not ensure minority representation on the board of directors by the exercise of that right." *Id.* at paragraph three of the syllabus. We interpret *Winous* to support Miller's argument, and as a result we sustain Miller's second assignment of error. The irreparable harm to be remedied here is the suppression of Vontz's right to vote. As a result, we instruct the trial court to strike the language of the injunctive order related to the equalization of the board.

[*P68] For the same reason, and to provide additional clarity, we also order the trial court to strike the language of the injunctive order instructing the parties "to work out the directors to be removed." Hice challenges this part of the injunctive order, along with the mandate that she "treat both shareholders equally," in her fourth assignment of error, which we sustain. As modified, the injunctive order should comply with Civ.R. 65(D), which requires every order granting an [**34] injunction to be specific and clear.

[*P69] Finally, we address the appellants' challenge to the provision of the injunctive order that relates to the payment of attorney fees. The trial court included in its order a statement that each party is to pay its own attorney fees. The appellants argue that if the trial court intended by this language to deny them the right of indemnification of their attorney fees by the corporation, then the trial court erred. But we do not read this statement to be a ruling on the corporation's obligation to indemnify the Miller family directors and officers for attorney fees, as the issue of indemnification was never an issue in the case. Accordingly, we overrule the relevant assignments of error (the Miller Directors' fourth and Hice's seventh) on the grounds that the error assigned is not demonstrated in the record.

[4] Our record does not include corporate by-laws, if any exist.

[*P70] Finally, the appellants seek reversal of the injunctive order for reasons related to the breach-of-contract and violation-of-corporate-requirement claims. Our disposition of the challenges addressed above render moot the challenges on appeal related to the trial court's grant of relief to Vontz based on those claims. Therefore, we do not reach [**35] the merits of those claims. *See* App.R. 12(A)(2).

III. Conclusion

[*P71] To summarize, the trial court erred by determining that Hice as general counsel breached her fiduciary duty to Vontz, by determining that Vontz was "irreparably harmed" by the board's refusal to schedule a shareholder meeting for the election of directors, and by incorporating terms in its injunctive order that were not narrowly tailored to remedy the irreparable harm caused by Miller's breach of her heightened fiduciary duty as a controlling shareholder. For these reasons, we reverse the trial court's judgment in part and remand for further proceedings consistent with this opinion and the law. In all other respects, we affirm the trial court's judgment.

Judgment affirmed in part, reversed in part, and cause remanded.

DEWINE and **MOCK, JJ.**, concur.

Please note: The court has recorded its own entry on the date of the release of this opinion.

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Dombroski v. WellPoint, Inc.

Supreme Court of Ohio

June 4, 2008, Submitted; September 30, 2008, Decided

No. 2007-2162

Reporter
119 Ohio St. 3d 506 *; 2008-Ohio-4827 **; 895 N.E.2d 538 ***; 2008 Ohio LEXIS 2582 ****

DOMBROSKI, APPELLEE, v. WELLPOINT, INC. ET AL., APPELLANTS, ET AL.

Prior History: [****1] CERTIFIED by the Court of Appeals for Belmont County, No. 06-BE-60, 173 Ohio App.3d 508, 2007 Ohio 5054, 879 N.E.2d 225.

Dombroski v. Wellpoint, Inc., 173 Ohio App. 3d 508, 2007 Ohio 5054, 879 N.E.2d 225, 2007 Ohio App. LEXIS 4440 (Ohio Ct. App., Belmont County, 2007)

Disposition: Judgment reversed.

Syllabus

To fulfill the second prong of the *Belvedere* test for piercing the corporate veil, the plaintiff must demonstrate that the defendant shareholder exercised control over the corporation in such a manner as to commit fraud, an illegal act, or a similarly unlawful act. (*Belvedere Condominium Unit Owners' Assn. v. R.E. Roark Cos., Inc.* (1993), 67 Ohio St. 3d 274, 1993 Ohio 119, 617 N.E.2d 1075, modified.)

Counsel: Vorys, Sater, Seymour & Pease, L.L.P., and Suzanne K. Richards, Robert N. Webner, and Michael J. Hendershot; and Thornburg, Bean & Glick and Charles H. Bean, for appellants.

Robert Gray Palmer Co., L.P.A., and Robert G. Palmer, for appellee.

Linda S. Woggon, urging reversal for amici curiae Ohio Chamber of Commerce, Ohio Council of Retail Merchants, the Ohio Chapter of the National Federation of Independent Business, and the Ohio Farm Bureau Federation.

Judges: MOYER, C.J. LUNDBERG STRATTON, O'CONNOR, O'DONNELL, LANZINGER, and CUPP, JJ., concur. PFEIFER, J., dissenting.

Opinion by: MOYER

Opinion

[*507] [***540] **MOYER, C.J.**

I

[**P1] The Seventh District Court of Appeals has certified this case pursuant to Section 3(B)(4), Article IV, Ohio Constitution [****2] and App.R. 25. The court of appeals found its judgment to be in conflict with the judgments of the Sixth District Court of Appeals in *Collum v. Perlman* (Apr. 30, 1999), Lucas App. No. L-98-1291, 1999 Ohio App. LEXIS 1938, and *Widlar v. Young*, Lucas App. No. L-05-1184, 2006 Ohio 868, on the following issue: "Does the second prong of [the test for piercing the corporate veil set forth in *Belvedere Condominium Unit Owners' Assn. v. R.E. Roark Cos., Inc.* (1993), 67 Ohio St. 3d 274, 1993 Ohio 119, 617 N.E.2d 1075], which states that the corporate veil can be pierced when control of the corporation 'was exercised in such a manner as to commit fraud or an illegal act against the person seeking to disregard the corporate entity,' also allow the corporate veil to be pierced in cases where control was exercised to commit unjust or inequitable acts that do not rise to the level of fraud or an illegal act?"

[**P2] For the following reasons, we answer the question in the negative and reverse the judgment of the court of appeals. However, we modify the second prong of the *Belvedere*test to require that a plaintiff must demonstrate that the defendant shareholder exercised control over the corporation in such a manner as to commit fraud, an illegal [****3] act, or a similarly unlawful act.

II

[**P3] The trial court dismissed the claims relevant to this matter upon a Civ.R. 12(B)(6) motion to dismiss. We therefore rely upon the allegations in the amended complaint to establish the material facts for our review. *Vitantonio, Inc. v. Baxter*, 116 Ohio St.3d 195, 2007 Ohio 6052, 877 N.E.2d 663, P 2.

[**P4] Plaintiff-appellee, Kimberly J. Dombroski, suffers from profound sensorineural hearing loss in both ears; in other words, she is completely deaf. Shortly after she was diagnosed with this condition, her treating physician determined that it was medically necessary for her to receive a cochlear implant. [1] [*508] Dombroski subsequently received a cochlear implant in her left ear, which restored her ability to hear in that ear.

[**P5] However, the implant did not increase Dombroski's ability to hear in her right ear. Her treating physician determined that it was medically necessary for [****4] her to receive a second cochlear implant so that she could localize sound and better communicate with others.

[**P6] Dombroski's initial implant was paid for by an insurance company that is not a party to this case. When she sought the second implant, she had a health insurance contract with defendant Community Insurance Company ("Community"). One of Community's affiliates, defendant Anthem UM Services, Inc. ("Anthem UM"), participated in the administration of Dombroski's [***541] policy, as did defendant-appellee Anthem Insurance Companies, Inc. ("Anthem Insurance"). Defendant-appellee WellPoint, Inc., which is a publicly traded company listed on the New York Stock Exchange, owns 100 percent of the stock of these three companies.

[**P7] In accordance with the terms of the Community insurance policy, Dombroski's treating physician requested authorization to place a cochlear implant in Dombroski's right ear. Anthem UM denied coverage, claiming that "the use of bilateral cochlear implants to improve hearing is considered investigational." Dombroski appealed this decision through Anthem UM's internal appeals process, but was unsuccessful.

[**P8] Dombroski filed the instant action against Community, Anthem UM, Anthem [****5] Insurance, and WellPoint. In her first two claims for relief, she alleged that the defendants had breached the insurance contract and were promissorily estopped from violating their promises to act in good faith and in accordance with their own policies and procedures. For her final claim, Dombroski alleged that the defendants had acted in bad faith in processing and repeatedly denying her requests for a cochlear implant in her right ear and that these actions caused her to suffer physical and pecuniary losses and emotional distress. Insurer bad faith is an actionable tort in this state. See *Hoskins v. Aetna Life Ins. Co.* (1983), 6 Ohio St.3d 272, 6 OBR 337, 452 N.E.2d 1315, paragraph one of the syllabus.

[**P9] As further support for her claims against WellPoint and Anthem Insurance, Dombroski alleged that "WellPoint through [Anthem Insurance] establishes certain 'corporate medical policies,' which it directs its subsidiaries to utilize

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[1] A cochlear implant is a small electronic device that is placed inside a deaf person's ear and provides him or her with a sense of sound. According to the amended complaint, such implants are approved by the Food and Drug Administration and have a success rate of approximately 90 percent.

in the administering, handling and processing of claims under its insurance products throughout the United States." She further alleged that a specific Anthem Insurance medical policy served as the primary basis for denying coverage for [*509] the cochlear implant [****6] and that the "handling, processing and repeated denials" of coverage constituted bad faith. Finally, Dombroski alleged that (1) WellPoint owned 100 percent of the stock of the other defendants, (2) WellPoint controlled those subsidiary corporations to such a degree that the subsidiaries had no separate minds, wills, or existences of their own, and (3) WellPoint and Anthem Insurance are operated and controlled by the same officers and have the same office headquarters, and one of WellPoint's officers signed the insurance certificate issued to Dombroski.

[**P10] WellPoint and Anthem Insurance filed motions to dismiss pursuant to Civ.R. 12(B)(6). They argued that Dombroski failed to raise a claim upon which relief could be granted because she did not have privity of contract with either organization and she failed to allege a legitimate basis for piercing the corporate veil to hold the organizations liable in their capacities as shareholders of Community and Anthem UM.

[**P11] The trial court found that Dombroski had not alleged facts showing privity of contract with either organization. It further found that Dombroski had failed to allege facts sufficient for piercing the corporate veil because she [****7] did not demonstrate "the type of illegal or unjust result intended by *Belvedere*." The trial court therefore dismissed Dombroski's claims against WellPoint and Anthem Insurance pursuant to Civ.R. 12(B)(6). This ruling did not affect her claims against Community and Anthem UM.

[**P12] The court of appeals reversed the decision of the trial court, holding that Dombroski had pleaded sufficient facts to [***542] advance claims against WellPoint and Anthem Insurance based on piercing the corporate veil. *Dombroski v. WellPoint, Inc.*, 173 Ohio App.3d 508, 2007 Ohio 5054, 879 N.E.2d 225, P37.

[**P13] The court of appeals' discussion of the second prong of the *Belvedere* test for piercing the corporate veil is relevant to our review. The second prong requires the plaintiff to show that shareholders exercised their control of the corporation to be pierced "in such a manner as to commit fraud or an illegal act against the person seeking to disregard the corporate entity." *Belvedere*, 67 Ohio St.3d 274, 1993 Ohio 119, 617 N.E.2d 1075, paragraph three of the syllabus. The court of appeals read this provision broadly, stating that a plaintiff can pierce the corporate veil for less than fraudulent or illegal acts: "Many appellate districts, [****8] including ours, have defined the second prong of *Belvedere* as including unjust or inequitable acts." *Dombroski* at P 25. Following that interpretation, the court concluded that the alleged bad-faith breach of the insurance contract at issue here was sufficiently unjust to survive a Civ.R. 12(B)(6) motion. Id. at P 33.

[**P14] The court of appeals determined that its decision conflicted with the judgments of the Sixth District Court of Appeals in *Collum v. Perlman* (Apr. 30, 1999), Lucas App. No. L-98-1291, 1999 Ohio App. LEXIS 1938, and *Widlar v. Young*, Lucas [*510] App. No. L-05-1184, 2006 Ohio 868, and certified the case as a conflict to this court. We recognized the certified conflict.

III

A. Limited Shareholder Liability and Piercing the Corporate Veil

[**P15] This case requires us to determine what conduct must be demonstrated to fulfill the second prong of the test for piercing the corporate veil created in *Belvedere*. To place our decision in context, we must first examine the nature of limited shareholder liability and the rationale for the principle that piercing the corporate veil operates as an exception to this limited liability.

[**P16] The principle that shareholders, officers, and directors of a corporation are generally not liable [****9] for the debts of the corporation is ingrained in Ohio law. See Section 3, Article XIII, Ohio Constitution; *Belvedere*, 67 Ohio St.3d at 287, 617 N.E.2d 1075, citing Presser, Piercing the Corporate Veil (1991) 1-4. The corporate form is useful primarily because it creates a division between shareholders and their business concerns: "[The corporate form] has been introduced for the convenience of the company in making contracts, in acquiring property for corporate purposes, in suing and being sued, and to preserve the limited liability of the stockholders, by distinguishing between the corporate debts and property of the company, and of the stockholders in their capacity as individuals." *State ex rel. Atty. Gen. v. Std. Oil Co.* (1892), 49 Ohio St. 137, 177, 30 N.E. 279.

[**P17] However, shareholders are not absolutely immune from liability for the actions of their corporations. "[L]ike every other fiction of the law, when urged to an intent and purpose not within its reason and policy, [the corporate form] may be disregarded." *State ex rel. Atty. Gen.* at paragraph one of the syllabus. Shareholders may thus be held liable for their own bad acts notwithstanding the protections afforded by the corporate [****10] form when they use the corporation "for criminal or fraudulent purposes" to the detriment of a third party. *Belvedere*, 67 Ohio St.3d at 287, 289, 617 N.E.2d 1075. Piercing the corporate veil in this manner remains a "rare exception," to be applied only "in the case of fraud or certain other [***543] exceptional circumstances." *Dole Food Co. v. Patrickson*, 538 U.S. 468, 475, 123 S. Ct. 1655, 155 L. Ed. 2d 643.

[**P18] In *Belvedere*, this court established a three-pronged test for courts to use when deciding whether to pierce the corporate veil, based on a test developed by the United States Court of Appeals for the Sixth Circuit in *Bucyrus-Erie Co. v. Gen. Prods. Corp.* (C.A. 6, 1981), 643 F.2d 413, 418. *Belvedere*, 67 Ohio St.3d at 288-289, 617 N.E.2d 1075. This test focuses on the extent of the shareholder's control of the corporation and whether the shareholder misused the control so as to commit specific egregious acts that injured the plaintiff: "The corporate form may be disregarded and individual shareholders held liable for wrongs committed [*511] by the corporation when (1) control over the corporation by those to be held liable was so complete that the corporation has no separate mind, will, or existence [****11] of its own, (2) control over the corporation by those to be held liable was exercised in such a manner as to commit fraud or an illegal act against the person seeking to disregard the corporate entity, and (3) injury or unjust loss resulted to the plaintiff from such control and wrong." Id. at paragraph three of the syllabus. All three prongs of the test must be met for piercing to occur.

[**P19] We must take as true the allegation that WellPoint and Anthem Insurance controlled the subsidiary corporations, Community and Anthem UM, to such a degree that those corporations had no separate minds, wills, or existences of their own. Thus, our review of this case focuses on the second prong of the *Belvedere* test.

B. Fraud or Illegal Acts versus Unjust or Inequitable Acts

[**P20] We must determine how broadly to construe the language of the second prong of the *Belvedere* test, that "control over the corporation by those to be held liable was exercised in such a manner as to commit fraud or an illegal act against the person seeking to disregard the corporate entity." *Belvedere*, 67 Ohio St.3d 274, 1993 Ohio 119, 617 N.E.2d 1075, paragraph three of the syllabus. The courts of appeals have interpreted the phrase "fraud or an [****12] illegal act" in two different ways.

[**P21] Several courts of appeals, including the Seventh District Court of Appeals in this case and the Third, Tenth, Eleventh, and Twelfth District

Courts of Appeals, have liberally construed the language of the second prong. These courts rely on the fact that piercing is an equitable remedy, seizing on language from *Belvedere* that piercing should occur "'when it would be unjust to allow the shareholders to hide behind the fiction of the corporate entity.'" *Stypula v. Chandler*, Geauga App. No. 2002-G-2468, 2003 Ohio 6413, at P 19, quoting *Belvedere*, 67 Ohio St.3d at 287, 617 N.E.2d 1075; see also *Wiencek v. Atcole Co., Inc.* (1996), 109 Ohio App.3d 240, 245, 671 N.E.2d 1339. "[T]he true question to be asked is whether it would be unjust under the circumstances of each case to not pierce the corporate veil." *Robert A. Saurber Gen. Contractor v. McAndrews*, Butler App. No. CA2003-09-239, 2004 Ohio 6927, at P 34. See also *Sanderson Farms, Inc. v. Gasbarro*, Franklin App. No. OIAP-461, 2004 Ohio 1460, at P 38.

[**P22] Because the plain language of the second prong of the *Belvedere* test imperfectly applies to this view, these courts have modified the requirement of "fraud [****13] or an illegal act" to allow for additional forms of misconduct. Their modified version of the second prong thus requires the plaintiff to "present evidence that the shareholders exercised their control over the corporation in such a manner as to commit [***544] a *fraud, illegal, or other unjust or inequitable act* [*512] upon the person seeking to disregard the corporate entity." (Emphasis added.) *Wiencek*, 109 Ohio App.3d at 245, 671 N.E.2d 1339. See also *Taylor Steel, Inc. v. Keeton* (C.A. 6 2005), 417 F.3d 598, 610 (adopting this interpretation in the United States Court of Appeals for the Sixth Circuit). Adding unjust or inequitable conduct to the second prong of the *Belvedere*test significantly increases the number of cases in which a plaintiff could pierce the corporate veil.

[**P23] The Sixth District Court of Appeals has adopted a narrower view of the *Belvedere* language. That court of appeals strictly follows the plain language of the second prong and limits piercing to those cases in which the defendant shareholder has used its control of the corporate form to commit fraud or an illegal act. *Collum v. Perlman* (Apr. 30, 1999), Lucas App. No. L-98-1291, 1999 Ohio App. LEXIS 1938; 1999 WL 252725. The Sixth District Court of Appeals [****14] has determined that the Third District Court of Appeals' interpretation of the second prong in *Wiencek* "goes too far" and has noted that this court "appears to have limited the application of the doctrine to those situations in which 'control over the corporation by those to be held liable was exercised in such a manner as to commit *fraud or an illegal act* against the person seeking to disregard the corporate entity.' (Emphasis added.)" Id.

[**P24] Under this interpretation, Dombroski would be unable to pierce the corporate veil to sue WellPoint and Anthem Insurance, since she has not alleged that they used their control over Community and Anthem UM to commit any fraudulent or illegal acts against her. [2]

[**P25] [****15] There are compelling reasons to follow the majority of the courts of appeals and expand the fraud-or-illegal-act test in *Belvedere*. Individuals are normally liable for their own actions, and it makes sense that this principle should be considered even when a corporate form stands between the plaintiff and the offending shareholder.

[**P26] Nevertheless, we continue to adhere to the principle that limited shareholder liability is the rule, see *Belvedere*, 67 Ohio St.3d at 287, 617 N.E.2d 1075, and piercing the corporate veil is the "rare exception" that should only be "applied in the case of fraud or certain other exceptional circumstances." *Dole Food Co.*, 538 U.S. at 475, 123 S.Ct. 1655, 155 L.Ed.2d 643. While we noted

[2] Dombroski argues in her brief that the tort of insurer bad faith could constitute an illegal act within the meaning of *Belvedere*. However, our order accepting the certified conflict limited the parties to briefing the issue of whether the corporate veil can be pierced for "unjust or inequitable acts" that do not rise to the level of "fraud or an illegal act." 116 Ohio St. 3d 1472, 2008 Ohio 153, 879 N.E.2d 781. Therefore, her arguments in this regard will not be considered. S.Ct.Prac.R. IV(3)(B).

in Belvedere that piercing should be allowed when it would be unjust for shareholders to hide behind the corporate fiction, we also stated that the test adopted there [*513] struck the correct balance between the guiding principles of limited shareholder liability and the fact that shareholders occasionally misuse the corporate form as a shield from liability for their own misdeeds. *Belvedere*, 67 Ohio St.3d at 287, 289, 617 N.E.2d 1075.

[**P27] Limiting piercing to cases in which the shareholders [****16] used their complete control over the corporate form to commit specific egregious acts is key to maintaining this balance. Were we to allow piercing every time a corporation under the complete control of a shareholder committed an unjust or inequitable act, virtually every close corporation could be [***545] pierced when sued, as nearly every lawsuit sets forth a form of unjust or inequitable action and close corporations are by definition controlled by an individual or small group of shareholders. See Black's Law Dictionary (8th Ed.2004) 365. Controlling shareholders in publicly traded corporations could also be subject to frequent piercing, regardless of the corporation's liability and its ability to pay for the plaintiff's injuries. Such expansive liability would run contrary to the concept of limited shareholder liability and upset the balance struck in *Belvedere*. Thus, the proposed expansion of the second prong of the *Belvedere* test to include unjust or inequitable conduct is simply too broad to survive exacting review.

[**P28] However, having reviewed the various tests for piercing the corporate veil developed by other authorities, we are convinced that our pronouncement in *Belvedere* is too limited [****17] to protect other potential parties from the wide variety of egregious shareholder misdeeds that may occur. Limiting piercing to cases of fraud or illegal acts protects the established principle of limited liability, but it insulates shareholders when they abuse the corporate form to commit acts that are as objectionable as fraud or illegality. In view of the reality that shareholders could seriously misuse the corporate form and evade personal liability under the second prong as presently worded, we find it necessary to modify the second prong of the *Belvedere* test to allow for piercing in the event that egregious wrongs are committed by shareholders.

[**P29] Accordingly, we hold that to fulfill the second prong of the *Belvedere*test for piercing the corporate veil, the plaintiff must demonstrate that the defendant shareholder exercised control over the corporation in such a manner as to commit fraud, an illegal act, or a similarly unlawful act. Courts should apply this limited expansion cautiously toward the goal of piercing the corporate veil only in instances of extreme shareholder misconduct. The first and third prongs of the *Belvedere* test are not affected by this ruling and must still [****18] be met for a piercing claim to succeed.

[**P30] However, even under this expanded version of the second prong of the *Belvedere* test, Dombroski's claim fails. Insurer bad faith is a straightforward tort, a basic example of unjust conduct; it does not represent the type of [*514] exceptional wrong that piercing is designed to remedy. Civ.R. 12(B)(6) provides a suitable vehicle for dismissing such a claim. We therefore reverse the judgment of the court of appeals.

IV

[**P31] For the foregoing reasons, we reverse the holding of the court of appeals and modify the second prong of the *Belvedere* test as set forth above.

Judgment reversed.

LUNDBERG STRATTON, O'CONNOR, O'DONNELL, LANZINGER, and CUPP, JJ., concur.

Dissent by: PFEIFER

Dissent

PFEIFER, J., dissents.

[**P32] Because this court never intended in *Belvedere Condominium Unit Owners' Assn. v. R.E. Roark Cos., Inc.* (1993), 67 Ohio St. 3d 274, 1993 Ohio 119, 617 N.E.2d 1075, to narrowly define the types of injustices that could satisfy the element of "fraud or an illegal act" required for piercing the corporate veil, because the vast majority of Ohio's appellate districts have effectively applied a less rigid standard to that part of the *Belvedere* test, because the majority's modification of the *Belvedere* [****19] test adds words to the test but no clarification, and [***546] because the violation of an insurer's duty of good faith satisfies even the majority's distortion of the *Belvedere* test to "fraud, an illegal act, or a similarly unlawful act," I dissent.

I

[**P33] In *Belvedere*, this court found that "the Sixth Circuit's approach [in *Bucyrus-Erie Co. v. Gen. Prods. Corp.* (C.A. 6, 1981), 643 F.2d 413] to piercing the corporate veil strikes the correct balance between the principle of limited shareholder liability and the reality that the corporate fiction is sometimes used by shareholders to protect themselves from liability for their own misdeeds." *Belvedere*, 67 Ohio St.3d at 289, 617 N.E.2d 1075. This court quoted the test enunciated in *Bucyrus-Erie Co.*:

[**P34] "In *Bucyrus-Erie*, the Sixth Circuit applied Ohio law in reviewing jury instructions in a veil-piercing case. It held that the corporate form may be disregarded when '(1) domination and control over the corporation by those to be held liable is so complete that the corporation has no separate mind, will, or existence of its own; (2) *that domination and control was used to commit fraud or wrong or other dishonest or unjust act*, and (3) injury or unjust loss resulted to the plaintiff [****20] from such control and wrong.' *Id.* at 418." (Footnote omitted; emphasis added.) Belvedere, 67 Ohio St.3d at 288, 617 N.E.2d 1075.

[**P35] [*515] In restating the *Bucyrus-Erie* test in *Belvedere*, this court expressed no intent to restrictively redefine what types of acts would satisfy the second element of the test enunciated in *Bucyrus-Erie*. Instead, this court truncated *Bucyrus-Erie's* phrase "fraud or wrong or other dishonest or unjust act" to "fraud or an illegal act." Nothing in *Belvedere* indicates that this court felt that *Bucyrus-Erie* was overly expansive in setting forth what kind of corporate misdeeds might be necessary to pierce the corporate veil. Indeed, the court made clear that it was the *injustice* of the underlying shareholders' acts that was significant: "[T]he 'veil' of the corporation can be 'pierced' and individual shareholders held liable for corporate misdeeds when it would be *unjust* to allow the shareholders to hide behind the fiction of the corporate entity." (Emphasis added.) Id. at 287, 617 N.E.2d 1075. Elsewhere in *Belvedere*, the court cited a corporation's "fraud or other wrongs" that could lead to liability for shareholders. Id. at 288. A leading treatise interprets this court's decision in *Belvedere* [****21] thusly: "[T]he Ohio Supreme Court has now clearly adopted the *Bucyrus-Erie* rule that it is not necessary to prove fraud to pierce the veil." Presser, Piercing the Corporate Veil (2004), 2-449, Section 2:39. That is, until today.

II

[**P36] As the majority sets forth, most Ohio appellate courts that have addressed the issue have held that the *Belvedere* element of "fraud or an illegal act" should not be rigidly and mechanically construed to include only fraud or criminal acts. For instance, the court in *Wiencek v. Atcole Co., Inc.* (1996), 109 Ohio App. 3d 240, 245, 671 N.E.2d 1339, held that the second element of *Belvedere* is satisfied where the corporation has committed a "fraud, illegal, or other unjust or inequitable act upon the person seeking to disregard the corporate entity." Ohio corporations have well withstood Ohio appellate courts' expansive view --

a view consistent with *Bucyrus-Erie* -- of the type of corporate activity that satisfies the second element of *Belvedere*. Piercing the corporate veil remains difficult to achieve; we accepted this case not to cure an epidemic of veil piercings but instead because one Ohio appellate district stood against the tide of Ohio appellate law, creating [****22] a conflict. Instead of resolving the conflict, this court has muddied the waters.

[***547] **III**

[**P37] "Now that the Ohio Supreme Court's *Belvedere* opinion has clearly addressed the veil-piercing issue there should be much less uncertainty about the appropriate Ohio tests. They are those to be found in *Bucyrus-Erie* and its progeny." (Footnote omitted.) Presser, Piercing the Corporate Veil, at 2-454455, Section 2:39.

[**P38] [*516] To the contrary, today the majority abrogates this court's previous reliance on *Bucyrus-Erie* and thus installs a much more restrictive test than it originally set forth in *Belvedere*. Ironically, the majority claims to be fine-tuning *Belvedere's* second element to cover "egregious wrongs" perpetrated by shareholders as it simultaneously greatly restricts the kinds of claims that can successfully be brought pursuant to *Belvedere*.

[**P39] The majority believes that it expands on the *Belvedere* element of a "fraud or an illegal act" by including the redundancy "or a similarly unlawful act." Thus, not only may an "illegal act" satisfy the second element of the *Belvedere* test, but so will an act that is similarly unlawful to an illegal act. The new language seems to be pulled from the air. Is there a notable [****23] distinction between an "unlawful" and an "illegal" act? Not that the majority identifies. The words appear to be two ways of saying the same thing. Potato, potahto, illegal, unlawful -- let's call the whole thing off.

[**P40] The majority would have been better served by adopting Tennessee's requirement of a "fraud or wrong, to perpetuate the violation of a statutory or other positive legal duty, or a dishonest and unjust act." *Continental Bankers Life Ins. Co. of the South v. Bank of Alamo* (Tenn. 1979), 578 S.W.2d 625, 632, or the simple standard set forth in many states requiring an "injustice." Presser, Piercing the Corporate Veil, 2-298-299, Section 2:26. Those standards, and the standards already set forth by Ohio appellate courts, provide useful distinctions between the types of acts that might lead to a piercing of the corporate veil. Today, the majority adds words but no distinctions, and by whitewashing *Belvedere's* reliance on *Bucyrus-Erie*, places Ohio within the most restrictive jurisdictions for proving a case for piercing of the corporate veil. That was never this court's intent in *Belvedere*.

IV

[**P41] The majority finds that even under its "expanded" version of the *Belvedere* test, Dombroski's [****24] claim fails. "Insurer bad faith is a straightforward tort, a basic example of unjust conduct; it does not represent the type of exceptional wrong that piercing is designed to remedy." Majority opinion, P 30. To the contrary, insurer bad faith is an exceptional wrong. "In contract actions, the corporate fiction generally will not be disregarded in cases of simple negligent performance of contractual duties." 1 Fletcher, Cyclopedia of the Law of Corporations (2005), 271, Section 41.85, 271. However, in a bad-faith case, what ordinarily would be a breach-of-contract claim is transformed into a tort action because of the unreasonableness of the insurer's behavior. *Zoppo v. Homestead Ins. Co.* (1994), 71 Ohio St.3d 552, 1994 Ohio 461, 644 N.E.2d 397, paragraph one of the syllabus. The insurer guilty of bad faith breaches a legal duty owed to the insured. I [*517] would hold that the breach of a legal duty constitutes an illegal or similarly unlawful act.

V

[**P42] For all of the above reasons, and because today's decision reverses the development of Ohio law, I dissent.

End of Document

Bates v. Rose

Court of Appeals of Ohio, Sixth Appellate District, Wood County

September 29, 2017, Decided

Court of Appeals No. WD-16-068

Reporter
2017-Ohio-7977 *; 2017 Ohio App. LEXIS 4321 **

Chris Bates, Appellant v. Richard Rose, Appellee

Prior History: [**1] Trial Court No. 15-CVF-00912.

Disposition: Judgment affirmed, in part and reversed, in part.

Counsel: John C. Filkins, for appellant.

Judges: JENSEN, P.J. Mark L. Pietrykowski, J., Arlene Singer, J., James D. Jensen, P.J., CONCUR.

Opinion by: James D. Jensen

Opinion

DECISION AND JUDGMENT

JENSEN, P.J.

I. Introduction

[*P1] Appellant, Chris Bates, appeals the judgment of the Bowling Green unicipal Court, which found in his favor on his claim for damages in the amount of 8,000 pursuant to a promissory note, and found in favor of appellee, Richard Rose, on ppellee's counterclaim for unpaid wages in the amount of $10,175, yielding a judgment in appellee's favor for the difference of $2,175. For the following reasons, we affirm, in part, and reverse, in part.

A. Facts and Procedural Background

[*P2] On September 1, 2015, appellant filed a five-count complaint with the Bowling Green Municipal Court. In count one of the complaint, appellant alleged that the parties entered into a promissory note on October 17, 2014 for the principal sum of $8,000.00. Appellant alleged that appellee had failed to make any payments on the $8,000 loan. Appellant attached a copy of the promissory note to the complaint. The promissory note, which was signed by both parties, required [**2] repayment in the form of six monthly installments beginning on November 20, 2014. In the event of default, the promissory note included a provision requiring appellee to pay "'reasonable attorneys' fees not exceeding a sum equal to 15% of the then outstanding balance owing on the Note, plus all other reasonable expenses incurred by [appellant] in exercising any of [his] rights and remedies upon default." Moreover, the note provided for interest to accrue at the rate of 7.5 percent annually.

[*P3] In count two of appellant's complaint, appellant alleged that appellee failed to reimburse him after he purchased 40 appliances from the Habitat for Humanity Restore for $3,744.57 on August 12, 2014, at appellee's request. A copy of the receipt for the purchase of the appliances was attached to the complaint.

[*P4] In counts three and four of appellant's complaint, appellant alleged that he lent appellee the use of an aluminum brake (a piece of equipment used to bend metal) with a fair market value of $500 and two Stihl yard trimmers with a value of

$249 each. According to the complaint, appellee failed to return the aluminum brake and the yard trimmers.

[*P5] In count five of the appellant's complaint, appellant [**3] alleged that appellee was unjustly enriched in the amount of $14,542.57, which included the amount appellee owed under the promissory note, with interest, as well as the amount appellee allegedly owed for the appliances, aluminum brake, and yard trimmers. Appellant also requested "reasonably attorney's fees of $1,200" pursuant to the terms of the promissory note.

[*P6] In responding to appellant's complaint, appellee filed his answer and counterclaim on November 16, 2015. In his answer, appellee indicated that his obligations to make payments under the promissory note were excused pursuant to an agreement between the parties that required appellee to perform labor for appellant at a worksite known as Johnson Rubber at a rate of $25 per hour in exchange for appellant forgiving installments on the note. Appellee alleged that he worked a total of 407 hours (for a value of $10,175). Because he had not been paid for his labor, appellee asserted a counterclaim against appellant for the sum of $2,175, representing the difference between the amount he earned working 407 hours for appellant and the $8,000 he borrowed from appellant.

[*P7] Following discovery, this matter proceeded to a trial before the [**4] bench on October 6, 2016. Several witnesses, including appellant and appellee, testified at trial. During appellee's testimony, he acknowledged that his signature appeared on the promissory note and further admitted that he had made no payments on the $8,000 loan he received from appellant. Appellee testified that the reason he did not make any payments on the promissory note was that he was not paid for work that he performed at Johnson Rubber for a corporation known as Bates Recycling, Inc. Appellant is the sole shareholder of Bates Recycling, Inc. Notably, appellee's counterclaim was not asserted against Bates Recycling, Inc., and the corporation was not named as a party in these proceedings. Rather, the counterclaim was brought against appellant in his individual capacity.

[*P8] During appellant's testimony, he acknowledged that appellee performed work for Bates Recycling, Inc. at Johnson Rubber. However, appellant indicated that Bates Recycling, Inc. paid appellee for the hours that he worked. Further, appellant insisted that there was no agreement for Bates Recycling, Inc. to pay appellee $25 per hour. Appellant testified that Bates Recycling, Inc. only pays between $15 and $17 per [**5] hour to its most experienced heavy equipment operators.

[*P9] Appellant went on to testify regarding the agreement he allegedly reached with appellee to finance the purchase of the appliances from Habitat for Humanity Restore. On that issue, appellant stated that appellee asked him to purchase 40 appliances from the Habitat for Humanity Restore so that appellee could restore the appliances and resell them, presumably at a profit. Pursuant to this agreement, appellant purchased 30 appliances for $99.99 apiece and purchased the remaining 10 appliances for $49.99 apiece, for a total expense, including sales tax, of $3,744.57. According to appellant, appellee did not reimburse him for the cost of the appliances.

[*P10] Appellee did not dispute that he had not repaid appellant for the cost of the appliances. However, appellee testified that he was not required to reimburse appellant the sum of $3,744.57 until he sold the appliances, and that the parties would then divide the profits evenly. According to appellee, he sold six of the appliances as of the date of trial. Appellee disbursed the proceeds from the sale of those appliances to appellant, but appellant returned the money to appellee.

[*P11] Concerning [**6] appellant's claims relating to the aluminum brake and the yard trimmers, appellant testified that he and appellee were together at a sale when appellant purchased these items. Thereafter, appellee took possession of the items and agreed to sell them and reimburse appellant for the purchase price. Appellee has not paid appellant for these items. However, appellee testified that he was not in possession of the aluminum brake. Further, appellee stated that he took the yard trimmers from appellant, paid for them to be repaired at his own expense, and then returned the yard trimmers to appellant.

[*P12] Following the presentation of the evidence at trial, the trial court found in favor of appellant on his claim for damages under the promissory note in the amount of $8,000. Notably, the trial court did not award appellant anything in the way of interest or attorney's fees as provided under the note. The court found no merit to appellant's claims concerning the appliances, the aluminum brake, or the Stihl yard trimmers. Further, the trial court found in appellee's favor on his counterclaim in the amount of $10,175. The court offset appellant's claim under the promissory note by the $10,175 it awarded [**7] appellee, leaving a judgment in appellee's favor in the amount of $2,175. It is from this judgment that appellant timely filed his notice of appeal.

B. Assignments of Error

[*P13] On appeal, appellant assigns the following errors for our review:

> ASSIGNMENT OF ERROR I: Whether the Trial Court, when granting judgment in favor of the Appellant, erred as a result of its failure to include in Appellant's judgment annual interest at the rate of 7.5% as well as attorney's fees of $1,200.00 as called for within the promissory note marked as Exhibit A.
>
> ASSIGNMENT OF ERROR II: Whether the Trial Court erred in its conclusion that the Appellee was owed any compensation by a corporation identified as Bates Recycling, Inc. for three reasons: First, Bates Recycling, Inc. is not a party to these proceedings; second, there was insufficient evidence presented to allow the trial court to pierce the corporate veil; and third, the evidence established at trial that the Appellee was paid for all services rendered while working for Bates Recycling, Inc.
>
> ASSIGNMENT OF ERROR III: Whether the Trial Court erred when it failed to render judgment in favor of Appellant and against Appellee as the result of Appellee's failure [**8] to reimburse the Appellant for a loan in the amount of $3,744.57 used to purchase appliances from Habitat for Humanity.
>
> ASSIGNMENT OF ERROR IV: Whether the Trial Court erred when it failed to render judgment in favor of Appellant and against Appellee as the result of Appellee's conversion of assets of Appellant for which he has failed to compensate Appellant.

II. Analysis

A. Interest and Attorney Fees

[*P14] In his first assignment of error, appellant argues that the trial court, upon its conclusion that appellee defaulted on the terms of the promissory note, erred in failing to award him interest and attorney's fees pursuant to the express terms of the note. We will address these two items separately.

[*P15] An award of prejudgment interest as to claims arising out of a breach of contract is governed by R.C. 1343.03(A). *Galmish v. Cicchini*, 90 Ohio St.3d 22, 33, 2000 Ohio 7, 734 N.E.2d 782 (2000). That statute reads in relevant part:

> * * * when money becomes due and payable upon any * * * note, * * * and upon all judgments, decrees, and orders of any judicial tribunal for the payment of money arising out of * * * a contract or other transaction, the creditor is entitled to interest at the rate per annum determined pursuant to section 5703.47 of the Revised Code, unless a written contract provides a different rate of interest [**9] in

relation to the money that becomes due and payable, in which case the creditor is entitled to interest at the rate provided in the contract.

[*P16] Here, it is clear from the express terms of the promissory note attached to the complaint and entered into evidence at trial that appellant was entitled to interest at the rate of 7.5 percent. Therefore, the trial court should have awarded interest to appellant at that rate from the date the note became due and payable, and erred in failing to do so. *See CitiFinancial, Inc. v. Barrett*, 6th Dist. Lucas No. L-07-1058, 2008-Ohio-1558 (trial court erred in failing to award lender interest at the rate provided in the promissory note upon its determination that the borrower defaulted on the note).

[*P17] Next, appellant argues that the trial court erred in failing to award him attorney fees on his claim under the promissory note.

[*P18] We review a trial court's decision on a request for attorneys' fees under an abuse of discretion standard. *Yarber v. Cooper*, 61 Ohio App.3d 609, 612, 573 N.E.2d 713 (6th Dist.1988). The term "abuse of discretion" implies that the court's decision was arbitrary, unreasonable or unconscionable. *Blakemore v. Blakemore*, 5 Ohio St.3d 217, 219, 5 Ohio B. 481, 450 N.E.2d 1140 (1983).

[*P19] Reasonableness is the chief inquiry governing a trial court's decision whether to award attorney's fees to a party. Therefore, the court must have evidence regarding the reasonableness [**10] of claimed attorney fees before it can award such fees to the claimant. *Yarber* at 614; *see also Baker-Chaney v. Chaney*, 5th Dist. Holmes No. 16CA005, 2017-Ohio-5548, ¶ 46 ("While the trial court has discretion in determining the amount of attorney fees, the court must base its decision on evidence showing the reasonableness of the time spent on the matter and the hourly rate.").

[*P20] As noted above, the promissory note included a provision requiring appellee to pay "'reasonable attorneys' fees not exceeding a sum equal to 15% of the then outstanding balance owing on the Note, plus all other reasonable expenses incurred by [appellant] in exercising any of [his] rights and remedies upon default." Notably, the record contains no substantive evidence as to the reasonableness of appellant's attorney fees. Indeed, appellant's claim for $1,200 in fees is based on the maximum allowable under the terms of the note, and is not tied to the actual expenditure of time or effort on the part of his attorney.

[*P21] We have previously held that we will presume the regularity of the proceedings below where the record contains no evidence regarding the reasonableness of attorney fees. *Albreqt v. Chen*, 17 Ohio App.3d 79, 83, 17 Ohio B. 140, 477 N.E.2d 1150 (6th Dist.1983). Given the fact that appellant failed to produce record evidence of the reasonableness of his attorney's fees, we [**11] reject his argument that the trial court abused its discretion in failing to award him such fees.

[*P22] Accordingly, appellant's first assignment of error is well-taken, in part.

B. Judgment on Appellee's Counterclaim

[*P23] In his second assignment of error, appellant asserts that the trial court erroneously entered judgment in favor of appellee on his counterclaim for unpaid wages earned while working at Bates Recycling, Inc. In support of his assignment of error, appellant notes that Bates Recycling, Inc. is not a party to these proceedings and argues that there was insufficient evidence presented to allow the trial court to pierce the corporate veil and hold him personally liable. Moreover, appellant contends that the evidence he presented at trial establishes that appellee was paid for the services he rendered while employed with Bates Recycling, Inc.

[*P24] "A fundamental rule of corporate law is that, normally, shareholders, officers, and directors are not liable for the debts of the corporation."

Belvedere Condominium Unit Owners' Assn. v. R.E. Roark Cos., Inc., 67 Ohio St. 3d 274, 287, 1993 Ohio 119, 617 N.E.2d 1075 (1993). This general rule may be set aside, and the corporate veil pierced, where the following three elements are established by the party asserting personal liability: (1) the parent's control over the subsidiary [**12] was so complete that the corporation has no separate mind, will, or existence of its own; (2) the parent exercised control over the subsidiary in such a manner as to commit fraud, an illegal act, or a similarly unlawful act; and (3) injury or unjust loss resulted to the plaintiff from such control and wrong. *Dombroski v. WellPoint, Inc.*, 119 Ohio St.3d 506, 2008-Ohio-4827, 895 N.E.2d 538, ¶ 18, 29.

[*P25] In *Dombroski*, the Supreme Court of Ohio emphasized that "limited shareholder liability is the rule * * * and piercing the corporate veil is the 'rare exception' that should only be 'applied in the case of fraud or certain other exceptional circumstances.'" *Id.* at ¶ 26, quoting *Dole Food Co. v. Patrickson*, 538 U.S. 468, 475, 123 S.Ct. 1655, 155 L.Ed.2d 643 (2003). Accordingly, piercing the corporate veil should be limited to cases in which "shareholders used their complete control over the corporate form to commit specific egregious acts." *Id.* at ¶ 27. Additionally, we note that appellee bears the burden of proof in this case as he is the party seeking to have the corporate form disregarded. *Starner v. Guardian Industries*, 143 Ohio App.3d 461, 469, 758 N.E.2d 270 (10th Dist.2001).

[*P26] Our review of the trial court's decision to pierce the corporate veil is limited to finding whether competent, credible evidence supports the trial court's decision. *State ex rel. DeWine v. S&R Recycling, Inc.*, 195 Ohio App.3d 744, 2011-Ohio-3371, 961 N.E.2d 1153, ¶ 29 (7th Dist.).

[*P27] In its judgment entry, the trial court stated the following, in relevant part: Plaintiff operates many interconnecting [**13] businesses. The common thread for all of the businesses is that plaintiff is the sole shareholder and in fact the businesses are plaintiff's alter ego. As such the court pierces the corporate veil finding plaintiff liable to credit defendant for the hours worked on the former Johnson Rubber jobsite against the promissory note.

[*P28] Appellant argues that the record contains no evidence to support the trial court's finding that Bates Recycling, Inc. was his alter ego. Having reviewed the evidence in its entirety, we agree that the trial court erred in piercing the corporate veil. Indeed, appellee acknowledged during trial that the work he performed at the Johnson Rubber site was performed for Bates Recycling, Inc. Appellant consistently testified that he was diligent in maintaining a separation between his personal affairs and the affairs of the corporation, a claim appellee failed to refute with any evidence. Moreover, appellee did not allege, nor did the evidence establish, any fraud, illegal act, or similarly unlawful act committed by the corporation as a result of appellant's control over the corporation. Finally, the evidence contained in the record fails to establish that appellant's [**14] injury resulted from appellant's wrongful control of Bates Recycling, Inc. We find that the alleged failure of a corporation to pay its employee, standing alone, is not a sufficient basis to set aside the general rule of shareholder limited liability and pierce the corporate veil.

[*P29] In sum, appellee introduced no evidence to meet his burden of establishing the three elements necessary in order to justify piercing the corporate veil. Therefore, we find that the trial court wrongfully held appellant personally liable for claims that should have been alleged against Bates Recycling, Inc. The trial court's judgment in appellee's favor on appellee's counterclaim was not supported by competent, credible evidence and was against the manifest weight of the evidence.

[*P30] Accordingly, appellant's second assignment of error is well-taken.

C. Trial Court's Judgment Regarding the Appliances, Aluminum Brake, and Yard Trimmers

[*P31] In his third assignment of error, appellant argues that the trial court erred when it failed to render judgment in his favor for the $3,744.57 appellee allegedly borrowed from appellant to purchase appliances from Habitat for Humanity. In his fourth assignment of error, appellant [**15] contends that the trial court erred when it rejected his claim for damages stemming from appellee's taking of appellant's aluminum brake and yard trimmers without compensation. We will address these assignments of error simultaneously.

[*P32] In essence, appellant's arguments challenge the trial court's determination as being against the manifest weight of the evidence. The standard of review for manifest weight is the same in a civil case as in a criminal case. *Eastley v. Volkman*, 132 Ohio St.3d 328, 2012-Ohio-2179, 972 N.E.2d 517, ¶ 17. That is, we weigh the evidence and all reasonable inferences, consider the credibility of witnesses, and determine whether in resolving conflicts in the evidence, the finder of fact clearly lost its way and created such a manifest miscarriage of justice that the judgment must be reversed and a new trial ordered. *Id.* at ¶ 20. In so doing, however, we must be "mindful of the presumption in favor of the finder of fact." *Id.* at ¶ 21.

[*P33] Concerning appellant's claim for damages arising out of appellee's purchase of appliances and alleged conversion of appellant's property, we agree with the trial court that "there was conflicting evidence produced during the trial of this matter." At trial, appellant maintained that he was asked by appellee [**16] to purchase 40 appliances from the Habitat for Humanity Restore so that appellee could restore the appliances and resell them. While appellee did not dispute that he had reimbursed appellant for the cost of the appliances, he insisted that appellant had agreed to delay reimbursement until appellee sold the appliances, at which time the parties would divide the profits. According to appellee's testimony, only six of the appliances had been sold as of the date of trial.

[*P34] As to the aluminum brake and the yard trimmers, appellant testified that appellee took possession of the items and agreed to sell them and reimburse appellant for the purchase price. However, appellee testified that he was not in possession of the aluminum brake, and that he has already returned the yard trimmers to appellant.

[*P35] Upon hearing the foregoing testimony, the trial court expressly found that "the evidence presented by [appellee] was more probable, more persuasive, more credible, more believable, and of greater probative value. The evidence presented by [appellee] outweighs and overbalances the evidence opposed to it." Having reviewed the evidence, we cannot say that the trial court clearly lost its way in weighing [**17] the parties' credibility concerning the appliances, aluminum brake, and yard trimmers. We find that the trial court's judgment on these claims was not against the manifest weight of the evidence.

[*P36] Accordingly, appellant's third and fourth assignments of error are not well-

taken.

III. Conclusion

[*P37] In light of the foregoing, the judgment of the Bowling Green Municipal Court is affirmed, in part, and reversed, in part. The trial court's judgment in favor of appellee on appellee's counterclaim is reversed, and this case is remanded to the trial court for the preparation of a judgment entry that includes interest in accordance with the terms of the promissory note between the parties. The trial court's judgment is affirmed in all other respects. The costs of this action are to be split between the parties pursuant to App.R. 24.

Judgment affirmed, in part and reversed, in part.

A certified copy of this entry shall constitute the mandate pursuant to App.R. 27. *See also* 6th Dist.Loc.App.R. 4.

Mark L. Pietrykowski, J.

Arlene Singer, J.

James D. Jensen, P.J.

CONCUR.

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Pappas v. FM2, LLC

Court of Appeals of Ohio, Tenth Appellate District, Franklin County

November 2, 2017, Rendered

No. 17AP-258

Reporter

2017-Ohio-8548 *; 2017 Ohio App. LEXIS 4955 **; 2017 WL 5451260

Patricia Pappas, Plaintiff-Appellee, v. FM2, LLC, et al., Defendant-Appellant.

Prior History: [**1] APPEAL from the Franklin County Court of Common Pleas. C.P.C. No. 14CV-11486.

Disposition: Judgment affirmed.

Counsel: On brief: James E. Arnold & Associates, LPA, Damion M. Clifford, and Alvin E. Mathews, Jr., for appellee. Argued: Damion M. Clifford.

On brief: Brian K. Duncan, for appellant Bret Adams. Argued: Brian K. Duncan.

Bret Adams, Pro se.

Judges: TYACK, P.J., LUPER SCHUSTER and BRUNNER, JJ.

Opinion

(REGULAR CALENDAR)

DECISION

PER CURIAM.

[*P1] Defendant-appellant, Bret Adams, appeals the judgment of the Franklin County Court of Common Pleas entered on March 17, 2017, adopting the magistrate's decision on bench trial rendered November 22, 2016, and overruling Adams' objections and supplemented objections to the magistrate's decision. For the following reasons, we affirm the decision of the trial court.

I. FACTS AND PROCEDURAL BACKGROUND

[*P2] The record indicates that plaintiff-appellee, Patricia Pappas, and her daughter, Christine Margarum, had approached Adams in 2013 to work with Margarum on a project, the Fashion Meets Music Festival ("FMMF"). Adams was then a practicing attorney with approximately 30 years of experience, with a focus on sports and entertainment law. Adams and Margarum formed FM^2, LLC ("FM^2"), with Adams as the [**2] majority owner and managing member and Margarum as the minority member, to promote FMMF for the 2014 Labor Day weekend. During 2013 and 2014, Pappas provided $549,881 in the form of secured and unsecured loans to help finance FMMF.

[*P3] On November 6, 2014, Pappas filed a one-count complaint against Adams, demanding judgment against him in connection with a March 4, 2014 promissory note Adams had signed, promising to repay Pappas $100,000 plus interest at the rate of 6 percent per annum on or before May 3, 2014. The complaint alleges Adams had defaulted on the obligation, warranting payment of additional interest at the rate of 8 percent per annum, as provided in the promissory note.

[*P4] On December 8, 2014, Pappas amended her complaint to add FM^2, LLC d/b/a FMMF as a party-defendant. The amended complaint set forth three counts and requested judgment against Adams and FM^2, jointly and severally, in the amount of $549,881, plus interests, costs, and attorney fees.

[*P5] Count 1 alleged breach of contract against FM[2] in connection with a $250,000 promissory note and a $100,000 loan fee, for which Pappas sought damages in the amount of $350,000 plus interest. Count 2 alleged breach of contract against [**3] Adams on the March 4, 2014 promissory note, for which Pappas sought damages in the amount of $100,000 plus contractual interest of 8 percent per annum. Count 3 alleged Adams and FM[2] were unjustly enriched by additional, unsecured loans Pappas had made to them in the amount of $159,881. Pappas sought damages in the amount of the additional loans plus interest. Count 3 further alleged that Adams had given Pappas a $40,000 check post-dated September 2, 2014, giving full assurance that the check would be good on that date. The complaint alleges that Pappas presented the post-dated check for payment on September 2, 2014, but it was dishonored because Adams had stopped payment on it. Pappas sought damages for $40,000 plus interest.

[*P6] On February 23, 2015, Adams filed a third-party complaint against Pappas' daughter, Margarum, alleging that she also was a party to the March 4, 2014 promissory note for $100,000 whereby Adams and Margarum agreed to pay Pappas pursuant to the terms of the note on or before May 3, 2014. That action, assigned Franklin C.P. No. 14 CV 011486, alleged that Pappas had failed to name Margarum as a party-defendant in her action against Adams and FM[2], but that Margarum [**4] was personally, jointly and/or severally liable for certain damages alleged by Pappas. Adams voluntarily dismissed his third-party complaint against Margarum pursuant to Civ.R. 41(A), without prejudice, on May 1, 2015.

[*P7] On June 3, 2015, Pappas filed a motion for partial summary judgment on Count 1 against FM[2] for a $250,000 promissory note dated July 1, 2013 and a $100,000 loan fee. On October 19, 2015, the trial court granted Pappas' motion and entered judgment against FM[2] in the amount of $350,000 plus statutory interest from the date of judgment.

[*P8] On December 2, 2015, a bench trial was held before a magistrate on the remaining causes of action as set forth under Counts 2 and 3 of the amended complaint. The record indicates the trial was not recorded electronically, but was recorded by a court stenographer who subsequently filed a transcript of the proceedings with the trial court. The parties filed post-trial briefs on December 23, 2015. However, the record further indicates that magistrate retired before filing a written decision and that, pursuant to Civ.R. 53 and Loc.R. 99.02 of the Franklin County Court of Common Pleas, General Division, the case was referred to another magistrate for a second bench [**5] trial.

[*P9] On August 25, 2015, a retrial of the bench trial was conducted by the second magistrate. Adams was the only witness called to testify at the retrial.

[*P10] Following the retrial, the parties submitted proposed findings of fact and conclusions of law as ordered by the magistrate. On November 22, 2016, the magistrate issued a 20-page decision on bench trial, which included detailed findings of fact and conclusions of law. In her findings of fact, the magistrate stated as follows:

> This Magistrate's Findings of Facts are based on the testimony of the sole witness, Bret Adams, and the exhibits introduced into evidence. This Magistrate reviewed all the exhibits and considered each as to its weight and credibility. The credibility of the witness was considered. The credibility of a witness is based upon the appearance of the witness upon the stand; his/her manner of testifying; the reasonableness of the testimony; the opportunity he/she had to see, hear and know the things concerning which he/she testified; his/her accuracy of memory; frankness (or lack of it); intelligence, interest and bias (if any); together with all the facts and circumstances surrounding the testimony.
>
> Of importance in [**6] deciding the Findings of Facts, this Magistrate notes that she is free to

> believe all, some, or none of the testimony of each witness appearing before her. *State v. Ellis*, 8th Dist., Cuyahoga No. 98538, 2013-Ohio-1184. It should be noted that for purposes of the Findings of Facts, this Magistrate found Adams to be evasive and lacking credibility at times during his testimony.

(Nov. 22, 2016 Mag.'s Decision at 3.)

[*P11] The magistrate found as not credible Adams' testimony regarding the March 4, 2014 promissory note for $100,000 that Adams had drafted and signed at Pappas' request. The magistrate stated:

> 7. In a check dated February 4, 2014 from Plaintiff payable to FM^2, Plaintiff loaned Adams and Margarum $50,000.00 for the Festival. Exhibit 3. At Plaintiff's request, Adams drafted the March 4, 2014 promissory note for $100,000 ("Note"). Adams testified that he did not sign the Note to be personally responsible. Adams' testimony to this effect lacks credibility, especially taking into consideration Adams' extensive legal career with an emphasis in contract law. This Magistrate notes that, in stark contrast to the prior promissory note drafted by Adams and executed on July 1, 2013, FM^2 is listed nowhere on the Note, the Note states "the undersigned BRET [**7] ADAMS and CHRISTINE MARGARUM promise to pay", and the Note is signed by Adams and Margarum personally without any reference to FM^2. The Note provides an interest rate of 6% per annum and was due on May 3, 2014. In the event of default, the Note provided an 8% interest rate per annum. Exhibit 7. In a check dated March 11, 2014 from Plaintiff to FM^2, Plaintiff loaned Adams and Margarum $60,000.00 for the Festival. Exhibit 3. This Magistrate finds that the checks in Exhibit 3 constitute consideration for the Note. Adams testified that both checks in Exhibit 3 were received by FM^2, were used for the Festival, and FM^2 benefitted from the payments. He further testified that none of the money leant by Plaintiff as evidenced by Exhibits 3 and 7 was repaid to Plaintiff.

(Mag.'s Decision at 4-5.)

[*P12] The magistrate next discussed the additional, unsecured loans totaling $189,000 that Pappas had made, as appeared in Exhibit 4. The magistrate considered Adams' testimony that all of those loans were received by FM^2, were used for FMMF that FM^2 benefitted from the payments, and that none of this $189,000 was repaid to Pappas.

[*P13] The magistrate found that Adams' had withdrawn $323,882 from FM^2 for his personal use. The magistrate's [**8] decision lists ten monthly withdrawals totaling $323,882 that Adams had made for himself in 2014. The magistrate's decision states:

> Adams could not definitively recall why he made these payments to himself, however the totals were well above his agreed upon monthly salary of $10,000.00. At one point he indicated that some of these payments could have gone toward artist payments for the Festival. At another point he testified that he had personally invested over $1.4 million by selling $1 million of personal assets and receiving personal loans from individuals and these withdrawals were to pay himself back for his personal investment. This Magistrate notes that Adams testimony in this regard[] lacks credibility in that (1) he indicated there was absolutely no documentation of such a large investment and/or loans from others; (2) despite very specific notations of other payments in the Check Detail, these substantial withdrawals noted above gave no notation other than "Bret Adams"; and (3) this testimony is contrary to his prior testimony that he did not want to take any risk in his career by investing in FM^2. As such, this Magistrate finds that in 2014, Defendant Adams withdrew $323,882 [**9] from FM^2 for his personal use.

(Mag.'s Decision at 6.)

[*P14] The magistrate also made a finding in regards to the post-dated (September 2, 2014) $40,000 check Adams had given Pappas, and which was returned after Pappas presented it because Adams had placed a stop payment order on the check. The magistrate found Adams' testimony that he had informed Pappas of the stop payment "unbelievable." (Mag.'s Decision at 6.)

[*P15] The magistrate's decision also sets forth specific findings supporting Pappas' claim that Adams had transferred FM² assets to another entity Adams had created, MSD Productions, LLC ("MSD"), specifically:

> 11. FM² was approximately $750,000.00 "in the hole" prior to the 2014 Festival. Exhibit 11 shows the extremeness of FM²' insolvency in August 2015. In October of 2015, Adams unilaterally dissolved FM² internally. FM² was dissolved corporately, but not officially with the Secretary of State. As of his testimony, FM² still had over $400,000.00 in liabilities and no creditors were given formal notice of the dissolving of FM².
>
> 12. On November 9, 2015, Adams formed MSD productions, LLC ("MSD") to run the Fashion Meets Music Festival. Adams testified that FM² had no assets at that time and, therefore, no assets of FM² were transferred [**10] to MSD. However, Adams testified that FM² had previously obtained an agreement from a California company to use the terms "Fashion Meets Music" because the California company owned the rights to the name "Fashion Meets Music". MSD continued to use those terms for its music festival. Adams also testified that MSD continued to use FM²'s website domain name, www.fmmf.us .
>
> 13. Adams testified that FM² received a grant from the City of Columbus for $25,000.00 ("Grant") which was to be used for 2015. Adams solely obtained the Grant in that Margarum was not involved. FM² received the check December 21, 2015. FM² was "dissolved" when Adams signed for the Grant and received the $25,000.00. Adams testified that he believed the check was deposited into FM²'s account, but he was not sure.
>
> 14. On February 16, 2016, FM² received a $69,000.00 check from Anheuser Busch as part of a sponsorship deal for the 2015 Festival. Adams initially testified that the Anheuser Busch check was not deposited into FM²'s account. However, when Adams was shown FM²'s bank statement from February 2016, he changed his testimony and stated that the Anheuser Busch check was deposited in FM²'s account. Adams denied that the [**11] $69,000.00 was transferred from FM² to MSD. He testified that those funds were pledged to an attorney in Athens, Ohio, Chris Garrick ("Garrick"), as a creditor and went directly to Garrick. He testified that funds ultimately went from FM² to Adams as a loan from Garrick when Garrick released the pledge. However, upon being shown bank records, Adams admitted the $69,000.00 went immediately to MSD. On cross examination by his attorney, Adams then stated that the $69,000.00 went to Adams because it was assigned to Garrick as a creditor and Garrick released the funds to Adams. This Magistrate finds that Adams' testimony with regards to the explanation of FM²'s $69,000.00 being transferred to MSD was not credible.
>
> 15. This Magistrate finds that the following FM² assets were transferred by Adams to MSD: (1) FM²'s website domain name; (2) use of the terms "Fashion Meets Music; and (3) the $69,000.00 from Anheuser Busch.

(Mag.'s Decision at 6-8.)

[*P16] In reaching her conclusions of law in her decision, the magistrate first addressed Count 2 of the amended complaint, Pappas' breach of contract claim against Adams regarding the March 4, 2014 promissory note for $100,000. The magistrate was not persuaded by Adams' arguments [**12] that the promissory note was void (1) for lack of consideration, or (2) because he signed the note on the condition and with the understanding that both Margarum and he were to be co-obligors under the note. Based on the evidence adduced at trial, the magistrate concluded that Pappas had met her burden in establishing the promissory note as a valid contract, and that she was entitled to judgment on her breach of contract claim against Adams for the note:

> This Magistrate finds that there was an offer by Plaintiff and acceptance by Adams, contractual capacity, legality of object and of consideration, and manifestation of mutual assent. The Note sufficiently stated all of the terms of the contract. Plaintiff completely performed under the contract when she paid $50,000.00 on February 4, 2014 and $60,000.00 on March 11, 2014 to FM². Adams' failure to pay any money whatsoever to Plaintiff under the Note was a material breach of the Note. Finally, Plaintiff has suffered damages by not being repaid the $100,000.00 due on or before May 3, 2014 under the Note.
>
> Accordingly, Plaintiff is entitled to damages of $100,000.00 plus the contractual interest rate of 8% per annum since May 4, 2014 against [**13] Defendant Bret Adams on Count 2.

(Mag.'s Decision at 11.)

[*P17] The magistrate addressed Pappas' unjust enrichment claim against FM², as set forth in Count 3 of the amended complaint. The magistrate discussed the case law on this topic, writing in part as follows:

> Unjust enrichment occurs where "a person has and retains money or benefits which in justice and equity belong to another." *Smith v. Vaughn* (2007), 174 Ohio App.3d 473, 2007 Ohio 7061, 882 N.E.2d 941, quoting *Johnson v. Microsoft Corp.* (2005), 106 Ohio St.3d 278, 2005 Ohio 4985, 834 N.E.2d 791. The purpose of an unjust enrichment claim is to enable the plaintiff to recover the benefit he has conferred on the defendant under circumstances in which it would be unjust to allow the defendant to retain it. *Johnson, supra* at ¶ 21, citing *Hughes v. Oberholtzer* (1954), 162 Ohio St. 330, 335, 123 N.E.2d 393. Restitution is the remedy provided upon proof of unjust enrichment "to prevent one from retaining property to which he is not justly entitled." *Keco Industries, Inc. v. Cincinnati Suburban Bell Tel. Co.* (1957), 166 Ohio St. 254, 256, 141 N.E.2d 465; *Santos v. Ohio Bur of Workers' Comp.* (2004), 101 Ohio St. 3d 74, 2004 Ohio 28, 801 N.E.2d 441.
>
> In order to prevail on a claim for unjust enrichment, a plaintiff must demonstrate by a preponderance of the evidence that: (1) the plaintiff conferred a benefit upon the defendant, (2) the defendant had knowledge of the benefit; and (3) the defendant retained the benefit under circumstances in which it would be unjust for him or her to retain that benefit. *Hambleton v. R.G. Barry Corp.* (1984), 12 Ohio St.3d 179, 183, 12 Ohio B. 246, 465 N.E.2d 1298.

(Mag.'s Decision at 11-12.)

[*P18] The magistrate concluded that [**14] Pappas had met her burden to prevail on her unjust enrichment claim against FM². Pappas had conferred a benefit of $199,881 on FM² in the form of five unsecured loans between March 11 and August 27, 2014. The evidence adduced at trial demonstrated that Pappas had loaned FM² this money to fund FMMF. All the funds were received by FM², which benefitted from them. The evidence also showed FM² had knowledge of the loans through Adams, its managing partner. Finally, FM² has not repaid Pappas the $199,881. The magistrate concluded:

> This substantial detriment to Plaintiff is clearly causally connected to the substantial benefit conferred on Defendant FM² as funding for the Festival. Principles of equity and justice confirm that it would be unjust from FM² to knowingly retain the benefit of the $199,881.00 loans without being required to repay Plaintiff for the entirety of the loans.

> Accordingly, Plaintiff is entitled to restitution in the amount of $199,881.00 against Defendant FM[2].

(Mag.'s Decision at 12-13.)

[*P19] Finally, the magistrate addressed Pappas' unjust enrichment claim for $199,881 against Adams personally as set forth in Count 3 of the amended complaint. The magistrate considered Adams' arguments that (1) Pappas [**15] failed to properly plead a claim to pierce the corporate veil, and (2) Pappas failed to meet her burden to justify piercing the corporate veil.

[*P20] The magistrate's decision sets forth this Court's standard for determining if a party properly pled a claim to pierce the corporate veil:

> Under the Ohio Rules of Civil Procedure, a complaint need only give the defendant fair notice of a desired claim and an opportunity to respond. *RCO Int'l Corp. v. Clevenger* (2008 10th Dist.), 180 Ohio App. 3d 211, 2008 Ohio 6823, 904 N.E.2d 941, ¶ 11. "Piercing the corporate veil is not a claim, it is a remedy encompassed within a claim. It is a doctrine wherein liability for an underlying tort may be imposed upon a particular individual." *Id. citing Geier v. Natl. GG Industries, Inc.* (1999 11th Dist.), Lake App. No. 98-L-172, 1999 Ohio App. LEXIS 6263.

(Mag.'s Decision at 13.)

[*P21] The magistrate's decision acknowledged the weight this Court affords to the *Geier* court's reasoning and noted the following principles adopted by the *Geier* court:

> * * * the complaint, and other relief-saving pleadings need not state with precision all elements that give rise to a legal basis for recovery as long as fair notice of the nature of the action is provided. However, the complaint must contain either direct allegations on every material point necessary to sustain a recovery [**16] on any legal theory, even though it may not be the theory suggested or intended by the pleader, or contain allegations from which an inference fairly may be drawn that evidence on these material points will be introduced at trial. *Geir* [sic] at ¶ 15.

(Mag.'s Decision at 14.)

[*P22] The magistrate's decision continued:

> To apply the controlling standards to determine if Count 3 of Plaintiff's complaint contained sufficient information to proceed under the doctrine of piercing the corporate veil, this Magistrate must decide if the complaint contains, at a minimum, allegations from which an inference may fairly be drawn that evidence on these material points will be introduced at trial.
>
> "The general rule is that corporations are distinct legal entities, and, thus, shareholders, officers and directors are not normally liable for debts of the corporation." *RCO* [sic], *supra* at ¶ 9, citing *Belvedere Condominium Unit Owners' Assn. v. R.E. Roarck Cos. Inc.* (1993), 67 Ohio St. 3d 274, 287, 1993 Ohio 119, 617 N.E.2d 1075. In *RCO*, the 10th District set forth the Supreme Court of Ohio's 3-prong test for courts to use when deciding whether to pierce the corporate veil. In order to pierce the corporate veil and impose personal liability upon shareholders, it must be shown that:
>
>> (1) control over the corporation by those to be held liable was so complete that [**17] the corporation has no separate mind, will, or existence of its own;
>> (2) control over the corporation by those to be held liable was exercised in such a manner as to commit fraud or an illegal act against the person seeking to disregard the corporate entity; and
>>
>> (3) injury or unjust loss resulted to the plaintiff from such control or wrong. *RCO, supra*. at [sic] ¶ 9.

(Mag.'s Decision at 14-15.) The magistrate discussed the subsequent holding of the Supreme

Court of Ohio in *Dombroski v. WellPoint, Inc.*, 119 Ohio St. 3d 506, 2008 Ohio 4827, 895 N.E.2d 538 (2008), which rejected expanding the second prong of the test to include "other unjust or inequitable acts," and thus limited the second prong to fraud or illegal acts.

[*P23] The magistrate determined that Count 3 of Pappas' amended complaint failed to make any allegations of acts committed by Adams which amounted to committing "fraud or an illegal act" against her. (Mag.'s Decision at 15.) Consequently, the magistrate found that Pappas had failed to properly plead her unjust enrichment claim to pierce the corporate veil.

[*P24] The magistrate further found, however, that although Pappas had not been granted leave expressly to amend the pleadings, the magistrate had permitted her to introduce evidence throughout the trial "on the issue over the repeated objections by Defendants." (Mag.'s Decision at 16.) The magistrate [**18] discussed this Court's holding in *Gioffre v. Simakis*, 72 Ohio App. 3d 424, 594 N.E.2d 1013 (10th Dist.1991), that in cases such as the instant case, "where an issue was not tried by the express or implied consent of the parties, Civil Rule 15(B) provides that the trial court may allow an amendment to the pleadings even when not expressly requested by the party." (Mag.'s Decision at 16-17.) The magistrate found that allowing Pappas to introduce evidence relevant to piercing the corporate veil pursuant to Count 3 did not prejudice either Adams of FM^2 because they had ample notice of Pappas' intentions, as both her final pretrial statement and trial brief explicitly stated that she would be seeking to hold Adams personally liable for $199,811 in loans to FM^2 under the theory of piercing the corporate veil. The magistrate found "[e]ven more compelling" the fact "that this very issue was fully litigated in the first trial * * * on December 2, 2015," and that the post-trial briefs both sides filed after the first trial evidenced that the piercing the corporate veil issue was "vigorously litigated." (Mag.'s Decision at 17.)

[*P25] The magistrate determined that the pleadings had been amended by the trial court pursuant to Civ.R. 15(B) to allow Pappas "to seek personal liability against Defendant Adams with regards to her claim of unjust enrichment." [**19] (Mag.'s Decision at 17.) Additionally, the magistrate concluded that Pappas had met her burden of proving that FM^2's corporate veil should be pierced. Accordingly, the magistrate found that Pappas was entitled to restitution in the amount of $199,881 against Adams personally.

[*P26] On December 6, 2016, Adams filed an objection to the magistrate's decision, arguing that the magistrate's conclusions of law were not supported by the evidence Pappas had offered at the bench trial, and that Pappas had "wholly failed to satisfy her burden of proof and the award is against the manifest weight of the evidence." (Dec. 6, 2016 Def.'s Objs. To Mag. Decision at 1.) On February 21, 2017, Adams filed a supplemental objection with the trial transcript, renewing his previously filed objection.

[*P27] On March 17, 2017, the trial court issued a decision and entry adopting the magistrate's decision on bench trial rendered November 22, 2016 and decision and entry overruling defendant Bret Adams' objections and supplemented objections. With respect to Adams' objections/supplemental objections, the trial court stated in its decision:

> When reviewing objections to a magistrate's decision, the Court is required to undertake the equivalent [**20] of a *de novo* review determination, and independently assess the facts and conclusions contained in the report of that magistrate. *DeSantis v. Soller* (1990), 70 Ohio App. 3d 226, 232, 590 N.E.2d 886 (citing *Normandy Place Assoc. v. Beyer* (1982), 2 Ohio St. 3d 102, 2 Ohio B. 653, 443 N.E.2d 161); *Randall v. Eclextions Lofts Condo Ass'n*, 10th Dist. No. 13AP-708, 2014-Ohio-1847, ¶ 7. The Court has reviewed the Decision of Magistrate [ ], the written briefs/memoranda

> submitted by the parties (including the respective Proposed Findings of Fact and Conclusions of Law), the transcript of the bench trial presided over by Magistrate [ ] which was filed on February 10, 2017, all evidence properly before the Court and the applicable law. After review of said materials, the Court does not find the objections/supplemental objections of Defendant Adams well taken. Rather, the Court finds that Magistrate [ ] considered all facts relevant to the matter before her and that she made the appropriate factual findings; that she properly construed and applied the applicable law; and that Defendant Adams has not presented any basis for this Court to sustain his objections and vacate or otherwise modify the Magistrate's Decision.

(Emphasis sic.) (Mar. 17, 2017 Decision at 3.)

[*P28] Adams timely appeals the trial court's judgment.

II. ASSIGNMENTS OF ERROR

[*P29] Adams presents for our review two assignments of error:

> [1.] The trial court erred and/or abused [**21] its discretion by upholding the Magistrate's Decision which found that Plaintiff is entitled to judgment against Defendant Bret Adams, individually, for $100,000 plus contractual interest rate of 8% per annum since May 4.
> [2.] The trial court erred and/or abused its discretion by upholding the Magistrate's finding that Plaintiff is entitled to judgment against Defendant Bret Adams, individually, in the amount of $199,881 as the same is wholly unsupported by law and contrary to the evidence and testimony elicited at trial, pursuant to the doctrine of piercing the corporate veil.

[*P30] The arguments Adams presents in support of his two assignments of error are the same, in all material respects, as the objection and supplemental objection to the magistrate's decision he filed with the trial court, and which the trial court considered and overruled in its decision.

III. LAW AND DISCUSSION

[*P31] When objections are filed to a magistrate's decision, the trial court must undertake an independent, de novo review of the matters objected to in order to "ascertain [whether] the magistrate has properly determined the factual issues and appropriately applied the law." Civ.R. 53(D)(4)(d). *See also James v. My Cute Car, LLC*, 10th Dist. No. 16AP-603, 2017-Ohio-1291, ¶ 13. The appellate standard for [**22] reviewing a trial court's adoption of a magistrate's decision varies with the nature of the issues that were (1) preserved for review through objections raised before the trial court and (2) raised on appeal by assignment of error. *Feathers v. Ohio Dept. Rehab. & Corr.*, 10th Dist. No. 16AP-588, 2017-Ohio-8179, ¶ 10. Generally, however, "'the appellate standard of review when reviewing a trial court's adoption of a magistrate's decision is an abuse of discretion.'" *Gilson v. Am. Inst. of Alternative Medicine*, 10th District No. 15AP-548, 62 N.E.3d 754, 2016-Ohio-1324, ¶ 77, quoting *Mayle v. Ohio Dept. of Rehab. & Corr.*, 10th Dist. No. 09AP-541, 2010-Ohio-2774, ¶ 15. "Therefore, we will only reverse a trial court's adoption of a magistrate's report if the trial court acted in an unreasonable or arbitrary manner." *Gilson* at ¶ 77. Based on the nature of the issues considered by the trial court, there is no basis to review the trial court's decision by any other standard than abuse of discretion.

[*P32] This Court has conducted an independent review of the magistrate's decision, the transcript of the August 25, 2016 bench trial, all evidence properly before the Court, the written briefs submitted by the parties, and the applicable law. On review, this Court does not find Adams' objections well taken. This Court agrees with the trial court's finding that the magistrate considered all facts relevant [**23] to the matter before her and made the appropriate factual findings, and properly construed and applied the applicable law. We do not find that the trial court abused its discretion in adopting the magistrate's decision.

A. First Assignment of Error

[*P33] Adams asserts in his first assignment of error that the magistrate's decision finding him liable to Pappas on the $100,000 promissory note is contrary to the manifest weight of the evidence. An appellate court will not reverse a judgment as being against the manifest weight of the evidence if some competent, credible evidence supports all the essential elements of the case. *Coffman v. Mansfield Corr. Inst.*, 10th Dist. No. 09AP-447, 2009-Ohio-5859, ¶ 10.

[*P34] In his brief, Adams states that no evidence and/or testimony was placed before the magistrate and/or the trial court that established that he ever received his bargained-for legal benefit; that is, no evidence was submitted that he personally received the $100,000 listed in the March 4, 2014 promissory note. He points to the magistrate's acknowledgement that "[t]he evidence is undisputed that any and all checks from Plaintiff were made payable to FM^2 or FMMF, not to Adams personally." (Adams' Brief at 5.)

[*P35] Adams also argues that the two payments the magistrate concluded constituted [**24] consideration for the $100,000 promissory note exceed that amount by $10,000. He asserts that, "[s]urely, [Pappas] would not have issued checks more than the secured obligation by $10,000 after 'requiring' a Promissory Note from Mr. Adams and Christine Margarum." (Adams' Brief at 8.)

[*P36] Adams submits that the trial court was unreasonable in adopting the magistrate's decision because the magistrate erred in finding that the two payments from Pappas consisting of $50,000 and $60,000, respectively, were consideration for the March 4, 2014 promissory note, and also that Adams was personally liable for the note. He argues the magistrate's decision was not in accordance with the evidence and/or testimony submitted by Pappas in support of her cause of action against him for breach of contract. He further argues that Pappas failed to causally link the two payments to the March 4, 2014 promissory note, and that no evidence or testimony supports an award of damages against him individually. He asks this Court to find "that the trial court abused its discretion by upholding the Magistrate's Decision because it is against the manifest weight of the evidence and is not supported in fact or law." (Adams' Brief [**25] at 9.)

[*P37] This Court disagrees with Adams' assessment of the evidence adduced at trial. The magistrate in her decision thoroughly and carefully examined all the evidence presented, including the credibility of the sole witness, Adams. She fully set forth her reasons for dismissing for lack of merit Adams' arguments that the promissory note was void. The magistrate recited with detail the evidence adduced at trial that demonstrated that Pappas had met her burden in establishing the promissory note as a valid contract, and that Pappas was entitled to judgment on her breach of contract claim against Adams for the note.

[*P38] The magistrate compared and contrasted the March 4, 2014 promissory note to the prior promissory note drafted by Adams and executed on July 1, 2013. Unlike the July 1, 2013 note, FM^2 is not listed anywhere on the March 4, 2014 note. The March 4, 2014 note contains this language: "the undersigned BRET ADAMS and CHRISTINE MARGARUM promise to pay," and it is signed by Adams and Margarum personally, without any reference to FM^2. (Dec. 8, 2014 Am. Compl. at Ex. B.) As the magistrate accurately noted, the March 4, 2014 note provided an interest rate of 6 percent per annum and was [**26] due on May 3, 2014; in the event of default, it provided an 8 percent interest rate per annum. The magistrate found that the $50,000 check and the $60,000 together constituted consideration for the March 4, 2014 note. The magistrate also noted that $10,000 of the total $110,000 was not covered by the March 4, 2014 promissory note; payment of that $10,000 was included in the demand of $199,881 for unsecured loans. The magistrate relied on Adams' testimony that both checks were received by FM^2, were used for FMMF, that FM^2 benefitted from the payments, and that none of the money leant by Pappas via those two checks was repaid to Pappas.

[*P39] Based on our review of the record, we agree with the trial court that the magistrate correctly found that there was an offer by Pappas and acceptance by Adams, contractual capacity, legality of object and of consideration, and manifestation of mutual assent. The promissory note sufficiently stated all of the terms of the contract. Pappas completely performed under the contract when she paid $50,000 on February 4, 2014 and $60,000 on March 11, 2014 to FM^2. Adams' failure to pay any money whatsoever to Pappas under the promissory note was a material breach [**27] of the note. Finally, Pappas has suffered damages by not being repaid the $100,000 due on or before May 3, 2014 according to the terms of the note. This Court finds that the trial court did not abuse its discretion in adopting the magistrate's decision that Pappas is entitled to damages of $100,000 plus the contractual interest rate of 8 percent per annum since May 4, 2014 against Adams on Count 2 of the amended complaint.

[*P40] Accordingly, we overrule Adams' first assignment of error.

B. Second Assignment of Error

[*P41] In his second assignment of error, Adams argues the trial court erred and/or abused its discretion by adopting that portion of the magistrate's decision finding that Pappas is entitled to judgment against Adams, individually, in the amount of $199,881 because the finding is wholly unsupported by law and contrary to the evidence and testimony elicited at trial, pursuant to the doctrine of piercing the corporate veil.

[*P42] This Court disagrees. The magistrate's decision contains a thorough and accurate discussion of the relevant law on this topic. Applying that law to the facts of the instant case, the magistrate made the initial determination that Count 3 of Pappas' amended complaint [**28] failed to make any allegations of acts by Adams which amount to committing "fraud or an illegal act" against her. (Mag.'s Decision at 15.) The magistrate concluded that Adams' act of providing Pappas a post-dated check and then stopping payment of the check before the date on the check did not rise to the level of fraud, an illegal act, or a similarly unlawful act. Consequently, the magistrate found that Pappas had failed to properly plead her unjust enrichment claim to pierce the corporate veil.

[*P43] The magistrate did not leave the issue there, however, but proceeded to discuss the principle that would allow amendment of the pleadings to allow piercing of the corporate veil against Adams. Writing that "[t]he Civil Rules contemplate that an action should be tried on its merits," the magistrate turned to Civ.R. 15(B), which provides for amendment of the pleadings to conform to the evidence. (Mag.'s Decision at 16.)

[*P44] The magistrate acknowledged that, although Pappas had not specifically moved to amend the pleadings to pierce the corporate veil as to Count 3 and so had not expressly been granted leave to amend the pleadings, the magistrate had permitted her to introduce evidence throughout the trial "on the issue over the repeated objections by Defendants." [**29] (Mag.'s Decision at 16.) The magistrate discussed this Court's holding in *Gioffre*, that in cases such as the instant case, "where an issue was not tried by the express or implied consent of the parties, Civil Rule 15(B) provides that the trial court may allow an amendment to the pleadings even when not expressly requested by the party." (Mag.'s Decision at 16.) The magistrate found that allowing Pappas to introduce evidence relevant to piercing the corporate veil under Count 3 did not prejudice either Adams or FM[2] because they had ample notice of Pappas' intentions, as both her final pretrial statement and trial brief explicitly stated that she would be seeking to hold Adams personally liable for $199,811 in loans to FM[2] under the theory of piercing the corporate veil. The magistrate found "[e]ven more compelling" the fact "that this very issue was fully litigated in the first trial * * * on December 2, 2015," and that the post-trial briefs both sides filed after the first trial evidenced that the piercing the corporate veil issue was "vigorously litigated." (Mag.'s Decision at 17.)

[*P45] Consequently, the magistrate found that the pleadings had been amended by the trial court pursuant to Civ.R. 15(B) to allow Pappas "to seek personal liability against Defendant Adams with regards to [**30] her claim of unjust enrichment." (Mag.'s Decision at 17.)

[*P46] The magistrate in her decision set out the piercing the corporate veil analysis, noting at the outset that "[o]ne of the purposes for incorporation is to limit the liability of shareholders," citing Section 3, Article XIII of the Ohio Constitution, and that "[t]he party seeking to have the corporate form disregarded bears the burden of proof." (Mag.'s Decision at 17., citing *State, ex rel. v. Standard Oil. Co.*, 49 Ohio St. 137, 177, 30 N.E. 279 (1982).)

[*P47] Observing that "Ohio courts have recognized that there is no precise test to determine whether the elements required to pierce the corporate veil have been satisfied, and each case should be regarded as *sui generis* and decided on its own facts." (Emphasis sic.) (Mag.'s Decision at 18.) The magistrate proceeded to examine the facts of the instant case, as follows:

> As to the first prong of the [*Belvedere Condominium Unit Owners' Ass'n v. R.E. Roark Cos.*, 67 Ohio St. 3d 274, 1993 Ohio 119, 617 N.E.2d 1075 (1993)] test, courts look at the following ***nonexclusive*** list of factors to determine whether an individual's complete control over the corporation warrants treating the corporation as the individual's alter ego: (1) whether the corporate formalities were observed; (2) whether corporate records were kept; (3) whether corporate funds were commingled with personal funds; and (4) whether corporate property was used for a personal purpose. *My Father's House No. 1 v. McCardle*, 3rd District No. 9-11-35, 2013-Ohio-420, 986 N.E.2d 1081 [**31] . To succeed, "a plaintiff must show that the individual and the corporation are fundamentally indistinguishable." *State ex rel. DeWine v. S & R Recycling, Inc.*, 195 Ohio App.3d 744, 2011 Ohio 3371, 961 N.E.2d 1153 (2011), quoting *Belvedere* supra.
>
> Plaintiff presented no evidence concerning the observance of corporate formalities or the keeping of corporate records other than the following: (1) that Adams and Margarum executed an operating agreement and formed FM[2], LLC and (2) that Adams failed to formally dissolve FM[2] with the Secretary of State and merely unilaterally dissolved FM[2] internally. However, there was significant evidence that Adams exercised substantial control over FM[2]. The evidence is clear that Adams and Margarum were the sole partners of FM[2], with Defendant Adams having 70% interest in FM[2]. As Managing Partner, Adams directed the overall operations and made the major financial decisions. He had the authority of deciding who was getting paid by FM[2], when they were getting paid, and how much they were going to get paid. Adams used his authority to withdraw $323,882 in 2014 from FM[2] for his personal use. Adams also held himself out to be personally liable for the $100,000 note which funds were used for the Festival. In addition, Adams made the decision to dissolve FM[2] in October 2015.
>
> Within [**32] one month, on November 9, 2015, Adams created MSD to run the Festival. Although FM[2] owned the website domain name www.fmmf.us and the rights to use the name

> "Fashion Meets Music Festival", Adams unilaterally took both for use by MSD. On February 16, 2016, after FM2 was dissolved, FM2 received a $69,000 check from Anheuser Busch. As stated previously, this Magistrate found Adams' testimony about the path the $69,000 took and the reasoning for its transfer to completely lack credibility. The evidence was clear that Adams ultimately received the full $69,000 for his personal use. Defendant Adams then gave the $69,000 to MSD. Additionally, while Adams was withdrawing substantial funds from FM2 for personal use, he personally stopped payment on FM2's $40,000 check to Plaintiff.
> Finally, Adams' pirating of FM2's website and rights and diverting $392,882 of FM2's money for his personal use resulted in injury and unjust loss to the Plaintiff. His fraudulent and unlawful actions substantially depleted FM2's assets and gave rise to FM2's inability to repay the $199,881 Plaintiff conferred upon FM2.
>
> Plaintiff met her burden of proving that FM2's corporate veil should be pierced. Accordingly, Plaintiff [**33] is entitled to restitution in the amount of $199,881 against Defendant Bret Adams.

(Emphasis sic.) (Mag.'s Decision at 18-20.)

[*P48] Based on our review of the record, this Court determines that the magistrate appropriately found that Pappas met her burden under the piercing the corporate veil doctrine. Consequently, this Court finds that the trial court did not abuse its discretion in adopting the magistrate's decision that Pappas was entitled to restitution in the amount of $199,881 from Adams, individually.

[*P49] Accordingly, we overrule Adams' second assignment of error.

IV. CONCLUSION

[*P50] For the foregoing reasons, this Court overrules Adams' two assignments of error, and affirms the judgment of the Franklin County Court of Common Pleas.

Judgment affirmed.

TYACK, P.J., LUPER SCHUSTER and BRUNNER, JJ.

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Ethical Pitfalls for Corporate Counsel

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Are You Present? The Ethics of Practicing Here, There, and Everywhere

By: *Jeffrey T. Kraus and Rachel T. Nguyen*

This article summarizes the second program presented at the 2017 Annual General Meeting (AGM). The program can be viewed in the ALAS Digital Resources Library, www.alas.com/digitalresources. The written program materials are available on the ALAS website.

I. Introduction

Advances in technology, the increasing mobility of lawyers, and the global reach of clients make the need for a brick-and-mortar office less relevant in the modern practice of law. Whether it's physically or virtually, lawyers are now called upon to negotiate, advise, litigate, and render other legal services to clients in jurisdictions in which they may not be admitted to practice. In doing so, lawyers risk engaging in the unauthorized practice of law—commonly referred to as UPL.

At the 2017 AGM, ALAS presented a program that explored a series of hypotheticals to identify common UPL traps and related loss prevention suggestions for lawyers that venture outside their home jurisdictions. This article recaps that program.[1]

II. The Perils of UPL

The consequences for UPL can be severe. Lawyers have been reprimanded, suspended, and even disbarred for engaging in UPL, and criminal fines and imprisonment are theoretically possible in some jurisdictions. Lawyers may also face more pedestrian penalties that can adversely impact a client, such as having an appeal dismissed, an administrative award voided, or a pleading stricken. Lawyers may also be disqualified. And—perhaps most unjustly of all—lawyers may forfeit the right to be paid for their work.

But there are other risks of engaging in UPL that may not be so apparent. First and foremost is what can be called the competency trap. It is axiomatic that lawyers have a basic duty to act competently, and that obligation is codified in Model Rule 1.1. But whenever a lawyer ventures into new territory, there is a risk that he will miss a quirk in the law of that jurisdiction. Indeed, our claims files are replete with examples of lawyers who missed an issue when they advised on unfamiliar laws. So competency is in play in almost every UPL scenario.

Even if an unadmitted lawyer arguably got the law right, a colorable UPL allegation still has negative effects. When jurors believe that a lawyer was not authorized to practice, they are very likely to conclude that he wasn't familiar with the relevant law and more readily accept the claim that he got it wrong. A UPL allegation can affect the lawyer's credibility; jurors often give less credence to the UPL lawyer's side of the story than they would to a properly admitted lawyer.

And the disciplinary risks of UPL don't stop at the border of the host state. Under Model Rule 8.5 and most state disciplinary rules, a lawyer who has been disciplined for UPL in an unadmitted state faces reciprocal discipline in his home state. And reciprocal discipline typically follows the sanction imposed by the state where the UPL occurred. So, if a lawyer is suspended for a year in the host state, her home state will likely impose the same discipline. The result is that the lawyer is prohibited from practicing *anywhere* for a year—a severe punishment indeed.

III. Model Rule 5.5 and State Adoption

Model Rule 5.5 and its state corollaries determine when a lawyer may lawfully practice in a state in which she's not admitted. In general terms, Rule 5.5(b) says that an unadmitted

[1] The panel for this program included David R. Atkinson, Co-General Counsel—Gunster, Yoakley & Stewart, P.A.; Wendy J. Muchman, Chief of Litigation and Professional Education—Illinois Attorney Registration & Disciplinary Commission (ARDC) of the Supreme Court of Illinois; and Moderators Jeffrey T. Kraus—ALAS Vice President and Senior Loss Prevention Counsel and Rachel T. Nguyen—ALAS Senior Loss Prevention Counsel.

lawyer cannot "establish an office or other systematic and continuous presence" or "hold out to the public or otherwise represent that the lawyer is admitted to practice law" in the jurisdiction. However, Rule 5.5(c) provides four safe harbors and expressly allows unadmitted lawyers to provide legal services on a "temporary basis" if they associate with an admitted lawyer; are authorized to appear by a tribunal or reasonably expect to be so authorized; participate in an arbitration, mediation, or similar proceeding, so long as the services are related to the lawyer's admitted jurisdiction and *pro hac vice* admission is not required; or when the legal services are "reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted." The key with all of these exceptions is that the practice has to be "temporary."

Beyond the temporary exceptions, Rule 5.5(d)(2), allows an unadmitted lawyer to maintain "a systematic and continuous" presence in the jurisdiction so long as the services offered are authorized by federal or other law. All but four states—Hawaii, Mississippi, Montana, and Texas—have adopted some version of this Model Rule. Still, there are significant variations between the states' approaches to UPL, and it's not always clear when a lawyer is stepping close to or over any particular state's line.

IV. Practice-Specific UPL Traps

A. Transactional Traps

A transactional lawyer can provide legal services on a temporary basis in an unadmitted state if those services are "reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice." Model Rule 5.5(c)(4). Whether a matter is "reasonably related" depends on a number of factors, including whether the lawyer represented the client previously, whether the client resides or has contacts in the lawyer's admitted state, whether the matter has a significant connection to the lawyer's admitted state, whether the matter involves multiple jurisdictions, and whether the matter draws on the lawyer's expertise in federal, nationally uniform, foreign, or international law. Model Rule 5.5, Comment [14].

Assessing those factors in real time is not always easy. Take, for example, an Illinois lawyer who represents a new client who lives in Illinois but also owns a weekend home in Wisconsin in a transaction involving parties and property located in Wisconsin. The client lives in Illinois, which is helpful, but the lawyer has not previously represented him and he owns a home in Wisconsin, both of which cut the other way. The other parties are all Wisconsin residents, which heightens the nexus to the unadmitted state. Finally, the transaction will involve the interpretation and application of Wisconsin law, which also increases the UPL risk. So, while the answer isn't certain, the transaction has little connection to Illinois, and the UPL risks are manifest.

Texas has a nifty trap for foreign lawyers; only Texas-admitted lawyers can prepare documents affecting title to real property located in the state.

The UPL risks in other types of transactional matters may be even more severe. Say you're an estate planning lawyer admitted in Ohio, and you have represented an Ohio resident for many years. The client has now retired and moved to Florida, and you intend to continue to advise him on estate planning matters. As time goes on, the "reasonably related" exception under Rule 5.5(c)(4) will become more tenuous, especially if Florida becomes the client's domicile and you advise him on matters involving Florida law.

Both of the above scenarios become even more complicated when state-specific UPL nuances are considered. For example, Texas has a nifty trap for foreign lawyers; only Texas-admitted lawyers can prepare documents affecting title to real property located in the state. Tex. Gov't Code Ann. § 83.001. And in

Nevada, an out-of-state lawyer can provide transactional services in the state only if he affiliates with local counsel, among other requirements. Nevada Rule of Professional Conduct 5.5A, Nevada Opinion 43 (Oct. 2011).

B. Litigation Traps

Model Rule 5.5 is more transparent for litigation and alternative dispute resolution matters. Litigators can handle pending or potential cases in an unadmitted state if they have been, or expect to be, admitted *pro hac vice*. And lawyers can handle pending or potential alternative dispute resolution matters in an unadmitted state if they are reasonably related to the lawyer's practice in his home jurisdiction and *pro hac vice* admission is not available. Model Rule 5.5(c)(2) and (3).

But even here, state-specific rules hold traps for the unwary. For example, in Alabama an out-of-state lawyer must show "good cause" to be admitted *pro hac vice* if he has previously been granted such admission five times in the same year. Rule VII of the Rules Governing Admission to the Alabama State Bar. Florida limits the frequency of an out-of-state lawyer's litigation activity to three appearances in separate matters within a 365-day period. Florida Rule Regulating the Florida Bar 1-3.10; Florida Rules of Judicial Administration 2.510. Delaware goes even further and requires that all papers filed with that state's Supreme Court must be signed by a lawyer who is an active member of the Delaware Bar and who maintains a physical office in the state. Delaware S. Ct. Rule 12(a)(d). So, even if you're admitted *pro hac vice* in Delaware, you need local counsel with an office in the state to sign the pleadings.

And it doesn't get any easier in many states if the case is going to be arbitrated. First of all, the arbitration has to be "reasonably related" to the lawyer's practice in his home state, so all the factors discussed above for transactional matters apply. And some states have erected even more barriers. In South Carolina, for example, an out-of-state lawyer can provide alternative dispute resolution services no more than three times in a calendar year before running afoul of the "temporary basis" exception of that state's Rule 5.5. South Carolina S. Ct. Rule 404(k). Florida's aforementioned three appearances per calendar year limit applies to domestic arbitrations. Florida Rule Regulating the Florida Bar 1-3.11. In New Jersey, out-of-state lawyers can participate in arbitrations and mediations only if they register with the Clerk of the Supreme Court, authorize the Clerk to accept service, and comply with New Jersey's rules on registration and fees. New Jersey Committee on the Unauthorized Practice of Law Opinion 43 (Jan. 2007).

V. Other UPL Traps

There are other, less practice-specific UPL traps worth noting. In one case, a Washington, D.C.-admitted lawyer who claimed to practice only federal law was disbarred after joining a Maryland firm as its managing partner and taking on matters that involved Maryland law, among other misdeeds. *Atty Grievance Comm. of Maryland v. Shephard*, 119 A.3d 765 (Md. 2015). In another case, a lawyer joined a firm in Ohio where he was not admitted. Although his practice was limited to advising clients on federal securities law, the court nevertheless found that he had engaged in UPL because he maintained a "systematic and continuous presence" in Ohio without being licensed there. The court noted several factors, including the lawyer's role in client development, his service as a resource to the firm's other securities lawyers, and a six-month delay in filing his application for admission. *In re Application of Swendiman*, 57 N.E.2d 1155 (Ohio 2016).

There are also UPL issues to consider when you telecommute, if you're a nonresident New York-admitted lawyer without an office in the state, and even if you handle a matter in a nonadmitted state without ever setting foot there.

A. Telecommuting Traps

Lawyers commonly work from home these days. That's usually not a problem, but what if your home is in Virginia, where you're not admitted, and your office is in D.C., where you are. Are you engaging in UPL when you work out of your bedroom in the Old Dominion state? Thankfully, the answer appears to be no, provided you don't solicit clients in your state of residence, meet with existing clients there, or otherwise hold yourself out as admitted there. We do caution, however, that there is scant authority on this issue. Arizona and New Hampshire are the only states that have revised their Rule 5.5 to expressly allow a lawyer who's not admitted in the state to maintain a presence there so long as the lawyer's practice relates solely to his home state. And Florida, typically a very protectionist state, has informally opined that an unadmitted lawyer who works out of his winter home in the Sunshine State does not "establish an office or other systematic and continuous presence" provided he does not solicit Florida clients or use a Florida telephone number or address when communicating with his home state clients. But we are not aware of any other authority that expressly sanctions this type of telecommuting. *See* ALAS *Loss Prevention Manual*, Tab III.Q, Section 10.

Lawyers who are admitted in New York—but live elsewhere—have a unique problem if their firm has no office in the Empire State.

B. The Nonresident New York Lawyer Trap

Lawyers who are admitted in New York—but live elsewhere—have a unique problem if their firm has no office in the Empire State. That's because New York Judiciary Law Section 470 requires nonresident New York-licensed "attorneys or counsellors" to maintain a physical office in the state. *See Schoenefeld v. Schneiderman*, 821 F.3d 273 (2d Cir. 2016), *cert denied*, 137 S.Ct. 1580 (2017) (upholding the constitutionality of Section 470); "Second Circuit Upholds New York Law Requiring Physical Offices for Nonresident New York Lawyers," ALAS E-Newsletter (July 2016) (further discussing the *Schoenefeld* case.)

The case law surrounding Section 470 leaves numerous questions unanswered. For example, it is not entirely clear if Section 470 applies only if the nonresident lawyer is physically present in New York or if it applies more broadly anytime that lawyer advises on New York law. We have heard anecdotal reports of nonresident New York-admitted lawyers having state-court pleadings stricken, but we are not aware of nonresident lawyers getting into trouble when advising on New York law from their out-of-state office. Nevertheless, until the contours of Section 470 are clarified, we suggest that firms that have no office in New York determine if they have nonresident New York-admitted lawyers that litigate or otherwise advise on New York law and how often they do so while physically located in New York.

C. Virtual Presence Traps

Continual or repeated physical presence in a state where you're not admitted obviously raises UPL issues. But so can virtual presence. Comment [4] to Model Rule 5.5 suggests as much, when it explains that "systematic and continuous presence" may be established "even if the lawyer is not physically present." And a recent Minnesota Supreme Court decision makes that frighteningly clear. In *In re Charges of Unprofessional Conduct in Panel File No. 39302*, 884 N.W.2d 661 (Minn. 2016), a Colorado lawyer who never set foot in Minnesota was privately admonished for UPL when he contacted a Minnesota lawyer several times to try to settle a judgment entered against his Minnesota-domiciled mother-in-law. Notwithstanding the lawyer's limited electronic contacts with the state, the court nevertheless found that the lawyer had engaged in UPL because the dispute had no nexus to his Colorado practice—it involved only Minnesota residents and a debt arising from a judgment entered by a Minnesota court.

VI. Loss Prevention Suggestions

Despite the increased mobility of lawyers and the ease with which they can practice virtually from any location, UPL remains an area that requires caution. Firms should proceed carefully and thoughtfully when addressing the various UPL scenarios that arise in today's legal environment, such as when lawyers move to firm offices in jurisdictions where they are not admitted, work virtually from out-of-state residences, or represent out-of-state clients in circumstances where the temporary practice exceptions arguably do not apply. The panelists offered the following suggestions to help reduce UPL risks.

A. Engage and Consult Local Counsel

Perhaps the best antidote to both the UPL competency trap and the knock-on effects discussed in Section II above is to retain and consult with local counsel whenever you are embarking on a significant engagement that involves a jurisdiction in which you're not admitted. Doing so takes the UPL "coloring factor" out of the malpractice equation because Model Rule 5.5 (c) expressly says that an unadmitted lawyer who is temporarily present in a foreign jurisdiction does not engage in UPL when the engagement is "undertaken in association with a lawyer who is admitted to practice in this jurisdiction and who actively participates in the matter." But more importantly, good local counsel will help you identify unique or arcane issues of local law that could trip you up and lead to a malpractice claim.

Simply put, lawyers should know what the UPL rules are and where to find them.

B. Document Client Communications

Lawyers should consult with clients on UPL issues, including the need to retain local counsel. If the client rejects this advice, lawyers should document that decision as well.

C. Audit and Monitor UPL

Firms can implement safeguards to help keep track of where their lawyers are going, who they're seeing, and what they're doing. For example, firms should consider adding trip-wire questions to their new business intake forms to flag UPL risk factors (*e.g.*, will local counsel be needed, will the matter involve out-of-state parties or property or another state's laws?). Firms should also be proactive in auditing and monitoring lawyer compliance with UPL rules and should keep an updated list of where their lawyers are admitted and where they have pending applications. Applications should be filed as soon as possible and monitored until the bar authorities issue a decision.

D. Know the Rules

Simply put, lawyers should know what the UPL rules are and where to find them. The starting point is the relevant jurisdiction's rules of professional conduct, local court rules, and bar admission rules. If it's a close call, consider reaching out to state bar authorities proactively with questions, but be warned that their advice may not be binding.

E. Think about How You're Holding Yourself Out

Step into the shoes of the state bar authorities and think about how you're holding yourself out to the public, because they certainly will. If you're regularly in a state where you're not yet admitted, make sure that you clearly and affirmatively state that limitation on your website bio, letterhead, business cards, other marketing materials, and email signature block.

See ALAS *Loss Prevention Manual,* Tab III.Q for a further discussion of the multistate law practice and the unauthorized practice of law. The written materials for this program also include a compilation of recent UPL cases from lawyer regulatory agencies that were prepared by panelist Wendy J. Muchman, with the assistance of ARDC law clerks Jacob Comrov and Christine Castro.

Disciplinary Counsel v. Harris

Supreme Court of Ohio

February 26, 2013, Submitted; September 26, 2013, Decided

No. 2012-1698

Reporter
137 Ohio St. 3d 1 *; 2013-Ohio-4026 **; 996 N.E.2d 921 ***; 2013 Ohio LEXIS 2154 ****; 2013 WL 5357105

DISCIPLINARY COUNSEL v. HARRIS.

Prior History: [****1] ON CERTIFIED REPORT by the Board of Commissioners on Grievances and Discipline of the Supreme Court, No. 11-077.

Disciplinary Counsel v. Harris, 134 Ohio St. 3d 1439, 2013 Ohio 196, 981 N.E.2d 901, 2013 Ohio LEXIS 249 (2013)

Counsel: Jonathan E. Coughlan, Disciplinary Counsel, and Philip A. King, Assistant Disciplinary Counsel, for relator.

Oglesby & Oglesby, Ltd., and Geoffrey L. Oglesby, for respondent.

Judges: O'DONNELL, J. O'CONNOR, C.J., and PFEIFER, LANZINGER, KENNEDY, FRENCH, and O'NEILL, JJ., concur.

Opinion by: O'DONNELL

Opinion

[*1] [***923] O'DONNELL, J.

[**P1] This issue in this case is whether Donald Harris, an attorney who is admitted to the practice of law in the District of Columbia and the Northern and Southern Districts of Ohio, but who is not admitted to the practice of law in the state of Ohio, is subject to the disciplinary authority of this court. Because Harris is not a member of the Ohio bar and has not taken an oath to be bound by the Ohio Rules of Professional Conduct, these rules do not apply to him; rather, his conduct is subject to review by the Board on the Unauthorized Practice of Law ("UPL Board").

[**P2] Accordingly, we dismiss the Aimee Skeel matter in deference to the authority of the bankruptcy court, and we dismiss the remaining matters and refer them to the UPL Board for further proceedings.

Factual and Procedural Background

[**P3] Donald [****2] Harris has never been admitted to the practice of law in the state of Ohio. However, as a member of the District of Columbia bar and of the bars of the United States District Court for the Northern and Southern Districts of Ohio, he has focused his practice in bankruptcy law before the federal courts geographically located in Ohio.

[**P4] In August 2011, disciplinary counsel filed a four-count complaint against Harris relating to his representation of an Ohio client in bankruptcy proceedings before the United States District Court for the Northern District of Ohio, his establishment of a limited-liability company on behalf of an Ohio client, his assistance to an Ohio client in a mortgage modification, and representations regarding the relationship between an Ohio-licensed attorney and the Donald [*2] Harris Law Firm. Disciplinary counsel maintains that since Harris is an out-of-state attorney practicing federal law within Ohio's boundaries, he is subject to the disciplinary authority of this state pursuant to Prof.Cond.R. 8.5.

[**P5] A hearing panel of the Board of Commissioners on Grievances and Discipline concluded that disciplinary counsel had properly filed the complaint against Harris pursuant to [****3] Prof.Cond.R. 8.5. The panel further found that Harris had engaged in numerous violations of the Ohio Rules of Professional Conduct and recommended that Harris be indefinitely suspended from representing Ohio citizens in the state of Ohio. Upon review, the board adopted the findings of fact, conclusions of law, and recommendation of the panel.

[**P6] In his objections to the report and recommendation of the board, Harris asserts that Prof.Cond.R. 8.5 does not authorize this court to enforce the Ohio Rules of Professional Conduct against attorneys who are not licensed in Ohio. Moreover, Harris maintains that Prof.Cond.R. 5.5(a)—which prohibits a lawyer from practicing law in a jurisdiction in violation of its regulation of the legal profession— [***924] applies only to attorneys licensed in Ohio who practice in another jurisdiction. And he further contends that the federal courts and the District of Columbia have jurisdiction over any disciplinary matters relating to his practice in the federal bankruptcy courts.

The Court's Authority to Regulate the Practice of Law in Ohio

[**P7] Article IV, Section 2(B)(1)(g) of the Ohio Constitution grants this court "'exclusive power to regulate, control, and define the [****4] practice of law in Ohio.'" *Greenspan v. Third Fed. S. & L. Assn.*, 122 Ohio St.3d 455, 2009 Ohio 3508, 912 N.E.2d 567, ¶ 16, quoting *Cleveland Bar Assn. v. CompManagement, Inc.*, 104 Ohio St.3d 168, 2004 Ohio 6506, 818 N.E.2d 1181, ¶ 39. We have explained that "[a]ny definition of the practice of law inevitably includes representation before a court, as well as the preparation of pleadings and other legal documents, the management of legal actions for clients, all advice related to law, and all actions taken on behalf of clients connected with the law." *Cleveland Bar Assn. v. CompManagement, Inc.*, 111 Ohio St.3d 444, 2006-Ohio-6108, 857 N.E.2d 95, ¶ 22.

[**P8] We have defined the unauthorized practice of law as "'the rendering of legal services for another *by any person not admitted to practice in Ohio* under Rule I and not granted active status under Rule VI, or certified under Rule II, Rule IX, or Rule XI of the Supreme Court Rules for the Government of the Bar of Ohio.'" (Emphasis added.) *Lorain Cty. Bar Assn. v. Kocak*, 121 Ohio St.3d 396, 2009 Ohio 1430, 904 N.E.2d 885, ¶ 17, quoting former Gov.Bar R. VII(2)(A), 103 Ohio St.3d XCIX, CI. Gov.Bar R. VII(2)(A)(4) defines the unauthorized practice of law to include "[h]olding out to the public or otherwise representing [****5] oneself as authorized to practice law in Ohio by a person not authorized to practice law by the Supreme Court Rules for the Government of the Bar or [*3] Prof.Cond.R. 5.5." And controlling in this case is our own precedent: "a lawyer admitted to practice in another state, but not authorized to practice in Ohio, who counsels Ohio clients on Ohio law and drafts legal documents for them is engaged in the unauthorized practice of law in Ohio." *Cleveland Bar Assn. v. Moore*, 87 Ohio St. 3d 583, 584, 2000 Ohio 253, 722 N.E.2d 514 (2000), citing *Cleveland Bar Assn. v. Misch* , 82 Ohio St. 3d 256, 1998 Ohio 413, 695 N.E.2d 244 (1998).

Rules of Professional Conduct Do Not Apply to Harris

[**P9] Although Harris is licensed to practice law in another jurisdiction, because he is not admitted to the Ohio bar, our Rules of Professional Conduct, designed to regulate conduct of attorneys admitted to practice law in Ohio, do not apply to him. He never subjected himself to them because he has never been admitted to practice law in this state.

[**P10] Every lawyer who is admitted to practice law in Ohio takes an oath of office. *See* Gov.Bar R. I(1)(F). As part of that oath, the attorney swears or affirms to support the Constitutions of the United States and [****6] the state of Ohio and to "abide by the Ohio Rules of Professional Conduct." Gov.Bar R. I(8)(A).

[**P11] Harris never took that oath and never agreed to abide by our rules, and we are reluctant to impose our rules of conduct on him or other such attorneys who engage in the practice of law in our state. It appears that this is precisely why we have created the UPL Board and why we have defined the unauthorized practice of law as "'[t]he rendering of legal services for another by any person not admitted to practice in Ohio.'" *Kocak*, 121 Ohio St.3d 396, 2009 Ohio 1430, 904 N.E.2d 885, ¶ 17, [***925] quoting former Gov.Bar R. VII(2)(A), now Gov.Bar R. VII(2)(A)(1).

[**P12] In this regard, Harris is no different from an accountant, a real estate agent, or a financial planner who undertakes activity that constitutes the practice of law and who becomes subject to discipline pursuant to the unauthorized practice of law framework. It is inconsistent to conclude that an attorney admitted in another jurisdiction who engages in the unauthorized practice of law in Ohio becomes subject to the Board of Commissioners on Grievances and Discipline when another professional, such as a real estate agent, who engages in the unauthorized [****7] practice of law becomes subject to the UPL Board. Similarly, our decision today is in accordance with Gov.Bar R. VI(3)(C), which provides:

> An attorney who is admitted to the practice of law in another state or in the District of Columbia, but not in Ohio, and who performs legal services in Ohio for his or her employer, but fails to register in compliance with this section or does not qualify to register under this section, *may be referred [*4] for investigation of the unauthorized practice of law* under Gov.Bar R. VII * * *.

(Emphasis added.)

[**P13] Additionally, our sanctions for serious violations of the Rules of Professional Conduct, suspension and disbarment, are ineffective and meaningless to Harris because he is not a member of the Ohio bar. We cannot suspend or disbar an attorney who is not a member of the Ohio bar. Thus, we consider these matters as alleged unauthorized practice of law violations.

Harris's Conduct

The Bankruptcy Proceedings

[**P14] Harris represented Aimee Skeel in two bankruptcy petitions filed in the United States Bankruptcy Court for the Northern District of Ohio. We determine that Harris did not engage in the unauthorized practice of law when he represented Skeel because, as a [****8] member of the District of Columbia bar, and having been admitted to practice in the Northern District of Ohio, he was *authorized* to practice before the United States Bankruptcy Court for the Northern District of Ohio. As such, he becomes subject to the disciplinary authority of those federal courts.

[**P15] As the Bankruptcy Court for the Northern District of Ohio explained, "[a] bankruptcy court has the power to regulate the practice of law in the cases before it." *In re Ferguson*, 326 B.R. 419, 422 (Bankr.N.D.Ohio 2005), citing *United States v. Johnson*, 327 F.3d 554, 560 (7th Cir.2003); *see also Chambers v. NASCO, Inc.*, 501 U.S. 32, 43, 111 S.Ct. 2123, 115 L.Ed.2d 27 (1991) ("the Court has held that a federal court has the power to control admission to its bar and to discipline attorneys who appear before it"). Specifically, Loc.R. 2090-2(b) of the United States Bankruptcy Court for the Northern District of Ohio states that "[p]rofessional conduct and attorney discipline shall be governed by Local Civil Rule 83.7," which provides that "any attorney admitted to practice before this Court may be subjected to such disciplinary action as the circumstances warrant." Loc.Civ.R. 83.7(b)(1) of the United [****9] States District Court for the Northern District of Ohio.

[**P16] Here, the United States Bankruptcy Court for the Northern District of Ohio exercised its authority and declined to sanction Harris or order the disgorgement of attorney fees for his representation [***926] of Skeel in bankruptcy proceedings. Because the alleged misconduct involving Skeel occurred before the United States Bankruptcy Court for the Northern District of Ohio and because that court has the power to discipline Harris for his practice before it, we [*5] dismiss this charge in deference to the disciplinary authority of the United States Bankruptcy Court for the Northern District of Ohio.

Formation of an L.L.C.

[**P17] Darlene Martincak engaged Harris to file a petition in bankruptcy. She also asked Harris to help her transfer five properties owned by her company to Alexander Roussos. Prior to the filing of the bankruptcy, Harris met with Martincak and Roussos to discuss the property transfers and agreed to assist them. In relation to these transactions, during oral argument, Harris's counsel admitted that Harris had formed an L.L.C. Harris did not inform Martincak or Roussos that he was not licensed to practice law in Ohio.

[**P18] Harris has never been [****10] admitted to the practice of law in Ohio, does not have active status, and is not certified. By definition, then, Harris did not commit a disciplinary violation because he never became subject to our disciplinary rules by gaining admission to the bar of the state of Ohio. Rather, Harris may have engaged in the unauthorized practice of law when he assisted Roussos in establishing an L.L.C. in accordance with Ohio law and when he participated in transferring properties to that L.L.C. *See Columbus Bar Assn. v. Verne*, 99 Ohio St.3d 50, 2003 Ohio 2463, 788 N.E.2d 1064, ¶ 1-4. In addition, by his silence, he may have further engaged in the unauthorized practice of law by leading Roussos and Martincak to believe that he was a member of the Ohio bar. *See* Gov.Bar R. VII(2)(A)(4), which defines the unauthorized practice of law to include holding out to the public or otherwise representing oneself as authorized to practice law. Thus, since Harris is not admitted to the Ohio bar and because the conduct with which he is charged has been defined by this court to constitute the unauthorized practice of law, we dismiss the disciplinary action and refer this matter to the UPL Board.

Modification of a [*11] Mortgage***

[**P19] Harris also agreed to seek modification of a mortgage that Ronald Sharp—a client whom Harris had represented in two prior bankruptcy proceedings—held on his residence and failed to inform Sharp that he was not licensed to practice law in Ohio.

[**P20] While we agree with the board that there is insufficient evidence to support the allegations that Harris committed any disciplinary violations relating to the modification of Sharp's mortgage, we refer this matter to the UPL Board for its consideration and review.

Violations Involving Information about Legal Services

[**P21] Harris formed the Donald Harris Law Firm in 2004. The firm maintained a website, which indicated that unnamed attorneys in his firm were [*6] licensed in various states, including Ohio. In addition, Harris's letterhead stated, "Attorneys at Law" below the firm name and listed Loretta Riddle, a member of the Ohio bar, as an attorney. However, the nature of the working relationship between Harris and Riddle is unclear. Thus, by holding out to the public that Riddle was a member of the Donald Harris Law Firm, he may have engaged in the unauthorized practice of law in Ohio. *See* Gov.Bar R. VII(2)(A)(4). We therefore refer this [****12] matter to the UPL Board for its consideration and review.

[***927] **Conclusion**

[**P22] Because Harris is not a member of the Ohio bar, he is not subject to this court's disciplinary authority. Rather, as an attorney not admitted to practice in Ohio, he may have engaged in the unauthorized practice of law by rendering legal services in Ohio to Ohio clients.

[**P23] Therefore, in conformity with our previous decisions in *Moore* and *Misch* and our longstanding definition of the unauthorized practice of law, we dismiss the Skeel matter in deference to the authority of the bankruptcy court. We further dismiss the Roussos/Martincak matter, the Sharp matter, and the charges relating to information about legal services and refer these matters to the UPL Board for further proceedings.

So ordered.

O'CONNOR, C.J., and PFEIFER, LANZINGER, KENNEDY, FRENCH, and O'NEILL, JJ., concur.

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attorney is "inactive." An inactive attorney shall not be listed as "of counsel" or otherwise be represented as being able to engage in the practice of law.

Section 6. Corporate Counsel Attorney Registration.

(A) Registration

(1) An attorney who is admitted to the practice of law in another state or the District of Columbia or a territory of the United States, but not in Ohio; who is employed as an attorney by a nongovernmental employer, the business of which is lawful and consists of activities other than the practice of law or the provision of legal services; and who, as a result of that employment, has a systematic and continuous presence in Ohio as permitted pursuant to Prof.Cond.R. 5.5(d)(1) shall register for corporate counsel status upon commencement of employment as an attorney by submitting to the Office of Attorney Services all of the following:

(a) The certificate of registration required for attorneys registering for active status pursuant to Section 2 of this rule for the current biennium and each biennia during which the attorney is so employed;

(b) The fee required for attorneys registering for active status pursuant to Section 2 of this rule;

(c) An application on a form provided by the office;

(d) Documents demonstrating admission to the practice of law and good standing in all jurisdictions in which the attorney has been admitted to the practice of law and demonstrating that the attorney is on active status in at least one other state or the District of Columbia or a territory of the United States;

(e) An affidavit on a form provided by the office completed by an officer, director, or general counsel of the employing entity attesting to the attorney's employment by the entity, the date of commencement of employment, and the capacity in which the attorney is so employed and stating that the employment conforms to the requirements of this rule;

(f) Any other documents or information as deemed appropriate by the office.

(2) Division (A)(1) of this section shall not apply to an attorney who is admitted to the practice of law in another state or the District of Columbia or a territory of the United States, but not in Ohio, and who is employed by, associated with, or a partner in an Ohio law firm. Until the attorney is admitted to the practice of law in Ohio, the attorney may not practice law in Ohio, hold the attorney's self out as authorized to practice law in Ohio, or practice before any nonfederal court or agency in Ohio on behalf of any person except the attorney's self, unless granted leave by the court or agency. The law firm may include

the name of the attorney on its letterhead only if the letterhead includes a designation that the attorney is not admitted in Ohio.

(B) Biennial registration

An attorney registered for corporate counsel status under this section shall register biennially with the Office of Attorney Services of the Supreme Court pursuant to the requirements of Section 2 of this rule.

(C) Failure to register

An attorney who is admitted to the practice of law in another state or the District of Columbia or a territory of the United States, but not in Ohio, and who performs legal services in Ohio for the attorney's employer, but fails to register in compliance with this section or does not qualify to register under this section, may be referred for investigation of the unauthorized practice of law under Gov. Bar R. VII and, at the discretion of the Chief Justice, may be precluded from applying for admission without examination under Gov. Bar R. I.

(D) Scope of practice

(1) An attorney who is registered for corporate counsel status under this section may perform legal services for the employing entity or its organizational affiliates; including entities that control, are controlled by, or are under common control with the employer; and for employees, officers, and directors of such entities, but only on matters directly related to the attorney's work for the entity and only to the extent consistent with Prof.Cond.R. 1.7.

(2) An attorney registered under this section shall not do either of the following:

(a) Appear before a court or any other tribunal in Ohio on behalf of the attorney's employer or any person except for the lawyer's self, except if granted leave by the court or tribunal as provided in Gov. Bar R. XII;

(b) Offer or provide legal services or advice to any person other than as described in division (D)(1) of this section, or hold the attorney's self out as being authorized to practice law in Ohio other than as described in division (D)(1) of this section.

(E) Pro bono legal service

(1) As used in this rule, "pro bono legal service" means legal service provided either to a person of limited means or to a charitable organization.

(2) Notwithstanding division (D) of this section, an attorney registered for corporate status under this section may provide pro bono legal service if the legal service is assigned or verified by any of the following:

(a) An organization receiving funding for pro bono programs or services from the Legal Services Corporation or the Ohio Legal Assistance Foundation;

(b) A metropolitan or county bar association;

(c) The Ohio State Bar Association;

(d) The Ohio Legal Assistance Foundation;

(e) Any other organization recognized by the Commission on Continuing Legal Education pursuant to Gov. Bar R. X, Sec. (5)(H).

(F) Application of rules

An attorney registered for corporate status under this section shall be subject to all rules and requirements governing the practice of law in Ohio, including the Ohio Rules of Professional Conduct.

(G) New lawyers training and continuing legal education requirements

An attorney registered for corporate counsel status under this section shall comply with the new lawyers training and continuing legal education requirements of Gov. Bar R. X.

(H) Obligation to provide and update contact information

An attorney registered for corporate status under this section shall provide the Office of Attorney Services with the attorney's current residence address, office address, office telephone number, and office or residence e-mail address and shall notify the office of any change in the information recorded on the certificate of registration pursuant to division (B) of this section.

(I) Obligation to report

An attorney registered for corporate status under this section shall notify the Office of Attorney Services within ten days of any of the following:

(1) Termination of the attorney's employment that was the basis for the attorney's registration as corporate counsel;

(2) Any change in the attorney's license status in another jurisdiction, including the attorney's resignation from the practice of law;

(3) The imposition of any disciplinary finding or sanction in any state other than Ohio or the District of Columbia or a territory of the United States where the attorney has been admitted to the practice of law.

(J) Termination of registration

The limited authority to practice law of an attorney registered for corporate status under this section shall automatically terminate upon the occurrence of any of the following:

(1) The employment that was the basis for the attorney's registration for corporate counsel terminates;

(2) The attorney is admitted to the practice of law in Ohio pursuant to Gov. Bar R. I;

(3) The attorney ceases to maintain active status in at least one other state or the District of Columbia or a territory of the United States;

(4) The attorney fails to maintain current good standing in at least one other state or the District of Columbia or a territory of the United States in which the attorney is admitted to the practice of law;

(5) The attorney is suspended or disbarred for disciplinary reasons in any state or the District of Columbia or a territory of the United States or by any federal court or agency in which the attorney has been admitted to the practice of law.

(K) Reinstatement of registration

An attorney registered for corporate status under this section whose registration is terminated pursuant to division (J) of this section may be reinstated upon submission of an application for reinstatement in a manner required by the Office of Attorney Services.

Section 7. Military Legal Assistance Attorney Registration.

(A) Registration

An attorney who is admitted to the practice of law and maintains active status in at least one United States jurisdiction other than Ohio; is employed by, serving in, or assigned to the armed forces at a military installation in Ohio as an attorney; and is otherwise authorized to provide legal assistance pursuant to 10 U.S.C. 1044 may apply for military legal assistance attorney registration by submitting to the Office of Attorney Services all of the following:

(1) A completed application on a form prescribed by the Office of Attorney Services;

In re Egan

Supreme Court of Ohio

May 17, 2017, Submitted; November 22, 2017, Decided

No. 2017-0397

Reporter

2017-Ohio-8651 *; 2017 Ohio LEXIS 2359 **

IN RE APPLICATION OF EGAN.

Subsequent History: Request granted In re Egan, 2017-Ohio-8650, 2017 Ohio LEXIS 2360 (Ohio, Nov. 22, 2017)

Prior History: [**1] ON REPORT by the Board of Commissioners on Character and Fitness of the Supreme Court, No. 663.

Counsel: Kegler, Brown, Hall & Ritter, L.P.A., and Jonathan E. Coughlan, for applicant.

The Law Office of James A. Whittaker. L.L.C., and Laura I. Murphy, for the Cincinnati Bar Association.

Tucker Ellis, L.L.P., Benjamin C. Sassé, and Irene C. Keyse-Walker, for the Board of Commissioners on Character and Fitness.

Judges: O'CONNOR, C.J., and O'DONNELL, KENNEDY, FRENCH, O'NEILL, and FISCHER, JJ., concur. DEWINE, J., concurs in judgment only.

Opinion

Per Curiam.

[*P1] Applicant, Shannon O'Connell Egan, of Cincinnati, Ohio, is a 1998 graduate of the Louisiana State University Paul M. Hebert Law Center. She was admitted to the Kentucky bar in October 1998 and the Indiana bar in October 2014. In November 2015, Egan applied to register as a candidate for admission to the practice of law in Ohio and to take the [**2] July 2016 bar exam. Based on findings that Egan engaged in the unauthorized practice of law ("UPL") by establishing offices in Cincinnati, Ohio, from which she practiced Kentucky law for more than ten years, the Board of Commissioners on Character and Fitness recommends that we disapprove her current application but permit her to reapply for the February 2018 bar exam. We adopt the board's findings of fact. Based on evidence of Egan's exemplary character and professional reputation and the steps she and her firm have taken to rectify her conduct, however, we find that Egan has carried her burden of proving that she currently possesses the requisite character, fitness, and moral qualifications to practice law in this state. We therefore approve Egan's pending application and permit her to sit for the February 2018 bar exam.

Summary of Proceedings

[*P2] In June 2016, the admissions committee of the Cincinnati Bar Association recommended that Egan's character, fitness, and moral qualifications to practice law be approved. The Board of Commissioners on Character and Fitness, however, invoked its sua sponte investigatory authority, conferred by Gov.Bar R. I(10)(B)(2)(e), and scheduled a hearing on the matter.

[*P3] The evidence [**3] presented at the hearing shows that Egan accepted a position in the Cincinnati law office of Lerner, Sampson & Rothfuss in September 2002 and practiced Kentucky law from that office until March 2013, when she accepted a position with another Cincinnati law firm. Lerner, Sampson's letterhead stated that Egan was "admitted in Kentucky." Although the letterhead did not affirmatively state that she was admitted *only* in Kentucky, it so implied, in that it described other attorneys as "also admitted in Kentucky." The board accepted Egan's testimony that she limited her practice to Kentucky matters, that she did not hold herself out as an Ohio lawyer or enter an appearance in an Ohio court, and that she neither met with clients nor conducted depositions in Ohio.

[*P4] In late 2008, Egan applied for admission to the Ohio bar without examination with the belief that she had completed the five years of practice in another jurisdiction required by Gov.Bar R. I(9)(A)(2). However, this court's bar-admissions counsel returned Egan's application with a letter stating that Egan did not meet all of the requirements for admission without examination. The letter did not state that Egan had violated any rule, but it informed her [**4] that her employment in the Cincinnati office of Lerner, Sampson & Rothfuss could not be counted as past practice of law for purposes of admission without examination because under Gov.Bar R. I(9)(B)(2), time in practice is credited only when it is "performed in a jurisdiction in which the applicant was admitted or in a jurisdiction that affirmatively permitted such practice by a lawyer not admitted to practice in that jurisdiction."

[*P5] Egan filed a second application for admission without examination after she joined the Cincinnati office of Graydon, Head & Ritchey, L.L.P., in March 2013. In rejecting that application, bar-admissions counsel reiterated the reasons that Egan's previous application was rejected and suggested that she contact the Board on the Unauthorized Practice of Law if she had questions about the effect of her legal employment in Ohio. In response to that letter, Graydon, Head & Ritchey moved Egan to the firm's Kentucky office—though she continued to work in the firm's Cincinnati office approximately 40 percent of the time—issued her new business cards, and changed her signature block. The firm also sought advice from the Cincinnati Bar Association, who downplayed the UPL issue and advised [**5] that Egan would have to take the bar exam and that she would likely be asked questions about potential UPL issues if she applied to take the exam.

[*P6] At the panel hearing, Egan testified that she is a community-minded person who would never intentionally violate professional rules. Under questioning from the panel, Egan insisted that it never occurred to her that she might be engaging in UPL until she received notice of the board's sua sponte investigation and met with her counsel in August 2016. She testified that since that time, she has performed legal services exclusively in Kentucky and Indiana, where she is licensed, and has stopped working from her Ohio home on evenings and weekends. In addition, Egan stated that one of her character and fitness interviewers expressed dismay that she had not been admitted on motion, and other attorneys react with incredulity when told of her difficulties. She also presented evidence that a former colleague had engaged in the same conduct with different results. His application for admission without examination was also rejected because the required five years of practice included practice in a jurisdiction in which he was not admitted, but he was [**6] later permitted to take the bar exam without a character and fitness hearing.

[*P7] The board found that Egan had engaged in the unauthorized practice of law by establishing an office in Ohio from which she practiced Kentucky law full-time from 2002 until at least 2013 and approximately 40 percent of the time from 2013 until August 2016. The board found that her conduct, to the extent that it continued after the February 1, 2007 effective date of the Rules of Professional Conduct, violated Prof.Cond.R. 5.5(b)(1) (prohibiting a lawyer who is not admitted to the practice of law in this jurisdiction to establish an office or other systematic and continuous presence in this jurisdiction for the practice of law). The board also acknowledged that by some accounts, conduct like Egan's is widespread in

Cincinnati.

[*P8] The board found that Egan's testimony seemed honest and sincere and that she has presented evidence that she is a very competent and careful attorney. But it also stated that it was "difficult to believe that she did not have some inkling that there might be a problem" when her applications for admission without examination were twice rejected for practicing law in a jurisdiction in which she was not admitted [**7] to the bar.

[*P9] Given the length of time that Egan had engaged in the unauthorized practice of law and the relatively short period of time that she had been in compliance with Prof.Cond.R. 5.5 at the time of the hearing, the board recommended that we disapprove her pending application but permit her to reapply for the February 2018 bar exam.

Disposition

[*P10] An applicant to the Ohio bar must prove by clear and convincing evidence that he or she "possesses the requisite character, fitness, and moral qualifications for admission to the practice of law." Gov.Bar R. I(11)(D)(1). Evidence that an applicant has committed an act constituting the unauthorized practice of law is one factor to be considered in determining whether an applicant is fit to practice law in this state. Gov.Bar R. I(11)(D)(3)(c).

[*P11] Prof.Cond.R. 5.5 governs the multijurisdictional practice of law in Ohio. It provides that a lawyer who is not admitted to practice law in this jurisdiction shall not "establish an office or other systematic and continuous presence in this jurisdiction for the practice of law," except as authorized by these rules or other law. Prof.Cond.R. 5.5(b)(1). The rule provides limited exceptions to this prohibition. It authorizes a lawyer who is admitted in another United States jurisdiction, who is in good [**8] standing in that jurisdiction, and who regularly practices law to provide legal services in Ohio *on a temporary basis* if the services fall within certain limits described in the rule. *See* Prof.Cond.R. 5.5(c)(1) through (4). But Egan admitted that her practice was not temporary within the meaning of the rule. The rule also authorizes a lawyer admitted and in good standing in another United States jurisdiction to provide legal services in Ohio through an office or other *systematic and continuous presence* in just three circumstances. But Egan has not proven that any of those circumstances exist here.[1] *See* Prof.Cond.R. 5.5(d)(1) through (3). Moreover, Official Comment [15] to the rule explains: "Except as provided in divisions (d)(1) through (d)(3), a lawyer who is admitted to practice law in another jurisdiction and who establishes an office or other systematic or continuous presence in this jurisdiction must become admitted to practice law generally in this jurisdiction." Egan never became admitted to the bar in Ohio. Thus, there can be no dispute that Egan's conduct constituted the unauthorized practice of law. For that reason, we adopt the board's findings of fact.

[*P12] Although we find that Egan engaged in the unauthorized practice of law in this state [**9] for an extended period of time, we note that she did not engage in the practice of Ohio law, and there is no evidence tending to demonstrate that she caused any harm to her clients or the citizens of Ohio. Based on evidence of Egan's exemplary character and professional reputation and the steps that she and her firm took to relocate her practice to Kentucky once they realized the import of her conduct, we find that Egan has carried her burden

[1] Prof.Cond.R. 5.5(d)(1) through (3) permit a lawyer who is admitted and in good standing in another United States jurisdiction to provide services in Ohio through an office or other systematic and continuous presence in just three circumstances: (1) the lawyer is registered for corporate-counsel status with the Office of Attorney Services and is providing legal services to the lawyer's employer or its organizational affiliates for which the permission of a tribunal to appear pro hac vice is not required, (2) the lawyer is providing services that the lawyer is authorized to provide by federal or Ohio law, or (3) the lawyer is registered for corporate-counsel status with the Office of Attorney Services and is providing authorized pro bono services.

of proving that she currently possesses the requisite character, fitness, and moral qualifications to practice law in this state. Therefore, we approve Egan's pending application and permit her to sit for the February 2018 bar exam, provided that she satisfies the remaining registration requirements.

Judgment accordingly.

O'CONNOR, C.J., and O'DONNELL, KENNEDY, FRENCH, O'NEILL, and FISCHER, JJ., concur.

DEWINE, J., concurs in judgment only.

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STATE OF MINNESOTA

IN SUPREME COURT

A15-2078

Original Jurisdiction

Per Curiam
Dissenting, Anderson, Lillehaug, and Chutich, JJ.

In re Charges of Unprofessional Conduct
in Panel File No. 39302

Filed: August 31, 2016
Office of Appellate Courts

Susan M. Humiston, Director, Binh T. Toung, Assistant Director, Office of Lawyers Professional Responsibility, Saint Paul, Minnesota, for respondent.

Eric T. Cooperstein, Law Office of Eric T. Cooperstein, PLLC, Minneapolis, Minnesota, for appellant.

S Y L L A B U S

1. Based on appellant's representation of Minnesota residents with respect to a Minnesota judgment and attempt to negotiate with a Minnesota lawyer, via e-mail, the satisfaction of that judgment, the Panel's finding that appellant engaged in the unauthorized

practice of law in Minnesota in violation of Minn. R. Prof. Conduct 5.5(a), even though appellant was not physically present in Minnesota, was not clearly erroneous.

2. The Panel's finding that appellant was not authorized to practice law in Minnesota temporarily, pursuant to Minn. R. Prof. Conduct 5.5(c), was not clearly erroneous where appellant took no steps to find local counsel or be admitted to practice pro hac vice, and appellant's clients were Minnesota residents with a debt owed to a Minnesota resident that was governed by Minnesota law.

3. In this case, an admonition is the appropriate disposition for an out-of-state attorney who engaged in the unauthorized practice of law in Minnesota.

Affirmed.

O P I N I O N

PER CURIAM.

The Director of the Office of Lawyers Professional Responsibility (the Director) issued a private admonition to appellant for engaging in the unauthorized practice of law in Minnesota. Appellant demanded that the Director present the charge to a Panel of the Lawyers Professional Responsibility Board (the Panel). Following an evidentiary hearing, the Panel affirmed the Director's admonition, finding that appellant had engaged in the unauthorized practice of law in Minnesota, in violation of Minn. R. Prof. Conduct 5.5(a), and that the misconduct was isolated and non-serious. Appellant filed a notice of appeal, contesting the Panel's determination that his conduct violated Minn. R. Prof. Conduct 5.5. *See* Rule 9(m), Rules on Lawyers Professional Responsibility (RLPR). We hold that engaging in e-mail communications with people in Minnesota may constitute the unauthorized practice of law in Minnesota, in violation of Minn. R. Prof. Conduct 5.5(a), even if the lawyer is not physically present in Minnesota. The Panel's finding that appellant engaged in the unauthorized practice of law in Minnesota, in violation of Minn. R. Prof. Conduct 5.5(a), was not clearly erroneous. Appellant represented a Minnesota couple with respect to a Minnesota judgment and attempted to negotiate, via e-mail, the satisfaction of that judgment with a Minnesota lawyer, and was not authorized to practice law in Minnesota temporarily. We further conclude that the appropriate disposition for this misconduct is an admonition.

I.

Appellant is an attorney licensed to practice law in the state of Colorado, where he maintains an office and has been practicing environmental law since 1986. He has also practiced personal injury law for approximately 7 years. Part of his litigation practice includes debt collection. Appellant is admitted to practice law in New York, Florida, and Alaska, but is currently on inactive status in those states. Appellant is also admitted to practice in federal court in the District of Colorado, the District of Alaska, the Southern and Western Districts of New York, and the United States Court of Appeals for the Ninth and Tenth Circuits. Appellant is not licensed to practice law in Minnesota.

Appellant's mother- and father-in-law live in Minnesota. They contacted appellant in May 2014 to obtain assistance regarding a judgment entered against them in conciliation court in Minnesota for $2,368.13 in favor of their condominium association, Voyager

Condominium Homeowners' Association, Inc. (VCHA). The couple told appellant that VCHA's attorney, D.R., a Minnesota-based lawyer and the complainant in this case, was harassing them with telephone calls attempting to collect on the judgment. The couple asked appellant for his assistance in negotiating with D.R. regarding payment of the outstanding judgment.

Appellant sent an e-mail to D.R. in late May 2014, informing D.R. that he was representing his in-laws and instructing D.R. to direct all future communications to him instead. Appellant and D.R. exchanged approximately two dozen e-mails between May 2014 and September 2014. In his first responsive e-mail to appellant, D.R. asked whether appellant was licensed to practice law in Minnesota. Appellant replied that he was not licensed in Minnesota and that if he needed to file suit in Minnesota he would hire local counsel. The subsequent e-mails consisted of discussions regarding the in-laws' assets and ability to pay and whether the VCHA judgment would have priority in a foreclosure sale. Appellant attached financial disclosure forms to one of his e-mails and made a settlement offer.

In the penultimate e-mail exchange between the two attorneys, D.R. asserted that appellant was engaging in the unauthorized practice of law because he was not licensed in Minnesota. The final e-mail prior to D.R. filing an ethics complaint was a settlement proposal from appellant to D.R. on that same day. The Director received D.R.'s ethics complaint in October 2014. Approximately 2 months after filing the complaint, D.R. sent additional e-mails to appellant to determine whether the settlement offer was still available and whether appellant still represented his in-laws. Appellant did not respond to the subsequent e-mails and had no further involvement in the case.

Nothing in the record shows that appellant researched whether his activities constituted the unauthorized practice of law under the Minnesota Rules of Professional Conduct. When asked by the Panel at the evidentiary hearing whether he researched the rules in Minnesota, appellant said that he did not recall. Appellant admitted that he had not researched Minnesota law on foreclosure and how it would apply to his in-laws' case. Appellant also admitted that when he considered the relevant law and the rules of professional conduct, he was more familiar with the laws and rules in Colorado.

The Panel affirmed the Director's admonition, finding that clear and convincing evidence demonstrated a violation of Minn. R. Prof. Conduct 5.5(a). *See* Rule 9(j)(1)(iii), RLPR. The Panel found that appellant "is not licensed in Minnesota . . . . He is licensed in Colorado . . . . He was—although maybe not paid, he certainly has held out the fact that he represented clients, which regardless of whether they're related or not, he did represent them, admitted to representing them in a purely Minnesota case."

Pursuant to Rule 9(m), RLPR, appellant appealed the admonition to this court. Specifically, appellant challenges the Panel's determinations that he violated Minn. R. Prof. Conduct 5.5(a) and that his conduct did not fall within one of the exceptions in Minn. R. Prof. Conduct 5.5(c). We address each issue in turn.

II.

We turn first to appellant's claim regarding Rule 5.5(a). It states, in relevant part, that "[a] lawyer shall not practice law in a jurisdiction in violation of the regulation of the legal profession in that jurisdiction . . . ." Minn. R. Prof. Conduct 5.5(a).

Appellant contends that he did not violate Rule 5.5(a) because he did not practice law *in* Minnesota. According to appellant, a lawyer practices *in* a jurisdiction in one of three ways: (1) by being physically present in the jurisdiction; (2) by establishing an office or other systematic and continuous presence in the jurisdiction; or (3) by entering an appearance in a matter through the filing of documents with a tribunal. Appellant argues that e-mail communication directed to a jurisdiction in which the lawyer is not admitted to practice does not fall within the definition of practicing law *in* a jurisdiction, and thus the Panel erred in its determination that he violated Rule 5.5(a).

We review findings made in lawyer discipline cases under a clearly erroneous standard. *In re Panel Case No. 23236*, 728 N.W.2d 254, 257-58 (Minn. 2007). We "will uphold the panel's factual findings if they have evidentiary support in the record and are not clearly erroneous." *In re Mose*, 754 N.W.2d 357, 360 (Minn. 2008) (citing *In re Singer*, 735 N.W.2d 698, 703 (Minn. 2007)).

Appellant concedes for the purpose of this appeal that he engaged in the practice of law, albeit in Colorado. Such a concession is consistent with our prior cases holding that negotiating the resolution of a claim on behalf of a client constitutes the practice of law. *See In re Ray*, 610 N.W.2d 342, 343, 346 (Minn. 2000) (upholding the referee's finding that the attorney engaged in the unauthorized practice of law by negotiating with the county attorney on behalf of a client while the attorney was subject to a disciplinary suspension); *In re Ray*, 452 N.W.2d 689, 693 (Minn. 1990) (holding that "the record support[ed] the referee's conclusion" that the attorney engaged in the unauthorized practice of law by attempting to negotiate settlements for two clients). Appellant maintains, however, that an attorney does not practice law in another jurisdiction merely by engaging in e-mail communications with individuals in that jurisdiction. Whether an attorney engages in the practice of law *in* Minnesota by sending e-mails from *another* jurisdiction is a matter of first impression.

Rule 5.5(a) of the Minnesota Rules of Professional Conduct does not explicitly define what it means to practice law *in* a jurisdiction. Certainly, physical presence is one way to practice law *in* a jurisdiction. But, as we set forth below, it is not the only way.

Other courts have addressed the issue of whether an attorney practices law in a jurisdiction even though the attorney was not physically present in that jurisdiction. In *Birbrower, Montalbano, Condon & Frank, P.C. v. Superior Court*, 949 P.2d 1, 5-6 (Cal. 1998), the California Supreme Court analyzed what constituted the practice of law in a jurisdiction by looking at the nature of the legal representation in the jurisdiction, instead of focusing solely on physical presence. In determining what it means to practice law in California, the court considered whether the lawyer had "sufficient contact with the California client to render the nature of the legal services a clear legal representation" and whether the lawyers' contact with California was merely "fortuitous or attenuated." *Id.*

at 5. The court determined that a lawyer "may practice law in the state . . . although not physically present here by advising a California client on California law in connection with a California legal dispute by telephone, fax, computer, or other modern technological means." *Id.* at 5-6; *see also In re Babies*, 315 B.R. 785, 791-93 (Bankr. N.D. Ga. 2004) (concluding that attorneys who were physically present in Illinois practiced law in Georgia by representing Georgia clients with respect to a bankruptcy, preparing documents related to that bankruptcy, and communicating with these clients via the telephone and mail).

The reasoning in *Birbrower* is persuasive. Based on that reasoning, we conclude that the Panel did not clearly err by finding that appellant practiced law *in* Minnesota, in violation of Minn. R. Prof. Conduct 5.5(a).[1] Appellant contacted D.R., a Minnesota lawyer, and stated that he represented Minnesota clients in a Minnesota legal dispute. This legal dispute was not interjurisdictional; instead, it involved only Minnesota residents and

[1] Clients frequently do business in multiple states, and modern technology makes rapid communication across state borders routine. As a result, many lawyers are involved in multijurisdictional practices. The rule governing the unauthorized practice of law accounts for multijurisdictional practices. It has exceptions that allow lawyers who are not admitted to practice in Minnesota to practice here temporarily in certain circumstances. *See* Minn. R. Prof. Conduct 5.5(c); *see also* Rule 9, Rules for Admission to the Bar (addressing temporary house counsel license). If there are concerns that these exceptions do not adequately meet client needs, the better way to address such concerns would be through filing a petition to amend Rule 5.5(c). The same is true for the dissent's claim that Rule 5.5(c) should allow lawyers not licensed to practice law in Minnesota to temporarily represent family members or friends in minor matters involving only Minnesota and Minnesota law. At the same time, lawyers must be cognizant of and respect each state's obligation to enact regulations that ensure the lawyers who represent its citizens are competent to do so. *See* Minn. R. Prof. Conduct 5.5 cmt. 2 ("Whatever the definition" of the practice of law, "limiting the practice of law to members of the bar protects the public against rendition of legal services by unqualified persons.").

a debt arising from a judgment entered by a Minnesota court. Appellant instructed D.R. to refer all future correspondence to him, and he continued to engage in correspondence and negotiations with D.R. over the course of several months. Appellant requested and received financial documents from his Minnesota clients and advised them on their legal options. By multiple e-mails sent over several months, appellant advised Minnesota clients on Minnesota law in connection with a Minnesota legal dispute and attempted to negotiate a resolution of that dispute with a Minnesota attorney. Appellant had a clear, ongoing attorney-client relationship with his Minnesota clients, and his contacts with Minnesota were not fortuitous or attenuated. Thus, there is ample support for the Panel's finding that appellant practiced law in Minnesota.

III.

Next, we turn to appellant's claim that even if the Panel did not err in determining that he was practicing law in Minnesota in violation of Minn. R. Prof. Conduct 5.5(a), his conduct was permitted under one of the exceptions in Minn. R. Prof. Conduct 5.5(c). Appellant argues that Rule 5.5(c)(2) authorized his conduct because he reasonably believed that he would be able to associate with local counsel and be admitted pro hac vice if necessary. Appellant further claims that Rule 5.5(c)(4) authorized his conduct because his in-laws reached out to him for assistance on a matter within his expertise; thus the matter "arose out of [Appellant's] law practice."[2]

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[2] At the Panel hearing, appellant argued that Minn. R. Prof. Conduct 5.5(c)(3) authorized his conduct. The Panel addressed Rule 5.5(c)(3) in its findings. In his brief to

Rule 5.5(c) permits an attorney to practice temporarily in a jurisdiction in which the attorney is not admitted. It states:

> A lawyer admitted in another United States jurisdiction, and not disbarred or suspended from practice in any jurisdiction, may provide legal services on a temporary basis in this jurisdiction which:
> . . . .
>
> (2) are in or reasonably related to a pending or potential proceeding before a tribunal in this or another jurisdiction, if the lawyer, or a person the lawyer is assisting, is authorized by law or order to appear in the proceeding or reasonably expects to be so authorized;
>
> . . .
>
> or
>
> (4) are not within paragraphs (c)(2) or (c)(3) and arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice.

Minn. R. Prof. Conduct 5.5(c).

Under Minnesota Rules of Professional Conduct 5.5(c)(2), a lawyer admitted in another jurisdiction may provide legal services in Minnesota on a temporary basis if the lawyer's services are reasonably related to a pending or potential proceeding before a tribunal and the lawyer reasonably expects to be authorized by law to appear in the proceeding. Comment 10 explains that a lawyer rendering services in Minnesota on a

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this court, appellant does not raise Rule 5.5(c)(3). Instead, he argues that Minn. R. Prof. Conduct 5.5(c)(2) and (4) authorized his conduct. It is not clear whether appellant properly preserved his arguments regarding the application of Rule 5.5(c)(2) and (4), because he did not raise them with the Panel. The Director, however, does not argue that appellant has forfeited these issues, and the Director expressly stated at oral argument that they were properly before us. As a result, we will assume these arguments are properly before us and address them.

temporary basis is permitted to engage in conduct in anticipation of a proceeding or hearing in which the lawyer reasonably expects to be admitted pro hac vice. Minn. R. Prof. Conduct 5.5(c)(2) cmt. 10.

Appellant suggests that there was a potential proceeding that could be brought on behalf of his in-laws. Because of this belief, appellant contends Rule 5.5(c)(2) protects him. The Director persuasively argues that appellant knew further litigation was unlikely because a court had already decided the underlying case involving his in-laws, and appellant was simply negotiating a potential debt resolution. In addition, Rule 5.5(c)(2), by its plain language, requires more than an attorney's speculation that the attorney can find local counsel and be admitted to practice pro hac vice. Appellant's e-mail correspondence does not indicate that he took steps to secure local counsel or investigate the possibility of pro hac vice admission. Thus, we conclude there is no support for appellant's claim that his conduct was authorized by Rule 5.5(c)(2).

Under Minnesota Rules of Professional Conduct 5.5(c)(4), a lawyer admitted in another jurisdiction may provide legal services in Minnesota on a temporary basis if the lawyer's services are not covered by paragraphs (c)(2) and (c)(3) and "arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice." Appellant contends that his services arose out of or were reasonably related to his practice in Colorado because the clients are his relatives who "reached out to him for assistance" and appellant's environmental and personal-injury practice involves debt collection.

Comment 14 of Minnesota Rules of Professional Conduct 5.5 provides guidance on this issue. Specifically, comment 14 instructs that several factors may demonstrate that an attorney's temporary legal services in Minnesota reasonably relate to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice ("lawyer's home jurisdiction"), including: whether the client is a resident of or has substantial contacts with the lawyer's home jurisdiction; whether the client has previously been represented by the lawyer; whether a significant aspect of the matter involves the law of the lawyer's home jurisdiction; whether the client's activities or the legal issues involve multiple jurisdictions; or whether the services "draw on the lawyer's recognized expertise developed through the regular practice of law on behalf of clients in matters involving a particular body of federal, nationally-uniform, foreign, or international law." Minn. R. Prof. Conduct 5.5 cmt. 14; *see also* Restatement (Third) of the Law Governing Lawyers, § 3 cmt. e (Am. Law Inst. 2000) (stating that a lawyer may provide legal services outside of a home jurisdiction if the services reasonably relate to the lawyer's practice in his or her home jurisdiction and listing factors similar to those in Minn. R. Prof. Conduct 5.5 cmt. 14 for determining if the services reasonably relate to the lawyer's practice in the home jurisdiction, including whether "the legal issues involved are primarily either multistate or federal in nature").

The legal services appellant provided to his in-laws were unrelated to his environmental and personal-injury practice in Colorado. The record establishes that appellant was involved in litigation in Colorado state court, including eight trials in the past

7 years in which collection issues arose,[3] and that appellant negotiated the resolution of a debt with an out-of-state creditor on behalf of several Colorado residents. Although Rule 5.5(c) may permit appellant to negotiate with a Colorado client's out-of-state creditor because this representation is reasonably related to appellant's Colorado practice, the facts of this case are substantially different. Appellant's in-laws are not Colorado residents, and appellant had no prior attorney-client relationship with them.

Moreover, appellant's representation of his in-laws did not "arise out of" or "reasonably relate" to his practice in Colorado simply because his in-laws contacted him in Colorado or appellant has done collections work in Colorado. As the Director notes, appellant's in-laws were not long-standing clients; nor was there any connection between the in-laws' case and the state or laws of Colorado. And while appellant's Colorado practice may involve judgment collections work, nothing in the record establishes that this work was based on a body of federal or nationally uniform law.[4] To the contrary,

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[3] Three exhibits in the Panel proceeding are appellant's filings in two Colorado state court matters related to judgments for costs and attorney fees that had been entered against his clients.

[4] The dissent's reliance on comment 14 to Rule 5.5 to support its claim that appellant's representation of his in-laws was reasonably related to his Colorado practice is misplaced. According to the dissent, the representation was reasonably related to appellant's Colorado practice because "appellant has developed experience and expertise in the area of judgment collections through his participation in eight trials and multiple filings." The dissent acknowledges, however, that the record does not establish that "appellant's collection practice is 'nationally uniform.' " *See* Minn. R. Prof. Conduct 5.5 cmt. 14 (stating that one of the factors that may demonstrate that a lawyer's temporary legal services in Minnesota reasonably relate to the lawyer's practice in a home jurisdiction is whether the services "draw on the lawyer's recognized expertise developed through the

appellant's clients were Minnesota residents with a debt that arose in Minnesota that they owed to a Minnesota resident and that was governed by Minnesota law. Accordingly, Rule 5.5(c)(4) does not apply to appellant's conduct.

IV.

Finally, we consider the appropriate discipline for appellant's misconduct. We give great weight to the recommendations of the Panel, but we have "the final responsibility for determining appropriate discipline for violations of the rules of professional conduct". *Panel Case No. 23236*, 728 N.W.2d at 258. We do not impose sanctions in attorney-discipline cases as punishment, but rather we impose sanctions "to protect the public, to protect the judicial system, and to deter future misconduct by the disciplined attorney [and] other attorneys." *In re Rebeau*, 787 N.W.2d 168, 173 (Minn. 2010). We impose sanctions according to the unique facts of each case, and "when considering appropriate sanctions for misconduct, we weigh the following factors: (1) the nature of the misconduct, (2) the cumulative weight of the disciplinary violations, (3) the harm to the public, and (4) the

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regular practice of law on behalf of clients in matters involving a particular body of federal, nationally-uniform, foreign, or international law"). In fact, the record establishes the opposite. When appellant asked D.R. whether relevant Minnesota law was the same as Colorado law, D.R. indicated that it was not.

Instead, the dissent argues, without citing any legal support for its claim, that the subject on which an attorney has expertise does not need to be nationally uniform in order for legal services provided outside the attorney's home jurisdiction to reasonably relate to the attorney's practice in his or her home jurisdiction. We disagree. Rule 5.5(c) is an exception to the general prohibition on the unauthorized practice of law. By interpreting the exception to apply to expertise in any subject matter, the dissent allows the exception to swallow the general rule.

harm to the legal profession." *Panel Case No. 23236*, 728 N.W.2d at 258 (citation omitted) (internal quotation marks omitted).

The nature of the misconduct in this case is non-serious. Appellant wrongly believed that he could negotiate a settlement in Minnesota without being licensed to practice law in the state. The cumulative weight of the misconduct is also minimal. Appellant engaged in a series of e-mail communications with one attorney in a single matter involving appellant's family members. In addition, the only harm appellant's clients suffered was a delay in the resolution of their debt because of appellant's actions. Accordingly, a private admonition is the appropriate discipline for appellant.

Affirmed.

DISSENT

ANDERSON, Justice (dissenting).

The court affirms the Panel's determination that appellant violated Rule 5.5(a), which provides that a "lawyer shall not practice law in a jurisdiction in violation of the regulation of the legal profession in that jurisdiction." Minn. R. Prof. Conduct 5.5(a). But as an exception to this rule, a lawyer admitted in another jurisdiction may provide temporary legal services in Minnesota if the services "arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice." Minn. R. Prof. Conduct 5.5(c)(4). The court concludes that Rule 5.5(c)(4) does not apply because the services that appellant provided here—assisting family members with a judgment-collection negotiation—are not "reasonably related" to his practice of law in Colorado. I disagree.

Appellant argues that Rule 5.5(c)(4) applies because his in-law's judgment-collection matter was "reasonably related" to his practice in Colorado, which includes judgment-collection work. Appellant contends that he has experience with judgment collections and that collection work is an integral and necessary part of his litigation practice in Colorado. Upon review of the record, I agree that appellant's temporary provision of legal assistance to his parents-in-law regarding the negotiation of a small collection matter in Minnesota is "reasonably related" to appellant's practice of law in Colorado. Therefore, the exception in Rule 5.5(c)(4) applies, and respectfully, I dissent.

In concluding that appellant's work for his parents-in-law was not "reasonably related" to his practice in Colorado, the court primarily focuses on appellant's practice in the areas of environmental and personal-injury law. But, as the court notes, appellant also has experience with collection work, as reflected in the record. Appellant argues that he has engaged in and developed experience with collection work in his litigation practice. More specifically, appellant testified to the Panel that "collection work" is "an integral part of my litigation practice." He testified that in the past seven years, he has engaged in judgment-collection work and has participated in eight trials in this area of practice. In addition, he demonstrated that, in a single previous month, he had made three filings dealing with judgment collections, which he submitted to the Panel as exhibits.

Based on this record, I would conclude that appellant's assistance with a small judgment-collection negotiation for his parents-in-law, including the emails to D.R., were "reasonably related" to appellant's practice in Colorado, which satisfies Rule 5.5(c)(4). The "reasonably related" exception in Rule 5.5(c)(4) is a *broad*, catch-all exception that is intended to exempt circumstances such as those presented here. Moreover, the familial connection between appellant and his in-laws, and the fact that they contacted appellant in Colorado for assistance, should be an additional consideration that supports a finding that the matter was "reasonably related" to his practice in Colorado under Rule 5.5(c)(4).

The exception established by ABA Model Rule 5.5(c)(4)—which is identical in wording to our Rule 5.5(c)(4)—is described as a "*broad* catch-all" and a "safe harbor" for out-of-state lawyers to engage in temporary practice that is "reasonably related" to the lawyer's home-state practice. Ronald D. Rotunda & John S. Dzienkowski, *Legal Ethics:*

The Lawyer's Deskbook on Professional Responsibility § 5.5-2, at 1112 (2016) (emphasis added); *see also* Am. Bar Ass'n & Bureau of Nat'l Affairs, Inc., *ABA/BNA Lawyer's Manual on Professional Conduct* 21:2110 (2009).

Rule 5.5(c)(4) also closely follows the Restatement, which states: "A lawyer currently admitted to practice in a jurisdiction may provide legal services to a client: . . . at a place within a jurisdiction in which the lawyer is not admitted to the extent that the lawyer's activities arise out of or are otherwise reasonably related to the lawyer's practice under Subsection (1) or (2)." Restatement (Third) of the Law Governing Lawyers § 3(3) (Am. Law Inst. 2000). One of the comments to this section states that it is "*clearly permissible* for a lawyer from a home-state office to direct communications to persons and organizations in other states (in which the lawyer is not separately admitted), by letter, telephone, telecopier, or other forms of electronic communication." *Id.* at § 3 cmt. e (emphasis added).

As explained in the Restatement, the prior, more restrictive rules governing interstate practice by nonlocal lawyers "were formed at a time when lawyers conducted very little [interstate] practice" and thus "imposed little actual inconvenience." *Id.* By contrast today, "as interstate and international commerce, transportation, and communications have expanded, clients have increasingly required a truly interstate . . . practice by their lawyers." *Id.* The ABA recognized that rule changes were needed as the frequency and ease of multistate practice increased, supported by electronic communication and remote services (e.g., e-mails, phone and video conferencing, electronic filing). Rotunda & Dzienkowski, *supra*, at 1100-01. In this modern context, lawyers routinely communicate from one jurisdiction with a client located in another jurisdiction. *Id.* at 1101. Thus, the ABA Model Rules "encouraged . . . [the removal of] unnecessary restrictions on interstate practice." *Id.* at 1100-01.

The comments to Rule 5.5(c)(4) provide guidance on whether a "reasonable relationship" exists between the lawyer's temporary services in Minnesota and the lawyer's practice in another jurisdiction. *See* Minn. R. Prof. Conduct 5.5 cmt. 13-14. Comment 14 explains that "[a] variety of factors" may evidence such a reasonable relationship. *Id.* at cmt. 14. The examples and factors to consider in comment 14 are not exhaustive, nor are they mandatory. *See id.* (providing examples and factors that "may" or "might" support a reasonable relationship); *see also* Minn. R. Prof. Conduct, Scope cmt. 14 ("Comments do not add obligations to the rules but provide guidance . . . ."). One factor provided in Rule 5.5, comment 14, relates to whether the lawyer's temporary services draw on the lawyer's "expertise developed through the regular practice of law" in a particular body of law. Minn. R. Prof. Conduct 5.5 cmt. 14. Here, the record reflects that appellant has developed experience and expertise in the area of judgment collections through his participation in eight trials and multiple filings.

The Director argues that the guidance in comment 14 weighs against applying the Rule 5.5(c)(4) exception because the record does not establish that appellant's parents-in-law specifically sought appellant for his "recognized expertise . . . involving a particular body of federal, nationally-uniform, foreign, or international law." *See* Minn. R. Prof. Conduct 5.5 cmt. 14. I agree that the record does not meticulously detail the extent to which the law applicable to appellant's collection practice is "nationally uniform" or the extent to which his experience with collection work is "recognized." But as discussed above, the explanatory language in the comments is not mandatory or exhaustive—it merely provides *examples* of the types of temporary legal services that may satisfy the broad, "reasonably related" catch-all exception under Rule 5.5(c)(4). The broad, "reasonably related" requirement and the principles underlying the guidance in comment 14 surely apply here.[1] The record reflects that appellant developed experience and "expertise" with a particular body of law—collections—in at least eight trials over seven years, including three judgment-collection filings within a single month.

In addition, the clients' relationship to appellant, including their familial connection and the clients' contacts with appellant in his home state, should be considered in the "reasonable relationship" analysis. The comments to the Restatement advise that, in determining whether an out-of-state lawyer's activities "reasonably relate" to the lawyer's practice in a state of admission, "several factors are relevant, including the following: . . . [whether the client] is from the lawyer's home state, has extensive contacts with that state, or *contacted the lawyer there*." Restatement (Third) of the Law Governing Lawyers § 3 cmt. e (emphasis added). Here, the clients contacted their son-in-law, appellant, in his home state of Colorado.

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[1] The court argues that I reach this conclusion "without citing any legal support." But comments to the Rules of Professional Conduct "explain[] and illustrate[] the meaning and purpose of the rule[s]." Minn. R. Prof. Conduct Scope cmt. 21. They are "intended as guides to interpretation" and therefore are persuasive when applying the Rules of Professional Conduct to the case at hand. *Id.*

The court is also incorrect that my interpretation "allows the exception to swallow the general rule." This is not so. The lawyer's services must still be "reasonably related" to the lawyer's practice in the state of admission. Although this exception is broad, it does not encompass subject matters unrelated to the lawyer's practice.

Additional analogous support is provided in comment 14 to Rule 5.5(c)(4), which states that one factor to consider is whether the "lawyer's client may have been previously represented by the lawyer." Minn. R. Prof. Conduct 5.5(c)(4) cmt. 14. Although the record does not indicate whether appellant ever previously represented his parents-in-law, the principle underlying this comment—a relationship of trust and familiarity with the lawyer's capabilities—is applicable here. The recognition that a sustained lawyer-client relationship would allow an attorney to perform legal work for the client in other jurisdictions, based on confidence and trust, is reflected in the ABA's recommendation for the proposed Model Rule 5.5. Regarding the exception under Rule 5.5(c)(4), the ABA stated:

> [Model Rule 5.5(c)(4)] would respect . . . client-lawyer relationships by permitting a client to retain a lawyer to work on multiple related matters, including *some having no connection to the jurisdiction* in which the lawyer is licensed. . . . [C]lients are better served by having a *sustained relationship with a lawyer or law firm in whom the client has confidence*.

Am. Bar Ass'n, *Client Representation in the 21st Century: Report of the Commission on Multijurisdictional Practice* 30-31 (2002) (emphasis added). The ABA recommendation further explains that in such cases of reasonably related, temporary services under Rule 5.5(c)(4), it is "sufficient to rely on the lawyer's home state as the jurisdiction with the primary responsibility to ensure that the lawyer has the requisite character and fitness to practice law" because the home state "has a substantial interest in ensuring that all aspects of the lawyer's provision of legal services, wherever they occur, are conducted competently and professionally." *Id.* at 30.

Finally, as a policy matter, the implications of the court's decision are troubling and counterproductive. The ABA Model Rule 5.5(c), as adopted by our state, was intended as a broad catch-all that "represent[s] a bold step towards new latitude in [a] multijurisdictional practice of law," which accommodates the increasingly mobile and electronic nature of modern, national legal practice. *See* Rotunda & Dzienkowski, *supra*, at 1100-01, 1112. Today's decision represents a step backwards. By the court's reasoning, when family members or friends—an abundant source of clients—email or call a practitioner admitted in another state, seeking assistance in areas in which the practitioner is experienced and competent, relying on a relationship of trust and confidence, they must be turned away. Those potential clients must then expend unnecessary time and resources to research and hire local counsel—even for minor, temporary services in which the out-of-state lawyer could have provided efficient, inexpensive, and competent service. Simply put, the court's decision is contrary to the principles and policy goals intended by Rule 5.5(c).

In sum, this case involves clients contacting an attorney, their son-in-law, in his home state of Colorado, to request his assistance regarding a small collection matter—an area that reasonably relates to appellant's expertise and experience in his Colorado litigation practice. Based on the relationship and contacts between the clients, appellant, and appellant's practice of law in Colorado, there is a sufficient "reasonable relationship" here to satisfy the broad, catch-all exception under Rule 5.5(c)(4). For the above reasons, I conclude that appellant did not engage in professional misconduct because the exception in Rule 5.5(c)(4) applies.[2] Therefore, I would reverse the Panel's decision to admonish appellant. I respectfully dissent.

LILLEHAUG, Justice (dissenting).

I join in the dissent of Justice Anderson.

CHUTICH, Justice (dissenting).

I join in the dissent of Justice Anderson.

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[2] In addition, I observe that any violation of Rule 5.5(a) requires reference to other Minnesota laws or rules to determine whether a lawyer practiced "in violation of the regulation of the legal profession." Minn. R. Prof. Conduct 5.5(a). The court's opinion does not cite the substantive "regulation" that appellant violated. The Director cited a statute that prohibits certain types of conduct except by persons admitted and licensed to practice as attorneys in Minnesota. *See* Minn. Stat. § 481.02, subd. 1 (2014). This statute prohibits several types of conduct, including "by word, sign, letter, or advertisement, [] hold[ing] out . . . as being engaged in advising or counseling . . . or in furnishing to others the services of a lawyer[,]" and "giv[ing] legal advice or counsel [or] perform[ing] for or furnish[ing] to another legal services" for a "fee or any consideration" *Id.* The second type of conduct is inapplicable because appellant did not charge any fee. The first type of conduct, a "holding out" violation, may or may not be applicable based on appellant's email exchanges with D.R., including his statement that he "represent[ed] [his parents-in-law] in all matters related to [the] delinquent account." The panel found that appellant "was—although maybe not paid, he certainly has held out the fact that he represented clients." But there are also persuasive arguments that appellant's conduct was not a "holding out" violation, including, but not limited to, the absence of any communication to the general public.

Although the issue of whether there was an underlying "holding out" violation was not argued by either party and therefore need not be resolved here, there are at least a couple of concerns worthy of comment. First, it is unclear to me whether, ultimately, appellant's emails were actually a violation of the "hold[ing] out" clause according to the meaning and intent of section 481.02, subdivision 1. Second, the Director's charges of unprofessional conduct did not clearly specify that appellant was charged with a violation of the "hold[ing] out" clause of this statute. Instead, the Director summarily referred to the entire statutory provision and described it as prohibiting nonlicensed attorneys from "providing legal services." This lack of specificity may raise due process concerns.

Ohio State Bar Ass'n v. Kolodner

Supreme Court of Ohio

August 17, 2004, Submitted ; November 3, 2004, Decided

No. 2004-1045

Reporter
103 Ohio St. 3d 504 *; 2004-Ohio-5581 **; 817 N.E.2d 25 ***; 2004 Ohio LEXIS 2600 ****

OHIO STATE BAR ASSOCIATION v. KOLODNER ET AL.

Prior History: [****1] ON REPORT of the Board of Commissioners on the Unauthorized Practice of Law, No. 02-09.

Disposition: Respondents enjoined from any further conduct constituting the unauthorized practice of law.

Counsel: Eugene P. Whetzel, General Counsel, Fanger Law Office and Jeffrey J. Fanger, and Jones Day and David A. Kutick, for relator.

Charles J. Kettlewell and Charles W. Kettlewell, for respondents.

Judges: MOYER, C.J., RESNICK, F.E. SWEENEY, PFEIFER, LUNDBERG STRATTON, O'CONNOR and O'DONNELL, JJ., concur.

Opinion

[*504] [***26] **Per Curiam.**

[**P1] [*505] On November 5, 2002, relator, Ohio State Bar Association, charged that respondent Robert Kolodner of Tampa, Florida, had engaged in the unauthorized practice of law in an individual and in a corporate capacity while doing business as respondents Abraham & Christiansen, Inc., Solomon & Forbes, Inc., and Jacobs & Mathews, Inc. The Board of Commissioners on the Unauthorized Practice of Law considered the cause on the parties' stipulations of fact and waiver of notice and hearing. Gov.Bar R. VII(7)(C). Accepting these filings, the board made the following findings of fact, conclusions of law, and recommendation.

[**P2] Kolodner conducted business in Ohio prior to 1999 as president of Abraham & Christiansen, Inc., a company that negotiated collection claims on behalf [****2] of debtors, including drawing up settlement agreements between the debtor and creditor, for a fee. After changing its name to Solomon & Forbes, Inc., Kolodner sold his company in 1999 and established Jacobs & Mathews, Inc., another company that negotiated collection claims, at times drawing up settlement agreements between the debtor and creditor. Kolodner continues to serve as president and sole shareholder of Jacobs & Mathews, Inc., which remains in business today, and no longer has any affiliation with Abraham & Christiansen, Inc., or Solomon & Forbes, Inc.

[**P3] Kolodner is not and has never been an attorney licensed or admitted to practice law in Ohio or any other state or jurisdiction. During the years from 1997 to the date of relator's complaint, however, Kolodner provided and was paid for legal services to Ohio residents within the state of Ohio on an individual basis and while doing business as Abraham & Christiansen, Inc., Solomon & Forbes, Inc., or Jacobs & Mathews, Inc. As examples of [***27] these services, the parties stipulated that the respondents advised, counseled, and represented various customers regarding payment of their outstanding debts and negotiated settlements [****3] of the debts. Moreover, at times when others referred to Kolodner in pleadings or correspondence by placing the term "Esquire" after his name, thereby implying that they believed he was an attorney at law, Kolodner did not rectify any misperception. Kolodner also referred to himself on at least one occasion as an debtor's attorney-in-fact while attempting to negotiate on the debtor's behalf.

[**P4] Based on this conduct, Kolodner conceded that he had engaged in the unauthorized practice of law while acting individually or doing business as Abraham & Christiansen, Inc., Solomon & Forbes, Inc., and Jacobs & Mathews, Inc.

[**P5] Kolodner also admitted that he had previously consented to a decree and injunction in the state of Florida pursuant to which he had acknowledged that his services to debtor-clients in that state constituted the unauthorized practice of law. Prior to the proceedings at bar, Kolodner had already served a one-year [*506] probation in Florida for these unlawful activities. He stated that neither he nor Jacobs & Mathews has since engaged in settlement negotiations on a debtor's behalf in that state. Kolodner stated that as of July 30, 2003, Kolodner and Jacobs & [****4] Mathews, Inc., had similarly ceased "advising, counseling, and/or negotiating" on behalf of debtors in Ohio.

[**P6] The board found that respondents had engaged in the unauthorized practice of law in Ohio. The board recommended, consistent with the disposition suggested by the parties, that Kolodner be enjoined from engaging in the unauthorized practice of law as follows:

[**P7] "A. Respondent will not represent debtors in Ohio by advising, counseling, and/or negotiating resolution of their debts with creditors or creditors' counsel;

[**P8] "B. Unless Respondent becomes an attorney at law licensed to practice law in Ohio, Respondent will not provide legal advice to any person in Ohio, including, but not limited to, advice regarding a person's rights as a debtor or as a defendant in a lawsuit or regarding the terms and conditions of a settlement of any dispute.

[**P9] "C. Respondent Kolodner agrees that he and his companies have ceased and will not re-engage in the conduct referenced herein, in the State of Ohio, to wit:

[**P10] "i. Respondent will not hold himself out to be an attorney admitted to practice law;

[**P11] "ii. In the event that any person incorrectly [****5] addresses him, by correspondence or otherwise, as being an attorney, by 'Esquire' or otherwise, Respondent will immediately correct any such person, clarifying to them that he is not an attorney admitted to practice law;

[**P12] "iii. In all correspondence, letterheads, forms, or written communication used by Respondent for business purposes, Respondent will not in any way convey the impression that he is an attorney and that any name that he is doing business under is not a law firm. [Sic.] In all correspondence, letterheads, forms, or written communication used by Respondent for his business purposes, Respondent will clearly and conspicuously state that he is not an attorney, that his business is not a law firm, and that he cannot provide any legal advice, including advice about a person's rights as a debtor or as a defendant in a lawsuit, or about the terms and conditions of settlement of any dispute;

[**P13] "iv. Respondent will notify in writing, at Respondent's expense, all parties that have been represented by Respondent [***28] in Ohio since Respondent began doing business as Jacobs & Mathews, Inc. Such notification shall include a copy of the findings of the Board of Commissioners [****6] on the Unauthorized Practice [*507] of Law of the Supreme Court of Ohio, as well as the final determination rendered by the Supreme Court of Ohio with regard to this case.

A copy of all such notices shall be forwarded to Relator's counsel.

[**P14] "D. Because Respondent had been ordered to cease and desist from his unauthorized practice of law in the State of Florida prior to his commencement of the same conduct in the State of Ohio, and because Respondent continued his unauthorized practice of law in the State of Ohio for over six months after being served with Relator's Complaint, the Board recommends that a fine in the amount of $1,000 be entered against Respondent pursuant to Gov.Bar R. VII(19)(D)(1)(c)."

[**P15] We concur in the board's findings and recommendation. Section 2(B)(1)(g), Article IV of the Ohio Constitution gives this court exclusive jurisdiction over all matters relating to the practice of law. The unauthorized practice of law consists of rendering legal services for another by any person not admitted to practice law in Ohio, see Gov.Bar R. VII(2)(A), and includes representation by a nonattorney who advises, counsels, or negotiates on behalf of an individual [****7] or business in the attempt to resolve a collection claim between debtors and creditors. *Cincinnati Bar Ass'n v. Telford* (1999), 85 Ohio St. 3d 111, 707 N.E.2d 462; *Cincinnati Bar Ass'n v. Cromwell* (1998), 82 Ohio St. 3d 255, 695 N.E.2d 243. Injunctive relief prohibiting such unauthorized representation is required for the public's protection, and a civil penalty is appropriate. *Toledo Bar Ass'n v. Chelsea Title Agency of Dayton, Inc.*, 100 Ohio St. 3d 356, 2003 Ohio 6453, 800 N.E.2d 29).

[**P16] Accordingly, respondents are hereby enjoined from any further conduct that constitutes the unauthorized practice of law. In accordance with the board's recommendation, respondents shall also comply with the following stipulated terms:

[**P17] 1. Kolodner will not represent debtors in Ohio by advising, counseling, or negotiating resolution of their debts with creditors or creditors' counsel;

[**P18] 2. Unless Kolodner becomes an attorney at law licensed to practice law in Ohio, Kolodner will not provide legal advice to any person in Ohio, including, but not limited to, advice regarding a person's rights as a debtor or [****8] as a defendant in a lawsuit or regarding the terms and conditions of a settlement of any dispute;

[**P19] 3. Kolodner will not hold himself out as an attorney admitted to practice law;

[**P20] 4. In the event that any person incorrectly addresses him, by correspondence or otherwise, as being an attorney, by "Esquire" or otherwise, Kolodner [*508] will immediately correct the person, clarifying that he is not an attorney admitted to practice law;

[**P21] 5. In all correspondence, letterheads, forms, or written communication used by Kolodner for business purposes, Kolodner will not in any way convey the impression that he is an attorney or that any name that he is doing business under is the name of a law firm. In all correspondence, letterheads, forms, or written communication used by Kolodner for his business purposes, Kolodner will clearly and conspicuously state that he is not an attorney, that his business is not a law firm, and that he cannot provide any legal advice, including advice about a person's rights as a debtor or as a defendant in a [***29] lawsuit or about the terms and conditions of settlement of any dispute;

[**P22] 6. Kolodner will notify in writing, at his expense, [****9] all parties that he has attempted to represent in Ohio since he began doing business as Jacobs & Mathews, Inc., that he is not a lawyer. The notification shall include a copy of our decision. A copy of all such notices shall be forwarded to relator's counsel.

[**P23] 7. Kolodner is further fined $1,000 and ordered to pay the costs and expenses of this proceeding.

Judgment accordingly.

MOYER, C.J., RESNICK, F.E. SWEENEY,

PFEIFER, LUNDBERG STRATTON, O'CONNOR and O'DONNELL, JJ., concur.

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The Supreme Court of Ohio
BOARD OF PROFESSIONAL CONDUCT
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OPINION 2016-5

Issued August 5, 2016

Withdraws Advisory Opinion 2005-3

Communication With Current and Former Corporate Employees

SYLLABUS: When a corporation is known to be represented with respect to a particular matter, Prof.Cond.R. 4.2 prohibits communication without the consent of the corporate lawyer with a current employee of the corporation who supervises, directs, or regularly consults with the corporation's lawyer concerning the matter, who has authority to obligate the corporation with respect to the matter, or whose act or omission in connection with the matter may be imputed to the corporation for purposes of civil or criminal liability. A lawyer may communicate on the subject matter of the representation with former employees of the corporation, without notification or consent of the corporation's lawyer, as long as the former employee is not represented by counsel. A lawyer representing an interest adverse to a corporation may communicate with certain employees of the corporation without the consent of a corporation's lawyer, even when a corporate lawyer asserts blanket representation of the corporation and all of its current and former employees.

QUESTION: May a lawyer who represents an interest adverse to a corporation communicate with current and former employees of the corporation without the consent of the corporation's lawyer, when the corporate lawyer asserts blanket representation of the corporation and all current and former employees?

APPLICABLE RULES: Prof.Cond.R. 1.6, 4.2, 4.3, and 4.4.

OPINION: A lawyer's communication with current and former employees of the corporation is addressed by Prof.Cond.R. 4.2, which provides:

> In representing a client, a lawyer shall not communicate about the subject of the representation with a person the lawyer knows to be represented by another lawyer in the matter, unless the lawyer has the consent of the other lawyer or is authorized to do so by law or a court order.

The rule "provide[s] protection of the represented person against overreaching by adverse counsel, safeguard[s] the client-lawyer relationship from interference by adverse counsel, and reduce[s] the likelihood that clients will disclose privileged or other information that might harm their interests." ABA, Formal Opinion 95-396 (1995), Prof.Cond.R. 4.2, cmt. [1].

Current employees

Certain categories of current employees of a corporation are considered represented by the corporation's lawyer and are shielded from contact by adverse counsel. Prof.Cond.R. 4.2, cmt. [7] sets forth three categories of employees an adverse lawyer may not contact without permission of corporate counsel. Specifically, the comment provides that communication is prohibited with current employees who 1) supervise, direct, or regularly consult with the corporation's lawyer concerning the subject of the representation; 2) have the authority to obligate the corporation with respect to the matter; and 3) employees whose "act[s] or omission[s] in connection with the matter may be imputed to the organization for purposes of civil or criminal liability." *Id.*

Extreme caution should be observed by adverse lawyers when interviewing current employees, even those employees who do not satisfy the categories set forth in Prof.Cond.R. 4.2, cmt. [7]. When an adverse lawyer interviews current employees, he or she may inadvertently violate Prof.Cond.R. 4.2 because the lawyer typically is not privy to which employees of the corporation regularly consult with the corporation's lawyer or have the authority to bind the organization. In close cases, it may be appropriate to notify the corporation's lawyer before making contact with current employees. If a legitimate basis for denying contact is given by the corporate lawyer, the adverse lawyer may need to conduct further investigation through other means or engage in limited discovery before initial contact with a current employee is made.

Former employees

Once a management employee has left the corporation, he or she no longer supervises, directs, or consults with the corporation's lawyer and cannot obligate the organization. Former employees cannot bind the organization and their statements cannot be introduced as admissions of the organization.[1] Geoffrey Hazard, Jr. & W. William Hodes, *The Law of Lawyering*, Sec. 38.7 (3d ed. Supp. 2011). Similarly, under the law of agency, the former management employee is no longer acting on behalf of the organization. *See* Mich. Op. RI-360 (2013). Consequently, a lawyer may communicate on the subject matter of the representation with any former and unrepresented corporate employees, including those in management, without notification or consent of the corporate lawyer.

Communications are also permitted under Prof.Cond.R. 4.2 with unrepresented former employees whose prior acts or omissions committed while they were employed may be imputed to the organization and give rise to civil or criminal liability. This conclusion is supported by the distinction between current and former employees, referred to as "constituents" in comment [7] to Prof.Cond.R. 4.2. The comment directs that, in the "case of represented organization, [the] rule prohibits communications with a <u>constituent of the organization</u> . . . whose act or omission may be imputed to the organization . . . ." (emphasis added.) This sentence is immediately followed by the statement that "[c]onsent of the organization's lawyer is not required for communication with a <u>former constituent</u>," thus clarifying that a lawyer's communication is permitted with former employees, even those whose prior act or omissions may eventually be imputed to the corporation. *Id*. (emphasis added.)

In 1991, the ABA concluded that Model Rule 4.2 did not prohibit communication with any former corporate employee, even if they were in one of the categories under which communication was prohibited while they were employed. ABA Formal Op. 1991-359 (a lawyer may communicate about the subject of the representation with an unrepresented former employee of the corporate party without the consent of the corporation's lawyer.)

The Board previously interpreted former DR 7-104(A)(1), the predecessor to Prof.Cond.R. 4.2, as permitting communication with former employees whose

[1] Statements made by a "party's agent or employee on a matter within the scope of that relationship and while it existed" are non-hearsay statements admissible against the party. Consequently, only communications with current employees of a corporation are prohibited when their admissions would constitute admissions of the corporation under Fed.R.Evid. 801(d)(2)(D).

prior acts or omissions may give rise to corporate or organization liability. Adv. Op. 1996-1. Federal courts are also in accord with the view that contact with all former unrepresented employees is permissible. In *United States v. Beiersdorf-Jobst, Inc., 9*80 F. Supp. 257, 262 (N.D. Ohio 1997) (citing with approval Adv. Op. 1996-1), the court held that contact with former employees was permitted under former DR 7-104(A)(1), based on the premise that the "unimpeded flow of information between adversaries . . . encourage[s] the early detection and elimination of both undisputed and meritless claims." The court made no distinction between different categories of former employees, *e.g.* management employees, employees with the authority to bind the corporation, or whose prior acts or omissions may be imputed, and suggested no exceptions to its general holding. *See also Smith v. Kalamazoo Ophthalmology*, 322 F. Supp. 2d 883, 890 (W.D. Mich. 2004) *(ex parte* contact with former employees is not subject to Rule 4.2).

Based on the foregoing, the Board reiterates its position in Adv. Op. 1996-1 and concludes that communication with a former employee, even one whose prior acts or omissions may be imputed to the corporation, is permissible under Prof.Cond.R. 4.2.

Before interviewing a former employee, a lawyer should disclose his or her identity, and fully explain that he or she represents a client adverse to the corporation. The lawyer also must immediately inform the former employee not to divulge any privileged communications that the former employee may have had with corporate or other retained counsel. Prof.Cond.R. 1.6, 4.4 (lawyers may not use methods to obtain evidence that violate the legal rights of third parties.) Consequently, a lawyer must endeavor not to solicit information from former employees that the lawyer knows or reasonably knows to be protected by the attorney-client privilege. *See* D.C. Bar Op. 287. Nor may a lawyer communicate *ex parte* with a former employee who is represented by independent counsel, or if the corporation's lawyer has agreed to provide representation in the matter. *See Davis v. Creditors Interchange Receivable Mgmt., LLC*, 585 F. Supp. 2d 968 (N.D. Ohio 2008).

Finally, Prof.Cond.R. 4.3 requires a lawyer not to give advice to an unrepresented former employee other than advice to seek counsel in the matter. In essence, the rule requires an adverse lawyer contacting a former employee of an opposing corporate party to identify his or her role in the matter, the identity of the lawyer's client and the fact that the witness's former employer is an adverse party to the litigation.

Blanket representation of representation

A corporate lawyer's blanket assertion of representation of the corporation and all of its current and former employees is unsupported by the Rules of Professional Conduct. Such a declaration by a corporation's lawyer does not, by itself, establish legal representation of all employees and is fraught with potential and inherent conflicts of interest for the corporate lawyer.

A lawyer representing a corporation may not prohibit contact with all current and former employees. A similar view was expressed by the ABA: "[A] lawyer representing the organization cannot insulate all employees from contacts with opposing lawyers by asserting a blanket representation of the organization." ABA, Formal Op. 95-396 (1995).

CONCLUSION: When representing an interest adverse to a corporation, a lawyer may communicate without the consent of a corporation's lawyer with certain current and any former employees of the corporation. Prof.Cond.R. 4.2 prohibits communications without the consent of the corporation's lawyer with a current employee of the corporation who supervises, directs, or regularly consults with the corporation's lawyer concerning the matter, has authority to obligate the corporation with respect to the matter, or whose act or omission in connection with the matter may be imputed to the corporation for purposes of civil or criminal liability. A lawyer's communication with unrepresented former employees does not violate Prof.Cond.R. 4.2, even if the employee's prior acts and omissions may be imputed to the organization. Subject to the three exceptions described above, a corporate counsel's blanket assertion of representation is not supported by the Rules of Professional Conduct. A lawyer must inform an unrepresented former employee not to divulge any information that is subject to attorney-client privilege and refrain from giving the employee advice.

Feature Article

Where We Are

In Location and Law

By Edwin W. Patterson III

The Minnesota Supreme Court disciplined a Colorado attorney who was not admitted to practice in Minnesota.[1] Why should this concern us? Because 10 years ago, the Ohio Supreme Court adopted a version of the ABA Model Rules of Professional Conduct, including Prof. Cond. Rule 5.5 ("Unauthorized Practice of Law; Multijurisdictional Practice of Law"). Minnesota's Rule 5.5 isn't identical to Ohio's, but it's close enough to be worrisome.

The Minnesota court held that "engaging in email communications with people in Minnesota may constitute the unauthorized practice of law in Minnesota, in violation of Minn. R. Prof. Conduct 5.5 (a), even if the lawyer is not physically present in Minnesota."[2] The disciplined attorney was not authorized to practice in Minnesota but briefly represented a Minnesota couple by attempting to negotiate, via email, the satisfaction of a Minnesota judgment.[3]

The appellant was licensed in Colorado since 1986, where he maintained an office and practiced environmental law, in addition to about seven years in personal injury and some debt collection. His mother-in-law and father-in-law lived in Minnesota. They contacted the appellant for help regarding a judgment for about $2,400 entered against them in Minnesota in favor of their condominium association. D.R., a Minnesota-based lawyer who represented the condominium association, had initiated collection efforts on the judgment.

The appellant sent an email to D.R., stating that he was representing his in-laws and instructing D.R. to direct all future communications to him. Over the next four months, the appellant and D.R. exchanged approximately two dozen emails. In his first response to the appellant, D.R. asked whether the appellant was licensed to practice law in Minnesota. The appellant replied that he was not licensed in Minnesota, but would hire local counsel if he needed to file suit there. Subsequent emails discussed the in-laws' assets and ability to pay; the appellant attached financial disclosure forms and made a settlement offer. D.R. asserted that the appellant was engaging in the unauthorized practice of law because he was not licensed in Minnesota. After D.R. filed a complaint with the Office of Lawyers Professional Responsibility, the appellant did not respond to subsequent emails and had no further involvement in the condominium case.

The director of the Office of Professional Responsibility issued a private admonition to the appellant for engaging in the unauthorized practice of law in Minnesota. The appellant demanded that this matter be presented to a panel of the Lawyers Professional Responsibility Board, which was done. The panel affirmed the director's admonition. The appellant then filed a notice of appeal in the Supreme Court of Minnesota, contesting the determination that his conduct violated Minn. R. Prof. Conduct 5.5.

The court began its analysis by noting that Rule 5.5(a) states, in relevant part, "[a] lawyer shall not practice law in a jurisdiction in violation of the regulation of the legal profession in that jurisdiction…" The appellant, however, contended that he did not violate Rule 5.5 because he did not practice law *in* Minnesota. The court noted that Rule 5.5 does not define what it means to practice law *in* a jurisdiction. Then: "Certainly, physical presence is one way to practice law *in* a jurisdiction. But, as we set forth below, it is not the only way."[4]

Because the issue of whether an attorney practices law in a jurisdiction without being physically present there was a matter of first impression in Minnesota, the court looked elsewhere. It found the reasoning in *Birbrower, Montalbano, Condon & Frank, P.C. v. Superior Court*, 17 Cal.4th 119 (1998) to be persausive. To

Feature Article

say that *Birbrower* was a seminal case is a gross understatement. It was seismic. It sent shock waves through the national bar which reverberate even today.

Birbrower addressed California Business and Professions Code §6125 which provides: "No person shall practice law in California unless the person is an active member of the State Bar." In *Birbrower*, the Supreme Court of California considered whether a New York law firm, none of whose members were licensed to practice law in California during the representation in question, violated §6125 when it performed legal services in California for a California-based client under a fee agreement stipulating that California law would govern. Birbrower attorneys traveled to California several times, where they gave advice to representatives of their corporate client, met with representatives of the opposing party, made a settlement demand, and filed a demand for arbitration with the San Francisco office of the American Arbitration Association. Birbrower's client eventually settled the matter without arbitration. The client subsequently sued Birbrower for legal malpractice, and the firm filed a counterclaim, including a claim for attorney fees which exceeded $1 million for work it performed in both California and New York.

Ultimately, the California Supreme Court concluded that the Birbrower firm had engaged in the unauthorized practice of law in California. With respect to the more than $1 million in fees, the Court held: "We agree with the Court of Appeal to the extent it barred Birbrower from recovering fees generated under the fee agreement for the unauthorized legal services it performed in California."[5] Thus, the aforementioned shock waves.

The California Court noted that the State Bar Act, of which §6125 is a part, did not define the term "practice law" and did not define the meaning of "in California."[6] The Court said the following about what constituted the practice of law in the state:

> In our view, the practice of law 'in California' entails sufficient contact with the California client to render the nature of the legal service a clear legal representation. In addition to a quantitative analysis, we must consider the nature of the unlicensed lawyer's activities in the state. Mere fortuitous or attenuated contacts will not sustain a finding that the unlicensed lawyer practiced law 'in California.' The primary inquiry is whether the unlicensed lawyer engaged in sufficient activities in the state, or created a continuing relationship with the California client that included legal duties and obligations.[7]

This language, it has been noted, is "remarkably reminiscent of the personal jurisdiction doctrine that defines presence within a state for due process purposes."[8]

Unfortunately for our lawyer helping his Minnesotan in-laws, *Birbower* provided persuasive authority to support the Minnesota Court's conclusion that the panel had not clearly erred by finding that the appellant had practiced law *in* Minnesota. It noted that he had contacted D.R., a Minnesota lawyer, and stated that he represented Minnesota clients in a legal dispute which was not interjurisdictional — it involved only Minnesota residents and a judgment entered by a Minnesota court. The appellant had advised his Minnesota clients on Minnesota law and attempted to negotiate a settlement with a Minnesota attorney. Therefore, the appellant's "contacts with Minnesota were not fortuitous or attenuated."[9]

The Minnesota court next addressed the appellant's argument that even if he had practiced law in Minnesota in violation of Minn. R. Prof. Conduct 5.5(a), his conduct was permitted under one of the exceptions in Rule 5.5(c). On this point, the seven Minnesota justices split, and delivered a four-three decision. In many cases, it might be reasonable to question the precedential value of such a decision. But this split may be viewed as a warning to the rest of us, going forward. The three justices who dissented agreed with the appellant's argument that his "temporary provision of legal assistance to his parents-in-law regarding the negotiation of a small collection matter in Minnesota" was "reasonably related"[10] to his practice of law in Colorado. The majority disagreed: "Rule 5.5 (c) is an exception to the general prohibition on the unauthorized practice of law. By interpreting the exception to apply to expertise in any subject matter, the dissent allows the exception to swallow the general rule."[11]

In the end, the answer to the question of whether an attorney engages in the practice of law in one jurisdiction by sending emails from another jurisdiction depends upon which jurisdiction you ask. The evolving law on this point is not consistent. Thus, regardless of where your feet are planted on the ground, in these situations ask yourself, "Where is my work intended to have legal effect?"

Patterson is General Counsel for the CBA.

1 In re Charges of Unprofessional Conduct in Panel File No. 39302, 884 N.W.2d 661 (Minn. 2016).

2 *Id.* at 663.

3 The Minnesota decision doesn't name the parties; the Colorado attorney is referred to as "Appellant," and the Minnesota attorney who filed the ethics complaint against Appellant is referred to as "D.R."

4 *Id.* At 665.

5 17 Cal.4th 119, 135.

6 17 Cal.4th 119, 127-128.

7 17 Cal.4th 119, 128.

8 Cynthia Fountaine, Have License, Will Travel: An Analysis of the New ABA Multijurisdictional Practice Rules, 81 W.U.L.Q. 737, 741 (2003).

9 884 N.W.2d 661, 666.

10 See Ohio Prof. Cond. Rule 5.5 (c) and Comment 14 thereto.

11 884 N.W.2d 661, 669 at fn. 4.

Real Estate Update: Current Issues in Real Estate Finance

Kenneth P. (Ken) Kreider
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CURRENT ISSUES IN REAL ESTATE FINANCE

KMK Legal Update
December 7, 2017

1. General discussion of status of lending market.

- While not in crisis, not all sectors are healthy either
- Non-bank and "private" lending is a trend
- The CMBS Refinance Cliff of 2017 was a non-event
- Insurance company portfolio loans offer flexibility and attractive economic terms
- See the attached articles:

  The Economy is Humming, but Businesses Aren't Borrowing [Loan Growth is in a Rut], Rexrode, Christina, *The Wall Street Journal*, November 26, 2017.

  Millennial Home Buyers Send a Chill Through Rental Markets, Grant, Peter and Kusisto, Laura, *The Wall Street Journal,* November 7, 2017.

https://www.wsj.com/articles/the-economy-is-humming-but-businesses-arent-borrowing-1511697600

MARKETS

The Economy Is Humming, but Businesses Aren't Borrowing

Banks see slowing loan growth as economy show signs of picking up

At the biggest U.S. banks, loan growth in the third quarter was spotty. Citigroup posted growth of 2%, while total loans at Wells Fargo fell 1%. At J.P. Morgan Chase and Bank of America, total loans grew 3%. PHOTO: ALBERTO PEZZALI/ZUMA PRESS

By Christina Rexrode

Nov. 26, 2017 7:00 a.m. ET

Loan growth at banks is slowing, casting a cloud over what was supposed to have been a banner year for financial institutions following last November's elections.

The rate of 12-month loan growth at U.S. banks in the third quarter hit its lowest level since the end of 2013, according to data released last week by the Federal Deposit Insurance Corp. That marked the sixth consecutive quarter of decline for this measure of loan growth.

Growth in each of the four major lending categories measured by the FDIC fell. Notably, the growth rate for business lending, an important source of revenues for banks in recent years, plumbed its lowest level since the first quarter of 2011.

While loan balances are still rising, the slowing rate of growth has defied the expectations of bankers. Many have spent the year looking for growth-reviving catalysts that never came and remain puzzled by the slowdown.

Even more surprising is that falling rates of loan growth are occurring as many signals point to a more buoyant U.S. economy. Unemployment continues to decline, gross domestic product growth came in at 3% in the third quarter and business investment is rising.

Tepid rates of loan growth along with continued low long-term interest rates have taken some of the sizzle out of bank stocks.

Financial shares were among the chief beneficiaries of last November's election surprise, soaring on hopes of a tax-code overhaul, lighter regulation and stronger economic growth. With progress in these areas spotty during 2017, gains are more muted.

The KBW Nasdaq Bank Index, a measure of 24 of the largest commercial banks, is up about 8% since the start of the year, about half the rise of the S&P 500.

"There was such enthusiasm coming out of the election," said Gerard Cuddy, CEO of Beneficial Bancorp Inc., a community lender in Philadelphia. "I think reality is setting in."

The slowdown in lending growth raises questions about firms' prospects for 2018, especially given that long-term interest rates haven't moved much, even as short-term ones are climbing. The difference, or spread, between 10-year and two-year U.S. Treasury debt, a rough proxy for bank profitability, is around 0.6 percentage point, its lowest level in a decade.

If loans balances aren't growing briskly and the interest-rate spread is narrow, it is far tougher for banks to increase net-interest income.

"The plane used to be flying at 30,000 feet, now it's at 10,000," said Christopher Marinac, director of research at investment-banking boutique FIG Partners. "There are many banks that are concerned about how much they can grow the loan book in 2018."

At the biggest U.S. banks, loan growth in the third quarter was spotty. At J.P. Morgan Chase & Co. and Bank of America Corp., total loans grew 3% from a year earlier. Citigroup Inc. posted growth of 2%, while total loans at Wells Fargo & Co. fell 1%.

Loan growth was anemic among many smaller banks. At BB&T Corp. , total loans in the third quarter were roughly flat compared with a year earlier. In an earnings call last month, CEO Kelly King said more clients were taking advantage of low rates in the bond markets and paying off their bank loans. Hurricanes in the southern U.S. also had an effect.

He added the bank is purposely restructuring its loan portfolio to focus on more-profitable loans. Still, Mr. King nodded at deeper issues around the downshift, saying "the mega issue here is that, you know, we've been on a nine-year slow economy."

An area of particular concern for all banks is business lending. In the third quarter, the 12-month growth rate for business loans fell to 2.48% from 2.79% the prior quarter and 7.67% a year earlier.

The drop-off is even more pronounced based on weekly Federal Reserve data. Commercial and industrial loans, or business lending, in early November were up less than 1% from a year prior, the data show. From mid-2014 through mid-2016, growth of such loans was regularly in the double digits.

This is putting 2017 on track to be the worst year for business-loan growth since 2010, when the economy was still wrestling with the immediate aftermath of the financial crisis.

Why that is remains unclear. Throughout the year, some banks have said that more subdued business lending was due to a lack of clarity from Washington on the fate of key initiatives such as taxes and health care.

Such worries should eventually fade, though, said Darren King, finance chief at M&T Bank Corp. , where loans in the third quarter were down 2% versus a year earlier. "Business owners are eventually going to get to the point where they say, 'I can't wait to find out what is going to happen in Washington,' " he said.

Even so, "that doesn't mean I think we're going back to 2015 or 2016 levels" of loan growth, Mr. King added.

Some bankers also have cited heightened competition. More business customers are tapping the bond market instead of bank loans to take advantage of low interest rates there, while insurance companies are offering to fund 30-year commercial mortgages and hedge funds are lending to riskier companies.

Others think the slowdown in business lending is a hangover from above-average growth in recent years. Many potential corporate clients are already loaded up on debt, said Kevin Barker, an analyst at Piper Jaffray & Co. That tamps down demand for loans. It also makes some banks wary of lending even more to these companies, Mr. Barker added.

Nonfinancial companies in the S&P 500 have a debt-to-adjusted earnings ratio of more than 150%, Mr. Barker calculates—meaning that, for every dollar of adjusted earnings, they have $1.50 in debt. That ratio was around 0.7 or 0.8 for much of the post-crisis period.

Write to Christina Rexrode at christina.rexrode@wsj.com

Appeared in the November 27, 2017, print edition as 'Loan Growth Hits a Rut.'

PROPERTY REPORT

Millennial Home Buyers Send a Chill Through Rental Markets

Homeownership has risen to its highest levels since 2014, causing analysts and investors to wonder whether the rental market's good times are ending

Many analysts predict that any pain that rising homeownership causes to the rental sector will be felt by house-for-rent companies before renters of luxury apartments in big cities. Here, workers make adjustments during construction on the 416 Kent Avenue apartment development in Williamsburg, Brooklyn, in July. PHOTO: JOHN TAGGART/BLOOMBERG NEWS

By Peter Grant and Laura Kusisto

Nov. 7, 2017 7:00 a.m. ET

Rising homeownership is adding to the jitters in the residential rental market, which has slumped recently after a long stretch near the top of the commercial real-estate industry.

For most of the current economic expansion, declining ownership rates have enabled landlords of apartments and single-family homes to raise rents far faster than the pace of inflation. Demand has been fueled by the millions of people who haven't had the money, credit or desire to pursue the traditional American dream.

But amid a hot housing market, the homeownership rate is now rising, in part because millennials are reaching the age when they're forming families and settling down.

The Census Bureau last week reported that ownership increased to 63.9% in the third quarter, the highest level since 2014. The rate was up from 63.7% in the second quarter and 63.5% a year earlier. It remains below the 69% clocked at the peak of the housing bubble a decade ago.

Still, the recent trend is causing analysts and investors to wonder whether the rental market's good times are coming to an end. Investors pumped tens of billions of dollars into the sector during the recovery, building and buying apartment complexes and amassing large portfolios of single-family homes.

One early warning sign came last week, when American Homes 4 Rent , AMH 0.83% ▲ which owns more than 50,000 single-family properties across 22 states, reported disappointing revenue growth for the third quarter. Analysts will be closely watching earnings from two other big companies with similar portfolios. Invitation Homes Inc. and Starwood Waypoint Homes , which agreed in August to merge, will both report results on Wednesday.

"Up to now, there really hasn't been a chink in the armor of rent growth," said John Pawlowski, an analyst with Green Street Advisors.

Many analysts predict that any pain that rising homeownership causes to the rental sector will be felt by these companies first, before renters of luxury apartments in big cities, for two reasons. First, house-for-rent companies tend to own properties in more affordable, nonurban markets. Second, people living in such homes have already opted for the single-family home lifestyle and so are more likely to become a homeowner.

To be sure, multifamily investors aren't headed for the door. The homeownership rate is still well below the historic norm of 65%, and growth could be slowed by such forces as rising interest rates and last week's tax code overhaul proposed by House Republicans.

A spokeswoman for American Homes 4 Rent said: "We believe our country's cumulative undersupply of housing stock, along with shifting preferences towards rentership provides a favorable landscape for single-family rentals into the future."

MORE FROM PROPERTY REPORT

- Landlords Sell Weak Malls Online November 28, 2017
- Commercial Real-Estate Firms Raise Money in Tough Climate November 28, 2017
- New Mortgages Allow Renters to Buy With Tiny Down Payments November 28, 2017
- Bringing Paris Style and New York Swagger to Hong Kong's Office Market November 28, 2017

Still, the rise in homeownership comes as other forces weaken the rental market, including a surge in supply from developers hoping to cash in on rising rents. In September, the seasonally adjusted rate of apartments under construction was 596,000, nearly twice the long-term average of 300,000 units, according to U.S. Census data.

Job growth also is slowing in some markets. That, coupled with new supply, boosted the national vacancy rate to 4.5% in the third quarter of this year, compared with 3.5% a year earlier, according to John Chang, head of research for real-estate services firm Marcus & Millichap. Nationally, rents were up 3.5% between the third quarters of 2016 and '17, compared with 4.5% the previous years, he said.

In many markets, developers completing new projects are offering concessions to woo new tenants, such as one or two months free rent. Lately, the trend has spread: Landlords in some markets are reporting that owners of previously built properties are also offering concessions.

This trend has been seen mostly in markets hit by the double-whammy of negative job growth and new supply, according to executives of one large owner, San Mateo, Calif.-based Essex Property Trust Inc. ESS **0.08%** ▲

"When those two intersect, bad things happen," said Michael Schall, chief executive of Essex. The company reported weakening market conditions on its quarterly earnings call, sending its shares lower.

During the early years of the recovery from the 2007-09 recession, shares of listed residential real-estate companies far outperformed the real-estate sector. Residential companies were up 40% in 2014, compared with 28% for the broader equity real-estate investment trust market. In 2015, residential companies and the broader REIT market were up 17.1% and 2.8% respectively, according to the National Association of Real Estate Investment Trusts.

This year, as of the end of the September, the gap had narrowed to a 6.9% increase for residential versus 6% for the broader equity REIT sector, the association said.

Some multifamily investors aren't too worried about rising homeownership, however, because new housing construction continues to lag behind the rate of household formation, even with the surge in rental housing development taken into account. Since 2010, household formation has outpaced construction by about 3.5 million units, according to CoStar Group Inc.

But Wall Street is closely watching demographic trends, particularly marriage rates among millennials—a life change often accompanied by a shift from renting to owning.

Millennials have been getting married later in life, often waiting until their late 20s, according to Mr. Chang, of Marcus & Millichap. Their marriage rate over the next five years will likely play an important role in demand for apartments and houses.

"We're at the leading edge of transition," he said.

Commercial/Multifamily Mortgage Bankers Originations Index

2001 quarterly average = 100

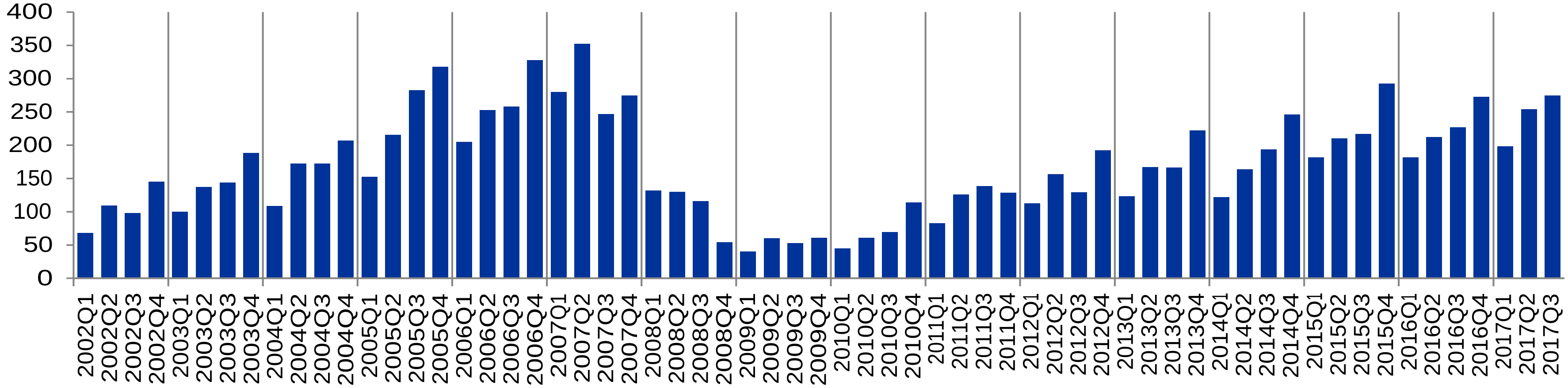
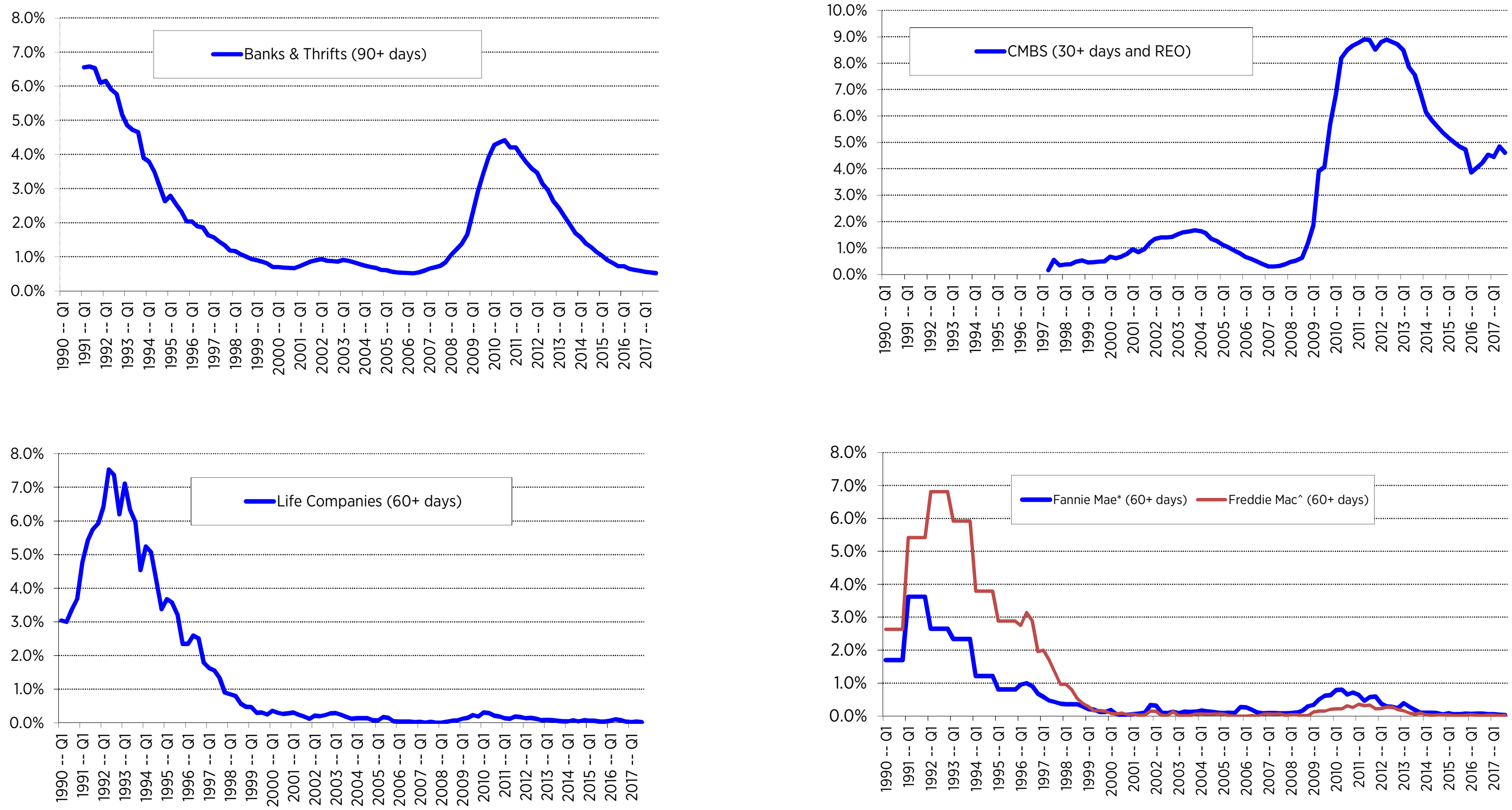


CHART 1. COMMERCIAL/MULTIFAMILY MORTGAGE DELINQUENCY RATES AMONG MAJOR INVESTOR GROUPS

Selected delinquency rates at the end of the period

NOTE: Delinquency rates shown are NOT comparable between investor groups. These rates show how performance of loans for each investor groups has varied over time, but cannot be used to compare one investor group to another.



Sources: Wells Fargo Securities, LLC and Intex Solutions, Inc., American Council of Life Insurers, Fannie Mae, Freddie Mac, OFHEO and Federal Deposit Insurance Corporation

2. The Extinction of LIBOR

- Timing: LIBOR has been a rate determined and published by the United Kingdom's Financial Conduct Authority (FCA) since the 1960s. Now, the FCA, in response to a rate-rigging scandal, has announced that it will no longer regulate or solicit [read, sponsor and approve] the Daily London Interbank Offer Rates.
- Will anybody fill the void? Does it matter?
- Loans and financial contracts in the hundreds of billons (USD) have adjusting interest charges that are pegged to the LIBOR rate.
- Many, but not all, name a substitute index; for those that do not, loan document and contract document amendments will become necessary unless LIBOR continues in some other form.
- See attached article, <u>You Can't Always Get What You Want (Loan Documents Need a LIBOR Alternate Rate Mechanism)</u>, Thalheimer, Jonathan, *ACREL Notes,* September, 2017.

ACREL Notes
September 2017

You Can't Always Get What You Want (Loan Documents need a LIBOR alternate rate mechanism)

Jonathan Thalheimer, *McGuire Craddock & Strother, P.C.,* Dallas, TX

LIBOR is going away (sort of). As there are an estimated $300-$800 trillion in LIBOR-denominated contracts, this is a big deal.

Matt Taibbi summarized the cause of LIBOR's demise in an August Rolling Stone article:

"Years ago, we found out that the world's biggest banks were manipulating LIBOR. That sucked.

Now, the news is worse: LIBOR is made up.

Actually it's worse even than that. LIBOR is probably both manipulated and made up. The basis for a substantial portion of the world's borrowing is a bent fairy tale."

Taibbi: Is LIBOR, Benchmark for Trillions of Dollars in Transactions, a Lie?
http://www.rollingstone.com/politics/news/taibbi-is-libor-crucial-financial-benchmark-a-lie-w497305

To understand why LIBOR is going away, a short history lesson is in order. In the 1960s, the London interbank offer rate, "LIBOR," represented the aggregated rates at which individual syndicate banks (or referenced banks) could borrow funds. This was not an objective "index," but changed from transaction to transaction depending on which banks formed the syndicate and the referenced rate. In the 1970s, financial institutions began developing derivative tools, such as interest rate swaps, to offset the LIBOR-rate risk. LIBOR-denominated contracts subsequently increased, but the opaque and inconsistent nature of the rate setting components curbed the derivatives market. Attempting to create a more transparent index, financial institutions turned to the industry trade/lobbying group the British Bankers' Association. The BBA set rates by asking a select group of large, "reputable" banks to submit quotes daily in answer to a question: "At what rate do you think interbank term deposits will be offered by one prime bank to another prime bank for a reasonable market size today at 11 am [London time]?" Subsequently, rather than referencing an undefined "prime bank," the BBA changed the question: "At what rate could you borrow funds, were you to do so by asking for and then accepting interbank offers in a reasonable market size just prior to 11 a.m. [London time]?" The LIBOR rate was then determined by calculating the trimmed arithmetic mean of the responses, i.e. the highest and lowest 25 percent of the responses were discarded (trimmed) and the mean of the remaining responses became the rate. This would then be repeated for every currency and maturity so that more than 100 rates were produced every business day. Haubrich, Joseph G., 2001. "*Swaps and the Swaps Yield Curve*," December 1, 2001, Federal Reserve Bank of Cleveland.

https://www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/economic-commentary-archives/2001-economic-commentaries/ec-20011201-swaps-and-the-swaps-yield-curve.aspx; see also, *Supplementary Memorandum from the British Bankers' Association*- Select Committee on Treasury Written Evidence, House of Commons. May 22, 2008 https://publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/536/536we05.htm.

These submission question changes did not entirely quell market concerns about transparency and possible rate manipulation. During the financial crisis, Barclays' activities with respect to its submissions were particularly suspicious. Subsequent investigations established that: "Barclays based its LIBOR submissions on the requests of Barclays' swaps traders…to benefit Barclays' derivatives trading positions" and "[d]uring the…financial crisis…, Barclays lowered its LIBOR submissions in order to manage what it believed were inaccurate and negative public and media perceptions that Barclays had a liquidity problem." *In the Matter of: Barclays PLC, Barclays Bank PLC and Barclays Capital Inc.*, Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, as Amended, Making Findings and Imposing Remedial Sanctions, U.S. Commodity Futures Trading Comm'n (June 27, 2012) http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfbarclaysorder062712.pdf. Additional investigations uncovered industry-wide manipulation, and additional fines were assessed against Barclays, Citi, UBS, the Royal Bank of Scotland, Deutsche Bank, JPMorgan, Lloyds Bank, Rabobank, ICAP, Bank of America and RP Martin. *Libor-rigging fines: a timeline*, The Guardian (April 23, 2015) https://www.theguardian.com/business/2015/apr/23/libor-rigging-fines-a-timeline, *Wall Street gets slammed with $5.8 billion in fines for rate rigging*, The Business Insider (May 20, 2015) http://www.businessinsider.com/libor-rigging-criminal-charges-and-fines-2015-5

In the aftermath of the scandal, Martin Wheatley, managing director of the Financial Services Authority and CEO of the Financial Conduct Authority, was asked to review matters relating to the setting and usage of LIBOR, including whether LIBOR should be eliminated. The Wheatley report rejected the idea of terminating LIBOR, concluding that with many reforms, including those intended to promote independent review and administration and to facilitate the use of transparent LIBOR submission transaction data, "the issues identified with LIBOR, while serious, can be rectified." *The Wheatley Review of LIBOR* (September 2012) https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/191762/wheatley_review_libor_finalreport_280912.pdf

Following the Wheatley Review, LIBOR is now supervised by the U.K.'s Financial Conduct Authority and is administered by an independent private corporation, the ICE Benchmark Administration. ICE, using a waterfall calculation methodology, has more closely linked LIBOR to actual market transactions. *Roadmap for ICE LIBOR*. (March 18, 2016) https://www.theice.com/publicdocs/ICE_LIBOR_Roadmap0316.pdf. However, even with these and other reforms, the FCA announced in July that, as of the end of 2021, it would no longer be involved in regulating LIBOR. The cause for withdrawal was the decline in unsecured interbank borrowing exemplified by the fact that in "one currency–tenor combination, for which a benchmark reference rate is produced every business day using submissions from around a dozen panel banks, these banks, between them, executed just fifteen [qualifying] transactions…in the whole of 2016." See *The future of LIBOR, July 27, 2017*, Andrew Bailey Chief Executive of the FCA, https://www.fca.org.uk/news/speeches/the-future-of-libor. Bailey stated that, after the FCA's withdrawal in 2021 of its power and authority to persuade or oblige panel banks to submit daily quotes, ICE could continue to produce LIBOR "if they wanted to, and were able to do so", but that the FCA would not guaranty LIBOR's continuance as a dynamic benchmark.

Around the world, regulatory bodies are beginning the development of alternate benchmark rates. The Alternate Reference Rate Committee ("ARRC"), a Federal Reserve sponsored group, is leading this effort in the U.S. In June, the ARRC voted to replace LIBOR with a benchmark based on the "Broad General Collateral Repo Rate" described by the Federal Reserve Bank of New York. This LIBOR alternative is a work in progress and ARRC intends to "refine its proposed transition plans, developing implementation options for its recommended rate in consultation with the members of its Advisory Group as well as through broader outreach efforts." *The ARRC Selects a Broad Repo Rate as its Preferred Alternative Reference Rate.* https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2017/ARRC-press-release-Jun-22-2017.pdf

In the meantime, it is important that even though "you can't always get what you want," your loan documents should contain alternate rate provisions so that "you get what you need." *You Can't Always Get What You Want*, Richards, Keith and Jagger, Mick (1969).

3. HVCRE

- What is HVCRE? High Volatility Commercial Real Estate, as defined in the Dodd-Frank Act joint rules of the Federal Reserve Board, Office of Comptroller of the Currency and the FDIC in July 2013. The rules took effect on January 1, 2015 and affect most regulated bank loans for purposes of real estate acquisition, construction, site development or other loans that are not "permanent" loans.

- Exceptions exist for certain loans made under the Community Reinvestment Act

- HVCRE classified loans require banks to assign higher risk weighting, which affects the loan pricing, underlying bank capital requirements, and the need for full personal or "deep pocket" guaranties

- Also leads to capital adequacy requirements in loan documentation (see next topic)

- The genesis of the HVCRE rules was the G20 Basel III accords, which updated earlier G20 rulemaking applicable to European and some Asian banks that concerned their capital reserves, loan risk disclosures and examination requirements.

- See attached article for a more in-depth discussion: Real Estate Finance in the Era of Basel III, Spyksma, Sara, *ACREL Papers*, Fall 2015.

REAL ESTATE FINANCE IN THE ERA OF BASEL III

By Sarah V.J. Spyksma[1]

I. Introduction.

A. *Origins of the Basel Committee on Banking Supervision.*

In 1971, realizing that Fort Knox then held a third or less of the required gold reserves to cover U.S. Currency then in circulation in foreign markets, President Nixon severed the tie between the US Dollar and gold thereby bringing an end to the "gold standard" that had been the basis of the Bretton Woods system of managed exchange rates. In response to the financial turmoil that ensued as banks scrambled to cover substantial foreign currency losses[2], the central bank governors of the G10 countries formed the Committee on Banking Regulations and Supervisory Practices, later renamed the Basel Committee on Banking Supervision (the "Committee"). The Committee was established as a forum through which member countries might work cooperatively to establish best practices in banking supervision on a global basis with a view to improving the resilience of the global banking system.

The Committee is charged with developing and agreeing upon supervisory standards for all banks. Almost since its inception, the Committee's main focus has been on capital adequacy and the role of capital adequacy in a stable international banking system.

B. *The Basel Accords.*

In 1988 the Committee issued its first Capital Accord – known as Basel I – which required banking organizations to maintain a minimum ratio of capital to risk weighted assets of eight percent (8%).[3] Basel I was amended several times and ultimately, in 2004, to address concerns over the increasing level of risk in a time of great financial innovation, the Committee adopted a new framework for capital adequacy ("Basel II") comprised of "three pillars".[4]

TAB 6

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[1] Nothing contained in this paper shall be construed as legal, tax or accounting advice. The author reserves the right to assert positions contrary to those stated in this paper.

[2] On June 26, 1974, West Germany's banking authority withdrew Bankhaus Herrstatt's banking license following the discovery that the bank's foreign exchange exposures exceed its capital by a factor of three and banks in many countries suffered substantial trading losses with Bankhaus Herrstatt. In October 1974, the Franklin National Bank of New York ceased operations in the face of its large foreign exchange losses. A Brief History of the Basel Committee, p.1, Bank for International Settlements, October 2014.

[3] "A Brief History of the Basel Committee", p. 3, Bank for International Settlements, October 2014.

[4] "A Brief History of the Basel Committee", p. 3, Bank for International Settlements, October 2014.

The "three pillars" of Basel II -- maintenance of minimum capital reserves, supervisory review of a financial institution's capital adequacy and imposition of significant risk disclosure obligations on such financial institutions -- were designed to "improve the way regulatory capital requirements reflect the underlying risks . . .."[5] However, even in advance of the 2008 financial crisis the Committee seemed to have concluded that the capital adequacy framework embodied in Basel II was in need of a substantial overhaul. The third of the Committee's Capital Accords -- Basel III -- was adopted in 2010 and approved by the G20 in Seoul later that same year. Basel III continues the "three pillars' of Basel II, but: (i) increases the required capital ratios to be maintained by banks, (ii) focuses more on the quality of the capital being reserved by limiting the instruments that may be included as capital for purposes of satisfying required minimum capital ratios, (iii) changes the risk weights of certain assets, and (iv) introduces the concepts of capital buffers and minimum liquidity requirements.

II. US Basel III.

A. *General.*

Basel III has been adopted, with some modifications, by numerous jurisdictions including the United States. In July 2013 the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (the "Agencies"), as a part of their mandate under the Dodd-Frank Act,[6] approved final rules, derived from Basel III, for the comprehensive revision of the regulatory capital framework applicable to the banking organizations regulated by them ("US Basel III"). The final rule was formally adopted by the Agencies in October 2013 ("Final Rule") [7].

B. *Implications for Real Estate.*

US Basel III has broad implications for the banking industry. It has received attention and interest from numerous financial specialists within the banking industry and has been greeted with varying levels of enthusiasm. In particular, US Basel III directly impacts commercial real estate in a number of important ways including by (i) changing the risk weighting of various real estate

[5] "A Brief History of the Basel Committee," p. 3, Bank for International Settlements, October 2014.
[6] The Dodd-Frank Wall Street Reform and Consumer Protection Act, passed into law on July, 2010, required that the Agencies adopt a comprehensive set of risk-based capital requirements for banks, bank holding companies and significant non-banks.
[7] 78 Fed. Reg. 62018 (October 11, 2013). The Dodd -Frank Wall Street Reform and Consumer Protection Act, passed into law on July 2010, mandated that the Agencies adopt comprehensive risk-based capital requirements.

credit exposures, including so-called high volatility commercial real estate loans, (ii) automatically increasing the risk weight assigned to loans that are more than 90 days past due or in non-accrual, and (iii) imposing new limits on the amount of mortgage servicing rights that may be included in the calculation of Tier 1 Capital as well as changing the risk weighting for those mortgage servicing rights. While all of these changes have the potential to dramatically change the face of commercial real estate lending in the United States, what seems to have attracted the most attention from the commercial real estate lending bar to date is the Final Rule's introduction of the High Volatility Commercial Real Estate Loan.

C. *High Volatility Commercial Real Estate Loans*

Under U.S. Basel III, high volatility commercial real estate loans ("HVCRE Loans") are deemed to be riskier than other credit exposures and, effective January 1, 2015, all acquisition, development or construction loans, whenever made, that can be classified as HVCRE Loans will be assigned a risk weighting of 150%.[8] This new risk weighting represents a significant departure from the risk weighting approach to real estate assets in Basel I and II, both of which charged a risk weight of 100% to some real estate loan assets and 50% to others. The net effect is a substantial increase (by half) in the capital required to be reserved in respect of certain real estate loans by banking organizations subject to the Final Rule.

An HVCRE Loan is defined under the Final Rule[9] as a loan that is not a "permanent" loan and which finances the acquisition, development, or construction of real property ("ADC Loan") unless the ADC Loan finances:

1. One to four family residential properties,
2. Real property that qualifies as an "investment in community development" or a "qualified investment",
3. Agricultural land, or
4. Commercial real estate properties in which
    a. the loan to value ratio is less than or equal to the applicable regulator's supervisory limit on loan to value ratios;[10]

[8] 78 Fed. Reg. 62181.
[9] 78 Fed. Reg. 62165.
[10] 65% in the case of raw land, 75% in the case of land development, for construction loans, 80% in the case commercial, multifamily and other non-residential property, and 85% in the case of 1 to 4 family dwellings, and 85% for already improved land (12 CFR part 34, subpart D; 12 CFR Part 160, subparts A and B; 12 CFR part 208, appendix C).

TAB 6

b. the borrower has contributed capital, in the form of cash, unencumbered readily marketable assets or out-pocket-expenses (incurred and paid by the borrower), of at least 15% of the real estate's appraised "as completed" value; and
c. the borrower has contributed such capital prior to the lender making any advances and such capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project for the "life of the project".

Per the Final Rule, the "life of the project" ends only when the project is sold or the ADC Loan is converted to "permanent" financing or is paid in full. The banking organization providing the ADC Loan may also provide permanent financing provided such permanent financing is subject to the banking organization's underwriting criteria for long-term mortgage loans.

The provisions of the Final Rule pertaining to HVCRE Loans ("HVCRE Rule") went into effect on January 1, 2015, and all banking organizations subject to risk based capital reporting requirements were required to determine by March 31, 2015, the status under the HVCRE Rule of each of their ADC Loans.

Unfortunately, the HVCRE Rule does not provide much guidance on how to apply the HVCRE exemption criteria, which has left those banking organizations subject to the Final Rule in a state of uncertainty as to how and when the HVCRE designation may be avoided. Both banks and other interested parties[11] have sought clarifications on the HVCRE Rule and have raised a number of questions and issues including (i) whether an HVCRE Loan can be "rehabilitated" after closing; (ii) whether the cash paid for raw land at purchase may count towards the borrower's required capital contribution; (iii) whether the borrower may include appreciated land value as part its required capital contribution; and (iv) whether the required capital contribution may be made with borrowed funds, and the point at which the developer may withdraw capital from the project.

In April 2015, the Agencies published a set of "frequently asked questions" ("FAQs")[12] and responses to those FAQs. Their responses covered many, but not all, of the issues raised by interested parties and with varying degrees of clarity.

In response to FAQ #1, the Agencies stated in no uncertain terms that a loan which at the time of funding is an HVCRE Loan cannot be rehabilitated by subsequent injections of capital

[11] e.g. the Mortgage Bankers Association, the CRE Finance Council, and the Real Estate Roundtable.
[12] "High Volatility Commercial Real Estate (HVCRE) Exposures", Frequently Asked Questions on the Regulatory Capital Rule, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, March 31, 2015.

from the borrower. The borrower's required capital contribution must be made before any portion of the loan is funded. Some lenders have begun to introduce provisions requiring the borrower to contribute additional equity as necessary to maintain the 15% capital requirement. In the context of a non-recourse loan, some of these provisions may not play well with borrowers and, in light of the Agencies' response, may be of little utility.

On a different but related topic, the Agencies indicated in their response to FAQ #14 that an ADC Loan, which is required to be risk-weighted as an HVCRE Loan at closing due to a loan-to-value ratio in excess of the applicable supervisory limits, cannot be reclassified upon the receipt of a new appraisal or valuation reflecting a new loan-to-value ratio that no longer exceeds the prescribed supervisory maximum. Thus an ADC Loan which by definition has become less risky will nonetheless continue to bear a risk weight of 150%.

The Agencies' response to FAQ #11 is helpful and makes clear that cash used to purchase land that is subsequently contributed to a project may be counted as borrower contributed capital in satisfaction of the 15% capital requirement, so long as the borrower has provided satisfactory evidence of cash payment. However, while helpful, the answer to FAQ #3 still leaves unanswered an important question – how will appreciated value in excess of the original purchase price of the property be treated? May a borrower who purchased property for cash and then held it while it appreciated in value "contribute" the appreciated value of the property as part of the required 15% capital requirement? To not give credit for demonstrated appreciation in value seems an unfair outcome. A borrower who purchased a property for $100,000 and held it (and maintained it and paid taxes on it) long enough for it to have appreciated to $250,000 will be worse off with a deemed capital contribution of only $100,000 than the borrower who has just bought that same property for $250,000 and is credited with a capital contribution in such amount.[13] One argument for the Agencies' response is that cash actually paid is a clear and objective measure for purposes of determining the amount of capital the borrower has contributed. However, given the willingness to rely on appraisals in so many other contexts, including for purposes of determining the "as-completed" value of the project under the Final Rule, any reluctance to give credit for the demonstrated appreciated value of the contributed property contribute will be difficult to understand.

That the borrower be required to have "real skin in the game" is a recurring theme in the Agencies' responses to the FAQs. Given the Agencies' clear concern that the borrower have a

[13] Mortgage Bankers Association's supplemental letter dated January 26, 2015, addressed to the Comptroller of the Currency, the Board of Governors of the Federal Reserve and the Federal Deposit Insurance Corporation, p. 3. Mortgage Bankers Association's follow-up letter dated April 1, 2015, addressed to the Comptroller of the Currency, the Board of Governors of the Federal Reserve and the Federal Deposit Insurance Corporation, p. 5.

true stake in the project, their responses to FAQs #3, #5 and #16 are not surprising. The required 15% capital contribution may not be satisfied through the Borrower's pledge of unrelated and otherwise unencumbered real property; a collateral pledge as security for an obligation is conditional and therefore not a contribution. The 15% capital contribution also cannot be made with (a) the proceeds of a loan from a third party lender secured by a second lien on the project, (b) the proceeds of a loan which is made to the borrower independent of the ADC Loan by the banking organization funding the ADC Loan, or (c) the proceeds of grants from non-profit organizations.

There are, however, several alternative sources of capital which the Agencies appear either not to have considered, or if they have considered them, have not yet determined to reject as an acceptable means of achieving the 15% capital requirement. The first alternative is unsecured debt or debt, secured by some other asset completely unrelated to the project. Given the Agencies' view on grants and the importance of having a meaningful stake in the project, it may be that borrower debt of any kind that is not entirely recourse in nature will not get much traction with the Agencies. A second alternative is mezzanine debt secured by ownership interests (direct or indirect) in the borrower. An important distinction from the first alternative is the identity of the borrower – typically a mezzanine loan is not made to the developer but rather to an entity that directly or indirectly owns the developer. The developer receives the proceeds of the mezzanine loan as a contribution of equity from its up tier owner and not as debt. The third option is another common source of capital in real estate transactions – preferred equity. The Mortgage Bankers Association is of the view that any infusion of capital into the borrower is for the good, although it is also quick to point out that any direct infusion of capital ought not to have the attributes of debt – such as maturity dates, security and payment defaults.[14]

In order to avoid classification as an HVCRE Loan, an ADC Loan must contain contractual provisions which require "the capital contributed by the borrower, or internally generated by the project . . . to remain in the project throughout the life of the project."[15] In its comment letter dated January 26, 2015, the Mortgage Bankers Association requested guidance on permitted uses of capital.[16] In April 2015, the Mortgage Bankers Association, perhaps sensing where things were headed, commented that one reading of the Final Rule would require that a borrower must be contractually prohibited from withdrawing capital in excess of the 15% capital requirement for the entire life of the project and urged the Agencies to focus their guidance on permitted uses of capital

[14] Mortgage Bankers Association's follow-up letter dated April 1, 2015, addressed to the Comptroller of the Currency, the Board of Governors of the Federal Reserve and the Federal Deposit Insurance Corporation, p. 4.
[15] 78 Fed. Reg. 62165
[16] Mortgage Bankers Association's supplemental letter dated January 26, 2015, addressed to the Comptroller of the Currency, the Board of Governors of the Federal Reserve and the Federal Deposit Insurance Corporation, pp. 3-4.

rather than on an absolute prohibition on the use of capital.[17] In response (FAQ #15), the Agencies seem to have adopted the less favorable reading of the Final Rule and stated that the borrower must be prohibited from withdrawing both its contributed capital and any internally generated capital until the life of the project has concluded.

As further pointed out by the Mortgage Bankers Association, some projects are capable of generating capital during the course of development and construction (e.g. sale of pads).[18] If the Final Rule is read to prohibit the withdrawal of any capital in excess of the 15% capital requirement, such borrowers will be precluded from covering the debt service, trade debt and operating costs of the project. While many ADC Loans will be structured to include reserves for interest and other expected expenditures during the period of construction, developers able to generate capital from, for example, the sale of pads may prefer to avoid costly reserves and cover certain operating costs on their own. This prohibition on the withdrawal of internally generated capital becomes even more problematic after the project is completed, but not stabilized (and therefore not yet eligible for permanent financing); the project may be throwing off enough income to scrape by, but under the Agencies' current interpretation of the Final Rule the borrower is not going to have access to these funds to cover the costs of operation and ramp up. Moreover, in a typical construction loan, payment recourse, if any, burns off upon completion of construction, along with the built in reserves. At that point, the borrower may be completely reliant on the project cash flow to cover operating expenses, taxes and the other items critical to the sound and proper operation of a project. If not permitted to access that cash flow is the borrower then required to take another loan or to infuse additional equity notwithstanding the non-recourse nature of the loan? This flies in the face of today's commercial real estate lending practices and it seems unlikely that sophisticated borrowers will stand for this.

III. Conclusion.

The jury is still out on how ultimately banking organizations will respond to the new regulatory capital rules embodied in US Basel III. Some speculate in respect of the HVCRE Rule that regulated banking organizations will decrease their activity in commercial real estate lending and that there will be an uptick in the number of mortgage REITS and private equity funds originating commercial real estate loans.[19]

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[17] Mortgage Bankers Association's follow-up letter dated April 1, 2015, addressed to the Comptroller of the Currency, the Board of Governors of the Federal Reserve and the Federal Deposit Insurance Corporation, p. 3.
[18] Mortgage Bankers Association's follow-up letter dated April 1, 2015, addressed to the Comptroller of the Currency, the Board of Governors of the Federal Reserve and the Federal Deposit Insurance Corporation, pp. 3-4.
[19] "Banking Regulators to Vote on Basel III Implementation in U.S.", Commercial Real Estate Direct Staff Report, July, 2013.

Increasingly commercial banking is a relationship business; many banking organizations will think long and hard before abandoning such a significant component of the relationship. That said, those banking organizations wishing to stay in the commercial real estate lending business will need to adjust their business models and expectations of profitability, and in some cases banking organizations unable or unwilling to suffer lower profitability may be forced to try and pass the 150% capital charge along to borrowers through higher interest rates or to get out of the business.

In any event, the more closely aligned the HVCRE Rule can be made to be with industry realities, the more likely it is that banking organizations will continue to be able to offer commercial real estate loan products that are desirable to both the banking organizations and their customers.

4. Capital Adequacy for Lenders

- Driven by the Dodd-Frank rules applicable to federally chartered banks
- May be prospective as to future regulations or retrospective as to future enforcement of existing regulations, or both
- Which other lenders include, or do not include, these provisions?
- The provisions can require a borrower to make additional principal pay downs during the term of the loan so that the lender's risk weight ratio for the subject loan and other similar loans does not exceed the regulatory maximum, which could trigger additional capital reserves being imposed on the lender by the regulators
- Does the "most-favored nation clause" help a borrower?
- Sample language:

> <u>Change in Capital Adequacy Requirements</u>. If Lender shall determine that the adoption after the date hereof (for purposes of this Note, the Dodd-Frank Wall Street Reform and Consumer Protection Act and all guidelines and regulations adopted in connection therewith are deemed to have been adopted after the date hereof) of any applicable law, rule or regulation regarding capital adequacy, or any change in any existing law, rule or regulation regarding capital adequacy, or any change in the interpretation or administration thereof by any governmental authority, central bank or comparable agency charged with the interpretation or administration of any such law, rule or regulation regarding capital adequacy, or compliance by Lender (or any of its branches) with any request or directive regarding capital adequacy (whether or not having the force of law) of any such authority, central bank or comparable agency, has or would have the effect of reducing the rate of return on Lender's capital as a consequence of its obligations hereunder or for the credit which is the subject matter hereof to a level below that which Lender could have achieved but for such adoption, change or compliance (taking into consideration Lender's policies with respect to liquidity and capital adequacy) by an amount deemed by lender to be material, then from time to time, within fifteen (15) days after demand by Lender, Borrower shall pay to Lender such additional amount or amounts reasonably determined by Lender as will compensate Lender for such reduction.

5. Participations and Syndications

- Typical scenario: a good bank customer (borrower) with many loans at the institution needs/wants a loan for a new real estate project; however, the Loan to One Borrower regulations would not allow the new loan to be made unless balances were reduced on the other outstanding loans; answer is a syndication or participation
- What is the difference between the two?
- Which is more prevalent, and why?
- What are the benefits to the lenders on both sides (Agent vs. Participants)?
- Is there any negative impact on the borrower?

6. The CMBS Market [Commercial Mortgage Backed Securities]

- We have been here before; Wall Street's answer to Main Street; loans are originated by commercial bank lenders and securitized into notes sold to investors, with the collateral rights held by a Trust, the loans serviced by a fee-based Servicer and enforced by a Trustee acting through a "Special Servicer."

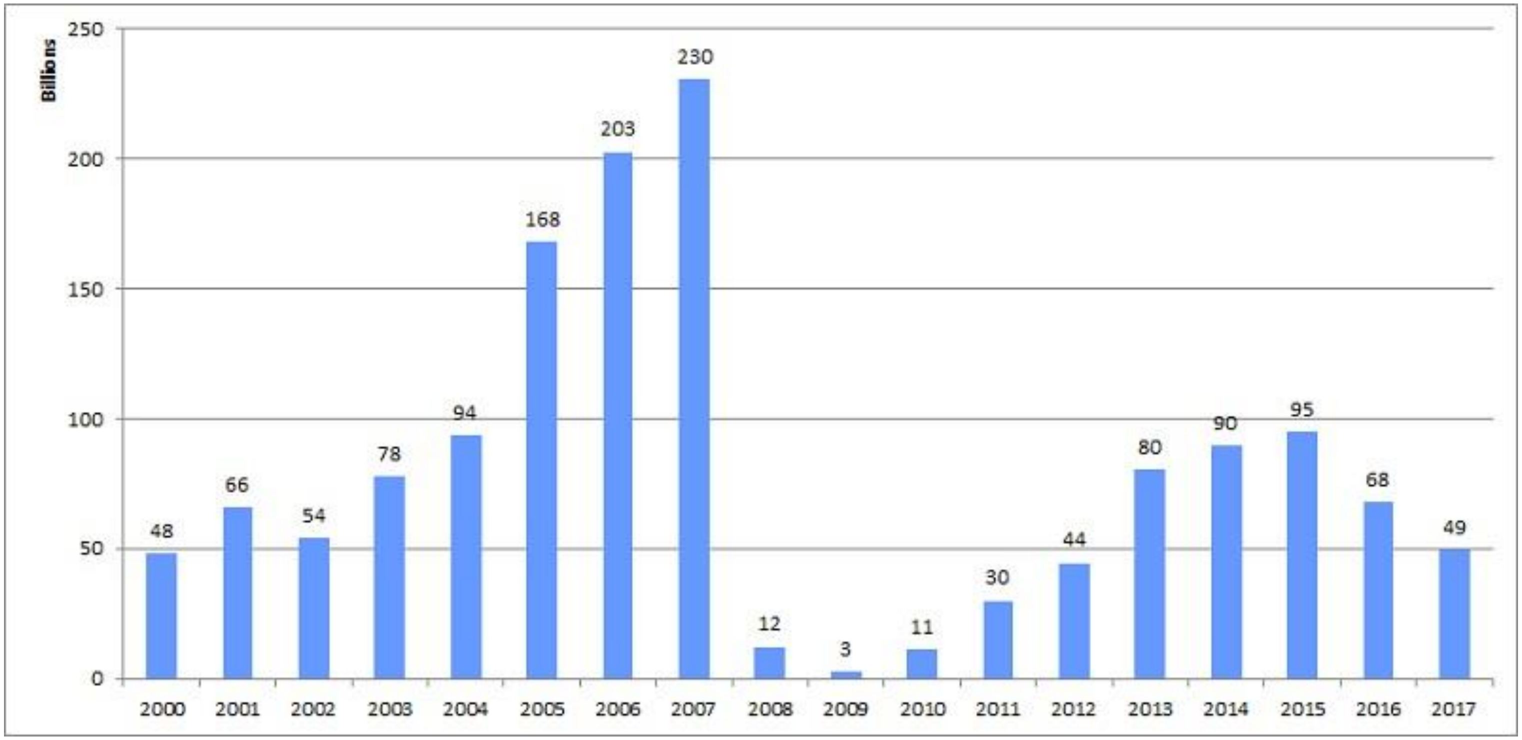
- Pros and Cons of a CMBS loan for a borrower

- status of the CMBS market. A very large amount of CMBS loans with a 10 year term were originated in 2006-07 timeframe. The prediction was that there would be a "cliff" off of which some borrowers with inadequate equity in their projects or other baggage would be thrown if denied access to the CMBS market in 2016-17.

- The meltdown was over-stated. Many bad loans had already been liquidated, asset prices improved across most classes and in most places; mezzanine structures were available to address inadequate equity (for a price), and other non-CMBS lenders were ready to make loans

- See attached article for additional insights to the suitability of CMBS loans for borrowers in various scenarios, and the limitations on CMBS lending today: <u>Debt Markets – Deal, Delayed or Dynamic?</u>, Goodwin, Ellen, *ACREL Papers*, Fall 2016.

U.S. CMBS Issuance by Year (through 3Q 2017)



Source: CRE Finance Council

Debt Markets – Dead, Delayed Or Dynamic? Developments in Mezzanine and CMBS Finance in 2016, and the Impact of New Regulatory Requirements on the Capital Markets Generally

By Ellen M. Goodwin[1]
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TAB 3

I. RECENT DEVELOPMENTS IN THE REAL ESTATE CAPITAL MARKETS

A. Recent Developments in Mezzanine Finance

1. Mortgage Loan Portfolio Lenders are Teaming Up with Mezzanine Lenders More Frequently in 2016

The demand for mezzanine finance remains strong in 2016 due to the refinancing boom that is occurring because of the large issuance of commercial mortgage-backed securities ("CMBS") debt in 2006 and 2007 ($198.3 billion and $228.5 billion, respectively).[2] However, due to the softness in the CMBS market for the first two quarters of 2016 (CMBS issuance is at $28.7 billion for the first two quarters of 2016 as compared to $46.7 billion for the first two quarters of 2015),[3] mezzanine lenders are teaming up more frequently with banks and insurance companies that originate portfolio loans instead of working with CMBS lenders who traditionally put together a debt package for a borrower which may have included a component of mezzanine debt. There are currently 86 firms that are providing high yield mezzanine debt on commercial properties.[4] These partnerships of portfolio or balance sheet lenders with the high yield mezzanine debt providers are more common in today's market, and they have highlighted the contrasting approaches and positions by these conservative balance sheet lenders to those historically and currently taken by their CMBS competitors on various covenants, requirements and rights contained and/or granted in the mortgage/mezzanine intercreditor agreements which are entered into in connection with a finance package comprised of both mortgage and mezzanine debt (the "Intercreditor Agreement").

2. The Release of the Mortgage Loan Recourse Carve-Out Guarantor Upon a Mezzanine Foreclosure and the Evolution of the "Deemed Replacement Guarantor" in the Intercreditor Agreement

First, let's examine an issue which arises frequently on mortgage loan recourse carve-out guaranties and environmental indemnity agreements when there is also a mezzanine loan provided

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[2] *Summary of CMBS Issuance: Historic*, COMMERCIAL MORTGAGE ALERT, (Dec. 31, 2015), https://www.cmalert.com/rankings.pl?Q=91.
[3] *Market Monitor*, COMMERCIAL MORTGAGE ALERT, June 3, 2016 at 7.
[4] *Mezz Lenders Shift Tactics as CMBS Slumps*, COMMERCIAL MORTGAGE ALERT, June 10, 2016 at 1.

to the equity owners of the mortgage borrower (and the interplay of corresponding provisions in the Intercreditor Agreement) through the differing lenses of the portfolio lender[5] and the CMBS lender. Many sophisticated mortgage borrowers will request that the mortgage borrower and any mortgage guarantor(s) be released from liability in connection with any events or circumstances which would trigger liability under the recourse carve-out guaranty and/or environmental indemnity on and after the date that the mezzanine lender forecloses on the mezzanine equity collateral or the date that a "Realization Event" occurs under the Intercreditor Agreement (which "Realization Event" may include the date that is the earlier of (1) the date that the mezzanine lender takes title to the mezzanine equity collateral, and (2) the date of the exercise of voting rights to direct the management or the policies of the mortgage borrower by the mezzanine lender pursuant to the mezzanine pledge agreement (which is a more recent addition to the definition)). The significance of a "Realization Event" in the Intercreditor Agreement is the obligation of the mezzanine lender to deliver a replacement recourse carve-out guaranty and an environmental indemnity agreement for the mortgage loan in connection with any such "Realization Event." The recent move toward the "early trigger" in the definition of "Realization Event" based on the exercise of voting rights by the mezzanine lender has evolved as an additional mitigant against the mezzanine lender exercising control over the mortgage borrower and causing the mortgage borrower to file for voluntary bankruptcy with no recourse to mezzanine lender or an affiliate of mezzanine lender for such action. Most mezzanine lenders have accepted the "early trigger" in the definition of Realization Event in the Intercreditor Agreement.

In connection with the release of the mortgage borrower and any mortgage guarantor, most CMBS lenders will agree in the mortgage loan documents to a borrower request for a release of a mortgage guarantor upon the consummation of a mezzanine foreclosure without the express requirement of the delivery of a replacement guarantor by the mezzanine lender pursuant to the Intercreditor Agreement (but many mortgage lenders are hesitant to permit the release of the mortgage guarantor on an exercise of "control" by mezzanine lender, as the definition of "control" may be difficult to define and is not a bright line test). In connection with such release, most CMBS mortgage lenders are willing to rely on their contractual right against a mezzanine lender under the Intercreditor Agreement for its failure to post a replacement guarantor upon a "Realization Event" and their ability to bring an application for a temporary restraining order (a "TRO") or declaratory judgment action to prevent (or set aside) such "Realization Event" due to the mezzanine lender's failure to satisfy a condition precedent (*i.e.*, the delivery of a replacement guarantor) as required under the Intercreditor Agreement. Portfolio lenders, however, typically are not willing to release a mortgage guarantor upon the consummation of a mezzanine loan foreclosure *unless* the mortgage loan documents *expressly* require the delivery of a replacement recourse carve-out guaranty and environmental indemnity agreement by a replacement guarantor, which such replacement guarantor shall either: (1) satisfy the requirements of the Intercreditor Agreement, or (2) be approved by the mortgage lender. Additionally, such replacement guarantor typically must satisfy any on-going financial covenants (*i.e.*, net worth and liquidity covenants that are set forth in the original mortgage loan recourse carve-out guaranty) unless otherwise negotiated in the Intercreditor Agreement.

The foregoing position concerning a release of a mortgage guarantor is typically not acceptable to a sophisticated borrower sponsor, as such borrower is not a party to the Intercreditor

[5] Note, the references to a balance sheet lender or portfolio lender herein shall always include an insurance company.

Agreement or otherwise involved in the posting of a replacement guarantor upon a mezzanine loan foreclosure, and it is unwilling to condition its mortgage guarantor's release on the actions and obligations of a third-party over which such borrower sponsor has no control (*i.e.*, the mezzanine lender). The balance sheet lender and the mortgage borrower are now at an impasse with respect to their contrasting positions on releases. A compromise position which has evolved from a balance sheet lender's unwillingness to rely on its contractual rights against a mezzanine lender under the Intercreditor Agreement and its ability to bring an action for a TRO or declaratory judgment due to their fear of being "uncovered" on a recourse event (including an environmental claim) is the concept of a "Deemed Replacement Guarantor" in the Intercreditor Agreement. Under the "Deemed Replacement Guarantor" alternative, in the event that a mezzanine lender subsequently defaults in its obligation to deliver a replacement guarantor upon a "Realization Event" pursuant to the terms of the Intercreditor Agreement, such mezzanine lender agrees in the Intercreditor Agreement that a guarantor (acceptable to the mortgage lender) provided by the mezzanine lender shall be deemed to have assumed all the obligations and liabilities of the guarantor under the mortgage loan recourse carve-out guaranty and the environmental indemnity agreement as if such "Deemed Replacement Guarantor" shall have executed such agreements. See Exhibit A attached hereto for a sample of a "Deemed Replacement Guarantor" provision for an Intercreditor Agreement. Generally, there is significant pushback from mezzanine lenders with respect to the "Deemed Replacement Guarantor" provision (rarely seen in a CMBS context), though some mezzanine lenders, in an effort to get a balance sheet mortgage loan transaction done, will agree to be a "Deemed Replacement Guarantor" upon execution of the Intercreditor Agreement.[6] This tension concerning releases of guarantors on the mortgage loan and replacement guaranties on the mezzanine loan among mortgage borrowers, mortgage lenders and mezzanine lenders is a point of serious negotiation among the various members that participate in and access the mortgage and mezzanine finance markets today.

TAB 3

3. A "Qualified Transferee" of the Mezzanine Loan – the Differing Requirements of the Balance Sheet Lender and the CMBS Lender

Another issue which highlights the different requirements of a balance sheet lender to those of a CMBS lender is the definition of a "Qualified Transferee" in the Intercreditor Agreement. A sample definition of "Qualified Transferee" is set forth on Exhibit B attached hereto. The definition is relevant with respect to certain rights and obligations set forth in the Intercreditor Agreement and how they relate to the initial mezzanine lender originating the mezzanine loan, the transfer of the mezzanine loan and the exercise of remedies by the mezzanine lender pursuant to the mezzanine loan documents. Balance sheet lenders may require an additional qualification to the definition of "Qualified Transferee" as set forth in Exhibit C attached hereto (*e.g.*, such Qualified Transferee must be a "Customer in Good Standing" and not a "Controversial Person"). These additional requirements (which are not relevant in the CMBS market) affect the liquidity of the mezzanine loan and make it very difficult for the pool of potential purchasers of a particular mezzanine loan to meet the definition of a Qualified Transferee; especially because, among other things, each of the sample definitions of "Customer in Good Standing" and "Controversial Person"

[6] Additional issues that may arise when negotiating the "Deemed Replacement Guarantor" provisions in an Intercreditor Agreement include, among other things, what time period the mezzanine lender is obligated to (1) maintain net worth and liquidity covenants contained in the mortgage recourse carve-out guaranty, and (2) deliver guarantor financial statements and other financial information to the mortgage lender.

contain very low bars concerning litigations and they also extend to such potential purchaser's affiliates. Many of the mezzanine players in 2016 were present in the most recent real estate market downturn and may have an affiliate equity fund, or may have, themselves, foreclosed as a lender on a mezzanine pledge and succeeded to the ownership interests in a mortgage borrower where, in either case, such affiliate of mezzanine lender or the mezzanine lender, itself, may have been involved in a work-out, restructure or litigation that would trigger its inability to be a "Customer in Good Standing," or alternatively, its ability to be a "Controversial Person" in today's market, and thus, unable to qualify as a "Qualified Transferee." Additionally, even if the initial mezzanine lender meets the definition of Qualified Transferee, as qualified above, these additional qualifications found in balance sheet lender Intercreditor Agreements may further have the potential to chill the bid at a public UCC sale when the mezzanine lender exercises remedies on a mezzanine loan in default, as the mortgage lender's consent must be obtained (which may include a rating agency confirmation on a CMBS loan) if such potential bidder does not meet the definition of a "Qualified Transferee." Furthermore, the additional requirements may also impact the "commercial reasonability" of the UCC sale by widely contracting the pool of potential bidders at the mezzanine foreclosure sale. These negative impacts are good reasons for mezzanine lenders to push back on and/or attempt to remove or significantly alter such additional qualifications in order that their execution on their mezzanine loan investments are not meaningfully devalued. Until the CMBS market becomes more robust in 2016, or thereafter, mezzanine lenders will need to meet the challenges they face among balance sheet lenders with the more stringent definition of a "Qualified Transferee" of a mezzanine loan.

Other issues for both mezzanine lenders and mortgage lenders to focus on with respect to the definition of a "Qualified Transferee" include the following questions: At the initial closing of the mezzanine loan, does the mortgage lender rely on a representation (other than being named specifically in the definition of a "Qualified Transferee") that such mezzanine lender is a "Qualified Transferee"? Or does the mortgage lender require the delivery of financial statements? Today, it is not uncommon for both CMBS lenders and balance sheet lenders to require organizational charts and financial statements from mezzanine lenders prior to loan closing or in connection with a mezzanine loan sale. Additionally, most Intercreditor Agreements (for both CMBS and portfolio lenders) require an officer's certificate from the mezzanine lender certifying that all of the applicable requirements of the Intercreditor Agreement have been met with respect to the exercise of remedies under the mezzanine loan documents, and the transfer of the mezzanine equity collateral to the mezzanine lender or a new transferee,[7] but also give the mortgage lender the right to request evidence to support such certificates. On these points, CMBS lenders and balance sheet lenders provide a consistent approach to mezzanine lenders.

Lastly, there have been additional rumblings from some players in the mortgage CMBS and balance sheet markets that there should be additional restrictions on transfers or sales of more than 49% *in a* mezzanine lender that is specifically named in the definition of a "Qualified Transferee." The rationale for this position would be the maintenance of the sponsorship of such mezzanine lender as such "specifically-named" mezzanine lender would not need to meet the

[7] Such certificate shall provide, among other things, that mezzanine lender or new transferee is a Qualified Transferee and a replacement guarantor has been provided which (1) has delivered a replacement recourse carve-out guaranty and environmental indemnity agreement, and (2) meets the net worth and liquidity requirements (or other financial requirements) set forth in the Intercreditor Agreement.

financial tests set forth in the definition of a Qualified Transferee upon the exercise of remedies under the mezzanine loan documents. This additional requirement is not customarily present in the current mortgage/mezzanine market, and would definitely be met with resistance by prospective mezzanine lenders and/or purchasers, as it may have the effect of restricting or limiting the execution on their business plans in the future. Only time will tell if this issue is raised and how the mezzanine market may react.

TAB 3

B. Recent Developments in CMBS Lending

1. The Effect of External Market Factors and New Regulatory Legislation on CMBS Finance in 2016

The first two quarters of CMBS lending in 2016 have been quite sluggish due to external factors such as the Chinese stock market, oil prices, the new risk retention regulations which will be implemented in December (discussed here in depth later), and uncertainty over our new President in November. Issuance as of May 31st is 42% lower than for the same period in 2015, and projections for overall CMBS issuance in 2016 have now been adjusted downward to $70 billion from $100—115 billion.[8] The volatility in the market has made it virtually impossible for CMBS lenders to quote a spread, and those lenders that did so earlier in 2016 found themselves in a position where it was necessary to invoke the material adverse change ("MAC") clauses in their term sheets and increase interest rate spreads in connection with closing, which such re-trades by CMBS lenders did not make borrowers happy. The third quarter of 2016 seems to be calming down a bit; spreads on CMBS securitizations have tightened and there is now increased activity in CMBS lending. The size of securitization pools in recent CMBS offerings in the second quarter has been well below the $1 billion benchmark which is driven by fear of aggregation risk. B notes are almost never seen, and there has been a solid movement by subordinate debt providers to mezzanine loans, as the players in that market want to control their destiny upon borrower default, and *pari passu* loan structures are more in favor in the capital markets today than single-asset securitizations (which seem to be reserved for flagship properties), as investors seem strongly to prefer diversity of asset type, geography, and borrower sponsorship found in conduit pools.

2. New Rating Agency Requirements for Leasehold Financings

From a legal perspective there has been increased scrutiny by rating agencies on leasehold financings in 2016—so beware! Moody's rolled out a piece in January focusing on a handful of key issues concerning leasehold mortgagee protections in ground leases.[9] New lease provisions should be written so they are granted to a leasehold mortgagee on any termination of the ground lease <u>and</u> upon a rejection of a ground lease in a borrower/ground tenant bankruptcy.[10] Due to the uncertainty in case law that a rejection of a ground lease may not be a termination of such lease (but only a breach), a ground lease that contains a new lease provision which is granted upon a "termination for any cause" is not a credit-neutral provision,[11] and the lender will have to suffer the consequences of a rating adjustment with respect to such loan. Loan size (as a percentage of a securitization pool) may well impact the degree of such ratings adjustment, so if a lender is faced with such a non-compliant new lease provision, a *pari passu* loan structure would be recommended in an effort to bring any loan component below a 10% threshold of the pool, which may help the ratings hit, but nothing (as we know) is guaranteed.

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[8] *Expectations for 2016 CMBS Issuance Slashed Sharply*, COMMERCIAL REAL ESTATE DIRECT (Mar. 2, 2016), http://www.crenews.com/general_news/general/expectations-for-2016-cmbs-issuance-slashed-sharply.html.
[9] MOODY'S INVESTOR SERVICE, THE TOP TWO GROUND LEASE FINANCING FLAWS: DEFICIENT "NEW LEASE" CLAUSES AND SUPERIOR FEE MORTGAGES, Jan. 6, 2016.
[10] *Id.* at 1-2.
[11] *Id.* at 2.

Similarly, Moody's has also focused in its recent article on the priority of a ground lease relative to a fee mortgage which may lien the fee estate of a property where such ground lease encumbers the leasehold estate of the same property. Under the foregoing scenario, such ground lease must be prior in lien priority to that of the fee mortgage to be credit neutral.[12] The inherent risk of a prior fee mortgage to a subordinated ground lease is the extinguishment of such ground lease upon a default and foreclosure of such fee mortgage—not a position a leasehold lender wants to finance. In order to avoid the potential risk of a total loss of a leasehold lender's collateral on a fee mortgage default, most fee lenders are comfortable subordinating their fee mortgage to the ground lease and relying on a state's eviction laws to dispossess a ground tenant in default once such fee lender succeeds to a fee owner's position on foreclosure (as opposed to having the direct right to extinguish a subordinate ground lease in default upon a fee mortgage foreclosure).[13] However, there are some older ground leases where a fee owner (with leverage) may have negotiated that a ground lease is subordinate to any existing and future fee mortgage, but such fee lender is obligated to deliver a subordination, non-disturbance and attornment agreement (an "SNDA") to the ground tenant, which would arguably mitigate any risk of termination of such ground lease on a fee mortgage foreclosure.

TAB 3

Historically, many CMBS leasehold lenders would accept such subordinate ground lease subject to an SNDA as its collateral package, but only if such SNDA was properly drafted to mitigate any risk that it would be considered an executory contract (and capable of rejection) upon the bankruptcy, insolvency or receivership of such fee lender (arguably a remote risk in and of itself). An SNDA may be deemed an executory contract that could be rejected under § 365 of the U.S. Bankruptcy Code.[14] If an SNDA is drafted such that the non-disturbance granted by the fee lender to the ground tenant and its leasehold lender is a "present non-executory grant of non-disturbance" which is based upon a condition subsequent—"a ground tenant's default"—arguably such SNDA is not an executory contract, pursuant to § 365 of the U.S. Bankruptcy Code (a "Non-Executory SNDA"). Participants in the CMBS market appeared to accept the foregoing language in the Non-Executory SNDA as a tool to minimize the risk that an SNDA would be deemed executory in a fee lender bankruptcy, insolvency, or receivership proceeding. However, since there is no case law directly on point supporting that the Non-Executory SNDA is not an executory contract under the Bankruptcy Code (but, note, there is also no case law directly supporting that a Non-Executory SNDA is an executory contract), Moody's is not willing to view a ground lease with a prior fee mortgage with a Non-Executory SNDA granted to the ground tenant and the leasehold lender as credit-neutral.[15] A ground lease needs to be structured as a prior encumbrance to a fee mortgage in order to avoid such credit-negative treatment upon securitization of the mortgage loan.

3. A Look at CMBS Underwriting Requirements in 2016

The CMBS market appears to continue to require solid underwriting requirements post-downturn. Deep pocket guarantors are still a must for both the rating agencies and B-Piece Buyers; however, strong sponsors with lower leveraged properties may get the benefit of a cap on some portion of their guarantor's recourse obligations under the loan documents (usually limited to the

[12] *Id.* at 3.
[13] *Id.* at 3.
[14] *Id.* at 3.
[15] *Id.* at 3.

bankruptcy recourse carve-out). Recourse carve-out liability caps of 50% and below will result in a rating adjustment by some of the agencies and/or pricing hits by B-Piece Buyers. With respect to caps above 50%, the treatment is less certain, but the rating adjustment and/or pricing hit will not be as severe. Similarly, net worth and liquidity requirements have evolved to be the "new normal" in the post-downturn CMBS market. The dollar thresholds are a subject of a negotiation, but an "unwritten rule of thumb" is the minimum net worth requirement is typically no less than the principal amount of the mortgage loan, and the corresponding liquidity requirement is 10% of such principal amount. Now that the requirements of net worth and liquidity covenants are commonplace in recourse carve-out guaranties, negotiations do surround the definitions themselves. Borrowers are typically requesting lenders to count lines of credit or capital commitments by investors available to a guarantor as "cash and cash equivalents" when calculating "liquidity." Many lenders will accept the following in connection with the calculation of required liquidity of the guarantor: "(a) funds available to Guarantor pursuant to an Eligible Credit Facility; and/or (b) Eligible Capital Commitments which are in excess of any outstanding loans secured by such commitments."[16]

Similarly, the lender requirement for audited financial statements, a cost issue to borrowers, seems to support continued discipline in the underwriting arena. Audited statements are important to both the rating agencies and B-Piece Buyers. There have been some recent rumblings by some rating agencies that loans in the $25MM - $40MM range without a requirement for audited financial statements may suffer a ratings hit. As December approaches, and the requirement for a sponsor of a securitization to comply with the new risk retention rules by retaining a 5% interest (either vertically or horizontally) in a securitization finally becomes a reality in the CMBS market,[17] CMBS lenders may support these more stringent underwriting standards, and some of these standards (such as audited financial statements for loans with a principal amount of $25MM) may become the "new normal" due to the increased long-term risk that a CMBS sponsor of a securitization may have with respect to the mortgage loans that it is contributing into such securitization pool.

[16] Definitions of "Eligible Capital Commitments" and "Eligible Credit Facility" may include the following:
"Eligible Capital Commitments" shall mean uncalled and unconditional capital commitments of the partners or members, as applicable, of the applicable Guarantor which are subscribed and irrevocable.
"Eligible Credit Facility" shall mean a credit facility or subscription facility, so long as such facility is irrevocable and not subject to any conditions to advance that would not be reasonably expected to be satisfied as of the applicable date of determination.
[17] Please see Part II (A) below for a more detailed description of the new risk retention regulations.

II. THE IMPACT OF RECENT REGULATORY DEVELOPMENTS ON MORTGAGE LOAN ORIGINATION AND LOAN DOCUMENTATION

A. The Risk Retention Rules

1. Background

In an attempt to thwart certain practices it believed destabilized the capital markets leading to the 2008 recession,[18] Congress enacted Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act[19] (the "Dodd-Frank Act"). Specifically, Congress referred to an "originate-to-distribute" business model through which lenders originated loans and quickly disposed of the loans by selling them into securitization pools.[20] While this model permitted lenders to enhance their liquidity, thereby making credit more widely available to borrowers, it also resulted in a decline in loan quality since lenders could originate loans without retaining any liability for the heightened credit risks of such loans. Accordingly, Section 941(b) of the Dodd-Frank Act added Section 15G to the Securities Exchange Act of 1934[21] (the "Exchange Act") and directed various federal agencies (the "Agencies")[22] to adopt credit risk retention rules intended to align the interest of sponsors of securitizations with investors, by requiring sponsors to keep some "skin in the game."[23]

TAB 3

On December 24, 2016, the joint Final Rule[24] (the "Final Rule") implementing the credit risk retention obligations required under the Dodd-Frank Act will be effective for all classes of asset-backed securities, including CMBS. The Final Rule generally requires a "sponsor"[25] (or its majority-owned affiliate) of both public and private "asset-backed securitizations"[26] to retain at least 5% of the credit risk of the assets collateralizing the securitization (referred to herein as the "risk retention obligation").[27] In transactions with multiple sponsors, risk retention cannot be apportioned among the sponsors but, instead, each sponsor must ensure that at least one of the

[18] *See* S. REP. NO. 111-176, at 128 (2010).
[19] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[20] Luis A. Aguilar, *Skin in the Game: Aligning the Interests of Sponsors and Investors*, (Oct. 22, 2014), U.S. SECS. AND EXCH. COMM'N, https://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370543250034.
[21] 15 U.S.C. § 78o-11 (2012). Section 15G generally requires the applicable federal agencies to prescribe regulations to (i) require a securitizer to retain not less than 5% of the credit risk of any asset that the securitizer transfers, sells or conveys to a third party (through the issuance of an asset-backed security) and (ii) prohibit a securitizer from hedging or otherwise transferring the credit risk such securitizer is required to retain.
[22] The "Agencies" include: the Securities and Exchange Commission; Office of the Comptroller of the Currency; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and, with respect to the rules relating to residential mortgages, the Federal Housing Finance Agency and the Department of Housing and Urban Development.
[23] *See* S. REP. NO. 111-176, at 129 (2010), http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf.
[24] Credit Risk Retention, 79 Fed. Reg. 77,601 (Dec. 24, 2014).
[25] The Final Rule defines a "sponsor" as "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." *Id.* at 77,742.
[26] An "asset-backed security" is defined by incorporating the definition of that term in Section 3(a) (79) of the Exchange Act and generally defined to mean "a fixed income or other security collateralized by any type of self-liquidating financial asset (including a loan, lease, mortgage, or other secured or unsecured receivable) that allows the holder of a security to receive payments that depend primarily on cash flow from the asset." *Id.* at 77,741, 77,653.
[27] *See id.* at 77,611.

sponsors complies with the requirements of the Final Rule.[28] In addition, the Final Rule generally prohibits any transfer, hedging or financing of the risk retention obligation, thereby insuring the sponsors are invested in the performance of the assets for the majority of the life of the transaction.[29]

2. Forms of Risk Retention – Vertical, Horizontal and L-Shaped

The Final Rule offers various methods by which a sponsor may satisfy the 5% risk retention obligation. Subject to any exemption or exception discussed herein, CMBS sponsors may satisfy the risk retention obligation under the standard risk retention option, whereby the sponsor must retain an "eligible vertical interest", an "eligible horizontal residual interest," or any combination of the two (often referred to as an "L-Shaped Interest").[30]

Vertical Risk Retention. An "eligible vertical interest" ("EVI") is a pro rata interest in each class of securities issued by the issuing entity and valued at 5% of the *face value* of each such class. An EVI may be held as either (i) 5% of the face value of each class of securities issued or (ii) a single vertical security entitling the holder to 5% of the cash flows (principal and interest) made to each issued security (other than such single vertical security).[31] The "single vertical security" is intended to lessen a sponsor's administrative burden by permitting it to hold the risk retention obligation in just one security.[32]

Horizontal Risk Retention. An "eligible horizontal residual interest" ("EHRI") is an interest with the most subordinate claim to payments of principal and interest and valued at 5% of the *fair value* of all securities issued by the issuing entity.[33] The terms of the EHRI must provide that the interest is a "first-loss position," such that if on any payment or allocation date, the issuing entity has insufficient funds to satisfy its obligations to pay all principal and interest due to the outstanding securities, any shortfall will reduce the amounts payable to the EHRI prior to reduction of amounts payable to any other security issued.[34] Additionally, the EHRI may be held as a single class or multiple classes of securities, provided that the multiple classes are in consecutive order based on subordination level.[35]

In lieu of holding all or part of its risk retention obligation as an EHRI, the Final Rules permit a sponsor to fund a horizontal cash reserve account to be held by the securitization trustee for the benefit of the issuing entity.[36] At the closing of the securitization, such reserve account must hold an amount equal to the fair value of the EHRI or any portion of the EHRI not held as a security issued by the transaction.[37] The amounts held in the account would absorb losses on the issued securities, similar to the way in which an EHRI acts as the first-loss position in the

[28] *See id.*
[29] *See id.*
[30] *See id.* at 77,614.
[31] *See id.* at 77,615.
[32] *See id.*
[33] *See id.*
[34] *See id.*
[35] *See id.*
[36] *See id.* at 77,615-16.
[37] *See id.* at 77615.

securitization.[38] No amounts held in a horizontal cash reserve account may be released to the sponsor until all securities issued in a transaction have been satisfied or the issuing entity is dissolved.[39]

Unlike vertical risk retention, which is valued based on the "face value" of the securities issued by a transaction, horizontal risk retention requires the sponsor to calculate and retain the "fair value" of the securities issued.[40] However, the Final Rule provides little guidance on the meaning of "fair value" or how to calculate such value. The Final Rule refers only to "a fair value methodology acceptable under U.S. generally accepted accounting principles"[41] and states that the methodology to calculate the fair value of the EHRI may take into consideration "the overcollateralization and excess spread in a securitization transaction as adjusted by expected loss and other factors."[42] Accordingly, sponsors will be left to determine the proper methodology for evaluating fair value and risk the possibility of running afoul of the Final Rule if any of the Agencies disagree.

Moreover, the Final Rule requires the sponsor disclose its valuation method to investors.[43] Sponsors will be required to disclose default, recovery and payment rate assumptions, as well as other historical information that would meaningfully inform third parties of the reasonableness of the assumptions underlying the sponsor's valuation methodology.[44] Formulating the required disclosure will be costly and sponsors risk utilizing a methodology later deemed unacceptable by one or more of the Agencies.

L-Shaped Risk Retention. Sponsors may also satisfy the risk retention obligation through a combination of vertical and horizontal risk retention.[45] The Final Rule does not prescribe any particular proportion of vertical to horizontal risk retention but does require that the percentage retained in the vertical form (held as a percentage of the face value) and the percentage held in the horizontal form (held as a percentage of the fair value) when combined reaches or exceeds 5%.[46] Therefore, a sponsor may hold 3% of the face value of the securities issued in an EVI and 2% of the "fair value" of the securities in an EHRI, for a total risk retention obligation of 5%.

3. Transfer, Hedging and Financing Restrictions

Subject to the exceptions discussed below, the Final Rule prohibits the sponsor from selling or otherwise transferring its risk retention obligation other than to a majority-owned (or wholly-owned) affiliate ("MOA")[47] or, solely with respect to CMBS transactions, to a qualified third-party purchaser after an initial holding period of five years by the sponsor of a securitization. A MOA is a separate entity formed to acquire the interest in a transaction representing the sponsor's

[38] *See id.*
[39] *See id.* at 77,742.
[40] *See id.* at 77,611-12.
[41] *Id.* at 77,612.
[42] *Id.* at 77,613.
[43] *See id.* at 77,619.
[44] *See id.* at 77,619-20.
[45] Credit Risk Retention, 79 Fed. Reg. at 77,614.
[46] *See id.* at 77,614.
[47] *See id.* at 77,645.

risk retention obligation.[48] Alternatively, a CMBS sponsor that complies with the Final Rule by retaining an EHRI at closing of the securitization may transfer the interest to a qualified third-party purchaser (or "B-Piece Buyer") after holding the EHRI for five years,[49] as discussed in further detail in Section IV below.

The Final Rule further prohibits the sponsor or its affiliates from financing the risk retention obligation and certain hedging activities.[50] Financing of the sponsor's interest is generally impermissible under the Final Rule unless the debt incurred is full recourse to the pledgor.[51] On the other hand, the prohibition against hedging is restricted to hedge positions relating to the credit risk associated with the retained interest. For example, a credit default swap referencing the risk retention obligation or a particular secured asset is prohibited but hedging activities not materially related to the credit risk of the interest retained by the sponsor are permitted.[52] Such permitted activities might include hedge positions related to currency exchange rates, interest rates or an index of instruments that include various asset-backed securities.

Pursuant to Section 15G of the Exchange Act, the Final Rule also specifies the minimum duration that the sponsor must retain its obligation.[53] Accordingly, the transfer and hedging restrictions with respect to CBMS transactions expire on or after the date that is the latest of: (1) the date on which the total unpaid principal balance of the securitized assets that collateralize the securitization has been reduced to 33% of the original unpaid principal balance of the securitized assets as of the cut-off date of the securitization, (2) the date on which the total unpaid principal obligations of the securities issued in the securitization are reduced to 33% of the original unpaid principal obligations as of the closing date of the securitization, or (3) two years after the closing date of the securitization.[54] The Final Rule also states that any risk retention obligation for CMBS transactions terminates once all mortgage loans have been fully defeased.[55]

4. Who is the Responsible Party?

While the sponsor (or its MOA) is generally responsible for satisfying the risk retention requirements, the Final Rule provides some alternatives to sponsor-held risk for CMBS transactions, including originators and third party purchasers.[56] However, despite the option to transfer the obligation to retain risk, the sponsor cannot transfer the obligation to comply.[57] A

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[48] The Final Rule requires that the sponsor must own "more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity" in order for such entity to be majority-owned by the sponsor. *See id.* at 77,741.
[49] *See id* at 77,648.
[50] *See generally id.* at 77,666-67.
[51] *See id.* at 77,666.
[52] *See id.*
[53] *See id.* at 77,669-70.
[54] *Id.* at 77,669.
[55] *Id.* at 77,749.
[56] *See id.* at 77,643-44. *See also id.* at 77,661-62.
[57] *See id.* at 77,643-44. *See also id.* at 77,662 n.204.

sponsor that relies on an alternative to sponsor-held risk retention remains legally responsible for the ongoing compliance by the alternative party and liable for any violations of the Final Rule.[58]

Originators

The Final Rule permits a sponsor to allocate a portion of its risk retention obligation to an "originator"[59] of the securitized assets (or a MOA of the originator), subject to certain conditions.[60] Any allocation to an originator reduces the sponsor's risk retention obligation commensurately.[61] In order to satisfy the risk retention requirements, the originator must be the original creditor that created the asset, not a subsequent purchaser or transferee of the asset.[62] In addition, the originator must assume at least 20% of the aggregate risk retention obligation required to be retained by the sponsor.[63] However, the originator cannot assume a percentage of the risk retention obligation exceeding the percentage, by unpaid principal balance, of the securitized assets it originated to the aggregate balance of all assets in the securitization.[64] Furthermore, the originator must acquire the portion of the sponsor's retained interest at the closing of the securitization and must retain its interest in the same manner and proportion (as between an EVI or EHRI) as the sponsor.[65] Finally, the originator must comply with the transfer and financing restrictions that are imposed on the sponsor.[66]

TAB 3

B-Piece Buyers

The Final Rule also permits sponsors of a CMBS transaction[67] to satisfy all or a portion of the risk retention obligation through one or two qualified third-party purchasers ("B-Piece Buyers").[68] A B-Piece Buyer may hold an EHRI from the closing of the securitization or by transfer from the sponsor after an initial five year holding period.[69] The sponsor may utilize the

[58] *See id.* at 77,643-44. *See also id.* at 77,662 n.204.
[59] The Final Rule defines an "originator" as "a person who: (1) through an extension of credit or otherwise, creates an asset that collateralizes an asset-backed security; and (2) sells the asset directly or indirectly to a securitizer or issuing entity." *Id.* at 77,741.
[60] *See id.* at 77,664-65.
[61] *See id.*
[62] *See id.* at 77,665.
[63] *See id.*
[64] *See id.* at 77,664-65. This cap on originator-held risk retention applies only to an entity holding a portion of the risk retention obligation on behalf of the sponsor. In a transaction with multiple sponsors, the sponsor tasked with satisfying the risk retention obligation may hold a percentage of the risk retention obligation in excess of the percentage of the securitized assets it originated or contributed to the transaction.
[65] *See id.*
[66] *See id.*
[67] Use of a B-Piece Buyer option is only available in transactions securitized solely by commercial real estate loans and related servicing assets. *See id.* at 77,643. The Final Rule defines "commercial real estate (CRE) loan" as "(1) A loan secured by a property with five or more single family units, or by nonfarm nonresidential real property, the primary source (50% or more) of repayment for which is expected to be: (i) The proceeds of a sale, refinancing, or permanent financing of the property; or (ii) Rental income associated with the property; (2) Loans secured by improved land if the obligor owns the fee interest in the land and the land is leased to a third party who owns all improvements on the land, and the improvements are nonresidential or residential with five or more single family units; and (3) Does not include: (i) A land development and construction loan (including 1- to 4- family residential or commercial construction loans); (ii) Any other land loan; or (iii) An unsecured loan to a developer." *Id.* at 77,754-55.
[68] *See id.* at 77,644
[69] *See id.* at 77,648.

B-Piece Buyer option for its entire risk retention obligation or in combination with an EVI held by the sponsor.[70] If the sponsor transfers two EHRI interests to two separate B-Piece Buyers, the transferred interests must be *pari passu* in right of payment.[71]

Any B-Piece Buyer must perform its own due diligence services on the securitized assets and purchase and hold the EHRI in the same form and amount as would be required of the sponsor under the horizontal risk retention option.[72] A B-Piece Buyer is also subject to the transfer and hedging restrictions but, like a sponsor, may transfer the EHRI after a five year holding period so long as the transferee satisfies all requirements of a B-Piece Buyer.[73] However, if a sponsor chooses to utilize the B-Piece Buyer option, the Final Rule requires that an operating advisor be appointed for the related securitization.[74] As holder of the most subordinate claim to payment in a transaction, a B-Piece Buyer is entitled to consultation rights with respect to certain actions by the special servicer. Once the EHRI held by a B-Piece Buyer has been reduced to 25% of its original principal balance, the operating advisor will assume the B-Piece Buyer's consultation rights and act in the best interest of all investors in the securitization.

While certain CMBS sponsors have indicated their intention to satisfy the Final Rule by utilizing the B-Piece Buyer option,[75] reliance on this option has certain risks. As discussed above, the sponsor remains wholly responsible for compliance with the Final Rule, even if a B-Piece Buyer holds the entire risk retention obligation.[76] Sponsors may not wish to rely on a third party for compliance with regulations instituted by multiple federal agencies, despite any indemnification offered.[77] Additionally, the financial institutions willing to act as B-Piece Buyers have traditionally invested in below-investment grade and non-rated securities. Such securities typically represent between 2-3% of the fair value of securities issued in a transaction. As the Final Rule requires risk retention at 5% of the fair value,[78] any EHRI is likely to encompass investment-grade securities, which offer a lower interest rate. Typical B-Piece Buyers raise funds on the premise of high-risk, high-returns and may not be able to raise funds needed to purchase lower yielding interests further up the capital stack, as such purchases are much less profitable.

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[70] *See id.* at 77,644.

[71] In a situation where the risk retention obligation is satisfied by both the B-Piece Buyer (as an EHRI) and the sponsor (as an EVI), the sponsor is still required to retain an interest in each class issued, including the most subordinate class. *Id.* at 77,644. In such circumstances, the EVI would not be considered a B-Piece Buyer interest and would not prevent two additional parties from assisting to satisfy the risk retention requirements.

[72] *See id.* at 77,643-44, 77,647.

[73] *See id.* at 77,647-48.

[74] *See id.* at 77,645.

[75] *See Vertical or Horizontal? Issuers Picking Sides*, COMMERCIAL MORTGAGE ALERT, June 17, 2016, at 1, 6 (stating that at least seven issuers initially favor passing the risk retention obligation to third-party purchasers but such issuers have cautioned that any plans for risk retention remain fluid).

[76] *See id.* at 77,643-44.

[77] The penalties for non-compliance are unclear, including non-compliance by an originator or third-party purchaser, but many industry participants fear a violation of the Final Rule may result in the sponsor's inability to issue new securities.

[78] *See id.* at 77,613-14.

5. Exemption for Qualifying Commercial Real Estate Loans

The Final Rule exempts asset-backed transactions from the risk retention requirements if all or a portion of the assets securing the transaction are commercial real estate loans that satisfy specified underwriting standards ("QCRE Loans").[79] For pools comprised solely of QCRE Loans, the sponsor is not required to retain any risk retention obligation.[80] If QCRE Loans are pooled with non-qualifying assets, the sponsor may reduce its risk retention obligation by the ratio of the principal balance of the QCRE Loans to the total principal balance of all assets in the pool, up to a maximum reduction of 50% (*i.e.*, lowering the sponsor's risk retention obligation to 2.5%).[81]

Underwriting standards for QCRE Loans focus primarily on the borrower's ability to repay and valuation of the collateral. Among other requirements, a QCRE Loan must have a debt service coverage ratio of 1.7 or greater (or, in the case of certain properties with a demonstrated history of stable net operating income, 1.5 or greater (in the case of qualifying leased CRE Loans[82]) or 1.25 or greater (in the case of qualifying multi-family property loans[83])); a loan-to-value ("LTV") ratio of no more than 65% and a combined LTV ratio of no more than 70%; a minimum term of 10 years; and a maximum amortization period of 30 years for multi-family loans and 25 years for other loans.[84] In addition, the loan must be a fixed rate loan (or swapped to a fixed rate through an interest rate swap or capped with an interest rate cap) and may not be an interest-only loan or have an interest-only period.[85] Many industry participants currently believe these criteria are too conservative for the realities of the commercial mortgage market and would permit few (if any) loans to benefit from this exemption.

TAB 3

6. The Preserving Access to CRE Capital Act of 2016

On March 2, 2016, the U.S. House Financial Services Committee passed House Bill 4620, entitled the Preserving Access to CRE Capital Act of 2016 (the "CRE Capital Act").[86] The CRE Capital Act seeks to provide greater flexibility for CMBS sponsors to comply with the Final Rule by, among other things, permitting B-Piece Buyers to hold their interests on a senior-subordinate basis and relaxing the criteria for QCRE Loans. A senior-subordinate structure for B-Piece Buyers would allow the sponsor to attract different investors with different tolerances for risk and appetites

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[79] *See id.* at 77,679, 77,736.
[80] *See id.* at 77,736.
[81] *See id.* at 77,736.
[82] "Qualifying leased CRE loans" are defined by the Final Rule as "a CRE Loan secured by commercial nonfarm real property, other than a multi-family property or a hotel, inn, or similar property: (1) That is occupied by one or more qualified tenants pursuant to a lease agreement with a term of no less than one (1) month; and (2) Where no more than 20% of the aggregate gross revenue of the property is payable from one or more tenants who: (i) Are subject to a lease that will terminate within six months following the date of origination; or (ii) Are not qualified tenants." *Id.* at 77,755.
[83] "Qualifying multi-family loans" are defined by the Final Rule as "a CRE Loan secured by any residential property (excluding a hotel, motel, inn, hospital, nursing home, or other similar facility where dwellings are not leased to residents): (1) That consists of five or more dwelling units (including apartment buildings, condominiums, cooperatives and other similar structures) primarily for residential use; and (2) Where at least 75% of the NOI is derived from residential rents and tenant amenities (including income from parking garages, health or swim clubs, and dry cleaning), and not from other commercial uses." *Id.*
[84] *See id.* at 77,757-59.
[85] *See id.* at 77,681, 77,760.
[86] H.R. 4620, 114th Cong. § 2(1) (2016).

for yields.[87] The financial institutions that have typically acted as B-Piece Buyers could retain the most subordinate 2-3% of the capital stack (with the highest available yield), while other investors, more comfortable with investment-grade securities, could retain the remaining required retention interest. Similarly, the CRE Capital Act seeks to amend the requirements for a QCRE Loan to more realistic standards, including: (i) permitting interest-only loans; (ii) removing the mandatory minimum 10-year term; and (iii) permitting loans with longer amortization schedules.[88] While it addresses certain industry concerns regarding the Final Rule, many industry participants believe that the CRE Capital Act is unlikely to pass (let alone be implemented) prior to the effective date of the Final Rule for CMBS securitizations in December of this year. Accordingly, most sponsors are preparing for risk retention compliance as if no such amendments have been proposed.

7. The Impact of the Risk Retention Rules on CMBS Mortgage Loan Origination

As stated earlier in this article, there has been a significant slowdown in CMBS mortgage loan origination during the first two quarters of 2016 as a result of a very volatile market which was caused by, among other factors, the Final Rule effective for CMBS securitizations in December, 2016. CMBS sponsors have been working feverishly this year to develop their own strategies on how they will comply with the Final Rule and how such compliance will affect their business models. Will such sponsors retain an EVI or an EHRI? Will they enlist the help of an originator contributing assets to their securitization to assume a portion of the sponsor's risk retention obligation? Or will such sponsor opt to sell their EHRI to a B Piece Buyer? How will such sponsor monitor compliance by such originator or B Piece Buyer with the Final Rule (as the sponsor retains the liability for breaches notwithstanding such sale)? Will an indemnity by an originator or B Piece Buyer be enough to protect the sponsor as the penalties for non-compliance with the Final Rule are not clear? These are just a handful of issues and questions that sponsors of securitizations have had to consider this year while developing strategies in the face of implementation of the Final Rule. Additionally, a sponsor must now address whether its underwriting standards will tighten due to the long-term risk such sponsor has with respect to the mortgage loan assets in the pool. Recently, one CMBS lender/sponsor advised that under its lending platform with risk retention contemplated, interest-only loans would likely not be offered. Indicators suggest that underwriting standards may become more stringent; however, the costs resulting from a sponsor complying with the Final Rule which will be passed on to borrowers accessing the CMBS market for loans are still uncertain.[89] 2016 remains a transition year for the CMBS market and risk retention. Wells Fargo is scheduled to launch the first risk retention compliant securitization in July. Wells Fargo plans to satisfy its risk retention obligations as sponsor by retaining an EVI, and Morgan Stanley and Bank of America are expected to contribute mortgage loans to the Wells Fargo securitization. Participants in the CMBS market hope that this first risk retention compliant securitization (and its aftermath) will help to clarify the issues and concerns CMBS lenders and sponsors are wrestling with today. This initial securitization will hopefully enable CMBS lenders and sponsors to develop a more concrete set of underwriting standards and loan pricing models which would be available to borrowers and help lenders and

[87] *See id.*

[88] *See id.*

[89] Some market experts advise, however, that risk retention obligations may add another 15-30 basis points to interest rate spreads.

sponsors to better understand how their long-term liability with respect to the risk retention rules, as well as the performance of the mortgage loan assets in such securitization, will affect their overall execution (and the profit realized) on each future CMBS securitization.

TAB 3

7. Death of Guarantor Provisions

- For many commercial real estate projects, a lender requires a “warm body” personal guaranty.

- CMBS loans may be made on a non-recourse basis, with a guarantor for the “carve-outs” to the non-recourse provisions of the promissory note. The carve-outs are for defaults that are intentional in nature, such as fraud, bankruptcy, misappropriation of rents or insurance proceeds, prohibited transfers, negative material changes to the borrower’s ownership structure, and the like.

- Traditional commercial bank real estate project development loans may be made on a full recourse basis, due to the risk inherent in HVCRE

- In either case, an individual guarantor is selected based on his or her net worth and liquid assets

- The death of such person can create problems for the project and the sponsor company; usually set up as a [curable] default under the loan agreement; making it binding on the estate of the guarantor is of limited utility; instead, what is needed is a “replacement” guarantor of sufficient net worth, and who is of similar “quality” of the deceased in terms of:

    - Low credit risk, good borrowing history, lack of adverse past events like bankruptcy

    - Liquid net worth at least equal to the loan or some pre-determined amount

    - Not being listed on the OFAC list, no pending litigation

    - No limitations due to other liabilities/guaranties

- A typical clause is below:

> The occurrence of the death or legal incompetency of Guarantor[s]; [unless within the sixty (60) day period immediately following such death or declaration of legal incompetency (i) Borrower provides Lender with a substitute guarantor whose creditworthiness and real estate experience and skills are comparable to those of the original Guarantor and who is otherwise acceptable to Lender in Lender’s sole discretion, and (ii) such substitute guarantor executes a guaranty in favor of Lender in form and substance substantially similar to the existing Guaranty and otherwise satisfactory to Lender.]

- Another version as negotiated in a limited recourse guaranty on a commercial loan with a life insurance company:

Successors and Assigns. Guarantor agrees that this Guaranty shall inure to the benefit of and may be enforced by Lender, its officers, directors, shareholders, employees, agents, attorneys, successors and assigns, and any subsequent holder of the Note and the other Loan Documents, and shall be binding upon and enforceable against Guarantor and Guarantor's heirs, legal representatives, successors and assigns. Notwithstanding the foregoing, within one hundred twenty (120) days of the death of any Guarantor (if Guarantor is a natural person) an Immediate Family Member (as defined in the Loan Agreement) or any trust for the benefit of an Immediate Family Member with net worth equal to or greater than $10,000,000.00 and otherwise acceptable to Lender in its commercially reasonable judgment, shall execute Lender's then current form of "Carveout Guaranty" and Indemnity Agreement, Lender shall receive such information, documentation and opinions as may be required by Lender in connection with such replacement guarantor, and Borrower shall reimburse Lender for all of Lender's reasonable attorneys' fees and costs and expenses incurred in connection with its review of the proposed replacement guarantor and the documentation of any substitution, whether or not Lender approves the proposed replacement guarantor.

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Effective Advocacy Before the Supreme Court

R. Patrick DeWine
Ohio Supreme Court Justice

[redacted]

APPELLATE PRACTICE »

Effective Appellate Brief Writing

By Hon. Richard A. Posner

Successful communication requires the communicator to understand how much the person or persons to whom he is communicating understands. If the communication takes the form of an appellate brief, the writer must understand the limits of understanding of the appellate judges, along with the concerns of the judges.

Communication is usually straightforward among peers; they understand each other; they know where each other is "coming from." The problem that the appellate brief writer faces is that his or her intended audience does not consist of other appellate brief writers, or indeed of other practicing lawyers. Many appellate judges were practitioners once, but many were not; and even those who were are unlikely to have been experts in the particular area of law in which a case arises, unlike (in all likelihood) the appellate brief writer. Moreover, modern people are good at playing different roles; and the role of the judge is very different from that of the practitioner. It is as a judge that a judge reads a brief, not as a former practitioner.

The judge is a decision maker. Everyone knows that distinction between an advocate and a judge. But it's just the beginning of the differences in perspective between the two roles.

So, my essential advice to the appellate brief writer is to put yourself in the judge's shoes all the way, as it were. That will help you grasp the relevant differences between judge and advocate and so will enable you to write a brief that will communicate your position effectively.

You will, if your imagination is working properly, understand the following things about appellate judges: that we won't spend nearly as much time on the case as you will; that we are likely to know far less about the parties and about the commercial field in which the cases arises, or other real-world context of the case, than you; and that unless you are arguing a criminal appeal, we're unlikely (because of the vastness of the jurisdiction of the federal courts, which via the diversity jurisdiction encompasses most state law as well) to have a deep or comprehensive knowledge of the law applicable to your case, although this will vary from judge to judge depending on the judge's background and interests. But in the Seventh Circuit, the appellate panel that will decide your case is not announced in advance. It is drawn randomly from the court's judges, so you cannot count on the panel's containing a judge who knows a lot about the particular field of law in which the case arises, even if there is such a judge on the court.

It will also help you as an advocate if you understand—though this is probably the most difficult thing for a practicing lawyer to understand about the judiciary—that we judges are for the most part practical people (even the former academics among us). We are conscious that our decisions make a difference in people's lives, which is a different feeling or sensation or awareness from being handed a case and told to make as persuasive an argument for it as you can within legal and ethical limits. We judges want to reach a sensible and reasonable result in those cases—and they are surprisingly common—that are not governed by clear statutory text or precedent. A result is sensible and reasonable if it could be explained and justified to a layperson. We therefore are interested not merely in the rule on which you rely, but in the rule's purpose as well, and not merely in the facts as developed in an evidentiary hearing, but also in nonadjudicative facts that illuminate the background and context of a case—that make the case come alive to a person not immersed in the field of law, or the commercial or personal situation, out of which it arises. Don't just state a rule and argue a semantic correspondence between it and the facts of the case.

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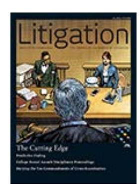

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So now that you know what you need to know about the bench, the specific advice that follows should be easy to understand and to follow. Do some online background research—explore Google, Wikipedia, Google Earth, and the other riches of the Web for information that will help you to help us to a realistic understanding of your case—just as "real" people do, and as judges and their law clerks (and even jurors!) increasingly are doing.

I have been doing this in some of my cases of late and have been criticized that in doing so I have been "going outside the record." It would be a just criticism if I was looking for adjudicative facts on the Web, the kind of facts that benefit from being tested in an adversary proceeding governed by the rules of evidence. But I am not. It should be obvious (if you imagine yourself an appellate judge) that much that goes into a judicial decision was never a part of any evidentiary record. The judicial mind is not a tabula rasa. It is informed and enriched by a judge's experiences, impressions, temperament, and outside reading, which increasingly is the reading of online materials. The Web is an open source; it is as great a resource for lawyers as for judges—and is underutilized by both.

Another way to think about Web research: When you're writing your brief, think of the questions that a layperson would ask about the case; a judge is likely to have the same or similar questions.

Wherever possible, use pictures, maps, diagrams, and other visual aids in your briefs. Some lawyers seem to think a word is worth a thousand pictures. The reverse, of course, is true. *Seeing* a case makes it come alive to judges.

Many years ago I was on the panel that heard an appeal in a trademark dispute between the Indianapolis Colts and the Baltimore CFL Colts. The briefs described the trademarked products (such as hats and T-shirts) but did not include pictures. At the oral argument, one of the judges (OK, I confess—it was I) asked the lawyer for the Indianapolis Colts whether he had any of the products with him. He was a little startled but went to his briefcase and pulled a pair of hats, one an Indianapolis Colt hat and the other a Baltimore CFL Colt hat. The hats looked identical. He won his case at that moment. He was lucky that he was asked that question. He would not have needed luck had he included a photograph in his brief.

Avoid jargon: business jargon, industry jargon, computerese and other technical jargon (and yes, economic jargon, too), and legal jargon. Avoid legal clichés, such as "plain meaning" (typically, and futilely, argued by both sides in the same case!). At an oral argument last year, baffled by the briefs in a case involving the Telecommunications Act of 1994—briefs bristling with esoteric legal and technical jargon—and we do not hear cases under that act often enough to become experts in it—I said to one of the lawyers that my law clerks and I had read the briefs and had no idea what the case was about, and would he please explain it to us in words of one syllable. Like the Indianapolis Colts' lawyer, he was a little taken aback, but complied, and, being in fact an excellent lawyer, he gave a perfectly lucid, totally jargon-free explanation of the case, and the judges were very happy (and he won). But again, he was lucky that he was asked to explain his case, and he would not have needed luck had he realized in writing his brief that generalist federal judges do not have the level of understanding of members of the Federal Communications Commission.

Do not beat us over the head with statutory language and precedent. Your case, unless it is a federal criminal case, probably would not have reached the court of appeals if it had been clearly governed by a statute or a case. I am not saying that you should ignore relevant statutory text and precedents, but they are more likely to narrow the area of contestable disagreement than to resolve the case. You will have to extract the purpose of the statute and excavate the policies underlying the precedents to make a cogent argument that the statute and the precedents support (and if you are lucky, compel) the outcome that you are urging.

And—a closely related point—do not exaggerate the cogency of reasoning by analogy by trying to persuade us to base our decision on a previous case, especially a case from another field of law. The value of analogous cases lies in the reasoning or policies that the opinions disclose that may bear on your case, and it is the reasoning and policies that you should emphasize.

Speaking of precedent, go light on district-court citations, remembering that they are *not* precedents. This is not said in disrespect of district judges, but in recognition of the fact that if district-court decisions were given precedential effect, there would be no uniformity of federal law within a district or circuit.

Be brief. Judges do a lot of reading. (Holmes once said that he was paid to read—that was his job.) We get tired or bored, and some of us tend to start skimming when we encounter a tedious, repetitious brief.

Two last points. One, do not omit from your brief, especially if you are the appellant, mention of the strongest points that you know your opponent will make in his or her brief. Often I read the appellant's brief and think, how could the district judge (or administrative agency) have made such a mistake, committed such an injustice! And then I read the appellee's brief and realized that the appellant's brief had omitted the points that showed that the lower-court opinion, whether ultimately persuasive or not, was at least reasonable. And when that happens, one loses confidence in the appellant's position.

When a lawyer plans to put his or her client, a criminal defendant with a criminal record that can be used to impeach his or her testimony, on the stand, the lawyer typically will bring out his or her client's record on direct examination to pull the sting by showing to the jury that he or she isn't afraid of the fact that the client has a record. And then the prosecutor's effort to use the record against the defendant on cross-examination is likely to fall flat (and indeed may be blocked by the judge as improper harping on the defendant's record). Similarly, when the appellant's brief "fronts" the weaknesses in his or her case, and deals with them as best he or she can, that prevents the appellee from making a seemingly devastating riposte.

Two, do not forgo the opportunity to file a reply brief. The appellee is bound to make *some* halfway decent points in rebuttal of your appeal. Don't let him or her have the last word.

And that is my last word on this important and challenging subject.

Keywords: litigation, appellate practice, brief writing

Hon. Richard A. Posner is a judge serving on the U.S. Court of Appeals for the Seventh Circuit.

This article appears in the Spring 2010 issue of *Appellate Practice Journal*, the newsletter of the Appellate Practice Committee.

Comments

- November 15, 2011 – I am a pro-se appllant in 3rd cir. in employment discrimination case (Funayama v Nichia America et al). This article was helpful for me to determine that I must file the rebuttal to Defendants' brief. Thank you!!

- September 1, 2010 – He's really on to something when he mentions photos and simple language in briefs- appellate court is 90% facts, 10% law, but people mistakenly think the opposite is true. As for discoursing in briefs about the 'purpose' of statutes, the 'adjudicative facts,' and Wikipedia and Internet sources- I say go light on that. Other than Judge Posner himself, many judges are downright suspicious of such citations, and will think you must have no law in your favor if you've got to give them policy arguments.

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Readable Briefs for Busy Judges

By Stephen Shapiro

Discussions of good legal writing are really discussions about the needs of the intended audience. Appellate judges write for a diverse group of readers: justices of the Supreme Court, judges in other circuits, district judges, winning and losing litigants, law-enforcement officials, lawyers advising clients, academics and law students, and even, as Justice Black once put it, "the boys in the barbershop." No wonder we have various theories about what makes a good appellate opinion.

But lawyers appearing in federal courts of appeals address a more limited audience. We write for three busy judges loaded down with briefs in six to nine cases every argument day, with over 1,000 pages of reading material. And the old advice about changing places with the judges applies more than ever as case loads rise. We need to help the judges get through this pile efficiently and understand our client's story, explained in terms of record facts and legal principles.

Good writing meets the needs of these busy people. Suggestions on good writing appear in Mayer Brown's recent volume, *Federal Appellate Practice* (2008), as well as *Making Your Case* (2008), by Antonin Scalia and Bryan J. Garner. I can sum up the key rules by repeating advice I got from Judge Easterbrook 30 years ago when he served as deputy solicitor general: Follow standard rules of usage, grammar, and punctuation. Use short sentences. Use short paragraphs. Use active verbs. Use headings or subheadings every three or four pages. Reduce footnotes to a minimum and keep them short. And include a short preamble at the beginning of argument sections to explain where your argument is headed.

Once you have drafted the brief and have made sure that it complies with all rules of the court in which you are filing, show it to someone in your office who has no knowledge of the case. Find out if the brief reads easily and tells a compelling story. I recommend the "one sitting" rule and the "two martini" rule. If the brief can't be read in one sitting, it is too long. If it can't be understood after two martinis, it is too complicated. When revising, do your best to minimize jargon. Judges appreciate direct, colloquial writing. And be sure to explain unfamiliar terms and technologies in simple language. A glossary of unfamiliar terms and acronyms at the front of the brief is required in some circuits and is good practice everywhere. In many cases, acronyms can be avoided by, for example, calling an agency with a cumbersome name "the Commission."

Let's talk for a minute about the first 15 pages of the brief, which lawyers struggle to get right. The biggest problem I see with statements of facts in briefs is that they go on and on in mind-numbing detail without letting the reader know why he or she is getting all this information. Without some indication of its ultimate relevance, the reader can't absorb the detail.

> When the judges see headings and subheadings in the table of contents, the argument pops up in short form.

The following techniques help.

In some cases, a two- or three-sentence preface before stating the questions presented opens the door to comprehension. The questions take on meaning from the preface; otherwise, they may be unintelligible. Examples of prefatory statements appear in the Mayer Brown book on appellate practice. Questions should not be overly argumentative, but they should orient the reader in a way that leads to a correct resolution of the case.

In the statement of facts, you can begin with a one-page preamble that says what the case and appeal are all about. This isn't the place to argue, but to advise the reader on what is at issue and why the case is important in real-world terms.

If the case comes up in a novel field, consider including a short opening section in the statement entitled "statutory background" or "regulatory background." This gives the court a snapshot view of the legal framework and makes the factual recital more understandable.

In the statement itself, I recommend subheadings that break up an endless scroll of detailed information. For example, you might break the statement down into "the gold mining industry," "background of the dispute," "allegations of the complaint," "proceedings in the trial court," "evidence presented," and "the trial court's rulings." Some lawyers write very long factual statements, but ordinarily that is a bad idea. Present the facts in digestible bites, all supported by accurate record cites. You can elaborate facts as relevant to particular legal arguments after your initial factual presentation.

As Judge Easterbrook recommended, the headings and subheadings in the argument should be short sentences that sum up the point developed in your next few pages. The headings and subheadings in sequence tell your whole story. So when the judges see them in the table of contents, the argument pops up in short form. Don't use mere "topical" headings, such as "The Due Process Issue." That doesn't give the reader any road map.

How about the number of questions presented? As a young lawyer, I was told that if anyone on the trial team thought an issue had merit, I should shovel it in. That wasn't very good advice. Judges will confirm that when they get shotgun appeals, they assume that the arguments are going to be weak ones. No one can believe that there are a dozen reversible errors in a single case. Wherever possible, assert one, two or three questions on appeal and weave them together in an integrated, thematic way in the body of your argument. That has more impact.

What about the summary? Justice Scalia's excellent book questions the value of summaries. I doubt that is the general view; after all, the rules still require them. And Justice Thomas has asserted just as vigorously that summaries are exceptionally important to him. Either way, Justice Scalia's view represents fair comment on the quality of summaries many lawyers provide. Save your summary for the last part of your drafting effort. Make it interesting and not just verbatim repetition. For most briefs, a summary of three or four pages suffices. Longer summaries bog down the reader. Again, think of this as a bridge to your argument that prepares the reader for the coming detail.

Lawyers give insufficient attention to the "standard of review" discussion preceding legal arguments. Most just say review is "de novo" or "deferential" and cite a case. Much depends on the standard of review, so it is best to spoon-feed the judges. Demonstrate what standard applies to particular issues. For example, legal standards, legal conclusions and reasoning, and policy analysis of lower courts get de novo review. Sometimes application of the law to a particular record gets searching review because of the need for appellate guidance, even in a jury case (e.g., *Brooke Group v. Brown & Williamson*).[1] Findings of historical fact and resolution of witness credibility get deferential review, but occasionally appellants prevail on such issues when the record is one-sided and a shocking error appears—the case thus flunks the "dead, unrefrigerated fish" standard. If you represent the appellant, cite cases from your circuit, showing that you are entitled to meaningful review on all your issues. The appellee will cite precedent showing that deferential review applies and requires affirmance. *Federal Standards of Review* by Steven Alan Childress and Martha S. Davis (1999), is a good starting place for research. Do your homework by focusing on the law of your circuit for particular issues.

On substantive legal arguments, I suggest sticking with the rule of first things first. The Supreme Court tells us to start with the statutory language if we have a statutory issue. Then turn to the structure and purpose of the statute and the lessons they teach. If regulations are involved, they come after the statute. Don't blow your credibility by saying that the language is "plain" if it is not.

Of course, when addressing case law, Supreme Court precedent deserves the most attention, along with precedent from your court of appeals. But the judges care about law in other circuits, too. And while district court precedent counts for less, you can, if true, point out that a majority of district courts agree with you.

Lawyers always seem to say too little or too much about the key cases. Many briefs go on for page after page about a particular case, giving all the facts and then offering lengthy block quotes. That isn't very effective. Nor is it effective to just cite cases in a string or offer snippet quotes. Describe the background and holding of an important case in a few sentences, with a short quote.

> Don't blow your credibility by saying that the language is "plain" if it is not.

But bear in mind the limits of case-law precedent. There are rarely "on point" holdings that compel a result. Because of this, you need to explain the sound reasons for applying the rule or precedent that you advocate. Justices and appellate judges have commented that if the precedents lead to a bad result, they will distinguish or rethink the precedents. As my mentor Bob Stern used to say, always explain "the reason why."

What about legislative history? Of course, it comes after your analysis of statutory language. Some judges attach importance to it. Others don't because Congress hasn't enacted it and the president hasn't signed it. To cover bases with judges who consider legislative history, I try to show that the enactment background supports the best reading of the statutory language. Use the most authoritative materials—conference reports, key committee reports, and, of course, statements of purpose that may be included in the statute itself. Statements in floor debates count for little unless a sponsor of the legislation has something important to say.

I should add a word about policy and pragmatic arguments. Lawyers need to cover these important arguments and do so in persuasive detail, but after wrestling with the statutory language and precedents. This is paradoxical. The policy argument may be the most effective part of your brief, but it can't be the first part, at least in full-blown form. You don't want your opening salvo to sound like an appeal for judicial legislation or, worse yet, an effort to dodge statutory language and case precedent.

So what policies count? The policies that count are those articulated by Congress and the Supreme Court, not our own sense of good and bad. But that doesn't mean you should leave out arguments based on fairness, predictability, the needs of law enforcement, economic effects, and burdens on the judicial system. A good pragmatic argument focuses on all the points that a reasonable person would view as significant, as Judge Posner has discussed in thoughtful books and articles, including *The Problems of Jurisprudence*.[2] It provides a powerful finale to your brief. Support policy arguments with conventional legal authorities and academic writing, including materials on the Web that are subject to judicial notice. Appellate judges not only read the newspaper but also search the Web.

What makes a brief interesting and worthy competition for the evening news? As the chief justice said in a recent interview: Tell a good story. Active verbs keep the story rolling. So do short sentences and conversational vocabulary, as used by the best journalists. Varied punctuation, sentence length, and sentence structure help maintain interest. You may want to italicize once or twice for emphasis, but no more. More than that looks like shouting. Bullet points add variety, but use them only once in a brief. A well-chosen metaphor enlivens your argument. And an occasional short paragraph gives extra punch. Avoid large numbers of footnotes, especially argumentative footnotes. Nothing interrupts a good story more than dizzy plunges from text to footnote, where type is small and single-spaced. And be sure to edit your brief energetically to cut out the flab. Always use a good page printer and photocopier: Big, dark type that jumps off the page helps the reader; faded or uneven type causes eye strain and annoyance.

Of course, practical consequences make your judges care about the outcome. Within the limits of controlling legislation and precedent, judges try to avoid bad consequences for society and the judicial system, while treating litigants fairly. So you need to explain why reversal or affirmance will make the world a better place. In doing so, write for the whole court, with arguments that will appeal to judges of various philosophies.

Complete candor in discussing record facts and legal authority is, of course, essential to any brief filed in court. Fess up to weaknesses and then deal with them in your argument; don't wait for the reply brief to do so. As Judge Posner has observed, a concession can be a source of strength rather than weakness. It proves that your position holds up under fire.

Whether filing a joint or separate appendix, try your best to make it a user-friendly document. Appellate judges have said repeatedly that appendixes are too long, so limit your appendix (beyond required materials) to one volume whenever possible. Include an informative index that tells the judges what each item is and where it appears in the record. Include enough testimony from key witnesses so that the reader understands who they are and what they have to say. Unless rules require otherwise, place key exhibits at the end—your best documents only—and always make sure they are readable.

My final comment is on typos and miscites. Many judges have said that if a lawyer doesn't care enough about the brief to root out typos and miscites, that reflects negatively on the whole presentation. So we should do our best to give the court perfect work. ■

Stephen Shapiro is a partner at Mayer Brown in Chicago, Illinois.

Endnotes

1. 509 U.S. 209, 230 (1993).
2. Richard A. Posner, The Problems of Jurisprudence 454–69 (1990).