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CORPORATE LAW UPDATE

Recent Developments in Ohio Corporate Law

There have been three recent, notable cases affecting Ohio corporate law. In *Dombroski v. WellPoint, Inc.*, the Ohio Supreme Court held that a plaintiff seeking to pierce the corporate veil must show that the controlling shareholder(s) acted “in such a manner as to commit fraud, an illegal act, or a similarly unlawful act.” In *Minno v. Pro-Fab, Inc.*, the Ohio Supreme Court held that a corporation’s veil cannot be pierced to reach a sister corporation’s assets where neither sister corporation has an ownership interest in the other. In *Century Business Services, Inc. v. Urban*, the Eighth District Court of Appeals held that non-compete covenants that accompany the sale of a business are subject to the same considerations as those in the employment context, but courts should not scrutinize the reasonableness of those restrictions to the same extent.

During 2008, there were also a few notable legislative developments. The Ohio General Assembly passed Substitute House Bill 332, which adopted the Revised Uniform Partnership Act for all new partnerships established after 2008 and for all existing partnerships as of January 1, 2010. The General Assembly also passed Substitute House Bill 160, which enables an LLC to be a nonprofit entity, and Substitute House Bill 374, which enables corporations to eliminate cumulative voting in their original articles, permits a corporation’s articles to provide for uncertificated shares, and exempts the sale of all or substantially all of a corporation’s assets to a wholly owned subsidiary from shareholder approval.

Finally, the Ohio Supreme Court has begun its pilot program for commercial dockets in select Ohio Courts of Common Pleas.

CASE LAW

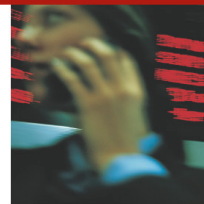
Test for Piercing the Corporate Veil Modified

In *Dombroski v. WellPoint, Inc.*, the Ohio Supreme Court resolved a split between the appellate courts regarding the interpretation of the second prong of the *Belvedere* test for piercing the corporate veil. In *Belvedere Condominium Unit Owners’ Association v. R.E. Roark Cos., Inc.* (1993), 67 Ohio St.3d 274, the Court held that a plaintiff may pierce the corporate veil “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 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.” In *Dombroski*, the Court concluded that the language of the second prong should be modified to read “in such a manner as to commit fraud, an illegal act, or a similarly unlawful act.” (emphasis added).

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The case arose when Dombroski’s health insurer, a wholly owned subsidiary of WellPoint, Inc., denied her request for coverage for a bilateral cochlear implant that was deemed “medically necessary” by her physician. After losing an internal appeal, Dombroski sued her insurance company, its administrator and WellPoint for denying her coverage in bad faith—an actionable tort in Ohio. Dombroski sought to recover damages from WellPoint because it owned 100 percent of her health insurer, the same officers ran WellPoint as did the insurer and WellPoint set the medical policy for the insurer.

After the trial court dismissed the case for failure to meet the *Belvedere* test, the Seventh District Court of Appeals reversed and held that Dombroski had pleaded sufficient facts to state a claim for veil-piercing because the second prong could be met by proving that the controlling shareholder(s) had used the corporation to commit “unjust or inequitable acts,” not just fraud or illegal acts. (*Dombroski v. WellPoint, Inc.*, 173 Ohio App.3d 508, 2007-Ohio-5054.)

That interpretation was at odds with the interpretation of other Ohio appellate courts. For example, in *Collum v. Perlman* (Apr. 30, 1999), Lucas App. No. L-98-1291, the Sixth District Court of Appeals narrowly interpreted the second prong and limited piercing to cases where the controlling shareholder(s) had used the corporation to commit fraud or an illegal act. The Seventh District acknowledged that its interpretation of the second prong conflicted with that of the Sixth District and certified *Dombroski* to the Ohio Supreme Court.

The Supreme Court’s holding tried to strike a balance between the two interpretations. The Court recognized that veil-piercing is an equitable remedy and that limiting it to cases of fraud or illegality might be insufficient to protect potential parties from shareholders’ misconduct. At the same time, enabling piercing for any unjust act could open the floodgates to piercing claims in nearly every suit involving a closely held corporation because such suits generally meet the first *Belvedere* prong by definition and “nearly every lawsuit sets forth a form of unjust or inequitable action.” In deciding not to recognize the more liberal interpretation of the Seventh District, the Court emphasized that piercing the corporate veil should be a “rare exception” that only applies “in the case of fraud or certain other exceptional circumstances.”

Although the Court slightly relaxed the second *Belvedere* prong for piercing the corporate veil to include “fraud, an illegal act, or a similarly unlawful act,” it held that the tort of insurer bad faith did not rise to that level. (*Dombroski v. WellPoint, Inc.*, 119 Ohio St.3d 506, 2008-Ohio-4827.)

No Veil Piercing to Reach Sister Corporation

In a second veil-piercing case, the Ohio Supreme Court held in *Minno v. Pro-Fab, Inc.*, that a corporation’s veil cannot be pierced to reach a sister corporation’s assets where neither sister corporation has an ownership interest in the other.

Minno, an ironworker, sued his employer, See-Ann, Inc., for injuries suffered in the scope of his employment and concurrently sued See-Ann’s sister corporation, Pro-Fab, Inc., “alleging that Pro-



Fab was in control of the work site, was the alter ego of See-Ann, and was, therefore, also liable for his injuries.” See-Ann and Pro-Fab shared “common owners and officers, engage[d] in a similar line of work, and [had] the same business address,” but were separate legal entities with separate incorporation dates. Based on the companies’ relationship, Minno sought to pierce See-Ann’s corporate veil to reach Pro-Fab’s general-liability insurance policy.

The trial court granted summary judgment for Pro-Fab because the court found that Pro-Fab had no control over Minno with regard to his employment activities. The Eleventh District Court of Appeals reversed the decision because it found “that Minno had presented sufficient evidence to demonstrate a genuine issue of material fact regarding whether Pro-Fab was fundamentally indistinguishable from See-Ann,” and consequently, whether Minno could pierce See-Ann’s corporate veil to reach its sister company’s assets.

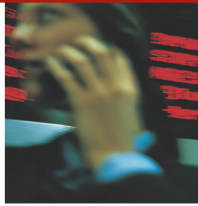
The Ohio Supreme Court reversed the appellate decision. Citing *Belvedere* and *Dombroski*, the court held that while the doctrine of piercing the corporate veil can be applied to situations where a shareholder or parent company has a controlling ownership interest in the corporation that committed the allegedly wrongful acts, “common shareholder ownership of sister corporations does not provide one sister corporation the inherent ability to exercise control over the other.” Consequently, because See-Ann and Pro-Fab were separately incorporated and neither had an ownership interest in the other, the doctrine of piercing the corporate veil did not apply. (*Minno v. Pro-Fab, Inc.*, Slip. Op. No. 2009-Ohio-1247.)

Less Scrutiny for Restrictive Covenants Ancillary to the Sale of a Business

In *Century Business Services, Inc. v. Urban*, the Eighth District Court of Appeals held that a non-compete provision (*i.e.*, restrictive covenant) in an employment agreement receives less scrutiny if the agreement was executed in the context of the sale of a business and the restriction should be enforced if it is reasonable under the *Raimonde* test.

In *Raimonde v. Van Vlerah* (1975), 42 Ohio St.2d 21, the Ohio Supreme Court addressed a restrictive covenant in an employment contract and found that for the covenant to be enforceable it must be no greater than required to protect the employer’s legitimate business interests; must not impose an undue hardship on the employee; and must not be injurious to the public. To determine whether such a covenant needs to be amended or modified to meet those criteria, courts are instructed to evaluate the facts and circumstances of each case, including, without limitation, any limits on the length or geographic reach of the restrictions, the employee’s knowledge of confidential information or past contacts with customers and the balance between the covenant’s benefit for the employer and the detriment to the employee.

The *Urban* case arose after Urban sold his accounting business in a deal that included non-competition and non-solicitation restrictions in the asset purchase agreement and resulting executive employment agreement. The provision in the asset purchase agreement prohibited Urban from



competing by offering accounting services in any county where the new firm operates for a period of five years. A similar restriction in the executive employment agreement lasted for 13 years.

Eight years after the sale, when the covenant in the asset purchase agreement had expired, but the longer covenant in the employment agreement was still active, the acquiring company fired Urban. He informed the acquirer that he intended to compete with the company, and the company sued to enforce the covenant. In arguing that the terms of the covenant were reasonable, the plaintiff relied on evidence showing the value Urban had received for his company's goodwill and that Urban had actively negotiated the restrictive provision.

The trial court found that Urban's covenant was reasonable based on the *Raimonde* factors. The Eighth District concurred and noted that restrictive covenants in an employment agreement entered into as part of the sale of a business should receive less scrutiny than those in a normal employment contract because the parties have greater power to negotiate and the seller receives additional compensation for the goodwill of the company. Consequently, where the covenant meets the reasonability test for a typical employment context, it will by definition meet it for the sale of a business context. (*Century Business Servs., Inc. v. Urban*, 2008-Ohio-5744.)

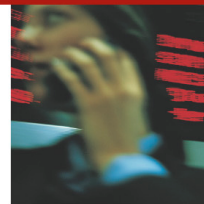
LEGISLATIVE DEVELOPMENTS

Adoption of the Revised Uniform Partnership Act

In passing Substitute House Bill 332, the Ohio General Assembly adopted the Revised Uniform Partnership Act (RUPA), chapter 1776 of the Ohio Revised Code (O.R.C.). More than 30 states have adopted RUPA or similar statutes. RUPA will govern new partnerships established on or after January 1, 2009, as well as partnerships that elect to be covered by it. Effective January 1, 2010, RUPA will govern all partnerships in the state, and the then-existing partnership laws in chapter 1775 will no longer govern any partnerships. Because the rights and obligations of a general partner in an Ohio limited partnership are based on those of a partner in a general partnership (*see* O.R.C. § 1782.24), the provisions of RUPA will affect limited partnerships, too.

Among the changes to Ohio's partnership law is a change in the effect of a partner leaving the partnership. Under the old law, if a partner died or was expelled, or an event specified in the partnership agreement occurred, the partnership was required to be dissolved. Under RUPA, such events constitute a partner's "dissociation" and do not necessarily trigger the partnership's dissolution. With the exception of a partner voluntarily leaving an at-will partnership, the exit of a partner from a partnership by death, expulsion or certain other events gives the remaining partners an opportunity to buy out the exiting partner's interests in the partnership without dissolving the partnership.

The adoption of RUPA also clarifies the fiduciary duties owed by a partner to the partnership, which the previous statute did not address. Until RUPA's adoption, partners had a fiduciary obligation to act in the utmost good faith and integrity in their partnership dealings based on courts' interpretations of the common law. RUPA codifies and bolsters partners' fiduciary duties by stating



that partners owe a duty of loyalty and care to the partnership, and those duties cannot be mitigated or eliminated by contract. Section 1776.44 describes the meaning of those duties:

Duty of Loyalty: (1) To account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity; (2) to refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to the partnership; and (3) to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.

Duty of Care: To refrain from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.

Additionally, Section 1766.44 requires a partner to exercise his duties and rights under the partnership in good faith and by fair dealing. Finally, the statute expressly states that a partner's actions made in his own self-interest, such as borrowing from or lending to the partnership, do not necessarily violate the partner's statutory obligations.

Enabling LLCs To Be Nonprofit Entities

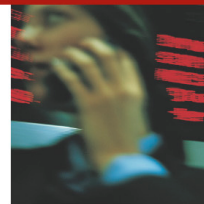
The Assembly's adoption of Substitute House Bill 160 provides that limited liability companies (LLCs) may be nonprofit entities. The act amends Section 5701.14 of the O.R.C. to define a limited liability nonprofit company as one "organized other than for the pecuniary gain or profit of, and [where] its net earnings or any part of its net earnings are not distributable to, its members, its directors, its officers, or other private persons, except [as] ... reasonable compensation for services rendered ..." The act also made changes regarding certain tax exemptions.

Allowing Elimination of Cumulative Voting in Director Elections

Substitute House Bill 374 primarily made three changes to Ohio law. First, it revised Section 1701.04(c) to enable corporations to eliminate cumulative voting for electing directors in the corporation's initial articles of the corporation. Previously, corporations were required to have cumulative voting for at least 90 days before they could amend their articles.

Second, the bill permits a corporation's articles to provide for uncertificated shares, whereas the previous provision entitled any shareholder to request a certificate.

Third, the bill exempts the sale of all or substantially all of a corporation's assets to a wholly owned subsidiary of the corporation from needing shareholder approval, as otherwise required by Section 1701.76.



For additional details on these and other legislative changes, see www.com.ohio.gov/secu/docs/2008%20Legislative%20Update%20Outline%20-%20Kelly.pdf.

JUDICIAL DEVELOPMENTS

Ohio Commercial Docket Pilot Program

The Ohio Supreme Court's commercial docket pilot program, originally announced in 2007, is under way in the Common Pleas Courts of Cuyahoga, Franklin, Hamilton and Lucas Counties and will continue through July 2012. The commercial docket program gives the Supreme Court the power to appoint judges from each participating court to preside over business-to-business disputes. The hope is that judges specializing in business disputes will enable the judiciary to handle such cases with greater expertise and efficiency and will encourage businesses to conduct more operations in Ohio as well as keep more of their legal expenses in the state. The cases tried on the commercial docket will include disputes regarding the formation or liquidation of a business; the rights of shareholders or owners; trade secrets or other intellectual property issues; non-competition agreements; and business-to-business contracts, investments or transactions.

The Supreme Court has adopted temporary rules governing the program, including requirements that commercial docket judges rule on motions within 60 days or appoint magistrates to preside over hearings. The participating judges are Judges Richard McMonagle and John O'Donnell (Cuyahoga County); Judges John Bessey and Richard Frye (Franklin County); Judges Steven Martin and Beth Myers (Hamilton County); and Judges Gary Cook and Gene Zmuda (Lucas County).

For more information on the program, see www.fccourts.org/gen/webfront.nsf/wp/86D40221179416698525750700593AE1?opendocument or www.sconet.state.oh.us/boards/commDockets/default.asp.

FOR MORE INFORMATION

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