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Shareholder Liability in Ohio: Confounding Attorneys and Others, South High Development Limited v. Weiner, Lippe & Cromley Co., L.P.A.

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PROFESSIONAL CORPORATIONS

Shareholder Liability in Ohio: Confounding Attorneys and Others

*South High Development Limited v.
Weiner, Lippe & Cromley Co., L.P.A.*

4 Ohio St. 3d 1, ___ N.E. 2d ___ (1983)

I. INTRODUCTION

THE LATEST CHAPTER in the unusual history of professional corporations was written recently by the Ohio Supreme Court in *South High Development Limited v. Weiner, Lippe & Cromley Co., L.P.A.*¹ The rationale of *South High Development* has laid the foundation for an argument that the usual limitations on corporate shareholder liability, provided by article XIII, section 3 of the Ohio Constitution, are inapplicable to professional corporations. The holding of *South High Development* has jeopardized the corporate status for tax purposes of existing legal professional associations² (L.P.A.) and may have brought to an end the short-lived but vigorous growth of that form of law practice in Ohio. Although these results may not have been intended, they are consequences which flow naturally from the court's opinion.

The purpose of this article is to explore the soundness and ramifications of *South High Development*. To begin, the case holding will be summarized and the history of professional corporations reviewed. Special emphasis will be placed on Ohio legal professional corporations. A critique of the court's rationale and analysis of its implications will then follow.

II. FACTS AND HOLDING OF SOUTH HIGH DEVELOPMENT

South High Development arose when an L.P.A., consisting of three attorney shareholders, breached a lease on office space. The lessor, South High Development Limited, instituted suit to recover for the breach naming both the L.P.A. and the individual attorneys/shareholders as defendants.³ The court of common pleas dismissed the individual defendants on the theory that the corporate form afforded them limited liability in their shareholder capacities. It later entered judgment against the L.P.A.⁴ This result was affirmed in the

¹4 Ohio St. 3d 1, ___ N.E.2d ___ (1983).

²The legal attributes of a L.P.A. are in most respects identical to those of a typical corporation. Consequently, the terms "association" and "corporation" are used interchangeably throughout this article.

³4 Ohio St. 3d at 2, ___ N.E.2d ___.

⁴*Id.*

court of appeals.⁵

Unsatisfied with a judgment solely against the L.P.A., plaintiff continued its appeal. Plaintiff appealed the dismissal of the individual attorneys/shareholders on the theory that Gov. R. III, section 4⁶ created individual liability for the corporate debt. Ultimately, the supreme court concurred with plaintiff's theory and held in its favor. This result involved three independent holdings. First, the court held that a distinction exists between "private" and "professional" corporations which places the latter group beyond the constitutional protection provided shareholders by Ohio Constitution article XIII, section 3.⁷ By drawing this distinction, the court defeated defendants' argument that limited liability is constitutionally mandated. Next, the court held that Gov. R. III, section 4, promulgated under authority of Ohio Constitution article IV, section 5(B)⁸, supersedes section 1785.04 of the Ohio Revised Code⁹ to the extent of inconsistency with the Rule. Section 1785.04 purports to preserve within professional corporations the legal relationships commonly found in non-professional corporations. With this second holding the court eliminated the only other positive law in defendants' favor. In opposition to such a holding and in an attempt to disarm Gov. R. III, section 4, defendants argued that the court's rule-making power is limited, under Ohio Constitution article IV, section 5(B),¹⁰ to matters of procedure; matters of substantive law are excluded. In response, the court finally held, in effect, that the constitutional limitation is applicable only to promulgation of procedural rules, not to promulgation of rules aimed at administering the court's inherent¹¹ and statutory¹² power over the practice of law.

III. THE HISTORY OF PROFESSIONAL CORPORATIONS

Before examining the soundness of the *South High Development* decision, it is helpful to trace the brief history of professional corporations. Statutes

⁵South High Development, Ltd., v. Weiner, Lippe & Cromley, No. 81AP-810 (Ohio App. March 9, 1982).

⁶Gov. R. III, § 4 provides: "The participation by an individual as a shareholder of a legal professional association shall be on condition that such individual shall, and by such participation does, guarantee the financial responsibility of the association for its breach of any duty, whether or not arising from the attorney-client relationship."

⁷OHIO CONST. art. XIII, § 3 provides: "Dues from private corporations shall be secured by such means as may be prescribed by law, but in no case shall any stockholder be individually liable otherwise than for the unpaid stock owned by him or her"

⁸OHIO CONST. art IV, § 5(B) provides in part: "The supreme court . . . shall make rules governing the admission to the practice of law and discipline of persons so admitted."

⁹OHIO REV. CODE ANN. § 1785.04 (Page 1978) states: "Sections 1785.01 to 1785.08, inclusive, of the Revised Code, do not modify any law applicable to the relationship between a person furnishing professional service and a person receiving such service, including liability arising out of such professional service."

¹⁰OHIO CONST. art. IV, § 5(B) provides in part: "The supreme court shall prescribe rules governing practice and procedure in all courts of the state, which rules shall not abridge, enlarge, or modify any substantive right."

¹¹See *Judd v. City Trust & Savings Bank*, 133 Ohio St. 81, 12 N.E.2d 288 (1937).

¹²OHIO REV. CODE ANN. § 4705.01 (Page 1977) states in part: "No person shall be permitted to practice as an attorney . . . unless he has been admitted to the bar by order of the supreme court in compliance with its prescribed and published rules."

authorizing professional corporations, most of which were enacted in the early 1960's,¹³ were passed primarily to allow professionals access to otherwise unavailable tax advantages.¹⁴ Under the Internal Revenue Code of 1954, qualified pension and profit-sharing plans provided tax benefits to corporations which were unavailable to other forms of business.¹⁵ The tax benefits of these plans included deductibility of employer contributions,¹⁶ non-taxability of interest earned on the plan investments,¹⁷ and deferral of employee taxation until actual distribution¹⁸ at which time the employee was likely to be in a lower tax bracket. Professionals grew envious in the late 1940's of small business operators who could incorporate and reap these benefits.

After years of failing¹⁹ to obtain comparable tax benefits via non-corporate plans, some professionals, prior to passage of professional corporation statutes, attempted to bring their organizations within the Internal Revenue Code's definition of "corporation," which includes "associations."²⁰ *Morrissey v. Commissioner*²¹ and its progeny²² had established in the late 1930's that organizations having a preponderance of corporate attributes — continuity of life, centralized management, free transferability of interest and limited liability — were "associations," and thus corporations for tax purposes. Professionals began organizing their businesses through mutual agreements or charters in such a way as to exhibit a preponderance of these corporate attributes.

In 1954, the corporate status of one such organization was challenged by the Commissioner of Internal Revenue in *United States v. Kintner*.²³ In *Kintner*, the Ninth Circuit Court of Appeals held a group of physicians to be an association, thus a corporation for tax purposes, despite the Commissioner's insistence that the state common law prohibition against incorporation by physicians controlled. In 1960, the Internal Revenue Service issued opposing regulations²⁴ which agreed with *Kintner* that the four-point *Morrissey* "corporate resemblance" test was applicable for determining the federal tax status, but looked to state law as the benchmark for evaluating the four corporate attributes. Under these "*Kintner* regulations," the character of the attributes identified by *Morrissey* were to be evaluated under state law rather than solely by the terms of the

¹³17 B. EATON, BUSINESS ORGANIZATIONS, PROFESSIONAL CORPORATIONS AND ASSOCIATIONS § 9.01 (1982).

¹⁴In the absence of authorizing legislation, professionals were generally prohibited from incorporating. See e.g., *State ex rel. Bricker v. Buhl*, 131 Ohio St. 217, 2 N.E.2d 601 (1936).

¹⁵Smith, *Professional Corporations in Ohio: The Time for Statutory Revision*, 30 OHIO ST. L.J. 439, 441 (1969).

¹⁶I.R.C. § 404(a) (1954).

¹⁷I.R.C. § 501(a) (1954).

¹⁸I.R.C. § 402(a)(1) (1954).

¹⁹B. EATON, *supra* note 13 at § 5.06 (1982).

²⁰I.R.C. § 7701(a)(3) (1954).

²¹296 U.S. 344 (1935).

²²See e.g., *Bert v. Helvering*, 92 F.2d 491 (D.C. Cir. 1973).

²³216 F.2d 418 (9th Cir. 1954).

²⁴Treas. Reg. § 301.7701-1 (1960).

professional organization's charter or partnership agreement. Corporate status was met only if a preponderance of the attributes resembled those of a typical corporation. Because the common law of most states banned incorporation by professionals the continuity of life, free transferability of interest and limited liability required to achieve corporate status under the *Kintner* regulations were difficult, if not impossible, to attain.

Through the *Kintner* regulations, however, the Internal Revenue Service placed control over the federal tax status of professional organizations in the hands of state legislators. Within approximately two years of their issuance, fifteen states, including Ohio, enacted legislation authorizing most professionals to incorporate.²⁵ These legislative enactments purported to confer sufficient corporate attributes upon the professional corporation, including, in most states, limited liability,²⁶ to satisfy the *Kintner* regulations. However, the Internal Revenue Service again responded in 1965 with regulations²⁷ aimed specifically at professional service corporations which imposed standards of "corporateness" considered impossible to satisfy.²⁸

Beginning in 1969 with *Empey v. United States*²⁹ these particular regulations were repeatedly invalidated by federal courts for unreasonableness³⁰ or inaccuracy of interpretation of the underlying statute.³¹ Some of these cases,³² after holding the professional service firm regulations void, went on to hold that the *Kintner* regulations contained the appropriate test to be applied to all would-be corporations. Others³³ rejected the *Kintner* regulations and the underlying *Morrissey* case and adopted a "state label" standard by which corporate status for tax purposes is defined solely by the entity's label as conferred by state law.³⁴

During this controversial period, the Internal Revenue Service Chief Counsel expressed concern that some professional corporation statutes did not go far enough, particularly on free transferability of interest and limited liability, to safely establish corporate resemblance even under the more liberal *Kintner* regulations.³⁵ Yet in 1970 the Service acquiesced and conceded that groups of

²⁵See Note, *Professional Corporations and Associations*, 75 HARV. L. REV. 776, 780 (1962).

²⁶*Id.* at 780.

²⁷Treas. Reg. § 301.7701-2(h) (1965).

²⁸See Smith, *supra* note 15, at 342.

²⁹406 F.2d 157 (10th Cir. 1969).

³⁰See *e.g.*, O'Neill v. United States, 410 F.2d 888 (6th Cir. 1969).

³¹See *e.g.*, Kurzner v. United States, 413 F.2d 97 (5th Cir. 1969).

³²See *e.g.*, *Id.*; Holder v. United States, 412 F.2d 1189 (5th Cir. 1969).

³³See *e.g.*, O'Neill v. United States, 410 F.2d 888 (6th Cir. 1969); *Empey v. United States*, 406 F.2d 157 (10th Cir. 1969).

³⁴This holding was reached by a fresh construction of I.R.C. § 7701(a)(3) (1965) after a finding that *Morrissey* was not controlling on the definition of corporateness since that case involved a trust, not a corporation.

³⁵Worthy, *IRS Chief Counsel Outlines What Lies Ahead for Professional Corporations*, 32 J. TAX'N 88 (1970).

professionals organized under most state professional corporation laws would generally be treated as corporations for tax purposes.³⁶ At that time the Service dropped its appeal in *Empey* and similar cases which involved the professional service firm regulations.³⁷ Later remarks by the Chief Counsel revealed that this concession represented an agreement that the special professional service corporation regulations were invalid but did not represent agreement that the "state label" would suffice in the event an organization failed to exhibit a preponderance of corporate attributes.³⁸ By its acquiescence in the holdings of *Empey*, *O'Neill*, *Kurzner v. United States*³⁹ and *Holder v. United States*,⁴⁰ the Service prevented the Supreme Court from determining the appropriate standards of corporateness for tax purposes.⁴¹ The present regulations still utilize the *Kintner* corporate resemblance standard with reference to state law for defining the legal attributes of the organization.⁴²

IV. PROFESSIONAL CORPORATIONS AND THE PRACTICE OF LAW IN OHIO

As noted above,⁴³ the acquisition of tax advantages was the primary purpose behind enactment of professional corporation statutes in most states, including Ohio. In a sense, the potential advantages of limited liability, free transferability of interest, continuity of life and centralized management could be viewed as incidental windfalls. Often essential to desired tax treatment under the *Kintner* regulations, these windfalls and their potential impact on the legal profession were a source of consternation for the legal community.⁴⁴

The American Bar Association Committee on Professional Ethics addressed

³⁶Rev. Rul. 70-101.

³⁷Rev. Rul. 70-101 states in part:

The Government has not applied for certiorari in the cases of *United States v. O'Neill*, 410 F.2d 888 (6th Cir. 1969); *Kurzner v. United States*, 413 F.2d 97 (5th Cir. 1969); *Empey v. United States*, 406 F.2d 157 (10th Cir. 1969); and *Holder v. United States*, 289 F. Supp. 160 (N.D. Ga. 1968), affirmed, *per curiam*, 412 F.2d 1189 (5th Cir. 1969).

³⁸"I believe it is appropriate to tell you that while we accept the conclusions of the courts that the 1965 regulations are invalid, we do not accept the suggestion of some of the court opinions that a state label will suffice to make an organization a corporation for tax purposes even if it possesses none of the traditional corporate characteristics. Certainly such a conclusion should not be read into our announcement of concession last August." Worthy, "Professional Corporations" Remarks delivered before the National Conference of Bar Presidents, St. Louis, Mo. (Aug. 7, 1970), reprinted in part in B. EATON, *supra* note 13, § 31.03 note 29.

³⁹413 F.2d at 97.

⁴⁰289 F. Supp. at 160.

⁴¹One commentator points out that the appropriate standard for corporateness remains unidentified, thus creating the opportunity for further litigation in the event that some change of circumstance provides an impetus. B. EATON, *supra* note 13, at § 13.01. South High Development may provide that impetus. This is especially so since the Sixth Circuit Court of Appeals in *O'Neill* adopted the state label theory which directly contradicts the *Kintner* Regulations as they appear in present day Treas. Reg. § 301.7701.

⁴²Treas. Reg. § 301.7701 (1983).

⁴³See *supra* note 15 and accompanying text.

⁴⁴"From . . . briefs it is obvious that so far as members of the bar are concerned the idea of the practice of law within a corporate structure is an emotional thing. It is much like cats, olives and Roosevelt; it is either enthusiastically embraced or resolutely rejected." State *ex Rel.* Green v. Brown, 173 Ohio St. 114, 115, 180 N.E.2d 157, 158 (1962).

these concerns in Formal Opinion 303⁴⁵ which was issued in the same year that the Ohio Professional Corporation Statutes were enacted. Whether by design or accident, the Ohio law as enacted, including its apparent limitations on liability,⁴⁶ appears to conform to the ethical requirements listed in that Opinion:

(1) The lawyer rendering the legal services to the client must be personally responsible to the client;⁴⁷ (2) Restrictions on liability as to other lawyers in the organization must be made apparent to the client;⁴⁸ (3) None of the stockholders may be non-lawyers,⁴⁹ or if stock falls into the hands of laymen, provisions must be made for transfer back to lawyers; (4) There must be no profit-sharing plans including employees who are non-lawyers;⁵⁰ and (5) No layman may be permitted to participate in the management of the firm.⁵¹

Yet the legal status of L.P.A.'s in Ohio remained uncertain following the passage of the professional corporation statutes until reviewed by the supreme court.

That court's opinion was first heard in 1962 in *State Ex Rel. Green v. Brown*,⁵² after an attorney named Green attempted to file articles of incorporation with the Secretary of State. When the filing was refused, Green sought a writ of mandamus which the supreme court denied. The court held that the power to admit a corporation to the practice of law was an exclusive function of the judiciary. Because the court had not granted such authorization, Green was not entitled to practice law in a corporate form.⁵³

Eight years later, in 1970, the court consented to a request by the bar that it be afforded the same tax benefits of incorporation being enjoyed by their fellow professionals⁵⁴ by promulgating Rule XVII(B).⁵⁵ In granting authorization for attorneys to practice in a corporate form, the supreme court imposed a condition which is at the heart of the *South High Development* decision: "The participation of an individual as a shareholder of a legal professional associa-

⁴⁵ABA Comm. on Professional Ethics, Formal Op. 303 (1961).

⁴⁶OHIO REV. CODE ANN. § 1785.04 (Page 1978). See *supra* note 9.

⁴⁷See *Id.*

⁴⁸See GOV. R. III, § 2 requiring that "[An incorporated law firm] name shall end with the legend, 'Co., L.P.A.' or shall have immediately below it, in clearly legible form, the words 'A Legal Professional Association'."

⁴⁹OHIO REV. CODE ANN. § 1785.07 (Page 1978) provides: "A shareholder of a professional association may sell or transfer his shares . . . only to another individual who is duly licensed . . . to render the same professional service as that for which the corporation was organized."

⁵⁰MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 3-102(A) (1979) provides: "A lawyer or law firm shall not share legal fees with a non-lawyer"

⁵¹MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 3-103(A) (1979) provides: "A lawyer shall not form a partnership with a non-lawyer if any of the activities of the partnership consist of the practice of law."

⁵²173 Ohio St. 114, 180 N.E.2d 157 (1962).

⁵³*Id.* at 115, 180 N.E.2d at 158.

⁵⁴Incorporation among physicians was gaining popularity as evidenced by *O'Neill v. United States*, 410 F.2d 888 (5th Cir. 1969).

⁵⁵SUP. CT. R. PRAC. XVII(B); later to become GOV. R. III.

tion shall be on the condition that such individual shall, and by such participation does, guaranty the financial responsibility of the association for its breach of any duty, whether or not arising from the attorney-client relationship." Prior to *South High Development*, at least one Ohio law commentator⁵⁶ had construed this Rule to alter the limited liability apparently provided to attorneys/shareholders through application of section 1785.04 of the Ohio Revised Code and article XIII, section 3, of the Ohio Constitution. Yet many people affected by the Rule, apparently including the defendants in *South High Development*, believed the limited liability acknowledged to exist with respect to corporations comprised of physicians⁵⁷ to be the rule for all professional corporations. Presumably those who held such a view would have considered Gov. R. III, section 4 solely a disciplinary provision.⁵⁸

V. CRITIQUE AND ANALYSIS OF THE SOUTH HIGH DEVELOPMENT RATIONALE

Though the *South High Development* opinion occupies only four pages of text, the court's reasoning is sufficiently complex to have justified much more explanation. To arrive at its ultimate conclusion, the *South High Development* court was required to overcome three difficult obstacles. First, the court was faced with article XIII, section 3, of the Ohio Constitution, which provides limited liability to corporate shareholders. Second, the court was confronted with the allegation that Gov. R. III, section 4, modifies substantive law and is therefore beyond the scope of the court's power under the constitution.⁵⁹ Third, the court's rationale necessitated an implicit claim of supremacy over the legislature in all facets of control over conduct of law practitioners both private and corporate — a position in conflict with the established view that the judiciary regulates admission and discipline of the bar while the legislature controls matters of corporate law.⁶⁰

A. The Court's Treatment of Ohio Constitution article XIII, section 3 Providing Limited Shareholder Liability

To avoid the plain language of the constitutional limitation on shareholder liability, the court identified two factors distinguishing "private" corporations from "professional" corporations, then proceeded to hold article XIII, section 3 of the Ohio Constitution inapplicable to the latter group. The first of

⁵⁶7 CAVITCH, OHIO CORPORATION LAW, § 18.23 (1982).

⁵⁷See *e.g.*, *Lenhart v. Toledo Urology Associates, Inc.*, 48 Ohio App. 2d 249, 356 N.E.2d 749 (1975) which held that a professional corporation comprised of physicians has the same general liability features as a general corporation.

⁵⁸Such was the view held by J. Whiteside's concurring opinion in *South High Development*, No. 81AP-810 (Ohio App. March 9, 1982) at 505:

With the understanding that neither unconstitutionality nor invalidity of Section 4 of Gov. R. III is suggested or determined hereby, I concur in the judgment. Gov. R. III does not purport to determine liability of shareholders of a legal professional association to third persons but, rather, regulates the conduct of attorneys in their capacity as shareholders of a legal professional association.

⁵⁹OHIO CONST. art. IV, § 5(B). See *supra* note 8.

⁶⁰See Note, *The New Ohio Professional Associations Act and the Preclusion of Corporations from the Practice of Law*, 24 OHIO ST. L.J. 685, 687 (1963). See also *infra* note 78.

the factors identified was a difference in corporate activity or purpose.⁶¹ The court stated that a professional corporation is organized to carry out a profession while a private corporation's sole purpose is to accumulate capital for return on shareholder investment. Based on this distinction the court concluded that it is reasonable to find that the constitutional protection afforded shareholders applies only to the private corporation. The second distinction offered by the court was the level of shareholder involvement in the corporation.⁶² The court noted that most professional corporations employ their shareholders whereas most private corporations do not. Consequently, the court concluded, only shareholders of private corporations need be insulated from corporate debt over which they have no participation or control as members of management.

Little thought is required to identify serious flaws in the court's reasoning. First, in attempting to establish a dichotomy between carrying out a profession and profit-making the court has drawn a false comparison since these activities need not be mutually exclusive. Most professionals do seek to profit from their efforts. It is not clear in the court's opinion why professionals should be less entitled to the constitutional protection than other profit-makers. The second distinction, relating to shareholder involvement, is slightly less troublesome but remains far from persuasive. It seems reasonable that shareholders closely associated with the corporate affairs ought to bear a greater responsibility for corporate actions, yet it is unlikely that the court would follow its own distinction and abrogate shareholder immunity in a closely held corporation. Moreover, the most troubling aspect of the court's rationale on this point is the scope of the distinctions drawn. It is doubtful that the court intended to abrogate shareholder immunity in all professional corporations, yet the distinguishing factors offered as reasons for evading the constitution carry a much broader application than to only legal professional associations. While valid reasons may exist for removing L.P.A.'s from the protection of the constitutional provision, the court's failure to accurately state such reasons injects uncertainty and confusion into the issue of professional corporate shareholder liability.

B. Treatment of Ohio Constitutional article IV, section 5 Limiting Judicial Rule-Making Power to "Procedural" Matters

The second obstacle which the court's rationale was forced to overcome was the claim by defendants that Gov. R. III, section 4, to the extent that it created shareholder liability for debts of the L.P.A., was a violation of the limitation on the court's judicial power under Ohio Constitution article IV, section 5 because the Rule modified a "substantive" right.⁶³ The distinction

⁶¹4 Ohio St. 3d at 3, ____ N.E.2d ____.

⁶²*Id.*

⁶³*Id.* at 4.

between substantive and procedural rights is quite nebulous⁶⁴ and recent court history has developed an expansive definition of "substantive," which in effect has narrowed the court's power of rule-making.⁶⁵ Nonetheless, the *South High Development* court summarily dismissed the above argument, stating: "[Gov. R. III] is not one of procedure, but one relating to the control of the practice of the profession of law."⁶⁶ The court further noted its inherent⁶⁷ and statutory⁶⁸ authority to regulate admission to the practice of law in Ohio, quoting from Ohio Constitution article IV section 5(B) which states in part: "The supreme court . . . shall make rules governing the admission to the practice of law and discipline of persons so admitted."

Despite the correctness of the court's claim to exclusive authority over admission to the practice of law, such a claim is not responsive to the argument that Gov. R. III, section 4 abridges a substantive right. Presumably the scope of the court's power over members of the bar would allow the court to define standards for admission to the bar, to discipline attorneys for conduct unbecoming the profession and, ultimately, to disbar an attorney. The court's power over attorneys in this regard exists only as an outgrowth of the attorneys' presence in the judicial system. The individual attorney could nullify the court's disciplinary power over himself or herself simply by leaving the legal profession.

In contrast, Gov. R. III, section 4 as applied by the court alters legal relationships between individual attorneys and third persons with whom the attorneys commercially deal through the L.P.A. The Rule creates a liability to third persons in the corporate context where they did not exist in the absence of the Rule.⁶⁹ It is thus difficult to understand the court's claim that Gov. R. III, section 4 does not abridge, enlarge or modify a substantive right and does not violate Ohio Constitution article IV, section 5. It is equally difficult to understand how the court could have viewed its assertion of inherent authority over admission and discipline of the bar as an argument responsive to the defendants' claim.

⁶⁴See Note, *Substance and Procedure: The Scope of Judicial Rule Making Authority in Ohio*, 37 OHIO ST. L.J. 364, 366 (1976): "It has been contended that such nebulous concepts as 'substance' and 'procedure' result in an illusory distinction and that the terms should be abandoned."

⁶⁵*Id.* at 378.

⁶⁶4 Ohio St. 3d at 4, ___ N.E.2d, ___.

⁶⁷See *Judd v. City Trust & Savings Bank*, 133 Ohio St. 81, 12 N.E.2d 288 (1937).

⁶⁸OHIO REV. CODE ANN. § 4705.1 (Page 1977). See *supra* note 12.

⁶⁹See *Krause v. State*, 31 Ohio St. 2d 132, 144, 285 N.E.2d 736, 744 (1972) in which the court, holding a rule of procedure unconstitutional for affecting a substantive right, stated: "If a defense of lack of consent by the General Assembly to suits against the state was available as a right of or defense to the state *before* the adoption of the new Rules of Civil Procedure, and if such right or defense was a *substantive* right of the state, then it must remain available to the state *after* the adoption of the [Rules] . . ." (*emphasis added*). The court goes on to characterize substantive law as that which ". . . both defines and regulates the rights of the parties." *Id.* at 145, 285 N.E.2d at 144. Application of this reasoning to Gov. R. III, § 4 leads to the conclusion that it is unconstitutional as construed by the court in *South High Development*.

C. *The Distinction Between Judicial and Legislative Control Over L.P.A.'s*

The third troublesome aspect of the court's rationale is closely linked with the first two. In its effort to impose liability through application of Gov. R. III, section 4, the court was faced with the need to assert the supremacy of that Rule over the particular substantive statute with which it potentially conflicts — Ohio Revised Code section 1785.04. This section, which preserves for professional corporations the legal structure found in general corporations, could be construed to provide shareholder immunity.⁷⁰ The court reasoned, however, that since Gov. R. III was promulgated under its constitutional authority over the conduct of the bar,⁷¹ the Rule supersedes the statute to the extent of inconsistency.

This claim of supremacy of the statute closely resembles the court's defense of the Rule as non-substantive. In fact, the issues are not clearly distinguished in the opinion. Nonetheless, the issue is distinct and involves reference to a separate constitutional provision as authority to override the Code. Mysteriously, the Code is overridden by a Rule defended as non-substantive elsewhere in the opinion.

As with the substantive/procedural holding, the court failed on this issue to distinguish between its power to regulate admissions to and conduct of the bar and the legislature's power to regulate substantive corporate law.⁷² This approach fails to recognize that the existence of L.P.A.'s requires two bodies to act — the legislature to authorize the formation of corporate entities for the purpose of practicing a profession, and the judiciary to admit such corporations to the practice of law.⁷³

D. *Liability Consequences for L.P.A.'s and Other Professional Corporations*

South High Development provides by judicial decree what very few states have adopted by legislative enactment⁷⁴ — unlimited liability for shareholders of legal professional corporations. While the facts of *South High Development* deal only with contractual liability, the language of Gov. R. III, section 4 seems to incorporate tort liability as well.⁷⁵ In effect, *South High Development* treats the L.P.A. as a partnership for liability purposes. Proponents of this treatment argue that it is necessary in order to preserve a professional relationship

⁷⁰See e.g., Vesely, *The Ohio Professional Association Law*, 13 CASE W. RES. L. REV. 195, 203 (1962).

⁷¹OHIO CONST. art. IV, § 5(B), *supra* note 10.

⁷²OHIO CONST. art. XIII, § 2.

⁷³See Note *supra* note 64, at 687 which states: "Thus the situation is one in which, to permit the practice of law through a corporate form, two agencies must act: The legislature must permit lawyers, as professional persons, to incorporate, and the supreme court must permit the corporations thus formed to practice."

⁷⁴Eaton indicates that 46 states had professional corporation statutes by 1970 and that only five of those statutes retained joint and several liability. B EATON, *supra* note 13 at §§ 9.01 and 4.02 [6], note 18.

⁷⁵See *supra* note 6.

between attorneys and their clients.⁷⁶ Others, including the ABA Committee on Professional Ethics in Formal Opinion 303, conclude that unlimited liability among professional associates is not necessary. Regardless of the view adopted, it is reasonable to conclude that the *South High Development* result will provide better policing of professional responsibility than if the court had ruled in favor of limiting liability. In this respect the court's decision may aid the integrity and reputation of the bar. Perhaps the court has reached a good conclusion based on incorrect legal reasoning.

As mentioned above, the most troubling aspect of the court's reasoning is that applied to Ohio Constitution article XIII, section 3. Nothing in the facts of *South High Development* or the surrounding opinion suggests that the court intended to abrogate shareholder immunity for all professional corporations. Yet the factors offered by the court to distinguish "professional" from "private" corporations certainly apply to more than just the legal profession. By drawing such a broad distinction, the court has provided future litigants with a solid basis for naming both the professional corporation and its individual owners as defendants in suits which involve the liability of either. When eventually faced with such a case on appeal, the supreme court will have the difficult task of explaining why shareholders of non-legal professional corporations have a preferred status.

An added effect of *South High Development* on the legal profession in particular is its influence on the decision of whether to practice as a legal professional corporation. Until recently, law firms were drawn to the L.P.A. form of organization by two factors: tax advantages⁷⁷ and limitations on liability for peer malpractice. Recent changes in the tax laws concerning pension plans have removed virtually any pension incentive for professionals to incorporate.⁷⁸ At the same time, the maximum individual tax rate was lowered to within a few percentage points of the maximum corporate rate.⁷⁹ Few tax advantages, if any, remain. In similar fashion, *South High Development* has eliminated potential liability benefits to incorporating the law practice. Thus, there appears to be no incentive in the near future for law firms to incorporate.

E. Potential Effect on "Corporateness" of Present L.P.A.'s

In addition to destroying what incentive remained to form an L.P.A., *South High Development* may prove to be the undoing of present L.P.A.'s. As noted above, some uncertainty over the present and future definition of "corporation" for tax purposes remains.⁸⁰ Some commentators feel that a strict "state

⁷⁶See e.g., Note, *supra* note 60, at 691. An alternative basis for effectively achieving the same result would have been to treat Gov. R. III as a disciplinary provision mandating certain levels of financial responsibility. Cf., *supra* note 58.

⁷⁷See *supra*, notes 16, 17 and 18 and accompanying text.

⁷⁸Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982).

⁷⁹*Id.*

⁸⁰See B. EATON, *supra* notes 13, 41.

label" definition applies while others feel the corporate resemblance standard is at the foundation of the tax laws and may re-emerge in the area of professional corporations if the standard is challenged in court.

South High Development makes Ohio ripe for the challenge. The Sixth Circuit in *O'Neill* embraced the "state label" theory while the Internal Revenue Service's present regulations still apply a corporate resemblance standard.⁸¹ Assuming, as is reasonable, that some future change in the tax laws will restore substantial benefits to the corporate form, *South High Development* will make Ohio a convenient forum for the Service to resolve the lingering uncertainty. With limited liability gone for Ohio L.P.A.'s, the corporate resemblance standard will require for corporate tax treatment that the remaining three attributes — free transferability of shares, centralized management and continuity of life — all resemble the corporate form. No doubt the Service could find an L.P.A. which after *South High Development* badly fails the corporate resemblance standard. Upon litigating the "corporateness" of such a firm the Service would lose under the Sixth Circuit's "state label" theory, then proceed to seek certiorari to resolve a conflict in the circuits and enter the Supreme Court with an unusually strong set of facts, thanks to *South High Development*. If this or any other scenario arises in which the Service renews its challenge to the corporateness of L.P.A.'s under the present Regulations, some will fail the test and be forced to amend their present compensation, pension and tax structures.

V. CONCLUSION

South High Development will bring to an abrupt halt the transition among law firms from the partnership to the professional corporation form of practice. Not only does it eliminate limited liability, the final attractive feature of L.P.A.'s remaining since the elimination of tax advantages, but it also jeopardizes the corporateness for tax purposes of present day L.P.A.'s. Of even greater significance is *South High Development's* potential impact on non-legal professional corporations. The court's rationale requires the conclusion, probably unintended, that no shareholder of professional corporations may enjoy the limited liability universal among non-professional corporations. While the result of *South High Development* may well enhance the integrity and image of the Ohio Bar, the potential tax effect and the liability implications for non-legal professional corporations, probably unintended by the court, may outweigh those benefits.

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⁸¹Treas. Reg. § 301.7701 (1983).