IN THE SUPREME COURT OF OHIO

HEALTHSOUTH CORPORATION,	:	
Appellee,	:	Case No. 2007-2281
v.	:	
	:	Appeal from BTA
RICHARD A. LEVIN, TAX COMMISSIONER OF OHIO,	:	Case No. 2005-A-1386
Appellant.	:	

AMICUS REPLY BRIEF IN SUPPORT OF APPELLANT, RICHARD A. LEVIN, TAX COMMISSIONER, BY THE OHIO SCHOOL BOARDS ASSOCIATION

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INTRODUCTION

The Merit Brief of Appellee HealthSouth Corporation ("Merit Brief") in this case only briefly addresses the substantive arguments raised by the Ohio School Boards Association in its Amicus Brief in Support of Appellant Richard A. Levin, Tax Commissioner ("Amicus Brief"). Appellee's rather dismissive discussion of the application of principles of equity in this case is confined to the two pages of Part III of the Merit Brief. In those two pages, Appellee appears to make the following arguments.

First, Appellee claims that there is no support under Ohio law for the proposition that "equitable estoppel should be applied to deny [Appellee] the refund request." Merit Brief, p. 12.

Second, Appellee suggests that if equitable estoppel were, in fact, a permissible defense it should be applied only to those "rouge [sic] employees [who] were fired by the Taxpayer," Merit Brief, p. 13, and that the application of equitable estoppel as a defense against HealthSouth's refund claim would harm "the true victims here [who] are the thousands of innocent HealthSouth shareholders who have already suffered through the revelation of the accounting fraud." Merit Brief, p. 13. In support of this assertion, Appellee cites a single, inapposite case from the U.S. Court of Appeals for the Third Circuit, Asphalt Indus., Inc. v. Commissioner, 384 F.2d 229 (3rd Cir. 1967).

Third, Appellee suggests that its refund in this case should be granted because the State of Ohio realized a benefit when HealthSouth was unable to obtain a refund of property taxes and corporate franchise taxes fraudulently reported and paid in prior years. Merit Brief. p.14.

Fourth, Appellee repeatedly claims that the property taxes at issue here should be refunded because they were paid on property that "never existed as assets" and was "non-existent." Merit Brief, pp. 12-14. The only support that Appellee can muster for this proposition is a state court case from Illinois that has no bearing on the fact situation presented in this case, In re Application of County Collector v. Arizona Metro Corp. 53 Ill. App.3d 156 (1977).

Each of the above arguments is addressed, in turn, in the following section of this reply brief. In addition, Amicus Ohio School Boards Association fully endorses the position set out in Part II of the Commissioner's brief regarding this Court's jurisdiction to decide the estoppel issue discussed herein.

LAW AND ARGUMENT

(1) There is support under Ohio law for this Court to apply the principle of estoppel to deny Appellee's refund claim.

As discussed in the Amicus Brief, The William Bayley Co. v. Lindley (Mar. 28, 1979), Clark Cty. App. No. 1308, unreported, 1979 Ohio App. LEXIS 9958 stands for the proposition that a taxpayer may not deny its own judgment of an asset's positive true value as reported in its financial statements and seek a retroactive conclusion by the tax assessor that the asset is in fact worthless. Id. at *8. In William Bayley, the taxpayer claimed in its books and in public statements that a note it held was worth $1.5 million, but reported to the Tax Commissioner that the note was worthless. The court rejected the taxpayer's zero-value claim with the observation that such a claim, "if accepted, would recognize a corporate fraud upon the public." Id. at *8.

As noted in the Amicus Brief, the case for denying HealthSouth's attempt to belatedly revise its property values is even stronger here than was the case in William Bayley. Amicus Brief, pp. 11-12. The taxpayer in William Bayley disputed the Commissioner's use of the value assigned by the company's financial statements to the note at issue in that case, but there was no direct evidence that such value was fraudulent. By contrast, in the instant case, Appellee admits that the inflated values of Appellee's Ohio property were a product of its widespread accounting fraud.

Thus, under William Bayley there is no justification for revising downward Appellee's fraudulently inflated property values and refunding the tax paid on those values. Appellee should not be permitted by this Court to recover the property taxes that it paid to the State of Ohio and that already have been put to use by Ohio's public school districts to fund their educational mission. This Court should follow the precedent set forth in William Bayley and deny the Appellee's attempt to perpetrate a fraud on the public.

Of course, William Bayley is not the only case supporting denial of Appellee's refund claim based on estoppel principles. As discussed at length in the Amicus Brief, there are at least three doctrines under Ohio law that provide the basis for denying Appellee's refund claim under these circumstances: estoppel, quasi-estoppel and unclean hands. Amicus Brief, pp. 12-22.

The broadest of these doctrines—estoppel—holds that a party will not be permitted to deny that which he has induced a second party to rely upon reasonably and in good faith. See First Federal Sav. & Loan Assoc. v. Perry's Landing, Inc. (1983), 11 Ohio App. 3d 135, 145; 463 N.E.2d 636, 648. On more than one occasion, Ohio courts have applied estoppel to prevent the Tax Commissioner from collecting taxes where a taxpayer reasonably relied on a representation of the Tax Commissioner that taxes were not owed. See NLO, Inc. v. Limbach (1993), 66 Ohio St. 3d 389, 613 N.E.2d 193; Ormet Corp. v. Lindley (1982), 69 Ohio St. 2d 263; 431 N.E.2d 686; and Kory v. Lindley (1980), Ohio App. LEXIS 11632; and Recording Devices v. Bowers (1963), 174 Ohio St. 518,190 N.E.2d 258.

If Ohio courts may apply estoppel against the Commissioner where equity generally is disfavored, this Court certainly may apply estoppel against a taxpayer that has admitted that it engaged in a fraud on the State of Ohio. Each of the elements of the defense of estoppel is present in the instant case as discussed in detail in the Amicus Brief. Amicus Brief, pp. 12-16.

Because Appellee has not disputed the presence of these elements, they will not be addressed again in this brief.

In addition to estoppel, each of the elements of the equitable doctrine of "quasi-estoppel" or "estoppel by acceptance of benefits" is present in this case. This doctrine holds that a "party who accepts the benefits of a contract or transaction will be estopped to deny the obligations imposed on it by the same contract or transaction." Ohio Bank v. Beltz, 2002 Ohio 4886 at ¶27. Quasi-estoppel may be invoked even where elements of the more common estoppel (such as knowledge and reliance) are missing. See Dayton Sec. Assocs. v. Avutu (1995), 105 Ohio App. 3d 559, 563-64; 664 N.E.2d 954, 957. As detailed in the Amicus Brief, Appellee fraudulently inflated the value of its Ohio properties as part of an overall scheme to inflate its earnings. Amicus Brief, pp. 7-10. The inflated property values created the illusion of a highly profitable company, which, in turn, had the beneficial effect of driving up Appellee's share price. Appellee now seeks to avoid the tax liability associated with the property values that helped create that benefit. This, under the doctrine of quasi-estoppel, Appellee cannot do.

The third equitable doctrine that precludes the granting of Appellee's refund claim is the doctrine of unclean hands. At the heart of this doctrine is the denial of equitable relief to a plaintiff who commits a wrong in the same transaction in which he claims to have been injured. See Smith v. World Ins. Co.,38 F.3d 1456, 1462 (8th Cir. 1994); Ohio Eng'g Co. v. Hardin Quarry Co. (1980) 1980 Ohio App. LEXIS 11124 at *9; LeCrone v. LeCrone (2004), 2004 Ohio 6526 at ¶25. Courts in the States of Alabama and Connecticut have applied the doctrine of unclean hands to the same set of facts at issue in this case. See Ex parte HealthSouth Corporation, (2007), 2007 Ala. LEXIS 174 (lower court decision denying Appellee's claim for a refund of Alabama property taxes overpaid as a result of listing fictitious items of personal property on its tax returns affirmed by Alabama Supreme Court); and HealthSouth Corporation v. City of Waterbury, 2008 Conn. Super. LEXIS 625 (Appellee's motion for summary judgment seeking writ of mandamus to compel removal from tax lists of non-existent personal property Appellee knowingly included in declaration of taxable assets denied). This Court, too, should deny the refund claim at issue here because Appellee seeks relief in a transaction in which it has admittedly committed fraud.

(2) Appellee may not avoid the application to its refund claim of the estoppel principles discussed above by arguing that Appellee was a victim, rather than a perpetrator, of accounting fraud.

Appellee seeks to distance itself from the wrongdoing that would invoke the estoppel principles discussed above by suggesting that a few rogue employees—rather than Appellee itself—committed the accounting fraud at issue here. What Appellee fails to acknowledge is that under one of the oldest and most firmly entrenched of legal concepts—namely, agency—the law views Appellee and its rogue employees as a single actor. In N.Y. Cent. & Hudson R.R. Co. v. United States, 212 U.S. 481, 495 (1909), the Supreme Court declared:

> We see no valid objection in law, and every reason in public policy, why the corporation which profits by the transaction, and can only act through its agents and officers, shall be held punishable by fine because of the knowledge and intent of its agents to whom it has entrusted authority to act . . . .").

This includes acts related to the filing of corporate tax returns. See United States v. Shortt Accountancy Corp., 785 F.2d 1448, 1454 (9th Cir. 1986); Inner-City Temps., Inc. v. Comm'r, 60 T.C.M. (CCH) 726, 733 (1990).

A corporation is not relieved of liability merely because the errant employee may have derived some personal benefit from his actions. United States v. Ruidoso Racing Ass'n, Inc. v. Comm'r, 476 F.2d 502, 505–06 (10th Cir. 1973); Crescent Mfg. Co. v. Comm'r, 7 T.C.M. (CCH) 630, 631–32 (1948). Moreover, a corporation generally may not avoid liability by simply asserting that an agent violated a corporate policy of adhering to the law. See United States v. Hilton Hotel Corp., 467 F.2d 1000, 1004 (9th Cir. 1972) ("[Corporate] liability may attach without proof that the conduct was within the agent's actual authority, and even though it may have been contrary to express instructions."); Cont'l Baking Co. v. United States,281 F.2d 137, 150 (6th Cir. 1960) ("A corporation which employs an agent in a responsible position cannot say that the man was only 'authorized' to act legally and the corporation will not answer for his violations of law which inure to the corporation's benefit."). Thus, Appellee may not escape culpability for the fraud at issue here and the resulting equitable consequences for its refund claim by claiming to be a victim, rather than a perpetrator, of fraud.

Nor can Appellee escape the consequences of its fraud by claiming that Appellee's shareholders are the true victims in this case.[1] No doubt some of Appellee's shareholders are among the victims of its widespread accounting fraud. Shareholders generally bear both the direct and indirect costs of any penalties imposed on a corporation (and forfeiture of the property taxes at issue here is merely a penalty in a different form).[2] However, shareholders assume the risks of their investment in a corporation, including risks related to the behavior of management.[3] Moreover, in this case, just eight institutional investors own over sixty percent of Appellee's stock. Such investors are highly sophisticated and are well equipped to hedge any risk associated with their equity investments in Appellee. See HealthSouth, Revised Definitive Proxy Solicitation Material (Form DEFR14A), at 55 (April 23, 2008).

[1] For a full discussion of the so-called "innocent investor" argument, *see* Craig M. Boise, *Playing with "Monopoly Money": Phony Profits, Fraud Penalties and Equity*, 90 Minn. L. Rev. 144, 201 (2005).

[2] Christopher Kennedy, *Criminal Sentences for Corporations: Alternative Fining Mechanisms*, 73 CAL. L. REV. 443, 448–49 (1985).

[3] *Id.* at 452–53 ("[W]hile the possibility of large fines introduces an added element of risk into the shareholder's investment, shareholders are uniquely situated to neutralize risk through diversification. What is more, this risk will have been reflected in lower share prices when the investor bought his shares. Hence the view that shareholders are 'innocent' should be no bar to fines that eliminate the prospective profit in criminal conduct.").

Appellee relies on Asphalt Indus., Inc. v. Commissioner, 384 F.2d 229 (3rd Cir. 1967) for the proposition that an innocent shareholder may not be made to bear the penalty associated with a corporation's tax fraud. However, Appellee misstates the Third Circuit's reasoning in that case. Appellee carefully lifts from that opinion a single sentence that appears to support its claim, but Appellee fails to disclose the Court's critical finding that,

> Here there is no innocent third party who dealt with the corporation in reliance upon [the corporation's president's] authority and between whom and [the innocent shareholder] it might therefore be said that *the greater innocence attends the one who had no part in entrusting to Anderson the power to commit the fraud.*

Id. at 234 (emphasis added). In the instant case, this condition—upon which the Court's decision turned—does not exist. Here, there *is* an innocent third party—the State of Ohio—of whom it *can* be said that the greater innocence attends. In other words, as between Appellee's shareholders and the State of Ohio, it is the latter that "had no part in entrusting to [Appellee's officers] the power to commit the fraud." Accordingly, the State of Ohio, rather than Appellee's shareholders, should prevail in this case.

The victims for which this Court must be concerned are the public schools of the State of Ohio. For better or worse, in the State of Ohio, public school districts rely substantially on funding provided through personal property taxes. The property taxes at issue in this case were distributed, after collection, to the appropriate Ohio public school districts, and were expended for those districts' operations years ago. By contrast, to Appellee's shareholders, Ohio's public schools did not voluntarily assume the risk of an equity investment in Appellee. Nor do Ohio's public schools have the ability to influence either the makeup of Appellee's management or its internal corporate policies. Nonetheless, Ohio's public schools—already financially strained—

will face further hardship as a result of Appellee's fraud unless Appellee's refund claim in this case is denied.[4]

(3) Appellee is not entitled to prevail in this case simply because the State of Ohio realized a benefit when HealthSouth was unable to obtain a refund of property taxes fraudulently reported in prior years.

Appellee's third argument makes little sense. After noting that its fraudulent property tax reporting began in 1998 and continued through 2002, the year at issue here, Appellee observes that the statute of limitations for obtaining a refund of its overpaid property taxes has expired with respect to years 1998 through 2001. Appellee then states that it also reported inflated income in those years that would have been subject to Ohio's corporate franchise tax. Based on the fact that the property tax and corporate franchise taxes paid from 1998 through 2001 provided a benefit to the State of Ohio, Appellee concludes that the Commissioner's decision to not allow "that one overpayment [for 2002] to be refunded to the shareholders is unconscionable." Merit Brief, p.14.

If Appellee indeed filed fraudulent property tax returns for the years 1998 through 2001 and the statute of limitations for refunds of taxes overpaid in those years had not run, Amicus would argue as it does in the instant case (and for the same reasons) that those refunds should be denied. However, the overpayment of taxes *velnon* in the years 1998 through 2001is not an issue that is before the Court in this case. Moreover, if overpayments of taxes were made in prior years for which the statute of limitations precludes refunds, it does not follow that Appellee is entitled to a set off in the form of a refund of taxes fraudulently overpaid for 2002.

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[4] The dramatic drop in property values occasioned by the subprime mortgage crisis is just one factor that is negatively affecting Ohio public schools, which rely on real estate taxes as well as personal property taxes for funding. *See* Laura Johnston, *Schools Dread Fall in Home Values; as Property Taxes Dip, So Will Districts' Revenues,* Cleveland Plain Dealer, June 15, 2008, p. A1; and Catherine Candisky and Charlie Boss, *Gloomy Returns; School Districts Took Hit at Polls; Bad Economy a Factor in Levies' Low Passage Rate,* The Columbus Dispatch, March 6, 2008, p. 01B.

(4) Appellee's argument that the property taxes at issue here must be refunded because they were assessed on property that never existed fails because Appellee's property tax returns fraudulently asserted that the property existed and Appellee is now estopped from claiming otherwise.

Appellee's Merit Brief states repeatedly that the property that is the subject of this litigation is not subject to Ohio personal property tax because the property never existed. This, of course, begs the question of the effect of Appellee's declaration to the contrary in its originally filed 2002 tax return, which was signed by a vice president and officer of the company under penalty of perjury as required by R.C. 5703.25. As discussed above, under any one of several doctrines, equity demands that Appellee not be permitted to deny its own sworn statements to the Tax Commissioner regarding the existence, and value, of its Ohio personal property.

In support of its contention regarding the non-existence of the personal property on which it voluntarily paid personal property taxes, Appellee marshals only a single case—<u>In re Application of County Collector v. Arizona Metro Corp</u>. 53 Ill. App.3d 156 (1977). Unfortunately, that case cannot bear the weight of Appellee's contentions. In <u>Arizona Metro</u>, the county tax authorities assessed personal property tax on the contents of certain storage tanks owned by that at the time the tax was assessed were, in fact, empty. The Illinois appellate court held that the assessment of personal property taxes on nonexistent personal property was void *ab initio,* and that the taxpayer therefore was not obligated to exhaust all of its statutory remedies before the assessment could be put aside.

Here again, however, as with its analysis of <u>Asphalt Industries</u>, Appellee has neglected to refer this Court to a critical factual distinction between of the instant case and <u>Arizona Metro</u> and <u>Arizona Metro</u>. Importantly, the assessor in <u>Arizona Metro</u> assessed the tax at issue there based only on the fact Specifically, the storage tanks had contained taxable personal property in a prior year. The tax assessor had no grounds for assuming the tanks still contained such property. The court noted, "we first reiterate that no one questions the fact that the assessment was made on non-existent property." Id. at 158. In other words, the taxpayer in Arizona Metro never falsely claimed that there was taxable property in the storage tanks in order to camouflage a financial fraud it was perpetrating on its shareholders and creditors.

By contrast, in the instant case, it is clear only now, in retrospect, that the personal property entries entitled "AP Summary" on Appellee's books did not reflect actual property. Indeed, Appellee willfully led the Ohio Tax Commissioner to believe, based on the declarations in Appellee's originally filed 2002 tax return—signed by a vice president and officer of the company under penalty of perjury—that Appellee owned Ohio personal property having the value indicated in the return. As discussed above and in the Amicus Brief, Appellee should not now be permitted to deny the existence of, or the value it asserted for, the AP Summary property on which it paid Ohio personal property tax.

CONCLUSION

For the foregoing reasons this Court should reverse the BTA and affirm the Commissioner's denial of HealthSouth's refund claim.

Respectfully submitted,

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CERTIFICATE OF SERVICE

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