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THE STATE OF SOUTH CAROLINA
In the Court of Appeals

APPEAL FROM RICHLAND COUNTY
Court of Common Pleas

G. Thomas Cooper, Jr., Circuit Court Judge

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SC Court of Appeals

Case No. 2013-CP-40-2655
Appellate Case No. 2014-000963

Allen Patterson, Steve Tilton, Richard Sandler, Lincoln Privette, Marc Ellis, Joey Carter, Barry Davis, Michael Nieri, Allen Patterson Residential LLC, Tilton Group, Sandler Construction Co., Inc., Privette Enterprises, Ellis Construction Co., Inc., The Barry Davis Company, Inc., Great Southern Homes, and J. Carter, LLC, on behalf of themselves and others similarly situated
..... Appellants,

v.

Herb Witter, Colin Campbell, Eddie Weaver, Tom Markovich, Keith Smith, Jim Gregorie, individually and as Trustees of the South Carolina Home Builders Self Insurers Fund, and the South Carolina Home Builders Self Insurers Fund..... Respondents.

FINAL BRIEF OF RESPONDENTS

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FINAL BRIEF OF RESPONDENTS

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TABLE OF CONTENTS

TABLE OF AUTHORITIESII

COUNTER-STATEMENT OF ISSUES ON APPEAL1

STATEMENT OF THE CASE.....1

FACTUAL BACKGROUND.....2

STANDARD OF REVIEW5

 I. THE CIRCUIT COURT CORRECTLY HELD THAT THE ACTION
 INVOLVES DERIVATIVE CLAIMS AND IS SUBJECT TO THE
 REQUIREMENTS OF RULE 23(B)(1). 7

 II. THE CIRCUIT COURT CORRECTLY HELD THAT THE FUND IS AN
 UNINCORPORATED ASSOCIATION AND NOT A TRUST, AND THAT
 RULE 23(B)(1), THEREFORE, APPLIES 14

 III. THE CIRCUIT COURT CORRECTLY FOUND THAT APPELLANTS
 FAILED TO SATISFY THE PLEADING REQUIREMENTS OF RULE
 23(B)(1)..... 17

CONCLUSION.....21

TABLE OF AUTHORITIES

CASES

| | |
|-------------------------------------------------------------------------------------------------------------------------------------------|---------------------------|
| <i>Abadian v. Lee</i> , 117 F.Supp.2d 481 (D.Md. 2000)..... | 6 |
| <i>Accord Hall v. Walters</i> , 226 S.C. 430, 85 S.E.2d 729 (1955) | 15 |
| <i>All Saints Parish Waccamaw v. Protestant Episcopal Church in Diocese of S. Carolina</i> , 385 S.C. 428, 685 S.E.2d 163 (2009) | 14 |
| <i>Babb v. Rothrock</i> , 303 S.C. 462, 401 S.E.2d 418 (1991) | 11 |
| <i>Bessinger v. BI-LO, Inc.</i> , 366 S.C. 426, 622 S.E.2d 564 (Ct. App. 2005)..... | 6 |
| <i>Biospherics, Inc. v. Forbes, Inc.</i> , 989 F. Supp. 748 (D.Md. 1997)..... | 6 |
| <i>Carolina First Corp. v. Whittle</i> , 343 S.C. 176, 539 S.E.2d 402 (Ct. App. 2000)..... | 5, 6, 7, 8, 9, 17, 18, 19 |
| <i>Clearwater Trust v. Bunting</i> , 367 S.C. 340, 626 S.E.2d 334 (2006) | 6, 11, 16, 19 |
| <i>Daily Income Fund, Inc. v. Fox</i> , 464 U.S. 523 (1984)..... | 9 |
| <i>Darcangelo v. Verizon Communications, Inc.</i> , 292 F.3d 181 (4th Cir. 2002) | 5 |
| <i>Elliott v. Greer Presbyterian Church</i> , 181 S.C. 84, 186 S.E. 651 (1936) | 14 |
| <i>Feeley v. NHAOCG, LLC</i> , 62 A.3d 649 (Del. Ch. 2012)..... | 16 |
| <i>Gardner v. Newsome Chevrolet-Buick, Inc.</i> , 304 S.C. 328, 404 S.E.2d 200 (1991) | 5 |
| <i>Graham v. Lloyd's of London</i> , 296 S.C. 249, 371 S.E.2d 801 (Ct. App. 1988)..... | 14 |
| <i>Grimes v. Donald</i> , 673 A.2d 1207 (Del. 1996) | 8, 17 |
| <i>Hayne Fed. Credit Union v. Bailey</i> , 327 S.C. 242, 489 S.E.2d 472 (1997) | 20 |
| <i>Hite v. Thomas & Howard Co. of Florence, Inc.</i> , 305 S.C. 358, 409 S.E.2d 340 (1991) | 11 |
| <i>Huntley v. Young</i> , 319 S.C. 559, 462 S.E.2d 860 (1995) | 11 |

| | |
|------------------------------------------------------------------------------------------------------------------------------------------|------------|
| <i>Int'l Association of Machinists v. Gonzales</i> , 356 U.S. 617 (1958)..... | 15 |
| <i>Latimer v. Richmond & D.R. Co.</i> , 39 S.C. 44 17 S.E. 258 (1893) | 7 |
| <i>Madison v. Am. Home Prods. Corp.</i> , 358 S.C. 449, 595 S.E.2d 493 (2004) | 6 |
| <i>Masters v. Rodgers Dev. Group</i> , 283 S.C. 251, 321 S.E.2d 194 (Ct. App. 1984)..... | 6 |
| <i>New Beckley Mining Corp. v. Int'l Union, United Mine Workers of America</i> , 18 F.3d 1161 (4th Cir. 1994) | 6 |
| <i>Queen's Grant II Horizontal Property Regime v. Greenwood Development Corp.</i> , 368 S.C. 342, 628 S.E.2d 902 (Ct. App. 2006)..... | 12 |
| <i>Renfro v. FDIC</i> , 773 F.2d 657 (5th Cir. 1985) | 9 |
| <i>Rice-Marko v. Wachovia Corp.</i> , 398 S.C. 301, 728 S.E.2d 61 (Ct. App. 2012)..... | 11, 12, 13 |
| <i>Slack v. James</i> , 356 S.C. 479, 589 S.E.2d 772 (Ct. App. 2003)..... | 5 |
| <i>State v. Jackson</i> , 338 S.C. 565, 527 S.E.2d 367 (Ct. App. 2000)..... | 14 |
| <i>Surowitz v. Hilton Hotels Corp.</i> , 383 U.S. 363 (1966)..... | 9, 10 |
| <i>Whetstone v. Whetstone</i> , 309 S.C. 227, 420 S.E.2d 877 (Ct. App. 1992)..... | 14 |
| <i>Williams v. Condon</i> , 347 S.C. 227, 553 S.E.2d 496 (Ct. App. 2001)..... | 5 |

RULES

| | |
|----------------------------|---------------------------------------------------------|
| Rule 12(b)(6), SCRCP | 5, 6, 16 |
| Rule 23(b)(1), SCRCP | 1, 2, 5, 6, 7, 8, 9, 10, 12, 13, 16, 17, 18, 19, 20, 21 |
| Rule 23.1(b), FRCP..... | 9 |
| Rule 8, SCRCP..... | 8, 16 |

OTHER AUTHORITIES

| | |
|-----------------------------------------------------------------------------------------|----|
| 3 Law of Trusts, Scott, Austin Wakeman, 4th Ed. §§ 265.2, 274, 274.1, 275, 276 | 14 |
| Restatement (Third) of Trusts § 44 (2003) | 14 |

COUNTER-STATEMENT OF ISSUES ON APPEAL

- I. **DID THE CIRCUIT COURT CORRECTLY HOLD THAT THE ACTION ASSERTS DERIVATIVE CLAIMS AND IS SUBJECT TO THE REQUIREMENTS OF RULE 23(b)(1)?**
- II. **DID THE CIRCUIT COURT CORRECTLY HOLD THAT THE FUND IS AN UNINCORPORATED ASSOCIATION AND NOT A TRUST, AND THAT RULE 23(b)(1), THEREFORE, APPLIES?**
- III. **DID THE CIRCUIT COURT CORRECTLY FIND THAT APPELLANTS FAILED TO SATISFY THE PLEADING REQUIREMENTS OF RULE 23(b)(1) AND, THEREFORE, PROPERLY DISMISS THE COMPLAINT?**

STATEMENT OF THE CASE

This appeal is from a derivative action filed against the South Carolina Home Builders Self Insurers Fund (“Fund”) and its Board of Trustees (“Board”).

In a prior action filed on February 16, 2012 (2012-CP-40-4311), Appellants brought suit against Respondents asserting various derivative claims. Some Appellants are corporate home builders, and others are individuals who are members/owners of the corporate home builders. The Appellants purported to represent themselves and all other members of the Fund. The Appellants alleged, among other things, that the Board removed assets without any benefit to the members and misused assets of the Fund.

Following an amendment of Plaintiffs’ Complaint in the prior action, Respondents moved to dismiss, based on Appellants’ failure to meet the pleading requirements of Rule 23(b)(1), SCRCF, in their pursuit of derivative claims. Judge Manning dismissed the lawsuit by an Order *proposed by Appellants*. The Order was based upon an alternative legal argument made by Respondents, that *if* the Fund was subsequently determined to be a trust, the circuit court did not have subject matter jurisdiction because such a claim would need to be filed first in the Probate Court.

Following dismissal without prejudice, Appellants filed a second lawsuit in the Richland County Probate Court, making claims similar to the first lawsuit. Appellants subsequently

removed that action to the circuit court (the lawsuit currently on appeal) and Respondents filed a motion to dismiss. The motion was heard by the Honorable G. Thomas Cooper, and after oral argument, he issued an Order denying the motion. Respondents timely served a motion to reconsider that Order. After a hearing on the motion to reconsider was held, Judge Cooper granted the motion and issued an Order dismissing the lawsuit. His Order was based on his determination that this was a derivative lawsuit and that the mandatory requirements of Rule 23(b)(1) had not been met. Appellants then filed a motion to reconsider the Order of Dismissal. That motion was denied without a hearing and this appeal followed.

FACTUAL BACKGROUND

The Fund was created by a document entitled Agreement and Declaration of Trust dated September 27, 1995. [Agreement and Declaration of Trust, R. p. 345] Its purpose, as spelled out in the document, is to provide a fund to meet and fulfill the home builder/member's obligations and liabilities under the South Carolina Workers' Compensation Act. The Fund is not an insurance company and is not regulated by the South Carolina Department of Insurance. [Mar. 15, 2012 Aff. J. Ranew ¶2, R. p. 124-25] Instead, the Fund is regulated by the South Carolina Workers' Compensation Commission, and provides home builders who voluntarily become members of the Fund an alternative for meeting the requirements of the Workers' Compensation Act. [*Id.*, R. p. 124-25]

If a home builder wants to become a member of the Fund, the home builder must complete a South Carolina Workers' Compensation Commission Form 6A, entitled "Application for Membership in a Self-Insured Fund," and pay a \$25.00 non-refundable application fee to the Commission. [*Id.*, R. p. 124-25] The application makes clear that "[i]f the applicant is approved, it is agreed and acknowledged that the applicant, along with the other members of the Fund, will be jointly and severally liable for any liability of the Fund which is incurred during

the applicant's membership in the Fund." [*Id.*, R. p. 124-25]; accord S.C. CODE ANN. § 15-35-170 ("On judgment being obtained against an unincorporated association..., the individual property of any copartner or member thereof found in the State shall be liable to judgment and execution for satisfaction of any such judgment."). Participation by the home builder is entirely voluntary. Upon Commission approval, the home builder becomes a member of the Fund and receives a certificate confirming membership in the Fund. [*Id.*, R. p. 125] The Fund also provides the new member with a new member packet and invoices the new member the amount due for providing the member with workers compensation benefits/coverage. [*Id.*, R. p. 125] The issued certificate sets forth the responsibilities of the Fund and the member. [*Id.*, R. p. 125] The member is required to pay premiums for the coverage provided by the Fund. The Fund administers and processes workers' compensation claims made against its members. [Mar. 15, 2012 Aff. J. Ranew ¶2, R. p. 125] The Fund is managed by a Board that is elected by the members.

Appellants repeatedly and incorrectly refer to the Fund's members (home builders) as "beneficiaries." Not true. The Fund is comprised of members who pay a premium to the Fund. The Agreement and Declaration, which established the Fund, refers to all fund participants as "members," as does the Workers' Compensation Commission Form 6A application. Reference to the members as "beneficiaries" is not found in any document and is simply a made-up term used by Appellants.

In their Complaint, Appellants make myriad allegations, claiming that alleged misconduct by the Board has harmed the Fund, which incidentally, is the core claim for a derivative action.

The Appellants' Brief and Complaint states many incorrect purported factual statements concerning the Fund:

- Appellants allege that they are beneficiaries of an Agreement and Declaration of Trust created in the Fund. [Complaint, R. p. 47] ***In fact, none are beneficiaries, and only some of the named Appellants remain as members of the Fund.*** [Agreement, R. p. 345; July 9, 2013 Aff. J. Ranew ¶2-3, R. p. 130-31]
- Appellants allege that the Trustees removed approximately \$5,000,000 from the Fund in order to incorporate a new member-owned insurance company. [Complaint, R. p. 49] ***In fact, the \$5,000,000 withdrawal for the purpose of establishing a member-owned mutual insurance company was done with the approval of the Workers' Compensation Commission using non-pledged assets. When the application for establishing the member-owned mutual insurance company was withdrawn, the \$5,000,000 was returned to the Fund.*** [Mar. 15, 2012 Aff. J. Ranew ¶4-5, R. p. 125-27]
- Appellants allege that the Trustees did not advise the members that the funds could be returned to them and failed to advise them of the potential tax consequences. [Complaint, R. p. 49] ***In fact, since the Fund's inception, the Board, in the exercise of its business judgment, when financially appropriate voted to declare a refund of member contributions due to excess reserve funds. In just the last 5 years, the members have received a return of member contributions totaling \$1,500,000. Of course, the ability of the Fund to make these past distributions was because of the fiscally sound and responsible management of the Board.*** [Mar. 15, 2012 Aff. J. Ranew ¶6, R. p. 127-28]
- Appellants allege that a building was purchased that provides no benefit to them. [Complaint, R. p. 50] ***In fact, the Fund, through a wholly-owned limited liability company, purchased a building with the approval of the Workers' Compensation Commission. The building generates revenue for the Fund and its members because a portion of the building is under lease to a third party.*** [Mar. 15, 2012 Aff. J. Ranew ¶3, R. p. 125]
- Appellants allege that the Trustees will use trust funds for the purpose of creating a member-owned mutual insurance company that would not benefit the members of the Fund. [Complaint, R. p. 51] ***In fact, the member-owned insurance company, if approved and created, would have a great benefit for the members: it would continue to offer workers' compensation coverage and at the same time eliminate the risk of joint and several liability that now exists with the present structure of the Fund. It would also provide more affordable rates for the members because the member-owned mutual insurance company would likely have a larger membership/risk pool.*** [Mar. 15, 2012 Aff. J. Ranew ¶5, R. p. 127]
- Appellants argue that if the current course for the Fund continues, there will be insufficient assets to cover the risks of the Fund. ***Appellants have not pleaded a single factual allegation to support this bald-faced statement.*** [Complaint, R. p. 47] ***In fact, the Fund has more than sufficient reserves, as shown by its required annual filings with the Workers' Compensation Commission.***

A running theme that permeates Appellants' misstatements are the allegations that the Fund has been harmed by the action/inaction of its Board. The allegations confirm that this is a derivative lawsuit. Accordingly, Appellants' failure to comply with Rule 23(b)(1), SCRCF, compelled the proper dismissal of their case.

STANDARD OF REVIEW

Reviewing the circuit court's decision with respect to Respondents' Rule 12(b)(6) motion, this Court is bound to apply the same standard of review used by the circuit court. *Williams v. Condon*, 347 S.C. 227, 233, 553 S.E.2d 496, 500 (Ct. App. 2001). When faced with a Rule 12(b)(6) motion, the circuit court should accept as true all well-pled factual allegations contained in the complaint, and view them in the light most favorable to the non-moving party. *Slack v. James*, 356 S.C. 479, 482, 589 S.E.2d 772, 774 (Ct. App. 2003), *aff'd*, 364 S.C. 609, 614 S.E.2d 636 (2005). The circuit court should dismiss a complaint for failure to state facts sufficient to constitute a cause of action if it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations contained in the complaint. *Slack*, 356 S.C. at 482, 589 S.E.2d at 773-74.

For purposes of considering Respondents' Rule 12(b)(6), SCRCF motion, the circuit court could only consider the complaint and any documents attached to or referenced in it, all of which comprise a portion of the Complaint. *Carolina First Corp. v. Whittle*, 343 S.C. 176, 190 & n.7, 539 S.E.2d 402, 410 & n.7 (Ct. App. 2000). In applying Rule 12, federal courts have recognized that where "collateral documents are inherent to the allegations in the complaint and the parties have noticed that the court will consider the documents" it is appropriate for the court to consider the referenced documents in deciding a motion to dismiss (without converting the

motion to one for summary judgment).¹ See *Darcangelo v. Verizon Communications, Inc.*, 292 F.3d 181, 195 n.5 (4th Cir. 2002) (citing *New Beckley Mining Corp. v. Int'l Union, United Mine Workers of America*, 18 F.3d 1161, 1164 (4th Cir. 1994)); *Abadian v. Lee*, 117 F.Supp.2d 481, 485 (D.Md. 2000) (citing *Biospherics, Inc. v. Forbes, Inc.*, 989 F. Supp. 748, 749 (D.Md. 1997), *aff'd*, 151 F.3d 180 (4th Cir. 1998)). Further, the circuit court may also take judicial notice of other matters of record in the same action. *Masters v. Rodgers Dev. Group*, 283 S.C. 251, 255, 321 S.E.2d 194, 196 (Ct. App. 1984) (holding judicial notice is appropriate for items whose “accuracy is capable of verification by reference to readily available sources of indisputable reliability”).

“When ‘the dispute is not as to the underlying facts but as to the interpretation of the law, and development of the record will not aid the resolution of the issues, it is proper to decide even novel issues on a motion to dismiss [pursuant to Rule 12(b)(6)].” *Bessinger v. BI-LO, Inc.*, 366 S.C. 426, 434, 622 S.E.2d 564, 568 (Ct. App. 2005) (quoting *Madison v. Am. Home Prods. Corp.*, 358 S.C. 449, 451, 595 S.E.2d 493, 494 (2004)).

Finally, and critical to this appeal, under Rule 23(b)(1), SCRPC, a plaintiff *must* meet certain pleading requirements in order to maintain a derivative action.² “A derivative action that does not meet the pleading requirements of Rule 23(b)(1), SCRPC, is properly dismissed pursuant to Rule 12(b)(6).” *Clearwater Trust v. Bunting*, 367 S.C. 340, 351, 626 S.E.2d 334, 339 (2006). This Rule seeks to prevent the unrestrained use of derivative actions. *Whittle*, 343 S.C. at 185, 539 S.E.2d at 407.

¹ Since [the South Carolina] Rules of Procedure are based on the Federal Rules, where there is no South Carolina law, [South Carolina courts] look to the construction placed on the Federal Rules of Civil Procedure.” *Gardner v. Newsome Chevrolet-Buick, Inc.*, 304 S.C. 328, 330, 404 S.E.2d 200, 201 (1991).

² Rule 23(b)(1) requires that “the complaint *shall* also allege with particularity the efforts made by the plaintiff to obtain the action he desires from the director . . . and the reason for his failure to obtain the action or for not making the effort.” (emphasis added).

I. THE CIRCUIT COURT CORRECTLY HELD THAT THE ACTION INVOLVES DERIVATIVE CLAIMS AND IS SUBJECT TO THE REQUIREMENTS OF RULE 23(B)(1).

A. Rule 23(b)(1) and Its Purpose

Rule 23(b)(1) addresses derivative actions filed by the shareholders of a corporation or members of an unincorporated association.³ The Fund is an unincorporated association. A derivative action is brought when one or more members of an unincorporated association, perceiving that the association has received an injury that the management has failed to redress, seeks to institute a suit for the benefit of the association. Rule 23(b)(1) is a departure from the Rule 8 pleading standards in that it explicitly provides additional pleading requirements for a derivative action. In *Carolina First Corp. v. Whittle*, this Court acknowledged that the “protective principles underlying the pleading requirements of Rule 23(b)(1) have long been recognized as important gatekeepers in South Carolina corporate jurisprudence.” 343 S.C. 176, 185, 539 S.E.2d 402, 407 (Ct. App. 2000).

The drafters of the rules of civil procedure rightly determined, building from common law jurisprudence, that derivative lawsuits must meet the additional requirements of a pre-suit demand in order for members of an unincorporated association to proceed with a lawsuit relating to the internal decision making of the association. *Latimer v. Richmond & D.R. Co.*, 39 S.C. 44, 51-52, 17 S.E. 258, 260-61 (1893) (stating that “before the shareholder is permitted, in his own name, to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to

³ The requirements of Rule 23(b)(1) apply with equal force in lawsuits against both an unincorporated association and a corporation. Thus, if a prior decision uses the word “corporation” when identifying a named defendant, the holding of that decision applies to derivative suits against “unincorporated associations,” as well. Also, in a derivative action against a corporation, the action will be brought by “shareholders” on behalf of the corporation. In a derivative action against an unincorporated association, the action will be brought by the “members” on behalf of the unincorporated association.

obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes”).

Rule 23(b)(1) provides that:

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation **or** of an unincorporated association, the corporation or association 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 or member at the time of the transaction of which he complains or that his share or membership 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 or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort.

Rule 23(b)(1), SCRCP (emphasis added).

In *Whittle*, this Court affirmed the circuit court’s dismissal of plaintiff’s complaint because it failed to meet the pleading requirements of Rule 23(b)(1). It held that “[d]emand is required in order to assure compliance with the most fundamental principle of corporate governance—directors are answerable to the shareholders and are charged with the duty and responsibility to manage all aspects of corporate affairs.” *Id.* at 188, 539 S.E.2d at 409. It is for that reason that a derivative action is referred to as a “remedy of last resort.” *Id.* at 187, 539 S.E.2d at 408.

The “protective principles” of Rule 23 have been adopted because a proper pre-suit demand alerts the Board so that it may exercise its reasonable business judgment as to whether any corrective action should be taken without litigation. *Id.* at 188, 539 S.E.2d at 409. Rule 23(b)(1) requires a plaintiff to allege **in the complaint** the details of his pre-suit demand with particularity. Again, “Rule 23 is a departure from the more liberal pleading requirements of Rule 8, SCRCP, in that it requires particularized allegations.” *Id.* at 188, 539 S.E.2d at 409. By pleading with particularity the actions sought by the plaintiff, the efforts he has made to convince the Board to take those actions, and the resulting decision by the Board, the Court is able to

exercise its gatekeeping authority. Thus, if a demand is rejected by the Board, then the particularized allegations set forth *in the complaint* allow the Court to determine whether the Board's decision deserves deference and, thus, whether a derivative suit should proceed. *E.g., Grimes v. Donald*, 673 A.2d 1207, 1219 (Del. 1996) (noting that if a demand is rejected, "the board rejecting that demand is entitled to the presumption of the business judgment rule unless the stockholder can allege facts with particularity creating a reasonable doubt that the board is entitled to the benefit of the presumption") (overruled on unrelated grounds related to standard of review).

South Carolina's Rule 23(b)(1) mirrors Federal Rule of Civil Procedure 23.1. The federal rule, from which South Carolina's rule is derived, was designed to protect against the potential abuses stemming from derivative actions. *Whittle*, 343 S.C. at 185, 539 S.E.2d at 407. Rule 23.1 seeks to prevent unrestrained use of derivative actions by shareholders of a corporation or members of an unincorporated association which would undermine the basic principles of corporate governance that certain decisions should be made by management of the entity. *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 (1984) (noting the requirements for bringing a derivative action were designed to limit actions to situations in which there is an unjustified failure by the entity to act for itself). Furthermore, such actions impinge on the inherent role of management to conduct the affairs of the entity. *Renfro v. FDIC*, 773 F.2d 657, 658 (5th Cir. 1985). Mandatory compliance with Rule 23(b)(1) provides the circuit court, as gatekeeper, with a roadmap to follow in determining whether an unincorporated association's management has been given an opportunity to address the alleged wrong before forcing it into litigation.

Appellants misconstrue the purpose of Rule 23 when analogizing to federal jurisprudence at pages 21-22 of their Brief. The portion of Rule 23(b) addressed in *Surowitz v. Hilton Hotels Corp.* is the predecessor to current Rule 23.1(b), FRCP, which primarily deals with the

requirement that a plaintiff in a derivative lawsuit verify the complaint before filing the same.⁴ 383 U.S. 363, 372 (1966). It is this verification requirement, and *not* the pleading requirements at issue here, that was written to prevent “strike suits,” in which suits were filed without regard to their truth in order to coerce corporate managers to settle. *Id.* at 371 (noting that verification requirement was “originally adopted . . . to discourage ‘strike suits’ by people who might be interested in getting quick dollars by making charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid of them”). To state that the entirety of Rule 23(b)(1) was created to prevent strike suits is grossly incorrect. Rule 23(b)(1) has clear and important gatekeeping functions that exist to allow management of a corporation or an association to use its business judgment when dealing with the operations and decision making of an organization. These pleading requirements are not mere “procedural technicalities”; they are designed to prevent minority members from taking an organization hostage.

The following are but a couple examples of why strict application of the pleading requirements of Rule 23(b)(1) are so important:

1. Assume the required pre-suit demand (which must be described with particularity in the complaint) asked a board to take action that would violate an SEC regulation or a decision of another regulatory agency (*e.g.*, the Workers’ Compensation Commission). If the pre-suit demand is denied and a member(s) brings an action against the unincorporated association because his demand was not met, a trial judge can properly dismiss the complaint at the earliest stage of the litigation.
2. Assume the required pre-suit demand asked a board to take action in a manner inconsistent with its managerial discretion. If the pre-suit demand is denied and the member brings an action against the unincorporated association because his demand was not met, a trial judge can look to the pleadings to determine whether the board’s decision falls within the protections of the business judgment rule. If it does, then the trial judge can properly dismiss the complaint at the earliest stage of the litigation. If it does not fall within the protections of the business judgment rule, then the trial judge can make that legal determination and allow the litigation to proceed.

⁴ *Accord* Rule 23(b)(1) (stating that the “complaint shall be verified”).

B. The Claims Sought by Appellants Are Derivative

Appellants brought claims that are clearly of a derivative nature and thus subject to the mandatory requirements of Rule 23(b)(1). Appellants assert claims for the association as opposed to individualized wrongs allegedly suffered by particular members. Their own allegations in their complaint regarding claimed wrongs committed by the Board establish the derivative nature of this lawsuit. Paragraph 41 of the Complaint states:

41. The plaintiffs are entitled to an Order of this Court ordering that the Trustees be removed for breach of their fiduciary duties and breach of trust, that new trustees be elected, **that all trust assets be returned to the Trust, that all damages incurred and funds taken out of the trust in breach of fiduciary duties and trust agreement be awarded**, enjoining further violations of the fiduciary duties and trust agreement, and awarding the plaintiffs and the class actual and punitive damages. (emphasis added).

[Complaint, ¶41, R.p. 52] Appellants could not maintain an individual action because they did not allege, nor could they, that any individual member's loss was separate and distinct from that of the Fund itself. In fact, they allege the opposite. For example, at paragraph 13 of the Complaint, Plaintiffs allege that their injuries are typical of the claims of the other members.

[Complaint, ¶13, R.p. 48] The Complaint identifies no personal, individualized damage to any Appellant, or an unnamed member for that matter.

A member of an association may maintain an individual action *only* if his loss is separate and distinct from that of the association. *Hite v. Thomas & Howard Co. of Florence, Inc.*, 305 S.C. 358, 361, 409 S.E.2d 340, 342 (1991), *overruled on other grounds by Huntley v. Young*, 319 S.C. 559, 462 S.E.2d 860 (1995); *Rice-Marko v. Wachovia Corp.*, 398 S.C. 301, 308, 728 S.E.2d 61, 65 (Ct. App. 2012). "A shareholder's suit is derivative if the gravamen of his complaint is an injury to the corporation and not to the individual interest of the shareholder." *Hite*, 305 S.C. at 361, 409 S.E.2d at 342. Allegations of corporate malfeasance that result in identical harm to all shareholders constitute a "breach of fiduciary duty [claim that] gives rise to a classic

shareholders' derivative suit." *Clearwater Trust*, 367 S.C. at 351, 626 S.E.2d at 339; *Babb v. Rothrock*, 303 S.C. 462, 464, 401 S.E.2d 418, 419 (1991) ("It is firmly established by our decisions that individual shareholders may not sue corporate directors or officers directly for losses suffered by the corporation.").

The gravamen of Appellants' Complaint alleges that the Fund has been injured and that each member may be liable for a shortfall in the assets of the Fund. This is not an allegation setting forth a specific, individualized injury. Instead, such an allegation meets the definition of a lack of a distinct injury to any single member. These alleged injuries are to the collective whole, and are not specific, differentiated injuries to particular members. Appellants do not allege particularized losses that the individual members of the Fund suffered or might suffer; instead, it is a collective loss that has been (or could be) allegedly suffered equally by all members.

In an effort to evade the Rule 23(b)(1) requirements of a derivative lawsuit, Appellants argue for the right to bring direct claims under the so-called "special duty" exception. [Appellants' Brief, pp. 15-16] The Appellants did not raise this issue to the circuit court; they raised it for the first time in their opening brief to this Court. Accordingly, it is not preserved for appellate review. *Queen's Grant II Horizontal Property Regime v. Greenwood Development Corp.*, 368 S.C. 342, 372, 628 S.E.2d 902, 919 (Ct. App. 2006) ("In order for an issue to be properly preserved for appeal, it must have been both raised to and ruled upon by the trial court.").

Issue preservation aside, Appellants' special duty argument fails as a matter of law. Appellants take the position that the general fiduciary duties the Board owes to all of the members of the Fund should be labeled as a *special duty*. That argument was rejected by the very decision Appellants cite.

In *Rice-Marko v. Wachovia Corp.*, 398 S.C 301, 728 S.E.2d 61 (Ct. App. 2012), former shareholders sought to bring direct claims against officers and directors of Wachovia for losses to their investment in Wachovia stock. The shareholders alleged they had a right to bring a direct claim for these losses based, in part, upon the special duty exception to the rule that “shareholders do not have standing to bring direct claims for wrongs that diminish the value of their shares in a corporation.” *Id.* at 307, 728 S.E.2d at 65. Affirming the circuit court’s dismissal of the shareholders’ complaint, the Court noted that “Appellants have failed to allege any facts from which it may be inferred that Respondents owed Appellants a duty that was personal to Appellants and distinct from the duty Respondents owed Wachovia and its shareholders.” *Id.* at 309, 728 S.E.2d at 65.

In support of their special duty argument, Appellants do not even cite to their Complaint. The omission is telling. Appellants’ Complaint does *not* identify any special duty between the Board and Appellants that is personal and distinct from the general fiduciary duties that the Board owes to all members. In fact, the Complaint repeatedly refers to the duties that the Board owed to the membership in terms of its general fiduciary duties. Accordingly, Appellants special duty argument fails as a matter of law.

It is clear from the pleadings that the Appellants are seeking damages on behalf of the Fund based on the alleged actions of the Board. Therefore, the claims are quintessentially derivative, making the entirety of the Complaint derivative in nature. The circuit court correctly held that the Complaint is derivative and that Rule 23(b)(1) applied.

II. THE CIRCUIT COURT CORRECTLY HELD THAT THE FUND IS AN UNINCORPORATED ASSOCIATION AND NOT A TRUST, AND THAT RULE 23(B)(1), THEREFORE, APPLIES

The circuit court held, as the Respondents maintained, that the Fund is an unincorporated association and not a trust. In making this determination, it is necessary to analyze the essence of each form of entity, rather than look to mere labels.

A. What is the Essence of a Trust?

A trust is an arrangement whereby property is transferred to another with the intent that it be administered by the trustee for the benefit of the transferor or a third party. *State v. Jackson*, 338 S.C. 565, 570, 527 S.E.2d 367, 370 (Ct. App. 2000). To prove the existence of a trust, the following elements must be shown: (1) a declaration creating the trust, (2) a trust *res*, and (3) designated beneficiaries. *Whetstone v. Whetstone*, 309 S.C. 227, 231, 420 S.E.2d 877, 879 (Ct. App. 1992) (holding that no trust existed because there was no initial trust *res*). “It is an axiomatic principle of law that a person or entity must hold title to property in order to declare that it is held in trust for the benefit of another or transfer legal title to one person for the benefit of another.” *All Saints Parish Waccamaw v. Protestant Episcopal Church in Diocese of S. Carolina*, 385 S.C. 428, 449, 685 S.E.2d 163, 174 (2009).

In a private, non-charitable trust, the beneficiaries normally must be ascertainable. *Restatement (Third) of Trusts* § 44 (2003). Such beneficiaries are normally named, or can be derived from, the formational document of the trust. Furthermore, it is a fundamental element of a trust that its beneficiaries do not face liability for the actions of the trust. For example, a beneficiary is not liable as the constructive owner of the underlying trust property, is not liable in contract or tort, and is not liable as a stockholder (*i.e.*, for a capital call for stock that is held by the trust). See 3 *Law of Trusts*, Scott, Austin Wakeman, 4th Ed. §§ 265.2, 274, 274.1, 275, 276.

B. What is the Essence of an Unincorporated Association?

As opposed to a trust, an unincorporated association is a body of individuals organized for the pursuit of some common enterprise. *Graham v. Lloyds of London*, 296 S.C. 249, 255, 371 S.E.2d 801, 804 (Ct. App. 1988). An unincorporated association is not a legal entity separate from the individuals who compose it. *Id.* The liability of members of an unincorporated association is joint and several. *Elliott v. Greer Presbyterian Church*, 181 S.C. 84, 186 S.E. 651, 658 (1936); S.C. CODE ANN. § 15-35-170 (“On judgment being obtained against an unincorporated association..., the individual property of any copartner or member thereof found in the State shall be liable to judgment and execution for satisfaction of any such judgment.”). *Accord Hall v. Walters*, 226 S.C. 430, 437, 85 S.E.2d 729, 732 (1955). Members freely and voluntarily choose to join an unincorporated association. A common example of such an association is a labor union. *See Int’l Association of Machinists v. Gonzales*, 356 U.S. 617 (1958). An unincorporated association is the predecessor to the many statutory business organizations common in today’s world, such as corporations, limited partnerships, and limited liability companies.

C. The Fund Is Not a Trust But an Unincorporated Association

Analyzing this Fund in accordance with the respective elements of a trust on the one hand and an unincorporated association on the other hand allows for a ready identification of the Fund as an unincorporated association – not a trust.

The Fund is missing several essential characteristics of a trust:

- At inception, an identifiable trust *res* was not provided by a grantor. The Fund’s property does not come from a third-party grantor or benefactor, but instead from contributions from the members themselves, through membership dues and workers’ compensation premiums; membership is voluntary.
- The formational document did not contain ascertainable beneficiaries. The Agreement states generally that home builders can voluntarily become members

of the Fund, but no specific grouping is derived as normally exists with a trust (for example, a trust created for the benefit of all children of Mr. Smith).

- The Fund does not hold property transferred from one person for the benefit of another. There is no transfer of property, in the sense of a grantor providing property to the Fund and then relinquishing his rights to have some form of control over the property. Instead, money is voluntarily contributed to the fund by each member to provide a pool of money for workers' compensation coverage.
- The members of the Fund do not operate without any risk of liability for the actions of the Fund. If there is a shortfall in assets, every member faces joint and several liability for the Fund's losses.

The Fund is an unincorporated association:

- The Fund is comprised of a body of members joined together for a common purpose. The members have voluntarily come together with a common purpose to form a fund that provides lower costs for workers' compensation coverage for South Carolina home builders and their companies.
- Members voluntarily join the Fund. Each member makes a decision to join the Fund, and does so through an application process. Every application for membership must be approved by the Workers' Compensation Commission.
- Liability for the members of the Fund is joint and several.

While the Fund was created by a document called a declaration of trust, the circuit court correctly looked at substance over form and held that the declaration does not create a trust. *See Feeley v. NHAOCG, LLC*, 62 A.3d 649, 668 (Del. Ch. 2012) (noting, in a breach of fiduciary duty case, application of equitable maxim that "equity regards substance rather than form"). The circuit court correctly concluded that the Fund is an unincorporated association. The primary significance of this is that since the Fund is an unincorporated association the requirements of Rule 23(b)(1) **must** be met. "The complaint **shall** also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors" Rule 23(b)(1), SCRCF (emphasis added).

III. THE CIRCUIT COURT CORRECTLY FOUND THAT APPELLANTS FAILED TO SATISFY THE PLEADING REQUIREMENTS OF RULE 23(B)(1)

A. Appellants Failed to Satisfy the Pleading Requirements of Rule 23(b)(1)

As noted above, the subject Complaint challenged the decisions of the Fund's Board. Furthermore, the subject Complaint alleged equal harm to all members. Consequently, this is a derivative action that must meet the mandatory pleading requirements of Rule 23(b)(1), SCRCF. "A derivative action that does not meet the pleading requirements of Rule 23(b)(1), SCRCF, is properly dismissed pursuant to Rule 12(b)(6)." *Clearwater Trust*, 367 S.C. at 351, 626 S.E.2d at 339. The pleading requirements of Rule 23 require particularized, detailed, and heightened allegations, and are a departure from the liberal pleading requirements of Rule 8. *Whittle*, 343 S.C. at 188, 539 S.E.2d at 409. This Rule seeks to prevent the unrestrained use of derivative actions. *Id.* at 185, 539 S.E.2d at 407.

Whittle represents good law, is controlling and compels affirmance of the circuit court's order. Recognizing that *Whittle* compels affirmance, Appellants resort to the only course available to them – they ask this Court to overrule *Whittle*. This Court should summarily reject Appellants' argument. The *Whittle* Court correctly based its holding on South Carolina jurisprudence as well as federal case law concerning Rule 23. The "protective principles" of Rule 23 have been adopted because a proper pre-suit demand alerts the Board so that it may exercise its reasonable business judgment as to whether any corrective action should be taken without litigation. *Id.* at 188, 539 S.E.2d at 409. A plaintiff must allege *in his complaint* the details of his pre-suit demand with *particularity*. A Court is able to exercise its gatekeeping authority and decide whether to allow a case to move forward only when a plaintiff pleads with particularity in the complaint the actions sought by the plaintiff, the efforts he has made to convince the Board to take those actions, and the resulting decision by the Board. *E.g., Grimes*, 673 A.2d at 1219. Appellants have clearly failed to meet these Rule 23(b)(1) requirements.

Appellants claim that they have indeed met the requirements of Rule 23(b)(1) by the allegations set forth in paragraph 8 of their Complaint. They clearly have not. Paragraph 8 states in its entirety:

8.
 - a. The Plaintiffs were beneficiaries of the trust at all times relevant including when the transactions complained of were made.
 - b. The Plaintiffs, their agents or others on their behalf have made efforts to obtain the action they desire in this matter including correspondence to Counsel for the Defendants, meetings with counsel for the Defendants, correspondence to the Trust and a previous lawsuit to no avail.

[Complaint, ¶ 8; R. p. 48].

To make the determination of whether the pleading requirements of Rule 23(b)(1) have been met, a court may look *only* to the “four corners” of the complaint. *Whittle*, 343 S.C. at 190, 539 S.E.2d at 410. Appellants failed to satisfy the following requirements:

- Appellants failed to allege “with particularity” the pre-suit efforts they made to convince the board to meet their demands.
- At a minimum, the complaint must specifically identify the alleged wrongdoers, describe the factual basis of the wrongful acts and the harm caused, and the requested remedial relief. *Whittle*, 343 S.C. at 189, 539 S.E.2d at 409.
- Plaintiffs only make a general allegation in paragraph 8 of the Complaint that they “made efforts to obtain the action they desire” by way of correspondence, meetings, and a previous lawsuit. South Carolina’s courts have deemed such general allegations totally insufficient. *Whittle*, 343 S.C. at 189, 539 S.E.2d at 402 (plaintiffs alleged they demanded “certain information” and “certain actions” in their derivative action; court deemed these allegations conclusory and insufficient).
- Plaintiffs also fail to allege any reasons for not making an appropriate pre-suit demand on the Trustees.

A simple review of the Complaint confirms the Appellants’ failure to comply with the requirements of Rule 23(b)(1). Comparing the facts alleged in the Complaint to the allegations set forth in the *Whittle* complaint establishes that the Complaint failed to meet the heightened pleading requirements of Rule 23(b)(1):

- In *Whittle*, the complaint alleged that plaintiffs demanded “certain information”; *Id.* at 189, 539 S.E.2d at 409. In the instant matter, Appellants Complaint states that they sent “correspondence to counsel for defendants.” [Complaint, ¶ 8; R. p. 48].
- In *Whittle*, the complaint alleged that plaintiffs demanded that “certain actions” be taken; *Id.* at 189, 539 S.E.2d at 409. In the instant matter, the Complaint alleged that Appellants had “meetings with counsel for defendants.” [Complaint, ¶ 8; R. p. 48].
- In *Whittle*, the complaint alleged that plaintiffs made a “supplemental demand”; *Id.* at 189, 539 S.E.2d at 409. In the instant matter, the Complaint alleges that Appellants “sent correspondence to the Trust.” [Complaint, ¶ 8; R. p. 48].

As in *Whittle*, this Complaint did “not allege what the [members] demanded and what the Board rejected.” *Id.* at 189, 539 S.E.2d at 409. Appellants alleged they sent “correspondence” without stating what was in the correspondence. Appellants allege they “had a meeting with counsel for defendants” without even hinting at what may have been said at the meetings. Appellants claim they sent “correspondence to the trust” without even summarizing what was in the correspondence. And finally, Appellants did not allege what the Board rejected—in fact, they could not include those particularized allegations because they did not even allow the Board to provide a substantive response. *See infra* n.5. As in *Whittle*, Appellants brought a derivative action that failed to comply with the requirements of Rule 23(b)(1) and, thus, Judge Cooper properly dismissed it. *Clearwater Trust*, 367 S.C. at 351, 626 S.E.2d at 339. The circuit court properly held that the Complaint failed to allege with particularity the efforts the Appellants made to satisfy the pre-suit demand requirements of Rule 23(b)(1).

During oral argument at the below motions hearing, Appellants asserted that they sent a demand letter to the Board setting forth specific demands.⁵ Contrary to the arguments posited by

⁵ After Respondents alerted Appellants to the Rule 23(b)(1) requirements by moving to dismiss their first complaint for failure to comply with the same, and while the parties were awaiting a ruling on that motion, Appellants sent a “demand letter” to Respondents. Respondents replied to that letter stating a substantive response would not be forthcoming until the circuit court ruled on their motion to dismiss. The circuit court entered an Order dismissing the first complaint on March 5, 2013; before Respondents were able to provide a substantive response, Appellants filed the second action (present appeal) on April 9, 2013. At the hearing on

Appellants, they did not articulate those demands in their Complaint, nor did they incorporate that letter into their Complaint, either by reference as an attachment or exhibit. The circuit court properly held that it could not review that letter in ruling on the motion to dismiss, pursuant to the pleading requirements of Rule 23(b). *Whittle*, 343 S.C. at 190, 539 S.E.2d at 410 (noting that court may only look to the “four corners of the pleading”).

The circuit court properly held that Appellants failed to meet the pleading requirements of Rule 23(b)(1), and did not commit any error in dismissing the Appellants’ Complaint.

B. Respondents Are Not Judicially Estopped from Maintaining that the Fund is an Unincorporated Association

Appellants argue that the Respondents were judicially estopped from maintaining that the Fund was an unincorporated association due to the order of dismissal in the first action. Put simply, this argument fails, and judicial estoppel does not apply.

Judicial estoppel precludes a party from adopting a position in conflict with one earlier taken in the same or related litigation. *Hayne Fed. Credit Union v. Bailey*, 327 S.C. 242, 251, 489 S.E.2d 472, 477 (1997). The purpose of the doctrine is to protect the integrity of the judicial process rather than to protect litigants from allegedly improper conduct by their adversaries. *Id.* Significantly, judicial estoppel generally applies only to inconsistent statements of fact, and the doctrine does not apply to conclusions of law or assertions of legal theories. *Id.*

In Respondents’ Motions to Dismiss in the first action, Respondents argued the very same Rule 23(b)(1) grounds that they argued in their Motions to Dismiss in the instant matter.

Respondents’ motion to reconsider their motion to dismiss, Respondents stipulated on the record that they would accept Appellants demand letter and provide a substantive response. The circuit court dismissed this action and in its order stated that Respondents had 60 days to respond to the demand letter. [Order, R. p. 20]. Respondents complied and provided a substantive response on April 16, 2014. [Response to Demand Letter, R. p. 320]. With the benefit of a stipulated demand letter and a substantive response, the Appellants were then equipped to allege with particularity in their new complaint all details of the demand process in a subsequent lawsuit. Appellants, however, opted to file a notice of appeal on April 30, 2014.

As in the second action, Appellants alleged in the first action that the Fund was a trust. Only as an alternative theory to Respondents' Rule 23(b)(1) grounds for dismissal, Respondents argued that *if*, as Appellants asserted, the Fund was subsequently determined to be a trust, then the Complaint still must be dismissed because the circuit court did not have subject matter jurisdiction. These arguments are not an inconsistent statement of fact; instead, they represent the normal practice of providing multiple legal theories to a court for grounds for dismissal of an action.⁶ That the circuit court in the first action used this alternative theory for dismissal, advanced by Appellants in their proposed order submitted to the circuit court, does not limit or estop the Respondents from asserting their primary arguments for dismissal upon the filing of a new action by Appellants. Appellants cannot use an alternative argument made by Respondents (and supported by Appellants through their proposed order to the circuit court) and bootstrap it to prevent Respondents from pursuing their primary justifications for dismissal.

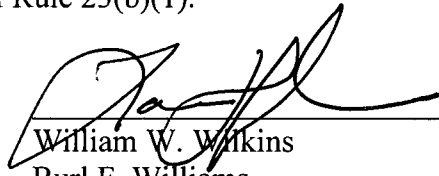
As a matter of law, Respondents' use of an alternative legal theory does not fall within the boundaries of judicial estoppel. Accordingly, they are not precluded from asserting that the Fund is an unincorporated association.

CONCLUSION

Appellants filed a complaint that alleged the Fund's Board acted in a manner that harmed all members of the Fund in the same manner. The Fund is an unincorporated association. Appellants' Complaint pleaded a classic derivative lawsuit. Appellants' Complaint, however, failed to meet the mandatory heightened pleading requirements of Rule 23(b)(1). Judge Cooper correctly identified the deficiencies in Appellants' Complaint and dismissed it. This Court

⁶ This is no different than Appellants' alternative positions in the circuit court and before this Court that they were not required to meet the pleading requirements of Rule 23(b)(1), but if they were, then they did so in paragraph 8 of their Complaint.

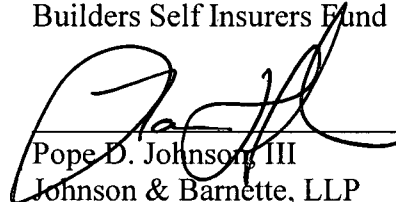
should affirm Judge Cooper's decision because it correctly followed this Court's decision in *Whittle* and the mandatory requirements of Rule 23(b)(1).



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November 19, 2014

THE STATE OF SOUTH CAROLINA
In the Court of Appeals

APPEAL FROM RICHLAND COUNTY
Court of Common Pleas

G. Thomas Cooper, Jr., Circuit Court Judge

Case No. 2013-CP-40-2655
Appellate Case No. 2014-000963

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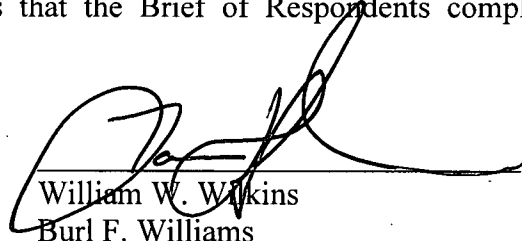
Allen Patterson, Steve Tilton, Richard Sendler, Lincoln Privette, Marc Ellis, Joey Carter, Barry Davis, Michael Nieri, Allen Patterson Residential LLC, Tilton Group, Sendler Construction Co., Inc., Privette Enterprises, Ellis Construction Co., Inc., The Barry Davis Company, Inc., Great Southern Homes, and J. Carter, LLC, on behalf of themselves and others similarly situated
..... Appellants,

v.

Herb Witter, Colin Campbell, Eddie Weaver, Tom Markovich, Keith Smith, Jim Gregorie, individually and as Trustees of the South Carolina Home Builders Self Insurers Fund, and the South Carolina Home Builders Self Insurers Fund..... Respondents.

CERTIFICATE OF COUNSEL

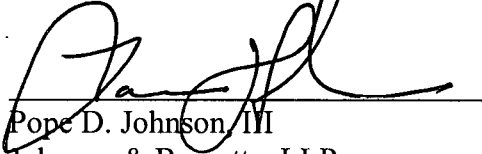
The undersigned hereby certifies that the Brief of Respondents complies with Rule 211(b) SCACR.



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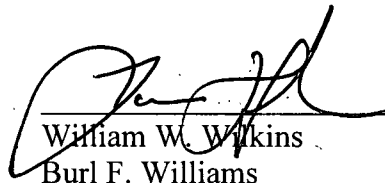
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PROOF OF SERVICE

The undersigned hereby certifies that on November 19, 2014, he served the foregoing **FINAL BRIEF OF RESPONDENTS** and **CERTIFICATE OF COUNSEL** on all counsel of record by placing a copy in the United States Mail, first class postage prepaid, addressed as follows:

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