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Division II
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No. 53991-8-II

IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION II

REAL CARRIAGE DOOR COMPANY, INC., ex rel. SCOTT T. REES, MARDIE A. R. BRODERICK and JEREMY E. BRODERICK, Shareholders Thereof; and SCOTT T. REES, MARDIE A.R. BRODERICK and JEREMY E. BRODERICK, Individually,

Appellants/Plaintiffs,

v.

DON T. REES,
Respondent/Defendant.

BRIEF OF APPELLANTS

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I. INTRODUCTION

This is a case of a family-business where a divorce deeply divided the family after the father, Defendant Don Rees, filed for divorce from his wife, Beth Rees. Before the divorce, Beth and Don Rees, and their children, Scott Rees, Mardie (Rees) Broderick and her husband, Jeremy Broderick, all worked for the Company. In addition, Beth, Don, Scott, Mardie and Jeremy were all shareholders in the Company. As part of the divorce settlement, Don acquired Beth's shares in the Company, resulting in Don owning 88 percent of the Company's shares, with Scott, Mardie and Jeremy owning the remaining 12 percent of the shares.

After Don filed for divorce, Scott, Mardie and Jeremy sided with Beth in the divorce. This greatly angered Don and he set out to make work difficult for Scott, Mardie, and Jeremy. As a result, all three stopped working for the Company. However, they all retained their shares in the Company.

As Don Rees explained to the Company's bookkeeper, he devised a plan to cease paying corporate dividends to all of the shareholders, except he would then increase his salary to approximately the same amount he would have received had the corporation paid dividends. Not only would Scott, Mardie and Jeremy not receive any corporate dividends, because the corporation is an IRS S corporation, they would be required to still pay their proportionate share of the taxes due on the corporation's net earnings without receiving any money from the corporation to pay those taxes. Only Don Rees would receive money from the corporation. He further explained to the Company's bookkeeper this would force Scott, Mardie and Jeremy to sell their shares to him at a below-market rate. Therefore, Don Rees directed the Company to stop paying dividends to the shareholders and instead dramatically increased his annual salary, from an average of $101,145 per year before the divorce filing to an average of $994,838 after the divorce filing. By disguising his dividend as salary, Don Rees improperly circumvented IRS regulations requiring that dividends be distributed to all shareholders on a pro rata basis, and that salaries of shareholders in a closely held corporation be reasonable.

In addition, Don Rees had the Company advance him $3 million, which he used to purchase Beth's shares as part of the divorce settlement. Because this payment constituted a distribution, the Company was required to make a pro rata distributions to the other shareholders. The Company failed to do so, however, and instead Don Rees attempted, more than a year later, to reclassify the $3 million dollar distribution as a loan.

As discussed below, the actions of Don Rees constitute a breach of his fiduciary duties to the Company and its shareholders, while also constituting minority shareholder oppression and fraud.

II. ASSIGNMENTS OF ERROR

1. The superior court erred in entering Findings of Fact Nos. 5, 6, 7, 8, 11, 12, 15, 16, 19 and 20 because these findings are not supported by substantial evidence in the record.

2. The superior court erred in entering Finding of Fact No. 5 because Jeremy Broderick is the son-in-law of Beth and Don Rees and not their step-son, and because this finding is not supported by substantial evidence in the record.

3. The superior court erred in entering Findings of Fact No. 6, 7, 8, and 12, because the findings that the Plaintiffs have "had no further involvement with the company" are not supported by substantial evidence in the record.

4. The superior court erred in entering Finding of Fact No. 11 because this finding fails to acknowledge that the funding received by Don Rees was a distribution from the Company.

5. The superior court erred in entering Finding of Fact No. 15 because this finding fails to acknowledge that the special meeting was held at a time the Plaintiffs could not attend the meeting and because it fails to acknowledge that the Plaintiffs' presence at the meeting would have been futile.

6. The superior court erred in entering Finding of Fact No. 16 because the finding that the Company funds given the Defendant "were supposed to have been documented as a loan to Defendant Rees" and that the Defendant made all payments due under the loan is not supported by substantial evidence in the record.

7. The superior court erred in entering Findings of Fact Nos. 17 and 18 because the finding that the Defendant's salary prior to 2015 was $190,000 per year is not supported by substantial evidence in the record.

8. The superior court erred in entering Findings of Fact Nos. 19 and 20 because these findings are not supported by substantial evidence in the record.

9. The superior court erred in entering Conclusion of Law No. 3 because the Defendant breached his fiduciary duty to the Company and the Plaintiffs, and the business judgment rule does not apply because the Defendant acted in bad faith.

10. The superior court erred in entering Conclusions of Law Nos. 4 and 11 because there was no "implied agreement" or expectation that dividends would only be made when the shareholders were employed by the Company.

11. The superior court erred in entering Conclusions of Law Nos. 5 and 7 because the salary paid to the Defendant was not reasonable.

12. The superior court erred in entering Conclusion of Law No. 6 because the decision to not distribute dividends was made in bad faith and because it was unreasonable.

13. The superior court erred in entering Conclusion of Law No. 8 because the Defendant's actions were made in bad faith and were oppressive to the minority shareholders, and because the business judgment rule does not apply.

14. The superior court erred in entering Conclusion of Law No. 9 because the court applied the wrong standard for fraud and because the conclusion is not supported by the law or substantial evidence.

15. The superior court erred in entering Conclusion of Law No. 10 because the conclusion that the funds provided to the Defendant was a loan, and not a disguised dividend, is not supported by the law or substantial evidence.

16. The superior court erred in entering Conclusions of Law Nos. 12, 13, 14, 15 and 16.

17. The superior court erred in entering Judgment Dismissing Plaintiffs' Claims with Prejudice.

In accordance with RAP 10.4(c), the superior court's findings of fact and conclusions of law are set out in Appendix A.

III. ISSUES RELATED TO ASSIGNMENTS OF ERROR

1. Did the superior court err in holding that the Defendant did not breach his fiduciary duty to the Company and minority shareholders when the Defendant's actions in disguising dividends as excessive salary and a personal loan improperly withheld dividends from the minority shareholders and jeopardized the S corporation status of the Company, which could cause the Company to incur income tax payments and penalties? (Assignments of Error Nos. 1, 6, 8-13, 15-17)

2. Did the superior court err in holding that the business judgment rule protected the actions of the Defendant because the rule does not apply when the Defendant acts in bad faith and not in the best interests of the Company? (Assignments of Error Nos. 1, 6, 8-13, 15-17)

3. Did the superior court err in holding that the Defendant did not oppress minority shareholders, when there was overwhelming evidence at trial that the Defendant acted in bad faith to punish the Plaintiffs for siding with their mother in the divorce, attempted to force the Plaintiffs to sell their shares to the Defendant at below market rates, and breached his fiduciary duties to the minority shareholders? (Assignments of Error Nos. 1, 6, 8-13, 15-17)

IV. STATEMENT OF THE CASE

A. The Company Before and After the Divorce

In the beginning, Real Carriage Door Company, Inc. (the "Company") was a family business in which Beth[1] and Don Rees and their children worked. Verbatim Report of Proceeding (VRP), June 18, 2019, at 7:21-8:7. The Company builds and ships doors that open like a carriage or barn door would open. Ex. 1 at ¶ 4.

Wanting to create a family business with the children eventually taking control, the parents gave shares of the Company's stock to the children. VRP 6/17/19 at 29:18-30:5. From 2010 through 2013, Beth and Don Rees made gifts of shares of stock to their son, Scott Rees, of six percent; to their daughter, Mardie Broderick, of 3.1 percent; and to their son-in-law, Jeremy Broderick (Mardie's husband), of 2.9 percent. VRP 6/18/19 at 8:12-18; Ex. 1 at ¶ 8. Beth Rees made approximately 59 percent of those gifts, and Don Rees approximately 41 percent. Ex. 1 at ¶ 8. After the gifting of shares, the parents owned 88 percent of the Company, while their children and son-in-law owned 12 percent.

[1] Beth Rees, the mother of Plaintiffs Scott Rees and Mardie Broderick, is occasionally referred to as Shirley Rees or Shirley Beth Rees. *See* VRP 6/17/2019 at 109:2-3; Ex. 115.

In April 2014, Defendant Don Rees, filed for divorce from his wife, Beth. Ex. 1 at ¶ 14. Scott, Mardie and Jeremy were against the divorce, and all took Beth's side, which greatly angered the Defendant. VRP 6/17/19 at 32:4-34:15; 56:24-57:3. From that point on, Don Rees created an "oppressive environment" that made it very difficult for Scott and Jeremy[2] to continue working for the Company. VRP 6/17/19 at 32:9-16; 57:7-14. The Defendant's actions created an atmosphere of distrust between himself and Scott and Jeremey. VRP 6/17/19 at 32:9-11; 57:7-10; 81:7-17. The Defendant asked the Company's bookkeeper, Jennifer Pomeroy, to report to him whenever Scott or Jeremy requested she perform a work-related task. VRP 5/17/19 at 81:18-82:11. His strategy worked as both Scott and Jeremy left the Company in November and December 2014. VRP 6/17/19 at 37:12-14; 58:24-59:2. However, Scott, Mardie and Jeremy all retained their shares of stock in the Company. VRP 6/17/19 at 37:15-18; 59:3-6.

After the divorce, the Defendant became the controlling shareholder of the Company as he acquired Beth's shares of stock, owning 88 percent of the Company's shares. VRP 6/18/19 at 36:25-37:6. Don Rees is also the President and Chief Executive Officer of the Company. VRP 6/18/19 at

[2] Mardie Broderick had ceased working for the Company several years earlier when her child was born, but occasionally worked part-time. VRP 6/17/19 at 51:14-20.

126:23-25. Thus, the Defendant has had complete control of the company since the divorce became final in April 2015. *See* the Decree of Dissolution, Exs. 5 and 103.

Prior to the divorce, the Company distributed to every shareholder enough money each year to enable them to pay their proportionate share of the net profit of the Company since it had filed an election with the IRS to be treated as an S corporation. After the divorce, however, the Defendant directed the Company to stop making distributions of Company profits in the form of S corporation dividends to the shareholders, while simultaneously and dramatically increasing his annual salary from the Company, from $120,000 the year before the divorce was filed to $1,216,367, after the divorce. Ex. 14 at p.3. He did this despite the fact the effect was to increase the amount of taxes that both he and the Company had to pay.

When Don Rees ceased taking payments in the form of S corporation dividends (which pursuant to the applicable IRS Regulations he would have to share proportionately with the Plaintiffs, as shareholders) and greatly increased his salary, that caused both the Defendant and the Company to pay greater taxes because no employment taxes are due on S corporation distributions, but they are due on salary payments. VRP 6/17/19 at 121:11-122:23; 143:10-18. This also increased the amount of income tax he had to pay because the amounts he received as compensation were fully taxable, whereas distributions of S corporation dividends are not taxable to the extent a shareholder has previously paid taxes on all or a portion of the amount distributed.

Before the divorce, the Company routinely made pro rata distributions to all shareholders on a quarterly basis so that the shareholders would have funds available to pay taxes on the Company's income. VRP 6/17/19 at 37:24-38:16; 45:16-17. After the divorce, the Company stopped making distributions to the Plaintiffs and the Plaintiffs were forced to use their own funds to pay the taxes on the Company's income. VRP 6/17/19 at 38:13-22.

The Defendant, however, took a bonus from the Company so that he could use those funds to pay his share of the Company's taxes in 2015. On April 14, 2015—one day before the federal income tax deadline—the Company issued Don Rees a payroll check with gross wages equaling $170,727. Ex. 14 at p.4. The Company's bookkeeper, Jennifer Pomeroy, testified at trial that:

> It was decided that Don would take a bonus to cover his -- his estimated tax payments instead of taking a distribution. If he took a bonus, then he didn't have to pay out a distribution to the kids to match their percentage of ownership.

VRP 6/17/19 at 74:23-75:2.

After the divorce became final in 2015, the Company stopped paying dividends to the shareholders. VRP 6/17/19 at 38:4-16. Instead, the Company significantly increased the salary of Don Rees. In the five years before his divorce became final, the Defendant's annual salary from the Company was:

2010	\$64,727
2011	\$96,000
2012	\$105,000
2013	\$120,000
2014	\$120,000

which averaged \$101,145 per year for those five years. Ex. 14 at p.3; VRP 6/17/19 at 112:16-21.

After the divorce, however, the Defendant's salary skyrocketed to an average of \$994,838 per year:

2015	\$1,216,367
2016	\$834,562
2017	\$973,926
2018	\$954,500

Ex. 14 at p.3; VRP 6/17/19 at 113:12-17.

Whether this nearly ten-fold increase in salary is reasonable, or whether it is primarily a disguised dividend to Don Rees, is a key issue in this case.

The bookkeeper also testified that Don Rees wanted 100 percent of the Company's shares and he wanted to find a way to force the Plaintiffs to sell their shares to him at below-market rates. He told her that his reason for not paying dividends was to force his children to have to pay taxes on their proportionate share of the Company's net income and to force them into selling their shares of stock to him at less than their fair-market value. VRP 6/17/19 at 73:21-74:5.

In December 2015, the Defendant also had the Company's bookkeeper issue him a check in the amount of $646,118, but withheld the entire amount as taxes to the IRS, thereby creating a "zero paycheck." VRP 6/17/19 at 83:19-84:10; Ex. 14 at p.4. This enabled the Defendant to pay his 2015 federal income taxes without making any distributions to the minority shareholders in violation of the applicable IRS Regulations. VRP 6/17/19 at 74:11-75:2.

In April 2015, Beth Rees and Don Rees settled their divorce through mediation. Ex. 1 at ¶ 16; Ex. 5. As part of the settlement, Don agreed to pay Beth approximately three million dollars ($3,000,000) for her interest in the Company. Ex. 1 at ¶ 16. In exchange for the payment, Beth agreed to assign her shares in the Company to Don, and she also agreed to resign as an officer, director and employee of the Company. Ex. 1 at ¶ 16; Ex. 5 (at exhibit A).

The $3 million payment would be comprised of an assignment to Beth of a Company's brokerage account (worth approximately $1,000,000) and a $ 2,000,000 cash payment by Don to Beth, made on or before May 15, 2015. Ex. 1 at ¶ 17. The Company was the source for this $3,000,000 payment. Ex. 1 at ¶ 17.

This $3,000,000 payment was a distribution of a dividend to Don Rees, however, he claims that it was a personal loan to him by the Company. Don Rees makes this claim even though he admitted at trial that the promissory note from him to the Company was not executed until after October 14, 2016. VRP 6/18/19 at 17:16:24-17:2. Thus, the promissory note was not executed until approximately one and one-half years after the Defendant received the funds from the Company and no interest was paid during the intervening one and one-half years. Accordingly, during that time it clearly was treated as a distribution to Don Rees rather than as a loan. It was only after the Appellants raised the issue that Don Rees and his accountant sought to recharacterize the distribution as a loan.

B. The Plaintiffs File Suit

On March 15, 2018, Plaintiffs Scott Rees, and Mardie and Jeremy Broderick filed suit individually, and as shareholders of the Company. Clerk's Papers (CP) at 1-7. The Complaint alleges breach of fiduciary duty, minority oppression, and fraud by the Defendant Don Rees. The Plaintiffs requested damages, a declaratory judgment, and an injunction requiring the Defendant to return to the Company all excess salary, disproportionate profit distributions, loans, and all other amounts the Defendant has improperly withdrawn from the Company. CP at 6.

Following a three-day bench trial, the Honorable G. Helen Whitener of the Pierce County Superior Court entered Findings of Fact and Conclusions of Law on July 26, 2019. CP at 261-265 (attached as Appendix A). The court dismissed the Plaintiffs' claims and denied their requests for a declaratory judgment and injunction. CP at 265. The Plaintiff's objected to the court's findings of fact and conclusions of law, but the court denied the Plaintiffs' objections. CP 283-84. The court entered judgment dismissing the Plaintiffs' claims with prejudice on August 23, 2019. CP 281-82. The Plaintiffs timely filed their notice of appeal on September 9, 2019. CP 285-89.

V. SUMMARY OF ARGUMENT

Washington law provides that corporate officers and directors owe a fiduciary duty of good faith and loyalty to the corporation they serve and its shareholders. Directors must act in a manner that they reasonably believe to be in the best interests of the corporation. In addition, Washington law recognizes that majority shareholders owe a fiduciary duty to minority shareholders and this duty requires that majority shareholders act with good faith towards the minority shareholders. The fiduciary duties of directors, officers and majority shareholders are enhanced when the company is a small, closely held corporation.

To avoid the double taxation that typically occurs with corporations—where the income of a corporation is taxed once at the corporate level and again when the income is distributed to the shareholder as dividends—federal law allows a small business corporation to elect to be an S corporation. As an S corporation, the income of the company is not taxed to the company. Instead, each shareholder must pay tax on his or her pro rata share of the corporate profits, based upon stock ownership.

To maintain this S corporation status, the corporation cannot have two classes of stock. If the corporation gives a dividend to one shareholder, but denies other shareholders their pro rata share of the dividends, the Internal Revenue Service may determine that the corporation has two classes of stock. As a result, the IRS may void the corporation's election to be treated as an S corporation and assess income tax and penalties to the corporation.

In addition, federal regulations provide that an excessive salary paid to shareholder-employee, or a loan to one shareholder, may actually be a disguised dividend. Because this disguised dividend is paid only to one shareholder, the IRS may determine that the corporation has two classes of stock, thereby endangering the corporation's election to be treated as an S corporation.

After the Defendant's divorce became final and the Defendant had control of the Company, the Defendant, as the corporation's 88 percent majority shareholder, director and president, directed the Company to not pay dividends to the shareholders. Instead, the Defendant directed the Company to pay him an excessive salary, increasing his annual salary from \$120,000 the year before the divorce to \$1,216,367 after the divorce. The Defendant took these steps to punish the Plaintiffs for siding with their mother in the divorce proceedings and to force the Plaintiffs into selling their shares in the Company to the Defendant at below-market rates.

In addition to paying himself an excessive salary, the Defendant also directed the Company to distribute to him the approximately \$3 million payment he needed to buy his ex-wife's shares in the Company as part of his divorce settlement with her. Over a year later, once he learned that under the applicable IRS Regulations the Company was required to make proportionate distributions of that amount to the minority shareholders, he tried to re-classify this $3 million payment as a loan.

Because the Defendant's excessive salary and $3 million "loan" were actually disguised dividends paid to one shareholder, the Defendant—without pro rata distributions to the other shareholders—the Defendant has, in effect, created two classes of stock and endangered the Company's election to be treated as an S corporation. For these reasons, the Defendant's actions has violated his fiduciary duty to the Company and the other shareholders. In addition, the Defendant's conduct constitutes the oppression of minority shareholders and fraud under the Washington Business Corporations Act. Because the superior court erred in denying these claims, the Plaintiffs request that this Court reverse the superior court's rulings.

VI. ARGUMENT

A. Standard for Review

Following a bench trial, the appellate court determines whether challenged findings of fact are supported by substantial evidence in the record, and if so, whether the findings support the conclusions of law. *Landmark Dev., Inc. v. City of Roy*, 138 Wn.2d 561, 573, 980 P.2d 1234

(1999). Substantial evidence exists if the record contains "evidence of sufficient quality to persuade a fair minded rational person of the truth of the declared premise." *World Wide Video, Inc. v. City of Tukwila*, 117 Wn.2d 382, 387, 816 P.2d 18 (1991). Questions of law are reviewed de novo. *Kim v. Lee*, 145 Wn.2d 79, 86, 31 P.3d 665 (2001).

B. Plaintiffs Have Standing To File a Shareholder Derivative Suit.

Washington law allows a shareholder of a corporation to bring an action in the name of the corporation when the shareholder seeks to prosecute a claim that the corporation has failed to bring. RCW 23B.07.400; *Goodwin v. Castleton*, 19 Wn.2d 748, 761, 144 P.2d 725 (1944); Civil Rule (CR) 23.1.

Consistent with CR 23.1, the Plaintiffs' verified Complaint asserted

> (a) Each of the individual Plaintiffs was a shareholder of the Company at the time of the transactions alleged above;
>
> (b) This action is not a collusive one to confer jurisdiction on this court which it would not otherwise have;
>
> (c) The Plaintiffs, through their attorney, have demanded that the Defendant repay to the Company all amounts he has improperly removed from the company;
>
> (d) The Plaintiffs fairly and adequately represent the interests of the shareholders similarly situated in enforcing the right of the Company as the individual Plaintiffs constitute all of the shareholders of the Company other than the Defendant

CP at 5. Because the Plaintiffs complied with the requirements of CR 23.1, they have standing to bring this suit as a derivative action. *See* CP at 5, 13, 98-99.

C. The Defendant's Fiduciary Duties to the Company and to the Minority Shareholders.

1. The Fiduciary Duties of Corporate Directors, Officers, and Majority Shareholders.

Washington case law provides that corporate officers and directors owe a fiduciary duty of good faith and loyalty to the corporation they serve and its shareholders. *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wn. App. 502, 509, 728 P.2d 597 (1986) (directors and officers are fiduciaries of the corporations they serve and are not permitted to retain any personal profit or advantage); R.J. McGaughey, *Washington Corporate Law Handbook* § 5.13 (2000) [3] ("McGaughey") ("[C]ourts will vigorously scrutinize transactions involving conflicts of interest or self-dealing."). Majority shareholders and directors act in bad faith when their actions benefit them, rather than the corporations they serve and the remaining shareholders. *Interlake Porsche & Audi, Inc.*, 45 Wn. App. at 509; *Hayes Oyster Co. v. Keypoint Oyster Co.*, 64 Wn.2d 375, 381, 391 P.2d 979 (1964) (noting fiduciary duty violated when

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[3] R.J. McGaughey's *Washington Corporate Law Handbook* is available at: http://www.law7555.com/washington-corporate-law-handbook-2000/

officers or directors "directly or indirectly acquire a profit for themselves or acquire any other personal advantage"). *See also Wagner v. Foote*, 128 Wn.2d 408, 908 P.2d 884 (1996); *Lang v. Hougan*, 136 Wn. App. 708, 150 P.3d 622 (2007); *Grassmueck v. Barnett*, 281 F. Supp. 2d 1227, 1230 (W.D. Wash. 2003).

In addition, the Washington Business Corporation Act states that directors are required to discharge their duties according to the following basic standards:

> (a) In good faith;
>
> (b) With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
>
> (c) In a manner the director reasonably believes to be in the best interests of the corporation.

RCW 23B.08.300(1).

Similarly, Washington law recognizes that majority shareholders owe a fiduciary duty to minority shareholders. *Wool Growers Service Corp. v. Ragan*, 18 Wn.2d 655, 691, 140 P.2d 512 (1943) ("majority stockholders occupy a fiduciary relation toward the minority stockholders.") This fiduciary duty incorporates a duty of good faith and fair dealing towards minority shareholders. *See Hay v. Big Bend Land Co.*, 32 Wn.2d 887, 897, 204 P.2d 488 (1949) ("The principle that a majority of the stockholders must, at all times, exercise good faith toward the minority stockholders is well recognized."); McGaughey at § 7.10 (2000).

Several general principles regarding the duty of good faith and loyalty can be derived from Washington cases:

(1) A director owes undivided loyalty to the corporation. *Hayes Oyster Co.* 64 Wn.2d at 381.

(2) A director is not permitted to obtain any personal profit or advantage at the expense of the corporation. *Wagner,* 128 Wn. 2d at 909.

(3) Where there is evidence of self-dealing and/or personal benefit, the burden shifts to the director to show good faith. *Interlake Porsche & Audi, Inc.,* at 509.

(4) Wholly apart from the substance of a transaction between a director and a corporation, nondisclosure by an interested director is, in itself, unfair. *Hayes Oyster Co.*, 64 Wn.2d at 382.

In addition, courts closely scrutinize loans to or from a corporate director, which must be characterized by the utmost good faith. *Saviano v. Westport Amusements, Inc.*, 144 Wn. App. 72, 79, 180 P.3d 874 (2008). The burden of proving good faith is on the officer or director because of his or her fiduciary capacity. *Id.* As a fiduciary, the officer or director has a strong influence on how the corporation conducts its affairs, and a correspondingly strong duty not to conduct those affairs to the unfair detriment of others, such as minority shareholders or creditors, who also have legitimate interests in the corporation but lack the power of the fiduciary. *Id.*

2. These fiduciary duties are enhanced in a closely held corporation.

A "closely held corporation" means a corporation with few shareholders, who are typically involved as owners and managers, and for which there is usually no ready market for the sale of the corporation's shares. *Rogers Walla Walla, Inc. v. Ballard*, 16 Wn. App. 81, 89 n.9, 553 P.2d 1372 (1976). The fiduciary duties of majority shareholders and directors are enhanced in a closely held corporation. *See, e.g., Wenzel v. Mathies*, 542 N.W.2d 634, 641 (Minn. Ct. App. 1996) (directors, officers, and shareholders in closely-held corporation have a fiduciary relationship that imposes the highest standard of integrity and good faith).

The duty owed between shareholders in closely held corporations, such as in this case, has been described as similar to the heightened fiduciary duty that exists among partners, a duty of utmost good faith and loyalty. 2 F.H. O'Neal and R.B. Thompson, *O'Neal's Oppression of Minority Shareholders and LLC Members* §§ 7:04, 7:05 (2006); *Shermer v. Baker*, 2 Wn. App. 845, 472 P.2d 589 (1970) (majority shareholders stand in a fiduciary relation to corporation and its shareholders and owe a duty to minority not to profit at their expense).

Here, the Company is a closely held corporation. CP at 264. For these reasons, the superior court correctly held that the Defendant owed a fiduciary duty to the Plaintiffs. *Id.*

3. The oppression of minority shareholders by majority shareholders.

In addition to the remedies available for breach of fiduciary duty, courts at common law could use their equitable power to liquidate the assets and business of a corporation on a showing of irreparable injury to the shareholders and the corporation due to gross or fraudulent mismanagement. *Henry George & Sons, Inc. v. Cooper-George, Inc.*, 95 Wn.2d 944, 948, 632 P.2d 512 (1981). Washington adopted the Washington Business Corporation Act, which allows judicial dissolution when the "directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent." RCW 23B.14.300(2)(b) (emphasis added). While RCW 23B.14.300 refers only to dissolution, courts retain authority to fashion remedies short of dissolution to redress oppressive conduct by controlling shareholders. *Scott v. Trans-System, Inc.,* 148 Wn.2d 701, 717-18, 64 P.3d 1 (2003).

The Washington Business Corporation Act does not provide a definition of what constitutes "oppressive" action. Therefore, Washington courts have adopted two tests from other jurisdictions to define oppressive conduct: the "reasonable expectations" and "burdensome, harsh and wrongful conduct" tests. *Scott*, 148 Wn.2d at 711.

The "reasonable expectations of the minority shareholder" test is generally used where the aggrieved shareholder was one of the original participants in the corporation. *Id.* These expectations have been described as "those spoken and unspoken understandings on which the founders of a venture rely when commencing the venture." *Id.* The second test applied describes oppression as "burdensome, harsh and wrongful conduct; a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members; or a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely." *Id. See also Robblee v. Robblee,* 68 Wn. App. 69, 76, 841 P.2d 1289 (1992).

In the case at hand, the Company is an S corporation. VRP 6/17/19 at 114:16-20. To understand how the conduct of the Defendant breached his fiduciary duties to the Company and constituted minority shareholder oppression requires a discussion of the law governing S corporations.

D. S Corporations and Dividends Disguised as Excessive Salaries and Loans to Shareholders

In general, the income of a corporation is taxed twice, once at the corporate level and again at the shareholder level when the money is distributed as dividends. *Minton v. Commissioner*, 562 F.3d 730, 731 (5th Cir. 2009). A small business corporation, however, may avoid this double taxation by electing to be an S corporation. *Id.*

As a pass-through entity, a S corporation does not have to pay income tax. I.R.C. § 1363(a). Instead, each shareholder must pay tax on his or her pro rata share of the corporate profits. *Minton*, 562 F.3d at 731; *In re Marriage of Sievers*, 78 Wn. App. 287, 295 n.2, 897 P.2d 388 (1995) ("Subchapter S corporation and partnership business income flows through to the business owner's individual income tax return.") At the end of each fiscal year, the net profits of the S corporation are taxed to the individual shareholders in proportion to the percentage ownership interest of each, regardless of whether any of the profits are actually distributed to the shareholders. VRP 6/17/19 at 114:24-115:115:5. The S corporation itself pays no income tax. *Id.*, *See Minton,* 562 F.3d at 731.

1. An S corporation may only have one class of stock.

Federal law provides that S corporations may not possess more than one class of stock. I.R.C. § 1361(b)(1)(D). Federal Treasury Regulations state that a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Treas. Reg. § 1.1361-1(*l*)(2)(i). Any distributions that differ in timing or amount are not considered to be identical. *Id.*

An S corporation may not make a distribution of corporate earnings to one shareholder which is disproportionate to the distribution of earnings to other shareholders. If one shareholder routinely receives a distribution, while the other shareholders do not receive their pro rata share, the S corporation risks creating two classes of stock. *See* Treas. Reg. § 1-1361-1(*l*)(2)(vi), Example (3). Therefore, making disproportionate distributions to shareholders may cause the IRS to terminate a corporation's S election. *Id.*; J.P. Rose, Tax Advisors Planning System, 4: S Corporations at 4:10.02(C) (Thomson Reuters 2020) ("Rose") (excessive payments designed to avoid the single class of stock requirement for an S corporation risk recharacterization of the payments as a non-pro rata distributions).

At trial, the Plaintiffs' expert, Shelley Drury, CPA, CVA, ABV, CFF, testified that a corporation could lose its S corporation's status if it made disproportionate distributions to its shareholders:

> As an S corporation, any distributions, sometimes referred to as "draws," must be made proportionately. Disproportionate distributions in an S corporation, effectively, can -- can render two shares of stock, and an S corporation can't have two shares of stock. So by making

> disproportionate distributions, it can cause an S corporation to lose its S corp status with the IRS, which would be detrimental in those cases.

VRP 6/17/2019 at 115:14-21.

For example, in a case before the Internal Revenue Service, an S corporation made disproportionate distributions for several years. Internal Revenue Service P.L.R. No. 201236003.[4] The corporation caught its mistake and asked the IRS to rule on whether it would be permitted to make corrective distributions to the shareholders who were shorted, which would also be disproportionate to "true up" its shareholders' distributions. The IRS held that despite having made several disproportionate distributions, the S corporation did not have a second class of stock, and thus did not terminate its S election, provided it made the necessary corrective distributions. Therefore, if a corporation is found to have made disproportionate distributions to one or more of its shareholders, the way it can avoid the termination of its S corporation status is to make corrective distributions.

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[4] Internal Revenue Service P.L.R. No. 201236003 is available at https://www.irs.gov/pub/irs-wd/1236003.pdf

2. An excessive salary may be a disguised dividend that results in the corporation having more than one class of stock.

The Internal Revenue Code allows a corporation to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered." I.R.C. § 162(a)(1). To be deductible, however, the amount of the compensation must be reasonable, and the payments must be purely for services. Treas. Reg. § 1.162-7(a); *Nor-Cal Adjusters v. Commissioner*, 503 F.2d 359, 362 (9th Cir. 1974).

If the compensation received by an employee-shareholder of an S corporation is "unreasonably high in relation to the services rendered to the corporation, the IRS may recharacterize a portion of the payments as distributions pursuant to its general authority under Code Section 162." Rose, 4: *S Corporations* at 4:10.02(C). Thus, "the IRS may deny corporation a deduction for salary payments that are unreasonable." *Id.* (citing Treas. Reg. § 1.162-8).

Furthermore, if the salary paid to a shareholder-employee of an S corporation is unreasonably high, the IRS may conclude that the excessive payment is actually a "distribution of earnings upon the stock." Treas. Reg. § 1.162-7; *Bramlette Bldg. Corp. v. Commissioner*, 424 F.2d 751, 752-54 (5th Cir. 1970) (excessive payments to the president of an S corporation constitute a dividend and not salary); B.I. Bittker, J.S. Eustice, *Federal*

Income Taxation of Corporations and Shareholders, § 8.05[3] (6th Ed. 1998) ("Bittker").

If the excessive salary paid to a shareholder constitutes a scheme to avoid pro-rata distributions to the other shareholders, the IRS may determine that there are two classes of stock, a condition that is incompatible with a S corporation. *See* Treas. Reg. § 1-1361-1(*l*)(2)(vi), Example (3); IRS P.L.R. No. 201236003.

A leading case in determining whether a shareholder-employee of a closely held corporation disguised dividends as salary is *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983). In *Elliotts* the shareholder-employee and the corporation were not dealing with each other at arm's length, as is the case here. The court held that the problem of determining whether compensation payments contain a disguised dividend is exacerbated where the shareholder-employee is the corporation's *sole* shareholder or when the shareholder has complete control over the corporation's operations (as is the case here.) *Id.* The court held that IRC §162(a)(1) permits a corporation to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered." There is a two-prong test for deductibility under IRC §162(a)(1): (1) the amount of the compensation must be reasonable and (2) the payments must in fact be purely for services. Treas. Reg. § 1.162-7(a); *Nor-Cal,* 503 F.2d at 362.

RCW 23B.08.700 addresses a director's conflict of interest when he or she takes excessive salaries. If a "director's conflicting interest transaction" exists, then, to insulate the action from attack, the transaction should be approved by either the board's disinterested ("qualified") directors pursuant to RCW 23B.08.720 or its qualified shareholders pursuant to RCW 23B.08.730. There can be no "inadvertent waiver" of a "director's conflicting interest transaction" under either the Business Corporation Act or existing common law.

3. A loan to a shareholder may be a disguised dividend that results in the corporation having more than one class of stock.

As with an excessive salary, a loan to shareholder may constitute a disguised dividend. *Alterman Foods, Inc. v. United States*, 505 F.2d 873 (5th Cir. 1974); Bittker at § 8.05[6] ("If corporate funds are loaned to a shareholder but the parties do not intend to create a bona fide creditor-debtor relationship, the withdrawals may be treated as constructive or disguised distributions; . . .")

In *Alterman*, a corporation had classified cash advances to a shareholder as a loan. *Id.* at 574. The IRS, however, held that that they were dividends and thus taxable income. As a result, the IRS assessed a tax deficiency with interest against the taxpayer. *Id.* at 574. Seeking a refund, the taxpayer filed suit. On appeal, the Fifth Circuit considered whether the cash advances were loans or dividends. *Id.* at 876.

In deciding this issue, the *Alterman* court did not rely on how the taxpayer classified the cash advance, but instead examined the facts surrounding the advance:

> We believe the proper rule is that mere declarations by the parties that they intend a certain transaction to constitute a loan is insufficient if it fails to meet more reliable indicia of debt which indicate the "intrinsic economic nature of the transaction."

Id. at 877 (citation omitted).

The *Alterman* court noted that there was no repayment schedule, no fixed date of maturity, no indication that the sums advanced would be repaid, no interest charged, that there was no absolute duty to repay, that the shareholder had not made any effort to repay the advances, and that there was no genuine intention to repay the advances. *Id.* at 578-79. As a result, the Fifth Circuit affirmed the IRS and the trial court, and held that the advances were dividends and not loans. *Id.* at 579.

Furthermore, whether a transaction is a bona fide loan is assessed at the time of the transaction and takes into consideration the relationship between the shareholder and the corporation:

> Whether a withdrawal is a bona fide loan is a factual question, and depends upon the existence of an intent on the shareholder's part to repay at the time the withdrawal is made, and the intent of his collective alter ego, the corporation, to enforce the obligation. [citation omitted] The disposition of such a factual issue turns upon a consideration and weighing of all the pertinent facts and circumstances surrounding the transaction between the stockholder and the corporation. [citation omitted] **When the withdrawers are in substantial control of the corporation, ... such control invites a special scrutiny of the situation.** [citation omitted].

Haber v. Commissioner, 52 T.C. 255, 266 (1969), *aff'd per curiam*, 422 F2d 198 (5th Cir. 1970) (emphasis added). Scrutinizing the transaction at the time it was entered into and considering the close relationship between the parties, the court found that the transaction was not a bona fide loan. *Id.*

As in *Haber* and *Alterman*, the close relationship here between Don Rees and the Company, analyzed at the time the funds were advanced, indicates no bona fide intention to create a creditor-debtor relationship.

E. By Paying Himself an Excessive Salary and by Attempting to Disguise Distributions as Loans, the Defendant Breached his Fiduciary Duty to the Company and its Minority Shareholders.

The Defendant's decision to pay himself an excessive salary and to advance himself approximately $3 million that he would later try to disguise as a loan violated his fiduciary duty to the Company and to the minority shareholders. The Defendant violated his fiduciary duty to the Company because his actions jeopardized the S corporation's status of the Company, required the Company to pay extra payroll taxes, and decreased the valuation of the Company. The Defendant breached his fiduciary duty to the minority shareholders because the Defendant's actions improperly deprived the minority shareholders of their rightful pro rata share of the Company's dividends while devaluing the worth of their shares.

1. The Defendant's excessive salaries constituted disguised dividends that threatened the S corporation status of the Company.

The concept of what constitutes "reasonable compensation" is generally found in the tax law. *See, e.g Charles Schneider & Co. v. Commissioner*, 500 F.2d 148, 151 (8th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975) Under IRC § 162(a)(1), a business may deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered" as ordinary and necessary business expenses.

As discussed in section VI.D.2 above, an unreasonable, excessive salary that is primarily a disguised dividend to one shareholder, without the corporation making pro rata distributions to the other shareholders, risks the a company's S corporation status because an S corporation cannot have two classes of stock.

Here, the Defendant received an average annual salary of $101,145 for the five years *before* the divorce, which soared to an average annual salary of $994,838 in the four years *after* the divorce. Thus, the Defendant's average salary after the divorce was almost ten times greater than the average salary he took during the years before the divorce.

At trial, the expert witness called by the Plaintiffs, Shelley A. Drury, CPA, CVA, ABV, CFF, testified that a reasonable, fair market salary for the Defendant would be $200,000, commencing in 2015 and thereafter. VRP 6/17/19 at 112:16-113:11, Ex. 14 at pp. 2-4. Ms. Drury based the $200,000 figure upon her research, experience and review of industry performance statistics, and the fact that Don Rees would be performing some of the duties previously performed by Beth Rees and/or others. Ex. 14 at p. 3. A copy of her research is attached to Exhibit 14 (see exhibit K attached to Exhibit 14).

The expert witness called by the Defendant, Robert Ryan, CPA, did not express an opinion either in his report (Exhibit 120) or during his testimony as to what either a reasonable salary or reasonable replacement salary would be for the Defendant. In his report, for example, Mr. Ryan stated: "I offer no opinion as to Ms. Drury's conclusion that $200,000 is an appropriate fair market value replacement salary for Mr. Rees." Ex. 120 at p. 3. At trial, Mr. Ryan admitted that he "did not do a salary survey and do the research to do that, so I could not opine about what is a fair-market replacement salary." VRP 6/18/19 at 81:2-4.

Thus, the only expert testimony of what a reasonable salary for an employee like the Defendant is the $200,000 figure provided by Ms. Drury. Moreover, even if assume that Don Rees was doing more work after Mrs. Rees and the Plaintiffs stopped working for the Company, his $1.2 million salary in the year after the divorce is still more than 3.5 – 4 times the combined salaries of Don Rees, Beth Rees and the Plaintiffs in the year before the divorce. VRP 6/19/19 at 76:8-79:11.

Thus, the superior court's conclusion that the Defendant's nearly $1 million average annual salary after the divorce is reasonable and not excessive, Conclusion of Law No. 5, is not supported by substantial evidence in the record.

At trial, the Plaintiff's expert also testified as to the harm caused by the Defendant's decision to pay himself an unreasonably excessive salary. Ms. Drury testified that an excessive salary:

- Increases expenses of the corporation;
- Increases payroll taxes;
- Decreases profit;
- Decreases the value of the business;
- Depletes cash that could be be used for distributions,
- Depletes cash that could be used for operating expenses; and

- Depletes cash that could be used for the expansion of the business.

VRP 6/17/19 at 117:1-17. Not only did the Defendant's taking an excessive salary cause the Company to incur greater payroll taxes, it also resulted the Defendant having to pay higher taxes than he would have had to pay had he taken a portion of the money as S corporation dividends. VRP 6/17/19 at 121:11-122:23; 143:10-18.

Regarding the harm that the Defendant's excessive salary caused the minority shareholder Plaintiffs, Ms. Drury stated that: "it potentially lowers the value of the company which would lower the value of their percentage interest in the company, and it potentially -- well, it does lower the cash that's available for a potential distribution." VRP 6/17/19 at 118:1-4. As Ms. Drury pointed out, the Internal Revenue Code provides that minority shareholders are entitled to their share of an S corporation's distributions based upon their ownership interest in the company. VRP 6/17/19 at 118:5-11.

Ms. Drury also noted that failing to provide minority shareholders with their pro rata share of an S corporation's distribution could create two classes of stock, and, because an S corporation cannot have two classes, this could "cause an S corporation to lose its S corp status with the IRS, which would be detrimental in those cases." VRP 6/17/2019 at 115:14-21.

At trial, the Defendant's expert, Robert Ryan, CPA, testified that he was unaware of the IRS ever challenging unreasonably high shareholder-employee compensation in an S corporation. VRP 6/18/19 at 77:11-16. Mr. Ryan even stated that the prohibition against paying an excessive salary that is actually the distribution of a dividend found in Treas. Reg. § 1-162-7(b)(1) does not apply to an S corporation. VRP 6/18/19 at 107:14-20.

Mr. Ryan's interpretation of § 1-162-7(b)(1) is incorrect for three reasons. First, nothing in the plain text of § 1-162-7 states that it does not apply to S corporations.

Second, the IRS has applied § 1-162-7's prohibition against an excessive salary constituting a disguised dividend to an S corporation. *Wycoff v. Commissioner*, No. 24158-09, 2017 Tax Ct. Memo LEXIS 203 (T.C. Oct. 16, 2017). In *Wycoff,* the court noted that "Special scrutiny is given in situations where a corporation is controlled by the employees to whom the compensation is paid because there is a lack of arm's- length bargaining." *Id.* The court also stated that: "Shareholder executive compensation in a closely held corporation that depletes most of a corporation's value is generally unreasonable when the deductible salary expenses are a disguise for nondeductible profit distributions." *Id.* at 42. Finding the compensation to be unreasonable, the court affirmed income tax and accuracy-related penalties against the S corporations. *Id.* 43-44.

Third, Ms. Drury testified at trial that she is aware of at least two instances where IRS audits of an S corporations that excessive salaries paid to executives required corrective distributions to minority shareholders. VRP 6/1/7/19 at 123:14-21.

For these reasons, Mr. Ryan's statement that § 1-162-7 does not apply to excessive salaries paid by S corporations is without merit.

Remarkably, the Defendant admitted at trial that he arrived at his $1.2 million salary in 2015 by simply shifting his dividend into his salary:

> Q. Did you increase your base salary in 2015?
>
> A. Yes, I certainly did.
>
> Q. And what did you do?
>
> A. I shifted my total compensation which, prior, had included salary and dividends. **I shifted the dividend amount basically over to the salary column.**

VRP 6/19/19 at 52:19-24 (emphasis added).

In his sworn declaration, the Defendant again admitted that his 2015 salary was effectively a dividend: "I took in salary the dividend I would have otherwise received that year." Ex. 1 at ¶ 27. Thus, the Defendant admits that his 2015 salary was a disguised dividend.

Moreover, the Company's bookkeeper testified at trial that the Defendant told her that the reason why he took his distribution as a bonus or salary was to avoid having to pay dividends to the Plaintiffs. VRP 6/17/19 at 74:23-75:4.

The only expert testimony at trial regarding a reasonable salary for an executive such as the Defendant was provided by Ms. Drury. Based upon her research, she concluded that $200,000 would be a reasonable salary for Don Rees. Any funds over $200,000 would be, as the Defendant admitted, simply be dividends disguised as salary.

For these reasons, the superior court's conclusion that the salary paid to the Defendant in 2015 and thereafter were reasonable is not supported by the record.

2. Cash advances to the Defendant were distributions and not loans.

As discussed above in section VI.D.3, whether a transaction is a loan or a disguised dividend, depends upon the intent of the shareholder to repay the amount and the intent of the corporation to enforce the obligation at the time the withdrawal was made. *Haber*, 52 T.C. at 266. When the withdrawers are in substantial control of the corporation, the court will apply "special scrutiny" to the transaction. *Id.* If the funds are "loaned" to the shareholder, but the parties do not intend to create a bona fide creditor-debtor relationship, then the withdrawals may be treated as a disguised distribution. Bittker at § 8.05[6].

In 2014 and 2015, the Defendant caused the Company to make two additional distributions to him: the sum of $156,547 in 2014 and the sum of $3,033,035 in 2015, totaling $3,189,582. Ex. 14 at p. 1; VRP 6/17/19 at 108:7-15. These two distributions decreased the amount of cash in the Company by that amount. These distributions were originally classified as "owner equity – owner draws" in the books of the Company, with $1 million to the Defendant's then wife and the rest to the Defendant. Ex. 12, Ex. 14 at p. 2. In actuality, the Defendant received all of the $3,189,582. Ex. 4 at p. 2; VRP 6/18/19 at 59:12-22.

More than a year later, the accounting records of the Company were changed to reflect that these were loans, with $1,000,000 being allocated to the Defendant's then-wife, Beth Rees. Ex. 14 at 2. However, this $1,000,000 was part of the cash payment Mr. Rees was obligated to make to his wife pursuant to their Divorce Decree. VRP 6/19/19 at 43:1-15; Ex. 103 (Exhibit A). Examining the Company's books, the Plaintiffs' expert witness, Shelley Drury, noted that these payments to the Defendant were later reclassified in the books of the Company as a loan to the Defendant, one year after Beth Rees was no longer a shareholder. Ex. 14 at p. 2; Ex. 12; VRP 6/17/19 at 108:20-109:6.

In an effort to legitimize the distribution of the $3,189,582, the Defendant convened a shareholders' meeting on October 14, 2016, and voted his 88 percent ownership of the Company in favor of treating the 2014 and 2015 distributions as loans to him. VRP 6/18/19 at 16:8-23; Ex. 112. The Defendant then backdated a Promissory Note to December 31, 2015 in support of the prior shareholder distributions being re-characterized as loans. VRP 6/18/19 at 16:1-7; Ex. 113.

When asked why it took him almost 1.5 years to sign a promissory note for the $3 million funds distributed in 2015, the Defendant testified that he was too busy to execute a one-page promissory note. VRP 6/19/19 at 42:4 ("I was incredibly occupied.")

When asked why he failed to make a payment on the $3 million Promissory Note in 2016, the Defendant testified that he was "busy," that the failure make his required payment was an "oversight," and that his accountant had failed to remind him to make a payment by the end of 2016. VRP 6/19/19 at 43:19-44:4. The Defendant signed the Promissory Note after October 14, 2016, yet he testified that he forgot that the first payment on the $3 million note was due approximately two months later.

The Plaintiffs' expert, Shelley Drury, found that neither the 2016 nor 2017 income tax returns of the Company reflect any interest payments made by Mr. Rees. VRP 6/17/19 at 109:7-17; Ex. 14 at pp. 1-2. Taking into consideration that the funds were originally classified as draws in 2015, that they were re-classified a year later, and that there was no timely promissory note, Ms. Drury concluded that the amounts in 2015 were distributions and not a loan. VRP 6/17/19 at 111:16-112:3; Ex. 14 at p. 2.

As the court held in *Haber*, whether the parties intended to create a creditor-debtor relationship is determined when the withdrawals are made and not when they parties attempt to re-classify the transaction. Here, the funds were withdrawn by May 2015 and were originally classified as draws. One year later, the transaction was re-classified and 1.5 years the Defendant finally got around to executing a promissory note. The Defendant paid no interest in 2015 or 2016, and the Company made no attempt to collect the debt.

Under *Haber* and *Alterman*, the funds were intended to be distributions in 2015 and not loans. Thus, the superior court's finding that in October 2016, it was "discussed and agreed" that the funds given to the Defendant in 2015 "were supposed to have been documented as a loan to Defendant Rees," is not supported by substantial evidence. CP at 263 (Finding of Fact No. 16). Furthermore, this finding does not support the court's conclusion that the parties entered into a loan in 2015. CP at 265 (Conclusion of Law No. 10.)

3. The Business Judgment Rule does not apply because the Defendant acted in bad faith.

Under RCW 23B.08.300(1) and the business judgment rule, courts will not substitute their judgment of a director unless the director acted with bad faith, fraud, dishonesty or incompetence. *In re: Spokane Concrete Products, Inc.*, 126 Wn.2d 269, 279, 892 P.2d 98 (1995), *Nursing Home Bldg. Corp. v. DeHart,* 13 Wn. App. 489, 498, 535 P.2d 137 (1975) (directors may take risks in the interest of their corporation so long as they comply with RCW 23B.08.300(1), which requires them to act in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner they reasonably believe to be in the best interests of the corporation).

Here, the Defendant acted in bad faith and not in the best interests of the Company when he attempted to punish the Plaintiffs for siding with their mother during the divorce. At trial, the Company's bookkeeper, Jennifer Pomeroy, testified that the Defendant wanted to find a way to force the Plaintiffs to sell their shares to him at a below-market rate so that he could have 100 percent of the Company's shares:

> When Don and Beth got divorced, he got Beth's stock in the company. At that point, things -- **Don wanted one hundred percent ownership in the company**, and so he wanted to find a way to get – ...
>
> ...

> **He wanted to put them in a financial situation that they couldn't make their tax payments, and so he was -- could buy them out and get them a better -- get a better rate for their stock.**
>
> Q. Now, when you say "get a better rate for their stock," are you telling us that he would purchase them at a better -- he would purchase the stock at a better price or something else?
>
> A. **That he would offer them a buyout at a lower -- lower rate than what their stock was worth.**

VRP 6/17/19 at 73:7-74:5 (emphasis added).

When asked if he made this statement to the bookkeeper, the Defendant did not deny making the statement. Instead, he said that he did "not recall any discussions such as Pomeroy [sic], but it would certainly be within the realm." VRP 06/18/19 at 32:25-33:2. Subsequently, the Defendant testified again that he could not recall the conversation with Ms. Pomeroy:

> Q. And I gather, then, that you're telling us you don't recall that conversation, but you're not denying that the substance of that conversation occurred at some point in time with Ms. Pomeroy; would that be accurate?
>
> A. I'm not recalling any conversation identified that she spoke to, though I have many conversations in the normal course of business.

VRP 6/19/19 at 73:7-13.

Because the Defendant acted in bad faith and not in the best interests of the Company, the business judgment rule does not apply. Thus, the superior court committed reversible error in holding that the business judgment rule protected the Defendant's conduct. CP at 264-65 (Conclusions of Law Nos. 3, 6, 7, 8).

4. The Defendant breached his fiduciary duty to the Company and the Minority Shareholders.

By taking excessive salaries that were disguised dividends, by taking funds from the Company that he later tried to classify as a loan but in fact were a disguised dividend, and by failing to pay the other shareholders their pro rata distribution of dividends, the Defendant breached his fiduciary duties to the Company and the other shareholders. Moreover, by engaging in self-dealing for his own personal profit or advantage at the expense of the Company, the Defendant breached his duty of good faith and loyalty to the Company. Through his actions in attempting to punish the Plaintiffs for siding with their mother during the divorce, the Defendant has risked that an IRS audit would disallow the Company's S corporation status for failure to make proportionate distributions, require the Company to recharacterize the portion of the Defendant's salary which is excessive as a shareholder distribution, either require the Defendant to return to the Company all disproportionate shareholder distributions he has taken or require the Company to make curative proportionate distributions to each of the minority shareholders, and assess penalties and interest based upon the foregoing violations.

For these reasons, the Defendant has breached his fiduciary duty to the Company and the Plaintiffs.

F. The Defendant's actions constitute Minority Shareholder Oppression.

Of the two tests for minority shareholder oppression in Washington, the second test identified in *Scott*, 148 Wn.2d at 711, is the most appropriate in this case. In this test, oppression is described as "burdensome, harsh and wrongful conduct; a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members; or a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely." *Scott*, 148 Wn.2d at 711.

G. The Actions of the Defendant In Taking Disproportionate Distributions, Excessive Salaries And Attempting To Disguise Disproportionate Distributions As Loans Constitute Fraud.

The superior court incorrectly applied the elements of common law fraud to the Plaintiff's claim. CP at 265 (Conclusion of Law No. 9). The superior court erred, however, because the term "fraudulent," as used in the Washington Business Corporation Act, is not limited to the elements of common-law fraud. Rather, the term encompasses a variety of acts involving breach of fiduciary duties.

The Supreme Court of Washington held that the Court of Appeals erred by defining "fraudulent" under RCW 23B.13.020 so narrowly as to encompass only common law actual fraud. *Sound Infiniti, Inc., ex rel. Pisheyar v. Snyder*, 169 Wn.2d 199, 208, 237 P.3d 241 (2010). The *Pisheyar* court held that an examination of the legislative history of RCW 23B.13.020 shows that the statute does not limit the fraudulent exception only to cases of common law actual fraud. *Id.*

The Supreme Court further held that one must look at the actual facts of the case to determine whether the corporate action was fraudulent. Here, the majority shareholder of the corporation took improper distributions, disguised them as loans, backdated documents, and paid himself excessive salaries as compared to the historical salaries paid by the corporation in an illegal attempt to deny the minority shareholders their proportionate distributions. These facts and actions meet the requirements of "fraudulent" under the Washington Business Corporation Act by showing that the corporate action itself is "fraudulent with respect to the shareholder or the corporation." RCW 23B.13.020(2). These actions breach the fiduciary duty of good faith and fair dealing by violating the reasonable expectations of a minority shareholder. Under *Pisheyar*, the actions of the Defendant constitute fraudulent conduct. The superior court's failure to apply the right standard to the Plaintiffs' fraud claim constitutes reversible error.

VII. CONCLUSION

For the above reasons, the Plaintiffs request that the Court reverse the judgment of the superior court and hold that the Plaintiffs have established their claims for breach of fiduciary duty, minority shareholder oppression, and fraud by the Defendant. This matter should be remanded to the superior court for a determination of damages and entry of judgment in favor of the Plaintiffs.

RESPECTFULLY SUBMITTED this 24th day of February, 2020.

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By ____________________
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Appendix

Appendix A: Findings of Fact and Conclusions of Law (CP at 261-265)

IN THE SUPERIOR COURT OF WASHINGTON, COUNTY OF PIERCE

REAL CARRIAGE DOOR COMPANY INC. ex rel., SCOTT T. REES, MARDIE A.R. BRODERICK, and JEREMY E. BRODERICK, Shareholders Thereof; and SCOTT T. REES, MARDIE A.R. BRODERICK, and JEREMY E. BRODERICK, individually, Plaintiff(s) , vs. DON T. REES, Defendant(s) .	Cause No: 18-2-06404-5 **FINDINGS OF FACT AND CONCLUSIONS OF LAW** **(OR)**

THIS MATTER having come before the Honorable G. Helen Whitener, Judge of the above-entitled Court, for trial on June 17, 2019, Plaintiffs appearing through counsels James Krueger and Defendant appearing through counsel Michael Hemphill, the Court having heard the testimony of the following witnesses:

(1) Plaintiff Scott Rees
(2) Plaintiff Mardie Broderick
(3) Witness Jennifer Pomeroy
(4) Witness Shelly Drury
(5) Defendant Don Reese
(6) Witness Robert Ryan
(7) Witness Kim Smith

The Court having received Exhibits Nos. 1, 3-17 and 101-128 admitted into evidence and having considered the arguments of counsel, and being otherwise fully advised in the premises, the Court makes the following:

FINDINGS OF FACT

1. Defendant Rees is a licensed home builder with over 30 years of experience

2. Defendant Rees is the President, CEO and founder of Real Carriage Door Company Inc. ("RCDC").

3. RCDC is a S corporation organization with its principal place of business in Pierce County.

4. Defendant Rees is a majority shareholder in RCDC and owns 88% of the company shares.

5. Defendant Rees and his ex-wife Beth Rees gifted shares to their children Scott Rees and Mardie Broderick and their step-son Jeremy Broderick as an incentive to have them work for and contribute to the success of RCDC.

6. Plaintiff Scott Rees, the Defendant's son was employed by RCDC and managed the company's website and IT needs. He was gifted and owned 6% of the company shares when he terminated his employment on or about December 1, 2014 and has had no further involvement with the company.

7. Plaintiff Mardie Broderick, the Defendant's daughter was employed by RCDC and worked in sales. She was gifted and owned 3.1% of the company shares when she terminated her employment in October 2009 following the birth of her child and has had no further involvement with the company.

8. Plaintiff Jeremy Broderick is married to Mardie Broderick and was employed by RCDC and worked as a door drafter, worked in pricing as well as in sales engineering. He was gifted and owned 2.9% of the company shares when he terminated his employment in January 9, 2015 and has had no further involvement with the company.

9. Defendant Rees and his ex-wife Beth Rees separated in March 2013 and Defendant Rees filed for divorce in April 2014. The divorce was finalized in January 2015.

10. Defendant Rees as part of the divorce was to make a cash payment of three million dollars to his ex-wife Beth Rees and he received her ownership interest in RCDC bringing his share total to 88% of the company shares.

11. To pay his ex-wife Beth Rees, Defendant Rees obtained funds from RCDC which was secured by a loan from Timberland Bank and existing RCDC cash reserves.

12. On or about 2015, each of the individual Plaintiff's terminated their employment with RCDC and have had no further involvement with the company.

13. June 2015, the RCDC directors were Defendant Rees, his daughter Kim Smith, and the officers have been Defendant Rees (President/CEO), Kim Smith (Vice President/Treasurer) and Defendant Rees' brother Ken Thornberg (Secretary).

14. Kim Smith, RCDC Vice President/Treasurer and Ken Thornberg, RCDC Secretary do not hold any shares in RCDC.

15. Plaintiff's received timely notice of A Special Meeting that was scheduled for October 14, 2016. Plaintiffs failed to attend the meeting.

16. On October 14, 2016 at the Special Meeting it was discussed and agreed that the RCDC funds given to Defendant Rees were supposed to have been documented as a loan to Defendant Rees. It was agreed that the loan was to be memorialized in a promissory note payable to RCDC and executed by Defendant Rees. Upon agreement, the promissory note was backdated to an effective date of December 31, 2015. Defendant Rees subsequently made all payments due under the loan.

17. Defendant Rees total compensation received from RCDC from 2013 to 2015 was as follows:

Year	RCDC Gross Annual Revenue	RCDC Gross Profit	Shareholder/ Officer Salaries	Shareholder/Officer Dividend Distributions	Total Shareholder/ Officer Compensation
2013	$6,930,534	$3,790,205	$190,000	$976,987	$1,166,987
2014	$9,387,838	$3,505,499	$190,000	$1,116,257	$1,306,257
2015	$10,084,824	$3,955,518	$1,213,618	-	$1,213,618

18. Prior to 2015 Defendant Rees took a salary of approximately $190,000 per year plus stock dividend distributions to take advantage of tax savings.

19. When RCDC's profits increased, all shareholders dividend distributions increased pro rata.

20. In 2015 RCDC ceased distributing dividends to shareholders and started paying Defendant Rees an increased salary because Defendant Rees now either performed or oversaw the previous duties of his ex-wife, Beth Rees, and the Plaintiff's, Scott Rees, Mardie Broderick and Jeremy Broderick who all were no longer employed at RCDC.

CONCLUSION OF LAW

1. RCDC is a closely held corporation.

2. Defendant Rees in his capacity as CEO/President, owed a fiduciary duty to the Plaintiffs in their capacity as minority shareholders.

3. Defendant Rees did not breach his fiduciary duty to the corporation and the minority shareholders. The evidence showed that the corporation's practice was to distribute profits to the Plaintiffs as salary and gifts of dividends. Not distributing gifts of dividends was a reasonable and honest exercise of the directors' judgment and was not a breach of his fiduciary duty.

4. There was an implied agreement to pay the minority stockholders a salary and gifts of dividends only during the period of their employment and was terminated when they left the corporation.

5. Defendant Rees' salary was not excessive but was reasonable and comparable to prior years when viewed as a whole given his role in RCDC and RCDC's success; his different job roles, job functions and increased work hours once the four family members left the company.

6. Defendant Rees' decision to not distribute dividends was within the power of RCDC and his authority of management. This decision was made in good faith and was reasonable.

7. Defendant Rees is authorized to pay himself a reasonable salary and the salary payment from 2015 to the present for Defendant Rees were reasonable for a President/CEO and were not excessive.

8. Defendant Rees actions were business judgments. He provided reasonable explanations for his conduct which were not oppressive. The minority shareholders failed to show oppressive conduct.

9. Plaintiffs, minority shareholders failed to prove fraud by clear, cogent and convincing evidence that Defendant Rees deceived them or that he did anything that was procedurally wrong regarding the distribution of salary, the termination of distribution of dividends or the corporation loan he received and paid after his marriage was dissolved.

10. The funds provided to Defendant Rees by RCDC used to pay his ex-wife Beth Rees was a loan secured by a promissory note. The Plaintiffs had terminated their employment with the corporation and failed to attend a special meeting after receiving timely notice. The Loan was not disguised.

11. The reasonable expectations for the minority shareholders were that they would receive a salary and gift distributions of shares while employed at RCDC.

12. The Plaintiffs have failed to prove their <u>Breach of Fiduciary Duty</u> claim, which is hereby DISMISSED with Prejudice.

13. The Plaintiffs have failed to prove their <u>Fraud claim</u>, which is hereby DISMISSED with Prejudice.

14. The Plaintiffs have failed to prove their <u>Minority Oppression claim</u>, which is hereby DISMISSED with Prejudice.

15. Plaintiffs requests for <u>Declaratory Judgment</u> is DENIED

16. Plaintiffs requests for an <u>Injunction</u> is DENIED.

DATED this 25th day of July, 2019.

JUDGE G. HELEN WHITENER

CERTIFICATE OF SERVICE

The undersigned makes the following declaration under penalty of perjury as permitted by RCW 9A.72.085.

I am a legal assistant for the firm of Vandeberg Johnson & Gandara. On the 24th day of February, 2020, I caused to be served via email and first class mail a copy of the foregoing document to:

Michael M.K. Hemphill
Roberts Johns Hemphill
7525 Pioneer Way, Suite 202
Gig Harbor, WA 98335
mikeh@rjh-legal.com
kris@rjh-legal.com

I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

Dated this 24th day of February, 2020, at Tacoma, Washington.

Rose M Jennison

Rose Jennison, Legal Assistant

VANDEBERG JOHNSON & GANDARA

February 24, 2020 - 3:13 PM

Transmittal Information

Filed with Court:	Court of Appeals Division II
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Superior Court Case Number:	18-2-06404-5

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