IN THE SUPREME COURT

OF THE

STATE OF SOUTH DAKOTA

Appeal No. 27158

STEVE SCHULTZ, MARK SCHULTZ, DAVID SCHULTZ and THE SCHULTZ FAMILY TRUST, as Stockholders of Cosmos of the Black Hills, Inc. a South Dakota Corporation, and as individuals, and DONALD SCHULTZ and ELOISE SCHULTZ as Trustees of the SCHULTZ FAMILY TRUST, and DAVID SCHULTZ as a Director of Cosmos of the Black Hills, Inc. on behalf of Cosmos of the Black Hills, Inc. a South Dakota Corporation,

Plaintiffs/Appellants,

vs.

LYLE SCANDRETT, and HEIDI BYBEE,

Defendants/Appellees.

APPEAL FROM THE CIRCUIT COURT
SEVENTH JUDICIAL CIRCUIT
PENNINGTON COUNTY, SOUTH DAKOTA

The Honorable Robert Gusinsky, Circuit Court Judge

Notice of Appeal filed July 29, 2014

APPELLANTS' BRIEF

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PRELIMINARY STATEMENT

Plaintiffs Steve Schultz, Mark Schultz, David Schultz, The Schultz Family Trust, Donald Schultz and Eloise Schultz will be referred to collectively as "Schultzes". Defendants Lyle Scandrett and Heidi Bybee will be referred to collectively as "Scandretts". Citations to the record will appear as "(R. ___)" with the appropriate page number in the Clerk's Appeal Index. Citations to the trial transcript will appear as "(Tr. ___)" with the appropriate page and line number. Citations to Trial Exhibits will appear as ("Ex. ___") with the appropriate Trial Exhibit number.

JURISDICTIONAL STATEMENT

This is an appeal from a final judgment dated June 30, 2014. (R. 1783.) Notice of Entry of Judgment was served July 2, 2014. (R. 1785.) Schultzes' Notice of Appeal was timely filed on July 29, 2014. (R. 1808.) The Court has jurisdiction of this appeal pursuant to SDCL § 15-26A-3(1).

STATEMENT OF THE ISSUES

I. WHETHER THE TRIAL COURT ERRED WHEN IT INSTRUCTED THE JURY THAT SCANDRETTS HAD NO FIDUCIARY DUTY TO REVIEW, REVISE OR TERMINATE THEIR COMPENSATION ARRANGEMENTS?

The trial court determined the instruction to be proper.

- *Mueller v. Cedar Shore Resort, Inc.*, 2002 S.D. 38, 643 N.W.2d 56
- *Landstrom v. Shaver*, 1997 S.D. 25, 561 N.W.2d 1
- *Gimpel v. Bolstein*, 477 N.Y.S.2d 1014 (N.Y. Sup. Ct. 1984)

II. WHETHER THE TRIAL COURT ERRED WHEN IT DECLINED TO INSTRUCT THE JURY ON EMPLOYMENT AT WILL CONCEPTS AND THAT OFFICERS AND DIRECTORS HAVE A DUTY TO TERMINATE A CONTRACT ENTERED INTO BY THE CORPORATION IF THE CONTRACT BECOMES AGAINST THE BEST INTERESTS OF THE CORPORATION?

The trial court determined the instruction was improper.

- *Lindskov v. Lindskov*, 2011 S.D. 34, 800 N.W.2d 715
- SDCL § 60-1-3
- SDCL § 60-4-4

III. WHETHER THE TRIAL COURT ERRED WHEN IT DECLINED TO INSTRUCT THE JURY THAT DIRECTORS OWE A FIDUCIARY DUTY OF UNDIVIDED AND UNSELFISH DUTY OF LOYALTY TO THE CORPORATION?

The trial court determined the instruction was improper.

- *Mueller v. Cedar Shore Resort, Inc.*, 2002 S.D. 38, 643 N.W.2d 56
- *Balvik v. Sylvester*, 411 N.W.2d 383 (N.D. 1987)
- *Schurr v. Weaver*, 74 S.D. 378, 53 N.W.2d 290 (S.D. 1952)

STATEMENT OF THE CASE

This is an appeal from the Seventh Judicial Circuit Pennington County, the Honorable Robert Gusinsky presiding. Schultzes sued Scandretts alleging breach of fiduciary duty of care, breach of fiduciary duty of loyalty, minority shareholder oppression, and request for accounting arising out of the generous salaries paid to Scandretts and their family as employees of Cosmos of the Black Hills, Inc., a closely-held corporation. Schultzes are the minority shareholders and Scandretts are the majority shareholders. A trial was held May 7-9, 2014 in which the fiduciary duty claims were tried before a jury and the oppression and accounting claims were simultaneously tried before the court.

The jury rendered a verdict in favor of Scandretts on the breach of fiduciary duty claims on May 9, 2014. Thereafter, both sides submitted proposed Findings of Fact and Conclusions of Law for the minority shareholder oppression claim (R. 1709, 1731) with both sides objecting to the other's submissions.[1] (R. 1754, 1762.) The court issued Findings of Fact and Conclusions of Law (R. 1770) in favor of Scandretts on July 1, 2014 on the minority shareholder oppression claim. Schultzes appeal requesting reversal and remand for a new trial.

STATEMENT OF THE FACTS

Cosmos of the Black Hills, Inc. ("Cosmos") is a corporation organized and existing under the laws of the State of South Dakota. Schultzes are the minority shareholders and members of the same family. Don and Eloise Schultz have four sons, Steve, Mark, David and Matt Schultz.[2] The Scandretts are the majority shareholders of the Cosmos and Lyle Scandrett is Heidi Bybee's father. Lyle and his wife Marlene Scandrett along with Heidi and her husband Kevin Bybee are the majority shareholders.[3]

In the early 1950s, Don Schultz conceived an idea to build an optical illusion tourist business. (Don Schultz Depo. 6-10.)[4] In 1953 he purchased land in the Black Hills, built the first "mystery house" with his father, and the business known as the Cosmos Mystery Area was born. *Id.* at 13-15. The business model consists of the customer purchasing a ticket, going on a 20-30 minute guided tour, and returning to the gift shop where souvenirs can be purchased. (Tr. 60:1-7.) The tours are lead primarily by high school and college students who present various optical illusion demonstrations such as balls rolling uphill and changes in height of tourists while standing on a level

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[1] The request for accounting was not pursued by the Schultzes at trial.
[2] Matt Schultz is not a party to this action.
[3] Marlene Scandrett and Kevin Bybee are not parties to this action.
[4] Don Schultz's deposition is part of the record. (R. 1629.)

platform. (Tr. 57:4-58:22.) The Cosmos is a simple operation that has remained virtually unchanged since its inception. (Tr. 60:18-21.)

In the early years, the Cosmos was operated by Don and Eloise Schultz or Don's parents. (Ex. 50.) The corporation was formed in 1959 with Don holding 1500 shares and his parents holding 1500 shares. *Id.* In 1960, Lyle Scandrett was hired to manage the Cosmos during the summer months and issued 1 share. *Id.* Don was issued another 50 shares and his shares were split equally with Eloise with each holding half of Don's 1550 shares. *Id.* In 1968, Lyle and his wife Marlene acquired Don's parents' shares, which were 1500 of the total 3051 outstanding shares, and Lyle became a director. *Id.* In 1972, Lyle and Marlene were issued an additional 100 shares of stock giving Lyle a controlling ownership interest in the Corporation. *Id.* Since that time, Lyle Scandrett and his family members have remained as a group the majority stockholders in Cosmos with the Schultz family owning 1550 shares and the Scandrett family owning 1601 shares. (Ex. 50) (Ex. 156.) This is the difference that still exists today.

Over the years, Don and Eloise gifted some shares to their sons Steve, Mark, David and Matt Schultz. (Ex. 50.) Heidi and Kevin Bybee also received their shares by gift from Lyle and Marlene. For estate planning purposes, Don and Eloise assigned their stock to the Schultz Family Trust in 2009 (Ex. 156), a revocable trust.

In 1960, Lyle was paid $5,000 to manage the Cosmos from Memorial Day to Labor Day. (Ex. 50.) In 1969, while Lyle was still a minority shareholder, an off-season bonus plan was implemented which reduced the manager's base salary to $2,500 for the summer season but added bonus compensation which included all ticket sales (less non-management employee wages and operating expenses) and one-half the net souvenir sales income for the period before Memorial Day and after Labor Day each year. (Ex. 50.) This part of the tourist season is often referred to as the "shoulder season" or "off-season". (Tr. 37:12-14; 82:13-14.) In 1986, the manager's base salary was increased to $10,000 with the off-season bonus remaining unchanged. (Ex. 50.) According to his own testimony, since 1969 Lyle considered the shoulder season as his business and the summer months as the corporation's business. (Tr. 3009:14; 301:20-22; 302:4-14; 339:11-12.)

In 2004, the corporate minutes were condensed into a document titled the "Historical Record". (Ex. 50.) Lyle requested each shareholder signify their agreement that the summary was accurate by signing and returning to him the last page of the document. (Ex. 49.) The Historical Record outlines the off-season compensation arrangement and indicates that the only salary paid is to Lyle as the manager. (Ex. 50.) Nothing in the Historical Record indicates the off-season compensation arrangement endures for Lyle's lifetime nor does it contain any duration. *Id.*

The Historical Record was signed by Lyle, Marlene, Don, Eloise and David in 2004. (Ex. 50.) At that time, however, while the Schultzes knew the formula by which Lyle was paid, they did not know the actual amount of compensation Lyle received. (Tr. 150:21-25; 152:22-23; 154:16-17) (Ex. 105.) Lyle had never provided the information to shareholders or directors that was necessary to calculate his compensation nor did he ever provide the actual calculations. (Tr. 89:19-25; 133:22-134:11) (Exs. 40-43, 45-46.) Only Lyle knew the amount of compensation he received. *Id.* Unbeknownst to the Schultzes, the shoulder season visitation and revenue had increased dramatically in South Dakota since Lyle's compensation scheme was agreed upon over 40 years previously. (82:10-15; 244:20-23; 341:8-12.) Additionally, at the time the Historical Record was disseminated and signed in 2004, Lyle failed to disclose to the Schultz family that he had started paying Heidi and Marlene (Lyle's daughter and wife) salaries. (Ex. 50.)

In 1997 Lyle hired his daughter, Heidi Bybee, without any involvement with the board of directors. (Tr. 97:15-9; 98:9-14.) He arbitrarily decided to pay her a salary as well as bonus consisting of 12% of the net profits of the corporation. (Tr. 98:18-99:9.) In 2008, Lyle hired Heidi's husband, Kevin Bybee again without any notification of the board or other shareholders. (Tr. 99:22-100:1.) Lyle also made Kevin a salaried employee and simply matched the salary he earned at a previous job as a loss prevention manager, supervising 15+ employees, working 52 weeks a year. Kevin is not a manager at Cosmos and does not work 52 weeks a year. (Tr. 102:21-103:9.)

Lyle's wife Marlene also receives a salary that was determined by Lyle. (Tr. 95:25-96:1.) Marlene used to process payroll, however, the task has been outsourced to an accountant, and Kevin provides the paperwork necessary to process payroll to the accountant. (Tr. 96:24-97:10.) Nevertheless, Marlene continues to draw the same salary. (Tr. 97:12-14.) In addition to Lyle, Marlene, Heidi and Kevin, the only salaried employees, approximately 15-20 hourly employees work at the Cosmos giving tours, running the cashier, cleaning and general maintenance. (Tr. 71:16-72:8.)

Over the years, Lyle slowed down and Heidi gradually began to take over more responsibilities. (Tr. 70:19-22.) By 2000, Lyle and Heidi were representing to the directors, shareholders and the public at large that Heidi was the manager of the

Cosmos. (Exs. 63-66.) Even so, Lyle continued to draw his manager's salary along with his off-season compensation. (Exs. 80, 109.)

On December 23, 2008, in response to Don Schultz's inquiry into low dividends, Lyle—for the very first time—provided the amount of his annual bonus. (Ex. 107.) He further disclosed, for the first time, the compensation scheme and amount paid to Heidi and the fact that he hired Kevin and was paying him a salary as well. *Id.* By this time, the board of directors consisted of Lyle Scandrett, Heidi Bybee and David Schultz. (Ex. 102.) At the 2009 Directors' meeting, David Schultz made a motion that the manager's salary for the entire year should be set at $60,000 with the off-season bonus being eliminated and only one manager being paid. *Id.* The motion failed for lack of a second. *Id.* Instead, Lyle made a motion that David's concerns be considered at a special board of director's meeting. *Id.* However, at that special meeting on June 13, 2009, the motion again died for lack of a second. (Ex. 101.) David then moved the corporation do some sort of market analysis for the manager's salary. *Id.* Discussion ensued, but ultimately neither Lyle nor Heidi would second the motion, even when David suggested voting after the meeting to allow them time to discuss the matter. (Exs. 100-101.)

From 2008 to 2013 the following salaries and bonuses were paid for the seven month seasonal business:

	Lyle	**Heidi**	**Marlene**	**Kevin**	**Total**
2008	$79,863.00	$70,140.28	$10,366.26	$40,160.00	**$200,529.54**
2009	$57,164.00	$60,723.23	$10,379.61	$28,486.80	**$156,753.64**
2010	$55,513.94	$72,444.86	$7,122.34	$65,093.80	**$200,174.94**
2011	$100,052.17	$69,999.19	$6,389.09	$42,937.40	**$219,377.85**

2012	$45,530.42[5]	$66,988.68	$6,844.08	$42,580.40	**$161,943.58**
2013	$145,204.70	$70,521.69	$6,761.26	$36,052.40	**$258,540.05**
Total:	**$483,328.23**	**$410,817.93**	**$47,862.64**	**$255,310.80**	**$1,197,319.60**

(Ex. 109.)

The Schultzes believe the off-season compensation arrangement has become increasingly adverse to the best interests of the corporation and the shareholders. In addition to the level of compensation being paid, the costs associated with generating the off-season revenue (i.e. advertising, marketing, insurance, utilities, etc.) have not been properly apportioned to the off-season. (Tr. 82:24-84:4; 121:17-122:12.) This further exacerbates the situation and the compensation Lyle receives as manager. Additionally, while Lyle's compensation has dramatically increased, his management responsibilities have decreased with the hiring of Heidi and Kevin and additional hourly employees. Many of the tasks once performed by Lyle as manager are now performed by Heidi and Kevin.

Schultzes brought suit against Scandretts for breach of fiduciary duty of care, breach of fiduciary duty of loyalty, minority shareholder oppression, and accounting. (R. 58.) The breach of fiduciary duty claims were tried before a jury and the oppression claim was simultaneously tried before the court. The trial court instructed the jury that South Dakota law did not allow a shareholder to use the fiduciary duty concept to rewrite his original deal. Schultzes objected to this instruction. (Tr. 545:9-546:8.) The trial court also failed to instruct the jury on employment at-will concepts and a corporation's duty to terminate contracts that are no longer in the best interests of the

[5] In 2012, Lyle underpaid himself by approximately $33,000. This amount was added to Lyle's 2013 wages which accounts for the disparity between these years. (Ex. 71) (Tr. 101:18-22.)

corporation. Finally, the trial court would not instruct the jury that directors owe a fiduciary duty of undivided and unselfish loyalty to the corporation. (Tr. 547:19-550:7) (R. 692-695.) The jury and the court found for Scandretts. This appeal ensued.

STANDARD OF REVIEW

A trial court has discretion in the wording and arrangement of its jury instructions. *Vetter v. Cam Wal Elec. Coop*, 2006 S.D. 21, ¶ 10, 711 N.W.2d 612, 615. A trial court's decision to grant or deny a particular instruction is reviewed under the abuse of discretion standard. *Id.* (*citing Luke v. Deal*, 2005 S.D. 6, ¶ 11, 692 N.W.2d 165, 168; *Parker v. Casa Del Rey-Rapid City, Inc.*, 2002 S.D. 29, ¶ 5, 641 N.W.2d 112, 116). "However, no court has discretion to give incorrect, misleading, conflicting, or confusing instructions: to do so constitutes reversible error if it is shown not only that the instructions were erroneous, but also that they were prejudicial." *Id.* (*citing First Premier Bank v. Kolcraft Enterprises, Inc.*, 2004 S.D. 92, ¶ 40, 686 N.W.2d 430, 448 (citations omitted)). "On issues supported by competent evidence in the record, the trial court should instruct the jury." *Overfield v. Am. Underwriters Life Ins. Co.*, 2000 S.D. 98, ¶ 11, 614 N.W.2d 814, 816. "Failure to give a requested instruction that correctly sets forth the law is prejudicial error." *Id.*

When in all probability erroneous instructions produced some effect upon the verdict and were harmful to the substantial rights of the parties, they are prejudicial. *Vetter*, 2006 S.D. 21 at ¶ 10. "Jury instructions are viewed as a whole and are sufficient if they correctly state the law and inform the jury. *Overfield*, 2000 S.D. 98 at ¶ 11. "[W]hen the question is whether a jury was properly instructed overall, that issue becomes a question of law reviewable de novo." *Id.* Under this de novo standard, the instructions are construed as a whole to see if they provided a full and correct statement of the law. *Kolcraft*, 2004 S.D. 92 at ¶ 92.

ARGUMENT

I. A DIRECTOR AND MAJORITY SHAREHOLDER HAS A FIDUCIARY DUTY TO MODIFY HIS COMPENSATION ARRANGEMENT FOR THE BEST INTERESTS OF THE CORPORATION

The trial court erred when it instructed the jury incorrectly regarding the fiduciary duty concept. The offending instruction provided:

> South Dakota law does not allow a shareholder to use the fiduciary duty concept to rewrite an original deal he or she made with the corporation.

(Instruction No. 27.) The language comes from *Mueller v. Cedar Shore Resort, Inc.*, 2002 S.D. 38, 643 N.W.2d 56 but is taken out of context, applied incorrectly, and is misleading and confusing.

In *Mueller*, minority shareholders sued three closely-held corporations, one of which was a family-owned corporation, and the majority shareholders alleging breach of fiduciary duty and minority shareholder oppression. The court analyzed the claims separately against the family-owned corporation and the traditional, closely-held corporations. The plaintiffs received their family-owned corporate shares by gift, but were original shareholders in the closely-held corporations. The court emphasized the distinction between the gifted shareholder and investing shareholder in its analysis.

A. Duties Owed in Closely-Held and Family-Owned Corporations

Before applying the *Mueller* language to this case, it is helpful to begin with a background on the duties owed by directors and majority shareholders in closely-held corporations.

1. Minority Shareholder Oppression

Minority shareholder oppression claims traditionally involve actions by the majority shareholders that substantially defeat the reasonable expectations held by the minority shareholders in committing their capital to the corporation. *Mueller*, 2002 S.D. 38 at ¶ 13. A shareholder's reasonable expectations such as employment, participation in management and economic return are usually judged in light of the capital the shareholder committed to the corporation. *Id.* at ¶ 18. When a shareholder receives shares via gift, and does not contribute any capital, "the standard is somewhat lower, requiring only ''decent' conduct by controlling shareholders.'" *Id.* (*quoting* Robert W. Hamilton, *Business Organizations: Unincorporated Businesses and Closely Held Corporations*, § 8.25 n84 (1996)).

The *Mueller* rationale is based on a New York Case, *Gimpel v. Bolstein*, 477 N.Y.S.2d 1014 (N.Y. Sup. Ct. 1984), cited at length by *Mueller*. *Gimpel* recognized that shareholders receiving shares via inheritance or gift in a *family-owned* corporation are not always entitled to the "reasonable expectation" standard for oppression claims. *Gimpel* identified two generally accepted definitions of oppression: (1) violation of the minority shareholders' reasonable expectations; and (2) burdensome, harsh and wrongful conduct. 477 N.Y.S.2d at 1018. "These two approaches are, of course, not mutually exclusive, and will frequently be found to be equivalent. Often, however, it will be found that one or the other lends itself more nearly to the facts of the case as an appropriate analytical framework." *Id.* The plaintiff in *Gimpel* was a third generation shareholder who acquired his shares by gift. He and the other third generation shareholders (one who purchased her shares) "in no sense chose each other as business associates" so Gimpel could not "lay claim to the reasonable expectations of any specific benefits". *Id.* at 1020. Nonetheless, the majority shareholders could not "treat him as shabbily as they please" and the alternative "burdensome, harsh and wrongful conduct" test was applied. *Id.*

Mueller recognizes both tests or standards for a minority shareholder oppression claim. Reasonable expectations are reserved for shareholders investing in closely-held corporations and gifted shareholders must show "inherent oppression" under the lower "decency" standard. *Mueller*, 2002 S.D. 38 at ¶¶ 18-19. The "decency" standard was described as good faith and fair dealing. "In this case, however, there are significant indications that Paul and Mary Pat's family members did not satisfy even this good faith and fair dealing standard." *Mueller*, 2002 S.D. 38 at ¶ 20. The court then analyzed the minority shareholders' complaints to determine if they rose to the level of "inherent oppression".[6] *Id.*

2. Fiduciary Duties

"[D]irectors of a corporation occupy a fiduciary position in respect to the corporation and its shareholders." *Landstrom v. Shaver*, 1997 S.D. 25, ¶ 84, 561 N.W.2d 1, 18 (*citing Case v. Murdock*, 488 N.W.2d 885, 890 (S.D. 1992)). "This fiduciary duty is characterized by a high degree of diligence and due care, as well as the exercise of utmost good faith and fair dealing." *Mueller*, 2002 S.D. 38 at ¶ 26 (*citing Landstrom*, 1997 S.D. 25 at ¶ 84; *Case*, 488 N.W.2d at 889-90; *Mobridge Cmty. Indus., Inc. v. Toure, Ltd.*, 273 N.W.2d 128, 133 (S.D. 1978)).

[6] *Mueller* used the reasonable expectations test when analyzing the minority shareholders' oppression claim against the closely-held corporation, Cedar Shore Resort, Inc. 2002 S.D. 38 at ¶ 22.

Additionally, *majority shareholders* in a closely-held corporation owe a fiduciary duty to the minority shareholders. *Mueller*, 2002 S.D. 38 at ¶ 26 (citations omitted). The fiduciary duty majority shareholders owe to minority shareholders is the same high degree of diligence, due care and utmost good faith and fair dealing owed by a director. *Mueller*, 2002 S.D. 38 at ¶ 26 (citations omitted).

However, if the minority shareholder received his shares by gift, the fiduciary duty owed to him in a *family-owned corporation* is something less than the high degree of diligence, due care and utmost good faith and fair dealing. *Mueller*, 2002 S.D. 38 at ¶ 28. "Because of the potential for abuse, the scope of the fiduciary duty owed by a *family-owned corporation* that has gifted its shares to the shareholders is somewhat more limited than that duty owed in the context of a *traditional close corporation*." *Id.* at ¶ 28 (emphasis added). Relying on its previous rationale under the minority shareholder oppression analysis, *Mueller* determined gifted shareholders in family-owned corporations were entitled to the lower "decentness" standard. *Id.* Thus, *Mueller* held that the same "decency" standard was applied to both minority shareholder oppression claims and majority shareholder breach of fiduciary duty claims when the minority shareholder received his shares by gift.[7] *Id.* at ¶¶ 18 and 28. The "decency" standard for majority shareholder breach of fiduciary duty was described as good faith and the duty of loyalty. *See Mueller*, 2002 S.D. 38 at ¶ 28 ("Paul and Mary Pat must show evidence of bad faith or a breach of the duty of loyalty.")

[7] The corporation must also be *family-owned* for the decency standard to apply under the majority shareholder breach of fiduciary duty claim. *Mueller*, 2002 S.D. 38 at ¶ 28.

B. *Mueller* Does Not Abolish Scandretts' Fiduciary Duty Owed to Schultzes

Instruction No. 27 effectively eliminated Scandretts' fiduciary duty owed to Schultzes, contrary to *Mueller*, the case from which the instruction was based. When analyzing the majority shareholder breach of fiduciary duty claim as applied to the *family-owned corporation*, the *Mueller* Court said:

> Because of the potential for abuse, the scope of the fiduciary duty owed by a <u>family-owned corporation</u> that has gifted its shares to the shareholders is somewhat more limited than that duty owed in the context of a <u>traditional close corporation</u>. As explained above, where the shareholder receives their stock by gift and invest no capital, the shareholders' minimum economic return and right of participation become limited. Hamilton, *supra* at § 8.25. <u>We are not prepared to allow a shareholder to use the fiduciary duty concept to rewrite the original deal he or she made with the corporation</u>, a modification that the original parties to the transaction almost certainly would not have chosen. To do so would significantly undermine a primary method of tax planning and wealth sharing by holding family business owners hostage, subject to the demands of every gifted shareholder, whether reasonable or not. Therefore, the question is whether Paul and Mary Pat have identified in the record sufficient evidence to demonstrate that the conduct of the individually named directors, under these circumstances, amounted to something below the 'decentness' standard set forth above.

2002 S.D. 38 at ¶ 28 (emphasis added). This paragraph does not hold there is no fiduciary duty to revise or terminate a compensation arrangement. Instead, it holds majority shareholders only owe a "decentness" standard to gifted minority shareholders in a *family-owned corporation*.

1. The "Deal" is the Minority Shareholder's Deal

The "deal" referred to in *Mueller* is the *gifted minority shareholder's* expectations when they are gifted shares, not the majority shareholder's compensation agreement. The gifted minority shareholder's "original deal" he made with the corporation is that he did not invest capital or resources. As such, his economic return expectation and right of participation are more limited than that of an investing shareholder. *Mueller*, 2002 S.D. 38 at ¶ 28. To be sure, there is no agreement or contract in *Mueller* that the minority shareholders were attempting to undo. They simply alleged a right of participation and employment, which was not part of their "deal" as non-investing shareholders. If the *Mueller* Court meant that "the deal" included employment contracts or compensation agreements, it would have said so.

The *Mueller* court set forth the premise that a gifted shareholder cannot "rewrite the original deal" he made with the corporation by claiming the majority shareholders have breached the high degree of diligence, due care and utmost good faith and fair dealing owed to him when he became a shareholder via gift. This is demonstrated by recognizing that exclusion of a minority shareholder from the benefits of the corporation is often a breach of the traditional fiduciary duty standard. *See e.g. Hayes v. Olmsted & Assocs.*, 21 P.3d 178, 181-182 (Or. Ct. App. 2001) ("Oppression of minority shareholders in closely held corporations is frequently linked to breaches of fiduciary duty. . . . a breach of fiduciary duty occurs when 'the majority shareholders of a closely held corporation use their control over the corporation to their own advantage and exclude the minority from the benefits of participating in the corporation, [in the absence of] a legitimate business purpose'. A breach of fiduciary duty by those who control a closely held corporation normally constitutes oppression.") (citations and quotations omitted) (cited with approval in *Mueller*, 2002 S.D. 38 at ¶ 30). "The original participants in a close corporation enter into their agreement on the basis of the assessments of each other's talents, assets, intentions and characters and their agreement must, therefore, be regarded as personal in nature." *Gimpel*, 477 N.Y.S.2d at 1019. A gifted shareholder does not enter the corporation on the same terms. Thus, a non-investing shareholder cannot demand employment or participation in the management of a corporation by claiming a breach of fiduciary duty, contrary to “his deal” with the corporation.

The gifted Schultz shareholders are not trying to “rewrite” *their* original deal with the Cosmos. They never argue or allege exclusion from management participation or employment is a breach of fiduciary duty. Instead, Schultzes’ argument is that the majority shareholders and directors breached their fiduciary duty by failing to review the off-season compensation arrangement to determine if it was in the best interests of the corporation. Thus, it was error to provide Instruction No. 27 because Schultzes’ claims had nothing to do with *their* deal.

2. Instruction No. 27 Confused and Misled the Jury

Instruction No. 27 confused and mislead the jury into believing South Dakota law does not require a majority shareholder or director to review, revise or terminate his compensation arrangement. In other words, the jury was led to believe that the fiduciary duty owed by directors and majority shareholders can be bargained away. The only claims presented to the jury were breach of fiduciary duty and the crux of those claims was that Lyle and his family overpaid themselves. As such, Schultzes’ claims were effectively taken from the jury under this instruction. If it followed the instruction, as it must, the jury simply could not find for Schultzes. In essence, the jury was instructed it was *not* a breach of fiduciary duty for Scandretts to continue under the off-season compensation arrangement even if the jury believed the arrangement was no longer in the best interests of the corporation. As such, the erroneous instruction was extremely prejudicial to Schultzes.

Throughout the course of the entire trial, Lyle's compensation arrangement was referred to as "the deal". Scandretts used the confusing instruction in their favor arguing Schultzes brought suit to undo Lyle's compensation arrangement, or "the deal". After the jury heard the instructions, Scandretts' attorney argued in closing:

> They've come here because they say 12 jurors are bigger than a hundred shares and your promise is no good. They're here to have you undo <u>the very deal</u> that they made.

(Tr. 569:20-23) (emphasis added.)

> But they're asking you to actually go back and take money from them from before they ever asked to get rid of <u>this deal</u>.

(Tr. 570:2-4) (emphasis added.)

> But here's the problem and I will go back to it again because it isn't diversion, it's <u>the deal</u>.

(Tr. 572:13-14) (emphasis added.)

> That's <u>his deal</u>.

(Tr. 575:4) (emphasis added.)

> I know you say that, but that's not <u>the deal</u> that you used to get Lyle to come. That wasn't <u>the deal</u> that they used to get Lyle to bring his family into this as well.

(Tr. 575:10-13) (emphasis added.)

> Let's pretend that Don had never made <u>the deal</u> to get Lyle to come. Let's pretend <u>that deal</u> never happened.

(Tr. 576:10-12) (emphasis added.)

> They don't like <u>the off season deal</u>.

(Tr. 580:18-19) (emphasis added.)

> This is about their decision that their <u>original deal</u> has gotten too good but they've always known <u>the deal</u>.

(Tr. 582:21-23) (emphasis added.)

> The only thing he did was adhere to <u>the deal</u> that he's had since 1969.

(Tr. 584:19-20) (emphasis added.)

Scandretts certainly represented "the deal" was Lyle's compensation arrangement, which is not "the deal" discussed in *Mueller*, thereby misleading the jury to believe Lyle's deal could not be changed by the Schultzes. Scandretts, in support of the instruction, argued "[t]he instruction accurately sets forth the law of the fiduciary duty <u>and the limitation on any fiduciary duty relating to an original concept</u>." (Tr. 546:1-3) (emphasis added.) That no "original concept" can be changed pursuant to a fiduciary duty is an incorrect statement of law. Schultzes objected to the instruction:

> The next objection, Your Honor, is to instruction number 27. I do not believe that this is a black letter law or the appropriate law to apply in this case. The language used from *Mueller* and in this instruction regarding a deal refers to the shareholders deal, more specifically the -- the shareholder who receives his shares by gift. It's the gifted shareholders deal. It's not the majority shareholders deal, which is how it's being applied in this case, and I think that objection can be illustrated if the original deal was never memorialized in 2004 and then the Schultz boys received their shares gifted later on, their original deal -- the Schultz's original deal is not Lyle's agreement. Their original deal is their gifted shares of the corporation. So I feel like it's a misstatement of the law and not applicable in this case.

(Tr. 545:9-24.) The objection was overruled and Scandretts were allowed to argue to the jury that Schultzes were powerless under the law to change Lyle's compensation arrangement, a misstatement of the law that was exacerbated by confusing and misleading instructions. At trial, there was no testimony, argument or mention of the Schultzes' "deal" as gifted shareholder—which is what *Mueller* is referring to. The instruction confuses and misleads the jury into believing the "black letter law" is that directors and majority shareholders have no fiduciary duty to review their compensation arrangements. That is not what *Mueller* stands for and the instruction was therefore incorrect, confusing and misleading. It was prejudicial to the Schultzes whose entire breach of fiduciary duty claims were effectively taken away from the jury with this instruction. The jury had no choice but to find for Scandretts when it is instructed Scandretts have no fiduciary duty to revise their compensation arrangements. Such an instruction influenced the verdict and was harmful to Schultzes' rights as a party.

C. *Mueller* Does Not Apply

1. Cosmos is not a Family-Owned Corporation

Cosmos is not a family-owned corporation and thus "the more limited duty" owed by a family-owned corporation does not apply. Instead, Scandretts, as majority shareholders and directors, owe Schultzes the traditional fiduciary duty of a high degree of diligence, due care and utmost good faith and fair dealing. The rationale for applying the limited duty to family-owned corporations and not traditional, closely-held corporations is that family-owned corporations are a method of tax planning and wealth sharing. That rationale is not present in this case. It was error for the trial court to use Instruction No. 27 because it is not applicable to the Cosmos, a traditional closely-held corporation.

2. The Language Does Not Apply to a Director's Fiduciary Duty

Even if this Court determines Instruction No. 27 is a correct statement of law as it relates to the fiduciary duty owed by majority shareholders, it is not the correct statement of law as applied to a *director's* fiduciary duty. South Dakota has long held directors owe a fiduciary duty to the corporation and shareholders that is "characterized by a high degree of diligence and due care, as well as the exercise of utmost good faith and fair dealing." *Mueller*, 2002 S.D. 38 at ¶ 26; *accord Landstrom*, 1997 S.D. 25 at ¶ 85; *Case*, 488 N.W.2d at 889-890; *Toure*, 273 N.W.2d at 133. There is no "limited" or "lessened" duty owed by a director to a gifted minority shareholder. The "deal" language from *Mueller* does not apply whatsoever to a director's fiduciary duty toward the corporation and shareholders. Instructing the jury that "South Dakota law does not allow a shareholder to use **<u>the</u>** <u>fiduciary duty concept</u> to rewrite an original deal he or she made with the corporation" is a misstatement of the law.

The *Mueller* language, if applicable at all, only applies to a *majority shareholder's* fiduciary duty toward a gifted minority shareholder in a family-owned corporation, not a *director's* duty to all shareholders. Lyle has been a director of the Cosmos since 1968 and Heidi has been a director since 2008. They owed a fiduciary duty of a high degree of diligence, due care and utmost good faith and fair dealing to the Cosmos and Schultzes.[8] Scandretts breached their fiduciary duty by refusing to modify or even discuss compensation. On two occasions, Lyle and Heidi refused to second Dave Schultz's motion to revise management compensation—even after Lyle specifically proposed a special meeting to discuss the matter.

[8] It is not even necessary to determine if Scandretts breached the lower "decency" standard because as directors, they also owe the higher "traditional" standard, which includes and trumps the lower standard. "[W]here a majority or controlling shareholder is also a director, then fiduciary duties apply in both capacities." 18A Am. Jur. 2d *Corporations* § 644 (2004). Analyzing the claim under the lower "decency" standard is pointless when it must be analyzed again using the higher "traditional" standard anyway.

It was error for the trial court to give Instruction No. 27 because it does not apply to a director's fiduciary duty. It further confused and mislead the jury into believing Scandretts had *no* fiduciary duty to review, revise or terminate their compensation arrangement, when in fact Scandretts' fiduciary duty owed as directors requires just that. Such an incorrect statement of law was highly prejudicial to the Schultzes. It effectively eliminated Schultzes' director breach of fiduciary duty claim which in all probability produced some effect on the verdict.

3. Don and Eloise Are Investing Shareholders

At a minimum, Don and Eloise are entitled to the traditional fiduciary duty standard since they are original, investing shareholders who did not receive their shares by gift. Instruction No. 27 is not applicable to Don and Eloise but does not differentiate between the two classes of shareholders. The jury was misled into believing it applied to all the Schultzes as a whole. Such a misunderstanding was prejudicial to Schultzes because the jury could have found Scandretts breached a fiduciary duty owed to Don and Eloise which would have changed its verdict had it been properly instructed.

II. THE DIRECTORS AND MAJORITY SHAREHOLDERS HAD A DUTY TO ANALYZE THEIR COMPENSATION

The trial court denied three interrelated instructions proposed by Schultzes that were correct statements of law and supported by evidence in the record. The instructions provided as follows:

> The length of time which an employer and employee adopt for the estimation of wages is relevant to a determination of the term of employment.

(Plaintiffs' Proposed Instruction No. 15) (R. 692.)

> An employment contract having no specified term may be terminated at will, or in other words, at any time, and for any reason or for no reason, by the employee of the employer.

(Plaintiff's Proposed Instruction No. 16) (R. 693.)

> If a contract entered into by a corporation becomes against the best interests of the corporation and the corporation can terminate the contract under the contract terms, then the officers and the directors of a corporation have a duty to terminate the contract.

(Plaintiffs' Proposed Instruction No. 17) (R. 694.)

Proposed Instruction No. 15 is verbatim SDCL § 60-1-3 which instructs the jury that since Lyle is paid annually, his term of employment, if any, is year to year. Proposed Instruction No. 16 sets forth South Dakota's employment at-will law and was modeled after South Dakota Civil Pattern Jury Instruction No. 30-40-20. *See also* SDCL § 60-4-4 ("An employment having no specified term may be terminated at the will of either party on notice to the other, unless otherwise provided by statute.") It instructs the jury that it may determine Lyle, Marlene, Heidi and Kevin at-will employees.

Proposed Instruction No. 17 is based on South Dakota authority that "[a]n officer or director of a corporation has a fiduciary duty to act in a manner that he reasonably believes is in [the corporation's] best interests." *Lindskov v. Lindskov*, 2011 S.D. 34, ¶ 15, 800 N.W.2d 715 (*citing* SDCL §§ 47-1A-830 -842.) It instructed the jury that if an officer or director determines a contract to be adverse to the corporation, they have a duty to terminate the contract.

Through the denial of these instructions, Schultzes were prevented from arguing to the jury that Lyle's compensation arrangement was an employment at-will arrangement that could be modify if it subsequently became adverse to the corporation.

The denied instructions also prevented the jury from determining if Scandretts had a duty to analyze the salaries of Marlene, Heidi and Kevin in relation to the best interests of the corporation. All three instructions are correct statements of law supported by competent evidence in the record and thus it was error to deny the instructions.

There is no written "contract" for Lyle's employment or compensation scheme. The only memorialization is the Historical Record which contains no term or duration. Nothing in the Historical Record indicates Lyle shall be employed for life or that his compensation arrangement will continue for life. (Ex. 50.) As such, his employment has no specified term and can be terminated and modified at-will. SDCL § 60-4-4; *Anderson v. First Century Federal Credit Union*, 2007 S.D. 65, ¶ 18, 738 N.W.2d 40. If his employment is terminable at will, the corporation has a duty to modify his compensation scheme if it is no longer in the best interests of the corporation.

III. FIDUCIARY DUTY REQUIRES A DIRECTOR AND MAJORITY SHAREHOLDER TO PLACE THE CORPORATION ABOVE PERSONAL INTERESTS

Directors and majority shareholders owe a duty of loyalty to the corporation and minority shareholders. *See e.g. Balvik v. Sylvester*, 411 N.W.2d 383, 387 (N.D. 1987) (acknowledging "stockholders in a close corporation owe one another substantially the same fiduciary duty of utmost good faith and loyalty in the operation of the enterprise that partners owe to one another.") (*citing Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505, 515 (Mass. 1975).[9] *See also Schurr v. Weaver*, 74 S.D. 378, 84, 53 N.W.2d 290, 293 (S.D. 1952) (stating that a director is required to make full and frank disclosure of circumstances affecting the corporation, implying a duty of

[9] *Balvik* is cited with approval in *Mueller*. 2002 S.D.38 at ¶ 29.

loyalty).

Schultzes offered an instruction pertinent to a director's duty of loyalty to minority shareholders. The offered instruction provided:

> The fiduciary duty owed by a Director to minority shareholders requires an undivided and unselfish loyalty to the Corporation and also requires that there be no conflict between the Director's fiduciary duty and self-interest.

(Plaintiffs' Proposed Instruction No. 18.) The instruction is a correct statement of law that should have been given because Lyle was not putting the corporation above his own self-interests (i.e. his compensation arrangement) which was a breach of his fiduciary duty of loyalty. "Hallmark behavior of such a breach [of fiduciary duty of loyalty] includes the failure to disclose information, director or shareholder self-dealing, making fraudulent misrepresentations regarding past or future events, and surreptitious conduct or communications." *Mueller*, 2002 S.D. 38 at ¶ 29 (*citing Hayes v. Northern Hills General Hospital*, 1999 S.D. 28, ¶ 57, 590 N.W.2d 243, 247; *Landstrom*, 1997 S.D. 25 at ¶¶ 84-85; *Balvik*, 411 N.W.2d at 387; *Toure*, 273 N.W.2d at 133; *Schurr*, 53 N.W.2d at 293).

Schultzes presented evidence that Lyle failed to disclose information and engaged in self-dealing thereby breaching his fiduciary duty of loyalty. The Historical Record indicates the only salary paid is to Lyle as the manager. Lyle knew Marlene and Heidi were salaried employees. Nevertheless, he disseminated the Historical Record requesting signatures from the Schultzes without revising the Historical Record or disclosing the salaries. More concerning is that Lyle did not disclose the amount of compensation he was paid or the information needed (off-season ticket and souvenir sales) to calculate his compensation.[10] He never disclosed that off-season tourism had increased dramatically since the inception of the off-season compensation arrangement nearly 40 years ago and never provided the actual calculations of his compensation (which he calculated himself). Disclosing this information, known only by him, was imperative to the other shareholders' and directors' (Don and David in 2004) decision to sign the Historical Record. Failure to do so was a breach of his duty of loyalty.

> A fiduciary cannot take advantage of his or her position for personal benefits to the detriment of the corporation or its shareholders. Specifically, it is a cardinal principle that officers and directors of a corporation are not permitted to make out of their official position an undisclosed profit adverse to the corporation's interest, but must give to the corporation the benefit of any advantage which they thereby obtain. In other words, officers and directors of a corporation are not permitted to profit personally at the expense of the corporation.

18B Am. Jur. 2d *Corporations* § 1483 (2004) (emphasis added).

> A fiduciary's duty of candor is encompassed within the duty of loyalty, and that duty requires corporate fiduciaries to disclose all material information relevant to corporation decisions from which they may derive a personal benefit, and not to withhold relevant information concerning any potential conflict of interest with the corporation. The duty of candor, integral to fair dealing, also dictates that fiduciaries, corporate or otherwise, may not use superior information or knowledge to mislead others into performance of their own fiduciary obligations. Thus, while occupying a fiduciary relation, the officers and directors of a corporation are precluded from receiving any personal advantage without the fullest disclosure to, and assent of, all concerned.
>
> A corporate director's duty of disclosure applies when the corporation is seeking stockholder action.

[10] The off-season compensation is directly linked to the number of off-season ticket and souvenir sales. The concern is not necessarily that Lyle paid himself too much per se, it is that off-season tourism has substantially increased. Therefore, it may no longer be in the best interests of the Cosmos to continue such an arrangement, because it is losing the opportunity for substantial revenue. The amount of Lyle's off-season compensation would have alerted Schultzes the off-season had dramatically changed.

18B Am. Jur. 2d *Corporations* § 1485 (2004) (emphasis added). Lyle maintained an interest adverse to the corporation that required full disclosure before shareholders signed the Historical Record. Schultzes should have been granted this instruction describing the fiduciary duty of loyalty as it is a proper statement of law and there was sufficient evidence in the record supporting a breach of the duty of loyalty. Failure to give the instruction was prejudicial because the jury could have found Lyle breached his fiduciary duty of loyalty to Schultzes had it been properly instructed.

CONCLUSION

Directors and majority shareholders in closely-held corporations have a fiduciary duty to modify their compensation arrangement if it becomes adverse to the corporation. Instruction No. 27 improperly instructed the jury no such duty existed, contrary to South Dakota Law, and confused and misled the jury. This erroneous instruction was exacerbated by the failure to instruct the jury on at-will employment concepts, a director and majority shareholder's duty to terminate contracts adverse to the corporation, and the undivided and unselfish fiduciary duty of loyalty owed by Scandretts to Schultzes. The granted and denied instructions prejudiced the Schultzes whose fiduciary duty claims were effectively taken from the jury and in all probability, had some effect on the verdict.

The trial court abused its discretion in granting Instruction No. 27 and denying Schultzes' proposed instructions. The jury was not properly instructed overall and not provided a full and correct statement of the law. Schultzes request this matter be reversed and remanded for a new trial.

REQUEST FOR ORAL ARGUMENT

Schultzes respectfully request oral argument in this case.

Dated this 12th day of November, 2014

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CERTIFICATE OF COMPLIANCE

Pursuant to SDCL § 15-26A-66(b)(4), I certify this Appellant's Brief complies with the type volume limitation provided for in South Dakota Codified Laws. This Appellant's Brief, including footnotes, contains 7,458 words. I have relied upon the word count of our word processing system as used to prepare this Appellant's Brief. The original Appellant's Brief and all copies are in compliance with this rule.

GUNDERSON, PALMER, NELSON
& ASHMORE, LLP

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CERTIFICATE OF SERVICE

I hereby certify on November 12, 2014, I emailed a true and correct copy of the foregoing **APPELLANTS' BRIEF and APPELLANTS' CERTIFICATE OF COSTS** to the following at his last known e-mail addresses:

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I further certify that on November 12, 2014, I emailed the foregoing **APPELLANTS' BRIEF and APPELLANTS' CERTIFICATE OF COSTS** and sent the original and two copies of both by U.S. Mail, first-class postage prepaid, to:

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David E. Lust

APPENDIX

IN THE SUPREME COURT OF THE STATE OF SOUTH DAKOTA

Appeal No. 27158

STEVE SCHULTZ, **MARK SCHULTZ**, **DAVID SCHULTZ**, and **THE SCHULTZ FAMILY TRUST**, as stockholders of Cosmos of the Black Hills, Inc., a South Dakota Corporation, and as individuals, and Donald Schultz and Eloise Schultz as trustee of the Schultz Family Trust, and David Schultz as a director of Cosmos of the Black Hills, Inc.,

Plaintiffs and Appellees,

vs.

LYLE SCANDRETT and **HEIDI BYBEE**,

Defendants and Appellants

Appeal from the Circuit Court
Seventh Judicial Circuit
Pennington County
Hon. Robert Gusinsky, Circuit Court Judge

Notice of Appeal filed July 29, 2014

APPELLEES' BRIEF

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Preliminary Statement

Appellees will refer to themselves by their given names, “Heidi” or “Lyle.” Appellees will refer to themselves collectively, as “Scandretts.” Appellees will refer to Appellants collectively as “Schultzes.”

Appellees will refer to the Record on Appeal as “R.,” followed by the page number(s) assigned by the Pennington County Clerk of Courts. Appellees will refer to the trial transcript as “TT:,” followed by the page number(s). Appellees will refer to Trial Exhibits as “Ex.,” followed by the applicable Trial Exhibit number. Appellees will refer to materials in the Appellants’ Appendix by “Appellants’ Appx.” followed by the page number(s). Appellees will refer to materials in the Appellees’ Appendix by “Appellees’ Appx.” followed by the page number(s).

Jurisdictional Statement

Appellees agree with Appellants that the Court has jurisdiction to consider this appeal. This is an appeal from a final judgment dated June 30, 2014. (R. 1783.) Notice of Entry of Judgment was served July 2, 2014. (R. 1785.) Schultzes’ Notice of

Appeal was filed on July 29, 2014. (R. 1808.) The Court has jurisdiction of this appeal pursuant to SDCL § 15-26A-3(1).

Statement of Issues

1. Where majority shareholders and directors give an employee a compensation agreement to induce him to take a position, and then make him the majority shareholder to induce him to give up his other businesses, may those shareholders then use the fiduciary duty concept to strip that compensation plan from the employee?

The circuit court ruled that the shareholders may not use the fiduciary duty concept to strip the employee of his compensation agreement.

Mueller v. Cedar Shores Resort, 2002 S.D. 38, 643 N.W.2d 56.

2. Whether a shareholder-employee in a closely-held corporation is an at-will employee, where his purpose in joining the corporation was for employment.

The circuit court ruled that the shareholder-employee is not an at-will employee.

Mueller v. Cedar Shores Resort, 2002 S.D. 38, 643 N.W.2d 56.

Hollander v. Douglas Cnty., 2000 S.D. 159, 620 N.W.2d 181.

Gigax v. Repka, 615 N.E.2d 644 (Ohio App. 1992).

3. Whether the circuit court is required to give a jury instruction that incorrectly augments other instructions, and on grounds which were not preserved.

The circuit court refused Plaintiffs' Requested Jury Instruction No. 18.

Landstrom v. Shaver, 1997 S.D. 25, 561 N.W.2d 1.

Delzer v. Penn, 534 N.W.2d 58, (S.D. 1995).

Jahnig v. Coisman, 283 N.W.2d 557 (S.D. 1979).

Statement of the Case

This is an appeal from a judgment on a jury verdict in the Seventh Judicial Circuit, Pennington County, the Honorable Robert Gusinsky presiding. Schultzes sued Scandretts asserting claims for breach of fiduciary duty, minority shareholder oppression, and a request for an accounting arising out of the management of Cosmos of the Black Hills, Inc. (the "Cosmos"). Schultzes hold just less than 50% of the Cosmos shares, and Scandretts and their spouses hold the rest.

The case was tried May 7-9, 2014. The fiduciary duty claim was tried to a jury, and the oppression and accounting claims were simultaneously tried to the circuit court. On May 9, 2014, the jury returned a verdict in favor of Scandretts on the fiduciary duty claims.

Each party submitted proposed Findings of Fact and Conclusions of Law to the circuit court regarding Schultzes claims for minority oppression and accounting. (R. 1709, 1731.) Scandretts and Schultzes filed objections to the other's proposed findings and conclusions. (R. 1754, 1762.) On July 1, 2014, the circuit court issued its Findings of Fact and Conclusions of Law in favor of Scandretts on Schultzes' claims for minority shareholder oppression and accounting. (Appellants' Appx. 8-20.)

On July 1, 2014, the circuit court entered a Judgment in favor of Scandrett on all claims. (Appellants' Appx. 1-2.)

Schultzes appeal the jury verdict and judgment on their claim for breach of fiduciary duty. They do not appeal the Findings of Fact and Conclusion of Law or Judgment on their claims for minority shareholder oppression or accounting.

<u>Statement of the Facts</u>

The Cosmos is a tourist attraction in the Black Hills. It has been a successful business. (Donald Schultz Deposition, 75:3-5 (R. 1703).) And its success is largely due to Lyle's management. (Ex. 50.) Since 1989, the dividends that Cosmos pays to the shareholders have increased, year over year, by an average of 17.84% (Ex. 175.)

1. HOW LYLE CAME TO MANAGE THE COSMOS.

Lyle began working for Cosmos as a guide in 1957. (TT: 288:10-21.) At that time, Cosmos was managed by Don Schultz's father and mother, Fred and Marie Schultz. (Donald Schultz Deposition, 26:7-21 (R. 1654).) Lyle taught school in Wessington, but worked at Cosmos during the summers from 1957 through 1959. In the fall of 1959, Fred and Marie traveled to Wessington and asked Lyle to take over the management of the Cosmos. (TT: 290:12-291:16.) Lyle has managed the Cosmos continuously since 1960. (TT: 292:5-7.)

Cosmos has always been a summer tourist business. It opens Memorial Day and closes Labor Day. (TT: 298:12-23.) Prior to 1969, Cosmos paid Lyle $5,000 per year to manage Cosmos during the summer. (FoF 16 (Appellants' Appx. 10).)

In 1969, Don asked Lyle to live at the Cosmos year-round, in exchange for which, Don offered Lyle a new compensation agreement. (Ex. 50; FoF 17 (Appellants' Appx. 10).) Under the new compensation agreement, Lyle's salary was cut in half, but the decrease was offset by the Cosmos' agreement that Lyle would receive most of the income from the "off-season"—that is, after Labor Day and before Memorial Day. (Ex. 50; FoF 18 (Appellants' Appx. 10).) Lyle could keep all of the ticket income, minus $5.00 per day for operating expenses, and minus any employee wages incurred in the off-season operations. (Ex. 50; FoF 19 (Appellants' Appx. 10).) He also received half of the souvenir income before Memorial Day and after Labor Day. (Ex. 50; FoF 20 (Appellants' Appx. 11).)

At the time Don offered the compensation agreement to Lyle, Don was the majority shareholder in Cosmos. (TT: 191:23-192-11.) Everyone approved the off-season compensation agreement for Lyle in 1969. (FoF 23 (Appellants' Appx. 11.); Donald Schultz Deposition, 57:25-58:6 (R. 1685-6).) And, in 2004, Schultzes again confirmed the compensation agreement. (Ex. 50; (FoF 24 (Appellants' Appx. 11).)

That same agreement remains in effect with two adjustments. Lyle's summer salary has been increased to $10,000 per year, and Lyle now pays all off-season expenses, rather than just $5 per day. (Ex. 50; (FoF 25 (Appellants' Appx. 11).)

2. How Lyle Acquired His Stock

Cosmos was incorporated in 1959, and in 1960, Fred issued a single share of Cosmos stock to Lyle, simply to give him the status of a shareholder. (TT: 50:7-12; Donald Schultz Deposition, 34:5-10 (R. 1662); Ex. 50.)[1] When Marie died, Fred obtained all of her shares in Cosmos. In 1967, Fred sold all of his shares to Lyle and Lyle's wife, Marlene. (TT: 50:13-24.) So, after Fred's sale to Lyle and Marlene, Don and Eloise owned 1550 shares of Cosmos, and Lyle and Marlene owned 1501 shares of Cosmos. (Ex. 50.)

In 1972, Cosmos issued Lyle another 100 shares in recognition of his past performance. (Ex. 50.) Don gave Lyle a controlling

[1] The Bylaws required that Lyle be an officer to sign checks, and required that he be a shareholder to be an officer.

interest in Cosmos for the express purpose of ensuring that Lyle would remain in control of the company, so that the Schultzes could not take away his position. (TT: 308:15-309:4; Donald Schultz Deposition, 68:21-69:8 (R. 1696-97).) This was important to Lyle because Don offered Lyle the compensation agreement and the majority of the stock to induce him to give up all of his other business interests, and devote himself entirely to Cosmos. (TT: 41:13-22.)

Since 1972, Scandretts have been the majority shareholders, but not the majority of the Board of Directors. Schultzes held two of the three directors' seats from Cosmos' incorporation until 2008. (Ex. 50; TT: 324:7-10.) But since 1958, Don and his immediate family have not taken any active role in the operation of Cosmos. Don obtained a doctorate in chemical engineering, and then spent his career teaching at the University of Arizona. (Donald Schultz Deposition, 26:7-21 (R. 1654).) Don's only role has been to attend annual board of directors' meetings. (Donald Schultz Deposition, 38:2-20 (R. 1666).) Eloise, Don's wife, took no role in the Cosmos since they left South Dakota. (TT: 48:6-10.) While she was a director from 1963 until 2003, she never fulfilled any of those duties. (TT: 43:22-44:6.)

3. The Dispute

Over the years, the shareholders discussed the need for new bathrooms at the Cosmos, as well as expanding the gift shop. The project was discussed at the 2005 board of directors meeting (Ex. 152.), the 2006 meeting (Ex. 153.), and the 2007 meeting. (Ex. 154.) In 2008, the shareholders again discussed the plans for the new souvenir shop, as well as a new deck. (Ex. 155.) But, this time, there was action. "A motion was made for Heidi to plan shop and deck construction for next fall and to get bids." (Ex. 155.)

The bids for the project came back higher than expected (Ex. 159.), so Dave Schultz called Heidi and expressed concern over the projects cost. In response to Dave's concern, Heidi tried to reduce the size of the project. (Ex. 162.) Heidi restructured the expansion, and reduced the cost by one-third. (Exs. 160 & 161.) However, this did not satisfy Schultzes.

Lyle and Heidi believed that the expansion was necessary for the continued profitability of the business, and they felt like the project had been pushed off as long as it could be. Schultzes opposed the expansion. Steve Schultz sent Scandretts a letter, informing them that they must "change your approach or prepare yourselves for a long, painful sequence of shareholder disputes." (Ex. 163.) To further make the point, at the board of directors meeting where the remodeling was being was being considered, David Schultz warned Scandretts that they were upsetting Steve, and that, "[h]e is wealthy, he is tenacious, and he enjoys confrontation. Dad has held him back for 30 years; Steve will fight you to his last breath and leave instruction in his will to keep the fight going beyond his lifetime." (Ex. 164.)

The Cosmos Board of Directors voted to approve a plan to expand the gift shop and restrooms, with Lyle and Heidi voting in favor, and Dave Schultz voting against. This litigation followed.

Argument

For 45 years, Scandretts have successfully operated the Cosmos. They have sent ever increasing dividend checks to

Schultzes. From 1989 to 2013, dividends totaled over $3 million. (Ex. 175.) Schultzes rarely came to South Dakota to see the business. But in 2008, Scandrett's voted to expand the gift shop over Schultzes' objections. Schultzes vowed to commence "a long, painful sequence of shareholder disputes" against Scandretts. True to their word, they sued Scandretts. It took a jury less than an hour to reject all of their claims. The Court should affirm.

1. THE CIRCUIT COURT PROPERLY HELD THAT THE SCOPE OF SCANDRETTS' FIDUCIARY DUTY DID NOT COMPEL THEM TO TERMINATE LYLE'S COMPENSATION AGREEMENT.

In Instruction No. 27, the circuit court instructed the jury as follows:

> South Dakota law does not allow a shareholder to use the fiduciary duty concept to rewrite an original deal he or she made with the corporation.

(Appellants' Appx. 3.) That instruction is correct. It comes directly from this Court's decision in *Mueller v. Cedar Shore Resort*. In *Mueller*, the Court stated:

> We are not prepared to allow a shareholder to use the fiduciary duty concept to rewrite the original deal he or she made with corporation, a modification that the

> original parties to the transaction almost certainly would not have chosen.

Mueller v. Cedar Shore Resort, Inc., 2002 S.D. 38, ¶ 28, 643 N.W.2d 56, 67. Schultzes made a deal with Lyle in 1969. We need not guess whether the parties to the transaction would have chosen differently because everyone agrees that Schultzes made Lyle the majority shareholder for express purpose of protecting his employment arrangement with the Cosmos.

This Court was right in *Mueller*, and Judge Gusinsky was right when he instructed the jury. The very reasons that the common law imposed fiduciary duties upon majority shareholders support the Court's preference for honoring the agreements that the shareholders made among themselves in the beginning. Rules relating to oppression prevent the majority shareholders from using their power to strip the minority of the reasonable expectations. And the *Mueller* Rule prevents the minority from stripping the majority of its reasonable expectations.

As a preliminary matter, it is important to note that this is a zero-sum game between Scandretts and Schultzes. There is no evidence, or even allegation, that the Cosmos has suffered. Dividends paid to Schultzes have gone up dramatically throughout the history of the Cosmos. Schultzes merely claim that they could make even more money if the Court took away Lyle's compensation agreement. (TT: 183:14-17 ("the focus of this lawsuit is that compensation is lowering dividends for the entire -- for all the shareholders.")).

Their argument is, bluntly, that the law should require majority shareholders to terminate their promised employment arrangements if it would result in higher dividends to the minority.

A. Standard of Review

The question of Scandretts' duty to terminate Lyle's compensation agreement is a mixed question of law and fact. As the Court recently described, where the facts are established, and the rule of law is undisputed, whether those facts "favorably satisf[y]" that rule of law is a mixed question of law and fact. *Huether v. Mihm Transportation Co.*, 2014 S.D. 93, ¶ 14, ___ N.W.2d ___. The facts in this case are either agreed upon, or have been established. There is no dispute that Scandretts, as majority shareholders, owe a fiduciary duty to the minority. The issue is what the fiduciary duty compels under these facts.

When there is a mixed question of law and fact, then the Court must ascertain the underlying nature of the inquiry. If the question requires the Court "to consider legal concepts in the mix of the fact and law and to exercise judgment about the values that animate legal principles," then the question is really one of law, and is reviewed *de novo*. *Huether*, 2014 S.D. 93, ¶ 14, ___ N.W.2d at ___ (*quoting Stockwell v. Stockwell*, 2010 S.D. 79, ¶ 16, 790 N.W.2d 52, 59.).

The issue before the Court is a legal issue. First, this case asks the Court whether parties to an agreement may use a fiduciary duty argument to back out of their agreement, which is a question about the scope of fiduciary duties. The scope of a fiduciary duty is a question of law for the Court. *Lien v. Lien*, 2004 S.D. 8, ¶ 30, 674 N.W.2d 816, 825 (*quoting Landstrom v. Shaver*, 1997 S.D. 25, ¶ 84, 561 N.W.2d 1, 18 (*citing Garrett v. BankWest, Inc.*, 459 N.W.2d 833, 839 (S.D.1990))). Second, in considering the scope of fiduciary duties in a closely-held business, the Court must analyze the reasons for, and principles behind the rules of fiduciary duty.

B. Lyle's compensation agreement does not implicate the reason that majority shareholders owe a fiduciary duty to the minority.

The majority shareholders owe a fiduciary duty to the minority as a check on the majority's power to take advantage of the minority. Corporations function like a democracy—they are run under the general principle that the majority rules. A majority of shareholders elect the board of directors. SDCL § 47-1A-803. A majority of the directors manage the corporation. SDCL § 47-1A-801.

The majority has a right to run the company. *See*, *Landstrom*, 1997 S.D. 25, ¶ 50, 561 N.W.2d at 11 ("It is not considered oppression when the controlling shareholders seek to control management and the affairs of their corporation."); *Mueller v. Cedar Shore Resort, Inc.*, 2002 S.D. 38, ¶ 14, 643 N.W.2d 56, 63 ("Even in the context of a close corporation, where the directors may have substantial personal interests, courts are loathe to second guess the business decisions of the directors."). But this "majority rules" structure subjects minority shareholders to the judgments of the majority. Because a majority has the power to run a company so as to take advantage of minority owners, courts have imposed upon the majority a fiduciary duty to the minority. *Hayes v. Northern Hills General Hosp.*, 2001 S.D. 69, ¶ 27, 628 N.W.2d 739, 747 (*Hayes II*) ("A fiduciary duty is created by law to protect a minority shareholder . . . from the oppression of his or her interest by the majority[.]"). Minority shareholders owe no fiduciary duty. *See*, *Mueller*, 2002 S.D. 38, ¶ 26, 643 N.W.2d at 66 (only majority shareholders owe a fiduciary duty). That distinction reflects the power that comes with a majority position.

In this case, Lyle's compensation agreement could not have come from his misuse of his majority control because he was a minority shareholder when it was created. (TT: 191:23-192:14.) In 1969, Don told Lyle that if he stayed at the Cosmos and operate it before Memorial Day and after Labor Day, then he could keep the revenue. Cosmos has paid Lyle that way since 1969. And, in 2004, Don, Eloise, and Dave each reaffirmed the manner in which Lyle is paid. (Ex. 50.)

C. <u>**Shareholders in a closely-held business may agree on how they will operate the business and compensate one another.**</u>

Nothing in fiduciary duty concepts prevents the parties from negotiating their own arrangements, so long as the majority does not use its power to impose the agreement upon the minority. While they were in the majority, Schultzes made an agreement with Lyle. Then, for the express purpose of protecting Lyle's position, Schultzes made Scandretts the majority shareholders. Now they argue that he has duty to sacrifice his agreement to increase their dividends. The law does not support that argument.

<u>**The Court has looked at this issue before.**</u>

This Court has twice been asked to review the relationship between fiduciary duty and contracts to which minority shareholders assented.

<u>*Hayes v. Northern Hills General*</u>

In *Hayes II*, 2001 S.D. 69, 628 N.W.2d 739, the Court was asked whether a contractual termination provision limited the fiduciary duty owed to a minority shareholder. The Court noted that "[t]he question of whether the scope of the fiduciary duty owed by majority partners, officers, and shareholders to a minority partner, employee, or shareholder can be limited by contract has not been addressed in South Dakota." *Id.* at ¶ 26, 628 N.W.2d at 746. The Court declined to rule on whether the scope of fiduciary duty can be limited by a contractual provision because the law of the case from *Hayes I*[2] precluded the issue. *Id.* at ¶ 30, 628 N.W.2d at 747.

But the Court noted that "[t]here is a tension between the requirement that shareholders, officers, and partners exercise the utmost good faith and integrity in their dealings with one another, and the right of the parties to bargain the scope of their relationships by contract." *Hayes II*, 2001 S.D. 69, ¶ 26, 628 N.W.2d at 743-4. The Court had an opportunity to address that tension in *Mueller*.

<u>Mueller v. Cedar Shores</u>

The next time the Court was asked to consider whether a minority shareholder could evade the terms of his contract by

[2] *Hayes v. Northern Hills General Hospital*, (*Hayes I*) 1999 S.D. 28, 590 N.W.2d 243.

pleading fiduciary duty was *Mueller*. The *Mueller* Court explained that

> We are not prepared to allow a shareholder to use the fiduciary duty concept to rewrite the original deal he or she made with corporation, a modification that the original parties to the transaction almost certainly would not have chosen.

Mueller, 2002 S.D. 38, ¶ 28, 643 N.W.2d at 67. That is the language that informed the circuit court's jury instruction. Schultzes attempts to distinguish *Mueller* fail because they fail to show any principled difference between *Mueller* and this case.

Schultzes argue that Mueller should be limited to single-family businesses. But, why? There is no special law for closely-held companies owned and handed down by one family as compared to those owned and handed down by two families. Schultzes do not explain why such a rule would be more consistent with existing law or policy. A family history might give rise to facts that affect both oppression and fiduciary duty claims, but it will be those facts that distinguished the case, not the familial status.[3] Additionally,

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[3] Indeed, with blended families, estranged siblings, or antagonistic in-laws, it would be difficult to fashion a principled rule for businesses based solely upon the status of "family."

Cosmos is family owned. Dave, Steve, Mark, and Matt are not strangers to the people who gifted them their stock. Heidi is not a stranger to Lyle. The considerations that informed the Court's decision in *Mueller*—long-standing agreements that informed the way parties planned and conducted their lives—are present here, even though there are two families instead of one.

Additionally, *Mueller* heavily cites Robert W. Hamilton, *Business Organizations Unincorporated Businesses and Closely Held Corporations* (1996), and Hamilton makes no distinction between family and non-family corporations. Hamilton's point is only that fiduciary duty concepts present a threat of mischief when used to assail agreements to which the shareholders consented. The language from Hamilton is as follows:

> The fiduciary principle also has a significant capacity for mischief, since it may be utilized by a sophisticated investor to obtain a court order in effect rewriting the original "deal" he cut with the corporation. Law and economics scholars have also criticized the cases creating a special fiduciary duty on the ground that it imposes and *ex post* duty that the parties to the transaction almost certainly would not have selected if they had considered what term to include in the corporate "contract."

Hamilton, § 8.35 (Appellees' Appx. 8.) Hamilton says nothing about "family" corporations. Finally, when the Court declined to review the issue in *Hayes II*, it said nothing about the fact that Black Hills Medical Center shareholders were not relatives.

Next, Schultzes seem to argue that *Mueller* prohibits a minority shareholder from using a fiduciary duty to rewrite "*his* deal." First, it is not clear what distinction they draw. Lyle's employment and compensation agreement was the Schultzes' deal. They proposed it to Lyle, and then reaffirmed it in 2004. Again, "the deal" that a shareholder may not assail is a deal the shareholder, or the shareholder's predecessor in interest, created. Don created the deal, and Don was acting as the agent for all of the Schultzes when he did so. (TT: 44:7-13.)

Second, Schultzes' argument takes the *Mueller* Rule out of context. The rule appears in the Court's discussion of Paul and Pat Mueller's breach of fiduciary duty claim against Al's Oasis. The Court explained what Paul and Pat Mueller were required to prove. As part of that, the Court explained what it would *not* permit, including that it was "not prepared to allow a shareholder to use the fiduciary duty concept to rewrite the original deal he or she made with corporation."

Finally, Schultzes argue that the *Mueller* Rule applies only to claims by those who obtain their shares by gift or inheritance, and that therefore it does not apply to Don or Eloise. First, the rule does not say that. Second, Don and Eloise are not shareholders, and none of the shareholder-plaintiffs purchased their shares. (Ex. 50; FoF 36 (Appellants' Appx. 12); FoF 20-22 (Appellants' Appx. 19).) Third, the authority from which the rule was drawn, Hamilton's *Business Organizations Unincorporated Businesses and Closely Held Corporations*, makes no such distinction. Indeed, the hypothetical culprit of such a plot was a "sophisticated investor."

In *Hayes II*, the Court noted that there can be tension between general fiduciary duties on one hand, and agreements among the shareholders on the other. The *Hayes II* Court was asked whether fiduciary duties augment the termination provisions of an employment contract to give additional protection to a shareholder employee. In *Mueller*, the Court ruled that shareholders may not attempt to rescind their agreements by use of a fiduciary duty action.

Other authorities would honor the parties' agreements, and apply fiduciary duty only where the parties did not otherwise have an agreement.

Other courts that have considered the question agree that the fiduciary duties in a closely held business are subject to contractual modification. *McConnell v. Hunt Sports Ent.*, 725 N.E.2d 1193, 1212 (Ohio App 1999) ("Contract provisions may affect the scope of fiduciary duties, and as such, the trial court was correct to indicate that the method of competing, not the competing itself, may constitute a breach of fiduciary duty."); *Vakil v. Anesthesiology Associates of Taunton, Inc.*, 744 N.E.2d 651, 655 (Mass. App. Ct. 2001) (majority stockholders' termination of minority owner's employment and repurchasing his stock in accordance with agreements did not constitute a breach of fiduciary duty.); *Cruz v. S. Dayton Urological Associates, Inc.*, 700 N.E.2d 675, 680 (Ohio App 1997) (Plaintiff waived his right to bring a fiduciary duty claim for his termination by contracting for "without cause" termination.).

The Chancery Court of Delaware explained that this rule is premised on the idea that the people who form the business may decide aspects of their relationship for themselves.

> Delaware's limited partnership jurisprudence begins with the basic premise that, unless limited by the partnership agreement, the general partner has the fiduciary duty to manage the partnership in its interest and in the interests of the limited partners. That qualified statement necessarily marries common law fiduciary duties to contract theory when it comes to considering actions undertaken in the limited partnership context. Thus, I think it a correct statement of law that *principles of contract preempt fiduciary principles where the parties to a limited partnership have made their intentions to do so plain*.

Sonet v. Timber Co., L.P., 722 A.2d 319, 322 (Del. Ch. 1998) (emphasis added).

The notion of fiduciary duty in a closely held corporation was created because small corporations are more like partnerships. *See*, *Balvik v. Sylvester*, 411 N.W.2d 383, 387 (N.D. 1987) (The resemblance of a close corporation to a partnership imposes "substantially the same fiduciary duty of utmost good faith and loyalty.") (*cited* with approval by *Mueller*, 2002 S.D. 38, ¶ 16, 43 N.W.2d at 63); and, F. Hodge O'Neal and Robert B. Thompson, *Oppression of Minority Shareholders and LLC Members*, § 7:4, p.7-35 (Appellees' Appx. 9), (*citing*, *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505 (Mass 1975), and § 7:5, pp. 7-41-42 (2004) (Appellees' Appx. 11-12).

While South Dakota partnership law prohibits blanket waivers of partnership duties by contract, it does permit the partners to specifically contract for things that might otherwise breach the duty. *See, e.g.*, SDCL § 48-7A-103(b)(3) (regarding duty of loyalty), (b)(5) (regarding obligation of good faith and fair dealing). Similarly, South Dakota law relating to limited liability companies "give[s] maximum effect to the principles of freedom of contract and to the enforceability of operating agreements." SDCL § 47-34A-114. The statutory authority to modify these duties means that "the traditional fiduciary duties among and between partners are defaults that may be modified by partnership agreements." *Sonet*, 722 A.2d at 322.

O'Neal suggests that these are rules of general application. "Indeed, a shareholder will generally be barred or estopped from attacking almost any transaction which he or she approved at the time it occurred or has ratified subsequently." O'Neal, § 7:32, p. 7-223-24 (Appellees' Appx. 14-15.) And Hamilton says that agreements among the shareholders should be the primary method of protecting the parties. "Because oppression and freeze-outs may be avoided so easily by rational investors, law and economics scholars tend to view these problems as rare, unusual, and of little practical importance. They view the close corporation, in short, as an example of contract law in action." Hamilton at § 8.25 (Appellees' Appx. 6.)

Here, it was the minority that created and approved the compensation arrangement, at a time when it was the majority. Schultzes have received everything they expected from their ownership of Cosmos. The circuit court concluded that Scandretts had not oppressed Schultzes, and Schultzes have not appealed that decision. So, Scandretts do not argue that only their expectations are entitled to protection. But Lyle's expectations, as given to him by Schultzes, are entitled to protection.

D. **<u>The rule urged by Schultzes would protect the reasonable expectations of the minority shareholders, but it would give them a weapon to defeat the reasonable expectations of the majority.</u>**

Lyle was a minority shareholder at the time he entered into his compensation agreement. And the law expressly protects the employment arrangements of minority shareholders.

> Employment by the corporation is often the shareholder's principal or sole source of income. As a matter of fact, providing for employment may have been the principal reason why the shareholder participated in organizing the corporation.

Mueller, 2002 S.D. 38, ¶ 16, 643 N.W.2d at 63. Employment was the only reason that Lyle moved from Wessington to manage the Cosmos. When Shultzes asked him to give up his other work, he asked for protection against putting all his eggs in the Cosmos basket, and then having the Schultzes later get rid of him. That was the express reason that Scandretts received a majority interest.

Schultzes agree that they want Lyle's employment agreement changed so that they can have more money for themselves. (TT: 183:14-17.) There can be no question that, if Lyle were a minority shareholder, the law of minority shareholder oppression would prevent them from taking away Lyle's compensation so that they could have more money for themselves. Shareholder oppression refers “to conduct that substantially defeats the ‘reasonable expectations’ held by minority shareholders in committing their capital to the particular enterprise.” *Mueller*, 2002 SD 38, ¶13, 643 N.W.2d at 62. Employment by the company is a classic example of a reasonable expectation, *Mueller*, 2002 S.D. 38, ¶ 15, 643 N.W.2d at 63, and whether that expectation is reasonable is “analyzed in light of the entire history of the parties' relationship.” *Mueller*, 2002 S.D. 38, ¶ 14, 643 N.W.2d at 62.

The unbroken light cast by “the entire history of the parties' relationship” demonstrates that any attempt by Schultzes to take away Lyle’s agreement would be oppressive . . . if he were a *minority* shareholder. Schultzes propose that, because he is a majority shareholder, oppressing Lyle is not merely authorized, but compelled by the concept of fiduciary duty. That is, the reasonable expectations of the majority are subject to the unchecked demands of the minority, so long as the minority would benefit from demand. The circuit court found that the fiduciary duty does not extend that far.

Rather, the circuit court properly held, consistent with *Mueller*, consistent with the purposes of the duties, and consistent with the weight of other authority, that where the minority assents to the majority's compensation, courts will not undo that agreement merely because it would be advantageous to the minority.

The Court's Jury Instruction No. 27 was correct.

2. THE CIRCUIT COURT PROPERLY REFUSED TO INSTRUCT THE JURY THAT SHAREHOLDER-EMPLOYEES IN CLOSELY-HELD BUSINESSES ARE AT-WILL EMPLOYEES.

Schultzes complain that the circuit court refused to instruct the jury on the employment at-will doctrine. The circuit court properly rejected the at-will employment instructions because they are wrong in the context of this case.

A. Standard of Review

The Court's "standard of review for the trial court's rejection of a proposed jury instruction is well settled."

> On issues supported by competent evidence in the record, the trial court should instruct the jury. The trial court is not required to instruct on issues lacking support in the record. Failure to give a requested instruction that correctly sets forth the law is prejudicial error. Jury instructions are reviewed as a whole and are

> sufficient if they correctly state the law and inform the jury. Error is not reversible unless it is prejudicial. The burden of demonstrating prejudice in failure to give a proposed instruction is on the party contending error.

Overfield v. American Underwriters Life Ins. Co., 2000 S.D. 98, ¶ 11, 614 N.W.2d 814, 816. But that does not mean that the Court gives every conceivable instruction that party demands. "This Court has repeatedly stated that a trial court must present only those instructions to the jury which are supported by competent evidence and set forth the *applicable* law." *Id.* (emphasis added).

B. <u>At-will employment was not an issue in the trial, and Lyle is not an at-will employee.</u>

Schultzes never raised the issue or argued about whether Scandretts had the *power* to terminate their own employment or compensation. The issue in the case was whether Scandretts had a *duty* to terminate their own employment or compensation. As addressed above, they did not have a duty to terminate a compensation agreement that Schultzes created, approved, and then reaffirmed.

Plaintiffs' Requested Instructions 15-17 also misstate the law. Employee/shareholders in a closely-held corporation are not at-will employees. *Gigax v. Repka*, 615 N.E.2d 644, 649 (Ohio App. 1992). At-will employees "may be dismissed at any time for any reason." *Hollander v. Douglas Cnty.*, 2000 S.D. 159, ¶ 13, 620 N.W.2d 181, 185. That simply is not true for owners in a closely-held corporation. *See*, *Mueller*, 2002 S.D. 38, ¶ 16, 643 N.W.2d at 62-3; and *Landstrom*, 1997 SD 25, ¶ 43; 561 N.W.2d at 10 (deprivation of employment as act of oppression). Closely-held companies are not free to terminate the employment of the owners "at-will."

The circuit court properly rejected Schultzes requested instructions on at-will employment because Lyle was not an at-will employee, because the Cosmos's power to terminate Lyle was not an issue in the case, and because it simply rebegged the question of whether Lyle's fiduciary duty obligated him to fire himself.

3. REQUESTED INSTRUCTION 18 IS NOT A CORRECT STATEMENT OF THE LAW, AND THERE ARE NO FACTS TO SUPPORT IT.

Schultzes requested the circuit court to instruct the jury as follows:

> The fiduciary duty owed by a Director to minority shareholders requires an undivided and unselfish loyalty to the Corporation and also requires that there

> be no conflict between the Director's fiduciary duty and self-interest.

(Plaintiffs' Requested Jury Instruction No. 18 (Appellants' Appx. 7).) The circuit court's refusal of the instruction is proper for a few reasons, any one of which is sufficient. First, Schultzes offer no legal support for the language of the instruction. Second, the basic premise of the instruction is contrary to South Dakota law. Third, Schultzes' did not preserve their argument in support of giving the instruction. And, fourth, the circuit court's instructions adequately defined the fiduciary duties that were at issue in the case.

A. Schultzes offer no authority supporting the language of the instruction.

The language of Schultzes' requested instruction is confusing. It begins by imposing a duty in favor of the minority, but then switches in the same sentence to imposing a duty in favor of the corporation. It then inserts a requirement that there be no conflict between the fiduciary duty and self-interest. It fails to say which duty—the one to the minority, or the one to the corporation—may not have a conflict. Nor is it helpful to tell the jury that there may be no conflict because there certainly can be a conflict. The instruction should, but does not, tell the jury what a party must do in the event of a conflict. It simply says that they cannot exist. The confusing language probably stems from the fact that the instruction is not based upon any existing legal authority.

The authority that Schultzes cite in support of their instruction (Appellants' Br. pp 23-4) contains none of the language used in the requested instruction. Schultzes cite authority for the proposition that there is a duty of loyalty and a duty of disclosure, but they fail to explain how that authority supports the instruction as written. The failure to provide authority in support of the instruction is fatal. *Steele v. Bonner*, 2010 S.D. 37, ¶ 35, 782 N.W.2d 379, 386 ("As has been stated many times by this Court, Bonner's failure to cite authority is fatal.").

B. Schultzes' Requested Instruction No. 18 is overreaching to the point that it is an inaccurate statement of the law.

While it is confusing, Schultzes might have intended Requested Instruction No. 18 to mean that, where the interests of the minority and majority conflict, the majority have a fiduciary duty to advance the interests of the minority. That is simply not the law. South Dakota law permits conflicts between the goals and interests of the majority and the minority without invalidating the majority's actions.

This Court has previously discussed an example that is similar to the disputed that led Schultzes to commence this action. Schultzes did not want to approve the gift shop expansion because they did not want to risk short-term dividends for long-term profits. That is the type of majority-minority conflict discussed in *Landstrom*.

> South Dakota is a state that contains substantial numbers of small corporations given the number of independently owned businesses and farms. Those who operate and manage these farms and businesses, often the majority shareholders, should not be subject to the demands of minority shareholders whose concern may be solely that of dividends and not the farm or business itself. Many of these small corporations and their management are ill-prepared to invest the time and money required to fend off a minority shareholder suit and are therefore influenced by the mere threat of such litigation.

Landstrom, 1997 S.D. 25, ¶ 60, 561 N.W.2d at 14 n. 16 (emphasis added). But, even where the majority and minority interest diverge, the majority is free to act on its own goals. "Even in the context of a close corporation, where the directors may have substantial personal interests, courts are loathe to second guess the business decisions of the directors." *Mueller*, 2002 S.D. 38, ¶ 14, 643 N.W.2d at 63.

Schultzes requested instruction does not properly set forth the law relating to conflicting interests between minority and majority shareholders, and the circuit court properly rejected it.

C. <u>There is no evidence of a breach of duty to Cosmos.</u>

Schultzes first argue that "[t]he instruction is a correct statement of law that should have been given because Lyle was not putting the corporation above his own self-interests (i.e. his compensation arrangement) which was a breach of his fiduciary duty of loyalty." (Appellants' Br., p. 24.) If Schultzes mean that it violates his duty to the minority, that was addressed above. If Schultzes mean that it violated his duty to the Cosmos, there is no evidence that Lyle put his own interests above Cosmos's interests. The undisputed record is that Cosmos has flourished and grown under Lyle's management, and dividends have dramatically increased.

Again, there is no evidence that Cosmos was not meeting its obligations, or somehow damaged. Revenue at the Cosmos has grown substantially faster than wages. (Ex. 176.) The only issue is whether those who manage, work, and grow the business should earn less so that passive investors may get larger dividends.

D. Schultzes' "failure to disclose" issue was not preserved, and is unsupportable in any event.

The meat of Schultzes' argument seems to be that the instruction should have been given because Lyle failed to disclose compensation information. (Appellants' Br., p. 24.) Schultzes did not preserve that argument, nor do the facts support a claim of failure to disclose. More fundamentally, though, the argument does not support the instruction. Plaintiffs' Requested Instruction No. 18 does not say anything about disclosure or candor. The instruction does not inform the jury about a duty of disclosure or how to comply with it.

Schultzes did not preserve a claim for breach of a duty of candor or disclosure.

Schultzes did not assert a failure to disclose or a failure of candor in their proposed claim instruction. Schultzes requested Jury Instruction 22 (Appellees' Appx. 4), and urged that it was a list of Scandretts' breaches of their fiduciary duties. (TT: 547:11-548:3.) By requesting Instruction 22, and not proposing an instruction on the duty of disclosure, Schultzes have not preserved the issue of failure to disclose. "Where an instruction was not requested, error cannot be predicated on the trial court's failure to so instruct." *Delzer v. Penn*, 534 N.W.2d 58, 62 n. 3 (S.D. 1995). But, that claim would fail even if it had been preserved.

Schultzes may not claim a failure to disclose because of their own willful ignorance.

The Cosmos Bylaws provide what information Lyle was to provide to the shareholders and directors. To the shareholders, Lyle was to provide "a one page summary of the business activity for the preceding year and the Presidents agenda for the meeting." (Ex. 150, Art. III, § 3) To the directors, Lyle was to provide "a statement of the business done during the preceding year, together with a report of the general financial condition of the Corporation, and of the condition of its tangible property." (Ex. 150, Art. IV, § 9) Schultzes agree that Lyle provided the information that the Bylaws instructed him to provide. (TT: 207:6-15.)

Schultzes admit that they had an obligation to obtain whatever information they thought they might need to exercise their duties as directors. (TT: 208:4-21.) Schultzes knew what information they had and what information they wanted, but they decided to remain willfully ignorant. From its founding until 2008, two of the three members of the Cosmos Board of Directors were Schultzes. From 1959 to 1968, the Cosmos board of directors was Marie Schultz, Fred Schultz, and Don Schultz. When Marie died, Eloise took her place on the Board. After Fred retired, Lyle took his place on the Board. (Ex. 50.) From 1969 until 2003, the board of directors was Eloise, Don, and Lyle. (Ex. 50.) From 2004 until 2008, the Cosmos board of directors was Dave Schultz, Don, and Lyle. (TT: 136:7-8 (Dave elected in 2004); Exs. 152-155 (directors from 2005-2008)).

As early as the 1980's, all of the Schultzes, except Don, believed that they should ask for more information from Lyle. Eloise actually asked Don to get more information, but they never asked for it because they were satisfied with the dividends. (TT: 46:25-48:1.) While Schultzes wanted more information, Lyle never knew that Schultzes wanted any information beyond what was provided in the Bylaws.

As directors, Schultzes were obligated to use due care in obtaining whatever information they thought they needed. *See*, *Mueller*, 2002 S.D. 38, ¶ 26, 643 N.W.2d 66 (requiring "a high degree of diligence and due care" in conducting the business of the Cosmos).) Schultzes knew about Lyle's compensation agreement. They knew that Heidi was employed by Cosmos. The information was always available. Lyle told Schultzes that they were free to obtain any information they wanted directly from the accountant; and she provided them with everything they ever requested. (TT: 380:18-381:6.)

If they did not believe that they had enough information, then Schultzes were required to ask for it. Having failed to do so, they cannot now complain that they did not have sufficient information.

> Where such a duty exists, ignorance due to neglect of that duty creates the same liability as actual knowledge and a failure to act thereon. Since appellants failed to exercise the duty imposed on corporate directors, they can hardly claim ignorance and lack of awareness by emulating the three fabled monkeys, hearing, seeing and speaking no evil.

Mobridge Community Industries, Inc. v. Toure, Ltd., 273 N.W.2d 128 133-4 (S.D. 1978) (citations omitted).

E. <u>The circuit court's instructions were proper.</u>

The circuit court properly instructed the jury. The issue in the case was whether Scandretts were improperly paying themselves as employees of the Cosmos. That was it. As Dave testified,

> I brought this lawsuit because the majority shareholders of the Cosmos are paying themselves not only in dividends but they're taking out so much in wages that it's -- it's reducing, really, my parents' retirement.

(TT: 184:3-6.) The court instructed the jury that Scandretts were prohibited from giving themselves any improper benefit from the

Cosmos. Plaintiff's Requested Instruction No. 18, adds nothing to the circuit court's instructions.

It is not error "to refuse to amplify instruction given which substantially cover the principle embodied in the requested instruction." *Jahnig v. Coisman*, 283 N.W.2d 557, 560 (S.D. 1979). The circuit court instructed the jury that it would be a breach of fiduciary duty to pay themselves improper salaries and benefits. (Jury Instructions Nos. 19-22 (Appellees' Appx. 1-22).) So, if the jury found that Scandrett, Bybee, or any of their family members received improper salaries or benefits, then they would have returned a plaintiffs' verdict. But the jury found that the Scandretts' compensation was not improper.

Plaintiffs' Requested Instruction No. 18 is confusing, misstates the law, and is not supported by the evidence urged by Schultzes. The circuit court correctly refused it.

Conclusion

The Court should affirm the Judgment entered by the circuit court in all respects.

Request for Oral Argument

Appellees respectfully request that the Court grant them oral argument on the issues presented in the appeal.

Respectfully submitted this 22nd day of January, 2015.

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This brief is submitted under SDCL § 15-26A-66(b). I certify that the brief complies with the type volume limitation. In reliance upon the document properties provided by Microsoft Word, in which this brief was prepared, the brief contains 8474 words and 43750 characters, including the table of contents, table of cases, jurisdictional statement, statement of legal issues, and any certificates of counsel, but excluding any addendum materials.

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The undersigned hereby certifies that he electronically filed a copy of this legal document with the South Dakota Supreme Court and that the original and two copies of the same were filed by serving them upon:

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Dated this 22nd day of January 2015.

Jeffrey G. Hurd
Jeffrey G. Hurd

Appendix

Page

IN THE SUPREME COURT

OF THE

STATE OF SOUTH DAKOTA

Appeal No. 27158

STEVE SCHULTZ, MARK SCHULTZ, DAVID SCHULTZ and THE SCHULTZ FAMILY TRUST, as Stockholders of Cosmos of the Black Hills, Inc. a South Dakota Corporation, and as individuals, and DONALD SCHULTZ and ELOISE SCHULTZ as Trustees of the SCHULTZ FAMILY TRUST, and DAVID SCHULTZ as a Director of Cosmos of the Black Hills, Inc. on behalf of Cosmos of the Black Hills, Inc. a South Dakota Corporation,

Plaintiffs/Appellants,

vs.

LYLE SCANDRETT, and HEIDI BYBEE,

Defendants/Appellees.

APPEAL FROM THE CIRCUIT COURT
SEVENTH JUDICIAL CIRCUIT
PENNINGTON COUNTY, SOUTH DAKOTA

The Honorable Robert Gusinsky, Circuit Court Judge

Notice of Appeal filed July 29, 2014

APPELLANTS' REPLY BRIEF

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Scandretts contend Schultzes' motive for this litigation stems from a disagreement involving the gift shop. This is merely a diversion, to draw attention away from their actions. The undisputed facts are Scandretts surreptitiously paid themselves the following salaries for a seven month seasonal business:

	Lyle	**Heidi**	**Marlene**	**Kevin**	**Total**
2008	$79,863.00	$70,140.28	$10,366.26	$40,160.00	**$200,529.54**
2009	$57,164.00	$60,723.23	$10,379.61	$28,486.80	**$156,753.64**
2010	$55,513.94	$72,444.86	$7,122.34	$65,093.80	**$200,174.94**
2011	$100,052.17	$69,999.19	$6,389.09	$42,937.40	**$219,377.85**
2012	$45,530.42	$66,988.68	$6,844.08	$42,580.40	**$161,943.58**
2013	$145,204.70	$70,521.69	$6,761.26	$36,052.40	**$258,540.05**
Total:	**$483,328.23**	**$410,817.93**	**$47,862.64**	**$255,310.80**	**$1,197,319.60**

(Ex. 109.) That is why Schultzes brought this action. Nevertheless, Schultzes' motives are irrelevant to the issues before this Court. Schultzes' concerns regarding the gift shop expansion or hard feelings between the families do not relieve Scandretts of their fiduciary duties as majority shareholders and directors.

Even so, the reality is that Schultzes <u>did</u> agree to expand the gift shop. (Exs. 152-155.) The two families had differing opinions as to the scope and cost of the project and Schultzes were simply out voted. When Don Schultz expressed concern with the gift shop expansion, Lyle's response was that he and Heidi, as majority shareholders, "obviously are not required" to address the minority shareholders' concerns. (Exhibit 51.) This was the first time in the history of the Cosmos a decision was made without general consensus. (Tr. 145:11-15.)

Later, Don questioned Lyle about a decrease in dividends in 2008. Lyle advised that increased salaries were the culprit. (Ex. 107.) He then provided, for the very first time, the amount of his annual bonus. *Id.* He further disclosed, for the first time, the compensation scheme and amount paid to Heidi and that he hired Kevin, putting him on salary, too. *Id.* Upon receipt of this information, the Schultzes began asking questions about management compensation, the financial position of the Cosmos, and voiced concerns at the 2009 meetings.

The Schultzes discovered that Lyle unilaterally and arbitrarily determined Heidi and Kevin's salaries, without input from the board or any market analysis. (Tr. 64:11-21; 102:18-103:4.) Lyle was working less and Heidi was taking over his duties. Heidi presented to the public and shareholders that she was the manager. (Tr. 65:1-4) (Exs. 40, 65, 66.) Lyle held himself out as retired. (Tr. 350:4-351:3.) Even so, Lyle still paid himself pursuant to his compensation arrangement as "the manager". They provided themselves additional, non-justifiable benefits including daycare, vehicles, cell phones, health insurance and personal vacations. (Tr. 96:13-20) (Tr. 104:15-20) (Tr. 105:3-11.)

The Scandretts were the only salaried employees but were also taking vacations during the summer months instead of working at the Cosmos. (Tr. 106:25-107:8.) The off-season business had increased dramatically over the years and the corporation was prevented from obtaining that business. Unable to convince Lyle and Heidi to even *review* management compensation, Schultzes were left with no choice but to bring the subject lawsuit.

Schultzes also discovered Lyle was self-dealing by charging rent to the corporation for use of two billboards on his property. (Tr. 93:9-95:14.) He purchased a sliver of property adjacent to the Cosmos for $1,000 and charges Cosmos $1,000 a year to rent the land. *Id.* He further charges $5,000 a year to lease a billboard on this property along with $5,000 for the lease of a second billboard for a total of $11,000 per year the corporation pays Lyle for billboard and land rentals. *Id.*

This dispute is not over the gift shop. It is over excessive salaries, unjustified bonuses and perks, and self-dealing.

I. SCANDRETTS HAVE A FIDUCIARY DUTY TO MODIFY THEIR COMPENSATION ARRANGEMENTS

A. The "Deal" Language contained in *Mueller* is Not the Applicable Standard

Mueller v. Cedar Shore Resort, Inc., 2002 S.D. 38, 643 N.W.2d 56 holds that gifted minority shareholders are not entitled to the "reasonable expectations" standard under a claim for oppression or the "high degree of diligence and due care, as well as the utmost good faith and fair dealing" standard for breach of fiduciary duty claim. Instead, the standard applied to both claims for gifted minority shareholders is the "decentness" standard. *Mueller*, 2002 S.D. 38 at ¶¶ 18-19 (oppression) and ¶¶ 26-28 (breach of fiduciary duty). In reaching its conclusion that gifted shareholders are entitled to the lesser decentness standard for breach of fiduciary duty claims, the Court stated:

> We are not prepared to allow a shareholder to use the fiduciary duty concept to rewrite the original deal he or she made with the corporation, a modification that the original parties to the transaction almost certainly would not have chosen.

Mueller at ¶ 28. This is not a separate standard, test, or rule of law. It is the Court's explanation for *why* the traditional fiduciary duty standard should not apply to a gifted shareholder. Applying the heightened standard would make it too easy for a gifted shareholder to claim a breach of fiduciary duty which would allow the gifted shareholder to undo his "deal" with the corporation—the "deal" of limited economic return and limited right of participation in exchange for no investment of capital or resources. "As explained above, where the shareholders receive their stock by gift and invest no capital, their shareholders' minimum economic return and right of participation become limited." *Mueller*, 2002 S.D. 38 at ¶ 28 (*citing* Robert W. Hamilton, Business Organizations: Unincorporated Businesses and Closely Held Corporations, § 8.25 (1996)).

Scandretts do an about-face in their brief now alleging the "deal" is actually Schultzes' deal, not Lyle's. This of course is in direct contrast to arguments made by Scandretts' counsel in closing arguments and to the court. (Appellants' Brief at pp. 17-18 citing Tr. 569-584 and 546:1-3.) Irrespective of whether Lyle's compensation arrangement is considered Lyle's deal or the Schultzes' deal, it is not "the deal" contemplated by *Mueller*. The "deal" in *Mueller* is the gifted shareholder's limited right of employment, participation and economic return in exchange for no investment into the corporation.

This is why Instruction No. 27 was so very prejudicial to Schultzes. It confused and misled the jury into believing the law is that Lyle's compensation arrangement cannot be undone. That is not what *Mueller* said and it was error to instruct the jury that Lyle's compensation arrangement was etched in stone.

B. There is No Contract or Agreement in *Mueller*

Of great importance is the fact that there is no contract, agreement, or employment arrangement in *Mueller* that the minority shareholders were attempting to rewrite. Scandretts' assertions that the *Mueller* Court "consider[ed] whether a minority shareholder could evade the <u>terms of his contract</u> by pleading fiduciary duty" and "ruled that shareholders may not attempt to <u>rescind their agreements</u> by use of a fiduciary duty action" are just plain wrong. (Appellees' Brief at pp. 17 and 20) (emphasis added). Conspicuously absent from Scandretts' brief is <u>any</u> identification of just what contract or agreement the *Mueller* minority shareholders attempted to evade and rescind. That is because there is none. To be sure, suppose Lyle's compensation arrangement never existed. Just what "deal" then would Scandretts argue Schultzes are attempting to undo? Would *Mueller* just not apply? Of course not, because the "deal" in *Mueller* is not a contract or agreement or employment arrangement. It is the "deal" of receiving ownership without investment, so the right to participation and employment is more limited. Use of the word "deal" rather than "contract" in *Mueller* is significant.

The actions alleged by the *Mueller* minority shareholders as a breach of fiduciary duty were exclusion from management participation and meaningful employment. *Mueller*, 2002 S.D. 38 at ¶¶ 3 and 20. Because the shareholders did not invest in the corporation, the Court would not hold the majority shareholders to the traditional fiduciary duty standard. To do so would allow the minority shareholders to change the original deal they made with the corporation—the limited right of employment or participation in exchange for no investment. Utilizing the high degree of diligence and due care, as well as the exercise of utmost good faith and fair dealing standard may very well have found a breach of the fiduciary duty for exclusion from management and employment. This is directly contrary to a non-investing shareholder's "deal" with the corporation.

C. Lyle's Previous Status as a Minority Shareholder is Irrelevant

Lyle cannot evade his fiduciary duty as a majority shareholder and director simply because his compensation arrangement was created when he was a minority shareholder. There is no assertion that Lyle misused corporate power when the arrangement was created. Lyle's status as a minority shareholder at the time the agreement was struck does not limit the fiduciary duty he owes today, as a majority shareholder and director.

D. Lyle's Compensation Arrangement Does Not Limit his Fiduciary Duty

Scandretts devote much effort to arguing that the fiduciary duty concept can be modified by contract. These arguments are all in vain, however, because Lyle's compensation agreement does not limit any fiduciary duty. Consequently, there is no need to determine "whether the scope of the fiduciary duty owed by majority partners, officers, and shareholders to a minority partner, employee, or shareholder can be limited by contract". *Hayes v. Northern Hills General Hospital*, 2001 S.D. 69, ¶ 26, 628 N.W.2d 739.

The only way Lyle's compensation arrangement can limit his fiduciary duty is if there is a term preventing modification or termination. There is not. The original arrangement made in 1969 was never reduced to writing. The only written evidence of Lyle's compensation arrangement is the Historical Record which simply recites the history of the agreement and indicates it is still in existence. (Ex. 50.) The Historical Record provides:

> In 1969 an incentive agreement was reached, the first goal of which was to keep the Cosmos open as early and as late in the tourist season as possible. This was to protect the property and the business from freeloaders, but more importantly, from malicious mischief. The second

> goal was to be specific regarding additional income that the manager might make to be able to realize due to the increased length of the tourist season.
>
> In the new incentive agreement the manager's salary was reduced to $2500 per year. This decrease was more than offset by the agreement that all of the ticket income before Memorial Day and after Labor Day and half of the souvenir income before Memorial Day and after Labor Day was to be paid to the manager as additional salary, minus $5.00 per day for operating expenses. Any employee wages, except for the managers, paid before Memorial Day and after Labor Day and except for maintenance work, shall be deducted from the manager's wages. There is an exception to this before Memorial Day, as some personnel do work on normal Cosmos business that is not associated with handling tourists. Consequently the wages for these employees is not taken out of the manager's salary. This incentive agreement continues in effect until the present time. In 1986 the fixed amount of the manager's salary was increased to $10,000. This agreement is in effect today.

(Ex. 50.) Notably, Lyle's compensation arrangement contains no duration. He is to be paid $10,000 per year plus ticket and souvenir income before Memorial Day and after Labor Day. "The length of time which an employer and employee adopt for the estimation of wages is relevant to a determination of the term of employment." SDCL § 60-1-3. Lyle's compensation is based on an annual term and thus the duration of his compensation agreement is year-to-year.

Nothing in the Historical Record limits Lyle's fiduciary duty owed to Schultzes or Cosmos and nothing in the Historical Record guarantees Lyle's employment or his compensation scheme for any period of time. Nothing prohibits salary modification. In fact, the arrangement has been changed—twice—by Lyle. His base salary increased to $10,000 in 1986 and he pays more than $5 per day for the off-season expenses.[1]

[1] Lyle does not "now pay[] all off-season expenses". (Appellees' Brief at p. 6.) He does not pay the off-season's proportionate share of insurance, advertising, or corporate debt. (Tr. 82:24-84:4; 121:17-122:12.).

Scandretts, as majority shareholders and directors, had a fiduciary duty to ensure compensation, including their own, is in the best interests of the corporation.

E. Business Success Does Not Relieve Scandretts of Their Fiduciary Duties

Scandretts are quick to argue this is a "zero-sum game" and allege there is no damage to the corporation since dividends have increased. (Appellees' Brief at p. 11.) Scandretts cite no authority for their proposition that so long as a corporation increases dividends, there can be no breach of fiduciary duty. Success does not relieve majority shareholders and directors of their fiduciary duties.

In *Jara v. Suprema Meats, Inc.*, 121 Cal. App. 4th 1238, 1258 (Cal. App. 1st Dist. 2004), a minority shareholder was allowed to maintain a direct action against the majority shareholders alleging they paid themselves excessive compensation. The company experienced extraordinary growth and the minority shareholder was satisfied with the way the majority shareholders operated the business. The minority shareholder did not claim the company would have experienced even more growth and prosperity if the salaries had been less, but alleged the excessive compensation was a device to distribute a disproportionate share of the profits to the other shareholders during a period of business success.

The same holds true here. Lyle, Heidi, Kevin, and Marlene are all shareholders. Profits not taken as salary would be distributed proportionately to all the shareholders, including the Scandretts. By taking exorbitant salaries, Scandretts have effectively eliminated proportionate sharing of profits. This is especially so considering Lyle takes <u>all</u> the profit from the off-season. Scandretts' "zero-sum game" argument is merely a diversion and should be quickly rejected.

F. *Mueller* is Applicable Only to Family-Owned Corporation and Gifted Shareholders

Despite Scandretts' argument to the contrary, there can be no question that *Mueller* made an express distinction between family-owned corporations and traditional close corporations. *See Mueller*, 2002 S.D. 38 at ¶ 27 ("Because of the potential for abuse, the scope of the fiduciary duty owed to a <u>family-owned corporation</u> that has gifted its shares to the shareholders is somewhat more limited than that duty owed in the context of a <u>traditional close corporation</u>.") (emphasis added). Cosmos is not a family-owned corporation and thus the *Mueller* language had no place in the jury instructions. The Historical Record confirms the same: "Clearly this was a closely held family corporation and continued as such until June of 1960 when Lyle A. Scandrett (Lyle) was hired as Manager of the Cosmos". (Ex. 50.)

The "deal" language in *Mueller* is further discussed in the gifted shareholder context. Scandretts refer to the "*Mueller* Rule" and contend the "rule" does not say it only applies to gifted shareholder. (Appellees' Brief at p. 20.) First of all, the "deal" language is not a "rule". The "rule" from *Mueller* is that gifted shareholders in a family-owned corporation are entitled to the lesser "decentness" standard for oppression and breach of fiduciary duty claims. *Mueller*, 2002 S.D. 38 at ¶¶ 18-19, 26-28.

Secondly, a plain reading of the "deal" paragraph in *Mueller* reveals it is applicable to gifted shareholders only. The Court notes that only gifted shareholders receive a limited fiduciary duty. *Id.* at ¶ 28. Because they receive their stock by gift and do not invest capital, they have a limited right of return and participation. *Id.* The Court was not prepared to allow the gifted shareholder to challenge his limited right of return and participation arguing a breach of fiduciary duty. *Id.* Scandretts read the "deal" sentence in isolation, failing to read the very next sentence which indicates allowing a shareholder to "rewrite the original deal he or she made with the corporation" "would significantly undermine a primary method of tax planning and wealth sharing by holding family business owners hostage, subject to the demands of every gifted shareholder, whether reasonable or not." *Id.* (emphasis added).

Don and Eloise are original, investing shareholders. They have transferred their shares to the family trust but should still be considered original shareholders. Instruction No. 27 was erroneous because it did not differentiate between gifted and original shareholders.[2]

G. Out-of-State Authority and Non-Corporate Statutory Schemes are Not Relevant

It does not matter if other courts have allowed contractual modification of the fiduciary duty concept. (Appellees' Brief at p. 21.) As indicated *supra*, Lyle's compensation agreement contains no duration and does not limit or modify his fiduciary duty. Even so, this Court recognized in *Hayes*:

> Some courts have held such contractual agreements valid in the limited context of alleged wrongful termination of a minority shareholder, partner, or employee, where the contract provides for termination without cause, there is a fair buyout provision for purchase of the minority interest, the issue involves the termination itself as opposed to self dealing conduct of the majority, and the litigants were original parties to the contractual agreement. *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 367 Mass. 578, 328 N.E.2d 505 (Mass 1975); *Evangelista v. Holland*, 27 Mass. App. Ct. 244, 537 N.E.2d 589 (MassAppCt 1989); *Jenkins v. Haworth*, 572 F. Supp. 591 (1983); *Blank v. Chelmsford Ob/Gyn, P.C.*, 420 Mass. 404, 649 N.E.2d 1102 (Mass 1995)).

[2] It is worth noting Scandretts do not address Schultzes' argument that the *Mueller* language, even if applied to the duty owed by majority shareholders, does not apply to a director's fiduciary duty owed to the corporation and shareholders.

Hayes, 2001 S.D. 69 at ¶ 28 (emphasis added). This is not a minority shareholder claim for wrongful termination, it does involve majority self-dealing conduct, and the litigants are not all original parties to the compensation arrangement.

Likewise, partnership and limited liability company statutes and authority are not applicable. Cosmos is a closely-held corporation. Each entity-type is distinct from the next, with specific rules that do not apply to the other. If the legislature deemed partnership or limited liability company law applicable to corporations, it would have added such authority in the South Dakota Business Corporation Act, SDCL Ch. 47-1A, et seq. Scandretts' attempt to utilize partnership and limited liability company authority must fail.

H. Lyle's "Reasonable Expectations" Are Immaterial

Lyle is not being "oppressed", he is being held accountable as a majority shareholder and director. Lyle is not a minority shareholder and applying the minority shareholder oppression standard to Lyle is inappropriate. Scandretts cite no authority for their proposition that somehow it is oppression to hold a majority shareholder to his fiduciary duty. Protection for Lyle's "reasonable expectations" was extinguished the moment he became a majority shareholder. His eggs in the Cosmos basket became protected as soon as he received the majority share. At that time, the agreement becomes superfluous because as the majority shareholder, Lyle has the power to keep himself employed.

Having the power to ensure his own employment with the Cosmos, however, does not provide Lyle carte blanche authority to pay himself any wage he pleases. That power comes with a duty, the fiduciary duty owed to the minority shareholders.

Schultzes do not argue Lyle's fiduciary duty requires him to terminate his own employment, rather just that there is an obligation to ensure his salary, along with others, are in the best interests of the corporation. And it is not just Lyle's salary that is at issue. The heart of the matter is that the off-season tourist season has changed dramatically since 1969. It may no longer be in the Cosmos' best interest to forgo that business. Schultzes should have been allowed to submit that question to the jury.

II. SCANDRETTS ARE AT-WILL EMPLOYEES

Scandretts rely on an Ohio case for their contention that employee/shareholders in a closely-held corporation are not at-will employees. (Appellees' Brief at p. 28 *citing Gigax v. Repka*, 615 N.W.2d 644, 649 (Ohio App. 1992).) However, this Court has already determined that employee/shareholders in a closely-held corporation <u>are at-will</u>. *Mueller*, 2002 S.D. 38 at ¶ 20, n.4. In *Mueller*, the Court stated:

> Paul and Mary Pat's claim that they had been deprived of their right to perpetual employment in a managerial capacity at Al's Oasis would not, alone, constitute shareholder oppression. In *Willis v. Bydalek*, the court stated that discharging a minority shareholder from employment, even if the discharge is wrongful, is "simply not the sort of 'burdensome, harsh or wrongful conduct,' or 'visible departure from the standards of fair dealing' that may constitute shareholder oppression." *Willis v. Bydalek*, 997 S.W.2d 798, 802-03 (TexApp 1999). The court held, in an at-will employment state, and in light of the broad discretion given under the business judgment rule, any expectation of continued employment without an employment contract cannot be "objectively reasonable." 997 S.W.2d at 803. South Dakota is also an employment at-will state. SDCL 60-4-4. Therefore, the same holds true here.

Mueller, 2002 S.D. 38 at ¶ 20, n.4. If Lyle's compensation arrangement is considered an employment contract, there is no duration term making it a year-to-year agreement pursuant to SDCL § 60-1-3. If it is not an employment contract, Lyle is subject to employment at-will. He simply cannot have it both ways. Heidi, Kevin, and Marlene have no employment contract and are also subject to at-will employment. As majority shareholders and directors, Scandretts owe a fiduciary duty to Schultzes and the corporation to ensure their compensation is appropriate. They have refused to even consider reviewing their compensation or whether the corporate season should be expanded.

An argument that Lyle has lifetime employment or that his compensation arrangement endures indefinitely does not save him from employment at-will:

> It is usually held that a promise of lifetime or permanent employment will be interpreted as indefinite and terminable at-will in the absence of some executed consideration in addition to the services being rendered. *Corum v. Farm Credit Services*, 628 F. Supp. 707 (D.Minn. 1986); *Wolfe v. Graether*, 389 N.W.2d 643 (Iowa 1986); *Hillesland v. Federal Land Bank*, 407 N.W.2d 206 (N.D. 1987); Annot., Validity and Duration of Contract Purporting to be for Permanent Employment, 60 A.L.R.3d 226 (1974).

Merritt v. Edson Express, 437 N.W.2d 528, 529-530 (S.D. 1989). "[S]imply foregoing other work opportunities by accepting one job over another does not constitute additional consideration." *Corum v. Farm Credit Services*, 628 F.Supp.707, 713 (D.Minn. 1986) (*citing Montgomery v. American Hoist & Derrick Co.*, 350 N.W.2d 405, 408 (Minn.Ct.App. 1984)). Lyle has provided no additional consideration beyond that of his employment services. He is an at-will employee and thus his compensation arrangement is subject to modification. *See* 27 Am. Jur. 2d *Employment Relationship*, § 47 (2015) ("An employer can make prospective changes to an at-will employee's compensation or commissions".) It was error to deny Schultzes at-will employment instructions.

III. THE DUTY OF LOYALTY REQUIRES LYLE TO PUT THE CORPORATION'S INTERESTS ABOVE HIS OWN

Scandretts misconstrue Plaintiffs' Proposed Instruction No. 18 regarding the fiduciary duty of loyalty. Directors owe a duty of loyalty to both the corporation and shareholders. *Balvik v. Sylvester*, 411 N.W.2d 383, 387 (N.D. 1987); *Schurr v. Weaver*, 74 S.D. 378, 53 N.W.2d 290, 293 (S.D. 1952). The instruction does not say, nor do Schultzes contend, majority shareholders <u>must</u> advance minority interests upon conflict. It properly instructs the jury that Lyle, as a director, cannot put his own interests above the corporation's interests. There is ample evidence that Lyle put his own interests above the corporation's interests. He hired his family members, paid himself and his family members excessive salaries, and actually considered the off-season as "his" business and the summer as the corporation's business. (Tr. 300:14; 301:20-22; 302:4-14; 339:11-12.)

The duty of candor and disclosure is encompassed within the duty of loyalty. 18B Am. Jur. 2d *Corporations*, § 1485 (2004). Schultzes have alleged a breach of duty of loyalty from the inception of this lawsuit and presented instructions alleging the breach of duty of loyalty. Lyle may not escape his duty of loyalty by arguing Schultzes had a duty to request information. Disclosure and candor are not contingent upon inquiry. Nor is it a defense that Lyle provided the information required by the Bylaws for the annual "statement of business". Just because the Bylaws do not require disclosure of his compensation in the annual "statement of business" does not mean he has no duty to disclose. The jury should have been allowed to address this question.

CONCLUSION

The trial court abused its discretion when it granted Instruction No. 27 and refused employment at-will and duty of loyalty instructions. Schultzes respectfully request this matter be reversed and remanded for a new trial.

Dated this 6th day of February, 2015.

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CERTIFICATE OF COMPLIANCE

Pursuant to SDCL § 15-26A-66(b)(4), I certify Appellants' Reply Brief complies with the type volume limitation provided for in South Dakota Codified Laws. This Appellants' Brief, including footnotes, contains 4,074 words. I have relied upon the word count of our word processing system as used to prepare this Appellants' Reply Brief. The original Appellants' Reply Brief and all copies are in compliance with this rule.

GUNDERSON, PALMER, NELSON
& ASHMORE, LLP

By: *___/s/David E. Lust___________*

David E. Lust

CERTIFICATE OF SERVICE

I hereby certify on February 6, 2015, I emailed a true and correct copy of the foregoing **APPELLANTS' REPLY BRIEF and APPELLANTS' CERTIFICATE OF COSTS** to the following at his last known e-mail addresses:

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I further certify that on February 6, 2015, I emailed the foregoing **APPELLANTS' REPLY BRIEF and APPELLANTS' CERTIFICATE OF COSTS** and sent the original and two copies of both by U.S. Mail, first-class postage prepaid, to:

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By:___*/s/David E. Lust*____________
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