THE STATE OF SOUTH CAROLINA
In the Court of Appeals

APPEAL FROM SPARTANBURG COUNTY
Court of Common Pleas

J. Mark Hayes, II, Circuit Court Judge

Case No. 2008-CP-42-3397

Quentin S. Broom, Jr., ... Respondent,

v.

Ten State Street, LLP, Timothy D. Scranton,
Mark Broadwater, and H. Hugh Andrews, ... Defendants,

Of whom

H. Hugh Andrews, Individually
and on behalf of Tri-Star
Communications, Inc. is the, ... Appellant.

v.

Quentin S. Broom, Jr., ... Third-party Defendant.

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ARGUMENT

There are three reasons why this Court should reverse the order that dismissed Hugh Andrews' claims against his business partner, Quentin Broom.

First, the circuit court erred when it held that Mr. Andrews' claims must be derivative and not direct. In a true derivative claim, there would be other injured shareholders, but no other shareholder has suffered the same injury as Mr. Andrews. The only other shareholder that exists is Broom, and according to Andrews, Broom has benefitted from the acts in question. There is a split of authority on this point, but this view is the better view.

Second, if Mr. Andrews' first argument is wrong—if his claims *are* derivative and not direct—the circuit court was still wrong to use a pleading defect to dismiss Andrews' claims. There is no cogent justification, none, for applying Rule 23 to a suit where one of a corporation's two shareholders is suing the other. The rules of procedure are designed to ensure just and speedy outcomes, but there is no justice in requiring someone to perform an obviously meaningless act. When one of a corporation's two shareholders is suing the other, the claim necessarily alleges the functional equivalent of demand futility.

Finally, *if* Rule 23 applies—if Mr. Andrews is required to put things in his pleadings despite the fact that these things are obvious—the circuit court nevertheless erred when it dismissed Mr. Andrews' claims without allowing him to amend them. If this must be a derivative suit, and if Mr. Andrews' claims are indeed defective, all of the defects are defects that Mr. Andrews could easily cure. Broom could not seriously claim prejudice. He litigated this case for 6 years before any of this became an issue. This matter should be reversed and remanded for trial. It is time for this foolishness to end.

A. Mr. Andrews' Claims Are Not Truly Derivative. In a Two Person Corporation, a Claim of Self-dealing Necessarily Alleges That the Plaintiff Has Suffered a Harm That Is Unique.

A claim for corporate self-dealing is normally a derivative claim. This is the basic tenor of Broom's response; this is supposedly a normal mismanagement case. Broom says that Andrews' alleged injury does not flow from what happened to him, but from what happened to Tri-Star, Andrews' company. Because Andrews' injury derives from his status as a shareholder, Broom argues that all of Andrews' claims must be derivative.

This is not true. The fact that Broom and Andrews are this corporation's only shareholders makes this case different.

In *Ward v. Griffin*, this Court explained that an individual stockholder will have a direct suit if he or she "has sustained a loss separate and distinct from that of other stockholders generally." 295 S.C. 219, 221, 367 S.E.2d 703, 703-04 (Ct. App. 1988). That is what has happened here. Broom and Andrews are Tri-Star's only shareholders. If Broom improperly took money from the company, it necessarily follows that Andrews was injured and Broom was not. Yes, Tri-Star was also injured, and yes, Andrews' injury derives from his status as shareholder, but that does not change the fact that if Andrews' claims are true, he is the *only* injured shareholder. Tri-Star cannot be the only owner of a claim that injured Andrews and no one else.

If there was a third shareholder—a silent partner—the result would be different. Andrews and the third shareholder would have the same injury, and the court would be justified in labeling that suit as derivative. When multiple parties have the same sort of injury, this signals that the corporation's rights are the real rights at stake.

That is not true here. Instead, this case makes the debate entirely semantic. Does it really matter whether these claims are labeled as "derivative" or "direct?" Either way, the two shareholders of this corporation will be on opposite sides of the suit and the suit will be between them. If Tri-Star owns the rights to sue for Broom's (alleged) wrongdoing, how does Broom propose that process will work? What steps does a corporation take to pursue its rights when one of its 50% shareholders alleges that the other 50% shareholder has plundered the assets and left the business defunct? Which one of the 50% shareholders gets to manage the litigation, and who gets to decide what to do with any recovery?

This is why there has been an evolution in how the law treats corporations that have a small number of stockholders. Professor Hodge O'Neal, whose scholarship on this topic is referenced by many of the decisions in this area, has written that the derivative/direct distinction makes "little sense" and becomes "technical" in these sorts of circumstances. O'Neal & Thompson, *O'Neal's Close Corporations*, § 9:26 (rev. 3d ed. 2012). Other courts have recognized that when there are only two shareholders, the self-dealing of one will result in a unique injury to the other. See, e.g., *Noakes v. Schoenborn*, 841 P.2d 682, 687 (Or. Ct. App. 1992); *Yanow v. Teal Industries, Inc.*, 422 A.2d 311, 321-22 (Conn. 1979).

This is the better view. Derivative suits are designed to protect the principles of corporate governance and discourage frivolous lawsuits, but these concerns do not exist when one 50% shareholder is suing the other. In that situation, there is no corporate governance to protect. The corporation cannot act because the controlling shareholders are fighting. When one of two shareholders is suing the other, the suit is obviously not frivolous. Because the corporation cannot function, nobody is left to resolve the dispute but the court.

There is no cogent reason to make this situation more complicated. There is no reason to shoehorn this case into a process designed for things that are more complex.

Broom has not presented the Court with any authority that persuasively rebuts this argument. At no point does Broom cite a case that considers this argument and rejects it.

Several of the cases cited by Broom deal with whether a corporate officer has the authority to bring a lawsuit in the corporation's name, as opposed to the officer's own name. See, e.g., *Ono v. Itoyama*, 884 F.Supp. 892, 895-99 (D.N.J. 1995); *L. W. Kent & Co. v Wolf*, 533 N.Y.S.2d 119 (N.Y. App. Div. 1988); and *Abelow v Grossman*, 457 N.Y.S.2d 30 (N.Y. App. Div. 1982); cited at (Brief of Respondent, p.14 n.5). This did not occur here. Andrews did not bring any claims in Tri-Star's name. Andrews brought claims in his own name, both on his own behalf and on behalf of Tri-Star. These cases are inapposite. Because they do not consider the question that Andrews has presented, they do not have any meaningful value, one way or the other.

Andrews' view of the law has not been universally adopted. Good expressions of the counter-argument include *Landstrom v. Shaver*, 561 N.W.2d 1 (S.D. 1997) and *Bagdon v. Bridgestone/Firestone, Inc.*, 916 F.2d 379, 384 (7th Cir. 1990). As Mr. Andrews' principal brief described, these cases should not be persuasive. These cases are premised on an unyielding respect for the corporate form, and while respecting the corporate form is a fair consideration, the reality is that a business cannot function when its equal shareholders are suing each other. In that situation, there is no substance to the direct/derivative distinction.

For these reasons, this Court should hold that the circuit court erred when it held that Mr. Andrews' claims are derivative and not direct.

B. *If* Mr. Andrews' First Argument Is Wrong (Meaning, If His Claims *Are* Derivative), There Was Still No Reason to Require Compliance with Rule 23 and Dismiss His Claims.

Even if the Court disagrees with the argument that Mr. Andrews' claims are direct and not derivative, this Court should still reverse the decision to dismiss them. There is no cogent justification—none—to apply Rule 23 to a suit where one of a corporation's two shareholders is suing the other.

Rule 23 requires a derivative claim to be verified by the plaintiff and to allege what the plaintiff has done to obtain relief from the company's management. Rule 23(b)(1), SCRCP. It also provides that the plaintiff must fairly represent the other shareholders who are similarly situated. *Id.* These are not statutory requirements. They derive from the rules. S.C. Code Ann. § 33-7-400 (2012) (pointing to the rules for derivative suits).

The requirements of Rule 23 serve specific functions. "Verification," one court has described, "serves the purpose of ensuring that the plaintiff or some other person has investigated the charges and found them to have substance." *Strickland v. Flue-Cured Tobacco Co-op. Stabilization Corp.*, 643 F. Supp. 310, 316 (D.S.C. 1986). Another court described verification as discouraging "strike suits" based on worthless claims that are made without regard to their truth. *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 371 (1966).

Nobody has argued that Andrews' suit against his business partner is a meritless "strike suit." In the circumstances of the present case, enforcing this requirement appears to be nothing more than requiring compliance with a hyper-technicality.

"The persuasive rationale for the demand requirement is that it allows [a corporation's] directors to make a business decision about a business question: whether to invest the time and resources of the corporation in litigation." *Starrels v. First Nat. Bank of Chicago*, 870 F.2d 1168, 1173 (7th Cir. 1989) (Easterbrook, J., concurring). Does anyone seriously contend that Andrews should be required to include a statement in his pleadings indicating that he asked Broom to sue himself? As far as Mr. Andrews has been able to discover, no court has adopted this theory, and several cases have openly described this proposition as nonsense. See, e.g., *Anderson v. Clemens Mobile Homes, Inc.*, 333 N.W.2d 900, 904 (Neb. 1983); *Funk v. Spalding*, 246 P.2d 184, 186 (Ariz. 1952).

Broom cites one such case favorably in his brief. In *Ono v. Itoyama*, a United States District Court in New Jersey found that Rule 23's requirements for a derivative suit were deemed satisfied when one 50% shareholder was suing the other. 884 F.Supp. at 899 (cited in the Brief of Respondent, p.14 n.5). The court ultimately dismissed the case due to incomplete diversity of citizenship, but the analysis on the demand requirement follows the same argument that Mr. Andrews is making.

Broom also cites a decision from the United States District court in Oklahoma. *New York Life Ins. Co. v. Ramco Holding Corp.*, 938 F.Supp. 754 (N.D. Okla. 1996). That decision involved the application of Texas law. *Id.* The citation is instructive because in the state of Texas, the pleading rules for derivative suits are deemed satisfied as a matter of law if the suit is on behalf of a close corporation and all of the remaining shareholders are named as defendants. *Eye Site, Inc. v. Blackburn*, 796 S.W.2d 160, 162-63 (Tex. 1990). Here again, the law supports the argument that Mr. Andrews is making.

Broom says that there are "serious ramifications" for relaxing the pleading rules in these circumstances. (Brief of Respondent, p.18). What are they? If the concern is protecting the corporation's creditors, that is a recovery question—not a pleading question. Deeming the requirements of Rule 23 to be satisfied would have no impact whatsoever on what would happen to any financial recovery on Andrews' claims. If the pleading rules are deemed satisfied, the claims would still be derivative.

Thus, if Mr. Andrews' first argument is wrong—if his claims *are* derivative and not direct—this Court should still hold that the circuit court was wrong to use a pleading defect to dismiss Andrews' claims. There is no cogent justification to apply Rule 23 to a suit where one of a corporation's two shareholders is suing the other.

C. This Is the Paradigm Case for Allowing Amended Pleadings, and Mr. Broom Is Taking a Position That Is Opposite to the Position He Placed on the Record in Circuit Court.

If this Court determines that the pleading requirements for Rule 23 are mandatory, Broom says that this Court should not allow Andrews to amend his claims because Andrews failed to obtain a specific ruling on this request from the circuit court.

After the circuit court dismissed Andrews' claims, Andrews filed two motions: a motion for reconsideration and a motion to amend his answer and counterclaims. The court heard arguments on these motions in the same hearing.

Broom told the circuit court that because Andrews' claims had been dismissed, he did not have any claims to amend. (R. pp. 293-294). Broom argued Andrews was "asking to be permitted to amend something that does not exist. Now they won't – will not be prohibited before the appellate courts if that's where this is headed from making the arguments that are contained within this proposed [filing] . . . [but] you can't amend something that doesn't exist." (R. p. 294).

Broom is right about the court's order. It never mentions the motion to amend. See (R. p. 17). But the obvious import of the order is to deny the motion. Broom had argued that the court could grant the amendment only if the court changed the order dismissing the case. The only rational view of the court's decision is that it agreed. In deciding *not* to alter the order that dismissed Andrews' claims, the circuit court necessarily rejected Andrews' request that he be allowed to amend his claims. Nothing else is possible.

There is no cogent justification for denying the motion to amend. Nobody has blown a jurisdictional deadline. Rule 23 is a rule of pleading and it must "be construed to secure the just, speedy, and inexpensive determination of every action." Rule 1, SCRCP. There is no justice in deciding this case based on a trivial technicality and not on the merits.

This is a pleading question, but it also affects the other issues in this appeal. In opposing the ALI exception, Broom says that "this record" does not present facts that justify considering that exception. What factual record? There has been no evidence presented in this case. This case was decided on the pleadings. Moreover, every previous instance where a South Carolina appellate court has considered the close corporation exception, the court was reviewing a case that had been decided on the merits by some sort of trial.[1]

There may be no need to protect corporate creditors. Perhaps there are none, or perhaps Broom and Andrews, like the shareholders in other small corporations, personally guaranteed Tri-Star's debts. See *Mynatt v. Collis*, 57 P.3d 513, 529 (Kan. 2002) (referencing

[1] *Brown v. Stewart*, 348 S.C. 33, 557 S.E.2d 676 (Ct. App. 2001) and *Todd v. Zaldo*, 304 S.C. 275, 403 S.E.2d 666 (Ct. App. 1991) were appeals from jury trials. *Babb v. Rothrock*, 303 S.C. 462, 401 S.E.2d 418 (1991) and *Davis v. Hamm*, 300 S.C. 284, 387 S.E.2d 676 (Ct. App. 1989) were appeals from proceedings in front of a judge alone.

the American Law Institute's observation on this point). This is why states adopting the ALI exception grant trial courts a measure of discretion. See *Richards v. Bryan*, 879 P.2d 638, 646-48 (Kan. Ct. App. 1994) (adopting this approach after rejecting the arguments to the contrary). But without an evidentiary record to review, all of this is just guesswork.

The point is this: at the pleading stage, nobody can say with any certainty that this case does not justify following the ALI approach. There is no evidentiary record, and the reason a record was not developed was because Andrews omitted things from his pleading. Because these things were obvious from this case's context, it was error to use a technical defect to dismiss this case with prejudice. The circuit court simply cannot meaningfully review the issues in question without having some sort of proceeding on the merits.

CONCLUSION

For the foregoing reasons, this Court should reverse the circuit court's decision and remand this case for additional proceedings.

Respectfully submitted,

November 22, 2013

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CERTIFICATE OF COMPLIANCE

Pursuant to Rule 211(a), SCACR, I certify that the *Brief of Appellant* and the *Reply Brief* comply with the provisions of Rule 211(b), SCACR, and with the August 13, 2007, Supreme Court Order regarding personal data identifiers.

/Signature page attached

Respectfully submitted,

November 22, 2013

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PROOF OF SERVICE

The undersigned hereby certifies that on the date indicated below she served counsel for the Respondent with a copy of the *Final Brief of Appellant, Reply Brief* and *Certificate of Compliance* by mailing copies of the same by United States Mail with first class postage prepaid to the following addresses:

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