

**COURT OF CHANCERY
OF THE
STATE OF DELAWARE**

WILLIAM B. CHANDLER III
CHANCELLOR

COURT OF CHANCERY COURTHOUSE
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GEORGETOWN, DELAWARE 19947

Submitted: September 7, 2006
Decided: October 16, 2006

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Re: *Smith v. McGee and Smitty McGee's, Inc.*
Civil Action No. 2101-S

Dear Counsel:

For the reasons set forth below, after carefully examining the arguments presented by counsel, I grant the motion for partial summary judgment in favor of defendants Dawn McGee and Smitty McGee's, Inc. ("Smitty McGee's").

I. BACKGROUND

This case involves a classic claim of minority shareholder oppression replete with allegations of wrongful withholding of income, excessive officer compensation, denial of access to corporate records, self-dealing, conversion, and fraud. Smith seeks a declaration stating that McGee breached her fiduciary duties of due care, loyalty and good faith to both Smith and the company; a complete and accurate accounting of all monies received; removal of McGee as the sole director of the company; disgorgement of ill-gotten gains; a constructive trust on ill-gotten gains and the fruits of ill-gotten gains; and an equitable lien on all shares of the

company owned by McGee. Before I discuss the merits of Smith's claims in the context of this motion for partial summary judgment, however, it may be helpful to first examine the factual background and procedural posture of this case.

In April 1989, Smith and Ronald ("Rick") McGee, Dawn McGee's ex-husband, invested personal capital and formed Smitty McGee's, a private, closely-held corporation. Shortly thereafter, they sold a 20% interest in the company to Alvah Price and each retained a 40% interest. In June 1989, Smith, Rick McGee and Price opened Smitty McGee's Raw Bar & Restaurant. Although the Restaurant met with great success, the business relationship seemed to have deteriorated by 1992. Rick McGee, without Smith's knowledge, purchased Price's 20% interest, giving Rick McGee a 60% controlling interest in the company. Two years later, Rick McGee called a special stockholders meeting at which he removed Smith as a director, accepted Price's resignation as a director, and elected himself the sole director of the company. Rick McGee also voted to amend the company's by-laws to reduce the whole board to one director and to permit corporate action through written consent of the majority holder of the company's outstanding stock. In the mid-1990s, Dawn McGee became a 60% owner of the company as a result of her divorce settlement and has remained the company's sole director and majority shareholder.

Smith asserts that McGee runs the business for her personal benefit and to Smith's detriment since she obtained control. Specifically, Smith alleges that McGee precludes him completely from recognizing any benefit from his investment in the company. For example, he has not received any dividends in over fifteen years, with the exception of a nominal dividend issued on the eve of this litigation, nor has he been an employee in over ten years. Further, McGee blocks Smith's access to company records and information by failing to hold shareholders meetings and by largely rejecting Smith's demand under 8 *Del. C.* § 220. From 2001-2004, however, McGee paid to herself \$884,811 in executive compensation for running the single location, seasonal restaurant and bar; granted interest free loans to herself and Rick McGee; and acquired at least six company owned vehicles for a business that does no off-site catering.

In 1997, Smith commenced a suit in his individual and derivative capacity against Rick McGee, Dawn McGee, and Smitty McGee's. Smith alleged breach of fiduciary duty, conversion of company funds, improper use of funds, fraud, unjust enrichment, and racketeering against Rick McGee. He asserted claims against Dawn McGee for negligent management, unjust enrichment, conspiracy to commit

racketeering, and aiding and abetting Rick McGee's breaches of fiduciary duties. All of these claims arose as a result of the McGees' alleged mismanagement and misappropriation of Smitty McGee's corporate assets. In May 1998, then-Vice Chancellor Steele dismissed Smith's RICO and common law fraud claims and denied Smith's motion to amend his complaint to assert claims for failure to declare dividends.¹ Then, on August 27, 2002, Vice Chancellor Noble dismissed the entire complaint pursuant to Court of Chancery Rule 41(e) for failure to prosecute.

In 2003, suspicions of improper behavior motivated Smith to make a books and records demand under 8 *Del. C.* § 220. Smith received documents as a result of this demand, but he did not initiate any litigation. Then in 2005, Smith again demanded to review the company's books and records. The company, however, rejected this request, and I granted a partial judgment in Smith's favor regarding this demand.² Smith contends that the documents produced pursuant to that court order put him on notice of McGee's mismanagement and self-dealing and form the basis of the current lawsuit.

Broadly, the crux of this dispute is whether McGee mismanaged the company and breached numerous fiduciary duties making her liable to both the corporation and Smith. Smith seeks relief pursuant to six counts. First, Smith claims that by virtue of McGee's domination of the company, she has oppressed his reasonable shareholder expectations in the company. Second, Smith alleges breach of loyalty and good faith. Third, Smith contends that McGee breached her duty of due care. Further, he contends that McGee wrongfully converted funds and committed fraud. Smith insists that both he and the company suffered economic injuries as a result of McGee's actions and, thus, both are entitled to monetary damages. Defendants McGee and Smitty McGee's respond with a motion for partial summary judgment stating that Smith is barred from asserting claims arising prior to April 25, 2003, on the grounds of laches and the statute of limitations or, alternatively, that Smith is barred from asserting claims arising prior to August 27,

¹ *Smith v. Smitty McGee's, Inc.*, 1998 Del. Ch. LEXIS 87 (May 8, 1998).

² *Smith v. McGee*, Del. Ch., C.A. No. 1295 (June 21, 2005).

2002, under the doctrine of *res judicata*. Today, I rule on this motion for partial summary judgment.

II. MOTION FOR SUMMARY JUDGMENT³

The standard for reviewing a Court of Chancery Rule 56 motion for summary judgment is well-settled in Delaware law. Summary judgment is appropriate where “the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.”⁴ Justice demands that the court view the facts in the “light most favorable to the nonmoving party, and the moving party has the burden of demonstrating that there is no material question of fact.”⁵ The nonmoving party, however, “may not rest upon mere allegations or denials of [their] pleading, but ... must set forth specific facts showing that there is a genuine issue for trial.”⁶

III. STATUTE OF LIMITATIONS

Smith asserts claims of breach of fiduciary duty, fraud, and conversion, all of which are subject to a three-year statute of limitations that begins to run at the time the alleged wrongful act is committed.⁷ This limitations period, which would preclude all claims arising before April 25, 2003, may be suspended under several tolling theories. Smith alleges that Dawn McGee’s actions impeded his access to the information that gave rise to this suit until 2005 and, thus, the limitations

³ Smith requests that this Court treat defendant’s motion for summary judgment as a motion to dismiss because plaintiff has not been afforded the benefits of discovery. Court of Chancery Rule 56(f) provides an avenue by which Smith may have challenged application of the summary judgment standard. Specifically, he should have filed an affidavit pursuant to Rule 56(f) outlining what facts, if proven by discovery, would make summary judgment impossible. This action would have halted the motion for summary judgment and first allowed discovery. Smith’s failure to utilize Rule 56(f) precludes the application of the motion to dismiss standard.

⁴ *Korn v. New Castle County*, 2005 Del. Ch. LEXIS 25, at *13 (Feb. 14, 2005).

⁵ *Elite Cleaning Co. v. Walter Capel and Artesian Water Co.*, 2006 Del. Ch. LEXIS 105, at *8 (June 2, 2006).

⁶ *Id.*

⁷ 10 *Del. C.* § 3106. The statute of limitations, of course, applies to equitable claims only by analogy. See *Fike v. Ruger*, 754 A.2d 254, 260 (Del. Ch. 1999) (applying the three-year limitations period of 10 *Del. C.* § 3106 to breach of fiduciary duty by analogy); see also *State ex rel. Brady v. Pettinaro*, 870 A.2d 513, 531 (Del. Ch. 2005) (applying the three-year limitations period to a claim of fraud); *Blake v. Town of Delaware City*, 441 F. Supp. 1189, 1205 n.62 (D. Del. 1977) (applying the three-year limitations period to a conversion claim).

period is tolled under three tolling theories: (1) inherently unknowable injuries; (2) equitable tolling; and (3) fraudulent concealment. As the party seeking to toll the limitations period, Smith bears the burden of pleading specific facts to demonstrate that the facts were so hidden that a reasonable plaintiff could not have made timely discovery of an injury necessary to file a complaint within the statute of limitations. Further, “if the limitations period is tolled under any of these theories, it is tolled only until the plaintiff discovers (or exercising reasonable diligence should have discovered) his injury”—that is to say, until plaintiff is on inquiry notice.⁸ Plaintiff is on inquiry notice if he “is in possession of facts sufficient to make him suspicious, or that ought to make him suspicious.”⁹ Thus, Smith must convince this Court that he was not on inquiry notice—not in possession of facts sufficient to make him suspicious of injury resulting from McGee’s behavior—before April 25, 2003.

A limitations period may be tolled under the inherently unknowable doctrine so long as “the discovery of the existence of a cause of action is a practical impossibility.”¹⁰ Specifically, “there must have been no observable or objective factors to put a party on notice of an injury, and plaintiffs must show that they were blamelessly ignorant of the act or omission and the injury.”¹¹ Plaintiffs may establish “blameless ignorance” by showing justifiable reliance on a person whom they have “no ostensible reason to suspect of deception.”¹² Such proof tolls the limitations period until a plaintiff had “reason to know” of a wrong.¹³

Equitable tolling is appropriate “where a plaintiff reasonably relies on the competence and good faith of a fiduciary.”¹⁴ Underlying this doctrine is the idea that “even an attentive and diligent [investor] relying, in complete propriety, upon the good faith of [fiduciaries] may be completely ignorant of transactions that . . . constitute self-interested acts injurious to the [Partnership].”¹⁵ This doctrine also

⁸ *In re Dean Witter P’ship Litig.*, 1998 Del. Ch. LEXIS 133, at *20 (July 17, 1998) (citations omitted).

⁹ *Id.* at *31 n.49.

¹⁰ *Id.* at *19-20.

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.* at *21-22

¹⁵ *Id.*

tolls the limitations period until an investor knew or had reason to know of the facts constituting the wrong.¹⁶

Fraudulent concealment, unlike the doctrines of inherently unknowable injuries and equitable tolling, “requires an affirmative act of concealment by a defendant—an ‘actual artifice’ that prevents a plaintiff from gaining knowledge of the facts or some misrepresentation that is intended to put a plaintiff off the trail of inquiry.”¹⁷ Nevertheless, “mere ignorance of the facts by a plaintiff, where there has been no such concealment, is no obstacle to operation of the statute.”¹⁸ Like the previously mentioned doctrines, tolling exists only “until his rights are discovered or until they could have been discovered by the exercise of reasonable diligence.”¹⁹

Neither of these tolling theories can suspend the limitations period here because Smith was on inquiry notice of McGee’s wrongdoing as of 1997. Setting aside what notice failure to be paid dividends for seven years may have provided, Smith filed a lawsuit against Rick and Dawn McGee that alleged breaches of fiduciary duty, conversion, fraud, RICO violations, and mismanagement of the company and its assets. Specifically, Smith alleged that Dawn McGee was an active and knowing participant in illegal transactions whereby she and her husband converted money from the company and committed fraud against Smith. Additionally, Dawn McGee was aware of, assisted in, and benefited from Rick McGee’s breaches of his fiduciary duties. In the current complaint, Smith contends that Dawn McGee was involved in self-dealing, numerous breaches of fiduciary duties, conversion, and fraud, all of which are the same types of claims present in the 1997 action. The allegations in both the 1997 complaint and the present complaint are based on the same type of behavior—mismanagement and misuse of the company’s assets—and, in some instances, the same incidents.

Thus, Smith cannot rely on the inherently unknowable doctrine because allegations in the 1997 complaint show that Smith had actual knowledge of improper and illegal activity and injuries to Smith and the company. This theory also fails because Smith cannot establish that he was blamelessly ignorant. He was

¹⁶ *Id.*

¹⁷ *Id.* at *20-21.

¹⁸ *Id.*

¹⁹ *Id.*

rightfully suspicious of his only other partner; thus, there is no one in the company upon which he could justifiably rely. Equitable tolling is inappropriate because Smith cannot say that he reasonably relied on the competence and good faith of Dawn McGee since he has been in and out of nine years of litigation alleging numerous claims of wrongful conduct including breaches of fiduciary duties. Finally, the theory of fraudulent concealment provides no relief for two reasons. First, Smith alleged fraudulent activity in the 1997 action. He cannot now say that he was unaware of the same activity. Second, Smith does not specifically allege any actual artifice or affirmative acts of concealment that were intended to put him off the trail of an injury. Thus, he cannot rely on that theory. Since Smith was on inquiry notice of McGee's activities and the resulting injuries, the tolling theories are unavailable and the statute of limitations applies.

As such, Smith was on inquiry notice of injuries and wrongdoing as early as 1997. Further, nothing has occurred to allay any of his suspicions such that it would be unfair to state that he has remained on inquiry notice since 1997. The case lasted from 1997-2002 and nothing changed. McGee continued and continues to exclude Smith from the company, and to date has not been forced to rectify any of the alleged ills. Thus, Smith is precluded from bringing claims that arose before April 25, 2003. This, of course, does not include any wrongful actions that occurred after April 25, 2003. Similarly, it does not include actions where the injuries did not occur until after April 25, 2003. For example, while Smith may not include claims regarding pre-April 25, 2003, loans that McGee granted to herself and her ex-husband, he may seek damages that he and the company suffered and continue to suffer as a result of the continued nonpayment of those loans. Smith failed to distinguish the claims by date; therefore, I will not detail the barred claims. The parties should instead be advised that all claims arising before April 25, 2003, are barred by the statute of limitations and may not be litigated.²⁰

²⁰ Dawn McGee asserts, in the alternative, that the doctrine of *res judicata* bars all claims arising before August 27, 2002. *Res judicata* would certainly bar all claims that were raised or should have been raised by Smith against McGee in the 1997 complaint. On the other hand, it would not bar any claims arising after the 41(e) dismissal of that action or any different claims that should not or could not have been included in the 1997 complaint. Since I am ruling in favor of defendant Dawn McGee based on the statute of limitations defense, however, there is no need to further discuss the applicability and effect of the *res judicata* defense.

IV. CONCLUSION

In sum, the three-year statute of limitations operates to bar all claims arising prior to April 25, 2003.

IT IS SO ORDERED.

Very truly yours,

A handwritten signature in cursive script that reads "William B. Chandler III". The signature is written in black ink and includes a horizontal line at the end.

William B. Chandler III

WBCIII:trm