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Commonwealth of Kentucky

Court of Appeals

NO. 2010-CA-000429-MR

MARROWBONE PHARMACY, INC.,
LAYTHE E. SYKES AND WILLIAM
MCCOY, JR. APPELLANTS

v.

APPEAL FROM PIKE CIRCUIT COURT
HONORABLE EDDY COLEMAN, JUDGE
ACTION NO. 04-CI-01609

CHRIS JOHNSON, ADMINISTRATOR
OF THE ESTATE OF RUSSELL
JOHNSON, JR. APPELLEE

OPINION
REVERSING AND REMANDING

** ** ** ** **

BEFORE: COMBS, STUMBO, AND WINE, JUDGES.

WINE, JUDGE: Laythe Sykes, William McCoy, Jr., and Marrowbone Pharmacy, Inc., (collectively, the "Appellants") appeal from a judgment and order of the Pike Circuit Court dissolving their private corporation. On appeal, the Appellants raise

numerous issues which may be summarized as follows: that the trial court erred in finding fraud and in allowing the Appellee to "ambush" them with unpled allegations of fraud at the hearing, that the trial court erroneously relied upon these unpled allegations in making its determination, that the trial court erred by applying the wrong standard for appointing a receiver, and that the Estate did not have standing to sue except in a derivative suit under the dissenter's rights provisions of Kentucky Revised Statutes (KRS) 271B.13-010. Upon a review of the record, we reverse and remand to the Pike Circuit Court for further proceedings consistent with this opinion.

Facts

Marrowbone Pharmacy is a small, locally owned drugstore in Pike County, Kentucky. It was established in 1976 by a partnership between the Appellants Laythe Sykes and William McCoy, Jr. The capital for the venture was provided by Sykes and McCoy, who also managed the business. Sykes and McCoy (and another individual) each owned one-third of the building in which the pharmacy was housed. Sykes and McCoy eventually sold their interest in the building and simply leased the property as tenants thereafter.

In the mid-1980's, Sykes and McCoy hired Russell Johnson, Jr., (Russell) as the pharmacist at Marrowbone Pharmacy. When Russell was hired, he was a salaried employee of the partnership. He served as the pharmacist at Marrowbone. By 1989, Sykes and McCoy made Russell a partner, giving him a

thirty (30) percent stake in the business and requiring no capital contribution.[1] After this time, in addition to his regular salary, Russell began receiving the use of a company vehicle and a monthly "distribution" of profits of $1,800. Sykes and McCoy also used company vehicles and received a monthly "distribution" of $2,100 apiece. Russell participated in the meetings with Sykes and McCoy where decisions were made concerning distributions and the use of company vehicles.

In 1998, Sykes, McCoy, and Russell decided to incorporate the business. The business was incorporated on February 19, 1998. Sykes, McCoy, and Russell were named the initial directors. Sykes was named as president and McCoy was named vice president. Following incorporation, all three directors voted to continue the practice of providing company vehicles and monthly distributions.

In 2002, following an audit by the IRS, it was determined that the monthly distributions given to the three directors were in the nature of employment income. The Corporation was required, thereafter, to go back and account for all of these distributions as "salary" and pay back taxes on those amounts. Thereafter, the monthly distributions were accounted for as "management fees" on the returns. The directors, Russell included, continued to vote in favor of the management fees.

[1] Although the parties required no capital contribution from Russell, Russell ran the day to day operations of the business, acted as the pharmacist, and maintained all of the bookkeeping. Sykes and McCoy still contributed time toward the running of the enterprise, undertaking such duties as negotiating with the drug companies, negotiating insurance contracts, having telephone conversations regarding buying and store discounts, and also handled the filing of taxes and other paperwork. Sykes and McCoy both testified that they frequently talked on the phone with Russell concerning decisions to be made in the pharmacy.

During all relevant time periods prior to his death, Russell drove a company vehicle and received management fees in addition to his regular salary from Marrowbone Pharmacy, Inc.

In 2003, Russell was diagnosed with terminal cancer. The Appellants allege that in December of 2003, Chris Johnson, Russell's son, removed certain documents from the pharmacy, including the corporate minute book. Appellants allege that Chris took the corporate minute book without their knowledge, and has since produced two pages from that book in discovery. Chris testified in his deposition that he did have the corporate minute book, although he testified that he found the minute book in a box of his father's things and, contrary to the Appellants' assertions, did not himself remove it from the pharmacy. Appellants aver that they believe other materials might have been taken from the pharmacy by Chris in addition to the minute book,[2] and that Chris even asked for the minute book in discovery, all the while knowing that he was in possession of it. Regardless of the circumstances, these facts are not relevant to the issues presented before us on appeal.

On January 9, 2004, Russell died. Chris was appointed the administrator of Russell's estate (the "Estate"). After Russell's death, the management fees to Russell (through his Estate) ceased. Chris alleged that Sykes

[2] Chris testified that his father began organizing the documents and records of the corporation once he became terminally ill, as he had been the individual running the day to day operations of the business. Chris further testified that, because of Russell's weakened condition, he enlisted the help of his sons to move boxes of documents and paperwork to a storage area. Chris testified that he removed nothing from the pharmacy or storage area at that time.

and McCoy wrongfully ceased the "distributions," to which the Estate was entitled, by disguising the profits of the corporation. Sykes and McCoy maintained that the Estate was not *entitled* to the management fees, as they had assumed all of the duties previously performed by all three directors.

Sykes and McCoy offered to purchase the Estate's shares for $48,000. The Estate rejected Sykes's and McCoy's offer, believing the amount offered to be less than the decedent's thirty (30) percent share in the business.[3] Chris believed he could receive a greater amount for the shares if the corporation was dissolved and the assets liquidated. Sykes and McCoy indicated to Chris that they were unwilling to sell the pharmacy and dissolve the corporation. Sykes and McCoy then retained counsel with the hopes of effecting a merger and triggering the dissenter's rights provision in KRS 271B.13-010. The theory was that if the provision was triggered by a merger, then Sykes and McCoy could pay Chris the fair value for the shares. Sykes and McCoy retained an independent CPA for the purpose of valuing the Estate's shares in the corporation. Counsel for Sykes and McCoy then informed the Estate of its intentions to conduct the merger and trigger the Estate's dissenters rights.

Chris, as administrator of the Estate, filed the present action in the Pike Circuit Court on November 19, 2004. The complaint demanded that a custodian be appointed to manage the business and affairs of the corporation under

[3] McCoy testified that there was a buy/sell agreement that had carried over from the partnership, but that the last time he saw the document it was at the Marrowbone Pharmacy with other paperwork. He testified that he has not been able to locate the agreement.

KRS 271B.14-320 and to recover "any and all monies and the value of any benefits provided to them for which no services were rendered to the corporation." The complaint further demanded that the corporate affairs be wound up and that the corporation be liquidated, with the proceeds to be distributed among the shareholders. The Estate also sought to recover the costs of the action.

Although the complaint alleges that Sykes and McCoy acted fraudulently, the only specific allegations of "fraud" in the complaint were that Sykes and McCoy: (1) "failed to comply with the legal demand pursuant to Kentucky Law for the right to inspect the records of the corporation . . . " (2) "are believed to have been paying themselves out of the corporate assets the sums of $2,100.00 per month each since the beginning of the business of the corporation for which they have provided no services . . . " and (3) that they "purchased with corporate assets vehicles for their own personal use and for which the corporation has received no benefits . . . ." (Plaintiff's Complaint at 4).

On December 10, 2004, Sykes and McCoy sent Chris notice of a shareholder's meeting to be held on December 14, 2010, along with documentation of a proposed plan of merger and share exchange. At the request of Chris's counsel, the shareholder's meeting was postponed until January 5, 2005, to give the certified public accountants for both sides a chance to exchange and review documents prior to the meeting.

On December 30, 2004, however, the Estate filed a motion for a restraining order to prevent the shareholders meeting and to prevent a vote on the

merger and share exchange plan. Chris alleged that the plan itself was an effort to "steal the shares" of the Estate. The trial court made a verbal ruling on the motion, enjoining the parties from holding the shareholder's meeting. On this same date, the court issued a scheduling order. The Appellants insisted that they had the right to proceed with the merger and asked that the court reconsider its prior order. The court refused.

The case was finally set for a hearing on March 24, 2008, which was scheduled to be heard by an advisory jury.[4] At the pretrial conference, held on March 19, 2008, the court asked the parties whether they were ready to try the case. The Appellants stated that they were not ready to proceed because the Estate had failed to disclose what the specific allegations of fraud would be, other than those related to director compensation and management fees, and they could not prepare to defend without knowledge of what the claims would be.

The trial court initially excluded all evidence pertaining to these allegations, stating that it would not allow a trial "by ambush." However, the court later allowed testimony concerning "missing money," a business lease taken out in McCoy's own name instead of the business name, and other allegations of fraud or illegality. In addition, the advisory jury heard allegations of fraud during the opening statements which the Appellants could not later effectively rebut.

[4] Neither party objected to the use of an advisory jury below and neither party raises any issue concerning the use of the advisory jury on appeal. Thus, we do not undertake any discussion of whether the claims in the present action are legal or equitable, or whether an advisory jury should have been empanelled under Kentucky Rules of Civil Procedure (CR) 39.03.

The advisory jury was presented with the sole question of whether the Appellants acted fraudulently. They returned a verdict for the Estate, finding that the Appellants had acted fraudulently. The court then ordered the Master Commissioner to hire a forensic accountant and commission an independent report to the court on whether all the receipts of the corporation had been accounted for and to determine the value of the corporation.

Finally, after nineteen months, the forensic accountant filed a two-paragraph report containing the results of his investigation. The report stated the value of the shares on the date of Russell's death and the current valuation of the shares. The Appellants objected to the report on the grounds that it was the result of an incomplete investigation, that it contained no supporting evidence, and that it relied on flawed methodology. The Appellants also argued that the report relied upon the "ambush" allegations of fraud which had not been disclosed prior to the hearing.

Thereafter, on February 12, 2010, the court entered a judgment and order dissolving the corporation.[5] The judgment stated, in pertinent part:

> The Court finds . . . that the Marrowbone Pharmacy profits have been disguised as management fees and increased bookkeeping fees. In other words, the decedent worked to earn his share of the corporation [during his lifetime] and at his death his earnings have been lost[.]

[5] It is of note, however, that the court specifically stated in its findings that the forensic accountant's report was incomplete because the accountant was unable to get third-party verification from Marrowbone's vendors and, and thus, that the report was not evidence.

Based upon these findings, the court concluded that Sykes and McCoy had acted, were acting, or would act in a fraudulent manner under KRS 271B.14-300(2)(b). The court's order appointed a custodian, during the interim before dissolution, who was ordered to:

> manage the affairs of the corporation in the best interests of its shareholders and creditors, including specifically to recover from the Defendants, Laythe E. Sykes and William McCoy, Jr., such monies and value of the benefits fraudulently taken from the corporation.

Sykes and McCoy were ordered to immediately surrender control and possession of all corporate assets to the custodian. The court also appointed a receiver to wind up the affairs of the corporation and liquidate its assets under KRS 271B.14-320(1).

Sykes, McCoy, and Marrowbone now appeal. On appeal, they allege numerous grounds of error, which can be stated more succinctly as follows: (1) that the trial court erroneously applied the standard for appointing a receiver, and that even if the standard had been properly applied, it was still not met, (2) that fraud was not particularly pled (and the Estate was allowed to "ambush" the Appellants at the hearing with allegations not disclosed in discovery) but, regardless, that the director compensation and management fees were a reasonable exercise of their discretion and were not fraudulent, and finally (3) that the Estate lacked standing to sue except in a derivative suit and the Estate's exclusive remedy is the right to dissent under KRS 271B.13-010.

Analysis

Pleading and Proof for Fraud

The Appellants argue that the items of fraud specifically pled in the complaint were not actually fraudulent. As previously stated, the only allegations of fraud pled in the complaint were that Sykes and McCoy had acted or would act in a manner that was fraudulent, because they:

> failed to comply with the legal demand pursuant to Kentucky Law for the right to inspect the records of the corporation. . .
>
> are believed to have been paying themselves out of the corporate assets the sums of $2100.00 per month each since the beginning of business of the corporation for which they have provided no services to the corporation nor has the corporation derived any benefits . . . .
>
> [and] have purchased with corporate assets vehicles for their own personal use and for which the corporation has received no benefits.

(Plaintiff's complaint at 4.). We may quickly dispense with the first allegation of "fraud" alleged in the complaint, as failure to comply with a statute is not an allegation of fraud, but a failure to comply with statutory law. The remedy for violation of KRS 271B.16-020, if a corporation does allow a shareholder to copy and inspect records within a reasonable time of the demand, is for the trial court to order inspection and copying.

Thus, there remain only the second two allegations of fraud, that Sykes and McCoy paid themselves $2,100 a month from Marrowbone and provided no services therefore, and that they purchased company vehicles which they did not use for corporate purposes.

The Appellants argue that these were items within their discretion under the business judgment rule. The Appellants also argue that all other allegations of fraud were not particularly pled, but that the Estate was allowed to "ambush" them at the hearing with allegations not previously disclosed. The Appellants argue, in the alternative, that even if the Court considers these "ambush" fraud charges, the proof was still insufficient for fraud.

The circumstances constituting fraud must be pled with particularity. CR 9.02. Further, all claims of fraud must be established by clear and convincing evidence. *Farmers Bank and Trust Co. of Georgetown, Kentucky v. Willmott Hardwoods, Inc*., 171 S.W.3d 4, 11 (Ky. 2005). Where the facts or circumstances of a case only allow for inferences, conjecture, or suspicion, such as would "leave reasonably prudent minds in doubt," there is a failure of proof to establish fraud. *Goerter v. Shapiro*, 254 Ky. 701, 72 S.W.2d 444, 446 (Ky. App. 1934).

The elements required to establish a claim of fraud are: (1) a representation which is material to the transaction, (2) that is false, (3) which is made with knowledge of the falsity or with reckless disregard for the truth, (4) with the intent to induce the other party to rely or act upon such representation, and (5) reliance thereon (6) which causes injury to the plaintiff. *Flegles, Inc. v TruServ Corp.*, 289 S.W.3d 544, 549 (Ky. 2009); *United Parcel Service Co. v. Rickert*, 996 S.W.2d 464 (Ky. 1999).

Fraud may also be alleged by omission, however. Fraud by omission has different elements from fraud by misrepresentation, and requires the plaintiff to

show: (1) that the defendants had a duty to disclose a fact or facts, (2) that the defendants failed to disclose such fact, (3) that the failure to disclose induced the plaintiff to act, and (4) that the plaintiff suffered actual damages therefrom. *Rivermont Inn, Inc. v. Bass Hotels & Resorts, Inc*., 113 S.W.3d 636, 641 (Ky. App. 2003). However, a duty to disclose is only created where a fiduciary or confidential relationship exists between the parties, where such duty is imposed by statute, or where the defendant has already partially disclosed facts creating the impression that a full disclosure had been made. *Rivermont Inn*, 113 S.W.3d at 641.

In the present case, the only two allegations of fraud which were pled with particularly concern the $2,100 in "management fees" that Sykes and McCoy paid themselves each month "since the beginning of the business of the corporation" and in their use of company vehicles.[6] The trial court, in its judgment and order, found that Sykes and McCoy "disguised [profits] as management fees and bookkeeping fees."[7] Thus, it is clear from the beginning that the trial court's finding of fraud was made with respect to an allegation which was not particularly pled.

[6] It is of note that the complaint finds fault with Sykes and McCoy for paying themselves $2,100 a month "since the beginning of the business of the corporation." However, no authority was cited before the trial court or before this court for the proposition that the Estate could sue for harms occurring before it was ever a shareholder thereof. Indeed, even if the Estate is viewed as standing in Russell's shoes, Russell himself would not have been able to make any such argument, as he himself voted in favor of the very fees in question.

[7] While the judgment and order mentions the findings of the forensic accountant's report and other instances of impropriety, the only actual factual finding with respect to fraud was that the "[corporation's] profits have been disguised as management fees and bookkeeping fees."

In this case, Sykes and McCoy attempted on numerous occasions to obtain a clearer picture of the allegations of fraud against them. Indeed, the Appellants moved to exclude the Estate's expert prior to trial on the grounds that they had been not been provided with even a basic summary of his testimony concerning fraud prior to the hearing. At the pretrial conference, Appellants' counsel stated, "We got Mr. Lester's report; it does not say anything about fraud." Appellants' counsel further stated that he was "still not exactly sure what the allegations of fraud are." Nonetheless, the trial court allowed in the expert's testimony, allowed the Estate to reference unpled allegations of fraud at the hearing, and eventually itself made extensive reference to a report (the forensic accountant's report) which made wholesale reference to unpled allegations of fraud.

Moreover, it is not apparent from the judgment and order that the trial court even found the elements for fraud or applied the proper test. Rather, the trial court makes broad references to fraud, but makes no findings and draws no conclusions relevant to the elements of fraud as established by Kentucky law. In addition, although the jury was empanelled only in an advisory capacity, it is of note that the jury instructions did not even require the jury to find all of the elements of fraud, as they omitted any reference to reliance, or actions taken in reliance upon any misrepresentation or failure to disclose.

Thus, we reverse the judgment and order of the trial court. On remand, the trial court may consider only those allegations of fraud which have

been specifically pled under CR 9.02.[8] When considering whether the monies paid to Sykes and McCoy in management fees and the use of company vehicles were fraudulent, the trial court shall apply the tests for fraud outlined hereinabove.

To avoid repetition on remand, we note that "[u]nless the articles of incorporation or bylaws provide otherwise, the board of directors may fix the compensation of [the] directors." KRS 271B.8-110. The business judgment rule establishes a presumption, that in making a business decision (such as the fixing of salaries or the purchase of use of company vehicles), the corporate directors "acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Allied Ready Mix Co., Inc. ex rel. Mattingly v. Allen*, 994 S.W.2d 4, 8 (Ky. App. 1998). Generally, "[i]n an action by a minority shareholder questioning the compensation voted on by the directors to an officer, the burden of proof to establish that the salary paid was unreasonable is on the plaintiff." 5A Fletcher, *Cyclopedia of the Law of Private Corporations* § 2181 (2005); *Winberg v. Camp Taylor Development Co*., 264 Ky. 612, 95 S.W.2d 261, 262-63 (Ky. App. 1936); *Venus Oil Corporation v. Gardner*, 244 Ky. 176, 50 S.W.2d 537, 538 (Ky. App. 1932).

However, the trial court shall also keep in mind that the business judgment rule only operates as a presumption in favor of the officers and directors where the decision in question does not involve self interest. "If the board of directors is interested in the transaction . . . the burden shifts to them to show that

[8] To the extent that the forensic report relies on any allegations of fraud not pled particularly, as delineated herein, it shall not be relied upon by the trial court in making its determination.

their actions were fair, honest and reasonable in all respects." 5A Fletcher Cyc. Corp. § 2181; *Holi-Rest, Inc. v. Treloar*, 217 N.W.2d 517 (Iowa 1974); *Evans on Behalf of D & E Copiers, Inc. v. Engelhardt*, 246 Neb. 323, 518 N.W.2d 648 (Neb. 1994); *Koos v. Cent. Ohio Cellular, Inc.*, 94 Ohio App. 3d 579, 641 N.E.2d 265, 272-273 (Ohio App. 1994). Thus, on remand, as Sykes and McCoy were both the voting directors and the officers receiving the monies and corporate vehicles in question, the burden will fall on them to show that their actions were "fair, honest, and reasonable." 5A Fletcher Cyc. Corp. § 2181. We note, as a caution, that the mere fact that a minority shareholder's dividends decrease after the majority shareholders in a closely-held corporation increase their own compensation, does not in itself establish unjust or fraudulent conduct. *Krukemeier v. Krukemeier Mach. & Tool Co., Inc.*, 551 N.E.2d 885 (Ind. App. 1990).

The Appointment of a Receiver

The Appellants also argue that the trial court erroneously applied the standard for appointing a receiver, but nonetheless, that even if the standard was applied properly, it was still not met.

A cause of action for shareholders seeking dissolution on the basis of fraud, illegality, or a deadlock is found under KRS 271B.14-300. In all actions brought under this statutory provision, a circuit court is free to appoint a receiver, so long as notice to all parties is given and a hearing is held on the same. Under KRS 271B.14-320,

> (1) A court in a judicial proceeding brought to dissolve a corporation may appoint one (1) or more receivers to wind up and liquidate, or one (1) or more custodians to manage, the business and affairs of the corporation. The court shall hold a hearing, after notifying all parties to the proceeding and any interested persons designated by the court, before appointing a receiver or custodian. The court appointing a receiver or custodian shall have exclusive jurisdiction over the corporation and all of its property wherever located.

The Appellants cite *Dulworth & Burress Tobacco Warehouse Co. v. Burress*, 369 S.W.2d 129, 132 (Ky. 1963), for the proposition that "[t]he appointment of a receiver . . . is a harsh and extraordinary course of action . . . [and is considered] a remedy of last resort." They further argue that "a receiver should not be appointed where there is available another safe, expedient and adequate remedy." *Id*.

However, the law the Appellants cite is based upon the now-superseded statute, KRS 27.061, which required proof that the property be at risk of loss, removal, or material injury. *Id*. No such requirement is found in KRS 271B.14-320. Rather, it appears that so long as a shareholder action for dissolution has been brought under KRS 271B.14-300 and a hearing has been held on same, then a receiver may be appointed in the trial court's discretion.

As we are reversing and remanding the judgment and order based upon the court's finding of fraud, the court must reconsider the question of whether judicial dissolution is appropriate under KRS 271B.14-300(2) on remand. On remand, the court is free, in its discretion, to reconsider the appointment of a receiver if it so chooses.

Exclusive Remedy of the Dissenter's Rights Provisions

We do not devote significant space to the Appellants' final argument that the Estate is limited to an action brought under the dissenter's rights provisions of KRS 271B.13-020, *et seq*., as nothing in the provisions of KRS 271B.14-300 would prevent the Estate from separately moving the court for judicial dissolution on the basis of fraud or illegality.[9] As the Estate properly brought a shareholder action under KRS 271B.14-300 for judicial dissolution, the court did not err in issuing an injunction to halt any plans of merger or exchange under KRS 271B.11-010, *et seq*.

However, it worthy of note that if the trial court finds no fraud or illegality under KRS 271B.14.300(2)(b) on remand, it would be without authority to further halt any plan of merger or exchange, as the present action was not brought under KRS Chapter 271B.13-010.

Conclusion

In light of the foregoing, we reverse and remand to the Pike Circuit Court for further proceedings consistent with this opinion.

STUMBO, JUDGE, CONCURS.

COMBS, JUDGE, CONCURS IN RESULT ONLY.

[9] Although the Appellants cite to KRS 271B.13-020(2) in arguing that the Chapter provided the Estate's exclusive remedy, this provision speaks to actions brought by a shareholder to challenge a plan of merger, sale or exchange. We agree that in that instance, the dissenter's rights provisions of KRS Chapter 271B.13 are the exclusive remedy. However, an action brought to dissolve a corporation on the basis of fraud or illegality, is not an action to challenge a plan of merger or share exchange.

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