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# Dead on Arrival

## The Perils of Litigating an Aggrieved Shareholder's Breach of Fiduciary Duty Claim

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While it's black letter law that the officers and directors of a corporation owe fiduciary duties to the corporation and its shareholders, applying this principle to the facts of a new case quickly poses complex questions. For example: What duties do officers and directors have to prospective shareholders? What duties do they face regarding injuries to all shareholders collectively? What about injuries to individual shareholders that are separate and distinct from those to other shareholders?

As even these few questions demonstrate, both suing and representing officers and directors in shareholder disputes can be challenging. To make matters worse, litigants commonly lump as many grounds for relief as possible into a single case—regardless of their applicability to the facts at hand. Failure to carefully identify and separate appropriate claims early on, however, can result in costly and protracted arguments over unnecessary and unsuitable theories of recovery. Accordingly, both parties (and the courts) should work to ensure that the initial legal framework actually fits the facts of the case. The following survey provides a simple roadmap to ensure that you, your client, and the court are proceeding with a full and accurate understanding of corporate fiduciary law in South Carolina.

### Corporate fiduciary law in South Carolina: Basic principles

The basic principles of corporate fiduciary law are well established in South Carolina. The South Carolina Code, building upon and incorporating common law fiduciary principles, imposes on directors, officers and majority shareholders the fiduciary duties of loyalty and care.[1] Specifically, the Code requires a director, officer or majority shareholder to act "(1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests

of the corporation and its shareholders."[2]

These fiduciary duties form the basis of corporate law, and they provide the broad outlines for how directors, officers and majority shareholders must conduct themselves.[3] Such fiduciaries cannot take actions that benefit themselves at the expense of the corporation.[4] For example, they cannot engage in transactions that divert proceeds to themselves or otherwise reward themselves with self-dealing bonuses.[5] Nor can they take actions that harm shareholders—for example, reducing a shareholder's equity percentage.[6] While a breach of these duties may be easy to identify, seeking relief for the breach is frequently more complicated. Indeed, litigating your case requires that you educate your client, your opposing counsel, and the court on the correct framework for the facts before you.

## Direct versus derivative claims

Shareholders commonly seek redress for what they believe are breaches of the statutory fiduciary duties described above. Of paramount importance when initiating a lawsuit on behalf of an aggrieved shareholder—or when defending a corporate fiduciary from such a suit—is determining whether the claims are ***direct*** or ***derivative*** in nature.[7]

A direct suit is an action by a shareholder for a harm suffered by that shareholder uniquely—that is, an injury "separate and distinct" from injuries to other shareholders or to the corporation itself.[8] A derivative suit, by contrast, is an action brought by a shareholder *on behalf of* the corporation for a wrong suffered *by the corporation*; it is the default manner of recovery.[9]

This direct-derivative distinction is not merely academic. Indeed, "an individual stockholder has no right to bring an action in his own name and in his own behalf for a wrong committed solely against the corporation."[10] Thus, a direct claim is dead on arrival without allegations of individualized harm. What's more, the procedural requirements of direct and derivative claims also meaningfully differ: complaints for derivative actions must comply with the heightened pleading and demand requirements of Rule 23(b)(1) of the South Carolina Rules of Civil Procedure.[11]

Thus, in order to understand the procedural, pleading, and evidentiary requirements for bringing (or defending) a suit, attorneys must determine initially whether the suit is direct, derivative, or contains claims of both types.[12] Attorneys must also make this distinction before assessing potential damages; while damages for direct actions accrue only to the harmed individual, damages for derivative actions accrue to the corporate entity and "should be divided among all the stockholders in the corporation."[13]

The South Carolina Supreme Court recently articulated a two-prong test for distinguishing direct and derivative cases.[14] "[T]o dis-

tinguish a derivative claim from a direct one, the court considers: (1) who suffered the alleged harm, the corporation or the suing stockholders, individually, and (2) who would receive the benefit of any recovery or other remedy, the corporation or the stockholders individually."[15]

### Derivative claims

*Rivers v. Wachovia Corporation* offers an example of a "classic" derivative action.[16] The plaintiff shareholder sued Wachovia's former officers to recover for the "precipitous decline in value" of his shares during the 2008 "financial crisis."[17] His primary allegation was that the officers' misrepresentations regarding "the financial health of Wachovia" prompted his misguided retention of those shares.[18] The Fourth Circuit Court of Appeals found that the plaintiff "had no leg to stand on," as his theory of personal recovery ran "directly afoul" of the direct-derivative distinction in claiming individual harm from a shareholder-wide injury.[19] It thus deemed dismissal of his action proper.[20]

### Direct claims

In contrast to *Rivers*, *Hite v. Thomas & Howard Company* offers an example of a shareholder's distinct injury providing grounds for a direct claim.[21] In *Hite*, the individual shareholder of a corporation sued its majority shareholder, alleging that the majority shareholder engaged in a scheme to reduce and devalue the percentage of his minority ownership.[22] As a result of a stock exchange agreement between the corporation and its majority shareholder, the individual's ownership interest was reduced from 33.3 percent to 11.5 percent.[23] The South Carolina Supreme Court deemed the harm to the plaintiff shareholder "clearly a particular loss separate and distinct from that of the corporation"; it was not simply a "general diminution in the value of corporate stock."[24] Accordingly, the Supreme Court affirmed the trial court's ruling that a direct action was proper.[25]

## Direct and derivative claims in the investment decision context

The direct-derivative distinction becomes even more significant in cases involving a prospective shareholder's decision to invest. Indeed, many plaintiffs allege damages arising from their decision to purchase stock altogether—typically claiming that the representations prompting their investment were untrue. In such cases, the parties should ask the following question prior to filing (or answering) any complaint: Are the damages based on pre-investment conduct?

Claims based upon misrepresentations to a potential shareholder that induced an investment are direct in nature.[26] Such claims will necessarily be unique because of the inherent factual differences in the representations to individual investors. However, the proper causes of action for such conduct are typically negligent misrepresentation or fraud.[27] Indeed, such facts typically will not give rise to a breach of fiduciary duty claim for one simple reason: fiduciary duties ordinarily cannot apply unless and until the potential investor becomes a shareholder by making the investment.[28] Prior to the formation of this special relationship by the plaintiff's actual investment, the plaintiff lacks grounds for a fiduciary claim.[29]

While this general rule has exceptions, particularly where a handful of individuals jointly form a business,[30] it rests on common sense. The extension of fiduciary duties to even prospective shareholders would create the absurd result that a corporation owes a heightened standard of care to all potential investors (i.e., everyone!).

## The importance of distinguishing direct and derivative claims

Both courts and litigants must take great care in distinguishing direct and derivative claims. As indicated above, litigants can easily misconstrue evidentiary and pleading requirements by misapprehending the nature of their case. What's more, if a trial court refuses to properly distinguish and dismiss

improper direct claims, parties will waste considerable resources litigating the claims only to have an appellate court swiftly dispose of them.[31]

Moreover, courts face an additional incentive to properly distinguish direct and derivative claims: Adherence to this distinction is vital to upholding the policy behind South Carolina corporate law.[32] If derivative actions were not required, a shareholder could recover at the expense of other equally injured shareholders and creditors, as the corporation might lack the capital necessary to satisfy the claims of all its shareholders and creditors. If derivative suits were allowed to proceed as direct suits, then these parties would be prejudiced in their ability to recover losses. A derivative suit properly allows for the equitable pro rata distribution to all parties, and the reasoned policy demanding such equitable distribution should be followed.

Accordingly, both litigants and courts must carefully scrutinize corporate fiduciary claims early on based on the above rules in order to facilitate the efficient—and *proper*—resolution of these matters. The earlier they can do so—and the earlier they remove inapposite claims—the sooner the cases can be resolved.

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## Endnotes

[1] *Protestant Episcopal Church in the Diocese of South Carolina v. Episcopal Church*, 421 S.C. 211, 247, 806 S.E.2d 82, 101 (2017) (citing S.C. Code Ann. § 33-8-300 (2006) for the proposition that a director of a nonprofit organization "owe[d] a fiduciary duty of care, loyalty, and good faith" to the organization).

[2] *Kreischer v. Kerrison Dry Goods Co.*, 172 F.3d 863 (Table), 1999 WL 30836, at *4 (4th Cir. Jan. 26, 1999) (internal quotation marks omitted) (noting that S.C. Code Ann. §§ 33-8-300(a)(1)–(3) provide the general standards for directors; noting that §§ 33-8-420(a)(1)–(3) provide the general standards for officers; and citing *Jacobson v. Yaschik*, 249 S.C. 577, 582–85, 155 S.E.2d 604–05 (1967), for the proposition that "controlling shareholders are also fiduciaries who owe the duties of loyalty and care to the other shareholders"); *see also Mason v. Mason*, 412 S.C. 28, 55 n.8, 770 S.E.2d 405, 419 n.8 (Ct. App. 2015) (citing *Davis v. Hamm*, 300 S.C. 284, 291, 387 S.E.2d 676, 680 (Ct. App. 1989), for the proposition that, "in closely held corporations, a minority stockholder can maintain an action for managerial misconduct and other forms of oppression by majority stockholders").

[3] To the extent that South Carolina case law has gaps, litigants should consult the well-developed body of Delaware law. South Carolina courts frequently examine the laws of other states, particularly Delaware, in the absence of applicable precedent under South Carolina law. *See Santee Oil Co., Inc. v. Cox.*, 265 S.C. 270, 272–73, 217 S.E.2d 789, 791 (1975) (noting that "the courts of Delaware, the home of so many corporations, have had fairly frequent occasion to define and apply such term under corporation law similar to ours").

[4] *See, e.g.*, *In re* NMFC, LLC, 522 B.R. 869, 880 (Bankr. D.S.C. 2015) (citing *In re* Worldwide Wholesale Lumber, Inc., 378 B.R. 120, 126 (Bankr. D.S.C. 2007), for the proposition that an "officer and director . . . had a duty of loyalty to not engage in self-dealing and to not usurp corporate opportunities").

[5] *See, e.g.*, *Brown v. Stewart*, 348 S.C. 33, 50, 557 S.E.2d 676, 685 (Ct. App. 2001) (discussing alleged damages arising from officers' diversion of proceeds to themselves via consulting fees).

[6] *See, e.g.*, *Hite v. Thomas & Howard Co.*, 305 S.C. 358, 361, 409 S.E.2d 340, 342 (1991) (discussing a majority shareholder's scheme to reduce a minority shareholder's ownership from "33.3%" to "11.5%"), *overruled on other grounds by Huntley v. Young*, 319 S.C. 559, 560, 462 S.E.2d 860, 861 (1995).

[7] *See Patterson v. Witter*, 425 S.C. 213, 231–233, 821 S.E.2d 677, 687–88 (2018) (distinguishing between direct and derivative suits and noting the materiality of "inquir[ing] whether the acts of mismanagement charged to the directors affected the plaintiffs *directly*, or as their interests were submerged in the corporation whose assets were thus dissipated" (quoting *Brown v. Stewart*, 348 S.C. 33, 49, 557 S.E.2d 676, 685 (Ct. App. 2001))).

[8] *Id.* at 231, 821 S.E.2d at 687 ("A shareholder may maintain an individual action only if his loss is separate and distinct from that of the corporation. If misconduct by the management of a corporation has caused a particular loss to an individual stockholder, the liability for the management is an asset of the individual stockholder." (citations and internal quotation marks omitted)).

[9] *Id.* ("An action seeking to remedy a loss to the corporation is generally a derivative one." (internal quotation marks omitted) (quoting *Brown*, 348 S.C. at 49, 557 S.E.2d at 684)).

[10] *Ward v. Griffin*, 295 S.C. 219, 221, 367 S.E.2d 703, 704 (Ct. App. 1988) (internal quotation mark omitted) (quoting 19 Am. Jur. 2d *Corporations* § 2245, 147–48 (1986)). Although South Carolina's appellate courts have occasionally acknowledged exceptions to the default rule demanding derivative suits absent shareholder-specific injury, none have applied them. One such exception might apply "where the underlying reasons for requiring a derivative action [are] absent." *See, e.g.*, *Babb v. Rothrock*, 303 S.C. 462, 401 S.E.2d 418 (1991) (consulting—but ultimately declining to apply—this exception where "[t]he claims of corporate creditors [might have been] jeopardized if individual shareholders [were] permitted to satisfy their personal debts by raising a claim which can only be asserted by the corporation"). Another exception might apply where a shareholder "cannot be made whole through a recovery by the corporation." *See Bowen v. Houser*, 2012 WL 2873873, at *3 (D.S.C. July 13, 2012) (declining to apply this exception where a shareholder "could not obtain full relief through a recovery by the corporation" given the FDIC's pending seizure of any recovery). *See also Brown v. Stewart*, 348 S.C. 33, 50, 557 S.E.2d 676, 685 (Ct. App. 2001) (discussing both exceptions).

[11] *See Patterson*, 425 S.C. at 231, 821 S.E.2d at 687 (noting that "the applicability of the . . . pleading requirements of Rule 23(b)(1) are to be determined" on the basis of "whether the claims at issue are direct or derivative"); *Carolina First Corp. v. Whittle*, 343 S.C. 176, 187, 539 S.E.2d 402, 408–09 (Ct. App. 2000) (noting that "the demand requirement of Rule 23 balances a share-

holder's right to assert a derivative claim against a board's duty to decide whether to invest the resources of the corporation in pursuit of the shareholder's claim of a corporate wrong" and characterizing derivative actions "as a remedy of last resort because these actions impinge on the inherent role of corporate management to conduct the affairs of the corporation, including the power to bring suit" (citing *Renfro v. FDIC*, 773 F.2d 657, 658 (5th Cir. 1985))).

[12] *See Patterson*, 425 S.C. at 232, 821 S.E.2d at 687 ("Direct and derivative claims may be brought simultaneously." (citing 19 Am. Jur. 2d *Corporations* § 1922 (2015)); noting further that plaintiffs may choose between direct or derivative claims when the injury suffered has a "dual aspect"—i.e., it "affect[s] both the corporation and the stockholders" (quoting *id.*)).

[13] *Ward*, 295 S.C. at 220, 367 S.E.2d at 703. After all, "any recovery in a derivative suit redounds to the benefit of the corporation. Because any recovered damages 'constitute assets which belong to the corporation,' 'any action therefor must be brought in the right of the corporation, for the benefit of all persons entitled to participate in the distribution of its assets.'" *Rivers v. Wachovia Corp.*, 665 F.3d 610, 615 (4th Cir. 2011) (quoting *Gary v. Matthews*, 148 S.C. 125, 145 S.E. 702, 703 (1928)).

[14] *Patterson*, 425 S.C. at 232, 821 S.E.2d at 687.

[15] *Id.* (internal quotation mark omitted) (quoting 19 Am. Jur. 2d *Corporations* § 1922 (2015)).

[16] *Rivers*, 665 F.3d at 616.

[17] *Id.* at 613.

[18] *Id.* at 614.

[19] *Id.* at 615, 616 (quoting *Allen ex rel. Allen & Brock Constr. Co. v. Ferrera*, 650 S.E.2d 761, 766 (N.C. 2000)).

[20] *Id.* at 616.

[21] *Hite v. Thomas & Howard Co.*, 305 S.C. 358, 361, 409 S.E.2d 340, 342 (1991), *overruled on other grounds by Huntley v. Young*, 319 S.C. 559, 560, 462 S.E.2d 860, 861 (1995).

[22] *Id.* at 360–61, 409 S.E.2d 341–42.

[23] *Id.*

[24] *Id.* at 361, 409 S.E.2d at 342.

[25] *Id.* at 361–62, 409 S.E.2d at 342.

[26] *Bivens v. Watkins*, 313 S.C. 228, 233, 437 S.E.2d 132, 134 (Ct. App. 1993) (noting that the two defendants' misrepresentations, which "induced [the plaintiff] to invest in and surrender her assets to the new business," caused injury "separate and distinct from that of the corporation" because the injury was "different from injuries arising from any actions these individuals may have taken as officers, directors, and managers of the new corporation in dissipating or wasting its assets").

[27] *See, e.g.*, *Bivens*, 313 S.C. at 234, 437 S.E.2d at 135 (analyzing the plaintiff's "negligent misrepresentation and fraud" causes of action); *Rivers v. Wachovia Corp.*, 665 F.3d 610, 613 (4th Cir. 2011) (applying South Carolina law) (noting a plaintiff's causes of action for negligent misrepresentation, fraud, and constructive fraud).

[28] For a summary of the circumstances under which South Carolina law recognizes a fiduciary duty, see *Wired Fox Techs., Inc. v. Estep*, 2017 WL 1135288, at *11 (D.S.C. Mar. 27, 2017) (summarizing *Steele v. Victory Sav. Bank*, 295 S.C. 290, 293–94, 368 S.E.2d 91, 93 (Ct. App. 1988)). Underlying all these relationships is the fiduciary's "actual[] accept[ance] or induce[ment of] the confidence placed in him." *Steele*, 295 S.C. at 295, 368 S.E.2d at 94 (citing 36A C.J.S. *Fiduciary* (1961)).

[29] Promoters, however, owe a fiduciary duty to prospective shareholders. *See* 18 Am. Jur. 2d *Corporations* § 103 (Feb. 2019 Update) ("A promoter participating in the formation and establishment of a corporation at any period prior to its incorporation stands in a fiduciary relation to both the corporation and its stockholders, present and prospective." (citations omitted)).

[30] *See Bivens*, 313 S.C. at 233, 437 S.E.2d at 135 (discussing *Duncan v. Brookview House, Inc.*, 262 S.C. 449, 205 S.E.2d 707 (1974)).

[31] *See, e.g.*, *Brown v. Stewart*, 348 S.C. 33, 38, 557 S.E.2d 676, 679 (Ct. App. 2001) (reversing a trial court's denial of directed verdict on a breach of fiduciary duty claim because the trial court mistook a derivative claim for a direct claim and improperly allowed a shareholder to proceed on an individual action for a generalized reduction in the value of corporate stock).

[32] See *Bowen v. Houser*, 2012 WL 2873873, at *4 (D.S.C. July 13, 2012), for a discussion of the "reasons for requiring a derivative action" upon which the analysis here is based.