STATE OF WISCONSIN
SUPREME COURT
No. 2015AP207

SCOTT SMITH,

Plaintiff-Respondent-Cross-Appellant,

ALPHA CARGO TECHNOLOGY, LLC,

Plaintiff,

v.

GREG KLEYNERMAN,

Defendant-Appellant-Cross-Respondent-Petitioner,

RED FLAG CARGO SECURITY SYSTEMS, LLC,

Defendant.

On Review of a Decision
of the Court of Appeals, on
Appeal from the Circuit Court for Milwaukee County,
Circuit Court Case No. 2011CV018551,
Honorable Pedro A. Colón, Presiding

BRIEF OF DEFENDANT-APPELLANT-CROSS-RESPONDENT-PETITIONER GREG KLEYNERMAN

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page No.

Cases

Statutes

Other Authorities

STATEMENT OF THE ISSUES

1. Whether a 50% member of a member-managed Wisconsin limited liability company owes a fiduciary duty to the other 50% member?

Answered by the court of appeals: The court of appeals held that Kleynerman, a 50% member of a Wisconsin LLC, owed Smith, the other 50% member, a fiduciary duty because Kleynerman held the title of "a corporate officer." *Smith v. Kleynerman*, No. 15AP207, unpublished slip op., ¶24 (Wis. Ct. App. June 16, 2016), App.008.

Answered by the circuit court: The circuit court entered judgment on the jury's award of damages to Smith without addressing any of Kleynerman's arguments regarding the legal insufficiency of Smith's breach-of-fiduciary-duty claim.

2. Whether an LLC member has standing to recover profits allegedly lost by the LLC itself, as an entity?

Answered by the court of appeals: The court of appeals held that Smith, an LLC member, had standing because the LLC's loss of

profits affected Smith "differently" from Kleynerman. *Smith v. Kleynerman*, No. 15AP207, unpublished slip op., ¶42, App.015.

Answered by the circuit court: The circuit court entered judgment on the jury's award of damages to Smith without addressing Kleynerman's standing argument.

3. What is the nature of the circuit court's gatekeeping role under Wis. Stat. § 907.02, which the Legislature adopted so as to import into Wisconsin law the standard under Fed. R. Evid. 702, as articulated in *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993), governing admissibility of expert testimony?

Answered by the court of appeals: The court of appeals held that Kleynerman's challenges to the reliability of the methodologies used by Smith's expert went "to the weight, not the admissibility," of the testimony, and that Kleynerman had "ample opportunity" to test the testimony by cross-examining Smith's expert and introducing the

testimony of his own. *Smith v. Kleynerman*, No. 15AP207, unpublished slip op., ¶38 n.3, App.014.

Answered by the circuit court: In response to Kleynerman's objections to the "principles and methodologies" that Smith's expert used on the witness stand, the circuit court stated "there's nothing for the court to do." (R.153, 9/25/14 Tr. at 195:25–196:14, App.291–292.)

STATEMENT ON ORAL ARGUMENT AND PUBLICATION

This case raises important issues concerning the rights and duties of the members of tens of thousands of Wisconsin limited liability companies, as well as application in our trial courts of the proper standard for admitting expert testimony. The Court should, as it normally does, hear argument and publish its decision.

STATEMENT OF THE CASE

I. NATURE OF THE CASE

This case began with a relatively simple commercial transaction between two Wisconsin limited liability companies. In June 2009, Alpha Cargo Technology, LLC (ACT) sold its patents (its only assets) to Red Flag Cargo Security Systems, LLC (Red Flag) and became a Red Flag sales representative. As the only members of ACT, Greg Kleynerman and Scott Smith both consented to the transaction and signed the operative documents, an Asset Sale Agreement and a Sales Representative Agreement.

Two-and-one-half years later, Smith, in his own right and on behalf of ACT, sued Kleynerman and Red Flag. Smith made numerous claims, but only three went to the jury—ACT's claim against Red Flag for rescission and Smith's claims against Kleynerman for misrepresentation and breach of fiduciary duty. The breach-of-fiduciary-duty claim was the only one on which Smith prevailed. The circuit court denied Kleynerman's motion for

judgment notwithstanding the verdict, and the court of appeals affirmed.

Before this Court are three issues. First, do 50-50 members of a member-managed LLC owe each other common-law fiduciary duties? If not, Smith's breach-of-fiduciary-duty claim fails as a matter of law.

Second, does an LLC member have standing to recover the entity's lost profits? If not, Smith lacks standing to recover the only damages claim he presented to the jury—Smith's 50% interest in profits that ACT purportedly lost because of Kleynerman's alleged misrepresentations.

Third, what is the nature of the circuit court's gatekeeping role with respect to expert testimony? The *only* damages evidence that Smith presented was expert testimony premised on patently unreliable methodologies for calculating ACT's lost profits. The circuit court should have excluded that testimony under Wis. Stat.

§ 907.02. Thus, Smith failed to prove any damages resulting from breach of fiduciary duty.

II. FACTS

A. THE PARTIES

Greg Kleynerman is a first-generation immigrant. Trained as an engineer, he worked as a tailor and owned a dry cleaning business after arriving in Milwaukee from Ukraine in the early 1990s. (R.153, 9/25/14 Tr. at 229:12–236:18.) When the markets in the former Soviet Union opened up to foreign investments, Kleynerman began exporting goods there and eventually concentrated on selling cargo security seals—locks for shipping containers. (*Id.*) Through this business, Kleynerman met Scott Smith. (*Id.* at 237:3–6.)

Smith lives in Minneapolis. In 2007, his wife of 20 years died, having been diagnosed with lung cancer that same year. (R.150, 9/22/14 Tr. at 164:6.) One of the claims that the jury rejected was that Smith had been mentally incompetent at the time of the 2009 transaction because of grief over his wife's death two years before.

(R.1.) Smith studied Spanish and international business, and at one point worked for a cargo security seal manufacturer. (R.150, 9/22/14 Tr. at 135:19–138:10.)

B. KLEYNERMAN'S AND SMITH'S CARGO SECURITY SEAL BUSINESS

1. Smith and Kleynerman Form ACT.

In 2002, Smith and Kleynerman formed ACT to distribute cargo security seals in the United States. ACT was organized as a Wisconsin limited liability company (R.139, DX1[1]), with Smith and Kleynerman each holding a 50% membership interest (R.2, Am. Complaint ¶8). They divided their responsibilities in ACT: Kleynerman was responsible for the "technical" aspects of the business, such as communications with a manufacturer, receipt of products in the United States, storage of inventory (in his garage), and packaging and shipment of products to customers, while Smith

[1] Citations to DX and PX are to defendants' trial exhibits and plaintiffs' trial exhibits, respectively.

was responsible for marketing and sales. (R.154, 9/26/14 Tr. at 24:21–25:16.) They ran ACT out of their homes in Milwaukee and Minneapolis.

The business model was simple. ACT bought cargo security seals, mainly made in Ukraine at a factory whose management and engineers Kleynerman knew and with whom he interacted on seal design, and then resold the seals to customers in the Americas. (R.153, 9/25/14 Tr. at 254:17–255:23; R.139, DX180.) Kleynerman and Smith believed that ACT would achieve improved sales if ACT had patents on the Ukranian seals it was selling. (R.153, 9/25/14 Tr. at 246:11–251:13.) Accordingly, ACT filed patent applications in the United States. (R.139, DX179.) Kleynerman was listed as one of the inventors, and the inventors assigned the rights in the U.S. patents to ACT. (*Id.*)

2. ACT Fails to Achieve Financial Success.

ACT struggled financially at all times. As the worldwide economy was collapsing throughout 2008 and early 2009, it became

evident to Smith and Kleynerman that ACT could not continue operating under the same business model. (R.154, 9/26/14 Tr. at 31:19–34:2; R.139, DX13.) They discussed a number of different options, including closing ACT and getting new jobs. (R.154, 9/26/14 Tr. at 34:11–14, 52:8–13.)

Kleynerman had no money to invest in ACT, and Smith was not willing to invest any of his personal funds. (*Id.* at 44:17–20.) Accordingly, Kleynerman suggested, and Smith agreed, that the only way for them to continue operating ACT was to find investors who would build a manufacturing facility in Milwaukee, which would in turn allow ACT to produce seals in the United States and fulfill orders from an existing inventory. (*Id.* at 46:6–17.)

In late 2008 and early 2009, Kleynerman began discussions with Milwaukee attorney and CPA Bruce Glaser, who expressed interest in forming new companies to buy ACT's assets and then retain ACT as a sales agent. (R.152, 9/24/14 Tr. at 173:12–179:24.)

Because Glaser was not willing to invest as much as was needed to establish manufacturing capabilities, Kleynerman also convinced his old friend, Greg Grinberg, to invest alongside Glaser. (*Id.* at 180:11–16.)

C. GLASER, KLEYNERMAN, AND SMITH NEGOTIATE A TRANSACTION.

1. Glaser Forms Red Flag.

Glaser set up two separate Wisconsin limited liability companies for this transaction: one for production and the other for sales. (*Id.* at 180:21–183:24.) The sales company was the one referred to in this brief as Red Flag. (R.139, DXs 40, 42; R.152, 9/24/14 Tr. at 181–183). Glaser became a 75% owner and Grinberg a 25% owner of each company, reflecting their investments. (R.152, 9/24/14 Tr. at 183:2–184:5.)

2. ACT and Red Flag Execute a Memorandum of Understanding.

In March 2009, Glaser prepared a Memorandum of Understanding (MOU) that described the terms of a potential

transaction between ACT and Red Flag. (R.139, DXs 55, 192; R.152, 9/24/14 Tr. at 184:22–185:6.) From the very first draft, the MOU provided that ACT would sell its patents to Red Flag and become Red Flag's sales representative, for an initial term of one year. (R.139, DX55.) Smith commented on the draft MOU and sought additional consideration for ACT's patents. (*E.g.*, R.152, 9/24/14 Tr. at 188:6–16.)

After the terms were agreed upon, Smith, Kleynerman, and Glaser signed the MOU. (R.139, DX56, App.161–162; R.152, 9/24/14 Tr. at 189:6–190:2.) The final version provided that Red Flag would pay ACT $70,000 for its patents if ACT made no sales (at the rate of $0.05 for each seal sold by Red Flag), or 5% of Red Flag's gross profit on each seal sold up to $45,000 once ACT began selling. (R.139, DX56, App.161.) In addition, as a sales representative of Red Flag, ACT would be paid a commission of 50% of the gross profit on every seal sold. (*Id.*, App.161.) The MOU also contained a provision

entitled "Authorization to Negotiate and Sign Documents," which authorized Kleynerman to sign, *on behalf of ACT*, ancillary documents to "assign all patents, the website, and logo to [Red Flag]." (*Id.*, App.162 (emphasis added).)

3. ACT and Red Flag Enter into Asset Sale and Sales Representative Agreements.

After the MOU was signed, Glaser's counsel prepared drafts of the transactional documents described in it. (R.152, 9/24/14 Tr. at 195:18–196:20.) Glaser and Smith (acting for ACT) negotiated these documents by email and phone over several weeks. (R.139, DX60.) Kleynerman was not involved in the negotiation of these documents and did not comment on the drafts. (*E.g.*, R.139, DXs 58–59.)

Late in the negotiation process, Smith requested a further change from the terms described in the MOU. Specifically, Smith wanted to retain *for himself* ACT's web address. (R.139, DXs 62–63.) Smith contended that, "if I am moved out of the equation for whatever reason," it "will be an undue hardship for me to move

consulting customers to a new site." (R.139, DX63, App.174.) Thus, Smith recognized that Glaser, as the controlling owner of Red Flag, could terminate ACT as a sales representative after one year and do no further business with Smith. Smith was hedging against that risk and ultimately obtained this concession from Glaser. (R.139, DX65.)

On June 4, 2009, Glaser emailed the revised drafts of the deal documents. (R.139, DX66.) Smith responded the next morning that he had signed the documents and would be mailing them back to Glaser. (*Id.*) Smith signed both the Asset Sale Agreement and the Sales Representative Agreement, not once but twice, in his capacity as a 50% member of ACT and also on behalf of ACT, using the title "President."[2] (R.139, DXs 67–68, App.180–197.) Kleynerman later

[2] Unlike corporations, which have shareholders, directors, and officers, *see* Wis. Stat. § 180.0840, LLCs have members and managers, *see* Wis. Stat. § 183.0401. ACT had no operating agreement and was member-managed, but Smith and Kleynerman gave each other the titles of President and Executive Vice President, respectively. (R.139, PXs 12, 15.)

signed the documents, too, as a member. (R.154, 9/26/14 Tr. at 60:17–21.)

4. After the Sale of Patents to Red Flag, Kleynerman Concentrates His Efforts on Establishing Manufacturing Capabilities, While Smith Concentrates on Marketing and Sales.

After June 2009, Red Flag located factory space in Milwaukee for production and began to buy the equipment necessary to make seals. (R.152, 9/24/14 Tr. at 211:7–23.) Kleynerman worked on production and design improvements (*id.* at 252:20–23), while Smith worked on sales (*id.* at 192:21–193:1, 212:6–10).

As Glaser spent more time with Smith, however, he became increasingly concerned with Smith's efforts and lack of responsiveness. (*Id.* at 212:11–17.) During the year after the sale of ACT's patents to Red Flag, ACT did not generate any significant sales in its capacity as a sales representative. (R.153, 9/25/14 Tr. at 220:13–221:11.) After Smith missed a scheduled pitch with a large potential customer and failed to file ACT's annual report with the

Wisconsin Department of Financial Institutions (resulting in ACT's administrative dissolution), Glaser terminated ACT as Red Flag's sales representative. (R.152, 9/24/14 Tr. at 214:12–216:10, 224:17–225:23; R.154, 9/26/14 Tr. at 78:17–80:24; R.139, DXs 112, 114.)

5. Kleynerman Continues to Work With Red Flag.

By the time Red Flag terminated ACT in May 2010, Glaser had already invested over $150,000 into the business. (R.139, DX50; R.152, 9/24/14 Tr. at 229:22–230:19.) Red Flag, however, still did not have any significant sales. (R.139, PX159.) Hoping to recover his investment, Glaser asked Kleynerman to continue to work on product improvements, and Kleynerman agreed, hoping to have Red Flag generate enough sales to pay ACT the purchase price for the patents. (R.152, 9/24/14 Tr. at 226:2–24.) Glaser also offered Smith the opportunity to make sales of Red Flag's cargo security seals and earn personal commissions on those sales, but Smith expressed no interest. (R.139, DX120.)

D. GLASER SELLS HIS 75% INTEREST IN RED FLAG TO KLEYNERMAN.

By February 2011, Glaser had invested over $210,000 in Red Flag but had yet to see significant sales; accordingly, he decided that he no longer wanted to be actively involved with the company. (R.152, 9/24/14 Tr. at 227:21–25.) So Glaser sold his 75% interest in Red Flag to Kleynerman for the same capital contribution that Glaser had made when he organized Red Flag with Grinberg in 2009. (*Id.* at 233:12–24.) Red Flag, however, remained liable for the loans it had received from both Glaser and Grinberg. (*Id.* at 228:6–10.)

Kleynerman then set about redesigning the seals to streamline the assembly process and reduce costs. (R.154, 9/26/14 Tr. at 94:9–24, 96:1–97:25.) Later, he also redesigned the software supporting the product, which led Red Flag to focus on a different customer base. (*Id.* at 98:3–99:23.) In contrast to ACT, which had operated with minimal overhead from Kleynerman's and Smith's homes, Red Flag

had numerous expenses relating to manufacturing space, utilities, equipment, and employee salaries. (R.139, PX154.) Thus, while Red Flag's revenues increased in the wake of Kleynerman's improvements, the company achieved only meager net income. (*See* R.139, DXs 161–164.)

III. PROCEDURAL HISTORY AND DISPOSITION BELOW

A. PROCEEDINGS IN THE CIRCUIT COURT

On December 19, 2011, Smith sued Kleynerman and Red Flag, on his own behalf and purportedly on behalf of ACT.[3] Smith's amended complaint alleged a host of claims, including: (1) rescission of the transaction between ACT and Red Flag because of Smith's mental incompetence; (2) intentional misrepresentation;

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[3] The amended complaint failed to describe with particularity Smith's authority to bring a derivative suit on behalf of ACT and why Kleynerman's interest should be disregarded. *See* Wis. Stat. §§ 183.1101 (setting forth requirement for "affirmative vote" of members to sue on behalf of a limited liability company) and 183.0404(1)(a) (defining "affirmative vote" as "more than 50%"); *Carhart-Halaska Int'l v. Carhart, Inc.*, 920 F. Supp. 2d 971, 973 (E.D. Wis. 2013) (describing the requirement under Wis. Stat. § 183.1101(3) that a complaint alleging a derivative claim "state with particularity the authorization of the member to bring this action").

(3) negligent misrepresentation; (4) strict responsibility misrepresentation; (5) breach of the duty of good faith; (6) breach of fiduciary duty; (7) accounting; (8) unjust enrichment; and (9) violation of Wis. Stat. § 968.61. (R.2.)

None of Smith's claims were dismissed during three years of pretrial activity, but the focus during both discovery and trial was on the rescission claim and Smith's alleged mental incompetence to negotiate and execute the transaction between ACT and Red Flag in 2009, on account of his grief over his wife's death in 2007. With respect to damages, the only evidence Smith introduced was the opinion of his expert, Paul Rodrigues, which was limited in his expert report to damages resulting from Kleynerman's alleged misrepresentation and the alleged loss of Smith's interest in ACT.[4]

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[4] When Kleynerman sought to clarify whether Rodrigues's testimony extended beyond the damages presented in the expert report, Smith's counsel said that he was stipulating that the expert's testimony was limited to what was asserted in the report. (R.153, Tr. 9/25/14 at 182:15–17, App.278.) When Kleynerman specifically asked if Rodrigues had calculated damages resulting from the alleged breach of fiduciary duty, Smith objected that the question called for a

Although his expert report calculated Smith's damages to be $175,000, Rodrigues testified at trial that Smith's damages comprised 50% of the profits that ACT supposedly lost from selling its patents to Red Flag—between $449,000 and $489,000. (R. 153, 9/25/14 Tr. at 146:2–22, App.242.) Then, at the end of trial, Smith abandoned all of his personal claims against Kleynerman except for the misrepresentation and breach-of-fiduciary-duty claims. (*See* R.112, App.059–064.)

Smith lost on all but one of the claims that went to the jury. The jury returned a verdict in favor of Red Flag on the rescission claim and in favor of Kleynerman on the misrepresentation claim. (*Id.*, App.059–060.) On the breach-of-fiduciary-duty claim, however, the jury found in favor of Smith and awarded him $499,000 in

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"legal conclusion" but then immediately added that he would "stipulate," again signifying that no damages for breach of fiduciary duty were ever calculated or presented to the jury. (*Id.* at 185:6, App.281.) Rodrigues also admitted that Smith did not lose and continues to hold a 50% interest in ACT. (*Id.* at 162:14–24, App.258.)

compensatory damages and $200,000 in punitive damages. (*Id.*, App.062–063.)

Both parties filed post-verdict motions: Kleynerman sought judgment notwithstanding the verdict or a new trial on the breach-of-fiduciary-duty claim and the award of punitive damages, while Smith sought to change the misrepresentation verdict. (R.116–121.) The circuit court granted Kleynerman's motion on punitive damages but entered judgment on the verdict in all other respects. (R.122, App.022–023.) The court did not address any of Kleynerman's arguments that the breach-of-fiduciary-duty claim was legally deficient, instead simply deferring to the jury's decision. The court explained:

> You know, the jury trial is something you both requested. The jury comes in here. They deliberate on the evidence. We're supposed to defer to them as to their findings. You know, it's basically the constitutional way in which we like to do things in this country. So you presented your cases before them. They found what they found and unless I see that you're citing to any particular lack of evidence which a

jury cannot draw the inference to find their answer to, they will be sustained.

(R.156, 11/25/14 Tr. at 19:3–13, App.043.)

B. PROCEEDINGS IN THE COURT OF APPEALS

Kleynerman appealed, again raising challenges to the breach-of-fiduciary-duty verdict. Smith's arguments about the source of Kleynerman's purported fiduciary duty changed on appeal. In the circuit court, Smith had argued that Kleynerman owed him a fiduciary duty because Kleynerman was his agent by virtue of a provision in the MOU giving Kleynerman authority to sign ancillary documents on behalf of ACT to effectuate assignment of patents.[5] (R. 121.) On appeal, Smith maintained his agency argument but also asserted that 50-50 members of a member-managed LLC have fiduciary duties to each other because they are "like" partners in a partnership. (Smith Ct. App. Resp. Br. at 18–29.)

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[5] Wis. Stat. § 183.0301(1) says plainly that "[e]ach member is an agent of the limited liability company *but not of the other members or any of them*, for the purposes of its business." (Emphasis added).

The court of appeals affirmed. *Smith v. Kleynerman,* No. 15AP207, unpublished slip op., App.001. In concluding that Kleynerman owed Smith a fiduciary duty, the court did not accept Smith's "like partners" argument, but adopted language from decisions involving *corporations* and holding that corporate officers have fiduciary duties to "the corporation and its shareholders." *Id.* ¶25, App.008. In this context, the court cited a jury instruction that Kleynerman "held an officer position with ACT" and that officers "occupy fiduciary positions and are held to strict rules of honesty and fair dealing *between themselves and their employers.*" *Id.* ¶26, App.008 (emphasis added). The court of appeals apparently concluded that this instruction meant Kleynerman had a fiduciary duty not only to his *employer* (ACT), but also personally to the only other LLC member (Smith), a point supported by neither the cited case law nor the jury instructions.

Regarding Smith's standing to recover ACT's lost profits, the court rejected Kleynerman's argument that "lost profits ... damages belong to ACT rather than its members." *Id.* ¶40, App.014. Beginning, oddly, with language from a case in which this Court held that the plaintiffs did *not* have standing to pursue their claim, *see Krier v. Vilione*, 2009 WI 45, ¶¶20–22, 317 Wis. 2d 288, 766 N.W.2d 517, the court of appeals held that Smith's claim for lost profits was properly a "direct" claim because ACT's lost profits affected Smith "differently" than they affected Kleynerman. *Smith v. Kleynerman*, No. 15AP207, unpublished slip op., ¶¶41–42, App.014–015.

Finally, the court of appeals devoted just a footnote to Kleynerman's argument that the testimony of Smith's damages expert should have been excluded under § 907.02:

> Kleynerman also challenges Rodrigues's methodology and calculations as part of his argument, both at trial and on appeal, that the circuit court erroneously did not exclude Rodrigues's testimony for failing to meet the *Daubert* standard set forth in Wis. Stat. § 907.02 (2013–14). However, we agree with the circuit court that

> Kleynerman's challenges go to the weight, not the admissibility, of Rodrigues's testimony, and that Kleynerman had ample opportunity to test Rodrigues's testimony through cross-examination and his own expert's testimony.

Id. ¶38 n.3, App.014.

STANDARD OF REVIEW

Whether a fiduciary duty exists is a question of law, subject to *de novo* review. *See Estate of Shepard ex rel. McMorrow v. Specht*, 2012 WI App 124, ¶5, 344 Wis. 2d 696, 824 N.W.2d 907.

Whether a member has standing to recover a limited liability company's lost profits is a question of law, subject to *de novo* review. *See Park Bank v. Westburg*, 2013 WI 57, ¶37, 348 Wis. 2d 409, 832 N.W.2d 539.

The decision to admit expert testimony is reviewed for an erroneous exercise of discretion. *Weborg v. Jenny*, 2012 WI 67, ¶41, 341 Wis. 2d 668, 816 N.W.2d 191. A circuit court erroneously exercises its discretion when it applies an incorrect legal standard. *Id.* Determining whether the circuit court applied the wrong legal standard requires the Court to interpret Wis. Stat. § 907.02, which presents a question of law, subject to *de novo* review. *Id; see also State v. Alger*, 2015 WI 3, ¶21, 360 Wis. 2d 193, 858 N.W.2d 346.

ARGUMENT

In its first and (so far) only discussion of the topic, this Court described a limited liability company as "a distinct business entity that adopts and combines features of both partnership and corporate forms." *Gottsacker v. Monnier*, 2005 WI 69, ¶¶13–14, 281 Wis. 2d 361, 697 N.W.2d 436. This case requires the Court to confirm several points implicit in *Gottsacker*.

First, as Justice Roggensack explained in her *Gottsacker* concurrence, LLCs are creatures of statute, so that the rights and obligations of both the entity and its members are set by statute. *Id.* ¶45 (Roggensack, J., concurring). Our LLC statute, the Wisconsin Limited Liability Company Law (WLLCL), Wis. Stat. ch. 183, does not impose default fiduciary duties on LLC members, *see* Wis. Stat. § 183.0402 (setting forth duties of managers and members), and ACT did not have an operating agreement to impose any such duties. Nevertheless, the court of appeals held that Kleynerman owed a common-law fiduciary duty to Smith. The court's decision is

inconsistent with the Legislature's pronouncement in chapter 183 and this Court's prior discussion of LLCs.

The court's failure to recognize the fact and consequences of an LLC's distinct legal form carried over to its standing analysis. One feature that LLCs take directly from the corporate context is the principle that certain claims belong to the LLC itself and may only be brought by its members on its behalf. *Compare* Wis. Stat. § 180.0741 (defining who may bring a derivative action on behalf of a corporation), *with* Wis. Stat. § 183.1101 (defining who may sue on behalf of an LLC). By holding that Smith had standing to recover ACT's lost profits, the court of appeals ignored this crucial distinction between claims belonging to an LLC and claims belonging to its members.

Finally, by holding that the circuit court had no role to play in ensuring the reliability of the expert testimony that Smith introduced as his only evidence of ACT's lost profits, both lower

courts failed to follow the *Daubert* standard for the admissibility of expert testimony, which the Legislature adopted in 2011. *See* 2011 Wis. Act 2. The testimony of Smith's expert was patently unreliable, and the lower courts' unwillingness to fulfill or mandate the trial court's exercise of its gatekeeping function under the statute calls out for both correction and clarification from this Court.

I. KLEYNERMAN DID NOT OWE SMITH A FIDUCIARY DUTY.

The court of appeals concluded that Kleynerman owed Smith a fiduciary duty "by virtue of [Kleynerman's] being a corporate officer of ACT." *Smith v. Kleynerman*, No. 15AP207, unpublished slip op., ¶ 24, App.001.[6] To reach that conclusion, the court looked to a

[6] The court of appeals did not rely on (or even mention) Smith's other arguments that Kleynerman assumed a fiduciary duty to Smith, either through a provision in the MOU that gave Kleynerman authority to sign ancillary documents on ACT's behalf to effectuate assignment of patents (R.139, PX8), or through Kleynerman's alleged assurances to Smith in 2007 that he would handle ACT's affairs while Smith grieved the loss of his wife (R.150, 9/22/14 Tr. at 167:14–21). None of these arguments is even remotely plausible, as Kleynerman demonstrated below. Indeed, both the MOU provision and the statements from Kleynerman that Smith cited *expressly* relate to Kleynerman's authority and

jury instruction providing that "Kleynerman 'held an officer position with ACT' and that officers 'occupy fiduciary positions and are held to strict rules of honesty and fair dealing between themselves and their *employers*.'" *Id.* ¶26, App.008 (emphasis added).

The instruction that the court cited provides an accurate statement of *corporate* law and the duties that corporate officers and directors owe *to the corporation*. However, the instruction does nothing to resolve the question of whether Kleynerman, who was a member of an *LLC*, owed a fiduciary duty *to the LLC's other member*, Smith.[7]

More importantly, Kleynerman could be described as an "officer" of ACT only in the sense that he and Smith gave each other

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obligations relative to *ACT*; the language that Smith points to makes no mention whatsoever of any duties to *Smith*.

[7] The breach-of-fiduciary-duty claim that Smith brought *on behalf of ACT* never made it to the jury, so the instruction that the court cited regarding a corporate officer's duties to his employer was irrelevant to the jury's verdict regarding *Smith's* fiduciary duty claim. After all, Smith was not Kleynerman's employer.

the titles of "President" and "Vice-President," but this surely did not transform ACT from a limited liability company into a corporation. *Cf. Obeid v. Hogan*, No. 11900-VCL, 2016 WL 3356851, at *6 (Del. Ch. June 10, 2016) (noting that while members of an LLC may choose to incorporate aspects of governance from the corporate and partnership contexts, "[i]t is important not to embrace analogies to other entities or legal structures too broadly or without close analysis"). It is undisputed that Kleynerman and Smith are 50-50 members of a member-managed LLC. *See, e.g.*, Smith Ct. App. Resp. Br. 19 (acknowledging that Kleynerman and Smith are "equal members in an LLC") and that ACT never elected to be governed by managers. Accordingly, the relevant question is whether LLC members owe fiduciary duties to each other as a matter of law. The WLLCL does not impose fiduciary duties between or among members, so, without an agreement by the members to undertake such duties, they do not arise. Justice Roggensack explained these

principles in *Gottsacker*, and this important point of the law governing Wisconsin LLCs should be confirmed.

Limited liability companies are creatures of statute. Accordingly, the rights and duties of LLC members are governed by the WLLCL. *Gottsacker*, 281 Wis. 2d 361, ¶45 & n.3 (Roggensack, J., concurring); *accord CML V, LLC v. Bax*, 28 A.3d 1037, 1045 (Del. 2011) ("[W]hen adjudicating the rights, remedies, and obligations associated with Delaware LLCs, courts must look to the LLC Act because it is only the statute that creates those rights, remedies, and obligations."). Nothing in Wis. Stat. § 183.0402, which sets forth the duties of managers and members, mentions any fiduciary duty *between* members, though the statute does permit members to undertake such duties through the LLC's operating agreement.

The policy decision expressed by the Legislature in § 183.0402 is sound. One who assumes a fiduciary duty "consciously sets another's interests before his own." *Zastrow v. Journal Commc'ns,*

Inc., 2006 WI 72, ¶28, 291 Wis. 2d 426, 718 N.W.2d 51. By its very nature, this sort of heightened duty can only be undertaken voluntarily. *Id.* (describing fiduciary duties as "those obligations that are ... based on the *conscious* undertaking of a special position with regard to another") (emphasis added). The Legislature's decision to permit LLC members to assume fiduciary duties by contract, but not to impose them by default, is consistent with their voluntary nature.

The Legislature's choice is also consistent with the nature of the relationship between members of an LLC. Our Wisconsin "[c]ourts have developed fiduciary law by analogy: by identifying paradigm cases in which a fiduciary relationship was found to exist and examining whether the relationship under consideration is sufficiently like those in paradigm cases to support an extension of the obligation to that relationship." *Id.* ¶25 (internal quotation marks omitted). Among these paradigmatic relationships are

principal-agent, attorney-client, trustee-beneficiary, and guardian-ward. *Id.*; *see also Prod. Credit Ass'n v. Croft*, 143 Wis. 2d 746, 752, 423 N.W.2d 544, 546 (Ct. App. 1988). Common to all of these relationships is that one individual has "accepted a position of authority with regard to the affairs of another." *Zastrow*, 291 Wis. 2d 426, ¶25.

The relationship between equal members of a member-managed LLC looks nothing like any of the paradigmatic fiduciary relationships. To the extent that the members of an LLC are the entity's owners, *see* Wis. Stat. § 183.0801, they are in many ways the counterparts of shareholders in a corporation, since an LLC (a *limited liability* company), like a corporation, limits an owner's liability for the debts of the firm. Just as equal shareholders do not undertake a fiduciary duty to each other by virtue of their stock ownership, *see Specht*, 344 Wis. 2d 696, ¶¶6–7 (holding that a 50% shareholder does not owe a fiduciary duty to the other 50% shareholder), equal

members of an LLC do not assume a responsibility to put the interests of their fellow members before their own.[8]

Regardless whether the Legislature's choice constitutes sound policy, setting that policy is its job. Some states have enacted statutes that explicitly impose fiduciary duties between members of a member-managed LLC, unless the LLC's operating agreement provides otherwise. *See, e.g.*, 805 Ill. Comp. Stat. 180/15-3; Minn. Stat. § 322C.0409; Ohio Rev. Code Ann. § 1705.281. The absence of a comparable provision in the WLLCL cannot simply be discounted

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[8] In contrast, majority shareholders owe a fiduciary duty to minority shareholders under certain circumstances, and corporate directors and officers always owe a fiduciary duty to all shareholders. *See Estate of Shepard ex rel. McMorrow v. Specht*, 2012 WI App 124, ¶¶7–8, 344 Wis. 2d 696, 824 N.W.2d 907. This makes sense. Corporate directors and officers *have* assumed "a position of authority with regard to the affairs" of other shareholders, bringing the relationship much more in line with the paradigmatic fiduciary relationships. *Zastrow v. Journal Commc'ns, Inc.*, 2006 WI 72, ¶25, 291 Wis. 2d 426, 718 N.W.2d 51. Whether similar duties should ever apply between managing and non-managing members of an LLC, or between majority and minority members, is debatable. *See Gottsacker*, 2005 WI 69, ¶45, (Roggensack, J., concurring) (explaining that, in the context of LLCs, "[c]ommon law concepts such as the fiduciary duty of a majority shareholder of a corporation to a minority shareholder are replaced by statutory obligations"). In any event, this case presents neither of those scenarios.

by "engraft[ing] a common law fiduciary duty" onto the statute. *Gottsacker*, 281 Wis. 2d 361, ¶45 n.3 (Roggensack, J., concurring); *see also Crown Castle USA, Inc. v. Orion Constr. Grp., LLC*, 2012 WI 29, ¶25, 339 Wis. 2d 252, 811 N.W.2d 332 ("We cannot interpret the silence of the statute to create a statutory right.").

The Virginia Supreme Court's decision in *Remora Investments, LLC v. Orr*, 673 S.E.2d 845 (Va. 2009), is instructive. The court was asked whether members of a Virginia LLC owe fiduciary duties to each other. Like its Wisconsin counterpart, the Virginia Limited Liability Company Act does not provide for default fiduciary duties between members. *Compare* Va. Code Ann. § 13.1-1024.1, *with* Wis. Stat. § 183.0402. In contrast, Virginia's general partnership law—again, like Wisconsin's newly enacted (2015 Act 295) version of the Uniform Partnership Law—expressly imposes certain specifically prescribed fiduciary duties between partners. *Compare Remora*, 673

S.E.2d at 847 (citing Va. Code Ann. § 50-73.102(A)), *with* Wis. Stat. § 178.0409.

Against this statutory backdrop, the Virginia court concluded that LLC members do not owe fiduciary duties to each other. *Remora*, 673 S.E.2d at 847. The court reasoned that "if the General Assembly had wanted to impose such fiduciary duties it would have done so explicitly, as it did in the partnership statute." *Id.* That reasoning applies with equal force here.

While courts in some states—and one federal trial judge in Wisconsin—have adopted a less textual approach to interpreting LLC statutes,[9] the Delaware Supreme Court, regarded as one of the leading authorities on the law governing organized business entities,[10] has cautioned against that approach. Before 2013, the

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[9] *See Exec. Ctr. III, LLC v. Meieran*, 823 F. Supp. 2d 883, 891–92 (E.D. Wis. 2011) (collecting cases from Indiana, Kentucky, California, Connecticut, and Idaho).

[10] Delaware is "a jurisdiction to which Wisconsin courts often look for 'guidance on corporate law.'" *See Notz v. Everett Smith Grp., Ltd.* 2009 WI 30, ¶35, 316 Wis. 2d 640, 764 N.W.2d 904.

Delaware Limited Liability Company Act provided: "To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager ... the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement." Del. Code Ann. tit. 6, § 18-1101(c) (2012). Although the Delaware Court of Chancery had interpreted the statute's reference to fiduciary duties "at law or in equity" to incorporate common-law fiduciary duties into the statutory scheme, the Supreme Court declared in 2012 that "the question remains open" whether members of an LLC owe default fiduciary duties to each other. *Gatz Props., LLC v. Auriga Capital Corp.*, 59 A.3d 1206, 1218 n.62 (Del. 2012).

Characterizing the Delaware statute as "consciously ambiguous," the court called on the Legislature to provide clarification. *Id.* at 1219. In response, the general assembly amended

the statute to provide: "In any case not provided for in this chapter, the rules of law and equity, *including the rules of law and equity relating to fiduciary duties* and the law merchant, shall govern." *See* Del. Code Ann. tit. 6, § 18-1104 (2014) (emphasis added).

If Delaware's pre-2013 Limited Liability Company Act, which *actually referred* to fiduciary duties, was ambiguous, Wisconsin's statute, which does not even mention fiduciary duties, is crystal clear: Members of an LLC do not owe default fiduciary duties to each other.

None of this is to say that members are without a remedy for wrongful conduct by another member. As this Court held in *Gottsacker*, a member can sue another member for a "willful failure to deal fairly ... in connection with a matter in which the member ... has a material conflict of interest." 281 Wis. 2d 361, ¶¶29–31 (construing § 183.0402(1)(a)). A member can also bring any number of other common-law tort claims against his fellow members; here,

for example, Smith sued Kleynerman for misrepresentation (and lost). Finally, LLC members can, of course, agree by contract that they will assume fiduciary duties to each other. *See id.*, 281 Wis. 2d 361, ¶45 (Roggensack, J., concurring) (citing Wis. Stat. § 183.0102(16)); *see also* Wis. Stat. § 183.0402(3).

Indeed, as the facts of the present case demonstrate, imposing common-law fiduciary duties on LLC members toward other, equal members is by far the more unworkable alternative. Boiled down, Smith's breach-of-fiduciary-duty claim was that Kleynerman was obliged to advance Smith's personal interests—at the expense of his own—*in a transaction that Smith himself negotiated, approved, and executed.* A decision to recognize such a duty would not only contravene the will of the Legislature but would also create a multitude of perverse incentives for LLC members who are disappointed with the results of any transaction of the enterprise that turns out poorly for them personally.

The court of appeals' decision that Kleynerman owed a fiduciary duty to Smith contradicts the will of the Legislature on the issue. This Court should hold that no common-law fiduciary duties exist between members of an LLC.

II. SMITH LACKED STANDING TO RECOVER ACT'S LOST PROFITS.

The court of appeals' errors regarding duties among LLC members carried over into its standing analysis, such as it was. By holding that Smith had standing to recover ACT's lost profits, the court wrongly permitted a member to assert a claim that belonged to the LLC.

Wisconsin law is clear that corporate shareholders may only recover damages sustained by the corporation through a derivative action brought on behalf of the corporation; they may not sue on their own behalf. *See Park Bank*, 348 Wis. 2d 409, ¶44 ("[I]n a direct action the individual may not claim damages sustained by the corporation or damages that the corporation could have sought in its

own capacity."); *see also Everett Smith Grp.*, 316 Wis. 2d 640, ¶20; *Rose v. Schantz*, 56 Wis. 2d 222, 229, 201 N.W.2d 593, 597 (1972). Likewise, the WLLCL provides that certain claims belong to the LLC itself and may only be brought derivatively by its members. *See* Wis. Stat. § 183.1101; *Gottsacker*, 281 Wis. 2d 361, ¶48 (Roggensack, J., concurring). This makes sense because an LLC, like a corporation, is an *organized* entity, which means that there is a distinction between claims belonging to it and claims belonging to its individual owners (shareholders or members). *Cf. Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 293–94 (Del. 1999) ("The derivative suit is a corporate concept grafted onto the limited liability form."); *Obeid*, 2016 WL 3356851, at *7 (noting that "case law governing corporate derivative suits is generally applicable to suits on behalf of an LLC").

Whether a claim belongs to an organized entity or its owners depends on who suffered the alleged injury. *See Everett Smith Grp.*, 316 Wis. 2d 640, ¶23. If the primary injury is to the entity, an owner

cannot bring a direct action, even if he or she suffers secondary harm as a result of the entity's injury. *Id.*; *see also Rose*, 56 Wis. 2d at 229 ("That such primary and direct injury to a corporation may have a subsequent impact on the value of the stockholders' shares is clear, but that is not enough to create a right to bring a direct, rather than derivative action."). Rather, a direct action is only available if the alleged injury affects the owner's rights "in a manner distinct from the effect" on other owners. *Everett Smith Grp.*, 316 Wis. 2d 640, ¶23 (quoting *Jorgensen v. Water Works, Inc.*, 2001 WI App 135, ¶16, 246 Wis. 2d 614, 630 N.W.2d 230).

At trial, the only evidence of damages that Smith presented was the testimony of his expert regarding the profits that ACT purportedly lost as a result of selling its assets to Red Flag. (*E.g.*, R.153, 9/25/14 Tr. at 116:15–18, App.211.) ("[D]id you come to an opinion regarding the lost profits to ACT in the period of time 2009 to the present? A. Yes, I did.") The expert calculated Smith's

damages as the 50% share of the profits that Smith would have been entitled to based on his membership interest in ACT. (*Id.* at 138:10–13, App.233.)

Lost-profits claims of this sort are quintessentially derivative claims because the damages to the entity and its owners are, by definition, one and the same. *See Park Bank*, 348 Wis. 2d 409, ¶43 ("Thus, where an individual's injury results from the corporation's injury, the resulting claim is derivative and the individual lacks standing to raise it in a direct action."); *accord Nelson v. Anderson*, 84 Cal. Rptr. 2d 753, 762 (Cal. App. 1999) ("A lost opportunity to increase corporate assets or net worth is the most common situation in which a derivative action is the only appropriate remedy."). The very fact that Smith sought damages in proportion to his membership interest demonstrates that he was pursuing a claim that properly belonged to the entity.

In holding otherwise, the court of appeals reasoned that Smith's injury was distinct from Kleynerman's because Kleynerman continued to profit from the patents that ACT sold to Red Flag, while Smith did not. *Smith v. Kleynerman*, No. 15AP207, unpublished slip op., ¶42, App.015. Though Kleynerman is a member of Red Flag, which now owns the patents that it bought from ACT, his interest in the patents derives only from his membership interest in Red Flag. As a member in ACT, Kleynerman suffered *precisely the same* "harm" that Smith did: the alleged loss of profits that (according to Smith's expert) ACT would have made had it not sold its patents. *Cf. Jorgensen*, 246 Wis. 2d 614, ¶18 (permitting a direct action against majority shareholders who used their position to deprive minority shareholders of compensation while themselves continuing to receive compensation *in their capacity as shareholders*).

Put differently, *both* Smith and Kleynerman continue to hold a 50% interest in ACT, which the court of appeals characterized as "essentially a defunct sales company now that it has been terminated by Red Flag." *Smith v. Kleynerman*, No. 15AP207, unpublished slip op., ¶42, App.015. The profits that Kleynerman is alleged to have obtained through his ownership interest in Red Flag do not change the nature of the alleged injury to ACT and its members. *See, e.g., Felton v. Teel Plastics, Inc.*, 664 F. Supp. 2d 937, 943 (W.D. Wis. 2009) ("Any action taken by [the] defendants to devalue the assets of [the corporation] would lower the value of all members' interest in the company equally. That defendants are alleged to have profited personally from their mismanagement of company resources does not alter the nature of the alleged injury to the company or the fact that the company owns the claim.").

This Court has repeatedly cautioned against permitting shareholders to bring direct actions based on injuries purely

secondary to the corporation's injuries, as doing so would leave "no reason" for "the concept of derivative actions for the redress of wrongs to a corporation." *Rose*, 56 Wis. 2d at 229–30; *see also Everett Smith Grp.*, 316 Wis. 2d 640, ¶23. That principle applies with no less force to LLCs, whose members are likewise permitted by statute to assert the rights of the company only through a derivative action.

III. THE COURTS BELOW IGNORED THE *DAUBERT* STANDARD FOR ADMITTING EXPERT TESTIMONY IN FAVOR OF THE LEGISLATIVELY SUPERSEDED "RELEVANCE" STANDARD.

In 2011, the Legislature amended the previous, Court-adopted Wis. Stat. § 907.02 governing the admissibility of expert testimony, and adopted the federal interpretation of Fed. R. Evid. 702 announced in *Daubert*. *See* 2011 Wisconsin Act 2. Under *Daubert*, the trial court acts as a "gatekeeper" for expert testimony, which must be based on reliable methodologies in order to be admissible. *See generally State v. Giese*, 2014 WI App 92, 356 Wis. 2d 796, 854 N.W.2d 687. Rather than applying this standard, however, both the circuit

court and the court of appeals applied the superseded, pre-*Daubert* "relevance" test. *See 260 N. 12th St., LLC v. State DOT*, 2011 WI 103, ¶55 & n.10, 338 Wis. 2d 34, 808 N.W.2d 372 (discussing Wisconsin's standard for the admissibility of expert testimony before 2011). Assessed under the proper standard, the methodology that Smith's expert used to calculate ACT's alleged lost profits was not just unreliable; it defied common sense. The expert's *ipse dixit* testimony was exactly the sort of "evidence" that should never be given to a jury to sort out on its own.

A. To Be Admissible Under the *Daubert* Standard, Expert Testimony Must Be Based on Reliable Methodologies.

The fundamental goal of *Daubert* "is to prevent the jury from hearing conjecture dressed up in the guise of expert opinion." *Giese*, 356 Wis. 2d 796, ¶19 (citing, *inter alia*, Daniel D. Blinka, *The Daubert Standard in Wisconsin: A Primer*, Wisconsin Lawyer, March 2011, at 60 ("[c]oursing through *Daubert* lore is a palpable fear of *ipse dixit* ('because I said so') testimony" (citation omitted)), and Ralph Adam

Fine, Fine's Wisconsin Evidence 34 (Supp. 2012) ("Under *Daubert*, the testimony of the witness [is to be] 'more than subjective belief or unsupported speculation.'" (quoting *Daubert*, 509 U.S. at 590))).

To that end, *Daubert* requires courts to "ensure that the evidence is relevant and reliable before admitting it." *Lees v. Carthage Coll.*, 714 F.3d 516, 521(7th Cir. 2013) (citing *Daubert*, 509 U.S. at 588–89) (emphasis added). Ensuring reliability in this context entails asking "whether the scientific principles and methods that the expert relies upon have a reliable foundation 'in the knowledge and experience of [the expert's] discipline.'" *Giese*, 356 Wis. 2d 796, ¶18 (quoting *Daubert*, 509 U.S. at 592) (alterations in original).

The circuit court ignored this gatekeeping function, and the court of appeals only compounded the error. First, the circuit court stated that "there's nothing for the court to do" regarding whether Smith's expert was applying "acceptable principles and methodology." (R.153, 196:2–14, App.292.) In affirming the trial

court's impotent approach, the court of appeals held that Kleynerman's challenges to the reliability of the expert's methodology "go to the weight, not the admissibility, of [the expert's] testimony." *Smith v. Kleynerman*, No. 15AP207, unpublished slip op., ¶38 n.3, App.014. In effect, both courts articulated and applied the old "relevance" test that governed the admissibility of expert testimony before the legislatively mandated change. *See, e.g., State v. Fischer*, 2010 WI 6, ¶7, 322 Wis. 2d 265, 778 N.W.2d 629 (stating, before the new law was enacted, that "[t]he law in Wisconsin continues to be that questions of the weight and reliability of relevant evidence are matters for the trier of fact"). *Cf. id.* (declining to "adopt a *Daubert*-like approach to expert testimony that would make the judge the gatekeeper."). By enacting the current § 907.02, the Legislature squarely rejected the former approach. The court of appeals' invocation of the old "goes to the weight" shibboleth must be equally squarely rejected.

B. The Circuit Court's Gatekeeping Function Does Not End When the Trial Starts.

Before the court of appeals, Smith attempted to excuse the circuit court's refusal to exercise its gatekeeping role by arguing that Kleynerman failed to raise a timely objection to Rodrigues's testimony and thus waived his *Daubert* challenge by not raising it in a pretrial motion. (Smith Ct. App. Resp. Br. 51–52.) To the contrary, Kleynerman's counsel clearly and unequivocally objected to Rodrigues's testimony following cross-examination, when it became clear that Rodrigues had departed drastically from the estimation of ACT's lost profits that he had provided in his expert report. In effect, Smith advocates for a rule that would confine the court's gatekeeping function to the pretrial period, with no role for the judge to play during trial, no matter how far removed the expert's testimony is from the methodologies that make it possible for the jury to get reliable evidence.

Smith's preferred rule has no basis in the current version of § 907.02 or in any Wisconsin case interpreting that provision, nor have federal courts adopted so restrictive a view of the trial court's gatekeeping function under Fed. R. Evid. 702.

Indeed, when a party raises an objection to expert testimony at trial, there is no principled basis for permitting the court simply to disregard its gatekeeping function, as happened here. *See In re Linc Capital, Inc.*, 312 B.R. 368, 375 (Bankr. N.D. Ill. 2004) ("Even without an objection being made, and certainly when it is made, a court must adequately demonstrate by findings on the record that it has performed its duty as 'gatekeeper' before accepting expert testimony."). Kleynerman raised a *Daubert* objection following cross-examination of Rodrigues (R.153, 9/25/14 Tr. at 193:17–20, App.289), giving the circuit court ample opportunity to consider the objection in the first instance. *E.g., Benjamin v. Peter's Farm Condo. Owners Ass'n.*, 820 F.2d 640, 642 n.5 (3d Cir. 1987) (holding that

objection to expert testimony was timely when made after it became clear through cross-examination that the testimony was based on the expert's "personal feelings rather than on a professional opinion."). Moreover, Kleynerman's objection came well before the evidence closed, meaning Smith also had ample opportunity to defend the soundness of his expert's methodologies, if he thought he could. *Cf. Macscenti v. Becker*, 237 F.3d 1223, 1233–34 (10th Cir. 2001) ("By waiting until after the close of all the evidence to raise the *Daubert/Kumho* objection ... [t]he proponent of the evidence was deprived of the opportunity to offer other supporting proof from [the expert] and from literature.").

The present case perfectly illustrates the pitfalls that would come from limiting the trial court's gatekeeping function to the pretrial period. Kleynerman's objection to Rodrigues's testimony was based in large part on the fact that Rodrigues departed

drastically from the estimate of damages in his expert report.[11] (R.153, 9/25/14 Tr. at 193:17–20, App.289 ("Your Honor, based on Mr. Rodrigues' testimony, I have concerns whether proper accounting methodology has been applied in his calculations.").) If, as Smith contends, the trial court has no role to play in ensuring the reliability of expert testimony once trial begins, experts could avoid the strictures of the *Daubert* reliability standard altogether by saying one thing in their reports and another at trial.

C. The Testimony of Smith's Expert Was Not Based on Reliable Methodologies.

Had the court fulfilled its gatekeeping function, it would have had to exclude Rodrigues's testimony regarding ACT's lost profits. While "trained experts commonly extrapolate from existing data," the *Daubert* standard does not require courts to admit "opinion evidence that is connected to existing data only by the *ipse dixit* of

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[11] Rodrigues's expert report estimated Smith's damages to be $175,000 (R.139, PX26), but during trial Rodrigues increased that number to a range between $449,000 and $489,000 (R.153, 9/25/14 Tr. at 145:23–146:23, App.241–242).

the expert." *GE v. Joiner*, 522 U.S. 136, 146 (1997). To the contrary, "[i]t is axiomatic that an expert, no matter how good his credentials, is not permitted to speculate." *Goebel v. Denver & Rio Grande W. R.R.*, 215 F.3d 1083, 1088 (10th Cir. 2000). With respect to lost-profits damages, calculations based on unfounded assumptions are not reliable testimony. *See, e.g., Target Mkt. Publ'g v. ADVO, Inc.*, 136 F.3d 1139, 1143–44 (7th Cir. 1998).

Such speculation comprised virtually all of what Rodrigues told the jury; indeed, he admitted as much. Rodrigues calculated ACT's purported damages by *taking the profit margin that ACT had* achieved during its two most successful years of operations *and imposing* that margin *on Red Flag's revenue* from 2009 through the date of trial in 2014. (R.153, 9/25/14 Tr. at 143:17–25, App.239.) To calculate the revenue generated by Red Flag's sales, Rodrigues took figures from the invoices that Red Flag sent to customers, which included *costs* that Red Flag had incurred and passed on to its

customers without any profit (*e.g.*, shipping costs, travel expenses, costs of additional devices accompanying seals, etc.). (R.153, 9/25/14 Tr. at 188:1–25, App.284.) This grossly inflated the revenue that Red Flag generated.

Two critical assumptions formed the basis for Rodrigues's calculations: (1) that ACT would have been able to achieve the same revenue as Red Flag had ACT not sold its patents, and (2) that ACT would have been able to maintain for five years straight a profit margin that it had only reached in two of its six years of operations. (*Id.* at 145:16–18, App.241.)

Of course, these assumptions defy common sense. A company like Red Flag that manufactures products, pays numerous employees, and absorbs other substantial overhead costs cannot generate the same profit margin as a company like ACT that bought and re-sold products out of its members' garages.

Even more problematically, Rodrigues provided no basis for his assumptions. *See Zenith Elecs. Corp. v. WH-TV Broad. Corp.*, 395 F.3d 416, 420 (7th Cir. 2005) ("Reliable inferences depend on more than say-so."). Rodrigues conceded that he "didn't know what Red Flag was actually doing in production." (R.153, 9/25/14 Tr. at 170:8–9, App.266.) As a result, he failed to understand that Red Flag only began to generate revenue after its manufacturing capabilities were established and Kleynerman had entirely redesigned the cargo security seals. (*See, e.g., id.* at 169:6–16, App.265.) Rodrigues furthermore disregarded the fact that Red Flag's actual profits for the five years from 2009 through 2013 totaled only $108,765. (R.139, DXs 154, 157, 159, 161, 163.)

With respect to ACT, Rodrigues never considered that the company was on the verge of closing its operations in 2009, had no money to establish manufacturing capabilities in the United States, and had no access to credit or new investors. (R.139, DX14.) He

likewise never considered that ACT's former operating model of buying and re-selling seals made by third parties was no longer viable because of the new duties imposed on the products' export from Ukraine. (R.153, 9/25/14, Tr. at 166:11–17, App.262.) Indeed, when asked *how* ACT would have achieved the same revenue as Red Flag did, Rodrigues insisted that *he was not offering an opinion that ACT would have done so.* (*Id.* at 164:5–8, App.260.) In short, his testimony was pure speculation. Under the *Daubert* standard, it should have been excluded. *See, e.g., Vill. of Slinger v. Polk Props., LLC*, No. 15AP1473, unpublished slip op., ¶10 (Wis. Ct. App. Aug. 31, 2016), 2016 Wisc. App. LEXIS 572 (affirming the exclusion of expert testimony where the expert admitted that his opinion was based on speculation).

Under the *Daubert* standard, the trial court may not simply "abandon the gatekeeping function." *Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 159 (1999) (Scalia, J. concurring); *see also Goebel*, 215 F.3d

at 1087 ("While the district court has discretion in the manner in which it conducts its *Daubert* analysis, there is no discretion regarding the actual performance of the gatekeeper function."). The Court should make it clear that the trial court's gatekeeping obligations must be satisfied and do not disappear the moment trial begins. No competent evidence of damages for breach of fiduciary duty was presented, and the damages award must, therefore, be vacated. *Murray v. Holiday Rambler, Inc.*, 83 Wis. 2d 406, 434, 265 N.W.2d 513, 526 (1978) (reversing damages award not based on competent evidence).

CONCLUSION

This Court should reverse the court of appeals and remand with instructions to the circuit court to enter judgment in favor of Kleynerman on the breach-of-fiduciary-duty claim, because Kleynerman owed Smith no fiduciary duty as a fellow-50% LLC member or otherwise; because Smith had no standing to collect damages on the LLC's claim; and because there was no competent

evidence of the LLC's lost profits. Any of these reasons calls for reversal; taken together they command it.

Dated: November 10, 2016

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CERTIFICATION OF FORM, LENGTH AND ELECTRONIC FILING

I hereby certify that this brief conforms to the rules contained in Wis. Stat. § 809.19(8)(b)&(c) for a brief produced with a proportional serif font. The length of this brief is 9,451 words.

I hereby certify that I have submitted an electronic copy of this brief, which complies with the requirements of Wis. Stat. § 809.19(12). I further certify that this electronic brief is identical in content and format to the printed form of the brief filed as of this date, except for the signature.

Dated: November 10, 2016

/s/ Max B. Chester
Max B. Chester

CERTIFICATE OF MAILING

I hereby certify that on November 10, 2016, I caused the foregoing Brief of Defendant-Appellant-Petitioner Greg Kleynerman and 22 copies to be sent by Federal Express for delivery to the clerk, and therefore, filed on this date, pursuant to Wis. Stat. § 809.80(3)(b)(2).

Dated: November 10, 2016

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