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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

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

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December 12, 2016

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INTRODUCTION

The continuous shifting in Smith's breach-of-fiduciary-duty claim demonstrates its baselessness. In the trial court, Smith argued that Kleynerman was his agent. In the court of appeals, Smith added references to "circumstances" and that LLC members are "like partners." The court of appeals found a duty here because 50/50 members gave each other "corporate" titles, and the jury had been instructed that corporate officers owe duties to their employer. Now, Smith uses the instruction to argue that Chapter 183 imposes inter-member fiduciary duties. The statutory plain language creates no such duties.

Smith's standing argument fails to appreciate that an LLC's members cannot directly recover its damages. While Smith pursued a lost profits claim, he now attempts to recast it as a constructive dividend, a squeeze-out, or restitution. The claim he asserted was none of these, and it is too late to shift gears.

The *Daubert* question likewise requiresmore careful treatment than Smith affords it. Under Wis. Stat. § 907.02(1), the trial court must keep unreliable expert testimony away from the jury. When, as here, an expert departs from his report and engages in speculation on the stand, the testimony is inherently unreliable, and the trial court must strike it.

ARGUMENT

I. KLEYNERMAN DID NOT OWE SMITH A FIDUCIARY DUTY.

A. Kleynerman Did Not Owe Smith a Fiduciary Duty as a "Corporate Officer" of ACT.

Throughout the proceedings, as confirmed by the inclusion of a jury instruction on agency (App.62), Smith claimed that Kleynerman owed him a fiduciary duty as his agent. Now, Smith bases his fiduciary duty claim on a jury instruction describing Kleynerman as holding "an *officer* position with ACT" and providing that "[o]fficers [are fiduciaries] … as to their *employers*." (Brief 16) (emphasis added). Smith suggests that Kleynerman's

failure to object to this instruction[1] somehow amounts to a concession that Kleynerman was a *corporate* officer who owed fiduciary duties *to Smith* as a matter of *corporate law*. Smith's argument fails for two reasons.

First, as Smith concedes, ACT is a *member*-managed LLC, not a corporation. (Brief 19.) ACT does not have any officers; Kleynerman and Smith always managed its affairs. Smith maintains that an LLC member who "undertakes a position as an officer … owes fiduciary duties" to other members (*id.*), but Chapter 183 does not support the assertion, and it makes no sense. LLCs do not have officers, so there is no principle that would stop one member from arguing in any case that the other "undertook" the non-existent position. Indeed, *Modern Materials*

[1] Here is how the instruction came to be given. Smith initially brought breach-of-fiduciary-duty claims both on his own and on ACT's behalf. (R.2 ¶¶88-95; App.112-14.) Before the case went to the jury (and after the jury instructions were prepared), Smith dropped ACT's claim, so only his individual claim was submitted to the jury. (App.62.)

v. Advanced Tooling Specialists, 206 Wis. 2d 435, 557 N.W.2d 835 (Ct. App. 1996), the only case Smith cites, deals exclusively with *corporate* officers and *corporations*. It says nothing about LLCs and does not hold that members assume fiduciary duties to each other simply by referring to themselves as "officers." *See id.* at 440-41 (concluding that the defendant was *not* a corporate officer despite references to him as one).

Smith's argument that an officer cannot escape his duties by claiming that appointment was "in name only" (Brief 19) suffers from a similar defect: The cases Smith cites deal exclusively with corporate officers, not LLC members. *See Burroughs v. Fields*, 546 F.2d 215 (7th Cir. 1976); *CSFM Corp. v. Elbert & McKee*, 870 F. Supp. 819 (N.D. Ill. 1994).

Burroughs said that a corporate officer could not disclaim his title because that would "create a second class of officers and directors not provided for by Wisconsin statutes." 546 F.2d at 217

(stating Wis. Stats. Chapter 180 recognizes "only one class of officers and directors"). But Chapter 183 does not provide for officers, so *Burroughs'* point is inapposite. Smith ignores this fundamental difference in the statutes governing corporations and LLCs.

Second, the jury instruction here addresses only the duties that a corporate officer owes the corporation-employer. *Smith* was not Kleynerman's employer, so the instruction has no bearing on whether Kleynerman owed *Smith* a fiduciary duty. Smith did not rely on the instruction below, showing that he understood this.

B. LLC Members Do Not Owe Each Other Common-Law Fiduciary Duties.

Smith's contention that Kleynerman owed him a fiduciary duty as a co-member of an LLC, relies on the federal trial-court decision in *Executive Center III, LLC v. Meireran*, 823 F. Supp. 2d 883 (E.D. Wis. 2011), which concluded that LLC members owe

common-law fiduciary duties *to the LLC and its creditors,* a point not relevant here.

Though *Executive Center* had nothing to do with whether LLC members owed each other duties, *id.* at 885-86, the premise for its conclusion about members' duties to the LLC and creditors is flawed and should be rejected as a basis for recognizing inter-member duties. Acknowledging that LLCs are "creatures of statute," *id.* at 891-92, the court nevertheless noted that, under case law, officers and directors of *corporations* (also creatures of statute), owe common-law fiduciary duties to it, its shareholders, and its creditors on insolvency. *See id.* at 891. The logical flaw comes next: "LLCs share much in common with corporations," from which the court jumped to the result that it was "unable to conclude that common law fiduciary duties ought not to apply to LLCs because of the mere existence of a statute relating to the creation and duties of LLCs." *Id.*

This analysis overlooked the principle underlying common-law fiduciary duties of corporate officers and directors and failed to ask whether the same principle applies to LLC members. "The fiduciary relationship comes into being by the manifestation of consent by the fiduciary to act on behalf of another." *Zastrow v. Journal Commc'ns*, 2006 WI 72, ¶31, 291 Wis. 2d 426, 718 N.W.2d 51 (involving trustees of express trust). Corporate officers and directors, too, manifest consent to act on behalf of corporations and shareholders by accepting their appointments. *See Racine v. Weisflog*, 165 Wis. 2d 184, 190, 477 N.W.2d 326, 329 (Ct. App. 1991); *accord CSFM Corp.*, 870 F. Supp. 819 ("[T]he officer's fiduciary duties are derived from the 'fundamental rules of agency….'") (citing *Racine*).

LLC members' relationship with each other is, by statutory directive, not one of agency. Section 183.0301 is clear that "[e]ach member is an agent of the limited liability company, but *not of the*

other members." (Emphasis added.) *Executive Center* did not encounter this statutory roadblock when it considered whether LLC members owe fiduciary duties to the LLC and its creditors. But any attempt to establish common-law fiduciary duties among LLC members must –and cannot – honor the command of § 183.0301.

Smith wants the Court to follow what he terms the "growing trend … across the country" that LLC members are fiduciaries of each other. (Brief 21-22.) But the specific language in Chapter 183 forecloses any principled ground to impose such duties on members of Wisconsin LLCs.

C. Chapter 183 Does Not Impose Fiduciary Duties Among Members.

Smith's argument that Wis. Stat. §183.0402 imposes fiduciary duties among LLC members (Brief 23-24) fundamentally misunderstands the fiduciary duty of loyalty. His citation to *Data*

Key Partners v. Permira Advisers, 2014 WI 86, 356 Wis. 2d 665, 849 N.W.2d 693, demonstrates this misunderstanding.

As the Court explained in *Zastrow*, the duty of loyalty goes well beyond requiring a fiduciary to "refrain from acting in his own self-interest." 291 Wis. 2d 426, ¶29. It requires a fiduciary to "act solely for the benefit of the principal in all matters connected with the agency, even at the expense of the agent's own interests." *Id.* ¶31.

The obligations that § 183.0402 imposes on members and managers of an LLC are far narrower. The distinction between those obligations and the situation in *Data Key* helps make the point. That case addressed a breach-of-fiduciary-duty claim in the context of the business-judgment rule, codified at § 180.0828(1)(a), which applies to actions of officers and directors. 291 Wis. 2d 665, ¶¶35-36. The rule shields them from breach-of-fiduciary-duty liability, but it has a few exceptions. One of these arises from "a

willful failure to deal fairly" in matters in which the director has a material conflict of interest and acts from which "the director derived an improper personal profit." *Id.*, ¶35. The Court described the obligation as "fiduciary" in the sense that it is the only component of a director's fiduciary duty that the business-judgment rule does not override. *Id.*, ¶36.

Smith, by contrast, has always maintained that Kleynerman owed him a broad fiduciary duty, which he allegedly breached by failing to put Smith's interests ahead of his own in the ACT-Red Flag transaction. (App.62,112-14.) Smith has never pleaded that Kleynerman willfully failed to deal fairly or that Kleynerman derived improper personal benefit. The jury was never asked to consider either of these issues, and neither of the courts below rested its decision on this basis. It is too late now to raise this new argument.

D. "Factual Circumstances" Did Not Create a Fiduciary Duty.

Smith also rehashes the factual arguments he made below, none of which bears on the issues before this Court. The court of appeals implicitly rejected each of these arguments; if the Court chooses to address them, it too should reject them.

1. The Memorandum of Understanding Did Not Create a Fiduciary Duty.

Smith argues that the Memorandum of Understanding (MOU) that he, Kleynerman, and Glaser signed "granted Kleynerman a power-of-attorney to act *on behalf of Smith*" (Brief 26) (emphasis added).

Nothing in the MOU authorizes Kleynerman to act on behalf of Smith. Smith quotes this provision: "Kleynerman is authorized by Smith to sign binding documents *on behalf of ACT*[,] to assign all patents …." (Brief 26.) (emphasis added) Plainly, "on behalf of ACT" is not "on behalf of Smith." Moreover, without the extra comma that Smith improperly inserts into the

text, the MOU pertains only to Kleynerman's authority to sign ancillary documents for ACT to effectuate the patent assignments. The MOU does not give Kleynerman general authority to act on ACT's behalf, and it gives him *no* authority to act for *Smith*. Rather, the provision simply confirms Kleynerman's statutory authority as a member of ACT to sign documents on its behalf. *See* § 183.0301.

All the cases that Smith cites (Brief 27-28) involve actually executed power-of-attorney documents. *See Praefke v. Am. Enter. Life Ins.*, 2002 WI App 235, ¶2, 257 Wis. 2d 637, 655 N.W.2d 456; *Miller v. Vorel*, 105 Wis. 2d 112, 213 N.W.2d 850 (Ct. App. 1981). The MOU did not grant Kleynerman power to act for Smith and is not the source of a fiduciary duty.

2. Kleynerman Did Not Undertake a Special Duty in 2007 to Look After Smith's Interests in 2009.

Smith also argues (Brief 28-29) that when Kleynerman told Smith in 2007 (R.154, 37:17) that he would "handle the business"

while Smith mourned for his wife, Kleynerman accepted a fiduciary duty to put Smith's interests ahead of his own in dealings with Red Flag. Nothing in *Zastrow,* the only case Smith cites, suggests that such a statement is enough to establish a multi-year fiduciary relationship.

3. Kleynerman Was Not a Controlling Member of ACT.

Smith next argues that Kleynerman was a fiduciary because Kleynerman[2] was a "controlling" member under the "circumstances" of Smith's alleged incompetence. (Brief 29.) Smith cites no Wisconsin law supporting this proposition because none exists. Instead, he relies on cases involving either corporate majority shareholders, *see Grognet v. Fox Valley Trucking Serv.*, 45 Wis. 2d 235, 172 N.W.2d 812 (1969); *In re Morton's Restaurant Grp.*, 74 A.3d 656 (Del. Ch. 2013), or LLC managers who exercised

[2] Smith actually identifies *himself* as the controlling member, which might be brushed off as a typo if he had not made the *exact same statement* in his court of appeals brief. (App.Br. at 23).

control through express provisions of an operating agreement, *see Feeley v. NHAOCG, LLC*, 62 A.3d 649 (Del. Ch. 2012). Moreover, Smith ignores the jury's unchallenged finding that Smith was *not* mentally incompetent in 2009 when the transaction occurred, and the various emails demonstrate Smith's active participation in the transaction. (R.112, App.151,163-79.)

4. Kleynerman and Smith Were Neither Joint Venturers Nor Partners.

Finally, Smith argues he and Kleynerman were joint venturers or partners in ACT. (Brief 31-32.) But ACT is an LLC, not a joint venture or partnership. While LLCs "borrow[]" certain characteristics from the partnership form, such as "informality of organization and operation," they also "borrow" from the corporate form in affording their members limited liability. *Gottsacker v. Monnier*, 2005 WI 69, ¶15, 281 Wis. 2d 361, 697 N.W.2d 436. Smith offers no persuasive reason why 50/50 LLC members should be considered fiduciaries any more than 50/50

corporate shareholders would be. *McMorrow v. Specht*, 2012 WI App 124, ¶7, 344 Wis. 2d 696, 824 N.W.2d 907 (50/50 corporate shareholders do not owe each other fiduciary duties).

II. SMITH HAS NO STANDING TO RECOVER ACT'S LOST PROFITS.

Smith insists that he can recover ACT's lost profits because "Kleynerman's course of conduct gave rise to *both* direct and derivative claims for breach of fiduciary duty." (Brief 36.) This merely begs the question. The only circumstances under which "both a direct and a shareholder derivative action may be commenced" is when the shareholder's injury is distinct from the corporation's. *Park Bank v. Westburg*, 2013 WI 57, ¶44, 348 Wis. 2d 409, 832 N.W.2d 539. Smith admits that he seeks to recover his share of *ACT*'s lost profits (Brief 36), meaning his injury is identical to ACT's. Accordingly, Smith has no standing to bring a direct action. *See Notz v. Everett Smith Grp.*, 2009 WI 30, ¶23, 316 Wis. 2d 640, 764 N.W.2d 904.

Smith now tries to recharacterize his claim. First, he argues that "Kleynerman deprived [him] of a constructive dividend when he … wrested away control of ACT's assets." (Brief 37.) But a constructive-dividend entails the improper distribution of the entity's assets on a non-pro-rata basis. *See Notz*, 316 Wis. 2d 640, ¶28. This Court has contrasted such claims with claims alleging "a scheme … to deplete the corporation of its [assets], rendering it incapable of continuing in business, and enabling [the defendant] to successfully engage in a competing business." *Id.* The latter type of claim entails an injury "to the corporation" that can only be pursued derivatively. *Id.* Smith's (false) claim that Kleynerman depleted ACT of its assets to enable Red Flag to thrive falls squarely into the latter category.

Nor is Smith's claim a "squeeze out." (Brief 39.) The squeeze-out cases Smith cites involved claims by minority shareholders. In contrast, Smith is a 50% member who signed the

asset sale agreement and even kept ACT's website and all its content for himself. (R.139, DX64-65.) That is not a squeeze-out.

Finally, Smith argues that he can "recover in the form of restitution." (Brief 40.) This argument makes no sense. Restitution is a measure of damages and has no bearing on standing. Moreover, Smith's argument that Kleynerman "was unjustly enriched" was unsupported by any evidence of *Kleynerman's* profits. *See Mgmt. Computer Servs. v. Hawkins, Ash, Baptie & Co.*, 206 Wis. 2d 158, 188-89, 557 N.W.2d 67, 80 ("loss of profit by plaintiff does not prove unjust enrichment of the defendant."). Smith's damages expert testified exclusively to ACT's lost profits; Kleynerman did not receive anywhere near $1 million in profits, under any calculation.

III. THE *DAUBERT* RULE REQUIRED EXCLUSION OF THE TESTIMONY OF SMITH'S EXPERT.

Confronted with the circuit court's undeniable abdication of its gatekeeping role under *Daubert*, Smith argues that Kleynerman

waived his objection by failing to raise it *in limine*. (Brief 41-43.) Neither § 907.02(1), nor Wisconsin case law, nor the federal cases Smith cites, requires *in limine* challenge to expert testimony. *See Macsenti v. Becker*, 237 F.3d 1223, 1232 (10th Cir. 2001) (objection was made after evidence closed); *U.S. v. Jasin*, 292 F. Supp. 2d 670, 680 (E.D. Pa. 2003) (no objection was made at all). And certainly one cannot move *in limine* to exclude testimony contrived on the witness stand.

Smith also suggests that *any* challenges to an expert's assumptions "bear on the weight to be given to expert testimony, not the admissibility …." (Brief 42.) This merely repeats the lower courts' errors and underscores the need to define the trial court's proper gatekeeping function after the Legislature's adoption of the *Daubert* rule.

While "[t]rained experts commonly extrapolate from existing data," *Daubert* requires the exclusion of expert testimony

when "there is simply too great an analytical gap between the data and the opinion offered." *GE v. Joiner*, 522 U.S. 136, 146 (1997). To be sure, the weight to give an expert's *reasoned* assumptions is a matter for the jury, but it is the court's job to prevent the jury from even considering pure speculation dressed up in the guise of "expert" testimony. *See State v. Giese*, 2014 WI App. 92, ¶¶19-28, 356 Wis. 2d 796, 954 N.W.2d 687.

When Kleynerman objected to Rodrigues's calculations based on "whether proper accounting methodology has been applied" (R.153, 193:18-19, App.289), the court had to consider whether those calculations had *some* nexus to accepted methodologies for determining lost profits, as they plainly did not. Instead, the judge stated that "there's *nothing* for the court to do." (*Id.* 196:2-14, App.292).

Had the testimony of Smith's expert been stricken, no even colorable evidence of damages would have supported the jury's verdict. Therefore, the Court can reverse on this ground alone.

CONCLUSION

The decision of the court of appeals should be reversed and the case remanded to the circuit court with instructions to enter judgment for Kleynerman on Smith's breach-of-fiduciary duty claim.

Dated: December 12, 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 2,954 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: December 12, 2016

/s/ Max B. Chester
Max B. Chester

CERTIFICATE OF MAILING

I hereby certify that on December 12, 2016, I caused the foregoing Reply 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: December 12, 2016

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