Appeal No. 2007AP203 **Cir. Ct. No. 2004CV285**

WISCONSIN COURT OF APPEALS
DISTRICT IV

MICHAEL S. POLSKY, AS RECEIVER FOR COMMUNICATIONS PRODUCTS CORPORATION,

PLAINTIFF-RESPONDENT-CROSS-APPELLANT,

V.

DANIEL E. VIRNICH AND JACK M. MOORES,

DEFENDANTS-APPELLANTS-CROSS-RESPONDENTS.

CERTIFICATION BY WISCONSIN COURT OF APPEALS

Before Higginbotham, P.J., Lundsten and Bridge, JJ.

The central dispute in this case raises the question whether officers or directors who are the sole owners of a corporation may manage that corporation for their own benefit at the expense of the corporation and its creditors. Existing case law suggests conflicting answers to this question, and its ultimate resolution presents a significant policy issue that is likely to have statewide impact on corporations, the banks who lend to them, and others who contract with them.[1] It appears that the question arises in this case, at least in part, because in Wisconsin, unlike in most jurisdictions, the rule is that directors and officers of an insolvent

[1] The Wisconsin Bankers Association, the Risk Management Association, and Wisconsin Manufacturers & Commerce have each filed an amicus brief.

corporation owe no fiduciary duty to creditors until the corporation ceases to be a "going concern." *See* ***Beloit Liquidating Trust v. Grade***, 2004 WI 39, ¶2, 270 Wis. 2d 356, 677 N.W.2d 298. To the extent that that rule may warrant modification or re-examination, only the supreme court is suited to the task. Accordingly, we certify this appeal.

Background Facts

Daniel Virnich and Jack Moores were officers, and Virnich a director, of Communications Products Corporation (CPC). Basic Products Corporation owned CPC's stock, and CePro, Inc., owned Basic. Neither Basic nor CePro had any other business activities, and existed solely to hold CPC's stock. Virnich and Moores owned CePro through a holding company of Virnich's and a trust Moores owned. Thus, Virnich and Moores indirectly but fully owned CPC, and Virnich made major financial decisions pertaining to the corporation in his role as officer and director.

In June 2003, after CPC defaulted on a loan, its largest creditor, American Trust and Savings Bank (American Trust), commenced a WIS. STAT. ch. 128 action alleging that CPC was insolvent. The court appointed Michael Polsky to manage the company as its receiver, and he commenced this action on CPC's behalf in May 2004, alleging that, for a number of years before the receivership was imposed, Virnich and Moores breached their fiduciary duties to CPC by taking excessive compensation and engaging in transactions that benefitted them personally at CPC's expense. The receiver also alleged that Virnich and Moores conspired to harm CPC.

Virnich and Moores moved to dismiss the complaint on the principle that one cannot sue oneself, pointing out that they were the sole shareholders in

CPC, and arguing that "the corporation is its shareholders." The receiver responded that CPC had "separate and distinct rights as a legal person," thus allowing him to pursue this action on its behalf against its only shareholders. The circuit court agreed with the receiver and denied the motion, and the case proceeded to trial.

The receiver introduced evidence that, in the period 1990-2003, Virnich and Moores used a combination of salaries, management fees, "loans" that were in fact cash withdrawals, dividends, and excessive rates they collected while leasing equipment to CPC to extract more than $10 million from the company. There was evidence that from 2001-03 they extracted approximately $3.8 million of that total. There was also evidence that during this latter period CPC's liabilities substantially exceeded its assets.[2] Witnesses testified that CPC experienced cash flow problems during 2001-03 that reduced the company's ability to timely pay its bills, increased the amount of its debt and interest costs, affected its ability to competitively price its product, and prevented beneficial investments in equipment. CPC eventually entered a period of acute financial distress, culminating in a loan default and the receivership.

The receiver requested a verdict of $1.9 million against each defendant on the breach of fiduciary duty claim for the amounts taken from CPC in the period 2001-03. He requested an additional $3.5 million against both

[2] On its books, CPC did not show liabilities exceeding assets. CPC's expert witness, however, explained that the only significant measure of the company's financial status was the combined net worth of CPC and its two parent corporations. As noted, the two parent corporations had no other business than holding CPC's shares, such that a liability on their books was in fact a CPC liability. The expert explained that CPC maintained itself in the black only by recording as receivables what were actually cash transfers "up and out" through the parent corporations to Virnich and Moores that were never going to be paid back.

defendants on the conspiracy claim. The jury awarded the requested amounts on the fiduciary duty claim, and awarded $2.7 million on the conspiracy claim. On motions after verdict, the circuit court upheld the $6.5 million verdict, and entered judgment accordingly. Virnich and Moores appealed. In a cross-appeal, the receiver challenges the decision to deny verdict questions on punitive damages.

Discussion

A corporate officer or director owes the corporation a fiduciary duty to act in good faith and to deal fairly in the conduct of all corporate business. ***Reget v. Paige***, 2001 WI App 73, ¶12, 242 Wis. 2d 278, 626 N.W.2d 302. Shareholders also owe the corporation a fiduciary duty. *See* ***Garvey v. Fox Valley Constr. Co.***, 246 Wis. 64, 68, 16 N.W.2d 432 (1944).

Virnich and Moores contend, however, that they could not be found in breach of a fiduciary duty to CPC when they, as its sole owners, consented to the alleged breaches. They point to Wisconsin case law for the proposition that "'if [a transaction between a corporation and its officers or directors] is consented to or ratified, with full knowledge of the facts, it is finally and absolutely binding, and neither the corporation nor individual stockholders nor strangers can afterwards sue to set it aside, or otherwise attack its validity.'" ***Davies v. Meisenheimer***, 254 Wis. 419, 427, 37 N.W.2d 93 (1949) (quoting 3 WILLIAM MEADE FLETCHER, ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 979, at 460 (perm. ed.)).

Virnich and Moores also find support in federal court decisions. For example, in ***Safety International, Inc. v. Dyer***, 775 F.2d 660 (5th Cir. 1985), the court noted that a corporation had no cause of action against its owners for their self-dealing transactions as corporate officers, because "[e]ven if [the defendants]

breached their fiduciary duty to Safety by taking the purchase option in their own names, no party to this action can complain of the breach. There are no nonconsenting shareholders; [the defendants] held all of the shares of Safety." ***Id.*** at 662.

In short, the cases Virnich and Moores cite offer support for the proposition that they were free to manage CPC for their own benefit, even if their acts damaged CPC or its creditors.

The receiver, in contrast, relies on what he describes as the "bedrock principle" that a corporation and its stockholders are distinct entities. *See* ***Jonas v. State***, 19 Wis. 2d 638, 644, 121 N.W.2d 235 (1963) ("A corporation is treated as an entity separate from its stockholder or stockholders under all ordinary circumstances."). Moreover, "the fiduciary duty of a director is owed to the individual stockholders *as well as to the corporation*." ***Rose v. Schantz***, 56 Wis. 2d 222, 228, 201 N.W.2d 593 (1972) (emphasis added); *see also* ***McGivern v. Amasa Lumber Co.***, 77 Wis. 2d 241, 260, 252 N.W.2d 371 (1977) ("Wisconsin law has long recognized that directors and officers owe a fiduciary duty to and are trustees for the individual shareholders (*as well as the corporation*) …." (emphasis added)). Thus, in the receiver's view, Virnich and Moores are wrong when they contend that the "corporation is its shareholders."

Complicating the matter is that it is clear, in our view, that this lawsuit has been pursued primarily for the benefit of CPC's creditors although it is brought in the name of CPC. In fact, American Trust financed this lawsuit, in an apparent attempt to collect the $750,000 outstanding on its loans as of the time of trial. Yet, this case would not have taken the form that it did in most jurisdictions because the general rule in most jurisdictions is that directors and officers of an

insolvent corporation owe a fiduciary duty to creditors, and the creditors will have a cause of action for the violation of that duty. 15A WILLIAM MEADE FLETCHER, ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 7468-7469 (perm. ed., rev. vol. 2000).

> [W]hen the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors.
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> > The law by the great weight of authority seems to be settled that when a corporation becomes insolvent, or in a failing condition, the officers and directors no longer represent the stockholders, but by the fact of insolvency, become trustees for the creditors, and that they cannot by transfer of its property or payment of cash, prefer themselves or other creditors ….

FDIC v. Sea Pines Co., 692 F.2d 973, 976-77 (4th Cir. 1982) (citations omitted), *cert. denied*, 461 U.S. 928 (1983); *see also* ***North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla***, 930 A.2d 92, 101-02 (Del. 2007) (creditors of insolvent corporation have standing to bring derivative claims on corporation's behalf against its directors).

In Wisconsin, however, "in order for officers and directors to have a fiduciary duty to creditors, a corporation must be both insolvent *and no longer a going concern*." ***Beloit Liquidating Trust***, 270 Wis. 2d 356, ¶2 (emphasis added). There is no dispute here that, during the time of the alleged breaches of Virnich and Moores' fiduciary duty, CPC was a going concern.

If Wisconsin followed the general rule, the receiver could have openly sued on behalf of CPC's creditors, or the creditors could have brought the action, with litigation focusing on the time of CPC's insolvency and whether Virnich and Moores violated their duty to the creditors after that date by placing

their interests ahead of the creditors' interests. Instead, however, this case necessarily proceeded on the theory that CPC had a direct cause of action against its shareholders.

Although not expressly characterized as such, we view the arguments of the receiver and supporting amici as presenting an implicit challenge to the Wisconsin rule. And, of course, we may not modify that rule. In any event, the case law points to conflicting results, and the parties' dispute involves a significant policy decision of statewide concern. We therefore certify this appeal to the supreme court.[3]

[3] Virnich and Moores raise other issues in their appeal, some of which will be resolved by the decision on the issue certified and some of which will not. These additional issues include whether: (1) a conspiracy cause of action exists if no fiduciary duty was owed; (2) the statute of limitations barred claims preceding May 17, 2002; (3) the circuit court improperly instructed the jury on fiduciary duty and improperly refused an instruction on when CPC discovered the acts giving rise to the receiver's claims; (4) the court erroneously barred the defense that Polsky was not properly appointed as the receiver; and (5) the award of damages should be vacated because the transfers of money from CPC did not violate the statute that regulates corporate distributions, WIS. STAT. § 180.0640 (2005-06). We do not believe that any of these issues entail more than the application of well-settled law to the facts. The same may be said of the issue presented in the cross-appeal.