

2006

GLFP v. CL Management : Response to Petition for Rehearing

Utah Court of Appeals

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Recommended Citation

Legal Brief, *GLFP v. CL Management*, No. 20060440 (Utah Court of Appeals, 2006).
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IN THE UTAH COURT OF APPEALS

GLFP, LTD., a former Utah limited
partnership,

Plaintiff/Appellant,

vs.

CL MANAGEMENT, LTD., a Utah
limited partnership; CLARK LEAMING
PROPERTIES, LTD., a Utah limited
partnership; HOWARD S. CLARK and
H. SCOTT CLARK, individuals,

Defendants/Appellees.

**APPELLEES' RESPONSE
TO PETITION FOR
REHEARING**

Court of Appeals No. 20060440-CA
Trial Court No. 050902498

From The Final Judgment of the Third Judicial District Court,
Salt Lake County, Utah, Honorable Glenn K. Iwasaki Presiding

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**FILED
UTAH APPELLATE COURTS**

JUN 27 2007

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Defendants-appellees, pursuant to Rules 27 and 35 of the Utah Rules of Appellate Procedure, hereby submit this response to the petition for rehearing filed by the plaintiff-appellant with respect to the Court's opinion of April 19, 2007.

ARGUMENT

Plaintiff-appellant GLFP, Ltd ("GLFP") seeks rehearing with respect to two issues decided by the Court, namely: 1) that the Court erred in affirming the trial court's ruling that GLFP's breach of fiduciary duty claim, which is based on allegations of fee and property mismanagement, constitutes a derivative claim as a matter of law (Op. at 3-5); and 2) that the Court erred in affirming the trial court's discretionary ruling whereby GLFP was denied the opportunity to directly pursue its derivative claim under the "close corporation" exception. (Op. at 7-12).

The Court correctly decided, as a matter of well-established law, both of the issues on which GLFP seeks rehearing. In fact, if the Court were to find otherwise, or alter its opinion on these issues as suggested by GLFP, the opinion in this case would stand in conflict to the opinions rendered in at least the following cases: Richardson v. Arizona Fuels Corp., 614 P.2d 636 (Utah 1980); Aurora Credit Services, Inc. v. Liberty West Dev. Inc., 970 P.2d 1273 (Utah 1998); Arndt v. First Interstate Bank of Utah, N.A., 991 P.2d 584 (Utah 1999); Warner v. DMG Color, Inc., 20 P.3d 868 (Utah 2000); and Dansie v. City of Herriman, 134 P.3d 1139 (Utah 2006).

I. GLFP’S SOLE DAMAGE CLAIM FOR BREACH OF FIDUCIARY DUTY IS NECESSARILY DERIVATIVE BECAUSE IT IS BASED ON FEES, FUNDS OR PROPERTIES OWNED EXCLUSIVELY BY THE LIMITED PARTNERSHIP ENTITIES.

GLFP, on numerous occasions, has tried to characterize its breach of fiduciary duty claim as direct, in an effort to avoid the requirements applicable to the proper assertion of a derivative claim for relief. However, each time GLFP does so, it defines a text-book derivative claim, and then GLFP simply labels it as direct. GLFP has characterized its lone damage claim as follows:

- “If GLFP’s claim was only that CL Mgmt had charged CLP excessive fees, to the equal detriment of the Clarks/HCFP and Leamings/GLFP as owners of CLP, the resulting legal claims could be classified as derivative and belonging to CLP. But the excessive fees were merely a starting point, and not the lynchpin of the Complaint. As noted, the wrongful conduct at issue was the commingling and misdirection of the excessive fees by CL Mgmt for the benefit of other Clark entities and properties, with the result that GLFP received less distributions than would otherwise have been true, and the Clarks received a benefit that GLFP did not.” (Brief of Appellant at 9) (Emphasis added).
- “GLFP’s claim was that the Clarks and CL Mgmt were using CL Mgmt funds for purposes that benefited only the Clarks, and not GLFP/the Leamings, i.e., that directly and uniquely harmed GLFP. GLFP was effectively funding – through reduced distributions – various Clark entities managed by CL Mgmt.” (Reply Brief of Appellant at 4) (Emphasis added).
- “[T]he financial health of CL Properties has very little to do with this claim. Instead, it is the actions of the Clarks and CL Mgmt in denying GLFP distributions from CL Mgmt - because the Clarks are using CL Mgmt funds to benefit other Clark entities – that is the basis of GLFP’s claim and special harm.” (Rehr’g Pet. at 2-3).

These allegations, although unproven and disputed, establish that GLFP's damage claim is based on a pure derivative theory of recovery. Despite its argument to the contrary, Exhibit 2 attached to GLFP's petition for rehearing is a diagram of a derivative theory of recovery. According to GLFP, purportedly "excessive fees" were charged by the limited partnership of CL Management, and paid by the limited partnership of Clark Leaming Properties. Then, under GLFP's theory, CL Management's funds were "commingled and misdirected" to benefit the Clarks, thereby resulting in reduced distributions to GLFP.

This is a fair and accurate characterization of GLFP's claim, which is necessarily derivative as a matter of law because it starts with excessive fees paid by Clark Leaming Properties, and ends with the misappropriation of CL Management's funds to support Clark only entities. Litman v. Prudential-Bache Properties, 611 A.2d 12, 17 (Del. Ch. 1992) ("Injuries that do not exist independently of the Partnership or that are not directly inflicted on the limited partners are derivative claims. Since plaintiffs have not complied with the requirements of bringing a valid derivative claim, they lack standing.").

Any claim related to excessive fees belongs to the entity that paid those fees—here, the limited partnership of Clark Leaming Properties. Any claim related to the misdirection or misappropriation of funds belongs to the entity that

owned those funds—here, the limited partnership of CL Management. There is no way around this inescapable legal conclusion.

In light of GLFP’s own characterization of its damage claim, the Court correctly and necessarily affirmed the trial court’s derivative ruling on summary judgment. The Court did not base its holding on any one narrow conclusion regarding either Clark Leaming Properties or CL Management; rather, the Court fully understood the claim, and properly held: “Here, GLFP’s claims of fiduciary breach, excessive fees, commingling of fees, and mismanagement of property each fall squarely in the category of claims that Utah law recognizes as classically derivative.” (Op. at 4).

This holding is amply supported by Utah law, and thus should not be altered. Aurora Credit Servs., Inc. v. Liberty W. Dev., Inc., 970 P.2d 1273, 1280 (Utah 1998) (“Actions alleging mismanagement, breach of fiduciary duties, and appropriation or waste of . . . [limited partnership] opportunities or assets generally belong to the . . . [limited partnership], and therefore, a . . . [limited partner] must bring such actions on its behalf.”).¹ GLFP’s lone damage claim for breach of

¹ See also Richardson v. Arizona Fules Corp., 614 P.2d 636, 640 (Utah 1980) (“Therefore, any compensatory damages which may be recovered on account of any breach by defendants of their fiduciary duty as directors and officers or arising as a result of mismanagement of the corporation by defendants belong to the corporation and not to the stockholders individually.”); Arndt v. First Interstate Bank of Utah, N.A., 991 P.2d 584, 589 (Utah 1999) (“It seems reasonable, then, to

fiduciary duty is founded on fees and funds paid or owned by the limited partnership entities of Clark Leaming Properties and CL Management. As such, the Court properly found that claim to be derivative as a matter of law. No rehearing is justified or otherwise warranted on this issue.

II. THE COURT CORRECTLY HELD THAT NO EVIDENCE SUPPORTED THE APPLICATION OF THE CLOSE CORPORATION EXCEPTION.

GLFP argues that the Court erred in affirming the trial court's ruling that no evidence supported the application of the "close corporation" exception. (Rehr'g Pet. at 3). GLFP contends that the Court's opinion "rescues" the trial court by inserting a rationale justifying the trial court's ruling that the trial court itself did not state, that rationale being that un-named third parties may be prejudiced if GLFP were allowed to directly pursue its derivative claim under the close corporation exception. GLFP charges that the Court's analysis in this regard is based on "rank speculation." (*Id.* at 4).

infer that the same principles apply to define derivative actions in the limited partnership context as in the corporate."); Warner v. DMG Color, Inc., 20 P.3d 868, 872 (Utah 2000) ("Claims of mismanagement, breach of fiduciary duties, and appropriation or waste of corporate opportunities are claims that the corporation has been injured. Accordingly, the cause of action belongs to the corporation and shareholders may sue only on its behalf."); and Dansie v. City of Herriman, 134 P.3d 1139, 1144 (Utah 2006) ("A shareholder does not sustain an individual injury [or a direct claim] because a corporate act results in disparate treatment among shareholders. Rather, the shareholder must examine his injury in relation to the corporation and demonstrate that the injury was visited upon him and not the corporation.").

This argument can be dispensed with quickly because it is premised on only a part of the Court's opinion. GLFP neglects to mention that the Court found that it was GLFP's burden to present evidence justifying the application of the close corporation exception: "[I]t appears that the party seeking to rely upon the close corporation exception has the burden to come forward with evidence negating the three prongs identified in section 7.01(d) of ALI's Principles of Corporate Governance [wherein the exception is defined]." (Op. at 11 n. 5) (Citation omitted). This holding is supported by existing Utah law, and the very case relied upon by GLFP. Aurora Credit Servs., Inc. v. Liberty W. Dev., Inc., 970 P.2d 1273, 1281 (Utah 1998) ("[A] minority . . . shareholder may proceed directly for corporate wrongdoing if the shareholder can show that one of the exceptions applies.").

GLFP argued in its initial appeal brief that it should not be required to bear the burden of proving the application of the close corporation exception. (Brief of Appellant at 16) ("[A] court should not place the burden on the limited partner or minority shareholder to prove that none of the exceptions cited in the PRINCIPLES apply."). GLFP lost that argument, consistent with established law. Once this is acknowledged, the trial court's explanation of its decision not to apply the close corporation exception was correct and fully explained: "Finally, although Plaintiff argued it should be excepted from the derivative requirement, given the

closely held nature of [the] corporation, the evidence in the record simply does not support such an exception and, further, no proper Rule 56(f) motion for continuance has been filed.” R. at 436. It is undisputed that GLFP failed to satisfy this burden, and no evidence whatsoever exists in the record justifying the application of the close corporation exception. Thus, the Court’s decision was correct, and no rehearing is warranted on this issue.

Moreover, GLFP’s claim of error in this regard is, in any event, legally flawed. The Court correctly points out that numerous parties potentially affected by GLFP’s claims are not party to this case. According to GLFP, the Court’s recognition of this reality was improper because no evidence—“other than rank speculation”—supports the suggestion that the absence of these parties may create inconsistent liabilities, prejudice or multiple claims. (Rehr’g Pet. at 4).

GLFP simply misapprehends the law. Established authority does not require proof of actual prejudice as claimed by GLFP. The mere possibility of prejudice is sufficient to deny GLFP’s effort to invoke the close corporation exception. Kemp v. Murray, 680 P.2d 758, 761 (Utah 1984) (“Allowing plaintiff to go forward individually could subject defendants to multiple liability and could spawn multiple litigation among the partnership, the individual partners, and defendants. This would be unfair to absent partners, unfair to defendants, and contrary to judicial economy. That is undoubtedly why Rules 17(a) and 19(a)

forbid such a result.”) (Emphasis added); Utah R. Civ. P. 23.1 (“The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation.”) (Emphasis added).²

The Court properly affirmed the trial court’s discretionary decision that no evidence in the record supported the application of the close corporation exception. The Court also correctly noted that numerous parties potentially impacted by GLFP’s direct assertion of a derivative claim are absent from the litigation, and therefore the close corporation exception should not be invoked. Seftel v. Capital City Bank, 767 P.2d 941, 944 (Utah App. 1991) (“We also note that a party may raise the issue of failure to join an indispensable party at any time in the proceedings, including for the first time on appeal.”). No basis exists in law

² GLFP skips over entirely that the Court made several assumptions in its favor by even addressing its request to rely on the close corporation exception: “Assuming without deciding that the close corporation exception is still viable in Utah, and assuming without deciding that the exception does, in fact, apply in the context of limited partnerships, we conclude that the trial court did not abuse its broad discretion in refusing to invoke it here.” (Op. at 10). The reality is the close corporation exception is a declining doctrine at a minimum, and may no longer be viable at all. Dansie v. City of Herriman, 134 P.3d 1139, 1145 (Utah 2006) (“From our vantage point eight years after . . . [recognizing the close corporation exception], we can see that our proclamation of a ‘growing trend’ in recognizing an exception to the derivative action rule for closely held corporations may have overstated matters. Some jurisdictions have rejected the closely held corporation exception or severely limited it.”).

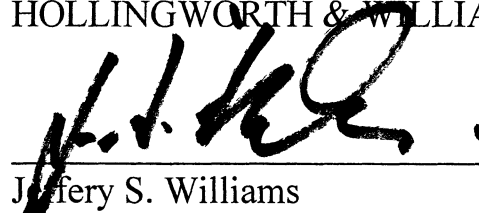
or procedure to rehear the Court's opinion affirming the trial court's discretionary ruling precluding GLFP's effort to invoke the close corporation exception.

CONCLUSION

For the above stated reasons, defendants-appellees request that the petition for rehearing be denied.

DATED this 27th day of June, 2007.

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A handwritten signature in black ink, appearing to read "J. S. Williams", is written over a horizontal line.

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CERTIFICATE OF SERVICE

I hereby certify that two (2) true and correct copies of the foregoing
APPELLEES' RESPONSE TO PETITION FOR REHEARING were served in
the manner indicated below on this 27th day of June, 2007, upon:

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