

**Uncovering Majority Shareholder Fraud in a Closely Held Corporation: A Case Study to
Develop Investigation Skills**

Cynthia E. Bolt

*Richard W. Powell**

Financial “irregularities” often arise in closely held businesses. When the majority shareholder controls the accounting records, employs family members, and conducts all legal and accounting transactions, opportunities are abundant for self-dealing and breach of fiduciary duty.

Students are placed in the role of a tax professional working with a small, closely held business in tax and financial statement preparation. A client, a minority shareholder in a construction company, engages the accountant after the majority shareholder states that cash flow is weak, salaries must be reduced, and that shareholders must make cash contribution to maintain liquidity. The client expresses concerns with the cash flow situation due to his knowledge and experience with recent collections of large accounts receivable, which is contrary to the majority shareholders’ claims.

The case addresses issues regarding the widespread problem of shareholder fraud within a closely held business. The student is required to determine an appropriate course of action, including the acquisition of corporate records withheld from the minority shareholder, analysis of records, potential coordination with forensic accountants, legal issues related to the discovery of personal expenses paid by the company, and failure to properly comply with associated laws. The client to date has only seen his personal K-1. Financial statements, 1120S tax returns, and other financial information have not been shared. The minority shareholder expresses concerns with what appears to be corporate self-dealing, including company vehicles for office personnel, excess rent paid for property owned by the majority shareholder, family member employment, and several expenses that appear personal in nature.

Acme Construction Company Facts

The client, Bob Mitchell, is a minority shareholder in a closely held construction company, Acme Construction. Annually you prepare Bob’s individual return, which includes a K-1 from his company’s Form 1120S. You have no responsibilities related to Acme Construction and have never seen any records other than the annual K-1 and the W-2 Bob receives as an Acme employee. Aside from the preparation of his individual return, you have not been involved in Bob’s financial affairs.

Bob sets up an appointment with you to discuss a recent situation with his company. Bob tells you that all shareholders in the company are related parties except for himself, and he was asked to join as an investor due to his extensive experience and sales base. When you talk to him before the appointment, he says that the majority shareholder called a meeting recently, requesting a \$10,000 contribution from each shareholder, indicating extensive cash flow problems and an inability to meet payroll requirements. He expresses extreme doubt as he knows sales are strong, and to his knowledge there are no large receivables outstanding.

* The authors are, respectively, Associate Professors at The Citadel School of Business and Pepperdine University.

Bob is responsible for company sales and operations. Family members, both shareholders and non-shareholders, conduct administrative and business matters including accounting and legal dealings. Bob has limited experience with the administrative side of the business, and after ten years he has stayed out of any management issues. According to Bob, any requests for financial information were discouraged by the majority shareholder/president of the company. You ask him to provide you with prior years' financial information including tax returns and financial statements.

When Bob arrives for his appointment, he doesn't have any of the information requested. His request to the majority shareholders was denied, and he was told that his job was to "manage the construction sites, not the company business." Given the harsh tone of this statement, you ask further questions about suspicious activity. Bob tells you that the majority shareholders consist of four family members owning eighty-five percent. Bob's share is fifteen percent. The majority shareholder who serves as president of Acme is employed full time elsewhere, but his immediate family members run office operations. His wife, one of the shareholders, is "CFO."

Specific details from Bob include the following:

- Most of the office employees are family members:
 - The majority shareholders' parents are employed, as well as the majority shareholders' college-aged children (during their holiday breaks and summer)
 - Family members work inconsistently throughout the week, and Bob has observed that personal chores are frequently performed at the office during business hours
 - The majority shareholder, employed fulltime at another company, draws a rather large salary, explaining to Bob that he works in Acme management as needed during the day, and also during the evenings and each weekend
- Family member employees each appear to have received a cell phone and automobile paid for by the company
- Operations are run from a business location that includes storage for equipment and construction inventory, where company trucks are parked and employees meet daily before going to job sites. Construction project managers are provided office space, and there are several empty offices. A small break room is available. The land and building used for operations is owned by the majority shareholder
- The office/administrative operations are located at a separate site in a family member's spare bedroom (presumably for convenience)

Bob asks you to assist with investigating the cash flow issue, but he's concerned that he doesn't have any rights to access the accounting records. At your request, Bob calls the tax preparer directly and copies of the prior three years' returns are e-mailed. As Bob leaves, you provide him with a copy of the state's laws related to minority shareholder rights, including an explanation of the laws against minority shareholder oppression. Bob plans to contact the majority shareholder to request accounting records given this new information.

When Bob leaves, you examine the S corporation tax return. Immediately several areas of concern appear:

- Travel expenses for the local company are extensive
- The company has reported a net loss for several years
- Consulting fees, found in "other expenses" on the tax return, are in excess of \$150,000

Journal of Forensic & Investigative Accounting
Volume 8: Issue 3, July–December, 2016

- Cell phone charges confirm the minority shareholders' suspicion as it appears there are numerous cell phone bills being paid due to the large dollar amount on "other expenses" on the tax return
- Office rent is extremely large, in contrast to Bob's statement that the location of business operations are on property owned by the majority shareholder. An online search of ownership records for the county confirms this fact
- Meals and entertainment expenses for the company are large, as well as donations to charities

You call the signing tax preparer, who states that he does not review records, but only uses the Acme trial balance (prepared by the majority shareholder), updates depreciation, and has a staff member prepare the return based on the client's information. His nominal involvement is done to ensure the client fees are kept to a minimum.

Bob returns the following week with electronic copies of the general ledger and financial statements. Bob and you pull up the information and project it on a screen to provide details of transactions in questionable accounts. Suspicions of self-dealing are confirmed, including several unexpected costs for personal expenses buried in the construction supplies expense account. It appears there are extensive issues with the due to/due from shareholder account, including mislabeled deposits and withdrawals, revealing considerable uncertainty as to the transactions recorded. Additionally, payroll tax withholding, including insurance and taxes, appears to be unreconciled and incorrect.

Required:

Identify the tax, legal, and potential fraud issues associated with Acme Construction. How should these issues be investigated? What assistance will you need? How do you proceed?

Provide details on your approach towards assisting Bob, the minority shareholder, with the challenge he is facing in a company where he is affiliated as not just an owner but also as an employee.

Write your response in a report for your firm's files as well as a personal letter to Bob. Thoroughly explain the approach you have chosen that you feel will best resolve the situation and challenges faced in this situation.

Issues for Discussion

- What questions should be asked of the majority shareholders working in management?
- What questions should be asked of the current tax advisor/CPA? Has he violated any professional standards?
- How should the reasonableness of compensation, rent, and other expenses paid to family members be determined?
- How should the compliance or lack of compliance with government regulations (such as the filing of a W-2 or 1099 for the president of the company) be addressed?
- What if management doesn't comply?
- Should legal counsel be hired? Is a forensic accountant required?
- What tax laws have been violated by the majority shareholders?
- Has the CPA who prepares the Form 1120S violated any laws or standards?
- What other issues should be addressed?

- Do these irregularities require an amended return? If so, what if management or the company's CPA fail to amend the return?

Case Learning Objectives

This case challenges students with a commonly-occurring scenario related to closely held businesses. Students are required to act as an advocate for a minority shareholder found in the frustrating position of uncovering alleged majority shareholder fraud combined with a lack of access to corporate records.

Specific Educational Objectives

- Recognize and identify tax, forensic, and legal issues
- Understand and recognize assumptions and inferences, as opposed to concrete facts
- Improve research and investigative skills
- Think analytically and critically
- Understand and assess interpersonal relationships between majority and minority shareholders
- Develop written communication skills
- Enhance professional judgment
- Communicate ideas and opinions
- Make and defend decisions

Teaching Notes

Resolving the Case

- Minority shareholder objectives must be determined:
 - Does the minority shareholder want illegal expenses of the majority shareholders repaid and tax filings corrected?
 - What changes should occur related to family member employment, excess rent paid to the majority shareholder, personal expenses paid, and inaccurate accounting records?
 - Does he want to sue the majority shareholders?
 - Will the minority shareholder continue to work with the majority shareholders?
- What are the options regarding the apparent misappropriation of assets and inaccurate tax return filings?
- Each state has specific laws related to shareholder access to financial records that must be researched
- The student/accountant must determine the extent of legal and forensics expertise needed given their decision for resolution
- The CPA filing the Form 1120S must be questioned regarding the tax return as well as Circular 230 issues
- If fraud is in fact uncovered and an amended return is not forthcoming, the minority shareholders should consider filing their own estimated amended K-1

- Research regarding the reasonableness of expenses per IRC Section 162 should provide a standing on excessive and unnecessary expenses as shown in the area of compensation and property rent

Tax Law Issues

Ethical Standards for Professional Tax Practice

The range of tax issues contained in this case provides an opportunity for a rich and robust discussion, both in class and by student submission. This common scenario replicates the many cases of minority shareholder fraud. Regrettably, such situations often go unreported and perpetrators continue to reap extensive benefits from illegal activities. Tax law violations in this case are extensive and transparent, yet often a lack of experience and knowledge by taxpayers results in a hesitancy to report such abuses.

Overriding all issues are the Circular 230 and the AICPA Statement on Standards for Tax Practice concerning ethical practice for tax advisors. The tax preparer for the Acme Company has failed to thoroughly examine the company to ensure compliance with tax laws. An examination of the client's records for reasonableness is a minimal requirement for those signing tax returns as a paid preparer. As well as determining the reasonableness of client information, tax advisors are required to communicate clearly with their client regarding the nature of the engagement.

Circular 230, applicable to all tax preparers and all federal taxing agencies, was designed to promote ethical practice among tax practitioners, maintain public confidence in the tax advisors, and advocate "best practices" in providing advice. Additionally, the IRS has stated that the guidelines are "intended to restore and maintain public confidence in tax professionals" and "ensure that tax professionals provide adequate advice to their clients, and disclose when their advice is incomplete." Apparently, the tax preparer in this case has been negligent in these requirements in an effort to keep fees low and retain the client.

The SSTS assists Circular 230 by providing measurable standards that will enhance "the public's awareness of the professionalism that is associated with CPAs as well as with the AICPA" by creating mandatory standards for AICPA members, enforceable under Rule 201 [General Standards requiring due professional care] of the AICPA Code of Professional Conduct. In addition, Rule 501 of the AICPA Code of Professional Conduct states that a CPA must not sign document (i.e., a tax return) containing materially false or misleading information. The specifics of the SSTS provide further clarification of these important standards and reinforce provisions in Circular 230.

The situation involving the Acme Construction Company appears to involve violations of these important ethical standards. The acknowledgment by the tax professional that he has performed little more than a transfer of information from a trial balance to an S corporation tax return form indicates a lack of examination of Acme's records to look for unreasonable expenses and compliance with tax requirements.

Reasonableness of Expenses

The seemingly vague requirements of I.R.C. Section 162 regarding the deduction of business expenses can be misleading. To be deductible, expenses must meet the general criteria of ordinary, necessary, and reasonable, as well as deemed to be a trade or business expense rather than a personal expenditure. The gray areas contained in this wording can be expanded when examining related regulations, but increasing details are revealed when reviewing judicial opinions.

Litigation in the area of business expense deductions is extensive and the courts regularly hold to a strict interpretation of the criteria. Violations by the Acme Construction Company are egregious

and transparent. The practice of hiring family members for minimal work is could be a violation. Family members receiving cell phones and company vehicles are not ordinary, necessary, and reasonable expenses. Excessive and unnecessary travel, entertainment, and meal expenses for a local company require investigation for a determination of whether they are primarily personal in nature or related to the trade or business activity. This investigation seems doubtful unless such expenses are incurred on behalf of the sales personnel. The failure to comply with requirements for compensation paid to the company's president will subject not only the company, but the employee to sanctions due to the violations of filing requirements. Additionally, excess compensation paid to a majority shareholder, particularly one who works part time, bring up the question whether the compensation should be reclassified as dividends.

Administrative operations conducted from a family member's home with personal expenses, such as the mortgage and electric bill, paid by the business in lieu of rent are yet another example of a failure to meet the criteria of I.R.C. Section 162. Not only are such expenses unnecessary, but it has been determined in the facts of the case that there is excess space available at the operations facility and it would be reasonable to assume company administrative duties could be run out of the same location as operations. Related party transactions can be suspicious in nature when involving such expenses.

Each of these unreasonable expenses can be rationalized by a savvy tax advisor. However the common law doctrine frequently invoked by the I.R.S. of substance-over-form reveals that these transactions are for tax advantages as well as personal gain by the majority shareholders. As such, business objectives stated by the majority shareholder to justify personal expenses, excess compensation, employment of family members, and excess travel, meals and entertainment will not be upheld upon examination of the specific facts.

Business Law Issues

Many of the relevant business laws can be found in the Model Business Corporation Act (MBCA), which has been adopted, with revisions, in many of the states. In addition, Mallor (2016) discusses the following business law relevant to this case.

The Close Corporation: Business Law

This teaching case concerns a closely held S corporation. Close corporations typically differ from regular corporations because of their limited number of shareholders and the absence of public trading of shares.

In close corporations, majority shareholders can control the board of directors, the appointment of officers, and the selection of employees. The majority shareholders can, therefore, dominate a minority shareholder in a way that might leave the minority shareholder with no role as a director, officer, or employee. Also, the majority shareholders might decide to pay no dividends. As a result the minority shareholder might receive little, if any, return on his investment. In order to avoid this problem and have any reasonable expectation of return on his investment, a minority shareholder can try to bargain for protection of his interest prior to purchasing the stock. To protect a minority shareholder, the close corporation might impose supermajority voting requirements for board actions. A supermajority vote might also be required to terminate an employment contract of an employee-minority shareholder, to reduce the salary of an employee-minority shareholder, to change bylaws, or to reduce dividends. Nevertheless, supermajority votes are not practicable for ordinary, daily business matters.

Duty of Care and Diligence

Even if the majority shareholders control the board of directors and the appointment of officers, the MBCA imposes a duty of care and diligence on directors and officers. The standard of care is that

of an ordinarily prudent person who must reasonably investigate relevant business matters. In addition, directors and officers must act in good faith and in a manner the director or officer reasonably believes to be in the best interests of the corporation.

The duty of care is sometimes expressed as the business judgment rule. Absent bad faith, fraud, breach of fiduciary duty, and conflict of interest, the managers are protected from liability to the corporation for harmful decisions if the managers have a rational basis for believing that their decisions are in the best interest of the corporation.

Duty of Loyalty

Directors and officers also owe the corporation a duty of loyalty. The managers must protect the interests of the corporation. This duty includes the obligation not to self-deal and also the obligation not to oppress minority shareholders.

When a manager deals with his corporation, there is a conflict of interest. The manager with a conflict of interest may prefer his own interests over those of the corporation. As a general rule, when the manager has a conflict of interest, the transaction with the corporation may be voided or rescinded. Nevertheless, there is no voiding if the transaction has been approved by a majority of informed, disinterested directors, the transaction has been approved by a majority of the shares held by informed, disinterested shareholders, or the transaction is fair to the corporation. Still, even if disinterested directors or shareholders approve a transaction, courts will void a conflict of interest transaction that is unfair to the corporation. A transaction is fair if a reasonable person in an arm's length bargain would have bound the corporation to it. This standard is sometimes called the intrinsic fairness standard.

Oppression of minority shareholders can occur when managers favor a group of shareholders to the detriment of minority shareholders. Examples can include high salaries for majority shareholders-employees and refusal to employ minority shareholders. If there are no dividends, the oppressed minority shareholders have investments that provide no return. Minority shareholders in a close corporation can then find it difficult then to sell their interest at a reasonable price. Courts treat oppression the same way they treat self-dealing. Transactions must be intrinsically fair to the corporation and the minority shareholders. The refusal to pay dividends or the payment of high salaries to majority shareholders might be unfair to minority shareholders.

Shareholders' Inspection and Information Rights

Inspecting the firm's books and records is sometimes essential to the exercise of shareholder rights. The MBCA grants shareholders an absolute right of inspection of a listing of the shareholders entitled to notice of a meeting, including the number of shares owned. There is also an absolute right of inspection of the articles, bylaws, and minutes of shareholder meetings over the past three years.

In addition, shareholders have a qualified right to inspect other records such as accounting records. The shareholder demand must be in good faith and have a proper purpose. A proper purpose might be determining the value of shares or the timing of dividends. An improper purpose can include learning business secrets or aiding a competitor.

The MBCA requires a corporation to furnish shareholders with the firm's financial statements and other information that is important to their voting and investing decisions.

Ensuring a Shareholder's Return on Investment

For a minority shareholder in a close corporation, obtaining a return on his investment can be a problem. The firm might not pay dividends, and there is no public market for the sale of shares even if they appreciate in value. Meanwhile, the majority shareholders do not suffer the same problem since they can employ themselves as directors, officers, or employees.

The minority shareholder has limited options. He can protect himself by bargaining prior to becoming a shareholder. The bargain can include mandatory dividends, an employment contract with a salary, or a requirement that the firm repurchase shares upon the occurrence of certain events.

Shareholder Lawsuits

Shareholder can file lawsuits based on breach of contract, the shareholder's right to inspection, the right to mandatory dividends, and the like.

Shareholders can also file derivative actions for the benefit of the corporation when the directors have failed to pursue a corporate cause of action. For example, if an officer diverts corporate assets to personal use and the directors fail to act, the shareholder can file a derivative action. For derivative actions, the shareholders must fairly and adequately represent the interests of shareholders similarly situated in enforcing the right of the corporation. Normally, shareholders must first demand that the board of directors bring the suit. If the directors refuse to bring the suit and the directors comply with the business judgment rule, then the shareholders cannot proceed.

Shareholders as Fiduciaries

A few courts have recognized a fiduciary duty of controlling shareholders to be fair and equitable to all shareholders. There is a duty of impartiality so that the majority shareholders do not prefer themselves over minority shareholders. Some courts have held that close corporation shareholders owe fiduciary duties to each other and the corporation. The fiduciary duty means the parties owe each other a duty of good faith and loyalty. In this context, minority shareholders can have reasonable expectations of benefit from their ownership of shares. Courts can enter orders protecting these expectations.

The Close Corporation

The Application of the Relevant Business Law to the Facts

First, the facts show numerous violations of the duty of care and the duty of loyalty. The majority shareholders are failing to behave in the best interest of the corporation so that transactions are fair to the corporation. For example, the firm is providing employees, who are primarily majority shareholders and their family members, with lavish company cars, travel, electronic products, and meals and entertainment. The corporation's best interest can justify only reasonable business expenses. The corporation is also unnecessarily employing related family members. It is unreasonable to employ related family members when such employment is not in the best interests of the corporation. Next, the corporation is also paying personal expenses of the related parties which do not qualify as reasonable business expenditures in the best interest of the corporation. In addition, the firm is paying large consulting fees to the majority shareholder. If these fees are unreasonably high, the consulting arrangement is unfair to the corporation and not in its best interests. Finally, the firm is paying the mortgage of a family member along with utility bills but is classifying the payment as office rent. If these payments exceed reasonable rent for the firm, then the transaction is unfair to the firm and not in the best interest of the corporation.

When there are violations of the duty of care and the duty of loyalty, the minority shareholder can file a derivative action for the benefit of the corporation if the directors fail to pursue a corporate cause of action. The remedies can include voiding transactions that violate the duty of due care and the duty of loyalty. For example, when the corporation pays personal expenses of the majority shareholder, the shareholder owes money damages so that the corporation can be made whole. The numerous violations show that the majority shareholders are subject to extensive claims by the minority shareholders.

Litigation over shareholder rights in a close corporation can be time-consuming and costly. Even when the minority shareholders prevail on their claims, the majority shareholders may be unable to fully pay the money damages after living an extravagant life on the corporation's resources. If the minority shareholders pursue an appraisal of their rights with a buyout, the firm again might lack sufficient resources to pay up and make the minority shareholders whole.

The minority shareholders also wish to exercise their inspection and information rights. These shareholders have absolute rights to inspect certain items such as a listing of the shareholders, the articles of incorporation, the bylaws and the minutes of shareholder meetings. They also have qualified rights to inspect the accounting records so long as the demand is in good faith and with a proper purpose. The majority shareholders have interfered with these shareholder rights and the court can order the majority shareholders to allow inspection.

Epilogue

This case is based on an actual situation in which one of the authors was approached by a minority shareholder of a local closely held construction company. Facts have been altered slightly due to a nondisclosure agreement between those involved.

The actual case included two minority shareholders. The majority shareholders did in fact tell the minority shareholders that they were not allowed access to business records. Annually, the majority shareholders required minority shareholders to sign a document from the company's attorney indicating that a shareholder meeting was unnecessary. The company's CPA did, in fact, indicate that he did not review the tax return information or financial statements, nor had he ever requested any information related to any unreasonable amounts. The majority shareholder's wife was employed as CFO. Her education consisted of one bookkeeping class, and it was revealed that countless accounting errors existed on all prior financial statements, and as a result, affected the tax returns.

Concerns were expressed regarding continuing employment by the minority shareholders in a company where there was suspicion and distrust. It was revealed that countless inappropriate payments and other transactions had occurred over the prior ten years, which appeared to begin when the company expanded and became more profitable during the early 2000's as construction strengthened in the area. Many of these transactions occurred to avoid taxes, such as the payment of "consulting fees" to the majority shareholder. A Form 1099 was not issued and this individual had not paid taxes on this amount, although the S corporation had deducted the large amount.

The decision was made to engage an attorney. The attorney did not have expertise in accounting or forensic accounting, but he acted rather as a "legal force" to assist the minority shareholders as they individually uncovered specific problems in the accounting records. The minority shareholders, along with one of the authors, obtained copies of the QuickBooks records and analyzed specific accounts. Problems uncovered included excessive rent paid to the majority shareholders for their personal property, employment of family members for minimal work, car payments and payment of cell phone bills for family members, consulting fees paid to the majority shareholder, incorrect accounting of the due to/from shareholder account, personal trips and meals paid from company expenses and deducted on the tax return, payment of the full mortgage, electric bills, etc., of the majority shareholder's sister's house in return for the use of one of her bedrooms as an office.

The decision was made to hire a forensic accountant, who was credentialed as follows: CPA, CFF, CFE, FCPA, CVA, and CDFA. This individual guided the attorney, associated author, and minority shareholders through the appropriate process.

Through work with the professionals hired, amended returns were filed for large errors, although the CPA who amended the returns did so without review from others involved and errors remained. The CPA was questioned regarding his compliance with Circular 230 and the SSTS. This

individual was defensive at first, but as the forensic accountant entered the picture, he agreed to comply with any questions.

The attorney requested that unnecessary family member employment stop, and that offices (and associated mortgages and other expenses) associated with the personal residence of one of the employees be terminated. The attorney also requested that an appropriate accountant be hired to correct the accounting records. When the company failed to do so, the attorney filed a lawsuit on behalf of the minority shareholders. The majority shareholders then sent a request for mediation, which was accepted by the minority shareholders.

Attorneys, forensic accountants, and other accountants for both sides met, with a professional mediator. After several hours of discussion, where it was revealed that the majority shareholders had no new information or defense, it was agreed that the minority shareholders would continue employment for the remainder of the year (six months) and receive compensation for their stock holdings. Negotiation on the dollar amount of the stock sale took several hours. Further, funds were set aside in case of tax consequences due to the inaccurate filing of the amended Form 1120S's. Such funds were to be paid to the minority shareholders after three years.

Conclusion

In this teaching case, students are placed in the role of tax practitioners faced with the challenges of alleged fraud and minority shareholder oppression as well as potential violations of standards for ethical tax practice. The students must analyze several tax and legal issues and determine the optimal approach to address this delicate situation. Not only is the client's position important, but the tax professional must also deal with the majority shareholders as well as the preparer of the S corporation return.

The purpose of the case is to improve the student's ability to deal with technical, forensic, fraudulent, ethical, as well as interpersonal issues that can typically arise in the career of a tax professional. Added benefits include enhanced communication and research skills and a demonstration of the multi-layered complications of business. Such real world scenarios are regrettably commonplace.

References

- American Institute of Certified Public Accountants (AICPA) (2000) Statements on Standards for Tax Services.
- Crumbley, D.L., L. Heitger, and S. Smith. 2015. *Forensic and Investigative Accounting*, Chicago: Commerce Clearing House.
- Internal Revenue Service. (Rev. 7-94). *IRS Circular 230*, U.S. Department of the Treasury.
- Mallor, Barnes, Langvardt, Prenket, and McCrory. *Business Law*. New York, NY: McGraw-Hill/Irwin, 2016.
- The Model Business Corporation Act (MBCA), prepared by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association, 2013.