Business Law Update

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Iowa Business Court

REG Washington, LLC v. Iowa Renewable Energy LLC, 2017 WL 4928222 (Equity No. EQCE128952, Iowa District Court for Scott County, Sept. 27, 2017)

Federal Cases

1. Internet Sales Taxes. *South Dakota* v. *Wayfair, Inc.*, 138 S.Ct. 2080 (2018). Held: the Commerce Clause permits a state to require on-line retailers to collect and remit sales tax on sales to state residents, even if the on-line retailer has no property or employees in the state. The decision rejects and overrules the "physical presence" rule announced in *Quill Corp. v. North Dakota*, 502 U.S. 808 (1992), as unworkable in the modern American economy. The *Wayfair* decision does not resolve all on-line sales tax questions, including whether due process permits collection of sales taxes accrued before *Wayfair* was decided.

Many states, including Iowa, anticipated *Wayfair*'s outcome and planned accordingly. The Iowa Legislature passed a new Internet Sales Tax as part of the changes to Iowa's tax laws in 2018. See Senate File 2417:

https://www.legis.iowa.gov/legislation/BillBook?ga=87&ba=SF2417

Summarized briefly, under new Iowa Code Section 423.14A, from and after January 1, 2019, companies like Amazon and eBay, and all internet sellers, referrers, or "facilitators" who receive some direct or even indirect value for facilitating an internet sale, will be required to collect and remit Iowa sales taxes. The tax applies to personal property, services, and "specified digital products" shipped or downloaded into Iowa above a certain threshold. If the sellers, referrers or facilitators do not collect and remit the tax, then the Iowans receiving the products and services are liable for payment. The Iowa Department of Revenue is currently drafting rules and designing systems to identify and communicate with out-of-state retailers about registration.

The Davis Brown law firm offers a more detailed summary of the Internet Sales tax features of Iowa's new tax law. See:

https://www.jdsupra.com/legalnews/understanding-iowa-s-new-internet-sales-77927/

2. SEC Staff Lacks Power to Appoint ALJs. *Lucia* v. *SEC*, 138 S.Ct. 2044 (2018). The Court held that SEC Administrative Law Judges, who have traditionally been appointed by the SEC staff, are "Officers of the United States" under the Constitution's Appointments Clause. As a result, the Court ruled, only the President or the SEC itself can appoint such judges. The Court further held that any litigant who has made a "timely challenge" to the validity of an ALJ's appointment is entitled to a new hearing before a different, properly-appointed ALJ, or before the SEC itself.

The Court's opinion noted that the SEC had issued an order in 2017 "ratifying" prior ALJ appointments, but did not rule whether that ratification action is sufficient to satisfy constitutional requirements. Until the ratification issue is resolved, the *Lucia* decision leaves open the path for some litigants to reopen prior SEC decisions. The case also raises questions about similar appointment procedures in other federal agencies.

3. State Court Jurisdiction Over 1933 Act Class Action Claims. *Cyan, Inc.* v. *Beaver County Employees Retirement Fund*, 138 S.Ct. 1061 (2018). The Court unanimously held that class-action claims brought under the Securities Act of 1933 may properly be pursued in state court. Defendants, relying on a provision in the Securities Litigation Uniform Standards Act ("SLUSA") that strips state courts of jurisdiction over certain securities class action claims, had argued that Securities Act class actions can be brought only in federal court. The Court disagreed, holding that under SLUSA's plain text, the state court class action ban extends only to securities claims based on *state* law. State court class actions seeking relief only under the Securities Act of 1933, like the class action in *Lucia*, are not affected by the ban.

It is worth noting that, under the text of the 1933 Act itself, state court class actions that seek enforcement of 1933 Act claims (with no pendent state law claims) *cannot* be removed to federal court. See, e.g., *Christians v. Kempharm, Inc.*, 265 F.Supp.3d 971 (S.D. Iowa 2017) (Pratt, J.).

4. Dodd-Frank Whistleblower Protections. *Digital Realty Trust, Inc.* v. *Somers*, 138 S.Ct. 767 (2018). Overruling the Ninth and Second Circuits, the Court held that Dodd-Frank whistle-blower protections extend only to those who disclose information to the SEC, not to "internal" whistle-blowers who alert their superiors to securities violations. Although the ruling will shut the courtroom door to certain whistle-blower plaintiffs, it may incentivize increased reporting to the SEC by employees.

5. Scope of Bankruptcy Avoidance Power Safe Harbors. *Merit Management Group, LP* v. *FTI Consulting, Inc.*, 138 S.Ct. 883 (2018), resolves a split in authority by adopting the narrower of two readings of the Bankruptcy Code's "safe harbors." The Bankruptcy Code allows certain pre-bankruptcy transfers by a debtor to be "avoided" and recovered for the benefit of creditors, but establishes safe harbors to shield certain financial-market transactions. One safe harbor, Section 546(e), protects "settlement payments" and transfers in connection with a "securities contract," if made "by or to (or for the benefit of)" a "financial institution" or other specified market participants.

Prior to *Merit Management*, many courts had applied the safe harbor to financial transactions based on the involvement of financial institutions as intermediary transferees rather than as end recipients, thus protecting potentially voidable transfers like LBO payments to shareholders.

The *Merit Management* Court unanimously concluded that when applying Section 546(e) the bankruptcy court should analyze the "overarching transfer" that the trustee seeks to avoid, rather than any component transactions among intermediaries. After *Merit Management*, the presence of financial intermediaries will not suffice to invoke safe harbor protection, increasing the risk of later bankruptcy litigation challenging such transactions.

6. Suits Against Foreign Corporations Under the Alien Tort Statute. In *Jesner* v. *Arab Bank, PLC*, 138 S.Ct. 1386 (2018), the Court held that foreign corporations cannot be sued under the Alien Tort Statute. The Court's decision resolves a circuit split, rejecting decisions from the Seventh, Ninth, Eleventh, and D.C. Circuits (which had permitted such suits) in favor of the Second Circuit's narrower interpretation of the statute.

7. Actual and Apparent Authority of LLC Managers. *Stine Seed Co. v. A&W Agribusiness, LLC*, 862 F.3d. 1094 (8th Cir. 2017), is a recent Eighth Circuit decision that presented interesting actual and apparent authority issues under Iowa and Illinois law. Stine Seed, an Iowa business, sought payments under a seed purchase contract with A&W, an Illinois limited liability company.

A&W's operating agreement provided for manager management but also required majority member approval for many ordinary course activities, like buying and selling property. This restriction on authority arguably encompassed the Stine Seed purchase contract. A&W's manager, Alexander, signed the contract, but Williams, the company's majority member, contended he never approved it and that his signature on the contract had been forged.

At trial the federal district court resolved the issues of actual authority in favor of A&W, concluding that Williams had never actually signed or approved the seed purchase contract as majority member of the company. As a result, the court concluded, under the operating agreement the company's manager, Alexander, lacked authority to enter the contract on A&W's behalf. The district court also rejected Stine's argument that Williams, through other actions, had ratified the contract or was liable to Stine for benefits of the contract under implied-in-fact contract or unjust enrichment theories.

Although the Eighth Circuit affirmed most of the district court's rulings, the Court reversed the district court's conclusion that the seed purchase contract was not binding on A&W. The Court held held that Alexander, as manager of A&W, had *apparent* authority to sign the contract. The Court did not rest its conclusion on the fact that Alexander held the title of "manager" of A&W—a plausible basis for apparent authority under common law agency principles. Rather, the Court based its apparent authority ruling on the fact that A&W *admitted during discovery* that Alexander had such apparent authority. This admission "conclusively bound" A&W, the Court ruled.

Note: Had A&W been organized under Iowa's original LLC Act (Iowa Code Ch. 490A), this case would have been easy for Stine to win. Because A&W was a manager-managed LLC, Alexander, as manager, would have statutory apparent authority to enter ordinary business transactions like the seed purchase contract (unless Stine knew that A&W lacked actual authority).

However, A&W was organized under the Illinois LLC Act. Like Iowa's current LLC Act (Iowa Code Ch. 489), the Illinois act omits any provision conferring statutory agency power or apparent authority on managers of manager-managed companies or on members of member-managed companies. The existence or scope of apparent authority of members and managers must be determined under common law agency principles. For further discussion of actual and apparent authority under Iowa Code Ch. 489, see Doré, 5 Iowa Practice—Business Organizations § 13:19.

8. Burden of Proof in Piercing Cases. *In re Civic Partners Sioux City, LLC*, 2017 WL 1155686 (Bankr. N.D. Iowa 2017). The court rejected a corporate piercing claim raised by Sioux City in a bankruptcy proceeding. The court noted the absence of support for the piercing claim "in the factual record" and cited Davis v. Ricketts, 765 F.3d 823, 827 (8th Cir. 2014), for the proposition that "where the court is asked to disregard the separate and distinct form of legal entities, the standards are narrow and rigorous, imposing a presumption of corporate separateness." In short, the party seeking to pierce the corporate veil bears a heavy burden of proof in a piercing case.

9. LLC Manager Removal. *R&R Real Estate Investors, LLC v. Urbandale West, LLC*, 2017 WL 5634152 (S.D. Iowa 2017). This decision is discussed below in conjunction with related state court cases.

State Cases

1. LLC Manager Authority; Removal of LLC Managers: *Urbandale Best, LLC v. R&R Realty* litgation.

Three recent Iowa Court of Appeals decisions, all unpublished, as well as a related federal district court case, addressed important issues relating to limited liability company managers. The cases stem from the activities of two Iowa limited liability companies, Paragon Best, LLC and Paragon West, LLC. Two related "Urbandale" entities—Urbandale Best and Urbandale West—together with R&R Realty, organize the Paragon companies to conduct real estate ventures. R&R was the managing member for both.

A. *Urbandale Best, LLC v. R&R Realty Group, LLC*, 863 N.W.2d 35 (Iowa Ct. App. 2015) (table, unpublished decision), construed the operating agreement for Paragon Best, which created a customized version of the Iowa LLC Act's default rules for manager-management. The purpose of the company was to develop agricultural real estate into an office park. The operating agreement allowed R&R to handle day-to-day affairs as company manager, but required the other member, Urbandale Best, to approve "major decisions."

   Urbandale Best alleged that R&R had exceeded its day-to-day management powers by: (1) executing a series of documents setting up governance of the office park, (2) giving R&R's own officers a majority vote in the new organization, and (3) conveying certain real estate to the new owners' association for a storm water retention pond. R&R sought injunctive and declaratory relief, but lost in the trial court.

   The Iowa Court of Appeals affirmed the trial court's refusal to enjoin R&R's actions, as well as its refusal to grant declaratory relief in favor of Urbandale Best. The Court observed that ordinary contract construction principles applied to interpretation of operating agreements, so that the parties' prior course of dealing and usage of trade were relevant to the meaning of "major decisions." The Court then held that the parties' prior dealings, as well as testimony about commercial real estate development practices, supported the trial court's conclusion that R&R's actions were not "major decisions" that required Urbandale Best's approval.

B. *Urbandale Best, LLC and Urbandale West, LLC v. R&R Realty Group, LLC*, 896 N.W.2d 784 (Iowa Ct. App. 2017) (table, unpublished decision). This case construed the operating agreement for Paragon West, specifically, a provision that authorized Urbandale Best and Urbandale West to remove R&R as manager of the company for "Cause." Under the operating agreement, "Cause" was defined to include any **"**breach of fiduciary duty involving personal profit." The Urbandale entities contended that this provision was triggered when R&R failed to inform the Urbandale entities of an opportunity to repurchase real estate Paragon West that had previously sold and instead purchased that land for R&R's own benefit.

The Iowa Court of Appeals affirmed the trial court's finding that R&R's conduct breached its duty of loyalty because the real estate option was a **"**limited liability company opportunity**"** that R&R Realty had misappropriated in violation of Iowa Code Section 489.409(2)(a)(3). The Court further held that R&R's duty of loyalty violation was a **"**breach of fiduciary duty involving personal profit,**"** thus triggering R&R's removal for "Cause" under the operating agreement.

C. *Urbandale Best, LLC v. R&R Real Estate Investors, LLC*, 2018 WL 5839873 (Iowa Ct. App. 2018) (unpublished decision). When the action discussed in (B) above was remanded to the trial court for further proceedings, Urbandale West asked the court for additional relief. Under the operating agreement, R&R's removal for cause (the relief granted in the case described in (B) above), triggered a right on Urbandale West's part to purchase R&R's interest in Paragon West. Accordingly, Urbandale West asked the trial court to enforce the buy-out remedy. The trial court refused, reasoning that Urbandale should have sought such relief earlier in the litigation. The Iowa Court of Appeals affirmed this ruling, stating:

> *Our previous opinion resolved the issue of the remedy for [R&R]'s breach of fiduciary duty: removal of [R&R] as managing member. The intent and mandate of that opinion is clear: eter an order removing [R&R] as a managing member. Any other action by the district court would have been null and void.*

D. *R&R Real Estate Investors, LLC v. Urbandale West, LLC*, 2017 WL 5634152 (S.D. Iowa 2017), involved the same claim by Urbandale West: that it was entitled to purchase R&R's interest in Paragon West because R&R had been removed as manager for cause—this time brought in a separate state court action. R&R removed the case to federal court based on diversity, and moved to dismiss the action on grounds of claim preclusion / res judicata.

Judge Jarvey agreed, holding that Urbandale West should have brought the buy-out claim together with the original lawsuit seeking R&R's removal as manager.

Query: Would claim preclusion / res judicata have barred Urbandale West from suing separately to enforce the buy-out remedy if the operating agreement had expressly authorized Urbandale West to pursue manager "for cause" removal and related remedies in separate actions?

2. Transfer Restrictions in LLCs. *REG Washington, LLC v. Iowa Renewable Energy LLC*, 2017 WL 4928222 (Equity No. EQCE128952, Iowa District Court for Scott County, Sept. 27, 2017).

Plaintiff REG Washington, LLC (REG) made a hostile tender offer to members of Iowa Renewable Energy, LLC (IRE) a widely-held (600 member), but not publicly-traded, limited liability company. The tender was partly successful, but IRE's directors (managers) refused to approve transfer of the tendered membership units to REG. The directors premised their refusal on various provisions in IRE's operating agreement—provisions plaintiff REG was apparently aware of prior to the tender. These provisions prohibited transfers of any part of a member's interest in the company, *including the member's transferable economic interest*, without approval of the company's directors. REG sought an injunction against enforcement of the restrictions.

Iowa Business Court Judge John Telleen denied injunctive relief, reading IRE's operating agreement to mean what it said—no transfers of a member's non-transferable management rights *or* transferable economic interests in the company without director approval. He further held that since REG was not a member of the company or party to the operating agreement, REG could not invoke the non-waivable obligation of good faith and fair dealing to challenge the directors' refusal to approve the transfer of membership interests.

Most important, Judge Telleen rejected REG's contention that transfer restrictions applicable to limited liability company membership interests are subject to judicial review under the same "reasonableness" standards that courts apply to corporate share transfer consent restrictions. See, e.g., I.C.A. § 490.627 (authorizing share transfer restrictions for a "reasonable purpose," including consent restrictions that are "not manifestly unreasonable.") See also Doré, 6 Iowa Practice—Business Organizations § 31:8 (discussing Iowa law relating to corporate share transfer restrictions).

Judge Telleen found support for his ruling in the plain text of Iowa's LLC Act, specifically, Section 489.502(6), which states that an operating agreement or other contract can restrict transfer of a member's transferable interest to a person with notice of the restriction. Section 489.502(6) does *not* include "reasonableness" qualifications. Judge Telleen found further policy support for his decision in "pick your partner/member" traditions that are foundational to limited liability companies, but not to corporations, and in the prevailing view that limited liability companies are contractual entities to which traditional corporate law rules do not always apply.

Daniel Kleinberger, a leading limited liability company expert, recently commented on the *REG* case, noting that the decision addressed issues of first impression. Kleinberger expressed the view that, given the common law's traditional hostility to restraints on alienation, courts might impose some reasonableness limits on limited liability company transfer restrictions—at least in some contexts. For example, where the transfer restrictions apply to pure economic interests in a limited liability company and serve no business purpose, Kleinberger questions whether the "pick your partner" analogy is appropriate. See Daniel Kleinberger, "We Interrupt This Program … to Talk of Transfer Restrictions," *Business Law Today* (Sept. 26, 2018). Available at:

https://businesslawtoday.org/2018/09/interrupt-program-talk-transfer-restrictions/?utm_source=newsletter&utm_medium=email&utm_campaign=september18_mib

3. Ratification as a Defense to Intentional Misconduct in the Corporate Setting. *Dubuque Injection Service Co. v. Kress*, 902 N.W.2d 592 (Iowa Ct. App. 2017) (table, unpublished decision). In 1987, three individuals, Steven, Randy and Doug, organized a corporation, Dubuque Injection Service (DIS), to conduct a diesel engine repair business. Steven was the only shareholder who was actively involved in the business and was primarily responsible for its success.

DIS did well for many years, paying dividends to all shareholders and a substantial salary to Steven. By 2011, Steven's salary had grown to nearly $500,000. Steven also employed family members on the payroll who did little or no work, and used company funds to purchase personal items, like gas, cell phone service, and vehicles. Steven contended that Randy and Doug were aware of these transactions, and that they acquiesced in them so that DIS could reduce its tax liability.

Disputes developed among the three owners in 2011. Randy and Doug complained about the size of Steven's salary and about his employment of family members, as well as about Steven's purchase of personal items with DIS funds. Steven offered to buy Randy and Doug's shares in DIS, but the negotiations were unsuccessful. Steven then left DIS and formed a new company to conduct a similar business. DIS sued Steven on several grounds, including breach of fiduciary duty claims based on Steven's management of DIS before his departure.

Steven successfully defended the breach of fiduciary duty claims at trial based on ratification. He argued that Randy and Doug were aware of his salary payments and of his use of DIS funds to purchase personal items, that Randy and Doug had acquiesced in those decisions, and that their knowledge and conduct in that regard were imputed to DIS.

DIS targeted Steven's ratification defense on appeal, citing older Iowa cases that appeared to hold that ratification is not a defense to claims based on intentional misconduct. DIS also argued that if Randy and Doug had acquiesced in Steven's decisions, that acquiescence could not be imputed to DIS.

The Iowa Court of Appeals sided with Steven. The Court explained that a principal *can* ratify "intentional misconduct" by an agent, so long as the agent's act was "done openly and admittedly for the principal and not … for personal or third party's benefit." The Court was satisfied that this rule could encompass Steven's salary payments and property purchases (presumably because these actions lowered the company's taxes), and that Doug's and Randy's knowledge of the transactions—and failure to object—was properly imputed to DIS.

4. Inadvertent Partnership / Joint Venture Cases.

A. *Ryan v. Belin McCormick*, P.C., 912 N.W.2d 855 (Iowa Ct. App. 2018) (table, unpublished decision), held that the trial court improperly determined that a joint venture existed between two parties, in part, because one of the purported venturers was not party to the litigation.

The decision was an appeal of a declaratory judgment action brought by a business known as "Rydex" who contended it had an attorney-client relationship with the Belin law firm. Rydex claimed it was Belin's client because of Rydex's relationship with another Belin client, Seneca Distribution. Belin admitted during the trial court proceedings that the firm had a limited attorney-client relationship with Rydex where Rydex's interests aligned with those of Seneca. Belin provided Rydex access to its files for a limited time frame that corresponded with Belin's view of the attorney-client relationship.

Rydex sought access to additional client files of Belin under the theory that Rydex's business relationship with Seneca established a joint venture between the two, and that Belin was counsel for the venture. The trial court granted a summary judgment in Rydex's favor on this theory.

The Iowa Court of Appeals reversed, holding that the trial court should not have determined that a joint venture existed between Rydex and Seneca for two reasons. First, because the determination of the existence of a joint venture exceeded the narrow scope of the issues presented in the declaratory judgment action—whether Rydex was Belin's client. Second, because Seneca was not a party to the suit and the joint venture determination could significantly affect Seneca's legal rights.

B. *Jamison v. Coddington*, 2018 WL 3912134 (Iowa Ct. App. 2018) (table, unpublished decision), affirmed a summary judgment ruling that a "custom farming" arrangement between an individual named John Trihus (Trihus) and the Coddingtons, a married couple who owned a farming operation, did not create a partnership between Trihus and the Coddingtons.

The summary judgment evidence established the following facts. Under a custom farming arrangement between Trihus and the Coddingtons, Trihus "was to provide all crop inputs and all labor and equipment to plant and tend a soybean crop" on lands the Coddingtons owned. The Coddingtons reimbursed Trihus for the inputs and labor after the crop was harvested. Jamison, a third party who provided seed and spraying services for the crop, was never paid. Jamison then sued the Coddingtons for payment, and they defended on the ground that Trihus alone was liable for the obligation.

Jamison had in fact discussed seed and spraying arrangements with one of the Coddingtons during the growing season, but the Coddingtons never signed any written contract for Jamison's seed sales or spraying services, as required by the UCC's statute of frauds. All of Jamison's contractual dealings were with Trihus.

Jamison contended that the Coddingtons were nonetheless liable for Trihus' seed and spraying purchases as either his employers (i.e., Trihus was their "hired hand") or because the arrangement between the Coddingtons and Trihus was a partnership. The trial court rejected both theories and granted summary judgment in favor of the Coddingtons.

The Iowa Court of Appeals affirmed, holding that there was no evidence that Trihus was the Coddington's employee. The only evidence supporting the existence of a partnership, according to the Court, were general discussions that had occurred between Jamison, Trihus and one of the Coddingtons concerning the land that was being farmed.

The Court of Appeals emphasized that:

> neither Coddington nor Trihus used the word partner or partnership. Jamison imputed the existence of a partnership from the conversations, but the evidence available to decide the summary judgment did not clearly manifest the creation of a partnership so as to generate a fact issue … .

The Court failed to note that the statutory test for partnership, Iowa Code Section 486A.202, says that partnership is "the association of two or more persons [who] carry on as co-owners a business for profit … whether or not the persons intend to form a partnership." Nothing in this definition requires use of the label "partners."

The Court did, however, support its decision with the following passage from *Chariton Feed & Grain, Inc. v. Harder*, 369 N.W.2d 777, 783-84 (Iowa. 1985), an Iowa Supreme Court decision that rejected a finding of partnership in the farm lease setting. The quote suggests that there is something akin to a presumption *against* finding inadvertent partnerships in the farm setting:

> *The courts hold quite generally that there are obvious reasons for holding that farm contracts or agricultural agreements, by which the owner of land contracts with another that such land shall be occupied and cultivated by the latter, each party furnishing a certain portion of the seed, implements, and stock, and that the products shall be divided at the end of a given term, or sold and the proceeds divided, shall not be construed as creating a partnership between the parties. Such agreements are common in this country, and are usually informal in their character, often resting in parol. In the absence of stipulations or evidence clearly manifesting a contrary purpose, it will not be presumed that the parties to such an agreement intended to assume the important and intricate responsibility of partners, or to incur the inconveniences and dangers frequently incident to that relation.*

5. Derivative Suits and Director Fiduciary Duties: Various Issues. *Tope, on behalf of Peripheral Solutions, Inc. v. Greiner*, 912 N.W.2d 499 (Iowa Ct. App. 2017) (table, unpublished decision). In *Tope* the Iowa Court of Appeals ruled on a variety of procedural and substantive issues in a derivative suit that alleged breaches of fiduciary duty by a director/officer of a closely-held Iowa corporation.

Fact Summary: Tope and Greiner organized two Iowa corporations, PSI and VendiPrint, in the mid-1990s for the purpose of selling computer systems. The two companies were successful, for the most part, but shareholder relations grew strained in 2010, when Tope tried to force Greiner out of the business.

Greiner moved corporate operations to his home at that point, and, along with two key employees, continued dealing with the corporations' customers on the corporations' behalf. Greiner opened new bank accounts for the corporations' re-located business operation. This new operation used some PSI and VendiPrint property, including a portion of existing bank deposits and the corporations' 1-800 phone numbers, as well as customer lists and customers. Greiner claimed the move was intended to preserve the companies for the benefit of employees and customers. During this same time frame, Tope closed old PSI and VendiPrint bank accounts and appropriated the proceeds.

In April 2011 Greiner moved all of PSI and VendiPrint corporate operations to SirkTech, a new company that he formed and continued carrying on their business. In October 2012, Tope sued Greiner derivatively on behalf of PSI and VendiPrint.

Tope and the companies generally prevailed at trial based on various fiduciary duty claims against Greiner, and the court entered judgments against him for nearly $1 million. Greiner appealed. The Court of Appeals affirmed in part and reversed in part, issuing a number of key rulings on derivative procedure and on the fiduciary duties of corporate directors and officers.

Derivative Suit Procedural Rulings—Unclean Hands. On the procedural front, the Court limited the corporations' damage award to the time period following April 2011, when Greiner moved PSI and VendiPrint's business operations to his new company, SirkTech. The Court reasoned that prior to that time, Tope, the shareholder who iniated the derivative suit, had "unclean hands" due to his own misappropriation of corporate funds from the corporation's bank accounts. It also appears that Greiner accounted to PSI and VendiPrint for profits and losses earned during this period.

In making the "unclean hands" ruling, the Court cited general Iowa equitable principles relating to "unclean hands," and an Illinois decision that barred corporate recovery in a shareholder derivative suit based on the shareholder plaintiff's conduct. The Court did *not* rely a statutory shareholder standing rule for derivative litigation that might have applied to Tope, as the shareholder plaintiff initiating derivative actions for PSI and VendiPrint. Iowa Code Section 490.741 requires that a derivative plaintiff "fairly and adequately represent[] the interests of the corporation." While potentially applicable to Tope, this standing rule is perhaps less flexible than the equitable "unclean hands" doctrine that the Court used to demark the time periods for which the corporations (and indirectly Tope) could recover damages.

Fiduciary Duty Rulings. The Court's fiduciary duty rulings included one win for Tope and one win for Greiner.

Tope prevailed on duty of loyalty claims against Greiner. It was not a stretch for the Court to affirm the district court's rulings that Greiner, in moving corporate business to his own corporation, SirkTech, had taken corporate opportunities and unfairly competed with PSI and VendiPrint. The Court stated: "*Greiner used his position as a director and officer of PSI and VendPrint to further his own private interests. The interests of SirkTech were adverse to PSI and VendPrint because SirkTech captured the profits and losses which should have belonged to PSI and VendPrint.*" The Court of Appeals agreed with the trial court that PSI and VendiPrint were entitled to an accounting and damages for all profits earned once the business was moved to SirkTech.

Greiner prevailed on one issue. Tope alleged that Greiner breached his duty of care to PSI by settling a lawsuit against a PSI customer who had not paid its bill. PSI had obtained a judgment for nearly $100,000 (including attorney's fees), but the customer did not have the ability to pay. Greiner accepted a settlement of $15,000, which Tope claimed was too low. The Court of Appeals agreed with the trial court that Greiner's decision to settle the case was protected by the business judgment rule, stating:

> *We conclude Greiner's decision to accept the settlement is protected by the business judgment rule. The decision did not involve self-interest. Greiner testified he considered the situation, including Felderman's ability to pay and the advice of counsel, and decided to accept the settlement. The evidence shows Greiner acted "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.*

6. <u>Application of "Reasonable Expectations" Oppression Standard</u>. *Van Horn v. R.H. Van Horn Farms, Inc.*, 2018 WL 3060240 (Iowa Ct. App. 2018) (table, unpublished decision).

The plaintiffs in *Van Horn* were off-farm minority shareholders in a family farm corporation who objected to decisions by majority shareholders who managed the farm. The plaintiffs claimed oppression based on the farm managers' decision to use a cash accounting method that, according to plaintiffs' expert, did not adequately show the corporation's true profitability. Plaintiffs also questioned other farm management decisions, including the decision to farm rather than lease the corporation's land, lending transactions involving the farm manager shareholders, and the expenditure of corporate funds to improve a farm homestead that one of the farm manager shareholders occupied with his family.

The Court of Appeals affirmed the Iowa Business Court's ruling that plaintiff minority shareholders had not established oppression, citing trial testimony that the farm management decisions at issue were consistent with normal Iowa practice, that the loans from the farm manager shareholders were good business moves for the corporation and made at low rates, and that the home remodel that indirectly benefited the majority shareholder was "necessary and not extravagant." The Court also rejected plaintiff minority shareholders' assertion that a "lowball offer" from the defendant majority shareholders to purchase their shares established oppression.

The Court held that, under *Baur*'s "reasonable expectations" oppression standard, lowball purchase offers by majority shareholders are not oppressive to minority shareholders in the absence of *repeated offers* by the minority to sell for "fair value."

One potential flaw in the *Van Horn* decision is the Court's statement that business judgment rule deference applies in an oppression case, even to alleged incidents of self-dealing by the defendant majority shareholders, like the farm manager lending transactions and homestead improvements at issue in *Van Horn*. The Court stated that: "*In this situation, we defer to the strategic decisions made by the farm corporate directors under the business judgment rule*."

Yet, nothing in Iowa corporate jurisprudence supports applying deferential business judgment review to director self-dealing transactions in this or any other situation. See generally Doré, 6 Iowa Practice—Business Organizations §§ 28:80-28:11. Moreover, courts in other states have maintained the traditional burden of proof for self-dealing transactions (requiring directors to show fairness unless the transactions were approved by independent directors or shareholders), even in oppression cases. See, e.g., *Giannotti v. Hamway*, 387 S.E.2d 725 (Va. 1990) ("affirming a trial court finding that majority shareholder/directors had oppressed plaintiff minority shareholders by taking excessive compensation and curtailing dividends, and noting that because the defendants had approved their own salaries, "the ultimate burden of proof lies with them on the issue of the reasonableness of compensation").

The *Van Horn* Court's error on this point seems harmless, however, given that there was substantial evidence that the defendant farm managers had, in fact, treated the corporation fairly. In other words, the majority shareholders would likely have been able to meet the burden of proof of fair dealing had it been applied. Moreover, as the Court of Appeals noted, the crux of plaintiffs' oppression complaint focused on the defendant farm managers' failure to pay adequate distributions—decisions that did not involve self-dealing.

7. <u>Piercing Cases</u>. The Iowa Court of Appeals decided three veil-piercing cases in 2018:

   A. *Laddie Nachazael Family Living Trust v. JKLM, Inc.*, 913 N.W.2d 273 (Iowa Ct. App. 2018) (table, unpublished decision). The court affirmed the district court's refusal to pierce.

      Plaintiff was a Trust that sold a restaurant business (a Paul Revere's Pizza franchise) to JKLM, Inc., a corporation formed by Kari Dearborn. JKLM paid $15,000 of the $120,000 purchase price at closing and financed the balance with the Trust. Two years into the arrangement, JKLM closed the restaurant and stopped payments to the Trust. The Trust sued JKLM for breach of contract, including piercing claims against Dearborn.

      At trial (to the court) there was conflicting testimony about the adequacy of JKLM's capitalization. The Trust emphasized that JKLM was formed with only $3,000 in cash and sustained operations only through periodic loans from other companies Dearborn controlled. Dearborn's expert emphasized that JKLM was able to pay its bills for two years following the restaurant purchase, and that related entity loans are common in closely-held businesses. There was also conflicting evidence on the observance of corporate formalities and about whether Dearborn kept her assets separate from JKLM.

The district court resolved the conflicts in favor of Dearborn and denied the piercing claim, finding that JKLM was adequately capitalized, and that it had sufficiently complied with formalities and kept corporate assets separate from Dearborn's assets. The Court of Appeals disagreed with the district court's conclusions on capitalization, but found that substantial evidence supported its findings on formalities and corporate separateness. The Court thus affirmed the district court's refusal to pierce, summarizing:

> *JKLM was undercapitalized but the corporation's finances were not co-mingled with the finances of its shareholders, and the corporation followed corporate formalities. We find the Trust was unable to prove the corporate veil should be pierced. We affirm the district court.*

B. *Woodruff Construction, LLC. v. Clark Farms, Ltd.*, 2018 WL 3913776 (Iowa Ct. App. 2018) (table, unpublished decision). The Court reversed the district court's decision not to pierce.

Clark Farms, Ltd. was an Iowa corporation in the business of bio-solids management. Woodruff, a commercian construction company, contracted with Clark Farms to remove sludge from a pond. Clark Farms abandoned the project, and Woodruff obtained a judgment against Clark Farms for over $400,000. When the corporation failed to pay the judgment, Woodruff filed a separate equitable piercing action against Casey Clark, the sole shareholder of Clark Farms, but the district court refused to pierce.

Because the piercing action below had been tried to the district court as equity action, the Court of Appeals reviewed the district court's decision not to pierce on a *de novo* basis. The Court agreed with the lower court's determination that Clark Farms was adequately capitalized, and that Clark Farms was not a "mere sham" because it had successfully conducted business for a number of years. However, the Court also found that (i) Clark had improperly commingled his own assets (and those of related companies) with Clark Farms' corporate assets, (ii) Clark Farms' books and records did not distinguish and track the corporation as a separate entity from Clark, and (iii) Clark failed to observe corporate formalities.

Noting that piercing is a multi-factor test, the Court concluded that piercing was appropriate and reversed the district court. The Court summarized:

Clark Farms successfully conducted business for a number of years, employing workers and completing contracts. That business began to struggle prior to 2010, and that struggle is not sufficient to pierce the corporate veil. However, Clark egregiously used the corporate bank account for non-corporate purposes, writing as many checks for his other businesses and for himself as for Clark Farms using the corporate account. The only corporate formalities that appear to have been followed after the 2001 incorporation are the filing of taxes, occasional biennial reports, and the officers named on those filings. Clark's and Halverson's testimony demonstrate the corporate books were not entirely separate from

Clark's other finances. Clark's testimony and actions indicate he did not consider the business or its finances to be a separate entity from himself and his other businesses. For these reasons, we determine the corporate veil should be pierced.

C. *Aldeen v. Gardener* 2018 WL 3057438 (Iowa Ct. App. 2018) (table, unpublished decision). The Court reversed the district court's decision to pierce.

Gardener was the majority shareholder of a corporation, GCI, that sold all of its assets (a book of insurance business) to a third party for $1.8 million. Although only part of these sale proceeds were non-compete payments to Gardener, the buyer paid *all* of the proceeds of the sale directly to Gardener, and to his son, a minority shareholder, rather than to GCI. As a result, GCI had no assets to pay creditors' claims.

Plaintiff Aldeen, a GCI employee who was terminated when he divorced Gardener's sister, had sued GCI for unpaid wages and commissions while the asset sale was in process, but did not obtain judgment on the claim until after the sale was consummated and the proceeds had been distributed to Gardener and his son. Aldeen then brought fraudulent conveyance and piercing claims against Gardener to collect the judgment.

The trial court sustained both claims, reasoning that the Gardener intentionally structured payments from the asset sale to avoid paying Aldeen's claim (a transfer of assets with the intent to hinder, delay or defraud creditors under Iowa Code Chapter 684), and that piercing was appropriate because, *inter alia*, the sale had rendered GCI undercapitalized for purposes of piercing analysis. The Court of Appeals reversed over Judge Doyle's dissent.

The majority reasoned that the asset sale and payment of proceeds to Gardener (without providing for Aldeen's claim) was not fraudulent under Chapter 684 because Aldeen had not adequately demonstrated that the transfer to GCI's shareholders was made with fraudulent intent. According to the majority, GCI's inability to pay Aldeen's claim was simply "a happy consequence of the sale of the business, as far as Gardener was concerned." However, as Judge Doyle pointed out in dissent—correctly in this author's view—the asset sale structure, where payment for GCI's assets was diverted from the corporation (the party who owed Aldeen's back wages) and instead made directly to its shareholders, was a clear violation of numerous "badges of fraud" under Chapter 684, and amply supported the trial court's fraudulent transfer remedy.

The majority also reversed the trial court's veil-piercing ruling, relying on cases holding that veil piercing is not appropriate simply because a corporation goes out of business without sufficient funds to pay creditor claims.

The latter proposition is clearly correct, but provides no support for the majority's holding. GCI went out of business because it sold all of its assets. The sale should have left GCI with ample funds (nearly $2 million) to pay creditors, but the shareholders appropriated the sale proceeds without properly documenting a corporate distribution. Documenting such a distribution would have required GCI to make provision for paying pending creditor claims before any corporate assets were disbursed to shareholders, and the same would have been true had GCI properly documented liquidating distributions following a corporate dissolution.

While Judge Doyle did not dissent on this ground, in this author's view, Gardener's appropriation of the proceeds of his corporation's asset sale without providing for payment of creditor claims (as Iowa corporate law requires) made the piercing remedy equally appropriate as in the leading Iowa piercing case—*Briggs Transp. Co., Inc. v. Starr Sales Co.*, 262 N.W.2d 805, 809-10 (Iowa 1978)—where controlling shareholders misappropriated the proceeds from the corporation's sale of goods.