

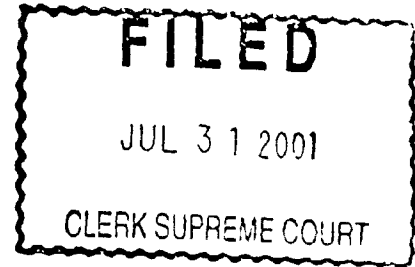
IN THE COURT OF APPEALS OF IOWA

No. 1-182 / 00-866
Filed July 31, 2001

ROBERT JEFFREY WHITE,
Plaintiff-Appellant,

vs.

JAY SHAFF,
Defendant-Appellee.



Appeal from the Iowa District Court for Polk County, Linda R. Reade,
Judge.

Unsecured creditor of a corporate entity appeals following the denial of his
action against the sole shareholder of that corporate entity. **REVERSED AND
REMANDED.**

Stephen V. Nielsen of Carney, Appleby & Nielsen, P.L.C., Des Moines,
and Anthony R. Epping of Reed & Epping, P.C., Des Moines, for appellant.

Thomas H. Burke of Whitfield & Eddy, P.L.C., Des Moines, for appellee.

Heard by Mahan, P.J., and Miller and Vaitheswaran, JJ.

VAITHESWARAN, J.

After obtaining a default judgment against a corporation, White, an unsecured creditor, sought to enforce the judgment against Shaff, the sole shareholder of the corporation, under breach of fiduciary duty, fraudulent transfer, and "pierce the corporate veil" theories. The district court rejected each of these theories following trial. We reverse and remand.

I. Background Facts and Proceedings

Madeleine Drake entered into a commercial lease with Lifeline Ambulance, Inc., a corporation whose sole owner, officer, and director was Jay Shaff. When she died, her estate assigned the lease to her grandson, Robert White.

Lifeline was obligated to pay \$2000 per month under the terms of the lease. Lifeline defaulted on its payments in January, February, and March of 1996. At about the same time, the company sold most of its hard assets to another ambulance company but retained its accounts receivable and its liabilities.

At around the same time, Shaff made arrangements to have another of his corporations, J.O. Shaff Leasing, lend Lifeline \$135,000 to repay its secured lenders. Lifeline in turn pledged its accounts receivable as collateral for the loan. The loan was memorialized in a promissory note, which specified that Lifeline would pay J.O. Shaff Leasing \$11,759.05 per month from April 1996 through March 1997. Shaff made no similar arrangements to repay unsecured creditors of Lifeline such as White.

White sued Lifeline for breach of the lease agreement and obtained a default judgment of \$29,225.29. In an effort to collect the judgment, White then sued Shaff, alleging he: 1) breached a fiduciary duty to unsecured creditors of Lifeline; 2) fraudulently transferred assets to himself in violation of Iowa Code section 684.4; and 3) used Lifeline and his other corporations to insulate his assets from unsecured creditors. At trial, White called Shaff and Lifeline's accountant, Michael Riley, as witnesses. After considering their testimony and extensive documentary evidence, the district court rejected each of his claims and dismissed the lawsuit. This appeal followed.

II. Scope of Review

As the parties tried this case at law, our review is for errors of law. *Iowa Waste Sys., Inc. v. Buchanan County*, 617 N.W.2d 23, 31 (Iowa 2000).

III. Breach of Fiduciary Duty

White asserts Shaff breached a fiduciary duty to him by authorizing Lifeline to repay the debts of Shaff before those of unsecured creditors during a time when Lifeline was insolvent. He specifically challenges fifteen transfers from Lifeline to Shaff between January and December 1996, totaling \$31,350.00. Shaff responds that White has failed to establish that a fiduciary duty exists between a corporate insider and an unsecured creditor of a corporation. We disagree with Shaff.

Generally, a creditor of a solvent corporation has no cause of action against officers or directors of a corporation for mismanagement or waste of assets. 15A Fletcher Cyc. Corp. § 7467 (Perm. Ed. 2000); *Cf. Unertl v. Bezanson*, 414 N.W.2d 321, 324 (Iowa 1987) (stating lack of privity between

creditors and corporation generally prevents them from bringing claims against officers and directors for waste or mismanagement of corporate assets). However, this rule may not apply if a corporation is insolvent or on the verge of insolvency. 15A Fletcher Cyc. Corp. at § 7468. Under those circumstances, most jurisdictions afford creditors a right of action against officers or directors who prefer themselves over other creditors in the repayment of debts. *Id.* at § 7469. Many of these jurisdictions reason that there exists a fiduciary relationship between corporate insiders and the corporation's creditors at the time of insolvency. *Id.* They posit:

[I]t is inequitable that directors, whose knowledge of conditions and power to act for the corporation give them an advantage, should be permitted to protect their own claims to the detriment of others at a time when it is apparent that all the unsecured debts of the corporation are equally in peril and that all of them cannot be paid.

Id.; see also *Helm Financial Corp. v. MNVA R.R., Inc.*, 212 F.3d 1076, 1080-81 (8th Cir. 2000).

Iowa has adopted a modified version of this breach of fiduciary duty rule. See *State v. Simmer Oil Corp.*, 231 Iowa 1041, 1045, 2 N.W.2d 760, 762 (1942); *Boyd v. Boyd & Boyd, Inc.*, 386 N.W.2d 540, 542 (Iowa Ct. App. 1986). Our courts allow an insolvent corporation to repay officers and directors for contemporaneous loans or advances but prohibit repayment of their preexisting loans to the corporation. *Simmer*, 231 Iowa at 1045, 2 N.W.2d at 762; *Boyd*, 386 N.W.2d at 542-43. This partial prohibition on the repayment of insider debts is "calculated to prevent fraud in the management of corporate property" and applies even in the absence of "actual or intentional fraud." *Simmer*, 231 Iowa at 1045-46, 2 N.W.2d at 762. The burden is on the fiduciary to show "utmost good

faith and fairness" in such dealings. *State v. Exline Fuel Co.*, 224 Iowa 466, 467, 276 N.W. 41, 43 (Iowa 1937).

Applying these principles to the case at hand, we must first determine whether Lifeline was insolvent at the time it transferred funds to Shaff. A debtor is considered insolvent "if the sum of the debtor's debts is greater than all of the debtor's assets at fair valuation." Iowa Code § 684.2(1); *First Nat'l Bank in Fairfield v. Frescoln Farms, Ltd.*, 430 N.W.2d 432, 436 (Iowa 1988) (adopting for common law purposes definition contained in Uniform Fraudulent Transfer Act); see also 15A Fletcher Cyc. Corp. § 7472.¹

The district court found Lifeline had been operating under a bankruptcy plan of reorganization since 1990. The court further found the company "had regular and consistent financial problems arising from the lack of adequate cash flow", noting that by early 1996, all Lifeline's bills were over thirty days in arrears and some were delinquent by over 300 days. Finally, the court found that the company's liabilities exceeded its assets in 1995 and 1996. These findings are binding on us if supported by substantial evidence. *Bergantzel v. Mlynarik*, 619 N.W.2d 310, 310 (Iowa 2000). We find they are.² Based on these findings, we conclude Lifeline was insolvent at the time it transferred \$31,350 to Shaff. Lifeline's insolvency triggered a fiduciary duty on the part of Shaff, its sole

¹ Defining corporation as insolvent "if the assets are insufficient to pay its debts, and it has ceased, or is about to cease operations, or has taken, or is about to take a step which will practically render it unable to continue its business with any reasonable prospect of success, or if its embarrassments are such that early suspension and failure must ensue."

² Balance sheets, billing statements and testimony from Michael Riley support these findings.

shareholder, towards the unsecured creditors of Lifeline. *Exline*, 224 Iowa at 468, 276 N.W. at 43; *Boyd*, 386 N.W.2d at 543.

The next question is whether Shaff breached that fiduciary duty by accepting payments from the corporation while it was insolvent. There is no question Shaff lent Lifeline money over the course of its existence. There is also no question Lifeline had not repaid Shaff by the beginning of 1996 when it began making the contested payments to Shaff. The key issue is whether these payments were for antecedent or contemporaneous debts. If they were for antecedent debts, they would be prohibited preferences. *Simmer*, 231 Iowa 1045, 2 N.W.2d at 762; *Boyd*, 386 N.W.2d at 542-43. If they were for a contemporaneous debt, the payments might be permissible, assuming the insider receiving the payments acted with "utmost good faith and fairness." *Boyd*, 386 N.W.2d at 543.

The district court found the checks to Shaff were in repayment of a contemporaneous debt reflected by the \$135,000 note from Lifeline to J.O. Shaff Leasing. We disagree. None of the fifteen contested payments in 1996 were for \$11,759.05, the amount specified in the note. Additionally, none of the checks were made out to J.O. Shaff Leasing, the entity that lent the money. Shaff asserts this fact is immaterial, as it is accepted practice for shareholders of closely held S-corporations³ to inject and extract funds from their corporations. This response however, begs the question. Our focus is not on whether transfers between a corporation and its majority shareholder are permissible for tax

³ S-corporations use a special IRS election; rather than pay corporate taxes, the gains and losses of S-corporations pass through to the personal tax returns of the individual corporate owner. See Iowa Code § 422.7 (1999).

purposes but on whether Shaff's receipt of payments from his insolvent corporation was permissible in light of his fiduciary duty to unsecured creditors. The fact that Lifeline made the contested checks payable to Shaff rather than J.O. Shaff Leasing raises doubts as to whether the payments were indeed intended to pay down the \$135,000 note. These doubts are reinforced by the fact that Lifeline wrote other checks to "J.O. Shaff Leasing" during the same time period. Additionally, Shaff could not ascribe all the challenged 1996 payments to repayment of the \$135,000 note. He testified that most of the checks were *either* payments on that loan *or* payments on prior debts owing to Shaff and his other corporations. For these reasons, Shaff failed to prove the contested 1996 payments were in repayment of the contemporaneous \$135,000 debt.

We find another reason to reject Shaff's argument that the contested payments were permissible transfers. Even if all the contested checks could be construed as repayments to J.O. Shaff Leasing for a contemporaneous loan, the payments were in actuality a means of absolving Shaff of personal liability for preexisting debts owed by Lifeline to third parties, at a time when unsecured creditors received nothing. See *Exline*, 224 Iowa at 467, 276 N.W. at 44 (noting insider served personal interests rather than fiduciary role to creditors in obtaining a security interest from corporation to cover antecedent debts); 15A Fletcher Cyc. Corp. § 7476 (noting general rule that preferential payments exonerating insiders from liability as sureties, guarantors or endorsers are invalid); *see also* § 7477 (noting rule prohibiting officers of an insolvent corporation from obtaining preference over other creditors prevents officers of same from preferring another corporation of which they are also officers). When asked why J.O. Shaff Leasing

would have any interest in lending money to Lifeline for repayment of Lifeline's secured debts, Shaff responded:

I personally have liability for the taxes owed to the federal government. I personally had a guarantee on the bank loan with Iowa State Bank, and had I not borrowed the money, the loan money from J.O. Shaff Leasing to Lifeline Ambulance, Inc. to pay, to satisfy those debts, the liens would not have been released from Lifeline, Inc. and the asset sale could not have gone forward because the purchaser would not of [sic] had clear title.

Under these circumstances, we conclude all fifteen of the contested 1996 payments from Lifeline to Shaff were impermissible preferential transfers.

As our resolution of White's common law breach of fiduciary duty claim is dispositive of the appeal, we find it unnecessary to address the fraudulent transfer and corporate veil theories.⁴

IV. Disposition

On appeal, White seeks judgment in the amount of \$20,827.00.⁵ We reverse and remand for entry of judgment against Shaff in this amount, plus interest and costs.

REVERSED AND REMANDED.

⁴ It appears clear that White's statutory fraudulent transfer theory does not supplant his common law breach of fiduciary duty claim. Iowa Code § 684.7(1)(b); see *Helm*, 212 F.3d at 1080; *Invo Florida, Inc., v. Somerset Venturer, Inc.*, 751 So. 2d 1263, 1267 (Fla. App. 3 Dist. 2000). Additionally, a personal judgment may be entered against Shaff on the common law breach of fiduciary duty claim, rendering it unnecessary for us to address the corporate veil theory. See *Rowen v. Le Mars Mut. Ins. Co.*, 282 N.W.2d 639, 662 (Iowa 1979).

⁵ Although White's petition seeks judgment against Shaff for the entire amount of his default judgment against Lifeline, White seeks approximately \$10,000 less on appeal, based on his reading of the Uniform Fraudulent Transfer Act. The conclusion portion of his brief restates his request for this lesser amount as to all three claims.