IN THE COURT OF APPEALS OF IOWA

No. 9-156 / 08-1005
Filed August 6, 2009

WILLIAM L. MCGINNIS, HEYOUNG L. MCBRIDE, and JOSEPH L. RHOADES,
Plaintiffs-Appellants,

vs.

THE IOWA CLINIC, P.C., et al.,
Defendants-Appellees.

Appeal from the Iowa District Court for Polk County, Glenn E. Pille, Judge.

The plaintiffs appeal from the district court order granting summary judgment in favor of the defendants on one count and dismissing another count. **AFFIRMED.**

Nick Critelli and Tre Critelli of Law Chambers of Nicholas Critelli, P.C., Des Moines, for appellants.

John F. Lorentzen, Patrick B. White, and Matthew R. Eslick of Nyemaster, Goode, West, Hansell & O'Brien, P.C., Des Moines, for appellees.

Heard by Vaitheswaran, P.J., and Potterfield and Doyle, JJ.

VAITHESWARAN, P.J.

A group of radiologists filed a multiple-count petition against the Iowa Clinic, P.C. (the Iowa Clinic) and other defendants. They alleged that they terminated their employment with the Iowa Clinic and went into business on their own after the clinic entered into a joint venture with their competitors for the purchase and operation of radiation equipment known as the Cyberknife.

The petition contained three claims: (1) a claim styled "shareholder derivative action for disgorgement," (2) a damage action for breaches of the defendants' claimed "fiduciary duties of loyalty, good faith and fair dealing," and (3) a claim seeking a declaration that the radiologists were not subject to a non-compete clause in their employment agreements because of the defendants' "obligations to the Plaintiffs in their Shareholder Employment Agreement, and/or . . . fiduciary duties of loyalty, good faith and fair dealing owed the Plaintiffs as fellow shareholders of the Iowa Clinic, PC, a close corporation."

The Iowa Clinic filed a counterclaim asserting in part that the radiologists violated the non-compete provisions of their employment agreements. Additionally, the Iowa Clinic and all the remaining defendants, except a company known as Cyberknife, L.L.C., moved to dismiss the "shareholder derivative action for disgorgement."

The district court granted the motion. The court also granted summary judgment for the defendants on the radiologists' breach of fiduciary duty claims against the corporation and its directors, shareholders, and officers. The court denied the defendants' motion for summary judgment as to the radiologists'

"breach of contract claim against the Clinic based on the implied covenant of good faith and fair dealing."

Following a bench trial, the district court concluded that the radiologists failed to prove their breach-of-contract claim. The court further concluded that the radiologists violated the non-compete provision of their employment agreements. The court ordered them to pay liquidated damages to the Iowa Clinic.

The radiologists appeal these rulings.

I. Motion to Dismiss "Derivative" Count

A district court ruling on a motion to dismiss is reviewed for errors of law. *Iowa Telephone Ass'n v. City of Haywarden*, 589 N.W.2d 245, 250 (Iowa 1999).

The "derivative" count of the radiologists' petition alleged in pertinent part that (1) "Defendants breached the fiduciary duties owed to Plaintiffs as fellow shareholders in a closely held corporation," (2) the Iowa Clinic allowed its professional name and logo to be used by competitors, which "directly benefitted those competitors at expense and costs to its own members," and (3) the Iowa Clinic directed business to its competitors, which "directly benefitted those competitors at expense and costs to its own members." The count also contained a relevant sealed allegation.[1] Finally, the count alleged that "defendants' conduct was oppressive and coercive to the Plaintiffs." The "derivative" count sought a variety of equitable relief including the disgorgement

[1] Although the radiologists and the district court referred to this allegation in public filings, it does not appear that the allegation was formally unsealed.

of "any ownership, revenue, control or economic interest in and from" the joint venture, and removal of the officers and directors of the Iowa Clinic.

The court granted the defendants' summary judgment motion on the grounds that (1) the radiologists did not comply with statutory prerequisites to the filing of a derivative action and (2) "[a]llowing Plaintiff's derivative suit [as a common law action] would eviscerate the comprehensive (and consequently exclusive) scheme the legislature adopted for derivative actions."[2]

On appeal, the radiologists only challenge the court's second conclusion. They argue that "common law recognizes a derivative action by a shareholder of a closely held corporation who has been personally damaged as a result of a breach of fiduciary duty by fellow shareholders." The radiologists resort to the common law because they wish to avail themselves of remedies associated with derivative actions while escaping the requirements associated with statutory "derivative proceedings." They characterize their common law action as a "derivative direct action."

The defendants respond that a "derivative direct action" is "an oxymoron." They assert,

> [a] shareholder claim is either derivative, in which case it is a representative action brought to remedy injury to the corporation, or it is direct, in which case it is brought to remedy an injury to the particular plaintiff bringing the claim.

In their view, the claim cannot be both derivative and direct. We agree.

A derivative action has been characterized as follows:

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[2] The district court found it unnecessary to address the defendants' assertion that the "derivative" count did not state a claim for relief.

> [E]quity permits a stockholder, as a representative of the corporation and of all other stockholders, and for the primary benefit of the corporation, and the secondary, indirect and derivative benefit of stockholders similarly situated, to bring action in his name. Such an action is known as a stockholders' derivative or representative action, in which the corporation is made a nominal defendant though it is in fact, the real plaintiff in interest.

State ex rel. Weede v. Bechtel, 244 Iowa 785, 811, 56 N.W.2d 173, 187 (1952). "As a matter of general corporate law, shareholders have no claim for injuries to their corporations by third parties unless within the context of a derivative action." *Cunningham v. Kartridg Pak Co.*, 332 N.W.2d 881, 883 (Iowa 1983) (citations omitted).

There is "a well-recognized exception to the general rule: a shareholder has an individual cause of action if the harm to the corporation also damaged the shareholder in his capacity as an individual rather than as a shareholder." *Id.* (citations omitted). This exception applies as follows:

> [I]n order to bring an individual cause of action for direct injuries a shareholder must show that the third-party owed him a special duty *or* that he suffered an injury separate and distinct from that suffered by the other shareholders.

Id.

In short, a derivative action is a vehicle to redress harm to the corporation, while an individual action is a vehicle to redress harm to the shareholder that is separate and distinct from that suffered by other shareholders.[3] Iowa common law does not recognize a "derivative direct action."

We must next determine whether the count raises a derivative claim or an individual claim. While the caption "Shareholders' Derivative Action for

[3] There is no allegation that a third party owed the radiologists a "special duty."

Disgorgement, Constructive Trust and Removal" indicates it is a "derivative" count, captions do not necessarily control the disposition of a motion to dismiss and reliance on them may elevate form over substance. *See Jones v. Iowa State Highway Comm'n*, 207 N.W.2d 1, 2 (Iowa 1973) (determining the subject of the suit based on the allegations made in the petition, not on the caption); *Lee v. Coon Rapids Nat'l Bank*, 166 Iowa 242, 248, 144 N.W. 630, 632-33 (1913) ("[I]n this state all 'forms of action' are abolished . . . and all that is necessary for one who invokes the power of the court to protect a right or redress a wrong is that he shall make a plain statement of the facts, avoiding mere legal conclusions, and he may recover thereon whatever the law will allow either for breach of contract or for tort without reference to the name or form of action which might have been necessary or available under the ancient practice.") Therefore, we will examine the substantive allegations contained within the count.

The first key allegation, that defendants "breached the fiduciary duties owed to Plaintiffs as fellow shareholders in a closely held corporation," includes within its ambit shareholders other than the plaintiffs. The second key paragraph, alleging harm based on the use of the clinic's name and logo at the "expense and costs to its own members," refers to harm affecting all the shareholders. The same is true of the third key allegation, referring to business that was directed to the clinic's competitors at "expense and cost to its own members," as well as the fourth sealed paragraph. All these allegations are derivative in nature. *See C Plus Northwest, Inc. v. DeGroot*, 534 F. Supp. 2d 937, 942 (S.D. Iowa 2008) (noting actions against corporate directors for competing with the corporation were typically derivative in nature); *Whalen v.*

Connelly, 545 N.W.2d 284, 292-93 (Iowa 1996) (noting claim that general partners were mismanaging the partnership and wasting partnership assets was derivative in nature). Additionally, the count seeks relief that is plainly derivative in nature. For example, the petition's general summary of the relief requested in this count states:

> Plaintiffs, as shareholders and for and on behalf of all fellow shareholders, bring action against the individual Defendants, all officers, directors and/or shareholders of The Iowa Clinic, PC for the establishment of a constructive trust against all assets, income or revenue relating to or emanating from the Defendant Central Iowa Cyberknife, LLC.

This paragraph plainly seeks redress for harm suffered by the corporation. *See First Nat'l Bank v. Fireproof Storage Bldg. Co*., 199 Iowa 1285, 1294, 202 N.W. 14, 18 (1925) ("An unlawful diversion of the funds of the corporation is an injury to the corporation. Stockholders may maintain an action therefor, if the directors on demand refuse to do so, but such a suit is for the benefit of the corporation and not in their individual right."). Indeed, the paragraph makes no reference to a "separate and distinct" injury to the radiologists. That allegation comes in the next count, styled "Compensatory and Punitive Damage Claim."

We are left with the allegation that "Defendants' conduct was oppressive and coercive to the Plaintiffs." Allegations such as this have been deemed allegations of individual rather than corporate injury. *DeGroot*, 534 F. Supp. at 942 ("Other types of actions are frequently classified as those which are, per se, appropriate subjects for individual suits: suits alleging oppression, harassment, ..."). However, read in context with the remaining allegations, we are convinced that the bare mention of "oppressive" conduct does not transform this

count from a derivative claim to a claim for redress of individual injury. We conclude that the "derivative" count pled a derivative action for harm to the corporation.

We return to the question that began this discussion: whether the radiologists pled a common-law derivative action that is not subject to the strictures of Iowa Code chapter 490 (2005) or a statutory "derivative proceeding" that is subject to those strictures. *See* Iowa Code § 490.740 (stating that a "derivative proceeding" is "a civil suit in the right of a domestic corporation or . . . foreign corporation"). The radiologists cite *Reiff v. Evans*, 630 N.W.2d 278, 288 (Iowa 2001), for the proposition that common-law derivative suits are authorized, notwithstanding the statutory derivative scheme set forth in chapter 490. *Reiff*, however, simply held that Iowa Code chapter 490, which applies to shareholders of a corporation, did not preclude policyholders in a mutual insurance company from filing a derivative action to hold third parties accountable to their corporation. *Reiff*, 630 N.W.2d at 288.

Unlike the policyholders in *Reiff*, the radiologists are shareholders of a professional corporation that is subject to the requirements of Iowa Code chapter 490. *See* Iowa Code § 496C.3. Therefore, their "derivative" count was a "derivative proceeding" under Iowa Code section 490.740 and they were required to comply with the statutory prerequisites for filing this type of proceeding. *See Ezzone v. Riccardi*, 525 N.W.2d 388, 394 n.2 (Iowa 1994) ("Derivative suits on behalf of Iowa corporations are governed by Iowa Code § 490.740 (1993)). Under that provision, certain procedures must first be followed before a shareholder is allowed to bring suit for a wrong done the corporation."). The

district court found that they did not do so. As the radiologists do not dispute those findings on appeal, we conclude the district court did not err in dismissing the "derivative" count based on non-compliance with the statutory prerequisites.[4]

II. Summary Judgment.

Summary judgment is appropriate where there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. Iowa R. Civ. P. 1.981(3).

As noted, the radiologists pled a "separate and distinct" claim for damages based on alleged breaches of the "fiduciary duties of loyalty, good faith, and fair dealing" by "Edward Brown as CEO," "Steve Herwig as President," and Drs. Carlstrom and Hlavin "as shareholders." The district court granted summary judgment in favor of the Iowa Clinic and its directors, officers and shareholders as to all Plaintiffs' breach of fiduciary duty claims. The radiologists seek reversal of that ruling.

We begin by characterizing the nature of the radiologists' claims. The alleged breaches of "the fiduciary duties of loyalty, good faith and fair dealing" are in fact two separate claims, one founded in tort for breach of a fiduciary duty of loyalty, *Cookies Food Prods., Inc. v. Lakes Warehouse Distrib., Inc.*, 430 N.W.2d 447, 451 (Iowa 1988), and one founded in contract for breach of an implied covenant of good faith and fair dealing. *Fogel v. Trustees of Iowa*

[4] Even if we were to assume that the radiologists' "derivative" count pled an individual action for separate and distinct injury, we would find no error in the district court's dismissal of the count. That is because the individual injury assumed to be alleged in that count is no different from the individual injury alleged in the damage count. That type of injury does not entitle the radiologists to the relief sought in their "derivative" count.

College, 446 N.W.2d 451, 456 (Iowa 1989). The district court denied summary judgment on the claim for breach of an implied covenant of good faith and fair dealing. Therefore, we only need to decide whether the district court properly granted summary judgment with respect to the tort-based claim of breach of the fiduciary duty of loyalty.

On this claim, the radiologists argue that the district court erred in granting the motion because the Iowa Clinic is a closely-held corporation, triggering fiduciary duties among shareholders which presumably entitle them to individual relief. We need not decide whether the Iowa Clinic is a closely-held corporation because we are persuaded that, even if it is, and even if that status generally triggers fiduciary obligations among shareholders entitling them to individual relief, the radiologists as a matter of law did not state a claim for breach of a duty of loyalty against the named defendants. *See Weltzin v. Cobank*, *ACB*, 633 N.W.2d 290, 292 (Iowa 2001) ("Whether defendants owed fiduciary duties or other duties under tort or contract law to the Coop are issues that can be properly resolved through summary judgment."); *but see Cemen Tech., Inc. v. Three D Indus., L.L.C.*, 753 N.W.2d 1, 13 (Iowa 2008) (stating the fiduciary duty issue could not be decided as a matter of law in light of confidentiality and non-disclosure agreements).

The duty of loyalty generally requires officers and directors to act in the best interests of the corporation and its shareholders, avoid conflicts of interests, and not engage in faithlessness and self-dealing. 18B Am. Jur. 2d *Corporations* § 1480 at 471 (2004). In Iowa, the duty has been stated as follows:

> A director of a corporation owes the corporation complete loyalty, honesty, and good faith. *Rowen v. Le Mars Mutual Ins. Co.*, 282 N.W.2d 639, 649 (Iowa 1979); *Holi-Rest, Inc. v. Treloar,* 217 N.W.2d 517, 525 (Iowa 1974); *Holden v. Constr. Machinery Co.,* 202 N.W.2d 348, 358 (Iowa 1972); *Gord v. Iowana Farms Milk Co.,* 245 Iowa 1, 16-17, 60 N.W.2d 820, 829 (1953); *Des Moines Bank & Trust Co. v. Bechtel & Co.,* 243 Iowa 1007, 1081, 51 N.W.2d 174, 216 (1952); G.G. Bogert and G.T. Bogert, *Trusts and Trustees* § 544, at 407-09 (2d rev. ed. 1978). That duty is owed the corporation and its shareholders whenever the actions of the director concern "matters affecting the general well being of the corporation." *Yerke v. Batman,* 176 Ind. App. 672, 676, 376 N.E.2d 1211, 1214 (1978).

Midwest Mgmt. Corp. v. Stephens, 353 N.W.2d 76, 80 (Iowa 1984). As noted, we assume without deciding that the same duty of loyalty applies among the shareholders of the Iowa Clinic. We turn to the specific allegations against the named defendants.

Edward Brown was the chief executive officer of the Iowa Clinic. The district court concluded that summary judgment was appropriate as to all claims against Brown, as "Plaintiffs have not supported their allegations that Brown was ever a shareholder or board member." On appeal, the radiologists' argument in favor of reversal is premised on "the fiduciary duties owed by physician shareholders in a professional corporation." As they do not take issue with the determination that Brown was not a shareholder, we affirm the summary judgment ruling as to him.

The next named defendant was the president of the Iowa Clinic, Steven Herwig. The radiologists responded to the defendants' partial motion for summary judgment with a "statement of uncontested material fact." They asserted that Herwig had a fiduciary duty of loyalty as follows:

> The Defendants Steven R. Herwig D.O., . . . by operation of the Shareholder Employment Agreement, are bound by a "loyalty" pledge to each physician shareholder to the effect that:
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> Physician shall not at any time or place or to any extent whatsoever, either directly or indirectly, without the prior written consent of the Board, engage in professional practice or in any activity competitive with or adverse to the business, practice or affairs of Clinic, whether alone, as a partner, or as an officer, director, employee, consultant to or shareholder of any other corporation or as consultant to or shareholder of any other corporation or as a trustee, fiduciary or other representative, except under and pursuant to this Agreement, and all fees or other income attributable to Physician's professional services during the term of this Agreement shall belong to Clinic except income permitted to be excluded as provided in the Manual. Physician shall provide through Clinic substantially all services that the Physician provides.

If this paragraph defines a legally cognizable fiduciary duty of loyalty, that duty runs from the physician to the Iowa Clinic. Nothing in this paragraph creates a duty from Dr. Herwig in any of his professional capacities to the radiologists. Therefore, we conclude that the radiologists were not entitled to relief as a matter of law on their claim against Dr. Herwig for breach of a fiduciary duty of loyalty.

This brings us to the radiologists' claims against Dr. Carlstrom and Dr. Hlavin, both shareholders of the Iowa Clinic. With respect to Dr. Carlstrom, the radiologists alleged,

> [A]t the same time as they were conducting their due diligence regarding radiation oncology SRS linear accelerator bases system equipment, the neurosurgeon, Defendant Thomas Carlstrom, was performing an independent investigation regarding SRS radiation oncology equipment known as the "Cyberknife."

They also alleged that Dr. Carlstrom, together with Edward Brown, "engaged Plaintiffs' professional competitors, Mercy Therapeutic Radiology Associates, in discussions regarding a joint venture concerning the purchase of a Cyberknife." And, they alleged that Carlstrom and Hlavin had discussions with Mercy about a

joint venture, "unbeknownst to the Plaintiffs." Finally, they alleged that Carlstrom and Hlavin became members of the Board of Managers of Central Iowa Cyberknife, L.L.C. "on behalf of the Iowa Clinic, P.C."

In their "statement of uncontested fact" the radiologists asserted that Drs. Carlstrom and Hlavin breached a duty of loyalty contained in the same paragraph of the shareholder employment agreement cited above. They also stated that the two physicians "began sending their radiation oncology cancer patients to a Minneapolis, Minnesota Cyberknife center."

We begin with the allegations that Drs. Carlstrom and/or Hlavin investigated the Cyberknife, held discussions with Mercy about the joint venture without the initial knowledge of the radiologists, and eventually became members of the board of the joint venture entity. The district court appropriately addressed these allegations in the context of the radiologists' claim for breach of an implied covenant of good faith and fair dealing. On our review of the summary judgment record, we can discern no legal basis for concluding that these facts separately evinced a breach of a duty of loyalty to the plaintiffs. *See Weltzin*, 633 N.W.2d at 295 (stating summary judgment appropriate where "the sum of the evidence available to the nonmoving party is legally insufficient to support the claim made").

Turning to the assertions in the radiologists' statement of uncontested fact, we have already noted that the cited language from the shareholder employment agreement does not create a cognizable duty of loyalty between or among shareholders. It creates a duty, if at all, only between physicians and the Iowa Clinic. As there was no duty created by the employment agreement that

redounded to the benefit of the radiologists, we conclude the district court did not err in granting summary judgment for Drs. Carlstrom and Herwig on the radiologists' claim of breach of a fiduciary duty of loyalty.

With respect to the assertion that Drs. Carlstrom and Herwig sent their business to a Minneapolis center, Dr. McGinnis conceded in deposition testimony that physicians could refer their patients to "whoever they wish." This concession disposes of their claim that Drs. Carlstrom and Hlavin breached a fiduciary duty of loyalty by sending patients elsewhere.

III. Covenant not to Compete/Breach of Implied Covenant of Good Faith and Fair Dealing

The radiologists finally sought a declaration that their obligation to comply with a covenant not to compete was discharged by the defendants' claimed violation of a covenant of good faith and fair dealing. In a thorough post-trial ruling, the district court rejected this claim.

On appeal, the radiologists contend that the district court "used the wrong standard to identify good faith and fair dealing." They argue, "[H]ad the employer been viewed as a professional corporation or partnership where the members were in uberrima fides, the standard of 'good faith and fair dealing' would have been viewed differently." Alternately, they argue, "[H]ad the trial court applied the correct commercial standard concerning good faith and fair dealing, the result would have been different." The radiologists do not elaborate on the first argument, conceding that the district court's reluctance to view the employer as a professional corporation was addressed in the court's earlier combined ruling on the motion to dismiss and motion for summary judgment. Therefore, we will

proceed to the radiologists' alternate contention, whether the court applied the "correct commercial standard."

In ruling on the plaintiffs' claim that the defendants breached an implied covenant of good faith and fair dealing, the court quoted the following language from *Kooyman v. Farm Bureau Mutual Insurance Company*, 315 N.W.2d 30, 34, (Iowa 1982):

> The phrase 'good faith' is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized (in other contexts) as involving 'bad faith' because they violate community standards of decency, fairness or reasonableness.

(Citing Restatement (Second) of Contracts § 205 cmt. a (1981)). The radiologists maintain that "[i]n essence the trial court required Plaintiffs to prove 'bad faith' as that term is used in the tort of third-party bad faith." We disagree.

While *Kooyman* involved bad faith representation by an insurance company, the quoted language is identical to language cited by the radiologists as the correct standard. The court's intermittent references to "bad faith" were either references to assertions made by the radiologists or, when read in context, reflected an accurate application of the *Restatement* standard.

The radiologists also argue that the district court was obligated "to take into account the fiduciary relationship of the parties" in deciding whether the defendants breached an implied covenant of good faith and fair dealing. As they cite no authority for this proposition, we reject this contention.

The radiologists do not challenge the fact-findings made by the district court to support the conclusion that the defendants did not breach an implied covenant of good faith and fair dealing. Therefore, we affirm the district court's judgment on that issue.

AFFIRMED.