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IN THE IOWA DISTRICT COURT FOR SCOTT COUNTY

REG WASHINGTON, LLC, Plaintiff, v. IOWA RENEWABLE ENERGY, LLC; LARRY RIPPEY; MARK COBB; ED HERSHBERGER; RON LUTOVSKY; MIKE BOHANNAN; JOHN HEISDORFFER; STEVE POWELL; AND TIM SWIFT, Defendants.	Equity No. EQCE128952 **RULING AND ORDER ON DEFENDANTS' PRE-ANSWER MOTION TO DISMISS**

Plaintiff REG Washington, LLC ("REG") filed its Petition in equity seeking a writ of mandamus or, in the alternative, an injunction against Defendants Iowa Renewable Energy, LLC ("IRE"), along with IRE's officers and directors, Larry Rippey, Mark Cobb, Ed Hershberger, Ron Lutovsky, Mike Bohannan, John Heisdorffer, Steve Powell, and Tim Swift. The Petition, filed on May 9, 2017, recounts Plaintiff's attempted purchase of membership Units in Defendants' limited liability company and alleges that this acquisition was improperly interfered with by the collective action of Defendants. Defendants responded on July 6, 2017 by filing a Pre-Answer Motion to Dismiss for failure to state a claim upon which relief can be granted. Plaintiff filed its Resistance to Defendant's Pre-Answer Motion to Dismiss on July 26, 2017, to which Defendants filed their Reply on August 2, 2017, and oral argument was held August 22, 2017. The Court, having considered the Motion to Dismiss, Plaintiff's Resistance, Defendant's Reply, and having considered the arguments of counsel, issues the following Ruling and Order:

Factual Background and Proceedings

A. Background Related to the Contested Transfers

REG is a producer of bio-based fuel and renewable chemicals located in Ames, Iowa. IRE is an Iowa limited liability company organized under chapter 489 of the Iowa Code that operates a bio-diesel production facility in Washington, Iowa. IRE has issued over 26,000 units, which are held by approximately 600 unitholders.

The individually-named defendants are Officers and Directors of IRE: Defendant Larry Rippey serves as Chairman, Chief Executive Officer, President, and Director of IRE; Defendant Mark Cobb is the Vice Chairman and a Director of IRE; Defendant Ed Hershberger is the Secretary and a Director of IRE; and Defendant Ron Lutovsky is the Chief Operating Officer and Chief Financial Officer of IRE. Defendants Mike Bohannon, John Heisdorffer, Steve Powell, and Tim Swift all serve as Directors of IRE. Pet. ¶¶ 3-11.

On December 30, 2016, REG made a tender offer to IRE unitholders in which REG offered to purchase 49% of IRE's Class A units and 49% of IRE's Class B units ("Initial Tender Offer") to acquire a minority share in the company. *Id.* ¶ 16. REG increased its proposed purchase price first on January 13, 2017 ("Amended Tender Offer"), and again on February 26 ("Final Tender Offer"). Only twenty-seven IRE unitholders ("Tendering Unitholders"), representing approximately 7% of total issued IRE units, responded to REG's Final Tender Offer. *Id.* ¶ 22. These Tendering Unitholders signed sales contracts with REG for the transfer of their collective 1,845 units at a purchase price of $442.50 per unit. *Id.* ¶¶ 22, 24. REG paid cash consideration for the acquisition of these units on March 3, 2017. In this same transaction, the Tendering Unitholders also provided REG with their respective proxies and powers of attorney associated with their units.

On March 8, 2017, counsel for REG informed IRE of its sales contract with the Tendering Unitholders and requested that the IRE Board of Directors ("Board") approve the transfer pursuant to IRE's Third Amended and Restated Operating Agreement ("Operating Agreement"). *Id.* ¶ 30; Ex. B ("REG opinion letter"); *see also* Ex. A ("Operating Agreement"). In this communication, REG provided IRE with an opinion letter stating that REG had complied with the terms of IRE's Operating Agreement and addressed various tax and regulatory issues, as required by the Operating Agreement. *See* Ex. A § 9.3 (setting forth conditions and representations required prior to a proposed transfer of membership interest). IRE, through counsel, replied to REG's opinion letter on March 25, 2017. Counsel for IRE informed REG that the Board had declined to approve the transfer of the IRE units. *Id.* ¶ 34. Among the reasons cited by IRE for its refusal to permit the transfer included "adverse tax consequences" for the company if more than a specified number of its units were transferred in any one calendar year. *Id.* ¶ 39. At the same time, IRE tendered an offer of its own to repurchase the Units from the Tendering Unitholders for a price of $600 per unit ("Unit Repurchase Offer").

On March 22, 2017, REG engaged in an additional "private" purchase of an additional 50 IRE units from Tim Burrack ("Burrack") for the same price. REG signed a second sales contract with Burrack ("Burrack Contract") for the acquisition of his units accompanied by his proxy and power of attorney. *Id.* ¶ 47-49. REG again informed IRE of the proposed transfer and requested that the Board approve the acquisition. *Id.* ¶ 51-52; Ex. C. Again, IRE declined to approve the transfer of the Burrock units to REG pursuant to its Operating Agreement and notified REG of its decision not to permit the transfer of the Burrack units to REG on April 26, 2017. Pet. ¶ 54-56; Ex. D.

B. The IRE Operating Agreement

Ownership interest in IRE is measured in "Units." Pet. Ex. A § 1.10(ccc). "Membership Interest" in IRE collectively includes two distinct interests in the company: "Membership Economic Interest" and "Membership Voting Interest." *Id.* § 1.10(jj). IRE's Operating Agreement delineates these two specific aspects of ownership in IRE held by an IRE Unitholder in Section 1.10:

> (ii) "Membership Economic Interest" means collectively, a Member's share of "Profits" and "Losses", the right to receive distributions of the Company's assets, and the right to information concerning the business and affairs of the Company provided by the Act. The Membership Economic Interest of a Member is quantified by the Unit of measurement referred to herein as "Units."
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> . . .
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> (ll) "Membership Voting Interest" means collectively, a Member's right to vote as set forth in this Agreement or required by the Act and as otherwise restricted by Section 6.5 of the Agreement regarding the voting rights of the Class A Members and Class B Members.

The provisions relevant to transferability of membership interest are provided in Chapter 9 of the Operating Agreement:

> Section 9.1 Restrictions on Transfers. Except for Permitted Transfers, no Member shall transfer all or any part of its Units, voluntarily or involuntarily, or by operation or process of law or equity, unless and until the Directors have approved the Transfer in writing, which approval may be withheld in the Directors' sole discretion.

Pet. Ex. A § 9.1. New Members are admitted to IRE pursuant to rules governing the provisions under Sections 9.7 and 9.8 of the Operating Agreement:

> Section 9.7 Rights of Unadmitted Assignees. A Person who acquires Units but who is not admitted as a substituted Member under Section 9.8 shall be an unadmitted assignee entitled only to the Membership Economic Interests with respect to such Units in accordance with this Agreement, and shall not be entitled to the Membership Voting Interest with respect to any information or accounting of the affairs of the Company, shall not be entitled to inspect the books or records of the Company, and shall not have any of the rights of a Member under the Act or this Agreement.

> Section 9.8 Admission of Substituted Members. A transferee of Units shall only be admitted as a substituted Member if approved by the Directors in their sole discretion and if such transferee has complied with the following provisions . . . .

Pet., Ex. A §§ 9.7, 9.8. Finally, the Operating Agreement dictates that

> Any purported Transfer of Units that is not permitted under [Chapter 9 of the Operating Agreement] shall be null and void and of no force or effect whatsoever; provided that, if the Company is required to recognize such a Transfer (or if the Directors, in their sole discretion, elect to recognize such a Transfer), the Units Transferred shall be strictly limited to the transferor's Membership Economic Interests . . . .

Pet., Ex. A § 9.4.

Applicable Law and Analysis

I. Motion to Dismiss Standard

A party is entitled to judgment as a matter of law "if the petition fails to state a claim upon which any relief may be granted." *U.S. Bank v. Barbour*, 770 N.W.2d 350, 353 (Iowa 2009) (citing Iowa R. Civ. P. 1.421(1)(f)). Though not a particularly favored litigation tool under Iowa law, see Cutler v. Klass, Whicher, & Mischne, 473 N.W.2d 178, 181 (Iowa 1991), a motion to dismiss is appropriate "when there exists no conceivable set of facts entitling the non-moving party to relief." *Rees v. City of Shenandoah*, 682 N.W.2d 77, 79 (Iowa 2004) (quoting *Barkema v. Williams Pipeline Co.*, 666 N.W.2d 612, 614 (Iowa 2003)). Even under Iowa's "notice-pleading standards," a petition may be properly dismissed as a matter of law upon a timely motion by the defendant where "a plaintiff's petition on its face shows no right of recovery under any state of facts." *Id.* (citing *Trobaugh v. Sondag*, 668 N.W.2d 577, 580 (Iowa 2003)). Therefore, "a dismissal at this stage must rest on legal grounds." *Mlynarik v. Bergantzel*, 675 N.W.2d 584, 586 (Iowa 2004).

When ruling on a motion to dismiss, the moving party admits the facts alleged in the petition. *Young v. HealthPort Techs., Inc.*, 877 N.W.2d 124, 127 (Iowa 2016). Additionally, the

non-moving party's petition is assessed in a light most favorable to the non-moving party; all doubts and ambiguities are resolved in its favor. *State ex rel. Miller v. Philip Morris, Inc.*, 577 N.W.2d 401, 403 (Iowa 1998).

II. Analysis

The primary issue to be decided is whether Defendant IRE's Operating Agreement may validly restrict a member's ability to transfer his or her interests to a non-member to only those transfers previously approved by IRE's Board of Directors. The Court will first decide the proper construction of IRE's Operating Agreement purporting to restrict the transferability of Membership Interest in the company. The Court will next address REG's claim that IRE breached the implied contractual obligation of good faith and fair dealing by declining to approve the transfer of Units to REG. Finally, the Court will consider whether this construction is consistent with principles of law governing Iowa limited liability companies.

For the reasons discussed below, the Court holds that IRE's Operating Agreement effectively restricts the transfer of both Membership Economic Interest and Membership Voting Interest, subject to the approval of the transfer by IRE's Board of Directors. The Court further rules that such restrictions are entirely consistent with legal principles governing Iowa limited liability companies.

A. Construction of the IRE Operating Agreement: IRE's Operating Agreement does expressly restrict transfer of its units.

The first issue is whether the terms of the Operating Agreement allow an outside non-member party to acquire Membership Interest in IRE without prior Board approval permitting the transfer. REG asserts that it is entitled to the Units it purports to have acquired under the transfer provisions in chapter 9 of the Operating Agreement by arguing that, even if the

Operating Agreement restricts the transfer of full membership interest, its terms do not restrict the transfer of economic interests and the right to receive distributions from the company. The Court disagrees. IRE's Operating Agreement effectively limits the transfer of all membership interests held by a Unitholding Member to only permit those transactions approved by the Board of Directors.

Iowa's Revised Uniform Limited Liability Company Act ("Re-ULLCA"), as adopted under chapter 489 of the Iowa Code, governs Iowa LLCs. Under the default provisions in Re-ULLCA, all members in an existing LLC must consent before an outside party is admitted to the company as a member unless the operating agreement provides otherwise or the transfer of interest is the result of a merger. Iowa Code § 489.401(4) (2017). Indeed, "membership status is personal to the member and cannot be freely transferred like corporate shares can." Matthew G. Dore, Iowa Practice Series—Business Organizations, § 13.15 & n.4 (2016).

By contrast, the transfer of economic interest in an LLC's business is certainly permissible under Iowa law. Economic interest in an LLC is personal property; non-member parties may possess limited financial rights when acquired as a transferee of a member's transferable, or economic, interest. Iowa Code §§ 489.501, 489.502(1)(a) (permitting transfer of a "transferable interest"). However, one major caveat exists. Re-ULLCA also provides that "[t]he obligations of a limited liability company and its members to a person in the person's capacity as a transferee or dissociated member are governed by the operating agreement." Iowa Code § 489.112(2). Any purported transfer of a member's transferable interest that violates restrictions on transfer contained in the operating agreement is ineffective. Iowa Code § 489.502(6). Ultimately, the contracting language of the parties controls. In the absence of relevant contractual provisions, chapter 489 provides default rules. *Id.* § 489.110(1)-(2). As such,

only those parties that have legal rights under the Operating Agreement may assert rights under them.

REG argues that even if the transfer provisions contained in chapter 9 of the Operating Agreement require Board approval to transfer a Unitholder's Membership Voting Interest, they do not require approval to transfer a Unitholder's Membership Economic Interest. According to REG's reading of the Operating Agreement, the prohibition in section 9.1 that no Member transfer "all" or "any part" of its Units without Board approval refers only to the total number of Units owned by that Member, or any lesser amount thereof. *See* Pl.'s Br. in Supp. of Resistance to Defs.' Pre-Answer Mot. to Dismiss ("Resistance"), at 7. In line with this position, REG first argues that the provision is silent as to the type of interest—Economic or Voting—that is restricted from transfer. It therefore cannot be said, so the argument goes, that the parties intended to restrict the transfer of both types of interests held by a Unitholding Member. In the alternative, REG argues that the there is sufficient ambiguity in the language to create a genuine dispute as to the proper construction of these contractual terms.

The Court is not convinced by REG's construction of the Operating Agreement provisions in question. REG goes to great lengths to construe the Operating Agreement in its favor but ultimately attempts to create an ambiguity in the contractual language where one does not exist. The plain language of the transfer restriction provisions in the Operating Agreement does not distinguish between "economic" and "voting" interests. *See* Ex. A § 9.1 Rather, it restricts both.[1]

[1] REG also draws a distinction between the dual interests provided for under the IRE Operating Agreement and the statutory "transferable interest" discussed under Iowa Code section 489.102(24). *See* Resistance, at 7, 11-12. The right to receive distributions provided for in the transferable interest is entirely consistent with, and not distinct from, the Membership Economic Interest provided for in the Operating Agreement. That the Operating Agreement uses a different term for this particular interest is of no legal consequence. *Compare* Iowa Code § 489.102(24) (defining a

A "Unit" is defined in the IRE Operating Agreement as "an ownership interest in the Company . . . including any and all benefits to which the holder of such Units may be entitled . . . together with all obligations . . . ." Pet., Ex. A § 1.10(ccc). Because a "Membership Interest" refers collectively to the benefits and obligations of both Economic and Voting Interests, any provision constricting the ability of a Member to transfer "all" or "any part" of its interest in the company must necessarily be referring to both. Thus, when section 9.1 restricts the transfer of "Units" and requires Board approval prior to such transfer, it by definition restricts all interests and obligations—both Economic and Voting—contained within that particular Unit. Even reading the Petition in a light most favorable to it the position advanced by REG cannot be maintained. It stands to reason that if the contracting parties had intended to limit the restrictions in section 9.1 to purely Membership Economic Interests, and not Membership Voting Interests, they would have expressly done so in the language of the Operating Agreement. In other words, if the contracting parties had meant not to restrict transfer of the Units *in full* (including both Membership Interests contained therein), then they would have explicitly stated which specific Membership Interest was restricted to transfer by Board approval and which Membership Interest was not.

REG next attempts to argue that section 9.7 provides evidence that there is no requirement of Board approval for transfer of the Membership Economic Interest because that provision allows REG to acquire ownership as an "unadmitted assignee." *See* Resistance, at 8-9. Section 9.7 states that a third party is entitled to Membership Economic Interest only where the

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"transferable interest" as "the right . . . to receive distributions from a limited liability company in accordance with the operating agreement . . .") *and* Dore, § 13.28 ("[The transferable interest] is a pure financial right and entails no management rights.") *with* Pet. Ex. A § 1.10(ii) (defining "Membership Economic Interest" as "a Member's share of 'Profits' and 'Losses,' the right to receive distributions of the Company's assets, and the right to information concerning the business and affairs of the Company provided by the Act").

party has "acquired" Units but has not yet been admitted as a substituted Member pursuant to Section 9.8. Pet. Ex. A § 9.7. Accordingly, REG argues that this language allows a party to "acquire" Units prior to the approval by the Board and, until the Board approves the transfer (or if it decides in its discretion not to approve the transfer), the party is still entitled to the financial rights of those Units, even if not their voting power. REG argues, in essence, that this language of chapter 9 only allows the IRE Board to restrict transfer of Voting Interest, but does not allow it to restrict the transfer of Economic Interest if the transaction has already taken place.

The Court finds this construction similarly unconvincing. REG's position assumes that Units in IRE can be "acquired" prior to Board approval and wholly depends on the contention that it has in fact already has. But the language in the Operating Agreement governing transfers is straightforward in providing that "no Member shall transfer all or any part of its Units . . . unless and until the Directors have approved the Transfer in writing, which approval may be withheld in the Directors' sole discretion." Pet., Ex. A § 9.1. Under the terms of the Operating agreement, only "Permitted Transfers" occurring by operation of law are exempt from the approval requirements of section 9.1. Pet. Ex. A § 9.2. However, transfers of economic interests in the company that do not occur by operation of law do not fall within the purview of this exception in section 9.2. If section 9.1 grants the Board discretion over proposed transfers in Units held by IRE members, but does not distinguish between the interests contained within the units, it follows that REG could not acquire any interest at all in the IRE units "unless and until" the Board affirmatively approved the transfer.

Both the Operating Agreement and default provisions in Re-ULLCA are clear on the position taken by REG: Any transfer of interests that is not conducted in compliance with specific contractual terms contained in the LLC operating agreement is void. *See id.* § 9.4

(stating that any "purported Transfer of Units that is not permitted under this Section shall be null and void and of no force or effect whatsoever"); Iowa Code § 489.502(6) ("A transfer of a transferable interest in violation of a restriction on transfer contained in the operating agreement or another agreement to which the transferor is a party is ineffective as to a person having notice of the restriction at the time of transfer.").[2] REG therefore could not have acquired the Units prior to Board approval to be considered an unadmitted assignee under § 9.7. In sum, the transfer procedures outlined in chapter 9 of the Operating Agreement do not provide REG with the acquisition of IRE Units, nor any legal interest therein.

B. Obligation of Good Faith and Fair Dealing

REG further lacks a statutory basis for the contractual rights it purports to assert. Re-ULLCA, as adopted by the Iowa Legislature under chapter 489 of the Iowa Code, dictates that managers in a manager-managed LLC "shall discharge the duties under this chapter or under the operating agreement and exercise any rights consistently with the contractual obligation of good faith and fair dealing." Iowa Code §§ 489.409(4); 489.409(8)(c); *see also* Rev. Unif. Ltd. Liability Co. Act, § 409(d) (Unif. Law Comm'n 2006) (amended 2013). Commentary to the Uniform Act endorses the notion that Re-ULLCA invokes the implied standard of conduct that governs parties in every contract. *See* Rev. Unif. Ltd. Liability Co. Act, § 409 cmt. (d) (2013)

[2] REG had notice of the provisions in the Operating Agreement that restricts the transfer of Units for purposes of this ruling. REG provided IRE with notice of the Sales Contracts and Burrack Contract and requested that the IRE Board approve the transfer according to its terms. Pet. ¶ 30; *see also id.* ¶ 51. REG further complied with other requirements in the Operating Agreement when it certified to IRE in an opinion letter that the "conditions for transfer of units set forth in the Operating Agreement had been met." Pet. ¶ 52; *see also id.* ¶ 32. Moreover, section 9.9(b) of the Operating Agreement conspicuously states:

> THE TRANSFERABILITY OF THE MEMBERSHIP UNITS REPRESENTED BY THIS CERTIFICATE IS RESTRICTED. SUCH UNITS MAY NOT BE SOLD, ASSIGNED, OR TRANSFERRED, NOR WILL ANY ASSIGNEE, VENDEE, OR TRANSFEREE OR ENDORSEE THEREOF BE RECOGNIZED AS HAVING ACQUIRED ANY SUCH UNITS FOR ANY PURPOSES, UNLESS AND TO THE EXTENT SUCH SALE, TRANSFER, HYPOTHECATION, OR ASSIGNMENT IS PERMITTED BY, AND IS COMPLETED IN STRICT ACCORDANCE WITH, THE TERMS AND CONDITIONS SET FORTH IN THE OPERATING AGREEMENT OF THE COMPANY AND AGREED TO BY EACH MEMBER.

(citing Rest.2d Contracts § 205 (Am. Law Inst. 1981) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.")). As a matter of basic contract law, the implied contractual obligation of good faith and fair dealing cannot be eliminated by the operating agreement. Iowa Code § 489.110(3)(e).

An LLC operating agreement is a contract between the parties agreeing to become members in the company and abide by negotiated terms. Iowa Code § 489.102(15) (defining "operating agreement"); Rev. Unif. Ltd. Liability Co. Act, § 110 introductory cmt. (2006) ("A limited liability company is as much a creature of contract as of statute, and Section 102(13) delineates a very broad scope for 'operating agreement.'"); *see also Elf Atochem N. America, Inc. v. Jaffari*, 727 A.2d 286, 295 (Del. 1999) (holding that "because the policy of the [Delaware Limited Liability Company Act] is to give the maximum effect to the principle of freedom of contract and to the enforceability of LLC agreements, the parties may contract to avoid the applicability of [statutory default provisions]"). Whether this obligation is fulfilled by the managers of a manager-managed LLC depends on the conduct between the members and managers of the LLC, and it is measured against the reasonable expectations sought by the contracting parties to the operating agreement. Rest. 2d Contracts § 205 cmt. (a) ("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 follows that such a contractual duty extends only to other managers and members of the company who are parties to the operating agreement; there is no independent obligation owed to non-members who are not parties to the contract.

It is clear that as a non-member, REG has no statutory basis for its claims against IRE. The Re-ULLCA explicitly states a "member may maintain a direct action against another

member, a manager or a limited liability company to enforce the member's rights and otherwise protect the member's interests . . ." Iowa Code §489.901 (emphasis added). The Re-ULLCA provides no independent statutory duty of good faith to non-members.

The 2013 harmonized comments provide guidance regarding the exact nature of the implied covenant of good faith and fair dealing imposed under state law based on the Uniform Act:

> "[F]or the most part th[ese] duties and rights apply to relationships *inter se* the members and the LLC and function only to the extent not displaced by the operating agreement . . . [S]tatutory default rules are intended in essence to function like a contract; applying the contractual notion of good faith and fair dealing therefore makes sense."

Rev. Unif. Ltd. Liability Co. Act, § 409 cmt. (d) (2013). Delaware courts have similarly found that the obligation of good faith and fair dealing is implied only for the benefit of the parties to the operating agreement—thus, a limited liability company and its managers owe duties solely to the LLC and its members, not non-members:

> An implied covenant claim . . . looks to the past. It is not a free-floating duty unattached to the underlying legal documents. It does not ask what duty the law should impose on the parties given their relationship at the time of the wrong, but rather what the parties would have agreed to themselves had they considered the issue in their original bargaining positions at the time of contracting.
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> "Fair dealing" is not akin to the fair process component of entire fairness, i.e., whether the fiduciary acted fairly when engaging in the challenged transaction as measured by duties of loyalty and care whose contours are mapped out by [state] precedents. It is rather a commitment to deal "fairly" in the sense of consistently with the terms of the parties' agreement and its purpose. Likewise "good faith" does not envision loyalty to the contractual counterparty, but rather faithfulness to the scope, purpose, and terms of the parties' contract. Both necessarily turn on the contract itself and what the parties would have agreed upon had the issue arisen when they were bargaining originally.

Gerber v. Enterprise Products Holdings, LLC, 67 A.3d 400, 418-19 (Del. 2013) (quoting *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*, 50 A.3d 434, 440-

42 (Del. Ch. 2012)), *overruled on other grounds*, 76 A.3d 808, 814 n.13 (2013). This Court finds compelling reasons to treat Iowa LLCs similarly.

Consequentially, REG's ability to sue to enforce the implied contractual obligation of good faith and fair dealing under the terms of the Operating Agreement rests on its status as a Member of IRE. Because the Court finds that REG did not actually acquire any Membership Interest in IRE through its transactions in the Sales Contract or Burrack Contract, REG is not a "member" with any rights to enforce in this instance. IRE's Board of Directors therefore does not owe an implied duty of good faith and fair dealing to REG pertaining to the transactions at issue.

Nor has REG shown that the obligation of good faith and fair dealing was intended to be implied for its benefit as a third party by the contracting members of IRE. Non-members who are not parties to a contract are not permitted to sue under the terms of the contract unless that non-member is a third-party beneficiary that the contracting members expressly intend to benefit from the agreement. *See Sygenta Seeds, Inc. v. Bunge N.A., Inc.*, 773 F.3d 58, 64 (8th Cir. 2014) ("A nonparty becomes legally entitled to a benefit promised in a contract . . . only if the contracting parties so intend."); *Bailey v. Iowa Beef Producers, Inc.*, 213 N.W.2d 642, 644-45 (Iowa 1973) (holding that "the right of a person to sue as a third-party beneficiary was limited to those cases where the person for whose benefit the promise was made has the sole, exclusive interest in its performance") (internal quotations omitted).[3] Indeed, an implied covenant of good faith and fair dealing must have an underlying contractual term to which it can be attached. *See Bagelmann v. First Nat'l Bank*, 823 N.W.2d 18, 34 (Iowa 2012) (holding that "the covenant [of

[3] The Iowa Court of Appeals has indirectly ruled that the covenant of good faith and fair dealing is only implied for the benefit of the parties to an operating agreement, not non-member parties. *See Urbandale Best, LLC v. R & R Realty Group*, No. 13-1879, 2015 WL 799544, at *23 (Iowa Ct. App. Feb. 25, 2015) (stating that "[w]hen agreeing to contract" to form an LLC operating agreement, "the parties enter an implied covenant not to act in a way that will destroy or injure the rights of the other party to receive the fruits of the contract.") (citing *Am. Tower, L.P. v. Local TV Iowa, LLC*, 809 N.W.2d 546, 550 (Iowa Ct. App. 2011)).

good faith and fair dealing] does not give rise to new substantive terms that do not otherwise exist in the contract" and finding "any allegation of bad faith here lacks a statutory duty to which it can be attached") (internal quotation marks omitted).

In the present case, there is no indication that the IRE Operating Agreement was intended to extend protection to non-member third parties seeking acquisition of Membership Interest.[4] As such, the Court finds that REG does not have the requisite basis to claim the right to sue under the terms of the operating agreement.[5] Viewing the Petition in light most favorable to the nonmoving party, REG fails to state a claim upon which relief may be granted. Even assuming, *arguendo*, that IRE's Board of Directors declined to approve the transfer of Units under the Sales and Burrack Contracts in bad faith, REG would still not be entitled to the relief its seeks because the obligation of good faith and fair dealing does not extend to a non-member third party like REG. REG has not cited, and the Court is unaware of, a single case where a Court has done what REG is requesting this Court to do—invalidate the provisions of an LLC Operating Agreement and force an LLC to approve a non-permitted transfer to a non-member.

C. "Corporification"[6] and the Applicability of Corporate Law Analogies

An LLC is a "hybrid business entity" that draws on principles of both partnership law and corporate law in its defining characteristics. *Estate of Countryman v. Farmers Co-op. Ass'n*, 679

[4] Even other jurisdictions cited by REG likewise recognize that whether the exercise of discretion by the managing board of an LLC is unreasonable and arbitrary to constitute a breach the implied covenant of good faith and fair dealing depends on the reasonable expectations of the parties at the time of contracting. *See Perry Capital LLC v. Mnuchin*, No. 14-5243, 2017 WL 3078345, at *29 (D.C. Cir. Feb. 21, 2017) (remanding the case to determine whether the conduct of the parties violated their reasonable expectations).

[5] In its Resistance, REG cites a number of cases from other jurisdictions that have granted a tender-offeror standing to challenge a target corporation's decision to deny the transfer of interest to the acquiring party. *See* Resistance, at 10-11. For reasons explained in Part C, *infra*, the Court finds these cases unpersuasive to the case at bar because each dealt specifically with incorporated entities, which are premised on fundamentally different principles of business organization than LLCs. Corporate law principles of free-transferability discussed in these cases are not applicable to the transferability of membership interest in an LLC under the Iowa Limited Liability Company Act.

[6] This term has been loosely used to describe the "incorporation" of corporate law principles to LLCs. *See* Bradley T. Bradley et al., *It's a Bird, It's a Plane, No, It's a Board Managed LLC!* 1-2 (Brooklyn L. Sch., Legal Studies Paper No. 488), http://ssrn.com/abstract=2940437.

N.W.2d 598, 602 (Iowa 2004); Matthew G. Dore, 5 Iowa Prac. Series—Business Organizations § 1.6 (2016). Yet REG routinely cites corporate law cases to support its allegations that the Operating Agreement's restrictions on transfers of Membership Interest are improper[7] and that IRE's Board violated the implied covenant of good faith and fair dealing, along with its fiduciary duties.[8] According to REG, "IRE's Board structure and large number of unitholders," alone, demand application of corporate law principles to Iowa limited liability companies. Resistance, at 15 n.6. REG argues that a transfer restriction is subject to a "reasonableness" standard that some courts apply to transfers of corporate stock. REG cites no case authority for its argument that this standard is applicable to LLC's. Iowa law does not support REG's position.

While analogies to corporate law may be appropriate in certain situations,[9] the transferability of membership interest in an LLC entity is not one of them. Contrasted with other principles of incorporated business organizations, "[o]ne of the most fundamental characteristics of LLC law is its fidelity to the 'pick your partner' principle. [S]ection [502] is the core of the Act's provisions reflecting and protecting that principle." Rev. Unif. Ltd. Liability Co. Act §§ 502 introductory cmt. (2006); *see also* Dore, § 13.28 ("While transfers of such interests resemble corporate share transfers in some respects, there are important differences because Re-ULLCA severely restricts the rights of a transferee of a member's transferable interest."). Ultimately, Re-ULLCA counsels that the intention of the contracting parties must be controlling: "Unless the operating agreement otherwise provides, a member acting without the consent of all other members lacks both the power and the right to: (i) bestow membership on a non-member; or (ii)

[7] *See* Resistance, at 3-4, 10.
[8] *See* Resistance, at 14 & n.5, 15-17, 18-19.
[9] *See, e.g.*, *Obeid v. Hogan*, No. CV 11900-VCL, 2016 WL 3356851, at *6-8 (Del. Ch. June 10, 2016) (determining that corporate law governing special litigation committees and demand futility in derivative litigation could be applicable to LLCs).

transfer to a non-member anything other than some or all of the member's transferable interest." Rev. Unif. Ltd. Liability Co. Act § 502 introductory cmt. (2006) (internal citations omitted).

Here, IRE has provided otherwise. The Member parties contracting to form IRE specifically limited their ability to transfer any aspect of Membership Interest under the Operating Agreement by requiring approval by the Board of Directors. *See* Pet., Ex. A § 9.1. These contracting parties left the decision of whether or not to approve the transfer to the "sole discretion" of the Directors. *Id.* Thus, it would be wholly inappropriate to apply principles of corporate law that undermine this basic premise—the underlying understanding of the Unitholding parties as set forth in their contract to consciously decide who they intend to enter into business with.

REG's analogies to corporate law principles regarding interest transferability are misplaced for this very reason. Iowa law recognizes the right of a party acquiring corporate stock to legal and equitable relief when the target corporation's board refuses to recognize the acquisition. *See Carlson v. Ringgold Cty. Mut. Tel. Co.*, 108 N.W.2d 478, 480-82 (Iowa 1961). However, the same legal rule does not control in the context of an LLC. As opposed to incorporated entities, which promote the free transferability of interests, see Dore, § 1.5(5), restrictions on the transferability of an LLC's membership interests lies at the heart of the limited liability company as a business entity choice. *See* Rev. Unif. Ltd. Liability Co. Act § 502, introductory cmt. (2006) (stating the "pick your partner" principle embodied by the Act). REG is correct to point out that, in limited instances, courts in other jurisdictions have applied corporate law principles to LLCs. However, REG fails to cite any case law indicating support to extend corporate principles to Iowa LLCs in matters specifically pertaining to the transferability of membership interest.

The Delaware Court of Chancery had the occasion in *Obeid v. Hogan* to analogize principles of corporate law to an LLC where the parties employed corporate labels and principles to the entity's management structure in the operating agreement. *See Obeid*, 2016 WL 3356851, at *5-7. Specifically, the *Obeid* case involved the applicability of special litigation committees and the requirement of demand futility in derivative litigation by a member party in the LLC context. There, the court held that, due to the corporate traits in the LLC at issue, corporate law precedent in *Zapata v. Maldonodo*, 430 A.2d 779 (Del. 1981) should guide analysis of the company's special litigation committee. *Id.* at *8. But due to the nature of LLCs as "creatures of contract," the Delaware court expressly cautioned against analogizing to corporate law too hastily and that such comparisons must be closely scrutinized:

> It is important not to embrace analogies to other entities or legal structures too broadly or without close analysis, because the flexibility inherent in the limited liability company form complicates the task of fixing such labels or making such comparisons. The drafters of an LLC agreement may have adopted partnership-like features for particular aspects of their relationship and corporate features for others.

Id. at *6 (internal citations omitted). Indeed, the court recognized that the corporate analogy largely depends on the entity's operating agreement and the particular substantive feature of the business entity at issue. *Id.* at *6.

In contrast to *Obeid*, the present action poses entirely different issues of law regarding the transferability of membership interest to an *outside, non-member party*. The *Obeid* Court acknowledged that membership in an LLC is starkly different in nature to that of a corporation and that "[t]he analogy may break down in other areas as well, such as in terms of the extent to which the interests and the rights they carry are fully alienable." *Id.* at *7 (comparing the default provisions regarding restrictions on transfer of interest in the Delaware corporate code to those in the Delaware limited liability company act). The *Obeid* Court noted that the analogy to corporate

shareholder derivative lawsuits was appropriate in that particular instance because "[t]he derivative suit is a corporate concept grafted onto the limited liability company form." *Id.* (quoting *Elf Atochem N. Am. v. Jaffari*, 727 A.2d 286, 293 (Del. 1999)). However, the Delaware court further contemplated the importance of examining the nature of the substantive feature and the legislative policy at issue, pointing out that case law governing corporate derivative lawsuits would not always apply to LLCs in every dispute. *See id.* & n.6 (comparing *VGS, Inc. v. Castiel*, No. C.A. 17995, 2003 WL 723285 (Del. Ch., March 27, 2003) (applying corporate law principles) *and Gotham P'rs, L.P. v. Hallwood Realty P'rs, L.P.*, 1998 WL 832431 (Del. Ch., Nov. 10, 1998) (same) *with CML V, LLC v. Bax*, 6A.3d 238 (Del. Ch. 2010) (declining to apply corporate law principles), *aff'd*, 28 A.3d 1037 (Del. 2011)). Accordingly, this Court finds corporate law inapplicable to provisions in chapter 489 of the Iowa Code in an LLC operating agreement regarding the transferability of interest in an LLC.[10]

Furthermore, applying corporate law principles in this instance would undermine the intent of the contracting parties under the IRE Operating Agreement to not permit transfers of any part of a Member's Membership Interest without the consent of the managing Board. *See* Rev. Unif. Ltd. Liability Co. Act § 409 cmt. (d) ("Courts should not use the obligation [of good faith and fair dealing] to change ex post facto the parties' or this Act's allocation of risk and power.") Allowing REG to pursue acquisition of Membership Interest in IRE in this way is inconsistent with the purpose of LLCs as business entities and the "pick your partner" policy endorsed by the Iowa Legislature as a matter of law.

[10] Because corporate law is not applicable to the issue of interest transferability, REG's argument regarding the application of *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) fails as a matter of law. *See* Resistance, at 15-19. It is especially convincing that the corporate standard in *Unocal* is inapplicable to Iowa LLCs because "*Unocal* defendants must actually articulate some legitimate threat to *corporate* policy and effectiveness." *Air Prod. & Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48, 92 (Del. Ch. 2011) (emphasis added). As discussed above, there is no corporate policy governing the transferability of membership interest in an Iowa LLC.

The Court also notes that it agrees with the compelling policy issues at play here as discussed in Defendants' Reply Brief: those of maximizing investor value and avoiding the unnecessary litigation and uncertainty for unit holders as to whether an offer is binding. As REG acknowledges in the Petition, IRE made its own redemption offer for units at the price of $600, or $157.50 per unit *higher* than REG's $442.50 offer. By this action, REG seeks to force the IRE Board to approve unit transfers at the lower price, thus forcing members to convey their units at a lower price than available under IRE's redemption offer. There is no argument that such a holding would be in the best interest of the IRE unit holders, indeed it would directly harm them. Further, it would not be in the best interest of Iowa LLC members to hold, as REG urges here, that any board decision to approve or not approve membership transfers is subject to suit by third-parties for a test of reasonableness, opening the door for litigation, second guessing board decisions, delay, and uncertainty for LLCs. This would all occur in spite of the fact that the contracting parties had expressly agreed by their contract that the sole discretion to approve membership transfers was vested with the Board. If the actual parties to the agreement, the members of the LLC, assert that they were treated unfairly or that the Board did not act in good faith, that is one thing—but to allow suits by third-parties is quite another.

D. Motion to Amend

REG's motion to amend its pleadings must be denied. Additional pleadings and factual discovery cannot cure the Petition's defects because, as a matter of law, REG is not entitled to purchase membership Units of IRE without Board approval. Parties may amend their pleadings once as a matter of course at any time prior to a responsive pleading being served. *See* Iowa R. Civ. P. 1.402(4). Outside of this time period, "leave to amend . . . shall be freely given when justice so requires." *Id.* Yet Courts are afforded "considerable discretion" to allow parties to

amend their pleadings; it may be inappropriate to deny a party leave to amend only when "a clear abuse of discretion" is shown. *Bennet v. City of Redfield*, 446, N.W.2d 467, 474-75 (Iowa 1989); *see also Daniels v. Holtz*, 794 N.W.2d 813, 825 (Iowa 2010) (finding the trial court did not abuse its discretion to in denying leave to amend the pleadings because there was no factual basis that could afford the plaintiff recovery under the law). Because REG Washington cannot plead additional facts that would alter the law governing transferability of membership interest in an Iowa LLC, leave to amend is not required here.

RULING

In conclusion, the Operating Agreement does not allow Members to transfer any aspect of their Membership Interest to non-member third parties without prior approval by the Board of Directors. Furthermore, the contractual obligation of LLC members and managers to act in accordance with the covenant of good faith and fair dealing does not extend to non-members like REG who are not parties to the Operating Agreement. Finally, corporate law analogies purporting to limit an LLC's ability to restrict the transfer of membership interest in the company are inapplicable to Iowa LLCs like IRE because such principles undermine the contracting intent of the Member parties and are irreconcilable with Iowa's Limited Liability Company Act. REG's Petition, on its face, shows no right of recovery under Iowa law. IRE's Pre-Answer Motion to Dismiss must therefore be granted as a matter of law.

IT IS THEREFORE ORDERED, ADJUDGED AND DECREED that Defendants, Iowa Renewable Energy, LLC, Larry Rippey, Mark Cobb, Ed Hershberger, Ron Lutovsky, Mike Bohannan, John Heisdorffer, Steve Powell, and Tim Swift's Pre-Answer Motion to Dismiss is GRANTED and Plaintiff's Petition is DISMISSED at Plaintiff's cost.

State of Iowa Courts

Type: OTHER ORDER

Case Number	**Case Title**
EQCE128952	REG WASHINGTON, LLC V. IOWA RENEWABLE ENERGY, LLC

So Ordered

John Telleen, District Court Judge,
Seventh Judicial District of Iowa