IN THE COURT OF APPEALS OF IOWA

No. 6-416 / 05-0794
Filed October 11, 2006

BALINS PROPERTIES, INC.,
Plaintiff-Appellant,

vs.

FIRST NATIONAL BANK OF WEST UNION, West Union, Iowa, and TEDDIE LENSING, d/b/a CURVES FOR WOMEN,
Defendant-Appellees.

Appeal from the Iowa District Court for Fayette County, Margaret L. Lingreen, Judge.

Plaintiff appeals the district court's directed verdicts for defendants on its claim of breach of contract, rescission, and reformation arising from a right of first refusal. **AFFIRMED IN PART AND REVERSED IN PART.**

James W. Radig of White & Johnson, P.C., Cedar Rapids, for appellant.

Jeffrey Clements of Clements Law Office, West Union, for appellee Bank.

Dennis G. Larson of Larson Law Office, Decorah, for appellee Lensing.

Heard by Vogel, P.J., and Vaitheswaran, J., and Schechtman, S.J.*

*Senior judge assigned by order pursuant to Iowa Code section 602.9206 (2005).

SCHECHTMAN, S.J.

This is an action by Balins Properties, Inc. (Balins), a Wisconsin corporation, the assignee of a lease containing a right of first refusal to purchase real estate, which housed its sub shop and other rental areas. The defendants, in separate counts, are the lessor, First National Bank of West Union (Bank), and the proposed purchaser and lessee of the remaining rental areas, Teddie Lensing (Lensing).

The action against the Bank is at law for breach of contract. Balins alleges the Bank violated its duty of good faith and fair dealing. It requests damages, attorney fees, and expenses.

The claim against Lensing lies in equity, asking the court to find her lease to be commercially unreasonable and terminable by the court. In the alternative, Balins requests that the lease be modified (reformed) to delete or amend certain unfavorable provisions. Lensing responds by requesting monetary sanctions under Iowa Rule of Civil Procedure 1.413.

Following a four-day bench trial, the district court sustained motions for directed verdict made by each of the defendants during the course of the trial, which it had taken under advisement. Judgment was entered for the Bank in the sum of $13,851.08, as the lease provided that attorney fees and costs shall be paid by the "prevailing party" in the event of litigation. Judgment was also entered against Balins and its attorneys in favor of Lensing for $6500 each, as sanctions for violation of rule 1.413.

I. Background Facts

In 1994, Brent Johnson constructed a one-story retail-office building situated in the southwest quadrant of the intersection of Highways 18 and 150 in West Union, Iowa. Subway Real Estate Corp. (Subway) had committed to the rental of the easterly 1200 square feet, which fronted Highway 150, prior to its construction. The space was finished pursuant to its specifications. The adjoining westerly 2000 feet consisted of two connecting units for lease to other enterprises. They were more modest in finish and design.

The Bank held the mortgage on the property. It was the subject of voluntary foreclosure proceedings in 1998, which resulted in it becoming the landlord. At that time, the two westerly units were vacant and in general disrepair.

Subway's lease began in January 1995. Its terms called for a monthly rental of $425 per month, plus a pro-rata share of real estate taxes, insurance, and maintenance of the exterior common areas, including the parking lots. The lease was for the term of two years, with the option to renew for nine consecutive terms of two years each. The written lease, on Subway's standard form, contained a right of first refusal clause:[1]

> If the Landlord receives an offer to purchase the property in which the demised premises is located during the term of this lease, and the offer to purchase shall be satisfactory to Landlord, Tenant shall have the opportunity to purchase the property at the price and on the terms of said offer. Landlord shall give Tenant written notice via certified or registered mail requiring the Tenant to accept the offer in writing and to sign a contract to purchase the

[1] "This conditional or contingent right is sometimes called a right of 'preemption' or of 'first refusal.'" *Imperial Refineries Corp. v. Morrissey*, 254 Iowa 934, 940, 119 N.W.2d 872, 876 (1963). We use the terms interchangeably herein.

> premises within thirty (30) days after the mailing of the notice. Tenant's failure to accept the offer to purchase or sign a contract within thirty (30) days shall nullify and void the Tenant's option and Landlord shall be at liberty to sell the premises to any other entity. Any subsequent sale, except to Tenant, shall be subject to this lease and any renewals or extensions hereof.

Todd Balekos of Monona, Iowa, had other Subway franchises. Balekos acquired the West Union franchise in 1997, operating as a sublessee of Subway. Balekos assigned the sublease and franchise to his operating corporation, Subalekos, Inc., sometime in 1998.[2] After the remaining 2000 square feet was vacated, Balekos exercised a lease provision that reduced his cash rent in half, and forgave the triple-net rental payments because less than seventy-five percent of the entire building space was occupied.

The Bank was interested in selling the property, not leasing, even though leasing the other units would have restored Subway's full triple-net rental payments. It listed the property for sale with a local realtor. The Bank did not receive any offers to purchase for four years, although the listing price was reduced, in varying stages, from $210,000 in October 1998 to $125,000 in September 2002. William Collins, an incorporator and shareholder with Balekos in Balins, offered $85,000 in November 2002, without identifying his ties with Balekos. The offer was rejected.

In September 2002, Lensing acquired the "Curves for Women" franchise for West Union. As a franchisee, Lensing was obligated to be in operation within six months. Her husband contacted the Bank about leasing the vacant areas of the subject property. The Bank reiterated its lack of interest in leasing it,

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[2] For simplification, we refer to the then lessee as "Balekos."

preferring a sale of the entire property. Lensing preferred a lease to avoid a large capital investment. Lensing was advised about Subway's right of first refusal. Balekos was contacted. Lensing urged Balekos to buy assuring him Curves would be willing to rent the vacant portion for a rental in the range of $500 to $600 per month. Balekos made no firm comment, one way or the other. Similar contacts ensued with similar results. Lensing looked at other locations for lease.

Facing a deadline for acquiring a location and adapting it to her needs, Lensing, through her husband, Russell, reluctantly negotiated a purchase of the real estate for $100,000 with the Bank on December 10, 2002. In order to assure a location, Lensing insisted upon the contemporaneous execution of a lease for the vacant areas with the Bank as lessor. The rental consideration was $150 per month, plus a pro-rata share of real estate taxes, insurance, and parking maintenance (estimated at $420 per month), for a total monthly outlay of $570. This exceeded the quoted rent for four other locations the Lensings had been shown. Lensing and the Bank considered the rental to be sufficiently attractive to induce Subway and/or Balekos to purchase. Lensing continued to prefer to rent.

The Bank advised Subway and Balekos, in writing, of the offer. It enclosed a copy of the leases to Lensing and Subway. Within thirty days, Subway exercised its right of first refusal. The following day, an attorney for Subway and Balekos affirmed the exercise of the right of first refusal in writing, adding they were "not waiving their rights that have arisen because of the lease that First National Bank of West Union entered into with Teddie Lensing, d/b/a

Curves for Women, on December 10, 2002." There followed a recitation of its claim against the Bank for "breach of implied covenant of good faith and fair dealing," and a claim against Lensing for inference with its business relations with the Bank and a conspiracy to make the purchase more "burdensome and expensive to Subway." Thereafter, Balins became the purchaser by assignment, approved by the Bank.

II. Standard of Review

Balins's contract against the Bank was tried at law. Our review is for the correction of errors at law. Iowa R. App. P. 6.4. Balins's action against Lensing was submitted in equity. In equity cases our review is de novo. *Id*. "In equity cases, especially when considering the credibility of witnesses, the court gives weight to the fact findings of the district court, but is not bound by them." Iowa R. App. P. 6.14(6)(*g*).

III. Good Faith and Fair Dealing

Every contract contains an implied covenant of good faith and fair dealing. *Harvey v. Care Initiatives, Inc.*, 634 N.W.2d 681, 684 (Iowa 2001); *Fogel v. Trustees of Iowa College*, 446 N.W.2d 451, 456 (Iowa 1989). Iowa has limited its application to the performance and enforcement of a contract, as opposed to its negotiation. *Engstrom v. State*, 461 N.W.2d 309, 314 (Iowa 1990) (citing Restatement (Second) of Contracts § 205 cmt. c, at 100 (1981)).

Iowa has adopted the definition of good faith employed by the Restatement (Second) of Contracts, which states that "[g]ood faith performance or enforcement of a contract emphasizes faithfulness to an agreed common

purpose and consistency with the justified expectations of the other party . . . ." Restatement (Second) of Contracts § 205 cmt. a, at 100 (1981); *see also Kooyman v. Farm Bureau Mut. Ins. Co.*, 315 N.W.2d 30, 34 (Iowa 1982).

The Restatement references the "duty of good faith and fair dealing," but our decisions have not treated "fair dealing" as an independent or separate duty. Our past analyses have addressed only "good faith" without acknowledging a distinct significance to "fair dealing." It appears to merely complement the duty of good faith and merges into that duty, without limiting or expanding upon it.

As the Eighth Circuit concluded in *Mid-American Real Estate Co. v. Iowa Realty Co.*, 406 F.3d 969, 974 (8th Cir. 2005), the implied covenant of good faith and fair dealing "prevents one party from using technical compliance with a contract as a shield from liability when that party is acting for a purpose contrary to that for which the contract was made." The holding in *Mid-America Real Estate* affords welcome and sound guidance to our analysis of the rule as applied to the facts of this controversy. Though recognizing that no Iowa court has detailed the covenant's limitations, the federal tribunal determined that Iowa would subscribe to the rule that the covenant does not "give rise to new substantive terms that do not otherwise exist in the contract." *Mid-American Real Estate*, 406 F.3d at 974 (citation omitted). As stated in *United States v. Basin Electric Power Co-operative*, 248 F.3d 781, 796 (8th Cir. 2001), the duty of good faith does not import new obligations of reasonable behavior not contained in express terms of contract.

There are valid reasons for this result. Courts should not be prodded into infusing contracts with judicially-generated obligatory terms beyond the bargained terms. It would be chaotic to allow courts to insert new terms into contracts theretofore bargained and negotiated at arms-length; that is, to demand compliance with terms never consented or agreed to by either party. This would injure the "institution of contract with all the advantages private negotiation and agreement brings." *Mid-American Real Estate*, 406 F.3d at 974 (quoting *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990)).

Balins, as assignee, had no justified expectation that it had the right to meet and trump any lease of the remaining areas; nor was the purpose of the right of first refusal to convey such a right. There had been previous leases to a chiropractor and a travel agency that had not been offered to Subway or any of its franchisees, without any notice or objection for lack of notice. The express terms of the lease to Subway did not confer an option to lease. To imply such a duty would insert new substantive terms to the lease that did not exist. The Bank, in executing the offer to purchase and lease to Lensing, did not act for a purpose foreign from that for which the right of first refusal was given.

Balins contends the Bank breached its lease and the right of first refusal by failing to allow it to rent the vacant quarters on the same terms as the lease to Lensing; the offer to purchase and the lease were a "package deal" which made the lease an actual part of the offer to purchase. Balins further asserts that the trial court neglected to address its claim that the Bank violated its implied duty of

good faith. To the contrary, the district court, in its ruling on the motions for directed verdict, acknowledged the allegation, then found the following facts, which had substantive support in the record:

> The Lensings wanted Balekos to purchase the West Union building and rent space to them for Curves. The Lensings even proposed to purchase the building with Balekos . . . . Although Balekos seemed interested in having a Curves close . . . he would not commit himself to purchasing the West Union building.
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> When Teddie Lensing discussed the possibility of renting space from Balekos . . . she mentioned rents of $500 to $600 per month. Balekos never responded that such a rent would be unacceptable, as it was too low. Russell Lensing told Todd Balekos that he thought the Subway building could be purchased from the bank for $100,000. However, Balekos did not appear interested in paying that sum for the building.
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> . . . [T]he Lensings were under pressure to locate space. The Subway building appeared to be best suited to their needs. . . . However, Lensing did not want to purchase the building.
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> . . . Russell Lensing testified he wanted to come up with a rent that would make it attractive to Subway to exercise its right of first refusal and purchase the building.

That this was a "package deal" did not offend the purpose of the right of first refusal. The Bank had the exclusive right to lease the remaining quarters without offering it to the Subway tenant. The lease was an independent agreement with separate consideration. The offer to purchase was similarly independent. Balekos wanted to purchase the property, not upon the Bank's terms, but upon his terms of $85,000. He was aware of the Bank's posture about leasing. Status quo and the passage of time would permit Balekos to continue with the substantially reduced rent, and, if there was a proposed sale, he continued to have the right of first refusal. Contrary to the allegations of Balins, the right of first refusal should not be used to hold the lessor hostage to the

whims of the tenant. An option to lease was not a justified expectation nor a purpose of the right of first refusal. The "package deal" was a fair use of the powers reserved by the landlord, was not arbitrary, and was not forbidden by the terms of the lease.

The property had been appraised in 2001 for $158,000 by a certified real estate appraiser acquainted with West Union valuations. A triple net lease for $570 per month ($150 cash plush $420 monthly for a share of the real estate taxes, insurance, and exterior maintenance) was likewise found to be comparable with similar rentals by an experienced local realtor.

Balins failed to prove that the First National Bank of West Union breached its implied duty of good faith and fair dealing. The terms of its preemptive right to purchase succumbed to the wholesale absence of any justified expectation by Subway and its assignees to elevate that right into a preemptive right to lease the vacant quarters. The Bank's conduct was consistent with the purpose of the lease agreement. Further, the record supports the award to the Bank for attorney fees and costs in the trial court.

IV. Claim against Lensing in Equity

Balins asks for rescission of the existing lease, and, in the alternative, to modification of the lease terms to (1) fairly apportion expenses for exterior maintenance per the parking space ratio; (2) restrict the terms of assignment and subletting; (3) inflate the rental consideration; and (4) increase the adjusted rental, expressed in a percentage, when the options to renew are exercised.

Written instruments affecting real estate may be set aside only upon evidence that is clear, satisfactory, and convincing. Iowa R. App. P. 6.14(6)(*l*); *Breitbach v. Christenson*, 541 N.W.2d 840, 844 (Iowa 1995). Reformation of a written instrument requires evidence of a similar weight proving fraud, duress, deceit, or mutual mistake. Iowa R. App. P. 6.14(6)(*k*); *Breitbach*, 541 N.W.2d at 844.

From the get-go, Balins has asserted that the lease to Lensing should be rescinded or reformed for the reason that it was commercially unreasonable. This is evident from the amended petition, as well as its trial briefs.

Balins cites cases from three foreign jurisdictions as authority for its requests: *Quigley v. Capolongo*, 383 N.Y.S.2d 935, 937 (N.Y. App. Div. 1976), aff'd 372 N.E.2d 797 (1977); *Rollins v. Stokes*, 123 Cal.App.3d 701, 710-12 (1981); and *Texas State Optical, Inc. v. Wiggins*, 882 S.W.2d 8, 11 (Tex. Ct. App. 1994), (relying upon *West Texas Transmission, L.P. v. Enron Corp.*, 907 F.2d 1554, 1563 (5th Cir. 1990)).

Each is factually distinguishable. In *Quigley*, 383 N.Y.S.2d at 937, a sale to a third party was purposely delayed until the expiration of the right of first refusal, though the purchaser had aborted a similar termed purchase upon learning of the plaintiff's preemptive rights.

In *Rollins*, 123 Cal.App.3d at 706, the landlord entered into an option to purchase with Rollins to be exercised starting with the first day after the expiration of the lease, which contained a preemptive right to purchase. Rollins contended that since the option date was beyond the lease period, the lessee

had no preemptive right to purchase. *Rollins*, 123 Cal.App.2d at 708. The California court dismissed Rollins's claim, holding that the tenant held a valid right of first refusal which was exercised prior to Rollins's option to purchase. *Id*. at 712.

The seminal case containing the plaintiff's contentions is *West Texas Transmission*, 907 F.2d at 1563, a federal case attempting to apply Texas law. The objectionable condition, imposed by the owner of the property upon the holder of the right of first refusal, required the latter to obtain the approval of the FTC in order to exercise its preemptive right. *West Texas Transmission*, 907 F.2d at 1557. The Fifth Circuit concluded:

> [T]he owner of property subject to a right of first refusal remains master of the conditions under which he will relinquish his interest, as long as those conditions are commercially reasonable, imposed in good faith, and not specifically designed to defeat the preemptive rights.

Id. at 1563.

Four years later, the Texas Court of Appeals, in *Texas State Optical*, 882 S.W.2d at 11, concluded that *West Texas Transmission*, stood for the proposition that there is an exception to the general rule that an acceptance of an offer must not change or qualify the terms of the offer. The Texas Court of Appeals stated:

> [I]f a seller imposes a term in bad faith to defeat an option, the option holder may validly exercise the option while at the same time rejecting the bad faith terms. . . . [A] holder of a right of first refusal has grounds to remove specific conditions from the contract, or to extract other concessions as part of the agreement, if the offered contract contains conditions that are not commercially reasonable, are imposed in bad faith, or are specifically designed to defeat the option holder's rights.

Texas State Optical, 882 S.W.2d at 11 (citations omitted).

West Texas Transmission has not been without learned criticism, starting with a dissent in *Texas State Optical*, 882 S.W.2d at 12-13:

> I believe that the *West Texas Transmission* case did not follow Texas law; rather, it created new law. The opinion in *West Texas Transmission* is long, loose, and hard to understand.
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> . . . I think we have both a weak record and a weak opinion in *West Texas Transmission* on which to announce a new rule of law.

In *Abraham Investment Co. v. Payne Ranch, Inc.*, 968 S.W.2d 518, 526-27 (Tex. Ct. App. 1998), the Texas Court of Appeals again criticized *West Texas Transmission*'s factors as being based upon the law of other jurisdictions rather than Texas law. In *McMillan v. Dooley*, 144 S.W.3d 159, 177 (Tex. Ct. App. 2004), the same Texas tribunal stated that "the factors identified in *West Texas Transmission* have not been unanimously embraced by Texas courts as a correct interpretation of Texas law."

This court is not prepared to adopt the reasoning of *West Texas Transmission*. The three factors may be among several considerations that are relevant, in varying degrees, when considering the issues of good faith (or bad faith) when those are relevant issues. But on our de novo review, we again repeat those facts contained in our consideration of the claim against the Bank, including a fair rental;[3] and, a clear intent by Lensing to form a lease attractive to Subway and its assignees, should they opt to purchase. The lease terms were not unreasonable, nor drafted to suppress the right of first refusal.

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[3] Balins contends Lensing's rental is $0.91 per square foot. But imputing the tenant's assumption of a part of the taxes, insurance, and maintenance, the rent approaches $3.45 per square foot.

Balins takes some comfort from *Myers v. Lovetinsky*, 189 N.W.2d 571, 573 (Iowa 1971), wherein a landlord sold a larger tract to a third party of which the smaller disputed property was a part with the right of first refusal. The buyer did not separately purchase the leased premises, and the landlord, in its notice, arbitrarily put a price on it. *Myers*, 189 N.W.2d at 574. The court, in denying specific performance, held that the tenant had slept on his rights, as the lease had expired when suit was brought. *Id*. at 577. The court did state that the tenant was not without remedies if timely asserted, either enjoining the landlord from conveying the property to the purchaser, or if already conveyed, to require the purchaser to reconvey the tract to the landlord. *Id*. at 576. Though these comments are observations not inherent in the ruling, they infer an enforcement of a contract against a third party, without privity with the plaintiff. *Id*. But it does little to support Balins's position on the remedies of rescission or reformation.

V. Sanctions

The district court imposed sanctions on plaintiff and its attorney under rule 1.413, finding the action against Lensing for reformation or rescission of the lease was not well grounded in fact, nor was it supported by existing law. This rule provides:

> Counsel's signature to every motion, pleading, or other paper shall be deemed a certificate that: counsel has read the motion, pleading or other paper; that to the best of counsel's knowledge, information, and belief, formed after reasonable inquiry, it is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law . . . .

Iowa R. Civ. P. 1.413(1). If rule 1.413(1) is violated, the court may impose sanctions, including reasonable attorney fees. We review the district court's imposition of sanctions for an abuse of discretion. *Weigel v. Weigel*, 467 N.W.2d 277, 280 (Iowa 1991).

In *Mathias v. Glandon*, 448 N.W.2d 443, 446-47 (Iowa 1989), the supreme court enumerated the factors the court should consider to determine whether an attorney, or client, made a reasonable inquiry into the facts and law. In determining whether there has been a reasonable inquiry into the facts and law, the court considers, among other factors, the complexity of the factual and legal issues in question. *Mathias*, 448 N.W.2d at 446. The court may also consider the clarity or ambiguity of existing law and the plausibility of the legal positions asserted. *Id*.

The court must view the reasonableness of a party's or attorney's judgment as of the time the pleading was filed, not with hindsight gained through hearing the evidence. *In re Prop. Seized from Williams*, 676 N.W.2d 607, 614 (Iowa 2004). An objective, rather than a subjective, standard should be used to measure conduct. *Schettler v. Iowa Dist. Court*, 509 N.W.2d 459, 466 (Iowa 1993).

The amended petition asked that the court "order the Lensing lease terminated immediately." In the alternative, plaintiff requested "the court should use its equitable powers to modify the commercially unreasonable provisions of the lease . . . ." The plaintiff admits there is no precedent for these forms of relief in Iowa.

While these forms of relief have not been adopted in Iowa, plaintiff and its attorney cited case law from Texas and other jurisdictions to support their claim that Iowa law should be extended to include these remedies. *See, e.g.*, *Mitchell v. Exhibition Foods, Inc.*, 194 Cal.App.3d 1033, 1046 (1986); *Texas Optical*, 822 S.W.2d at 11; *Prince v. Elm Inv. Co., Inc.*, 649 P.2d 820, 845 (Utah 1982). That support distinguishes this case from *Breitbach*, 541 N.W.2d at 844-45, where a would-be third-party purchaser sought reformation of a contract between the landlord and a tenant holding a right of first refusal, and sanctions were imposed. The court specifically found, "There are no legal arguments made by plaintiff that form any basis for his filing or prevailing on his claim to purchase this real estate." *Breitbach*, 541 N.W.2d at 846. In the present case plaintiff and its attorney presented plausible, though ultimately unsuccessful, legal arguments.

We next consider whether plaintiff's arguments were well grounded in fact. Plaintiff presented expert testimony to support its claim the Curves lease was commercially unreasonable. The district court found the defendants' witnesses to be more credible, but this does not mean the plaintiff's case was not well grounded in fact for the purpose of the rule.

Roscoe Pound, a renowned legal educator, taught that "[l]aw must be stable, and yet cannot stand still." We should remain diligent in enforcing the rule when clearly violated; yet we should listen to and ponder warranted advancements to our guiding principles of law. Again, that the plaintiff failed to convince us of these qualities, does not itself violate the rule and require sanctions.

After careful consideration, we find the district court abused its discretion in assessing sanctions against plaintiff and its attorney. We note the courts' reluctance to impose sanctions "that may result in discouraging access to the courts to resolve honest disputes that have arguable merit." *Breitbach*, 541 N.W.2d at 845. Plaintiff's arguments were "warranted by . . . a good faith argument for the extension, modification, or reversal of existing law . . . ." Iowa R. Civ. P. 1.413(1).

VI. Attorney Fees

Balins points out that under the terms of the Subway lease, if it is successful on appeal, then the Bank should pay its appellate attorney fees. Balins was not successful in its claim against the Bank on appeal, and the Bank is not responsible for Balins's appellate attorney fees. The Bank has made no request for appellate attorney fees.

VII. Disposition

We affirm the district court on the merits of the case. We reverse the award of sanctions and vacate the judgments against Balins and its attorney. Costs of this appeal are assessed three-fourths to Balins and one-fourth to Teddie Lensing.

AFFIRMED IN PART AND REVERSED IN PART.