IN THE SUPREME COURT OF IOWA

NO. 19-2151

SUSAN A. GUGE and PEGGY MCDONALD,

Plaintiffs/Appellees/Cross-Appellants

vs.

KASSEL ENTERPRISES, INC.; CRAIG KASSEL; and DEBORAH KASSEL,

Defendants/Appellants/Cross-Appellees.

APPEAL FROM THE DISTRICT COURT OF PALO ALTO COUNTY
THE HONORABLE CHARLES BORTH

APPELLEES'/CROSS-APPELLANTS' FINAL REPLY BRIEF

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ARGUMENT

I. THE DISTRICT COURT PROPERLY REJECTED A DISCOUNT FOR CORPORATE "BUILT-IN GAINS" TAXES BECAUSE THERE IS NO FACTUAL OR LEGAL SUPPORT FOR THAT DISCOUNT IN A S CORPORATION.

In their Reply, Defendants' argument is unequivocal the fair value of a corporation in a dissolution action must be determined in the context of a hypothetical liquidation sale. (Defendants' Reply, pp. 9-17). However, it is that hypothetical sale that vitiates any claimed discount for alleged corporate "built-in gain" taxes because the taxable gain on any sale (whether of the stock or appreciated assets) would flow only to the shareholders. Stated otherwise, including a tax discount at the corporate level when it has no tax consequences is disingenuous and unsubstantiated. Accordingly, the District Court properly rejected a discount for the hypothetical corporate tax on "built-in gains" because there is no factual or legal support for that discount in the context of a S corporation.

In an S corporation situation, the tax impact on the unrealized gain related to Plaintiffs is not transferred to KE or Craig because KE's payments for Plaintiffs' stock will increase Craig's tax stock basis and, similarly, a purchaser of KE's stock would not discount the purchase price as it would if it were a C corporation because the purchaser of an S corporation's stock can obtain a step-up tax basis in the underlying assets, without an additional

tax just by liquidating it (whereas if it were a C corporation that would result in an additional corporate tax to obtain the stepped up tax basis). This double taxation issue is the rationale for the *Baur* discount concept that is inapplicable here.

It is undisputed that KE is – and at all relevant times was – a S corporation. (App. v. V pp. 88:19-89:8, Hearing tr., pp. 80:19-81:8). For S corporations, all tax consequences pass-through to the shareholder level and the company itself pays no income taxes on any income or gains. *See* 26 U.S.C. § 1363(a) ("S corporation shall not be subject to the [income] taxes imposed by this chapter"); *see also* 26 CFR 1.1363-1(a) and Eustice & Kuntz, FEDERAL INCOME TAXATION OF S CORPORATIONS, 7.1 (4th ed. 2013) (E&K). Simply stated, the fundamental difference between C corporations and S corporations is that to get assets or funds to its owners, C corporations incur double taxation, once at the corporate level when the gain is realized and then again at the shareholder level when the proceeds are distributed.

Conversely, a S corporation's sale of appreciated property flows only to the shareholder (increasing their tax basis in their stock, which would be correspondingly reduced upon the distribution of sale proceeds), resulting in a single layer of shareholder taxation. 26 U.S.C. § 1366(a) (determining S

corporation shareholder's income tax "there shall be taken into account the shareholder's pro-rata share of the corporation's" income, deduction, and loss items); 26 U.S.C. § 1367(a) (gains passed through a S corporation increase the shareholder's basis by a corresponding amount); *see also* 26 CFR 1.1366-1(a) and E&K, 7.07.

To be sure, if KE was sold (whether as an entity or a liquidation of its farmland), only a single layer of tax would be incurred by the respective shareholders for their separate equity interests; there would be no gains taxed at the entity level. Defendants' expert Crotty admitted this fact, noting that capital gain taxes are paid at the corporate level (and then again at the shareholder level) in C corporations, but passed down to shareholders in S corporations for a single tax layer. (App. v. V pp. 88:19-89:8, Hearing tr., pp. 80:19-81:8).

In spite of this significant distinction, Defendants nonetheless seek a discount for a tax that does not exist and for which Defendants cannot cite a single supporting legal authority. Instead, Defendants continue to blindly cite the *Baur v. Baur Farms, Inc.* decision without appreciating the discount authorized there was specifically because the entity itself would incur a significant tax burden, that in fairness ought to be spread across the owners proportionately. *Baur*, (No. 14-1412) 885 N.W.2d 829 (table), 2016 WL

4036105 at *4 (Iowa Ct. App. July 27, 2016) (recognizing liquidation of C corporation with appreciated assets would cause substantial gain to entity and other shareholders).

Despite the *Baur* decision is factually distinguishable because it deals with a C corporation, Defendants' Reply fails to cite a single authority supporting a tax discount in determining the fair value of a S corporation. Instead, Defendants haphazardly cite an entire book and law review article[1] without any analysis whatsoever. (Defendants' Reply, p. 10). In that same vein, Defendants next cite foreign divorce cases – again without context or analysis, presumably because such cases undermine Defendants' position. (Defendants' Reply, pp. 16-17; *see e.g.*, *Liddle v. Liddle*, 410 N.W.2d 196, 198-99 (Wis. Ct. App. 1987) (allowing discount for partner's equity interest in divorce case because purchaser of partner's partnership interest would consider taxes flowing directly to partner when property to be sold within 7 years); *In re Marriage of Hay*, 907 P.2d 334, 335 (Wash. Ct. App. 1995) (adopting majority position that "[i]f tax consequences are imminent, or arise directly from the trial court's property disposition, and the amount is

[1] Defendants cite page 1127 of the law review article apparently for the proposition that the "asset-based approach" is the best method to determine the "fair market value" of a capital-intensive business. However, Defendants' Brief previously chastised the District Court for considering "fair market value" when the determination was of "fair value." (Defendants' Brief, p. 29).

not speculative, such consequences are properly considered in valuing martial assets.")).

Defendants' demanded discount for taxes that will not be incurred at the entity level is a contrived issue. Defendants feign an inconsistency in Lodden's testimony in the *Baur* decision as compared to Wagner's (Lodden's partner) testimony here – namely because a discount was appropriate there, but not here. However, the opinions are not inconsistent. Rather, the outcome is different because the facts are different; *Baur* involved a C corporation while KE is a S corporation. *Baur*, 2016 WL 4036105 at *4. Defendants' argument and sole reliance on *Baur* never accounts for the tax differences between S and C corporations.

Nevertheless, Defendants' Reply underscores just how misleading its position really is. Namely, Defendants seek a discount in KE's purchase of Plaintiffs' stock ***not*** because such a tax would be incurred in a hypothetical liquidation, and ***not*** because KE might incur a future capital gains tax if the company or its assets are someday sold (although Craig denies it will be sold and regardless KE will not incur such a tax), but instead because ***Craig*** individually might incur capital gains tax if he later decides to sell the company (despite that his tax basis would have been increased by payments to the Plaintiffs and thus no tax incurred related to Plaintiffs' interest).

(Defendants' Reply, p. 15 ("Consequently, when Craig Kassel sells his shares . . . he will be responsible for . . . capital gain tax.")). In fact, although Defendants demand a discount for transactional costs on the basis of an immediate hypothetical liquidation, when it comes to the tax discount they no longer seek liquidation, noting "the hypothetical dissolution here assumes a true redemption by Kassel Enterprises." (Defendants' Reply, p. 14). Stated otherwise, in a "have your cake and eat it too" situation, Defendants demand a "hypothetical liquidation" to obtain a discount for transactional costs, but simultaneously seek a "redemption" to obtain a make-believe tax discount. Yet, in both scenarios, Craig admits neither KE nor its land will be sold. (App. v. V pp. 118:25-119:3, 125:23-126:1, Hearing tr, pp. 110:25-111:3, 117:23-118:1).

The tax discount demanded by Defendants is factually and legally unsupported. Indeed, applying that discount in a S corporation would result in double tax determent to Plaintiffs – a point even Defendants' expert Crotty plainly conceded, noting the "double taxation argument comes from discounting [the value of KE] now and then having a – a purchase of the [discounted] shares where they then are, in effect, having the impact twice of tax." (App v. V pp. 107:21-109:25, 113:11-114:12, Hearing tr. pp. 99:21-101:25; 105:11-106:12). This penalty is even more egregious considering

the attempted tax shift is not from KE to Plaintiffs, but instead from Craig individually to Plaintiffs, particularly when Craig admits that neither KE nor its land will be sold, and thus no tax incurred.[2]

The District Court properly rejected a discount for hypothetical corporate tax on KE's "built-in gains" because there is no factual or legal support for that discount in the context of a S corporation or on the facts of this case; a result also reached by the Iowa Business Court in *Goettsch v. Goettsch*, (No. EQCV015164) 2014 WL 12809997 (Ida County Nov. 3, 2014). Accordingly, the District Court's decision should be affirmed on this point.

[2] Defendants defend their request for an unsubstantiated discount on the basis they are simply stuck with an irrevocable election to redeem, and that if no discount is applied Craig may not have made the election in the first place. (Defendants' Reply, pp. 17, 18). Poor legal advice notwithstanding, Craig and KE could have avoided the issue (including even the *possibility* of taxes) entirely by Craig directly purchasing Plaintiffs' shares. However, doing so would have foreclosed Craig's improper attempts to further penalize his sisters by discounting their interest for a make-believe tax. This is consistent with Craig's argument that Plaintiffs were each "gifted" their 23.75% interest, ignoring that Craig likewise was gifted 23.75% and that he alone was given the opportunity to purchase a majority interest at a substantially discounted price. (App. v. V pp. 47:1-7, 48:11-49:3, Hearing tr. pp. 39:1-7, 40:11-41:3; App. v. IV pp. 16:20-21, 19:10-12, Craig Kassel tr. pp.8:20-21, 11:10-12).

II. THE IOWA CODE EXPRESSLY AUTHORIZES AN AWARD OF ATTORNEYS' FEES AGAINST A CORPORATION IN A FAIR VALUE DETERMINATION WHEN THOSE IN CONTROL OF IT HAVE WASTED OR MISAPPLIED ITS ASSETS.

In its reply, Defendants admit the District Court's finding that Plaintiffs' petition for dissolution of KE based on Craig's waste and misapplication of assets is supported by probable grounds in the record. (Defendants' Reply, pp. 20-21). Consequently, the Iowa Code specifically authorizes an award of attorneys' fees against the company and there is no requirement that the bad shareholder (Craig, in this case) be a party to the action. Accordingly, the District Court's award of fees was authorized by, and is consistent with Iowa law.

Here, importantly, Defendants concede the record supports a finding that Craig misapplied or wasted corporate assets. (Defendant's Reply, pp. 20-21). Defendants further admit that such a finding supports an award of attorneys' fees under the Iowa Code. (Defendants' Reply, pp. 20-21). Defendants argue, however, that fees cannot be awarded against KE directly because it is a "passive" party.[3] Defendants' position is not supported by the Iowa Code. To the contrary, Iowa law explicitly authorizes an award of fees

[3] Of course, this ignores that Craig – the bad actor – was solely in control of KE and has directed all of its actions. Moreover, Defendant's position ignores that by virtue of the dissolution action and fair value hearing, he is the sole shareholder of KE so the award of fees only impact Craig.

as part of a fair value hearing when the dissolution action was based on "probable grounds." Iowa Code §§ 490.1430(1)(b)(4); 490.1434(1); 490.1434(4); 490.1434(5) (2017). Thus, in spite of the plain language of the Iowa Code, Defendants argue attorneys' fees cannot be awarded unless the "bad actor" is a party to the proceeding. Of course, the Iowa Code expressly rejects that position, stating "is not necessary to make shareholders parties to a proceeding to dissolve a corporation unless relief is sought against them individually." Iowa Code § 490.1431(2) (2017).

Nevertheless, Defendants then spend several pages arguing that Craig's waste and misapplication of assets did not harm KE but the vast majority of Defendants' argument is not supported by citation to the record and, instead, appears mostly to be conjecture by counsel.[4] However, Defendants are correct in their argument that the District Court did not measure the damages suffered by KE as a result of Craig's waste and misapplication of assets. Although true, this is not a failure of Plaintiffs'

[4] Defendants assail Plaintiffs' record designation as "abusive." However, it is notable that Defendants' briefing is so lacking in citations (*e.g.* approximately 10 record citations in 40+ page Reply Brief). Notably, Defendants designated only ***their portion*** of the various pleadings (*e.g.*, their motion for summary judgment), ignoring Plaintiffs' responsive pleadings or counter-pleadings. Given Defendants' partisan designation and consistent failure to cite the record, Plaintiffs believed it was important for the Court to have the full factual record before it, despite Defendants' attempts otherwise.

evidence, but of the District Court to consider these claims in determining the fair value of KE. The value of these claims will be a matter of fact to be determined on remand. Nevertheless, the record and the District Court's findings are sufficiently-detailed for this Court to affirm the District Court's award of attorneys' fees as being allowed by law, substantially supported by the record, and within its considerable discretion.[5]

Accordingly, this Court should both affirm the District Court's award of attorneys' fees and also instruct the District Court on remand to award reasonable appellate attorney fees incurred in the present appeal.

III. THE DISTRICT COURT ERRED BY NOT CONSIDERING KE'S CLAIMS AGAINST CRAIG KASSEL IN DETERMINING THE FAIR VALUE OF THE COMPANY.

A. Cross-Appellants properly preserved error on the issue that claims by KE against Craig Kassel must be considered in determining the fair value of the Company.

Under Iowa law, error is preserved for appeal where "a party raises an issue and the district court rules on it." *Fenceroy v. Gelita USA, Inc.*, 908 N.W.2d 235, 248 (Iowa 2018). "The underlying objective of this rule is to ensure "orderly, fair[,] and efficient administration" of justice by preventing

[5] Section C of Defendants' Reply Brief argues no cause of action supported an award of attorneys' fees. This ignores the plain language of Iowa Code § 490.1434(5), which explicitly authorizes an award of attorneys' and experts' fees if the petition alleging waste or misapplication of assets (§ 490.1430(1)(b)(4)) is founded on probable grounds, which the District Court found existed on the facts of this case.

parties from presenting one case at trial and another on appeal." *Estate of Gottschalk by Gottschalk v. Pomeroy Dev., Inc.*, 893 N.W.2d 579, 585 (Iowa 2017) (quoting *State v. Mann*, 602 N.W.2d 785, 790 (Iowa 1999)). This rule "serves the purpose of ensuring both opposing counsel and the district court receive notice of the basis for a claim at a time when corrective action is still possible." *Id.*

In applying these rules, Iowa recognizes "an exception to the general error-preservation rule when the record indicates that the grounds for a motion were obvious and understood by the trial court and counsel." *Id.* (citations omitted). "Generally, so long as a party timely brings the nature of the error claimed to the attention of the district court, error preservation does not turn on the thoroughness of counsel's researching or briefing." *Id.* (citations omitted). Again, the standard merely requires that an issue must be raised by counsel and the District Court must rule on it.

In this case, the issue of including legal claims by KE against Craig in the value of the company was clearly raised by counsel and plainly rejected by the District Court. Indeed, this issue spans nine pages of the hearing transcript. (App. v. V pp 12:8-16:21, 71:17-75:21; Hearing Tr. pp. 4:8-7:21; 63:17-67:21). Moreover, immediately upon opening the record, the District Court noted:

> I know that the plaintiffs are going to make a record that a number of exhibits and evidence they propose to offer should be admitted for purposes of adding value to the corporation in determining the fair market value. The Court has made an indication to the parties that the Court does not intend to allow the evidence for that purpose but finds that it is relevant to the purpose of the attorney fee issue.

(App. v. V p. 12:14-22, Hearing tr. p. 4:14-22). Importantly, the District Court did not disallow the evidence of Craig's waste and misapplication of assets; instead, it received that evidence (including via affidavits, as agreed-upon by the parties) for the issue of awarding attorneys' fees, but rejected that same evidence on the issue of the fair value of the company. (App. v. V pp 12:8-16:21, 71:17-75:21; Hearing Tr. pp. 4:8-7:21; 63:17-67:21). Nevertheless, Plaintiffs' counsel made clear the evidence must also be considered in determining the fair value, as follows:

> Of course, we want to preserve the record for the fact that we do believe that defendants' actions and conduct where he misapplied or wasted assets of this corporation, Kassel Enterprises, that we – we feel and are arguing that the cash asset would still be in the corporation and, therefore, the Court should add back into the corporation the amounts it finds Craig Kassel and Deborah Kassel misapplied or wasted.

(App. v. V pp. 13:22-14:5, Hearing tr. pp. 5:22-6:5). This purpose was confirmed through detailed briefing in Plaintiffs' trial brief, which explicitly argued the fair value of KE must be increased for assets misapplied by Craig Kassel and described with specificity those instances. (App. v. II pp.103-

108). Plaintiffs' purpose for this evidence was sufficiently clear that the District Court understood its purpose and rejected it anyway, as follows:

> That is noted for the record. And the Court did make an indication off the record that that evidence would not be allowed for determining the fair market value as it wasn't relevant to that issue and, instead, was actually relevant to Count II [breach of fiduciary duties] of the petition, which is scheduled for a jury trial in November of this year. And pursuant to the stipulation of the parties on the submission of the attorney fee issue, which these items would be relevant to, submission of that issue by affidavit and deposition and as otherwise indicated on the record at the commencement of the hearing.

(App. v. V pp. 72:19-73:6, Hearing tr. pp. 64:19-65:6). Understanding the District Court's ruling, Plaintiffs' counsel persisted anyway, arguing testimony and exhibits must be admitted for the issue of the fair value of Plaintiffs' interest in KE. (App. v. V pp. 73:11-74:1, Hearing tr. pp. 65:11-66:1). Defendants' counsel – fully understanding the issue – objected to the admission of that evidence on the basis that it was "just totally irrelevant to any issue and the cause – the issue and the cause is the fair value of Kassel Enterprises." (App. v. V p. 74:2-6, Hearing tr. p. 66:2—6). Again, the District Court received the various evidence, but limited its consideration to the issue of attorneys' fees, but rejecting it for the fair value determination. (App. v. V pp. 74:7-75:19, Hearing tr. pp. 66:7-67:19).

It is precisely because this issue was raised and decided (*i.e.*, error was preserved) that Defendants argue Plaintiffs twice raised the issue and "[a]t both times, the District Court told Plaintiffs' counsel he [the Court] believed the proffered evidence was irrelevant to the issues of fair value." (Defendants' Reply, p. 31). Nonetheless, Defendants misleadingly argue Plaintiffs never appealed the summary judgment ruling or filed a Rule 1.904 motion related thereto. (Defendant's Reply, p. 34). This is true because the issues are different. The District Court's summary judgment dismissal of Count II of the Petition (breach of fiduciary duties) on the basis that such claims belonged solely to Kassel Enterprises only underscores the District Court's error in failing to consider that evidence in determining the fair value of KE.

Thus, this case is not one of not knowing the nature or extent of the proffered evidence, as might be the case in an inadequate offer of proof. Instead, this case involves significant evidence[6] being received and considered for one issue (award of attorneys' fees) but rejected for another issue (increasing the fair value of Plaintiffs' interest in KE). Thus, the issue on cross-appeal is whether the District Court erred by not at least

[6] Which the parties – including both Plaintiffs and Defendants – stipulated would be submitted to the Court via affidavits. (App. v. V pp 12:8-16:21, 71:17-75:21; Hearing Tr. pp. 4:8-7:21; 63:17-67:21).

considering whether Craig Kassel's waste and misapplication of assets ought to be considered in determining the fair value. On this issue, error was clearly preserved.

B. In determining the fair value of Kassel Enterprises, the District Court was required to consider all assets of the Company, including claims for waste and misapplication of assets by Craig Kassel.

In determining the fair value of Kassel Enterprises, the District Court was required to consider all assets of the Company, including any claims it might have against Craig Kassel for wasting or misapplying its assets. This point is axiomatic.

Nonetheless, tellingly, Defendants spend several pages denying the sufficiency of the evidence to support additional sums being added to the fair value of KE. (Defendants' Reply, pp. 36-38). Importantly, however, the District Court's error is not assigning the wrong value to these claims, but instead its wholesale failure to consider them at all. The parties, their experts, and the District Court all agreed the fair value of KE is dictated by the value of its assets. (App. v. II p. 272; Proposed Hearing Exhibits 28-29, App. v. IX p. 209; App. v. V pp. 84:23-85:25, 112:17-22, 140:3-7, 169:8-14, Hearing tr pp. 76:23-77:1-25, 104:17-22, 132:3-7, 161:8-14). Any claim KE has against Craig Kassel for misapplying or wasting corporate assets constitutes a separate asset of the company. *In re Marriage of Keener*, 728

N.W.2d 188, 194–95 (Iowa 2007) (labeling ongoing litigation as an "intangible asset"); *See Bob McKiness Excavating & Grading Inc. v. Morton Bldgs., Inc.*, 507 N.W.2d 405, 410 (Iowa 1993) ("[O]nce a cause of action accrues, a plaintiff has a vested property right that cannot be summarily destroyed by legislative action."); *Arbie Mineral Feed Co., Inc. v. Farm Bureau Mut. Ins. Co.*, 462 N.W.2d 677, 680 (Iowa 1990) ("A cause in action is in existence prior to judgment and is personal property upon which, under Iowa law, a creditor may levy."); *Branson Label, Inc. v. City of Branson*, 793 F.3d 910, 917 (8th Cir. 2015) (recognizing legal claims as "assets of value"); *Asset*, Black's Law Dictionary (11th ed. 2019) ("An item that is owned and has value."). Thus, the District Court was obligated to consider the value of those claims in determining the fair value of KE. *See Keener*, 728 N.W.2d at 195 (recognizing litigation proceeds should be included in division of property subject to sufficient evidence supporting the measure of the claims fair market value).

Importantly, seemingly in agreement with the District Court's dismissal of Plaintiffs' direct claims, Defendants' Reply Brief admits that any claim for waste or misapplication of assets by Craig Kassel belongs to Kassel Enterprises. (Defendants' Reply, pp. 39-40). This is consistent with the District Court's summary judgment ruling that such claims are

derivative, observing that a corporation (rather than the shareholder) should maintain the action because "any proceeds resulting from the litigation will be treated as corporate assets." (App. v. II pp. 286 (emphasis added)). Nevertheless, given that determination, neither the District Court nor Defendants have cited any authority whatsoever that claims admittedly belonging to the company should be ignored just because it is a fair value determination. The District Court's arbitrary failure to consider such claims in the asset-based valuation of KE constitutes clear error.[7]

Consequently, because the District Court believed the harm caused by Craig's waste and misapplication of corporate assets flowed only to KE, the Court was compelled to consider that damage (an asset of KE) in determining the value of KE (under the asset-based approach) and the fair value of Plaintiffs' interest therein. Its failure to do so constitutes error. Although Defendants seek to argue the value of those claims on appeal, those are clearly issues that will be decided by the District Court on limited remand on this point.

[7] This is particularly salient where the District Court held that the evidence of Craig Kassel's waste and misapplication of corporate assets was sufficiently substantial that it supported an award of attorneys' fees.

CONCLUSION

For the reasons and authorities set forth herein, the District Court correctly rejected Defendants' requested discounts for transaction costs and alleged "built-in gains" in the context of a S corporation. Likewise, the District Court's award of attorneys' fees and costs was both authorized by law and well within the court's discretion, based on the evidence of the case. Accordingly, the District Court's decisions on these issues must be affirmed.

Conversely, in determining the fair value of Kassel Enterprises, the District Court erred in not considering the value of claims Kassel Enterprises has against Craig Kassel for his waste and misapplication of corporate assets. This Court should order a limited remand instructing the District Court to receive evidence on value of such claims as related to the fair value of Plaintiffs' equity interest in Kassel Enterprises and undertake necessary steps to grant Plaintiffs' reasonable attorney fees incurred on appeal pursuant to Iowa Code section 490.1430(5).

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This Brief complies with the type-volume limitation of Iowa R. App. P. 6.903(1)(g)(1) because it contains 4,180 words, excluding the parts of the Brief exempted by Iowa R. App. P. 6.903(1)(g)(1).

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The undersigned certifies a copy of this Brief was filed with the Clerk of the Iowa Supreme Court via EDMS and served upon the following persons by EDMS on the 9th day of July, 2020.

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