IN THE UNITED STATES DISTRICT COURT

FOR THE WESTERN DISTRICT OF WISCONSIN

PINNACLE LABS, LLC and
DOUGLAS A. LARSON,

Plaintiffs,

v.

MEMORANDUM AND ORDER
07-C-196-S

DAVID D. GOLDBERG, GREGORY
PALEN, JOE DOUGHERTY, a/k/a
JOSEPH DOUGHERTY, ROD PROCHASKA, a/k/a
RODNEY PROCHASKA, and APEX
INTERNATIONAL, INC.

Defendants.

Plaintiffs Pinnacle LLC and Douglas Larson claim that David Goldberg, Gregory Palen, Joseph Dougherty, Rodney Prochaska and APEX International Inc. breached fiduciary duties owed to them during the operation of Pinnacle's business. Jurisdiction is based on diversity of citizenship, 28 U.S.C. 1332. The matter is presently before the Court on defendants' motion for summary judgment. The following is a summary of the facts viewed most favorable to plaintiffs.

FACTS

Jennico2 was a contract manufacturer of private label liquid laundry products, owned by plaintiff Larson and Steve and Connie Alf. Jennico2 operated part of its business in Eau Claire,

Wisconsin and leased the land and buildings for its Eau Claire facility from Larson. Jennico2 had severe cash flow problems for many years. In 2005 Jennico2's board of directors hired a Minnesota consulting firm, Manchester Companies, to explore options for selling the company or improving its fortunes. Manchester solicited defendant Goldberg to purchase Jennico2.

In April 2006 Goldberg sent two different draft letters of intent to Manchester offering to create a new company which would acquire Jenneco2's assets. Both letters proposed that the new company would operate the Jennico2 business for two months prior to committing to a final purchase. In furtherance of the transaction, Pinnacle Labs, LLC was created with Goldberg and Palen as its sole members. Larson, Goldberg and Palen met on April 23, 2006 to discuss the terms of a transaction based on the letters of intent. The negotiations culminated on May 2, 2006 when Larson and Pinnacle executed a loan agreement ("loan agreement") and engaged in various other related transactions.

Pursuant to the loan agreement, Pinnacle used $2.5 million of the loan proceeds to purchase Jennico2 notes held by its principal creditor, Royal Credit Union. On the same day, Pinnacle and Jennico2 entered a voluntary surrender and foreclosure agreement whereby Jennico2 surrendered all of its assets to Pinnacle in satisfaction of the purchased notes. Pinnacle in turn pledged all of the assets as security for the loans from Larson. In a separate

transaction, Royal Credit Union also loaned $1.5 million to Pinnacle, secured by an interest in Pinnacle's equipment and a personal guaranty from Larson.

Section 10.2 of the loan agreement provided Pinnacle with a "put option" which permitted Pinnacle to operate the Jennico2 business assets for sixty days while it conducted due diligence to determine whether it wished to retain the assets. During the period Pinnacle was managing and operating Jennico2 assets Larson agreed to "indemnify borrower for any and all losses or damages sustained by the business operation. Such indemnification shall not include indemnity for any intentional acts or gross negligence of Borrower of its owners and/or staff..." Under the terms of the provision, Pinnacle could notify Larson in writing that it was exercising the put option, in which case a previously signed Voluntary Surrender and Foreclosure Agreement ("Pinnacle surrender agreement") would become effective. In addition, upon exercising the option Pinnacle's members were required to assign their memberships to Larson. These transfers were to be in full satisfaction of Pinnacle's obligations to Larson.

Under the terms of the Pinnacle surrender agreement, upon surrender Pinnacle was to act as liquidating agent to wind up and liquidate Jennico2's business. Section 13B of the surrender agreement provides:

> Debtor shall be compensated for such services as the rate of $15,000 per month. Upon

> exercise of this Agreement, Debtor shall be entitled to such compensation commencing with the initial Closing Date (as defined in the Pinnacle Loan Documents) and continuing for the Performance Period.

Both the loan agreement and Pinnacle surrender agreement included clauses providing that they included the entire agreement of the parties and could be altered only in writing.

Pursuant to the terms of the loan agreement Pinnacle, through its members and employees defendants Goldberg, Palen, Dougherty, and Prochaska, operated the Jennico2 assets from May 2, 2006 to June 29, 2006. On June 29, 2006 Pinnacle exercised the put option. From June 30, 2006 to July 19, 2006 Pinnacle, through Goldberg and Palen operated the assets as liquidating agent. Financial statements for Pinnacle indicate that liabilities exceeded assets on May 31, 2006 and June 30, 2006. From May 2 to June 29, 2006 Pinnacle sustained a net loss of $781,597.30.

During the period defendants operated the Jennico2 assets defendants did the following:

- Paid Defendant Apex (who employed the individual defendants) $15,000 on June 15 and $18,331.59 on June 28, 2006.
- Made a loan of $35,906.86 to Steve Alf, who had been retained as a Pinnacle employee, for business expenses incurred by Alf.
- On July 6, Goldberg and Palen agreed to loan Pinnacle up

to $200,000.

- On July 6 or 7, Goldberg and Palen loaned Pinnacle $150,000
- On July 12, 2006 defendant Dougherty wire transferred $150,000 to Apex as repayment of the July 6 loan.
- Laid off employees and hired temporary employees in their place, costing more in labor costs.
- Handling freight and warehouse issues improperly resulting in excessive freight costs.
- Made decisions which significantly increased material costs.
- Failed to pass price increases on to a principal customer, Aldi, costing $800 per shipment.
- Failed to order bottle caps necessary to ship 159,000 cases of fabric softener, resulting in $1.3 million in lost sales.
- Obtained an unnecessary environmental site assessment for the property on which Pinnacle operated.
- Failed to properly weigh product to detect over use of resin, resulting in loss of 55,000 pounds of resin and scrapping of 12,000 pounds.
- Failed to properly monitor and direct efficient line changeovers.
- Failed to staff with full time managers.

- Disregarded the advice of Steve and Connie Alf.
- Failed to retain counsel in a lawsuit brought by Heritage Brands resulting in a loss of $194,820.
- Retaining counsel that had previously represented defendants Goldberg, Palen and Apex.

On July 19, 2006 Larson sent a letter accepting the tendered assets and terminating Goldberg and Palen’s association with Pinnacle as liquidating agents.

MEMORANDUM

Plaintiffs’ amended complaint includes three independent causes of action: (1) that defendants as governors and managers breached fiduciary duties to Pinnacle; (2) that defendants breached fiduciary duties to Larson as a secured lender; (3) that defendants maliciously injured Pinnacles business in violation of Wis. Stat § 134.01. Defendants seek summary judgment on all claims arguing that the first claim is an inappropriate derivative action, that defendant’s owed no fiduciary duty to Larson, that Wisconsin law is inapplicable so no claim is available under § 134.01, and that all claims are precluded because defendants conduct falls within the business judgment rule.

Summary judgment is appropriate when, after both parties have the opportunity to submit evidence in support of their respective positions and the Court has reviewed such evidence in the light

most favorable to the nonmovant, there remains no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. Rule 56(c), Fed. R. Civ. P. A fact is material only if it might affect the outcome of the suit under the governing law. Disputes over unnecessary or irrelevant facts will not preclude summary judgment. A factual issue is genuine only if the evidence is such that a reasonable factfinder, applying the appropriate evidentiary standard of proof, could return a verdict for the nonmoving party. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 254 (1986). Under Rule 56(e) it is the obligation of the nonmoving party to set forth specific facts showing that there is a genuine issue for trial.

Initially, the parties dispute whether the law of Minnesota, Wisconsin, or some combination of the two should apply. Plaintiffs maintain that Minnesota fiduciary duty laws should govern but that Wisconsin tort law should control. In a diversity case, the governing choice-of-law principles are those of the forum state, in this case Wisconsin. Klaxon Co. v. Stentor Elec. Mfg. Co., 313 U.S. 487 (1941). A Wisconsin statutory choice of law statute, Wis. Stat. § 183.1001(1), unequivocally dictates that Minnesota substantive law applies to plaintiff's claims:

> The laws of the state ... under which a limited liability company is organized shall govern its organization and internal affairs and the liability and authority of its managers and members, regardless of whether the foreign limited liability company obtained

> or should have obtained a certificate of registration under this chapter....

There is no doubt that plaintiffs' claims exclusively concern defendants' liability for conduct while acting as managers and members of Pinnacle and therefore fall expressly within the statute. Plaintiffs make no reasoned argument to the contrary. This is true of both claims by Pinnacle that defendants breached their duties to it while managing the company and claims by Larson that defendants breached a duty to him when dealing with the collateral for his loans. It is equally true of plaintiffs' claims that defendants conspired to damage the business while they controlled its operations falls within the choice of law rule. All of plaintiffs claims seek to impose liability on the LLC managers based on their conduct as managers of the company. Accordingly, the claims are governed exclusively by Minnesota law.

Breach of Fiduciary Duties To Pinnacle

Defendants advance two arguments in support of summary judgment on plaintiffs' first claim. First, that the action is a disguised derivative action precluded by the fact that Larson was not a Pinnacle member during the alleged period of actionable conduct. Second, that none of the alleged conduct rises to a breach of fiduciary duty because it falls within the business judgment rule.

Defendants may be correct that to the extent the first claim

is asserted by Larson, it is a derivative action. However, Plaintiffs concede at page 12 of their opposition brief that claim one is asserted solely by Pinnacle on its own behalf. As such, there is no basis to contend that it is a derivative action. The essence of a derivative action is that a member may commence an action on the company's behalf, only if the company has failed to pursue the claim itself. See Minn. R. Civ. P. 23.09; Stocke v. Berryman, 632 N.W.2d 242 (Minn. App. 2001). Where, as here, the limited liability company brings the claim on its own behalf, rules and limitations relating to derivative actions have no application. The fact that Larson is pursuing a separate claim as a Pinnnacle secured creditor has no impact on Pinnacle's action for breach of fiduciary duty by its managers. It is certainly not unusual that Pinnacle's assets which may have been diminished by defendant's conduct also served as collateral to a secured creditor who might be personally injured by the same conduct. Such a claim by a secured creditor does not somehow imply that the company does not have a direct action for breach of fiduciary duty.

Concerning the second argument, the issue is whether facts presented at summary judgment and admissible at trial are such that a reasonable factfinder could conclude that defendants breached their duties to Pinnacle. Minnesota Statutes section 322B.69 prescribes the following standard of care for individuals performing management functions for a limited liability company:

> A manager shall discharge the duties of an office in good faith, in a manner the manager reasonably believes to be in the best interests of the limited liability company, and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. A person exercising the principal functions of an office or to whom some or all of the duties and powers of an office are delegated pursuant to section 322B.689 is considered a manager for purposes of this section and sections 322B.38 and 322B.699.

The business judgment rule influences the factual inquiry concerning whether defendants met their fiduciary obligations. To protect corporate officers and directors from hindsight lawsuits in reaction to unprofitable business decisions and to avoid judicial second guessing of business decisions, the rule presumes that business decisions were consistent with fiduciary duties so long as they can be attributed to a rational business purpose. St. James Capital Corp. v. Pallet Recycling Associates of North America, Inc., 589 N.W.2d 511, 515 (Minn. App. 1999); Potter v. Pohlad, 560 N.W.2d 389, 391-93 (Minn. App. 1997)(applying Delaware law, cited with approval in St. James Capital). To overcome the presumption, a plaintiff must present evidence that the officer or director breached one of the three essential components of fiduciary duty -- good faith, loyalty, and due care. Id. at 392. To prove lack of due care, a plaintiff must demonstrate gross negligence. Id.

Defendants position is that each of the long litany of alleged

improper actions is protected by the business judgment rule and that plaintiffs have failed to bring forth evidence which would overcome the presumption that the business decisions were made in good faith and with due care. Several of the claimed failures and missteps are clearly protected by the rule. For example, pricing policies, choices on which supplier to pay, negotiation of credit terms, and staffing allocations are business decisions which are not subject to challenge in the absence of bad faith or self dealing, which has not been demonstrated by anything but speculation. Such decisions are typical difficult choices which managers of a cash strapped enterprise must make and which are not subject to legal challenge with the benefit of hindsight. Furthermore, the attempt to prove breach of fiduciary duty by proving business losses is directly contrary to the essential purpose of the business judgment rule -- to preclude the inference of breach from the fact of negative financial results.

However, several allegations arguably fall outside the realm of business judgment and tend to demonstrate gross negligence and the absence of a rational business purpose. For example, there is no apparent rational purpose for ordering bottles without caps or eliminating production management procedures and accounting controls. While trial may prove that these allegations are false or that they in fact stem from a rational business purpose, this cannot be discerned under the summary judgment standard.

In addition, the June 15 and 28, 2006 payments to defendants for management services raises the issue of whether defendants personally benefitted as creditors by an inappropriate preferential cash distribution. Preferential payments to managers implicate the good faith and loyalty components of the business judgment rule and may overcome the presumption. Potter, 560 N.W.2d at 392. Although defendants may have been entitled to $15,000 payments in accordance with paragraph 13B of the surrender agreement, that right did not arise until exercise of surrender on June 29. Thus, at a minimum the payments were premature. Beyond that, there are factual issues concerning whether the fees were properly earned by defendants.

Accordingly, Pinnacle's claim based on defendants' alleged failure to fulfill its statutory fiduciary duty survives defendants motion for summary judgment.

Breach of Fiduciary Duty to Larson

Plaintiff Larson first contends, relying on Wisconsin law, that defendants assumed a role as trustees as a result of the debtor creditor relationship. There is no basis for such a claim either in the loan documents or in Minnesota law. The loan agreement does not suggest a relationship other than that of lender and borrower. Minnesota law expressly rejects the notion of a trust relationship or a duty to manage the company for the benefit of particular creditors under these circumstances. St James

Capital, 589 N.W.2d at 516.

> Creditors are not owed a duty by an insolvent corporation's directors and officers to minimize any loss that may occur as a result of the corporations insolvency. To hold otherwise would allow creditors of a corporation, solvent or insolvent, to interfere unduly and inject themselves in the day-to-day management of the corporation.

Minnesota law recognizes that "when a corporation is insolvent, or on the verge of insolvency" managers become fiduciaries of the corporate assets for the benefit of creditors. Snyder Elec. Co. v. Fleming, 305 N.W.2d 863, 869 (Minn. 1981). However, even that duty is limited and does "not extend beyond the prohibition against self-dealing or preferential treatment." Helm Financial Corp. v. MNVA R.R., Inc., 212 F.3d 1076, 1081 (8th Cir. 2000)(applying Minnesota law). The duty is breached only if the managers' transfer of assets enables them to recover a greater portion of their debt than other similarly situated creditors. Id. Contrary to Larson's contention, there is no prohibition against extension of credit by managers to the company nor against repayment of debts to managers which does not result in a preference. Snyder, 365 N.W.2d at 869. However, the burden is on the manager to show that any payment to him was in good faith and not a preference. Id.

Under this standard allegations of mismanagement and losses resulting from allegedly poor or reckless business practices cannot form the basis for a claim by Larson even if he could establish

that they fell outside the business judgment rule. He can prevail only to the extent that defendants made preferential transfers to themselves while Pinnacle was insolvent or on the verge of insolvency. Defendants seek summary judgment on both elements, contending that Pinnacle was not insolvent and that no preferential transfers were made.

Plaintiffs have provided ample evidence of insolvency to preclude summary judgment on that issue. "A debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets, at a fair valuation." Minn. Stat. § 513.42(a). Insolvency is presumed if a debtor is generally not paying debts as they come due. Minn. Stat. § 513.42(b). It is undisputed that Pinnacle was having severe cash flow problems for a significant period prior to defendants' involvement. Pinnacle's own May 31, 2006 financial statements, prepared by defendant Dougherty, show that liabilities exceeded assets on that date. The financial statements also disclose substantial, ongoing losses. These facts amply support the conclusion that Pinnacle was insolvent, or certainly on the verge of insolvency, during the relevant period.

Defendants seek to overcome the evidence by arguing against applying the debts-greater-than-assets standard for insolvency. Rather, defendants argue that because Pinnacle was paying its creditors on a regular basis it should be deemed solvent. The payment of creditors is merely an indicator of solvency – a

substitute for the well recognized comparison of assets to liabilities – useful primarily because it is often difficulty to accurately value assets in an ongoing concern. For this reason, the statute plainly identifies the payment of creditors test as merely a basis for presumption of insolvency in the asset/liability sense.

While defendants correctly note that this case does not involve a fraudulent conveyance, to which the definitional statute applies directly, there is no question that the purpose is analogous. As long as an entity's assets exceed its liabilities, all creditors will be fully paid in a liquidation and therefore have no interest in how the entity chooses to make payments among the creditors. However, once liabilities exceed assets any payment potentially reduces the recovery of the other creditors. So the point at which liabilities exceed assets is the appropriate threshold for imposing limitations on payments to insider creditors.

The second issue is whether the facts could establish that there were any preferential transfers to defendants which might fall within the prohibition. Plaintiff Larson relies on two transfers: repayment of a short term $150,000 note held by Goldberg and Palen on July 12, 2006, and $15,000 and $18,331.59 payments to Apex on June 15 and 28, 2006 as management fees in accordance with the terms of the surrender agreement. The Court has already

addressed the possibility that the two management fee payments were premature and otherwise preferential. This issue precludes summary judgment on the claim. Notwithstanding defendant Palen's separate argument that he did not own or control Apex which received the payments his own deposition testimony makes it impossible to discern his relationship with Apex, his role in the decision to pay money to Apex and his expectation with regard to sharing proceeds from those payments.

However, there is no basis to find that the $150,000 loan repayment was preferential. The undisputed documentary evidence establishes that defendants loaned this money to Pinnacle with Larson's express approval and agreement to subordinate his security interest to the extent of loans up to $200,000. Consequently, repayment of that loan could not have been a preferential payment as it concerns Larson.

<u>Wis. Stats. §§ 134.01 and 895.043</u>

Because the action is controlled exclusively by Minnesota law, plaintiffs' Wisconsin statutory claim pursuant to Wis. Stat. § 134.01 and its Wisconsin statutory punitive damage claims are not viable. Plaintiffs have made no attempt to state analogous claims under Minnesota law.

Beyond that, there is no suggestion of any evidence which could sustain a finding by clear and convincing evidence of

malicious conduct or deliberate disregard required to sustain claim for punitive damages. The sole argument offered by plaintiffs in is speculation that defendants were misusing their positions of authority “to systematically destroy Pinnacle’s value to cut a new deal.” However, there is no evidence of any attempt to “cut a new deal” which would lend any credence to the theory. Furthermore, as purchasers of the assets, destroying the value of the business would be contrary to their own financial interests. In any event, there is no evidence which could satisfy the clear and convincing standard that defendants maliciously or willfully injured plaintiffs.

ORDER

IT IS ORDERED that defendants’ motion for summary judgment is DENIED as it concerns Pinnacle’s claim for breach of fiduciary duty, and Larson’s claim for breach of fiduciary duty based on the payment of management fees, and is in all other respects GRANTED.

Entered this 5th day of September, 2007.

BY THE COURT:

/s/

JOHN C. SHABAZ
District Judge