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H. R. Waldo, Jr.; Ray, Rawlins, Jones & Henderson; Attorneys for Appellant;

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DEC 19 1958

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In the
Supreme Court of the State of Utah

CLYDE J. KNAPP, OLIVE S. KNAPP,
JEFF KNAPP, an infant, by Clyde
J. Knapp, his Guardian ad Litem,
VICKIE KNAPP, an infant, by Clyde
J. Knapp, her Guardian ad Litem,
Plaintiffs and Respondents,

vs.

LIFE INSURANCE CORPORATION
OF AMERICA, a Utah corporation,
Defendant and Appellant.

Case No.
8875

FILED

DEC 11 1958

Clerk, Supreme Court, Utah

BRIEF OF APPELLANT

H. R. WALDO, JR.,

of Ray, Rawlins, Jones
& Henderson,

Attorneys for Appellant.

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BRIEF OF APPELLANT

STATEMENT OF FACTS

This is an action for rescission of an exchange by plaintiff and respondent, Clyde J. Knapp, of certain real and personal property subject to contracts of sale for a total of 1500 shares of the capital stock of defendant and cash in the amount of \$4,383.03. (For convenience, defendant and appellant will be referred to as defendant, plaintiffs and respondents will be referred to collectively as

plaintiffs and plaintiff and respondent, Clyde J. Knapp will be referred to as Knapp.)

Defendant is a small Utah life insurance corporation incorporated as a stock company in 1953. Following a period of growing pains and severe financial distress (of which more will be said later) during which period the transaction complained of took place, the defendant company was reorganized in the fall of 1955, some \$200,000.00 was invested therein by the present management and the present management completely replaced all former officers and all but one of the former directors. None of the present principal stockholders nor any of the present officers or directors had any part in the transaction complained of in this case.

Knapp is a local businessman and has dealt in investments and real estate (Tr. 76). He has made loans in substantial amounts over the years (Tr. 100-102). He was at the time of transaction complained of the president, a director and a stockholder in Knapp Uranium Company. The other plaintiffs are Knapp's wife and children, respectively, who received certain shares of defendant's stock as a part of the transaction complained of.

Negotiations for the exchange transaction began in early November of 1955 (Tr. 4, 177) when Daniel H. Heaton, an old friend and business acquaintance of Knapp (Tr. 99-102, 174), (who was also a stock salesman for the defendant), approached Knapp concerning an investment in the company. He emphasized the fact that it was not necessary to invest cash and that the company would ac-

cept real estate (Tr. 4). Knapp and Heaton testified (Tr. 4-6, 178) that Heaton showed Knapp letters concerning the company and its prospects written by Dr. Wesley L. Bayles (Ex. P-1) and John H. Coles (Ex. P-3), who were both directors of the company at the time and by Cleo H. Bullard (Ex. P-2), who was the president and a director of the company at the time. Later in November, Heaton took Knapp to talk to Mr. Coles, Mr. Peter M. Lowe (who was then vice-president and a director of the company) and Mr. Bullard. These men discussed with Knapp the prospects of the company, their opinion of its investment potential and the financial situation of the company. With respect to the latter, Knapp and Heaton stated that Mr. Coles and Mr. Bullard discussed in some detail the company's September 30, 1954 financial statement (Ex. P-4). A sort of prospectus was also furnished Knapp (Ex. P-28).

It would unnecessarily burden this brief to set out in detail the discussions had during this negotiation period. (For further detail see Tr. 9-20, 180-192.) It is sufficient to say that plaintiffs alleged that some sixteen statements made during these discussions or in the letters from the directors or in the September 30, 1954 financial statement were false. Generally, these statements related to the financial condition of the company and its prospects for the future and included such statements as—the company was in “good standing” with the State Insurance Department, the company was going to pay a dividend of ten per cent on its outstanding stock in 1954, the September 30, 1954 financial statement set forth the true financial condition of the company at that time, that the company had passed its

period of growing pains. (See Findings of Fact, R. 17 for a list of the alleged statements.)

The actual exchange transaction took place at the end of the year 1954. The exchange contract (Ex. P-9) was dated December 30, 1954. By the terms of the contract, plaintiffs received a total of 1500 shares of defendant's capital stock (Ex. P-10, Tr. 38) and cash of \$4,383.03. (The contract erroneously states this figure as \$4,385.03. The smaller amount was actually paid and accepted.) Defendant received a deed to certain farm property in Salt Lake County (Ex. P-8) and a bill of sale to certain livestock and equipment used on the farm. Both the farm and part of the livestock and equipment were transferred subject to contracts of sale to Daniel H. Heaton (the same Heaton who first approached Knapp concerning the transaction) and Volma W. Heaton, Daniel H. Heaton's son. The balance of the livestock and equipment was sold subject to a contract of sale between Knapp and his wife as Sellers and Volma W. Heaton and his wife as Buyers (see Exs. P-5, P-6, P-7 and P-8). The instruments of transfer all were dated January 5, 1955.

The exchange contract recites that the value of the 1500 shares of stock is \$20.00 per share and that the total value of the contracts covering the land, livestock and equipment was \$34,385.03 (this figure should be \$34,383.03). \$34,383.03 equalled the total unpaid balance then due on all of the contracts of sale made up of \$27,875.00 then due on the farm property and certain of the livestock and equipment therein described (Ex. P-5) and \$6,508.03 then due on the balance of the livestock and equipment (Ex. P-6 and P-7).

At about the same time as the transaction between plaintiffs and defendant, new contracts of sale between defendant and the Heatons were substituted for the old contracts between Knapp and the Heatons which had been assigned to defendant (Exs. P-33 and P-34). The same property was covered but the amount of the monthly payments was reduced. These substituted contracts were both dated December 30, 1954.

From time to time during the year 1954, the Insurance Commissioner had questioned the financial condition of defendant (see Exs. P-45 and P-48, Tr. 676-681) but a regular license was issued for the year 1954 (Tr. 391). On April 8, 1954, the Insurance Commissioner notified defendant of an impairment in its capital stock (Ex. P-45). Correspondence ensued between the Insurance Commissioner and the defendant (Exs. P-46 and P-49) and the September 30, 1954 financial statement was prepared at the request of the Commissioner and submitted to him in October of that year (Tr. 682-683). The Insurance Commissioner met with officers of the defendant but no action was taken to implement the impairment notice.

However, when the 1954 license expired on February 28, 1955, only a conditional license was issued to defendant (Ex. D-58, Tr. 392). The Commissioner by letter of March 25, 1955 (Ex. P-52) notified defendant of certain deficiencies in its financial condition. In particular, the Commissioner noted that the defendant's holding of two parcels of real property was illegal. One of these parcels was the property Knapp had traded and the other was some property Heaton had transferred in exchange for stock.

On April 6, 1955, the Commissioner formally notified defendant of his intention to revoke defendant's certificate of authority to do business (Ex. P-53). The time when the revocation would take effect was extended each month for thirty days each time until about September 1, 1955 (Tr. 357).

Shortly after the April 6, 1955 order was given, the Insurance Commissioner appointed Herman L. Wood and Richard K. Nelson of the accounting firm of Wood, Child, Mann & Smith to conduct an audit of the company. Because the books of the company were not made immediately available to these auditors the Commissioner issued his order of April 20, 1955 (Ex. P-54) threatening immediate revocation of the company's license because the books were not supplied. The auditors were given access to the books and no action was taken to implement the order of April 20th, but the company continued under the threatened revocation order of April 6th as extended from month to month. The audit continued through the summer of 1955 and was completed in September. The audit report (Ex. P-55) was given to the Insurance Commissioner and based on this report demand was made on the company for a prompt reorganization to cure its impaired financial condition (Ex. P-56). The reorganization of the company then took place and was completed early in November of 1955.

During this period, the company continued operating and efforts were made to satisfy the demands of the Insurance Commissioner. There was unrest among some of the stockholders and a proxy fight was threatened to unseat Mr. Bullard and other directors up for re-election at the

May, 1955 annual meeting. There is evidence (Tr. 691) that prior to the annual meeting Bullard had approached Knapp with an offer to return the property Knapp had traded if Knapp would return his stock. Knapp denies such an offer was made (Tr. 156-157).

The stockholders' meeting in May of 1955 came at a period of crisis for the company. The Insurance Commissioner's demands on the company were pressing and the proxy fight did develop. It is noteworthy that Knapp was on the opposition slate of directors (Tr. 129-130, 736). Knapp attended the meeting with his friend, Heaton (Tr. 130, 688).

At the meeting there was considerable and heated discussion of the actions taken and the attitude of the Insurance Commissioner. The Insurance Commissioner's orders of April 6, 1955 and April 20, 1955, (Exhibits P-53 and P-54) were discussed (Tr. 698-699, 730-732) and the Commissioner's letter (Ex. P-52) referring to certain deficiencies, including the illegal investment in the property traded by Knapp, was read (Tr. 894, 695-696). Bullard told the stockholders that the company had been impaired (Tr. 730), but that steps were being taken to correct the situation. When Bullard was questioned further as to what impaired meant, Vernal Bergeson, a stockholder in attendance at the meeting, said it meant the company was broke and that "Mr. Bullard has thrown our money away" (Tr. 731).

A financial statement of the company (Ex. D-68) was distributed to the stockholders at the meeting (Tr. 696,

824) and was discussed (Tr. 824). Knapp testified that he did not recall receiving this statement but he did receive another financial statement (Ex. P-69) through the mail (Tr. 137). Knapp testified that he was unconcerned about what went on at the meeting (Tr. 136) and was willing to rely on Mr. Bullard to correct the situation (Tr. 135). He stated "the only things * * * of any importance" which needed correcting was to change into an acceptable form the real estate holdings of the company, including the real estate he had traded to the company for his stock (Tr. 134-135).

Going back to the property Knapp traded, the Heaton's were in possession of the property at the time of the trade and continued in possession until the summer of 1955. However, the payments on the contract fell in arrears (Tr. 231, 285-286). Defendant took no action at that time to collect the delinquencies. Heaton testified that in the spring of 1955, Bullard authorized Heaton to try to sell the property. Heaton arranged a trade of the property for other property but the deal fell through (Tr. 226-230). About this same time Volma Heaton, with the consent of the defendant, sold the livestock and equipment to a third party (Tr. 244).

Because of the delinquent payments on the contract, a notice to quit was served on the Heaton's (Ex. P-36). No court action was taken because early in August of 1955, the company began negotiations with Daniel H. Heaton to rescind a transaction between the defendant and Heaton involving a trade of stock for real property (Tr. 237, Exhibit P-31). It was suggested that a similar trade-back be arranged between Knapp and the company, and Heaton was

authorized to approach Knapp on the subject. There is a dispute in the testimony as to whether the offer was to trade-back the real property for an equivalent amount of stock with no cash being involved or whether the offer was to return the real property in exchange for plaintiff's stock and \$2,000.00 (Tr. 157-159, 166-170, 256, 261, 263-267, 268-278, 303-305, 309-312, 744-795). Knapp was approached at least twice on this subject and turned the proposition down saying "when you make an investment you don't want to take it back, you want to make some money" (Tr. middle page 158).

After Knapp refused to trade-back, the real property Knapp had turned in was sold to Heaton and the company took back a mortgage on the property which it now holds. At about the same time, Heaton resold the property to J. E. Morrison, on a real estate contract (Ex. P-39).

According to Knapp, the first idea he had that he had been defrauded was early in September of 1955 when he received the letter dated August 30, 1955 (Ex. P-11) from Reese Anderson concerning the necessity for reorganization of the company. Knapp went to his attorney, Vernon Romney, to discuss the matter. Romney went to the Insurance Department and was told that an audit of the defendant had been ordered which would ultimately be available for public inspection. Knapp testified that during September he contacted his attorney to ask about the matter and was told that the audit was not yet available. In October, Mr. Romney was able to inspect the audit report. A notice of rescission (Ex. P-15) was served on the company and its

directors on October 25, 1955 and the company refused to rescind by letter dated November 3, 1955 (Ex. P-16).

The trial court found that of the sixteen allegedly false statements one had not been made and another was not entirely false. Of the remaining fourteen the trial court found that Knapp did not reply or had no right to rely on three of the statements. Of the remaining eleven statements the court found that the statements were false, were made for the purpose of inducing Knapp to consummate the exchange, were material, were relied on and believed by Knapp, and that he had the right to rely on such statements. The trial court further found and concluded that plaintiffs are entitled to rescind the transaction, did not waive their right to rescind, were not guilty of such delay or laches as to justify denying their right to rescind, and are not estopped by their conduct or by any delay to demand rescission.

The plaintiffs prayed in the alternative for rescission and return of all the property Knapp had traded to the company or "in case defendant is unable to or fails to reconvey" said property, for a money judgment "for the value of any such property which cannot be or is not so reconveyed and returned". It is self evident and conceded by plaintiffs below that the latter alternative must apply for, as previously stated, the livestock and equipment were sold by Volma Heaton and are now beyond defendant's control and the real property is now vested in D. H. Heaton subject to a contract of sale to J. E. Morrison with defendant holding only a mortgage.

The defendant being unable to rescind in kind, the court awarded plaintiffs a money judgment for \$34,383.03, less the cash plaintiffs had received in the trade, plus interest. The amount of the judgment was based on a finding that the reasonable and "agreed" value of the property traded by Knapp was \$34,383.03. The court made no finding as to what the fair market value of the traded property was at the time of the trade or at the time the notice of rescission was given or at the time of the trial. Defendant's attempts to prove by appraisals the fair market value of the traded property were rejected (Tr. 795-809, Ex. 71; Tr. 88-91, Exs. D-18 and D-19) and defendant's attempt to inquire whether all of the property referred to in the instruments transferred was actually transferred was rejected (Tr. 123-124).

At the trial, plaintiffs offered to accept the return of the real property subject to the Morrison contract if defendant could negotiate successfully with Heaton to get a reconveyance of the property (Tr. 68-72, 252-256, 803-804, 860-861). The unpaid balance due on the Morrison contract at the time of reconveyance to plaintiffs would be credited on the money judgment awarded and said judgment would be partially satisfied accordingly. A money judgment was rendered and said method of partial payment thereof was authorized.

We have not referred in this Statement of Facts to the testimony of Victor K. Cummings (Tr. 435-590) and Herman L. Wood (Tr. 590-625) as we believe their testimony is not directly involved on this appeal.

STATEMENT OF POINTS

POINT I.

IF THERE WAS FRAUD, PLAINTIFFS ARE NOW BARRED FROM ASSERTING IT BY THEIR LACK OF DILIGENCE IN RESCINDING AND BY LACHES.

(a) *A Party seeking rescission must give notice of his intention to rescind promptly after discovery of the fraud or of facts putting him on notice of the fraud.*

(b) *Plaintiffs' action should be barred by laches.*

POINT II.

THERE IS NO EVIDENCE TO SUPPORT THE MONEY JUDGMENT AWARDED PLAINTIFFS IN THIS ACTION.

ARGUMENT

POINT I.

IF THERE WAS FRAUD, PLAINTIFFS ARE NOW BARRED FROM ASSERTING IT BY THEIR LACK OF DILIGENCE IN RESCINDING AND BY LACHES.

(a) *A Party seeking rescission must give notice of his intention to rescind promptly after discovery of the fraud or of facts putting him on notice of the fraud.*

It is well settled in Utah and the great majority of other jurisdictions that a defrauded party must act promptly to rescind a transaction after acquiring knowledge of fraud or, its equivalent, knowledge of facts putting him on notice of fraud. Rescission, being an equitable remedy, will be denied where the defrauded party has not exercised the diligence equity requires. This court in *Taylor v. Moore*, 87 Utah 493, 51 P. 2d 222, stated that:

“The party who has been misled is required, as soon as he learns the truth, and discovers the falsity of the statements on which he relied, with all reasonable diligence to disaffirm the contract and give the other party an opportunity of rescinding it, and of restoring both of them to their original position. The party deceived is not allowed to go on deriving all possible benefit from the transaction and then claim to be relieved of his own obligation by seeking its rescission.”

The court relied on the statement in 5 Ruling Case Law, 514 as follows:

“The great weight of authority holds that if the party defrauded continues to receive benefits under the contract after he has become aware of the fraud, or if he otherwise conducts himself with respect to it as if it were a subsisting and binding engagement he will be deemed to have affirmed the contract and waived his right to rescind.”

Again, in *McKeller Real Estate and Investment Company v. Paxton*, 62 Utah 97, 218 Pac. 128, this court stated:

“Any action on the part of the purchaser treating the contract as in force, when done with a knowl-

edge of the facts creating a right of rescission, amounts to a waiver of the right to rescind because of the existence of such facts."

See also *Skola v. Merrill*, 91 Utah 253, 64 P. 2d 185 and *Levine v. Whitehouse*, 37 Utah 260, 109 Pac. 2.

Delay alone is enough to preclude an action for rescission.

In the recent case of *Gedstad v. Ellichman*, 124 C. A. 2d 831, 269 P. 2d 661, the court denied rescission of a contract holding:

"In such a suit acting promptly is a condition of his right to rescind, *Victor Oil Co. v. Drum*, 184 Cal. 226, 243, 193 Pac. 243; *Neff v. Engler*, 205 Cal. 484, 488, 271 P. 744, and therefore diligence must be shown by the actor whereas in other actions laches is an affirmative defense to be alleged by the defending party. Absence of explanation of delay may even cause a complaint for rescission to be demurrable. *Bancroft v. Woodward*, 183 Cal. 99, 109, 190 P. 445. A delay of more than one month in serving notice of rescission requires explanation. *Campbell v. Title Guarantee Etc. Co.*, 121 Cal. App. 374, 377, 9 P. 2d 264. The diligence is required throughout and it applies as well to the time a person will be held aware of his right to rescind as to the time he will be held to have discovered the facts on which that right is based. *Bancroft v. Woodward*, supra, 183 Cal. 99, 108, 190 P. 445; *First Nat. Bk. v. Thompson*, 212 Cal. 388, 401, 298 P. 808."

It has been held that unless a plaintiff gives notice of rescission within 30 days after receiving knowledge of the fraud or after obtaining facts which would put one on notice

of the fraud, he is completely barred from an action of rescission. See *Campbell v. Title Guarantee & Trust Co.*, 121 C. A. 374, 9 P. 2d 264, where the court stated: "From an examination of authorities, it would appear that 30 days is about the utmost limit of time which the courts are disposed to allow to the purchaser for rescission, unless there are unusual circumstances in the case excusing longer delay." In *King v. Los Angeles County Fair Association*, 161 P. 2d 468, there are numerous cases cited where a delay in taking action for less than a year was held to bar relief. See also the cases cited in *Campbell v. Title Guarantee & Trust Co.*, supra, and in *Estrada v. Alvarez*, 38 Cal. 2d 386, 240 P. 2d 278.

The above rulings apply not only when the plaintiff fails to act diligently after knowledge of the fraud itself, but also when the plaintiff fails to act diligently after receiving knowledge of facts putting him on notice of the fraud. Thus, the Utah court in barring an action for rescission of the sale of stock stated "all of the facts concerning which he alleges misrepresentations could have been learned by him, if indeed he did not already know the truth about them, very shortly after the transaction". *Skola v. Merrill*, 91 Utah 253, 64 P. 2d 185. The California court in *Bancroft v. Woodward*, 183 Cal. 99, 190 Pac. 445 stated the rule very clearly:

"It is well settled that where a party has knowledge of facts of a character which would reasonably put him upon inquiry, and such inquiry, if pursued, would have led to a discovery of the fraud or other ground for rescission, he will be charged with having discovered the fraud or other ground as of the

time he should have discovered it, that is, as of the time when he would have discovered it if he had with reasonable diligence, pursued the inquiry when he should have done so. *Lady Washington, etc., Co. v. Wood*, 113 Cal. 482, 45 P. 809; *Harrington v. Patterson*, 124 Cal. 542, 57 P. 476.

“The reason for this rule is that diligence throughout is required of one who would rescind. It is a reason which applies with equal if not greater force to the time at which such a person, after learning of the facts upon which his right is based, will be held to be aware of their legal consequence, his right to rescind. It is at least intimated in *Ruhl v. Mott*, 120 Cal. 668, 679, 53 P. 304, and *Hannah v. Steinman*, 159 Cal. 142, 153, 112 P. 1094, that the rule is the same in regard to the time as of which a person seeking rescission will be charged with knowledge of his right, as it is in regard to the time as of which he will be charged with a discovery of the facts which give him the right, and the reason for this is so plain that we have no hesitation in declaring it to be the case.”

See also, *Lady Washington Etc. Co. v. Wood*, 113 Cal. 482, 45 Pac. 809; *Gedstad v. Ellichman*, supra; *Garstang v. Skinner*, 165 Cal. 721, 134 Pac. 329.

Considering now the facts in this case, it is apparent that Knapp knew of the fraud or of extremely suspicious circumstances in connection with the company long prior to October 25, 1955, when he finally gave defendant notice of rescission. The court will note that virtually all of the alleged misrepresentations relate to the financial condition of the defendant. It was, of course, primarily financial difficulties that caused the concern of the Insurance Com-

missioner and led to his actions as outlined in the Statement of Facts and eventually to the financial and managerial reorganization of the company in the fall of 1955.

Finding of Fact No. 6 of the court (R. 19) we consider very significant. The court stated that representations (l) and (m) (R. 17) relating to the absence on the September 30, 1954 financial statement of a liability for reserves and of a liability for unearned premiums was not believed by Knapp "since it appears probable that if plaintiff, Clyde J. Knapp, gave consideration to such items he would have assumed that there would be liabilities for outstanding policies and for unearned premiums". In other words, Knapp either knew these representations were false and did nothing about it, or he could not reasonably rely on such statements. Certainly, the absence of these items which are normally found on an insurance company's financial statement should have made Knapp somewhat suspicious at the very outset of the negotiations.

The trial court also found that the alleged misrepresentation (h) that the company would pay a 10% dividend in the year 1954 was not relied on by Knapp as he questioned that fact (R. 19). According to Heaton, when Bullard made this statement "kind of a grin came upon his [Knapp's] face, he noticed it in particular because he couldn't take that * * *" (Tr. 191). Knapp testified he questioned Bullard about such a dividend "it didn't sound right for a new insurance company to start paying so soon * * *" (Tr. 96) But Knapp went no further with the matter, questioned no one about it and apparently made no objection to anyone when the company paid no

dividend, although certainly a dividend for 1954 would have been declared early in 1955.

After the transaction was consummated and prior to the May stockholders' meeting, Knapp heard rumors that the president of the company, Bullard, was turning down business simply because he did not like the salesman who wrote the business (Tr. 129). Such a shocking accusation certainly suggested managerial incompetence if not wrong doing, and if true, must have had a serious effect on the financial condition of the company, but Knapp apparently ignored it—made no investigation at all.

The evidence shows that the president of the company, Bullard, apparently anticipating a proxy fight at the May stockholders' meeting attempted to "wash out" Knapp's block of stock by offering to trade back the property Knapp had turned in for the stock he received (Tr. 691-692). Whether Knapp did agree to the trade or not, the very fact that the offer was made should have indicated to him that something was wrong, else Bullard would not have been so anxious to buy off Knapp's voting power.

But assuming these facts separately or together did not give Knapp notice or establish a duty to inquire, certainly he received an eye-opener at the May stockholders' meeting. There Bullard stated that the Insurance Commissioner "was giving trouble" about the Heaton and Knapp real estate (Tr. 131). Knapp grudgingly admitted (Tr. 134) that "there was some mention" of the Insurance Commissioner's Notice of Intention to Revoke the Company's license in 30 days (Exhibit P-53). In fact, Bullard was

sharply questioned about such notice and about the subsequent order (Exhibit P-54) giving the Company only five days to surrender its books or suffer receivership (Tr. 698-699, 730-732) and was, in effect, called a liar for not admitting the issuance of the second order (Tr. 699). Accusations were made that the company was broke (Tr. 731) and Bullard admitted that if new money was not put into the company, liquidation would be necessary and "we would lose everything" (Tr. 737). Reese Anderson stated that unless the company was refinanced, it would be taken over by the Insurance Commission, operated for the benefit of the policyholders and the stockholders would get nothing (Tr. 826).

The letter from the Insurance Commissioner to Mr. Lowe (Exhibit P-52) was read (Tr. 824, 695-696). There was a discussion of the Commissioner's objections to the Knapp and Heaton properties (Tr. 696, 134). Bullard said that the company had been impaired (Tr. 730), but that steps were being taken to correct the situation. When Bullard was questioned further as to what impaired meant, Vernal Bergeson, a stockholder in attendance at the meeting said it meant the company was broke and "Mr. Bullard has thrown our money away" (Tr. 731). That there was merit in this statement was shown by the financial statement (Exhibit D-68) distributed to the stockholders at the meeting (Tr. 696, 824). The financial statement was discussed (Tr. 824).

If anything could shock Knapp out of his lethargy, the financial statement should have done it. It showed, among other things, a bank overdraft of in excess of \$1,000 and

cash on hand of only \$270.69. Amounts due from agents had increased to \$43,000—nearly double the amount shown on the September 30th statement. (The comparison is important because it is the financial data shown on the September 30, 1954 statement (Exhibit P-4) which Knapp claims he relied on in making the trade of his property for the stock.) Liabilities of about \$18,000 were shown, plus an additional amount of \$4,500 shown in the footnote to the balance sheet. Quite a contrast from the \$3,400 liabilities on September 30th.

Knapp did not recall such a statement at the meeting though he admitted it might have been distributed (Tr. 136-137). He did recall receiving Exhibit P-69. There it was plainly stated that on March 31, 1955, the company had a bank overdraft of nearly \$3,000. Cash had decreased from \$10,000 at the end of 1953 to \$1,600 at the end of 1954 and was only slightly more than \$900 as of March 31, 1955. Although liabilities had decreased slightly from December 31, 1954, as of March 31, 1955, the liabilities were about 8 times larger than the liabilities shown on the September 30, 1954, statement. Of the \$23,000 in bonds shown on the September 30th statement, only \$11,900 was left on March 31, 1955.

Despite all this, Knapp was unconcerned about what went on at the meeting (Tr. 136). He was willing to rely on Mr. Bullard to correct the situation (Tr. 135) even though he agreed to run as a director on Mr. Lowe's slate—the purpose of which was to unseat Bullard. He wanted to be a director to protect his investment and “so I could get in and perhaps correct affairs” (Tr. 135-136). He felt

that the only corrective measures necessary were to change the nature of the real estate acquired from himself and Heaton—real estate which he knew made up a major part of the assets of the company. But he did nothing to determine whether the corrective measures were taken. Although he had run as a director so he could participate in these corrective measures, when a dispute arose as to the computation of the vote, he sat back and decided the only thing to do was to forget being elected a director (Tr. 147). He did not inquire of the Insurance Department of the status of the orders referred to at the meeting and whether the company had corrected the matter. The extent of his diligence was to ask Mr. Bullard at a casual meeting, “How are things coming?”, to which Bullard answered, “Fine” (Tr. 149).

May passed and Knapp did nothing. June passed and Knapp did nothing. July passed and Knapp did nothing. Then in August, 1955, Heaton called Knapp and asked him if he wanted to trade back his stock for the property (Tr. 157-160). Knapp claims that he felt the corrective measures referred to in the stockholders’ meeting had been made by August (Tr. 157). But was he concerned that no such measures had been taken by August when the Company still had the real estate and wanted to get rid of it to Knapp? Apparently not. His reaction was to stand pat for “when you make an investment you don’t want to take it back, you want to make some money” (Tr. middle page 158).

By his own inaction after notice, Knapp waived his right to rescind. He had notice prior to the stockholders’ meeting but when rumors of mismanagement were circu-

lated he was apparently unconcerned. When no dividend was paid as represented Knapp did nothing. He had notice of the most startling kind, for such an "innocent" as he, from the statements made at the stockholders' meeting and from the financial statements distributed there. He had notice when the company offered to trade back, a trade back made necessary in order to remove the inadmissible real estate from the company's books and thus satisfy the Insurance Commissioner. Knapp knew of the Commissioner's demand at the time of the stockholders' meeting. In fact, according to Knapp this conversion of assets was the only thing he recalled "of any importance that was to be done" (Tr. 134-135). That this had not been done more than three months after the meeting where the need for immediate correction was first stated, should have excited some suspicion in a man with his business background.

Contrast these facts with what Knapp claims (Tr. 43) first excited his suspicion—the letter from Reese Anderson (Exhibit P-11) dated August 30, 1955. The letter merely referred to the necessity for a reorganization and urged prompt action by the stockholders to effectuate it. Reorganization of a sort involving investment by a group of doctors had been discussed at the stockholders' meeting in May (Tr. 131, 132) and it was stated that the Insurance Commissioner would take over the company unless it was recapitalized (Tr. 826). The letter was rather mild in tone, merely requesting a prompt decision on signing the voting trust agreement. It speaks of continuing the company in business by a recapitalization in contrast to the discussion at the stockholders' meeting three months earlier of the

Insurance Commissioner's order threatening to terminate the company's right to do any business. If the letter made him suspicious of fraud committed in December, why then did he ignore the Commissioner's orders or the financial statements discussed at the May meeting? We respectfully contend that Knapp failed to exercise the diligence required of him and is thus precluded from rescinding at this time. As Justice Elias Hansen stated in his concurring opinion to *Skola v. Merrill*, *supra*:

“He should not be permitted to hold the stock to see if it would turn out to be a profitable investment despite the claimed fraud, and then when it did not prove profitable recover back all that he paid. It may be that plaintiff has an action at law for fraud, but upon this record he is not entitled to rescission (64 P. 2d at 192)”.

(b) *Plaintiffs' action should be barred by laches.*

In addition to Knapp's lack of diligence¹ which we feel is an element of plaintiffs' cause of action, we believe the facts also support the affirmative defense of laches.

Upon notice from the Insurance Commissioner that the Knapp property was an inadmissible asset, it became necessary for the company to convert it into admissible form. In August defendant approached plaintiff in an attempt to arrange a trade back of the property. When Knapp turned the deal down “to wait and see what happens”, the company was forced to sell the property to Heaton. Upon the sale it became impossible to place the parties in status quo. Had Knapp acted diligently it would now be possible to return the property to him.

In *Raht v. Sevier Mining & Milling Company*, 18 Utah 290, 54 Pac. 889, plaintiffs sued to recover certain mining stock which had been sold under an invalid assessment. The Utah court in declaring the claim barred by laches stated:

“A party claiming an interest should be held to prompt action and decide whether he will share the risks or stand clear from them.”

See also *Skola v. Merrill*, *supra*; *Sanders v. McGill*, 9 Cal. 2d 145, 70 P. 2d 159; *Twin Lick Oil Co. v. Marbury*, 91 U. S. 587.

The necessity of refinancing the company was discussed as early as the May stockholders' meeting and beginning in August and continuing through September and October the company took steps to reorganize. By September 13th (Exhibit P-12) it became apparent that there would be a devaluation of the stock in order to establish an equitable division between the new and old stockholders. It was only after the reorganization plan was nearly completed that Knapp gave notice of his intention to rescind. By that time it was too late for the new stockholders to back out as their investment of \$200,000 had already been placed in escrow (see Exhibit P-14).

Thus, due to Knapp's delay, the defendant has been prejudiced in these two respects and Knapp's claim should be barred by laches.

POINT II.

**THERE IS NO EVIDENCE TO SUPPORT THE
MONEY JUDGMENT AWARDED PLAINTIFFS
IN THIS ACTION.**

Plaintiffs' complaint is for rescission and prays for reconveyance of the real and personal property and contracts therefor, or in case defendant is unable to so reconvey, for the value of such property. They further allege that the "agreed and reasonable value" of such property was the sum of \$34,383.03. It was conceded that the alternative prayer applied for both the real estate and the personal property are out of defendant's hands and defendant cannot be required to do that which it has no power to do.

We contend it was incumbent upon plaintiffs to prove, as a prerequisite to any money judgment, that the property was worth what they allege it to be. The purpose of an action in rescission is to restore the status quo. Assuming the other prerequisites to the action have been met, including diligence of the plaintiff, the ordinary result is to restore the property in kind. If plaintiff had paid cash, then the court restores that amount of cash, plus interest. If an exchange of property is involved, the court orders a reconveyance. But where the property cannot be reconveyed, the court must award its equivalent in cash and since the purpose of the action is to restore the status quo, this equivalent must be the value of the property at the time of the transaction. Otherwise, there is no assurance that the true status quo is restored without penalty to the defendant or unjust enrichment to the plaintiffs.

This was clearly recognized in the case of *Marks v. Howkins*, 55 Cal. App. 664, 203 Pac. 1035. In that case the plaintiffs traded their home plus some cash for a farm. Because the farm was not as represented, they asked and received rescission. The court awarded judgment requir-

ing reconveyance by both parties, but if defendant failed to reconvey within 60 days, plaintiffs were given a money judgment which the findings recited represented the cash value of the house traded by plaintiffs. On appeal, complaint was made of the alternative judgment. The court held the judgment was proper so that the parties could be returned to status quo. Noting that the property might depreciate or have been transferred to innocent third parties (there was no evidence that either of these things had happened) the court stated:

“Certainly, in either of the suppositious cases, the plaintiffs would be entitled to be paid, in lieu of the delivery to them of the possession of the property, the value thereof *at the time of the consummation of the agreement of exchange.*” (Emphasis added.)

In *Blahnik v. Small Farms Improvement Co.*, 181 Cal. 379, 184 Pac. 661, plaintiff purchased real estate for \$3,750. Defendant acknowledged receipt of \$2,300 which it was shown was paid not in cash but by the transfer of other real estate. On rescission, the property traded not being available for reconveyance, judgment was awarded for \$2,300 notwithstanding evidence of value which at most would have fixed the actual value at only \$2,000. In reversing this judgment, the court stated:

“The [trial] court, apparently, proceeded upon the theory that the plaintiffs were entitled to treat the amount for which said property was taken in exchange as a payment in money upon the price of the property sold to the plaintiffs by defendant and to recover said amount upon a rescission. In this

the court erred. If the defendant had retained the title to the property, the most that the plaintiffs could have demanded upon the rescission would have been a reconveyance thereof to them. The defendant having parted with the title thereto, and being unable to restore the plaintiffs to the position in which they were at the time the contract was made, the rule in equity is that they must compensate the plaintiffs for the loss thereby sustained. This would not be the price at which the property had been accepted upon the contract of sale, but would be its value at that time and it was therefore necessary for the court to determine such value. * * * The plaintiffs were not entitled to more than the actual value of the property at the time of the exchange. The judgment giving them the full amount at which it was taken in the contract is erroneous to the extent of the difference between the actual value and the price so fixed in the exchange. For this reason a reversal is necessary. The complaint did not raise this question, but it was put in issue by the allegations of the answer. There should have been a finding of the actual value of the property at that time and the judgment should have covered that amount only."

Lasher v. Faw, 209 Cal. 726, 289 Pac. 821, directly supports our position. There property was deeded defendant under an agreement of plaintiff to pay \$2,500 or convey the property. He chose the latter alternative. Thereafter, the defendant sold the property for \$2,000. The court granted rescission and because reconveyance was impossible, gave plaintiff judgment not for \$2,000 or the \$2,500 value stated in the contract but for \$4,000, the reasonable market value of the property.

In *Swan v. Talbot*, 152 Cal. 142, 94 Pac. 238, 17 L. R. A., N. S. 1066, plaintiff, through defendant's fraud, conveyed property worth \$21,900 in exchange for \$200 cash and satisfaction of a \$10,600 indebtedness. Because rescission could not be granted in kind, the property having been conveyed to a third person, judgment was granted and affirmed on appeal for the difference between the value of the property conveyed and the amount of the indebtedness.

In *Merigold v. Gagnon*, 131 Cal. App. 213, 20 P. 2d 986, plaintiffs sought to rescind a land transaction wherein plaintiffs agreed to purchase land from defendants. In payment plaintiffs transferred land which the contract recited was worth \$3,735, paid cash of \$50 and agreed to make additional monthly payments of \$50. The trial court denied rescission and on appeal plaintiffs contended a finding they had paid only \$50 was unsupported by the evidence as land worth \$3,735 had also been "paid". The appellate court held the finding was proper, that the \$3,735 represented the land and on rescission plaintiffs could only recover the value of the land at the time of the transaction. There being no evidence of value offered "the finding of the trial court was actually demanded by the state of the evidence". Note that the statement in the contract that the land was worth \$3,735 did not fix the value of the land on rescission and was not considered by the court even to be evidence of value.

Plaintiffs have completely failed to prove the value of the property they transferred. They took the position throughout the trial that the amount stated in the exchange

agreement (Ex. P-9) was binding upon the parties to the exchange agreement and no proof could be introduced of the actual value of the property at the time of the exchange. We offered proof as to the fair market value of the traded property (Tr. 795-809, Ex. 71; Tr. 88-91, Exs. D-18 and D-19), but plaintiffs insisted that the "agreed value" stated in the exchange agreement controlled and no evidence to the contrary could be introduced. Plaintiffs did not assert that the price stated in the exchange agreement was evidence of the fair market value but in effect stated that the fair market value was unimportant because the price had been agreed upon in the written contract between the parties. The trial court accepted this view and gave judgment accordingly.

The result is that plaintiffs have recovered a money judgment for what we believe to be in excess of the fair market value of the traded property. The status quo has not been restored. Plaintiffs have been enriched to the extent of the difference between the value of the property they traded and the fair market value at the time of the trade and defendant has been penalized accordingly. To avoid this unjust result the judgment must be reversed.

CONCLUSION

It is respectfully submitted that the judgment should be reversed.

Respectfully submitted,

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