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Fay L. Branch, Phyllis L. Branch, Ray Branch And Sylvia Branch v. Western Factors, Inc., Et Al., And John H. Allen, Trustee For Western Factors, Inc., Bankrupt v. Arnell E. Heaps, And William G. Fowler, Trustee For Western National Investment Corporation : Brief of Respondents

IN THE SUPREME COURT OF THE STATE OF UTAH

FAY L. BRANCH, PHYLLIS L. BRANCH, RAY BRANCH and SYLVIA BRANCH,

Plaintiffs-Respondents,

vs.

WESTERN FACTORS, INC., et al., and JOHN H. ALLEN, Trustee for Western Factors, Inc., Bankrupt,

Cross-Claimant-Respondent,

vs.

ARNELL E. HEAPS, Respondent and WILLIAM G. FOWLER, Trustee for Western National Investment Corporation, Appellant,

Cross-Defendants

Case No. 12761

BRIEF OF RESPONDENTS

Appeal from Third Judicial District Court of Salt Lake County
Honorable James S. Sawaya, Presiding

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ARNELL E. HEAPS, Respondent and WILLIAM G. FOWLER, Trustee for Western National Investment Corporation, Appellant,

Cross-Defendants

Case No. 12761

BRIEF OF RESPONDENTS

STATEMENT OF FACTS

The appellant, in his statement of facts, has covered the material he relies on for a reversal, but has distorted

the facts as they were presented to the trial court, has omitted some of the important evidence, and has misstated some of it.

According to the evidence, the transactions involving the Mecham Apartments developed in this way:

The property was listed for $95,500 in May 1961 and sold for $80,000 in June 1961. The listing card showed income of $815 per month (R. 251). The property was listed on March 21, 1962, for $95,000 showing income of $962.50 per month (R. 252 and 254) and was sold to the respondent Arnell Heaps in June 1962 for $93,000 (Ex. 1-C). At that time, defendant Heaps inspected the Mecham Apartments carefully and went over the records of income and expenses before making his purchase (R. 264-265). He assumed the contract balance, paid $6,000 cash and transferred to Wilkins an interest in a contract of sale on the duplex in Bountiful in the amount of $7,089.44 (R. 264, Ex. 1-C).

While he owned the Mecham Apartments, Mr. Heaps spent several thousand dollars for new roof, furniture, and water heating system and had considerable work done. (R. 265)

In September 1963, the Valley-Hi Corporation was long on vacant land and short on income property and was attempting to remedy its situation (R. 183, 207, 223, 232) and about that time the President of Valley-Hi, Kay Allen, approached Arnell Heaps several times in an effort to acquire the Mecham Apartments (R. 265). Heaps had offered his equity in the Mecham for stock,

which was more favorable to the corporation (R. 208) and Director Holmquist moved that the Liston property in Davis County be offered for Heaps' equity (R. 191, Ex. 8-CDW). Prior to the purchase, several of the directors inspected the property and examined Heaps' records of income and expense (R. 183, 266) and several of the members of the Board of Directors were experienced real estate men (R. 270).

Kay Allen conducted "a one man crusade * * * to reacquire that property in Davis County so that he could resell it to develop some much needed cash in the corporation." (R. 186) In December 1963, the Davis County property taken by Heaps for his equity in the Mecham was conveyed back to the corporation for stock in the corporation (R. 186, 208, Ex. 19) and after reacquiring the land, the corporation made sales of three parcels for cash in December 1963, January and March 1964 (R. 272).

Arnell Heaps owned the Mecham for fifteen months (Exs. 1 and 5). According to Exhibits 15 and 17, the gross income for September 1963 was $1,141.27 and for April 1964 was $890 and while the corporation owned and managed the property, its gross income went to as low as $250 per month in 1967 (R. 234). Vacancies existed because the corporation didn't keep the apartments up (R. 234-235) and the income from the Mecham was diverted to other obligations of the corporation (R. 233-235).

The Mecham Apartments were listed July 18, 1968

at $89,500, listing gross income as $800 per month (R. 252) and the price was later reduced to $75,000 and in a listing agreement on October 4, 1969 at $91,000 (R. 252) with gross income shown at $1,080 per month (R. 254).

Although no special testimony was given concerning the effect of the depreciation of the Mecham Apartments on the cash flow of the income of the corporation, it was utilized by the corporation as shown in Exhibit 7, the financial statement at page 2, stating that the Mecham will be depreciated in the amount of $97,208.59.

Appellant's brief refers to testimony that no fee appraisal was made of the Mecham Apartments by Western National at the time of purchase. Exhibit 11, the prospectus of the corporation under title "Property," paragraph 9, states as to the Mecham Apartments:

"This property has been appraised at $100,000." The prospectus is dated April 12, 1965.

Exhibit 18, which is the appraisal report of Sterling Webber gives one formula for reaching cash value as gross income times 7 to 8½. In another portion of the report he uses $960 as the monthly income, making an annual gross of $11,520; and if this were multiplied by the factor 8½, it would total $97,920. Mr. Webber reduced his gross by ten percent to reach $10,370 and applying the varying factor of 7 to 8½ would result in a figure of from $72,500 to $88,145 as the cash value. He testified that property sold on contract is usually at a higher price than the cash value (R. 253).

Appellant's brief at the bottom of page 9 states that the debtor corporation subsidized payments on the mortgage. Mr. Inouye's testimony on cross-examination was that the Board of Directors instructed him to spend no money on the Mecham Apartments, that expenses were left unpaid and that although he collected the rents, he didn't use the money for the Mecham Apartments (**R.** 233-234).

Appellant's brief at the top of page 10 quotes from Exhibit 16:

> "The property at the present time is appraised at approximately $50,000."

Exhibit 16 was discussed in the record and although the court admitted the exhibit, it stated:

> "I won't give it any weight unless I know the basis of it from somewhere. Somebody has got to have made an appraisal of this property." (**R.** 223-225)

No foundation was supplied for the figure.

Appellant's brief on page 10 states that the valuation by the appraiser Sterling G. Webber "assumed full occupancy, and if a vacancy factor were considered the value would be less." The witness testified that he allowed a vacancy factor of 10% (R. 249) and his appraisal report states the same thing (Ex. 18).

ARGUMENT

APPELLANT'S POINTS

1. Reference of a contingent and unliquidated claim in a Chapter X reorganization proceeding for expeditious determination by a state court requires that court to give due regard to the interests of the debtor and its creditors and stockholders.

2. Heaps occupied a fiduciary relationship at all times material to his dealings with the debtor corporation.

3. Claims of stockholders and directors are subject to rigid scrutiny by virtue of their fiduciary relationship and proof must meet the highest standard of persuasiveness.

4. As a matter of law Heaps failed to establish the adequacy of the price, the benefits to the corporation and the inherent fairness of the transaction.

5. Assuming the validity of the judgment, the trial court erred to the extent said judgment included interest accrued after the commencement of the Chapter X proceedings.

Respondents will make their argument under the points as stated by appellant.

POINT I

REFERENCE OF A CONTINGENT AND UNLIQUIDATED CLAIM IN A CHAPTER X

REORGANIZATION PROCEEDING FOR EXPEDITIOUS DETERMINATION BY A STATE COURT REQUIRES THAT COURT TO GIVE DUE REGARD TO THE INTERESTS OF THE DEBTOR AND ITS CREDITORS AND STOCKHOLDERS.

Appellant refers to "the desire of the United States District Court," which is not in the record and was not before the trial court. No such statement as appellant makes under Point I was made at any stage of the proceedings to the District Court.

Respondents take the position that this case was tried by the District Court as though the trustee spoke for the corporation and all its stockholders and all its creditors and as though at no stage of the proceedings was any challenge made to the status of the appellant trustee.

POINT II

HEAPS OCCUPIED A FIDUCIARY RELATIONSHIP AT ALL TIMES MATERIAL TO HIS DEALINGS WITH THE DEBTOR CORPORATION.

Respondents do not take issue with the statements made in appellant's brief under this Point. The cases cited by appellant on page 14 involved actions against directors for negligence in disposing of the assets of the corporations involved and the cases hold that the enforcement of such an action belongs to the trustee in bank-

ruptcy. The reference to § 838 of Fletcher on Corporations is appropriate, although at page 337, § 919 the following statement is made:

> The most frequent applications of the rules of the text are cases of sales to or purchases from the company by its directors and other officers. But the rules have also been applied to claims by a director to profits in the shape of bonuses and commissions, to loans by officers to the corporation, to releases of officers from their liability to the company, and to mortgage transactions between the company and its officers. Also where a director acquired timber land from his corporation for a very small part of its real value, although under an option to the company to repurchase it within a certain time, the corporation may have the transfer set aside. But, even in a case of inadequacy of consideration, if the corporation was represented by disinterested officers and the officer adversely interested informs them of his interest and fully discloses all of the facts pertinent to the transaction, within his knowledge, it would seem that the courts would be loath to relieve the corporation even though it had received the worst of the deal.

This court has had occasion to pass on this question several times and respondents have no quarrel with the Utah cases cited in the brief of appellant as stating the standards of conduct for directors.

POINT III

CLAIMS OF STOCKHOLDERS AND DIRECTORS ARE SUBJECT TO RIGID SCRUTINY BY VIRTUE OF THEIR FIDUCIARY

RELATIONSHIP AND PROOF MUST MEET THE HIGHEST STANDARD OF PERSUASIVENESS.

Respondents find no Utah case stating, "the highest standard of persuasiveness' as the applicable rule; but the difference between that and "very strict proof of good faith" (*Noble Mercantile Co. v. Mt. Pleasant Co-op*, 12 Utah 213, 42 P. 869, 872 (1895)) and "should be scrutinized with great care" (*Sweeney v. Happy Valley, Inc.*, 18 Utah 2d 113, 417 P.2d 126, 129) and "bound by the same rules of good faith, full disclosure, and fair dealing as surrounds the trustee in dealing with the *cestui que* trust" (*Glen Allen Mining Co. v. Park Galena Mining Co.*, 77 Utah 362, 384, 296 P. 231, 240), or "held to a strict measure of care, duty, fidelity, and disability" (*McIntyre v. The Ajax Mining Co.*, 17 Utah 213, 224, 53 P. 224 (1898)) does not seem very great.

The question in this case is not so much whether the trustee has a right to bring the action, or whether Arnell Heaps was a director, or what standard of conduct is required of a director, but are the facts in this case such as support the judgment of the District Court?

POINT IV

AS A MATTER OF LAW HEAPS FAILED TO ESTABLISH THE ADEQUACY OF THE PRICE, THE BENEFITS TO THE CORPORATION AND THE INHERENT FAIRNESS OF THE TRANSACTION.

It must be borne in mind that the appellant seeks to reverse the judgment holding Western National Investment Corporation liable on its contract and "relieving it of liability" completely (Appellant's Brief, page 3) and asking that the agreement "be deemed null and void and unenforceable as against the corporation" (Appellant's Brief, page 23). Appellant's answer to the cross-claim of Arnell Heaps likewise attacks the agreement in the same manner, saying:

> "That the said Heaps violated his fiduciary duty to Valley-Hi Associates, Inc., thereby rendering said assumption of said indemnity agreement null and void." (R. 146-147)

Appellant cites no case in any court of a holding against a director who abstained from participating in the decision and whose vote was not essential to the decision of the board. Appellant cites no case in which a contract of sale was held null and void where a director sold or exchanged a property to the corporation of which he was a director.

The position of respondents on this point is threefold:

(a) This transaction met all requirements for lawful and valid dealings between the director and the corporation of which he is a director;

(b) This transaction is at most voidable; and

(c) The claim of the trustee, if any exists, is against the other directors and not Arnell Heaps.

A

This transaction met all requirements for lawful and valid dealings between the director and the corporation of which he is a director.

There appears to be general agreement as to what factors are determinative of the validity of a transaction with a corporation by one of its directors. In 19 Am. Jur. 2d, Corporations, ¶ 1305, these four factors are listed as determining whether a transaction appears to have been an arms length transaction and therefore valid:

1. Did the director represent the corporation in the transaction?
2. Did the director influence and control the board of directors?
3. Did the director disclose pertinent facts and circumstances?
4. Adequacy or inadequacy of the price.

An annotation on the subject at 24 ALR 2d 71 reviews the cases from all jurisdictions and concludes that the modern courts follow the tests as indicated, citing cases dealing with each of the several tests. Most important is the identification of the director with the corporation, or the independence of the board (p. 74) and of next importance is whether the director dealing with the corporation in fact influenced and controlled the board; thirdly, whether pertinent facts were disclosed or held back; and finally, adequacy or inadequacy of the price

(p. 75). One additional test mentioned is whether the purchase was initiated by the director or by the corporation (p. 76). The annotation cites *Hanson v. Granite Holding Co.*, 117 Utah 530, 218 P.2d 274 (1950). There the sale was made by a father who dominated and controlled the corporation to a son who paid a completely inadequate price with undisclosed payments to the father for the rest of his life.

Fletcher's Cyclopedia of Corporations (permanent edition) states this majority rule at § 931:

> "The great weight of authority is that in case of dealings between an interested director or other officer with his corporation, where the corporation is represented by other officers, the transaction is valid and cannot be set aside merely because of the relationship of the parties, where the transaction is not unfair to the corporation and the directors have acted in good faith, * * *."

and at § 950 *Fletcher* states:

> "* * * if the officer originally bought the property, not for the purpose of selling it to the company, nor at a time when it was his duty to buy it for the company, the officer may sell it to the company for more than he paid for it plus expenses, and he may purchase property and resell it to the company at an increased price if the purchaser's board of trustees or board of directors was advised or should have been advised of the facts."

In *McIntyre v. The Ajax Mining Co., supra*, this court held that when a director deals with a corporation, because of the fiduciary relationship, the transaction

> "will be closely scrutinized in equity, and the directors held to a strict measure of care, duty, fidelity and disability * * *"

and the directors will not be permitted

> "to gain a pecuniary advantage over the stockholders because of their official positions * * *."

In that case the court upheld the transaction as not violative of those principles. Likewise, in *Runswick v. Floor*, 116 Utah 91, 208 P.2d 948 (1949), this court upheld a transaction with a corporation saying that the director is not precluded from dealing with a corporation if he deals fairly. And in *Glen Allen Mining Co. v. Park Galena Mining Co., supra*, the burden of the fiduciary is to recognize that he is

> "bound by the same rules of good faith, full disclosure, and fair dealing as surrounds the trustee in dealing with the *cestui que* trust." (P. 240 of 296 P.)

And in *Sweeney v. Happy Valley, Inc., supra*, this court noted that the burden of a fiduciary when dealing with his corporation is "to show good faith in the transaction."

In the principal case, Judge Sawaya found:

> "16. The transaction between the cross-defendant, Arnell E. Heaps and Western National Investment, Inc., was made in good faith and for a fair and adequate consideration." (R. 156)

An interesting analysis of the Utah law on dealings of a director with his corporation is at 1966 *Utah Law Review* 660, and especially at 673-674. The author con-

cludes that Utah takes a liberal view toward permitting directors to deal with their corporation, including:

> "The transaction is void if scrutiny by the court reveals any genuine conflict of interest that would make it unfair or in bad faith. However, even blatant self-dealing on the part of the contracting directors may not be enough in itself to vitiate the contract if it is not unfair."

The evidence fully supported the above standards and the Finding of Fact made by the trial court. Arnell Heaps was not present when the board of directors approved the transaction and offered the Davis County property for the Heaps' equity rather than stock. This was the testimony of Mr. Heaps (R. 267) and is confirmed by the minutes of the meeting (Ex. 8).

John Holmquist testified that the transaction was discussed by the board of directors, that he did not handle it or "ramrod it" (R. 193) and that the transaction was equitable to the corporation (R. 207).

There is no evidence whatever that Heaps exerted any influence on the board of directors or that he was in a position to do so, and any such suggestion was negatived by the testimony of Mr. Holmquist.

There was a full disclosure of the facts and circumstances to the board of directors. John Holmquist had handled the purchase of the Mecham Apartments by Heaps and so was very familiar with it (R. 183 and 188). Holmquist and several other members of the board inspected the Mecham Apartments (R. 183). Arnell

Heaps testified that it was Kay Allen who approached him and that he was willing to trade for what he had in the Mecham Apartments (R. 265-266). Several of the directors looked at his records (R. 266) and there were several real estate men on the board of directors (R. 270).

The price was apparently adequate and fair. Holmquist so testified (R. 207). Respondent Heaps said he would let the corporation have it for what he had in the property (R. 266) and the record shows that that was the transaction. Arnell Heaps paid Wilkins $6,000 cash and $7,089.44 represented by an assignment of mortgage from the sale of a duplex in Bountiful (Ex. 1C and R. 191 and 264). After acquiring the Mecham Apartments, he

> "spent several thousand dollars in terms of furniture, the water heating system,"

and a new roof (R. 265). He also did a lot of work and his manager did a lot of work on the apartments (R. 265), so that what the respondent had in the Mecham Apartments was around $18,000, assuming that "several thousand" meant $5,000. Heaps had been paying on the mortgage for fifteen months.

Then Kay Allen put on a one-man crusade to get the Davis County property back from Arnell Heaps for stock (R. 186). Mr. Heaps acquiesced in that transaction, knowing that the corporation wanted to sell parcels of the land for cash and it did make three sales in December 1963, January and March 1964 (R. 272).

Thus Mr. Heaps had an equity of $18,000 to $20,000 in the Mecham Apartments which he let go for the Davis County land of equal value and then traded the land for stock so as to give the corporation a better asset for raising cash, in each instance acquiescing in the will of the corporation determined by the board of directors without the participation of Mr. Heaps, he ending up with stock only for his $18,000 to $20,000 investment and fifteen months of work.

The corporation got exactly what it wanted out of respondent Heaps. It managed the property for several years, putting nothing back in (R. 207 and 233) without even a hint of dissatisfaction with its bargain. In March 1967, the President reported to the Board of Directors "that Mr. Heaps has no obligation to WNIC as far as the Mecham Apartment transaction is concerned." And the board asked for investigation of possible liability of the several successive owners threatened with foreclosure (Ex. 13, pp. 3 and 4). And, at the October 4, 1967 meeting, mention was made of the pending foreclosure and of a possible deficiency judgment if WNIC be unable to perform (Ex. 14, p. 3). In neither case was there any dissatisfaction expressed or that the transaction had been disappointing.

Appellant argues about appraisals. There were several real estate men on the board, including Mr. Holmquist; they were well acquainted with the property and its operations and had no need for an appraisal at the time of purchase. They later had an appraisal made and reported it in their prospectus at $100,000 (Ex. 11,

center page). Mr. Webber appraised the property at $70,000 cash and testified that on a contract customarily the price was higher (R. 253, Ex. 18); and by making the transaction, the corporation was getting the benefit of depreciation of the Mecham Apartments and was converting its vacant land into income producing property, which was the avowed purpose of the board (R. 183, 208, 223, 232).

B

This transaction is at most voidable.

Appellant's brief cites no authority that the transaction being attacked by the trustee in this case can be held void under any of the decided cases or authorities. The relief sought requires that the contract be held void, since there is no proposal for dealing fairly with Mr. Heaps. *Fletcher on Corporations* in § 917 states:

> "Except for a few straggling cases, of more or less doubtful authority, it is well settled in nearly all jurisdictions including the federal courts, that the transactions or contracts wherein a director or other coporate officer is interested adversely to the corporation are not void, but are merely voidable at the option of the corporation, unless such dealings are otherwise void as being in contravention of public policy."

He states the same principles in § 924, except there notes that the contract could be void if the director acts for himself and also for the corporation, because in that case there would not be two contracting parties. This court noted that rule and accepted it in *Baker v. Glenwood*

Mining Co., 82 Utah 100, 107, 21 P.2d 889, where the court said:

> "This rule was adopted to secure justice and not to work an injustice, and where the contract is free from actual fraud it cannot be avoided without restoration of the money paid or value received by the corporation."

Also, in *Cox v. Berry*, 19 Utah 2d 352, 356, 431 P.2d 575, this court discusses the voidability of such a contract and that it would be inequitable for the corporation to take the benefits of the agreement and seek to declare the contract void.

C

The claim of the trustee, if any exists, is against the other directors and not Arnell Heaps.

If the transaction here were voidable, the remedy of the appellant would be rescission or recovery of profits or action against the directors for dealing improperly with the corporation's assets. Rescission is not available, because the property has been lost. Recovery of profits is not available, because there were no profits in Mr. Heaps, who ended up only with worthless stock, while the corporation had its cake and ate it, too. The only other remedy would be an action for misconduct or negligence which would have to be against the directors who represented the corporation in the transaction.

POINT V

ASSUMING THE VALIDITY OF THE JUDGMENT, THE TRIAL COURT ERRED TO THE EXTENT SAID JUDGMENT INCLUDED INTEREST ACCRUED AFTER THE COMMENCEMENT OF THE CHAPTER X PROCEEDINGS.

Paragraph 5 of the Pre-Trial Order provides as follows:

> "It is stipulated between the cross-claimants and the cross-defendant, William G. Fowler, Trustee for Western National Investment, Inc., that in the event the cross-defendant, Arnell E. Heaps, prevails in his contention that Western National Investment, Inc. legally agreed to hold Arnell E. Heaps harmless, that the cross-complainant would be entitled to judgment jointly and severally against Western National Investment, Inc., in the event Western National Investment, Inc. prevails in its contention that the hold harmless agreement contained in the assignment of contract is unlawful, then the cross-complainant would not be entitled to judgment against Western National Investment, Inc."

Thus, appellant attempts to raise the issue of the payment of interest for the first time on appeal. However, even if this issue has been raised before the trial court, the case cited by plaintiff, (*Vanston Bondholders Protective Committee vs. Green*, at 329 U.S .156, 67 S.Ct. 237, 91 L.Ed. 162 (1946)), is not controlling. It stands for the proposition that interest on claims in a bank-

ruptcy stops for the purpose of liquidating a bankrupt's estate at the commencement of the proceedings. This situation is not true in a Chapter X reorganization for the reason that it is possible that the corporation, in this instance, the Western National Investment Corporation, may have sufficient assets to pay all of its creditors in full. There is no evidence before the Court with regard to this matter and the amount which the appellant may be required to pay to Western Factors, Inc. to indemnify Arnell E. Heaps can only be determined in the bankruptcy court. This proposition is clearly set forth in 9 *Am. Jur. 2d Bankruptcy*, p. 380, Sec. 490 as follows:

> "If it should happen, as it seldom does in bankruptcy, that the assets are sufficient to leave a surplus after payment of all claims in full, *interest is allowable on claims duly proved and allowed, from the date of the filing of the petition in bankruptcy to the date of payment.* Interest on claims accruing after the filing of the petition in bankruptcy is payable before the distribution of surplus to the bankrupt, although the contracts upon which the claims are based do not expressly provide for interest, and no demand for after-accruing interest was made by the claimant. The bankrupt cannot object to the payment of interest accruing on claims from the time of the filing of the petition where there is a surplus remaining after the payment of all claims proved, on the ground of the discharge granted him in bankruptcy. The trustee is entitled to retain possession of the assets until he has accumulated funds enough to satisfy such interest." (Emphasis added). See also *American Iron & Steel Mfg. Co. vs. Seaboard Air Line R. Co.*, 233 US 261,

58 L ed 949, 34 S Ct 502; *Coder vs. Arts*, 213 US 223, 53 L ed 772, 29 S Ct 436.

Error cannot be predicated upon the fact that the trial court determined the amount of interest which was due Western Factors, Inc. by Arnell E. Heaps.

CONCLUSION

This case was tried in the District Court on principles applicable to a transaction between a non-participating director and the corporation of which he is a director. No reason appears from appellant's brief why the review of the District Court's decision should not be according to those same standards. The principal questions of fact are whether the director attempted to deal on both sides of the contract, or from a superior position of dominance, influence or control, all of which are definitely absent from this transaction. The corporation knew everything about the property that Heaps knew, desired to take over his position in which Heaps acquiesced. To demonstrate his willingness to be helpful in the interests of the corporation, Heaps then permitted the corporation to reacquire the property which it had exchanged with Heaps by delivering stock of the corporation to Mr. Heaps. In both transactions the corporation expressed what it desired in accordance with its best interests as its board of directors saw them. Heaps gave the corporation its way and the corporation at no time endeavored to set aside this transaction or expressed any

dissatisfaction with it. The evidence fully sustains the judgment of the District Court. That judgment should be affirmed.

Respectfully submitted,

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