IN THE COURT OF APPEALS OF IOWA

No. 6-729 / 96-0427

000292

R & S ENTERPRISES, L.C.,

Plaintiff-Appellant,

vs.

MICHAEL GRAHAM,

Defendant-Appellee.

Appeal from the Iowa District Court for Polk County, George W. Bergeson, Judge.

R&S Enterprises appeals from the district court's order awarding damages to Michael Graham for breach of contract. **REVERSED.**

Jill Mataya Corry and Louis R. Hockenberg of Sullivan & Ward, Des Moines, for appellant.

F. John Spellman of Duffy, Spellman, Ryan & Clark, Des Moines, for appellee.

Heard by Habhab, C.J., and Streit and Vogel, JJ.

STREIT, J.

R&S Enterprises appeals from the district court's order awarding damages to Michael Graham for breach of contract. R&S purchased the assets of an automotive paint restoration business from Michael Graham. R&S sought rescission of the contract based on misrepresentation and material breach of the asset purchase agreement. It claims the contract was rescinded, thus it is entitled to restitution of the expenses incurred under the contract and attorney fees. In the alternative, if the contract cannot be rescinded, R&S claims it is entitled to damages caused by Graham's breach of contract.

Michael Graham was a co-owner of Auto Touch-Up, an automotive paint restoration business. In April or May 1994, he listed the business with Joseph Batten of KR Business Brokers. Ronald and Susan Bassman contacted Batten about the business, and negotiated the purchase. Graham provided Batten with business receipts and a confidential report indicating that its annual receipts were "in excess $100,000" in 1993, with "operating profit in excess of $45,000."[1] The Bassmans then formed R&S Enterprises to purchase Auto Touch-Up.

R&S and Graham entered into an asset purchase agreement on August 10, 1994. Pursuant to the agreement, R&S paid Graham $25,000 and agreed to pay the

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[1] The Statement of Income and Expenses for the period ending December 31,1993, signed by Graham, said sales were $100,563.30 and "operating income" was $45,993.63.

remaining purchase price to him based on ten percent of the gross receipts for a thirty-six month period, not to exceed $25,000. R&S obtained assets and inventory valued at $10,000. The remainder of the purchase price represented goodwill and continued business with established clientele.

In addition, the contract provided (1) Graham would "take all necessary steps to introduce [R&S] to [Graham's] customers and to facilitate the transfer of customers," (2) Graham would assist in training the owners and employees for one year, (3) R&S would lease the premises from Graham, and (4) Graham would not compete in the automotive touch-up business for six years within a five-mile radius. The contract contained various warranties and representations by Graham, including that he owned the assets. The first purchase price payment was due on September 15, 1994, as well as the lease payment of $800. Neither the contract nor the separate lease agreement mentioned Graham had a business partner.

R&S took possession of the business on August 13, 1994. Two employees under Graham, Todd Stephens and Stacy Martin, continued to work for Auto Touch-Up. R&S operated the business for five and one-half weeks, and earned total receipts of between $7450 and $7760. (The Bassmans' 1994 schedule C tax form shows gross receipts of $7760, whereas at trial, they offered receipts totaling $7450.) On or about September 14, 1994, R&S fired Stephens, and a few days later Martin quit.

R&S did not pay the purchase price payment or lease payment due on September 15. It notified Graham on the 16th that it was rescinding the contract due to his misrepresentation of sales, failure to facilitate the transfer of clients, and violating the non-compete clause of the contract. On October 11, 1994, Graham gained possession of the business by forcible entry and detainer action. R&S filed a petition seeking rescission of the contract, or alternatively, damages for breach of contract and misrepresentation. Graham filed an answer and counter-claim for R&S's breach of contract.

The court rejected all of R&S's claims against Graham. It determined that Graham did not breach the contract and there was no misrepresentation with regard to the level of sales or operation of the business. The court determined R&S was not entitled to rescission because it was in default for failing to pay the rent and ten percent of the gross revenues as part of the purchase price of the business on September 15, 1994. The court found that R&S breached the contract, and ordered it to pay Graham $25,000 plus interest for the balance of the purchase price, $7500 plus interest for commissions for Batten's fees, and attorney fees.

R&S appeals. It contends the court erred in determining that: (1) R&S was not entitled to rescission of the contract and restitution; (2) any alleged breach of contract by R&S precluded granting rescission; (3) Graham's misrepresentations did not constitute fraud, and failure to abide under the contract provisions did not

constitute a breach of contract, giving rise to damages. R&S also contends the court erred in awarding Graham damages for loss of bargain.

I. Rescission Based on Misrepresentation–Seeking to Avoid a Contract.

Review of equity cases is de novo. Iowa R. App. P. 4. We do, however, give weight to the findings of fact made by the trial judge. *Hyler v. Garner*, 548 N.W.2d 864, 870 (Iowa 1996).

R&S claims it was entitled to rescind the Asset Purchase Agreement and Lease Agreement due to Graham's misrepresentations of the level of sales and net profit generated by the business; the degree of involvement in the business by the owners that would be required to maintain the stated level of sales and net profit; and ownership of the business and the building leased to R&S.

A party may seek to avoid a contract by suing for rescission using misrepresentation as a basis for the requested relief. *Id.* (citing *Robinson v. Perpetual Services Corp.*, 412 N.W.2d 562, 568 (Iowa 1987)); 2 Dan B. Dobbs, *Dobbs Law of Remedies* § 9.1, at 547 (2d ed. 1993); 1 E. Allen Farnsworth, *Farnsworth on Contracts* § 4.10 (1990). As a general rule, fraudulent representations leading to the creation of a contract give rise to a right of rescission. *Robinson*, 412 N.W.2d at 568. In order to grant rescission, we must find there is a basis for fraudulent representation. *Id.*

A. Did R&S rely on Graham's representation that the level of sales generated by the business were $100,568 instead of $79,260? The district court found there was no misrepresentation because even if the representation was false it was not material. The court reasoned that if R&S sales for the next eleven months were the same as the first month, total sales would be around $90,000, close enough to the represented $100,000. Since R&S stopped doing business after five weeks of operation, the materiality of the representation was unable to be ascertained.

The district court incorrectly applied the test of the tort of misrepresentation.[2] The court's application of the test was also mistaken.[3]

The district court should have applied the test for rescission based on misrepresentation. The elements of an equitable claim for rescission based on misrepresentation are: (1) a representation; (2) falsity; (3) materiality; (4) an intent

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[2] The district court found the plaintiff must prove by a preponderance of clear, satisfactory and convincing evidence all of the following: (1) the representations were false; (2) the representations were material; (3) defendant knew the representations were false; (4) the defendant intended to deceive plaintiff; (5) plaintiff acted in reliance on the truth of the representation and was justified in relying on the representation; (6) the representation was a proximate cause of the plaintiff's damage; and (7) the amount of the damage. If the plaintiff fails to prove any of the foregoing the plaintiff cannot recover damages.

[3] The court found Graham's representation about the previous year's sales was not a proximate cause of R&S rescinding the contract, and not the proximate cause of Auto Touch-Up closing.

The correct application of this test, even if it is the wrong test for the situation, would have been whether R&S relied upon Graham's representations about the previous year's sales when entering into the contract and that representation was the proximate cause of R&S's damages (the loss of their $25,000 down payment in a contractual relationship based upon false representations).

to induce the other to act or refrain from acting; and (6) justifiable reliance. *Hyler*, 548 N.W.2d at 872. Because the remedy of rescission is seen as less severe than an award of damages, rescission has traditionally been available upon a lesser showing than necessary for the tort of misrepresentation. *Hyler*, 548 N.W.2d at 871; *accord First Nat'l Bank v. Brown*, 181 N.W.2d 178, 181 (Iowa 1970) (rules for recovery in equity based on fraud "less strict" than in law actions); *see also Wilden Clinic, Inc. v. City of Des Moines*, 229 N.W.2d 286, 292 (Iowa 1975). When rescission rather than damages is sought, relief may be obtained without proof of scienter or pecuniary damage. *Hyler*, 548 N.W.2d at 871 (citing *Wilden Clinic, Inc. v. City of Des Moines*, 229 N.W.2d 286, 292 (Iowa 1975)).

At trial in October 1995, it was established that the actual receipts for Auto Touch-Up in 1993 were $79,260.95. Graham testified that he believed that Auto Touch-Up did $100,000 worth of business in 1993, but he was running three different businesses and did not have a good bookkeeping system. He said it was possible that the receipts he forwarded to the broker may have included receipts from one of his other businesses.

The figures given by Graham represent a $20,000 difference in annual net profit when taken into account the receipts for the business were only $79,260.95, not $100,568.30. The difference in the amount of sales was significant enough to constitute a material misrepresentation.

In order to allow for rescission we must also find Graham acted with an "intent to induce" the Bassmans to buy Auto Touch-Up through his misrepresentation of sales and profit. *See Hyler*, 548 N.W.2d at 871-72 (Iowa 1996). Considering Graham's bookkeeping methods, it is quite possible to believe that Graham inadvertently included a few receipts from his other businesses in Auto Touch-Up's report of sales and profits. It is much more difficult to believe, however, $20,000 worth of receipts that ranged from $50 to $300 were accidentally included in the calculation. We find the amount of incorrect receipts clearly demonstrates Graham's intent to induce the Bassmans to purchase the business based on the represented amount of sales and profit.

Graham argues the Bassmans should have investigated his documents themselves. Graham testified at trial, however, he operated three businesses on the same books, through the same bank accounts, under the same name, and often on the same receipts. The only information the Bassmans really had to rely upon was the report prepared by Graham and his business broker.

Clearly, a businessperson may rely upon the amount of revenues specifically represented by the seller. This is not a case where the seller estimated the future revenues nor where he stated the past revenues to be in a certain range, *e.g.* $70,000 to $100,000. Even though a reasonable business person would "check the books," this does not relieve the seller from the requirement that he be accurate in his

statements of specific facts. The Bassmans were justified in relying on Graham's representations.

We find there is clear and convincing evidence the Bassman's were subject to fraudulent representation by Graham. The Bassmans are entitled to rescission of the contract.

B. Restitution. "A party who seeks relief by way of rescission must not himself be in *substantial* default." *Folkers v. Southwest Leasing*, 431 N.W.2d 177, 182 (Iowa App. 1988) (emphasis added). Substantial performance is an equitable doctrine. *Moore's Builder and Contractor, Inc. v. Hoffman,* 409 N.W.2d 191, 195 (Iowa App. 1987).

The contract stated that the buyer "shall default in the payment of any sums due . . . and if such default shall continue for . . . 10 days after written notice to the Buyer shall have been given by the Seller," this will constitute as default. Graham did not give R & S written notice of default as required by the contract. Since R & S was not given notice, there was no default and rescission is allowed.

Even if R & S Enterprises were in default for not paying the first monthly payment, their breach was not substantial enough to bar rescission of the contract. The Bassmans failed to make the first monthly lease and contract payment due September 15, 1994. They notified Graham on the 16th they were rescinding the contract. According to the contract, the total amount owed on September 15, 1994,

to Graham under the contract was approximately $750 (10% of the gross revenues from the previous month's revenues).[4] The remaining purchase price of the contract was not to exceed $25,000. The one-day delinquency of paying $750 in what could have been a $50,000 contract is not substantial enough to bar R&S from rescinding the contract. R&S already paid Graham $25,000 on August 10, 1994, the day the contract was signed. It would be senseless to require the plaintiff to make the $750 payment at a time they believed Graham had made false representations in getting them to sign the contract and place them in a position of asking for the return of $25,750 rather than $25,000. *See Binkholder v. Carpenter*, 260 Iowa 1297, 1308, 152 N.W.2d 593, 600 (1967) (court found it absurd to require payment $5000 payment and place purchaser in position to ask for $15,000 rather than $10,000 when a letter of rescission was sent four days after payment was due on land contract that had less acres of crop land than either party believed).

> In a case such as is here presented, the law does not require that the purchaser shall pay the balance of the purchase price or tender the same before he can rescind the contract and seek the recovery of the payment

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[4] The Asset Purchase Agreement stated as follows:
Payment of Purchase Price. Upon the execution of this Agreement, the Buyer shall pay to the Seller the sum of Twenty-Five Thousand Dollars ($25,000.00), with the balance of the purchase price, not to exceed Twenty-Five Thousand Dollars ($25,000.00) with interest thereon at the rate of 10% per annum, to be paid as follows:

> Buyer shall make 36 monthly principal and interest payments, commencing on September 15, 1994, which payments shall equal 10% of the gross revenues of the previous month's revenues.

> already made. The breach on the part of the vendor is the basis of the right of the vendee to rescind and to recover the purchase price. . . . He [the vendee] acted promptly in the matter, and by his notice advised the appellant [vendor] fully of the basis of his rescission. As applied to the facts in this case, nothing more than this was required.

Binkholder, 260 Iowa at 1308-09, 152 N.W.2d at 600 (1967).

We reverse the district court and find the contract was rescinded based on misrepresentation. Parties seeking rescission are entitled to restitution for expenses incurred under the contract. *Robinson*, 412 N.W.2d at 568. Plaintiff is entitled to restitution. This court orders Graham to return to R&S its $25,000 down payment towards the purchase price. The equipment purchased under the contract should be returned to Graham. Graham is responsible for the brokerage fee commission. The contract being rescinded, it cannot be used to provide for attorney fees. Each party is responsible for their attorney fees at the district court level and on appeal.

II. Remaining Issues on Appeal. Since we granted rescission of the contract based on misrepresentation, the other issues raised on appeal concerning breach of contract do not need to be addressed by the court.

REVERSED.