

**COURT OF APPEALS
DECISION
DATED AND RELEASED**

October 9, 1996

A party may file with the Supreme Court a petition to review an adverse decision by the Court of Appeals. See § 808.10 and RULE 809.62, STATS.

NOTICE

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No. 95-2781

STATE OF WISCONSIN

**IN COURT OF APPEALS
DISTRICT II**

PEPPERKORN BROS., INC.,

Plaintiff-Appellant,

v.

NATIONAL INCOME REALTY TRUST,

Defendant-Respondent,

**JOHN L. HILL and
RICHARD DAVID MORGAN,**

Third Party Defendants.

APPEAL from a judgment of the circuit court for Manitowoc County: FRED H. HAZLEWOOD, Judge. *Affirmed.*

Before Anderson, P.J., Brown and Snyder, JJ.

PER CURIAM. Pepperkorn Bros., Inc., appeals from a judgment dismissing its action to recover from the National Income Realty Trust (NIRT) the unpaid balance of a mortgage made when NIRT purchased Pepperkorn's commercial property. The note was found to be unenforceable as contrary to

public policy. Pepperkorn argues that we should overrule precedents regarding the unenforceability of contracts and that the evidence does not support the court's decision. We affirm the judgment.

Pepperkorn operated a carpet and furniture store in Manitowoc. The location was referred to as the Eighth Street property. The building was leased from Pepperkorn's sole shareholder and controlling principal, John Hill, and his wife for \$32,000 a year.

NIRT owns a shopping center located in the outskirts of Manitowoc known as the Lakeview Centre. Lakeview Centre was managed by TARA Group, Inc. In January 1991, Richard David Morgan, TARA's president and minority shareholder, contacted Hill to see if Pepperkorn was interested in relocating its business to the Lakeview Centre. Hill was interested but wanted to sell the Eighth Street property as part of the transaction.

Ultimately in July 1991, Hill and his wife sold the Eighth Street property to Pepperkorn. Pepperkorn sold the Eighth Street property to NIRT for \$1,150,000, a sum in excess of market value. NIRT made a cash payment of \$130,000 and a mortgage was made for the remaining amount due. In a leaseback arrangement, Pepperkorn leased the Eighth Street property from NIRT for \$135,000 a year. Under a separate agreement, Pepperkorn also leased space at Lakeview Centre. Due to the high interest rate utilized in the mortgage, NIRT's monthly payments on the mortgage note fully offset Pepperkorn's monthly rent on the Eighth Street property and monthly common area and maintenance payments due under the Lakeview Centre lease. As a result, Pepperkorn did not actually pay rent under the Eighth Street property lease.

Pepperkorn moved its store to the Lakeview Centre. The leased space at the Eighth Street property was used solely for an oil change operation and some storage. TARA was retained by Pepperkorn to serve as the management agent of the Eighth Street property.

It is undisputed that during negotiations between Hill and Morgan, both knew that the city of Manitowoc would be condemning the

Eighth Street property in order to complete a bridge project. Appraisers hired by the city determined that the leaseback arrangement was not reflective of market rental values and would not support use of the income valuation approach of the Eighth Street property. The property was taken by condemnation on July 1, 1993 and the condemnation award was only \$175,000.

The mortgage note required NIRT to pay the outstanding balance if any portion of the property was taken by governmental condemnation. When NIRT failed to pay off the over \$1 million balance, Pepperkorn withheld money due under the Lakeview Centre lease. NIRT counterclaimed in this action for a declaration that the note was unenforceable because it was part of an illegal scheme to defraud the city of Manitowoc on the value of the Eighth Street property.

The matter was tried to the court. The trial court found that Hill and Morgan knew that the sale of the Eighth Street property involved misrepresentations about the value of the property in an attempt to exact greater compensation in the condemnation proceeding. It also found that there was no legitimate business purpose for the leaseback arrangement and that it was merely to create an appearance of a healthy rental stream to support a valuation in excess of the property's fair market value. It found that Hill knew that the structure of the transaction would be used by Morgan to establish that the purchase price approximated fair market value in order to obtain NIRT's approval of the transaction. The trial court concluded that the mortgage note was unenforceable. Because it found NIRT to be "culpably negligent" in protecting its own interest in the transaction, Pepperkorn was not required to repay rent and maintenance charges owed under the Lakeview Centre lease.

"An agreement which 'contemplates or necessarily involves the defrauding or victimizing of third persons as its ultimate result' is void as against public policy." *Shea v. Grafe*, 88 Wis.2d 538, 544, 274 N.W.2d 670, 673 (1979) (quoted source omitted). "A promise may be unenforceable if it involves conduct offensive to public policy, even though the promise does not actually induce the conduct." *Blossom Farm v. Kasson Cheese*, 133 Wis.2d 386, 395, 395 N.W.2d 619, 623 (Ct. App. 1986). See also *Associate Wis. Contractors v. Lathers*, 235 Wis. 14, 17, 291 N.W. 770, 771 (1940) ("[I]f the mere tendency or purpose of a contract works against public policy, it is illegal, even though no actual damage be shown.").

Pepperkorn argues that the holdings of *Blossom* and *Lathers* should be overruled so that a contract may not be void for public policy reasons unless the contract itself is illegal on its face or, while facially valid, the contract itself has an illegal or improper purpose or by necessary implication calls for the performance of an illegal act. Pepperkorn claims that only by tempering the "draconian rule" set out in *Blossom* and *Lathers* is the freedom of contract between parties preserved. We decline the invitation to overrule or modify those holdings. We are bound by the decisions of the supreme court and the published decisions of our court. *State v. Clark*, 179 Wis.2d 484, 493, 507 N.W.2d 172, 175 (Ct. App. 1993); *Ranft v. Lyons*, 163 Wis.2d 282, 299-300 n.7, 471 N.W.2d 254, 261 (Ct. App. 1991). They represent good law. A contract with an illegal purpose is not rendered enforceable simply because the illegality was not successful.

Likewise, we reject Pepperkorn's argument that *Lathers* should be limited to contracts whose terms have not been fully disclosed to the third parties upon whom the potential fraud could have been perpetrated. Pepperkorn suggests that by fully disclosing the structure of the transaction to the city of Manitowoc, no fraudulent use was made of its contract with NIRT and the contract was "revitalized" to enforceability. The argument Pepperkorn makes is nothing more than a challenge to the sufficiency of the evidence to support a finding that there was an intent to deceive the city as to the income stream of the Eighth Street property. There is no basis to limit *Lathers* as Pepperkorn suggests.

Pepperkorn claims that the trial court erred in concluding that the facts here were similar to *Shea* and *Blossom*. Pepperkorn's attempt to distinguish those two cases fails.

In *Shea*, inflated figures were used to induce a loan. "Insofar as the inflated contract figures were designed to induce the lending institution to finance the transaction, the contract contemplated misleading the institution and therefore is tainted with illegality." *Shea*, 88 Wis.2d at 544, 274 N.W.2d at 673. Here, an inflated purchase price and a sham leaseback arrangement to support that price were used to induce NIRT's approval of the transaction and to attempt to deceive the city. The contract is tainted.

In *Blossom*, a supplier chose to overlook its customer's illegal use of its product and continued to supply volume shipments. The court concluded that the contract was unenforceable because the supplier engaged in a course of dealing which facilitated the customer's improper conduct and the contract anticipated such improper conduct to the benefit of the supplier as well. *Blossom*, 133 Wis.2d at 395-96, 395 N.W.2d at 623. Here, Pepperkorn had knowledge that the structuring of the transaction was for the improper purpose of creating an above market income stream to support an excessive property value. Like the supplier in *Blossom*, Pepperkorn facilitated that end and benefitted from it. The trial court correctly relied on *Shea* and *Blossom*.

The remaining issues are whether the evidence supports the trial court's finding that Hill and Morgan had the intent to induce a higher condemnation award and mislead NIRT about the value of the property and that Hill and Morgan were *in pari delicto*. The trial court's findings will not be set aside unless clearly erroneous. *Blossom*, 133 Wis.2d at 391, 395 N.W.2d at 622. For purposes of appellate review, the evidence supporting the court's findings need not constitute the great weight and clear preponderance of the evidence; reversal is not required if there is evidence to support a contrary finding. *Bank of Sun Prairie v. Opstein*, 86 Wis.2d 669, 676, 273 N.W.2d 279, 282 (1979). Rather, the evidence in support of a contrary finding must itself constitute the great weight and clear preponderance of the evidence. *Id.* In addition, the trial court is the ultimate arbiter of the witnesses' credibility when it acts as the fact finder and there is conflicting testimony. *Id.* We accept the inference drawn by the trier of fact when more than one reasonable inference can be drawn from the evidence. *Id.*

Pepperkorn argues that the trial court ignored the "reliable and credible" testimony of its expert witness on real estate transactions, Samuel Freshman. Freshman testified as to possible reasons why the transaction was structured as it was. He suggested that for tax reasons Pepperkorn may have wanted to recharacterize an incentive it was receiving for leasing at Lakeview Centre and obtain storage space at the Eighth Street property. He also indicated that NIRT may have sought to capitalize the lease incentive in a manner which would not adversely affect the valuation of Lakeview Centre or its cash flow, that it may have sought to avoid other Lakeview Centre tenants from thinking that Pepperkorn received a substantial incentive, and that it may have sought to keep insurance premiums down by having the Eighth Street property under lease. He indicated that it was not unusual for a shopping center to pay a

premium price for a prospective tenant's property. Pepperkorn contends that if the trial court had given any weight to Freshman's testimony, NIRT could not meet its burden of proof.

Freshman's testimony did not preclude the trial court from determining that while other reasons may exist for structuring the transaction as was done here, those reasons did not come into play. On cross-examination, Freshman admitted that he had never viewed the properties at issue, that he had not examined the tax returns, and that the \$135,000 yearly rental for the Eighth Street property was an excessive storage charge. NIRT presented contrary expert testimony that no reasonable landlord under the circumstances then existing in the Manitowoc area would have paid a lease premium anywhere approaching the amount Freshman contended that NIRT gave as an incentive to Pepperkorn. He gave three reasons why the alleged incentive payment was unreasonable.

The trial court made a credibility determination between the two experts. We reject any notion Pepperkorn has that the trial court was required to explicitly reject the credibility of its expert witness. See *Marshall v. Lonberger*, 459 U.S. 422, 433 (1983) (where it is clear that the trial court would have granted the relief sought by the defendant if it believed the defendant's testimony, its failure to grant the relief is tantamount to a finding against the defendant's credibility). We must accept the trial court's credibility determination. The evidence was sufficient to find that there was no legitimate business reason to structure the transaction as the parties did here and that Hill and Morgan had the intent to create a false income stream to support a higher property value.

Pepperkorn argues at length that NIRT's attorney and Morgan drafted all of the contract documents, and therefore, Hill did not participate with Morgan to structure the transaction. It asserts that Morgan's conduct should not be imputed to Hill or Pepperkorn.

We conclude that there was ample evidence to support an inference that Hill knew what Morgan intended through the structuring of the transaction. Hill knew that the most he could expect out of the condemnation proceeding was between \$400,000 and \$700,000. He received a continuing

interest in the condemnation proceeds in the event that they exceeded the principal due on the mortgage. Hill acknowledged that he knew in April 1991 that Morgan was attempting to structure the transaction for use in establishing the fair market value in the later condemnation proceeding. He also knew that Morgan could not complete the transaction unless an appraisal was obtained for the Eighth Street property substantially equivalent to the purchase price. The leaseback arrangement arose when Morgan had difficulty obtaining a high enough appraisal. Morgan told Hill that the leaseback was necessary to justify NIRT's investment and possible recovery of the investment in the condemnation proceeding. Hill was aware that the \$135,000 annual rent far exceeded that ever obtained on the Eighth Street property. Previously, Pepperkorn had only paid \$32,000 annually to lease the property. We sustain the trial court's finding that Hill and Morgan acted together to structure the contracts which were declared unenforceable.

Finally, Pepperkorn argues that because of NIRT's "culpable negligence," voiding the mortgage note is an inequitable result. It reasserts its claim that because the city was never defrauded, the contract should not be voided. Under controlling precedents it is not necessary that the wrongful purpose of the contract have been successfully completed.

Pepperkorn asserts that it should not suffer simply because NIRT mistakenly analyzed the value of the transaction or persons within NIRT exceeded their authority in signing contracts. Pepperkorn conveniently ignores Hill's knowledge of the purpose of structuring the transaction to create the false income stream and to hopefully exact a condemnation award in excess of that which Hill knew the property could command. Had the condemnation award been higher than the inflated purchase price, Pepperkorn would have received additional monies. Hill and Pepperkorn were not innocent bystanders to what Pepperkorn portrays as the secret mission of Morgan.

The trial court's finding that NIRT was "culpably negligent" was based on NIRT's failure to have adequate monitoring systems within its organization with regard to execution of the transaction. It does not suggest "unclean hands" by NIRT in structuring the agreement for the purpose of deceiving the city. The finding was made in balancing the equities in devising a remedy between the parties once the contract was declared unenforceable. We cannot conclude that the trial court erroneously exercised its discretion in

fashioning a remedy which declared the mortgage note unenforceable and prevented NIRT from recovering past rent or avoiding the Lakeview Centre lease.

By the Court. – Judgment affirmed.

This opinion will not be published. *See* RULE 809.23(1)(b)5, STATS.