Fraudulent Concealment:

Silence Isn't Always Golden

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What happens when a turnaround professional advising a seller in a potential transaction discovers information that, if disclosed, might drastically reduce the purchase price or, worse, tank the deal altogether? Does a lender have a duty to inform a potential guarantor or surety of damaging financial information about a borrower prior to the execution of the personal guaranty? Does a Chapter 7 trustee or an assignee for the benefit of creditors selling off inventory have a duty to disclose material defects in the products being sold? These situations do more than raise serious ethical questions. They also create potential liability for turnaround professionals.

Turnaround professionals owe a fiduciary duty of loyalty and confidence to their clients. This is true for attorneys, accountants, brokers, lenders, and consultants. However, in certain circumstances, this duty may conflict with an equally important obligation to disclose materially adverse information to the other side of a transaction.

A knowing and intentional failure to share potentially harmful information, when a duty to speak exists, can subject turnaround professionals and/or their clients to liability for conspiracy, fraudulent concealment, or aiding and abetting the commission of a fraud. See, *e.g.*, *Huls v. Clifton, Gunderson & Co.*, 179 Ill. App. 3d 904, 535 N.E.2d 72 (4th Dist. 1989) (accounting firm that prepared financial statements was sued for failing to disclose it was not independent with respect to the businesses because a partner of the firm acted as a member of management of both the accounting firm and the businesses) and *Chapman v. Hosek, et al.*, 131 Ill. App. 3d 180, 475 N.E.2d 593 (1st Dist. 1985) (buyers sued listing and selling brokers of a severely flooded house for fraudulent misrepresentation).

What Constitutes Fraud?

Fraud may be perpetrated by misrepresentation or by concealment. *Chatham Surgicore, Ltd. v. Health Care Service Corp.*, 356 Ill. App. 3d 795, 803, 826 N.E. 2d 970, 977 (1st Dist. 2005). "While mere silence in business transactions does not generally amount to fraud, a party's 'duty to speak' is triggered when [the] party's silence is accompanied by deceptive conduct or suppression of material facts results in active deception." *FE Digital Investments Ltd. v. Hale*, 499 F. Supp 2d 1054, 1061 (N.D. Ill. 2007). In other words, the failure to disclose a material fact, if intended to induce or allow a false belief, is as much fraudulent conduct as is making an affirmative misrepresentation.

Creating a false impression by words, actions, or other

conduct can also constitute a fraudulent misrepresentation. *Illinois Rockford Corp. v. Kulp*, 41 Ill. 2d 215, 224, 242 N.E.2d 228, 234 (1968); *Glazewski v. Coronet Insurance Co.*, 108 Ill. 2d 243, 250, 483 N.E.2d 1263, 1266 (1985). Even a statement that is "technically" true may still constitute misrepresentation if it omits qualifying information that would cause the other party to act differently. *Integrated Genomics, Inc. v. Gerngross*, 636 F. 3d 853 (7th Cir. 2011). See also *William v. Chicago Osteopathic Health Sys.*, 274 Ill. App. 3d 1039, 1052, 654 N.E.2d 613, 622 (1st Dist. 1995), citing *Lindsey v. Edgar*, 473 N.E.2d 92, 95-96 (1984) and *Huls v. Clifton, Gunderson & Co.*, 535 N.E.2d 72, 76 (1989). "A half truth may be more misleading than an outright lie." In re *Midway Airlines, Inc.*, 180 B.R. 851 (Bankr. N.D. Ill. 1995).

However, nondisclosure alone does not amount to fraud absent a duty to speak. *Apotex Corp. v. Merck & Co., Inc.*, 229 F.R.D. 142, 148 (N.D. Ill. 2005); see, e.g., *Athey Products Corp. v. Harris Bank Roselle*, 89 F.3d 430, 435 (7th Cir. 1996). Silence or concealment constitutes fraud "only when the silent party had an opportunity and a duty to speak." (Citation omitted.)

The duty to speak only arises when a fiduciary relationship is present or when the silent party's nondisclosure contributes to the other party's misapprehension of a material fact. *PXRE Reinsurance Co. v. Lumbermens Mut. Cas. Co.*, 342 F. Supp.2d 752, 757-758 (N.D. Ill. 2004), citing *Coca-Cola Co. Foods Div v. Olmarc Packaging Co.*, 620 F. Supp. 966, 973 (N.D. Ill. 1985). "In a confidential or fiduciary relationship, the dominant party's silence alone may constitute fraudulent concealment." *Janowiak v. Tiesi*, 402 Ill. App. 3d 997, 1006, 932 N.E.2d 569, 579 (1st Dist. 2010), quoting *Thornwood, Inc. v. Jenner & Block*, 344 Ill. App. 3d 15, 25, 799 N.E.2d 756, 765 (1st Dist. 2003), quoting *Melko v. Dionisco*, 219 Ill. App. 3d 1048, 1061, 580 N.E. 2d. 586, 593 (2nd Dist. 1991).

What Is a Fiduciary?

A fiduciary relationship may arise as a matter of law by virtue of the parties' relationship (e.g., attorney-client), or it may arise as a result of the special circumstances of the parties' relationship when one places trust in another so that the latter gains superiority and influence over the former. *State Security Insurance Co. v. Frank B. Hall Co.*, 258 Ill. App. 3d 588, 592. A fiduciary relationship exists in all cases in which a confidential relationship has been acquired, and the origin of that confidence may be moral, social, domestic, or merely personal. *Illinois Rockford*, 41 Ill.2d at 22, citing *Pfaff v. Petrie*, 396 Ill. 44, 50, 71 N.E.2d. 345, 348 (1947). Examples of fiduciaries include trustees, guardians, executors, administrators, agents, attorneys, partners, joint venture partners, directors, officers, and even shareholders of corporations.

Each of these fiduciaries owes a duty of loyalty to the person or entity for which the fiduciary is acting. One of the functions of this duty of loyalty is an obligation to disclose certain information that falls within the scope of the fiduciary relationship. *Janowiak*, 932 N.E.3d at 581. The burden of proving that a fiduciary relationship exists lies with the party seeking relief. *Gas Technology Institute v. Rebmat*, 524 F. Supp. 2d 1058, 1072 (N.D. Ill. 2007), *Neptuno Treuhand-Und Verwaltungsgesellschaft Mbh v. Arbor*, 295 Ill. App. 3d 567, 573, 692 N.E.2d 812, 817 (1st Dist. 1998).

Fortunately, however, the inquiry does not end with a showing that information was withheld by a fiduciary that had a duty to speak. This is just a threshold requirement. To prove that the concealment amounted to a fraudulent misrepresentation, the accuser must also prove that:

1. A material fact was concealed
2. The concealment was intended to induce a false belief, under circumstances creating a duty to speak
3. The innocent party could not have discovered the truth through a reasonable inquiry or inspection, or was prevented from making a reasonable inquiry or inspection, and relied on silence as a representation that the fact did not exist
4. The concealed information was such that the injured party would have acted differently had he been aware of it
5. Reliance by the person from whom the fact was concealed led to his injury.

Lefebvre Intergraphics, Inc. v. Sanden Mach. Ltd., 946 F. Supp. 1358, 1367 (N.D. Ill. 1996), quoting *Stewart v. Thrasher*, 242 Ill. App. 3d 10, 16, 610 N.E.2d 799, 804 (4th Dist. 1993), citing *Huls v. Clifton, Gunderson & Co.*, 179 Ill. App. 3d 904, 909, 535 N.E.2d 72, 76 (4th Dist. 1989).

By and large, most of the reported cases dealing with fraudulent concealment focus on the elements of materiality and the reasonableness of the injured party's reliance. For example, in the Polo Builders bankruptcy, the true identity of the purchaser following an auction sale held pursuant to Section 363 of the Bankruptcy Code was found not to be a material fact. *In re Polo Builders, Inc.*, 388 B.R. 338 (Bankr. N.D.Ill. 2008). The Chapter 7 trustee sued the successful bidder, claiming that the estate had been defrauded because the true purchaser had not been disclosed.

The court found no evidence that the identity of the purchaser was material to the trustee in accepting the winning bid, holding that "a misrepresentation is 'material' if it is such that had the other party been aware of it, he would have acted differently." *Id.* at 379, quoting *Brown v. Broadway Perryville Lumber Co.*, 156 Ill. App. 3d 16, 508 N.E.2d 1170, 1176 (2nd Dist. 1987) (citing *Mack v. Plaza Dewitt, Ltd. Partnership*, 484 N.E.2d 900 (1985)). The court acknowledged the common practice of using a "straw person" to bid on property and determined that the trustee would not have acted differently had he known who the true purchaser was.

This contrasts sharply to the decision in *Heider v. Leewards Creative Crafts, Inc.*, in which the purchaser sued the seller for failing to disclose the existence of asbestos on the property. 245 Ill. App. 3d 258, 613 N.E.2d 805 (2nd Dist. 1983). In that case, the court concluded that the asbestos was material to the purchaser's decision to buy the building and to the amount it was willing to pay. It also emphasized that the asbestos was a latent defect, which is hidden or concealed, and not easily discovered. *Id.* at 813.

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What If There Is No Duty to Speak?

Even when no express fiduciary relationship exists between a professional and a wronged party, a turnaround professional should be aware of the potential risk of claims for aiding and abetting clients in the commission of a tort or for conspiracy to commit fraud. Illinois courts have allowed conspiracy claims to be maintained against attorneys when there is evidence that the attorneys participated in a conspiracy with their clients. *Id.*; and, *e.g.*, *Bosak v. McDonough*, 192 Ill. App. 3d 799, 804-05, 549 N.E.2d 643, 646 (1989). And, as pointed out in *Thornwood v. Jenner & Block*, 344 Ill. App. 3d 15, 799 N.E.2d 756 (1st Dist. 2003), while no Illinois courts have found an attorney liable for aiding and abetting, neither have these courts prohibited such claims. *Id.* at 28, citing *Reuben H. Donnelly Corp. v. Brauer*, 275 Ill. App. 3d 300, 655 N.E.2d 1162 (1st Dist. 1995).

Furthermore, turnaround professionals and their clients are also not necessarily out of the woods once a deal closes. Parties have five years from the date of discovery or from when they reasonably should have discovered concealed information to pursue a claim for fraudulent concealment. This is the point when the injured party possesses information sufficient to put a reasonable person on inquiry to determine whether actionable conduct is involved. *Melko v. Dionisio*, 219 Ill. App. 3d 1048, 1058, 580 N.E.2d 586, 591 (2nd Dist. 1991). Remedies may include rescission, compensatory damages, and punitive damages.

Don't Sit Idle

This may seem like scary stuff, and it is. After all, no one wants to be sued or to have their integrity called into question in the court of public opinion. The lesson to be learned from this discussion is to avoid potential claims by convincing clients to conduct their business dealings honestly and aboveboard.

If turnaround professionals discover undisclosed information that they recognize may be material to a transaction and might cause the other side to act differently, they have a duty to prevent the deal from proceeding without this information being disclosed. This is for their protection, as well as their clients'. A deal tanked by such a disclosure was never meant to be, and reputations will be better for it.

The opinions expressed in this article are those of the author and do not reflect the views of her firm or its clients. This article is for general informational purposes and is not intended to be and should not be taken as legal advice.

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