BY DANYA SHAKFEH

Justifiably Defrauded?

What a recent court case tells us about justifiable reliance.

BAMBOOZLED. HOODWINKED. DEFRAUDED. Those words send shivers up our spines, as we have all probably been taken for a ride once or twice in our lives. The legal definition and standard for demonstrating fraud, however, makes it hard for plaintiffs to prove, or even plead, fraud. Specifically, Illinois courts have made fraud an extremely subjective and fact-specific claim. This subjective standard is evidenced by the First District of the Illinois Appellate Court's September 2020 decision in *Metropolitan Capital Bank & Trust v. Feiner*.[1]

Illinois courts have previously held that the elements of common-law fraud are: 1) a false statement of material fact; 2) the defendant's knowledge that the statement was false;

1. *Metropolitan Capital Bank & Trust v. Feiner*, 2020 IL App (1st) 190895.

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ISBA RESOURCES >>

- Michael Weissman, *Failure to Review UCC Filings Leads to Loss for Lender*, Commercial Banking, Collections, and Bankruptcy (Dec. 2020), law.isba.org/3bCrJCH.
- J. Matthew Pfeiffer, *Don't Believe Everything You Hear: A Lesson in Due Diligence and Unjustified Reliance on Representations*, Trial Briefs (Oct. 2020), law.isba.org/3hAetrB.
- Charles W. Murdock, Jasmina Hamulic, & Ronni Tansey, Kim v. Song: *A Primer on How Not to Plead a Securities Case*, Business and Securities Law Forum (Nov. 2018), law.isba.org/2QuNJYE.

TAKEAWAYS >>

- Illinois courts expect sophisticated plaintiffs in a fraud action to have conducted thorough due diligence to claim justifiable reliance on fraudulent misrepresentations.
- There is no caselaw contemplating the level of sophistication of a serial-fraudster defendant when weighing whether a plaintiff justifiably relied on the defendant's misrepresentations.
- If an account is defaulted upon multiple times, parties should conduct heightened due diligence to claim justifiable reliance in a cause of action for fraud.

3) the defendant's intent that the statement induced the plaintiff to act; 4) the plaintiff's reliance upon the truth of the statement; and 5) the plaintiff's damages resulting from reliance on the statement.[2] "[N]o recovery for fraudulent misrepresentation, fraudulent concealment or negligent misrepresentation is possible unless plaintiffs can prove justifiable reliance, *i.e.*, that any reliance was reasonable."[3] "[T]he crucial question is whether the plaintiffs' conduct was unreasonable under the circumstances and in light of the information open to him, that the law may properly say that this loss is his own responsibility."[4] Given the many ways a person can lie, the varying levels of information available, and the sophistication of plaintiffs, Illinois courts are presented with an array of decisions with no objective standard to determine whether a plaintiff justifiably or reasonably relied on a defendant's representations.

Metropolitan Capital Bank & Trust v. Feiner

This is apparent in the recently decided *Metropolitan Capital Bank & Trust v. Feiner*.[5] In *Metropolitan,* the plaintiff Metropolitan Capital Bank & Trust ("Metropolitan") loaned $4.5 million in the fall of 2014 to its customer, defendant Zvi Feiner. Feiner was owner and operator of the Rosewood Care Center chain of nursing homes, which were mainly in the Chicago suburbs. By early 2017, Feiner was on his fourth default and submitted paperwork to obtain a fifth modification. Naturally, Metropolitan wanted to ensure security for itself and asked that, this time, Feiner put up additional collateral and that the collateral be unencumbered. When Feiner applied for the fifth modification and Metropolitan asked for additional collateral, Feiner, on March 31, 2017, pledged his right to receive membership distributions from two of his Delaware limited liability companies, FNR Norridge LLC and FNR Woodview. Feiner—surprise—defaulted yet again.

It soon became clear, however, that no money from the FNR Woodview or FNR Norridge entities was flowing through FNR Healthcare into the account set up to service the loan. It was not until July 2017, when Metropolitan was "doing its research into how [it was] going to go about collecting this loan," that the bank discovered that FNR Norridge had in fact already been pledged as collateral to an entity known as SLG Limited Partnership ("SLG").[6]

Metropolitan brought actions for breach of contract, common-law fraud, and conspiracy to defraud the lender. The court granted Metropolitan summary judgment on its breach-of-contract claim but did not grant summary judgment in favor of Metropolitan on the fraud-related claims because the bank failed to prove that Metropolitan *justifiably* relied on Feiner's misrepresentations.

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2. *Connick v. Suzuki Motor Co., Ltd.*, 675 N.E.2d 584, 591 (1996).
3. *Neptuno Treuhand-Und Verwaltungsgesellschaft Mbh v. Arbor*, 692 N.E.2d 812, 818 (1998).
4. *Id.*
5. *Metropolitan*, 2020 IL App (1st) 190895.
6. *Id.* ¶ 13.

WHEN ENTERING INTO TRANSACTIONS THEMSELVES, PLAINTIFFS SHOULD PRESUME TRANSACTIONS ARE *NOT* FAIR AND HONEST WHEN THERE IS A HISTORY OF HABITUAL DEFAULT.

Being lied to isn't enough

The judge believed that Metropolitan had "certainly proved that the defendant, Feiner, made material misrepresentations of fact in this loan transaction process" regarding "the Norridge entity."[7] Indeed, the trial court judge noted that he did not find Feiner to be a credible witness and "was more than a little surprised at the occasions on which [Feiner] thought that things were laughable and he laughed while testifying."[8] The court nevertheless concluded that the bank had failed to prove justifiable reliance and a corresponding theory of damages by clear and convincing evidence.

The judge explained that this conclusion was based on the credible testimony of Metropolitan Senior Vice President Phillip Wilson "that the nature of [Metropolitan's] business is to make nonconventional and non usual [*sic*] loans; and that in this circumstance [the bank] was going into a fifth modification where [it] knew that the [borrower] was in default," and yet it still failed to follow up on the Uniform Commercial Code (UCC) reports that would have demonstrated the pledged collateral was encumbered. In the trial court's view, Metropolitan "certainly should have chased down this UCC."[9] According to the circuit court, there was support in the record for the trial court's determination that, following the borrowers' fourth default, Metropolitan, as a sophisticated lender specializing in nontraditional loans requiring personal guarantees, should not have simply relied on Feiner's representations regarding the status of the pledged collateral. Metropolitan appealed.

Sophisticated plaintiffs & sophisticated fraudsters

Feiner is unarguably an incredibly sophisticated fraudster. But must a court consider a defendant's level of sophistication when assessing whether a plaintiff "justifiably" relied on a defendant's misrepresentations? To give more background, according to a U.S. Securities and Exchange Commission's (SEC) complaint filed on Sept. 19, 2019, Feiner, a well-regarded ordained Orthodox Jewish rabbi, had been running his Ponzi scheme since 2014, and defrauded victims from his Orthodox Jewish community out of millions of dollars.[10] Feiner's scheme involved the misappropriation of proceeds raised through the offer and sale of membership interests in limited liability companies that would purchase, own, and sell nursing homes and assisted living facilities. Feiner's scheme also led to a record-setting $146 million default in the U.S. Department of Housing and Urban Development's default servicing program.[11]

Manipulation tactics commonly used by those who engage in fraudulent schemes can fool even the most sophisticated and educated victims. Indeed, the term "con man" is short for "confidence man" and is rooted in the "confidence trick," which is an attempt to defraud a person after gaining their trust.[12] However, given the timing of this case in the circuit court and the subsequent appeal, of which Metropolitan's brief was filed Oct. 19, 2019 (just a month after the above SEC complaint was filed), it is possible that Metropolitan's attorneys were not aware of the breadth and level of Feiner's schemes to contemplate this angle. Yet, the court in *Metropolitan Capital Bank & Trust* does touch on where a defendant creates a false sense of security and cites *Mother Earth, Ltd. v. Strawberry Camel, Ltd.* where the defendant sold a nightclub and falsely represented monthly profits of $10,000 and the seller inhibited the purchasers' inquiries by telling them that the business's books were unavailable.[13] The court in *Metropolitan Capital Bank & Trust* distinguishes *Mother Earth, Ltd.* by noting there was no impediment to Metropolitan's investigation.[14]

Metropolitan also argued that even if the plaintiff in an action for fraud was negligent for failing to insist on verification of an alleged misrepresentation, fraud is "an intentional tort, and it is well settled that an action for an intentional tort cannot be defeated by an assertion of negligence on the part of the plaintiff."[15] However, the court in *Metropolitan Capital Bank* did not accept this proposition on its face and noted that this maxim "is qualified in that the defrauded party must first show he had a right to rely on the misrepresentations."[16]

To fraud or not to fraud?

Interestingly enough, the trial court in *Metropolitan Capital Bank*, as cited by the First District, further notes that "[i]n the trial court's view, Metropolitan 'certainly should have chased down this UCC, this SLG UCC, and that is frankly what dooms the plaintiff's case in that regard.'"[17] The Court also notes that fraud claims are held to a higher evidentiary standard and that the "law presumes that transactions are fair and honest," that "fraud is not presumed," and that fraud is an action

7. *Id.* ¶ 30.
8. *Id.*
9. *Id.* ¶ 31.
10. *United States Securities Exchange Commission v. Zvi Feiner et al*; 1:19-cv-06269, *available at* law.isba.org/33YN2ds.
11. Mathew Goldstein, *$146 Million Default by Nursing Home Chain Leaves U.S. on the Hook*, The New York Times (May 31, 2019), *available at* law.isba.org/3u11aNN.
12. Lindsey Huang & Barak Orbach, *Con Men and Their Enablers: The Anatomy of Confidence Games*, Social Research: An International Quarterly, law.isba.org/33YcNuo.
13. *Mother Earth, Ltd. v. Strawberry Camel, Ltd.*, 72 Ill. App. 3d 37, 52 (1979).
14. *Metropolitan Capital Bank & Trust v. Feiner*, 2020 IL App (1st) 190895, ¶ 54.
15. *Id.* ¶ 54.
16. *Id.* ¶ 53.
17. *Id.* ¶ 31.

notably different than an action merely for the recovery of the account balance.[18]

It is worth noting here that when Feiner applied for the fifth loan, Metropolitan had no reason to suspect fraud but only had evidence that Feiner was a serial defaulter. Against this grain, the circuit court and First District cite Metropolitan's failure to follow up on the UCC filings in light of Feiner's multiple defaults.[19] This effectively puts plaintiffs in a position where it is legally presumed that transactions are fair and honest unless there is evidence of fraud for the purpose of pleading fraud. Despite this legal presumption, when entering into transactions themselves, plaintiffs should presume transactions are *not* fair and honest when there is a history of habitual default. Even without evidence of fraud, if plaintiffs intend to justifiably rely on fraudulent statements they should treat defaulted transactions as potentially fraudulent ones when conducting their due diligence.

The bottom line

Attorneys advising plaintiffs in cases alleging or involving potential fraud should be aware that a defendant's savviness will likely not be considered when a plaintiff finds him or herself a victim of fraud. Further, plaintiffs' attorneys or in-house counsel should advise clients to: 1) treat transactions that have a history of default or suspicion as transactions that potentially involve fraud, even if there is no evidence of potential fraud; and 2) never skimp on standard procedures of due diligence, such as fully reviewing available documents, (*e.g.*, UCC filings).

Defendants' attorneys should be aware that there is scant precedent involving savvy fraudsters (if you have the misfortune of representing such a character). Further, there is quite some room, based on precedent, to push the limits of a defendant's misrepresentations concerning what is not justifiable reliance. IBJ

THE FIRST DISTRICT OF THE ILLINOIS APPELLATE COURT NOTES THAT FRAUD CLAIMS ARE HELD TO A HIGHER EVIDENTIARY STANDARD AND THAT THE "LAW PRESUMES THAT TRANSACTIONS ARE FAIR AND HONEST," THAT "FRAUD IS NOT PRESUMED," AND THAT FRAUD IS AN ACTION NOTABLY DIFFERENT THAN AN ACTION MERELY FOR THE RECOVERY OF THE ACCOUNT BALANCE.

18. *Id.* ¶¶ 42-43.
19. *Id.* ¶ 31.

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