

FRAUD: WHAT IT IS AND HOW TO AVOID IT

I. INTRODUCTION

This article will first review the basics of a fraud claim in real estate cases. We will then examine the cases that have come out in Michigan over the last couple of years. It should be noted that the majority of Michigan property sale fraud cases over the last two years have been unpublished. This means that a written opinion is issued by the appeals court, but the opinion is not mandatory or binding precedent that other courts must follow. Thus, these opinions offer a window into current trends, but little certainty. Further, the decision in these cases have not always been consistent. While broker or salesperson fraud liability in Michigan is rare, REALTORS® involved in this type of litigation find that considerable time, energy and money is spent, even if the REALTOR® eventually prevails. It is hoped that through increased awareness, REALTORS® will be better able to avoid these resource-draining disputes.

II. DISCUSSION

A. What Is Fraud?

Fraud is a creature of common law, meaning that the vast majority of fraud principles have been articulated, over time, by the courts. There are statutes that impact this common law fraud, most notably, Michigan's Seller's Disclosure Act, MCL 565.961 ("SDA"). Common law fraud in the real estate context requires that: (1) the defendant have made a material misrepresentation (usually concerning condition of the property); (2) the representation was false; (3) at the time the representation was made, the defendant knew it was false or made it recklessly, without knowledge of its truth; (4) the defendant intended the plaintiff to rely upon the representation; (5) the plaintiff acted in reasonable reliance upon it; and (6) the plaintiff suffered damages as a result. *M&D, Inc v McConkey*, 231 Mich App 22, 27; 585 NW2d 33 (1998).

There are additional aspects of fraud claims which are not always listed as "elements" in the cases. First, fraud must be shown by "clear and convincing" evidence. This requires a higher showing than the "preponderance" of evidence that is typically required in civil cases. In practical terms, this means that fraud claims are easy to allege and difficult to prove. Moreover, people (including attorneys) carelessly throw the term around and use it as a threat. If confronted with such a situation, remain calm; there are many steps between threatening a fraud claim and winning one.

There are many statements or actions that appear to be fraud on their face, but which have been excluded from the law of fraud by the courts. For example, the challenged statement must be one of present or past fact. Statements of opinion generally do not qualify, nor do aspects of a "sales pitch" that a court would consider to be "puffing" (e.g., statements that one can "haul in fish by casting off the back porch"). Further, it has often (but not always) been held that where an exaggerated statement is made and the other party can investigate its truth but does not, there is no fraud. Thus, hypothetically, if a seller claims that Abraham Lincoln slept in his

house, and his house was built in 1890, there should be no fraud claim, as the buyer could have easily determined that Lincoln died long before the house was built. In some cases, this principle is described as the “reasonable reliance” requirement. In most of these cases, the court determines that it is simply not reasonable for a buyer to rely on a seller’s claims that appear outlandish on their face. Further, promises to do something in the future (described as “promises of future performance” in the cases) typically do not rise to the level of fraud.

Two other sub-species of fraud are also noteworthy, as they are frequently alleged in real estate fraud cases. The first is “innocent” or “negligent” misrepresentation. With innocent or negligent misrepresentation, the “intent to deceive” element is not required, but two other considerations are: the party must rely on the representation in a manner whereby the injury suffered provides a benefit to the party who made the representation, and the misrepresentation must arise in the context of making a contract, where some duty of accuracy is imposed. In other words, a person may be liable if he accidentally provides false information under circumstances where he had a duty to be truthful.

Similarly, claims of “silent fraud” are often raised in the real estate sales context. Silent fraud involves a failure to speak when there was a duty to do so. A duty of disclosure has been found where the buyer has expressed specific concerns about a property and the seller does not answer, or answers in an incomplete or deceptive manner. In other words, silent fraud arises where there is a duty to speak up. More specifically, with silent fraud, the Michigan Court of Appeals has found that silent fraud is not established by merely showing that the seller knew of a hidden defect and the buyer didn’t; rather, the non-disclosure must relate to a specific inquiry by the buyer that makes the seller’s statements (or silence) misleading.

B. Recent Cases – Fraud Principles Applied

Over the last couple of years, there have been several cases where either seller fraud was found, or enough of a showing of fraud was made, that the appeals court found a trial was warranted. There are several lessons to be learned from these cases.

The leading property fraud case in recent years is *Bergen v Baker*, 264 Mich App 376; 691 NW2d 770 (2005). *Bergen v Baker* was a case that was dismissed by the trial judge, but reversed by the Court of Appeals, because the court felt that plaintiffs had provided enough evidence of possible fraud to warrant a trial. In *Bergen*, the defect concerned leaking in the glass-paneled roof on a part of the house described as the “hot tub room.” The seller’s disclosure form indicated that the roof had leaked but that there was a “complete tear-off and replacement” in June 1998. There was no mention of leaking skylights in the hot tub room, even though, in 1999, the sellers had hired a glass company to repair leaks. The glass company advised sellers that the caulking, in large part, had failed completely, and the rotting wood in the glass panel frames would need to be replaced by a carpenter. The sellers apparently replaced the caulking, but not the wood.

Before closing, the buyers had the home inspected. The inspector revealed signs of past leaking in the hot tub room, but could not confirm an active leak. This same inspector returned after closing and did see water “freely running into the hot tub room,” which he testified to in an affidavit. The trial court, however, dismissed the case, holding that because the buyers had had

an inspection and could have investigated the leak for themselves, they could not have reasonably relied on the statements in the seller's disclosure form.

The Court of Appeals reversed, and remanded the matter to the trial court, to determine what the sellers knew about the roof leaks in the hot tub room and when they knew it. The court found that the language in the disclosure form acknowledging past leaks and a complete roof tear-off and replacement could lead a buyer to believe that all leaks had been cured. Further, evidence of the leak after closing was so pervasive that it provided strong evidence that the leak existed before the sale. If so, this would make the disclosure statement (stating that there were no leaks) knowingly false. The appeals court sent the case back to the trial court, as there was enough evidence to show that the sellers knew or should have known about the active leak.

The 2006 opinion in *Pena v Ellis*, No. 257840; 2006 WL 1006444 (Mich App. April 18, 2006) (unpublished; per curiam), presented a situation where the seller's disclosure statement indicated that there were no signs of water in the basement, that a new roof had been added in 1993, and that sellers were unaware of any firing ranges in the area. The purchasers also had the property inspected, and the inspection failed to reveal these problems. The purchasers learned of the problems after moving into the home. Thus, the purchasers brought suit under fraudulent misrepresentation and silent fraud theories, as well as a claim for violating the SDA.

Specifically, after moving in, the purchasers observed grading problems that resulted in water in the basement. Further, they discovered past water damage in the basement, which was covered by paint. In the course of the court proceedings, the sellers admitted that the basement had flooded 26 years prior, when they first purchased the home. Because it was so long ago, the sellers didn't think this flooding needed to be disclosed. The appellate court found, however, that the SDA provides no time limit; it simply requires the sellers to disclose whether there has been "evidence of water." The sellers also apparently admitted that, within the last five years, water had leaked in through some basement windows and that they had painted the basement. This raised an issue of defect concealment and was sufficient evidence of a misrepresentation on the disclosure form to require a reversal. Further, it was revealed that the sellers issued their disclosure statement before they did some roof repairs and before they attempted to treat attic mold with bleach. However, they did not amend their disclosure statement. Finally, the disclosure form indicated that the home was not in "proximity" to a firing range, but it was, in fact, about a half mile away.

The Court of Appeals found all these matters sufficient to raise the possibility of a fraud claim. It sent the matter back to the trial court for further proceedings.

Another case that shows that concealing possible damage from an inspector can lead to fraud claims is *Prince v Gentz*, No. 252772; 2005 WL 1684468 (Mich App, July 19, 2005) (unpublished; per curiam). In *Prince*, the disclosure statement indicated that a pump and well were in working order, that there was no water in the basement, and that there were no flooding, drainage or structural problems. The buyers had the home inspected twice before closing. However, after the sale, the basement flooded. The buyers brought claims of fraud and silent fraud against the sellers. The sellers sought dismissal on grounds that, in light of the inspections, the buyers could not have reasonably relied on the sellers' disclosure form. However, the trial court found (and the appeals court affirmed) that, based on the buyers' insurance adjuster's investigation, the sellers had likely painted over water damage in the basement prior to sale.

Evidence also showed that the sellers concealed water damage by stacking items against the basement walls during the home inspection. The evidence of the sellers' active concealment, the court held, distinguished this case from other cases holding that the buyers' reliance was not reasonable. It also appeared that sellers made some pre-sale modification to the well water pump to increase water line pressure that caused the pump to burn out prematurely. These facts were sufficient to allow the case to proceed forward to trial.

These cases collectively show that, at a minimum, courts are highly sensitive to evidence of active concealment of defects. Further, courts will entertain circumstantial evidence concerning a seller's knowledge of a condition. In other words, if the defect somehow eludes an inspector, but becomes obvious once plaintiffs move into the home (such as the skylights that leaked like a sieve), courts will entertain the theory that the sellers either knew or should have known of the defect and may allow the case to proceed forward for trial.

C. Recent Cases – Defending Fraud Claims

Most fraud claims fail. A review of dozens of real estate fraud claims decided from 2004 to the present revealed only a handful that survived for trial. However, courts are not entirely consistent with real estate fraud claims. Further, different appellate panels give differing weight to the effect of property inspections on the "reasonable reliance" element. That said, fraud claims have been defeated by facts or legal principles described below.

Many claims have been defeated or strongly influenced by the principle that the buyer could not reasonably rely upon the seller's statements because the defect would have been obvious upon inspection. In *PM Innsbrook, LLC v Innsbrook Associates, LP*, No. 268796; 2006 WL 2959677 (Mich App, Oct 17, 2006) (unpublished; per curiam), the issue concerned sale of an apartment building. The sellers provided a "rent roll" that purported to show several years of rental activity on the building. However, under the purchase agreement and closing documents, the representations did not survive beyond closing, and the sellers essentially disclaimed the validity of all the information they provided to the buyer, including the rent roll. Further, in exchange for a lower sales price, the buyers waived both physical and economic inspection provisions. Thus, they didn't inspect the building or the books for the building. In light of all these disclaimers and a waiver of these inspection provisions (*i.e.*, a failure of buyer's due diligence), the court held that the buyer's reliance on seller's materials was unreasonable as a matter of law.

In *Seit-Olsen v Reliance Appraisals*, No. 264470; 2006 WL 1113936 (Mich App, April 27, 2006) (unpublished; per curiam), a buyer closed on a home, following an inspection, and later found out she did not purchase what she thought she was purchasing. The gist of her many complaints concerned the fact that the home was not 1,720 square feet; it was actually 938 square feet plus 768 square feet in the basement. Advertising materials (presumably, the MLS listing) described the home as being 1,720 square feet with an "in-law suite" in the basement. The sellers had also indicated that there was a possibility for expansion for a two-car garage. These statements proved untrue.

Here, the buyer sued everybody, from her sales agent to her broker, to appraisers, the sellers, and the sellers' agents. The accuracy of the MLS listing was disclaimed, and various

documents (including the purchase agreement) foreclosed any buyer reliance on representations made by the brokers. Although there were several claims and defenses at issue, the case boiled down to the facts that the public record would have established that setbacks precluded building a two-car garage; the basement lacked egress windows and was legally uninhabitable as an “in-laws’ suite”; and that the square footage in the listing obviously included the upstairs and the basement. Basically, because the truth was so easy to ascertain, the court found that buyer’s reliance on information in the MLS listing and other statements by the sellers was unreasonable.

Similarly, in *Sterrett v Theisen*, No. 262226; 2005 WL 2292677 (Mich App, Sept 20, 2005) (unpublished; per curiam), the sellers’ disclosure statement indicated they were unaware of easements on the property. However, the buyers’ title insurance commitment showed an easement which was not disclosed on the sellers’ disclosure form. The buyers purchased the property without an inspection. The trial court dismissal of the fraud claim against the sellers was affirmed on appeal. Both courts felt that the buyers’ reliance on the disclosure form for easement information was unreasonable, as the title insurance commitment clearly revealed the easement.

At least on one occasion, the Court of Appeals has applied the “reasonable reliance” element rather strictly. In *Nalepka v Hnatio*, No. 262000; 2005 WL 2249088 (Mich App, Sept 15, 2005) (unpublished; per curiam), the trial and appeals courts found that the buyers were not reasonable in relying on the seller’s disclosure form under the circumstances. Here, the buyers found significant mold under a carpeted bedroom floor, which was later discovered to have been caused by water that leaked through the roof, down the walls, and apparently soaked back up through the sub-flooring. Other defects, including wiring issues and operation of the sprinkler system, were also raised.

In affirming dismissal of these fraud-based claims, the court held that the buyers could not have reasonably relied on sellers’ disclosures (which denied any problems with leakage) due to plaintiffs having had the property inspected. The gist of the holding was that the buyers could only rely on their inspector, even though the inspector could not access all areas of the attic because it was basically full of junk. Further, the inspector advised that an electrician would have to inspect the circuits and a sprinkler technician would have to opine concerning the sprinkler. Buyers apparently did not have any follow-up inspections and took the property knowing that the inspector never made it through the attic. The court basically held that they should have made more rigorous inspections, and that the buyers’ reliance on the disclosure statement was unreasonable.

Another line of cases illustrates the principle that where the seller is, in fact, unaware of a defect or can show that it has been remediated, there is no fraud. One such case is *Huhtasaari v Stockemer*, No. 256926; 2005 WL 3481429 (Mich App, Dec 20, 2005) (unpublished; per curiam), a case alleging fraud claims against the sellers and the brokers and agents on both sides. Here, the sellers listed the home and provided a disclosure statement indicating the roof was three years old and did not leak. A prospective purchaser’s inspector found mold in the attic and terminated the inspection. The sellers’ broker advised the sellers to take the home off the market and to have the problem studied and remediated. The sellers did so, and re-listed the home after “soda blasting” the attic. The sellers did not make any changes to their disclosure statement.

A second set of buyers were interested in the property and had it inspected. The inspection revealed water stains in the basement from a prior leak and revealed some replaced wood and evidence of water incursion near doors in the home. The inspector also saw new wood and insulation in the attic, and as with the basement evidence, surmised that there must have been past leaks which had “been taken care of.” Based on this (and based on an inquiry from the buyer about the attic), the sellers disclosed their prior withdrawn listing and the mold remediation in the attic. Buyers’ broker asked for a copy of the environmental report, but the sellers never produced it. The buyers closed without reviewing the report.

When the buyers began remodeling, they found significant mold between the walls in the kitchen, deteriorated studs, and water running between walls into the basement. An insurance adjuster report found that this was the likely result of ten or more years of leakage. The trial court granted defendants’ motions for summary judgment, and the Court of Appeals affirmed. The Court of Appeals found that the attic mold situation was disclosed and remediated and was not a hidden defect. In other words, the disclosure was truthful concerning the attic. The court also found that other water problems (between the walls) were hidden defects, which could not have been revealed until someone started taking the walls apart. In other words, the court found that the sellers disclosed what they knew and were not responsible for the defects they did not know about.

Other simple manifestations of this principle are illustrated in *Seyco v Renny*, No. 252296; 2005 WL 1123633 (Mich App, May 12, 2005) (unpublished; per curiam) and *Lane v Dinnocenzo*, No. 268370; 2006 WL 2381495 (Mich App, Aug 17, 2006) (unpublished; per curiam), both being cases where the buyers could not establish that the sellers knew of the defect. In *Lane v Dinnocenzo*, the sellers inherited a cottage and sold it. The buyers later found that the carpeting concealed rotting, water-damaged floors, that paneling covered a water-damaged fireplace, and that there were ants. Even though one of the sellers did all the repair work on his mother’s cottage, the buyers had no evidence that the sellers knew of the water damage. Further, the buyers could not establish a known and undisclosed ant infestation.

III. CONCLUSION

Hopefully, a survey of cases where buyers had varying degrees of success claiming fraud, and sellers and brokers successfully defended against such claims, will enable you to spot potential problems. REALTORS® (and sellers) should be particularly cautious when responding to buyers who have made a specific inquiry. Sellers should also be cautioned against making cosmetic changes that could be viewed as an effort to conceal an existing defect. While Michigan courts typically hold buyers responsible for making their own thorough investigation of the home they are purchasing, they are reluctant to do so if they believe that the seller or his agent has interfered with this investigation.