· Parallel Obligations of Disclosure and Investigation in Divorce Actions[1]

[Fiduciary Duty, Fraud, Concealment v. Conscious Ignorance and Conscious Negligence]

Elliott Scheinberg

mc2raises a critical issue many practitioners comfortably assumed had a built in simple and ready answer: can a spouse, who stands in a fiduciary relationship to the other spouse and who is further required by decisional and statutory authority to make broad disclosure during a divorce action, conceal information during settlement negotiations and still prevail in a subsequent action to vacate the agreement?

The obligation to accurately disclose does not exist in a vacuum. Although the first spouse may not engage in wrongdoing in making disclosure, a parallel obligation is imposed upon the other party to independently investigate and confirm the transmitted information, if such information is available and the other party has the means to do so. This is the equal and opposite counterbalancing reaction to disclosure in contract doctrine.

Marital Agreements, Contract Construction

Interspousal agreements are contracts subject to principles of contract construction and interpretation.[2] The Court of Appeals has underscored that agreements between spouses, unlike ordinary business contracts, involve a fiduciary relationship requiring "the utmost of good faith."[3] *Meinhard v. Salmon* 249 N.Y. 458 (1928),[4] synthesized the duties of the fiduciary as something "stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."

Disclosure

Broad and searching financial disclosure[5] during a divorce action is a fundamental right[6] shielded by public policy.[7] A duty to disclose is triggered when a fiduciary has reason to believe

---

[1] N.Y.L.J., September 11, 2009.

[2] Meccico v. Meccico, 76 N.Y.2d 822 (1990).

[3] Christian v. Christian, 42 N.Y. 2d 63 (1977).

[4] See Mercury Bay Boating Club Inc. v. San Diego Yacht Club, 76 N.Y.2d 256 (1990).

[5] Kaye v. Kaye, 102 A.D.2d 682 (2nd Dept., 1984).

[6] Rubenstein v. Rubenstein, 117 A.D.2d 593 (2nd Dept., 1986).

[7] Richter v. Richter, 131 A.D.2d 453 (2nd Dept., 1987).

that information is material and germane[8] that can reasonably bear on consideration of the offer. Nondisclosure is tantamount to an affirmative misrepresentation where a party to a transaction is duty bound to disclose certain pertinent information; such duty is created in a fiduciary relationship or where a party has superior knowledge not available to the other[9] and the first party knows that the other is acting on the basis of mistaken knowledge.[10] Contractual disclaimers do not relieve a party of full disclosure where a fiduciary relationship exists between the parties.[11]

Elements of Fraud

To establish fraud, the injured party must prove: a false representation to a material fact; known to be false by its maker, made to induce reliance upon it; and *rightful* reliance in ignorance of its falsity to his injury.[12] Fraud includes intentional and successful employment of any cunning, deception, or artifice, used to circumvent, cheat, or deceive another.[13] Concealment with intent to defraud of facts which one is duty-bound in honesty to disclose is of the same legal effect and significance as affirmative misrepresentations of fact especially when it is a fact basic to the transaction.[14]

In *Bridger v. Goldsmith,*143 N.Y. 424 (1894),[15] the Court of Appeals emphasized the assault against public policy if a party guilty of fraud were permitted to contractually insulate his wrongdoing from redress: "A rogue cannot protect himself from liability for his fraud by inserting a printed clause in his contract." Significantly, a general merger clause does not bar

---

[8] Botti v. Russell, 180 A.D.2d 947 (3rd Dept.,1992).

[9] Botti, id; Blue Chip Emerald LLCAS, id; Callahan v. Callahan, 127 A.D.2d 298 (3rd Dept.,1987).

[10] Stevenson Equipment, Inc. v. Chemig Const. Corp., 170 A.D.2d 769 (3rd Dept., 1991), aff'd, 79 N.Y.2d 989 (1992); Callahan, id.

[11] Salm v. Feldstein, 20 A.D.3d 469 (2nd Dept.,2005); Birnbaum v. Birnbaum, 73 N.Y.2d 461 (1989).

[12] Abbate v. Abbate, 82 A.D.2d 368 (2nd Dept., 1981); Adams v. Gillig, 199 N.Y. 314 (1910).

[13] Quadrozzi Concrete Corp. v. Mastroianni, 56 A.D.2d 353 (1977).

[14] Abbate, id.; Nondisclosure and concealment are separately actionable as a breach of a fiduciary's duties and under fraud.

[15] See Sabo v. Delman 3 N.Y.2d 155 (1957); Kalisch-Jarcho, Inc. v. City of New York, 58 N.Y.2d 377 (1983) ("An exculpatory clause is unenforceable when, in contravention of acceptable notions of morality, the misconduct for which it would grant immunity smacks of intentional wrongdoing.")

allegations of fraud in the inducement.[16]

Reliance: Rightful, Reasonable, Justifiable

To establish the reliance component of a fraud claim, plaintiff must show not only actual reliance on defendant's misrepresentations, but also that such reliance was rightful as basic to the transaction,[17] reasonable,[18] or justifiable,[19] and that a reasonable inquiry was made.[20] Where a party has the means to discover the true nature of the transaction by the exercise of ordinary intelligence, and fails to make use of those means, he cannot claim justifiable reliance on defendant's misrepresentations.[21]

Doctrine of Special Facts

The special facts doctrine targets situations where one party possesses superior knowledge, not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge, creating a duty to disclose that information; superior knowledge of essential facts renders a transaction without disclosure inherently unfair.[22] The doctrine engages a two-prong inquiry which imposes a burden upon each party to the agreement: 1) does the material fact rest peculiarly within the knowledge of one party; and 2) could the fact have been discovered through the exercise of ordinary intelligence by the other party[23] and its veracity ascertained on their own.[24]

---

[16] Callahan v. Miller, 194 A.D.2d 904 (3rd Dept.,1993).

[17] Abbate, id.

[18] Oko v. Walsh, 28 A.D.3d 529 (2nd Dept., 2006); Stuart Silver Associates, Inc. v. Baco Development Corp., 245 A.D.2d 96 (1st Dept.,1997).

[19] Shultis v. Reichel Shultis, 1 A.D.3d 876 (3rd Dept.,2003);

[20] Marsh v. Hasbrouck, 37 A.D.3d 1010 (3rd Dept., 2007).

[21] Young v. Williams 47 A.D.3d 1084 (3rd Dept.,2008); Stuart Silver Associates, Inc. v. Baco Development Corp. 245 A.D.2d 96 (1st Dept.,1997); Morey v. Sings 174 A.D.2d 870 (3rd Dept.,1991).

[22] P.T. Bank Central Asia v. ABN AMRO Bank N.V., 301 A.D.2d 373 (1st Dept., 2003); see, Black v. Chittenden, 69 N.Y.2d 665 (1986).

[23] Louis Foodservice Corp. v. 839 Restaurant Corp., 15 Misc.3d 1102(A) (N.Y.City Civ.Ct., 2007).

[24] Black, id; Bailey Ford, Inc. v. Bailey, 55 A.D.2d 729 (3rd Dept., 1976); Shultis, id; see Guerrand-Hermès v. Guerrand-Hermès, NYLJ 3/18/09, (p. 26).

Danann Realty Corp. v. Harris 5 N.Y.2d 317 (1959),[25] emphasized the general rule of the special facts doctrine: if the represented facts are not peculiarly within the party's knowledge and the other party has the means available of knowing, by the exercise of ordinary intelligence, the truth, or the real quality of the subject of the representation, he must make use of those means, or he will not be heard to complain that he was induced to enter into the transaction by misrepresentations.

Conscious Ignorance, Conscious Negligence

A burden of due diligence rests upon a party who receives information during contract negotiations. A party may not seek to void an agreement by intentionally proceeding without further investigation of his or her rights but rather by forging ahead with "conscious ignorance"[26] or "conscious negligence"[27] A party may not purposefully proceed with limited knowledge[28] as such negligence is a bar to rescission.[29] A marked lack of diligence in determining one's rights defeats entitlement to equitable relief,[30] which applies to claims of fraud.[31]

Under the separation agreement, in *Verschell v. Pike* 85 A.D.2d 690 (2nd Dept., 1981), plaintiff deeded to defendant his interest in the marital residence. Defendant rented space to plaintiff in the marital residence for his dental practice. Litigation arose when defendant asserted that use of the premises for the dental practice was illegal under a local zoning ordinance. Plaintiff sought to rescind the agreement limited to the deed and lease. The wife and her attorney knew of the violations throughout the negotiations, while plaintiff and his attorney did not. The Appellate Division found no cause of action in fraud, since deception by a false representation not only requires belief of its truth, but the reliance thereon must also be *justified*. Plaintiff's attorney was not justified in relying upon his adversary's statement that the lease was legal under the zoning ordinance.

---

[25] Marsh, id; Fiorilla v. County of Putnam, 1 A.D.3d 475 (2nd Dept., 2003).

[26] Estate of Hatch, ex rel. Ruzow v. NYCO Minerals Inc., 270 A.D.2d 590 (3rd Dept., 2000).

[27] P.K. Development, Inc. v. Elvem Development Corp. 226 A.D.2d 200 (1st Dept.,1996); Culver & Theisen, Inc. v. Starr Realty Co., 307 A.D.2d 910 (2nd Dept., 2003); Da Silva v. Musso 53 N.Y.2d 543 (1981).

[28] P.K. Development, Inc., id.

[29] Da Silva, id.; Surlak v. Surlak, 95 A.D.2d 371 (2nd Dept., 1983), appeal dismissed, 61 N.Y.2d 906 (1984).

[30] Gimbel Bros., Inc. v. Brook Shopping Centers, Inc., 118 A.D.2d 532 (2nd Dept.,1986); Da Silva, id.

[31] Black, id; Jana L. v. West 129th Street Realty Corp., 22 A.D.3d 274 (1st Dept., 2005).

Kojovic

In *Kojovic v. Goldman* 823 N.Y.S.2d 35 (1st Dept., 2006), the husband was CEO of CIQ, in which he held a 7-8% interest. The parties agreed to terminate further discovery, and the wife waived her right to evaluate the husband's interest in CIQ based on his representation, through counsel, that the liquidation of CIQ was "not contemplated", and "the stock in the company is now completely non-liquid as it cannot be sold and will be subject to market competitive and execution risk for several years." Slightly over one month following the execution of the agreement, CIQ was acquired for approximately $225 million, of which the husband received $18 million.

The Appellate Division dismissed the wife's action to vacate the agreement on fraud and overreaching because, inter alia, her attorney and accountant "declined" to "have freely availed themselves of any number of valuation and discovery procedures during the divorce proceeding." The Court imputed an awareness of the possibility that CIQ could be sold and deemed her waivers an end run to an "immediate and certain payout" instead of the uncertainty of an eventual sale. However, knowledge of the negotiations surrounding CIQ's acquisition was peculiar to the husband[32] and no amount of effort or combination of discovery devices by the wife's team could have possibly unearthed the sub rosa negotiations from a husband bent on deception. *Kojovic* is a rather disquieting decision. Key doctrines not considered by *Kojovic* were previously reviewed: E. Scheinberg, "*Kojovic v. Goldman*: Scienter and Marital Agreements," NYLJ, Jan. 11, 2007.

Empie

Empie v. Empie 46 A.D.3d 1008 (3rd Dept., 2007), rejected a claim for vacatur based on concealment of an intended purchase of property because of the absence of a definite purchase offer until after the agreement was signed: "under these circumstances, nondisclosure of any such potential interest in the commercial property, without more, does not amount to fraud." The appraiser also noted that even if he had been aware of the buyer's interest in acquiring the property, his conclusion would not have changed without an offer. Finally, the defendant knew that the buyer had previously contacted the plaintiff and she had attempted to contact the buyer – the decision does not tell about what she learned.

Paolino

Although the wife, in *Paolino v. Paolino* 51 A.D.3d 886 (2nd Dept., 2008), had retained financial experts, she agreed to waive her claim to any of the defendant's business interests in exchange for the marital residence plus $1,300,000. Learning of a subsequent sale of one of the businesses, she sought to vacate the agreement. The Appellate Division affirmed the dismissal of the complaint because "bare legal conclusions and factual claims which are flatly contradicted by the record are not presumed to be true."

---

[32] Danann Realty Corp., id.; McManus v. Moise, 262 A.D.2d 370 (2nd Dept., 1999); Fiorilla v. County of Putnam, 1 A.D.3d 475 (2nd Dept., 2003).

***Etzion*, Public Domain**

In *Etzion v. Etzion* 62 A.D.3d 646 (2nd Dept., 2009), the parties signed two agreements. Under the earlier agreement (March 22, 2005) the wife received nearly $13 million in assets and the husband retained certain waterfront property. In the June 8, 2005 agreement, which incorporated the earlier agreement, the husband represented that, as of March 22, 2005, he had "no active deals or pending negotiations relating to the sale or reorganization of [the property]."

On October 6, 2005, the husband contracted to sell the property for $84,570,000. The increase in the value resulted from the June 18, 2003 rezoning plan by New York City, which plan received media coverage throughout the administrative process leading to its approval. The City adopted the rezoning plan two months following the earlier agreement and one month before the settlement. The wife commenced an action to rescind and/or reform the settlement.

The Appellate Division rejected the cause of action alleging breach of fiduciary duty, to wit, the husband's failure to disclose the possibility of the proposed rezoning plan and its potential impact on the value of the property because there is no duty arising out of the marital relationship to volunteer information freely available in the public domain. The wife alleged that the negotiations were premised upon a report prepared by a neutral appraiser who last valued the property at $6.5 million, as of March 27, 2003. The wife chose to forego an updated appraisal relying instead on the two-year-old appraisal. Her realization that she had entered into an improvident deal does not constitute a basis to set aside the agreement.

Etzion's declaration regarding volunteering information about matters in the public domain is piercing because it repaves the doctrine of conscious ignorance and conscious negligence with an added coating of insulation in favor of the nonvolunteering spouse. There is a clear distinction between not volunteering and not disclosing – volunteering strips away the notion of sanctionable duty or obligation.

The Appellate Division apparently took judicial notice *[*CPLR 4511(b) permits "every court" to "take judicial notice without request of ... *ordinances*"*]* of the rezoning ordinance process and implicitly viewed it against the backdrop of the principles which require the other spouse to conduct an independent verification. This is captured in *Etzion*'s terse observation that the wife "chose to forego an updated appraisal." The Appellate Division appears to have said that although an independent investigation might not have revealed any sales negotiations for the property, it certainly would have alerted the wife to its updated value which she could have leveraged during the negotiations. She was basically deemed to have slept on her rights.

Unlike *Kojovic*, *Etzion* dismissed only the wife's action for breach of fiduciary duty and preserved her cause of action in fraud to engage in additional discovery regarding the husband's representations as to any active deals or pending negotiations on the property in March 2005: due to their "fiduciary relationship", "if the wife can substantiate that the husband concealed an existing agreement to sell the property, she may be able to succeed on fraudulent misrepresentation, which are a sufficient basis for reformation and/or rescission, as well as to

impose a constructive trust on the property or the proceeds received from the sale of that property." Like *Kojovic*, there is no way that the wife could have known of any pending deals absent the husband's forthcoming honesty. Nevertheless, if the property's post-ordinance value had appreciated significantly or was in the price range for which the husband sold it, but for her failure to engage her expert to reappraise the property his concealment matters little because she had not accessed her available means. Although the decision stirs initial discomfort, it is well supported by settled law, albeit unstated in the decision.

Conclusion

Disclosure has a yin and a yang: honest representations followed by a shift of the burden onto the other party to confirm the information. Reliance must ultimately be rightful, reasonable, and justifiable – the law helps only those who help themselves.

Counsel faces daunting exposure and needs to be extremely cautious. Merger clauses must be carefully crafted to identify key representations and reliances to disincentivize concealment via contractual vacatur upon discovery of deception. The structuring of such provisions is well anchored in settled law: (1) signatories to an agreement may chart their own course[33] by tailoring their contract to meet their particular needs to include or exclude relevant provisions;[34] and (2) parties may contractually make a law for themselves and their proceeding[35] to include control of their rights,[36] waiver of defenses,[37] or uniquely fashioned rules of evidence.[38] Parties may establish an individualized contractual circumference which negotiates out of the doctrine of special facts or conscious ignorance and conscious negligence, or their equivalents, by squarely imposing the entire obligation of honesty upon the party making the disclosure. A later defrauded party is thus contractually empowered to seek automatic and certain redress without first clearing other legal hurdles.

It remains to be seen whether the Court of Appeals will weigh in on this issue.

---

[33] Cullen v. Naples 31 N.Y.2d 818 (1972).

[34] Grace v. Nappa, 46 N.Y.2d 560 (1979).

[35] Kneettle v. Newcomb 22 N.Y. 249 (1860).

[36] Potter v. Rossiter 96 N.Y.S. 177 (1st Dept. 1905); In re Malloy's Estate, 278 N.Y. 429 (1938).

[37] Deitsch Textiles, Inc. v. New York Property Ins. Underwriting Ass'n, 62 N.Y.2d 999 (1984).

[38] Brady v. Nally, 151 N.Y. 258 (1896).