New York Law Journal

WWW.NYLJ.COM

An ALM Publication

VOLUME 252—NO. 87

TUESDAY, NOVEMBER 4, 2014

Outside Counsel

Interstate Land Sales Act, Fraud and Specific Disclaimers

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On Sept. 26, 2014, President Barack Obama signed into law the Interstate Land Sales Disclosure Act Update of 2013. The update exempts condominium developments from the registration requirements under the Interstate Land Sales Act (ILSA), but it does not immunize sponsors from liability under ILSA's anti-fraud provisions. Because of the potential advantages ILSA offers to plaintiffs over New York law, sponsors should prepare for claims brought under its anti-fraud provisions. This article explores the benefits to plaintiffs of ILSA's anti-fraud provisions over claims under New York law, and discusses potential defenses to such claims including New York's law of specific disclaimers.

Fraud Liability in New York

In New York, a public offering of securities consisting of participation interests in real estate, including new construction condominiums, is governed by the Martin Act. However, because there is no private right of action (i.e., the attorney general bears sole responsibility for implementing and enforcing the legislation), condominium purchasers seeking to assert a private right of action for fraud must rely on New York common law fraud.

To assert a common law fraud claim, a plaintiff has the heavy burden of proving by clear and convincing evidence "a representation of material fact, the falsity of the representation, knowledge by the party making the representation that it was false when made, justifiable reliance by the plaintiff and resulting injury."[1]

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In contrast to both the Martin Act and New York's common law fraud, ILSA specifically authorizes a purchaser of a unit to bring a private right of action in state or federal court within three years after discovery of the violation (or after discovery should have been made by the exercise of reasonable diligence). Furthermore, a sponsor's liability under ILSA's anti-fraud provisions is not constrained by the same requirements necessary to establish common law fraud.

ILSA

ILSA was passed in 1968 to "prevent false and deceptive practices in the sale of unimproved tracts of land by requiring developers to disclose information needed by potential buyers."[2] It was based on the full disclosure philosophy of the Securities Act of 1933, and in fact many of the provisions, including §1703(a)(2)(B)—the focus of this article[3]—trace the Securities Act's language. The prong of the private right of action in §1703(a)(2)(B) makes it unlawful, in using interstate commerce in selling or leasing or offering to sell or lease a non-exempt unit,

> to obtain money or property by means of any untrue statement of a material fact, or any omission to state a material fact necessary in order to make the statements made (in light of the circumstances in which they were made and within the context of the overall offer and sale or lease) not misleading…

Section 1703(a)(2)(B) was substantially amended in 1979, when Congress (1) explicitly included "omission" of material fact; (2) replaced the language prohibiting material "misrepresentation" with a prohibition of "untrue statement" of a material fact; and (3) deleted reference to purchaser reliance.

However, due to a dearth of decisions from federal circuit courts interpreting the provision, and disagreement among federal district courts as to the elements necessary to establish a violation, there is no bright-line rule for asserting a claim under §1703(a)(2)(B). In particular, the most problematic are the elements of reliance and, to a lesser degree, scienter.

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Scienter. Section 1703(a)(2)(B) prohibits any "untrue statement" of material fact, which seemingly requires only a factual determination that the statement complained of was untrue (i.e., an innocent mistake would give rise to ILSA liability if material). Indeed, most case law interpreting §1703(a)(2)(B) has held that scienter is not a required element. For example, in *Pierce v. Apple Valley*, an Ohio district court explained that "the language of §1703(a)(2)(B) does not support the conclusion that scienter is necessary to a violation."[4] However, the U.S. Court of Appeals for the Tenth Circuit in *Solomon v. Pendaries Properties* suggested that claims brought

under §1703(a) require the plaintiff to show fraudulent intent.[5]

Reliance. Following the 1979 amendments to §1703(a)(2)(B), which deleted the reference to purchaser reliance from the statute, a three-way split has developed among federal district courts regarding whether reliance remains a required element of the cause of action.

Some district courts continue to require reliance as a necessary element of a cause of action under §1703(a)(2)(B), typically because it is viewed as "one of the well known elements of fraud,"[6] while other district courts do not require such a showing to prove a violation.[7] Still others require a showing of reliance to state a cause of action under §1703(a)(2)(B) for misrepresentations, but allow a rebuttable presumption of reliance for omissions.[8]

The House Report for the 1979 amendments stated that although "actual reliance" was being eliminated as an element of proof, "in proving that an untrue or omitted fact was material, it must be established that the fact was important enough that a reasonable person would have *relied* upon it in making a decision to purchase or lease that particular piece of land."[9] Accordingly, Congress intended that courts interpreting §1703(a)(2)(B) subsume reliance into their inquiry of materiality.

Materiality. A showing of materiality of the untrue statement or omission complained of is, indisputably, a required element of a cause of action under §1703(a)(2). Courts have interpreted ILSA's standard of materiality consistently with the securities laws. In particular, the test of materiality is "whether a reasonable investor might have considered the omitted fact or erroneous statement as important in making a decision,"[10] or, as stated in the House Report, whether a reasonable purchaser would have relied on the statement in deciding whether to purchase the property.

Specific Disclaimers

Specific Disclaimers Under New York Law. The attorney general's regulations under the Martin Act forbid sponsor disclaimers of liability for failure to perform any obligation imposed by law, but they do not restrict the sponsor's ability to add specific factual disclaimers. New York's Court of Appeals has held that a disclaimer in a purchase agreement specific as to a matter will bar a purchaser's action for recovery of damages for fraud with respect to that matter, because a specific disclaimer "destroys the allegations…that the agreement was executed in reliance upon" the contrary representations.[11] In other words, in a typical house contract, a disclaimer providing that the seller makes no representation as to whether the roof leaks will preclude the purchaser's claim for fraud based on an alleged oral misrepresentation by the seller as to a post-closing roof leak.

However, even where the purchase agreement contains a specific disclaimer, the purchaser will not be precluded from claiming reliance on the sponsor's misrepresentations if the facts allegedly misrepresented were "peculiarly within the [sponsor's] knowledge."[12]

Disclaimer Provisions and Rebuttal of Reliance in the Context of ILSA §1703(a)(2)(B) Claims. Federal law governs the interpretation of ILSA's fraud provisions, but state law governs the interpretation of purchase agreements, and accordingly, the effect of disclaimer provisions.[13]

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Federal district courts interpreting California and Colorado law have held that an inclusion of a specific disclaimer provision does not bar a purchaser's claim under §1703(a)(2)(B) at the motion to dismiss stage. For instance, a federal district court interpreting Colorado law which, similarly to New York law, requires that a disclaimer be "couched in clear and specific language" held that when a purchaser alleges active concealment of sales prices of other homes in the development, a disclaimer of reliance on representations of "value" and "marketability or investment potential" of the purchaser's property is not sufficiently specific to preclude claims of reliance under §1703(a)(2)(B).[14]

By contrast, under Florida law, a purchaser's reliance is unreasonable as a matter of law where the purchase agreement expressly disclaims reliance on prior oral representations or where the alleged written or oral misrepresentations contradict the express terms of the purchase agreement. In *Taplett v. TRG Oasis* (*Tower Two*), a Florida district court held that a clause in a purchase agreement providing that the purchaser entered into the agreement "without reliance upon any representations concerning any potential for future profit, any future appreciation in value, any rental income potential, tax advantages, depreciation or investment potential and without reliance upon any monetary or financial advantage" rebutted a presumption of the purchaser's reliance on the suggestion of the sponsor's agent that the condominium would be "a good investment."[15]

Sponsors should keep in mind that even though federal district courts differ as to the effectiveness of specific disclaimer provisions within the context of ILSA's anti-fraud provisions, a general disclaimer provision (i.e., merely stating "no other representations made") would be ineffective under §1703(a)(2)(B) of ILSA as it is under New York law.

Practical Considerations for Sponsors. Although it is difficult to predict how New York courts will interpret §1703(a)(2)(B), decisions of New York courts have strongly supported specific disclaimers. Therefore, we suggest that sponsors always include specific disclaimers in their purchase agreements. Of course a long list of specific disclaimers may cause marketing issues due to the necessarily stark nature of the warnings, so each sponsor will need to evaluate market conditions and the potential risk presented by circumstances in question.

1. *Kaufman v. Cohen*, 760 N.Y.S.2d 157, 165 (1st Dept. 2003).
2. *Flint Ridge Dev. Co. v. Scenic Rivers Ass'n of Oklahoma*, 426 U.S. 776, 778-79 (1976).
3. Section 1703(a)(2), ILSA's general anti-fraud provision, contains a total of four sub-sections. See §1703(a)(2)(A)-(D). We focus on §1703(a)(2)(B) since this sub-section potentially offers plaintiffs an alternative to New York's fraud laws.
4. 597 F.Supp. 1480, 1492 (S.D. Oh. 1984); see also *Disandro v. Makahuena Corp.*, 588 F.Supp. 889, 894 (D. Hawai'i 1984).
5. 623 F.2d 602 (10th Cir. 1980).
6. *Ivar v. Elk River Partners*, 705 F.Supp.2d 1220, 1237-38 (D. Colo. 2010); see also *Dongelewicz v. First Eastern Bank*, 80 F. Supp.2d 339 (M.D. Pa. 1999).
7. *Kenneally v. Bank of Nova Scotia*, 711 F.Supp.2d 1174 (S.D. Cal. 2010).
8. E.g., *Taplett v. TRG Oasis (Tower Two)*, 755 F.Supp.2d 1197 (M.D. Fla. 2009).
9. H.R. Rep. 96-154, 35, 1979 U.S.C.C.A.N. 2317, 2350 (emphasis added).
10. *Paquin v. Four Seasons of Tennessee*, 519 F.2d 1105, 1109 (5th Cir. 1975).
11. *Danann Realty v. Harris*, 5 N.Y.2d 317, 320-321 (N.Y. 1959).
12. *Danann Realty v. Harris*, 5 N.Y.2d 317, 323 (N.Y. 1959).
13. *Hillman v. Loga*, 697 F.3d 299, 302 (5th Cir. 2012).
14. *Ivar v. Elk River Partners*, 705 F. Supp. 2d 1220, 1239-40 (D. Colo. 2010); see also *Kenneally v. Bank of Nova Scotia,* 711 F.Supp.2d 1174 (S.D. Cal. 2010).
15. *Taplett v. TRG Oasis* (*Tower Two*), Ltd., 755 F.Supp.2d 1197, 1203 (M.D. Fla. 2009).

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