

## OUTSIDE COUNSEL

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### 'Standing' to Sue Sham Condo, Co-op Sponsors Changed

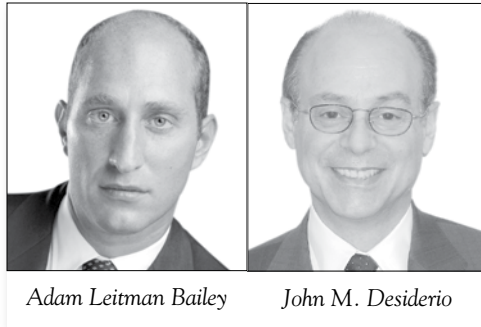
**K**ramer v. W10Z/515 Real Estate Ltd. Partnership,<sup>1</sup> a recent decision of the Appellate Division, First Department, is a case of great importance to purchasers of new condominium and cooperative apartment units.

In a sweeping opinion, the court completely overhauled, if not expressly overruled, a line of its own decisions that appeared to effectively bar any private suit against condo and co-op sponsors who make fraudulent representations in offering plans for newly constructed or converted condominiums and cooperative apartments.

The court definitively held that the Martin Act (General Business Law, Art. 23-A) does not preclude a private party from prosecuting an otherwise valid common-law fraud claim in connection with the sale of securities whenever the alleged fraudulent conduct is such that the attorney general would be authorized to bring an action against the defendant under the Martin Act.

In truth, the First Department, in *Kramer*, did nothing more than reaffirm the law as set forth by the Court of Appeals in *CPC International v. McKesson Corp.*<sup>2</sup> and in *Vermeer Owners v. Guterman*,<sup>3</sup> which hold that there is no private right of action under the Martin Act, but that common-law fraud claims are not barred where the plaintiff can prove scienter and reliance.

However, in a line of cases beginning with *Whitehall Tenants Corp. v. Estate of Olnick*,<sup>4</sup> the First Department had interpreted *CPC International* and *Vermeer* to mean that the



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attorney general's exclusive right to enforce the Martin Act against fraudulent securities and real estate offerings barred private litigants from asserting a common-law fraud cause of action for any act or omission that the attorney general was otherwise authorized to prosecute.<sup>5</sup>

To be sure, the First Department did not hold explicitly that a private litigant could never have standing to bring a fraud action against a sponsor, but the court did hold, in *Whitehall*, that standing to bring such actions could not be achieved through "artful" pleading and that private plaintiffs would not be permitted to "press any claim based on the sort of wrong given over to the attorney general under the Martin Act." Thereafter, in a series of subsequent decisions, the court seemed intent on creating a barrier against private fraud actions that appeared to be nearly insurmountable.

In *Thompson v. Parkchester Apartments Co.* (*Thompson I*), the court held that plaintiffs must plead "a unique set of circumstances whose remedy is not already available to the attorney general," in order "to establish a viable independent claim for deception and false representation." The court reiterated the "unique circumstances" formula in *Thompson II*. However, just what "unique circumstances" would satisfy this criterion, for a sponsor's affirmative misrepresentations, as opposed to a sponsor's failure to make required disclosures, was not explained.

Moreover, the "unique circumstances" pleading requirement established by the court in *Thompson I* and *Thompson II* was actually derived from an earlier decision, *15 East 11th Apartment Corp. v. Elghanayan*,<sup>6</sup> in which the plaintiffs had alleged fraud based solely on the sponsor's failure to make certain disclosures in the offering plan, but not upon any affirmative misrepresentations in the plan itself. In *Elghanayan*, the court affirmed summary judgment dismissing the plaintiffs' complaint with this analysis:

The Complaint...alleges the *Elghanayan* defendants' concealment of certain dangerous structural conditions from the purchasers.... We are concerned primarily with the first cause of action in that complaint, alleging six specific instances of fraud in connection with the failure to disclose this information in the Offering Plan. There is nothing unique about the pleading of a common-law remedy in Action No. 1 that is not already available to the attorney general under the statute. It would thus appear that plaintiff in Action No. 1, rather than pleading common-law fraud, is in reality alleging nothing more than a private cause of action which is prohibited under the Martin Act.

In *Kramer*, the First Department noted that the holding against "artful pleading" in *Whitehall* "makes good sense" because, common-law fraud was alleged, and, unlike the attorney general who need not allege or prove either scienter or intentional fraud, "there was no evidence of reliance by the allegedly defrauded shareholder or intent to defraud by the sponsor." The *Whitehall* holding was therefore intended "to prevent an end run around the rule prohibiting a private right of action under the Martin Act" because "a private plaintiff cannot be permitted to bring a cause of action that, although styled as one for common-law fraud, lacks proof of an essential element of common-law fraud."

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Nevertheless, *Kramer* further noted that “the reasoning of *Whitehall Tenants Corp.*... has erroneously been extended to cases in which there is no legitimate reason to question at the pleading stage the ability of the plaintiff to prove all of the essential elements of common-law fraud.”

And *Kramer* went on to say that:

The decisions of this Court after *Whitehall Tenants Corp.* appear to regard as an example of the “artful pleading” first decried in *Whitehall Tenants Corp.* every claim of common-law fraud arising out of conduct that could have been the basis for an action by the Attorney General. Certainly none of those decisions suggest a principled basis for identifying those claims of common-law fraud that would not be regarded as such impermissible ploys.

### The Martin Act

The court said that it is no “end run” around the Martin Act for the plaintiff to have an opportunity to prove the truth of the allegations when all the elements of fraud have been properly pleaded.

In such cases, the court said it “makes no sense” to “throw the plaintiff out of court merely because the attorney general would be entitled to relief under the Martin Act.” In addition, the Court reasoned that, as the Martin Act was enacted to protect the public from fraudulent exploitation and has a broad remedial purpose, to construe the act “to have abolished the right of purchasers of condominium and cooperative interests (and purchasers of other securities) to sue sellers for common-law fraud is to give the Martin Act a construction that is antithetical to its remedial purpose.” Moreover, the court noted, there is not anything in the text of the Martin Act, nor in any decision of the Court of Appeals, that lends support to such a construction.

*Kramer* is a ringing reaffirmation of the rights of condo/co-op apartment owners who purchased their “new homes”<sup>7</sup> essentially sight unseen—before the building construction or conversion was even begun or completed—and in full, complete, and necessary reliance upon the builder developer who is offering the premises for sale. While there is good reason to confine prosecutions, for failing to comply with the Martin Act disclosure requirements, to the jurisdiction of the attorney general, to ensure unified and consistent regulatory enforcement, there

is no good reason to prevent victimized purchasers from recovering damages for very real and palpable injuries incurred in connection with shoddy construction by fraudulent sponsors.

While the First Department in *Kramer* has justifiably re-set the balance between purchasers and sellers of new condominium and cooperative apartments, when fraud is present in the transaction, the decision may also add significantly to the obligation that honest sponsors have to make full disclosure in their offering plans of material defects or needed major repairs to the building.<sup>8</sup> This was actually the issue in the lower court upon which the plaintiffs’ claim foundered, but which the First Department did not discuss in its opinion permitting the *Kramer* plaintiffs to assert their common-law fraud claim.

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### Common-Law Fraud

The plaintiffs in *Kramer* had moved to amend their complaint to allege common-law fraud. However, as Justice Jane Solomon noted in her opinion, which denied plaintiffs’ motion,<sup>9</sup> the plaintiffs’ claim relied principally upon the fact that the sponsor had failed to disclose in the offering plan the transitory construction problems that were experienced while the building was under construction. Justice Solomon noted that, at oral argument, “the court voiced doubt over whether an offering plan should disclose such transitory construction problems.” The plaintiffs then submitted an additional letter argument contending that the sponsor had intentionally withheld the information from the offering plan.

Justice Solomon said that the plaintiffs’ distinction had “some appeal, because the Attorney General does not have to prove scienter to establish a Martin Act violation.” But, she reasoned, “this distinction is unworkable on these allegations, because the nature of the wrong is based on

omissions of legally required disclosures[,] [and] [a]n intentional omission is no less a violation of the Martin Act than a careless omission, and the Attorney General may prosecute both.”

The “doubts” that Justice Solomon voiced at oral argument were based on her concern that the “duty of disclosure sought by the *Kramers* would significantly expand a sponsor’s disclosure obligations and burdens under the Martin Act.” Specifically, the *Kramers* had “maintained that offering plan amendments must also disclose the historical fact that a construction problem occurred, even if the sponsor fixed the problem.” Justice Solomon noted, therefore, that “allowing these fraud claims to go forward would have broad policy repercussions on every sponsor of a condominium project.”

### Conclusion

The First Department apparently had no qualms about the policy implications that bothered Justice Solomon. Nevertheless, in “making sense” of the standing requirements for common-law fraud cases involving real estate offerings, it is clear that the First Department has made it necessary for all sponsors of new condominium and cooperative apartment construction to closely review the disclosures made in their offering plans and plan amendments concerning the problems encountered during the course of construction. Honesty is still the best policy, but the First Department may have just made that policy a lot more expensive.

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1. AD3d \_\_\_, 844 NYS2d 18 (1st Dept. 2007).  
 2. 70 NY2d 268, 519 NYS2d 804 (1987).  
 3. 78 NY2d 1114, 578 NYS2d 128 (1991).  
 4. 213 AD2d 200, 623 NYS2d (1st Dept. 1995), leave denied, 86 NY2d 704, 631 NYS2d 608 (1995).  
 5. See, e.g., *Thompson v. Parkchester Apartments Co.*, 271 AD2d 311, 706 NYS2d 637 (2000) (*Thompson II*); *Thompson v. Parkchester Apartments Co.*, 249 AD2d 68, 670 NYS2d 858 (1st Dept. 1998), leave dismissed, 92 NY2d 946, 681 NYS2d 476 (1998) (*Thompson I*).  
 6. 220 AD2d 295, 632 NYS2d 119 (1st Dept. 1995).  
 7. See General Business Law, Article 36-B, §777(5).  
 8. See 13 NYCRR 20.3.  
 9. 10 Misc3d 1056A, 809 NYS2d 482 (2005).