

Realty Law Digest

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Condominiums—Martin Act Preempted Several, but Not All Claims—Lack of Privity Between Plaintiffs and Architects—Fiduciary Duties—Interstate Land Sales Act—GBL §349

A board of managers and a group of purchasers of commercial condominium units commenced an action against the sponsor, principals of the sponsor (principal) and architect, alleging "construction and design defects." The architect and the sponsor moved to dismiss the complaint. The offering plan (plan) had been accepted for filing by the attorney general on or about April 26, 2006.

The plan contained representations by the sponsor that it would construct the building in accordance with the descriptions and specifications set forth in the plan. The sponsor's obligations under the plan and certification were incorporated into each purchase agreement (agreement). The sponsor further covenanted that correction of any construction defects to the extent required under the plan, are the "sole responsibility of the Sponsor."

The sponsor's contract with the architect provided that nothing in the agreement "shall necessarily create a contractual relationship with or a cause of action in favor of a third party against either the Owner or the Architect." The architect had issued an architect's report (report) as to the then current conditions of preexisting structures, as well as planned modifications. The plan also included a required certification of the sponsors' architect which stated that the architect had read the report, investigated the relevant facts and that such certification was "made for the benefit of all persons to whom this offer is made." The architect also certified that the report described the physical condition of the property as it would exist upon completion, "provided that construction is in accordance with the plans and specifications that [he] examined" and that the report did not "omit any material fact"; "contain any untrue statement of a material fact"; "contain any fraud, deception, concealment, or suppression"; "contain any promise or representation as to the future, which is beyond reasonable expectation or

unwarranted by existing circumstances"; or "contain any representation or statement which was false." The certification noted that it was not intended as a "guaranty or warranty of the physical condition of the property."

A certificate of occupancy (C of O) had been issued by the NYC Dept. of Buildings. The architect certified that it had completed its scope of work in Dec. 2007, prior to issuance of the C of O and had sent its final bill for services on Jan. 15, 2008. A first and second amendment to the plan described certain physical changes in the condominium and contained an addendum to the report. Six subsequent amendments did not identify any physical changes and noted that there were no other "changes to the...plan."

The subject action was commenced on Feb. 22, 2011. The complaint alleged that the design and construction of the condominium were "grossly deficient," with numerous deviations from what was promised to the purchasers and defects caused significant water leak problems. The defects had allegedly been identified in a "limited inspection" conducted by the Sponsor's engineering consultant ['A']." The sponsor's insurance company had allegedly denied coverage because it found "faulty, inadequate and defective construction." The plaintiffs further alleged that construction defects were also identified in a report prepared by "B", an engineer whom they had retained, after gaining control of the Board. "B" allegedly found defects and deviations from the plan, building code violations and conditions which he found to be "sub-industry standard."

The complaint alleged claims for breach of contract against the sponsor and others, breach of duty to build in a skillful and workmanlike manner against the sponsor and others, breach of contract against the architect, the sponsor and others, negligence against the sponsor, architect and others, negligent supervision of construction against the sponsor and others, professional malpractice against the architect, fraud and negligent misrepresentation as against the sponsor and others, fraud and/or negligent misrepresentation against the architect, violation of GBL §349(a) as against the sponsor and others, a violation of 15 USC §1703(a)(2) as against the sponsor and others, conversion against the principals and others and breach of fiduciary duty against the principals and others.

The architect argued that the Martin Act preempted the claims against them.

The Martin Act is a disclosure statute and the attorney general:

is charged with enforcing its provisions and implementing regulations.... A private common-law cause of action for fraud or otherwise...may be brought by a plaintiff where its basis is distinct from the Martin Act and it "is not entirely dependent on the Martin Act for its viability"; the "[m]ere overlap between the common law and the Martin Act is not enough to extinguish common-law remedies" A plaintiff's claims are not preempted by the Martin Act where the plaintiff alleges "not that [the] defendant omitted to disclose information required under the Martin Act but that it affirmatively misrepresented, as part of the offering plan, a material fact about the condemnation"

However, "a private litigant may not pursue a common-law cause of action where the claim is predicated solely on a violation of the Martin Act or its implementing regulations and would not exist but for the statute"

The plaintiffs contended that their claims were based on affirmative misrepresentations, rather than omissions. However, the plaintiffs had failed to allege "what affirmative misrepresentations were made" by the architect. The report and certification "merely use, verbatim, the statutory language mandated by the Martin Act." Moreover, the architect's statements had described the property, as it was to be constructed, and when the certification and report were issued, "no construction had yet taken place" and the architect's statements "could not have been false or negligent at the time that they were made."

The plaintiffs had further alleged that the architect had failed in its "continuing responsibility to oversee construction...in accordance with the building documents and all applicable codes." The plaintiffs cited amendments to the plan and argued that the architect had continued to "stand by the...Report and Certification when they knew, or should have known, with the exercise of due professional care, that their representations were false."

The court explained that such alleged failure could not render the architect's actions "fraudulent or negligent." "A claim for fraud and negligent misrepresentation cannot be maintained where it is based on the failure to disclose facts in amendments which are required only because of the Martin Act...." Since the plaintiffs had based their claims upon omissions in the amendments to the plan, they had improperly asserted "a private cause of action under the Martin Act and are preempted." The court also dismissed the

claims against the architect for negligence and professional malpractice since they were also preempted by the Martin Act.

Additionally, the court dismissed the plaintiffs' breach of contract claim against the architect since the purchasers were merely "incidental third-party" beneficiaries to the contracts between the sponsor and service providers and they had no "standing to bring a breach of contract claim against such contractors...." Here, the plaintiffs were not parties to the contract between the architect and the owner and the plans were "merely incorporated into the larger...plan amid the other numerous provisions. Neither the plans nor any other agreement between the plaintiffs and the Architect, reflect[ed] an intent to specifically benefit the plaintiffs."

Given the absence of privity, or a relationship approaching privity, the court also dismissed the claim against the architects for professional malpractice. The malpractice claim was also barred by the three year statute of limitations. There was no evidence that any services were performed by the architect after it completed work in December 2007. Moreover, the claim against the architects for negligence in the design and oversight of construction was "duplicative" of the invalid breach of contract claim and did not allege any independent cause of action for negligence. Thus, the architect's motion to dismiss the complaint was granted.

The sponsor had argued that its liability for breach of contract was limited pursuant to the terms of the plan and agreements. The plan provided that the plaintiffs accepted the property "as is." The sponsor contended that the theory of "caveat emptor applies and extinguishes the implied warranty that the building and units therein will be free from material defects." The court rejected that argument, noting that the plan provided that the sponsor was responsible for construction and correction of any defects in construction. The purchasers could not have waived their right to sue for breach of contract for construction defects "before the Sponsor...completed construction and before plaintiffs could have possibly conducted meaningful inspections of the premises."

The court also rejected the sponsor's argument that the building had been constructed in conformance with the contract specifications and codes because a C of O had been issued. The plan provided that issuance of a C of O would be deemed "presumptive evidence" that the construction had been completed in accordance with the plans and specifications. However, the plan provided that "nothing herein...shall excuse sponsor

from its obligations to correct any defects in construction in accordance with the condition set forth in the plan."

The sponsor also argued that the plan provided that members of the board would not be liable to purchasers for "any mistake of judgment, negligence, or otherwise, except for willfulness misconduct or bad faith." Such provision explicitly applied to the board, giving the board "business judgment rule" protection. It was inapplicable to the sponsor defendants and did not "shield the Sponsor...from liability for breach of contract." The court also found that the plan's "risk of loss provision" was inapplicable to shield the sponsor from liability for breach of contract. That provision related only to risk of loss from fire or other casualty. Thus, the court denied the sponsor's motion to dismiss the breach of contract claim.

The sponsor also argued that there were insufficient allegations to justify "piercing the limited liability company veil, and [holding the principal] personally liable for breach of contract or fraud." The complaint alleged that the principal controlled and dominated the sponsor as a "personal enterprise" and that it would be inequitable for him to use the limited liability form of ownership structure to perpetuate the wrongs alleged, while transferring to himself, the assets of the sponsor that would otherwise be available for paying the damages suffered by plaintiffs. Even absent a piercing of the limited liability veil, an appellate decision had held that a plaintiff may seek damages for breach of contract against individual principals of the sponsor based upon certification of the plan and incorporation of the terms of the plan in a purchase agreement. Therefore, the sponsor's motion to dismiss the claim against the principal was denied.

As to other claims against the principal, i.e., for fraud, the court held that "at this juncture, there are sufficient allegations...to sustain these claims (to the extent that they are otherwise maintainable) as against [sponsor's principal], individually...." The court also dismissed the claim against the sponsor for breach of duty to build in a skillful and workmanlike manner. Such claim was duplicative of the invalid negligence claim.

Further, the court dismissed the breach of contract claim asserted against the sponsor and architect, which alleged that the sponsor had a duty to know or confirm that the architects had fulfilled their obligations under the architects' agreement and that the principal may be held liable for such conduct. The plaintiffs were merely incidental

third-party beneficiaries and not intended beneficiaries of the contract between the sponsor and the architect.

Additionally, the court dismissed the negligence claims against the sponsor and architect relating to the failure to exercise reasonable care and skill according to the "standard practices in their trades...." The plaintiff had failed to allege that the sponsor had owed them a legal duty outside the contract and it was nothing more than an alleged breach of contract against the sponsor and its principal. This was duplicative of the breach of contract claims and did not allege any independent cause of action for negligence.

The complaint alleged that the sponsor had not merely omitted to disclose information required under the Martin Act, but that the sponsor had affirmatively misrepresented, as part of the plan, material facts. The plaintiffs alleged that the sponsor was aware of building leaks before the sponsor offered the units for sale, but the plan made no disclosure about such leaks or problems with the roofing and windows and that the sponsor repainted unsold units in between rainstorms in order to "make the unsold units look presentable to prospective buyers and renters." The court held that the plaintiffs' fraud claim was not preempted by the Martin Act and denied the sponsor's motion to dismiss such claims.

However, the court further found that a fraud claim was not duplicative of the breach of contract claim and the alleged fraudulent statements did not merely relate to future performance. The plaintiffs had sufficiently pled justifiable reliance on the sponsor's allegedly false representations, in deciding to enter into the agreements and the alleged misrepresentations about the physical conditions were "the direct and proximate cause of the losses claimed."

Moreover, the plaintiffs had pled their fraud claim with the requisite particularity required by CPLR 3016(b). However, the court dismissed the GBL §349 claim since it arose from a "private contractual dispute between the parties without ramification for the public at large."

The court then rejected the sponsor's arguments that federal courts have exclusive jurisdiction over the plaintiffs' claim based on the Interstate Land Sales Full Disclosure Act (ILSA) and that the board lacked standing to bring the ILSA claims on behalf of the

individual unit owners. Such claim was brought by the individual unit owners, not the board. Therefore, the court denied the motion to dismiss the ILSA claim.

The plaintiffs had also alleged a conversion claim against the sponsor based on the principal's wrongful use of funds to pay for items and services that should have been paid for by the sponsor, e.g., an allegedly exorbitant management fee, repairs to the outer walls of the buildings and certain construction work. The plaintiff needed to "show legal ownership or an immediate superior right of possession to a specific identifiable thing and must show that the defendant exercised an unauthorized dominion over the thing in question...to the exclusion of the plaintiffs' rights...."

Here, the plaintiffs did not allege that a "specific identifiable thing" was entrusted to the sponsor's principal. The plaintiffs' claim arose from promises embodied in the plan and sound "in breach of contract." Accordingly, the court dismissed the conversion claim.

Additionally, the plaintiffs had alleged that the principal had failed to act in the best interests of the unit owners in several ways, including failure to keep accurate books and records and causing expenditure of condominium funds and resources on items and services related to the construction of the condominium. As a member of the board, the principal "stood in a fiduciary relationship and was required to act in good faith...."

The court explained that "individual board members may be validly sued for breach of fiduciary duty if the complaint pleads independent tortious acts on the part of those individual directors." The plaintiffs had pled fraud claims as against the principal and "at this early pre-answer stage of the action," the court found that the sponsor had "not shown, as a matter of law, that there is no basis for this breach of fiduciary duty claim against [principal]."

Although the sponsor argued that such claim was merely duplicative of the breach of contract claim, the court found that such claim was based on a breach of duty which was "separate and distinct from plaintiffs' breach of contract claim." Therefore, the court refused to dismiss the breach of fiduciary duty claim.

Comment: Adam Leitman Bailey, who represented the plaintiffs, stated that this decision shows that a sponsor "cannot evade liability for breach of contract based on the 'as is' clause contained within the unit owners' purchase agreements because the agreements were executed prior to the completion of construction and the sponsor

retained responsibility for constructing the building in accordance with the plans and specifications set forth in the Offering plan."

He noted that the court had "rejected the caveat emptor theory" and found that "the common law implied warranty that the building and the units will be free from material defects applies." **Bailey** also observed that the decision permits the plaintiffs to pursue their claim to pierce the limited liability status of the sponsor and seek damages from the sponsors' principal for breach of contract and fraud. Finally, **Bailey** noted that the decision permitted a claim for breach of fiduciary duty against the sponsor's principal based on alleged independent tortious acts.

Counsel for the sponsor defendants... stated that claims survived because of "knowingly false allegations of fact that cannot be decided at this early stage." He also noted, inter alia, that there was an ongoing dispute about the use of the condominium's revenue to pay legal fees for claims relating to the individual unit owners.

The Board of Managers of the 231 Norman Avenue Condominium v. 231 Norman Avenue Property Development, **Sup. Ct., Kings Co., Index No. 4197/11, decided 7/20/12, Demarest, J.**