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Navigating Buyers and Developers Through New Construction Deals

BY ADAM LEITMAN BAILEY AND JOHN M. DESIDERIO

In late 2008, the real estate sky had started to fall and fall quickly. As a result of the loss of financing and wages, many purchasers in contract to buy a unit in a newly constructed building were either no longer able or willing to close on their units. To make matters worse, the credit markets had been greatly curtailing the flow of money into the hands of developers from purchasers. In March 2008, one of the last outposts of lending, Fannie Mae and Freddie Mac, put the brakes on loans to newly constructed buildings by requiring sales of at least 70 percent of a building's units in order for its buyers to obtain a loan. Although this policy later changed to 50 percent and "sold" became "in contract" for most lenders' purposes, the perfect real estate storm became a hurricane when many developers no longer had the capital to deliver the building as promised in the marketing materials. Engineers found serious problems with many structures including in some cases the failure to build in accordance with fire prevention protocols and materials.

This crisis required that all sides battle Goliath in several different forms, and this time David had neither a sling, nor a stone or a sword. So real estate attorneys struck with our pens. We became creative, bold and brave.

The buyers battled the developers and the developers fought off their lenders. Both sides prayed for governmental assistance of varying kinds: (a) from Congress to open the credit markets, (b) from the Department of Buildings to make sure buildings were built safe, and (c) from the attorney general's office to enforce the promises made in the offering plans.

Since neither financial hardship nor changed economic circumstances provide legal grounds for rescinding valid contracts, real estate lawyers enmeshed in this unprecedented set of circumstances, which continue to affect the current market, utilized the legal tools available to them—sophisticated laws and technical arguments from a detailed analysis of legal documents and offering plans—to spur negotiations that would lead to closings, wherever possible, despite the crisis.

The most adept developers realized that, even if a discount had to be made to close a deal, a

Adam Leitman Bailey

John M. Desiderio

sizable portion of their loan could be paid off with the sale of each unit. The majority of developers came to the negotiating table to make deals, and, in many cases, not because of the merits but due to the real necessity of having to put people into the newly constructed homes. The available legal tools became opportunities for both sides to negotiate.

The principal tools for obtaining rescission of a contract or agreements providing discounted prices (while ensuring that a client's largest financial investment was the home he or she was promised) included: (1) The buyers' contract terms; (2) the Martin Act (General Business Law [GBL] §§352, et seq.) and the regulations promulgated under it by the attorney general (13 NYCRR §§20.1 et seq.); (3) the private common law fraud action; and (4) the Interstate Land Sales Full Disclosure Act (ILSA), 15 USC §§1701, et seq.

The Contract Terms

The most obvious tool to reverse a deal is the buyer's contract itself. The typical condo purchase agreement, drafted for the sponsor's benefit, which buyers in almost all cases receive on a "take it or leave it" basis, is designed to bind buyers to the deal and force them to close as early as possible after the issuance of the TCO. Typically, buyers find themselves forced to close, under threat of losing their deposit money, when the building and its promised amenities, in their view, are still in a construction mode. Nevertheless, the condo contract does provide the buyer with one very significant right—the right to a pre-closing inspection of the premises—that may enable the buyer to identify a basis for rescinding the deal.

Sponsors uniformly give buyers the right to one "official" walk-through of the premises before the closing date. Contracts normally require that buyers exercise this right no sooner than one week before the scheduled closing. In many cases, the actual walk-through may take place only one or two days before the closing. Buyers faced with such pressure often find their new "dream" home in hardly "move-in" condition.

Condo contracts provide that the buyers may compile "punch lists" of items that the sponsor agrees to repair or correct after the closing, but condo offering plans exclude from the sponsor's "repair or correct" obligations almost all cosmetic defects found during the walk-through, and, unless a construction defect is deemed "material" and non-reparable after the closing, the attorney general will not require a sponsor to refund a buyer's deposit.

Accordingly, buyers are advised to seek access to the building and to their unit through one or more "unofficial" walk-through inspections, well before their closing date, with a consulting engineer (or team of engineers) capable of inspecting the building's common elements, including its roof, elevators, mechanical, electrical, and plumbing and heating systems. All condo contracts expressly provide that, in addition to the individual unit specified in the agreement, the buyer is also purchasing, together with other buyers in that condo, an undivided interest in all of the building's common elements.

Demand should always be made that the official walk-through include an inspection of the building's roof and other common elements. The buyers' engineers will be looking to determine whether the building-wide systems are in operational condition or materially defective in any way. They will be looking to see if the sponsor's construction exhibits the skillful workmanship required under (a) the Housing Merchant Implied Warranty Law (HMIW) (GBL §§777, et seq.),1 (b) such limited warranty as the law may otherwise permit the sponsor to provide

where the HMIW does not apply, or (c) the common law implied warranty for new home construction.2

In addition, the engineers will be looking for any apparent violations of the Department of Buildings Code and for any material variations from the building's plans and specifications (to the extent disclosed in the architect's description of the building contained in the offering plan).

While sponsors contend that there is no provision in law or in the contract requiring them to permit such an inspection, there also are no provisions in a typical purchase agreement that necessarily preclude buyers from conducting such an inspection during their "walk through." Indeed, such an inspection is nothing less than the "due diligence" that any buyer is obliged to perform before making a lifetime investment in that new home, and which, for lack of doing so, a buyer may otherwise be held bound to his or her purchase "as is."

Sponsors can be expected also to characterize the demand for such an inspection as a "fishing expedition" intended for no other purpose than to find an "excuse" for not closing. However, persons who buy a new automobile at least get to have a "test drive" before driving the car out of the dealership. Moreover, once the sponsor relinquishes control of the building's board of managers, it becomes the responsibility of the residential owner-members of the board to manage and maintain the building for all unit owners. Given that fact, buyers clearly have a right to inspect the building systems they will be responsible for maintaining in the future.

There currently are no legal precedents that either grant or deny the right of the buyer to conduct a pre-closing inspection of the common element building-wide systems. However, in Andesco Inc. v. Page,3 where the buyer contended that the seller had improperly denied it access to the premises to secure financing for the transaction, the First Department held that a question of fact existed as to whether access to the premises had been denied and whether the denial was a material breach of the contract.

More recently, in Alligory Business Ltd. v. 86th & 3rd Owner LLC and Related 86th & 3rd Owner LLC, New York County Supreme Court held (a) that the condo buyers' causes of action for breach of purchase agreement, rescission, and refund of their deposits, for sponsor's refusal to allow inspection of the common elements, could proceed, and (b) that "if plaintiffs prove an entitlement to inspection of the restricted areas, and upon inspection find material noncompliance with the plans and specifications of the building, they may seek to recover damages proved."4 (Emphasis added). (The authors' firm represents the buyers in Alligory.)

The Martin Act

Although buyers may not sue to rescind their contracts due "solely" to omissions from the offering plan of any required disclosures,5 buyers may nevertheless seek refunds of their deposits under terms in their contracts and offering plans that are mandated by the Martin Act and the Attorney General's implementing regulations.

Under 13 NYCRR 20.3, sponsors are required to state in their offering plans (which are incorporated into the purchase agreement) the anticipated commencement date for the first year of condominium operations (i.e., the date of first closing) together with the estimated budget for that first year of operations.

If the actual or anticipated date of commencement of condominium operation is delayed more than six months from the commencement date of the projected budget year, the sponsor is required to amend the offering plan to disclose revised budget projections. In such cases, if the amended budget projections exceed the original projections by 25 percent or more, the sponsor must offer all purchasers the right to rescind and a reasonable time (of not less than 15 days) in which to exercise that right.

In addition, the sponsor is also obliged to offer the buyer the right to rescind if the first closing does not occur within twelve months after the anticipated date stated in the offering plan. For example, if the first year of condominium operations stated in the offering plan was Nov. 1, 2008 through Oct. 31, 2009, but a first closing did not take place within that twelve-month period, the sponsor is obliged (a) to offer all then-current contract vendees the right to rescind, and (b) to amend the offering plan, to include an amended first year of operation and an amended budget projection for that new first year, for all buyers who subsequently sign purchase agreements for that development.

To avoid having to offer the right of rescission for failing to close within the projected first year of operations, some sponsors have appeared to speed up construction to obtain the requisite TCO that enables them to implement the first closing within the twelve-month period projected in their plan. Such speeding-up of construction often results in shoddy finishing that causes great dissatisfaction and cause for complaint even among buyers who do not wish to back out of their contracts.

In such cases, there is often reason to suspect that the "first closing' within the twelve-month period was done with an "insider" friend of the sponsor and is therefore a sham closing. Where such sham first closings can be documented, rescission of all contracts necessarily follows, and the sponsor's subsequent development activities receive special scrutiny and oversight from the attorney general.

However, unless the connection between the sponsor and the "insider" is undeniable, the sham nature of the "first closing" must be proven through litigation in a private law suit or through the attorney general's dispute resolution process. The rule prohibiting a private cause of action under the Martin Act does not preclude a private cause of action for common law fraud where it is alleged that the sponsor has engaged in a deceptive course of conduct not consisting "solely" in having failed to comply with Martin Act disclosure requirements.6 Fraudulent conduct will also subject the sponsor to liability under New York's Deceptive Practices Act (GBL Article 22-B, §§349-350).7

The Interstate Land Sales Act

In 2009, buyers' attorneys in New York, for almost the first time in nearly forty years, had reason to seek the protections and remedies provided to their clients by ILSA.

ILSA is a federal consumer protection statute that is intended to protect purchasers of new residential housing that purchasers contract to buy prior to the completion of construction. It applies to all condominiums that are not exempted from the act, and it is a "strict liability" statute that (a) mandates certain registration, disclosure, and contractual requirements, and (b) prohibits fraudulent and misleading sales practices.

Where ILSA applies, sponsors who have violated its provisions are liable to refund all of the moneys received from buyers who revoke their contracts within two years of the contract's execution date, and buyers may sue, within three years of the contract signing, to recover the moneys paid to the sponsor, plus costs and reasonable attorney's fees. ILSA provides buyers' attorneys with a powerful new weapon to use against the sponsor.

The primary ILSA violations that provide buyers with the right to revoke the contract and obtain a full refund of their deposit moneys are: (1) failure to give the buyer, in advance of signing the purchase agreement, a property report containing information required by federal HUD regulations, (2) failure to include in the contract a description of the property being purchased that is acceptable for recording in the jurisdiction in which the property is located,8 and (3) failure to include a provision in the contract clearly stating that, in the event of a buyer's default, after the buyer has paid 15 percent of the purchase price, the seller is obligated to refund any amount remaining after subtracting (A) 15 percent of the purchase price,

excluding any interest owed under the contract, or the amount of damages incurred by the seller as a result of the breach, whichever is greater, from (B) the total amount paid by the buyer, excluding interest.

ILSA had been virtually unknown to most New York real estate attorneys since its initial enactment in 1968. While there are many reported decisions (in both federal and state courts) in cases brought under the act in other states, there are only a handful of New York cases involving ILSA. There is not yet an authoritative body of New York federal or state case law interpreting ILSA's application to New York real estate transactions. Whether newly constructed New York condominiums are exempt from ILSA is a question that is likely to be much litigated in New York courts over the next few years.9

Conclusion

New York real estate attorneys have used each of the legal tools noted in this article to negotiate substantial price discounts and partial deposit refunds for their buyer clients. Faced with meeting urgent financial obligations to construction lenders, and needing to complete the most sales possible, to avoid possible bankruptcy and loss of their investments, many developers have been willing to negotiate contract price reductions. They have been less willing to provide deposit refunds (except for refunds required in the circumstances specified above under the Martin Act or the partial refunds to defaulting purchasers mandated by ILSA).

However, the most financially sound developers have stood fast and forced purchasers to resort to litigation to obtain redress. Many of these litigations remain pending. Whatever their ultimate result, the outcome in these cases is likely to have great impact on the rights of developers and purchasers in the New York real estate market for many years to come.

Endnotes:

1. See Fumarelli v. Marsam Development Inc., 92 NY2d 298 (1998) (for buildings of five stories or less).

2. See Caceci v. DiCanio Construction Corp., 72 NY2d 52 (1988) (for buildings of six or more stories),

3. 137 AD2d 349, 530 NYS2d 111 (1st Dept. 1988).

4. Slip Opinion, at 5. Index No. 601824/2009 (Sherwood, JSC). (Adam Leitman Bailey, P.C. represented the buyers in Alligory).

5. See Kerusa v. W10Z/515 Real Estate Limited Partnership, 12 NY3d 236 (2009).

6. See Board of Managers of Woodpoint Plaza Condominium v. Woodpoint Plaza LLC, Index No. 12579/06 (Supreme Court, King's County, 8/10/09) (Demarest, J.) 24 Misc.3d 1233A, 2009 WL 2432346.

7. See, e.g., B.S.L. One Owner Corp. v. Key International Manufacturing Inc., 225 AD2d 643, 640 NYS2d 135 (2d Dept. 1996).

8. See 15 USC §1703(d)(1). Given N.Y. Real Property Law §339-o (requiring all condominium unit conveyances to include "liber, page and date of recording of the declaration"), it is an open question whether any New York condo contract's property description can be deemed a valid legal description acceptable for recording before the filing of the condo declaration.

9. See, e.g., Bodansky v. Fifth on the Park Condo, LLC, 2010 WL 334985 (S.D.N.Y. 2010).

Adam Leitman Bailey *is the founding partner of Adam Leitman Bailey, P.C., and* ***John M. Desiderio****, a partner in the firm, is the chair of the firm's real estate litigation practice group.*