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Fraud Claims in Purchase And Sale Transactions


By **Peter E. Fisch**
And **Salvatore Gogliormella**

In allocating responsibility for losses and liabilities, parties to a real estate transaction rely on express contractual provisions that are negotiated for the transaction at hand, guided by legal principles that apply to transactions generally. In an agreement for the purchase and sale of real estate, the seller customarily makes representations about matters such as its ability to enter into the transaction, litigations affecting the seller or the property, leases and other agreements affecting the property, the seller's disclosure of environmental reports for the property, title to the personal property used in connection with the real estate, and notices from governmental authorities regarding condemnations, assessments and violations with respect to the property.

The buyer, in turn, typically disclaims reliance on actions or statements other than the seller's express representations in the agreement and the buyer's own due diligence. In this way, the seller seeks to limit its exposure to matters that lie within its knowledge and control and that it has had an opportunity to vet, and the buyer seeks to make the seller disclose—and to establish a right to sue the seller after closing for failing to disclose—matters that the buyer is generally unable to uncover through its independent diligence.

Even if the seller did in fact intentionally misrepresent material facts in the manner alleged by the buyer, the buyer's ability to prevail on its claim will depend on the provisions of the contract signed by the parties and on principles of law.

In striking this balance, however, the parties are not always aware of the interaction between these contractual provisions and the principles of law operating in the background, particularly laws pertaining to fraud.

A party that acquires real property and subsequently uncovers defects or problems affecting the property may assert that the seller committed fraud in connection with the sale of the property. Even if the seller did in fact intentionally misrepresent material facts in the manner alleged by the buyer, the buyer's ability to prevail on its claim will depend on the provisions of the contract signed by the parties and on principles of law.

The general rule in New York is that "a claim for fraud is barred by the existence of a specific disclaimer and failure to exercise reasonable diligence." *Steinhardt Grp. Inc. v. Citicorp*, 272 A.D.2d 255 (2000). This rule was articulated by the New York Court of Appeals in the case of *Danann Realty Corp v. Harris*, 5 N.Y.2d 317 (1959), and remains the approach followed by New York courts today.

The first prong of the *Danann* rule (as it is sometimes called) focuses on whether language in the parties' written agreement disclaims with sufficient specificity the buyer's reliance on the false statement allegedly

PETER E. FISCH *and* SALVATORE GOGLIORMELLA *are partners at Paul, Weiss, Rifkind, Wharton & Garrison.* SAMI KATTAN, *a law clerk at the firm, assisted in the preparation of this article.*

made by the seller. As noted by the *Danann* court, a "general and vague" provision in the agreement would not bar a claim for fraud. 5 N.Y.2d at 320.

For example, a so-called "merger" clause in a contract for the sale of a property—providing that the entire agreement between the parties is set forth in the contract and that any other understandings between them are "merged" into and superseded by the contract—would not preclude the buyer from prevailing on a claim that oral misrepresentations by the seller about the property fraudulently induced the buyer to enter into the contract. *Id.*

The same is true of a clause categorically stating that there are no representations other than those expressly set forth in the contract. *Id.* Similarly, a so-called "as-is" clause (stating generally that a buyer is acquiring title to the property in its existing state with whatever defects it may have) is not sufficient to bar a claim of fraud. *Schooley v. Mannion*, 241 A.D.2d 677 (1997).

In *Schooley*, the Appellate Division reversed a trial court's dismissal (for failure to state a cause of action) of buyers' claim of fraud regarding the insulation in an apartment building, noting that, while the contract contained an "as is" clause, it did not "specify that they were *not* relying upon any representations as to the physical condition of the property …, let alone any representations made regarding the installation of insulation." 241 A.D.2d at 678 (italics in original).

In contrast, a more robust disclaimer that squarely covers the particular matter as to which the seller allegedly defrauded the buyer, undermines the buyer's ability to show that it relied on the seller's statements and so bars a claim that those statements were fraudulent.

In *Danann*, for example, the fact that the contract at issue specifically stated that the seller did "not make any representations as to the…rents, leases, expenses, operation or any other matter or thing" relating to the property "destroy[ed] the allegations" by the buyer that the seller had misrepresented the operating expenses and profits associated with the property. *Id.* at 320-321.

Buyers and sellers of real estate must consider how legal principles pertaining to fraud might affect sellers' liability for any false statements made in the context of their transactions.

More recently, in *JMC Northeast Corp. v. Porcelli*, 100 A.D.3d 552 (2012), the Appellate Division held that a similar contractual disclaimer "as to the past, present or prospective income or profits" of a business barred a claim of fraudulent misrepresentation as to the revenues, expenses and net profits of the business.

Even if an agreement for the purchase and sale of real estate specifically disclaims reliance by the buyer on certain representations by the seller, the buyer may prevail on a claim that that those representations were fraudulent if the buyer did not fail to exercise reasonable diligence. Under this second prong of the *Danann* rule, courts look at whether the subject matter of the alleged fraud lies "peculiarly within the [seller]'s knowledge," such that reasonable diligence on the part of the buyer would not uncovered the fraud. *Danann*, 5 N.Y.2d at 322.

In *Schooley*, the court concluded that a defect regarding insulation was peculiarly within the seller's knowledge, noting that the seller had "recently gutted and renovated the entire property" and that "insulation is a nonvisible component, not easily verified without destructive testing." 241 A.D.2d at 678. Similarly, in the case of *TIAA Global Investments, LLC v. One Astoria Square LLC*, 127 A.D.3d 75, 88 (2015), the court affirmed a lower court's denial of sellers' motion to dismiss the buyer's claim of fraud regarding air infiltration and insulation in an apartment building, concluding that it was unclear whether "it would truly have been *practical* for [the buyer], prior to taking possession of the building, to do the requisite testing, some of it possibly destructive, that would have been necessary to reveal the alleged defects." The court also noted that this "special facts" doctrine applies "regardless of the level of sophistication of the parties." 127 A.D.3d at 87.

Of course, it is not always the case that a seller is aware of key facts to which the buyer does not have effective access. For instance, the *JMC Northeast* court held that a buyer's independent knowledge of the purported inaccuracy precluded the buyer from demonstrating that it had justifiably relied on the list of expenses or general ledger

provided by the sellers. 100 A.D.3d at 553.

Rather than risk being barred from claiming fraud, buyers of real estate frequently preserve their right to bring an action for fraud by expressly carving fraud out of the disclaimers in their contracts. A recent case offers a useful example of how a New York court is likely to treat such a carveout. In *470 4th Ave. Fee Owner, LLC v. Adam America LLC*, No. 595126/2020, 2020 WL 5893744 (2020), the plaintiff alleged, among other things, that it had been fraudulently induced to enter into a contract to acquire a luxury residential building in Brooklyn.

The seller argued, among other things, that a broad waiver and release in the contract precluded the buyer from asserting a claim of fraud. The waiver and release in question contained the following carveout: "Notwithstanding anything to the contrary set forth in this agreement, the release set forth herein does not apply to … any act constituting fraud by Seller."

The trial court described this carveout as "integral" and concluded that such a carveout "undermines" and "militates against" an argument that the buyer is barred from claiming fraud. 2020 WL 5893744 at *5. In affirming the trial court's denial of the seller's motion to dismiss the fraud claim, the Appellate Division agreed that "the fraud claims also fall within the carve-out to the PSA…which specifically states that it does not apply to any acts constituting fraud." *470 4th Ave. Fee Owner, LLC v. Adam Am. LLC*, 205 A.D.3d 512, 513 (2022).

While we are not aware of a study tracking the prevalence of these fraud carveouts in agreements for the purchase and sale of real estate, studies by the American Bar Association found that the contracts entered into by parties to private mergers and acquisitions (M&A) typically contain disclaimers of representations not expressly set forth in those contracts and that there was a steady and pronounced increase in the use of fraud carveouts to those disclaimers in recent years—from 2% in 2015 to 17% in 2017 and to 54% in 2019.

A likely factor in that increase is the requirements of insurers that commonly provide representation and warranty insurance to buyers in M&A transactions and expect the right to pursue sellers for fraud by exercising the insurers' subrogation rights in the event of claims under the policies. If the use of representation and warranty insurance continues to grow in real estate transactions, we may see an increase in the prevalence of fraud carveouts in real estate contracts.

Interestingly, the most recent study (from 2021) in the same series conducted by the American Bar Association found an appreciable drop (to 35%) in the use of fraud carveouts in private M&A transactions. While the reason for the drop is unclear, we note that there has been some criticism of the use of fraud carveouts.

For example, a 2014 article by Glenn D. West in *Business Lawyer* (entitled "That Pesky Little Thing Called Fraud: An Examination of Buyers' Insistence Upon (and Sellers' Too-Ready Acceptance of) Undefined 'Fraud Carve-Outs' in Acquisition Agreements") argues that such carveouts risk rendering meaningless agreed-upon contractual limitations (such as the scope of sellers' representations, the period of their survival, and caps and baskets with respect to the sellers' liability) and exposing sellers to open-ended liability for a myriad of claims that may or may not be related to the representations they make in their contracts.

The article also notes that the word "fraud" by itself is an "elusive and shadowy term" that may encompass a range of activity that extends beyond deliberate lying. A claim of fraudulent inducement under New York's common law involves misrepresentation of a material fact intentionally made to deceive the claimant that was justifiably relied on by the claimant and resulted in injury to the claimant. *Channel Master Corp. v. Aluminium Ltd. Sales, Inc.*, 4 N.Y.2d 403, 406-407 (1958). However, the term "fraud" in isolation may be read to include equitable concepts with looser requirements.

Buyers and sellers of real estate must consider how legal principles pertaining to fraud might affect sellers' liability for any false statements made in the context of their transactions. In particular, they should consider whether and how to address claims of fraud in the negotiation of their agreements.