COMMERCIAL LEASING LAW & STRATEGY

MARCH 2019

'Sophisticated' Losers

By Joseph I. Farca

Your attorney just emailed you a copy of a court decision in your fraud case against a landlord who leased you space that you subsequently learned could not legally be occupied for your intended use. If the court decision called you "sophisticated," it was probably not intended as a compliment, but instead signaled the death knell of your fraud claim.

What's in a name? "Sophisticated" parties who cry "fraud" when they believe they did not receive the full benefit of their bargain are often turned away by the courts because they could and should have conducted due diligence before signing or closing on their contract.

New York: The Sophisticated

New York's fraudulent misrepresentation rule appears relatively simple on its face. It requires the complaining party to establish five elements, sometimes colloquially referred to as the "five fingers of fraud":

1. A representation regarding a material fact;
2. Which was false;
3. Which was made with the intent to deceive;
4. And on which the complainant reasonably relied;
5. To his detriment.

See, Channel Master Corp. v. Aluminium Limited Sales, Inc., 4 NY2d 403, 407 (1958).

New York law requires that a fraud claim state "the circumstances constituting the wrong … in detail." CPLR 3016(b). *See, Eurycleia Partners, LP v. Seward & Kissel, LLP*, 12 NY3d 553 (2009) (there is no requirement of "unassailable proof" at the pleading stage, but the complaint must "allege the basic facts to establish the elements of the cause of action"). If tenant's attorney can write, and if the landlord really misled the tenant about whether the space is legal for tenant's use, drafting the complaint will not be the problem.

Long ago, New York's high court gave succor to the purchaser who bought a farm in reliance on the seller's false representation that he kept there 100 head of cattle and 16 horses. In *Schumaker v. Mather*, 133 N.Y. 590 (1892), the buyer learned too late that the farm could not support that much livestock, and sued for fraud. The high court upheld a jury's verdict of fraud, finding that the buyer reasonably relied on the seller's false representation, stating:

> [T]he particular representation made by Mather to induce the purchase of his farm was as to a material fact, affecting the quality of the farm and its actual value for a certain purpose, and which lay peculiarly within his knowledge. It is difficult to see how the exercise of common prudence and the use of ordinary intelligence, or of the faculty of sight, would have enabled plaintiff to detect the falsity of Mather's statement, and, therefore, why she was not entitled to rely absolutely upon it.

Since the misrepresentation in *Schumaker* was as to a fact within the seller's knowledge that the purchaser's due diligence would not suffice to ascertain, the purchaser was able to establish reasonable reliance on that misrepresentation.

In modern-day commercial leasing, the landlord's first line of defense in such cases would be the "no representations" and merger clauses of the lease. The Real Estate Board of New York's (REBNY's) lease forms contain a "No Representations by Owner" paragraph which provides, in sum, that the landlord makes no representations, the tenant takes the premises "as is," and that all understandings and agreements are contained in the lease. That's usually enough to send the tenant packing when he complains that he can't get the municipal approval or license he needs to run his business in the premises.

But what if you can show that the landlord knew all along, for example, that the building's Certificate of Occupancy would not permit the tenant to engage in the very use for which the lease expressly provides that tenant may use and occupy the property? The answer for "sophisticated" plaintiffs is a resounding "too bad."

In *HSH Nordbank AG v. UBS AG*, 95 A.D.3d 185, 194-95 (1st Dept. 2012), the Court reiterated that:

> … "'[a]s a matter of law, a sophisticated plaintiff cannot establish that it entered into an arm's length transaction in justifiable reliance on alleged misrepresentations if that plaintiff failed to make use of the means of verification that were available to it' " …

In that case, the court explained as follows:

> The principle that sophisticated parties have "a duty to exercise ordinary diligence and conduct an independent appraisal of the risk they [are] assuming" [citations omitted] has particular application where, as here, the true nature of the risk being assumed could have been ascertained from reviewing market data or other publicly available information [citations omitted].

Since a building's Certificate of Occupancy is a matter of public record available to anyone, a commercial tenant who fails to investigate it to determine whether it permits the tenant's intended use will be out of luck.

But what of the "unsophisticated" commercial tenant?

Who is 'Unsophisticated?'

In *Jack Kelly Partners LLC v. Zegelstein,* 140 A.D.3d 79 (1st Dept. 2016), the court left open the door to a commercial tenant seeking to rescind a lease on the grounds of fraud or frustration of purpose where the Certificate of Occupancy allowed only residential use, not commercial use. Notably, nowhere in the court's opinion is the word "sophisticated" used, either affirmatively or negatively, though there is no indication that the tenant was anything but.

Moreover, and in contrast to its holding in *HSH Nordbank* that, as a matter of law, a "sophisticated" plaintiff cannot establish justifiable reliance on alleged misrepresentations, the court in *Jack Kelly* turned that notion on its head, holding that:

> … as a matter of equity, defendants should not be able to hide behind the "no representations" clauses included in the lease while at the same time having represented to plaintiff that the premises are suitable for commercial use, and in fact stating in the lease that plaintiff's use of the space as an office is "deemed to be a material inducement to the Landlord to enter into this Lease" and that tenant shall use the space for "no other purpose." The same paragraph provided that the parties "agree … that any use or occupancy by Tenant of the Demised Premises for a purpose not specifically set forth above shall be deemed a material default by Tenant." Under this scenario, plaintiff was in "default" immediately upon the execution of the lease since the stated commercial use was in violation of the CO, an incongruous result.

Jack Kelly Partners, *supra*, 140 A.D.3d at 84-85.

Note also that the court in *Jack Kelly Partners* expressly refused to give effect to the "no representations" clauses of the lease, instead construing other, apparently inconsistent lease clauses as constituting superseding representations.

Perhaps betraying the result-oriented nature of the court's decisions in such cases is the sentence in *Jack Kelly Partners* which follows:

> Of course, "[t]here is no hard and fast rule on the subject of rescission, for the right usually depends on the circumstances of the particular case" [citation omitted].

And that's when the court in in *Jack Kelly Partners* opened the door wide for the tenant to make out a case for rescission, even without all five fingers of fraud, by stating:

> Further, fraud sufficient to support the rescission requires only a misrepresentation that induces a party to enter into a contract resulting in some detriment; proof of scienter is not necessary and even an innocent misrepresentation is sufficient for rescission [citations omitted]. Accordingly, even assuming defendants were truly unaware that the CO prohibited commercial use of the premises and made an innocent misrepresentation, rescission may be appropriate (*see, e.g., New Talli Enters., Inc. v. Van Gordon,* 2003 N.Y. Slip Op. 51066(U) [Civ.Ct., Richmond County 2003] [granting rescission of a lease where, unbeknownst to the parties, use of premises not permitted under the CO, even though the lease included boilerplate provision that the landlord had made no promises or representations with respect to the demised premises]).

And as if that were not enough, the court in *Jack Kelly Partners* effectively advocated for the tenant by augmenting its causes of action to include frustration of purpose, stating:

> Finally, as an alternative consideration, there is an issue of fact as to whether the lease should be terminated on the ground of frustration of purpose. In order to invoke this defense, "the frustrated purpose must be so completely the basis of the contract that, as both parties understood, without it, the transaction would have made little sense" [citations omitted]. Here, without the ability to use the premises as an office, the transaction would have made no sense, and the inability to lawfully use the premises in that manner combined with defendants' alleged failure and refusal to correct the CO constitutes a frustration of purpose entitling plaintiff to terminate the lease (*see, Elkar Realty Corp. v. Kamada,* 6 A.D.2d 155, 175 N.Y.S.2d 669 [1st Dept.1958], *lv. dismissed* 5 N.Y.2d 844, 181 N.Y.S.2d 786, 155 N.E.2d 669 [1958]; *see also, Two Catherine St. Mgt. Co. v. Yam Keung Yeung,* 153 A.D.2d 678, 544 N.Y.S.2d 676 [2d Dept.1989] ["Since the intended purpose of the lease may have become impossible to effectuate through no fault of the defendant tenant, he may have been entitled to terminate the lease"]).

Conclusion

What can we learn from these cases? That the answer to the question of who wins often depends on how the parties appear or are portrayed to the court: If the court does not feel moved to do your client any favors, it will call him “sophisticated.”

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