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ASK THE FORMER REGULATOR

Expert Analysis

When Is Rescission Warranted Under the Martin Act?

By
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Question: I am an attorney representing a sponsor of a new construction condominium. We are preparing for a changing market and would like to understand when rescission is warranted under the Martin Act. Can you explain?

Answer: While there are in fact some instances where rescission must be offered to purchasers as of right, there is also the materiality standard that applies to offerings governed by the Martin Act—New York's blue sky law. I will try to give you a general overview of instances where the Department of Law regulations expressly provide for rescission, as well as some important cases that discuss the materiality standard under the Martin Act.

As with any analysis, we need to start with the statute. N.Y. Gen. Bus. Law §352-e, et. seq., governs the offer and sale of new construction condominium units in New York. The Martin Act is a disclosure statute meant to afford prospective purchasers the necessary information to make an informed decision on whether to purchase or not. Moreover, the "Part 20 Regulations" at 13 NYCRR Part 20—regulations governing newly constructed, vacant or non-residential condominiums—requires every sponsor to explain that the purpose of an offering plan is to set forth all the material terms of the offer. See 13 NYCRR §20.3(d)(1).

The Part 20 Regulations have some specific instances where rescission must be offered, as well as a broad category for rescission rights when there is a "material adverse change" to the existing disclosures in the offering plan. A summary of the rescission rights follows:

- **Failure To Timely Escrow Down Payments.** The regulations require that the escrow agent notify the purchaser that the down payment has been placed in escrow within 10 business days of the date the escrow agreement is signed. If the purchaser does not receive such notice within 15 business days after the tender of the deposit, the purchaser may cancel the purchase agreement and rescind within 90 days after the tender of the deposit.

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It should be noted that rescission will not be afforded if proof satisfactory to the Attorney General is submitted establishing that the funds were in fact escrowed and the requisite notice was timely mailed to the purchaser as required herein. See 13 NYCRR §20.3(o)(3)(iv).

• **Delay in Commencement of First Year of Operation Projected in Schedule B.** Every offering plan includes a budget for the first year of operation, and such budget has a projected timeframe for commencement. If the first year of operation is delayed 12 months or more, sponsor must offer purchasers rescission. See 13 NYCRR §20.3(o)(12). Moreover, if the first year of operation is delayed by six months, the sponsor must update the offering plan and disclose any changes to the projected first year of operation. If the budget projections exceed original projections by 25% or more, the sponsor must offer all purchasers a 15-day right to rescind. See 13 NYCRR §20.3(h)(1). It should be noted that the Department of Law has issued guidance on these rescission rights. The May 18, 2012, memo titled "Delay in First Closing in Newly-Constructed Condominiums and Rescission" provides guidance on when a first closing is in fact bona fide, disclosure requirements regarding first closings and how changes to the first year of operation impact rescission rights. Most notable in the May 18, 2012 memo is the ability of a sponsor to tie rescission rights to buyers based upon the disclosed projected first year of operation on the date the contract of sale was executed by the purchaser. Therefore, it is possible to have varying rescission rights under an offering plan based upon the projected first year of operation in effect at the time of contract signing. This drives home the importance of promptly updating the offering plan to disclose any changes to the budget as soon as the sponsor becomes aware of the changes.

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• **Seven-Day Period To Review the Offering Plan.** While most sponsors and selling agents ensure that a purchaser is provided the offering plan in advance of signing the purchase agreement, there may be instances where that does not happen. In the event a purchaser is not provided at least three business days to review the offering plan and all filed amendments prior to execution of a purchase agreement, sponsor must provide the purchaser a seven-day right to rescind. The purchaser must provide to either sponsor or selling agent written notice of election of the right to rescind within the seven-day period. See 13 NYCRR §20.3(x)(15)(i).

• **Material Adverse Changes**. 13 NYCRR §20.5(a)(5) states that "[i]f there is a material amendment to the offering plan that adversely affects purchasers, sponsor must grant purchasers a right of rescission and a reasonable time that is not less than 15 days after the date of presentation [of the amendment] to exercise the right." Materiality is not defined in the Martin Act or regulations, and must be gleaned from case law. In most cases, sponsors are disclosing new information in an amendment

that the Department of Law may deem material. Therefore, it is important to look at seminal cases about material omissions in an offering plan (vs. misrepresentations).

The New York Court of Appeals in *State v. Rachmani*, 71 N.Y.2d 718, 726 (1988) provides the best roadmap for determining when a new disclosure is deemed material and therefore warranting rescission. In determining whether an omission was material under the Martin Act, the Court of Appeals relied on federal securities laws and set the test for materiality as requiring: "a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed *actual significance* in the deliberations of the reasonable [purchaser]. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the *'total mix'* of information made available" (emphasis is original).

The recent decision in *People v. Exxon Mobile*, Index No. 452044/2018 (N.Y. Sup. Ct. N.Y. Cnty. Dec. 10, 2019) has restated the standard set forth in *Rachmani*, applying same to a case of alleged affirmative misrepresentation:

> [I]n addition to falsity, a Martin Act claim requires proof of materiality … "[a] statement or omission is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to act." In other words, courts must determine whether there is a "substantial likelihood that the [misrepresentation or the] disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." "The standard of a 'reasonable investor,' like the negligence standard of a 'reasonable man,' is an objective one." The "total mix" of information looks to "the sum of all information reasonably available" to investors …. a material misstatement must assume "actual significance in the deliberations of the reasonable shareholder." (Citations omitted).

While both *Rachmani* and *Exxon Mobile* set a relatively high standard for when new information should be treated as materially adverse, the Department of Law takes a very conservative approach on when new information is material. Therefore, my best guidance is to get in front of any change that could be deemed material as quickly as possible to try and lessen the impact.

While a changing market can be stressful, it is not necessarily grounds for rescission. As discussed above, the Part 20 Regulations have only a few instances where rescission must be offered, and those instances are easy to plan ahead for. The biggest issue is the disclosure of materially adverse information, but as held by the highest court in New York, materiality is a high standard, and your best defense is to get ahead of any change, whether material or immaterial, as quickly as possible. The sooner new information is disclosed the better.

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