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ASK THE FORMER REGULATOR

Expert Analysis

‘Grossing Up’ and ‘Seller Concessions’: Advice for Sponsors

By
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Question: *I am a sponsor of a new construction condominium in New York City. I have received mixed messages on whether “seller concessions” and “grossing up” are permissible. Can you explain what is legal under the Martin Act?*

Answer: This is definitely an issue that I grappled with as Chief of the Real Estate Finance Bureau. Although there is no official Department of Law guidance on the subject, I’ll give you the same advice now that I would have given you back when I was a regulator.

First, some background: The Martin Act is New York’s blue sky law that protects the purchasing public from fraudulent and misleading conduct in the advertisement, distribution, exchange, transfer, sale, and purchase of real estate securities. See *Caboara v. Babylon Cove Development*, 54 A.D.3d 79 (2d Dep’t 2008); *Kralik v. 239 East 79th Street Owners*, 5 N.Y.3d 54 (2005).

A “seller’s concession” is simply a credit given to the purchasers at closing often applied to closing costs, repairs or other expenses.

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“Grossing up” is when the seller increases the sales price in an amount equivalent to the amount of the seller’s concession.

Generally, there are four types of scenarios where you will see grossing up or seller concessions, and each must be treated differently when selling condominium units under an offering plan:

- **Scenario One:** Grossing up a sales price to create the illusion of a higher purchase price than what the open market can bear. An example would be where a sponsor enters into a purchase agreement for $5,000,000—even though the buyer will only pay a purchase price $4,500,000—with a side deal to give the buyer a credit of $500,000 as long as the buyer agrees in the purchase agreement to pay $5,000,000 at closing. This is the most egregious form of grossing up, and would likely be treated as a violation of the Martin Act.
- **Scenario Two:** Grossing up the purchase price for legitimate seller’s costs (such as transfer taxes or other fees that sellers are normally responsible for) that are then passed along to the buyer. As long as this is disclosed in the offering plan, purchase agreement, closing statement, and the public ACRIS transfer tax forms, this practice is legal and has been a common practice for years.
- **Scenario Three:** Grossing up the purchase price to accommodate a buyer oftentimes in need of financing. For example, a sponsor agrees to sell a unit for $1,000,000, yet the buyer needs $50,000 to cover closing costs. The sponsor enters into a purchase agreement for $1,050,000, thereby affording buyer the ability to borrow the $50,000 needed to consummate the sale. For ethical reasons, an attorney involved with the transaction must ensure that this practice is disclosed in the purchase agreement, closing statement, and the public ACRIS transfer tax forms along with the following statement: “The purchase price reflects an increase equal to the amount of the seller’s concession.” It’s best for the

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sponsor's attorney to also disclose this practice in the offering plan, to ensure that the Attorney General does not view it as a violation of the Martin Act.

- **Scenario Four:** Agreeing to a purchase price and later giving the buyer a credit for a concession prior to closing, usually for the sole purpose of consummating the sale. For example, a sponsor agreed to sell a unit to a buyer for $1,000,000, but failed to install the California Closet that the buyer was promised. Instead of delaying the closing, the buyer agrees to a credit of $15,000 at closing, and will pay for and install the California Closet directly. This seller concession should be disclosed in the purchase agreement, closing statement, and the public ACRIS transfer tax forms. Like Scenarios 2 and 3 above, this is also likely not a Martin Act issue.

Numerous *Ethics Opinions* issued by the New York State Bar Association have discussed the issue of grossing up and seller concessions. See New York State Bar Association Committee on Professional Ethics Opinion #817 (Nov. 2, 2007), #882 (Oct. 14, 2011), and #993 (Nov. 13, 2013). While a common industry practice, this does not change the fact that lawyers are ethically forbidden from engaging in any conduct that involves dishonesty, fraud, deceit or misrepresentation. See Rule 8.4(c) of the New York Rules of Professional Conduct. And all sponsors of condominium offerings (and principals of sponsors) are held to a very similar standard under the Martin Act.

Interestingly, neither the Martin Act nor its governing regulations regulate price. In fact, the regulations require disclosure in every offering plan, "[t]hat the prices are not subject to approval by the Department of Law or any other government agency." 13 N.Y.C.R.R. § 20.3(d)(9). However, this should not be read to mean that the Martin Act does not govern the grossing up of a sales price.

While the regulations may shy away from regulating price—something that makes sense under a disclosure statute—it is important to keep in mind the plain language of the Martin Act. For instance, N.Y. Gen. Bus. Law §352-c(1)(c) states:

"It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, to use or employ any of the following acts or practices: (a) Any fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale; (b) Any promise or representation as to the future which is beyond reasonable expectation or unwarranted by existing circumstances; (c) Any representation or statement which is false, where the person who made such representation or statement: (i) knew the truth; or (ii) with reasonable effort could have known the truth; or (iii) made no reasonable effort to ascertain the truth; or (iv) did not have knowledge concerning the representation or statement made; where engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from this state of any securities or commodities, as defined in section three hundred fifty-two of this article, regardless of whether issuance, distribution, exchange, sale, negotiation or purchase resulted."

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A zealous regulator could easily shoehorn grossing up as described in the first scenario above into the criminal provisions of the Martin Act, and find a sponsor guilty of a misdemeanor or felony for engaging in this practice. This is because the Martin Act is liberally construed when employed to protect the public from fraud. See *State v. Rachmani*, 71 N.Y. 2d 718 (N.Y. Ct. App., 1988). To hold a sponsor liable for violations, the Martin Act merely requires the Department of Law to demonstrate that the sponsor was materially misleading. Id. at 726. Moreover, the Martin Act does not require a finding of intent or reliance to establish a claim for fraud (see *People v. Federated Radio*, 244 N.Y. 33, 38 (N.Y. Ct. App., 1926)), which means that the reasons for grossing up, as well as the reliance on grossed up prices by another buyer in paying more for a similar unit, are irrelevant.

Therefore, my advice to sponsors is to limit grossing up to scenarios two and four above, and make sure everything is properly papered. Under no circumstances would I permit the first scenario. And, for the third scenario (a sponsor selling units where buyers will need to gross up for purposes of obtaining financing), I would require clear disclosures in the offering plan as well as the other sale documents. Moreover, I would only do so in situations where the lender understands the ethical disclosure requirements and has agreed in advance that the practice will be included in the purchase agreement and closing documents.

"This column is for informational purposes only and is not a substitute for agency guidance from the Department of Law."