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Breach of Fiduciary Duty and Fraud Claim Against Broker Rejected—Broker Acted Without Fully Understanding His Duties to His Client and Acted in a Personally Opportunistic Manner, Maximizing His Financial Gain to the Detriment of His Clients—However, Broker's Disclosures Were Sufficient to Fulfill Fiduciary Duty—Fraud Claim Rejected—Parole Evidence Admissible to Show Fraud—Code of Ethics of Trade Organizations Are Admissible to Support a Breach of Fiduciary Duty Claim

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Plaintiff owners of a condominium unit (condo) sued a real estate broker for fraud and breach of fiduciary duty. Following a trial, the court rejected both claims.

The plaintiffs had purchased a three bedroom condo. The defendant was an owner of an adjacent two bedroom condo. Approximately two years after they purchased their unit, the plaintiffs signed an exclusive brokerage agreement to list their unit with broker "A." The defendant, a licensed real estate agent, had also been considering selling his unit. The defendant had suggested, and the parties agreed, that by marketing the two condos together, as well as individually, they could "reach an additional target market and increase the potential for a sale." The plaintiffs, with "A"'s consent, gave the defendant an exclusive "co-broker" status with "A." The plaintiffs' condo was offered at $4,695,000 and the combined units were listed collectively for sale at $7,725,000.

The plaintiffs claimed that the defendant never advised them that "there was any conflict of interest in [defendant] acting both as the real estate agent attempting to sell the two apartments together and as the owner of one of the apartments being offered for sale." The defendant testified that he believed "there was no conflict of interest." Until there was a "bona fide offer," the parties had never agreed how to allocate a purchase price for the two condos.

A prospective purchaser, a husband and wife, offered $7,050,000 for both condos. The plaintiffs and the defendant accepted the offer and agreed that the plaintiffs would receive $3,725,000 and the defendant would receive $3,325,000. In reaching such allocation agreement, the defendant had relied on his knowledge of the plaintiffs' bottom line acceptable price. The defendant had told the plaintiffs what the defendant's bottom line price was prior to the parties allocation agreement.

The purchasers however insisted that $4,000,000 be allocated to the plaintiffs' condo and $3,050,000 to the defendant's condo. The purchasers' broker allegedly advised the defendant that such allocation reflected their view that the purchasers' apartment "was worth more than [the defendant's condo]."

The defendant was allegedly "upset and shocked" by the price allocation since he believed that his condo was worth more than the purchasers were willing to pay for it. The defendant thereafter advised the plaintiffs that the purchasers' price allocation was because of some type of "tax issue" and that such allocation was not acceptable. The defendant then said he did not want to deal with the purchasers. The defendant claimed that even at this point, he did not believe that "he had any conflict of interest with the [plaintiffs]…."

The plaintiffs and the defendant agreed to proceed with the sale pursuant to an agreement that the defendant would receive an additional $275,000 for his condo. An "adjustment agreement" was signed by plaintiffs and the defendant. Additionally, the defendant had convinced the purchasers' broker to cut her commission. The defendant, however, did not cut his own commission on the seller's side, nor did he ask his co-broker to do so. The plaintiff husband claimed that at the closing of his apartment, he first learned that the purchasers wanted to pay $4,000,000 for his condo because "they thought it was worth that amount." However, the plaintiffs honored their adjustment agreement and paid the defendant the $275,000 adjustment. "It is this payment that largely forms the basis for [the plaintiff's] claim of damages."

The defendant argued that since the adjustment agreement was unambiguous, the court should not consider parole evidence with respect to such agreement. However, "the parole evidence rule…does not apply to exclude evidence of fraud." Here, the plaintiffs alleged that the defendant had misrepresented or withheld information from them which induced them to enter into the adjustment agreement. The court held that the parole evidence did not apply.

Moreover, fiduciary duty issues "may exist, even apart from the written contracts executed between the parties." "[A] fiduciary cannot by contract relieve itself of the duty to disclose the very information of the beneficiary needs in order to make an informed decision about whether to agree to the contract in the first place." Thus, the court permitted parole evidence relating to the negotiation of the adjustment agreement.

The defendant had also argued that the plaintiffs' expert's testimony should be inadmissible because it was "impermissibly based upon his interpretation of statutes" and it "impermissibly seeks to hold [defendant] to rules of a membership organization that exceed what is otherwise required under law." The expert had based his opinion on "The Code of Ethics of the Real Estate Board of New York; The Code of Ethics of the National Association of Realtors; all of the textbooks that he uses to teach broker/salesperson licensing law for the State of New York; The Constitution of the Real Estate Board of New York; and 50 years of experience in training real estate salespersons and brokers as to professionalism." The expert's opinions were also based in part, on "the statutes and regulations of the Department of State." The plaintiffs' expert, however, gave no "express testimony citing or interpreting any specific statutes, regulations or in the street code of ethics."

In *Pergament v. Roach*, 18 Misc.3d 1141, Justice Ira Warshawsky (Nassau County) explained that "the line between admissible and inadmissible expert testimony as to the customs and practices of a particular industry often becomes blurred when the testimony concerns a party's compliance with customs and practices that implicate legal duties."

Adopting Justice Warshawsky's approach, the court excluded expert opinion on what is required under a statute and whether a defendant complied with a statute. However, it permitted expert testimony as to "the level of trust reposed" in an advisor "based upon custom and practice" in an industry. The court considered the issue of whether the defendant had violated state law "without regard to the testimony of either expert."

The court also rejected the defendant's argument that the plaintiffs' expert's testimony should be stricken because it relied in part "on the code of ethics of certain organizations in the real estate industry." Prior precedent held that "an internal rule book and/or manual which imposes a higher standard of care than otherwise imposed by law is not admissible." However, the defendant's authorities were decided "in the context of the legal duty of care applied in a negligence action." The subject case is based upon fiduciary duties, "the scope of which can be established by, among other things, custom and practice in the industry, which may be informed by the codes of conduct developed within that industry."

The court refused to draw negative inferences because the plaintiff failed to call the purchasers as witnesses. A party requesting a negative inference "has the burden to notify the Court as soon as practicable of the issue. This is to allow the opposing party to adjust the trial strategy, by possibly trying to call that witness and/or explaining at trial the reason for the failure." The defendant had raised the issue "for the first time in his post-trial submissions."

Moreover, the purchasers were not under the plaintiff's control and there was no showing that the purchaser wife had any knowledge on any material issue. Her husband primarily handled the negotiations, transactions and occurrences.

In essence, the plaintiffs had alleged that the defendant fraudulently induced them to "enter into a contract to split the proceeds of the sale of the combined apartments in a particular manner, disadvantageous to the [plaintiffs]." However, the plaintiffs knew that the purchasers insisted on the subject price allocations. Such fact was recited in the adjustment agreement and in the purchase/sale agreements.

Additionally, the defendant had told the plaintiff-husband that the purchasers insisted on such allocation. Thus, there was no misrepresentation or concealment about what the purchasers were willing to pay for each of the condos.

The purchasers argued that the defendant had misrepresented and concealed the real reason that the purchasers wanted the particular purchase price allocation. However, such issue could not support a claim of fraud since the purchasers' opinion of the true value of the condos were just "an opinion," as opposed to a misrepresentation or concealment of a material fact. There was no evidence that the purchasers had any "superior knowledge,…or expertise in Manhattan residential real estate, not otherwise available to [the plaintiffs], which would have made their statement about the value of [the plaintiffs'] apartment anything more than opinion."

Thus, the missing information was "not crucial" for the plaintiffs in their negotiations with the defendant as to how to divide the sale proceeds. Also missing was the element of reliance. Sellers generally "do not rely on the buyers to establish an accurate value" of property that they are purchasing. Further, the plaintiffs had access to their own co-agent "A," for expertise as to value of their apartment and whether the allocation was appropriate.

A real estate broker/sales person has a fiduciary duty to the principal and such duty is breached by "failing to disclose information obtained during the period of engagement, which affects the transaction in which the broker/salesperson is retained." However, even if the defendant had violated industry custom and ethics by insinuating himself as a co-exclusive broker with "A," the plaintiffs had failed to show that such violation caused them any damages. The plaintiffs paid the same commission, "regardless of whether there were one or two co-exclusive brokers."

The court further noted that the fiduciary's conflict of interest could be "ameliorated by full disclosure." "[W]here a broker's interests or loyalties are divided due to a personal stake in the transaction of representation of multiple parties, the broker must disclose to principal the nature and extent of the broker's interest in the transaction or the material facts illuminating the broker's divided loyalties."

The court also held that the adjustment agreement did not bar any claim for breach of fiduciary duty, since a fiduciary may not, by contract, "relieve itself of the fiduciary obligation of full disclosure by withholding the very information the beneficiary needs in order to make a reasoned judgment on whether to agree to the proposed contract." The court also rejected the defendant's argument that a broker's personal stake in a transaction does not constitute an "inherent conflict."

Here, the issue was whether the information disclosed to the plaintiffs, before they signed the adjustment agreement "was sufficient for [defendant] to have fulfilled his fiduciary duty." The court held that the defendant had made sufficient disclosure to fulfill his fiduciary duty. The court noted that "all the operative facts were known to the [plaintiffs]." The plaintiffs knew that the defendant was a co-owner of the adjacent condo and they knew or should have known that there was an inherent conflict in selling the condos jointly, since the parties at some point would have to determine "how to split the gross proceeds." The plaintiffs also knew of the price allocations.

The court opined that the purchasers' subjective personal reasons for insisting on a particular allocation "are not material facts which should have reasonably affected [the plaintiffs'] decision how to proceed with the transaction and structure it the way they did."

Additionally, although the plaintiff-husband may not have been an expert on the Manhattan real estate market, he was a "savvy businessman with access to professionals, including their real estate salesperson, ['A'], acting solely for them in this matter." Thus, the court found that the defendant's disclosures fulfilled his fiduciary duty and that such finding was not undermined by the defendant having acted "without fully understanding his duties to the [plaintiffs] and in a personally opportunistic manner, maximizing his personal financial gain to the detriment of his clients." The court emphasized that the defendant's disclosures were sufficient to make "reasoned decisions about whether and how to proceed with the transaction" and the defendant's actions to maximize his own benefit "was fully known to the [plaintiffs] when they negotiated and agreed to the Adjustment Agreement."

Comment: David Rosenberg, of Marcus Rosenberg & Diamond, attorneys for plaintiffs, stated that "Justice [Judith] Gische issued a carefully reasoned decision. As she found, the defendant did not understand his fiduciary obligations as a real estate salesperson; knew or should have known the clear potential conflict in the dual positions that he assumed; and 'acted in an opportunistic manner, maximizing his personal financial gain to the detriment of his clients.' However, she concluded that plaintiffs possessed sufficient information to protect themselves from the defendant's conduct. While disappointed with the ultimate result, our clients feel vindicated in Justice Gische's findings about the defendant."

Adam Leitman Bailey, attorney for the defendant, stated that "Justice Gische wrote a thoughtful reasoned opinion providing the current state of the brokerage law and its intersection with the tort breach of fiduciary duty. Even when finding that a duty has been breached, damages must be sustained for an award of monetary damages to be considered."

***Gelb v. Cave*, Sup. Ct., N.Y. Co., Index No. 400450/07, decided Feb. 4, 2011, Gische, J.**