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Michael E. Satterwhite

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REAL PROPERTY—INTERSTATE LAND SALES FULL DISCLOSURE ACT—OMISSION OF BANKRUPTCY OF GRANDFATHER CORPORATION NOT A MATERIAL MISREPRESENTATION

In *Paquin v. Four Seasons of Tennessee, Inc.*[1] the United States Court of Appeals for the Fifth Circuit held that the developer's failure to include in a required property report the fact that it was the wholly owned subsidiary of a bankrupt corporation[2] was not a material misrepresentation under section 1404(a)(2)(B) of the Interstate Land Sales Full Disclosure Act.[3]

The case arose out of the sale of a lot in an uncompleted development known as Four Seasons of Georgia. Four Seasons of Tennessee was responsible for construction of the development and, pursuant to the sales contract, it was also considered the seller of the instant lot. The "developer,"[4] Diversified Land Developers, Inc., a Tennessee corporation, was the parent company of Four Seasons of Tennessee and, to compound the situation, Diversified was the wholly owned subsidiary of Whale, Inc., also a Tennessee corporation. At the time of the sale to the Paquins, Whale was in the throes of bankruptcy.[5]

On July 12, 1970, the Paquins purchased a lot in the Four Seasons of Georgia development pursuant to a sales contract which named appellees, Four Seasons of Tennessee, as the seller and Cronk as its authorized representative. Prior to the execution of the sales contract and in accordance with section 1404 of the Act,[6] Cronk supplied the Paquins with the required property report which specifically stated that completion of the development was contingent "upon the satisfactory sale of lots at Four Seasons of Georgia and the developer's ability to secure adequate financing."[7] Al-

1. 519 F.2d 1105 (5th Cir. 1975).

2. *Id.* at 1111.

3. 15 U.S.C.A. §1703(a)(2)(B) (Rev. 1974) provides in pertinent part that "[i]t shall be unlawful for any developer or agent . . . in interstate commerce . . . to obtain money or property by means of a material misrepresentation with respect to any information included in the statement of record or the property report. . . ."

4. 15 U.S.C.A. §1701(4) (Rev. 1974) defines "developer" as any person "who, directly or indirectly, sells or leases, or offers to sell or lease, or advertises for sale or lease any lots in a subdivision."

5. Two months before the Pacquins purchased the lot, Whale, Inc. petitioned for Chapter X bankruptcy relief.

6. 15 U.S.C.A. §1707 (Rev. 1974) specifically states the requisite elements of a porperty report while section 1703 requires that a purchaser must be served with the report.

7. 519 F.2d at 1108. The appellees' property report stated further in pertinent part:

> [N]o assurances of completion can be given for any of the above services to be expressly provided by the developer at Four Seasons of Georgia other than the good faith and past reputation of the developer. *Completion of these, as in other areas of development, is dependent upon the satisfactory sale of lots at Four Seasons of Georgia and the developer's ability to secure adequte financing.*

Id. (emphasis added).

though this warning was repeated at seven other places in the property report, the Paquins nevertheless paid the purchase price and received delivery of a deed of conveyance.

Within a year the development failed as a result of the inability of Four Seasons of Tennessee to sell the required number of lots. Thereafter, the Paquins brought this action to recover $8,010.30, the purchase price of the lot and the cost of recording the warranty deed, plus interest and costs. The suit was filed in the United States District Court for the Northern District of Georgia against Four Seasons of Tennessee as seller and Norman H. Cronk as its agent, alleging a violation of the Interstate Land Sales Full Disclosure Act.[8] Specifically, they alleged that Four Seasons of Tennessee's omission in the property report of the existence of Whale, Inc. and its status, *i.e.*, the bankrupt grandparent company of Four Seasons of Tennessee, was a material misrepresentation prohibited by section 1404(a)(2)(B) of the Act.[9] The Paquins failed to recover in the district court and appealed to the Fifth Circuit Court of Appeals.

The Housing and Urban Development Act of 1968[10] was enacted by Congress "to provide a decent home and a suitable living environment for every American family."[11] One of the titles under this Act is the Interstate Land Sales Full Disclosure Act[12] which requires certain developers and sellers of unimproved lots in interstate commerce, pursuant to a common promotional plan, to file a statement of record with the Secretary of Housing and Urban Development to disclose all relevant information concerning the property sold or leased.[13] The reasoning behind the full disclosure requirement is to prohibit the sale of land in interstate commerce through misrepresentation of material facts relating to this property.[14] The Act parallels the Securities Act of 1933 in that the "underlying purpose of both is that prior to the purchase the buyer must be informed of facts which would enable a reasonably prudent individual to make an informed decision about purchasing the security or the property."[15] To facilitate this purpose, a property report which includes portions of the statement of record must be furnished to the purchaser. Section 1404(a) details the prohibitions relating to the sale or lease of lots in subdivisions[16] while

8. 15 U.S.C.A. §1701 (Rev. 1974).
9. 519 F.2d at 1110.
10. §1 *et seq.*, 82 Stat. 476, codified in various sections of title 12 and 15, U.S.C.A.
11. 1968 U.S.C.C. & ADMIN. NEWS 2873.
12. 15 U.S.C.A. §1701 (Rev. 1974).
13. 1968 U.S.C.C. & ADMIN. NEWS 3066.
14. *Id.*
15. 519 F.2d at 1109.
16. 15 U.S.C.A. §1703 (Rev. 1974) provides:
(a) It shall be unlawful for any developer or agent, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce, or of the mails—

section 1410(b) provides for civil liabilities for the making of material misrepresentations in the property report.[17]

There has been a paucity of case law involving civil suits for damages under the Act. In fact as late as 1973, the district court in *Hoffman v. Charnita, Inc.*[18] noted: "[t]here have been no reported cases involving civil suits for damages brought pursuant to the Interstate Land Sales Full Disclosure Act. . . ."[19] A year later another district court, in *United States v. Pocono Int'l Corp.*,[20] likewise stated: "[w]e have been cited to no case, nor have we found any in this Circuit or elsewhere, dealing with an indictment charging violations of . . . the Interstate Land Sales Act fraud provisions."[21] Although both of these cases were decided on the basis of procedural aspects,[22] they demonstrate the lack of precedent in this area. There have also been several inconsequential decisions dealing with other aspects of the Act,[23] but *Paquin* appears to be the first case dealing with the question of whether an omission of a specific fact from the property report is a material misrepresentation within the purview of section 1404(a)(2)(B).

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(1) to sell or lease any lot in any subdivision unless a statement of record with respect to such lot is in effect in accordance with section 1706 of this title and a printed property report, meeting the requirements of section 1707 of this title, is furnished to the purchaser in advance of the signing of any contract or agreement for sale or lease by the purchaser; and

(2) in selling or leasing, or offering to sell or lease, any lot in a subdivision—

(A) to employ any device, scheme, or artifice to defraud, or

(B) to obtain money or property by means of a material misrepresentation with respect to any information included in the statement of record or the property report or with respect to any other information pertinent to the lot or the subdivision and upon which the purchaser relies, or

(C) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon a purchaser.

17. 15 U.S.C.A. §1709(b) (Rev. 1974) reads:

(b) Any developer or agent, who sells or leases a lot in subdivision—

(1) In violation of section 1703 of this title, or

(2) by means of a property report which contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein, may be sued by the purchaser of such lot.

18. 58 F.R.D. 86 (M.D. Pa. 1973).

19. *Id.* at 90.

20. 378 F. Supp. 1265 (S.D.N.Y. 1974).

21. *Id.* at 1266.

22. In *Hoffman* the court certified the claim under the Act as a class action; and in *Pocono* the court allowed prosecution under the Act to be combined with prosecution for mail fraud.

23. *See* Happy Investment Group v. Lakeworld Properties, Inc., 396 F. Supp. 175 (N.D. Calif. 1975) (dealing with disclosure of the purpose for which the property is being offered for sale); Hall v. Bryce's Mtn. Resort, Inc., 379 F. Supp. 165 (W.D. Va. 1974) (dealing with the applicatility of the statute of frauds); *see also* Lukenas v. Bryce's Mtn. Resort, Inc., 66 F.R.D. 69 (W.D. Va. 1975), *and* White v. Deltona Corp., 66 F.R.D. 560 (S.D. Fla. 1975) (both dealing with class action under the Act).

Before a court can rule on the materiality of such an omission, it is important to note the procedural obstacles that it must overcome. In *Campbell v. Glacier Park Co.*[24] the court held that a purchaser, who did not allege any material misrepresentation or nondisclosure of a material fact and whose suit was not based on fraud, failed to state a claim upon which relief could be granted.[25] On the issue of whether a plaintiff must show reliance on the misrepresentation there appears to be a split of opinion.[26] However, in *Paquin* the appellants avoided these hurdles by alleging a material nondisclosure upon which they relied to their detriment.[27] In the absence of such procedural hurdles, the court was faced with the substantive issue of determining the materiality of an omission under the Act without the benefit of any established precedent.

The first question confronting the court in *Paquin* was whether section 1403(a)(10)[28] exempted the sale from the scope of the Act. The court, without discussion, merely accepted the lower court's determination that the sale was not exempted.[29] A second question the court had to resolve, and the essence of the *Paquin* decision, was provided by the Paquins' allegation that once Whale, Inc. filed a petition in bankruptcy, the developer was required by the provisions of the Act to divulge this fact in the property report.[30] Therefore, the court had to decide whether the failure to mention Whale and its status in the property report was a material omission as proscribed by section 1404(a)(1) of the Act.[31] The *Paquin* court adopted the following test from the United States Supreme Court[32] to deal with this problem: "[t]he test of materiality is whether a reasonable investor might have considered the omitted fact or erroneous statement as important in making a decision."[33]

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24. 381 F. Supp. 1243 (D. Idaho 1974). In *Campbell* the owner of the subdivision lot alleged that the developer, by constructing a community recreation area violated the intent and purpose of the property report.

25. *Id.* at 1248.

26. *See* Hoffman v. Charnita, Inc., 58 F.R.D. 86 (M.D. Pa. 1973), in which the court held that recovery could be had without reliance upon the material misrepresentation or omission. *But cf.* U.S. v. Pocono Int'l Corp., 378 F. Supp. 1265 (S.D.N.Y. 1974), in which the court held that when the government is attempting to secure a conviction under the Land Sales Act, it must prove that each purchaser relied on the false statements and was damaged.

27. 519 F.2d at 1110.

28. 15 U.S.C.A. §1702(a)(10) (Rev. 1974) exempts the sale of the land from the scope of the Act, where the land is free of incumberances and the purchaser has made an on-the-lot inspection in accordance with the rules of the Secretary of Housing and Urban Development.

29. 519 F.2d at 1111. As an additional point, the court noted that this suit could not be maintained against agent, Cronk, because he did not actually "sell" the lot which is a prerequisite for his liability under section 1709(b).

30. *Id.* at 1110.

31. 15 U.S.C.A. §1703(A)(1) (Rev. 1974).

32. *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153-54, 92 S.Ct. 1456, 1472, 31 L.Ed.2d 741, 761 (1972).

33. 519 F.2d at 1109.

Application of the above test of materiality to the present factual situation was preceded by the court's discussion of the theory of corporate existence in which it stated that "[w]e have already pointed out that Four Seasons of Tennessee was a corporation in its own right, a separate entity, a legal being with an existence separate and distinct from that of its stockholders."[34] Using this concept as a starting point, the court briefly reviewed three other relevant facts: first, Four Seasons of Tennessee did not hold itself out as relying on the financial assistance of Whale, Inc.; second, the development was in no way controlled by Whale, Inc.; and third, the property report contained repeated warnings "that success depended on satisfactory sale of the lots and the ability of Four Seasons of Tennessee to secure adequate financing."[35] The test of materiality adopted by the *Paquin* court, as applied to these facts, led the court to hold that failure to mention Whale, Inc., and its status was immaterial.[36] Consequently, the Paquins failed to meet their burden of proof as to the materiality of the omission and the Fifth Circuit affirmed the district court's denial of recovery.[37]

The *Paquin* court established a viable standard in determining liability for a misrepresentation of material facts under the Interstate Land Sales Full Disclosure Act. This standard encompasses a test of materiality[38] which is to be applied to each particular factual situation. Although the test is not a novel approach to the problem,[39] the importance lies in its value as precedent. In addition, the practitioner has a guide to assist him not only in bringing suit under the Act, but also in the preparation of property reports for client-developers. The decision in *Paquin* is consistent with Congress' intention that the purchaser should be informed of facts which would enable a reasonably prudent individual to make an informed decision about purchasing the property.[40] Future litigation should be limited to the confines of this established standard for determining liability with the probable result of reducing ill-founded suits. *Paquin* should serve as a warning flag, both to the wary purchaser and the informed developer.

MICHAEL E. SATTERWHITE

34. *Id.* at 1110-11.
35. *Id.* at 1111.
36. *Id.*
37. *Id.* In contrast, Clark, J., dissenting, was of opinion that there was a material misrepresentation within the prohibitions of the Act.
38. The court in *Paquin* adopted the test of materiality which is essentially whether the reasonable investor would have considered the omitted fact important in making a decision.
39. *See, e.g.*, Mills v. Electric Auto-Lite Co., 396 U.S. 375, 90 S. Ct. 616, 24 L.Ed.2d 593 (1970), *and* SEC v. Texas Gulf Sulpur Co., 401 F.2d 833 (2d Cir. 1968).
40. 519 F.2d at 1109.