# COUNSEL'S COMMENTS

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## *Prohibitions or Limitations for Investor Rental Units– Are They Legally Valid?*

One of the more pervasive problems in many common interest communities is the number of investment units occupied by tenants. When they exceed a reasonable threshold in a given development, problems inherent in a transient mentality often manifest themselves. These may include disregard for the rules and regulations, disrespect for the maintenance of the property, non-involvement in the social dynamics of the community, and instability of the population. Moreover, an inordinate percentage of non-owner occupied homes can have an adverse impact upon resale values and the availability of mortgage financing for resale purchasers. For example, Fannie Mae and Freddie Mac require at least sixty percent (60%) of units to be owner occupied in order to meet their underwriting standards.

Then why does one seldom see an outright prohibition against leasing in the governing documents for common interest communities? Normally, the only limitations are minimum lease terms of six months or a year. Presumably, one answer to this question is that many lawyers who are involved with the drafting of these governing documents have a visceral belief that an outright prohibition on leasing or a limitation on the number of units that could be leased at any one time would be an unlawful restraint on the alienation of real property, a doctrine that has its genesis in English common law.

Although there are no reported cases in New Jersey which directly address the enforceability of a prohibition against leasing in a common interest community, the New Jersey law in general seems to be that enforceability of a restrictive covenant must pass a test of reasonableness based upon a fact specific analysis. See *Davison Brothers, Inc. v. D. Katz & Sons, Inc., 121 NJ 196, 211(1990)* in which the New Jersey Supreme Court sets forth the factors that should be considered in reaching a determination of reasonableness.

Moreover, in a community association context, there are two categories of restrictions, each of which can impact the ultimate determination. The first is those restrictions which are found in the governing documents for the common interest community prior to the acquisition of title to a unit. The second encompasses rules established by the association subsequent to the purchase of a unit. In essence, the courts seem to be more inclined to scrutinize a newly adopted rule than one which is set forth in the pre-purchase governing documents and which is presumptively valid unless it is deemed against public policy or violates some fundamental constitutional right of the unit owners. See *Apple Two Condominium Association v. Worth Bank & Trust Co., 277 Ill. App. 3rd, 345 (1995)* in which a post-purchase amendment by the unit owners of the condominium declaration to prohibit leasing was upheld based upon a "presumption of validity" theory.

Restrictions prohibiting or limiting leasing have been upheld in Florida and other jurisdictions for many years. See *Seagate Condominium Association, Inc. v. Duffy (Fla App.1976)* holding that leasing restrictions are not an unreasonable restraint on alienation and that associations have a legitimate right to adopt restrictions to promote the residential character of their communities. In the *Duffy* case, over 96% of the unit owners affirmatively voted to amend the governing documents to include an outright prohibition against the leasing of units. See also *Flagler Federal Savings & Loan Association v. Crestview Towers Condominium Association (Fla. App. 1992)* upholding a prohibition against leasing.

In California, a balancing test was applied in a publicly subsidized condominium in the case of *City of Oceanside v. McKenna, 213 Cal. App. 3rd 1420 (1989)* wherein the Court stated "In determining whether a restraint on alienation is unreasonable, the Court must balance the justification for the restriction against the quantum of the restraint. The greater the restraint, the stronger the justification must be to support it." Specifically, the Court endorsed a public policy of "maintaining a stabilized community of low or moderate income residents and discourages speculation by real estate investors."

In the more recent Washington case of *Sherwood West Condominium Association v. Sadry, 92 Wash. App. 752 (1998)*, the Court upheld a by-law amendment which grandfathered units already leased from a post-purchase prohibition against leasing of condominium units. In addition, the association adopted rules allowing owners to petition the board to lease their units under certain circumstances such as job relocation, extended vacation, disability, difficulty in buying or selling a unit, or any other circumstance that the board deemed appropriate. The *Sherwood* case expressly recognized (i) the inhibition of transiency, (ii) the discouragement of purchase for investment rather than residency, (iii) the promotion of stability and a sense of community and (iv) the protection of economic interests and social preferences as being valid reasons for prohibiting leasing.

With respect to grandfathering pre-restriction purchasers from restrictions against leasing, it appears that in most jurisdictions this is not necessary and that existing unit owners are bound by subsequent amendments to the governing documents, including the prohibitions against leasing. See *Woodside Village Condominium Association, Inc. v. Jahren, 806 So. 2nd 452 (Fla. 2002)* which notes that "The majority of courts in other jurisdictions have held that a duly adopted amendment restricting either occupancy or leasing is binding upon unit owners who have purchased their units before the amendment was effective." See also *Worthinglen Condominium Unit Owner Association v. Brown, 57 Oh. App. 3rd 73 (1989).*

Finally, although there are no New Jersey cases addressing the validity of lease restrictions in common interest communities, it should be noted that N.J.S.A. 46 8B-9(m) authorizes "restrictions or limitations upon the use, occupancy, transfer, **leasing,** or other disposition of any unit (providing that any restriction or limitation shall be otherwise permitted by law)". Although this provision only applies technically to New Jersey condominium developments, it certainly can be viewed as indicative of a New Jersey public policy to permit leasing restrictions in common interest communities.

In summary, it is my view that there is substantial likelihood that prohibitions against leasing would be upheld by courts of New Jersey if they are uniformly enforced against all unit owners regardless of whether or not the restrictions are in place prior to a purchase of a unit in a common interest community. The odds for such a result would be enhanced by "grandfather" provisions or the implementation of systems which authorize the combination of a limited number of rental units with a waiting list procedure. This latter technique has been upheld at a lower court level in New Jersey and has been implemented elsewhere on a limited basis. Another potential approach might be to limit the frequency of rentals. However, it should be clear that there cannot be discrimination against investor units such as a requirement that security deposits be paid to the association for rental units only. See *Coventry Square Condominium Association v. Halpern, 181 N.J. Super 93 (Dist. Ct. 1981)* or higher parking fees for non-residents. See *Thanasoulis v. Winston Towers 200 Association, 110 N.J. 650 (1988).* On the other hand, a reasonable rental fee may be charged to investor unit owners to cover administrative costs of reviewing the rental arrangement and inspecting the unit. See *Chin v. Coventry Square Condominium Association, 270 N.J. Super 323 (App. Div. 1994).*

In conclusion, a large number of investor units in a particular common interest community may be problematic and association boards should consult with their attorneys regarding the implementation of leasing restrictions. There is sound authority for these controls elsewhere throughout the nation which would seem to dictate that they would not be deemed to constitute unlawful restraints on the alienation of real property under New Jersey law. ■

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