

# NEW JERSEY LAWYER

REPRINT

the Magazine

## The Regulation of Common Interest Communities

by Christine F. Li

By the time a community welcomes its first residents and its association begins operations, it is not uncommon for the approval and development process of the community to have been in progress for many months, if not years. Central to the concerns of the developer at the outset is properly structuring the community and the documenting of the community structure that will serve as the foundation of the community's operations and governance throughout the history of the project.

**I**ntertwined with the evolution of the structure of the community and the preparation of the governing documents is the crucial importance of doing so in a manner that complies with the statutory and regulatory body of law governing planned real estate developments. The understanding of the labyrinth of

statutes, regulations and case law governing the creation, offering of interests within, and operation of such communities affords the developer an advantage in ensuring that its actions at the early stages of the community, and the conduct of the association long after the developer has sold all of the homes in the community, are in compliance.

### **Regulatory Control and the Structure of the Community**

While the laws governing the land use approval process and environmental protection are widely known in the real estate development arena, developers of planned real estate developments, and sponsors of rental premises being converted to the condominium form of ownership, are faced with a body of unique statutes and regulations. The compliance process is time-consuming, with the timeframes of reviews and approvals statutorily determined. Encountered delays further exacerbate the burdens, economic or otherwise, in obtaining land use approvals, conducting environmental remediation, acquiring title to the property, and resolving litigation impacting the project. Until there has been compliance with the regulatory process, a developer may not commence the marketing and sale of homes, thereby inviting serious economic consequences.

A critical aspect of regulatory compliance is ensuring that the structure created under the regulations produces the practical administration that is intended for the project once the operation of the community becomes the responsibility of homeowners. Not anticipating potential operational problems, at a minimum, can result in an administrative night-

REPRINTED BY PERMISSION OF THE NEW JERSEY STATE BAR ASSOCIATION

mare and, potentially, in a distressed or disabled community. The expertise of not only the lawyer, but other professionals such as engineers, architects, accountants, and managing agents, is essential to the creation of a fiscally and operationally sound community.

A planned community, subject to regulation, may be in the form of a condominium, fee-simple ownership of individual lots on which dwellings have been constructed subject to governance by a homeowners association, or a cooperative. The condominium form of ownership may be employed in the conversion of rental property to condominium units for sale to individual purchasers. Condominiums are popular not only for residential communities, but also for business and commercial developments, and for mixed-use communities providing ownership opportunities to both residents and businesses. The New Jersey Condominium Act<sup>1</sup> also allows for somewhat untraditional concepts to be brought into play in a development, such as sub-regimes of condominium ownership created from master units within a master condominium, and leasehold condominiums.

It is not unusual for developments to have multiple tiers of facilities for use by different classes of owners, with *master* or *umbrella* associations formed to dictate the rights to use and the obligations to pay for such improvements. Use of facilities may be restricted to certain residents, or available for use by multiple communities, with the related costs allocated among all communities entitled to such use. Frequently, owners within a planned community automatically become subject to membership in two and sometimes three associations, each empowered to govern different facilities the owner is entitled to use.

Furthermore, the documentation of the community may operate to reserve

to the developer rights should the developer elect to limit or cease the development in the future due to conditions in the governmental approvals or a downturn in market demand. Expandable developments allow for the incorporation of additional or modified improvements and land on a phased or sectionalized basis, which increases the developer's flexibility in the decision to proceed with, and the improvements that may be included in, future phases. Regardless of the specific configuration of the proposed improvements, the goal is to ensure that the governing documents of the community properly reflect the conceptual structure and phasing of the community, while satisfying the statutory and regulatory requirements applicable to the development.

#### **Statutory Framework**

The New Jersey Condominium Act<sup>2</sup> and the Nonprofit Corporation Act<sup>3</sup> govern the creation and operation of condominiums and condominium associations. Communities offering dwellings constructed on fee-simple lots subject to governance by a homeowners association are subject to the Business Corporation Act,<sup>4</sup> and are not subject to an enabling legislation. Cooperatives and cooperative corporations, which do not enjoy popularity in New Jersey, are subject to the New Jersey Cooperative Recording Act<sup>5</sup> and the Business Corporation Act.

The condominium act establishes the manner in which condominiums are to be created, specifically by the making and recordation of a master deed recorded in the county recording office of the county in which the property is located. Ownership of a unit in the condominium community will be subject to the terms, conditions and restrictions of the master deed, which may include age restrictions, affordability controls, and

maintenance obligations imposed by the municipality upon the association, as well as covenants and restrictions upon the community to ensure a common scheme of ownership. The condominium act identifies the contents that are to be set forth within or contained as exhibits to the master deed.<sup>6</sup> While including 12 required items that appear fairly obvious on their face, a statute allows the drafter license in structuring, such as in allocating the proportionate interests in the common elements of the condominium, and the liability for common expenses.

While no enabling legislation governs communities consisting of dwellings constructed upon subdivided lots, a declaration of covenants, easements and restrictions typically embodies the respective rights and obligations of the homeowners association and the homeowners and, once recorded, encumbers the property. A declaration is able to affect the property, in much the same manner as a master deed would, by imposing restrictions and limitations on ownership, such as prohibiting the construction of improvements such as sheds and fences on the lots.

#### **Disclosure Law**

The regulation of planned real estate developments in New Jersey comes under the scrutiny of the Planned Real Estate Development Section of the Division of Codes and Standards, New Jersey Department of Community Affairs. Subject to certain exemptions, all residential planned real estate developments located within the state of New Jersey are governed by the Planned Real Estate Development Full Disclosure Act (PREDFDA),<sup>7</sup> which mandates that certain information about a project be made available to a potential purchaser so an informed purchase may be made.

The term "planned real estate development" means "any real property situated

within the State, whether contiguous or not, which consists of or will consist of, separately owned areas, irrespective of form, be it lots, parcels, units or interest, and which are offered or disposed of pursuant to a common promotional plan, and providing for common or shared elements or interests in real property."<sup>8</sup> The statutory definition specifically includes property subject to the condominium act, any form of homeowners association, any housing cooperative, or community trust or other trust device.

PREFDA is primarily a disclosure law, not a regulatory law. As such, it generally protects the purchaser of a dwelling in a condominium or other planned real estate development against those risks arising from lack of information or misrepresentation only. No activity that may be construed as an "offer"<sup>9</sup> or "disposition"<sup>10</sup> of an interest in a development may be made prior to the registration of a project with Department of Community Affairs (DCA), as evidenced by the issuance of an order of registration.<sup>11</sup> The definition of these terms effectively operates to prohibit a sponsor from communicating with prospective purchasers to promote a subject development project without first complying with PREFDA.

#### *Exemptions—Automatic or by Application*

Certain projects are automatically exempt from registration under PREFDA, and other exemptions may be granted upon application to the DCA.<sup>12</sup> Exclusions include industrial, commercial or other non-residential projects; cemetery lots; developments consisting entirely of rental units; and fee-simple planned real estate developments of less than 100 units or that are limited to the provision of common unimproved open space, such as a subdivided development with detached dwellings with

open space maintained by a homeowners association. Presently, an administrative policy exempts offerings that consist of fewer than 10 lots, parcels, units or interests, and offerings consisting entirely of units affordable to persons of low and moderate income,<sup>13</sup> provided a proper application is made.

It should be noted that, in the conversion of rental properties, a "full plan of conversion" must still be provided to residential tenants,<sup>14</sup> even if the offering consists of fewer than 10 units and is exempt from PREFDA. The Department of Community Affairs is also given discretion to exempt projects in which the purchase price is low, or the offering itself is limited, *i.e.*, there is a small number of units, or the shared common elements are limited.<sup>15</sup>

PREFDA did not repeal or supersede the New Jersey Planned Retirement Community Full Disclosure Act,<sup>16</sup> which applies to all age-restricted communities, including those subject to PREFDA. While the registration requirements are generally the same as the PREFDA guidelines, there are two important jurisdictional differences. Contrary to the PREFDA requirements, there exists no exemption for fee-simple developments of under 100 units, and age-restricted rental housing must be registered.

#### *Application for Registration and Public Offering Statement*

Prior to the registration of a project by the Department of Community Affairs, PREFDA allows for the registration of a nonbinding reservation application,<sup>17</sup> which affords the developer a limited opportunity to conduct a test marketing effort to start communication with prospective purchasers and determine market demand for the project. Not until the developer has secured the registration of an application for registration, which includes as an exhibit the public offering statement, may it enter into binding con-

tracts and close title to homes.<sup>18</sup>

The public offering statement, which is required to be disseminated to prospective purchasers, contains the salient details about the development and is the most important part of the application. The application includes large quantities of information regarding the entity serving as developer and its principals, and the development, including title reports, environmental reports, and governmental approvals, all of which are maintained in the state's file.

Developers can routinely anticipate a total period of four to five months in which to secure the registration of an application. Unanticipated circumstances, which may further delay the registration of the project, include pending litigation affecting the sponsor and/or the development, environmental remediation that has not culminated in either the recordation of a deed notice and/or the issuance of a no further action letter by the New Jersey Department of Environmental Protection, the failure of the sponsor to secure all applicable governmental approvals for the project, or the failure of the sponsor to obtain title to the lands, assuming the application for registration, when submitted, evidenced the sponsor's interest in the land by means of a contract or option to acquire the land. Accordingly, the developer needs to anticipate the time required to register the project in developing its marketing program.

#### **Continuing DCA Obligations of the Developer**

##### *Annual Reports and Amendments*

Developers have continuing obligations under PREFDA and the related regulations. The major responsibilities include filing amendments, and submitting annual reports to the DCA. An amendment must be filed when there are

any "material changes" in the facts set forth in the application for registration.<sup>19</sup> Similarly, the annual report must include any material changes in either the public offering statement or other portions of the application for registration.<sup>20</sup> A new annual common expense budget is a prime example of such a change.

It is frequently difficult for a sponsor to ascertain a change that might be deemed material under PREDFDA. Some changes warranting the registration of an amendment are obvious, such as a significant change in the homes or common facilities that are proposed to be constructed. Other events may not be so obvious as to warrant the registration of an amendment, such as a budget deficit where the magnitude of a deficit or the length of time it was in existence may bring into question its materiality, or receipt of unverified information of a potential change in the use of property surrounding the development. In any event, the Department of Community Affairs strictly enforces the statutory requirements governing the submission of annual reports and the registration of amendments, notwithstanding the potential for a colorable argument that the change in circumstances was not material and, therefore, did not precipitate the need for an amendment.

In light of such a position and the impact of the remedies available to the Department of Community Affairs, especially the imposition of fines, the prudent path is to counsel developers to proceed conservatively in filing amendments and timely submitting complete annual reports.

### **Condominium Conversions and the Removal of Tenants**

If the project involves the conversion of rental property to the condominium form of ownership, the property may be occupied by tenants whose tenancies

were established prior to the recordation of the master deed. The sponsor must decide at the outset if it intends to undertake an eviction plan, whereby the sponsor exercises its rights to remove pre-conversion tenants; or a non-eviction plan, whereby the sponsor relies on the routine turnover of tenants foregoing its legal rights to remove tenants.

The decision to proceed with a non-eviction plan is largely determined by a tenant profile for the premises that supports the voluntary departure of the tenant within the three-year notice period, or before the completion of an eviction action culminating in the removal of the tenant via an eviction action. If the sponsor elects to proceed with a non-eviction plan, it is not required to comply with the statute governing the removal of tenants and the regulations thereunder.<sup>21</sup> The sponsor should be aware of the need to comply with the conversion requirements of PREDFDA in undertaking a non-eviction plan.

If the goal is to remove pre-conversion tenants, the sponsor must comply with the aforesaid statute governing the removal of tenants, and the regulations thereunder. The Senior Citizens and Disabled Protected Tenancy Act,<sup>22</sup> and the regulations thereunder,<sup>23</sup> will protect senior citizens over the age of 62 (for a period of 40 years) and disabled tenants from eviction proceedings, provided that they make less than three times the county per capita income level. Furthermore, if the property is located in Hudson County, the Tenant Protection Act of 1992<sup>24</sup> extends further protections to residents of the county due to the rental housing shortages there. The statute imposes lower income thresholds upon protected tenants, and greater protections for disabled residents or those over the age of 75.

Once the project has been registered with the Department of Community Affairs, the sponsor must give pre-con-

version tenants a 90-day exclusive option to buy their respective units after service of the notice of intention to convert and the public offering statement. For the removal of tenants, the sponsor must give a three-year notice to quit, with the potential that a court may grant up to five one-year stays of eviction.

### **Remedies Against the Developer (and its Attorney)**

Registration by the Department of Community Affairs does not mean the department approves the application. In fact, PREDFDA and the regulations expressly provide that the department does not approve or recommend the development or disposition of the interests in the planned real estate development.<sup>25</sup> Consequently, the sponsor cannot raise the prior registration of a public offering plan as a defense should the sponsor be deemed in violation of PREDFDA after registration.

The Department of Community Affairs may hold the sponsor liable for double damages and attorney's fees for offering interests in a community subject to PREDFDA prior to registration.<sup>26</sup> Actual damages emanating from the violation must be demonstrated. Furthermore, once a project has been registered, penalties may be imposed under PREDFDA for express statutory or regulatory violations, or for making an untrue statement or omitting a material fact. Administrative penalties include revocation of the registration, issuance of cease and desist orders, or levying of fines up to \$50,000 per violation.<sup>27</sup> Although the DCA does not have the power to award compensatory damages for misrepresentations and omissions in the public offering statement, such relief may be found in the courts.<sup>28</sup>

The attorney preparing the public offering statement may also be subject to possible malpractice claims by a pur-

chaser, regardless of the fact that there is no privity between the attorney and the buyer. Accordingly, the attorney preparing a public offering statement must make sure he or she has made the proper inquiry in order to obtain all necessary information.<sup>29</sup>

### **Department of Community Affairs and the Association**

While this article largely has focused on the regulation of developers and sponsors of planned communities, the oversight of the community association is another aspect of PREDFDA and the Department of Community Affairs' regulatory authority. The department's jurisdiction comes into play not only while the developer is in control of the association, but also during and after the developer's efforts to transfer association responsibilities to the homeowners. For example, while the developer controls a majority of positions on the governing board, an annual audit of the association's funds shall be performed by an independent public accountant, and a copy of the audit must be delivered to each owner within 90 days of the expiration of the fiscal year.<sup>30</sup> The department also requires that while the developer maintains a majority of the positions on the governing board, a bond or guarantee acceptable to the department shall be posted in the full amount of the annual budget plus any accumulated reserves.<sup>31</sup>

The general requirements in PREDFDA and the condominium act<sup>32</sup> impose upon a developer the obligation to organize and operate the community association, and to gradually surrender control of positions to homeowners based upon the number of homes in the community that have been conveyed to individual owners. This process allows for the progressive takeover of control by homeowners of the operations of the

association, and is commonly referred to as transition.<sup>33</sup>

In addition to establishing the timing of the election of owners to the governing board, statutory and regulatory requirements compel the transfer of materials and other matters relative to transition.<sup>34</sup> The Department of Community Affairs has assumed an increasing role in the enforcement of the transition process.

The role of the DCA is expanding in the regulation of associations after the developer has completed the turnover of control. Under PREDFDA, associations are required to provide a fair and efficient procedure for the resolution of disputes between individual unit owners and the association, and between unit owners, as an alternative to litigation.<sup>35</sup> Meetings of the governing board of the association are required to be open to attendance by unit owners, subject to certain requirements and restrictions.<sup>36</sup> The Department of Community Affairs has stepped in to enforce these and other provisions where voluntary compliance is not forthcoming from the association.

### **Conclusion**

The scope of regulations governing the creation of planned developments and compliance with disclosure requirements is broad under the existing statutory and regulatory scheme. The interpretation of the law has attempted to keep pace with the evolution of these developments through the years. There has been a broad spectrum of application, commencing initially with the developer and the formation of the development and progressing to protections necessitated by community associations as they have become more sophisticated in structure and mature in operation. More and more, the legislative scheme has given rise to conflicts in interpretation as evidenced by the

advent of alternative dispute resolution methods and, where unsuccessful, recourse to litigation between and amongst developers, associations and owners' groups.

Concomitantly, the Department of Community Affairs' compliance efforts, including the imposition of fines upon developers and associations, has been a regulatory response in furtherance of stemming violations of the public's interests. It becomes obvious that the regulatory scheme for common interest communities is extensive, and requires a collaborative effort of developers, associations, governing boards, and their respective legal counsel and the other professionals, to ensure compliance as mandated.  $\delta\delta$

### **Endnotes**

1. N.J.S.A. 46:8B-1 *et seq.*
2. N.J.S.A. 46:8B-1 *et seq.*
3. N.J.S.A. 15A-1.1 *et seq.*
4. N.J.S.A. 15:1-1 *et seq.*
5. N.J.S.A. 46:8D-1 *et seq.*
6. *See* N.J.S.A. 8B-9.
7. N.J.S.A. 45:22A-21 *et seq.*
8. N.J.S.A. 45:22A-23 h.
9. N.J.S.A. 45:22A-23 c.
10. N.J.S.A. 45:22A-23 a.
11. N.J.S.A. 45:22A-30
12. N.J.S.A. 45:22A-25.
13. *See* N.J.A.C. 5:26-2.2(a)10.
14. N.J.S.A. 2A:18-61.8, N.J.A.C. 5:24-1.1.
15. N.J.S.A. 45:22A-25 b.
16. N.J.S.A. 45:22A-1 to 45:22A-20.
17. N.J.A.C. 5:26-10.1.
18. N.J.S.A. 45:22A-27; N.J.S.A. 45:22A-28; N.J.A.C. 5:26-3.1; and N.J.A.C. 5:26-4.2.
19. N.J.S.A. 45:22A-27.d.
20. N.J.S.A. 45:22A-31.
21. N.J.S.A. 18-61.8 *et seq.*, N.J.A.C. 5:24-1.1 *et seq.*
22. N.J.S.A. 2A:18-61.22 *et seq.*
23. N.J.A.C. 5:24-2.1 *et seq.*
24. N.J.S.A. 2A:18-61.40 *et seq.*

25. N.J.S.A. 45:22A-b., N.J.A.C. 5:26-4.7.
26. N.J.S.A. 45:22A-26a.(1) and 45:22A-37.a.
27. N.J.S.A. 45:22A-34 and N.J.S.A. 45:22A-38
28. See N.J.S.A. 45:22A-37.
29. See *Atlantic Paradise v. Perskie, Nehmad*, 284 N.J. Super. 678 (App. Div. 1995), *certif. den.* 143 N.J. 518 (1996), finding that reliance by purchasers on the content of a public offering statement is foreseeable and that the failure to include known restrictions that would prevent use of the condominium for the purposes claimed in the public offering statement subjects the preparing attorney to a malpractice claim).
30. N.J.S.A. 5:26-8.7)(c).
31. N.J.S.A. 5:26-8.7(d).
32. N.J.S.A. 46:8B-12.1 a.
33. N.J.S.A. 45-22A-47, N.J.A.C. 5:26-8.4.
34. N.J.S.A. 46:8B-12.1 d.
35. N.J.S.A. 45:22A-44 c, N.J.A.C. 5:26-8.2(c).
36. N.J.S.A. 45:22A-46, N.J.A.C. 5:26-8.2(d).

**Christine F. Li** is a partner in the law firm of Greenbaum, Rowe, Smith & Davis LLP in Woodbridge and Roseland, where she is a member of the firm's planned real estate practice group.