New Jersey Law Journal

VOL. CLXXXVIII– NO.13 – INDEX 1176 JUNE 25, 2007 ESTABLISHED 1878

Real Estate
Title Insurance &
Construction Law
JUNE 25, 2007 ALM

Protecting Developers from Rescission

Sellers of unfinished residential condos must comply with federal disclosure requirements

By Stephen Hankin

The spoils of the rich real estate market during the past half decade have left condominium buyers with the desire to reap immediate profits by assigning their purchase contracts before construction has been completed, or in some cases, before it has begun. Now that the market has either returned to normal or taken a downward spiral, buyers are feverishly searching for ways to rescind. In most instances, resort to traditional equitable principles or to state statutes governing condominium offerings has proven unsuccessful. However, federal legislation may provide a solution if the condominium was uncompleted at the time the contract of sale was signed and the offering involves one hundred or more units.

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This article discusses a condominium buyer's right of rescission where a developer has failed to qualify for what has been dubbed as the improved lot exemption under the Interstate Land Sales Full Disclosure Act, 15 U.S.C. § 1701 et seq.

ILSFDA was enacted in 1968 as an antifraud statute to prohibit the sale (or lease) of certain unimproved or subdivided real estate by means of interstate commerce unless exempted or registered with the United States Department of Housing and Urban Development. Interstate commerce is broadly construed to include the telephone, the mails and other types of media having an interstate circulation, regardless of whether a developer engages in marketing or sales activities intended for out-of-state. Federal and state courts have concurrent jurisdiction over ILSFDA claims.

A "sale" occurs when a purchaser signs a contract of sale, rather than when the actual transfer of title occurs. ILSFDA is administered by HUD, which has promulgated a score of detailed regulations. See 24 C.F.R. § 1710 et seq. ILSFDA is not to be construed technically but rather in a liberal, flexible fashion to effectuate its remedial purposes. Although ILSFDA was first enacted as a prophylactic and punishment for fraudulent developers attempting to sell unbuildable lots and other property without access or utilities, ILSFDA is no longer limited to the sale of raw land. While ILSFDA does *not* apply to a contract for an already fully completed condominium unit, it is now well settled that the sale of a single unit as part of a common promotional plan to sell 100 or more units in an *unconstructed* condominium is subject to ILSFDA's registration and disclosure requirements.

ILSFDA's underlying purpose is to ensure that when a buyer purchases certain kinds of real estate, he is fully informed of all the facts that might enable him to make an informed decision. To achieve this purpose, ILSFDA's primary tool is disclosure. For all nonexempt sales, a developer must file a "Statement of Record" with HUD's Office of Interstate Land Sales Registration and provide all prospective purchasers with an extensively documented "Property Report" *before* a contract of sale is signed.

ILSFDA has a number of statutory and regulatory exemptions, all of which have been narrowly construed to achieve its remedial purposes. Indeed, it is not even a defense to a rescission claim under ILSFDA for a developer to claim that it gave a buyer all of the information a

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Property Report would have provided, or that the buyer may be a sophisticated business person who has actually viewed the site. Even equitable defenses such as estoppel, laches and waiver will not impair a purchaser's right of rescission. The right of rescission is simply absolute.

Some developers concentrate too little on contract provisions that will effectively exempt them from ILSFDA's Statement of Record registration and Property Report distribution requirements. It is particularly important that a developer comply with ILSFDA or make certain the transaction is exempt. If a transaction is not an exempt sale, noncompliance, despite the absence of any fraud or other wrongdoing, ipso facto entitles the purchaser to revoke the contract at any time within two years from the date the contract is signed, regardless of whether title has been transferred. If rescission is granted, a purchaser is also entitled to recover his deposits, with interest, court costs, reasonable attorneys' fees and expenses of travel to and from the unit.

The improved lot exemption is often sought by developers who have failed to register their projects or provide Property Reports to prospective buyers. According to the statute and subsequent court interpretations, most of which emanate from Florida, to qualify for the exemption, developers should take care to satisfy the following requirements:

1. Guaranteed two-year completion. The improved lot exemption requires clear and unconditional contract language guaranteeing completion of the condominium building within two years. It is of no moment that a condominium building happens to be completed in the two-year period if the agreement does not unconditionally guaranty completion. Any reservation of right to extend the closing beyond that two-year period, for any reason other than an act of God (for which HUD permits additional time) renders the two-year guarantee illusory and the improved lot exemption unavailable. State law determines whether the completion obligation is transparent.

2. The agreement of sale cannot limit a buyer's right to specific performance and damages in the event of a breach. While parties to a contract generally have the right to limit their respective remedies, for purposes of ILSFDA, a developer's right to do so must be analyzed in the context of § 1702(a)(2). The remedy of specific performance alone is insufficient because by selling the unit the developer can avoid both specific performance *and* damages. This would_effectively allow developers to breach with minimal consequences. Some condo developers have inserted contract provisions limiting a buyer's recourse to their interest in the condo building. In doing so, however, these developers risk the viable argument that such language is really no different from a contract provision limiting the buyer to specific performance or a return of his downpayment, thereby precluding use of the improved to exemption. Thus, not only must a developer obligate himself to complete construction in two years but the agreement must provide a buyer with the right to enforce that obligation in a real rather than illusory way.

3. The two-year completion requirement must extend to the entire building. The two-year completion requirement appears to apply not only to the condominium unit being purchased, but to all of the common (and limited common) elements as well as all of the other units in the condominium building.

Some developers have maintained that §1702(a)(2) does not require the two-year completion of anything other than the unit itself and limited common elements, that is, portions of the building to which the buyer is entitled to exclusive possession. However, not only does this argument ignore the plain language of §1702(a)(2) but it also confuses what triggers ILSFDA's threshold jurisdiction with a developer's right to an exemption once jurisdiction is triggered. ILSFDA admittedly only applies to the sale of real estate to which there is some exclusive right of use. ILSFDA thus applies to a contract of sale for an uncompleted condominium unit (when 100 or more units will exist) because of a buyer's right to use the unit exclusively. However, once jurisdiction exists, in order for the sale of an otherwise nonexempt condominium unit to qualify for an exemption under §1702(a)(2), the contract of sale must obligate the seller within two years to erect the condominium "building" as distinct from merely the unit itself. In other words, once threshold jurisdiction obtains, a developer is not entitled to a §1702(a)(2) exemption if the contract does not guaranty completion of the other units and common elements in the building despite the fact that the buyer has no exclusive right to enjoy them.

HUD's "Guidelines for Exemptions under the Interstate Land Sales Full Disclosure Act," 49 Fed. Reg. 31375, providing "for a building or unit to be considered complete, it must be physically habitable *and* usable for the purpose for which it was purchased" [emphasis added], do not require a contrary conclusion.

4. The agreement of sale should not contain a savings clause designed to evade § 1702(a)(2). In an unwise effort to evade the strict exemption requirements of § 1702(a)(2), some developer agreements provide that if any term violates § 1702(a)(2), then those provisions shall be deemed invalid and unenforceable. A developer should not be able to have it both ways by inserting contract language which rather obviously precludes an exemption under § 1702(a)(2), but which in the same breath purports entitlement to the exemption once a purchaser is forced to litigate and a court interprets the contract as exemption preclusive. In fact, one Florida court has refused to enforce this kind of contract provision, finding it a method of disposition designed to evade ILSFDA.

Many states have enacted legislation similar to New Jersey's Planned Real Estate Development Full Disclosure Act, N.J.S.A. 45:22A-21 et seq., proscribing registration and pre-agreement distribution of Public Offering Statements similar to ILSFDA's requirements. Counsel for developers should thus take whatever additional time may be necessary to conform that information with ILSFDA's registration and Property Report requirements rather than defend costly rescission suits arising out of contracts which may fail to satisfy § 1702(a)(2) requirements. ■