Study H-851 June 13, 2001

Memorandum 2001-54

Nonjudicial Dispute Resolution Under CID Law: Administrative Hearing Procedure

BACKGROUND

At its May meeting the Commission requested the staff to investigate the possibility of a state level administrative hearing process as an option for nonjudicial resolution of common interest development disputes.

It was suggested that an agency such as the Department of Fair Employment and Housing or the Department of Real Estate would have both the expertise and an existing structure in place, with sufficient local offices, that it could undertake such a task. The concept is that a commissioner or administrative law judge could hear and resolve the dispute using informal administrative hearing procedures. Judicial review would be available by writ of mandate; the standard of review would depend on the appropriate deference to be afforded the decisionmaker selected for this function. Funding of such a system would need to be investigated.

This memorandum presents the requested analysis.

SEPARATION OF POWERS

At the outset we must confront a fundamental concern with such a program — the constitutional requirement of separation of powers.

Article III, Section 3, of the California Constitution provides that the powers of state government are legislative, executive, and judicial. "Persons charged with the exercise of one power may not exercise either of the others except as permitted by this Constitution." The judicial power of the state is vested in the courts. Cal. Const. art. VI, § 1.

The Constitution itself vests judicial power in a few administrative agencies, such as the Public Utilities Commission and the Alcoholic Beverage Control Appeals Board. Cal. Const., art. XII; art. XX, § 22. In addition, the Constitution expressly delegates to the Legislature the authority to provide nonjudicial

dispute resolution of some matters, such as workers' compensation. Cal. Const. art. XIV, § 4.

There is a long tradition of legislative creation of regulatory agencies by statute; these agencies typically exercise adjudicative powers subject to judicial review by administrative mandamus. Statutory programs of regulation such as this have been sustained against separation of powers challenges. See, e.g., 7 B. Witkin, *Summary of California Law*, Constitutional Law § 113 (9th ed. 1988).

However, administrative agency exercise of adjudicative power has historically been limited to enforcement of a state regulatory program. A legislative delegation of adjudicative power to a state agency to resolve what may be viewed as a common law dispute between two private parties (e.g., between owners of common interests in property, or between an association board of directors and a member of the association) involves different considerations.

Over the past decade the California courts have considered a number of challenges to state administrative adjudicative authority that may be considered to infringe on judicial branch powers because it deals with essentially private disputes.

The seminal case is *McHugh v. Santa Monica Rent Control Board*, 49 Cal. 3d 348, 261 Cal. Rptr. 318, 777 P.2d 91 (1989). That case involved a rental dispute between a landlord and tenant. The case was brought before a local administrative agency pursuant to a local regulatory scheme of rent control. The administrative agency found that the landlord had overcharged; it awarded restitution of excess rent by withholding from current rental payments, as well as treble damages authorized by the regulatory scheme. The Supreme Court invalidated the immediate withholding of rent and the award of treble damages as violations of the separation of powers doctrine.

The court in *McHugh*, departing from earlier precedent, announced that in the future it would apply a two-prong test to determine whether an administrative adjudication scheme can survive a separation of powers challenge. The first prong is a "substantive" test — is the administrative procedure reasonably necessary to accomplish the agency's regulatory purposes. The second prong is the "principle of check" — the judicial branch must retain the ultimate power of decision in the case.

Under this test, the court will carefully apply the "reasonable necessity/legitimate regulatory purpose" requirement in order to guard against

unjustified delegation of authority to decide disputes that otherwise belong in the courts (49 Cal. 3d at 374 (fn. omitted)):

> Specifically, we will inquire whether the challenged remedial power is authorized by legislation, and reasonably necessary to accomplish the administrative agency's regulatory purposes. Furthermore, we will closely scrutinize the agency's asserted regulatory purposes in order to ascertain whether the challenged remedial power is merely incidental to a proper, primary regulatory purpose, or whether it is in reality an attempt to transfer determination of traditional common law claims from the courts to a specialized agency whose primary purpose is the processing of such claims.

Thus, by way of example, the court indicates that it would not approve the Board's adjudication of a landlord's counterclaims (extraneous to the Board's regulatory functions) against a tenant. Such an adjudication would not reasonably effectuate the Board's regulatory purpose, and it would shift the Board's primary purpose from one of ensuring the enforcement of rent levels, to adjudicating a broad range of landlord-tenant disputes traditionally resolved by the courts.

The courts since *McHugh* have shed considerable light on the dimensions of the separation of power issue with respect to administrative resolution of private disputes. Cases that will be of substantial interest to the Commission in considering whether to construct a system for administrative resolution of common interest development disputes include:

- *Peralta Community College Dist. v. Fair Employment & Housing Comm.*, 52 Cal. 3d 40, 276 Cal. Rptr. 114, 801 P.2d 357 (1990). Administrative agency, in employment discrimination proceeding, could not adjudicate compensatory damage claims for emotional and other injuries, traditionally awarded in judicial actions between private parties. The statute creating the agency did not expressly authorize an award of general compensatory damages, and it was unlikely the Legislature would grant "unbridled power to an administrative agency to make monetary awards without guidelines or limitations." 52 Cal. 3d at 60.
- *Walnut Creek Manor v. Fair Employment & Housing Comm.*, 54 Cal. 3d 245, 284 Cal. Rptr. 718, 814, P.2d 704 (1991). Legislative grant of authority to administrative agency to award compensatory damages in housing discrimination proceeding must be limited to special (as opposed to general) damages — the agency may award quantifiable out of pocket restitutive damages but not general

compensatory damages for emotional distress and other intangible injury. "The award of unlimited general compensatory damages is neither necessary to [the regulatory] purpose nor merely incidental thereto; its effect, rather, is to shift the remedial focus of the administrative hearing from affirmative actions designed to redress the particular instance of unlawful housing discrimination and prevent its recurrence, to compensating the injured party not just for the tangible detriment to his or her housing situation, but for the intangible and nonquantifiable injury to his or her psyche suffered as a result of the respondent's unlawful acts, in the manner of a traditional private tort action in a court of law." 54 Cal. 3d at 264.

- *Konig v. Fair Employment & Housing Comm.*, 79 Cal. App. 4th 39, 93 Cal. Rptr. 2d 690 (2000). Administrative agency may not assess general compensatory damages even though statute has been amended to allow respondent to "opt out" by having those claims adjudicated in court. The "opt out" provision does not cure the substantive limitation on legislative authority to delegate to an administrative agency judicial powers not necessary to the regulatory purposes of the agency.

The staff believes this line of cases imposes significant limitations on the ability of the Commission to devise an administrative dispute resolution system that can deal effectively with the range of disputes that come up in the common interest development context. Moreover, there is a real concern that an administrative adjudication scheme whose sole function is to resolve disputes apart from any other regulatory purpose would be found to violate the constitutional requirement that administrative adjudication authority must be reasonably necessary to accomplish the administrative agency's regulatory purposes. If the Commission decides to proceed with this approach, it will be necessary to somehow tie the dispute resolution process to state laws regulating common interest developments.

SUBJECT MATTER JURISDICTION

What sorts of issues should be referred for administrative adjudication? As we know, a wide variety of issues can arise in the common interest development context. These include construction defect issues involving the developer, governance issues (procedures, voting, etc.), assessment issues, homeowner v. board disputes, neighbor v. neighbor disputes, etc.

The staff suggests that at least at the outset we set aside construction defect issues. We have not focused on them to date in this project, and do not have a feel for the dynamics of that sort of litigation. Moreover, there is currently substantial legislative activity on this matter. In the interest of most efficient allocation of resources, the staff recommends that the Commission deal only with operational issues.

The concept of administrative resolution of common interest development issues grew out of the Commission's investigation of the possibility of expanding small claims court jurisdiction. A major concern with giving the small claims court equitable powers was that the types of issues involved may require more extended procedures and may require more sophisticated factual, legal, and balancing considerations, than the temporary judges and truncated procedures used in small claims court can accommodate.

But the administrative hearing process is more sophisticated than the small claims process. Administrative law judges are experienced adjudicators and are capable of handling complex issues. This would argue for broader, rather than narrower, subject matter jurisdiction for the administrative adjudication process.

Interestingly, the separation of powers cases identify as problematic the determination of compensatory damages by administrative adjudication. Dicta in the cases seem to indicate that equitable relief would not present the same separation of powers concerns for administrative adjudication.

This would suggest categorization of cases for administrative adjudication not by subject matter but by remedy. Equitable relief (including restitution) would be the exclusive remedy in administrative adjudication. A person seeking monetary damages would be relegated to the court system. There might still be a role for small claims court in that respect.

MANDATORY OR PERMISSIVE?

Should the administrative adjudication procedure be mandatory or permissive? Note that making the procedure permissive does not avoid separation of powers problems. See discussion of *Konig v. Fair Employment & Housing Comm.*, above.

When the Commission began its review of common interest development law, it found that one of the criticisms of the existing provisions relating to alternative dispute resolution was that the existing provisions are permissive

rather than mandatory. A party may offer to use mediation or arbitration, but the other may reject that option, forcing the dispute into court. A further criticism was that litigation is prohibitively expensive, making it impractical for the ordinary homeowner to pursue or defend rights relating to day to day living arrangements.

These concerns suggest that an administrative adjudication program ought to be mandatory rather than permissive. However, for such a program to be successful, it would have to be readily accessible to associations and homeowners throughout the state. At least the court system is readily accessible; can an administrative adjudication system even come close?

APPROPRIATE AGENCY

Ideally, the administrative agency designated to conduct hearings to resolve CID disputes should have some expertise in the subject matter and should have offices throughout the state. State level agencies suggested at the May Commission meeting included Department of Fair Employment and Housing, and Department of Real Estate.

The Department of Fair Employment and Housing has offices in a fair number of locations, including Sacramento, San Francisco, Oakland (2 offices), San Jose, Fresno, Bakersfield, Ventura, Los Angles (4 offices), San Bernardino, Santa Ana, and San Diego. Unfortunately, that agency does not generally conduct administrative hearings; it is an investigative and prosecutorial agency. Hearings for the department are conducted by the Fair Employment Housing Commission, a small agency with one office. It is not equipped to hold hearings on the scale that would be involved with CID jurisdiction.

The Department of Real Estate likewise has offices around the state (Sacramento, Oakland, Fresno, Los Angeles, San Diego). That agency likewise has its hearings conducted by another entity — in this case the state Office of Administrative Hearings.

We are familiar with the operation of the Office of Administrative Hearings from our earlier work on the state's Administrative Procedure Act. OAH is a unit of the state Department of General Services. It provides administrative hearing services for a large number of state agencies, particularly licensing agencies. It also provides hearing services for a number of local agencies. It is well-staffed with experienced Administrative Law Judges, who undoubtedly could become

expert in CID dispute resolution in short order. We understand that there is experimentation going on currently in OAH with mediation as an adjunct to administrative adjudication. OAH has offices in Sacramento, Oakland, Los Angeles, and San Diego, although the ALJs will travel to the exact locale where the hearing will be held.

A significant problem with OAH jurisdiction, in the staff's opinion, is the separation of powers issue. In what way does administrative adjudication by OAH relate to its regulatory purpose? Referral of disputes to OAH for resolution would seem to be a raw exercise of legislative power to divest the courts of jurisdiction, without redeeming regulatory value.

We have not discussed with the current OAH director whether there is an interest or willingness to take this on. We will do that if the Commission decides to proceed on these lines.

PROCEDURE

Filing

What is the mechanism by which a party will invoke the administrative adjudication system? How will the party know where to go and how to go about doing it? In a traditional administrative adjudication system these are not issues, since the administrative agency initiates an enforcement action and notifies the parties of the opportunity for a hearing.

A drawback to the administrative adjudication system is the lack of widespread, decentralized offices. A disputant needs to have a place close by to turn to. Unlike the court system, there will not be a fully staffed administrative office in every county.

Perhaps electronic communication offers some opportunities here. The administrative adjudicator could maintain a website with information about the dispute resolution process. Perhaps complaints could be lodged by email. (There would still be a filing fee issue — see discussion of "Funding" below).

Whether the summons is mailed or emailed, there is a danger that a respondent who receives a directive from some obscure administrative agency will simply trash it as a piece of junk mail.

One thing is clear — implementation of this system will require an enormous educational effort. It will not be obvious to most CID disputants that the proper

forum for resolution of their dispute is a state agency in Sacramento or another metropolis, rather than the local court.

Timing

Part of the concept behind administrative adjudication of disputes in the CID context is that matters can be addressed relatively quickly, without all the procedural trappings of judicial proceedings. To some extent this is true. But there must be time even within the administrative adjudication context to provide adequate notice to parties, allow a response, accommodate discovery, attempt to achieve pre-hearing settlement or otherwise limit issues, hear the case, issue a preliminary decision, and allow time for post-decision proceedings.

Conversations with OAH hearing personnel indicate that they have a reasonably quick turn-around time — 120 days from the time a hearing is assigned. This could arguably go down to 90 days in the CID context since there is no other agency that is a party to the dispute contributing to scheduling problems.

Informal Hearing Procedure

To some extent the formal hearing procedure under the Administrative Procedure Act has become overly judicialized and characterized by adversarial behavior, and probably does not present a significant advantage over judicial proceedings. For that reason, the staff would propose that CID adjudicative hearings be conducted under the informal hearing procedure.

The informal hearing procedure was enacted in 1995 on recommendation of the Commission. The informal procedure is basically a simplified administrative adjudication. It involves no prehearing conference or discovery. At the hearing the presiding officer regulates the course of proceedings and limits witnesses, testimony, evidence, rebuttal, and argument. It is essentially a conference that lacks courtroom drama but nevertheless provides assurance that the issues will be aired, an unbiased decisionmaker will make a decision based exclusively on the record of the proceedings, the decision will be explained, and it will be subject to judicial review.

Enforcement

A problem with administrative adjudication to resolve CID disputes is the question of enforcement — how will the ALJ's decision be effectuated. Suppose the ALJ finds that the homeowner has been delinquent in paying assessments

and issues an order that they be paid. Or that the board has neglected its obligation to enforce certain CC&Rs relating to architectural standards and mandates that the board take steps to enforce them.

In the ordinary administrative regulation context, there is an administrative agency that is charged with enforcement authority and given enforcement powers — e.g., the power to revoke a license or assess penalties. How can that be accomplished when we have only an administrative adjudicator and no regulatory agency?

The staff thinks we can probably devise some appropriate enforcement mechanisms. We may authorize an administrative order to be filed with the county clerk and enforced by the district attorney in case of a mandatory order or by the levying officer in case of a monetary award. Ultimately the power of the judicial system would be needed to back up the administrative order. The staff will propose specifics if the Commission decides to proceed down this line.

Judicial Review

Judicial review of the administrative decision is a sine qua non for separation of powers purposes. Remember that *McHugh* announced a two-prong test. The first prong is the "substantive" rule that adjudicative powers be limited to those reasonably necessary to effectuate the administrative agency's primary, legitimate regulatory purposes. The second prong is the "principle of check" — the "essential" judicial power (i.e., the power to make enforceable, binding judgments) must remain ultimately in the courts, through review of agency determinations.

The court in *McHugh* noted that an opportunity for judicial review must be available before an administrative order may be enforced. Thus the rent control board's order in that case authorizing the tenant to withhold rent violated constitutional separation of powers requirements because it went into immediate effect, before the parties had an opportunity to seek judicial review.

Administrative mandamus is the appropriate means for judicial review of agency action. However, as we know from our previous work in this area, the standard of review is critical. The staff thinks that it is important that substantial evidence review be the standard here — otherwise the parties will be required to relitigate all the facts in the case. Any savings hoped for in a system of administrative adjudication will be illusory if that system ultimately results in the parties having to litigate the same dispute twice.

The staff is troubled, however, by a footnote in *McHugh* — "we observe that in cases such as this — in which a private party has a 'direct pecuniary interest' in the administrative agency's determination — the independent-judgment test may be the appropriate standard for a court to apply in reviewing the administrative determination." 49 Cal. 3d at 375, fn. 36. While we could address this matter by statute, the implication of the court is that it has a constitutional dimension.

Is there a jury trial issue here as well? The Constitution guarantees the right to a jury trial (Cal. Const. art. I, § 16), but this right has been construed to refer to causes for which a jury trial was available at common law. See discussion in 2 B. Witkin, *California Procedure*, Trial §§ 89-107 (4th ed. 1997). The *McHugh* court discusses the jury trial issue at length and concludes that, if the substantive basis for administrative adjudication is satisfied, the right to a jury trial is not an impediment (49 Cal. 3d at 379-386):

> Once a court has determined that exercise of a challenged administrative power meets the "substantive limitations" requirement imposed by the state constitution's judicial powers doctrine — i.e., the challenged activities are authorized by statute or legislation, and are reasonably necessary to, and primarily directed at, effectuating the administrative agency's primary, legitimate regulatory purposes — then the state constitution's jury trial provision does not operate to preclude administrative adjudication.

The staff does not think there is a large role for jury trial in common interest development litigation, in any event. Many of the types of disputes we have identified tend to demand equitable, rather than legal, relief. Moreover, for the types of disputes that might otherwise qualify for a jury trial, the question at issue in CID cases is often one of law rather than fact.

FUNDING

Another issue the Commission must address before the staff can begin sensibly to construct an administrative adjudication dispute resolution system is the funding of the system.

One option is to have the litigants fund the system. The cost for OAH hearing services, for example, is about $140/hour, and a typical dispute probably could be disposed of with a half-day hearing. So, let's say $500 for hearing costs, to be assessed against the losing party. That could be tough for some persons to

handle, although certainly a lot less than hiring a lawyer and going to court. And the parties to these disputes are homeowners, so they are not destitute.

Mechanically, how would the funding be handled? Presumably OAH or whichever administrative adjudicator conducts the proceedings would want a deposit of estimated costs up front; they wouldn't want to get into the collection business, trying to squeeze money out of disgruntled losing litigants.

The staff wonders, though, whether a scheme that mandates use of administrative adjudication and charges the parties for its use would pass constitutional muster. There are no cases addressing this point, but given the fact that the judicial system is already in place and is taxpayer funded, the staff suspects the added burden would cause the administrative adjudication system to fall.

A better option, perhaps, is to assess CIDs universally — e.g., one dollar per unit per year. There are obvious mechanical problems with this system also. Who administers it? Does each association transmit payment to the Secretary of State with its corporate filings? What happens if the association fails to pay? Perhaps it could be administered by the County Tax Collector, in the form of an add-on to the property tax bill of individual homeowners. The Tax Collector could then transmit to the State Treasurer, who could maintain a trust fund for the purpose of covering the cost of these hearings. Are there Proposition 13 issues with this approach? The staff will research the matter if the Commission wants to pursue it.

There's also a fairness problem with a parcel tax or assessment. Associations and homeowners around the state will resist paying into a fund for the purpose of resolving disputes in dysfunctional communities. We have no statistics, but we suspect that disputes in well-managed associations are not a major problem.

Other funding ideas that have been suggested to the Commission in the past include the concept of using Secretary of State late filing fees, and tapping into federal housing block grants. We do not have detailed information about either of these potential funding sources, but we will investigate them if the Commission decides to proceed with this.

Finally, there is the possibility of an appropriation out of the state budget to cover the adjudicative function. While this matter is of substantial interest to many state residents and taxpayers, the staff is dubious about the political prospects for such an appropriation. For one thing, the state budget is currently stressed by energy expenditures, and there are no surplus funds to go around.

Additionally, there will be resistance to creation of a tax-supported dispute resolution system for CIDs when there is already an extensive and decentralized tax-supported dispute resolution system in place and available, known as the court system.

CONCLUSION

While the concept of an administrative adjudication system to resolve common interest development disputes is intriguing, the staff is not sanguine about its prospects. We think such a scheme would be constitutionally suspect under the separation of powers doctrine (unless it is administered by an agency whose regulatory function includes oversight of common interest development operations). There are also serious mechanical difficulties — state-level adjudicators will not be readily accessible to local communities, and the funding of such a scheme is problematic.

The staff thinks it makes more sense to work within established judicial and non-judicial dispute resolution frameworks. That would argue for using mediation and arbitration as an adjunct to the judicial system. The existing laws governing dispute resolution in common interest communities seek to do just that, but experience with them has been mixed, apparently because they are optional rather than mandatory. The staff thinks the Commission can do more good in this area by seeking to improve upon the existing framework than by trying to engraft an administrative adjudication scheme absent a state regulatory body to administer it.

Respectfully submitted,

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