

First Supplement to Memorandum 2004-20

**State Oversight of Common Interest Developments
(Discussion of Issues)**

This supplement presents letters commenting on the issues raised in the main memorandum. They are attached in the Exhibit as follows:

| | <i>Exhibit p.</i> |
|---|-------------------|
| 1. Mel Klein (March 31, 2004) | 1 |
| 2. Norma Walker (April 3, 2004) | 3 |
| 3. Duncan McPherson (April 4, 2004) | 4 |
| 4. Samuel Dolnick (April 5, 2004) | 5 |
| 5. Lloyd Smith (April 7, 2004) | 8 |

The memorandum also presents some recently acquired empirical data.

SUPPORT FOR STATE OVERSIGHT

Homeowner Mel Klein submitted a letter commenting on issues raised in Memorandum 2004-20. He concludes his letter with a statement of support for the concept of state oversight of CIDs (Exhibit p. 2):

It goes without saying, but establishing such an agency would to some extent relieve a burden of the Courts, producing some offsetting savings there.

More than anything else, establishing an agency, that could write rules and interpret Davis-Stirling, that could mediate, that could adjudicate, might help finally get a handle on the disturbing and non-ending parade of problems in CIDs.

Homeowner Norma Walker expresses general support for the state oversight concept and appreciation for the Commission's work (Exhibit p. 3): "I read the document, and I thought, 'this commission works very hard for many people.' I would like to thank all of you again, for all of the difficult work [you] do."

Homeowner Sam Dolnick also writes in support of the state oversight concept (Exhibit p. 4):

Thank you for the objective and complete treatment in your March 30, 2004 discussion of issues on state oversight of CIDs. It is about time, in my opinion as a homeowner involved in CIDs for

over twenty years, that a serious examination be made to involve some state agency in monitoring and overseeing this segment of society that generates hundreds of millions of dollars in income and expenditures. This is a tremendous amount of money to escape state oversight as CIDs exist by state fiat.

Mr. Dolnick believes that state oversight would provide accountability that is otherwise missing in an association, where one elected body combines executive, legislative, and judicial type powers. See Exhibit p. 5. Mr. Dolnick also suggests the need for reform of existing accounting requirements. See Exhibit p. 5-6. That issue is not directly relevant to state oversight, though compliance with accounting requirements would be an appropriate matter for state oversight. The adequacy of existing accounting requirements will be added to the list of issues for future Commission study.

OPT-OUT OF ADMINISTRATIVE ADJUDICATION

The main memorandum discusses possible separation of powers constraints on administrative adjudication. As discussed, court decisions have suggested that an administrative award of damages could invade reserved judicial powers. However, an administrative award of damages should be constitutional if the state regulatory scheme provides an opt-out, allowing the parties to choose judicial determination of the damage claim instead of administrative adjudication.

Mr. Klein is troubled by even a limited opt-out provision, as it might force some homeowners into costly litigation. See Exhibit p. 1. Of course, an opt-out would be better for homeowners than an absolute bar on administrative adjudication of damage claims, as it leaves the door open to the possibility of less expensive adjudication of the claim. If the Commission decides to proceed with development of a state oversight proposal, the scope of remedies available to the enforcement agency will need to be given careful thought.

AGENCY LOCATION

Mr. Klein suggests that the Attorney General's office be considered as one possible location for a CID oversight agency. See Exhibit p. 1. Lloyd Smith also suggests assigning state oversight duties to the Attorney General. See Exhibit p. 8. The staff agrees that the Attorney General's office should be considered as a possible host department for a CID oversight program.

REGULATION OF PROPERTY MANAGERS

Mr. Klein suggests that the Commission consider state regulation of CID property managers (at Exhibit p. 2):

Another source of funding might be a licensing fee for CID managers, whether employees of the CID, or whether a professional Management firm. The benefits would be 3-fold: a source of income to the agency, a means of requiring competence in managing the CID, and finally, a means of sanctioning management misconduct: revocation of licenses.

Such regulation would seem to be a natural complement to regulation of CIDs themselves. If the Commission decides to pursue state regulation of CIDs, the possibility of regulating CID property managers should also be examined.

FUNDING ISSUES

Mr. Klein expresses support for the general concept of a fee-per-unit funding mechanism. He also sees merit in a modest filing fee to be paid when filing a complaint with an oversight agency. See Exhibit p. 2.

Attorney Duncan McPherson identifies some technical issues that will need to be considered if the Commission recommends a fee-per-unit mechanism for funding of an oversight agency. In particular, he notes that a single home might belong to more than one homeowners association, which could lead to one home being charged multiple fees. See Exhibit p. 4. If the Commission decides to proceed with a fee-per-unit, the staff will examine this issue more closely.

SCOPE OF DAVIS-STIRLING COMMON INTEREST DEVELOPMENT ACT

Mr. McPherson also notes that some planned communities do not fall within the statutory definition of "common interest development," because there is no common property. The declaration in such a community might still call for some collective entity to enforce restrictions, including architectural control. See Exhibit p. 4. Should the state regulate such developments? That issue has broader implications than can be addressed in the study of administrative oversight of CID disputes. That issue is on the Commission's list of CID issues for future study.

NEW DATA

Report of Public Policy Institute of California

The Public Policy Institute of California has released a report on *Planned Developments in California: Private Communities and Public Life* (2004). The report examines data on real estate activity, with an emphasis on examining any racial or income segregation existing in planned unit developments. That particular issue is beyond the scope of our current inquiry. However, some general empirical data reported by PPIC is helpful in defining the scope and character of CIDs in California. Notable findings include the following:

- There are over 36,000 CIDs in California, ranging in size from three to 27,000 units each. The average planned unit development has 128 units. The average condominium or cooperative has 52 units. *Id.* at 21-22.
- CIDs include over three million total housing units, approximately one quarter of the state's housing stock. *Id.* at 20-21.
- CIDs accounted for 60% of all residential construction starts during the 1990s. The planned unit development alone represented more than 40% of single family home sales during that period. *Id.* at 3.
- Monthly assessments vary widely. In 2002, the median assessment was \$112 in a planned unit development and \$186 in a condominium or cooperative. Total homeowners association revenues were estimated to be \$6.3 billion in 2003. *Id.* at 24.

Adjudication of CID Disputes in Montgomery County, Maryland

The staff has received a report on recent experience under the Montgomery County CID dispute resolution program. The program currently serves 111,223 units in 783 registered communities. The program is funded by a \$2.25 annual per-unit fee, yielding an approximate total of \$250,000 in annual revenue. There is also a \$50 fee to file a dispute.

In recent years, an average of 40 to 64 cases have been filed each year (about one dispute for every 2,200 registered units). About half of all complaints filed are resolved without a formal hearing. An average of about three cases per year are appealed to the courts.

Respectfully submitted,

Brian Hebert
Assistant Executive Secretary

Exhibit

SUBMITTED BY ELECTRONIC MAIL BY MEL KLEIN

Davis-Stirling MM04 – Comments
March 31, 2004

THE OPT-OUT PROVISION:

From MM04: “One final consideration — the cases on separation of powers suggest that an agency may not award general compensatory damages unless the law permits either party to opt out of administrative adjudication and into the courts. If a CID oversight agency is authorized to award general damages then the law should include an opt-out provision in cases involving such damages.”

The opt-out provision, even under these limited circumstances, is mildly troubling. The purpose of administrative adjudication is to provide homeowners with means to challenge the association, yet with this opt-out provision you allow the association to disable the process, and force the homeowner into a costly appeal to the courts.

If legislation were written to explicitly allow awards under certain circumstances, as a means to ensure harmonious and reasonable management of CIDs, might the Courts view it as “substantive” (McHugh)? You appear to believe say otherwise since you write: “If a CID agency is authorized to award general damages then the law should include an opt-out provision in cases involving such damages.”

There must be some mechanism available to skirt this problem, or at least to provide the damaged party with some reasonable access to recovery.

AGENCY LOCATION:

One option you do not explicitly mention is hosting the agency under the Attorney General, who apparently already has some such authority (8216). In your earlier memorandum, 2001-44, that you reference, you identify the major sources of complaints from homeowners, and fraud is not among them, but that may be due to the inability of homeowners to get to Corporate records, etc.

A CID agency might be able to benefit from resources in the office of the Attorney General for audits, legal advice, investigation of financial and election fraud... and prosecution of crimes. This kind of thing may or may not be not be terribly widespread, but to the extent that it exists, it is one of the more important issues that a CID agency should be addressing. Additionally, locating the CID agency in

the office of the Attorney General might be a useful warning signal to current and potential violators. Just a thought...

FUNDING (1):

Another source of funding might be a licensing fee for CID managers, whether employees of the CID, or whether a professional Management firm. The benefits would be 3-fold: a source of income to the agency, a means of requiring competence in managing the CID, and finally, a means of sanctioning management misconduct: revocation of licenses.

FUNDING (2):

I agree that a \$5 yearly fee is insignificant and tolerable by the vast majority of homeowners. I would also advocate your proposal to assess a modest fee on homeowners who bring complaints, and that if they prevail, the other party be obliged to reimburse the fee. This would help defuse the protests of those who would argue, we make no trouble, why should we pay a fee? Those that make trouble pay an additional fee.

BENEFITS OF A CID AGENCY:

It goes without saying, but establishing such an agency would to some extent relieve a burden of the Courts, producing some offsetting savings there.

More than anything else, establishing an agency, that could write rules and interpret Davis-Stirling, that could mediate, that could adjudicate, might help finally get a handle on the disturbing and non-ending parade of problems in CIDs.

EMAIL FROM NORMA WALKER

Date: Sat, 3 Apr 2004

Subject: Memorandum 2004-20

Dear Brian:

I downloaded Memorandum 2004-20 today, and it was exciting for me. It was truly wonderful to see your work. I read the document, and I thought, "this commission works very hard for many people." I would like to thank all of you again, for all of the difficult work do.

I look forward to seeing the process. Carole, and I will see you soon.

Norma J. Walker

EMAIL FROM DUNCAN MCPHERSON

Date: Sun, 4 Apr 2004

Subject: Memorandum 2004-20

Brian, I was reviewing Memorandum 2004-20 relating to State Oversight of CIDs this weekend and I wanted to call to your attention some issue related to this issue. There are a substantial number of large developments where a house or unit may belong to two or three associations. Because the DRE requires separate associations for multifamily projects located within a master association or even for groups of lots which share high value facilities not shared by other members of a large association you end up with houses located within a master association, an association that maintains a gated community within a master association and then an association that maintains a condominium project or even consists of houses located on a lake or other amenity. The funding in such a case may want to make some allowance for these overlapping situations so as not to charge an individual homeowner effectively with two or three charges. A second issue which I have not seen dealt with elsewhere is that far more conflicts tend to crop up in associations which have more of an impact on an owner such as an association which manages a multi-family condominium project or other multifamily project as opposed to associations which only exist to maintain minor landscaped areas. The assessments are also higher. It might make more sense from a funding point of view to charge more to units or lots in a multifamily project than for lots in a simple planned development. There are also a substantial number of owners' associations for residential developments which are not subject to Davis Stirling since they are not technically CIDs. They have been set up to avoid the definition generally by not having "common areas". Will members of these associations which are not subject to any of the D-S regulation want to make use of the services of any such oversight agency? This is one of the reasons that I think a basic look at D-S and its definitions may be in order before tackling some of the separate areas. Not big issues but things to consider. Duncan

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April 5, 2004

Mr. Brian Herbert
Assistant Executive Secretary
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Palo Alto, CA 94303-4739

VIA FAX: 650-494-1827
Total: 3 pages

Re: Comments on Study H-853 Memorandum 2004-20
State Oversight of Common Interest Developments (Discussion of Issues)

Dear Mr. Herbert:

Thank you for the objective and complete treatment in your March 30, 2004 discussion of issues on state oversight of CIDs. It is about time, in my opinion as a homeowner involved in CIDs for over twenty years, that a serious examination be made to involve some state agency in monitoring and overseeing this segment of society that generates hundreds of millions of dollars in income and expenditures. This is a tremendous amount of money to escape state oversight as CIDs exists by state fiat.

My comments refer to **Governance** that is discussed in the paper. The other is on **Finances** that the paper does not explore.

GOVERNANCE

On page 24 the following appears: "Under existing law, a homeowner in a dispute with a homeowners association has no effective way to enforce CID law other than litigation. Many homeowners do not have the resources to pursue a meritorious case, especially if no monetary damages are involved. This reduces the accountability of associations, making it easier to disregard the law when convenient to do so."

Comment: I am sure that your files contain many illustrations where the association's board of directors, either as a group or as individuals, violated the association's governing documents and state codes pertaining to CIDs so it is not necessary for me to give more examples. However, if you wish to have some very disturbing examples where the board of directors fined and punished homeowners for the exact, same violations that the board itself did, I will be more than pleased to send them.

On page 15 under **Separation of Powers**, the following appears: "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.""

Comment: Residential community associations, legally known as CIDs, are often considered to be mini-governments or quasi-governmental agencies. Some legal scholars characterize them as the privatization of local governments. [Advisory Commission on Intergovernmental Relations. "Residential Community Associations: Private Governments in the Intergovernmental System." Publication A-112, May 1989.]

This is understandable as these CIDs collect assessments (analogous to taxes to provide services), repair and maintain roads, provide various types of amenities, collect trash, discipline members allegedly violating governing documents and state laws, and in other ways function as government do. However, there are some distinguishing features, true of governments but that are not true of CIDs.

As noted from the quote above from page 15 of your Discussion of Issues, there are three branches of the government—the legislative, executive and judicial. These three branches are consolidated in CIDs in the elected board of directors; the branches are not distinct and separate.

The boards of directors are elected by the total membership of the association. These board members then elect their own officers, including the president, who then acts as the executive officer of the board and the association. The board members, including the president, then act as the legislative branch, adopting policies including rules and regulations, and finally, they act as the judicial branch by holding hearings to discipline members of the association who allegedly violate the policies, rules and regulations that the board adopted as a legislative body.

As presently constituted there is no oversight or control over an association board. They have a free hand to do as they wish. Recalling an individual board member is almost an impossibility because of the cumulative voting provision in the governing documents, and removal of the entire board is not always prudent. Provision must be made, as a minimum, for the judicial aspect of the board to be separated from the board.

A state oversight agency would do much to level the playing field and would provide a neutral body to adjudicate the problems.

FINANCES

Although your discussion of state oversight issues does not touch upon annual financial statements and required disclosures as found in Civil Code 1365(b) it is being suggested that this be re-evaluated. Civil Code 1365(b) reads as follows.

"A **review** of the financial statement of the association shall be prepared in accordance with generally accepted accounting principles by a licensee of the California Board of Accountancy for any fiscal year in which the gross income exceeds seventy-five thousand dollars (\$75,000). A copy of the **review** of the financial statement shall be distributed within 120 days after the close of each fiscal year." [Emphasis not in original]

Comment: As noted above at least a "review" is mandatory; an "audit" is optional. The standards by the American Institute of Public Accountants (AICPA) state that a review of the financial records is less stringent than that of an audit. The differences are noted.

Review: (a) A review consists principally of asking questions of officers, directors and other personnel about the preparation of financial statements. It does not involve a consideration of internal controls and is less stringent than an audit. (b) In a review the CPA does not express an "opinion regarding the financial statement taken as a whole."

Audit: (a) An audit includes an examination on a test basis of the financial documents and requires obtaining evidence supporting the amounts and disclosures in the financial statements. The responses to this request are

submitted directly to the CPA in written form. Thus, the audit attempts to verify the material the association produces and may uncover material withheld by the association. (b) In an audit the CPA states that the "audit provides a reasonable basis for our opinion" based on the overall evaluation of the financial statements. An opinion is thus stated.

In short, in a review the auditor accepts whatever is presented to him/her without any critical analysis. An audit tests and examines the data to insure its accuracy.

A simple change to 1365(b) would substitute the word "audit" where ever the word "review" appears. With the hundreds of millions of dollars involved in CIDs, a review of association finances is not sufficient to protect the CID homeowners. Hopefully, the CLRC will consider the change.

Thank you, Mr. Herbert, for considering the above suggestions and comments to Memorandum 2004-20. I am available to you if needed.

Sincerely yours,



Samuel L. Dolnick
Condo Homeowner

EMAIL FROM LLOYD SMITH

Date: Wed, 7 Apr 2004

Subject: Homeowner Association Regulatory Unit

HOMEOWNER ASSOCIATION OVERSIGHT

PROPOSED BILL OUTLINE

- Require the Office of the Attorney General to establish an oversight / ombudsman unit to regulate homeowner associations (HOA) (aka Common Interest Developments or Non Profit Mutual Benefit Corporations).
- Provide the Office of the Attorney General with a mandated regular source of funding from a fee on each of the homeowner associations in CA based on the number of units in the HOA.
- Jurisdiction of unit should address the failure of CIDs to provide member rights under the Davis-Stirling Act and corporations law in general including such issues as:
 - Homeowner access to books and records
 - Boards meeting in secret or without notice
 - Vague or arbitrary governing documents
 - Voting irregularities
- Jurisdiction should exclude daily living issues that homeowners face such as barking dogs, untrimmed trees, etc.
- Bill to take effect 1/1/05 but implementation delayed until 7/1/05 or 1/1/06 to provide said agency with sufficient time to collect fees and establish program.

Sincerely

Lloyd Smith
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