Study H-851 April 8, 2004

Memorandum 2004-23

Common Interest Development Law: AB 1836 (Harman); AB 2376 (Bates)

There are currently two bills before the Legislature that would implement Law Revision Commission recommendations on common interest development law:

- AB 1836 (Harman) would implement the recommendation on *Alternative Dispute Resolution in Common Interest Developments*, 33 Cal. L. Revision Comm'n Reports 689 (2003).
- AB 2376 (Bates) would implement the recommendation on *Common Interest Development Law: Architectural Review and Decisionmaking*, 34 Cal. L. Revision Comm'n Reports __ (2004).

Both of these bills have been "double-referred" in the Assembly, meaning that they will need to be heard and approved by two policy committees — the Committee on Housing and Community Development and the Judiciary Committee. Both bills were unanimously approved by the Housing and Community Development Committee on March 24. AB 1836 has been set for hearing in the Assembly Judiciary Committee on April 20.

We have received a number of suggestions for improvement of the bills. They are discussed in this memorandum. Unfortunately, the hearing schedule may be such that we will need to make decisions on some of the suggestions before the April 15 meeting of the Law Revision Commission. If so, the staff will follow our usual practice of consulting with the chair or vice-chair before approving a significant substantive change.

Except as otherwise indicated, all statutory references in this memorandum are to the Civil Code.

SUPPORT AND OPPOSITION

Wilbur Haines III, a private attorney, has concerns about the ADR bill (AB 1836). One of the points he raises exposes an apparent defect in existing law (see "Refusal of ADR" below).

The California Association of Community Managers ("CACM") will support the architectural review bill (AB 2376) if one change is made.

The California Association of Realtors has indicated that it might support the architectural review bill (AB 2376) if its proposed changes are made.

The Congress of California Seniors ("CCS") opposes both bills. Its opposition has been echoed by the Older Women's League and the California Alliance of Retired Americans. At CCS' urging, the Gray Panthers withdrew a letter of support for the architectural review bill.

ALTERNATIVE DISPUTE RESOLUTION

Refusal of ADR

Under existing law, a person who wants to file a civil suit to enforce an association's governing documents must first endeavor to submit the dispute to some form of ADR. Section 1354(b). The non-filing party is not required to participate in ADR. However, refusal of ADR by the non-filing party has legal consequences (as discussed below).

There appears to be an ambiguity in existing law as to what constitutes "refusal" of ADR. Suppose that the filing party offers one form of ADR (e.g., mediation). The nonfiling party declines the offered form, but counters with an offer of another form (e.g., arbitration). Has the nonfiling party refused to participate in ADR?

Existing law includes a requirement that the nonfiling party "accept or reject" an offer of ADR within 30 days or the offer is deemed rejected. Section 1354(b). However, that doesn't resolve the ambiguity, it merely shifts it to another context. The non-filing party could respond to an offer of ADR with acceptance conditioned on a particular form of ADR being used. Would such qualified acceptance be considered rejection?

The staff has not found any published appellate decision that addresses this ambiguity, though the issue is discussed in two unpublished decisions. Those cases do not provide binding legal precedent but do illustrate that the ambiguity is more than hypothetical. See Seven Oaks Homeowners Association, Inc. v. Abureyaleh, 2003 WL 22112008 (offer of different mediator was not refusal of ADR), The Courtyards Of West Hollywood Homeowners' Association, Inc. v. Fine, 2003 WL 128777 (rejection of binding arbitration not "outright refusal" of ADR).

The meaning of "refusal" or "rejection" of ADR is relevant in two contexts:

Attorneys Fees

If one party refuses to participate in ADR, the court may consider that fact in determining the amount of attorneys fees and costs awarded to the prevailing party. Section 1354(f). In this context it isn't crucial that we decide whether declining a particular form of ADR should be considered "refusal" of ADR generally. A court can examine all of the circumstances surrounding the offer and counter-offer and reach its own conclusions on the equities of the situation. The Commission previously considered the meaning of "refusal" in this context and decided that no clarification of the law was required.

Demurrer

At the time of filing a complaint to enforce governing documents, a plaintiff must also file a certificate stating that ADR has been "completed." Failure to file such a certificate is grounds for demurrer. However, there is an exception to the demurrer if the plaintiff certifies in writing that one of the other parties to the dispute "refused alternative dispute resolution prior to the filing of the complaint…." Section 1354(c). Thus, in order to proceed with litigation, one must either certify that ADR was completed or that it was refused by the other party.

If the non-filing party declines an offer of mediation and counters with an offer of arbitration, has it refused ADR? If so, the filing party can certify that ADR was refused and proceed with litigation. If not, the filing party must either accept the offer of arbitration and complete it, or must drop the suit. Under the latter construction, the non-filing party controls the form of ADR and can attempt to block litigation by choosing a form that the filing party is unlikely to accept.

Existing law excuses compliance with the ADR requirements if necessary to avoid "substantial prejudice" to one of the parties. That could provide a remedy for the problem described above. Section 1354(c). However, it would probably be better to have a bright line rule on which the filing party could rely.

Any problems caused by the existing ambiguity would be worsened by the proposed law, which would expand the scope of actions that are subject to pre-litigation ADR requirements (to include an action to enforce the Davis-Stirling Common Interest Development Act or the Nonprofit Mutual Benefit Corporation Law).

Recommendation

The staff recommends that proposed Civil Code Section 1369.560(b) be revised as follows:

> 1369.560.…
> (b) Failure to file a certificate pursuant to subdivision (a) is grounds for a demurrer or a motion to strike unless one of the following conditions is satisfied:
> (1) The party commencing the action certifies in writing that one of the other parties to the dispute ~~refused~~ did not accept the offered form of alternative dispute resolution before commencement of the action, or that preliminary or temporary injunctive relief is necessary.
> (2) The court finds that dismissal of the action for failure to comply with this article would result in substantial prejudice to one of the parties.
>
> **Comment.** …
> Subdivision (b) continues the substance of the second sentence of former Section 1354(c), ~~but~~ with two exceptions. (1) It no longer excuses compliance if the statute of limitations would run within 120 days after filing. *Cf*. Section 1369.550 & Comment (tolling of statute of limitations). (2) It eliminates an ambiguity in prior law as to whether refusal of the offered form of alternative dispute resolution excuses compliance. Nothing in this section affects a court's discretion to consider refusal to participate in alternative dispute resolution in determining the amount of fees and costs awarded under Section 1369.580. See also Code Civ. Proc. §§ 430.10 (demurrer), 435 (motion to strike).

Note that the term "refused" would be replaced with the phrase "did not accept." This would provide slightly better coordination with the rule that failure to accept ADR within 30 days is deemed rejection of ADR.

This is not a perfect solution. It would allow a plaintiff who wishes to avoid ADR to offer a form that the other party is likely to decline. However, that problem is not as serious as the existing problem of a plaintiff being forced to choose between accepting an unwanted form of ADR or being barred from litigation.

The proposed change would not address the meaning of "refusal" in the context of determining the amount of fees and costs awarded to a prevailing party. The staff prefers to leave that issue to the discretion of the court. In some cases a counter-offer of a different form of mediation may be made in good faith and for good reason. In another case it might be purely tactical. That determination can best be made after considering all of the facts of the case.

Small Claims Court as an Alternative to ADR

Mr. Haines approves of the provision of the proposed law making clear that the ADR requirement does not apply to a case brought in small claims court. Small claims court serves much the same function as ADR, providing a relatively informal dispute resolution process at little cost. Mr. Haines offered two suggestions regarding use of small claims court to resolve CID disputes.

Expanded Jurisdiction

Mr. Haines suggests that the jurisdiction of the small claims court in a CID case be expanded to include actions for declaratory relief and injunction. The Commission considered that issue at length. See Memorandum 2001-43 (5/4/2001) (available at www.clrc.ca.gov/memocat2001.html). Ultimately, the Commission decided against recommending such a change. The Commission's reasons included the following:

(a) Resolution of equitable issues is complex and would complicate small claims procedure.
(b) Personnel used in small claims court may not be qualified to make these types of determinations.
(c) Equitable relief is more far-reaching than monetary relief and should only be awarded with due care and appropriate legal representation.
(d) Equitable relief can have a major impact on parties not before the court, which makes it particularly inappropriate for the small claims context.

The staff sees no reason to revisit that decision.

Prominence of Small Claims Court Exemption

The proposed law expressly provides that the ADR requirement does not apply to a case brought in small claims court. See proposed Section 1369.520(b). ("This section does not apply to a small claims action.") Mr. Haines feels that the placement and phrasing of this sentence may make it hard for a layperson to understand that a small claims case may be brought without first submitting it to ADR.

The staff feels that the provision is reasonably clear. However, interested persons and groups are invited to offer suggestions on how the provision might be made clearer.

Presumption that Procedure is Fair, Reasonable, and Expeditious

Proposed Section 1363.820(b) provides:

> A dispute resolution procedure provided by an association is presumed to be fair, reasonable and expeditious. The presumption created by this subdivision is a presumption affecting the burden of proof.

Both Mr. Haines and the Congress of California Seniors object to the presumption as tilting the table too far in the board's favor.

In principle, the presumption is sensible. The point of the internal dispute resolution process is to bring the parties to the table, in the hope that they can reason their way to a solution. We don't want the negotiation process itself to provoke a dispute over the procedure, which would do nothing to resolve the underlying substantive dispute. What's more, the presumption is consistent with general law on who carries the burden of proof. Evidence Code Section 500 provides that "a party has the burden of proof as to each fact the existence or nonexistence of which is essential to the claim for relief or defense that he is asserting." So even without the presumption, a person claiming that an association's procedure is defective would bear the burden of proving the defect.

Unfortunately, the presumption may appear to favor boards at the expense of homeowners. We were successful in explaining the rationale for the presumption to the Assembly Housing and Community Development Committee. However, it is likely that opposition to the presumption will continue to surface. Eventually, it may become necessary to remove the presumption.

Notice of Internal Dispute Resolution Procedure

The Congress of California Seniors correctly notes that the bill does not provide for homeowner notice of the internal dispute resolution process. If we give notice of every legal right we risk overloading homeowners with information. However, annual notice of the right to informal resolution of disputes would probably be helpful and shouldn't be terribly burdensome. The notice could be incorporated into the existing annual notice of the pre-litigation ADR requirements. **The staff recommends that Section 1363.850 be added and Section 1369.590 be amended, as follows:**

> 1363.850. The notice provided pursuant to Section 1369.590 shall include a description of the internal dispute resolution process provided pursuant to this article.

Comment. Section 1363.850 is new. See Section 1351(a) ("association" defined).

1369.590. (a) An association shall annually provide its members a summary of the provisions of this article, that specifically references this article. The summary shall include the following language:

> Failure of a member of the association to comply with the prefiling requirements of Section 1369.520 of the Civil Code may result in the loss of your right to sue the association or another member of the association regarding enforcement of the governing documents or the applicable law.

(b) The summary shall be provided either at the time the pro forma budget required by Section 1365 is distributed or in the manner prescribed in Section 5016 of the Corporations Code. The summary shall include a description of the association's internal dispute resolution process, as required by Section 1363.580.

ARCHITECTURAL REVIEW

Right of Appeal

The proposed law on architectural review provides for appeal of a disapproval decision to the board of directors of the association, at an open meeting. Recognizing the futility of appeal if the disapproval decision was itself made by the board of directors at an open meeting, the proposed law specifically exempts such decisions from the right of appeal.

The California Association of Community Managers maintains that in some associations the board of directors makes architectural review decisions, but it does so under separate authority as the architectural review committee, rather than under its authority as board of directors. In other words, the board of directors adjourns as board of directors and reconvenes as the architectural review committee — the same people wearing different "hats."

If it is futile to require an appeal of a decision made by the board of directors, then it is also futile to require an appeal of a decision by the board wearing different hats, *provided that the decision is made at an open meeting satisfying all of the procedural requirements that govern board meetings*. CACM asks that the exception to the right of appeal be expanded to include decisions made under such circumstances.

The staff recommends that proposed Section 1378(a)(4) be revised as follows:

> If a proposed change is disapproved, the applicant is entitled to reconsideration by the board of directors of the association that made the decision, at an open meeting of the board. This paragraph does not require reconsideration of a decision that is made by the board of directors or a body that has the same membership as the board of directors, at ~~an open meeting of the board~~ a meeting that satisfies the requirements of Section 1363.05.

Section 1363.05 is the section that governs the procedure by which board meetings are held. It generally requires that the meeting be open to members, that members be allowed to speak, that minutes be maintained, and that notice of the meeting be given in advance of the meeting.

Time Period for Review

The proposed law requires that architectural review be "expeditious" but does not impose any specific timeframe. The Congress of California Seniors is concerned that the absence of a timeframe could lead to unreasonable delay. This could harm an applicant who needs a prompt decision (e.g., a homeowner who is about to lose a favorable interest rate on construction financing).

One possible solution would be to require that an association state a timeframe as part of its architectural review procedure. That would give homeowners guidance on what to expect, without tying all associations in the state to one fixed timeframe. That approach seems reasonable.

One member of the Housing Committee offered a further wrinkle, suggesting that the statute might set a ceiling. E.g., "The association's procedure shall include a time period for response to an application or a request for reconsideration. The time period shall not exceed __ days."

However, such a ceiling could conflict with regular meeting schedules. Suppose a board meets every other month and the statute requires reconsideration of a disapproval within 30 days. The board would need to hold a special meeting to hear that appeal. In a large association with many architectural review cases this could be a significant drain on association resources.

A possible solution to that problem would be to require action no later than the next regularly scheduled meeting. However, that approach has its own drawbacks. First, it would not work if an architectural committee does not hold regular meetings. Second, some applications and appeals would be on a very short fuse. Suppose an application is submitted one day before the next meeting of the architectural committee. The committee would have no time to prepare.

It makes sense to require that an association state its own timeframes. However, the idea of setting a statutory ceiling may raise too many practical problems to be workable. **The staff recommends the following change to Section 1378(a)(1)**:

> The association shall provide a fair, reasonable, and expeditious procedure for making its decision. The procedure shall be included in the association's governing documents. The procedure shall state the maximum time for response to an application or a request for reconsideration by the board of directors.

Annual Notice of Architectural Review Policy

The California Association of Realtors suggests that an association should provide annual notice to its members, indicating what type of changes are subject to architectural review and what procedure will be followed in reviewing a proposed change and making a decision. Such notice is obviously beneficial, *if it is read*. As discussed above, the staff is concerned about overloading homeowners with cumulative annual notices (all of which would probably be mailed at the same time). Nonetheless, many problems might be avoided by reminding homeowners of the sorts of changes that require association approval.

The staff recommends that the following provision be added to Section 1378:

> An association shall annually provide its members with notice of association policy on physical changes to property. The notice shall describe the types of changes that require association approval and shall include a copy of the procedure used to review and approve or disapprove a proposed change.

Time and Place of Hearing

The California Association of Realtors also suggests that an owner who applies for approval should be told when and where the application will be considered. In some associations the procedure for making an initial architectural review decision will not involve a hearing. For those associations, the proposed notice would be unnecessary. In an association where the initial decision is made at a hearing, it seems self-evident that the association would tell the applicant when and where to appear. The staff does not believe that the proposed law needs to specify procedures at that level of detail. The general approach in the proposed law is to avoid overly-detailed procedures.

PROCEDURE FOR DEVELOPING PROCEDURES

AB 1836 would require that an association maintain an internal dispute resolution procedure. If it does not, a statutory meet and confer procedure would apply. AB 2376 would require that an association maintain a fair, reasonable, and expeditious architectural review procedure. Neither bill specifies the process by which a procedure would be adopted.

In some cases, an association may already have an adequate procedure as part of its governing documents. However, many associations would need to adopt or amend a procedure to comply with the proposed laws. It is likely that most associations would do so by adopting operating rules rather than amending their declarations or bylaws.

The Congress of California Seniors believes that any procedural change should be made by the board of directors and the homeowners working together. CCS believes that this will result in a greater commitment to the process and greater compliance with the law.

One way to implement that concept would be to provide that any procedural change that is adopted as an operating rule be subject to the rulemaking procedures enacted last year in AB 512. This would provide homeowners with advance notice of the proposed procedure, an opportunity to comment, a final decision at a meeting of the board, and notice of the resulting procedure. If 5% or more of the homeowners are unsatisfied with the procedure, it would be subject to reversal by referendum. That strikes the staff as a reasonable approach.

In its most recent communications, CCS indicates that it would accept application of the AB 512 rulemaking process as a means of developing the statutory procedures. **The staff recommends that Section 1357.120 be amended to include provisions along the following lines:**

> 1357.120. (a) Sections 1357.130 and 1357.140 only apply to an operating rule that relates to one or more of the following subjects:
>
> (1) Use of the common area or of an exclusive use common area.
>
> (2) Use of a separate interest, including any aesthetic or architectural standards that govern alteration of a separate interest.
>
> (3) Member discipline, including any schedule of monetary penalties for violation of the governing documents and any procedure for the imposition of penalties.
>
> (4) Any standards for delinquent assessment payment plans.
>
> (5) Any procedures adopted by the association for resolution of ~~assessment~~ disputes.

(6) Any procedures for reviewing and approving or disapproving a proposed physical change to a member's separate interest or to the common area.

Comment. Section 1357.120 is amended to expand the types of operating rule changes that are subject to the rulemaking procedures provided in Sections 1357.130 and 1357.140. See Sections 1363.820 (internal dispute resolution process), 1378(a)(1) (procedure for reviewing proposed physical change to separate interest or common area).

This would broaden the scope of operating rules that are subject to the notice, comment, and referendum provisions, to include any operating rule affecting the procedures required in AB 1836 and AB 2376. There are technical drafting issues that would arise if both bills amend the same section, but those issues are easily addressed.

Note that the proposed amendment would not preclude adoption of a procedure by amendment of an association's declaration or by-laws. Changes to those documents require a vote of the membership, providing a higher degree of member involvement than that provided under the operating rule procedures.

OTHER ISSUES

The Congress of California Seniors raises a number of other issues that the staff believes do not warrant an amendment. They are discussed briefly below. The staff does not intend to discuss these issues at the meeting unless Commissioners have questions.

Alternative Dispute Resolution

Lack of Neutral in Internal Dispute Resolution Process

CCS objects that the meet and confer process does not involve a neutral third party, which they suggest is a necessary element. In fact, numerous "meet and confer" requirements exist in state law, especially in the context of labor negotiation, and they typically do not involve the participation of a neutral third party. See, e.g., Gov't Code § 3505. The purpose of a "meet and confer" is to see whether there is room for compromise before the parties incur the expense associated with involvement of a third party.

Assessments Exempt from Internal Dispute Resolution Requirements

CCS objects that the meet and confer procedure does not apply to an assessment dispute that is subject to Section 1367.1(c). See proposed Section 1363.810(c).

Section 1367.1(c) provides an informal procedure for disputing an assessment or requesting a payment plan for an overdue assessment. That provision serves much the same purpose as the proposed meet and confer requirement. The Commission did not want its general procedure to override a newly-minted procedure that applies to a specific type of dispute.

Choice of ADR Form

CCS would require that the form of ADR chosen by the parties be "inexpensive." Specifically, CCS suggests that the law require use of "community-based mediation programs" that are included on lists maintained by the Department of Consumer Affairs and the federal Department of Housing and Urban Development. Nothing in the proposed law precludes use of these programs. However, it isn't clear why the parties should be barred from using other resources. What if the parties believe that a slightly more expensive form of ADR would be significantly more likely to resolve their dispute (thereby sparing them the greater expense of litigation). Shouldn't they be free to choose the form of ADR they think best suited to their circumstances?

The Commission recommended that existing law on this issue be continued, leaving the parties free to choose whatever form of ADR they consider appropriate to resolving their dispute. Absent some evidence that the parties would be better off with a more limited range of choices, the staff sees no reason to revisit the Commission's decision on this point.

Lack of "Enforcement Mechanism"

CCS objects that the proposed law does not include an "enforcement mechanism." If an association declines to adopt and use an internal dispute resolution process, the homeowners could address the problem by recalling the board or electing a new board at the next general election. They could also litigate the issue. It isn't clear what additional mechanism CCS has in mind. State administrative oversight would be helpful. We are currently studying that possibility.

Architectural Review

Architectural Standards and Local Building Codes

CCS objects that the proposed law does not require that there be consistency between an association's architectural standards and local building and safety codes. That is an important topic, but it is beyond the scope of the proposed law, which addresses the *procedure* to be used in architectural review decisionmaking, not the substantive standards that an association applies.

Unlawful Review

CCS objects to the fact that the proposed architectural review requirements would only apply to the extent that an association has authority to conduct architectural review. CCS believes that the proposed law should also apply to associations that conduct architectural review without legal authority to do so.

The staff disagrees. Statutory regulation of conduct that exceeds a board's lawful authority could be seen as accepting or legitimizing such conduct. What's more, it is unlikely that a scofflaw board would comply with the proposed law, even if it did apply.

Unlawful exercise of architectural control, if it is a problem, is beyond the scope of the proposed law.

Retroactive Application of Revised Standards

CCS is concerned that an association may amend its governing documents so as to substantively change its architectural standards and then apply those standards to properties that were purchased prior to the amendment. CCS believes that this should be limited in some fashion. That issue might be worth studying, but it is beyond the scope of the current proposal.

Terminology and Scope of Application

CCS is generally concerned that the term "physical change" is too broad, potentially encompassing any trivial change a homeowner might make. However, that is not a problem. The proposed law only applies to the extent that the governing documents require architectural review. Therefore, it is the association's governing documents, and not the proposed law, that define the scope of architectural review. Because the proposed law is protective and not unduly burdensome, it should apply to any lawful exercise of architectural control. The language used in the proposed law should be as broad as possible.

Lack of "Enforcement Mechanism"

CCS again objects to the lack of an "enforcement mechanism." As discussed above, it is not clear what CCS has in mind. The practical problems relating to enforcement of CID law are general ones, which the Commission should address as part of its study of state oversight options.

Respectfully submitted,

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