Study H-856 December 2, 2008

Memorandum 2008-63

Common Interest Development Law: Nonresidential Associations (Scope and Methodology of Study)

The Commission has broad authority to study revision of statutory law relating to common interest developments ("CIDs"). 2007 Cal. Stat. res. ch. 100. At its October 2008 meeting, the Commission decided to study the application of the Davis-Stirling Common Interest Development Act (Civ. Code §§ 1350-1378) to nonresidential CIDs. CLRC Minutes (October 2008), p. 3.

This memorandum introduces the project, discusses its scope, and proposes a methodology for analysis of the issue presented. Future memoranda will apply that methodology to formulate a tentative recommendation.

The following materials are attached as exhibits:

GENERAL DESCRIPTION OF STUDY

Scope of Study

It has been suggested to the Commission that certain provisions of the Davis-Stirling Common Interest Development Act (hereafter, "Davis-Stirling Act"), the chief statutory authority governing CIDs, create problems when applied to exclusively nonresidential CIDs (e.g., commercial or industrial developments). In response to that concern, this study will address whether entirely nonresidential CIDs should be exempted from some or all provisions of the act.

The study will not propose any revision to any aspect of CID law affecting residential CIDs. Further, although many nonresidential CIDs are incorporated, the study will not propose any revision of the Corporations Code, nor propose

any legislation affecting common law principles applicable to nonresidential CIDs.

The staff encourages input from stakeholders and other interested persons as to the practical considerations relevant to this project. It is expected that this input will substantially affect the Commission's recommendations in this matter.

NATURE OF THE PROBLEM

Coverage of the Davis-Stirling Act

The Davis-Stirling Act, enacted in 1985, is a comprehensive statute governing many aspects of a common interest development, including governance, ownership rights, operations, fiscal considerations, and litigation issues. The scope of the act is quite broad, by its terms applying to any real estate development in which ownership of separate interests in a real estate development is coupled with an interest in common area within the development. Civ. Code §§ 1351(b), 1351(c), 1351(*l*), 1352.

Much of the text of the act suggests that the act is intended to apply primarily to residential common interest developments. See, e.g., Civ. Code §§ 1360.5 (rules relating to number of pets owner may keep); 1376 (restrictions on installation or use of antenna). However, the act is applicable to purely nonresidential CIDs as well, including business parks, medical office parks, shopping centers, and industrial developments.

Civil Code Section 1373

In 1988, the Legislature partially addressed the application of the Davis-Stirling Act to nonresidential CIDs by enacting Civil Code Section 1373. The section presently reads as follows (with additional explanatory information italicized and shown in brackets):

> 1373. (a) The following provisions do not apply to a common interest development that is limited to industrial or commercial uses by zoning or by a declaration of covenants, conditions, and restrictions that has been recorded in the official records of each county in which the common interest development is located:
> (1) Section 1356 [*amendment of declaration*].
> (2) Article 4 (commencing with Section 1357.100) of Chapter 2 of Title 6 of Part 4 of Division 2 [*operating rules*].
> (3) Subdivision (b) of Section 1363 [*budget and financial reporting*].
> (4) Section 1365 [*budget and financial reporting*].

(5) Section 1365.5 [*fiscal duties of directors*].

(6) Subdivision (b) of Section 1366 [*limit on annual increase of regular assessments*].

(7) Section 1366.1 [*limit on assessments or fees to actual cost*].

(8) Section 1368 [*disclosure to prospective purchaser of separate interest*].

(9) Section 1378 [*architectural review*].

(b) The Legislature finds that the provisions listed in subdivision (a) are appropriate to protect purchasers in residential common interest developments, however, the provisions may not be necessary to protect purchasers in commercial or industrial developments since the application of those provisions could result in unnecessary burdens and costs for these types of developments.

As stated in subdivision (b), the Legislature recognized in 1988 that application of some provisions of the Davis-Stirling Act to purely commercial or industrial CIDs may be unnecessary and burdensome. Nevertheless, since 1988 the Legislature has made only two additions to the "nonapplicability list" in Section 1373, despite numerous changes to the Davis-Stirling Act. (For example, in the last six years, at least 22 bills significantly revising CID law have been enacted.)

Further, both of the additions to Section 1373 were made on the Commission's recommendation. See *Common Interest Development Law: Association Rulemaking and Decisionmaking*, 33 Cal. L. Revision Comm'n Reports 81 (2003), *Common Interest Development Law: Architectural Review and Decisionmaking*, 34 Cal. L. Revision Comm'n Reports 107 (2004). In each of those recommendations, the Commission concluded that the new law it was proposing should not apply to nonresidential CIDs, for the reasons stated in Section 1373(b).

In contrast, every other new change to the Davis-Stirling Act since 1988, including many that appear to be aimed solely at protecting unsophisticated homeowners, has been enacted without a corresponding amendment to Section 1373. As a result, all of these changes in the law (other than amendments to sections listed in Section 1373) are now applicable to a nonresidential CID by default.

Enactment of Section 1373

The staff has reviewed the legislative history of the bill enacting Civil Code Section 1373 (1988 Cal. Stat. ch. 123 (AB 2484 (Hauser)). Although there is not a significant amount of citable history available, a handful of documents located in

the California State Archives provide some historical insight as to the legislative view on this issue:

- Two sources suggest that the Davis-Stirling Act as originally enacted was not intended to apply to nonresidential CIDs *at all*. See letter to Michael Krisman, administrative aide of Assembly Member Dan Hauser, the author of the bill, from Jerold L. Miles, dated September 16, 1986, p. 1, and an enrolled bill report on AB 2484 from the Office of Local Government Affairs, dated May 23, 1988, p. 2, both on file with the Commission.
- A draft amendment to AB 2484 prior to its enactment appears to indicate that Section 1373, as originally introduced, would have exempted nonresidential developments from *all* provisions of the Davis-Stirling Act.
- A letter from the Building Industry Association (hereafter, "BIA") to Assembly Member Hauser suggested a narrower approach. Exhibit, p. 1. In the letter, BIA argued that certain parts of the Davis-Stirling Act were useful to nonresidential CIDs, and should continue to apply to such CIDs (i.e., Sections 1352 (statutory creation of a CID), 1355 (amendment of a declaration), 1351(i) (establishment of exclusive use common area), 1354 (enforcement of declaration), and 1366 and 1367 (assessments and assessment liens)). BIA therefore proposed that only a handful of unhelpful provisions be made inapplicable to such developments.
- A subsequent amendment to AB 2484 implemented BIA's proposal, and the bill was enacted in that form. See 1988 Cal. Stat. ch. 123; Civ. Code § 1373 (a)(1), (3)-(8).
- In the same letter, BIA had also suggested that AB 2484 provide that any "additional provision" added to the Davis-Stirling Act in the future would be inapplicable to nonresidential CIDs, unless the new provision was "expressly made applicable" to such CIDs. Exhibit, p. 2. That proposal was not implemented.

This history suggests legislative ambivalence about whether the Davis-Stirling Act as a whole is appropriately applied to nonresidential CIDs, combined with recognition that some parts of the Davis-Stirling Act may be useful to nonresidential CIDs.

Subsequent Amendment of Section 1373

Section 1373 has been amended twice. Both amendments were recommended by the Commission.

In 2003, the Commission recommended improvements to the law governing association rulemaking, and thereafter ratified a proposed amendment to the bill effectuating the Commission recommendation that made the new rulemaking

provisions inapplicable to nonresidential CIDs. See *Common Interest Development Law: Association Rulemaking and Decisionmaking*, 33 Cal. L. Revision Comm'n Reports 81 (2003) (enacted as 2004 Cal. Stat. ch. 346). The Commission agreed that the new proposed law could cause unintended consequences if applied to nonresidential CIDs. See CLRC Memorandum 2003-23, pp. 4-6.

In 2004, the Commission recommended improvements to the law governing architectural review of an owner's proposed changes, again including a recommendation that the new architectural review provisions be inapplicable to nonresidential CIDs. See *Common Interest Development Law: Architectural Review and Decisionmaking*, 34 Cal. L. Revision Comm'n Reports 107 (2004) (enacted as 2003 Cal. Stat. ch. 557).

There was no opposition to either of those proposed amendments to Section 1373.

Other Changes to the Davis-Stirling Act Since 1988

The Davis-Stirling Act has been changed many times since 1988. A review of committee analyses of several bills making those changes does not show any express consideration of whether the changes should be applicable to nonresidential developments. Instead, most analyses focus on issues relevant to "homes," "housing," "homeowner's associations," and similar terms associated with residential CIDs.

For example, the synopsis in a 2005 committee analysis of a bill adding Civil Code Section 1365.2, concerning member inspection of association records, includes the following:

> No longer limited to condominium associations, common interest developments are now reported to be the dominant form of new *housing* construction in California. As the author reports, the *homeowner* associations that run these developments have important responsibilities and extensive power over the *homes* of people who purchase properties in these developments. In light of these powers and responsibilities, supporters argue, this bill is necessary to establish clear and fair election procedures regarding key association functions, and to promote fairness and transparency in the management of these associations by detailing the financial records that *homeowners* are entitled to inspect.

Assembly Committee on Judiciary Analysis of AB 1098 (Jones) (April 26, 2005), p. 1 (emphasis added).

Commenter Concerns

In connection with the Commission's study of *Statutory Clarification and Simplification of CID Law*, the California Association of Community Managers, Inc. (hereafter, "CACM") suggested that nonresidential CIDs should be exempted from Civil Code Section 1363.03. That section added to the Davis-Stirling Act in 2006 to establish detailed rules for member elections. CACM explained why the provisions were not needed by owners and managers of nonresidential CIDs, and instead were causing unnecessary burden and expense. Exhibit, p. 3. As CACM explained:

> We believe this proposed revision will be non-controversial. The only objection we can candidly imagine is a blanket argument that this is a whittling away of the recently passed legislation imposing secret ballots on all community associations. However, the protections of that legislation were never intended for this market. The following two demographic facts differentiate the purchaser of a commercial building or unit from the purchaser of a residence: (1) Approximately 90% of the owners who purchase buildings or commercial units in the associations own them as a corporation, LLC, trust or partnership. Almost all of these, whether they are owned as noted above or as individuals/joint tenants, own and operate an incorporated business within the building or unit. These parties are sophisticated. They have hired legal counsel to form their legal entities and have the legal and financial resources to hire legal counsel when they believe it appropriate to protect their interests. (2) The typical purchase price, represented as the middle 70% of the building or units sold today, varies between $1,000,000 - $4,000,000. The purchase and sale of these buildings and units are typically facilitated by one or more attorneys, who are obligated to protect the interests of their clients through the diligence process. In summary, these are parties who have the sophistication to manage businesses, take advantage of legal and tax opportunities presented to such businesses and to purchase multimillion dollar buildings for the tax and estate benefits provided thereby.

Exhibit, p. 4.

The Commission agreed to recommend the exemption proposed by CACM. See further discussion in the Fourth Supplement to CLRC Memorandum 2007-4, pp. 2-3. The exemption was included in AB 1921 (Saldana), which implemented the Commission's recommendation. There were no objections to the proposed amendment of Section 1373.

Duncan McPherson, a Stockton attorney, has also expressed concern about the application of provisions in the Davis-Stirling Act to nonresidential CIDs. Exhibit to CLRC Memorandum 2008-05, pp. 9-10, 14. Mr. McPherson argues that significant differences between residential and commercial CIDs in terms of types of ownership interests, organization, and complexity raise serious questions as to whether many provisions of the Davis-Stirling Act should apply to nonresidential developments.

Need for Revision

Before further considering how this study should proceed, the Commission might want to evaluate whether any revision of existing law in this area is warranted at all.

One *could* argue, in light of the existence of Civil Code Section 1373, that each legislative change to the Davis-Stirling Act since 1988 implies a legislative determination that the new change in the law should be applicable to nonresidential CIDs.

However, it seems unlikely the Legislature has made such determinations. The lack of controversy surrounding the two Commission recommended amendments to Section 1373, the clear focus of many of the newer provisions of the Davis-Stirling Act on homeowner protections, and comments from knowledgeable stakeholders all strongly suggest that the Legislature has not been focused on whether reforms to the Davis-Stirling Act should apply to nonresidential CIDs.

The staff recommends that **the Commission study the question and draft a recommendation to exempt nonresidential CIDs from unnecessary regulation under the Davis-Stirling Act.**

METHODOLOGY OF STUDY

Meaning of "Nonresidential CID"

In this memorandum, the staff has generally referred to a "nonresidential CID." That term is used as a shorthand for the more detailed language in Section 1373(a):

> 1373. (a) The following provisions do not apply to *a common interest development that is limited to industrial or commercial uses by zoning or by a declaration of covenants, conditions, and restrictions that*

has been recorded in the official records of each county in which the common interest development is located:
(1) ….

(Emphasis added).

That language was developed in part by the Commission in 2004, in connection with its recommendation on CID architectural review. See discussion in CLRC Memorandum 2004-5, pp. 10-12. The Commission agreed to amend the language to bring Section 1373 into conformity with parallel language used in Business and Professions Code Section 11010.3, which provides an exemption for nonresidential CIDs from certain provisions relating to subdivided land.

The language in Section 1373 could perhaps be improved upon. However, it is Commission policy not to recommend a reversal of language enacted upon Commission recommendation absent good reason. CLRC Handbook of Practices and Procedures Rule 3.5 (May 2005). **The staff recommends that the definitional language in Section 1373 be left unchanged.** The language in Section 1373 is familiar to owners and practitioners, and is consistent with the exemptions provided by Business and Professions Code Section 11010.3.

Determining Applicability of Particular Provisions

Future memoranda will address in detail whether particular sections of the Davis-Stirling Act should be made applicable or inapplicable to nonresidential CIDs. In making those determinations, the staff recommends that **the following principles be applied:**

Preserve Existing Legislative Determination

Section 1373 reflects an express legislative determination that certain sections of the Davis-Stirling Act should not apply to nonresidential CIDs. Barring a change in circumstances since 1988, those determinations should be respected and preserved.

Along the same lines, the letter from BIA to the author of the bill that enacted Section 1373 lists certain sections of the Davis-Stirling Act that the organization felt should be applicable to a nonresidential CID. Considering that the Legislature thereafter amended the bill to effectuate BIA's preferred approach, it would be safe to assume that the Legislature concurred in BIA's view that the sections listed by BIA are helpful to nonresidential CIDs, and should be

applicable to them. At least presumptively, it would seem that the sections listed in BIA's letter should remain applicable to nonresidential CIDs.

Extrapolate to Similar Provisions

The staff will search through the Davis-Stirling Act to see whether there are any provisions that are similar in kind to the sections that are inapplicable to nonresidential CIDs under Section 1373. Presumptively, those provisions should be inapplicable as well.

The staff will also search for provisions that are similar in kind to the sections listed in BIA's letter as being helpful to nonresidential CIDs. Presumptively, those provisions should be applicable to nonresidential CIDs.

Legislative Intent

Another source of guidance in conducting this study is the legislative intent language in Section 1373(b):

> The Legislature finds that the provisions listed in subdivision (a) are appropriate to protect purchasers in residential common interest developments, however, the provisions may not be necessary to protect purchasers in commercial or industrial developments since the application of those provisions could result in unnecessary burdens and costs for these types of developments.

That language provides a basis for analyzing the applicability of each of the provisions of the Davis-Stirling Act to a nonresidential CID: (1) Is it the sort of provision that is necessary to protect homeowners, but not necessary to protect commercial or industrial owners? (2) Alternatively, would the provision impose an unnecessary burden or cost on a commercial or industrial owner?

Adequacy of Corporations Code Provisions

Another relevant consideration will be the extent to which the Corporations Code and the Davis-Stirling Act both address the same subject matter. Where the Corporations Code provides a "back-stop" of law on a subject, business entities may not need the extra layer of regulation provided in the Davis-Stirling Act.

For example, Corporations Code Section 8333 states a general right for members to inspect the corporation's accounting books and records. The Davis-Stirling Act provides a much longer and more detailed set of rules on the same subject. See Civ. Code § 1365.2. It may well be that business entities are adequately served by the Corporations Code approach and do not need the

protections of Section 1365.2, which may have been developed solely with homeowners in mind.

Default Rule

The Commission will also need to decide what "default" rule should apply to the proposed revision.

Under existing law — Section 1373 — all of the Davis-Stirling Act applies to nonresidential CIDs, except for sections that are specifically listed as inapplicable. This creates a default rule of inclusion. Under this rule, any new enactment will automatically apply to a nonresidential CID, unless it is listed in Section 1373 as inapplicable.

That rule could be inverted, so that *none* of the Davis-Stirling Act applies to a nonresidential CID, except those sections that are specifically listed as *applicable*. This would create a default rule of exclusion. Under this default rule, any new section would automatically be *inapplicable* to a nonresidential CID, unless it is specifically listed as applicable.

The proper approach will depend on which result would be most consistent with legislative intent. In order to answer that question, it would be helpful to have completed the analysis of which provisions of the Davis-Stirling Act should apply to a nonresidential CID. If we find that most of the recently enacted provisions should apply, then a default rule of inclusion may make sense. If, however, we find that most new provisions should not apply, then a default rule of exclusion would probably make sense.

The staff therefore recommends **deferring a decision on this issue until later in the study.**

Respectfully submitted,

Steve Cohen
Staff Counsel

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June 12, 1987

Assemblyman Daniel Hauser
Room 2091
State Capitol
Sacramento, CA 95814

Re: Assembly Bill No. 2484

Dear Assemblyman Hauser:

The Northern California BIA Department of Real Estate Committee has reviewed Assembly Bill 2484 and has certain comments that it would like to offer for your consideration.

The Committee agrees with the basic premise of your bill that industrial and commercial developments should not be subject to all of the provisions of the Davis-Stirling Common Interest Development Act (California Civil Code §§1350-1372) (the "Act"). The Committee, however, feels that it would be a mistake to exempt these developments from the Act completely.

Although the Act primarily was enacted for the purpose of regulating residential developments, it contains provisions that are beneficial to industrial and/or commercial common interest developments as well. For example, it describes the statutory steps to create a common interest development (CC §1352), to amend the declaration (CC §1355), the establishment of exclusive use common areas (CC §1351(i)), provisions for the enforcement of the declaration (CC §1354) and statutory authority for levying assessments and establishing and enforcing assessment liens (CC §1366 and §1367). Without the benefit of the foregoing statutory provisions, commercial and industrial common interest developments would have to resort to common law for interpretation and enforcement of their CC&Rs. The Act offers clear advantages by providing a degree of certainty in these areas.

In addition, if commercial or industrial condominium projects were exempt from the Act, the statutory definitions of "condominium plan" would no longer apply. As a result, there would be no certainty as to the steps needed to prepare a valid commercial or industrial condominium plan. This could lead to title and financing problems for these types of developments.

The Committee would support your bill if it were amended so that rather than providing a blanket exemption, it exempted commercial and industrial developments from the following provisions of the Act:

The Act	Provision
1356	Amendment of Declaration by Petition
Last paragraph of §1363	Requirement that the Association prepare a budget pursuant to §1365 and disclose information required by §1366
1365	Financial statement requirements
1365.5	Financial record review requirements and reserve account requirements
1366(b)	Limitations on regular and special assessments
1366.1	Limitations on assessments
1368	Disclosure requirements

The above-referenced provisions may be appropriate to protect purchasers in residential common interest developments but are not necessary to protect purchasers in commercial or industrial developments. They simply provide unnecessary burdens and costs on these types of developments.

Finally, we would suggest adding a section that would provide that if any additional provisions are added to the Act, the provisions would not apply to commercial or industrial developments unless expressly made applicable to these developments.

At the suggestion of your office, we are forwarding a copy to the Assembly Housing Committee. If you or any of the committee members have any questions with respect to this letter, please contact the undersigned.

Very truly yours,

Jeffrey G. Wagner

JGW:sf
cc: Assembly Housing Committee, Attn: Michael Krisman
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March 22, 2007

Mr. Brian Hebert
California Law Revision Commission
3200 5th Avenue
Sacramento, CA 95817-2799

Re: CLRC Study H-855, Statutory Clarification and Simplification of CID Law: Suggestions for Amendment to Proposed Section 4020

Dear Mr. Hebert:

Thank you for meeting with us on March 16th to discuss the uniqueness of commercial associations and why we believe they should be treated differently in certain areas of Common Interest Development law. We are hopeful that you will include our recommendation in your CLRC Study H-855. The information and recommendations set forth in this letter were compiled by Mark Guithues of Jackson, DeMarco, Tidus and Peckenpaugh, whom you met during our meeting.

We believe that Section 4020 of the Proposed Legislation regarding Civil Code §§ 4000-_____ Common Interest Developments should be revised to include "Article 4 of Chapter 3 commencing with Section 4625." This revision would be the functional equivalent of revising Civil Code Section 1373 to include Sections 1363.03 to 1363.09, exempting commercial associations from the secret ballot provisions recently added to the Civil Code for all community associations.

Although the secret ballot provision are appropriate to protect purchasers in most residential common interest developments, they are not necessary nor appropriate to protect the sophisticated purchasers in commercial or industrial developments. The application of those provisions result in unnecessary administrative and management burdens and costs for these types of developments which the owners resent and have stated they do not want.

We believe this proposed revision will be non-controversial. The only objection we can candidly imagine is a blanket argument that this is a whittling away of the recently passed legislation imposing secret ballots on all community associations. However, the protections of

that legislation were never intended for this market. The following two demographic facts differentiate the purchaser of a commercial building or unit from the purchaser of a residence: (1) Approximately 90% of the owners who purchase buildings or commercial units in the associations own them as a corporation, LLC, trust or partnership. Almost all of these, whether they are owned as noted above or as individuals/joint tenants, own and operate an incorporated business within the building or unit. These parties are sophisticated. They have hired legal counsel to form their legal entities and have the legal and financial resources to hire legal counsel when they believe it appropriate to protect their interests. (2) The typical purchase price, represented as the middle 70% of the building or units sold today, varies between $1,000,000 - $4,000,000. The purchase and sale of these buildings and units are typically facilitated by one or more attorneys, who are obligated to protect the interests of their clients through the diligence process. In summary, these are parties who have the sophistication to manage businesses, take advantage of legal and tax opportunities presented to such businesses and to purchase multi-million dollar buildings for the tax and estate benefits provided thereby.

The distinction between the unsophisticated residential buyer and the sophisticated commercial buyer has been acknowledged and accepted by the legislature in the past. Civil Code Section 1373 presently provides commercial associations with several exemptions to the Davis-Stirling Act, which include annual disclosures, informal dispute resolution provisions, reserve studies, various disclosure requirements of the Board and elimination on limitations on raising assessments.

The majority of commercial associations are comprised of less than a dozen owners. The typical annual meeting takes half an hour and may be moved multiple times before quorum is achieved. Assuming the third party inspector of elections has a flexible enough schedule to attend, their costs divided over such a small group is prohibitive.

Thank you for your attention to this matter. Should you have any questions, please contact our Legislative Advocate, Jennifer Wada, at (916) 448-4000 or at Jennifer@wadawilliams.com.

Very truly yours,

Karen Conlon, CCAM
President
California Association of Community Managers

Cc: Mr. Mark Guithues, Attorney, Jackson, DeMarco, Tidus and Peckenpaugh
Mr. Craig Stevens, Principal, Mar West Real Estate
Ms. Jennifer Wada, Legislative Advocate, Wada Williams Law Group, LLP