Study H-858 August 3, 2011

First Supplement Memorandum 2011-29

Common Interest Development Law:
Commercial and Industrial Subdivisions

The Commission has received a letter from Duncan R. McPherson, on behalf of the "Nonresidential Common Interest Development Stakeholder Group" (hereafter "stakeholder group"), commenting on the issues raised in Memorandum 2011-29. The letter is attached as an Exhibit.

The purpose of this supplement is to present the comment letter and to briefly discuss the outcome of a July 28, 2011, meeting between Executive Director Brian Hebert, Assistant Real Estate Commissioner Chris W. Neri, and attorneys Duncan McPherson and Jeffrey Wagner (the last two representing the stakeholder group).

As a general matter, the stakeholder group agrees with the conclusions and recommendations expressed in Memorandum 2011-29: "We generally concur with your conclusions and the general scope of the recommendations." See Exhibit p. 1. Their reasons for that position are discussed in more detail on pages 1-3 of the Exhibit.

However, the stakeholder group has concerns about the specific reform language proposed in Memorandum 2011-29: "there is some fine tuning that must occur in the definitions that are proposed for the definitions to work correctly." See Exhibit p. 1. The bulk of this supplement addresses those drafting concerns.

At the meeting, Assistant Commissioner Neri was not able to take any official position on the proposed reforms. However, he was able to confirm that long-standing Department of Real Estate ("DRE") practice is generally consistent with the overall thrust of the proposed reforms. That is, he confirmed that the DRE generally does not assert Subdivided Lands Act jurisdiction over a proposed subdivision that is entirely comprised of "nonresidential personal-use subdivisions" (such as a marina, storage facility, parking lot, etc.). For a fuller discussion of nonresidential personal-use subdivisions, see Memorandum 2011-29, pp. 22-27.

Assistant Commissioner Neri also confirmed that DRE generally views the operation of an apartment building to be a "commercial use" within the meaning of Business and Professions Code Section 11010.3.

PROPOSED LEGISLATION

The stakeholder group has two general concerns about the legislative language proposed in Memorandum 2011-29. Those concerns are discussed below. After that discussion, new proposed language is set out, to address the group's concerns.

Incidental Residential Use

The language proposed in Memorandum 2011-29, to include nonresidential personal-use subdivisions within the scope of the existing exemptions, turns on whether "residential use" is permitted in a subdivision (under both governing law and the subdivision's recorded declaration). If residential use is not permitted, then the subdivision would be "nonresidential" and the subdivision would be exempt from the Subdivided Lands Act and parts of the Davis-Stirling Act.

However, the stakeholder group points out that some subdivisions may permit "incidental" residential uses, despite the fact that they are otherwise entirely nonresidential in character. See Exhibit p. 3. For example:

- A commercial subdivision may permit a property manager, security person, or other staff of the governing association or of a member business to reside within the subdivision as an incident of that person's job. For example, a storage condominium might have a resident manager, who lives onsite so as to be available if an emergency or security problem arises after hours.
- A marina, parking lot, or recreational campground might permit short-term incidental occupation of a boat, camper, motor coach or other vehicle that is stored on an owner's separate interest, while prohibiting long-term residential use. For example, an owner might want to stay overnight on a boat on a holiday weekend, but doesn't live on the boat as a primary residence.

The stakeholders suggests that such incidental uses not be included within the meaning of "residential use." This would prevent an otherwise nonresidential subdivision from being classified as residential (and thereby taken out of the statutory exemption), merely because it permits incidental residential uses of the types discussed above.

The draft language set out later in the memorandum defines "short-term" occupation as occupation for no more than 30 days out of each calendar year. The Commission should consider whether 30 days is an appropriate time period in this context.

Residential Rental as Commercial Use

Memorandum 2011-29 proposes that the use of a single lot or parcel to "operate an apartment building" should not be considered a residential use of that lot or parcel. The operation of residential rental property as a business is a commercial activity that, for the purposes of the Subdivided Lands Act and Davis-Stirling Act, should probably be treated like all other commercial activities. See discussion in Memorandum 2011-29, pp. 27-33.

The proposed legislation to implement that policy would turn on whether or not a lot, parcel or subdivision is being used as "residential rental property." Such a use would be treated like any other commercial use.

The stakeholder group has serious concerns about whether such a standard could lead to circumvention of the Subdivided Lands Act, undermining consumer protection. Suppose that a dishonest subdivider develops a subdivision where each lot contains a single home. The subdivider records a declaration stating that the homes may only be used as residential rental property. Under the proposed law, the subdivision would be exempt from the Subdivided Lands Act. The subdivider could then avoid the public report process and sell the homes to persons who intend to live in them as residences, advising the buyers to ignore the restriction or wait until all of the homes are sold and then amend the declaration to eliminate the restriction.

To avoid that problem, the stakeholder group recommends that the statute use a slightly different approach. Rather than condition the scope of the statutory exemption exclusively on whether property is restricted to use as "residential rental property," the exemption would also be conditioned on the number of apartment units located within a single lot or separate interest. Because those apartment units cannot be sold individually, they must, as a matter of practical necessity, be used as rental property.

The group advises that the exemption for the operation of an apartment building be limited to a lot or separate interest that contains at least three apartment units. That would avoid the application of the exemption to the

somewhat common situation in which a single lot contains both a primary residence and an "in-law cottage" or "granny flat."

Proposed Alternative Language

After much discussion at the July 28 meeting, it was proposed that the exemption language be grounded on the following principles:

(1) The definition of "residential use" should include an exception for incidental residential uses.

(2) Such incidental residential use should include the provision of living space to an employee or agent of the governing association or a member business who lives on site as a condition of employment.

(3) Incidental residential use should also include the short-term occupation of a boat, trailer, or motor vehicle that is located on but not permanently affixed to the lot, parcel, or separate interest. Short-term use could perhaps be defined as occupation of no more than 30 days per calendar year.

(4) The rental of apartments in a lot, parcel, or separate interest that is divided into three or more apartment units is a commercial use of the lot, parcel, or separate interest.

In order to make the implementing language easier to understand, the staff divided each of the exemptions (for the Subdivided Lands Act and the Davis-Stirling Act) into two pieces. The first piece would define the terms "residential" and "nonresidential." The second would state the scope of the existing exemption. Thus:

> **Bus. & Prof. Code § 11002 (added). "Residential subdivision," "nonresidential subdivision" defined**
>
> 11002. (a) For the purposes of this section, "residential subdivision" means a subdivision in which residential use is permitted by both law and by any declaration of covenants, conditions, and restrictions that is recorded in each county in which the subdivision is located.
>
> (b) For the purposes of subdivision (a), the following uses are not considered to be residential uses and the fact that one or more of these uses is permitted within a subdivision does not make the subdivision a "residential subdivision":
>
> (1) The operation of a residential rental business within a lot, parcel, or separate interest, that contains three or more apartment units.
>
> (2) The provision of living space to an agent or employee of a governing association or a business that is located within the subdivision, as an incident of agency or employment. For the

purposes of this paragraph, "agent or employee" includes, but is not limited to, a property manager, caretaker, or security guard.

(3) The short-term occupation of a boat, trailer, or motor vehicle that is located on but not permanently affixed to a lot, parcel, or separate interest. For the purposes of this paragraph "short-term occupation" means occupation for no more than 30 days out of each calendar year.

(c) For the purposes of Section 11010.3, "nonresidential subdivision" means any subdivision that is not a residential subdivision.

(d) For the purposes of this section, "separate interest" has the meaning provided in subdivision (*l*) of Section 1351 of the Civil Code.

Comment. Section 11002 is new. Subdivision (a) defines "residential subdivision" for the purposes of the section. Under the definition, if both the law and any recorded declaration of covenants, conditions, and restrictions permit any residential use within a subdivision, the subdivision is a "residential subdivision."

Subdivision (b) states specific exceptions to the general rule provided in subdivision (a). The fact that one or more of the uses listed in subdivision (b) is permitted within a subdivision is not enough to make the subdivision a "residential subdivision."

Under subdivision (c), any subdivision in which all residential uses (other than those listed in subdivision (b)) are precluded, by law or by a recorded declaration of covenants, conditions, and restrictions, is a "nonresidential subdivision."

See also Section 11010.3 (exemption of nonresidential subdivision from provisions of this act).

Bus. & Prof. Code § 11010.3 (amended). Exemption of nonresidential subdivision

11010.3. The provisions of this chapter shall not apply to the proposed sale or lease of lots or other interests in a <u>nonresidential</u> subdivision ~~in which lots or other interests are (a) limited to industrial or commercial uses by zoning or (b) limited to industrial or commercial uses by a declaration of covenants, conditions, and restrictions, which declaration has been recorded in the official records of the county or counties in which the subdivision is located~~.

Comment. Section 11010.3 is amended to expressly extend the exemption provided by the section to any subdivision in which residential use (other than certain incidental residential uses) is not permitted by law or by a recorded declaration of covenants, conditions, and restrictions. See Section 11002(c) ("nonresidential subdivision" defined).

Civ. Code § 1373 (amended). Nonresidential common interest development exemptions

1373. (a) The following provisions do not apply to a nonresidential 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~~:

…

Comment. Section 1373 is amended to expressly extend the exemption provided by the section to any common interest development in which residential use (other than certain incidental residential uses) is not permitted by law or by a recorded declaration of covenants, conditions, and restrictions. See Section 1373.5(c) ("nonresidential subdivision" defined).

Civ. Code § 1373.5 (added). "Residential common interest development," "nonresidential common interest development" defined

1373.5. (a) For the purposes of this section, "residential common interest development" means a common interest development in which residential use is permitted by both law and by any declaration of covenants, conditions, and restrictions that is recorded in each county in which the common interest development is located.

(b) For the purposes of subdivision (a), the following uses are not considered to be residential uses and the fact that one or more of these uses is permitted within a common interest development does not make the common interest development a "residential common interest development":

(1) The operation of a residential rental business within a separate interest that contains three or more apartment units.

(2) The provision of living space to an agent or employee of the association or a business that is located within the common interest development, as an incident of agency or employment. For the purposes of this paragraph, "agent or employee" includes, but is not limited to, a property manager, caretaker, or security guard.

(3) The short-term occupation of a boat, trailer, or motor vehicle that is located on but not permanently affixed to a separate interest. For the purposes of this paragraph "short-term occupation" means occupation for no more than 30 days out of each calendar year.

(c) For the purposes of Section 1373, "nonresidential common interest development" means any common interest development that is not a residential common interest development.

Comment. Section 1373.5 is new. Subdivision (a) defines "residential common interest development" for the purposes of the section. Under the definition, if both the law and any recorded

declaration of covenants, conditions, and restrictions permit any residential use within a common interest development, the common interest development is a "residential common interest development."

Subdivision (b) states specific exceptions to the general rule provided in subdivision (a). The fact that one or more of the uses listed in subdivision (b) is permitted within a common interest development is not enough to make the common interest development a "residential common interest development."

Under subdivision (c), any common interest development in which all residential uses (other than those listed in subdivision (b)) are precluded, by law or by a recorded declaration of covenants, conditions, and restrictions, is a "nonresidential common interest development."

See also Section 1373 (exemption of nonresidential common interest development from specified provisions of this act).

The Commission should consider this language as an alternative to the language proposed in Memorandum 2011-29.

Respectfully submitted,

Brian Hebert
Executive Director

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July 27, 2011

Mr. Brian Hebert
Executive Secretary
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4000 Middlefield Road, Room D-1
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Re: Stakeholders Group Response to CLRC Memorandum 2011-29

Dear Mr. Hebert:

The non-residential stakeholders group (**Stakeholders**) has reviewed CLRC Memorandum 2011-29 regarding Commercial and Industrial Subdivisions. We generally concur with your conclusions and the general scope of the recommendations. However, there is some fine tuning that must occur in the definitions that are proposed for the definitions to work correctly.

The proposal of what we suggested for a change in the "industrial or commercial uses" definitions, contained in *Civil Code Section 1373* and Business and *Professions Code Section 11010.3*, had as its *primary* purpose to point out that a definition is needed that will provide a clear basis for determining whether a real estate development was subject to the *Davis-Stirling Common Interest Development Act* (**DSA**) or to the proposed new act for non-residential developments (**NRA**). The proposal had, as its *secondary* purpose, to suggest that the line be drawn so as to place most of the uncommon types of Common Interest Developments (**CIDs**) that you call "Non-Residential Personal Use Subdivisions" (**NRPUS**) in the NRA. While we think that drawing the line in this fashion is good policy for reasons set out below, the most important point that we want to make is that a clear and unambiguous definition is necessary, separating the developments subject to the *DSA* from developments subject to the proposed *NRA*. We did not initially propose the new definitions in connection with the revisions to the *DSA*, but only when the *NRA* was proposed, due to the increased significance of the definition if the *NRA* is enacted.

It became obvious to us as we discussed the various types of *CIDs* that the "industrial or commercial uses" did not adequately describe the distinctions drawn by custom and usage in this area of the law, even before considering the *NRPUS*-type *CIDs*. A better definition would be appropriate for *Section 1373* of the *DSA*, but a better definition became more important when the *NRA* was proposed, for it is extremely important that both developers

and owners' associations be able to determine which law applies to the development and to its owners' association(s).

In our view, the law has been interpreted over the years to treat developments consisting of residential separate interests differently than other developments. We believe this is because these developments are for the most part owner-occupied primary or secondary homes, even though some of the separate interests may be rented or leased to tenants and not occupied by the owners. The point has been that, since these developments are primary residences that are owned by their occupants, the owners deserve additional protections and disclosures, both at the point of purchase and in the operation of the owners' associations. Thus, the *Department of Real Estate* (**DRE**) has consistently interpreted *Section 11010.3* as meaning that the *DRE* jurisdiction extended only to subdivisions made up of residential separate interests and the *DRE* management has told our group that they do not want to see that jurisdiction expanded into non-residential areas. The *DRE* jurisdiction also extends to non-residential use undivided ownership developments, but that is because of a separate provision of the *Subdivided Lands Act*, which will not be effected by this legislation. The use of the term "lease" in the *Subdivided Lands Act* is for the purpose of regulating subdivisions whose separate interests were transferred on long-term leases, such as ground leases as an alternative to outright sales, and should not be interpreted as an intent to regulate true rental projects, such as apartments (which are separately carved out as exempt from the *Subdivided Lands Act*). Consumer-friendly regulation of all types of transactions is common in both California law and in federal law. In California, numerous laws draw a distinction between residential property consisting of 1 to 4 residential units and other types of property.

It is also important to keep in mind what these distinctions actually mean. There is not a great deal of difference for most purposes between a development being classified as subject to the *NRA*, as opposed to being classified as subject to the *DSA*. The formational provisions of the two acts will be the same and the proposed differences between the *DSA* and the *NRA* are for the most part items dealing with budgeting and assessments, assessment collections, elections, and a few other matters. The owners in developments subject to the NRA will have the protections in the NRA, as well as the rights of members under the non-profit mutual benefit corporation law, which is the law that provides for the rights of members of non-profit corporations which are not subject to the DSA. Also, since most of the *NRPUS*-type subdivisions do not qualify for the same tax treatment as do residential subdivisions, and have problems in retaining reserves due to the income tax treatment of non-residential subdivisions, the flexibility of assessments given to commercial associations is important for the same reason to the *NRPUS* associations. Similarly, it is not likely that owners of *NRPUS*-type subdivision consisting of storage units, parking spaces, or boat berths, are likely to want to be subject to the complexities of the election law and other procedural protection that now apply to residential associations. Also, in the case of boat berths and motor home parking spaces or camping spaces, which are separate interests, the residential use is not of the separate interest itself but of a mobile unit (the boat or motor home or tent or trailer) that is parked, placed, or berthed in the separate interest. The regulation of the separate interest only incidentally affects the actual residential component, which is not attached to the separate interest. Thus, the foreclosure for non-payment of assessments of a boat berth does not foreclose on the boat, and the foreclosure on a parking space or a storage space does not foreclose on the vehicles parked in the space or the contents of the storage

space. In this way, these separate interests are very different from a lot with a house or a lot with a stationery mobile home attached on a foundation.

The distinction between the type of residential property where there are residential separate interests and rental property, such as an apartment house, is also clear. In the case of rental property, the individual separate interests cannot be separately sold, so only the owner/landlord is involved in any purchase of the property and the tenants do not have any standing as members of any owners association, which has a rental property component since they are not owners. There are of course numerous laws protecting the rights of tenants, which are not dependent on whether the property is part of a *CID* or not. Thus, as you have concluded, it is not logical to place property under the *DSA* as opposed to the proposed *NRA*, just because it has components consisting of rental properties.

The specific issues we have are with the proposed definitions, which show up for the first time on page 26 of the Memorandum. The problem is with the phase, "*prohibits any residential use within the subdivision*". This is too broad for its purpose. Many purely commercial projects contain residential quarters for managers, security or other such uses. Most self-storage projects and many marinas contain a residence for the resident manager, and many industrial complexes, marinas, and other such subdivisions have a residence or at least sleeping quarters for on-site security. Also, if in boat berth subdivisions, people may live or at least sleep from time to time on the boats berthed in the subdivision. The same thing is true for interests in camping spaces or parking spaces for motor homes. Laws do not generally prohibit such uses nor do the CC&Rs bar such activities if they are incidental to the primary use of the subdivision. The key here is that the "*separate interests*" are not residential in character and the quarters for resident managers and security details *are not separate interests* in themselves, which can be conveyed separately from the commercial portion of the subdivision. Zoning laws generally allow these incidental residential uses in commercial and industrial zoning areas. Based on our group's attempts at a definition, our suggestion is to define non-residential in a manner that is similar to the proposed definition that we previously sent you and allow all other developments fall by default into the residential category. If the Commission would prefer to use a definition of non-residential similar to what you have suggested, then we suggest that non-residential include any subdivision where the law or the declaration prohibits a separate interest for residential purposes. It should be clear that incidental residential uses allowed by law do not defeat the non-residential designation. This type of definition also deals with the issues of apartment complexes which may be a part of an otherwise commercial *CID* such as the situation where the first floor of a building is made up of retail separate interests and the upper floors is a single apartment complex. Since in the apartment complex the individual apartments are not separate interests this proposed definition which relies on the primary use of separate interests rather than the use of the property deals with the apartment issue without having to use terms such as "residential rental property". The use of that proposed language in the proposal for *Section 1373(c)(2)* also does not work since the exception, "*other than the use of a separate interest as residential rental property*" could in fact exempt out the rental of individual condominium units. It is only the case where the residential use consists of multiple residential units which are part of a single lot or condominium unit where the use should be considered non-residential.

Generally, we feel that we are in agreement on how the division between the residential and non-residential should be made, but that more refinement is needed in the definitions that have been proposed. We will try to provide you with some suggestions for the definition at our meeting with the *DRE* in Sacramento, later this week.

Very truly yours,

DUNCAN R. McPHERSON

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