Study H-858 July 11, 2012

Memorandum 2012-33

Common Interest Development Law: Commercial and Industrial Subdivisions (Draft Tentative Recommendation)

At its August 2011 meeting, the Commission began a study of the scope of application of Business and Professions Code Section 11010.3 and Civil Code Section 1373. The Commission directed the staff to prepare a draft tentative recommendation for its review, based on the language proposed on pages 4-7 of the First Supplement to Memorandum 2011-29, with specified changes. See Minutes (August 2011), p. 5. A staff draft is attached. **The Commission needs to decide whether to approve it for public circulation, with or without changes.**

The Commission also requested information about the cost of the public report requirements of the Subdivided Lands Act. The staff is grateful to attorneys Duncan McPherson and Jeffrey Wagner for providing information on that topic.

Acting on those instructions, the staff prepared Memorandum 2011-35 and its First Supplement. However, the meeting at which that those materials were scheduled to be considered was canceled for lack of a quorum.

This memorandum reiterates the substance of Memorandum 2011-35 and its First Supplement. **It supersedes those materials, which were never considered by the Commission.**

The staff recommends that any Commissioner who is new to this material first read the attached draft tentative recommendation, before reading the remainder of this memorandum. The draft provides a good summary of the subject matter of the study. It also provides necessary context for the matters discussed in this memorandum.

Any California Law Revision Commission document referred to in this memorandum can be obtained from the Commission. Recent materials can be downloaded from the Commission's website (www.clrc.ca.gov). Other materials can be obtained by contacting the Commission's staff, through the website or otherwise.

The Commission welcomes written comments at any time during its study process. Any comments received will be a part of the public record and may be considered at a public meeting.

PUBLIC REPORT PROCESS COSTS

As discussed generally in Memorandum 2011-29, the Subdivided Lands Act requires that a subdivider apply for and receive a "public report," before commencing the sale or leasing of any lot or parcel within a subdivision that is subject to the Act. This entails the preparation and submission of extensive disclosure documents. The submission is then reviewed by the Real Estate Commissioner, who must determine whether the submission and the subdivision it describes are in compliance with the requirements of the Act.

There are four types of costs associated with the public report process:

(1) Fees paid by the subdivider to the Department of Real Estate ("DRE").
(2) The cost of preparing and submitting the required documents.
(3) The cost of required bonds and other security.
(4) The indirect costs associated with delay.

Those costs are discussed briefly below.

Statutory Fees

The first cost associated with the public report process is the statutory fee that a subdivider must pay the DRE on submission of an application. The fee is variable, depending on a number of factors, but is typically around $2,000 for an initial report. See Bus. & Prof. Code § 11011. If the project is to be developed in phases, there will be additional costs for the reports on subsequent phases.

The staff has learned, through informal discussions with DRE staff, that the statutory fee revenue is generally sufficient to cover the cost incurred by DRE in processing public report applications.

Document Preparation and Submission

The public report process requires the preparation and submission of numerous detailed documents, as specified by statute and DRE regulations.

Many subdividers contract with a "Single Responsible Person" or "SRP" who works with DRE to manage the public report application process.

Although the cost of preparation and submission of an application varies widely depending on the size and complexity of the subdivision, an SRP might charge around $5,000 for an average subdivision. Emails from Duncan McPherson to Brian Hebert (Sept. 18, 2011; Sept. 28, 2011) (on file with Commission).

In addition, the subdivider would pay "several thousand" dollars for the preparation of security and title documents, extra engineering costs, and the cost of preparing a budget in the format required by DRE. *Id*.

Taken altogether, the document preparation and submission costs would likely exceed $10,000.

Security Costs

The Subdivided Lands Act requires a number of bonds (e.g. bonds for six months of regular assessment income and for completion of common area structures and amenities). The fee for these bonds will typically be about 1 or 2% of the bonded amount.

The bonded amount can vary dramatically, depending on the size, character, and circumstances of a subdivision. In a fully constructed subdivision, the bonds might be fairly modest. In an incomplete condominium project, a completion bond might cover the entire cost of construction. *Id*. For example, on a million dollar condominium project, the cost to bond the common area construction might be $10,000-20,000.

Because of the wide range of bonding costs, it is not possible to estimate an "average" security cost. However, it seems clear that these costs can be significant.

Cost of Delay

While a "perfect" public report application could be processed in just a few months, typically an application will include deficiencies that need to be corrected, resulting in an exchange of materials back and forth between the DRE and the subdivider. Consequently, an average public report application will take from eight to nine months to approve. The process can take longer, especially if the subdivider needs to coordinate the public report process with local jurisdiction approval processes. *Id*.

During that time, interest is accruing on any outstanding loans that the subdivider may have on a project (including the loan to purchase the property and any construction loan). This cost must be paid, even though the subdivider cannot yet sell any parcels in the subdivision and so is not deriving any income from the project. *Id*.

If the public report process extends beyond the term of a loan, the subdivider will need to negotiate an extension of the loan. Reportedly, a lender may charge a fee of 1 or 2% for extending the term of the loan. *Id*.

Because of differences in loan amounts and terms, it is not possible to estimate a typical debt service cost for the period of DRE public report review. However, it is clear that the cost is not trivial.

In addition, delay can result in significant opportunity costs. During the public report review period, funds remain tied up in a subdivision project, with no ability to generate new revenue from sales. This may be particularly problematic if the market is declining. By the time the public report is issued and sales can begin, the property may have lost significant value.

Conclusion

The basic cost to prepare and submit an application for a "typical" subdivision appears to be around $10,000. In addition, the subdivider must obtain specified bonds and pay debt service costs during the review period. Those costs are too contingent on the size, character, and circumstances of a subdivision to be easily estimated, but they can be significant.

Furthermore, the public report process typically takes the better part of a year, during which the developer has money invested in the project but cannot derive revenue from sales. In a construction market downturn, this could be a serious problem.

Although the cost of the public report process is too variable to be readily quantified, it is clear that the cost is not trivial and can be quite significant. Those costs should probably not be imposed where the benefits of regulation are unclear or minimal.

DEFINITION OF "RESIDENTIAL USE"

The attached draft would provide, among other things, that "residential use" of subdivision property does not include the short-term occupation of a vehicle:

> (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":
>
> …
>
> (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 60 days out of each calendar year.

See proposed Bus. & Prof. Code § 11002(b)(3). Proposed Civil Code Section 1373.5 is a parallel provision.

Attorney Duncan McPherson, a regular contributor to the Commission's study of common interest development law, has informally suggested a minor clarifying revision along these lines:

> (3) The short-term residential 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 residential occupation" means occupation for no more than 60 days out of each calendar year.

The point of the revision is to make clear that "occupation" does not refer to the mere presence of a boat, trailer, or other vehicle on subdivision property. Rather, "occupation" refers to the use of the vehicle as a temporary residence. **The staff believes that would be a useful clarification and recommends that it be made in both of the provisions cited above.**

NEXT STEP

The Commission needs to decide whether to approve the attached tentative recommendation for public circulation, with or without changes.

Respectfully submitted,

Brian Hebert
Executive Director

#H-858

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

STAFF DRAFT

TENTATIVE RECOMMENDATION

Nonresidential Subdivisions

August 2012

The purpose of this tentative recommendation is to solicit public comment on the Commission's tentative conclusions. A comment submitted to the Commission will be part of the public record. The Commission will consider the comment at a public meeting when the Commission determines what, if any, recommendation it will make to the Legislature. It is just as important to advise the Commission that you approve the tentative recommendation as it is to advise the Commission that you believe revisions should be made to it.

COMMENTS ON THIS TENTATIVE RECOMMENDATION SHOULD BE RECEIVED BY THE COMMISSION NOT LATER THAN _____.

The Commission will often substantially revise a proposal in response to comment it receives. Thus, this tentative recommendation is not necessarily the recommendation the Commission will submit to the Legislature.

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SUMMARY OF TENTATIVE RECOMMENDATION

Business and Professions Code Section 11010.3 exempts "commercial" and "industrial" subdivisions — i.e., subdivisions that are limited to commercial or industrial uses by zoning or a recorded declaration — from the requirements of the Subdivided Lands Act. Similarly, Civil Code Section 1373 exempts commercial and industrial subdivisions from specified provisions of the Davis-Stirling Common Interest Development Act.

The legislative history of the Subdivided Lands Act and the Davis-Stirling Common Interest Development Act suggests that, when originally enacted, those statutes were only intended to regulate residential subdivisions. When it was discovered that they also applied to nonresidential subdivisions, express exemptions were added for business property.

However, because of the way that those exemptions are phrased, they may have a narrower effect than was intended. Specifically, the exemptions do not appear to govern the following types of nonresidential subdivisions:

(1) A subdivision that is limited to nonresidential uses, where the permitted uses are neither "commercial" nor "industrial" (e.g., a subdivision comprised of storage units, parking spaces, or boat slips that are used by their owners for private noncommercial purposes).

(2) A subdivision that is limited to nonresidential uses by a law other than a zoning law (e.g., a non-zoning statute that prohibits residential use of property near a hazardous waste area).

(3) A commercial subdivision where the owners are permitted to operate businesses that provide residential accommodations to their customers. Despite the nature of such a business, the property owner's use is nonresidential.

The Commission recommends that the exemptions be revised to make them applicable to all nonresidential subdivisions. This would effectuate the apparent legislative intent and would help to eliminate unnecessary regulatory costs.

This tentative recommendation was prepared pursuant to Resolution Chapter 98 of the Statutes of 2009.

NONRESIDENTIAL SUBDIVISIONS

Business and Professions Code Section 11010.3 exempts "commercial" and "industrial" subdivisions — i.e., subdivisions that are limited to commercial or industrial uses by zoning or a recorded declaration — from the requirements of the Subdivided Lands Act.[1] Similarly, Civil Code Section 1373 exempts commercial and industrial subdivisions from specified provisions of the Davis-Stirling Common Interest Development Act.[2]

The legislative history of the Subdivided Lands Act and the Davis-Stirling Common Interest Development Act suggests that, when originally enacted, those statutes were only intended to regulate residential subdivisions. When it was discovered that they also applied to nonresidential subdivisions, express exemptions were added for business property.

However, because of the way that those exemptions are phrased, they may have a narrower effect than was intended. Specifically, the exemptions do not appear to govern the following types of nonresidential subdivisions:

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(3) A commercial subdivision where the owners are permitted to operate businesses that provide residential accommodations to their customers. Despite the nature of such a business, the property owner's use is nonresidential.

For the reasons discussed below, the Commission recommends that the exemptions be revised to make them applicable to all nonresidential subdivisions.

SUBDIVIDED LANDS ACT

Purpose and Effect of the Subdivided Lands Act

The Subdivided Lands Act regulates the sale or lease of lots or parcels within a "subdivision" or "subdivided lands,"[3] in order to protect consumers against "fraud

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1 Bus. & Prof. Code §§ 11000-11200.

2 Civ. Code §§ 1350-1378.

3. As a general rule, the synonymous terms "subdivision" and "subdivided lands" mean

> improved or unimproved land or lands, wherever situated within California, divided or proposed to be divided for the purpose of sale or lease or financing, whether immediate or future, into five or more lots or parcels.

and sharp practices" by subdividers.[4] The Act achieves its purpose by requiring that a subdivider, before selling or leasing any lots within a regulated subdivision, obtain a "public report" from the Real Estate Commissioner.

On applying for a public report, a subdivider must provide a wide range of detailed information about the subdivision, including information about the status of title, the proposed terms of sale, access to public utilities, any restrictions on use or occupancy, any lien that may exist on the property, any existing or proposed indebtedness incurred for the construction of promised facilities, the location of public schools, the presence of nearby airports, and specified geological and soil conditions.[5]

A subdivider must also demonstrate compliance with a number of substantive requirements, including requirements intended to ensure that the subdivider will deliver the property in the promised condition, for the promised price, with protection against blanket encumbrances.[6]

If the subdivision is also a common interest development, the subdivider must demonstrate that reasonable arrangements have been made for completion of the project, transfer of ownership and control, and ongoing operation and maintenance.[7] The subdivider must also submit a draft declaration of covenants, conditions, and restrictions that makes reasonable arrangements on a number of specified operational issues.[8]

On receipt of a complete application for a public report, the Real Estate Commissioner must review the substance of the application and, unless there are

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Bus. & Prof. Code § 11000(a). Common interest developments are expressly included in the definition of "subdivision" or "subdivided lands." See Bus. & Prof. Code § 11004.5.

4. In re Sidebotham, 12 Cal. 2d 434, 436, 85 P.2d 453 (1938) ("The object of the present law, prevention of fraud and sharp practices in a type of real estate transaction peculiarly open to such abuses, is obviously legitimate; and the method, involving investigation and disclosure of certain essential facts, and a protection for the innocent purchaser against loss of his land by foreclosure of the underlying mortgage, is perfectly reasonable."). See also Property Owners of Whispering Palms, Inc. v. Court of Appeal, 132 Cal. App. 4th 666, 33 Cal. Rptr. 3d 845 (2005) ("The Act is a consumer protection statute intended primarily to prevent 'fraud and sharp practices' by requiring disclosure of all relevant information to potential purchasers and lessees…."); Westbrook v. Summerfield, 154 Cal. App. 2d 761, 766, 316 P.2d 691 (1957) ("purpose of Subdivided Lands Act is to protect individual members of the public who purchase lots or homes from subdividers and to make sure that full information will be given to all purchasers concerning public utility functions and other essential facts with reference to the land.").

5. Bus. & Prof. Code § 11010(b). See also Bus. & Prof. Code § 11010.05 (special notice for senior citizen housing development); 10 Cal. Code Regs. §§ 2792 (standard subdivision), 2792.1 (common interest development).

6. Bus. & Prof. Code §§ 11013-11013.4. See generally, Miller, Starr & Regalia, California Real Estate *Subdivision Offerings, Sales, and Leasing* § 25C:33 (2007 update).

7. Bus. & Prof. Code § 11018.5.

8. Bus. & Prof. Code § 11018.5(e); 10 Cal. Code Regs. §§ 2792.4(b), 2792.15-2792.21, 2792.23-2792.24, 2792.26-2792-28.

grounds for denial, issue a public report.[9] The subdivider is then free to sell or lease lots in the subdivision.

Grounds for denial of a report include failure to comply with the Subdivided Lands Act; misrepresentation, deceit, or fraud; and the inability of the subdivider to meet a number of substantive requirements relating to transfer of title and the condition of the property.[10]

The subdivider must provide a copy of the public report to a prospective purchaser.[11] The public report must also be made available for public inspection.[12]

Purpose and Effect of Business and Professions Code Section 11010.3

Business and Professions Code Section 11010.3 provides a complete exemption from the Subdivided Lands Act for a subdivision that is restricted to commercial or industrial uses by zoning or by a recorded declaration of covenants, conditions, and restrictions.

The original version of the exemption was enacted in 1969. At that time, it only applied to "expressly zoned industrial subdivisions which are limited in use to industrial purposes" and "commercial leases of parcels in a shopping center."[13]

The author of the bill enacting that exemption explained that the Subdivided Lands Act had only been intended to apply to residential subdivisions:

> [The] Subdivided Lands Act was placed there when only residential subdivisions were conceived and used in California. It is only in the past 20 years that industrial subdivisions have spread all over the State.[14]

Once it became apparent that the Subdivided Lands Act applied to commercial and industrial subdivisions, the exemption was enacted to eliminate that application.

As the legislative history explained, purchasers of nonresidential property in industrial subdivisions and shopping centers do not require the protections that were provided by the Subdivided Lands Act,[15] in part because they are presumed to be more sophisticated than residential property purchasers.[16] Furthermore, there

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9. Bus. & Prof. Code § 11018.

10. *Id.*

11. Bus. & Prof. Code § 11018.1.

12. *Id.*

13. See 1969 Cal. Stat. ch. 373.

14. Letter from Assembly Member Hayes to Governor Reagan (July 27, 1969) (attached to Commission Staff Memorandum 2011-29 (July 13, 2011), at Exhibit p. 1). The Department of Finance expressed a similar view in an enrolled bill report, noting that the Subdivided Lands Act had been "designed primarily for residential subdivisions." Department of Finance, Enrolled Bill Report on AB 63 (Hayes) (attached to Commission Staff Memorandum 2011-29 (July 13, 2011), at Exhibit p. 4).

15. Department of Finance, Enrolled Bill Report on AB 63 (Hayes) (attached to Commission Staff Memorandum 2011-29 (July 13, 2011), at Exhibit p. 4).

16. Letter from California Real Estate Association to Governor Reagan (July 27, 1969) (attached to Commission Staff Memorandum 2011-29 (July 13, 2011), at Exhibit p. 6).

are practical differences between nonresidential and residential subdivisions that make it difficult or unhelpful for a commercial or industrial subdivider to comply with the Subdivided Lands Act.[17]

The Legislature has amended the exemption provision twice to broaden its scope. In 1974, the provision was amended to replace the narrow category of "shopping centers," with the broader "commercial use" category.[18] In 1980, the amendment was broadened again, to include any subdivision that is limited to commercial or industrial use by a recorded declaration (in addition to any subdivision that is restricted to such uses by zoning).[19]

DAVIS-STIRLING COMMON INTEREST DEVELOPMENT ACT

Purpose and Effect of the Davis-Stirling Common Interest Development Act

The Davis-Stirling Act was enacted in 1985,[20] to consolidate and generalize the law that governed condominiums, so that it would also apply to other types of "common interest developments"[21] — i.e., planned developments, community apartment projects, and stock cooperatives.[22]

At the time of enactment, the Davis-Stirling Act was relatively modest in scope. It consisted of only 23 sections, most of which were enabling provisions, authorizing and defining the common interest development property ownership form.[23] Only a few provisions regulated the operation of a common interest development's managing association.[24]

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17. For example, a commercial developer may defer making many infrastructure decisions until after lots have been sold, so that the infrastructure can be better tailored to the needs of the eventual property owners. This makes it difficult to provide the Real Estate Commissioner with information about those improvements prior to the sale of the lots. *Id.* at Exhibit pp. 5-6. Department of Finance, Enrolled Bill Report on AB 63 (Hayes) (attached to Commission Staff Memorandum 2011-29 (July 13, 2011), at Exhibit p. 3).

18. 1974 Cal. Stat. ch. 606.

19. 1980 Cal. Stat. ch. 1336.

20. 1985 Cal. Stat. ch. 874.

21. In general, a "common interest development" is a real property development in which ownership of a separate interest is coupled with an interest in common area property. See Civ. Code § 1351(b), (d), (f), (k), (*l*), (m).

22. Civ. Code § 1351(c).

23. See generally 1985 Cal. Stat. ch. 874.

24. See former Sections 1363 (existence, powers, and duties of managing association), 1365 (financial statements of association), 1366-1367 (assessments); 1985 Cal. Stat. ch. 874.

The Davis-Stirling Act has been amended numerous times since its original enactment and has more than tripled in size.[25] While the original enabling provisions remain, most of the statute is now regulatory in character, with numerous provisions imposing detailed mandatory operational procedures for rulemaking,[26] board meetings,[27] dispute resolution,[28] member elections,[29] record inspection,[30] accounting and budgeting,[31] and the imposition and collection of assessments.[32]

Purpose and Effect of Civil Code Section 1373

Civil Code Section 1373 exempts commercial and industrial common interest developments from specified provisions of the Davis-Stirling Act. The section was enacted in 1988, shortly after the enactment of the original Davis-Stirling Act.[33]

The legislative history of Section 1373 suggests that the Legislature had not originally intended for the Davis-Stirling Act to have any application to nonresidential common interest developments.[34]

Two years after the Davis-Stirling Act was enacted, when it became apparent that the Act also applied to commercial and industrial CIDs, a bill was introduced to entirely exempt such developments from the Davis-Stirling Act.[35] However, persons representing commercial property owners objected to that approach, noting that some provisions of the Act were beneficial for all CIDs, regardless of type.[36] The bill was amended to instead exempt commercial and industrial CIDS

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25. The Act is now comprised of 94 code sections, some of them many pages in length. See Civ. Code §§ 1350-1378.

26. Civ. Code §§ 1357.100-1357.150.

27. Civ. Code §§ 1363.05, 1363.09.

28. Civ. Code §§ 1363.810-1363.850, 1369.510-1369.590, 1375-1375.1.

29. Civ. Code §§ 1363.03-1363.04, 1363.09.

30. Civ. Code § 1365.2.

31. Civ. Code §§ 1365, 1365.2.5, 1365.3-1365.5.

32. Civ. Code §§ 1365.1, 1366.2-1367.6.

33. 1988 Cal. Stat. ch. 123. Note that Civil Code Section 1373 was given the same scope of application as the exemption in Business and Professions Code Section 11010.3. *Compare* 1988 Cal. Stat. ch. 123 *with* 1980 Cal. Stat. ch. 1336.

34. See letter from Jerold L. Miles to Michael Krisman (Sept. 16, 1986) (on file with Commission) ("In a recent conversation between my partner Bob Thomson and Assemblyman Davis, Assemblyman Davis assured Mr. Thomson that the act was intended to apply only to residential projects."); Office of Local Government Affairs, Enrolled Bill Report on AB 2484 (May 23, 1988) (on file with Commission) ("According to the consultant for the Assembly Housing Committee, the Davis-Stirling Act was enacted to benefit residential common interest developments. However, the language of the Davis-Stirling Act *inadvertently* included commercial and industrial developments.") (emphasis added).

35. AB 2484 (Hauser) (1987).

36. See, e.g., letter from Jeffrey G. Wagner to Assembly Member Daniel Hauser (June 12, 1987) (attached to Commission Staff Memorandum 2008-63 (Dec. 2, 2008), at Exhibit pp. 1-2); letter from F.

from those provisions of the Act that are beneficial to residential property owners but unnecessary and burdensome for commercial or industrial property owners.[37]

Civil Code Section 1373 was enacted in that form.[38] In effect, the section preserved the application of the Davis-Stirling Act's foundational provisions (those that define the basic property ownership and governance structure for CIDs), while exempting commercial and industrial CIDs from the act's operational regulations (those that impose mandatory procedures for the operation of a CID's governing association).[39]

A committee analysis of the bill that added Section 1373 identified the following rationale for the exemption of commercial and industrial common interest developments from the operational regulations of the Davis-Stirling Act:

> 1. Commercial and industrial common interest developments are business endeavors in which the parties engage the professional services of attorneys, accountants, management companies, and developers. Unlike groups of neighbors providing for the governance of their living conditions, these business people are well informed and governed by other provisions of commercial law.
>
> 2. The operational needs of commercial and industrial common interest developments are different than those of a residential association, e.g., "An individual business owner's assessment may increase disproportionately, but fairly, in a given assessment period based on business expansion, change of use, or other negotiated factors, such as an extrahazardous use which raises insurance premiums."
>
> 3. Business parks often add amenities and new facilities as the park is developed. Increased assessments are needed in a timely manner to pay for improvements. Unlike residential owners, business owners pass these increased costs on to their customers.

Scott Jackson to Assembly Member Hauser (June 29, 1987) (on file with Commission); letter from Donna L. May to Michael Krisman (May 7, 1987) (on file with Commission).

37. See Civ. Code § 1373(b) ("The Legislature finds that the [provisions declared inapplicable to commercial or industrial CIDs] may be appropriate to protect purchasers in residential common interest developments, however, the provisions are not necessary to protect purchasers in commercial or industrial developments since the application of those provisions results in unnecessary burdens and costs for these types of developments."). See also Assembly Floor Analysis of AB 2484 (Jan. 19, 1988), p. 1 (specified provisions of Davis-Stirling Act were "enacted to benefit residential common interest developments"); Assembly Committee on Housing and Community Development Analysis of AB 2484 (Jan. 11, 1988), p. 1 (specified provisions of Davis-Stirling Act were "enacted primarily to regulate and benefit residential common interest developments"); Senate Committee on Housing and Urban Affairs Analysis of AB 2484 (May 12, 1987), p. 1 (specified provisions of Davis-Stirling Act were "designed to protect individuals in residential common interest developments"); Committee Statement of Assembly Member Hauser on AB 2484 (on file with Commission) (problems to be solved by Davis-Stirling Act "revolved around residential subdivisions").

38. 1988 Cal. Stat. ch. 123.

39. For further discussion of the distinction between foundational and operational provisions of the Davis-Stirling Act, see Tentative Recommendation on *Commercial and Industrial Common Interest Developments* (Feb. 2011).

> 4. Regulatory requirements designed to protect individuals in residential developments are inappropriate in business developments, interfere with commerce, and increase the costs of doing business.[40]

In addition, express legislative findings were included in Section 1373(b), declaring:

> The Legislature finds that the [provisions declared inapplicable to commercial and industrial CIDs] 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.

Those rationales were based in part on the assumption that business property owners generally have greater sophistication than residential property owners and greater access to professional resources to aid them in purchasing or managing business property. While the assumption of greater sophistication and resources is likely to be true as a general proposition, it will not be true in every case. Some business owners will be less sophisticated, and some residential property owners will be more sophisticated. However, there is good reason to believe that a typical business owner who purchases real property for the operation of a business is a sophisticated actor.[41]

Section 1373 has only been amended three times by the Legislature. The first two amendments were made in connection with Law Revision Commission recommendations, in order to exempt commercial and industrial common interest

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40. Senate Rules Committee Analysis of AB 2484 (Hauser) (May 18, 1988), pp. 2-3. See also Assembly Floor Analysis of AB 2484 (Jan. 19, 1988) (on file with Commission); Assembly Committee on Housing and Community Development Analysis of AB 2484 (Jan. 11, 1988) (on file with Commission); Senate Committee on Housing and Urban Affairs Analysis of AB 2484 (May 12, 1987) (on file with Commission); Committee Statement of Assembly Member Hauser on AB 2484 (on file with Commission).

41. As the California Association of Community Managers observes, in a letter to the Commission:

> The following two demographic facts differentiate the purchaser of a commercial building or unit from the purchaser of a residence:
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> (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.

See Commission Staff Memorandum 2008-63 (Dec. 2, 2008), at Exhibit p. 4.

developments from new regulatory provisions[42] that the Commission had recommended.[43] The Commission recognized that its recommendations had been developed to benefit residential property owners, without any separate consideration of their effect on nonresidential property. Rather than inadvertently impose inappropriate regulatory burdens on commercial or industrial property owners, the existing exemption was expanded to include the new reforms.

The third amendment was made in 2011, to exempt commercial and industrial common interest developments from a new provision[44] that protects an owner's existing right to lease separate interest property.[45]

POLICY RATIONALE FOR REGULATION OF RESIDENTIAL PROPERTY

As discussed above, the legislative history of the exemption provisions strongly suggests that the Subdivided Lands Act and the operational provisions of the Davis-Stirling Act were enacted in order to protect residential property owners, without any intention that they apply to nonresidential property.

Residential subdivisions have two important attributes that justify special regulatory protection.

As explained below, nonresidential subdivisions do not possess those attributes. Therefore, laws enacted to protect residential property may not be necessary or appropriate for nonresidential property.

Residential Property is a Uniquely Important Investment

Residential property is a uniquely important investment, because "the purchase of a home is usually the largest investment a person makes in his or her life."[46] Many laws have been enacted to protect the security of the investment that a person makes in a home.[47]

The Subdivided Lands Act protects an owner's investment by regulating the purchase transaction. A subdivider is required to demonstrate the ability to transfer good title at the promised price, with the necessary infrastructure and promised

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42. See 2003 Cal. Stat. ch. 557 (exemption from rulemaking procedures); 2004 Cal. Stat. ch. 356 (exemption from architectural decisionmaking procedure).

43. See *2003-2004 Annual Report*, 33 Cal. L. Revision Comm'n Reports 569, 645-47 (2003); *Common Interest Development Law: Architectural Review and Decisionmaking*, 34 Cal. L. Revision Comm'n Reports 107 (2004).

44. Civ. Code § 1360.2 (operative January 1, 2012).

45. 2011 Cal. Stat. ch. 62.

46. Senate Floor Analysis of AB 452 (Aug. 22, 2001), p. 3.

47. See, e.g., Civ. Code §. 1102 *et seq.*, which requires numerous specific informational disclosures to a prospective purchaser of residential property. The law does not require the same disclosures when selling nonresidential property.

amenities. Subdividers must also provide protection against blanket encumbrances, and must provide prospective purchasers with detailed information about the property to be purchased.

The Davis-Stirling Act protects an owner's investment by regulating the association that manages and maintains the common area property. The financial operations of the association are required to be transparent and democratic, so that owners can monitor the financial condition of the development and take whatever steps might be necessary to avoid loss of value. Owners are also protected against the use of nonjudicial foreclosure to collect assessment delinquencies below a specified threshold.

Residential Property is Typically the Owner's Home

In addition to being an important financial investment, residential property is typically the owner's home. There is a strong public policy interest in protecting the quality of living conditions within residential communities.

The Davis-Stirling Act achieves this purpose by regulating ongoing ownership rights and responsibilities. It expressly protects certain important property use rights, guarantees minimal due process when enforcing restrictions, requires fair and open governance procedures, and provides a range of informal dispute resolution mechanisms that can be used to resolve problems without recourse to more adversarial and expensive processes. These regulatory provisions help to provide a sound basis for amicable community self-governance.

The Subdivided Lands Act does less to protect living conditions, being almost exclusively focused on the initial sales transaction. However, it does require that a subdivider of a common interest development make reasonable arrangements, in the governing declaration, on a wide range of self-governance issues. This helps to ensure that the common interest development will maintain certain minimum standards regarding the operation of its association.

Rationale for Regulation Inapplicable to Nonresidential Property

Nonresidential subdivisions do not possess the attributes discussed above.

Nonresidential property is not the owner's home. Owners in a nonresidential subdivision are not neighbors and may be expected to deal with one another at arm's length. This eliminates any special public policy concern about maintaining amicable living conditions within a residential community.

Nor is nonresidential property likely to be a uniquely important investment, of the same magnitude as the investment that a person makes in a home. Consequently, there is less of a compelling public policy need to regulate the sale and operation of such property in order to protect the owner's investment.

Consequently, the rationale for regulation of residential property does not seem applicable to nonresidential property. Furthermore, laws that have been tailored to

the needs of residential property owners[48] may not be suited to the needs of nonresidential property owners and may unduly interfere with the transfer or operation of nonresidential property.[49]

Cost of Regulation

Compliance with the Subdivided Lands Act and the operational provisions of the Davis-Stirling Act is not cost-free.

The Subdivided Lands Act requires the payment of fees, the purchase of bonds or other securities, and the professional preparation of extensive reports. The process also produces significant delay, which can increase debt service costs and lead to opportunity costs.[50]

The Davis-Stirling Act imposes ongoing management costs, through its mandatory one-size-fits-all operational requirements.

The cost of regulation can be justified when imposed on a group that is benefitted by the regulation. It is harder to justify when imposed on groups that do not need or receive regulatory benefits.

PROBLEMS RELATING TO THE SCOPE OF THE EXISTING EXEMPTIONS

The Commission has identified three concerns relating to the scope of the existing exemption provisions:

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48. The Commission believes that most reforms to the Davis-Stirling Act have been made to solve problems faced by residential property owners, without separate consideration of their effect on nonresidential property owners. For example, the legislative analyses of the most significant recent regulatory reforms of CID law make no mention of the bills' effects on nonresidential CIDs, instead expressly focusing on their effects on "homeowners." See, e.g., Senate Transportation and Housing Committee Analysis of SB 528 (Feb. 22, 2007) (open meetings), p. 1 ("A common-interest development (CID) is a form of real estate where each *homeowner* has an exclusive interest in a unit or lot and a shared or undivided interest in common area property.") (emphasis added); Senate Floor Analysis of SB 61 (Sept. 5, 2005), p. 7 (member elections) ("According to the author's office, ballots in CID elections are not required by law to be secret. This leaves an opening for potential abuse wherein *homeowners* can be intimidated and disinclined to vote in accordance with their true desires.") (emphasis added); Senate Floor Analysis of SB 137 (Sept. 7, 2005) (foreclosure limitations) ("This bill protects owners' equity in their *homes*…") (emphasis added); Assembly Floor Analysis of AB 1098 (Sept. 8, 2005), p. 2 (record inspection) ("The author identifies the purpose of the bill as preserving common interest developments as affordable *housing* by detailing the financial records that are subject to *homeowner* inspection.") (emphasis added). Moreover, CID reform bills are routinely referred to the Housing policy committees in the Legislature, without being heard by committees that consider proposed business regulations.

49. For example, the complex and costly record inspection procedures mandated by Civil Code Section 1365.2 can be justified as necessary to safeguard investments in residential property against mismanagement by volunteer association boards. However, the less burdensome requirements of Corporations Code Sections 8330 and 8333 are probably adequate for the governance of a business development or a development that is comprised of nonresidential amenities (e.g., a parking condominium).

50. See Commission Staff Memorandum 2012-33 (July 11, 2012).

(1) By their terms, the existing exemptions only apply to a subdivision that is limited to "commercial" or "industrial" uses. As discussed below, there are some subdivisions that are entirely nonresidential, but that permit uses other than commercial or industrial uses. Read strictly, the existing exemptions do not apply to such subdivisions. Yet such an interpretation would seem to conflict with the legislative intent to limit the application of the Subdivided Lands Act and the operational regulations of the Davis-Stirling Act to residential subdivisions.

(2) The existing exemptions apply to a subdivision that is limited to commercial or industrial uses by "zoning." As discussed below, there are laws other than zoning laws that can restrict property to nonresidential uses. Read strictly, the existing exemptions do not apply to a subdivision that is limited to nonresidential uses by a law other than a zoning law. Again, however, such an interpretation would seem to conflict with the legislative intent to limit the Subdivided Lands Act and the operational regulations of the Davis-Stirling Act to residential subdivisions.

(3) The existing exemptions apply to a subdivision that is limited to "commercial" uses, but the term "commercial" is not defined. As discussed below, there are some business subdivisions in which the operation of a residential rental business is a permitted use. It is not clear that the business of renting residences to third party tenants would be considered a commercial use under the existing exemptions.

Those concerns are discussed more fully below.

Nonresidential Subdivision with Non-Commercial Uses

Some subdivisions are restricted to nonresidential uses, but permit uses that are neither commercial nor industrial.[51] For example, a subdivision might be developed with separate parcels comprised of storage units, parking spaces, or boat slips, to be sold to a purchaser for the purchaser's own noncommercial use.[52] The lots in such subdivisions are used as personal amenities, rather than as businesses or industrial operations.

Because such nonresidential subdivisions are not limited to commercial or industrial uses, they do not fall within the letter of the existing exemption provisions.

This is problematic because, as discussed above, the rationale for regulation of residential property does not seem applicable to nonresidential property.

A storage unit or parking space is not the owner's home and is unlikely to be the owner's most important economic investment. Thus, public policy concerns about protecting the value and stability of personal residences and preserving amicable

51. See generally First Supplement to CLRC Staff Memorandum 2011-29 (Aug. 3, 2011).

52. This discussion is not intended to address parking spaces, storage units, or other amenities that are appurtenant to residential property. Nor is it intended to address the operation of a parking lot, storage complex, or marina as a commercial enterprise, with the owner leasing space to customers.

living conditions within a residential community are not relevant to these nonresidential subdivisions.

Moreover, general law governing property ownership and the governance of voluntary associations[53] should be adequate to safeguard and regulate an owner's interest in a parking space, storage unit, or boat slip. It is not clear that the imposition of an additional layer of operational regulation, tailored to the needs of residential property owners, is necessary or beneficial for owners in these types of nonresidential associations.

For the reasons discussed above, the Commission recommends that the existing exemptions be revised to make clear that they apply to all nonresidential subdivisions, regardless of type.[54]

A "nonresidential subdivision" would be a subdivision in which residential use is not permitted by law or is not permitted by a recorded declaration of covenants, conditions, and restrictions.[55] The Commission further recommends that "residential use" not include specified incidental or transitory uses (e.g., residential occupation by an on-site caretaker, or the short-term occupation of a boat).[56]

Non-Zoning Restrictions on Property Use

The existing exemptions apply to a subdivision that is limited to commercial or industrial uses by "zoning." However, there are other sources of law that can restrict or prohibit residential use of property. For example, the law restricts residential use of property that is on the "border-zone" of hazardous contamination.[57]

There is no good policy reason for limiting the existing exemptions to subdivisions that are restricted by zoning. The key policy consideration is the *effect* of the restriction, not its source.

For that reason, the Commission recommends that the existing exemptions be revised to make clear that they include a subdivision that is restricted to specified uses by any law, not just a zoning law.[58]

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53. Typically, the governing association of a nonresidential subdivision would be regulated by the Nonprofit Mutual Benefit Corporation Law, which includes well-developed law on the conduct of meetings, elections, record-keeping, and other governance issues. See Corp. Code §§ 7110-8910.

54. This reform appears to be consistent with the long-standing practice of the Department of Real Estate, which reportedly does not require a public report for a subdivision that contains no residences (regardless of whether the permitted uses are "commercial" or "industrial").

55. See proposed Bus. & Prof. Code § 11002; Civ. Code § 1373.5.

56. See proposed Bus. & Prof. Code § 11002(b)(2)-(3); Civ. Code § 1373.5(b)(2)-(3).

57. See, e.g., Health & Safety Code § 25232(b). See also Health & Safety Code § 25117.4 ("border-zone property" defined).

58. See proposed Bus. & Prof. Code § 11002; Civ. Code § 1373.5.

Residential Rental Business as "Commercial" Use

In some subdivisions that are restricted to commercial uses, a single parcel may be further divided into separate apartments, which are then rented by the owner of the parcel, as a business.

From the perspective of the property owner, this is plainly a commercial use of the property. The owner's primary reason for purchasing the property is to operate a business. The owner is reasonably presumed to be more sophisticated and have greater access to professional resources than a typical homeowner. Therefore, the policy rationale for exempting commercial property from the Subdivided Lands Act and the operational provisions of the Davis-Stirling Act appears to be fully applicable to property that is used to operate a residential rental business.

While it is true that the Subdivided Lands Act and the operational provisions of the Davis-Stirling Act are also intended to promote the quality of living conditions within a subdivision, they do so only with respect to property *owners*. Neither statute confers any meaningful benefit on an owner's *tenants*. The Subdivided Lands Act regulates the sales transaction between the subdivider and the purchaser of a lot or parcel. It has no effect on the purchaser's future tenants. Similarly, the Davis-Stirling Act confers a host of rights and obligations on property owners, but has almost no direct effect on an owner's tenants.[59]

For those reasons, the Commission recommends that the exemptions be revised to make clear that the provision of rental apartments is a commercial use of property, and therefore "nonresidential" for the purposes of the statutory exemptions.[60] This will avoid undue burdens on the property owners, without affecting the rights that tenants possess under general landlord-tenant law.[61]

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59. There are only two provisions of the Davis-Stirling Act that confer a direct benefit on non-owner occupants of separate interest property, but neither of those provisions is included within the scope of the exemption provided by Civil Code Section 1373. They are therefore irrelevant in determining whether other provisions of the Davis-Stirling Act (which do not directly benefit tenants) should apply to a commercial development in which an owner operates an apartment building. See Civ. Code §§ 1361.5 (occupant guaranteed egress), 1364(d)(2) (warning to occupant before being relocated for termite abatement).

60. See proposed Bus. & Prof. Code § 11002(b)(1); Civ. Code § 1373.5(b)(1). Note that these provisions only apply to a lot that is divided into three or more separate apartments. This is intended to avoid the misapplication of the provisions to owner-occupied residences that have a single associated "in-law cottage" or "granny flat."

61. See generally, M. Moskovitz, N. Lenvin, California Landlord-Tenant Practice, §§ 2.1-3.75, at 281-395 (Cal. Cont. Ed. Bar, 2d ed. 2011)

PROPOSED LEGISLATION

Bus. & Prof. Code § 11002 (added). "Residential subdivision" and "nonresidential subdivision" defined

SECTION 1. Section 11002 is added to the Business and Professions Code, to read:

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 60 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."

Subdivision (b)(3) establishes an exception for "short-term occupation," which is defined as 60 days out of each calendar year. For a similar short-term occupation rule, see Section 51.3(d) (60 day per year exception to age restrictions on occupants of senior housing).

Under subdivision (c), any subdivision in which residential use is entirely 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).

☞ **Note.** The Commission particularly invites public comment on whether the period specified in proposed Section 11002(b)(3), for "short-term" occupation of property, is appropriate.

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

SEC. 2. Section 11010.3 of the Business and Professions Code is amended to read:

11010.3. The provisions of this chapter shall not apply to the proposed sale or lease of lots or other interests in a nonresidential 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 make clear that the section applies to any subdivision in which residential use 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

SEC. 3. Section 1373.5 of the Civil Code is amended to read:

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~~:

(1) Section 1356.

(2) Article 4 (commencing with Section 1357.100) of Chapter 2 of Title 6 of Part 4 of Division 2.

(3) Section 1360.2.

(4) Subdivision (b) of Section 1363.

(5) Section 1365.

(6) Section 1365.5.

(7) Subdivision (b) of Section 1366.

(8) Section 1366.1.

(9) Section 1368.

(10) Section 1378.

(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.

Comment. Section 1373 is amended to make clear that the section applies to any subdivision in which residential use 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" and "nonresidential common interest development" defined

SEC. 4. Section 1373.5 is added to the Civil Code, to read:

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 60 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."

Subdivision (b)(3) establishes an exception for "short-term occupation," which is defined as 60 days out of each calendar year. For a similar short-term occupation rule, see Section 51.3(d) (60 day per year exception to age restrictions on occupants of senior housing).

Under subdivision (c), any common interest development in which residential use is entirely 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).

☞ **Note.** The Commission particularly invites public comment on whether the period specified in proposed Section 1373.5(b)(3), for "short-term" occupation of property, is appropriate.