

Memorandum 2011-35

**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.

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.

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.

- (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 an “SRP” (the “Single Responsible Person” who works with DRE to manage the report process) to prepare and 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 and develop 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.

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

CALIFORNIA LAW REVISION COMMISSION

STAFF DRAFT

TENTATIVE RECOMMENDATION

Nonresidential Subdivisions

November 2011

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.

California Law Revision Commission

4000 Middlefield Road, Room D-2

Palo Alto, CA 94303-4739

650-494-1335

<commission@clrc.ca.gov>

SUMMARY OF TENTATIVE RECOMMENDATION

Business and Professions Code Section 11010.3 and Civil Code Section 1373 exempt “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 (Bus. & Prof. Code §§ 11000-11200) and from specified provisions of the Davis-Stirling Common Interest Development Act (Civ. Code §§ 1350-1378), respectively.

The legislative history of the Subdivided Lands Act and the Davis-Stirling Act suggests an intent to protect residential real property subdivisions, and to exempt other types of subdivisions. However, application of the existing exemptions is ambiguous in the following situations:

- (1) When a subdivision is limited to nonresidential uses that are neither commercial nor industrial (e.g., private storage units, parking spaces, or boat slips).
- (2) When a subdivision is limited to commercial or industrial uses, but not through zoning (e.g., through a law prohibiting residential use of property near a hazardous waste area).
- (3) When a subdivision includes one or more parcels that are used to operate a residential rental business, with the owner of the property renting apartments to third party tenants.

The Commission recommends that the exemptions be revised to clarify their application and make them applicable to all nonresidential subdivisions. This approach reflects sound policy and would effectuate the legislative intent.

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

NONRESIDENTIAL SUBDIVISIONS

1 Business and Professions Code Section 11010.3 and Civil Code Section 1373
2 exempt “commercial” and “industrial” subdivisions from the requirements of the
3 Subdivided Lands Act (Bus. & Prof. Code §§ 11000-11200) and from specified
4 provisions of the Davis-Stirling Common Interest Development Act (Civ. Code §§
5 1350-1378), respectively. In some contexts, the scope of those exemptions is not
6 clear.

7 The available legislative history suggests that the Subdivided Lands Act was
8 enacted to regulate and protect residential real property subdivisions, without any
9 expectation or intention that the act would affect nonresidential subdivisions.
10 When it became apparent that the act applied to a particular type of nonresidential
11 subdivision, an exemption was added to eliminate that application. The exemption
12 was later broadened, on more than one occasion, to encompass other types of
13 nonresidential subdivisions. The exemption now extends to subdivisions that are
14 limited to commercial or industrial uses by zoning or a recorded declaration.

15 The Davis-Stirling Common Interest Development Act (hereafter “Davis-
16 Stirling Act”) also appears to have been intended to regulate residential property.
17 When it was pointed out that the act also applied to commercial and industrial
18 common interest developments, an exemption was added to limit that application.

19 It is now apparent that there are types of nonresidential subdivisions that do not
20 fall within the letter of the existing exemptions. It is unclear whether a court would
21 apply the exemptions to those types of nonresidential subdivisions.

22 The Commission has analyzed the purpose and effect of the Subdivided Lands
23 Act and the Davis-Stirling Act and recommends that the existing exemptions be
24 revised to clarify their application and make them applicable to all nonresidential
25 subdivisions.

SUBDIVIDED LANDS ACT

Purpose and Effect of the Subdivided Lands Act

27 The Subdivided Lands Act regulates the sale or lease of lots or parcels within a
28 “subdivision” or “subdivided lands,”¹ in order to protect consumers against “fraud
29

1. 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.

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.

1 and sharp practices” by subdividers.² The Act achieves its purpose by requiring
2 that a subdivider, before selling or leasing any lots within a regulated subdivision,
3 obtain a “public report” from the Real Estate Commissioner.

4 On applying for a public report, a subdivider must provide a wide range of
5 detailed information about the subdivision, including information about the status
6 of title, the proposed terms of sale, access to public utilities, any restrictions on use
7 or occupancy, any lien that may exist on the property, any existing or proposed
8 indebtedness incurred for the construction of promised facilities, the location of
9 public schools, the presence of nearby airports, and specified geological and soil
10 conditions.³

11 A subdivider must also demonstrate compliance with a number of substantive
12 requirements, including requirements intended to ensure that the subdivider will
13 deliver the property in the promised condition, for the promised price, with
14 protection against blanket encumbrances.⁴

15 If the subdivision is also a common interest development, the subdivider must
16 demonstrate that reasonable arrangements have been made for completion of the
17 project, transfer of ownership and control, and ongoing operation and
18 maintenance.⁵ The subdivider must also submit a draft declaration of covenants,
19 conditions, and restrictions that makes reasonable arrangements on a number of
20 specified operational issues.⁶

21 On receipt of a complete application for a public report, the Real Estate
22 Commissioner must review the substance of the application and, unless there are
23 grounds for denial, issue a public report.⁷ The subdivider is then free to sell or
24 lease lots in the subdivision.

2. 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.”).

3. 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).

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

5. Bus. & Prof. Code § 11018.5.

6. 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.

7. Bus. & Prof. Code § 11018.

1 Grounds for denial of a report include failure to comply with the Subdivided
2 Lands Act; misrepresentation, deceit, or fraud; and the inability of the subdivider
3 to meet a number of substantive requirements relating to transfer of title and the
4 condition of the property.⁸

5 The subdivider must provide a copy of the public report to a prospective
6 purchaser.⁹ A public report must also be made available for public inspection.¹⁰

7 **Purpose and Effect of Business and Professions Code Section 11010.3**

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

12 The original version of the exemption was enacted in 1969. At that time, it only
13 applied to “expressly zoned industrial subdivisions which are limited in use to
14 industrial purposes” and “commercial leases of parcels in a shopping center.”¹¹

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

17 [The] Subdivided Lands Act was placed there when only residential
18 subdivisions were conceived and used in California. It is only in the past 20 years
19 that industrial subdivisions have spread all over the State.¹²

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

22 As the legislative history explained, purchasers of property in industrial
23 subdivisions and shopping centers do not require the protections that were
24 provided by the Subdivided Lands Act,¹³ in part because they are presumed to be
25 more sophisticated than residential property purchasers.¹⁴ Furthermore, there are
26 practical differences between commercial and residential subdivisions that make it

8. *Id.*

9. Bus. & Prof. Code § 11018.1.

10. *Id.*

11. See 1969 Cal. Stat. ch. 373.

12. Letter from Assembly Member Hayes to Governor Reagan (July 27, 1969) (attached to CLRC 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 CLRC Staff Memorandum 2011-29 (July 13, 2011), at Exhibit p. 4).

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

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

1 difficult or unhelpful for a commercial or residential subdivider to comply with the
2 Subdivided Lands Act.¹⁵

3 The Legislature has amended the exemption provision twice to broaden its
4 scope. In 1974, the provision was amended to replace the narrow category of
5 “shopping centers,” with the broader “commercial use” category.¹⁶ In 1980, the
6 amendment was broadened again, to include any subdivision that is limited to
7 commercial or industrial use by a recorded declaration (in addition to any
8 subdivision that is restricted to such uses by zoning).¹⁷

9 DAVIS-STIRLING COMMON INTEREST
10 DEVELOPMENT ACT

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

12 The Davis-Stirling Act was enacted in 1985,¹⁸ to broaden and consolidate the
13 law that governed condominiums, so that it would also apply to other types of
14 “common interest developments”¹⁹— i.e., planned developments, community
15 apartment projects, and stock cooperatives.²⁰

16 At the time of enactment, the Davis-Stirling Act was relatively modest in scope.
17 It consisted of only 23 sections, most of which were enabling provisions,
18 authorizing and defining the common interest development property ownership
19 form.²¹ Only a few provisions regulated the operation of a common interest
20 development’s managing association.²²

21 The Davis-Stirling Act has been amended numerous times since its original
22 enactment and has more than tripled in size.²³ While the original enabling
23 provisions remain, most of the statute is now regulatory in character, with

15. 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 CLRC Staff Memorandum 2011-29 (July 13, 2011), at Exhibit p. 3).

16. 1974 Cal. Stat. ch. 606.

17. 1980 Cal. Stat. ch. 1336.

18. 1985 Cal. Stat. ch. 874.

19. 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).

20. Civ. Code § 1351(c).

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

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

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

1 numerous provisions imposing detailed mandatory operational procedures for
2 rulemaking,²⁴ board meetings,²⁵ dispute resolution,²⁶ member elections,²⁷ record
3 inspection,²⁸ accounting and budgeting,²⁹ and the imposition and collection of
4 assessments.³⁰

5 **Purpose and Effect of Civil Code Section 1373**

6 Civil Code Section 1373 exempts commercial and industrial common interest
7 developments from specified provisions of the Davis-Stirling Act. The section was
8 enacted in 1988, shortly after the enactment of the original Davis-Stirling Act.³¹

9 As with the Subdivided Lands Act, the legislative history of Section 1373
10 suggests that the Legislature had not originally intended for the Davis-Stirling Act
11 to have any application to nonresidential common interest developments.³²

12 Two years after the Davis-Stirling Act was enacted, when it became apparent
13 that the Act also applied to commercial and industrial CIDs, a bill was introduced
14 to entirely exempt such developments from the Davis-Stirling Act.³³ However,
15 persons representing commercial property owners objected to that approach,
16 noting that some provisions of the Act were beneficial for all CIDs, regardless of
17 type.³⁴ The bill was amended to instead exempt commercial and industrial CIDs
18 from those provisions of the Act that were identified as necessary to protect

24. Civ. Code §§ 1357.100-1357.150.

25. Civ. Code §§ 1363.05, 1363.09.

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

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

28. Civ. Code § 1365.2.

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

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

31. 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.

32. 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).

33. AB 2484 (Hauser) (1987).

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

1 residential property owners, but unnecessary and burdensome for commercial or
2 industrial property owners.³⁵

3 Civil Code Section 1373 was enacted in that form.³⁶ In effect, the section
4 preserved the application of the Davis-Stirling Act's *foundational* provisions
5 (those that define the basic property ownership and governance structure for
6 CIDs), while exempting commercial and industrial CIDs from the act's
7 *operational* regulations (those that impose mandatory procedures for the operation
8 of a CID's governing association).³⁷

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

12 1. Commercial and industrial common interest developments are business
13 endeavors in which the parties engage the professional services of attorneys,
14 accountants, management companies, and developers. Unlike groups of neighbors
15 providing for the governance of their living conditions, these business people are
16 well informed and governed by other provisions of commercial law.

17 2. The operational needs of commercial and industrial common interest
18 developments are different than those of a residential association, e.g., "An
19 individual business owner's assessment may increase disproportionately, but
20 fairly, in a given assessment period based on business expansion, change of use,
21 or other negotiated factors, such as an extrahazardous use which raises insurance
22 premiums."

23 3. Business parks often add amenities and new facilities as the park is
24 developed. Increased assessments are needed in a timely manner to pay for
25 improvements. Unlike residential owners, business owners pass these increased
26 costs on to their customers.

35. 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").

36. 1988 Cal. Stat. ch. 123.

37. 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).

1 4. Regulatory requirements designed to protect individuals in residential
2 developments are inappropriate in business developments, interfere with
3 commerce, and increase the costs of doing business.³⁸

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

6 The Legislature finds that the [provisions declared inapplicable to commercial
7 and industrial CIDs] are appropriate to protect purchasers in residential common
8 interest developments, however, the provisions may not be necessary to protect
9 purchasers in commercial or industrial developments since the application of
10 those provisions could result in unnecessary burdens and costs for these types of
11 developments.

12 Those rationales were based in part on the assumption that business property
13 owners generally have greater sophistication than residential property owners and
14 greater access to professional resources to aid them in purchasing or managing
15 business property. While the assumption of greater sophistication and resources is
16 likely to be true as a general proposition, it will not be true in every case. Some
17 business owners will be less sophisticated, and some residential property owners
18 will be more sophisticated. However, there is good reason to believe that a typical
19 business owner who purchases real property for the operation of a business is a
20 sophisticated actor.³⁹

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

38. 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).

39. 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:

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

1 developments from new regulatory provisions⁴⁰ that the Commission had
2 recommended.⁴¹ The Commission recognized that its recommendations had been
3 developed to benefit residential property owners, without any separate
4 consideration of their effect on nonresidential property. Rather than inadvertently
5 impose inappropriate regulatory burdens on commercial or industrial property
6 owners, the existing exemption was expanded to include the new reforms.

7 The third amendment was made in 2011, to exempt commercial and industrial
8 common interest developments from a new provision⁴² that protects an owner's
9 existing right to lease separate interest property.⁴³

10 POLICY RATIONALE FOR REGULATION OF 11 RESIDENTIAL PROPERTY

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

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

18 Nonresidential subdivisions do not possess those attributes. Therefore, as
19 discussed below, laws enacted to protect residential property may not be necessary
20 or appropriate for nonresidential property.

21 **Residential Property is a Uniquely Important Investment**

22 Residential property is a uniquely important investment, because “the purchase
23 of a home is usually the largest investment a person makes in his or her life.”⁴⁴
24 Many laws have been enacted to protect the security of the investment that a
25 person makes in a home.⁴⁵

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

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

41. 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).

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

43. 2011 Cal. Stat. ch. 62

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

45. 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.

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

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

11 **Residential Property is Typically the Owner's Home**

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

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

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

28 **Rationale for Regulation Inapplicable to Nonresidential Property**

29 Nonresidential subdivisions do not possess the attributes discussed above.

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

34 Nor is nonresidential property likely to be a uniquely important investment, on a
35 par with the investment that a person makes in a home. Consequently, there is less
36 of a compelling public policy need to regulate the sale and operation of such
37 property in order to protect the owner's investment.

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

1 the needs of residential property owners⁴⁶ may not be suited to the needs of
2 nonresidential property owners and may unduly interfere with the transfer or
3 operation of nonresidential property.⁴⁷

4 **Cost of Regulation**

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

7 The Subdivided Lands Act requires the payment of fees, the purchase of bonds
8 or other securities, and the professional preparation of extensive reports. The
9 process also produces significant delay, which can increase debt service costs and
10 lead to opportunity costs.⁴⁸

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

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

16 PROBLEMS RELATING TO THE SCOPE OF THE 17 EXISTING EXEMPTIONS

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

46. 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.

47. 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).

48. See CLRC Staff Memorandum 2011-35 (Oct. 4, 2011).

- 1 (1) By their terms, the existing exemptions only apply to a subdivision that is
2 limited to “commercial” or “industrial” uses. As discussed below, there are
3 some subdivisions that are entirely nonresidential, but that permit uses other
4 than commercial or industrial uses. Read strictly, the existing exemptions do
5 not apply to such subdivisions. Yet such an interpretation would seem to
6 conflict with the legislative intent to limit the Subdivided Lands Act and the
7 operational regulations of the Davis-Stirling Act to residential subdivisions.
- 8 (2) The existing exemptions apply to a subdivision that is limited to commercial
9 or industrial uses by “zoning.” As discussed below, there are laws other than
10 zoning laws that can restrict property to nonresidential uses. Read strictly,
11 the existing exemptions do not apply to a subdivision that is limited to
12 nonresidential uses by a law other than a zoning law. Again, however, such
13 an interpretation would seem to conflict with the legislative intent to limit
14 the Subdivided Lands Act and the operational regulations of the Davis-
15 Stirling Act to residential subdivisions.
- 16 (3) The existing exemptions apply to a subdivision that is limited to
17 “commercial” uses, but the term “commercial” is not defined. As discussed
18 below, there are some business subdivisions in which the operation of a
19 residential rental business is a permitted use. It is not clear that the business
20 of renting residences to third party tenants would be considered a
21 commercial use under the existing exemptions.

22 Those concerns are discussed more fully below.

23 **Nonresidential Subdivision with Non-Commercial Uses**

24 Some subdivisions are restricted to nonresidential uses, but permit uses that are
25 neither commercial nor industrial.⁴⁹ For example, a subdivision might be
26 developed with separate parcels comprised of storage units, parking spaces, or
27 boat slips, to be sold to a purchaser for the purchaser’s own use.⁵⁰ The lots in such
28 subdivisions are used as personal amenities, rather than as businesses or industrial
29 operations.

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

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

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

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

50. 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.

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

3 Moreover, general law governing property ownership and the governance of
4 associations⁵¹ should be adequate to safeguard and regulate an owner’s interest in
5 a parking space, storage unit, or boat slip. It is not clear that the imposition of an
6 additional layer of operational regulation, tailored to the needs of residential
7 property owners, is necessary or beneficial for owners in these types of
8 nonresidential associations.

9 For the reasons discussed above, the Commission recommends that the existing
10 exemptions be revised to make clear that they apply to all nonresidential
11 subdivisions, regardless of type.⁵²

12 A “nonresidential subdivision” would be a subdivision in which residential use
13 is not permitted by law or is not permitted by a recorded declaration of covenants,
14 conditions, and restrictions.⁵³ The Commission further recommends that
15 “residential use” not include specified incidental or transitory uses (i.e., residential
16 occupation by a business’ on-site caretaker, or the short-term occupation of a
17 boat).⁵⁴

18 **Non-Zoning Restrictions on Property Use**

19 Taken literally, the existing exemptions apply to a subdivision that is limited to
20 commercial or industrial uses by “zoning.” However, there are other sources of
21 law that can restrict or prohibit residential use of property. For example, the law
22 restricts residential use of property that is on the “border-zone” of hazardous
23 contamination.⁵⁵

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

27 For that reason, the Commission recommends that the existing exemptions be
28 revised to make clear that they include a subdivision that is restricted to specified
29 uses by any law, not just a zoning law.⁵⁶

51. 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.

52. 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”).

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

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

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

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

1 **Residential Rental Business as “Commercial” Use**

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

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

12 While it is true that the Subdivided Lands Act and the operational provisions of
13 the Davis-Stirling Act are also intended to promote the quality of living conditions
14 within a subdivision, they do so only with respect to property *owners*. Neither
15 statute confers any meaningful benefit on an owner’s *tenants*. The Subdivided
16 Lands Act regulates the sales transaction between the subdivider and the purchaser
17 of a lot or parcel. It has no effect on the purchaser’s future tenants. Similarly, the
18 Davis-Stirling Act confers a host of rights and obligations on property owners, but
19 has almost no direct effect on an owner’s tenants.⁵⁷

20 For those reasons, the Commission recommends that the exemptions be revised
21 to make clear that the rental of apartments is a commercial use of property, and
22 therefore “nonresidential” for the purposes of the statutory exemptions.⁵⁸ This will
23 avoid undue burdens on the property owners, without affecting the rights that
24 tenants possess under general landlord-tenant law.⁵⁹

57. 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 before being relocated for termite abatement).

58. 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.”

59. 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

1 **Bus. & Prof. Code § 11002 (added). “Residential subdivision,” “nonresidential subdivision”**
2 **defined**

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

5 11002. (a) For the purposes of this section, “residential subdivision” means a
6 subdivision in which residential use is permitted by both law and by any
7 declaration of covenants, conditions, and restrictions that is recorded in each
8 county in which the subdivision is located.

9 (b) For the purposes of subdivision (a), the following uses are not considered to
10 be residential uses and the fact that one or more of these uses is permitted within a
11 subdivision does not make the subdivision a “residential subdivision”:

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

14 (2) The provision of living space to an agent or employee of a governing
15 association or a business that is located within the subdivision, as an incident of
16 agency or employment. For the purposes of this paragraph, “agent or employee”
17 includes, but is not limited to, a property manager, caretaker, or security guard.

18 (3) The short-term occupation of a boat, trailer, or motor vehicle that is located
19 on but not permanently affixed to a lot, parcel, or separate interest. For the
20 purposes of this paragraph “short-term occupation” means occupation for no more
21 than 60 days out of each calendar year.

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

24 (d) For the purposes of this section, “separate interest” has the meaning provided
25 in subdivision (l) of Section 1351 of the Civil Code.

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

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

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

36 Under subdivision (c), any subdivision in which residential use is precluded, by law or by a
37 recorded declaration of covenants, conditions, and restrictions, is a “nonresidential subdivision.”

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

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

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

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

6 11010.3. The provisions of this chapter shall not apply to the proposed sale or
7 lease of lots or other interests in a nonresidential subdivision ~~in which lots or other~~
8 ~~interests are (a) limited to industrial or commercial uses by zoning or (b) limited to~~
9 ~~industrial or commercial uses by a declaration of covenants, conditions, and~~
10 ~~restrictions, which declaration has been recorded in the official records of the~~
11 ~~county or counties in which the subdivision is located.~~

12 **Comment.** Section 11010.3 is amended to make clear that the section applies to any
13 subdivision in which residential use is not permitted by law or by a recorded declaration of
14 covenants, conditions, and restrictions. See Section 11002(c) (“nonresidential subdivision”
15 defined).

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

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

18 1373. (a) The following provisions do not apply to a nonresidential common
19 interest development ~~that is limited to industrial or commercial uses by zoning or~~
20 ~~by a declaration of covenants, conditions, and restrictions that has been recorded~~
21 ~~in the official records of each county in which the common interest development is~~
22 ~~located:~~

23 (1) Section 1356.

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

26 (3) Subdivision (b) of Section 1363.

27 (4) Section 1365.

28 (5) Section 1365.5.

29 (6) Subdivision (b) of Section 1366.

30 (7) Section 1366.1.

31 (8) Section 1368.

32 (9) Section 1378.

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

38 **Comment.** Section 1373 is amended to make clear that the section applies to any subdivision
39 in which residential use is not permitted by law or by a recorded declaration of covenants,
40 conditions, and restrictions. See Section 1373.5(c) (“nonresidential subdivision” defined).

1 **Civ. Code § 1373.5 (added). “Residential common interest development,” “nonresidential**
2 **common interest development” defined**

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

4 1373.5. (a) For the purposes of this section, “residential common interest
5 development” means a common interest development in which residential use is
6 permitted by both law and by any declaration of covenants, conditions, and
7 restrictions that is recorded in each county in which the common interest
8 development is located.

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

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

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

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

23 (c) For the purposes of Section 1373, “nonresidential common interest
24 development” means any common interest development that is not a residential
25 common interest development.

26 **Comment.** Section 1373.5 is new. Subdivision (a) defines “residential common interest
27 development” for the purposes of the section. Under the definition, if both the law and any
28 recorded declaration of covenants, conditions, and restrictions permit any residential use within a
29 common interest development, the common interest development is a “residential common
30 interest development.”

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

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

38 Under subdivision (c), any common interest development in which residential use is precluded,
39 by law or by a recorded declaration of covenants, conditions, and restrictions, is a “nonresidential
40 common interest development.”

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

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