The DRE's application review process occurs before the HOA is functioning. The DRE does not have jurisdiction under the SLA to intervene in the affairs of the HOA such as mediating an operating HOA dispute regarding member compliance with CC&Rs, or a homeowner assessment delinquency with their HOA. The DRE does not have jurisdiction over the financial affairs of an operating HOA and generally cannot compel a specific budget adoption once an HOA is in operation. To the extent possible, DRE may disclose significant conditions or obligations that a homebuyer or an HOA is responsible to satisfy such as city/county approval conditions; environmental mitigation measures; and other significant restrictions or policies such as affordable housing programs.

BACKGROUND FOR UNDERSTANDING CALIFORNIA'S SUBDIVISION PROCESS

Subdividers, Developers and Homebuilders

Throughout this study, the term "developer" is used generically to mean the party who acquires land, subdivides it, installs site improvements, builds homes, and sells the homes to homebuyers, all of which constitutes the housing development process described in detail on pages 30-44. This term is also used generically to refer to the "subdivider" as that term is defined by the Map Act and the SLA. However, it should be noted that in practice it is common for different parties to perform the role of the developer at various stages of the development process. A ***speculator*** is an investor who purchases land that is expected to be in the path of development and whose goal is to sell the land when it has appreciated in value. A speculator often is not active in moving the property forward for development but relies mostly on improving market conditions to generate profits. A ***land developer*** acquires land and actively works to develop the property by moving it through the entitlement process and/or installing site improvements. As such, the land developer is the party that pursues the legal subdivision of property under the Map Act (the subdivider as defined by the Map Act). A homebuilder is one who builds homes on improved lots and sells them to homebuyers. In some cases, a homebuilder may perform the function of the land developer by acquiring entitled land and installing the site improvements him/herself. Nevertheless, as the seller of subdivision interests, the homebuilder is almost always the party that applies for the public report (the subdivider as defined by the SLA), even though the homebuilder may not have been the party responsible for creating the legal subdivision under the Map Act.

Title Records

One of the first acts of California' legislature was to adopt a recording system by which evidence of title or title interests could be collected and maintained. ***Title***, in the context of real estate, is an ownership interest in real property. The purpose of the recording system is to inform persons planning to purchase or otherwise deal with real property about the ownership and condition of the title. Recordation by the County Recorder gives ***constructive notice*** of title matters to purchasers of real property, which, to the extent a document is properly recorded, presumes that purchasers and lenders have been given notice (whether or not they have been given actual notice) of such documents affecting the subject property. This system was designed to protect innocent purchasers and lenders against secret sales, transfers, or conveyances and from undisclosed encumbrances/liens. The overriding purpose of this system is to allow the title to the real property to be transferable, and this system is essential to the efficient functioning of real estate markets and the development process.

In large part, California's subdivision laws are concerned with preserving the integrity of the title of real property when the property is subdivided and, once subdivided, that there is adequate disclosure of various matters affecting the property to the purchaser of the subdivided interest. A written instrument called a grant deed transfers title. One of the essential elements of a valid grant deed is that the property is properly described. Ensuring that real property is properly described after it is subdivided is also one of the purposes of the Map Act.

A type of encumbrance common to real estate transactions in California is a ***deed of trust***. A deed of trust is a security instrument, or a pledge of real property as collateral for a financial obligation such as a promissory note (loan) used to purchase a home. A deed of trust is similar to a mortgage, which is common to other states and is generically referred to as a mortgage. A home loan is often referred to as a mortgage when, in actuality, the mortgage is the pledge of the property as collateral for the loan, not the loan itself.

When a document is recorded, the priority of the rights established by the document is determined by the chronological order of recording. For example, a mortgage is superior in priority to that of another mortgage recorded the following day (or hour or minute). In this example, the mortgages are referred to as a first mortgage and second mortgaged based on the priority of the liens. In the event of alienation (voluntary or involuntary transfer of the property), the mortgage lien holders are entitled to enforce their rights to the property based on the priority of their liens. The interests of lower priority documents are said to be ***subordinate*** to those of higher priority documents.

Title Insurance

Real estate transactions typically involve large sums of money, and purchasers and lenders run the risk of loss due to matters discovered after the property is purchased that may adversely affect title. It is impractical for purchasers and lenders to search county records themselves, and thus title insurance companies are relied upon to conduct this search on their behalf. In real estate transactions, escrow is the process by which a third party facilitates the transfer of property. The escrow holder follows the instructions of the buyer, seller, lender(s), and any other parties who have an interest in the transaction. In California, the title insurance company or an independent escrow company may perform the escrow function.

Prior to the transaction closing, the title insurance company will provide the parties with a ***preliminary title report*** of documents in the public records that affect the subject property. The report includes the name of the owner, the type of estate held, the legal description of the property, and a list of exceptions to insurance coverage. With the preliminary title report, the insurance company is indicating its willingness to insure the property title, excluding those items listed. Thus, it behooves those acquiring an interest in a property to carefully review these exceptions to determine how their use of or interest in the property may be affected.

Title insurance is intended to protect owners and lenders from loss or damages they may incur due to matters adversely affecting the title that were not disclosed by the title company prior to closing. Because title companies are liable under insurance policies issued, they are expected to be thorough when conducting reviews of public records that may affect title, when recording documents, and when managing the escrow process on behalf of their clients. Consequently, a title insurance company is involved in every stage of the subdivision process. Developers rely upon the title company to provide accurate legal descriptions and title information when purchasing property, when processing subdivision maps under the Map Act, when processing public reports under the SLA, and when transferring property to others. Much of the DRE's review and final public report will be based on information obtained from or referenced in the preliminary title report.

Land Use Restrictions

All real property is subject to restrictions on its use, and ensuring adequate disclosure of such restrictions is a major purpose of the SLA. The two categories of restrictions are public and private. ***Public restrictions*** include zoning and building codes that are concerned with the health, safety, welfare, and morals of the community. Restrictions, such as the types of uses that occur on property, heights of buildings, setbacks from property lines, etc. are found in these regulations. Public restrictions typically do not appear in public records unless they are coincidentally referred to in a recorded document. The main reason for this is that public restrictions, such as those found in the zoning code, apply to all properties within the subject city or county and are not specific to individual parcels. Residents are expected to comply with public restrictions as they do with other laws of the community. They are also expected to contact the local planning or building department when considering changes in their property.

In addition to complying with restrictions pertaining to the use of and conduct on their property, all homeowners are expected to use and maintain their properties according to the standards of the community. Residents may not interfere with their neighbors' ability to enjoy their property and they must not create a nuisance. A public nuisance, according to state law, is anything that is: 1) injurious to health, 2) indecent to the senses, 3) unlawfully impeding free use of the streets, or 4) obstructing free use of property so as to interfere with the comfortable enjoyment of life or property. As a practical matter, nuisance laws and zoning codes can be difficult to enforce. Local code enforcement officials and police may be limited, either by resource allocation priorities or procedural requirements, in the actions that they can take to effect compliance. Homeowners may pursue civil action (such as small claims court) to recover damages they have suffered as a result of the nuisance, but even success in court may not solve the problem. Furthermore, a homeowner's conduct or activity may not rise to the level of a nuisance, but still may lead to frustration among neighboring homeowners. Local governments can do little to prevent clutter, poor appearance, or bad taste. For example, a homeowner failing to maintain his/her yard as often as he/she should, a homeowner installing a large satellite dish or other equipment, or a homeowner parking a large recreational vehicle on the street are common sources of irritation in some neighborhoods.

Private restrictions are those that are placed on a property by the property owners. Such restrictions may be found in individual deeds or in a separate recorded document. When subdivisions are developed, CC&Rs may be placed on the property by the developer either voluntarily or in order to comply with regulations such as the DSA. The title of the document will often appear as "The Declaration of Covenants, Conditions, and Restrictions for [Subdivision Name]" and may be referred to as simply "the declaration." A covenant is a promise to do or not to do something and it signifies an agreement. A condition is a qualification of the grant of interest, i.e., the interest is being granted with the expectation that the condition will be met by the owner or the grant will be terminated.[4] A restriction restricts the free use of the land by the owner.

Developers often use CC&Rs to enhance long-term values and to provide controls that go beyond the local agency's controls and powers. CC&Rs "run with the land." That is, the rights and obligations contained in them remain with the land, regardless of ownership, and pass from deed to deed as the land is transferred from one owner to another. CC&Rs are in effect a contract among the property owners, who are subject to them, by which they agree to abide by them. There need not be an HOA associated with the CC&Rs, i.e., standard subdivisions can be and often are subject to CC&Rs as well. However, enforcement of CC&Rs is easier with an HOA, which usually has the power to impose fines, suspend the offending member's rights in the association, and deny access to common area amenities. Absent an HOA, homeowners would have to file a civil action in order to enforce the CC&Rs.

Essential Residential Services and Quasi-Governmental Associations

The private restrictions within a CID are enforced by the HOA of the CID and the common facilities within CIDs are owned by the HOA. In this regard, HOAs can be considered **quasi-governmental**. That is, they supplement, and in some cases substitute for, the facilities and services that may otherwise be provided by local governmental agencies (cities and counties).

Every residence must have adequate access via roadways, utility services (water, sewer, storm drainage, electricity, gas, and communications), access to public amenities (parks, recreation, education, etc.), and public safety (police protection, fire protection, etc.). The majority of these facilities are constructed and funded by developers, while ongoing services are funded by taxes, assessments, and user fees paid by residents of the community. In a sense, these facilities can be considered "common area" facilities in that they are owned in common and paid for by all of the members of the local community.

[4] Although the traditional use of conditions in real property grants was sharply restricted by the adoption of Civil Code Section 885.010, the term "condition" has continued to be used in the title of the primary property-related document for common interest developments.

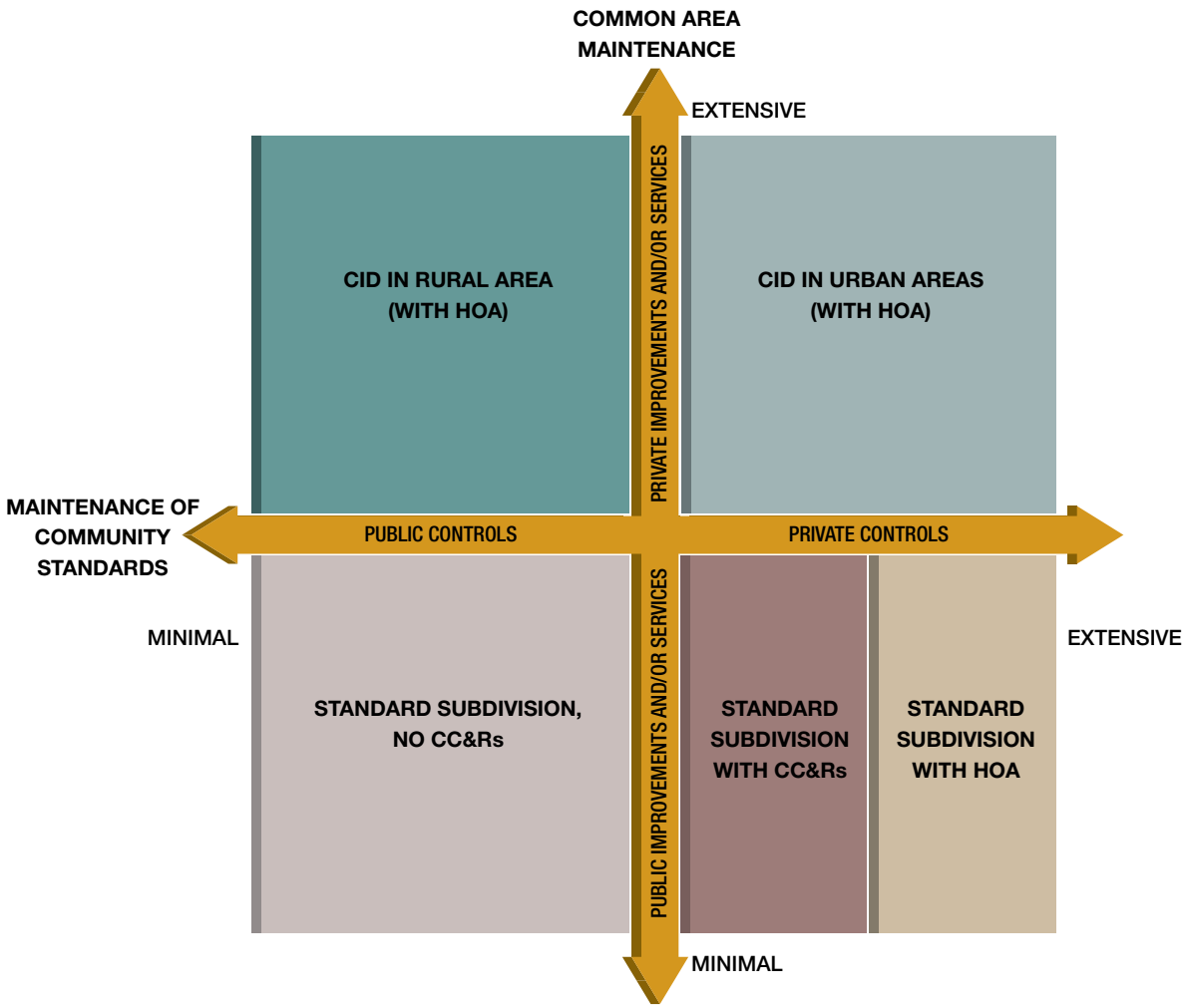
Note that local agencies derive their ability to fund residential services largely from property taxes and property-based assessments. Delinquent taxes and assessments can become liens on the property, which can be foreclosed upon by the taxing authority. The DSA vests HOAs with similar powers. HOAs are authorized to collect assessments to fund the operations of the association and to maintain association property. Delinquent assessments may accrue interest and penalties, and the association can seek a personal judgment and/or lien on the delinquent owner's property to recover delinquent amounts.

HOAs provide a governance mechanism to make up for the inability or limitations of local agencies to provide the level of service required by the developer and the successive homeowners. The developer of a subdivision may propose a subdivision containing a private recreation area for the exclusive use of residents, either because the public parks are inadequate or because the value of the homes in the subdivision will be enhanced as a result.

Other facilities or services may be treated similarly. For example, the HOA may decide to pay for private security in the subdivision, in addition to police services provided by the local agency.

It may be helpful to compare various subdivision types with regard to the controls residents are subject to in each. The various subdivision types are defined and described on pages 21-27. The matrix in Figure 4 compares various subdivision types on a continuum of controls for community standards and provision of services.

Figure 4 - Land Use Controls and Community Services



The horizontal axis represents the continuum of controls for maintaining community standards. The left side of the axis represents public controls, which may be limited to generic codes and ordinances and the enforcement of which may be limited. The vertical axis represents the continuum of controls for owning and maintaining the common areas of the subdivision, a term used generically to include public facilities. The lower portion of the axis represents projects where there are no privately owned common facilities, and the upper portion represents projects containing privately owned facilities, i.e., CIDs governed by HOAs.

This simple matrix demonstrates the relative controls of different project types. The type of project with the fewest number of restrictions would be a standard subdivision with no CC&Rs and with no HOA (southwest quadrant). The type of project with the most controls would be a CID in an urban area (northeast quadrant). A distinction is made between CIDs in rural and urban areas since a rural area would be expected to have fewer or less accessible public facilities and services compared to an urban area.

Ownership Interests

The SLA and the Map Act both deal with what are referred to as divided interests and undivided interests. ***Divided interests*** result from standard subdivisions – the owner of the subdivided interest owns the entire interest (lot or parcel) exclusively with no common ownership of anything associated with it. ***Undivided interests*** are the ownership interests in property held by two or more owners in common. Projects involving the sale of undivided interests are defined as ***common interest developments***. As noted above, CIDs are the most prevalent type of residential subdivision developed in California today, and the DSA governs all aspects of CIDs.

Some common interest projects – planned developments and condominiums – result in the homeowners having *both* an undivided interest and a divided interest. (The SLA and DSA both refer to the divided interests in CIDs as ***separate*** interests.) Other common interest projects couple the undivided interest with an ***exclusive right*** to use a portion of the property rather than a separate ownership interest. Table 1 classifies subdivisions by the type of interest conveyed.

Table 1 - Ownership Interests by Subdivision Type

DIVIDED INTEREST	DIVIDED INTEREST + UNDIVIDED INTEREST		UNDIVIDED INTEREST + EXCLUSIVE RIGHTS		
STANDARD SUBDIVISION	COMMON INTEREST DEVELOPMENTS				
	PLANNED DEVELOPMENT	CONDOMINIUM	COMMUNITY APARTMENT	STOCK COOPERATIVE	TENANCY IN COMMON

A ***grant deed*** is the evidence of ownership in real property, which identifies the owner and the property that was conveyed to the owner when the property was acquired. A description of a divided interest, i.e., a separate lot with no associated undivided interest, will be contained in the legal description of the property. The evidence of an undivided interest will be found in the deed, in CC&Rs recorded against the property, or in the governing documents of the ownership entity. For example, the deed to property in a planned development or condominium project may contain a description such as "an undivided 1/x interest in and to the common area," where "x" is the number of units in the subdivision. Exclusive rights are spelled out in an agreement separate from the deed to the property itself, and this agreement is not typically recorded.

Common Area

Common area is the property within CIDs owned or controlled by the HOA. The DSA has two separate definitions for common area.

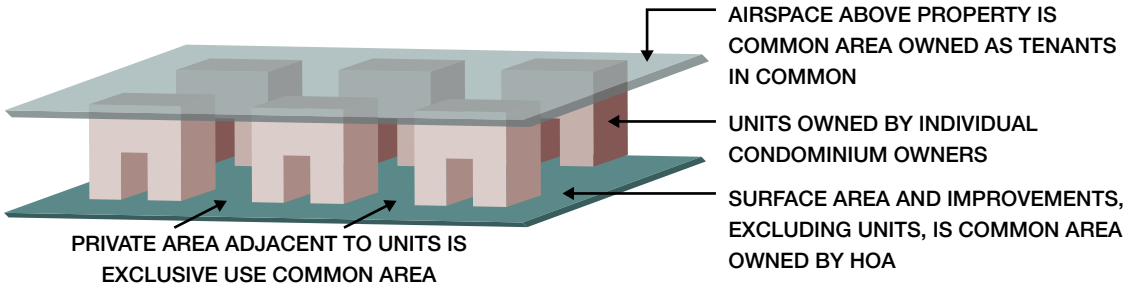
Civil Code Section 4095(a) defines common area as, "the entire common interest development except the separate interests therein. The estate in the common area may be a fee, a life estate, an estate for years, or any combination of the foregoing." Stated another way, common area is the separate parcel of real property that is not a condominium unit, lot, or apartment in a community apartment or stock cooperative. This definition applies to virtually all condominium projects, as a condominium project by definition consists of separate interests (i.e., the condominium units) and common area. A similar definition is applicable for community apartments and stock cooperatives.

For planned developments, however, Civil Code 4095(b) expands the definition to include portions of the separate interests (individual lots) which are subject to "mutual or reciprocal easements rights." In other words, for a planned development, the common area need not need be a separate legal parcel, in which case neither the HOA nor the lot owners would own fee title to any common area. For common area that consists of a lot, parcel, or other defined interest that is not a mutual or reciprocal easement, the common area may be owned either by an HOA itself or by all of the owners as tenants in common. Historically, most common area parcels were owned by all of the lot owners within a subdivision as tenants in common. Thus, a grant deed for a lot within a planned development would identify the separate interest lot, as well as a fractional interest in the common area parcel, which the lot owners would own together as tenants in common. However, because of the potential for direct liability associated with the ownership of common area, and the cumbersome process of obtaining all of the common area owners' (and their lenders') consent to grant an easement or to make a minor boundary line adjustment, many new subdivisions now have the HOA hold title to a subdivision's common area parcels.

For condominium projects, condominium unit owners must own at least some portion of the project's common area as tenants in common, as required by the DSA. As referenced above, this is problematic in that it imposes direct liability on the individual condominium owners. In order to shift this liability to the HOA, condominium developers have incorporated two types of common area into their projects. The first type is the common area owned by the association. The common area owned by the association would include all of the land and improvements within the project, which is also the property that could lead to any liability among the owners. The second type of common area is the area within the project that is owned as tenants in common as required by the DSA. This common area is designated as a three- dimensional area extending to the project boundaries but excluding the condominium units and the common area owned by the association. This type of common area is essentially a cloud of empty space over the project. Dividing the three dimensional space in this way meets the requirement of the DSA while attaching potential liability to the association instead of the individual owners. Such cloud common areas are facilitated by Section 66427 of the Government Code (the Map Act). When title to a condominium unit is conveyed, it is conveyed along with the undivided interest in the common area; actual title to the common area is not conveyed. The fact that property is common area does not preclude it from being designated for the exclusive use of one or fewer than all of the owners by grant of an easement. An easement is a right to enter and use another person's real property within definable limits. The original owner retains ownership of the real property that is subject to an easement for all other purposes. An easement may be exclusive or non-exclusive, and is usually recorded within a specific agreement, a deed, or a deed restriction.

It is common in planned developments and condominiums for the HOA and individual owners to have easements over one another's property. Often such easements are referred to as ***exclusive use common area***. The DSA defines "exclusive use common area" as "a portion of the common areas designated by the declaration for the exclusive use of one or more, but fewer than all, of the owners of the separate interests and which is or will be appurtenant to the separate interest or interests." Thus, private yard areas, driveways, parking spaces, etc., may be designated for the exclusive use of individual owners within the project, as shown in Illustration 1. In such cases the owner's rights to the exclusive use common area would be found in the owner's deed.

Illustration 1 - Condominium Ownership Areas



The DSA further clarifies that auxiliary improvements or facilities that are incidental to a separate interest – such as shutters, awnings, window boxes, doorsteps, stoops, porches, balconies, patios, exterior doors, doorframes, and hardware incident thereto, screens, windows, or other fixtures, and telephone wiring – are automatically deemed to be exclusive use common areas allocated exclusively to that separate interest.

Subdivisions – Ownership Form vs. Physical Form

In comparing various types of subdivisions, confusion can arise between the terms used in subdivision regulations and the terms used in the vernacular of homeowners and homebuyers. For example, some consider a condominium an architectural style or housing type, when it is in fact a legal term defined by the DSA. This is in direct contrast to the term "townhome" which is an architectural style and not a legal term defined by the DSA.

Much like the term "townhome," the phrase "planned unit development" or PUD is the source of significant confusion with respect to CIDs. There are no statutory definitions of townhome, or PUD within the DSA, despite the frequent use of these terms. What these terms all have in common is that they typically refer to an architectural style of multiple residences within a single building structure, where the residences are two or more stories, and are configured so separate residences are not above or below each other. These types of developments can be created as any type of CID (most commonly as planned developments or condominiums). Consequently, it is best to avoid these terms as they represent an architectural style and not a legal arrangement for a subdivision.

Furthermore, "planned development" as it is used under the SLA should not be confused with a zoning designation of "planned development" or "planned unit development" that is often used by local agencies. Local agencies may include such designations in their zoning codes as a means of providing flexibility in development standards as specified in the ordinance. Developments within such zoning may or may not be considered planned developments under the SLA depending on whether they meet the above conditions.

Attached Housing and Subdivision Types

There may be a tendency to think of CIDs as attached housing such as attached condominiums, yet most CIDs reviewed by the DRE consist of detached housing units, i.e., planned developments. Even some condominium projects consist of single-family detached homes. Thus, the legal subdivision type may not be discernible from simple observation of the physical improvements within the project. Among attached housing types, it is likely that there will be no discernible difference between a typical rental apartment complex (not a subdivision), a condominium project, a community apartment, and a stock cooperative.

A subdivision of attached homes may be one of five subdivision types:

- A community apartment
- A stock cooperative
- A common interest subdivision

- A condominium project
- An undivided interest project (tenancy in common)

Detached Housing and Subdivision Types

Single-family detached homes continue to be the most prevalent type of ownership housing being built. To accommodate single-family detached homes, the subdivision must be one of four types:

- A standard subdivision
- A planned development
- A detached condominium
- A stock cooperative

Planned developments are the most prevalent type of subdivision reviewed by the DRE. Many planned development projects do not differ in appearance from standard subdivisions. Two single-family detached subdivisions may be identical in every way – number of lots, street layout, lot layout, etc., except in the matter of common ownership. If one of the subdivisions has any common area, the subdivision is considered a planned development an HOA must be formed to own and maintain the common improvement, pursuant to the DSA. The following are common examples or situations requiring single-family subdivisions to be planned developments.

- The project has private streets owned and maintained by the HOA. There are a number of reasons for a project to have private streets. If the project is gated or public access is otherwise prohibited, the local agency will not typically own and maintain the street. If the street design proposed by the developer does not meet the minimum local standard, e.g., street width, the local agency may be unwilling to own and maintain it. If the street design exceeds the local standard, e.g., enhanced paving, the local agency may be unable to provide proper maintenance, thereby necessitating private ownership and maintenance.
- The project proposes private recreational facilities such as a recreation center, swimming pool, tot lot, nature areas, or trails.
- The project includes environmentally sensitive areas such as wetlands or a habitat for endangered species that must be maintained in perpetuity.

Maintenance Responsibility

One of the more confusing issues involving townhome or cluster type projects arises when maintenance responsibilities must be divided between individual owners and the HOA. These projects may be condominiums or planned developments, which make broad generalizations regarding ownership and maintenance of the residences, as well as the role of the HOA, somewhat subdivision-specific. With the exception ofDRE regulation 2797, the DRE relies upon policy considerations when reviewing a proposed subdivision's HOA maintenance responsibilities with respect to the exterior siding and roofs of the residences. The DRE's general policy, based upon DRE's "reasonable arrangements" regulatory authority, generally permits individual owner maintenance of shared roofs and exterior siding in halfplex and triplex configurations where each lot or unit contains a single residence, which is attached to another residence on one or both sides, provided the total number of residences is three or fewer.

DRE regulation 2797 permits a subdivider to design and document a subdivision with multiple residences in close proximity to each other so that the individual owners are responsible for the exterior maintenance of their residences, and the HOA is only responsible for the maintenance of the shared roofing system for the cluster of residences.

Where the cluster or multiple residences are designed with individual roofing systems serving each residence and are architecturally delineated consistent with the property boundaries for each residence, the DRE may permit individual owner maintenance of the entire residence, including the roof, provided the residences are structurally independent and separately insurable.

Developer Preference for Single-Family Detached Homes to Attached Housing

Single-family detached homes have been and continue to be the most prevalent construction type of housing built in the U.S. and in California.

- According to the 2010 census, 56.4 percent of the housing units in California were single-family detached units while 23 percent were attached units within buildings of five or more units.
- Periodic National Association of Realtors© surveys show that the majority of home sales consist of single-family detached homes. For example, in 2007, 82 percent of homebuyers surveyed reported purchasing a single-family detached home.
- According to National Association of Home Builder (NAHB) surveys, homebuyers and homeowners prefer detached housing to attached housing. The NAHB's 2012 survey, What Homebuyers Really Want, found that 71 percent of survey respondents preferred a single-family detached home versus 10 percent who preferred single-family attached homes.

According to DRE data, from 1993 to 2012, approximately 68 percent of the applications processed were for detached subdivisions.[5] Figure 5 shows the annual public report applications from 1993 to 2012.

While the single-family detached housing type has remained the predominant housing type, housing density has increased over past decades. According to the Public Policy Institute of California, the state's housing density is 35 percent above the national average and rising. Housing in California has become denser since the 1970s for a variety of reasons.

A primary reason for the increase in density has been the high cost of land. Land values increase with housing prices relative to the supply of developable land. As housing prices and land prices have increased, developers have developed housing on smaller and smaller lots and housing and subdivision types where housing structures can be separately owned. Note that a common feature of planned development projects is that individual unit structures are separately owned while site improvements are owned in common.

Based on the above, it is apparent that developers favor building single-family homes of any density so long as they remain detached, as opposed to a building density that requires units to be attached. There are several reasons that this may be so.

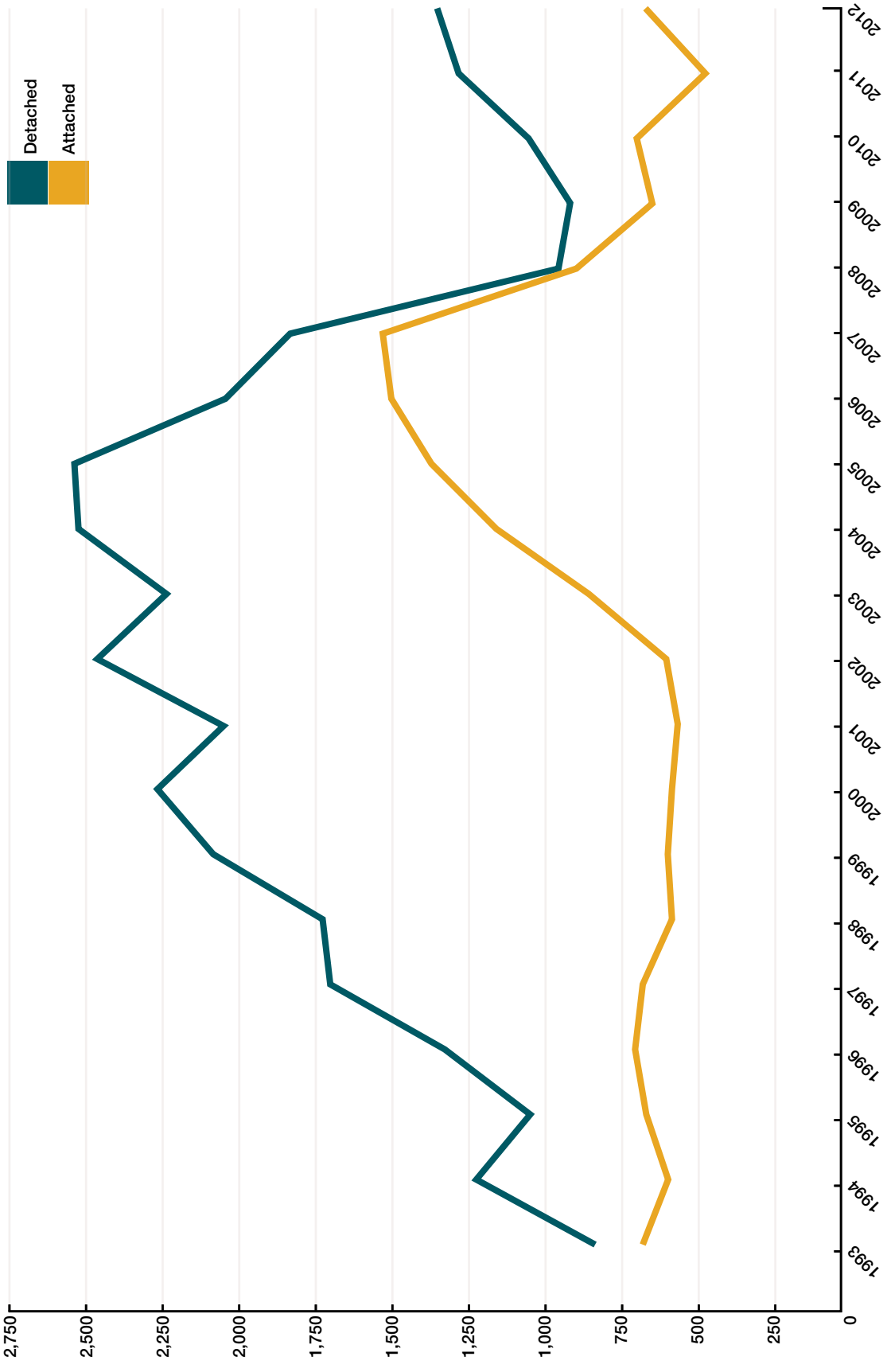
Marketing Concerns. First, with the exception of homes in dense urban environments where there is little alternative to attached housing, single-family detached homes are considered more marketable than attached homes due to consumer preference. Other things being equal, there is a larger pool of buyers seeking to purchase single-family detached homes rather than attached housing types. Higher sale values of single-family homes compared to attached condominiums bear this out.

Second, single-family detached homes provide the developer with the ability to manage market risk better than with attached housing. In building a subdivision of detached homes, a builder typically will build the project in small phases of homes one at a time rather than building all of the homes in the subdivision at once. This allows the builder to make changes in the housing product as homes are built and sold in response to the market acceptance of the homes. If certain aspects of homes are unpopular, the developer can modify such aspects in the future. The nature of attached housing, where all homes usually must be built at once, makes design changes much more difficult once construction has started.

Third, the requirements of home mortgage providers also pose a marketing challenge. In order to maximize the potential for sales, a builder will work to ensure that all homes conform to the conditions of mortgage insurers – Fannie Mae (FNMA Federal National Mortgage Association), Freddie Mac (FHLMC, Federal Home Loan Mortgage Corporation), and FHA (Federal Housing Administration). These agencies require each attached condominium project to be pre-approved as a whole before they will insure homebuyer loans. Additionally, and more significantly,

[5] Figure includes standard subdivisions and planned developments but does not include detached condominiums; the number of housing units (vs. the number of applications) by subdivision type is not available.

Figure 5 - Public Report Applications Detached vs. Attached



each agency requires a percentage of condominium units to be pre-sold prior to any mortgages being insured. FHA requires at least 30 percent of the total units to be sold prior to endorsement of a mortgage on any unit. FNMA/FHLMC requires that at least 70 percent of the total units in the project (or at least 70 percent of the sum of the subject legal phase and prior legal phases) be conveyed or must be under contract to purchasers (other than the developer or his/her successor) who will occupy the units as their primary residences or second homes. Detached condominium projects (defined on page 24) are not subject to these presale requirements.

Expertise. Fourth, developers tend to focus on the housing product types with which they have expertise. Given the choice between developing what they know versus building a product type that is more complex (attached housing), they will choose to develop single-family homes. Construction of attached housing is more complex than construction of detached housing, and compliance with building codes is similarly more complex.

Construction Defect Liability. Fifth, concerns about higher construction defect liability with attached housing causes many developers to avoid building housing where an HOA owns portions of residential structures. The DSA permits an HOA to file a construction defect lawsuit against a builder for any claims if the HOA owns or maintains the defective improvement, or if the HOA owns or maintains an improvement that is integrally related to any improvement owned or maintained by the HOA.

Residential improvements are near and dear to each of the residents living in them, and any perceived defect is likely to have a constant emotional impact on the resident. Compare the impact of residents living under a leaky roof to the impact of residents living with a pothole in a common area or even a leaky roof in a recreational building of a planned development. The latter examples are much less inconvenient, and the motivation to sue is much lower as well. Furthermore, site improvement defects are likely to be easier to correct and are subject to more accepted, objective standards.

An association of similarly affected individuals who are already financially organized and prepared to fund the cost of litigation by means of the association can make the decision to litigate easier. Costs of litigation are more easily borne by the association compared to an individual homeowner because of the association's power to assess its members to pay the costs and because these costs can be spread over a larger number of individuals. Association board members also may be pressured as a result of their fiduciary duties to the association to act on behalf of affected homeowners. In some cases, the board may act on its own, without the explicit consent of the members, subject to the provisions of the association's governing documents.

The potential liability of a builder under construction defect laws is significant. In the current legal environment, a homebuilder is generally considered to be the manufacturer of a product. As such, builders are held liable for defects in their projects similar to other manufacturers. Generally speaking, there is a 10-year statute of limitations for latent defects (defects that are not readily visible) and a four-year statute of limitation for patent defects (defects that are not readily discoverable or apparent) within which the homeowner has to sue for damages due to construction defects. A typical construction defect lawsuit not only will involve the developer, but also the developer's contractor and/or subcontractors, and design professionals involved in the project. Defending such suits usually falls to the insurance company of the defendants. As a result, insurance for such projects by each of the parties may be difficult or costly to obtain compared to non-HOA projects or planned developments where only site improvements or non-residential structures are owned in common.

The California legislature has attempted to address the construction defect litigation issue with the adoption of SB 800, the "Right to Repair" law (Senate Bill 800, SB 800, California Civil Code Sections 895-945.5). The law addresses construction defect legislation and warranties for all newly constructed residential property intended to be sold as individual units. It does not apply to condominium conversions.

Prior to SB 800 there was no statutory definition of what constitutes a "construction defect," thereby providing an opportunity and significant latitude for plaintiffs to convince a judge that their particular problem was a construction defect by the builder. SB 800 sought to address this by setting forth a set of standards for the major

buildings systems of a home. While these standards have provided further clarification of what defines construction defects, some ambiguity remains in that the law states: "to the extent a function or component is not addressed by these standards, it shall be actionable if it causes damage." This "catch-all" provision opens up a builder to possible litigation for problems not addressed and there is no clear definition of "damage" for this section.

Common Interest Developments of Single-Family Detached Homes

While developers may prefer or only be willing to build single-family detached homes, thereby avoiding common ownership of residential structures, other factors may dictate that the project be a CID (which requires an HOA) rather than a standard subdivision. Projects that have common recreation facilities, private streets (such as gated communities), private utilities, or other privately owned facilities must have an HOA to own and maintain these facilities, and will need to be developed as planned developments or site condominiums (defined on page 24).

The need for a project to be a common interest subdivision is driven by the temporary nature of the developer's involvement, which ends once the last subdivision interest has been conveyed. Thus, if any improvements are to be privately owned in perpetuity, an entity must be in place to own and maintain the improvements. This can occur by design, e.g., private recreational facilities, can result from a condition of project approval imposed by the local agency, or can result from the developer proposing an improvement that is beyond the willingness or capacity of the local agency to maintain.

All projects having an HOA are not necessarily CIDs. In some cases, a developer may voluntarily establish an HOA in order to enhance the value of the homes within the subdivision, even though the HOA is not required by the DSA. For example, a developer may form an HOA as a means of providing long-term architectural controls or enforcing other community standards. HOAs may provide a more effective governance and enforcement mechanism than can be provided by local governments or than can be provided by CC&Rs without an association.

Distinctions of Subdivision Types

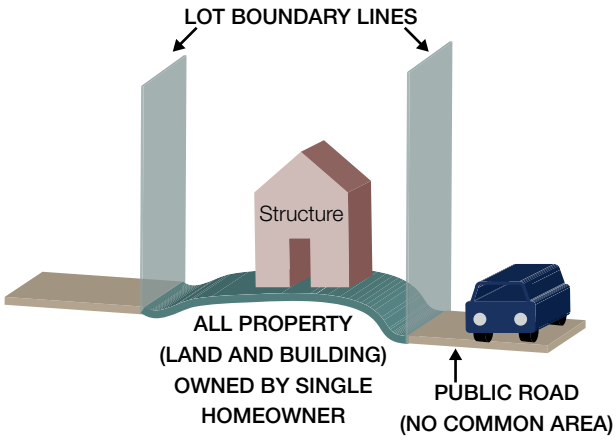
This section describes the various subdivision types covered by the SLA. Please note that some of these subdivision types, though provided for by the law, are rarely developed in California. According to DRE data, planned developments are by far the most common type of new subdivisions. From 1993 to 2012, 58 percent of the subdivision applications processed by the DRE were planned development, 32 percent were condominiums, and 10 percent were standard subdivisions. Meanwhile, relatively few stock cooperative, community apartment, or undivided interest subdivisions have been developed.

Standard Subdivisions

In processing applications for public reports, the DRE distinguishes between standard subdivisions and common interest subdivisions. A standard subdivision (Illustration 2) is one in which the owner has exclusive ownership of a particular lot or parcel and which provides no common or mutual rights of ownership among the owners of the lots or parcels. Typically, lots within a standard subdivision are served by public streets, although access to lots within some standard subdivisions is provided by private road easements rather than publicly owned streets. A standard subdivision would be one that meets the definition in BPC 11000 of the SLA and none of the definitions of the other sections; i.e., the subdivision is not a common interest subdivision.

BPC Section 11010.4 of the SLA exempts standard subdivisions from the public report requirements of the SLA if: 1) the subdivision is within the boundaries of a city with completed residential structures and with all other improvements necessary to occupancy completed or with financial arrangements determined to be adequate by the city to assure completion of such improvements (such as provided by the Map Act); and 2) purchase money is handled as set forth in BPC Sections 11013.2 or 11013.4, i.e., buyer funds are deposited into a neutral escrow depository until close of escrow or an alternative handling procedure is approved by DRE. Thus, the SLA implies that consumer protections in subdivisions that meet these criteria are adequate.

Illustration 2 – Typical Standard Subdivision

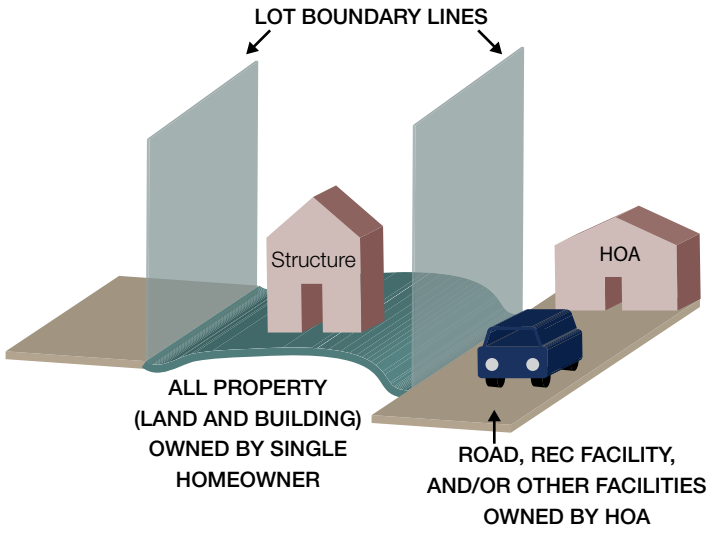


Common Interest Developments

A ***common interest subdivision*** is one in which the owner has exclusive ownership of a particular lot or unit combined with common ownership or beneficial use of certain areas and facilities that are owned jointly with other owners. The property owned in common is said to be an ***undivided interest***, that is, none of the "bundle of rights" are exclusive to any one co-owner. No one co-owner may unilaterally use, mortgage, or transfer a portion or all of the property owned in common. The most common examples of common interest subdivisions are planned developments and condominiums. Less common are stock cooperatives and community apartments. These types of projects are further described below.

A ***planned development*** (Illustration 3) is a development (other than a community apartment project, a condominium project, or a stock cooperative) having either or both of the following features: 1) the common area is owned either by an association or in common by the owners of the separate interests who possess rights to the beneficial use and enjoyment of the common area; or 2) a power exists in the association to enforce an obligation of an owner of a separate interest, with respect to the beneficial use and enjoyment of the common area, by means of an assessment which may become a lien upon the separate interests in accordance with California Foreclosure Law.

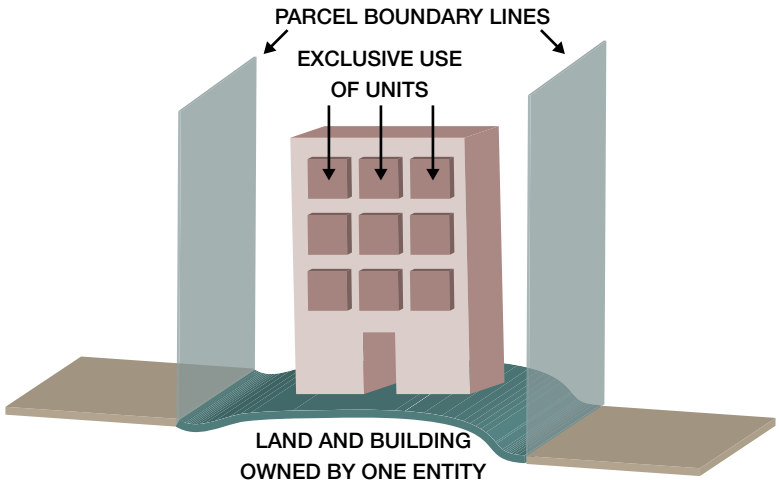
Illustration 3 - Planned Development



Planned developments usually physically resemble standard subdivisions; i.e. they consist of detached homes on separately owned lots, and may not be distinguishable at all. The main difference is that planned developments contain property owned by an HOA. Common examples of planned developments include gated communities where streets must be privately owned and maintained since the general public is excluded from them; master planned communities or communities with private amenities such as swimming pools, clubhouses, lakes, nature areas, etc.

A ***community apartment*** project (Illustration 4) is one in which an undivided interest in land is coupled with the right of exclusive occupancy of any apartment located thereon. In a community apartment project, the apartment "tenant" has an ownership interest in the overall apartment complex in addition to having an exclusive right to occupancy of an apartment. The SLA applies to community apartment projects of five or more units/interests, but it does not apply to the leasing of traditional apartments where one entity owns the land and building(s) and rents out units under the terms of residential leases. In these cases, the tenant has the exclusive right to occupancy of an apartment but not an ownership interest in the property.

Illustration 4 - Community Apartment



Although there are exceptions, a community apartment project must also comply with the requirements of the Map Act.

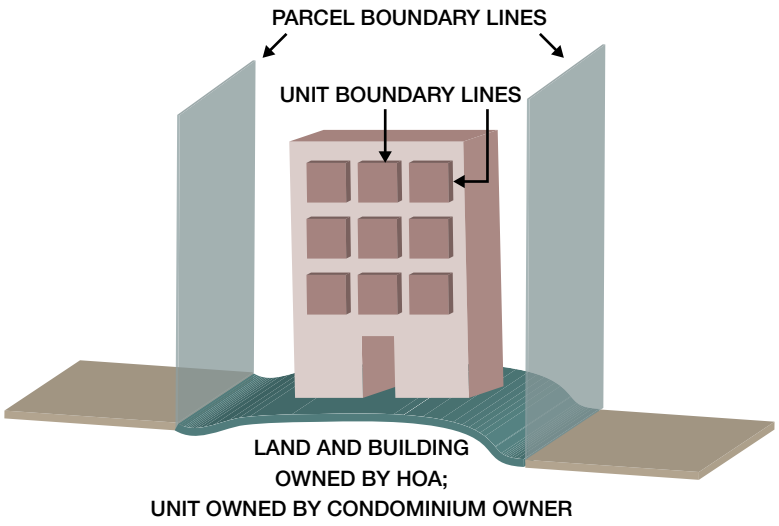
A ***condominium*** is not a building type but a legal form of ownership and a type of subdivision. There are two components of property ownership required for condominiums – an undivided interest and a separate interest.

The ***undivided interest*** is the ownership interest in real property held in common among condominium owners, i.e., the common area. The portion(s) of the real property held in undivided interest may be all of the real property, except for the separate interests, or may include a particular three-dimensional portion thereof, the boundaries of which are described on a recorded final map, parcel map, or condominium plan. Thus, every deed conveying a condominium must contain a fraction (or percentage) of common ownership in some form of real property.

The separate interest is a three-dimensional space called a unit, which has legally described boundaries shown on a recorded map or recorded condominium plan. The area within these boundaries may be filled with air, earth, or water, or any combination thereof, and need not be physically attached to land except by easements for access and, if necessary, support. The description of the unit may refer to: 1) boundaries described in the recorded final map, parcel map, or condominium plan; 2) physical boundaries, either in existence or to be constructed such as walls, floors, and ceilings of a structure or any portion thereof; 3) an entire structure containing one or more units; or

4) any combination thereof. In addition, an individual condominium within a condominium project may include a separate interest in other portions of the real property. An airspace condominium is shown in Illustration 5.

Illustration 5 - Airspace Condominium



In recent years, projects known as ***detached condominiums*** or ***site condominiums*** (Illustration 6) have begun to be developed. These types of projects are not explicitly defined by the SLA, but these types of projects would be considered condominiums under the SLA. A site condominium combines elements of the planned development and condominium subdivision types. A site condominium is a subdivision of single-family detached homes with the following features:

- There are no shared buildings or building features.
- The project is encumbered by a declaration of condominium covenants or condominium form of ownership.
- Each condominium unit consists of the entire home structure as well as the site and airspace, which are not considered to be common areas or limited common areas.
- Insurance and maintenance costs of the unit are totally the responsibility of the unit owner.
- Any common assessments collected are for amenities outside of the footprint of the individual unit boundaries.

The primary motivation for developing a site condominium project rather than a planned development has to do with compliance with the Map Act. Depending on the entitlements previously granted for the site, a developer may be able to forego the tentative map/final map process otherwise required for a single-family home subdivision (a significant undertaking), and proceed to record a condominium plan to accomplish the legal subdivision pursuant to Government Code Section 66427 (the Map Act). Changes to a condominium plan are generally accomplished more easily than changes to a recorded map.

A ***stock cooperative*** (Illustration 7) is a development in which a corporation is formed for the purpose of holding title to improved real property, and all or substantially all of the shareholders of the corporation receive a right of exclusive occupancy in a portion of the real property, title to which is held by the corporation. The owners' interests in the corporation are evidenced by a stock certificate or a membership certificate. Thus, the deed to the property will reflect ownership by the corporation, and the corporation's information about the corporation's structure and management will be found in the articles of incorporation and bylaws. Separate documents such as occupancy agreements, leases, subscription agreements, and house rules will address individual ownership and associated rights.

Illustration 6 - Detached Condominium

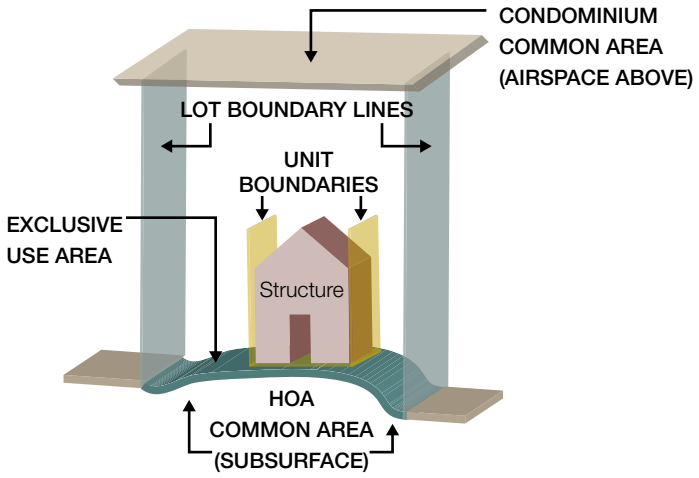
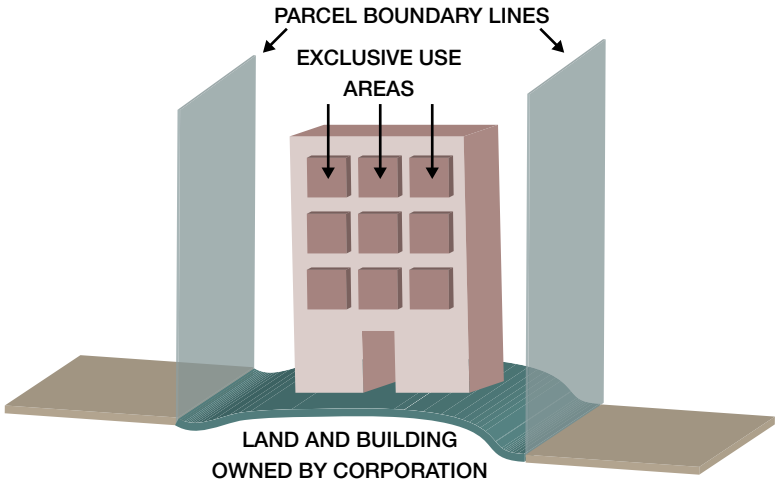


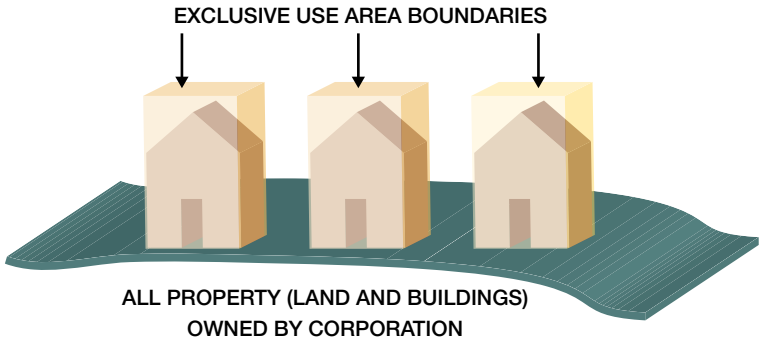
Illustration 7 - Stock Cooperative



A stock cooperative differs from a community apartment project in several ways. First, the entity holding title under a stock cooperative is a legally formed corporation. A community apartment project need not be owned by a corporation and title may be held in any manner, e.g., joint tenancy, tenants in common, partnership, Limited Liability Company, etc. While a community apartment project consists of residential apartments, the type of property owned by a stock cooperative may be apartments, single-family detached homes, or non-residential property. Note that the owner's exclusive use under a stock cooperative is for a portion of the property, not necessarily a unit. For example, although uncommon, a residential property may be divided into use areas such as rooms rather than units. Similarly, portions of undivided land may be allocated among members of the stock cooperative.

The SLA explicitly excludes a limited-equity housing cooperative from the definition of a stock cooperative, meaning that offering an interest in such a cooperative would not require a public report. A ***limited equity housing cooperative*** (Illustration 8) is a type of stock cooperative where each owner has a less than proportionate share of ownership of the project; such a project typically would be developed by a nonprofit housing developer with government funding. Limited equity cooperatives are usually developed as a means of providing affordable housing where the shareholders would enjoy advantages over tenants of conventional rental situations.

Illustration 8 - Limited Equity Housing Cooperative



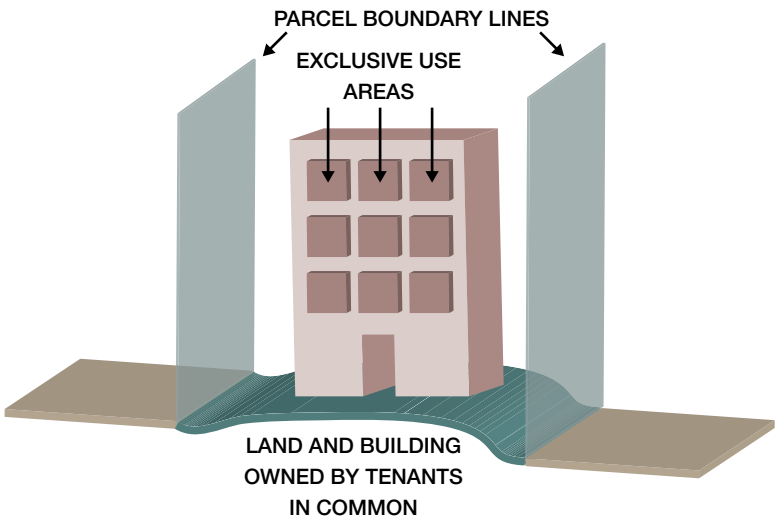
BPC Section 11000.1 of the SLA defines a type of subdivision called, somewhat paradoxically, an undivided interest subdivision. Such a subdivision consists of five or more ***undivided interests*** in real property where each interest has an associated right of exclusive use or right to generate income from a portion of the property. Note that although these types of subdivisions are similar to other common interest subdivisions, they are not common interest developments as defined by the SLA or the DSA.

Title to real property is often held by multiple owners where the ownership interest is undivided; that is, none of the individual owners has an exclusive right to possession nor claim any specific portion for him/herself alone. This most often occurs when a husband and wife own property together. An undivided interest subdivision occurs when exclusive rights are divided among five or more parties, referred to as a tenancy in common (TIC) subdivision (Illustration 9). Distinctive of TIC ownership is the right of survivorship belonging to each co-owner, i.e., the successor of each owner may acquire the owner's interest upon the owner's death. This compares to joint tenancy where the co-owner's interest automatically transfers to the surviving joint tenant(s).

In recent years, TICs have been formed to co-own apartment projects where each co-owner has the exclusive right to use or lease out a particular unit. This generally has occurred in higher cost areas as an alternative to higher cost single-family homeownership. TICs are not subdivisions subject to the Map Act.

Formation of a TIC does not require the recordation of any documents or approval by local agencies. Thus, a TIC structure may be preferred to a condominium or stock cooperative for a given property, both of which would be subject to the Map Act. TICs may offer the individual owners tax advantages similar those associated with single-family and condominium ownership; however, individual owners may find it difficult to finance their ownership interests.

Illustration 9 - Tenancy in Common



An undivided interest subdivision is exempt from the SLA if the interests:

- Are held or to be held by persons related to one another by blood or marriage
- Are to be purchased and owned solely by 10 or fewer investors meeting stated criteria ("sophisticated investors") as approved by the Real Estate Commissioner
- Are created as the result of a foreclosure sale
- Are created by a valid order or decree of a court
- Have been expressly qualified as required by securities laws

Homeowners Associations

A ***homeowners association*** is a "nonprofit corporation or unincorporated association created for the purpose of managing a CID." Most HOAs are organized as nonprofit corporations, i.e., nonprofit mutual benefit corporations pursuant to Sections 7110-8910 of the California Corporations Code. Nonprofit mutual benefit corporations exist to serve their members and are not charitable organizations.

When a lot, unit, or parcel in a CID is transferred, membership in the association is automatically transferred with it. Membership in the association cannot be separated from the property ownership. Evidence of membership in the association is the title to property encumbered by the declaration, which describes association membership.

An HOA has the powers enumerated in its governing documents (the articles of incorporation, bylaws, and declaration further described on page 28) as limited by the Corporations Code, and are similar to the powers of other types of corporations. Most significant are the powers of the corporation to enter into contracts, assume obligations, and levy dues and assessments on its members. Similar to other types of corporations, associations are governed through or at the direction of their boards of directors who have broad authority to govern. The general purpose of associations is to maintain the common areas on behalf of the membership and to enforce the governing documents.

When Required

The DSA requires all CIDs to be governed by an HOA. Thus, any planned development, condominium, community apartment, or stock cooperative (of five or more units) must have an HOA. The developer usually determines whether an HOA will be formed as part of a project early in the development process, when the project is conceptualized and the type of ownership interests to be offered is determined.

Formation

As a practical matter, the HOA only becomes active once the first home transfers to a homebuyer, yet HOA formation usually occurs well in advance of offering the first home for sale. Pursuant to the DSA, an HOA may be incorporated or unincorporated. An incorporated HOA is formed by filing ***articles of incorporation*** with the Secretary of State. The DSA requires HOAs for CIDs to have certain specific provisions beyond the minimum provisions required for other corporations. When properly filed, the association is formally recognized as a corporation by the state of California. An unincorporated HOA is formed when the developer signs the articles of association. Although commonly overlooked, unincorporated associations are required to file a "Statement of Common Interest Development" with the California Secretary of State. The only specific reason for having an unincorporated association is to avoid California Franchise Tax Board minimum corporate tax of $800 per year, which is applicable to commercial CIDs and those mixed use CIDs, which do not qualify for tax-exempt status. Incorporated associations have statutory tort and contract liability protections for association members and corporate directors and are considered more broad and comprehensive than the common law protections afforded to unincorporated associations.

The developer controls the new HOA, with the developer's appointed representatives serving as the initial officers and board members of the association. DRE regulations require all HOAs to permit the election of at least one board member by the votes of the consumer- purchasers of the lots or units within the HOA, with elections taking place no later than six months following the first conveyance of a lot or unit within the HOA.

The bylaws are the rules for conduct of the internal affairs of corporations and organizations and are created at the time of formation. The bylaws address such matters as the appointment of directors, their number, term of office, qualifications, powers, and duties. The bylaws also prescribe when and how meetings are held, quorum and voting requirements, and other matters essential to the basic operation of the association.

The board of directors is responsible for managing the affairs of the association on behalf of all members in order to preserve, enhance, and protect the value of the CID. Board members must deal in good faith and exercise reasonable care in executing their duties. The primary responsibility of the board is to ensure that the association's assessments are collected, its bills are paid, it is operated efficiently, and violations of its rules are addressed. It is common for the board of directors to contract with a professional management company to run the day-to-day affairs of the association; nevertheless, the board is ultimately responsible for the management of the association. The board's responsibilities are specified in the declaration (CC&Rs), bylaws, the Corporations Code and the DSA.

The ***Declaration of Covenants, Conditions, and Restrictions***, sometimes called "the Master Declaration," "the declaration," or CC&Rs, is a document recorded against the subdivided property by the subdivider, who is referred to as "the declarant." The declaration describes the rights and obligations of the property owners/association members within the subdivision and the association itself. The declaration runs with the land, that is, the rights and obligations contained in the declaration remains with the land, regardless of ownership, and pass from deed to deed as the land is transferred from one owner to another. As such, CC&Rs are considered "equitable servitudes," which means that justice in the legal process will be administered according to fairness. Buyers of property subject to CC&Rs are presumed to accept them, having received constructive notice of them when they decided to purchase the property. The declaration may be amended as specified in the declaration, typically by majority or super majority vote of the membership.

CC&Rs are typically supplemented by ***rules***, which further set forth the rules and regulations by which the members of the association are expected to live. The rules can be thought of as an extension of the declaration, but are beyond the scope of the formal declaration document. They are used to interpret and clarify the administration of the HOA. For example, the declaration may set forth the ways in which a clubhouse building may be used, but the rules would set forth the allowable hours of use, behavioral requirements while using the facility, etc. Another example would be that of design guidelines. The declaration typically will include a set of design guidelines or standards as well as the establishment of a design review committee, but the rules would further delineate the

specific application process, the application submittal requirements, etc. Rules are adopted by the HOA board and are changeable by the HOA board, subject to the provisions of the bylaws and the declaration.

Budget

Operation of an HOA is a significant financial enterprise. According to Levy, Erlanger and Company, CPAs, in 2012 there were 48,864 associations in California with annual revenues estimated to total $10.4 billion. Consider a hypothetical 200-member association whose members pay $300 per month in assessments. The annual revenues for this enterprise would be $720,000 per year. According to Levy, the estimated average annual revenue for an association in California is $210,000.

Also significant is the quasi-governmental power of associations to collect funds from its members. The DSA empowers associations to impose late fees and interest on delinquent assessments, allows the association to seek a personal judgment and/or a lien on the delinquent member's property for amounts owed plus attorneys' fees and costs, and allows the association to foreclose on the lien.

Assessments. The HOA budget consists of revenues, operating expenses, and reserves. The HOA may have up to five sources of revenue. ***Regular assessments,*** or monthly dues, are the amounts collected from members on a regular basis to fund day-to-day operations and the reserves of the association. ***Special assessments*** are charges levied to pay for extraordinary costs such as for a major repair, replacement, or new construction of common area property, or for an unanticipated expense that cannot be covered by regular assessments. ***Reimbursement assessments*** are charges paid by members to cover damage they have caused to common area. Depending on what is allowed by the governing documents, *fines* may be levied against members as a penalty for rule violations. The governing documents also may allow the association to charge ***user fees*** for special use of association property. User fees are charges paid by members or non-members to utilize an amenity owned or controlled by the HOA.

The DSA contains specific provisions regarding how assessments are determined, how they are noticed, how they may be increased, and how they are adopted, as well as limitations and procedures for special assessments. It also contains specific provisions regarding budget procedures and how delinquent assessments may be collected. A powerful collection tool of associations is their ability to file a lien against a delinquent member's property and to foreclose on the lien if necessary. Foreclosure by a mortgage lender will eliminate a lien for amounts owed to an HOA because HOA liens are subordinate to the first mortgage lender's lien (see page 66); however, pursuant to Civil Code Section 5700(b) of the DSA, the HOA has the ability to seek a monetary judgment against the homeowner personally, after foreclosure. The "one action rule"[6] regarding liens/foreclosures and direct legal action does not apply to HOA assessments.

Operating Expenses and Reserves. When the budget is prepared, the amounts necessary for daily operation and long-term reserves for maintenance and replacement are determined based on the level of service the association is both required and willing to pay. Although the DRE is not involved in the management of HOAs, the DRE is very much involved in the formation of associations of new CIDs. As such, the DRE has established a standardized format for association budgets with five categories of costs as follows:

- Fixed costs: Taxes, insurance, filing fees
- Operating Costs: Utilities, goods and services, cleaning, and maintenance
- Reserves: Replacement and major maintenance of facilities such as painting, roofing, lighting, carpet, pool, furniture, and paving
- Administration: Legal, accounting, and management
- Contingency: Allowance for expenses exceeding budgeted amounts or shortfall in revenues

[6] California Code of Civil Procedure Section 726 is commonly known as the "one-action rule" because it requires any deficiency judgment to be sought in the same action as the foreclosure. This section also requires the creditor to foreclose and sell the real property security before obtaining a judgment on the debt.