However, conversions are subject to additional provisions of the Map Act designed to provide some protection to residents of the project prior to conversion. These additional provisions require the developer to provide certain notices to residents regarding the developer's intent and the public hearing process, and to give residents certain purchase rights after conversion. The conversion of a community apartment or stock cooperative to a condominium may be exempt from the Map Act pursuant to Section 66412 of the Government Code.

Conversions are subject to the same public report requirement of the SLA that new construction projects are subject to. The developer will need to provide supplemental information as to the condition of the property. Additional disclosures will also be required as to the condition and defects of improvements.

Comparison of the Subdivided Lands Act and the Subdivision Map Act

Due to the similarity of their titles, confusion often arises between the SLA and the Map Act. The Map Act is much broader and more extensive in scope and regulatory authority than the SLA. The following summary is a comparison of the two laws across various factors:

- The SLA is part of the California BPC, which is primarily concerned with the conduct of businesses and individuals within the state. The Map Act is part of the California Government Code and contains the general laws of the state.
- The primary purpose of the SLA is consumer protection. The primary purpose of the Map Act is to establish the legal means by which property may be divided while preserving the integrity of property titles.
- The SLA vests regulatory authority with the Real Estate Commissioner and the Department of Real Estate, a state agency. The Map Act vests authority to approve the subdivision of real property with local agencies.
- The Map Act applies to all subdivisions of real property. Every project that is considered a subdivision under the SLA is considered a subdivision under the Map Act, except for undivided interests. The SLA primarily deals with subdivisions of five or more lots or separate interests.
- Compliance with the Map Act always precedes compliance with the SLA. To the extent the SLA applies, the subdivision must be created (recorded) before a final public report can be issued and binding purchase and sale agreements executed.
- Unless exempted, local agency approval of a subdivision is a project under CEQA, and the local agency is the lead agency. Issuance of a public report by the DRE is not a project under CEQA and the DRE is not a responsible agency under CEQA.
- The application and approval process under the Map Act may be uncertain, lengthy, and extensive. This is due to the quantity and quality of documentation that must be produced and mandatory review timeframes such as contained in CEQA. The application for a public report under the SLA can be accomplished in a relatively predictable, less discretionary period of time.

THE SUBDIVIDED LANDS ACT

The Subdivided Lands Act is codified in Chapter 1 (Subdivided Lands) of Part 2 (Regulation of Transactions) of Division 4 (Real Estate) of the California BPC, Sections 11000-11200.

California first enacted legislation regulating the sale and leasing of subdivided land in 1921. This legislation gave the Real Estate Commissioner authority to investigate and to issue public reports on the subdivision and sale of agricultural land for residential purposes. The Commissioner's authority was expanded to include regulation of business and residential subdivisions in 1933. The current structure of the SLA was adopted in 1943 when Division 4, Part 2, Chapter 1 (Subdivided Lands) was added to the BPC.

The focus of the regulation of subdivisions historically was to protect the public from fraud by requiring full disclosure by the developer to the Department of Real Estate (DRE) (changed to the Department of Real Estate (DRE) in 2013). The information gathered when the DRE processed subdivision applications was communicated

to prospective buyers or lessees through the publication and circulation of the public report. This approach was satisfactory as long as the subdivider did not promise to make substantial improvements to the property in the offering. However, by the early 1960s subdivisions were taking on aspects of self-governing housing communities; therefore, efficient organization and operation of the HOA to manage and maintain commonly owned or controlled property became an important factor that had to be addressed by the DRE when reviewing subdivisions applications. Thus, over the years, as shown in Appendix B, numerous additions, amendments, and deletions have been made to Chapter 1, also known as the Subdivided Lands Act (SLA). A detailed legislative history of the sections present in the SLA today is found in Appendix A.

The basic requirement of the SLA is the provision of a disclosure document called a ***public report***. Any developer, defined as a subdivider by the SLA, offering to sell, finance, or lease an interest in real property within the jurisdiction of the DRE as prescribed by the SLA, must first obtain a public report from the DRE.

The SLA consists of three articles: Article 1: General Provisions (11000-11008); Article 2: Investigation, Regulation, and Report (11010-11023); and Article 3: Sales Contracts (11200):

- Article 1 contains the definitions of the types of projects that are subject to the SLA as well as exemptions from the SLA.
- Article 2 contains the application requirements and procedures for obtaining a public report. This section also lists exemptions and exceptions to the public report requirement.
- Article 3 consists of one sentence requiring every sales contract relating to the purchase of real property in a subdivision to set forth the legal description of the property, the encumbrances outstanding at the date of the sales contract, and the terms of the contract.

The primary purpose of the SLA is consumer protection – to protect homebuyers from misrepresentation, deceit, and fraud in the sale or lease of "subdivisions" to the public. The SLA contains the mechanism by which prospective homebuyers are provided sufficient information on material aspects of the subdivision interest. The SLA is concerned with the creation and marketing of *new* residential subdivisions. The SLA presumes that subdivision interests are being marketed to consumers whose intent is to use the property as a residence. The law contains certain exemptions for projects where this is explicitly not the case (listed below).

The DRE will not issue a public report unless the SLA's standards as to fair dealing and suitability for intended use, referred to as "affirmative standards," are met. These standards are further defined by the Regulations of the Real Estate Commissioner, the Map Act, and the BPC. Fair dealing refers to the consumer getting what is bargained for. That is, deposit money will be secure, off-site improvements described by the subdivider (roads, sewers, etc.) will be completed, and clear title will be conveyed. Suitability for residential use means that residents of the subdivision will be provided with essential services such as water for domestic use, adequate sewage disposal, and vehicular access.

The public report serves as a disclosure document providing significant consumer information about the project for which it is issued. Each prospective purchaser must be given a copy of the public report and must be given a chance to read it before a binding contract is signed. Thus, the public report can alert the consumer to any material or negative aspects of the offering. Although the DRE has some flexibility as to what information may be disclosed in a public report, the DRE has no flexibility in meeting affirmative standards because they are specified by statute. Obtaining a public report involves an application process with the DRE whereby the DRE is reasonably assured that the proposed project meets the requirements of the SLA. The application process is described in further detail on page 58.

Subdivision Definition and Applicability of SLA

The Map Act defines a subdivision as the division of any unit or units of improved or unimproved land, or any portion thereof, shown on the latest equalized county assessment roll as a unit or as contiguous units." Thus, a subdivision is simply the activity of creating new ownership interests in real estate where only one interest or fewer interests existed before. The SLA's definition is similar to, but narrower than, that of the Map Act. BPC Section 11000

gives the general definition of a subdivision as "the 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." BPC Sections 11000.1 and 11004.5 add ***undivided interest***, ***planned development***, ***stock cooperative***, and ***community apartment projects*** of five or more lots, units, or interests to the definition.

Note that all of the projects that are considered subdivisions under the SLA are subject to the Map Act except for undivided interest subdivisions. Therefore, developers of these types of projects must obtain approval from the local agency according to the procedures established by the Map Act and local subdivision ordinances and regulations. Undivided interest subdivisions are not subject to the Map Act and are subject only to the review process specified by the SLA.

Exemptions

The following is a summary of projects that are exempt from the SLA:

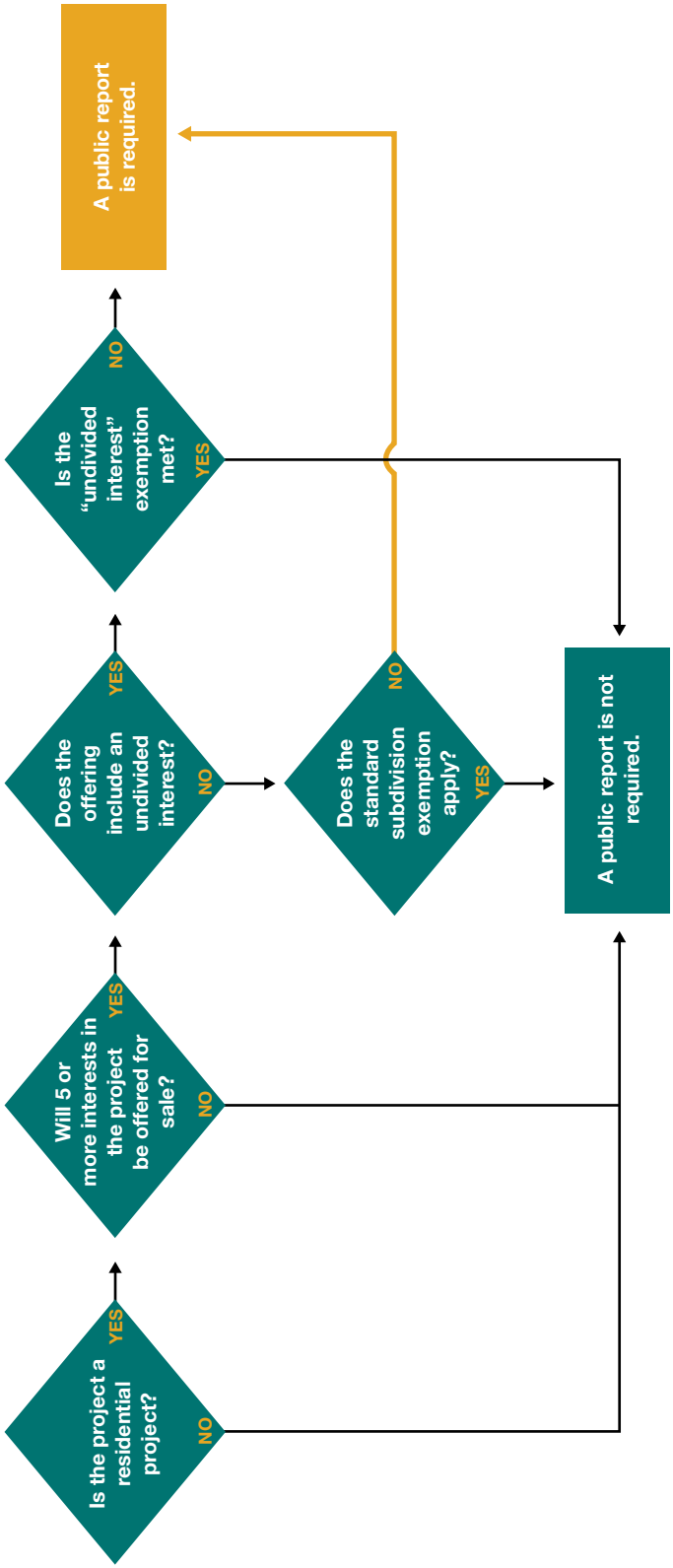
- Minor subdivisions: Subdivision, undivided interest, planned development, stock cooperative, and community apartment projects of fewer than five lots, units, or interests.
- Large parcel subdivisions: Projects containing parcels of no less than 160 acres described by government survey, unless the project is for the purpose of sale for oil and gas purposes.
- Commercial subdivisions: Projects limited to industrial or commercial use (by zoning or deed restriction).
- Standard subdivisions in cities: Non-common interest development projects located within a city, where all lots are completed with homes, where adequate security has been provided to the city to assure completion of the public improvements, and where certain purchase money handling procedures are followed, are exempt from the public report requirements of the SLA.
- Public agency projects: Subdivided land offered or proposed for sale, lease, or financing by a public agency.
- Nonbinding intents for conversions: Nonbinding expressions of intent as required by the Map Act for conversions to condominium, community apartment, or stock cooperative projects.
- Bulk transactions: Sale of lots parcels, or interests where they are intended to be further subdivided into five or more lots, parcels, or interests and the acquirer's purpose is to engage in the business of constructing residential, commercial, or industrial buildings, or for the purpose of resale or lease of the lots, parcels, or other subdivision interests to persons engaged in this business and the requirements of BPC Section 11010.35 are met.
- Undivided interests: Created to be held by persons related by blood or marriage; to be purchased and owned solely by "sophisticated investors;" created as the result of a foreclosure sale; created by a valid order or decree of a court; or qualified pursuant by the issuance of a permit from the Commissioner of Corporations.
- Limited equity cooperatives: Limited equity housing cooperative or workforce housing cooperatives meeting all of the various conditions contained in BPC Section 11003.4.
- Fractionals: Time-share plans, exchange programs, incidental benefits, and short-term products. Such projects are subject to other regulations.

The Public Report

If a project is considered a subdivision for purposes of the SLA, any subdivider offering to sell or lease an interest in real property within the jurisdiction of the DRE as prescribed by the SLA, must first obtain a "public report" from the DRE, unless exempted from the public report requirement as stated above. A ***public report*** is a report issued by the DRE evidencing compliance with the SLA. The final public report is a form containing all of the disclosures the DRE deems necessary regarding the subdivision offering and directing attention to significant aspects of the offering. The information contained in the report is primarily information submitted to the DRE as part of an application (the "notice of intention") by the subdivider and reviewed by DRE staff. The subdivider must print the final subdivision public report on the subdivision public report on white paper; hence, the report is commonly referred to as "white paper" or the "white report."

Figure 10 illustrates the process for determining whether a public report is required for most subdivisions.

Figure 10 - Flowchart: Is a public report required?



In order to assist subdividers with preliminary marketing efforts, the DRE may issue a ***preliminary public report*** at the request of the developer, provided that the DRE believes it is reasonable to expect that the requirements of the final report will be met in due course. A preliminary report may be issued without all of the requirements of the final report being met, e.g., the tentative map has been approved, but the final map has not been recorded, unless the prospective purchaser would have an incomplete picture of the subdivision without such information. The subdivider must print the preliminary public report on pink paper; hence, the report is commonly referred to as a "pink paper" or the "pink report."

With a preliminary report, the developer may accept nonbinding reservations, subject to the DRE's stipulations with regard to handling purchase money deposits, cancellation rights, etc.

Larger subdivisions are often developed and sold in phases over many months, years, or over an indefinite period of time, yet a final report must be obtained for the sale of every home in every phase. In such cases, a preliminary public report can be issued for the entire project with final reports being issued for each phase as they are developed. Once the final report is issued, the developer may convert the reservation to a binding purchase and sale agreement subject to the provisions of the final report. The preliminary report is valid for one year, but expires sooner if the final report is issued before that time, except if the report is an overall preliminary report and a final report is issued on a phase covered by the overall preliminary report.

At the request of the developer, the DRE also may issue a ***conditional public report***, which permits the subdivider to enter into binding contracts subject to satisfying certain specified conditions. The final report must be issued and delivered to buyers before closing can occur. The term of a conditional public report must not exceed six months, but the report may be renewed for one additional six-month period if the Commissioner determines that the requirements for issuance of a public report are likely to be satisfied during the renewal term. The term may be longer for certain condominium projects. The subdivider must print the conditional public report on yellow paper; hence, the report is commonly referred to as a "yellow paper" or the "yellow report."

Circumstances may arise that modify the above reports. California Code of Regulations 2800 provides a partial list of "material change" circumstances, which require the subdivider to notify the DRE and potentially amend the above reports. If, during the term of a final report, there are substantial changes in the subdivision offering resulting in the public report being outdated, an amended public report must be obtained. If a public report expires – a public report is valid for five years – it must be renewed prior to proceeding with subdivision sales. In either of the above situations, an interim public report may be issued, which would allow the developer to take non-binding reservations until an amended or renewed final report is issued.

Issuance of Public Reports – Historical Data

Not surprisingly, the issuance of all types of public report follows the general housing market. Figure 11 shows the number of reports of various types issued from 1993 to 2012, with a dramatic reduction in reports following the peak of the housing market in 2005.

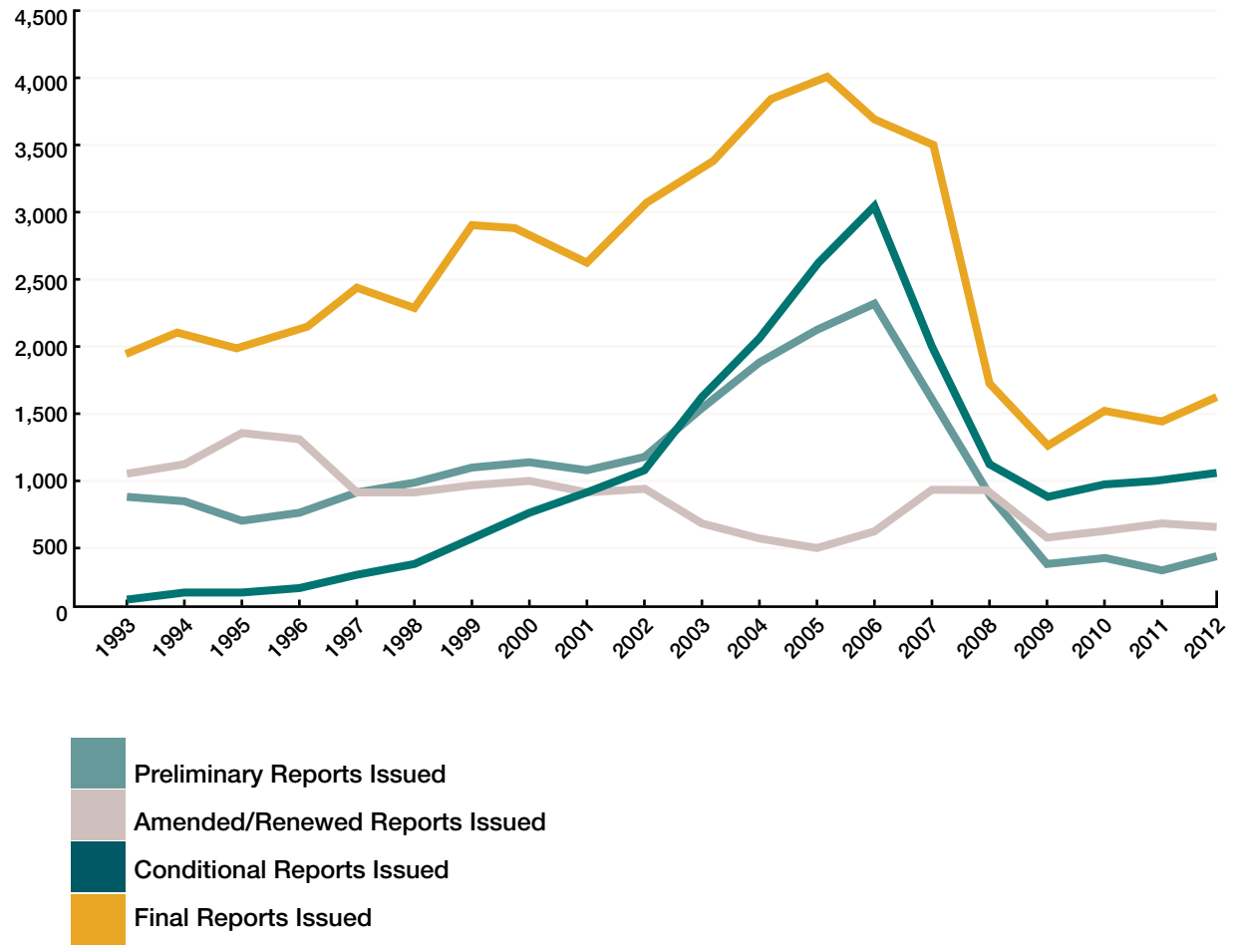
Figure 12 shows the percentages of reports issued compared to the number of final reports issued. The data indicate that developers came to rely on conditional reports more than preliminary reports over the past 20 years. This may be due to the fact that with a conditional report, the developer may enter into binding contracts prior to the final report being issued.

The Public Report Application Process

Public report application requirements are spelled out in BPC Section 11010 of the SLA, referring to a notice of intention and its contents. The notice of intention, the application forms, and the supporting documentation represent the application package submitted to the DRE.

Most developers assemble a team of professionals to prepare and manage the application process. The developer provides the project information such as ownership information and land use entitlement documentation. An attorney is typically required to produce and file legal documents such as the HOA formation and management

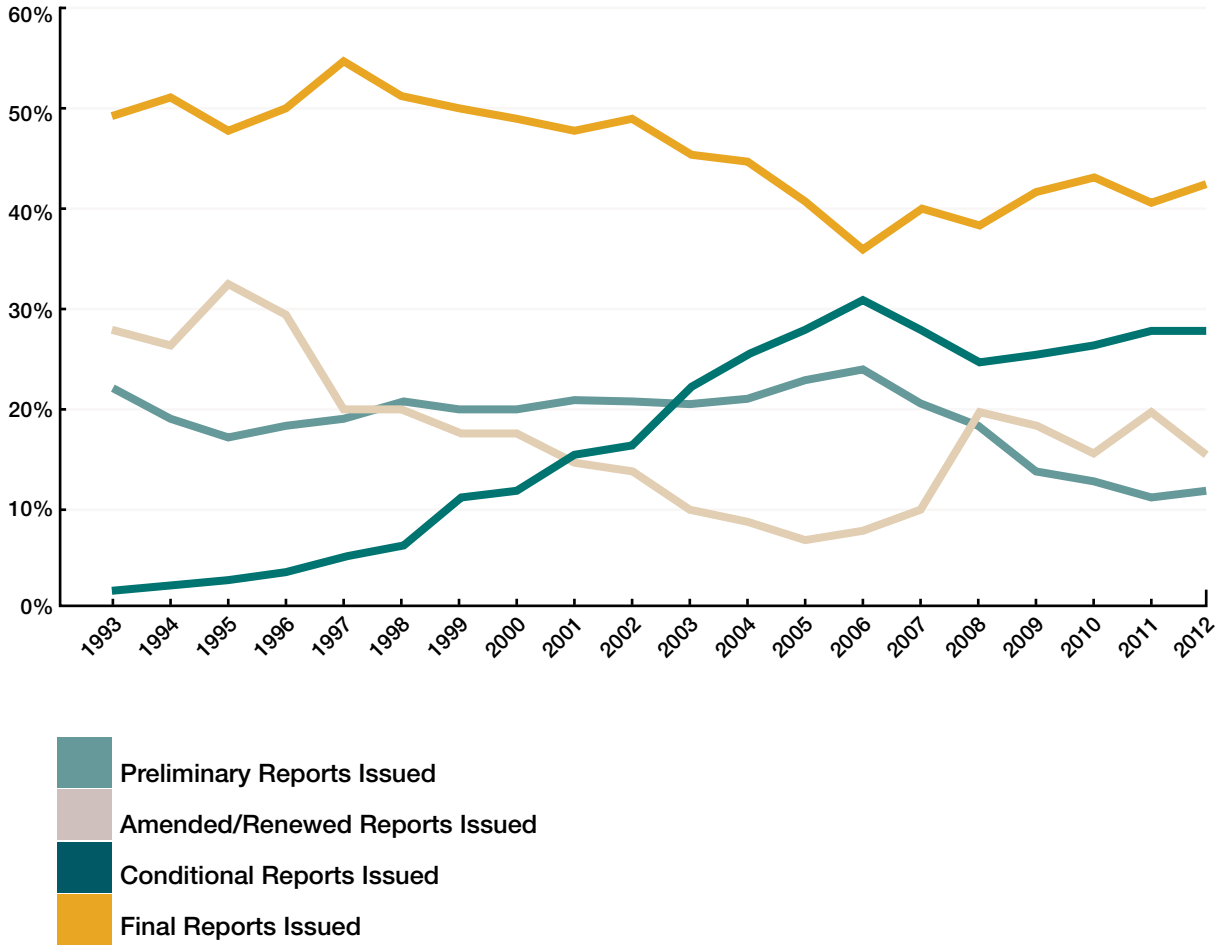
Figure 11 - Issuance of Public Reports by Report Type



documents (if any), the CC&Rs (if any), and draft sale documents. Because the title company is closely involved in the mapping and sales process, the title company usually will be involved to provide title documents, map documentation, and pro forma sale documentation. Some title companies staff individuals that specialize in managing the application process. If an HOA is involved, a draft budget must be submitted, which is typically prepared by a special HOA budget consultant.

Figure 13 illustrates the DRE's application review process.

Figure 12 - Issuance of Public Reports by Type



The following is a list of items and issues that will be disclosed in the public report:

General Information

- Name of applicant
- Location and size of the project

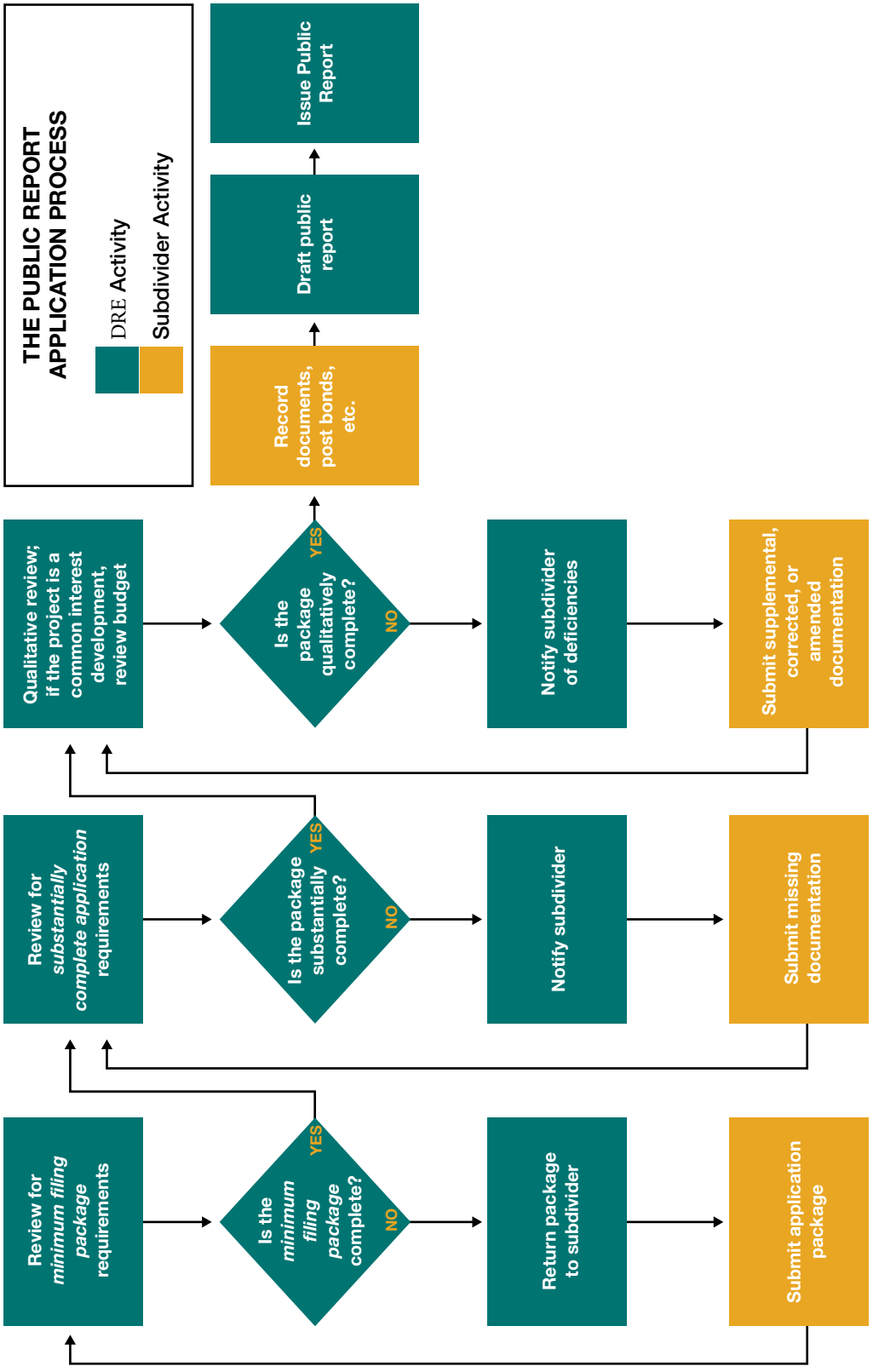
Location Information

- Unusual adjacent uses and zoning
- Airport influence area
- Notice if within SF Bay Conservation or Development Commission Jurisdiction
- Notice of "right to farm"
- Hazards, if any
- Location of soils conditions data

Services

- Sewage disposal
- Water source
- Utility providers

Figure 13 - Flowchart: Public Report Application Review Process



- School information

Title Information

- Map and CC&R recordation data
- Exceptions to title insurance preliminary report
- Assessments, if any
- Transfer fees
- Taxes
- Unusual title conditions
- Unusual easements, rights of way, or setbacks
- Contract information
- Purchase money handling
- Conditions of sale
- Unusual restrictions or conditions imposed upon buyers
- Any unusual or potentially harmful financial or conveyance arrangements

Common Interest Developments

- Common interest project management
- Common interest project maintenance and operational expenses

Special Conditions

- Any special permits that may be needed in order to build houses, sewer systems, etc.
- Any unusual costs that buyers will have to bear
- Any other matters that would assist a buyer in making an informed choice

The Public Report Application

The application for a public report is referred to as the ***notice of intention***. The notice of intention is an application form (RE 624 for CIDs, RE 628 for standard subdivisions) consisting of three parts: Part I contains the application instructions; Part II contains questions and lists documentation to be submitted for a complete application package; and Part III is a project questionnaire and certification.

Application forms and detailed instructions (Public Report Application Guidelines) are available on the DRE's website. The initial application package consists of five items (six for CIDs):

- Notice of Intention Part III: Project questionnaire and certification
- Notice of Intention Part II: Index/quantitative deficiency notice
- Filing fee
- Address labels (used by DRE staff to send documents to the applicant)
- Supporting documentation referenced in Part II
- Duplicate budget packet (CIDs only)

The Public Report Application Review

The scope of the application review process is found in BPC Section 11018.5 of the SLA. In order to issue a public report, the DRE must find that:

- Reasonable arrangements have been made to assure completion of the subdivision, all offsite improvements, and common areas included in the offering.
- The documents (deeds, conveyances, leases, subleases, instruments, or assignments) to be used are adequate to transfer the interests (the legal interests and uses of which the owner or developer represents) to the purchasers.
- After transfer of title to the first lot, apartment, or condominium in the subdivision to any purchaser, the provisions of the declaration of restrictions, articles of incorporation, bylaws, management contracts, and

other relevant documents shall be binding upon the purchaser and occupant of every other lot, apartment, or condominium in the subdivision.

- Reasonable arrangements have been made for delivery of control over the subdivision and all offsite land and improvements included in the offering to the purchasers of lots, apartments, or condominiums in the subdivision.
- Reasonable arrangements have been or will be made as to the interest of each of the purchasers of lots, apartments, or condominiums in the subdivision with respect to the management, maintenance, preservation, operation, use, right of resale, and control of their lots, apartments, or condominiums, and such other areas or interests, whether or not within or pertaining to areas within the boundaries of the subdivision, as they have been or will be made subject to the plan of control proposed by the owner and developer, and are included in the offering.

Such findings are based on the data submitted by the developer in the application process; data that is also included as disclosure information in the public report document. Information provided in the application and to be disclosed in the report is found in BPC Section 11010 of the SLA.

The application review process consists of two types of review – quantitative and qualitative. The ***quantitative review*** includes DRE verification that application submittal requirements have been met. The initial application will only be accepted for review if it consists of a ***minimum filing package***. The requirements of a minimum filing package are identified in Part II of the application. The purpose of the quantitative review is to achieve a ***substantially complete application***, i.e., all of the documentation necessary for the DRE staff to conduct a qualitative review of the application. The substantially complete application will consist of the minimum filing package plus most other documentation required for the final public report.

Once the application is substantially complete, DRE staff begins its qualitative review. The ***qualitative review*** is the essence of the DRE's responsibility under the SLA, the major areas of which are described below.

Purchase Money Handling. The typical real estate purchase and sale agreement requires the buyer to put up a deposit prior to the actual closing of the purchase and sale, when the contract is signed. The buyer's deposit will be refundable to the buyer for a period of time as specified in the contract, giving the buyer time to perform due diligence before he/she proceeds with the purchase, obtain financing, etc. Once that period expires or specified contingencies are satisfied, the deposit becomes subject to the contractual terms of the agreement should the buyer fail to close under the terms of the agreement. Oftentimes, the seller must fulfill certain obligations prior to the closing. For example, in new subdivisions, the purchase agreement is often signed prior to the home being completed, and a condition of closing would be the actual completion of the home.

When a developer obtains financing for construction of a subdivision, a deed of trust is recorded on all of the land within the subdivision as collateral for the financing. The deed of trust in this situation is considered a ***blanket encumbrance*** on the subdivision. In order for the developer to transfer the home to the homebuyer, the home must be released from the blanket encumbrance.

The purpose of the SLA and DRE regulations is to ensure that the buyer's deposit funds will not be expended until the contracted interest has been conveyed free of encumbrances and that the funds will be returned to the buyer if the interest cannot be conveyed per the terms of the contract. These regulations therefore limit the ability of the developer to access deposit funds prior to the close of escrow. The regulations provide various alternatives for such access; however, as a practical matter, the most commonly used method for handling purchase money is for funds to be impounded in an escrow account until the close of escrow, although a purchase money bond posted with the state of California is often used.

Completion of Improvements. Given the developer's desire to minimize the overall development schedule, home sales often occur well in advance of the completion of off-site, on-site, and common area improvements.[8]

[8] For purposes of this study and as is the practice in the homebuilding industry, a "home sale" occurs when a purchase and sale agreement is signed by the parties. The actual conveyance occurs at the close of escrow or closing, when title is transferred to the buyer. Closing can occur any time from one to several months after the purchase and sale agreement is signed.

On-site improvements are generally the improvements within the boundaries of an individual lot or parcel such as buildings, fences, landscaping, and driveways. DRE review is concerned with assuring that, if any of these improvements have not been completed prior to the final public report being issued, adequate provision has been made to assure their completion. A specific provision of the purchase and sale agreement will call for the closing to occur sometime after the home (on-site improvements) has been completed, and the buyer has conducted an inspection of the completed home. Such a provision is sufficient to ensure completion so long as the buyer's purchase money is protected as described above.

In the context of a single-family home sale, off-site improvements are the overall subdivision improvements such as underground utilities (sewer, water, and storm drain lines) and street improvements (curb, gutter, sidewalk, and landscaping). For off-site improvements that are required by the local agency, i.e., as a condition of the subdivision approval, DRE will look to the security posted by the developer with the local agency (payment and performance bonds or letter of credit) that ensures completion of the subdivision improvements. In cases where the off-site improvements are not required by the local agency, the DRE will require that the developer post a bond or letter of credit to ensure such completion. Some projects may be within a special tax district (community facilities district or "Mello-Roos" district) or assessment district, the purpose of which is to fund off-site improvements or community services. In such cases, the DRE will require detailed information about the district for adequate assurance that the improvements funded by such a district will actually be completed.

DRE is particularly concerned with the completion of the common improvements within CIDs. When the common improvements have been completed prior to the issuance of the final public report, the DRE requires that the common improvements be delivered free of mechanics lien claims. When the common improvements have not been completed, the developer must demonstrate that the common improvements will be completed at a reasonable time. The developer must also post completion security for these improvements.

Phasing/Annexation. Larger subdivisions are often constructed in phases in order to match development costs with expected revenue and available financing. For CIDs, it is important for the developer to consider how all of the property (common area and individual units) will one day come under the control of the HOA and the corresponding budget and assessments as annexation occurs. The developer will want the governing documents to allow for the annexation of subsequent phases without needing the approval of the association.

It is advantageous to the developer to process a "master file" for phased projects. The master file procedure allows the developer to submit a master application filing for the initial map/phase, which contains all the documents that will also be completely applicable to all proposed maps/phases that will follow. Master files work best in those cases where subsequent phases are annexed promptly and the construction and sales of homes proceed on an orderly schedule. An extended annexation schedule may result in some master documents becoming obsolete or out of compliance with new laws or regulations, thereby requiring master documents to be updated or replaced.

A ***subsidy agreement*** is an agreement between the developer and the association whereby the developer agrees to pay a certain portion of assessments for a certain length of time. This is usually done in phased projects where the bulk of the common facilities are installed in the first phase. The homeowners' assessments would be burdensome on the initial homeowners if the developer did not pay a large part of the total assessments. The developer's subsidy allows regular assessments to be set at or close to build-out assessment amounts rather than at the otherwise high amounts that would be detrimental to the initial homebuyers in the project. As subsequent phases are built and sold out, the per-unit/lot assessments usually decrease and the subsidy program is phased out. Additionally, the agreement may cover maintenance or other work the developer may perform in lieu of paying a full assessment on units/lots, which are subject to assessments.

A ***maintenance agreement*** is a similar agreement between the developer and the association, but it makes no promise of any specific savings to the homeowners. The agreement will provide that all owners will share any cost savings equally. The agreement usually provides for the developer to maintain some portion of the project in lieu of paying the full portion of the assessment obligation.

In determining the phasing, the developer must consider a number of factors including the overall development budget, the corresponding HOA budget and assessments as completely built out, the number of units and the common area to be included in each phase, and the budget and assessment corresponding to each phase. A common challenge for the developer is to match the level of assessments in the early phases with the build-out assessments. If the budget in early phases must be spread over too few units, a very high per unit assessment may result. This problem may be managed by the developer deferring annexation of common area to subsequent phases when the corresponding cost can be spread across more units. When common area is added to the project in subsequent phases, the developer must provide reasonable assurance as to its completion if the developer wishes to advertise or refer to its prospective existence.

Homeowners Association. If the subdivision has an HOA, the review of matters related to the association is a large part of the application review process and is based on the DRE's authority to ensure that reasonable arrangements have been made for the management and operation of the project. A critical area of focus is operation of the association and the project during the selling stage of the project, i.e., that interim period from the time the association is formed until the last unit is conveyed by the developer. During this period, the developer not only controls the association, but is a major financial contributor to the association as the owner of unsold lots or units in the subdivision. The developer also may be a provider of goods and services to the association during that period.

The DRE's review of the association is concerned with five major areas as described below.

- Budget: From both the DRE's and the homebuyer's perspective, an accurate estimate of association assessments is the most important information contained in the public report, and accuracy of the budget is the focus of DRE's review. The amount of the assessments can greatly affect the buyer's decision and may affect the buyer's financial qualifications to purchase the home. DRE staff reviews the developer's submitted budget for cost reasonableness and accuracy. Toward that end, the DRE requires the budget to be submitted on standardized forms using the DRE's published cost and reserve data, or other justifiable cost data. For phased projects, the budget must set forth the assessments per phase, as additional phases are annexed into the HOA.
- Special Arrangements for Maintenance: During the interim period, the developer will bear a large assessment burden and will control the HOA, so the DRE must make sure that the developer actually contributes to the HOA as required. There are various arrangements the developer can make to provide assurance to the DRE in regards to the availability of funds to make assessment payments. One possibility is to agree to a presale requirement i.e., that no sales will be closed until contracts have been obtained for a specified number of units. A more popular method is to provide a security bond (or other security convertible to cash for the performance of the obligation) to the HOA to pay for assessments for a specified number of months for operation of the HOA. For larger projects, it is common for the developer to enter into a subsidy agreement as described above.
- CC&Rs: The SLA specifies that the DRE may not issue a public report for CID unless every lot/unit will become subject to the governing documents when the developer makes the first conveyance to the purchaser. This requirement is simply to ensure that the governing documents will be enforceable against every unit in the subdivision. The DRE enforces this by requiring recordation of the CC&Rs prior to the issuance of the public report.

  The CC&Rs cannot be subordinate to any liens on the property at the time the property is conveyed to the first purchaser, otherwise, a senior lien holder would not be subject to the CC&Rs after foreclosure in the event of foreclosure on the lien. This requirement is typically not a problem since normally, all liens such as those related to construction financing are removed at the closing i.e., the construction loan is paid by the developer as a condition to the closing of the home. At the closing, based on the order of recording, the CC&Rs would become higher in priority to the homebuyer's new mortgage. In the unusual circumstance where a lien remains on the property post closing, special arrangements would have to be made to have the lien become subordinate to the CC&Rs.

If the lien of any assessments created by the CC&Rs were not subordinate to mortgage financing, it would be difficult for homebuyers to obtain purchase financing. To address this, a provision called a ***mortgagee protection clause*** is included in the CC&Rs that allows for the lien for regular or special assessments to be automatically subordinated to the lien of any *first* (not junior mortgages or deeds of trust) mortgage or deed of trust. In the event of a judicial foreclosure or trustee's sale by the first mortgage lender, any assessment liens will be extinguished. Thus, in the event of a foreclosure, the mortgage lender's financial rights are superior to those of the HOA, but after foreclosure, the property would still be subject to the CC&Rs.

- Governing Documents: The DRE's review of the governing documents, also referred to as "management documents" is based on the reasonable arrangements regulations of the SLA and as enumerated in California Code of Regulations Sections 2792.8-2992.32 (Regulations of the Real Estate Commissioner). The regulations list the main provisions that should be included in management documents. Some of these provisions are described further below.
  - *Transfer of Common Area.* The DRE requires the transfer of common areas to the HOA, or alternatively, into a trust for future conveyance to the HOA, prior to the first conveyance. In phased projects, the developer may not advertise or make representations concerning future common area unless financial arrangements have been made for the completion of improvements. In cases where common area is conveyed while common area improvements have not been completed, the developer will need to provide evidence of financial arrangements for completion to the DRE. The developer's rights to access the common area after conveyance also needs to be addressed in the CC&Rs.
  - *Assessments.* Although the HOA may receive revenue from special assessments, fines, and user fees, the primary source of revenue is from regular assessments. The DRE usually requires the allocation of assessments to be on a straight allocation calculation (total budget amount divided by the total number of lots or units), where every lot or unit pays the same amount. However, if it can be demonstrated that variability among lots or units results in more than a 10 percent difference in the benefit received from the common area and services, a weighted allocation formula may be used to allocate assessments more accurately. For example, in a subdivision where some homes are located behind gates and some are not, the homes behind the gates could be allocated higher assessments. Another situation where disparate assessments may be allowed is in subdivisions where lots will be vacant for an extended period of time such as in subdivisions where individual lots are marketed to custom homebuilders. In such cases, vacant lots may be allocated lower assessments until construction proceeds on the vacant lots.

    The DRE reviews HOA management documents for various matters related to assessments, many of which are specified by the DSA. Specific provisions regarding assessments are as follows:

    - The HOA board may not increase regular assessments by more than 20 percent over the regular assessment of the previous year without approval of the majority of the membership of the HOA, excluding the developer.
    - The HOA board may not impose a special assessment in a given fiscal year of more than 5 percent of the aggregate budgeted gross expenses for that year without approval of the majority of the membership of the HOA, excluding the developer.
    - Special assessments must be allocated on the same basis as regular assessments.
    - Assessments must commence as of the date of the first conveyance in the subdivision phase or as of the first day of the month following the first conveyance.
    - An HOA member does not have voting rights until assessment has been levied against his/her property.
    - The developer will need to pay the assessments on the lots or units he/she owns within the phase until those lots or units have been conveyed, unless he/she has made other arrangements such as a subsidy agreement to mitigate these payments.

— *Governance.* A board of directors must manage the HOA pursuant to the governing documents. The governing documents must specify the manner in which board members will be elected, their terms, and the manner in which they may be removed from office. Special provisions will be included to provide for procedures during the time the developer is still involved in the subdivision.
The powers and limitations of the board are listed in the Regulations of the Real Estate Commissioner, but this list is not exhaustive. The DRE recommends that powers and limitations be listed in governing documents in as much detail as possible. The DRE is sensitive to provisions of governing documents that may create a conflict of interest among board members. A list of some of these disallowed provisions is included in the Commissioner's Regulations. The DRE is also sensitive to provisions that may lead to conflict between the board and a majority of HOA members. Consequently, the following provisions will not be approved:

- Entering into a contract for goods or services for the common area for a term of longer than one year, except as specified in the regulations.
- Incurring aggregate expenditures for capital improvements to the common area or selling HOA property having an aggregate value exceeding 5 percent of the budgeted gross expenditures for that year.
- Providing compensation, except for reimbursement of legitimate expenses, to members of the board.

A complete list of prohibitions is included in California Code of Regulations Section 2792.21(b).

The governing documents must provide for the manner in which annual and special meetings of the HOA and the board will be scheduled. The HOA membership must meet at least once annually with the first meeting being held within 45 days after closing of sales of 51 percent of the lots or units in the first phase or no later than six months following the closing of the first sale, whichever is earlier.

The governing documents must provide for one vote per lot or unit unless a multi-class voting structure is included, even if assessments are allocated on other than a straight-line basis. A multi-class structure is often used to provide the developer with control until the later stages of the subdivision development. Under such a structure, the Class A members (the homeowners) would each have one vote. The Class B member(s) (the developer) would have three votes for every subdivision interest owned. This would allow the developer to control a majority vote of the HOA until 75 percent of the subdivision has been sold.

The management of the financial matters of the HOA is a major responsibility of the board. As such, the governing documents must include the following provisions:

- A budget for the fiscal year must be distributed to members at least 45 days before the beginning of the fiscal year. The budget must include an itemized estimate of income and expenditures, the amount of cash reserves, an estimate of the remaining life of common area facilities and a statement of the method for repairing or replacing those facilities, and a statement of the procedures used by the board to establish reserve amount.
- A statement of the HOA's policies and practices in enforcing lien rights and other legal remedies against members in default of paying assessments.
- An annual report describing the HOA's fiscal operations, including a balance sheet, an operating statement, and a statement of change in financial position must be distributed to all members within 120 days after the close of each fiscal year.
- Board members must be granted the right to inspect all books, records, and physical properties of the HOA.
- General members of the HOA must be afforded the opportunity to examine and copy the membership register, books of account, and meeting minutes.

- *Amendments.* The vote of at least a simple majority of the HOA, not including the developer, must be taken to approve an amendment. Amendment of the articles of incorporation must require approval of a simple majority of the board and the HOA not including, the developer. Amendment of the bylaws requires at least a simple majority of a quorum, but not more than a simple majority of the HOA, not including the developer. In all cases, the percentage approval necessary may not be less than the percentage necessary to take action under that clause of the original document, e.g., if approval of two thirds of the HOA is required for a specific provision, an amendment to that provision may not be approved without two thirds' approval.
- *Disciplining Members.* The ability to discipline members is an essential component of the governing documents. The need for disciplinary action can arise from three areas –non-payment of amounts owed to the HOA, violation of the CC&Rs and rules of the HOA, and damage to the HOA property caused by the member. Disciplining of members may consist of imposing financial penalties or restricting them from the use of common area, except for rights of ingress and egress.

  Annexation. When property is annexed it becomes subject to the CC&Rs, and purchasers become members of the HOA. The DRE requires annexation to be approved by at least two- thirds of the non-developer members unless the DRE has approved a detailed annexation plan and included it in a master file public report application. Each annexed phase must be covered by a public report, and a new, separate application is required unless an annexation plan has been approved. The annexation plan must identify the land proposed for annexation and the total number of units to be included in the overall development. It also must demonstrate that common area facilities will not be overburdened and that assessments of existing owners will not substantially increase over the amount disclosed to them in the original public report.
- *Architectural Control.* A provision of governing documents designed to preserve and enhance property values and community standards, but that can lead to irritation of HOA members, is the HOA's architectural controls. Architectural controls are typically administered by a committee appointed by the board. The developer may appoint the original members for the first year following the issuance of the public report. After that, the board must have the power to appoint at least one member until 90 percent of the subdivision interests have been conveyed.

· Warranties and Guaranties. The DRE is concerned with the warranties and guaranties offered by the developer in marketing the subdivision. This is different than the warranties associated with the physical improvements of the property. Generally, the DRE requires that financial arrangements be made to fulfill any promise that constitutes a sales inducement if the promise is one that cannot be performed before the close of escrow. The developer's agreement to subsidize HOA operations is one such inducement.

Issuance of the Public Report

In processing applications for final public reports, the DRE operates under processing timeframes mandated by the SLA as shown in Figure 14.

Figure 14 - Mandated Application Processing Timeframes

STANDARD SUBDIVISION FINAL PUBLIC REPORT PROCESSING SCHEDULE MANDATE					
WITHIN	10	DAYS OF	RECEIVING THE MINIMUM FILING PACKAGE OR A RESPONSE TO A QUANTITATIVE DEFICIENCY NOTICE,	THE DRE MUST ISSUE A	QUANTITATIVE DEFICIENCY NOTICE OR SUBSTANTIALLY COMPLETE NOTICE.
	20		DETERMINING THE APPLICATION IS SUBSTANTIALLY COMPLETE,		QUALITATIVE DEFICIENCY NOTICE.
	20		RECEIVING A RESPONSE TO A QUALITATIVE DEFICIENCY NOTICE,		RESPONSE TO DEFICIENCY CORRECTIONS OR NOTICE TO "PERFECT" FILE (RECORD CC&RS, OBTAIN BONDS, ETC).
	10		RECEIVING A "PERFECTED FILE,"		FINAL PUBLIC REPORT.

COMMON INTEREST DEVELOPMENT FINAL PUBLIC REPORT PROCESSING SCHEDULE MANDATE					
WITHIN	10	DAYS OF	RECEIVING THE MINIMUM FILING PACKAGE OR A RESPONSE TO A QUANTITATIVE DEFICIENCY NOTICE,	THE DRE MUST ISSUE A	QUANTITATIVE DEFICIENCY NOTICE OR SUBSTANTIALLY COMPLETE NOTICE.
	60		DETERMINING THE APPLICATION IS SUBSTANTIALLY COMPLETE,		QUALITATIVE DEFICIENCY NOTICE.
	30		RECEIVING A RESPONSE TO A QUALITATIVE DEFICIENCY NOTICE,		RESPONSE TO DEFICIENCY CORRECTIONS OR NOTICE TO "PERFECT" FILE (RECORD CC&RS, OBTAIN BONDS, ETC).
	15		RECEIVING A "PERFECTED FILE,"		FINAL PUBLIC REPORT.

The schedule for processing a final report application for a CID is significantly longer due to additional submittal requirements, e.g., HOA documents, budget, etc. The above schedule does not reflect the amount of time it takes the applicant to produce the original application materials or responses to comments. The final report is issued upon payment of all required fees, completion of the application, and submission of all necessary documentation. The term of the final report is ordinarily for five years, but may be renewed for additional five-year periods.

It is unlawful for the developer to materially change the subdivision offering after issuance of the public report without giving written notice of the change to the DRE. If there is a material change in the offering, the report terminates and an amended report must be obtained. A change in the governing documents while the developer is still involved in the subdivision is likely to be considered a material change. Failure to properly notify DRE and/or

to obtain an amended public report may have serious consequences including rescission of sales contracts, monetary damages, and civil action against the developer.

If a change is made in the subdivision offering, it is best for the developer to consult with the DRE in order to determine if the change is considered material. If the change is material, an application for an amended public report must be submitted and approved for the developer to continue marketing activities. The application package consists of an application form, an explanation of the change(s), and supporting documentation.

A copy of the final public report must be given to a purchaser or lessee before execution of a binding contract to purchase or lease. The purchaser or lessee must be given an opportunity to read the report and acknowledge receipt in writing before a written offer is taken or money is solicited or accepted. When a preliminary report is issued, the prospective purchaser or lessee must be given a copy of the report and acknowledge receipt before a reservation can be taken.

Although the SLA provides for the denial of an application for public report for various reasons, as a practical matter, applications are rarely denied. The DRE actively communicates deficiencies with applicants and, to the extent deficiencies are corrected, the public report is issued after application requirements have been satisfied. In the event of a formal denial, the applicant has hearing rights as set forth in the SLA.

APPENDIX A:

LEGISLATIVE HISTORY OF THE SUBDIVIDED LANDS ACT