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Residential Subdivision Buyer's Guide

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PURPOSE

The development and initial marketing of residential subdivisions are subject to several state laws and local ordinances. The California Department of Real Estate (DRE) is the state agency responsible for regulating the marketing and sale of subdivision interests. This document is intended to be a simple guide for consumers who are considering purchasing a home in a new subdivision in California. For more in-depth information, please refer to *A Guide to Understanding Residential Subdivisions in California* published by the DRE.

SUBDIVISIONS

A **subdivision** is simply the division or separation of ownership interests in real property – the land and anything attached to it, including the space above and below the land. A subdivision may be one of several types as summarized below.

Standard Subdivision

In a **standard subdivision**, the homeowner has exclusive ownership of a particular lot or parcel with no additional ownership of any property or rights within the subdivision, other than any appurtenant easement rights.

A standard subdivision may or may not have a homeowners association (HOA) and may or may not have Covenants, Conditions, and Restrictions (CC&Rs).

Subdivision types are defined by law and distinguished by ownership rights, not by physical design or architectural style.

Common Interest Development (CID)

In a CID, the homeowner owns two things: 1) the lot, unit, or right to exclusive use of a portion of property and 2) certain areas or facilities, or the right to use them, owned jointly with other owners. A CID will be one of the following types:

Planned Development

In a **planned development**, the homeowner owns 1) a home

on a separate lot and 2) “common area” property or facilities by virtue of the homeowner’s membership in an association that owns the common area.

Condominium

In a **condominium**, the homeowner owns 1) a separate condominium unit (a three-dimensional space filled with air, earth, and/or water), 2) “common area” (as a co-owner), and 3) common area property or facilities by virtue of the homeowner’s membership in an association that owns the common area.

Community Apartment

In a **community apartment** project, the homeowner owns 1) the entire apartment project (as a co-owner) and 2) an exclusive right to occupy an apartment in the building.

Homebuyers considering a CID should also refer to Living in a California Common Interest Development published by the DRE.

Stock Cooperative

In a **stock cooperative**, the homeowner owns 1) shares in a corporation that owns residential property, and 2) an exclusive right to occupy a unit or portion of the property.

Homebuyers considering a CID should also refer to *Living in a California Common Interest Development* published by the DRE.

Undivided Interest Subdivision

In an **undivided interest subdivision**, the homeowner owns 1) a residential property (as a co-owner) and 2) an exclusive right to use a portion of the property (such as an apartment unit).

Note that subdivision types are defined by law and are not indicative of a particular design or architectural style. For example, a building that appears to be a typical single-family detached home may be part of a standard subdivision, a planned development, a condominium, or a stock cooperative. Similarly, a building that appears to be a typical apartment building may be a condominium, community apartment, stock cooperative,

or undivided interest subdivision. Note also that a “new” subdivision may result from the conversion of real property to any of these subdivision types. For example, it is common for rental apartments to be converted to condominiums. The developer of such conversions must comply with the same subdivision laws as developers of newly constructed subdivisions.

HOMEOWNERS ASSOCIATION

State law (the Davis-Stirling Common Interest Development Act) requires all CIDs to have a **homeowners association (HOA)**, which is a nonprofit corporation or unincorporated association created for the purpose of managing a CID. Most HOAs are organized as nonprofit corporations that 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.

HOAs are formed by the developer of the CID, and the developer’s representatives are the initial board members. The developer controls the HOA for an extended period of time via preferential voting powers; however, 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 such elections taking place no later than six months following the first conveyance of a lot or unit within the HOA.

HOA membership is automatic and cannot be separated from property ownership.

HOAs operate most successfully when members actively participate in HOA affairs and understand the governing documents. Prior to purchasing a home in a CID, the homebuyer should be familiar with the following features of the HOA that are critical to its operation.

Articles of Incorporation

Most HOAs are formed as nonprofit corporations. The **articles of incorporation** is the legal document filed with the Secretary of State that creates the legal corporation in the state of California. The

corporation is formed for the general purpose of maintaining the common areas on behalf of the membership and to enforce the governing documents of the HOA. The corporation has the power to enter into contracts, assume obligations, and levy dues and assessments on its members. The HOA must be governed through, or at the direction of, a board of directors that has broad authority to govern.

The articles of incorporation, bylaws, and CC&Rs are referred to as the governing documents of the HOA and describe the powers of the HOA and its members.

Bylaws

The **bylaws** are the rules for conduct of the internal affairs of corporations and organizations and are created at the time of the formation of the HOA. The bylaws also prescribe when and how meetings are held, quorum and voting requirements, and other matters essential to the basic operation of the HOA.

CC&Rs

The CC&Rs, short for **Covenants, Conditions, and Restrictions**, are private regulations of real property. A covenant is a promise to do or not to do something. 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. A restriction limits the free use of the property by the owner.

When subdivisions are developed, CC&Rs are placed on the property by the developer either voluntarily or in order to comply with government regulations. CC&Rs are often used by developers to enhance long-term values and to provide controls that go beyond the government'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. When a homebuyer

The CC&Rs describe the rights and obligations of the property owners/HOA members and the HOA itself.

purchases a property subject to CC&Rs, the homebuyer is in effect agreeing to abide by them.

There need not be an HOA associated with the CC&Rs; 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, other homeowners would have to file a civil action in order to enforce the CC&Rs. The CC&Rs describe the rights and obligations of the property owners/HOA members and the association itself.

Board of Directors

All HOAs must be governed by a board of directors. The board's responsibilities are specified in the governing documents. The board is responsible for managing the affairs of the association on behalf of all its 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.

Rules

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 CC&Rs, but are beyond the scope of the CC&R document. They are used to interpret and clarify the administration of the HOA. For example, the CC&Rs may set forth the purposes for 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 CC&Rs

typically will include a set of design guidelines or standards and 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 governing documents.

Budget and Assessments

The HOA must be prepared to pay for costs related to the common area of the CID. These costs can be categorized as:

- **Fixed costs:** Taxes, insurance, and 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 shortfalls in revenues

Once these costs have been estimated, the total cost is allocated among all members as the regular assessment. The budget will be affected by the level of service the HOA is both required and willing to pay.

Regular assessments, or monthly dues, are the amounts collected from members on a regular basis to fund the day-to-day operations and the reserves of the association. The board of directors can increase the amount of the assessment by following certain mandated procedures, but it may not increase the regular assessment more than 20 percent per year, without the approval of the members.

If regular assessments collected are insufficient to pay the bills, the board of directors is allowed to levy a **special assessment**. Special assessments may also be levied to pay for extraordinary costs such as major repairs, replacements, or new construction of common area

property, or for an unanticipated expense that cannot be covered by regular assessments. Without member approval, the total of special assessments in any fiscal year cannot exceed 5 percent of the gross budgeted expenses for that year.

Regular and special assessments are the primary source of revenue for the HOA. The HOA also may collect **reimbursement assessments**, charges paid by members to pay for damage they have caused to the common area; **finances** levied against members as a penalty for rule violations; and **user fees**, charges paid by members or non-members to utilize an amenity owned or controlled by the HOA.

State law 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 HOAs is their ability to file a lien against a delinquent member's property and to foreclose on the lien if necessary. All of these matters are specified in the CC&Rs.

THE PUBLIC REPORT

In order to transfer an interest in a new subdivision, the developer must comply with state regulations (the Subdivided Lands Act), which usually require that a disclosure document called a **public report**, be provided to prospective homebuyers prior to their signing a purchase contract. The **public report** is produced by the DRE based on information submitted by the subdivision developer. The report contains summary information on:

- The location of the property relative to unusual land uses such as agricultural operations, airports, special conservation areas, and special hazard areas related to geologic, soils, or drainage conditions, etc.

The subdivision developer is required by law to provide a prospective homebuyer with a copy of the public report before he/she signs a purchase contract.

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- Essential services such as sewage disposal, water supply, and other public utilities, transportation improvements, and public services such as schools
 - Matters affecting title to the property including CC&Rs, easements, taxes, and assessments, special transfer fees, etc.
 - Purchase contract information including special terms
 - HOA matters, if any, including assessment information, common area information, special arrangements made by the developer concerning common area, governance matters, etc.

The primary purpose of the public report is to protect prospective homebuyers from misrepresentation, deceit, and fraud in the public sale, lease or financing of subdivisions. Because of the large amounts of money and the complexity involved in real estate transactions, the possibility of fraudulent or dishonest activity is increased. A developer also may be motivated to withhold information that, if known, may lead to a lower value, may affect a buyer's decision, or that may ultimately negatively affect the buyer's quality of life. Thus, the public report is intended to disclose material information to homebuyers when they are deciding to purchase in the subdivision.

RISKS ASSOCIATED WITH PURCHASING A HOME IN A NEW SUBDIVISION

Homebuyers should also be aware of matters beyond the scope of the public report that may affect their ownership in the subdivision. The public report alerts prospective buyers to general factors that affect homes in the subdivision; it makes no inference as to the suitability of a particular home for a particular homebuyer or the general risks associated with homeownership.

A prolonged or severe market downturn may affect the health of the HOA. The failure to pay by a significant number of members will reduce the HOA's ability to pay for services.

In addition to the financial obligations of mortgage loan payments, property taxes, and insurance, homeowners must be prepared to maintain and pay for the costs of maintenance and repairs associated with the home. Homeowners in common interest developments must also be prepared

to pay HOA dues and assessments. Many of these costs may increase over time, and the homeowner must be prepared to pay for them, even in times of declining home prices. Homebuyers should also be aware and understand that HOA assessments will increase at the end of any developer subsidy program during the initial sales period of the subdivision.

A prolonged or severe real estate market downturn may affect the health of the HOA. HOA operations are funded entirely by assessments paid by its members, and a failure to pay by a significant number of members will negatively affect the finances of the HOA. Even with the best collection efforts by the HOA, the timing of collection of delinquencies and the costs of collection will negatively impact the HOA's budget. The result of a decline in revenues will be a decrease in the level of services provided by the HOA, or increased assessments on paying owners, or both.

Homebuyers in properties that have been converted from a previously constructed building or buildings should be aware of the potential for higher costs of maintenance and repairs. Depending on the age and condition of the property prior to conversion, the property may require corrections and improvements that go beyond the typical cosmetic improvements necessary to attract homebuyers. In addition to exterior improvements such as roofing, siding, paving, and landscaping that are readily visible and somewhat obvious, infrastructure, mechanical, electrical, and plumbing systems – most of which are not visible – may require significant rehabilitation or updating. The DRE's HOA budget review and acceptance process requires condominium converters to submit reserve studies which estimate the funds necessary for the HOA to take over the project's maintenance responsibilities; however, condominium converters often are not long-term owners of the property prior to conversion, and therefore do not have direct knowledge of a project's true maintenance or operational

Homebuyers in conversion subdivisions may be surprised by actual property needs, and increases in assessments to pay for them, after the developer's obligation to pay assessments has expired.

costs. Thus, there are limits to the amount of disclosure and the reliability of budget estimates for conversion projects. Consequently, homebuyers may be surprised by actual property needs and increases in assessments to address such needs after the developer's obligation to pay assessments has expired. Active participation in the HOA provides homeowners a better opportunity to ensure that reserve accounts are being adequately funded.

Review Period

The excitement of purchasing a new home combined with the significant obligations the homebuyer is agreeing to can make the homebuying process emotional as well as stressful. When contracts are signed, the amount of documentation that must be read and signed can be overwhelming. Many buyers may neglect to read all of the documents thoroughly. Real estate purchase contracts typically allow the buyer a period of time to satisfy him/herself in regards to various matters concerning the property and to cancel the contract without penalty. The buyer should use this period to examine the documentation, particularly the matters raised in the public report, to determine that the property, with all of its restrictions and obligations, will be a suitable home for many years.

ABOUT THE CALIFORNIA DEPARTMENT OF REAL ESTATE

The DRE is responsible for reviewing applications for public reports and issuing public reports. The DRE's activities are only a small part of the subdivision development process. The DRE's involvement begins when an application for a public report is submitted, at about the time that construction has begun on the subdivision, and ends once the last lot or unit in the subdivision is conveyed by the developer. The DRE has jurisdiction over a developer only during the time that he/she is marketing homes in a subdivision that is subject to the SLA. Additionally, the DRE seeks to ensure that adequate provisions are made for the completion of essential subdivision improvements. If public improvements or common

The DRE only has jurisdiction over the developer during the time the developer is marketing the subdivision.

area improvements within CIDs have not been completed when the public report is issued, the DRE ensures that adequate performance security has been provided to the local agency and/or to the HOA. The DRE also ensures that the developer properly secures homebuyer purchase money until the subdivision interest is conveyed. The DRE does not exercise land use authority nor does it exercise authority over HOAs.



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