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UNITED STATES BANKRUPTCY COURT

CENTRAL DISTRICT OF CALIFORNIA

SAN FERNANDO VALLEY DIVISION

In re LE PARC SIMI VALLEY ASSOCIATION Debtor.	Bk. No. SV 97-20190 GM (Chapter 11) BRIEF RE INTERPRETATION AND APPLICATION OF CALIFORNIA CIVIL CODE SECTION 1366(b) Date: October 17, 1998 Time: 10:00 A.M. Courtroom: 303

I. INTRODUCTION

The Court has requested briefing on the appropriateness of application of California Civil Code § 1366(b) in the context of this pending proceeding. There is no precedent, no judicial interpretation, and no Legislative History of that Code section which will be dispositive as to application of CC 1366(b). Rather, application of the statute will need to be determined as a case of first impression, based upon logical interpretation of the language and purpose of the statute.

One of the processes which underlies most all logical analysis is based on the principles of "Occam's Razor". The principle states that one should not make more assumptions than the minimum needed to solve a particular problem. In any given model, Occam's Razor suggests that one must 'cut away' the concepts, variables, constructs and hypotheses which are not really needed to find the solution to a problem. This brief discusses why the solution which has been proposed by ZM Corporation [hereinafter "Creditor"] to satisfy its judgment is so complex and convoluted as to be the 'wrong' solution in the context of this proceeding.

In order to understand the import and interplay of the statutory scheme of operation of community associations in California, one must first have an understanding of the bodies of law which apply and the context in which they exist.

II. DISCUSSION OF ISSUES

1. COMMUNITY ASSOCIATION LAW

The explosive growth of common interest developments [CIDs] and their community associations is a relatively recent phenomenon. In 1970, there were approximately 10,000 common interest communities in the entire United States. Community Association Factbook, (1993), Community Associations Institute [hereinafter Factbook]. By 1990, that number had grown to approximately 130,000, and the number continues to grow. Factbook, infra

Common interest developments are the fastest growing form of housing in California. In 1990, there were over 20,000 CIDs in this State, and the number of such developments was increasing at the rate of approximately 1,500 per year. 1990 Final Report, Assembly Select Committee on Common Interest Developments, Dan Hauser, Chairman. The California

Department of Real Estate estimates that there are over 30,000 such developments in California today, with an average of approximately 100 units in each development and an average of just over two residents per household. That means that California CIDs provide housing for approximately 6 million residents. That also means that the Court's decision in this matter has implications far beyond the narrow interests of the technical parties to this matter.

Paralleling the growth of CIDs in the State, the Legislature has adopted a series of laws intended to regulate their operation. In 1978, the Legislature adopted the new California Corporations Code which took effect in 1980. Among other things, it divided the previous omnibus nonprofit corporation law into several segments, with somewhat different rules for 'public benefit', 'mutual benefit', and 'religious' corporations among others. In 1985, the Legislature adopted the Davis-Stirling Common Interest Development Act, [hereinafter the 'Davis-Stirling Act'] which brought together disparate statutory provisions which previously had been spread among various Code sections and updated the laws to provide for better management of CIDs.

Although the statutory schemes for CID operation and community association management are related, it should be noted that they are not the same. The Corporations Code nonprofit mutual benefit law generally regulates the activities of the community association which is created by law to manage each CID. The Civil Code generally regulates the developments themselves and the real property interests of the owners within each CID.

California law recognizes four distinct types of "common interest development", (1) a community apartment project; (2) a condominium project; (3) a planned development; and (4) a stock cooperative. [CC 1351(c)] Each of the types of CIDs describes, in turn, an interest in real property. [see CC 1351(d), (e) and (f), and 1351(K), (l) and (m)] The type of CID managed by Debtor herein is the type of development known as a 'condominium project'. When referring to the persons who hold title to an interest in a CID, the Civil Code routinely refers to them as "owners", although that word is not specifically defined as such. See, for example, CC 1364(a) describing maintenance duties within a common interest development.

California law recognizes two types of "community association", those which are incorporated and those which are unincorporated. [CC 1363(a)] The word "Association", as used

in the Davis-Stirling Act, is defined as "a nonprofit corporation or unincorporated association created for the purpose of managing a common interest development." [CC 1351(a)]. When referring to the persons who have an interest in a community association entity, the Civil Code routinely refers to them as "members". See, for example, CC 1363 and 1363.05.

The distinctions between the rights of a person as an "owner", as distinguished from the rights of that same person as a "member", are important to a clear understanding of the issues which have arisen in the pending matter. A person has rights and duties as an owner which are different from that same person's rights and duties as a member. The CC&Rs of the Association, described hereinbelow, themselves contain specific definitions of "member" and "owner", which coincide with the distinctions noted above.

Claimant herein, itself a corporation, can be presumed to understand the differences between dealing with an individual and dealing with a corporate client. If Claimant had intended to secure payments to it from the owners, and not the corporate entity with which it was contracting, it could have demanded personal guarantees for its contract and the owners, in turn, could have either accepted the provision or not.

2. MEMBER LIABILITY

There does not appear to be any dispute over the fact that, under California statutory and case law, the member/shareholders of a corporation are not liable for the liabilities, obligations or debts of the corporation. Corp. C. §§7350(a); Advising California Nonprofit Corporations, 2d. CEB, 1998, §9.108. The single statutory exception to the above rule is that a member/shareholder can be compelled to pay the unpaid portion of a subscription price for their stock to a creditor in order to satisfy a judgment against the corporation. Corp. C. §§ 414, 7353..

The discussion of Le Parc member/owner responsibility for payments to Claimant in the instant case really should stop with the above corporate analysis. Were this a normal 'for profit' corporation in bankruptcy, it would be the end of the discussion. Were this a Nonprofit Public Benefit corporation, it would be the end of the discussion. Were this a 'typical' Nonprofit Mutual

Benefit corporation, it **would** be the end of the discussion. Were this a Religious Corporation, it **would** be the end of the discussion. Were this a California 'unincorporated' association, it **would** be the end of the discussion. In fact, were this anything other than a unique form of Nonprofit Mutual Benefit corporation, a "community association", it would be the end of the discussion. Except in a few particular sets of circumstances, none of which have been asserted, claimed or even suggested by claimant, the shareholder/members of a corporation are simply not liable for the debts of the corporation. Rather, shareholder/members have personal exposure to liability for the debts of a corporation only to the extent of their equity in the corporation. If the corporation becomes insolvent, the shareholder/members lose their equity, i.e., their investment, in the entity.

3. OWNER LIABILITY

Owners of land in California, including owners of the land which constitutes the bulk of the real property in a condominium development, have liability for damage and injury attributable to the condition of the land. Davert v Larson (1985), 163 CA3d 407; Ruoff v Harbor Creek Community Association (1992), 10 CA4th 1624. Recognizing that the tenant-in-common owners of interests in a condominium project have exposure to liability arising from that ownership, but virtually no control over management of the land, the Legislature responded to the Ruoff decision in 1994 and added a new § 1365.9 to the Davis-Stirling Act, which provides in part:

> "(a) It is the intent of the Legislature to offer civil liability protection to owners of separate interests in a common interest development that have common areas owned in tenancy-in-common if the association carries a certain level of prescribed insurance that covers a cause of action in tort."

Similarly, owners of separate interests in a condominium project have liability for mechanic's liens recorded against the project. But here too, it should be noted that the Legislature has seen fit to limit an owner's maximum exposure for a mechanic's lien: first, by the reasonable value of labor, services, equipment, and materials **actually furnished by the claimant** [CC 3121(b)]; and second, by their proportional share of the total sum secured by the lien which is attributable to their condominium [CC 1369].

These types of liabilities arise not from membership in any association or as part of any

community association, but rather from the personal ownership interest in real property. These liabilities track historical concepts of real property law, not corporate law. In each of these instances the California Legislature has seen fit to **limit** the exposure to liability of owners of separate interests in condominium projects, even in the face of such longstanding common law and statutory law provisions.

4. APPLICATION OF CIVIL CODE § 1366(b)

The Davis-Stirling Act does not, in and of itself, authorize the imposition of any kind of an assessment upon an owner of land, whether the land is part of a common interest development or not. Rather, the right to impose assessments arises from one of the Governing Documents by which a common interest development is managed. All of the separate interests and common areas in a condominium project are encumbered by a recorded instrument formally known as the 'Covenants, Conditions and Restrictions' of the project, informally referred to as the "CC&Rs" [hereinafter 'CC&Rs'].

Article 4, §4.3 of the Le Parc CC&Rs describes the powers of the Association, including its power to assess. Section 4.3.1.1 describes the Association's assessment power as follows:

> "The Association shall have the power to establish, fix, and levy assessments against the Owners and to enforce payment of such assessments, in accordance with the provisions of this declaration."

Article 6, §6.1 of the CC&Rs creates a power, vested in the Association, to impose assessments upon the owners, as follows:

> "The Declarant, for each condominium owned by it in the Project that is expressly made subject to assessments as set forth in this Declaration, covenants and agrees, and each purchaser of a condominium by his acceptance of a deed covenants and agrees, for each condominium owned, to pay to the Association regular assessments and special assessments, such assessments to be established, made and collected as provided in this Declaration."

Section 6.3 of Article 6 of the CC&Rs specifies and limits the purposes for which the Association may exercise its assessment power. It states that:

> "The assessments levied by the Association shall be used exclusively to promote the recreation, health, safety, and welfare of the members of the Association, the improvement, replacement, repair, operation and maintenance of the Common Area and the performance

of the duties of the Association as set forth in this Declaration."

Section 6.4 of Article 6 of the CC&Rs describes a method for determining the amounts which the owners may be assessed, and specifically limits the power of the Association to increase assessments or levy special assessments without owner approval.

Civil Code §1366 is generally understood as being a statute which regulates the exercise of the power to impose assessments which is created by a set of CC&Rs. As such, and by its own terms, it creates limits on the authority of an association to impose assessments beyond specified limits unless the owners, who will be subject to payment of the assessments, give their consent. The language of the statute itself, which requires associations to "levy regular and special assessments", qualifies the requirement by indicating that the assessments are to be "sufficient to perform its obligations under the governing documents and this title." The "title" referred to in the foregoing sentence is Title 6 of Part 4 of Division 2 of the California Civil Code, i.e., the "Davis-Stirling Common Interest Development Act". [see CC 1350] A related statute, Civil Code section 1366.1, contains a specific prohibition against an association imposing any assessment which "exceeds the amount necessary to defray the costs for which it is levied."

The 'title' of the Civil Code which contains the Davis-Stirling Act, and to which its provisions apply, does not contain any provision which imposes liability on a community association for breach of contract. The Davis-Stirling Act does not contain any provision which imposes tort liability on a community association for the acts of its directors. The Davis-Stirling Act does not contain any provision which imposes any liability on any owner of a separate interest in a common interest development for the liabilities, obligations or debts of the Association. Rather, in its basic scheme, the Davis-Stirling Act requires a community association to attend to the repair, replacement and maintenance of the portions of the common interest development which are allocated to it by the CC&Rs, for which the association was created in the first instance, and then creates a statutory scheme which clarifies and regulates how the mechanics of the repair, replacement and maintenance are to be handled.

There is nothing in the history of the Davis-Stirling Act, and nothing in the body of the Davis-Stirling Act, which suggests that the 'emergency assessment' provisions of CC §1366(b) were

meant to give an association the unfettered power to impose assessments which are unrelated to maintenance of the development or its basic administration.

To give CC §1366(b) the meaning necessary for the Claimant's Plan to become feasible would not only contravene classic rules of interpretation of statutes, it would lead to a logical conflict with the philosophical underpinnings of the owner immunity provisions enacted by the Legislature when CC § 1365.9 was adopted, and as demonstrated by CC 1369. If any court can order any association to impose an 'emergency assessment' for any reason, then there would be nothing to prevent the imposition of an assessment to pay an 'excess' award for a tort which occurred within the common area of a condominium project despite the fact that the Legislature has stated that "It is the intent of the Legislature to offer civil liability protection to owners...." [CC §1365.9] Similarly, there would be nothing to prevent any owner from becoming liable for association debts over and above the amount represented by the owner's proportional part of a mechanic's lien claim, even after they satisfied their portion of the lien.

5. SUGGESTED MEANING OF CC § 1366(b)

The 'emergency situation' portion of CC § 1366(b) describes four sets of circumstances under which 'emergency assessments' can be imposed by a community association.

Subsection (2) of §1366(b) deals with situations in which it is 'discovered' that there is an imminent threat to personal safety within the development, and the association has the responsibility to repair or maintain the area or improvement which poses the threat. This subsection relates directly to the purposes and duties of the association, and allows the association to perform needed maintenance to correct the threat to personal safety. In other words, if a hillside is in imminent danger of failing, or a structure is in danger of collapse, the association can collect funds from the owners to remove the threat to their safety.

Subsection (3) of §1366(b) deals with situations in which an association already has a duty to repair or maintain some portion of a common interest development, but for reasons which were not reasonably foreseeable, funds had not been allocated for the repair or maintenance in the normal budgeting process. In this type of situation, such as where the association believed that common

roofs would last another 5 or 6 years, but El Nino arrived and the severity of the storms caused unexpected serious leaks to appear, the association would be allowed to impose assessments to make needed repairs so as to preserve and protect the structures, the interiors of the homes and personal property of the owners.

Subsection (4) of §1366(b) is now obsolete, but it initially dealt with situations where it was necessary to raise funds needed to make "the first payment of the earthquake insurance surcharge" which came into existence as part of changes to insurance law. Since many community associations are required to insure the multifamily residential structures which contain individual living units, thereby protecting the owners' investments in their homes from earthquake damage, the association was allowed to impose a limited 'emergency assessment' in the event that the state imposed or allowed imposition of a surcharge for the insurance coverage. This right of assessment, and the funds derived thereby, would inure directly to the benefit of the owners within the common interest developments affected by it by allowing insurance protection for those interests.

Subsection (1) of §1366(b), by contrast, does not by its terms mention anything about maintenance of the subdivision or any common areas or any improvements within a common interest development. Instead, it provides that an emergency assessment may be imposed to deal with "An extraordinary expense required by an order of a court." In the context of the remainder of §1366(b), logic and basic rules of statutory construction compel an interpretation of subsection (1) which relates it back to the purposes for which an association is created, and to carrying out its responsibilities as described in the CC&Rs which empower the association to impose assessments at all.

Not cited here as authority for any legal proposition, the fact situation described in the now depublished opinion in Lamden v La Jolla Shores (1998) 62 Cal.App4th 1145, 98 Daily Journal D.A.R. 3389, is nonetheless illustrative. The La Jolla Shores development is a condominium project which had experienced serious termite problems over a long period of time. The Association chose to address the infestation with 'spot treatments' and ongoing repair or replacement of damaged portions of the improvements within the project. Part of the reasoning behind the use of spot treatments was that they were less costly than alternatives. Mrs. Lamden

objected, and demanded that the Association 'tent' the residential structures so as to eliminate the termites and the need for constant repairs. Eventually she sued. In this type of case, if the court determined that the association was not performing its maintenance duties pursuant to the CC&Rs and the Davis-Stirling Act, it could order the Association to tent all of the buildings, and, more importantly, could order the association to impose an emergency assessment to raise the funds necessary to carry out the tenting. This type of "order of a court" would be sufficiently related to the purposes of the association, and the maintenance of the properties, so as to be a reasonable exercise of judicial discretion. This type of order would be rationally related to the power to impose assessments granted to the association by the owners pursuant to the CC&Rs since it relates to the core purpose of an association, which is the management, maintenance, repair, and replacement of the elements of the common interest development for which the association was created in the first place.

Creditor, in its Reply Brief dated October 8, 1998, lists a series of situations for which assessments are imposed by an association in order to justify imposition of the their 'super assessment' in the present situation. It states that:

> "The Association's members also typically may not have personal liability for the Association's contract with the poolman, gardener, security patrol and other persons with whom the Association deals; yet, each month, the Association's members are compelled to pay assessments for the liabilities of the Association for those contracts and goods and services."

Were Claimant in the present action the poolman, or the gardener, or the security patrol service, the interpretation of CC §1366(b) which is being urged could have some merit. In each of those situations, there is a clear and understandable nexus between the claim and the owners. In each of those situations, it could be presumed that the owners actually received a 'benefit' which accrued to their interest in their homes. In each of those situations the owners would be unjustly enriched at the expense of the claimant because they were the actual recipient of the goods and services which had been provided.

The claim of ZM in the instant case is so quantitatively and qualitatively different from the claim of a landscaper or poolman that it has no bearing on application of CC §1366(b) under the present circumstances. ZM does not claim that it was unpaid for the goods and services which it