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The Newsletter of the Real Property & Financial Services Section of the Hawaii State Bar Association

From the Chair

November 2003

Dear Section Members:

Welcome to our rejuvenated newsletter. With the recent period of low interest rates, the refinancing boom, and the active residential real estate market, many of you and your fellow section members have been incredibly busy this past year . . . which of course is a good thing. My thanks to Chair-elect Ken Marcus, Secretary Andrew Bunn, Treasurer Janel Yoshimoto, and board members Gail Ayabe, Andrew Char, Nancy Grekin, Max Graham, Grace Kido, Peter Kubota, Bud Quitiquit, Tom Rosenberg, Robert Rowland, Jack Wong, and Rodd Yano, for their hard work and dedication to the section. My thanks also to Professor David Callies for his continued leadership and support of the section's educational agenda.

The year has flown by with many ongoing challenges and opportunities. The Bureau of Conveyances continues to be pressed with the huge increase in numbers of recordings, which the Bureau staff is handling with super-human effort. Howard Matsuura deserves our congratulations on his appointment in August as Registrar of the Land Court. Gordon Arakaki, Mitch Imanaka, and a number of attorneys and Real Estate Commission staff members have been working hard on the recodification of Chapter 514A relating to Condominium Property Regimes. This first major re-write of the law in over twenty-five years will go to the Legislature in January 2004. Also on the legislative front, look for the re-introduction of H.B. 1471 relating to the deregistration from Land Court of fee simple timeshare interests.

This year, the section has continued its mission of putting on educational seminars. In July, Duane Fisher teamed up with member of the Business Law Section to put on the Real Property and Business Law Legislative Update. At the October Bar Convention, we put on a program which featured a half-day of presentations by insurance professionals on property liability insurance and a half-day of reports on updates to the Hawaii Commercial Real Estate Manual. Thanks go to program chairs Mark Hazlett and Deb Chun, and to Nancy Grekin, Dan Devaney, Bob Strand, Trevor Brown, Kepa Dwight, and Bruce Graham for an informative program. Don't forget to sign up for the November 21, 2003 Real Property Litigation Update moderated by Bill Deeley. And on December 4, 2003 the section will co-sponsor a program on the Akaka Bill And Its Effect On Land Development In Hawaii with the Urban Land Institute and the Office of Hawaiian Affairs.

This Fall, the section awarded scholarships to Aaron Creps and Anne Matsunaga, students at the William S. Richardson School of Law, for outstanding papers written for their second-year seminars. In this edition of the newsletter, we feature Aaron Crep's paper, winner of the C. Jep Garland Award given by our section for excellence in writing on a topic relevant to the fields of real estate and financial services. The paper, edited here by Mr. Creps for space considerations, is entitled *Common Interest Communities: The Appropriate Standards of Review*.

Finally, our Annual Meeting will be held at the Plaza Club at noon on Thursday, December 11, 2003. The notice of the meeting and the ballot for next year's directors will be mailed shortly. Mahalo for all of your continuing support!

Lorrin Hirano

Common Interest Communities: The Appropriate Standards of Review

By Aaron Creps

Aaron Creps is a law student at William S. Richardson School of Law and the 2003 C. Jep Garland Award Winner.

This article has been redacted and footnotes omitted due to space limitations. For a copy of the complete article, please e-mail your request to ken@starnlaw.com (or call Ken Marcus at 537-6100).

I. Introduction

The case of Bennett v. Huwar provides an appropriate starting point for discussing judicial review of common interest communities (hereinafter "CICs"). At issue in Bennett was the decision of an architectural control committee denying the plaintiff homeowner's construction plans. The property in question was located in a residential subdivision of rural land. Generally the lots were of considerable size, and there were nine residences in addition to the plaintiff's. There were barns and metal outbuildings in many of the lots, and residents were allowed to keep cows and horses for personal use. There was a farmhouse on the lot directly across from the plaintiff's, which was also used by the local water supply district store and park its heavy equipment.

Recent Land Court Procedure Notice

On September 18, 2003, Howard Matsuura, Registrar of the Land Court issued a notice that all signature pages attached to a Land Court Petition, including those signed by the Petitioner and those to be signed by the Registrar for the Judge of the Land Court, contain a description of the document being filed with the Land Court, either on the top or the bottom of the page. As an example, the page on which the Order appears ("[u]pon the record and the evidence herein, the prayer of the petition is hereby granted and the Assistant Registrar of this court is so ordered"), there should be a header or a footer that says "Petition of ABCD LLC For Amendment of Land Court Certificate of Title No. 123,456 And Order."

The plaintiff desired to build an "earth contact home," which is designed to be energy efficient by having at least one wall below the earth grade. Such a home has a conventional roof, but on the side where the wall is below grade, the roof eave is near ground level. The plaintiff began construction prior to receiving the requisite approval of the architectural control committee, which eventually rejected the plans on the ground that the structure was not in harmony with the rest of the neighborhood. In particular, the association objected to the below ground wall facing the street.

The trial court disagreed, finding that the earth contact home was harmonious because the subdivision lots were large, barns and livestock were permitted, and there was a barn across the street. The appellate court reversed, holding that the trial court was "not entitled to substitute its opinion for that of the committee," and that the association's decision need only be reasonable. The court gave the plaintiff two options. It could either modify the existing structure to bring it into harmony with the surrounding homes, or tear it down and start over.

While an extreme example, Bennett demonstrates the potential CIC associations possess "to exert tremendous influence on the bundle of rights normally enjoyed as a concomitant part of fee simple ownership of property." As of 1998, approximately forty-two million Americans were living in CICs, and some believe this form of privatized governance may soon rival local governments in size and power. According to Paula Franzese, "the success of any shared ownership arrangement depends . . . on the 'subordination of individual property rights to the collective judgment of the owners' association." There is the potential for association board members to use their position to line their pockets, punish enemies, or reward friends through the exercise of the association's discretionary powers. Clearly then, "[b]ecause the stakes are so high, directors and officers should be held to high standards."

Common Interest Communities (continued)

As Bennett demonstrates, however, this is currently not the case. Generally, association decisions need only be "reasonable," no matter how significant the adverse impact is on a homeowner. This paper suggests that this is an imprudent approach to such an important, growing area of the law. The appropriate method of judicial review would recognize that associations make two types of decisions. The first are largely ministerial, management-type decisions, including repair, maintenance, and the like. The second, and more crucial, are the discretionary decisions; such as where an association's architectural control committee imposes design standards. As this paper will demonstrate, judicial scrutiny should vary based on the type of decision being challenged.

Section II provides context for the discussion of CICs, including relevant definitions, common critiques, and the current standards of judicial review. Section III begins with a look at the types of decisions associations make, considers how much deference they should be afforded based on constitutional considerations, and ends with a proposed standard and appellate mechanism. Section IV concludes with some final thoughts.

II. Background

A. Relevant Definitions

A "common interest community" is:

> a real-estate development or neighborhood in which individually owned lots or units are burdened by a servitude that imposes an obligation . . . to pay dues or assessments to an association that provides services or facilities to the common property or to the individually owned property.

Essentially, two interests are conveyed in a CIC: an interest in a dwelling unit and or lot, and a proportionate share of a commonly held property. Ordinarily, membership in an "association" is mandatory. An "association" is the entity that manages the common property and general affairs of a CIC. Many associations are incorporated, usually as nonprofit corporations, although sometimes the for-profit form is used. Unincorporated associations such as partnerships or trusts are less common. A CIC's "governing documents," also known as "covenants, conditions, and restrictions" (CCR's), delegate authority to the association and determine the rights and obligations of community members.

B. Critiques of CICs

There are several critiques of CICs. Sheryll Cashin argues that the increasing privatization of formerly public services is resulting in a civic "succession of the successful." Cashin notes that several states already allow residents of CICs to adjust their local taxes to account for services provided by their association. This, she contends, encourages CIC residents to feel they should have only a limited fiscal obligation beyond their immediate community, and cultivates a "secessionist mindset." At the extreme, CICs can formally secede by forming an incorporated municipal government, which is especially likely in states like California and Florida that have permissive government formation laws. While this may simplify the issue of judicial review, it exacerbates the secessionist mindset.

David Drewes contends that CICs are not living up to their potential. He believes that CICs arose in part to return a sense of community to a landscape typified by the sprawling building patterns that dominated real estate development in the latter half of the twentieth century. Rather than "fostering participatory communities in which residents interact and cooperate to forge a common future," however, CICs often breed "feelings of apathy, alienation, and frustration." Drewes argues that this is due in large

part to a lack of homeowner participation in CIC governance, which can be remedied by "enhanced procedural review through existing legal standards aimed at increasing resident participation in policymaking."

Others are critical of the exclusionary effects of CICs. Professor Clayton Gillette reasons that since not everyone can live where they choose, "decentralization for the select few will encourage them to seek isolation from the fiscal and physical burdens of urban life instead of working for the improvement of the larger community." The select few who flee generally share similar income levels and racial backgrounds, and hence the composition of many CICs appears homogenous and unwelcoming to those who differ. When combined with association-administered servitude regimes, many CICs become "aesthetically undifferentiated and culturally desolate."

C. Current Standards of Review

Generally speaking, courts have employed one of two standards when reviewing association actions: either the "business judgment rule" of corporate law or a "reasonableness" test. The New York appellate court in Schoninger v. Yardarm Beach Homeowners' Ass'n defined the business judgment rule as limiting "the court's inquiry . . . to whether the board acted within the scope of its authority under the bylaws . . . and whether the action was taken in good faith to further a legitimate interest of the condominium." The court elaborated that "[a]bsent a showing of fraud, self-dealing or unconscionability, the court's inquiry is so limited and it will not inquire as to the wisdom or soundness of the business decision." Proponents of the corporate analogy point to what an association is, how it is structured, and how it is intended to operate. As previously noted, most CICs are incorporated, have the functional equivalent of a board of directors (the association) and shareholders (the homeowners), and both CICs and business corporations are created to benefit stakeholders.

There are several critiques of the corporate analogy. The first concerns the nature of the investment. Directors of business corporations are afforded greater decision-making leeway because shareholders can protect themselves by divesting their relatively small individual stakes. With CICs, the investment in real property is more significant and much less liquid, and hence the association should be held to a higher standard of care. The second critique focuses more on metaphysical differences. As articulated by Paula Franzese, "to superimpose corporate or business models upon residential, family settings seems inconsistent with, if not a dehumanization of, the values, norms, and needs of home life." In other words, the comparison just does not feel right.

The "reasonableness test," a variation of which most courts have used, imposes a duty on associations "to act reasonably in the exercise of [their] discretionary powers including rulemaking, enforcement, and design-control powers." California employs a more detailed reasonableness standard

MOVING INTO THE 21ST CENTURY

We know it isn't as pretty, but the Section could save a fair amount of money (on paper and stamps), not to mention time (getting the newsletter out more promptly), if the members were prepared to receive the newsletter by email rather than hard copy via US mail. Please let us know if you would like to receive the Section newsletter by email – just drop a note to Ken Marcus at the following email address: ken@starnlaw.com. In your note, let us know whether MS Word format would work for you, or whether you would require delivery in another format (and if so what format),

If you *don't* want to receive by email, you can drop us a note to say so, but we'll presume that anyone who hasn't sent an email indicating they'd like to receive the Newsletter electronically is telling us that you don't want it electronically (or don't have email at all, which comes to the same thing).

Thanks – we'll let you know next issue what we hear.

which requires that association decisions "represent [a] good faith effort to further the purposes of the common interest development, [are] consistent with the development's governing documents, and comply with public policy. Association actions are generally reasonable unless arbitrary, capricious, discriminatory, or made in bad faith. This standard also has its detractors.

First, the reasonableness test is vague. It is inevitably difficult for a third party to determine whether an action was reasonable under the circumstances. Some fear this uncertainty will lead to a flood of costly litigation. Second, some courts have been unwilling to place the burden of proof on associations to show that their actions were reasonable. For example, in Levandusky v. One Fifth Avenue Apartment Corp., where the New York Court of Appeals adopted the business judgment rule, it noted that "unlike the business judgment rule,

NEXT YEAR'S LEGISLATION

As you may be aware, last legislative session a bill was introduced to remove all time share projects located on Land Court land from Land Court registration. That bill was defeated, and the chief administrators from the Bureau and Land Court, together with representatives of the real estate industry, the title insurance industry, the HGEA and other interested parties, met to work out a bill that was hoped to be acceptable to all concerned (and especially the Legislature). We would welcome your views on that effort, and on the final bill when introduced. The Section plans to testify at the next legislative session with respect to the new bill, and we would welcome your opinion, whether for or against. Please email your thoughts to ken@starnlaw.com.

In addition, it is expected that a new Condominium chapter for HRS will be unveiled shortly. The Section plans to make sure that you are made aware of the bill when proposed, that your views are taken into account and that if and when a new chapter is enacted we gain an understanding of it as quickly as possible. Look for more in upcoming newsletters.

Finally, the Section hopes to participate in a review of existing recording laws and practices to aid in efforts to make the process more responsive to the needs of practitioners. Once again, if you have any suggestions that you would care to share, please feel free to email them to ken@starnlaw.com.

which places on the owner seeking review the burden to demonstrate a breach of the board's fiduciary duty—reasonableness review requires the board to demonstrate that its decision was reasonable." Similarly, in Nahrstedt v. Lakeside Village Condominium Ass'n, the California Supreme Court moved from a reasonableness standard to an unreasonableness standard and shifted the burden to the person challenging the action to establish unreasonableness. Finally, there is a concern that the reasonableness standard inappropriately allows for judicial second-guessing of board decisions. The court in Levandusky, rejecting the reasonableness standard in favor of the business judgment rule, concluded that "courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments," and that "board members . . . possess experience of the peculiar needs of their building and its residents not shared by the court."

A third standard, which has received only minimal treatment from the courts, likens CICs to municipal governments. CICs frequently provide their members with services like road maintenance, street and common area lighting, and refuse removal. But for the association, a municipality would provide these services. CICs also "tax" in the form of assessments, elect representatives, and through architectural restrictions have the power to permit construction or grant variances.

Several courts have made similar observations. In Cohen v. Kite Hill Community Ass'n, the court stated that the defendant association's approval of a nonconforming fence was analogous to the award of a zoning variance. In the oft cited condominium case Hidden Harbour Estates, Inc. v. Norman, the court observed that CIC homeowners "comprise a little democratic subsociety." The court in Holleman v. Mission Trace Homeowners Ass'n, noted that one of the purposes for which the CIC at issue was organized was to promote "the health,

safety, and welfare of the property owners," language traditionally employed to describe the municipal police power. In Terre Du Lac Ass'n v. Terre Du Lac Ass'n, Inc., the court opined that the "association performs what is essentially a governmental function. Finally, the court in Levandusky termed CICs a "quasi-government."

There are, however, numerous distinctions. Unlike CICs, municipalities have a police force, the power to condemn property, and, absent waiver, enjoy sovereign immunity from tort liability. Agreement to submit to the authority of a CIC is voluntary, while submission to government authority is not. Some fear that applying public law principles to CICs will destroy the freedom to choose between restricted and unrestricted communities.

These distinctions, however, are unpersuasive. The remainder of this paper seeks to demonstrate that the quasi-governmental description is appropriate as applied to non-managerial decisions. This will be achieved by first looking at the types of decisions that CICs make, then fleshing out the constitutional issues raised by CICs and how they affect the amount of deference CICs should be afforded, and concluding with a proposed standard and system of review.

III. Discussion

A. Roles of the Association

In order to arrive at the appropriate standard of review of CICs, it is first necessary to analyze the types of decisions CICs make. The court in Terre Du Lac Ass'n v. Terre Du Lac, Inc. determined that CIC associations perform two "distinct" roles: managerial and quasi-governmental. It follows that there should be two distinct legal standards. This concept was raised by Judge Titone's concurring opinion in Levandusky. Titone concluded that "there is no sound reason to insist upon a single standard for judicial review for cases presenting diverse legal problems simply because they arise within the setting of [CICs]."

Under the first standard, the business judgment rule would apply to the "managerial" decisions of an association. This would include routine maintenance, repair, rehabilitation and other largely ministerial decisions. Association board members are better situated to make such decisions because they "possess experience of the peculiar needs of their [CIC]." Application of the business judgment rule in these instances is appropriate because they involve actual fiscal determinations. Consequently, it is fitting to impose a fiduciary duty regarding such decisions.

Limiting the business judgment rule to managerial determinations also addresses a significant critique of the corporate law analogy, namely the difference in liquidity of the investment. As discussed *infra*, some have argued that corporations are afforded greater deference because stakeholders can divest their relatively small investments rather easily. On the other hand, the stake in a CIC is usually a parcel of real property, which is difficult to transfer and represents a significant investment. Managerial decisions are funded by assessments that represent small individual contributions, and hence are more akin to corporate investments. Additionally, managerial decisions have a smaller impact on actual property rights, and thus deserve less judicial attention. For example, at issue in Lamden v. La Jolla Shores Clubdominium Homeowners Ass'n was the defendant association's decision to combat termite infestation by "spot treatment" rather than by fumigation.

The business judgment rule, however, is an inappropriate standard for discretionary decisions. Issues surrounding architectural review, use standards, and rule enactment are more akin to the

decisions that municipalities traditionally make. As the following section seeks to demonstrate, the discretionary decisions of associations should be afforded less judicial deference and instead be treated as though they were made by a government.

B. Constitutional Issues and Deference

1. Freedom of Contract

An argument can be made that because homeowners "voluntarily" buy into CICs, they should not be allowed to later dispute the provisions and procedures found in their governing documents. Courts have no place in such private transactions and should respect the parties' freedom to contract as they wish. In Cypress Gardens v. Platt, the court, while considering the appropriate standard for reviewing a CIC's equitable servitudes, noted that "private contractual arrangements are not subject to constitutional requirements." However, "the freedom of contract is a qualified and not an absolute right." The fact "that both parties are of full age and competent to contract does not necessarily deprive the State of the power to interfere where the parties do not stand upon an equality." There are several indications that the parties to a CIC contract do not "stand upon an equality."

First, the housing options for a majority of homebuyers are significantly limited by considerations of price, size, and location. As a result, the homeowner is not freely contracting in the traditional sense. Second, little or no bargaining takes place with respect to the governing documents. Typically, developers devise CCRs prior to the sale of any units, without the participation of the parties who will eventually be subjected to them. Further, as Professor James Winokur suggests, with the growth of CICs and proliferation of standard servitude regime forms, "[w]hat might be objectionable in one set of restrictions will increasingly be contained in restrictions of other area subdivisions." Third, buyers of CIC property "tend to focus on price, location, schools, and physical characteristics of the property, rather than on the details of the documents that impose servitudes . . . and create the governing association." In other words, the restrictions to which CIC homeowners are subject are infrequently "intelligently review[ed]." Although in theory buying into a CIC is voluntary and represents a unique contractual agreement, in practice, the matter is one of convenience reflecting "little autonomous will," and should be treated as such. For these reasons, the discretionary decisions of associations should be afforded less judicial deference.

2. State Action

As a caveat, it is not the purpose of this section to argue that CICs are state actors because that would unnecessarily complicate their operation. For example, the potential for association board members being liable for damages under Section 1983 would likely deter participation. Rather, the state action doctrine is used because it illustrates that private entities have been held to municipal standards, and fleshes out compelling reasons for applying public law to non-managerial association decisions.

That being said, since it is clear that CICs should not be afforded the same amount of deference as other private arrangements, the next issue is whether their discretionary decisions should be held to public law standards. Nominally private entities have been treated as state actors, subject to constitutional limitations through the 14th Amendment, in three situations: when delegated a public function by the state, when entwined with governmental policies, or when the government is entwined in its management. Wayne Hyatt and Jo Anne Stublefield have suggested that these three situations translate into three theories by which

community associations may be found to be engaged in a state action.

The first is the "judicial enforcement theory," where a state action could be found if a CIC seeks judicial enforcement of a discriminatory covenant. The seminal case in this area is Shelley v. Kraemer, where the Supreme Court held that a private group's attempt to enforce a racially restrictive covenant constituted a state action. Although the current application of Shelley to CICs is debatable, it is probably a moot point because generally, courts have held that association decisions cannot be against public policy. As a result, discriminatory decisions can be invalidated without a state action determination.

The second is the "state involvement theory." The idea is that where the state is significantly involved in the affairs of a private entity such that it effectively aids or encourages the injurious conduct, the state has acted. As states become more involved with CICs by regulating the creation of condominiums and other forms of common interest ownership, this theory becomes more viable. Currently, however, it appears that it would be difficult to show a "sufficiently close nexus" between the state and a CIC given the latter's self-sufficient nature. As the Florida court of appeals stated in Brock v. Watergate Mobile Home Park Ass'n, "[t]he state cannot be implicated in the association's activities solely because the association is subject to State law."

The third, and most compelling, is the "public function theory." The Supreme Court has found a state action "in the exercise by a private entity of powers traditionally exclusively reserved to the State." Several challenges to CIC decisions have employed the public function argument, primarily relying on the Supreme Court's decision in Marsh v. Alabama. In Marsh, the Court held that a company-owned town had violated the plaintiff's 1st Amendment right to free exercise by criminalizing the distribution of religious literature. The fact that the town was private was "not sufficient to justify the State's permitting a corporation to govern a community of citizens so as to restrict their fundamental liberties."

As discussed *infra*, "[a]n association performs what is essentially a governmental function." Where an association must approve new construction or remodeling, the association is essentially granting a building permit. Similarly, as noted in Cohen v. Kite Hill Community Ass'n, the association's "approval of a fence not in conformity . . . is analogous to the administrative award of a zoning variance." When associations act in these capacities, they should be treated as quasi-governments.

The arguments for not subjecting CICs to this standard are unpersuasive. First, in rejecting the CIC/municipality comparison, the court in Brock v. Watergate Mobile Home Park Ass'n concluded that "the services provided by a homeowners association . . . are merely a supplement to, rather than a replacement for, those provided by local government." Likewise, the Supreme Court in Evans v. Newton contended that "the fact that government has engaged in a particular activity does not necessarily mean that an individual entrepreneur or manager of the same kind of undertaking suffers the same constitutional inhibitions." The suggestion that association restrictions merely supplement traditional municipal land use restrictions is misguided. Architectural review provisions are particularly illustrative of this point.

Take, for example, the covenants at issue in Riss v. Angel. They gave the association "the right to refuse to approve the design, finishing or painting of any construction or alteration which is not suitable or desirable in said addition *for any reason*, aesthetic or otherwise." While municipalities are

held to objective standards and easily met building criteria, CIC covenants are more restrictive and have governing documents that frequently give associations unfettered discretion in reviewing proposed construction plans. Consequently, because an association can prohibit construction sought by a homeowner who has received a municipal building permit, non-managerial association decisions have the effect of supplanting, rather than supplementing, a traditional public function. The opinion of the association board is paramount and should be reviewed accordingly.

Moreover, the Court in Evans was discussing the private/public school distinction raised in Pierce v. Society of Sisters. While the state could not segregate its own schools, the fact that private organizations also ran schools did not mean they were subject to similar constitutional limitations. The fact that a private entity is providing a service that the government also provides does not bring it within the proscriptions of the Constitution. However, where the private organization is effectively supplanting a traditional public service, it makes sense to hold it to a similar standard.

Second, the differences between CICs and municipalities as advanced by commentators are inconsequential. As discussed *infra*, CICs are generally smaller, perform a narrower range of functions, and lack the redistributive, police, conscriptive, and enforcement privileges of a municipality. These distinctions, however, deal more with form than substance. The public function analysis does not require that the private entity be a replica of the municipal counterpart. Rather, it necessitates only that the "predominant character and purpose" are municipal.

Treating CICs in this manner is also supported by policy considerations. Private property ownership is a fundamental right. The 5th Amendment equates property with life and liberty: "No person shall be . . . deprived of life, liberty, or property, without due process of law." The Restatement notes that the "home is . . . a haven of personal autonomy, liberty, and security." Further, historically, restrictive covenants, which are in derogation of the right to free use of land, have been strictly construed, with doubts resolved in favor of the free use of land. Yet "associations are often administered by amateurs who are not familiar with, do not understand, or are otherwise inept at enforcement of association rules." Association board members "are often pressed into service . . . even though they may lack experience in handling affairs similar to those of the association." It therefore makes little sense to defer to their judgment with respect to discretionary decisions, especially considering that they impact such a fundamental right. Judges, on the other hand, are frequently called upon to interpret contracts and can provide an objective view of the situation, such that the intent of the covenant can be more effectively realized.

C. Proposed Changes

At this point, it should be apparent that treating associations as quasi-governments when making non-managerial decisions is appropriate. What remains is to consider the ramifications of this change in judicial review. More specifically, what would the elements of a public law standard be as applied to CICs, what effect would this have, and how might this change the system of review?

1. A New Standard of Review

Discretionary decisions by associations should be reviewed as governmental agencies are. They should be subject to due process requirements like the opportunity to be heard. The association's decision would carry a presumption of validity and the challenging party would have the heavy burden of proving the decision was invalid because of its unjust and unreasonable consequences. An

association decision would be reversible if:

(1) In violation of constitutional provisions; or

(2) In excess of the authority granted to it by the respective governing documents; or

(3) Clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record; or

(4) Arbitrary, capricious, or characterized by abuse of discretion or clearly unwarranted exercise of discretion.

The effect of this modification is illustrated by its application to the particularly troubling area of architectural review committee decisions. Currently, most jurisdictions recognize the validity of covenants requiring approval of construction plans even if the covenants do not contain explicit standards for approval. Consequently, covenants frequently state that plans may be refused for any reason, "including purely aesthetic grounds," or where the intended structure is "not in harmony with the rest of the neighborhood."

In Europco Management Co. v. Smith, the plaintiff homeowner sought to add a screened in porch to the rear of his house. The architectural review committee denied the application because the materials to be used and roof overhangs were not consistent with the primary residence. The trial court ruled that the committee failed to prove that the proposed addition would diminish the value of the surrounding property, would change the pattern of development in the subdivision, or was noticeably different than other homes in the CIC. The Florida Court of Appeals reversed, holding that the committee had exercised its "plenary discretion" in a reasonable manner. It also denied the plaintiff's claim that they were entitled to an opportunity to be heard before the committee.

The finding of "not harmonious" in Europco was clearly reasonable because the addition differed in appearance. The association was not required to consider any information other than what it deemed necessary. Had the association been required to provide the plaintiff an opportunity to be heard, however, plaintiff's testimony would have become part of a record. The plaintiff could have pointed out that the "harmony" provision was likely included to protect surrounding home values, and argued that by being at the rear of the home and only minimally inconsistent with the original structure, the porch would have a *de minimis* effect on value. Consequently, the due process requirement would force the association to consider this information and would likely result in a more reasoned decision. For the association to ignore plaintiff's evidence, if compelling, would likely render their decision "clearly erroneous."

Where an association allows a homeowner to act in a manner otherwise prohibited under the governing documents, the association should be treated as if it granted a variance. Accordingly, the applicant must show that, because of some peculiar characteristic of his property, the strict application of the CCR's would produce an unusual hardship. This would give added protection to a CIC's other homeowners from reasonable yet unwise association decisions in the same way that the application of public law protects homeowners seeking to act consistent with governing documents.

2. A New Procedure for Review

Currently the only way to challenge an adverse association ruling is through litigation. The expense of litigation, however, likely deters most of these challenges, some of which are meritorious. If certain association decisions are going to be held to a quasi-governmental standard, it seems that they should be able to make use of a non-judicial appellate body similar to a zoning board of appeals. The system currently employed in Nevada provides an insightful example.

Under Nevada Revised Statutes (hereinafter "NRS") section 38.310, no civil action based upon the "interpretation, application or enforcement of any covenants, conditions or restrictions applicable to residential property or any bylaws, rules or regulations adopted by an association" may be commenced in court without first being submitted to arbitration or mediation. If a party commences a civil action upon the conclusion of arbitration or mediation and fails to obtain a more favorable award or judgment, he or she is required to pay all costs and reasonable attorney's fees subsequently incurred. Mediator and arbitrator fees are paid through an account funded by fees collected from associations.

Nevada has also created an office of the ombudsman for CICs. The ombudsman processes claims submitted to mediation or arbitration pursuant to NRS section 38.310, aides CIC homeowners in understanding their rights and responsibilities as set forth in their governing documents, and assists persons elected to association boards in carrying out their duties. Additionally, the ombudsman must compile and maintain a registration of each association organized within Nevada that includes its contact information and general characteristics.

Much like a zoning board of appeals, the Nevada system of review has the potential to filter out many managerial and non-meritorious claims. The attorney fee provision lends authority to the arbitration/mediation process, and courts are left to settle disputes over non-managerial decisions using public law standards. CICs benefit by spending less time in court and encountering less judicial interference with their routine operations. Homeowners challenging adverse decisions also benefit from reduced costs, and through the use of municipal standards, are assured greater protection when important land use issues are implicated.

IV. Conclusion

Common interest communities generate peculiar disputes. Paula Franzese recounts the story of an association (Tampa Palms) that attempted to enforce a restrictive covenant against six-year old Brage Sassin's tree house. One of the few sources of comfort for the boy as he battled leukemia, the tree house exceeded the height maximum by six feet. The association declared that it was being compassionate because if it had gone by the book, "a fine would have been imposed long ago." Eventually the association relented in the face of national pressure.

Conflicts such as this are the result of the structure of CICs. An association board, often comprised of unqualified individuals, is given significant discretion to enforce highly restrictive covenants that impact the largest investment that most people make. In order to be effective, the law of common interest communities must address these unique characteristics.

CICs represent a private contractual agreement, and so covenants should be upheld so long as reasonable. The association performs managerial duties not unlike a business, so a fiduciary duty should be imposed when it acts as such. It also interprets and enforces its covenants, which can effectively supplant decisions traditionally made by land use boards. Where this is the case, the association should be treated as a quasi-government. Who knows, if Tampa Palms were held to this standard, Brage Sassin may have been entitled to a variance for his tree house based on "undue hardship."

KA NU HOU, the Newsletter of the
Real Property and Financial Services Section
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