Construction Defect Litigation Has Reached Its Pinnacle - And Now Moves to Arbitration

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With its recent decision in *Pinnacle Museum Tower Association v. Pinnacle Market Development (US) LLC, et al.* (2012 WL 3516134), the California Supreme Court has decisively moved the forum of construction defect litigation from civil courtrooms to the relatively unknown world of binding arbitration and private arbitrators.

Before *Pinnacle*, Associations seeking redress for construction defects had been able to pursue those claims in civil courtrooms, regardless of the provisions calling for binding arbitration in CC&Rs and purchase agreements. This was true despite the fact that developers had been trying for years to move such claims to binding arbitration by placing irrevocable binding arbitration provisions in CC&Rs and purchase agreements. Prior to *Pinnacle*, these efforts had uniformly failed. (See, *Villa Milano Homeowners Assn. v. Il Davorge (2000)*, 84 Cal.App.4th 819)

In *Pinnacle*, the Supreme Court held that binding arbitration provisions within CC&Rs are enforceable against associations, thereby disapproving *Villa Milano*. In reaching its decision, the Court decided that an association, although not yet formed and, once formed, completely under the control of the developer, can consent to waive its right to a jury trial and agree to binding arbitration of construction defect disputes.

In reaching its decision, the Supreme Court looked at three major issues: 1) the rules governing compelled arbitration of claims; 2) the principles relating to the contractual nature of CC&Rs recorded pursuant to the Davis-Stirling Act; and 3) the doctrine of unconscionability. We look at each briefly in turn.

1. The Rules Governing Compelled Arbitration.

The CC&Rs in *Pinnacle* stated that construction disputes were to be resolved by binding arbitration pursuant to the Federal Arbitration Act ("FAA"; 9 U.S. C. § 1 et seq.) and the California Arbitration Act. ("CAA"; *Code of Civil Procedure* § 1280, et seq.) Since the FAA applies in any instance involving interstate commerce, and given the liberal policy favoring arbitration, exceptions from FAA are rare. Added to this is the FAA's pre-emption of state laws which discriminate against arbitration. With the latter in mind, the Supreme Court also ruled out the application of *Code of Civil Procedure* § 1298.7, which excludes construction defect claims from arbitration in real estate contract arbitration. Thus, the Court decided that the principles of general contract law would determine whether the binding arbitration provision was enforceable.

2. The Contractual Nature of CC&Rs.

In reviewing CC&Rs, the Court distinguished between what is required to be included in CC&Rs and what could be. In drawing this distinction, the Court noted that that a developer may include "any other matters the original signator of the declaration [e.g., the developer] or the owners consider appropriate." (*Civil Code* § 1353 (b).; Cal.Code Regs., tit. 10, § 2792.8 (a).) In other words, if developers want something in CC&Rs, as long as it is not unreasonable, it is enforceable.

Here, the Court leaned heavily on the theory that owners had expectations, derived from the CC&Rs, that any construction defect dispute would be arbitrated. Giving force to arbitration clauses, it reasoned, protects owners' expectations, the community as a whole and the developer. In light of these expectations, the Court held the terms in the CC&Rs reflected written promises and agreements that are enforceable against the association.

3. Contractual Unconscionability.

The closing analysis addresses whether an arbitration provision may be unenforceable due to contractual unconscioniability. In California, there are two kinds of contractual unconscionability - procedural and substantive.

Procedural unconsionability concerns the circumstances of contract negotiation and formation, focusing on oppression or surprise due to uneven bargaining power. (See *Armendariz v. Foundation Health Psychcare Services, Inc.* (2000) 24 Cal.4th 83, 114.) Substantive unconscionability concerns the fairness of the actual terms of the agreement and whether they are overly harsh or one-sided. (*Armendariz* at 114.) However, to be deemed substantively unconscionable, the term must be "so one-sided as to 'shock the conscience.'" (*24 Hour Fitness, Inc. v. Superior Court* (1998) 66 Cal.App.4th 1199, 1213.) The

party resisting arbitration has the burden of proving unconscionability.

Here, there was no surprise and the arbitration provisions did not "shock the conscious." Further, since the developer procedurally complied with the Davis-Stirling Act in preparing the CC&Rs, the claim of procedural unconscionability was rejected.

So what, really, does this mean for associations? If your association is more than 10 years old it means nothing as your association's construction claims, if any, are already barred by the applicable statutes of limitations.

The associations which will be affected most by this decision are those in the initial stages of pursuing a construction defect claim or who are considering such a claim. While the decision does not change the pre-litigation (now pre-arbitration) steps outlined in Civil Code §§ 895, et seq. or 1375, it decidedly changes the forum in which the claims will be tried and decided.

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