

OWNERS CAN USE BINDING REFERENCE PROVISIONS TO REDUCE THEIR EXPOSURE IN CONSTRUCTION DEFECT ACTIONS IN CALIFORNIA

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by Gregory R. Shaughnessy

In the last twelve months three California Court of Appeal decisions have been issued addressing the use of alternative dispute resolution procedures in real estate sales contracts. The most recent of the three, issued in April 2003, upheld the validity of provisions that required construction defect disputes to be resolved by binding reference proceedings. These decisions are important, as the ability of developers to utilize binding alternative dispute resolution provisions to eliminate the specter of a massive award of damages by a jury is a critical aspect of risk management in a real estate development project.

Villa Milano Homeowners Association v. Il Davorge (2000) 84 Cal.App. 4th 819, sets the stage for this cutting edge area of law. The court, in what it called a “case of first impression,” held that a developer could not use a declaration of CC&R’s containing a binding arbitration clause as a device to preclude condominium owners and the homeowners’ association from pursuing an action for construction defects in a court of law. The court found that the CC&Rs were an adhesion contract, in that the purchasers were faced with a “take or leave it” proposition to either purchase subject to the CC&Rs or not to purchase at all. Significantly, the CC&Rs also provided that the arbitration provision could not be amended without the consent of the developer. In going on to find the arbitration clause unconscionable, the court focused on the fact that the CC&R’s were 70 pages long, the arbitration clause was on pages 67 and 68, and the clause failed to comply with Code of Civil Procedure section 1298, which requires arbitration clauses in contracts to convey real property to be clearly entitled “Arbitration of Disputes,” and to meet certain print size and capitalization requirements. The court also relied on Code of Civil Procedure section 1298.7, which it characterized as permitting a purchaser “to pursue a construction and design defect action against the developer in court, even if the purchaser signed an agreement to convey real property containing an arbitration clause.” Logically, the court reasoned that if the developer could not mandate arbitration in the individual sale agreements, it could not mandate arbitration by the association in its representative capacity in the CC&Rs.

Basura v. U.S. Home Corporation (2002) 98 Cal.App. 4th 1205, involved an action by 60 purchasers of single family homes for construction defects. Each purchaser had initialled the arbitration clause in the sale contracts, which apparently complied with Code of Civil Procedure section 1298. The court held that Code of Civil Procedure section 1298.7 could not be applied to invalidate the arbitration provisions, as it was preempted by the Federal Arbitration Act (“FAA”), citing the United States Supreme Court decision in Doctor’s Associates, Inc. v. Casarotto (1996) 517 U.S. 681, 683. In so holding, the Basura court recognized that “generally applicable contract defenses, such as fraud, duress, or unconscionability may be applied to invalidate arbitration agreements without contravening” the FAA, but noted that “[c]ourts may not, however, invalidate arbitration agreements under state laws applicable only to arbitration

provisions.” The opinion does not analyze whether the arbitration clause was unconscionable under the facts of the case. Clearly the Basura decision undermines that portion of the Villa Romano decision that relied on section 1298.7, leaving the enforceability of arbitration clauses subject only to an unconscionability analysis.

Pardee Construction Co. v. Superior Court (2002) 100 Cal.App. 4th 1081, involved a class action by the purchasers of single family homes. The sales contracts included a provision that all agreement-related claims, including those for construction defects, would be determined by a general reference conducted by a single referee (a retired superior court judge) appointed under Code of Civil Procedure section 638. The referee would try all issues relating to such claims, whether of fact or law, any dispute about the validity and interpretation of the judicial reference provision would be decided by a court without a jury, and if the judicial reference provisions were found to be invalid, all claims would be tried by a court without a jury. Each purchaser initialled the paragraph including these provisions. The subject paragraph also provided that both parties waived their right to punitive damages.

The Pardee court held that the contracts were adhesion contracts and were unconscionable and that the reference provisions were unenforceable. The court focused on the unequal bargaining power of the parties (plaintiffs were the “purchasers of entry level homes”), the misleading caption in the paragraph containing the reference provisions, the fact that the waiver of punitive damages was only for the benefit of the developer, the importance of the waiver of the right to a jury trial, and the fact that the buyers received nothing in return for the waiver. The court found that invalidating the reference provisions was consistent with a public policy favoring a trial with full procedural and constitutional rights over alternative dispute resolution in the context of construction defect litigation, citing Code of Civil Procedure section 1298.7.

Woodside Homes of California, Inc. v. Superior Court (2003) 132 Cal.Rptr. 2d 35, involved a construction defect action by purchasers of new single family homes. The sales contracts required any lawsuit “relating to the condition, design or construction of any portion of the [purchased home]” to be submitted to judicial reference pursuant to Code of Civil Procedure section 638. The clause went on to provide that: the referee is to be a retired judge or attorney with substantial experience in real estate matters; the parties shall be entitled to discovery; the referee shall render a statement of decision with findings of fact and conclusions of law; the decision may be entered as a judgment, but is also appealable; and the parties were to share the referee’s costs and fees equally and to bear their own costs and attorney’s fees.

The contracts also provided that “Seller shall not be required to participate in the judicial reference proceeding unless it is satisfied that all necessary and appropriate parties will participate.” The Seller represented that all of the subcontractors were bound by agreement to participate in any reference of disputes.

The court held that the reference provisions were NOT unconscionable and were binding and enforceable. In so doing, it went to great lengths to distinguish Pardee, noting that there was no evidence that the subject homes were “entry level,” the reference provisions in Pardee were “buried in the form contracts,” and that the clause in Pardee contained a “surprise

component” in that it made no mention of the referee fees. The court found that the buyers did get something in addition for their jury waiver – the seller’s matching waiver. In language that will surely shock members of the Plaintiffs’ bar the court, in discussing the impact of the waiver of the right to a jury trial, stated:

There is nothing “unconscionable” in requiring a party to a contract to give up the possibility of obtaining a windfall from a jury irresponsibly generous with someone else’s money.

The Woodside Homes decision is important because it is the first decision in California to hold that binding alternative dispute provisions in real estate sales documents are not unenforceable based on unconscionability. Further, the Woodside Homes court also cited Villa Romano in its discussion on unconscionability, suggesting that the same analysis would apply to a provision in CC&Rs that required construction defect disputes to be submitted to judicial reference.

In summary, the current state of the law in California is that provisions for binding arbitration and reference provisions in real estate sales contracts and CC&Rs can be enforceable. Code of Civil Procedure section 1298.7, which purports to invalidate arbitration provisions in construction defect actions, is preempted by the FAA and may not be relied upon to invalidate an arbitration clause. However, since there is no published California decision finding that arbitration provisions in real estate sales contracts or CC&Rs are enforceable, prudent developers will utilize binding reference provisions.

Given the nature of construction defect litigation in California and the relatively minor effort required, sellers of ALL mass-produced real estate should include binding reference provisions in their real estate sales documents. Ideally, the provisions should be in a separate document that is signed by the buyer that complies with the requirements of Code of Civil Procedure section 1298, with appropriate modifications to the statutory notice provisions. In the case of condominium projects, the provisions would be provided with the sales contracts and included in the CC&Rs, with a further provision in the CC&Rs that allows the reference provisions to be amended by a vote of 75% of the members eligible to vote (as opposed to 75% of the number of votes cast). No waiver of punitive damages should be included, and the provision should require the referee fees to be split among the parties.

Attached to this article is a copy of the judicial reference provisions in the Woodside Homes decision for the use of developers (or contractors who can provide them to developers) as they may find appropriate.

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10. JUDICIAL REFERENCE OF DISPUTES. If either BUYER or SELLER commences a lawsuit for a dispute arising under this Agreement or relating to the condition, design or construction of any portion of the Property, all of the issues in such action, whether of fact or law, shall be submitted to general judicial reference pursuant to California Code of Civil Procedure Sections 638(l) and 641 through 645.1 or any successor statutes thereto. BUYER and SELLER shall cooperate in good faith to ensure that all necessary and appropriate parties are included in the judicial reference proceeding. SELLER shall not be required to participate in the judicial reference proceeding unless it is satisfied that all necessary and appropriate parties will participate. The Parties shall share equally in the fees and costs of the referee, unless the referee orders otherwise. The Parties shall bear their own attorneys' fees.

The general referee shall have the authority to try all issues, whether of fact or law, and to report a statement of decision to the court. The Parties shall use the procedures adopted by Judicial Arbitration and Mediation Services/Endispute ("JAMS") for judicial reference (or any other entity offering judicial reference dispute resolution procedures as may be mutually acceptable to the parties), provided that the following rules and procedures shall apply in all cases unless the parties agree otherwise:

- (a) The proceedings shall be heard in the county in which the Project is located;
- (b) The referee must be a retired judge or a licensed attorney with substantial experience in relevant real estate matters;
- (c) Any dispute regarding the selection of the referee shall be resolved by JAMS or the entity providing the reference services, or, if no entity is involved, by the court with appropriate jurisdiction;
- (d) The referee may require one or more prehearing conferences;
- (e) The parties shall be entitled to discovery, and the referee shall oversee discovery and may enforce all discovery orders in the same manner as any trial court judge;
- (f) A stenographic record of the trial shall be made, provided that the record shall remain confidential except as may be necessary for posthearing motions and any appeals;
- (g) The referee's statement of decision shall contain findings of fact and conclusions of law to the extent applicable; and
- (h) The referee shall have the authority to rule on all posthearing motions in the same manner as a trial judge.

The statement of decision of the referee upon all of the issues considered by the referee is binding upon the Parties, and upon filing of the statement of decision with the clerk of the court, or with the judge where there is no clerk, judgment may be entered thereon. The decision of the referee shall be appealable as if rendered by the court. This provision shall in no way be construed to limit any valid cause of action which may be brought by any of the Parties.

BY INITIALING BELOW, THE PARTIES ACKNOWLEDGE THAT THEY HAVE READ AND UNDERSTAND THE FOREGOING AND ACCEPT THAT THEY ARE WAIVING THEIR RIGHT TO A JURY TRIAL.

BUYER'S INITIALS: _____

SELLER'S INITIALS: _____