

**TREND IN CALIFORNIA TO ENFORCE BINDING REFERENCE PROVISIONS IN
RESIDENTIAL REAL ESTATE SALES CONTRACTS FOR CONSTRUCTION
DEFECT CLAIMS**

(2006)

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From 2000 – 2003 several California Court of Appeal decisions invalidated alternative dispute resolution procedures (“ADR”) in real estate sales contracts for new residential construction in cases involving construction defects. As of 2003 only one California decision upheld the use of such ADR procedures. Two recent cases, in 2004 and 2005, have upheld the use of such clauses, thus establishing a trend of enforcing such clauses in California. These decisions are important, as the enforcement of such binding alternative dispute resolution provisions eliminates the right to a jury trial by the purchaser of allegedly defective new residential construction.

The State of the Law as of 2003

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 of a condominium project could not use a declaration of CC&R’s (covenants, conditions and restrictions) containing a binding arbitration clause as a device to preclude the homeowners’ association from pursuing an action for construction defects in a court of law. The court essentially found that the arbitration clause was unconscionable under the facts of that case. The court emphasized that its finding of procedural unconscionability was strongly supported by the fact that the arbitration clause, included in the CC&Rs, was presented as a non-negotiable term.

The Villa Milano court further found that the arbitration clause was invalid under Code of Civil Procedure Section 1298.7, which provides that a contractual arbitration provision does not apply to an action for construction defects. The court logically reasoned that if such a clause

would be unenforceable in an action between a condominium owner and the developer, it should not be enforceable in an action between the homeowner's association and the developer.

Pardee Construction Co. v. Superior Court (2002) 100 Cal.App. 4th 1081, involved a class action by the purchasers of numerous single family homes in the same development for construction defects. The individual 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 appointed under Code of Civil Procedure section 638.

A judicial reference is different than an arbitration. In a general judicial reference, a lawsuit is filed, but the referee is empowered to "hear and determine any or all of the issues in an action or proceeding, whether of fact or of law" (C.C.P. Section 638(a)) and to make a binding decision that "must stand as the decision of the court" (C.C.P. Section 644(a)).

The Pardee court held that the contracts were adhesion contracts and were unconscionable and that the reference provisions were unenforceable.

In Basura v. U.S. Home Corporation (2002) 98 Cal.App. 4th 1205, the court did hold that the arbitration clauses in the sales contracts of 60 single family homes were enforceable, holding that California 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"). The opinion did not analyze whether the arbitration clause was unconscionable under the facts of the case. Basura clearly conflicts with the Villa Milano decision, which did not even discuss the federal preemption issue.

Woodside Homes of California, Inc. v. Superior Court (2003) 107 Cal.App.4th 723, 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 court held that the reference provisions were NOT unconscionable and were binding and enforceable.

Thus, as of 2003 there were four recent California decisions in this area of the law. On the issue of whether C.C.P. Section 1298.7 invalidated arbitration clauses in construction defect actions, one decision held that it did, and one decision held that it did not (based on federal preemption). On the issue of the enforceability of ADR provisions, of the three decisions that conducted an unconscionability analysis, only the Woodside Homes decision held that binding ADR provisions in real estate sales contract were enforceable; the other two decisions held that such clauses were unenforceable based on unconscionability. And no California decision had upheld either an arbitration or a general reference provision in the CC&R's of a condominium project.

The State of the Law as of 2006

Both Greenbriar Homes Communities, Inc. v. Superior Court (2004) 117 Cal.App.4th 337 and Trend Homes, Inc. v. Superior Court (2005) 131 Cal.App.4th 950 involved sales of new single family homes in large subdivisions. In both cases the developers had included, in ALL of the sales contracts for the homes, binding general judicial reference provisions.

In both cases the courts upheld the validity of the reference provisions. In so doing, both courts recognized that “the validity and enforceability of a judicial reference provision in a home purchase contract must be determined on a case-by-case basis.” Trend Homes, supra, 131 Cal.App.4th at p. 956. The courts then undertook to determine whether the reference provisions were procedurally unconscionable, and considered such factors as: the absence of a meaningful choice not to agree to a reference; whether there was an element of surprise to the provision; and whether similarly priced housing was available in the area.

The courts next analyzed whether the reference provisions were substantively unconscionable, whether the terms of the reference provisions were so one-sided as to “shock the conscience,” and considered such factors as: the home owners were required to bear half of the costs of the reference; the reference provisions did not limit the amount or type of relief the purchasers could obtain; and that the provisions attempted to resolve disputes in an efficient and fair manner, consistent with the rules of evidence that apply to a trial.

Both courts found that the reference provisions were neither procedurally nor substantively unconscionable.

So, as of 2003, only one California decision had held that binding general reference provisions in residential real estate sales contracts were valid. Given that the analysis required to determine whether such provisions are binding is a fact-intensive, “case-by-case basis,” having one case law decision as guidance on the enforceability of such provisions hardly provided reasonable assurances that such provisions were enforceable.

As of 2006, there are now three decisions in a row upholding the validity of binding general reference provisions in residential real estate contracts in actions involving construction defects. The three decisions, taken together, provide solid guidance as to the use of these provisions.

It is still unsettled whether C.C.P. Section 1298.7 invalidates arbitration clauses in contracts for the purchase of residential construction, although the decision in Basura is strong authority that the Federal Arbitration Act preempts such provisions.

Another open issue is whether general reference provisions are enforceable against a homeowner’s association on a condominium project. Recall that the court in Villa Milano held that an arbitration clause in CC&Rs was unenforceable against the association. It is not clear how the Villa Milano court would have ruled if a binding reference provision had been involved. Such binding reference provisions in CC&Rs would be “non-negotiable,” but this element alone may not cause a court to find procedural unconscionability. And reference provisions are not subject to the invalidation of C.C.P. Section 1298.7, which applies only to arbitration clauses. Finally, as the court found in Trend Homes, binding reference provisions are far less onerous to plaintiffs than are arbitration clauses.

Conclusion

The absence of a right to a jury trial in a construction defect case substantially decreases the likelihood of a large, and perhaps irrational, jury verdict, and therefore also reduces the settlement value of the case. This is why the plaintiffs and defendants in the cases discussed

above fought so hard over the enforceability of the clauses that denied plaintiffs this right. However, the trend of California courts is to enforce ADR clauses that effectively waive the right to a jury trial, perhaps influenced in part by the following sentiment expressed by the court in Woodside Homes, *supra*, 107 Cal.App.4th at p. 723:

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.

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