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California Supreme Court Makes it Clear - Arbitration Provisions in Residential CC&RS are Enforceable

8.17.12 | Client Alert
CCN Client Alert

On Thursday, August 16th, the California Supreme Court held in *Pinnacle Museum Tower Association v. Pinnacle Market Development* that a residential developer can compel a condominium homeowners association to arbitrate construction defect claims pursuant to arbitration provisions contained in project covenants, conditions and restrictions ("CC&Rs"). Much anticipated by residential builders and developers, who continue to battle construction defect and other claims brought by condominium associations, the court's ruling is a huge victory for the homebuilding industry.

An Enforceable "Agreement" to Arbitrate. After confirming that the Federal Arbitration Act ("FAA") preempts and prohibits state laws that discriminate against arbitration, the court focused on whether a sufficient "agreement" to arbitrate existed under the CC&Rs. Central to the court's decision was the common interest development statutory scheme known as the Davis-Stirling Act ("Davis-Stirling"). In response to the association's arguments that CC&Rs are inherently not consensual and, therefore, should not be binding on homeowners associations, the court held that the inclusion of arbitration provisions in CC&Rs "is consistent with the Department of Real Estate's contemplation that a recorded declaration may feature a provision for binding arbitration between a developer and an owners' association." There was nothing in Davis-Stirling that prohibited the developer from including an arbitration provision in the CC&Rs. Finally, the court concluded that even though the Association did not participate in the

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drafting of the CC&Rs, the terms of the CC&Rs, including the arbitration provisions, reflected written agreements that were enforceable against the Association.

Arbitration Provisions Not Unconscionable. The court then addressed whether the CC&R arbitration provisions were inherently unconscionable; that is, whether such provisions were unfair. Unconscionability is the primary basis upon which lower California courts previously have struck down arbitration provisions. In this case, the trial court had found procedural unconscionability, including because the CC&Rs were drafted and recorded against the project before the homeowners association was even formed. The high court disagreed. Turning again to Davis-Stirling, the court noted that the CC&Rs were drafted and recorded as "dictated by the legislative policy choices embodied in the ...Act." The court went on to say that "a developer's procedural compliance with the Davis-Stirling Act provides a sufficient basis for rejecting an association's claim of procedural unconscionability." Regarding substantive unconscionability, after a lengthy discussion of the specific arbitration terms relating to legal remedies, cost sharing and the like, the court rejected the Association's arguments and held that the arbitration provisions in the CC&Rs were not substantively unconscionable.

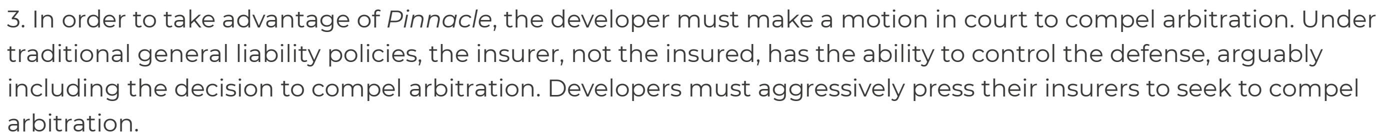
Practical Implications. To be sure, the *Pinnacle* decision provides reason for the homebuilding industry to celebrate. At the same time, the decision likely will not be the last word, especially if those who oppose the ruling try to pursue a legislative antidote. *Pinnacle*, thus, should prompt builders, developers and investors to take a fresh look at their dispute resolution structures and implementation strategies. Some thoughts:

1. For ground-up developers, *Pinnacle* should not be viewed as a carte blanche to include any type of dispute resolution provision in CC&Rs and expect it to be enforceable. *Pinnacle*, even while it recognizes the enforceability of arbitration clauses in CC&Rs, compels builders and developers to take a critical look at their project documents, and to develop a comprehensive and integrated approach to construction dispute resolution. The sales packages and project documents, including purchase agreements, warranties and CC&Rs, should all be aimed at creating fair, reasonable and, most importantly, statutorily enforceable dispute resolution provisions. Consider:

- Incorporating consistent dispute resolution provisions in purchase agreements, warranties and CC&Rs.
- Giving conspicuous and redundant notice to purchasers of the existence of dispute resolution provisions.
- Drafting arbitration provisions to be consistent with the requirements of the California Code of Regulations.

For purchasers of existing projects, whether completed or partially completed, legal due diligence should be conducted to ensure that existing recorded project documents meet all statutory requirements and meet or exceed the guidelines in *Pinnacle*.

2. The court made it clear that the preemptive benefits of the FAA do not apply to California's judicial reference statutes, and in this case implied that judicial reference provisions in CC&Rs might not be treated the same as arbitration provisions. Many builders and developers have preferred judicial reference over arbitration for various reasons. *Pinnacle* should cause reevaluation on this front.



3. In order to take advantage of *Pinnacle*, the developer must make a motion in court to compel arbitration. Under traditional general liability policies, the insurer, not the insured, has the ability to control the defense, arguably including the decision to compel arbitration. Developers must aggressively press their insurers to seek to compel arbitration.

4. The decision applies only to homeowner association arbitration and, thus, does not address capturing homeowners or subsequent homeowners to arbitration, which requires a contractual approach.

5. Even as to associations, the decision does not entirely do away with unconscionability attacks. As such, builders and developers who use arbitration as a means of resolving construction disputes should still expect such attacks in the future.

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