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Homeowners' Association Case May Signal Change in Unconscionability Analysis

By Kenneth R. Van Vleck and Bryan M. Haynes – December 13, 2012

In a case of first impression, the California Supreme Court ruled that, despite the apparent unconscionability of a developer negotiating an agreement “with itself,” the arbitration provision was nevertheless enforceable in *Pinnacle Museum Tower Ass’n v. Pinnacle Market Development*, 55 Cal. 4th 223, 282 P.3d 1217, 1221 (2012).

Facts and Procedural History

Pinnacle Market Development developed a mixed-use condominium known as the Pinnacle Museum Tower Condominium. Pursuant to California’s Davis-Stirling Common Interest Development Act, the developer drafted and recorded a “Declaration of Restrictions” to govern the use and operation of the condominium. The declaration contained a number of easements, restrictions, and covenants, which are “binding on all parties having any right, title or interest” in the property, and their heirs, successors, and assigns. The declaration also created the Pinnacle Museum Tower Association.

The declaration dictated that, by accepting a deed to any part of the condominium, the association and each individual unit owner agreed to waive any right to a jury trial in the event of a dispute with the developer. Instead, the declaration required that any construction disputes would be resolved exclusively through binding arbitration in accordance with the Federal Arbitration Act (FAA) (9 U.S.C. § 1 et seq.) and the California Arbitration Act (California Code of Civil Procedure § 1280 et seq.). The declaration’s arbitration clause also specifies that no amendment may be made to its terms without the developer’s written consent.

The association filed an action against the developer, seeking recovery for damage to its property and damage to the separate interests of the individual unit owners as a result of an alleged construction defect. The developer petitioned to compel arbitration, based on the arbitration clause in the recorded declaration of covenants, conditions, and restrictions. After decisions in favor of the association in the trial court and court of appeal, the developer appealed to the California Supreme Court.

The California Supreme Court’s Analysis

To determine whether the arbitration clause was binding on and enforceable against the association, the California Supreme Court considered the rules governing compelled arbitration of claims, the principles relating to the contractual nature of the covenants and restrictions in a declaration recorded pursuant to the Davis-Stirling Act, and the doctrine of unconscionability.

Arbitration under the FAA

Both the trial court and the court of appeal determined that the FAA applies to the declaration because materials and products incorporated into the condominium were manufactured in other states. The Supreme Court adopted that finding.

Section 2 of the FAA provides in relevant part: “A written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.” The court had no trouble determining that the declaration is a contract, subject to the FAA.

Having determined that the FAA controls, the court considered whether it trumps section 1298.7 of California’s Code of Civil Procedure, which allows a purchaser to bring a construction and design defect action against a developer in court, in spite of a written agreement to arbitrate those claims. The court found that the FAA preempts the law because it discriminated against arbitration. Thus, the court needed only to determine whether there were other independent grounds to invalidate the arbitration agreement.

Enforceability of the Arbitration Agreement

In holding that the arbitration clause in the declaration was not binding on the association, the court of appeal found that the association could not have agreed to arbitrate or waive its constitutional right to a jury trial, because “for all intents and purposes, [the developer] was the only party to the ‘agreement,’ and there was no [association] when [the developer] recorded the” declaration.

But the California supreme court disagreed, finding that various legal theories allow for delegated authority to consent. The court cited common-law principles such as fiduciary duty and agency, which permit enforcement of arbitration agreements against non-signatory third parties. The court held that there was no question that “each owner of a condominium unit either has expressly consented or is deemed by law to have agreed to the terms in a recorded declaration.” And in so ruling, the court concluded that the individual members of the association can expect that the association itself will also be bound by the arbitration provision and that it will abide by the covenants in the declaration, including, of course, the covenant to arbitrate construction disputes with the developer.

In his dissenting opinion, Justice Kennard reached the opposite conclusion, arguing that the right to a jury trial is guaranteed by the California constitution and can be deprived only by knowing consent, which is absent when the allegedly consenting party did not even exist at the time the consent was “given.” Justice Kennard concluded that “the majority deprives the owners association of its constitutional right to have its construction defect dispute decided by a jury.”

The California Supreme Court also disagreed with the court of appeal’s reliance on dispute resolution schemes in the California Civil Code (section 1369.510(a)), which states: “The form of alternative dispute resolution chosen pursuant to this article [governing enforcement actions filed by an owner or an association] may be binding or nonbinding, *with the voluntary consent of the parties.*” The court of appeal reasoned that the italicized clause meant that a waiver of the right to a jury requires an actual agreement and that arbitration provisions in a recorded declaration were not agreements and, therefore, not enforceable. But the supreme court disagreed with that reasoning, finding that the Civil Code’s language in section 1369.510(a) “simply adheres to the familiar principle that arbitration is a matter of consent, not coercion.”

The majority opinion seems to conclude without analysis that the individual members of the association, having accepted their deeds and, by extension, the covenants that run with them, bound the association to the arbitration provisions in the declaration. The decision turns on this key point. Yet, the court did not materially expound on its reasoning other than to say that past authority compels its conclusion:

In sum, even though the Association did not bargain with [the developer] over the terms of the [declaration] or participate in their drafting, it is settled under the statutory and decisional law pertaining to common interest developments that the covenants and terms in the recorded declaration, including [the arbitration clause], reflect written promises and agreements that are subject to enforcement against the Association.

The Doctrine of Unconscionability

Having determined that the arbitration provision was binding on the association, the court next considered whether the provision was unconscionable and, thus, unenforceable.

Under California law, unconscionability consists of both procedural and substantive elements. The procedural element addresses the circumstances of contract negotiation and formation, focusing on oppression or surprise due to unequal bargaining power. Substantive unconscionability pertains to the fairness of an agreement's actual terms and to assessments of whether they are overly harsh or one-sided. Under California law, a "contract term is not substantively unconscionable when it merely gives one side a greater benefit; rather, the term must be "so one-sided as to 'shock the conscience.'" *Pinnacle*, 282 P.3d at 1232.

The trial court found no evidence of surprise but perceived a high degree of procedural unconscionability because the declaration was drafted and recorded by the developer before any unit was purchased and before the association was formed. The trial court determined that the arbitration agreement was therefore oppressive. But the supreme court disagreed.

The supreme court reasoned that the developer's compliance with the statutory scheme for creating a common interest development showed that there was no procedural unconscionability. "Thus, while a condominium declaration may perhaps be viewed as adhesive, a developer's procedural compliance with the Davis-Stirling Act provides a sufficient basis for rejecting an association's claim of procedural unconscionability."

Likewise, the court found that the arbitration provisions were not substantively unconscionable. The court remarked that "the Department of Real Estate reviewed and approved" the declaration as part of the development process. And the court found that the association, bearing the burden of proving unconscionability, neglected "to identify any aspect . . . that is overly harsh or so one-sided that it shocks the conscience."

The association argued that the declaration required the association to obtain the developer's written consent before amending the arbitration provisions. Because the developer drafted the document before the association existed as an independent entity, the association contended, "the consent provision demonstrates that [the developer] was 'looking after its own self-interests' and playing 'unfairly to its unilateral benefit.'" Again, however, the court found these arguments to lack merit.

The court said that the statute governing these declarations "specifically contemplates that a recorded declaration may restrict or even eliminate the authority of an owners association and owners to amend its terms." Cal. Civ. Code § 1355(b). More to the point, though, the statute "flatly prohibits a court from approving any amendment to a declaration that '[w]ould eliminate any special rights, preferences, or privileges designated in the declaration as belonging to the declarant, without the consent of the declarant.'"

The Conclusion and Disposition of *Pinnacle*

The California supreme court relied heavily on the Davis-Stirling Act in finding that even when there is no strict privity of contract, the manifested intent and expectations of the developer, as reflected in the declaration, will be honored and enforced unless they are unreasonable. In *Pinnacle*, the court found that "the expectation of all concerned is that construction disputes involving the developer must be resolved by the expeditious and judicially favored method of binding arbitration."

Other States Have Not Considered the Issue

Other jurisdictions have not yet weighed in on this topic. In North Carolina, however, the court of appeals considered whether two homeowner associations' construction defect claims against a builder were subject to mandatory arbitration. The builder asserted that arbitration was mandatory, under both the third-party warranty provided to each homeowner and the associations' declarations.

In *University Heights Community Ass'n v. Portrait Homes Construction Co.*, 2007 N.C. App. LEXIS 1586 (N.C. App. July 17, 2007), the North Carolina Court of Appeals analyzed the dispute's arbitrability under North Carolina law, which requires a determination of whether the parties have a valid agreement to arbitrate and whether the specific dispute falls within the scope of that agreement.

Unlike in *Pinnacle*, the North Carolina court assumed that the parties had agreed to arbitrate through the declarations. The court did not analyze whether the arbitration provisions in the declarations were valid agreements or whether they represented agreement between the builder and itself, as in *Pinnacle*. Nor did the court analyze whether the arbitration provision was unconscionable. Instead, it found that the parties' dispute fell outside the declarations' arbitration provisions, because those provisions exempted any disputes involving parties that were not "Bound Parties" under the declarations. Because the developer had named a subcontractor as a third-party defendant and that subcontractor was not a "Bound Party" under the declarations, the court found that the dispute was exempt from arbitration.

The correlation between these two cases lies in the fact that the North Carolina court simply assumed that the declarations contained a valid, binding arbitration agreement and was not called upon to determine its unconscionability because the North Carolina court simply determined that a non-bound party was included as a defendant, and under North Carolina law, the presence of a non-bound party may defeat enforcement of an arbitration provision.

In *Roberson v. The Cliffs Communities, Inc.*, 2010 U.S. Dist. LEXIS 68540 (D.S.C. July 8, 2010), a federal district court in South Carolina granted a developer's motion to compel the arbitration of a dispute between individual homeowners and the developer. The homeowners alleged that the developer refused to approve the design for their residence and that the developer failed to provide promised amenities. The developer moved to compel arbitration based on the community's declaration, which mandated the arbitration of disputes between the developer and homeowners relating to the declaration or the development. The homeowners claimed that the declaration's arbitration provision was not incorporated into their sales agreement and therefore was not binding.

The South Carolina district court found that the declaration's arbitration provision was incorporated into the sales agreement, however. Accordingly, the court did not need to analyze whether the homeowners agreed to the declaration, because the homeowners had agreed to the sales agreement. The court also did not analyze whether the arbitration requirement was unconscionable. Reasoning that the homeowners' claims dealt with their dissatisfaction with the development (as defined in the declaration), as well as their dissatisfaction with the enforcement of the declaration's restrictions, the court found that the homeowners' claims fell within the scope of the arbitration provision, but the court noted that it was "a close call."

The Reach of *Pinnacle*

The impact of *Pinnacle's* unique analysis on California homeowners' associations is clear. What it means more generally for homeowners' associations throughout the country remains to be seen. It seems very likely that developers in all jurisdictions will rely on *Pinnacle* when drafting conditions and covenants that are beneficial to them. When those self-interested restrictions conflict with constitutionally protected rights, as in California, the *Pinnacle* analysis and outcome may be a model for other courts in balancing those conflicting rights and responsibilities.

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