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HOMEOWNER ASSOCIATIONS AND MEMBERS NOT NECESSARILY BOUND BY ARBITRATION PROVISIONS IN CC&RS OR IN RELATED PURCHASE AGREEMENT WHERE DEVELOPER IS INITIAL DECLARANT

Pinnacle Museum Tower Association v. Pinnacle Market Development (US) LLC, No. D055422 (4th Dist. July 30, 2010)

By Michael Wilmar and Aaron Kleven

Homeowners and homeowner associations are not necessarily bound by arbitration provisions in a declaration of covenants, conditions and restrictions, or in a related purchase agreement, where the developer is the initial and only declarant. That is the implication of a July 30th ruling of the Fourth District of the California Court of Appeal. In Pinnacle Museum Tower Association v. Pinnacle Market Development (US) LLC, a homeowner association brought a construction defect suit on behalf of itself and its members for damage to common areas. The developer of the condominium project attempted to block the suit, claiming the plaintiff was bound to an arbitration provision recorded in the project CC&R's. It argued the provision committed the Association to resolve all construction disputes through arbitration and waived the Association's right to a jury trial. The purchase and sale agreements signed by the individual condominium owners also contained a jury waiver and a provision compelling owners to comply with the arbitration provision in the CC&R's. But the court concluded that the provision in the CC&R's did not constitute an agreement sufficient to wave the Association's constitutional right to a jury trial. And it found the corresponding provision in the purchase and sale agreement unconscionable and unenforceable against the individual owners.

The problem with the arbitration provision in the CC&R's was that the Association had no meaningful opportunity to agree to it. This arises from the way most homeowner associations are created. The developer (Pinnacle) drafted the CC&R's, including the arbitration provision, before the formation of the homeowner association. The Association then "[sprung] [sic] into existence" when the developer recorded the declaration. Pinnacle signed the CC&R's in its capacity as the Association's creator and initial declarant. The effect was that the CC&Rs were in effect before the Association had begun to function as a genuinely independent entity. Neither it not any of its members (other than the developer) ever had the opportunity to agree (or not agree) to waive their rights. As the court explained:

> Based on the application of fundamental contract formation principles, we fail to see how the Association could have agreed to waive its constitutional right to a jury trial because, for all intents and purposes, Pinnacle was the only party to the "agreement," and there was no independent homeowner's association when Pinnacle recorded the CC&R's.

The court noted the absence of any express or implied conduct on the part of the Association indicating acceptance of the agreement. It found that the Association had no choice in the matter, and ruled that such a transaction could not form the basis of a binding agreement.

The decision marked a departure from the court's previous decision in Villa Milano Homeowners Ass'n v. Il Davorge, 84 Cal.App.4th 819 (2000), in which it had found the CC&R's to be a binding contract between a developer and a homeowner association. The court declined to follow that portion of the Villa Milano decision, calling it "poorly reasoned" and noting that the Villa Milano court was aware of the lack of an analytical framework for addressing "why the homeowners association, which makes no purchase, is also bound contractually." The Pinnacle court relied instead on its decision in Treo @ Kettner Homeowners Ass'n v. Superior Court, 166 Cal.App.4th 1055 (2008), in which it also declined to follow Villa Milano. In Treo, the court concluded that a provision in the CC&R's making all disputes between a developer and a homeowner association subject to judicial reference was not a written contract, and hence insufficient to waive a constitutional right like trial by jury. The Treo court, explaining the lack of meaningful consent, noted the exhaustive length of most CC&R's; that they are often written long before units are purchased; that they cannot be modified by the association; and that they are not signed by the parties. While the Pinnacle developer tried to distinguish Treo because it involved only judicial reference, the court found the general principal of voluntary consent between parties to be equally applicable to arbitration.

The developer also advanced an argument that the Association should be bound to the contract as a third party beneficiary, referencing Motorsport Engineering, Inc. v Maserati SPA, 316 F.3d 26 (1st Cir. 2002), in which a non-party to a contract was able to enforce it. But the court rejected this, noting that the case supported a third party beneficiary seeking enforcement of a contract but not a *party* to the contract seeking enforcement against a third party. In other words, the Association, as a third party beneficiary, might have the right to enforce the contract against the developer, but the developer, as a party to the contract, would not have that same right against the Association.

But the court clarified that this does not mean a developer cannot place an arbitration provision in CC&R's. What made this provision unenforceable was the fact that it could not be modified by the Association or a homeowner without the written consent of the developer. As a viable alternative, the court suggested a provision that would let an association and its members decide via the amendment process whether to ratify

a binding arbitration provision. It also suggested that a provision that went into effect automatically if an association failed to amend would be acceptable. The court stressed the “knowing and voluntary agreement” of all parties. Without this the right to a jury trial could not be waived.

The court also found the jury waiver in the purchase and sale agreement, and its reference to the arbitration provisions of the CC&R's unconscionable. Thus, even if it had decided that the Association was bound by the CC&R’s, individual owners would not be. The purchase and sale agreement contained a jury waiver, which the court noted was not emboldened or capitalized. It also included a clause whereby the owner agrees to "comply with Article XVIII of the [CC&R's] with respect to the dispute referenced therein." This clause *was* emboldened and capitalized, but contained no reference to arbitration, the subject of Article XVIII. Nor did it explain the types of disputes for which the owners had waived their right to a jury. To discover this information, the owner would have to read the CC&R's, which the developer had recorded but did not provide.

The court, relying on Chan v. Drexel Burnham Lambert, Inc., 178 Cal.App.3d 632 (1986) and King v. Larsen Realty, Inc., 121 Cal.App.3d 349 (1981), ruled that to provide for arbitration in a secondary document, an agreement must make a clear and specific reference to that document, and the contracting parties must know or have easy access to the terms of that document. The court did not view simply recording the documents as sufficient to satisfy these requirements. Without easy access the court found there would be a high degree of surprise because the purchaser had no easy way of finding out what rights are being waved.

The court also found the provisions unconscionable because they were presented on a take-it-or-leave-it basis at the end of a lengthy legal document. This, combined with their not being modifiable without the developers consent, meant the purchaser had no opportunity to negotiate the provision.

In addition, the court found the provision unfairly one-sided. It noted that the kinds of construction disputes subject to arbitration by the provision are the type most likely to be brought by an individual owner against the developer. It pointed out that numerous courts have found arbitration agreements unconscionable if they apply only to the types of claims likely to be brought by the weaker party, but exempt types of claims likely to be brought by the stronger party.

Judge O’Rourke wrote a brief dissent, adhering to the reasoning of Villa Milano, which essentially found that individual owners have constructive notice of the CC&R’s, and reasoned that they should not be permitted to use the Association as a “shell to avoid the application of the arbitration clause.” Judge O’Rourke also found no evidence of unconscionability, viewing the written consent clause as a simple application of California contract law, which states a contract cannot be modified without the consent of all parties.

The effect of this decision seems to be that developers cannot bind a homeowner association or an individual

homeowner to an arbitration provision without giving them an opportunity to agree to it as an independent party. Drafting a binding arbitration agreement into the CC&R's upon creation of the homeowner association may not guarantee the association is bound to that agreement. Furthermore, presenting the arbitration provision to individual purchasers on a take-it-or-leave-it basis might not form the basis of a binding contract. The court noted the fact that a jury trial is a constitutional right. It is unclear whether this ruling applies to provisions affecting rights that are not protected by the constitution.

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