SUMMER

Lorber, Greenfield & Polito, LLP

Perspectives

MANDATORY ARBITRATION IN CONSTRUCTION DEFECT CASES: FRIEND OR FOE

by Ron U. Lunski, Esq. and Travis R. Campbell, Esq.

Introduction

It is increasingly common for civil disputes to be resolved in arbitration rather than in court. With respect to construction defect cases, this is particularly true in both homeowner association and single-family home cases. While arbitration is a quick and relatively inexpensive way to resolve a construction defect dispute, there are some important advantages and disadvantages to arbitration from the perspective of a contractor/developer.

There are two types of arbitration: binding and non-binding. In binding arbitration, the parties agree to waive their right to go to court for a judicial and/or jury decision. In non-binding arbitration, the parties have the discretion as to whether to abide by the arbitrator's decision. Non-binding arbitration usually takes place as a form of alternative dispute resolution (ADR) at the election of the parties or as ordered by the court.

Binding arbitration almost always arises from a contractual obligation to submit to arbitration if a dispute arises pertaining to the performance and enforcement of the subject contract. In construction defect cases, a binding arbitration provision is often found in the contract between 1) the developer and the buyer of a single family home, 2) the developer and homeowner's association as defined in the CC&Rs, 3) the general contractor and the homeowner for the construction of a custom home or major repairs to a home, 4) the builder/contractor and its subcontractors, or 5) the subcontractors and product manufacturers involved in a particular project. Sometimes a situation

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Inside this issue:

ARIZONA BUILDERS RECEIVE FAVORABLE DECISIONS ON THE DUTY TO DEFEND

by Jill Ann Herman, Esq.

Over the last year, builders continue to receive favorable decisions from the Arizona Appellate Courts on defense obligations owing pursuant to indemnity obligations in insurance policies. Arizona litigants are still adapting to the ramifications of *Lennar Corp., et al. v. Auto-Owners Ins. Co., et al.*, 151 P.3d 538 (Ariz. Ct. App. 2007) which was decided over a year ago.[1] In *Lennar*, the court reconfirmed that the duty to defend was broader than the duty to indemnify and, more importantly, found that written evidence of a contractual requirement to name the builder as an additional insured ("AI") will trigger an "AI" defense obligation. With respect to the AI defense obligation, this confirmation is critical given that the majority of Arizona builders' subcontract agreements contain language requiring a subcontractor to name the builder as an additional insured.

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occurs where there is an arbitration agreement between a developer and the homeowner, but not the general contractor and the subcontractors involved in the construction of the home. Conversely, a situation can arise in which there is an arbitration provision contained in the contract between the developer and the subcontractors but no arbitration provision contained in the contract between the developer and the homeowner. In such cases, there would be no way to bring all of the necessary parties into the arbitration and the case can either proceed in court *in lieu* of arbitration if all of the parties agree to do so, or the case may have to be divided with some parties pursuing their claims in arbitration and others having to pursue their claims in court.

In 1984, the United States Supreme Court stated that "the Federal Arbitration Act (FAA or Act), 9 U.S.C. §1, *et seq.* (2000 ed. and Supp. V), establishes a national policy favoring arbitration when the parties contract for that mode of resolution." The authority to create the Act derives from the Commerce Clause of the U.S. Constitution, and, therefore, the substantive rules of the Act were intended to apply in both federal and state court proceedings. However, while we have now had for more than twenty years a "national policy" favoring arbitration when the parties agree to arbitrate their dispute, the question remains, do the contracting parties favor private arbitration as the best mode of resolving their disputes?

Advantages of Arbitration

Of all the methods of ADR, arbitration most closely resembles legal proceedings in court. Private arbitration is a more relaxed forum, particularly with respect to rules governing admissibility of evidence, and because of this, the trier of fact is generally more concerned with the substance of the dispute rather than the parties' compliance with procedural and evidentiary rules. This focus on 'substance over procedure' can be further bolstered in private arbitration because the parties are free to select the trier of fact: instead of an attorney or retired judge whose knowledge of a particular subject matter may be limited, the parties may benefit from choosing an arbitrator(s) with expertise in the specific field at issue.

Typically, there is no public record of the pleadings and arbitration proceedings. It is also relatively quick and inexpensive, with the parties having broad control over the proceedings and nature of the arbitration. The entire case is usually resolved within less than one year from the date the action is filed. Although the arbitrator's award may be reduced to a judgment, the contracting parties have broad discretion to define the degree of confidentiality of the award and proceedings.

Disadvantages of Arbitration

The path of private arbitration, of course, has its fair share of potential hazards. Many of the benefits of private arbitration can quickly become detriments when precise arbitration procedures are either not precisely defined and/or not adhered to. Whereas private arbitration's relaxed procedures encourage the arbitrator(s) to focus on substance over procedure, those same relaxed procedures fail to offer many of the protections afforded by civil rules. For instance, discovery is not permitted as a matter of right; therefore relevant documents, depositions of witnesses, disclosure statements and the like are not available, though the arbitrator(s) may require—or the parties may agree to—the exchange of certain relevant information. Moreover, since the arbitrator does not strictly adhere to evidentiary rules, unsubstantiated hearsay and/or documents without established validity can be entered as evidence which may form the basis of an award.

Another disadvantage to arbitration is the procedural inability to join necessary third-parties as cross-defendants or third-party defendants. Generally, the only parties who may be joined to a private arbitration are those parties who are bound by contract, or who subsequently stipulate to arbitration and/or the arbitrator(s)' decision. Accordingly, a subcontractor whose negligence is at issue with respect to damage cannot be brought into, nor be bound by, a private arbitration decision.

Arbitrators are not required to be lawyers or judges; hence, it becomes problematic where the arbitrator makes incorrect legal decisions pertaining to evidentiary matters and/or issues pertaining to the burden of proof. Furthermore, many

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arbitrators do not have experience in construction defect litigation. While the arbitrator selection process generally provides an opportunity for the parties to select the arbitrator, there is no guarantee that agreement between the parties will be reached.

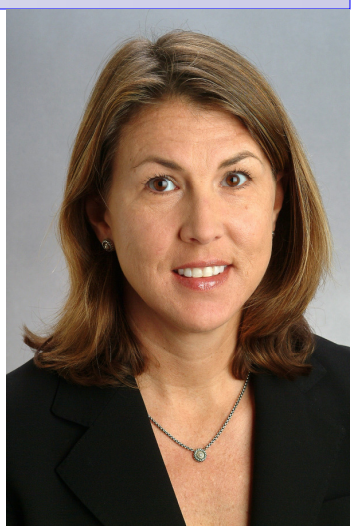
Geography can also make a difference with respect to the type of awards arbitrators render in construction defect related arbitration. For example, arbitrators in Northern California have a history of making arbitration awards that very often favor the homeowners while arbitrators in Southern California and Arizona tend to try to split their decisions down the middle by awarding the homeowners half of what they wanted. Often times these split decisions result from the fact that many of the arbitrators also serve as mediators and don't want to upset any of the parties to the arbitration by ruling completely in favor of one side or another.

Finally, perhaps the "ugliest" aspect of private arbitration is where the arbitrator issues a decision based on wrong facts or law and the award is held sacrosanct by the court. Generally, there is no right to appeal. Trial courts provide great deference to the arbitrator's award and the arbitrator(s)' decision can only be set aside in very narrow circumstances, *i.e.*, corruption, fraud, evident partiality by an arbitrator, excess of authority, etc. Within the confines of the arbitration, the decision of the arbitrator as to the facts and law is usually final and, therefore, it will not be reversed by a court even where the court believes the ruling is erroneous.

Conclusion

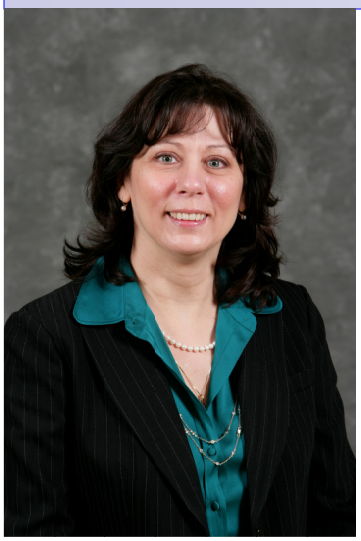
Both State and Federal courts have shown that they will honor the parties' agreement to arbitrate as written. Consider the factors discussed herein before you decide to arbitrate. The advantages to arbitration can quickly dissolve with non-binding arbitration where a decision is not enforceable, binding arbitration where the "runaway" arbitrator issues a decision based on incorrect facts and/or law, or binding arbitration where a necessary third-party is not bound by the arbitrator's decision. Be careful and aware. ❖

FEATURED PARTNER. . .



Lisa Cappelluti joined Lorber, Greenfield & Polito in 2005 to open the San Francisco office for the firm. She is a native of California and has been a construction lawyer in the Bay Area for the past twelve years. She attended Santa Clara University and the University of San Francisco Law School, and was admitted to practice in 1995. Throughout her career, she has been actively involved in various professional organizations including the San Francisco Barristers Club, Construction Law Section, Earl Warren Inn of Court, ABA Construction Law Committee and State Bar of California Litigation Section, Executive Committee. Ms. Cappelluti has significant construction trial experience, which in one case led to the published decision of *Kimbark v. McCrary* concerning delegation of responsibilities and indemnification application in a commercial construction injury case. She was active in many of the early mold/construction cases and represented a general contractor in one of the earliest mold/environmental cases in 1996 in the Bay Area. Ms. Cappelluti recently acted as moderator for the Northern California Section of the 2008 Meeting of the Masters, which included a panel of construction special masters discussing recent updates in construction law cases. The Northern California office has now grown to include ten exceptional construction attorneys assisted by a twelve person staff to create a highly skilled legal team. ❖

ARIZONA BUILDERS RECEIVE FAVORABLE DECISIONS ON THE DUTY TO DEFEND (Continued from Front Page)



Recently, in *Regal Homes, Inc. v. CNA Insurance*, 518 Ariz. Adv. Rep. (App. Div. 1, 2007), the Court of Appeals expanded the *Lennar* decision, finding that oral evidence of a contractual requirement to name the builder as an AI was sufficient to trigger the duty to defend. In *Regal*, the trial court granted summary judgment in favor of the subcontractor and a final judgment was entered from which no appeal was taken; accordingly, the court assumed that the subcontractor was not at fault for the alleged defects. The blanket additional insured endorsement, however, provided that the builder was an additional insured with respect to liability "arising out of" the subcontractor's work and the Appellate Court determined that the requisite nexus ("arising out of") was established. The *Regal Homes* court confirmed, again, that the duty to defend is still broader than the duty to indemnify and, more importantly, found that this duty exists even where there is a determination of **no fault or liability by the subcontractor**. Accordingly, in lieu of the "causation" standard, the "arising out of" standard will be the applicable standard to apply in determining the duty of an AI insurer in providing a defense to the additional insured developer/builder.

Finally, in analyzing whether or not a defense obligation is owed, the common question is whether the builder's alleged liability "arises out of" a subcontractor's work. This determination is made from the allegations of the complaint or facts known at the time. *See*, *Kepner v. W. Fire Ins. Co.*, 109 Ariz. 329, 331 (1973). Accordingly, if a builder tenders a pre-litigation notice under the Purchaser Dwelling Act, A.R.S. §12-1361, *et seq.*, or complaint, potential AI insurers need to be aware that they may have an immediate defense obligation owing, regardless of whether or not there is written documentation of a duty to defend and/or fault of their named insured. The *Regal* court also confirmed that an AI insurer may, in fact, assume the legal obligation of becoming the "sole" primary insurer if the subcontract terms provide that such coverage be primary and noncontributory to the direct coverage of the developer/builder. ❖

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1 In *Lennar*, the Court of Appeals finally provided Arizona builders with much needed answers to, as well as confirmations of, important coverage questions where there is ongoing property damage and/or multiple insurers. Specifically, the court held that 1) accidental property damage to property resulting from a continued exposure to faulty construction is an "occurrence" under a CGL policy; and 2) ongoing property damage during the policy period triggers a defense obligation even if other similar damage preceded the policy period.

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QUICK CASE SUMMARIES IN CALIFORNIA

by David B. Roper, Esq.

In ***Johnson v. American Standard Inc.***, (2008) 43 Cal.4th 56, the California Supreme Court decided that a sophisticated user defense defeats all causes of action for a manufacturer's alleged failure to warn.

In ***Bruni v. Didion***, (2008) 160 Cal.App.4th 1272, the California Court of Appeal refused to enforce an arbitration clause, holding that the arbitration provision was unconscionable where it was contained in a contract of adhesion and where it violated plaintiffs' reasonable expectations. Plaintiffs purchased single-family homes which came with "an added bonus" or "extra protection", *i.e.*, an express limited warranty. In actuality, the express warranty was limited and contained an arbitration provision purporting to require the purchaser to arbitrate disputes arising from or related to not only the warranty, but also the home, the sale of the home, and the arbitration provision itself.

In ***Metters vs. Ralphs Grocery Company***, (2008) 161 Cal.App. 696, the California Court of Appeal (4th District) decided that an arbitration clause is not binding where the person who signed it is unaware that it is a contract. Plaintiff alleged racial discrimination and was provided by the employee relations manager a Notice of Dispute and Request for Resolution form. This form stated that the employee was agreeing to submit the dispute to informal resolution and if the employee wanted to pursue his or her claim further, the employee would have to resolve the dispute through mediation or binding arbitration. The plaintiff signed the form.

In ***Great West Contractors Inc. vs. WSS Industrial Construction Inc.***, (2008) 162 Cal.App. 4th 581, the California Court of Appeal (2nd District) found that a subcontractor was barred from bringing suit against a general contractor because the Construction Services Licensing Law requires a subcontractor to be licensed at all times. ❖

RECENT COURT DECISIONS IN ARIZONA

by Louis W. Horowitz, Esq.

In ***Levy v. Alfaro***, 160 P.3d 1201 (2007), Arizona's Supreme Court denied review of an appellate ruling on Offers of Judgment, Rule 68 of the Arizona Rules of Civil Procedure which provides for a sanction of "reasonable expert witness fees and double the taxable costs" incurred after making the offer. The Court examined the definition of sanctions that are awardable against a party who rejects an Offer of Judgment and ultimately obtains a less favorable result and confirmed that "reasonable expert witness fees" under Rule 68 were not limited to costs of testifying and specifically included other fees such as investigation.

In ***Pueblo Santa Fe Townhomes Owners' Assn. v. Transcontinental Insurance Company, et al.***, 178 P.3d 485 (App. 2008), The Arizona Court of Appeals (Division 1) determined whether or not an insurer was estopped from asserting coverage defenses, *i.e.*, "your work" exclusion, under a commercial general liability policy where the insured entered into a $1.1 million *Morris* agreement with the Association. The trial court found that the insurer knew that a potential policy defense existed for approximately eighteen months without informing its insured. During this time frame, the insurer controlled the litigation defense, including all discovery, investigation, and strategy, as well as the right to settlement. The trial court concluded that the eighteen month delay by the insurer prejudiced the subcontractor since it did not have an opportunity to have its own expert participate in destructive testing, which would have supported a defense to the claims against it. Specifically, the insurer was estopped from asserting coverage defenses and denying coverage since it did not "properly and timely communicate" its reservation of rights.

In ***1800 Ocotillo, L.L.C. v. The WLB Group, Inc.***, 176 P.3d 33 (App. 2008), the Arizona Court of Appeals (Division 1) held that public policy does not prohibit contractual limitation of liability provisions in construction or architect/engineer contracts. Specifically, the court stated that the enforceability of those provisions must be decided by a jury. The language at issue had a limitation on indemnity to the extent of the amount paid, which is a term that is often used in architects' and engineers' agreements.

In ***Schrum v. The Burlington Northern Santa Fe Railway Co.***, 2007 U.S. Dist. LEXIS 38139 (D. Ariz. May 24, 2007), the United States District Court of Arizona, interpreting Arizona law, upheld the duty to defend obligation owing under an express indemnity provision. The District Court rejected various defenses to the contractual defense obligation, including conflict of interest, insufficient notice and lack of specificity in the tender, lack of a defense obligation under the agreement, and sole negligence of the indemnitee. ❖

WHO WE ARE . . .

Bottom Row From Left: *Bruce W. Lorber, Joyia Z. Greenfield and Steven M. Polito*
Top Row From Left: *Holly P. Davies, Jill Ann Herman, Thomas F. Olsen, J.D. Turner and Lisa M. Cappelluti*

Lorber, Greenfield & Polito, LLP is a full-service civil litigation defense firm. The Firm was established in 1980 and is A-V rated with Martindale-Hubbell. Lorber, Greenfield & Polito, LLP handles a broad range of civil litigation matters. The primary emphasis of our practice has been and continues to be representation of developers and general contractors in complex construction defect claims. The Firm has had over twenty-five years of experience in representing developers and general contractors in some of the largest construction defect and civil litigation cases in the States of California and Nevada. Litigation matters are handled throughout California, Arizona and New Mexico.

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We welcome suggestions for future articles. Please contact Julie Young at Lorber, Greenfield & Polito, LLP, 13985 Stowe Drive, Poway, California, T: 858.513.1020; E: jyoung@lorberlaw.com

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