Heads We Win Tails You Lose:

How "*Cherry Picking*" SB 800 Has Created The *Perfect Storm* For Unconscionability Litigation

I. INTRODUCTION

In the landmark case *Aas v. Superior Court* (2000) 24 Cal. 4th 627, the California Supreme Court prohibited tort recovery for "*economic loss*" cases, where defects had not yet manifested into actual physical harm.

> "Defects are not enough: 'appreciable, non-speculative present injury' is an essential element of a tort cause of action." *Aas* at 646.

This highly controversial case created an avalanche of industry discussion and subsequent legislative tinkering intended to improve California construction defect claims.

Remarkably, legislative action was actually invited by the *Aas* Supreme Court which held that a *rule for defects without damage* is best left to the legislature:

> "In our view, the many considerations of social policy. . emphasize that certain choices are better left to the Legislature. That body has at its disposal, a wider range of options and superior access to information about the social costs and benefits of each. Legislatures in making such policy decisions, have the ability to gather empirical evidence, solicit the advice of experts, and hold hearings at which all interested parties may present evidence and express their views." *Aas, supra*, 652.

This judicial "*punt*" bypassed the opportunity to address how trial courts should handle "serious defects" that were certain to manifest serious damage in the near future. Chief Justice George, in his dissent asked;

> "Why should a homeowner have to wait for a personal tragedy to occur in order to recover damages to repair known serious building code safety defects caused by negligent construction? It obviously is preferable to pay a relatively few dollars at an early date to correct a serious safety risk that may cost millions or billions of dollars to redress if inhabitants are forced to wait for disaster to strike and for death, personal injury or property damage to ensue." (*Aas* dissent, 653,654 C.J. George)

This question would ultimately be addressed by the legislature in the enactment of SB 800, which allows for recovery for defects without damage in certain circumstances. *Civil Code* section 895 et.seq.

SB 800 followed *Aas* as the long awaited "*Messiah*" bringing light to practitioners of residential construction defect litigation. Certainly, the expectations for this post *Aas* legislation was high:

- Manifestation of damages under *Aas* was supposed to be explained;
- appreciable property damage was supposed to be defined;

- guidelines for handling serious defects that had not yet shown "appreciable damage" were supposed to be enacted, and
- building standards that could function as "standards for claims" were to be enacted to help the courts define when the parties had "actionable defects."

Unfortunately, the California Legislature acted with more haste than judgment. In 2002, a transportation bill was hijacked by the legislature and its entire contents deleted and swiftly replaced with SB 800, the new "fix it" legislation that would "fine tune" the residential construction industry claims practice. Unfortunately, SB 800 became a "*devil's compact*" between lawyers, the construction industry and their insurers by legal commentators. (*James Acret* cite)

Eventually, SB 800, CC §895 et. seq., would include significant "pro buyer" provisions that would protect home buyers at builders' expense. It is these "consumer friendly" provisions of SB 800 that builders are now actively attempting to "*defang.*" Whether they are successful will depend on the court's interpretation of legislative intent and whether "public policy" allows SB 800 to be "cherry picked" to permit builder's sympathetic purchase contracts.

Chapter 2, CC §896, the "*actionable defect"* standards[1], is sometimes called the legislative "*super building code*," enacted into SB 800, so that litigating parties would know which defects are "actionable" and which are not. Significantly, serious actionable defects were enacted within SB 800 that **do not** require actual manifestation of physical harm. Predictably, many of those actionable defects standards are being modified by builder contracts to eliminate builder liability, in violation of stated legislative policy.

Chapter 4, the extensively ordained "*pre-litigation*" procedure, is being replaced with non binding "*feel good Kumbaya*" kinds of "*non adversarial*" procedures that were neither contemplated nor intended by the legislature. We will ask whether CC §914, the Election to Pursue Other Non-Adversarial Contractual Procedures" is being abused by builders to eliminate CC §905, the Enhanced Protection Agreements.

Specifically, how are practitioners to assert that SB 800 builder contracts, are one-sided, unfair and unconscionable? Can these new "untested" builder contracts pass procedural and substantive due process muster? Do they violate the letter and the spirit of SB 800 when builders "*cherry pick*" the *good stuff* from SB 800 and eliminate the pro buyer provisions?

II. THE PUBLIC POLICY UNDERLYING SB 800 AND ITS MAJOR PROVISIONS

Let us consider for a moment the high minded legislative history for SB 800, in which the California Legislature proclaimed:

a. "The California system for the administration of justice is one of the fairest in the world . . .

[1] Essentially the *actionable defect* categories include; 1. Water Intrusion, 2. Structural, 3. Fire Protection, 4. Plumbing and Sewer, 5. Electrical, and, 6. Hardscape, and Slabs . CC §896 et. seq.

b. The prompt and fair resolution of construction defect claims is in the interest of consumers, homeowners, and the builders of homes, and is vital to the state's continuing growth and vitality. However, under current procedures and standards, homeowners and builders alike are not afforded the opportunity for quick and fair resolution of claims. Both need *clear standards* and *mechanisms* for the prompt resolution of claims.

c. It is the intent of the Legislature that this act improve the procedures for the administration of civil justice, including standards and procedures for early disposition of construction defects." CC §895 *Legislative Findings, Declarations and Intent Relating to Stats.* 2002, c.722 (SB 800) *section 1, Historical and Statutory Notes*

The central ideal seems to be that "justice delayed is justice denied," so lets enact new rules for residential construction that will allow for speedy resolution of buyer / builder claims. In exchange for this "expedited" process, some procedural safeguards normally guaranteed litigants under California civil law, can be lessened. There is now a significant procedural and substantive difference between pursuing a defendant in a civil car crash case and in pursuing a builder for defective / damaged residential housing. Taken together, the *Aas*, case, mandatory arbitration provisions and the "cherry picking" of SB 800, have come together to create the "*perfect storm*" for challenging "*unconscionable*" and/or "*extra judicial*" SB 800 builder provisions.

III. BINDING ARBITRATION: THE LYNCHPIN OF THE BUILDER'S CONTRACT

We start with the proposition that arbitration was devised to offer litigants a *fast-track*, cost-effective alternative to courtroom litigation. Like most benefits in life, however, arbitration requires litigants to make significant trade-offs.[2] *Moncharsh v.*

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[2] In a very real sense, arbitration is significantly different from civil law, which arises out of the fundamental principles of democracy and constitutionalism. By its very nature, arbitration constitutes a *denial of access to the courts* and the civil litigation rules of law. Parties considering arbitration as an alternative to civil action should be mindful of the following:

(1) Parties who draft contracts with arbitration clauses (often non-negotiable) can "arbitrarily" and unilaterally deny other contracting parties entree to the constitutional protections of our judicial system;

(2) Arbitrations do not require arbitrators to be lawyers or even judges;

(3) Arbitrators do not have to follow the law;

(4) Arbitration litigants generally waive trial by jury;

(5) Arbitration litigants generally waive the right of discovery; and

(6) Arbitration litigants generally waive the right of appeal.

(7) Once a matter is ordered into arbitration, it is critical for parties to understand that there is no relief from the court system for errors of law or fact [" the arbitrator's findings on both law and fact are conclusive. The court cannot set aside an arbitrator's error of law no matter how egregious." *Moncharsh v. Heily* (1993) 3 Cal.4th 1, 8)]

Heily & Blase (1992) 3 Cal.4th 1, 9; *Ericksen, Arbuthnot, McCarthy, Kearney & Walsh, Inc. v. 100 Oak Street* (1983) 35Cal.3d 312, 322; *Madden v. Kaiser Foundation Hospitals* (1976) 17 Cal.3d 699, 707. Moreover, it is no secret that builders have long used binding arbitration provisions not for their economy and efficiency, but instead to keep buyers out of court and as far away from the civil rules and sympathetic jurors as possible. The traditional view of arbitrations as economical, efficient and equitable alternatives to litigation in court has recently come under scrutiny.

Initially, the *builder community* was delighted with their assessment of SB 800 as "builder friendly" and believed its provisions could be added to their purchase contracts to further restrict buyer's rights. However, when the industry dust had settled, the builder community was less than pleased with buyer friendly provisions that permitted recovery for defects without the necessity of *Aas* type physical harm. Residential construction litigators whose clients purchased after January 1, 2003, must now undertake a careful analysis to determine whether offending provisions in are legally unconscionable and whether it makes sense to invalidate them entirely and litigate in civil court.

IV. BROAD BASIS FOR RELIEF

Code of Civil Procedure sections 1281 and 1281.2 allow a court to invalidate a written agreement to submit to arbitration on grounds that exist for the revocation of any contract. *Discover Bank v. Superior Court* (2005) 36 Cal.4th 148, 165; *Armendariz v. Foundation Health Psychcare Services, Inc*. (2000) 24 Cal.4th 83, 114 ("*Armendariz*").

9 U.S.C. §2 provides that "A written provision . . . to settle by arbitration a controversy thereafter arising . . . or . . . to submit to arbitration an existing controversy . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." Thus, the Federal Arbitration Act does not preempt California's Arbitration Statutes, *Code of Civil Procedure* §§1280, et seq. *Armendariz, supra,* 24 Cal.4th at p. 97-98.

Code of Civil Procedure §1667 states that a contract is unlawful if it is contrary to an express provision of law, contrary to the policy of express law, though not expressly prohibited, or otherwise contrary to good morals. *Code of Civil Procedure* §1668 provides that a contract that exempts any one from responsibility for his own fraud, or willful injury to the person or property of another or violates a law, whether willful or negligent, is against the policy of the law. *Code of Civil Procedure* §1670.5 allows a court to refuse to enforce any contract if the contract is unconscionable at the time it was made or it may enforce the remainder of the contract without the unconscionable clause in order to avoid an unconscionable result.

Preliminarily, litigants must distinguish between procedural and substantive unconscionability to attack unfair builder SB 800 provisions. The court in *Pardee Construction Co. v. Superior Court* (2002) 100 Cal.App.4th 1081, set out the guidelines for determining whether an alternate dispute resolution provision is unconscionable. The prevailing view is that procedural and substantive unconscionability must both be

present, but they do not have to be present in the same degree. *Pardee* and other courts have adopted a sliding scale that the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa. *Id.* at p. 1088.

Procedural unconscionability looks at the manner in which the contract was negotiated and circumstances of the parties. *Kinney v. United Healthcare* (1999) 70 Cal.App.4th 1332, 1329. *Substantive unconscionability* focuses on the actual terms of the contract itself and whether the terms are unfairly one-sided for the party with the superior bargaining power, and whether there is commercial justification for the lack of mutuality. *Armendariz*, *supra*, 24 Cal.4th at p. 117-118, *O'Hare*, *supra*, 107 Cal.App.4th, 273-274.

When builders go too far, buyers may challenge the agreements as unconscionable. Below are some example SB 800 contract provisions and their analysis.

A. UNCONSCIONABLE PROVISION TO LIMIT BUYER'S RECOVERY TO "ACTUAL DAMAGES"

The following is an example of a contested builder SB 800 contract provision:

"DAMAGES PURSUANT TO TITLE 7 CHAPTER 2: For all disputes involving a Title 7, Claimed Violation, including a breach or non-compliance of a standard set forth in California Civil Code Sections 895 through 897,

Buyer is only entitled to *actual damages*. Actual damages are measured by the lesser of the (i) cost of repair or (ii) diminution in current value of real property caused by the nonconformity."

This type of modification has been employed by builders' counsel because of the widespread belief that certain SB 800 "actionable defect" provisions did not require the occurrence of "actual damage" as defined in *Aas*. Pursuant to CC §896(a)

- "(1), "A door shall not allow unintended water to pass **beyond, around**, or **through** the door or its actual moisture barriers . . ."
- Pursuant to CC §896(a)(2), "Windows, patio doors, deck doors, and their systems shall not allow water to pass **beyond, around**, or **through** the window, patio door, or deck door or its designed or actual moisture barriers, including, internal barriers within the systems themselves . . ."
- Pursuant to CC §896 (a)(4), "Roofs, roofing systems, chimney caps, and ventilation components shall not allow water to enter the structure or to pass **beyond, around**, or **through** the designed or actual moisture barriers, including, without limitation, internal barriers located within the systems themselves. For purposes of this paragraph, "systems" include, without limitation, framing, substrate, and sheathing if any."
- Pursuant to CC §896(a) (10), "Stucco, exterior siding, exterior walls, exterior framing, other exterior wall finishes and fixtures . . . pot shelves, horizontal surfaces, columns, and plant-ons, shall be installed in such a way so as not to allow unintended water to pass into the structure or to pass beyond, around, or

through the designed or actual moisture barriers of the system, . . ."

Pursuant to CC §896 (b), "With respect to structural issues:

- "(1) Foundations, load bearing components and slabs, shall not contain significant cracks or significant vertical displacement.
- Pursuant to CC §896 (b)(2) Foundations, load bearing components and slabs, shall not cause the structure, in whole or in part to be structurally unsafe."
- Pursuant to CC §896 (b)(3), "Foundations, load bearing components, and slabs and underlying soils, shall be constructed so as to materially comply with the design criteria set by applicable government building codes regulations and ordinances for chemical deterioration or corrosion resistance in effect at the time of original construction."
- Pursuant to CC §896 (b)(4), "A structure shall be constructed so as to materially comply with the design criteria for earthquake and wind load resistance, as set forth in the applicable government building codes regulations and ordinances in effect at the time of original construction."

Nowhere do these provisions of SB 800 (CC § 896) mention "actual damage" as a requirement for a justiciable claim. This was one of the compromises enacted by the legislature to protect buyers who had foundation, slab and/or soils defects that could be addressed before they caused actual serious damage.

B. UNCONSCIONABLE PROVISION TO PERMIT BUILDER ARBITRATION APPEAL

The following is another contested builder SB 800 contract provision:

"PROCEDURES FOR APPEAL OF CERTAIN CASES. In any Proceedings in which a claim or arbitration award exceeds $500,000 in value, Buyer and Seller hereby adopt and agree to the JAMS Optional Appeal Procedure.

This provision has been employed by builders' counsel because of the widespread belief that even in arbitration, owners could receive substantial six figure awards that would otherwise bind builders to pay. By including the arbitration appeal provision builders tried to provide themselves a "get out of jail free" card that made the arbitration anything but "binding."

However, builder appellate provisions inordinately benefit builders without benefit to buyers. The appellate procedure in the above exemplar builder arbitration appeal provision defeats the very purpose of arbitration, which is to achieve a fast and final resolution of a dispute. Moreover, provisions with monetary thresholds can only benefit the sellers and not buyers.

The California courts have uniformly held that such an arbitration appeal provision is substantively unconscionable, because such an appellate review procedure defeats the finality and conclusiveness expected of an arbitration award. The court in *Saika v. Gold* (1996) 49 Cal.App.4th 1074 stated:

"The 'very essence' of arbitration is finality. By choosing arbitration, parties

avoid the palaver of procedural challenge that lend, at least for a time, uncertainty to any judgment rendered in the courts. With only very narrow exceptions, an arbitrator's decision cannot be reviewed for error of fact or law. 'Conclusiveness is expected; the essence of the arbitration process is that an arbitral award shall put the dispute to rest.' " *Id*. at p. 1076. [Citations omitted.]

Moreover, the court in *Saika* rejected an appellate procedure that had a monetary threshold, because it "*tilts the playing field in favor of the doctor*." *Id*. The *Saika* court pointed out the illusory nature of the appeal procedure:

> "But, in the vernacular of late 20th century America, let us 'get real.' As a practical matter, the benefit, which the trial de novo clause confers on patients, is nothing more than a chimera . . .
>
> In sum, while the trial de novo clause in the present case purports to apply to both parties, it is the same "heads I win, tails you lose" proposition that the court condemned in *Beynon*." *Id*. at p. 1080. [Citation omitted.] what are these???

In *Little v. Auto Stiegler, Inc.* (2003) 29 Cal.4th 1064, the Supreme Court found that a $50,000 threshold was substantively unconscionable:

> "Auto Stiegler and its amici curiae make several arguments to distinguish this case from *Beynon* and *Saika*. . . But if that is the case, they fail to explain adequately the reasons for the $50,000 award threshold . . . Thus, the $50,000 threshold inordinately benefits defendants. Given the fact that Auto Stiegler was the party imposing the arbitration agreement and the $50,000 threshold, it is reasonable to conclude it imposed the threshold with the knowledge or belief that it would generally be the defendant." *Id*. at p. 1073. [Citations omitted.]

Although the Supreme Court remarked that an asymmetrical provision may be permissible, such asymmetry had to have a *legitimate commercial need*:

> "Although parties may justify an asymmetrical arbitration agreement when there is a 'legitimate commercial need,' that need must be 'other than the employer's desire to maximize its advantage' in the arbitration process. There is no such justification for the $50,000 threshold. The explanation for the threshold offered by amicus curiae Maxie, Rheinheimer, Stephens & Vrevich--that an award in which there is less than that amount in controversy would not be worth going through the extra step of appellate arbitral review--makes sense only from a defendant's standpoint and cannot withstand scrutiny." *Id*. [Citations omitted.]

The Supreme Court also rejected the last argument that this procedure was less objectionable than a second arbitration:

> "Auto Stiegler also argues that an arbitration appeal is less objectionable than a second arbitration, as in *Beynon*, or a trial de novo, as in *Saika*, because it is not permitting a wholly new proceeding, making the first arbitration illusory, but only permitting limited appellate review of the arbitral award. We fail to perceive a significant difference. Each of these provisions is geared toward giving the arbitral defendant a substantial opportunity to overturn a sizable arbitration award. Indeed, in some respects appellate review is more favorable to the employer attempting to protect its interests." *Id.* at p. 1073-1074.

A $500,000 threshold can only be viewed as applying primarily, if not exclusively, in favor of the builder. A builder under SB 800 can never have a claim or arbitration award in any amount or in excess of $500,000 against a buyer. The builder would reasonably know that when it imposed such a threshold, that builder would be the defendant and the appealing party. Thus, a builder would not be able to satisfy the requirement that such a threshold is necessary to meet a legitimate commercial need other than the desire to maximize its advantage.

C. SUBSTANTIVELY UNCONSCIONABLE PROVISION REQUIRING BUYER TO LITIGATE IN TWO DIFFERENT FORUMS, WHICH IS EXPENSIVE, INEFFICIENT AND RISKS INCONSISTENT RESULTS

Another contested builder SB 800 contract provision is as follows:

> "BUYER AND SELLER, to the extent either such party is ***defending*** a claim in the Proceedings may, if it chooses, HAVE ALL NECESSARY AND APPROPRIATE PARTIES INCLUDED AS PARTIES TO THE PROCEEDINGS."

Although the above provision appears to apply equally to both a builder and buyer, it does not. In order to determine if an arbitration provision is sufficiently bilateral, a court must look beyond the appearance of mutuality and examine the actual effects of the provision. In *Stirlen, supra,* 51 Cal.App.4th at p. 1519, *Supercuts* justified the arbitration provision on the theory that the employment disputes to which it applies could be initiated by an employer as well as an employee. The court found the argument:

> "***exceedingly disingenuous***. The mandatory arbitration requirement can only realistically be seen as applying primarily if not exclusively to claims arising out of the termination of employment, which are virtually certain to be filed against, not by, *Supercuts*." *Id*. at p. 1540-1541, emphasis added.

Fitz v. NCR Corp. (2004) 118 Cal.App.4th 702, 725; *Szetela, supra* (credit card companies typically do not sue their customers in class action lawsuits).

In *Woodside Homes v. Superior Court* (2003) 107 Cal.App.4th 723, the court noted in a footnote that "Woodside, having received its money from Buyers (or their lenders), would have little reason to think it would ever initiate litigation against Buyers." *Id.* at p. 734, fn. 16.

Nevertheless, a builder may argue that the term "dispute" in such a provision is not limited to construction defect claims but any claims arising out of the property or the relationship between Purchaser and Seller. This argument is equally disingenuous.

No matter how broadly builder defines the word "dispute," a builder would never have a reason to initiate litigation against buyers for any claims that arose after the close of escrow. If buyers had failed to complete the purchase of the property, the purchase agreement would likely contain a separate provision for arbitration of those claims.

A builder may, if it so chooses, bring in all necessary and appropriate parties, because it, invariably, will be the defendant in such proceedings. However, the right to arbitration depends on a contract. Therefore, a party cannot be compelled to submit a

dispute to arbitration unless that party has agreed in writing to do so. See, *Code of Civil Procedure* §§1281 and 1281.2(c); *Boys Club of San Fernando Valley, Inc. v. Fidelity & Deposit, Inc.* (1992) 6 Cal.App.4th 1266, 1271. If the builder did not provide the court with any evidence of any contract between the builder and the construction subcontractors containing an arbitration agreement, there is no guarantee that the subcontractors could or would participate in the arbitration.

In contrast, the builder in *Woodside Homes* represented to the court and provided a declaration that the subcontractors on the project were all bound by agreements to participate in any reference of disputes related to their work. *Woodside Homes, supra,* 107 Cal.App.4th at p. 725-726. This representation and declaration satisfied the appellate court that the builder had gotten all of its subcontractors to agree to participate and that unless all subcontractors did not agree to the reference, the entire case would remain in court. *Id.* at 731 and fn. 9. If a builder does not make provision for their subcontractors to be included in binding arbitration, the buyer may well be forced to litigation in arbitration and in civil court.

Moreover, even if a buyer had the right to bring other parties responsible for the defects in his home into the arbitration, the buyer cannot compel any of the construction subcontractors to participate in the arbitration. Buyers typically have no contractual relationship with any of the construction subcontractors.

Thus, the claims of multiple parties and multiple causes of action which involve common issues of law and fact should be litigated in one forum. It is prohibitively expensive and inefficient to litigate concurrently in two forums common issues of law and fact. Moreover, proceeding in two different forums poses the risk of different or inconsistent outcomes. Under *Code of Civil Procedure* §1281.2(c) and *Cronus Investments, Inc. v. Concierge Service*s (2005) 35 Cal.4th 376, 394, trial courts can decline to order arbitration because of substantive unconscionability.