No. S186149
(Court of Appeal No. D055422)
(San Diego Super. Ct. No. 37-2008-00096678-CU-CD-CTJ)

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA

PINNACLE MUSEUM TOWER ASSOCIATION,

Plaintiff and Respondent,

v.

PINNACLE MARKET DEVELOPMENT (US), LLC, PINNACLE INTERNATIONAL (US), LLC, MARKET DEVELOPMENT (CANADA), LTD., MICHAEL DE COTIIS, an Individual, and APRIANO MOELA, an Individual,

Defendants and Petitioners.

ANSWER BRIEF ON THE MERITS

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COMES NOW Pinnacle Museum Tower Association ("Association" or "Respondent") through Fenton Grant Mayfield Kaneda & Litt, LLP, its attorneys of record to answer Petitioners' Brief on the Merits ("PBM") filed by Pinnacle Market Development (US) LLC; Pinnacle International (US), LLC; Market Development (Canada), Ltd.; Michael De Cotiis; Apriano Meola; and Rick Bortolussi (Collectively, "Pinnacle") as follows:

INTRODUCTION AND SUMMARY OF ARGUMENT

This case is about a developer's scheme to force a common interest development association to give up its constitutional right to a jury trial by stealth. The courts below refused to allow it and so too should this Court.

To satisfy Code of Civil Procedure section 1281, Pinnacle urges the Court to determine arbitration provisions contained in common interest development CC&Rs are a contract between the declarant party who drafts and records the CC&Rs and the association created by their recordation. (PBM 12-21.) Pinnacle finds support for this proposition in the dissent by Justice O'Rourke in the Court of Appeal. (Slip Op. dissent at pp. 1-2.) Both Pinnacle and Justice O'Rourke rely on the reasoning in *Villa Milano Homeowners Association v. Il Davorge* (2000) 84 Cal.App.4th 819, 824-825 ["Individual condominium unit owners are deemed to intend and agree to be bound by the written and recorded CC&Rs, inasmuch as they have constructive notice of the CC&Rs when the purchase their homes. CC&Rs have thus been construed as contracts in various circumstances.", Citation and punctuation omitted].

Pinnacle and the dissent overlook the fact none of the cases relied upon by the *Villa Milano* court stands for the proposition that CC&Rs

are a contract between an association and a developer. Each of those cases involved either an owner to owner or an owner to association dispute. As the majority in the Court of Appeal noted, *Villa Milano* stands alone in reaching the conclusion that CC&Rs can be construed as a contract (albeit unenforceable) between an association and a developer. (Slip Op. at pp. 10-11.)

The essence of any agreement is mutual consent, and mutual consent is the rationale underpinning the enforcement of pre-dispute arbitration agreements. *Villa Milano*, poorly reasoned on the central point of how an independent association can be said to have "agreed" to an arbitration provision forced upon it before it is created, should not be approved by this Court. Any notion of mutual consent to an arbitration provision in CC&Rs, purporting to govern disputes between the developer and an association, is pure fiction because the developer is on both sides of the "negotiations" and is free to include one-sided protection of its own interests. Pinnacle fails to answer the Court of Appeal's primary question of how an association can be compelled to arbitrate claims absent mutual consent reached after the association is independent of the developer's control. (PBM 17.)

Pinnacle pledged to convey title to certain elements of the Subject Property directly to the Association and caused the Association to have the maintenance responsibility for its own property and the common areas. Thus, when the Association "sprang" into existence by the recording of the CC&RS and the conveyance of title to the first unit, the arbitration provisions automatically burdened it.

A more basic principle of California contract law than that cited by Pinnacle and in the Court of Appeal's dissent is before a contract is

formed there must be consent of the parties. (Civil Code, § 1550, subds. (1) & (2).) Because the Association did not exist before the CC&Rs were recorded, it was impossible for it to have consented to the arbitration provisions before they became operative. Further, Pinnacle could have, but did not, include a provision for ratification or some other means to allow an independent Association to either opt in or opt out of the arbitration provisions. (Slip Op. at p. 17.)

Pinnacle drafted the CC&Rs with a provision prohibiting the Association from amending the CC&Rs to eliminate the arbitration provisions without Pinnacle's written consent. (AA p. 0144.) In the dissent, citing *Riverside Rancho Corp. v. Cowan* (1948) 88 Cal.App.2d 197, 208 for the proposition that "[a] modification of a contract can be made only with the consent of all parties to it," Justice O'Rourke asserted "[t]he provision requiring Pinnacle's written consent for modification of the arbitration agreement does nothing more than apply a general principle of California contract law." (Slip Op. dissent at p. 2.) One flaw in this reasoning is, unlike general contracts negotiated by parties at arms length, the independent association Pinnacle intended to bind had no role in forming the original "contract." In other words, the Association was not a "party" to the "contract" until it was thrust upon the Association when the Association had no recourse but to accept it. Another flaw is it overlooks the Legislature's intent to allow associations to unilaterally amend CC&Rs. (Civ.Code, § 1356.)

As drafted the arbitration provision would cause both Pinnacle and the Association to arbitrate "construction disputes" that includes "disputes regarding boundaries, surveys, soils conditions, grading,

design, specifications, construction, installation of improvements or disputes which allege breach of implied or express warranties as to the condition of the Project." (Appellants' Appendix ["AA"] p. 0141.) At first blush, this provision gives the illusion of fairness to both Pinnacle and the Association. However, in reality, while Pinnacle controlled the Association, it certainly was not going to bring "claims, disputes and disagreements" against itself and after it disposed of all of its property interest in the Subject Property, it would have no conceivable reason to bring claims, disputes and disagreements which may arise concerning the Property and/or express or implied warranties against the member controlled Association. Therefore, it is abundantly clear this provision was directed only at the Association (and its members) as the most likely parties to bring these specific claims and exempts Pinnacle from arbitrating the claims it most likely would bring against the Association and/or its members.

Pinnacle also argues the Federal Arbitration Act, 9 U.S.C. § 2 ("FAA"), does not allow a state court to find an arbitration provision repugnant while allowing the enforceability of the remaining provisions of the contract. (PBM 21-35.) Even if the FAA were applicable in the circumstances of this action, a proposition the Association does not concede, Pinnacle's argument misses the mark four ways. First, having disposed of its ownership interests in the Subject Property, Pinnacle has no right of enforcement of the remainder of CC&Rs if the arbitration provisions were eliminated. Secondly, the CC&Rs provide a savings clause where the finding of unenforceability of any section of the CC&Rs by a court of competent jurisdiction has no effect on the remainder of the provisions. (AA p. 0135.) Thirdly, the United States

Supreme Court, in multiple instances, consistently has held arbitration agreements are severable from the remainder of a contract. Finally, Pinnacle misconstrues the High Court's instruction that the FAA proscribes a State's policy from singling out the unenforceability arbitration provisions while letting other provisions of contracts to stand. A State's policy is found in its constitution and statutes, not in individual trial court decisions.

As a nonprofit benefit corporation, the Association has all the powers of a natural person, including the right to enter into contracts (Corp. Code, § 7140, subd. (i)), and can act only through its board of directors. (Corp. Code, § 7210.) Acting as the both the developer of the Subject Property and the Association, Pinnacle signed the CC&Rs. But, there was no agreement by the Association, free of Pinnacle's control, to arbitrate its claims against Pinnacle. Therefore, there is no enforceable agreement for arbitration as between Pinnacle and the Association.

The purchase and sale agreements ("P&SAs") incorporated the arbitration provisions of the CC&Rs. Citing *Jones v. Aetna Casualty & Surety Co.* (1994) 26 Cal.App.4th 1717, 1722, the Court of Appeal correctly held the Association is not bound by the purchase and sales agreements signed by the original units purchasers because it was not a party to them and has no standing to enforce them. (Slip Op. at p. 18.) Further, not all of the current owners and members of the Association were original purchasers of the units. They also are not bound by the original purchase and sale agreements.

Pinnacle's enforcement of the arbitration provisions also is precluded because the CC&Rs are equitable servitudes for which

Pinnacle has no continuing right of enforcement once it disposed of all of its interests in the Subject Property. Covenants running with the land must "be for the direct benefit of the property." (Civ. Code, § 1462.) Pinnacle's one-sided attempt to defend itself from future claims by the Association or its members does not protect any interest in the property.

Even if the Court were to find that an arbitration agreement exists, this agreement still would be unenforceable because it is unconscionable. It is contained in a form document prepared by Pinnacle and, without any opportunity to negotiate its terms it burdens the Association and virtually eliminates the Association's right to amend the CC&Rs pursuant to Civil Code sections 1355 and 1356. It contains elements of surprise because there is no evidence the members who make up the Association were provided with the CC&Rs at the time they entered into their purchase agreements with Pinnacle. The provisions are one-sided burdening only the Association and through this provision causing the Association to bear its own costs of experts, it deprives the Association of the right to recover costs pursuant to Civil Code section 3333 and *Stearman v. Centex Homes* (2000) 78 Cal.App.4th 611, 624.

Finally, the CC&Rs are intended to guide the governance of the Association and have no effect whatsoever on interstate commerce nor do the Association's claims arise out of the CC&Rs. Therefore, the Federal Arbitration Act does not preempt California law.

STATEMENT OF FACTS

Association is the governing body of a condominium common interest community formed under California law in a single high rise mixed use building located in San Diego, California ("Subject Property") that was planned, designed, developed, constructed, and sold by Pinnacle. The Association is comprised of the owners of the 182 residential and 9 commercial condominium units and common areas. The original residential condominium purchasers took the property subject to the terms and conditions of the P&SA and the CC&Rs.

At issue for purposes of the appeal are section 8 of the P&SA and article XVIII of the CC&Rs. Section 8 provides:

> "Buyer and Seller agree that any certain disputes shall be resolved according to the provisions set forth in Article XVIII of the Declaration and waive their respective right to pursue any dispute in any manner other than as provided in that Article. ...¶...Buyer and Seller acknowledge that by agreeing to resolve all disputes as provided in the Declaration, they are giving up their respective right to have such disputes tried before a jury. ... ¶ ... [All Caps] We have read and understand the foregoing and agree to comply with Article XVIII of the declaration with respect to the dispute (sic) referenced therein."

(AA p. 0067).[1]

The CC&Rs outline the governance of the Association ranging from membership and voting rights to the maintenance responsibilities of the Association and its members. Article 18, however, deals with "Construction Disputes" and requires that notice be given to Pinnacle and allows Pinnacle the right of entry and repair. If the parties cannot

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[1] For simplicity, when referencing the P&SAs and CC&Rs, the Association will cite to the ones attached to the original motion to compel and found at AA pp. 0060-0087 (P&SAs) and 0089-0150 (CC&Rs).

resolve the issues, they must submit it to mediation and if mediation does not resolve the claim, it must be submitted to binding arbitration with the Judicial Arbitration and Mediation Services. The mediation / arbitration provisions are not applicable unless Pinnacle is a party. Only a party defending the "construction dispute" can "have all necessary and appropriate parties included as parties to the arbitration." Article 18 states Pinnacle, and by accepting a deed to any part of the Subject Property, the Association and each member agree to give up the right to a jury trial and appeal. Article 18 cannot be amended without Pinnacle's written consent. (AA pp. 0089 - 0150.)

The P&SA submitted to the trial court and included in the Appendix is dated February 17, 2003. (AA p. 0069.) The CC&Rs submitted to the trial court and included in the Appendix was recorded on September 27, 2005 and re-recorded on October 1, 2007. (AA pp. 0089, 0091.)

The Association was created pursuant to Civil Code section 1352. Each owner in the project is a member of the Association. (Civ. Code, § 1358, subd. (b).) There are three types of ownership at the Subject Property. Each purchaser took an airspace condominium in fee and a proportionate undivided interest in the common area as a tenant in common. According to the CC&Rs and the condominium plan, the common area is airspace 100 feet above the high-rise tower. (AA p. 0099.) All other real property, including the tower building, parking structure, and other appurtenances, was deeded directly to the Association in fee. (AA p. 0104.) The unit owners have easements over the "Tower Association's Property." (AA p. 0104.)

When this action was filed, Pinnacle had completed all of its construction and marketing activities and had disposed of all its ownership interests in the Subject Property. Pinnacle is not a member of the Association.

LEGAL STANDARD

On appeal from the denial of a motion to compel arbitration, the court reviews "the arbitration agreement de novo to determine whether its is legally enforceable, applying general principles of California contract law." (*Kleveland v. Chicago Title Insurance Co.* (2006) 141 Cal.App.4th 761, 764.)

Interpretation of statutes presents a question of law. (*California Teachers Assn. v. San Diego Community College District* (1981) 28 Cal.3d 692, 699.) The court's goal of statutory construction is to ascertain the intent of the Legislature. (*Renee J. v. Superior Court* (2001) 26 Cal.4th 735, 743.) A court looks to the language of a statute and where that language is clear and there is no uncertainty as to the Legislature's intent, the court need look no further and must simply enforce the statute according to its terms. (*Phelps v. Stostad* (1997) 16 Cal.4th 23, 32.) The court must consider the statutory language in the context of the entire statute. (*Ibid.*) It is only where the statute is ambiguous that a court will resort to a variety of extrinsic aids and "select the construction that comports most closely with the apparent intent of the Legislature, with a view to promoting rather than defeating the general purpose of the statue, and avoid an interpretation that would lead to absurd consequences." (*Wilcox v. Birtwhistle* (1999) 21 Cal.4th 973, 977.)

Under both federal and California state law, arbitration is a matter of contract between the parties. (*First Options of Chicago, Inc.*

v. Kaplan (1995) 514 U.S. 938, 944-945; see also, *Mastrobuono v. Shearson Lehman Hutton, Inc.* (1995) 514 U.S. 52, 56-57; *Moncharsh v. Heily & Blase* (1992) 3 Cal.4th 1, 8.) This Court has stated that, "[T]he policy favoring arbitration cannot displace the necessity for a voluntary agreement to arbitrate." (*Victoria v. Superior Court* (1985) 40 Cal.3d 734, 739.)

The Federal Arbitration Act applies to any written agreement to arbitrate a transaction involving interstate commerce (*Allied-Bruce Terminix Cos. v. Dobson* (1995) 513 U.S. 265, 281) and preempts state laws applicable only to arbitration agreements. (*Perry v. Thomas* (1987) 482 U.S. 483, 492, fn. 9.) Even where the FAA applies, it defers to state contract law principles to determine the enforceability of arbitration provisions, recognizing as defenses "grounds that exist at law or in equity for the revocation of any contract." (9 U.S.C. § 2; accord Code Civ. Proc., § 1281; see generally *Doctor's Associates, Inc. v. Casarotto* (1996) 517 U.S. 681, 686-687.) Thus, "the FAA does not apply until the existence of an enforceable arbitration agreement is established under state law principles involving formation, revocation and enforcement of contracts generally." (*Banner Entertainment, Inc. v. Superior Court* (1998) 62 Cal.App.4th 348, 357.) Under the procedures set forth in Code of Civil Procedure section 1280, et seq., "the petitioner bears the burden of establishing the existence of a valid agreement to arbitrate, and a party opposing the petition bears the burden of proving by a preponderance of the evidence any fact necessary to its defense. (*Ibid.*)

ARGUMENT

I. THE COURT MUST AFFIRM BECAUSE UNDER PRINCIPLES OF CALIFORNIA CONTRACT LAW NO AGREEMENT TO ARBITRATE WAS FORMED BETWEEN PINNACLE AND AN INDEPENDENT ASSOCIATION.

Pinnacle contends the FAA applies to the arbitration provisions in the CC&Rs because they are a written agreement to arbitrate a transaction involving interstate commerce (*Allied-Bruce Terminix v. Dobson, supra,* 513 U.S. at p. 281) that preempts state law applicable only to arbitration agreements (*Perry v. Thomas, supra,* 482 U.S. at p. 492, fn.9). (PBM 21 -24.) As will be more fully briefed *post,* the Association disputes the FAA is controlling or that California law regarding the arbitration of construction defect claims is preempted in the case before the Court. However, assuming, *arguendo,* the FAA applies, it clearly defers to state law contract principles to determine the enforceability of arbitration clauses. (9 U.S.C § 2; accord, Code Civ. Proc., § 1281.) The FAA specifically allows a defense on "grounds that exist at law or in equity for the revocation of any contract." (9 U.S.C. § 2.) Moreover, the FAA only applies in the first place when, under state law contract principles, a contract is formed. Here, no arbitration agreement was reached.

A. UNDER CALIFORNIA CONTRACT FORMATION PRINCIPLES THERE IS NO ENFORCEABLE ARBITRATION CONTRACT BETWEEN PINNACLE AND THE ASSOCIATION BECAUSE AN INDEPENDENT ASSOCIATION DID NOT CONSENT TO ARBITRATION.

The party seeking arbitration has the burden of proving the existence of an enforceable arbitration agreement by a preponderance of the evidence. (*Engalla v. Permanente Medical Group, Inc.* (1997) 15 Cal.4th 951, 972.) "Arbitration may not be compelled absent an agreement to submit the particular claims at issue to arbitration."

(*Badie v. Bank of America* (1998) 67 Cal.App.4th 779, 787-88.) "[T]here is no policy compelling persons to accept arbitration of controversies which they have not agreed to arbitrate." (*Id.* at p. 788.) "The right to arbitration depends upon contract; a petition to compel arbitration is simply a suit in equity seeking specific performance of that contract." (*Engineers & Architects Assn. v. Community Development Dept.* (1994) 30 Cal.App. 4th 644, 653.) "It is essential to the existence of a contract that there should be: 1. Parties capable of contracting; 2. Their consent; 3. A lawful object; and, 4. A sufficient cause or consideration." (Civ. Code, § 1550.) "The consent of the parties to a contract must be ... [¶] ... [¶] ... communicated by each to the other." (Civ. Code, § 1565, subd. (3).)

Civil Code section 1352 provides a common interest development is created with recording of the CC&Rs, and other governing documents, and a conveyance of a separate interest coupled with an interest in the common area or membership in the association. "Thus, by statute the Association 'essentially [sprung] into existence' when [the declarant] recorded the declaration and conveyed a separate interest coupled with an interest in the common area or membership in the Association." (*Treo@Kettner Homeowners Ass'n v. Superior Court* (2008) 166 Cal.App. 4th 1055, 1066 (*Treo*).)

At all times prior to Pinnacle's conveyance of the first unit and appurtenances, including when the CC&Rs were drafted and recorded, the Association did not exist. As the Court of Appeal correctly observed, "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 homeowners association when Pinnacle recorded the CC&Rs." (Slip Op. at pp. 8-9.) This trick, whereby a developer attempts to obtain a jury waiver by including it in the CC&Rs, has been called a "stealthy device of the developer that is prohibited by public policy." (*Villa Milano, supra,* 84 Cal.App.4th at p. 829.) Here, Pinnacle was on both sides of the "bargaining" leading to the introduction of the arbitration provisions in the CC&Rs and there was no consent by an independent Association. Without that consent, the CC&Rs are not a contract sufficient to support a motion to compel arbitration between Pinnacle and the Association.

The Court of Appeals decision is consistent with the rule established in *Citizens for Covenant Compliance v. Anderson* (1995) 12 Cal.App.4th 345, 367-368. In *Citizens*, this Court determined that servitudes could be created by inclusion in recorded CC&Rs and be binding on future purchasers by constructive notice. The issue involved a disputed between owners of different parcels in a subdivision, not involving a common interest association but the Court stated, "The rule is consistent with the rationale that a covenant requires an agreement between the buyer and seller, and not a unilateral action by the developer." (*Id.* at p. 367.) When a common interest community is created, the inclusion of arbitration provisions in the CC&Rs that are intended to bind the association is a unilateral action by the developer.

The importance of the absence of the Association's knowing and informed agreement to arbitrate, after notice and an opportunity for meaningful reflection, is underscored by *Moncharsh v. Heily & Blase, supra,* 3 Cal.4th at p. 11 wherein this Court confirmed the general rule,

with narrow exceptions, is "an arbitrator's decision cannot be reviewed for errors of fact or law." The Court explained it tolerates the risk of an erroneous arbitration decision because "by voluntarily submitting to arbitration, the parties have agreed to bear that risk in return for a quick, inexpensive, and conclusive resolution to their dispute." (*Ibid.*) The Association had no opportunity to assess the risk of an arbitrator's mistake or the worthiness of a trade-off of the right for a jury trial in order to obtain a speedy decision. (*Id.* at p. 12.)

An impartial observer might question whether the reasoning of the previous paragraphs could not be applied to all of the provisions in CC&Rs, not just the arbitration provisions. The answer has to be in the affirmative; however, the Legislature, through Civil Code section 1356, has provided a process whereby the Association could amend other provisions in the CC&Rs, but Pinnacle isolated the arbitration provisions to preclude amendment without its consent.

B. CC&Rs ARE NOT A CONTRACT BETWEEN THE ASSOCIATION AND PINNACLE.

While California courts routinely interpret CC&Rs as contracts with respect to disputes between members or between members and associations (see, e.g., *Barrett v. Dawson* (1998) 61 Cal.App.4th 1048, 1054; *Franklin v. Marie Antoinette Condominium Owners Association* (1993) 19 Cal.App.4th 824, 828, 833-834; *Frances T. v. Village Green Owners Association* (1986) 42 Cal.3d 490, 512-513) only the court in *Villa Milano Homeowners Association v. Il Davorge, supra,* 84 Cal.App.4th at pp. 825-826, fn. 4 has found that an arbitration clause in CC&Rs can be construed as a contract between an association and an unrelated third party. On this point, the Court of Appeal correctly stated:

> "[T]hat portion of the *Villa Milano* opinion was poorly reasoned ... We agree ... insofar as it holds CC&Rs can reasonably be 'construed as a contract' and provide a means for analyzing a controversy arising under the CC&Rs when the issue involved is the operation or governance of the association or the relationships between owners and between owners and the association ...' Notably, other than *Villa Milano*, we are aware of no California cases treating CC&Rs as a contract between anyone other than as between owners, or between owners and a homeowners association." [2]

(Slip Op. at pp. 11-12, punctuation and citations omitted.)

As will be discussed *post*, the *Villa Milano* court having found that the CC&Rs arbitration provision was a contract, refused to enforce it on the grounds of unconscionability. (*Villa Milano*, 19 Cal.App.4th at p. 829.)

The holdings in *Treo* and the Court of Appeal are easily reconciled with *Barrett, Frances T.* and *Franklin.* CC&Rs are *interpreted* as contracts, but they are *enforced* as equitable servitudes. (*Chee v. Amanda-Goldt Property Management* (2006) 143 Cal.App.4th 1360, 1377 ["The same rules that apply to interpretation of contracts apply to the interpretation of CC&R's."]; *Nahrstedt v. Lakeside Village Condominium Association* (1994) 8 Cal.4th 361, 379 [Civil Code section 1354 states that covenants and restrictions appearing in the recorded declaration of a common interest development are enforceable equitable servitudes, unless unreasonable].)

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[2] A detailed electronic search of all jurisdictions has revealed that nationally *Villa Milano* also stands alone on the question of whether CC&Rs can be interpreted as a contract between an association and an unrelated third party declarant with no property interest in the project.

This Court explained:

> "One significant factor in the continued popularity of the common interest form of property ownership is the ability of homeowners to enforce restrictive CC&R's against other owners (including future purchasers) of project units. Generally, however, such enforcement is possible only if the restriction that is sought to be enforced meets the requirements of equitable servitudes or of covenants running with the land."

(*Nahrstedt*, 8 Cal.4th at p. 375 [citations omitted].)

The Court also noted courts will not enforce equitable servitudes containing restrictions "that are arbitrary, that is, bearing no rational relationship to the protection, preservation, operation or purpose of the affected land." (*Id.* at p. 381.) Here, the declaration imposes limitations on the power of the Association to deal with Pinnacle that are more restrictive than the limitations imposed on the Association to deal with other persons. Because the arbitration provisions apply only when Pinnacle is named as a party, it is unreasonable to assume that they bear a rational relationship to the protection, preservation, operation or purpose of the Subject Property.

C. THE COURT CANNOT RELY ON UNILATERAL EMPLOYEE HANDBOOK CASES BECAUSE THEY ARE INAPPOSITE.

This case differs significantly from those California cases recognizing arbitration clauses in employee handbooks are binding as unilateral contracts. For instance, in *Craig v. Brown & Root, Inc.* (2000) 84 Cal.App.4th 416, 420, the court determined an agreement to a unilateral contract in an employee handbook may be shown by an employee's express acceptance or may be implied by the parties' conduct. (See also, *Asmus v. Pacific Bell* (2000) 23 Cal.4th 1, 11 [employee impliedly accepted changed rules regarding job security by

his continued employment]; *DiGiacinto v. Amriko-Omserv Corp.* (1997) 59 Cal.App.4th 629, 635 [employee's continued employment constituted implied acceptance of changed compensation rules].)

The Association did not expressly accept the arbitration provision. Nor has it done anything that would imply acceptance.

The case before the Court also differs significantly from unilateral employment contracts where continued employment infers the employee's acceptance of the contract terms. Unlike an employee, once formed, the Association could not quit to show its objection to the arbitration provisions. In fact, to assure the Association could not walk away from arbitrating its claims, Pinnacle attempted to place a significant hurdle in the Association's path by making it nye onto impossible for the Association to amend the CC&Rs to eliminate the arbitration provision.

D. THE ASSOCIATION IS NOT BOUND BY THE ORIGINAL P&SAS.

Pinnacle also argues the Association's is bound to arbitrate its claims because the original purchasers agreed to arbitrate any construction defect claims they may have. (PBM 9.) Pinnacle misses the mark three ways. First, the Association was not a party to the P&SAs and neither can enforce them nor is bound by them. Second, the Association is a corporation that can only be contractually bound by its board of directors. Third, the Association has causes of action in its own right as a property owner.

1. THE ASSOCIATION IS A NON-SIGNATORY NOT BOUND BY THE P&SAS.

It is virtual black letter law that a contract cannot bind third parties. (*EEOC v. Waffle House, Inc.* (2002) 534 U.S. 279, 294 ["It goes without saying that a contract cannot bind a nonparty."].) In the

arbitration arena, there are two exceptions to this rule: 1) cases where there exits a pre-existing relationship between the non-signatory and one of the parties to the arbitration (see, e.g., *Madden v. Kaiser Foundation Hospitals* (1976) 17 Cal.3d 699, 702-709 [state employers allowed to contract for medical plan on employee's behalf]; *Wilson v. Kaiser Foundation Hospitals* (1983) 141 Cal.App.3d 891, 896-900 [spouse must arbitrate wrongful death claim if decedent spouse applied for health insurance containing arbitration clause]; *Pietrelli v. Peacock* (1993) 13 Cal.App.4th 943, 947 [preconception contract binds child]) and 2) third party beneficiaries who are seeking benefits under the contract containing an arbitration clause. (See, e.g., *Goldman v. KPMG, LLP* (2009) 173 Cal.App.4th 209, 231 [third party may not make use of a contract containing an arbitration clause and then attempt to avoid the duty to arbitrate] citing *Boucher v. Alliance Title Co., Inc.* (2005) 127 Cal.App.4th 262, 272.)

Neither of these circumstances is before the Court. There was no pre-existing relationship between the original purchasers and the association when the purchase agreements were signed. Further, the Association has not sought, nor could it seek, the benefits of the purchase and sales agreements. As the *Goldman* court explained: before a plaintiff can be compelled to arbitrate, its allegations must rely on or depend on the terms of the written agreement containing the arbitration provision. (*Goldman*, 173 Cal.App.4th at p. 231; accord *Benasra v. Marciano* (2001) 92 Cal.App.4th 987, 991 ["It is one thing to permit a nonsignatory to relinquish his right to a jury trial, but quite another to compel him to do so."].) The Association's claims do not arise out of the purchase and sales agreements and it is not seeking to

enforce arbitration.[3] Accordingly, the Association is not bound by the P&SAs or by the CC&Rs that Pinnacle seeks to bootstrap through the P&SAs.

2. THE ASSOCIATION MEMBERS CANNOT CONTRACTUALLY BIND THE ASSOCIATION.

Individual home buyers have different goals than do associations and the home buyers are not bound by the fiduciary duty that burdens members of an association's board of directors to act in the best interest of the community at large. (*Raven's Cove Townhomes, Inc. v. Knuppe Development Company* (1981) 114 Cal.App.3d 783, 800-801.) Merely because a home buyer agrees to arbitrate separate interest claims against the developer on his own behalf at the time of purchase, does not mean that the separate entity association is bound to the buyer's agreement to arbitrate made even before the buyer is a member of the association, let alone a member of the association's board. Moreover, purchase and sales agreements do not meet the legislative standard for rules and voting procedures required by Civil Code section 1363.03 and are not considered "governing documents" as defined in Civil Code section 1351, subdivision (j).

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[3] "Nonparties have been allowed to *enforce* arbitration agreements where there is sufficient identity of parties, where one has acted as an agent for a signatory, where one is estopped because he has voluntarily joined an arbitration proceeding, where an individual partner is bound by his partnership's agreement, where the person urging enforcement can show he is a third party beneficiary of the arbitration agreement, and where a construction contract or subcontract incorporates an arbitration procedure found in a related contract." (*Benasra,* 92 Cal.App.4th at p. 991, fn. 1 citing *Valley Casework, Inc. v. Comfort Construction, Inc.* (1999) 76 Cal.App.4th 1013, 1021-1022, original emphasis.)

Importantly, the members of a non-profit corporation, like the Association, can never bind the corporation to a contract. (Corp. Code, § 7210 [the activities and affairs of a corporation shall be conducted and all corporate powers shall be exercised by or under the direction of the board of directors].) And, at the time the P&SAs were executed, the purchasers were not members of the Association. They became members, with voting rights, only upon transfer of condominium unit's title to them at the close of escrow. (Civ. Code, § 1358, subd. (b).)

The case of *Smith v. Laguna Sur Villas Community Association* (2000) 79 Cal.App.4th 639, 644 illustrates the separation between an association's rights and the rights of its members. In *Smith*, the association members sought to waive an association's attorney-client privilege on the suggestion the association was merely a representative of the members. The *Smith* court rejected this notion, holding the individual owners could not waive the association's right to attorney-client privileged information – a right possessed only by the association's board members who, unlike individual owners, owe a fiduciary duty to make decisions in the best interest of the community. (*Smith*, 79 Cal.App.4th at p. 645.)

Here, assuming all of the original purchasers voluntarily agreed to the arbitration provisions in the P&SAs and CC&Rs, the Association is not bound by those purchaser agreements because the purchasers were not vested with the right to bind the corporate association. If the members of an association cannot waive the attorney-client privilege on behalf of the association, they certainly cannot waive the association's constitutional right to a jury trial simply by entering into a purchase

and sales agreement containing an arbitration provision or by accepting title to property that purportedly contains such a provision.

3. THE ASSOCIATION'S CLAIMS ARE NOT DERIVATIVE OF ITS MEMBERS.

The Association's claims arise out of the planning, design, development and construction of the "Tower Association's Property" that the Association holds in fee. Because the common area is merely air space, there are no claims relating to it. Therefore, the Association's claims in this action are on its own behalf as a property owner. To the extent necessary, Civil Code section 1368.3 also authorizes the Association's claims. (See, e.g., *Windham at Carmel Mountain Ranch Assn. v. Superior Court* (2000) 109 Cal.App.4th 1162, 1177 [an association's standing to bring an action against a developer for breach of implied warranty arises out of Civil Code section 1368.3 and is not derived from the privity of its members with the developer].)

The United States Supreme Court determined the FAA does not preclude a party with statutory standing from prosecuting a judicial action seeking remedies that would benefit an individual who is bound by an arbitration agreement governing any separate disputed the individual could bring on his own. (*EEOC v. Waffle House, Inc, supra,* 534 U.S. at pp. 293-294.) Such is the case before the Court. Civil Code section 1368.3 provides the Association with statutory standing to prosecute construction defect actions and as a non-party it is not bound by the P&SAs. Thus, under *Waffle House*, the FAA does not prohibit the Association from seeking judicial remedies that ultimately may benefit those of its members who may be bound to arbitrate their putative claims under the P&SAs.

II. PINNACLE HAS NO STANDING TO ENFORCE THE CC&RS AFTER IT HAS DISPOSED OF ALL OF ITS PROPERTY INTERESTS IN THE SUBJECT PROPERTY AND BECAUSE THE ARBITRATION PROVISIONS ARE SEVERABLE FROM THE REMINDER OF THE CC&RS, IT WAS NOT ERROR TO INVALIDATE ONLY THOSE PROVISIONS.

Pinnacle incorrectly contends the Court of Appeal erred because it invalidated the arbitration provisions in the CC&Rs while letting the other provisions stand. (PBM 21-35.) To support this conclusion, Pinnacle relies on the United States Supreme Court's instruction if "a contract is fair enough to enforce all its basic terms (price, service, credit)," then it must be "fair enough to enforce its arbitration clause." (*Allied-Bruce*, 513 U.S. at p. 281.) This new argument was raised the first time in the Court of Appeal via six short obtuse lines in the reply brief. (Court of Appeal Reply Brief 22.) The limited issue before the Court is whether the CC&Rs support Pinnacle's motion to compel the Association to arbitrate its defect claims.

A. THE COURT OF APPEAL DID NOT ERR BECAUSE AFTER DISPOSING OF ALL OF ITS PROPERTY INTERESTS IN THE SUBJECT PROPERTY, PINNACLE COULD NOT ENFORCE ANY OF THE CC&S PROVISIONS.

After wrongly assuming the CC&Rs are a contract, Pinnacle goes further askew by assuming it has the right to enforce any of the provisions of the CC&Rs after disposal of its property rights in the Subject Property.

Paragraph 15.1 of the CC&Rs states:

> "The Association, Declarant, and/or any Owner shall have the right to enforce against one another, by any proceeding at law or in equity, all restrictions, covenants, reservations, liens and charges now or hereafter imposed by this Declaration."

This paragraph must be read within the context of California law and public policy. "An equitable servitude will be enforced unless it

violates public policy; it bears no rational relationship to the protection, preservation, operation or purpose of the affected land; or it otherwise imposes burdens on the affected land that are so disproportionate to the restriction's beneficial effects that the restriction should not be enforced." (*Nahrstedt, supra*, 8 Cal.4th at p. 382.)

The right of enforcement of a provision in CC&Rs is a question of standing. Under clear California law, Pinnacle has no such enforcement right.

The strong public policy favoring control of common interest communities by their members requires a developer to relinquish control when the developer has completed construction and marketing of the project. (*Property Owners of Whispering Palms, Inc. v. Newport Pacific, Inc.* (2005) 132 Cal.App.4th 666, 675 [Subdivision Lands Act sets forth special requirements that must be met before the California Real Estate Commissioner will issue a public report relating to a common interest development including "[r]easonable arrangements have been ... made for delivery of control over the subdivision ... to the purchasers of lots."]; see also, RESTATEMENT (THIRD) PROPERTY, SERVITUDES § 6.19 ["After the time reasonably necessary to protect its interest in completing and marketing the project, the developer has the duty to transfer the common property to the association, or its members, and to turn over control of the association to its members other than the developer."].) Attempts to retain control beyond that point, particularly when the purpose is to reduce the chance the developer will be sued for faulty construction are against public policy.

Specific statutes, like statues of limitations or repose and statues governing construction defect litigation, sufficiently protect the

developer's interests. (*Gundogdu v. King Mai, Inc.* (2009) 171 Cal.App.4th 310, 315 *quoting Acosta v. Glenfed Development Corp.* (2005) 128 Cal.App.4th 1278, 1294.) Therefore, developers like Pinnacle cannot create additional protections for themselves by including such provisions in the governing documents that outlast the period of declarant control.

Civil Code section 1354, subdivision (a) provides:

> "The covenants and restrictions in the declaration shall be enforceable equitable servitudes, unless unreasonable, and shall inure to the benefit of and bind all owners of separate interest in the development. Unless the declaration states otherwise, these servitudes may be enforced by any owner of a separate interest or by the association, or by both."

The statute can only be read as limiting the right of enforcement of CC&Rs to an association and its members. The term "unless the declaration states otherwise" does not create an open door through which a developer can maintain control of an association long after it has disposed of all of its property rights at the project. Any other conclusion would not meet the reasonable expectations of the community and would lead to outlandish results whereby the declarant could intervene in disputes when it has no benefited interests in the outcome of those disputes.

Even a superficial review of these CC&Rs would reveal they were drafted with the intent to benefit the owners of the separate interests and provide a right of enforcement, consistent with Civil Code section 1354, subdivision (a), only to the Association and its members. There is no intent to benefit Pinnacle in its capacity as the developer beyond the period Pinnacle had a property interest in project. (See CC&Rs Recitals [CC&Rs "shall run with Tower Module and be binding on all

parties having any right, title or interest in the Tower Module"], AA at p. 0098.)

CC&Rs run with the land, meaning they "touch and concern" the land, and their enforcement is based upon privity of estate, not privity of contract. (*Kelly v. Tri-Cities Broadcasting, Inc.* (1983) 147 Cal.App.3d 666, 678-679.) "When the privity of estate no longer exists, those covenants running with the land, based upon that privity, are no longer enforceable.") (*Id.* at p. 679.) Accordingly, once the declarant has disposed of all ownership interests in the project, its standing to enforce any of the provisions in the CC&Rs is no greater than any unit owner who disposes of his interests in the property, which is to say, it has no standing. (See, e.g., *Farber v. Bay View Terrace Homeowners Association* (2006) 141 Cal.App.4th 1007, 1011 [one who no longer owns land in a development subject to reciprocal restrictions cannot enforce them]; see also, *Martin v. Bridgeport Community Association* (2009) 173 Cal.App.4th 1024, 1036 ["What is bound by an equitable servitude enforceable under CC&Rs is a parcel, a lot, in a subdivided tract, not an individual who has no ownership interest in the lot."].)

In *B.C.E. Development v. Smith* (1989) 215 Cal.App.3d 1142 the court allowed a developer to enforce the provisions of the CC&Rs after disposing of its property rights, but it is entirely different from the case *sub judice.* In *B.C.E.*, for over twenty years, the developer was allowed to enforce CC&Rs as to homeowners on behalf of an association with the association's participation and consent. Here, it is the developer who seeks to enforce the arbitration provisions in the CC&Rs *against* the Association and its members for its own benefit where there is no history of the Association's consent.

Pinnacle retains no ownership rights in the Subject Property and there is no evidence the parties against whom enforcement is sought intended Pinnacle would retain enforcement rights once it divested all ownership rights in the property. In fact, the evidence is to the contrary. CC&Rs Article II, section 2.2(l) through (n) granted Pinnacle the right to use the Tower Association Property and Common area for construction and marketing "only until close of escrow to Retail Purchasers of all Condominiums planned for the Project." (AA p. 0106.) Article III, section 3.2 (b) established Pinnacle's voting rights and 3.2(c) allowed those voting rights only until the owners' voting rights exceeded Pinnacle's or until "four (4) years following the date of the first conveyance of record by Declarant of a Condominium to a Retail Purchaser." (AA p. 0108.) Thus, read as a whole, the CC&Rs limited Pinnacle's declarant's enforcement right only so long as it retained ownership rights in the Subject Property.[4]

The declaration is not like a two party consumer contract addressed by the *Allied-Bruce* court, or other conventional commercial contracts where one party may wish to enforce the terms of the contract but avoid arbitration. Here, once it disposed of all real property rights in the Subject Property, Pinnacle has no right to enforce any of the provisions of the CC&Rs, but the Association and its members' enforcement rights continue. Therefore, the lower court's determination that the arbitration provisions are unenforceable does not violate the *Allied-Bruce* instructions.

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[4] Because the CC&Rs were not freely negotiated, any ambiguity regarding the intent of the parties must be interpreted against Pinnacle. (*Diamond Bar Development Corp. v. Superior Court* (1976) 60 Cal.App.3d 330, 334; *Badie v. Bank of America, supra,* 67 Cal.App.4th at p. 801; Civ.Code, § 1654.)

B. THE COURT OF APPEAL DID NOT ERR BECAUSE THE ARBITRATION PROVISIONS OF THE CC&RS ARE SEVERABLE AND THE UNITED STATES SUPREME COURT HAS RULED CONSISTENTLY STATE COURTS CAN INVALIDATE ARBITRATION PROVISIONS BASED ON STATE CONTRACT PRINCIPLES.

The declaration itself provides evidence the lower court's decision has no effect on the other provisions of the declaration. (See CC&Rs § 17.1 ["Should any provision in this Declaration be void or become invalid or unenforceable in law or equity by judgment or court order, the remaining provisions hereof shall be and remain in full force and effect."], AA p. 0135.) When it drafted the CC&Rs, Pinnacle clearly intended the remaining provisions of the declaration would be left intact if the arbitration provisions were determined to be unenforceable.

Section 17.1 is a savings or severability clause of the type found in *Keene v. Harling* (1964) 61 Cal.2d 318, 320 where this Court noted "If the contract is divisible, the first part may stand, although the latter is illegal." (See also, Civ. Code, § 1599 ["Where a contract has several distinct objects, of which one at least is lawful, and one at least is unlawful, in whole or in part, the contract is void as to the latter and valid as to the rest."].) "Severability" can be, and has been, applied to all California contracts, not just those containing arbitration clauses. (*Keene*, 61 Cal.2d. at p. 321.)

The United States Supreme Court has recognized the severability of arbitration provisions. (*Buckeye Check Cashing, Inc. v. Cardegna* (2006) 546 U.S. 440, 445 [an arbitration provision is severable from the remainder of the contract as a matter of federal substantive law that applies to the states].) The question of the validity of an entire contract containing an arbitration clause is to be resolved by the arbitrator. (*Id.*

at p. 449; *Prima Paint Corp. v. Flood & Conklin Mfg. Co.* (1967) 388 U.S.395, 403-404.) However, because the arbitration clause is severable, a court on "ordinary state-law principles that govern the formation of contracts" decides the question of arbitrability. (*First Options of Chicago v. Kaplan, supra,* 514 U.S. at pp. 944-944.) California Courts of Appeal have adopted the federal standard that a court decides arbitrability absent clear and unmistakable evidence the parties intended to submit the question of arbitrability to the arbitrator. (See *Dream Theater, Inc. v. Dream Theater* (2004) 124 Cal.App.4th 547, 551-553; *Rodriguez v. American Technologies, Inc.* (2006) 136 Cal.App.4th 1110, 1117, 1123.)

The *Allied-Bruce* "basic terms (price, service, credit)" instruction is only one half of the equation and is easily reconcilable. In *Allied-Bruce*, the court was addressing state contract policy generally, not specific contracts. (*Allied-Bruce, supra,* 513 U.S. at p. 281 ["The Act makes any such *state policy* unlawful, for that kind of *policy* would place arbitration clauses on an unequal 'footing,' directly contrary to the Act's language and Congress' intent."], emphasis added; *Doctor's Associates, Inc. v. Casarotto* (1996) 571 U.S. 681, 687 [stating "generally applicable contract defenses, such as fraud, duress, or unconscionability, may be applied to invalidate arbitration agreements"].)

California's policy is found in its Constitution and statutes. (*Sharon v. Sharon* (1888) 75 Cal. 1, 13; see also (*Wong v. Tenneco, Inc.* (1985) 39 Cal.3d 126, 142, J. Mosk dissenting.) The High Court has stated, "The public policy of any state is to be found in its constitution, acts of the legislature, and decisions of its courts. Primarily it is for the

lawmakers to determine the public policy of the state." *Building Service etc. Union v. Gazzam* (1949) 339 U.S. 532, 539, citations and punctuation omitted.)

For instance, in *Allied-Bruce*, the High Court struck down an Alabama *statute* making pre-dispute arbitration agreements invalid (*Allied-Bruce*, 513 U.S. at p. 269) and in *Doctor's Associates* it struck down a Montana *statute* requiring only arbitration contract provisions to be "typed in underlined capital letters on the first page of the contract." (*Doctor's Associates*, *supra*, 517 U.S. at p. 683.) In those cases, the Supreme Court was addressing the Alabama and Montana state policies of invalidating arbitration provisions not applied to other provisions of a contract such as price, service and credit.

In *Allied-Bruce*, the court set forth the background of the case before it, noting in *Southland Corp. v. Keating* (1984) 465 U.S. 1, 15-16 "it held that state courts cannot apply *state statutes* that invalidated arbitration agreements,"[5] and stated 20 state attorneys general had asked it to overrule *Southland*. The court explained the task before it:

> "We therefore proceed to the basic interpretive questions aware that we are interpreting an Act that seeks broadly to overcome judicial hostility to arbitration agreements and that applies in both federal and state courts. We must decide in this case whether that Act used language about interstate commerce that nonetheless limits the Act's application, thereby carving out an important statutory niche in which a State remains free to apply its antiarbitration *law or policy*. We conclude that it does not.

(*Allied-Bruce*, 513 U.S. at pp. 272-273, emphasis added.)

The interpretation of *Allied-Bruce* urged by Pinnacle does not comport with the large body of law generated by the United States

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[5] Emphasis added.

Supreme Court addressing that court's intent to cause the FAA to preempt state policy that places arbitration provisions on an inferior footing to other contracts but at the same time recognizing the right to challenge arbitration provisions in specific contracts because arbitration provisions are severable.

Simply put, Pinnacle's interpretation of *Allied-Bruce* cannot be squared with *Buckeye Check Cashing; Prima Paint; First Options* or *Doctor's Associates*. The United States Supreme Court has ruled consistently the FAA allows state courts to invalidate an arbitration agreement provided the law applied to invalidate an arbitration clause governs contracts generally and does not apply only to arbitration agreements. (*Doctor's Associates,* 517 U.S. at pp. 686-687; accord *Little v. Auto Stiegler, Inc.* (2003) 29 Cal.4th 1064, 1078-1079 [general state law contract principles regarding the unwaivability of public rights not preempted by the FAA]; *Cronus Investments, Inc. v. Concierge Services* (2005) 35, Cal.4th 376, 385 [state law can regulate arbitration clauses if that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally].)

Under California law, unconscionability is an affirmative defense to the enforcement of all contracts. (*Armendariz v. Foundation Health Psychcare Services, Inc.* (2000) 24 Cal.4th 83, 113-114; see also, Civ. Code, § 1670.5, subd. (a).) California also precludes enforcement of all contracts not formed under general state contract principles. Accordingly, the Court of Appeal did not err when it determined the arbitration provisions are unenforceable under California contract principles without invalidating the entire CC&Rs.

III. THE COURT MUST AFFIRM BECAUSE EVEN IF THE CC&Rs WERE A CONTRACT, THE ARBITRATION PROVISIONS ARE UNCONSCIONABLE AND, HENCE, UNENFORCEABLE.

Pinnacle contends the arbitration provisions in the CC&Rs are enforceable, yet no California appellate court ever has enforced provisions in CC&Rs causing common interest associations to arbitrate construction defects claims against the developer. (See, e.g., *Villa Milano Homeowners Association v. Il Davorge, supra*, 84 Cal.App.4th 819; see also, *Treo@Kettner Homeowners Ass'n v. Superior Court, supra,* 166 Cal.App.4th 1055 [CC&Rs provision to force an association to submit its construction defect claims to judicial reference is unenforceable].) This does not reflect any judicial predisposition against arbitration in general. In fact, the courts have repeatedly found California has a strong public policy favoring arbitration. (See, e.g., *County of Contra Costa v. Kaiser Foundation Health Plan, Inc.* (1996) 47 Cal.App.4th 237, 244 ["Public policy favors arbitration as an expedient and economical method of resolving disputes, thus relieving crowded civil courts."].)

The problem for many developers, like Pinnacle here, is they overreach by placing the arbitration provisions in CC&Rs that are drafted even before an association exists and in their zeal to force arbitration on an association they make no provision for ratification after the association is independently controlled. Frequently, the developers either prohibit amendment of the arbitration provision or set the amendment bar so high that amendment of the CC&Rs becomes virtually impossible. Then, to top it off, these developers attempt to limit the claims, limit the recovery, limit discovery, and limit their

liability. In other words, some developers attempt to create conditions for arbitration that are procedurally and substantively unconscionable

A. Unconsionability Generally.

Unconscionability is ultimately a question of law for the Court. (*American Software, Inc. v. Ali* (1996) 46 Cal.App.4th 1386, 1391.) The Court is well aware of California law regarding unconscionable contracts:

> "The doctrine of unconscionability " 'has both a "procedural" and a "substantive" element,' the former focusing on ' "oppression" ' or ' "surprise" ' due to unequal bargaining power, the latter on ' "overly harsh" ' or ' "one-sided" ' results. [Citation.] 'The prevailing view is that [procedural and substantive unconscionability] must *both* be present in order for a court to exercise its discretion to refuse to enforce a contract or clause under the doctrine of unconscionability.' [Citation.] But they need not be present in the same degree.... In other words, 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."

(*Thompson v. Toll Dublin, LLC* (2008) 165 Cal.App.4th 1360, 1371-1372 quoting *Armendariz*, 24 Cal.4th at p. 114; see also, Civ.Code, § 1670.5.)

The analysis for unconscionability "begins with an inquiry into whether the contract is one of adhesion." (*Amendariz*, 24 Cal.4th at p. 113 ["The term [contract of adhesion] signifies a standardized contract which, imposed and drafted by the party of superior bargain strength, relegates to the subscribing party only the opportunity to adhere to the contract or reject it."].)

Procedural unconscionability focuses on oppression or surprise. (*Armendariz*, 24 Cal.4th at p. 114.) "Oppression arises from an inequality of bargaining power that results in no real negotiation and

an absence of meaningful choice," while "[s]urprise involves the extent to which the supposedly agreed-upon terms are hidden in a prolix printed form drafted by the party seeking to enforce them." (*Flores v. Transamerica HomeFirst, Inc.* (2001) 93 Cal.App.4th 846, 853.) This form of unconscionability is often found in adhesion contracts.

Substantive unconscionability is concerned with contractual terms that produce unfair or one-sided results. (*Armendariz*, 24 Cal.4th at p. 114.) "In assessing substantive unconscionability, the paramount consideration is mutuality." (*Abramson v. Juniper Networks, Inc.* (2004) 115 Cal.App.4th 638, 664.)

B. PROCEDURAL UNCONSCIONABILITY.

In this case, Pinnacle drafted the arbitration provisions in the CC&Rs and recorded them before the Association was formed. Upon conveyance of the first unit to a homeowner, the Association was automatically bound by the CC&Rs. An independent Association had no opportunity to negotiate the terms of the CC&Rs and had no opportunity to either opt-in or opt-out of the arbitration provisions. The original purchasers were offered to either buy a unit at the project subject to the CC&Rs or not buy a unit at all. In other words, their choice was take-it-or-leave-it. But, the Association did not even have that choice – it had no choice at all.

Pinnacle contended in the courts below all of the original purchasers agreed to arbitrate construction defect claims subject to the terms of the CC&Rs. (AOB 9-10.) To support this contention, Pinnacle attached an exemplar P&SA and copies of the CC&Rs to its motion to compel arbitration. (AA pp. 0060-0090 [P&SA]; 0091-0151 [CC&Rs].) Pinnacle's problem is that the CC&Rs that were submitted postdate the exemplar P&SA by over three years.

There is no evidence before the Court the missing draft CC&Rs contain the same arbitration language as the exemplar CC&Rs. Moreover, there is no evidence before the Court as to when the Association's members received copies of the exemplar CC&Rs, if at all. The Court of Appeal correctly found surprise in Pinnacle's failure to provide the CC&Rs at the time the original P&SAs were signed:

> "The CC & R's are 50 pages long. Without specific evidence showing when Pinnacle made the CC & R's available for examination, and when Pinnacle provided purchasers with a copy of the CC & R's, we cannot conclude that the CC & R's were readily or easily obtainable so as to be properly incorporated by reference into the purchase and sale agreements. ... ¶ ... Additionally, the first page of purchase and sale agreements informed purchasers that the CC & R's are recorded or will be recorded in the Official Records of San Diego County. Assuming the CC & R's had been recorded before the sale of the first condominium, we cannot conclude that recording a document qualifies as making the document readily or easily obtainable. It is unreasonable to assume that buyers eager to complete their purchase of a condominium will stop the process and travel to the county recorder's office to locate a copy of the CC & R's. Thus, there is a high degree of surprise because purchasers have no means of ascertaining the type of dispute for which they have agreed to waive their right to a jury, or that they will be required to arbitrate those disputes when they sign the purchase and sale agreements. (*Baker v. Osborne Development Corp.* (2008) 159 Cal.App.4th 884, 896 [substantial evidence supported trial court's finding of surprise where arbitration provisions were not readily available to the plaintiffs].)

(Slip Op. at p. 22.)

The arbitration provisions at issue here begin on the 46th page of the document. (AA p. 0141.) Pinnacle's representative signed the CC&Rs (AA p. 0144), but the CC&Rs became binding on the

Association when Pinnacle unilaterally conveyed the property to the Association.

Oppression "arises from an inequality of bargaining power of the parties to the contract and an absence of real negotiation or meaningful choice on the part of the weaker party." (*Pardee Construction Co. v. Superior Court* (2002) 100 Cal.App.4th 1081, 1089; accord *Villa Milano, supra,* 84 Cal.App.4th at pp. 828-829.) Even if the Court were to speculate the exemplar CC&Rs were provided to the purchasers in a timely manner, the facts demonstrate oppression because the CC&Rs were drafted by Pinnacle before the close of escrow on the first unit and became operable when the Association had no choice, let alone a meaningful choice, in accepting the deeded property and no opportunity to negotiate the terms of the arbitration provisions. Having controlled all of the elements in creating the Association and unilaterally burdening it with the virtually non-amendable arbitration provisions in the CC&Rs, Pinnacle clearly was in a stronger position than the Association.

C. APPROVAL BY THE DEPARTMENT OF REAL ESTATE IS NOT BINDING ON THE COURT.

Pinnacle asserts the CC&Rs cannot be procedurally unconscionable because the declaration was submitted to the Department of Real Estate ("DRE") for approval under California Code of Regulations title 10 § 2791.8 that grants developers the authority to include arbitration provisions in the CC&Rs. (PBM 32-33.) This argument was made in *Villa Milano* and to the court in *Woodside Homes of California, Inc. v. Superior Court* (2003) 107 Cal.App.4th 723, both courts rejected it. The *Villa Milano* court stated:

> "[T]he fact that the DRE permits subdividers to utilize CC&R's containing certain types of arbitration clauses does not mean those clauses are necessarily binding in every conceivable context."

(*Villa Milano*, 84 Cal.App.4th at p. 833.)

The *Woodside Homes* court was even more emphatic:

> "It is for the courts to determine whether a provision is unconscionable, and we are not bound by a permissive regulation even if we were to assume that it was the result of deliberate consideration."

(*Woodside Homes*, 107 Cal.App.4th at p. 736, fn. 19.)

The Court of Appeal also rejected this proposition stating:

> "We fail to see how the issuance of a public report amounts to a ruling on the enforceability of any arbitration provision. Significantly, the Real Estate Commissioner can deny a public report only under limited circumstances, such as the failure to comply with applicable regulations. (Bus. & Prof. Code, §§ 11018, 11018.5.) Moreover, the DRE regulation addressing the insertion of dispute resolution clauses in CC&R's 'merely indicates that [the] clauses must be fair and meet certain minimum criteria in order to receive DRE approval.' (*Villa Milano, supra,* 84 Cal.App.4th at p. 833.) Nothing in the regulation addresses the enforceability of a binding arbitration clause on homeowners associations. (See Cal.Code Regs., tit. 10, § 2791.8.)"

(Slip Op. at pp. 16-17.)

The grounds for denial of a public report for subdivisions are enumerated in Business & Professions Code sections 11018 and 11018.5 do not suggest that the issuance of a public report (after approval of a pro forma sales agreement and CC&Rs) suggests in any way the provisions have undergone a review as to whether they are enforceable. Even a detailed review of those sections would not support a conclusion that the DRE reviews the supporting documentation for

compliance with applicable constitutional criteria for the protection of the right to a jury trial.

Governmental approval as to form and compliance with minimum standards does not provide a presumption of legitimacy. The DRE is not charged with the authority to determine whether a pre-trial jury trial waiver is made in a manner which is expressly provided for by Code of Civil Procedure sections 1280, et seq.

Other examples of unenforceable or deficient documents, that underwent some form of governmental approval, abound. For instance, plans and specification submitted to a building department for pre-construction approval does not guaranty the design or relieve an architect from liability. (*Cooper v Jevne* (1976) 56 Cal.App.3d 860, 869.) Nor do building department inspections during construction relieve a builder from liability. (*Firemen's Insurance Co. of Newark, New Jersey v. Indermill* (1960) 182 Cal.App.2d 339, 342-43.) Nor does FDA approval of a drug's label preempt state law such as to eliminate tort liability for the drug manufacture. (*Wyeth v. Levine* (2009) ___ U.S. ___, [129 S.Ct. 1187, 1204, 173 L.Ed. 51].) The same goes for approval of documents such as CC&Rs and purchase contracts by the DRE - there is no cloak of legitimacy over those documents, particularly as to the issue involved in this appeal.

The fact California law requires the declaration to be filed before any unit is sold does not lessen the fact that neither the Association nor the purchasers had a meaningful opportunity to negotiate the terms of arbitration with Pinnacle. But for Pinnacle's intent to force the arbitration provisions on the Association and its members, there could have been included in the arbitration provision a meaningful way, for

instance, of opting out, or a provision for ratification after Pinnacle released control over the Association's Board of Directors to the homeowners. Given the importance of a waiver of right to jury trial, the Association (as an independent entity) should have been given a choice. Clever lawyers draft CC&Rs and clever lawyers can draft those provisions to avoid the pitfall of take-it-or-leave-it.

D. SUBSTANTIVE UNCONSCIONABILITY.

The arbitration provisions are highly procedurally unconscionable, accordingly, the proof of substantive unconscionability can be to a lesser degree.

In *Armendariz, supra,* 24 Cal.4th at p. 120, this Court explained if the party with the stronger bargaining power creates a unilateral arbitration agreement without justification greater than a "desire to maximize its advantage based on the perceived superiority of the judicial forum" the agreement is substantively unconscionable. Here, Pinnacle has caused the Association and its members to arbitrate all disputes related "to the use or condition of the Project or any improvements to the Project" (AA at 0141), but did not bind itself to arbitrate any claims it may have either against the Association or the owners. "[A]n arbitration agreement imposed in an adhesive context lacks basic fairness and mutuality if it requires one contracting party, but not the other, to arbitrate all claims arising out of the same transaction or occurrence or series of transactions or occurrences." (*Armendariz,* 24 Cal.4th at p. 120.)

This Court also concluded that an arbitration agreement is substantively unconscionable if it limits the weaker party's right to full recovery of damages. (*Armendariz,* 24 Cal.4th at p. 121.) Here, the arbitration provisions state, "Each of the parties shall bear its own

attorney's fees and costs (including expert witness costs) in the arbitration." (AA p. 0143.) It is extremely expensive to investigate a complex construction defect case, especially one in a high-rise tower. Thus, while the "bear their own costs" provision appears to be facially neutral, when one goes behind this apparent facial neutrality, it is realized the Association would be deprived of its right to recover those costs of investigation allowed as damages under *Stearman v. Centex Homes, supra,* 78 Cal.App.4th at p. 624.

In *Armendariz,* the Court determined that where an arbitration agreement contains more than one unlawful provision such as an unlawful damages provision and an unconscionable unilateral arbitration clause, the multiple defects "indicate systematic effort to impose arbitration on an employee not simply as an alternative to litigation, but as an inferior forum that works to the employer's advantage." (*Armendariz, supra,* 24 Cal.4th at pp. 124-125.) In this case, Pinnacle has included in the arbitration provision both an unlawful damages provision and an unconscionable unilateral arbitration clause that were intended to work to Pinnacle's advantage. The Court would have to reform the provisions by augmentation to make it lawful. However, augmentation is not authorized under Civil Code section 1670.5, Code of Civil Procedure section 1281.2, or the Court's inherent limited authority to reform. (*Ibid.*)

In addition, Pinnacle also attempted to tie the hands of the Association to prohibit it from amending the CC&Rs by imposing a requirement that the Association must obtain Pinnacle's written consent before amendment. With respect to gaining Pinnacle's consent to amend the arbitration provisions, some might say this is a normal

business practice because all contracts require the consent of the other party before the contract can be amended. (Slip Op. dissent at p. 2.) But, of course, that presupposes both parties negotiated the original contract terms. That did not happen here.

As clearly demonstrated above, the original negotiations of these arbitration provisions, if any negotiations took place at all, had Pinnacle on one side, wearing the hat of the developer, and Pinnacle on the other side, controlling the Association even before it was formed. The "meeting of the minds," necessary to form the original "contract," was easy - it was the same mind.[6] It is beyond quibble Pinnacle knew control of the Association eventually would pass to its members. And, it does not take a crystal ball to recognize that in drafting the CC&Rs to essentially proscribe amendment of only the odious arbitration provisions, Pinnacle was looking after its own self-interests. To conclude this is only "normal business" is to turn a blind eye to the reality that Pinnacle held the only cards in the game. And, it played them unfairly to its unilateral benefit.

The Court must affirm because the arbitration provisions in the CC&Rs are procedurally and substantively unconscionable.

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[6] See *Robinson & Wilson, Inc.* (1973) 35 Cal.App.3d 396, 407 ["Although the terms of a contract need not be stated in the minutest detail, it is requisite to enforceability that it must evidence a meeting of the minds upon the essential features of the agreement ..."].)

IV. RELIANCE BY PINNACLE ON THE FAA FOR ENFORCEMENT OF THE CC&RS ARBITRATION PROVISIONS IS MISPLACED BECAUSE THE CC&RS DO NOT AFFECT INTERSTATE COMMERCE AND THE ASSOCIATION'S CLAIMS DO NOT ARISE FROM THE CC&RS.

Pinnacle asserts the FAA preempts California law with respect to these arbitration provisions. (PBM 22-24.) This assertion is without merit.

The FAA provides, in pertinent part, that a:

> "[W]ritten provision in any maritime transaction or *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 grounds as exist at law or in equity for the revocation of any contract." [Emphasis added.]

The United States Supreme Court has interpreted the statutory language of the FAA such "that the 'transaction' in fact 'involv[es]' interstate commerce, even if the parties did not contemplate an interstate commerce connection." (*Allied-Bruce Terminix Companies, Inc. v. Dobson, supra*, 513 U.S. at p. 281; see also, *Citizens Bank v. Alafabco, Inc.* (2003) 539 U.S. 52, 57 [debt-restructuring transaction.) The High Court determined Congress intended a broad interpretation of the statute's language so to be consistent with the "Act's basic purpose, to put arbitration provisions on the same footing as a contract's other items." (*Id.* at p. 275.) Even under a broad *Allied-Bruce* interpretation of the Act, it does not reach a document, such as the one before the Court, burdening the use of property within the

State of California having no interstate commerce implications whatsoever.[7]

Pinnacle contends the FAA is applicable since it used materials and/or products produced outside of California in the construction of the project. Pinnacle incorrectly frames the issue, asks the Court to answer the wrong question, and ignores the nature of the Association's claims. The issue before the Court is whether federal law preempts the interpretation of a provision in the CC&RS because some of the materials used to construct the Subject Property came across our State border. The answer is no because the Association's claims are not predicated on defective materials shipped in interstate commerce. Instead, the claims before the Court arise out of California law including strict liability, negligence, and breach of warranty.[8] These claims are not based on interstate commerce but on the developer's obligation to select appropriate materials and install them in a workmanlike manner, all of which occurred wholly within the State.

The plain language of the Act unambiguously provides preemption is warranted only when the contract involves interstate commerce *and* where the claim arises from that contract. Neither of those conditions is met in this action.

There can be little doubt Congress has the "power to regulate purely local activities that are part of an economic 'class of activities' that have a substantial affect on interstate commerce." (*Gonzales v. Raich* (2005) 545 U.S. 1, 17.) For instance, *Wickard v. Filburn* (1942)

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[7] See *Cronus Investments, Inc., supra,* 35 Cal.4th 376, 383-386 for an overview of the FAA's purpose and preemptive effect.

[8] The Association's other claims, like breach of fiduciary duty, arise out of the CC&Rs but do not fall into the category of "Construction Disputes" to which the arbitration provisions apply.

317 U.S. 111 established "that Congress can regulate purely intrastate activity that is not itself 'commercial,' in that it is not produced for sale, if it concludes that failure to regulate that class of activity would undercut the regulation of the interstate market in that commodity." (*Raich*, 545 U.S. at p. 18.)

That being said, the issue here is whether these CC&Rs involve interstate commerce. They do not.

A. THE FAA IS NOT CONTROLLING BECAUSE THE DECLARATION DOES NOT AFFECT INTERSTATE COMMERCE.

Pinnacle relies on CC&Rs 18.3(i) for the proposition that the FAA is controlling law. (PBM 8.) There is no basis for that reliance.

CC&Rs ¶ 18.3(i) provides, in pertinent part:

> "Because many of the materials and products incorporated into the residences and other improvements constructed within the Project are manufactured in other states, this Declaration involves and concerns interstate commerce and is governed by the provisions of the Federal Arbitration Act (9 U.S.C. §1, *et seq.*) now in effect and as the same may from time to time be amended. Accordingly, The Federal Arbitration Act shall govern the interpretation and enforcement of the arbitration provisions of this Article."

(AA p. 414.)

This is not a choice of law provision, but an impermissible "stipulation" of a legal conclusion. The Court has recently reiterated, "[I]nterpretation of the Constitution, statutes, and ordinances is a subject within the authority of the courts, not the parties. ... The matters normally subject to stipulation relate to pleadings, issues, evidence, liability, procedure, and damages, but not to interpretation of the law." (*People v. Castillo* (2010) 49 Cal.4th 145, 171 quoting *Oakland Raiders v. City of Berkeley* (1976) 65 Cal.App.3d 623, 629.)

States and localities possess broad regulatory and zoning authority over land within their jurisdictions. (See *Village of Euclid v. Ambler Realty Co.* (1926) 272 U.S. 365.) The United States Supreme Court in *United States v. Morrison* (2000) 529 U.S. 598, aff'g *Brzonkala v. Virginia Polytechnic Institute and State University* (4th Cir. 1999) 169 F.3d 820 properly emphasized courts must carefully evaluate legislation in light of our federal system of government. "The Constitution requires a distinction between what is truly national and what is truly local." (*Morrison*, 529 U.S. at p. 617, citing *United States v. Lopez* (1995) 514 U.S. 549, 568.) Courts have a particular duty to scrutinize regulated activity that "falls within an area of the law where States historically have been sovereign and countenance of the asserted federal power would blur the boundaries between the spheres of federal and state authority." (*Brzonkala*, 169 F.3d at p. 837.)

Pinnacle asks this Court to conclude the governance of the Association sufficiently implicates interstate commerce such that preemption applies and the arbitration provisions in the CC&Rs must be enforced. Such a conclusion is inconsistent with the established principle that real estate, and the interpretation of governing documents, is solely a question of state law. California closely regulates real property law, especially with respect to common interest developments such as the one before the Court. (See, e.g., Civ. Code, §§ 1350, et seq.) Conversely, the federal government does not, as a "general practice," regulate real property. (See *Pike v. Bruce Church, Inc.* (1970) 397 U.S. 137, 142 ["Where the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the

burden imposed on such commerce is clearly excessive in relation to the putative local benefits."].)

A homeowners association is "'a quasi-government entity paralleling in almost every case the powers, duties, and responsibilities of a municipal government ... with powers vested in the board of directors, council of co-owners, board of managers, or other similar body clearly analogous to the governing body of a municipality.'" (*Cohen v. Kite Hill Community Association* (1983) 142 Cal.App.3d 642, 651[9]; see also, *Chantiles v. Lake Forest II Master Homeowners Association* (1995) 37 Cal.App.4th 914, 922 ["For many Californians, the homeowners association functions as a second municipal government, regulating many aspects of their daily lives."].) Indeed, because of the governmental nature of homeowners associations' actions, the Legislature has required board meetings to be open and allow for members to speak publicly, akin to "California's open meeting laws regulating government officials, agencies and boards." (*Damon v. Ocean Hills Journalism Club* (2000) 85 Cal.App.4th 468, 475.) CC&Rs are like a city charter and as such the CC&Rs would not qualify as a contract "evidencing a transaction involving commerce" as required under the FAA.

Pinnacle argues preemption is warranted because the construction of the condominium project involved products that moved in interstate commerce. (PBM 23.) There is no ambiguity in FAA § 2, it is preemptive only when the *contract* affects interstate commerce. Pinnacle improperly looks to the Association's claim rather than to the

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[9] Citing CONCEPTS OF LIABILITY IN THE DEVELOPMENT AND ADMINISTRATION OF CONDOMINIUM AND HOME OWNERS ASSOCIATIONS, 12 Wake Forest Law Review 915

"contract" to argue the FAA is controlling. The claim is for defective construction, however the CC&Rs have nothing to do with the construction of the Subject Property. This is evidenced by the fact, as previously briefed, a common interest development's CC&Rs come into effect and an association is created only when the first separate interest is conveyed and has been recorded in a California county. The entire purpose of the CC&Rs is to govern the use of land in California. Therefore, it must be concluded this governance begins after the conclusion of the construction of, at least, the first unit to be conveyed.

That the CC&Rs are not part of the construction process also is evidenced by the many California residences constructed and sold but are not subject to the Davis-Sterling Common Interest Development Act (Civ. Code, §§ 1350, et seq.) requirement for recording a declaration that applies only when "a separate interest coupled with an interest in the common area or membership in the association is, or has been, conveyed." (Civ. Code, § 1352.) Further, unlike purchase and sales agreements that may evidence a transaction, the CC&Rs are neutral and become effective only after the transaction has occurred.

In *City of San Jose v. Superior Court* (1974) 12 Cal.3d 447, 462, this Court noted the "fundamental maxim that each parcel of land is unique" and commented:

> "Although this rule was created at common law, the very factors giving it vitality in the simple days of its genesis take on added significance in this modern era of development. Simply stated, there are now more characteristics and criteria by which each piece of land differs from every other."

The rules required to govern unique parcels of land also are unique. A California common interest development community is created under California law and the community's declaration governs

the use of land in California. Other jurisdictions have different laws and requirements such that there is no nationwide standard for the governance of common interests developments. Even within the State, governing documents for common interest developments vary from project to project. Therefore, unlike the wheat farmer in *Wickard*, where the High Court based its decision on the amalgam of "many others similarly situated" (*Wickard*, 317 U.S. at pp. 127-128), every common interest development is different and its governing documents have no effect on "others similarly situated" or on the whole. In other words, interstate commerce does not feel the pinch of the local activity of regulating land use within a California common interest community. (*Heart of Atlanta Motel, Inc. v. United States* (1964) 379 U.S. 241, 258.)

The declaration, at issue here, was recorded in California, it is intended to govern and restrict the use of California real estate and the Association is a California nonprofit corporation with the sole purpose of ensuring the health, safety and welfare of its members and their California real estate. The CC&Rs have no reach beyond the common interest community. Even if purchasers of the project were out of state residents, and even if the marketing of the project stretched across California's borders, and even if the purchases are financed through federally regulated banks, and even if components of the project were manufactured out of state, none of those things are governed by the CC&Rs. The CC&Rs quite simply are equitable servitudes with the sole purpose of supporting the governance of unique California real estate and have no substantial, if any, effect on interstate commerce.

B. THE FAA IS NOT PREEMPTIVE BECAUSE THE ASSOCIATION'S CLAIMS DO NOT ARISE FROM THE CC&RS.

The FAA specifically states the *contract* must evidence interstate commerce, not the claim or the project construction. This is where Pinnacle's argument goes wrong. It looks to the Association's claims for defective construction and attempts to squeeze them into the arbitration provisions of the declaration when the declaration, as a whole, has no relation to construction activities affecting interstate commerce. Pinnacle grafted the provisions for the arbitration of construction defects onto the declaration exclusively for its own benefit with the clear knowledge that the declaration is intended for application in the *future,* after all construction was completed.

The second element of the FAA is the claim must arise out of the contract. Again assuming, for argument only, the CC&Rs are a contract, the Association's claims for negligence, strict liability and breach of warranty do not arise out of the CC&Rs.

For instance, in *Allied-Bruce* had the plaintiff suffered a personal injury resulting from the termite exterminator's negligent operation of the company's truck, that claim would have been a tort prosecutable under state law. It would have been independent of the contract and not subject to the FAA. Such is the case with the Association's construction defect claims; they are independent of the CC&Rs.

Even if the Court were to address the Association's claims, they do not affect interstate commerce. Assuming, for instance, lumber was shipped to the site from a mill in Oregon. If the lumber was inappropriate for the proposed use, the decision to use it was made in California. If the lumber was improperly installed, the workmanship took place in California.

The majority in *Allied-Bruce* off handily noted that the case before it involved interstate commerce because "the termite-treating and house-repairing material used by Allied-Bruce in its (allegedly inadequate) efforts to carry out the terms of the Plan, came from outside Alabama." (*Allied-Bruce*, 513 U.S. at p. 282.) But, that fact was coupled with the "multistate nature of Terminix and Allied-Bruce." (*Ibid.*) It is clear from the totality of the decision the out-of-state nature of the materials played no part in the court's determination that the contract, itself, involved interstate commerce.

In *Basura v. U.S. Home Corporation* (2002) 98 Cal.App.4th 1205 1214, the court relied on the snippet from *Allied-Bruce* regarding the use of out-of-state materials to conclude that the FAA governed the controversy over whether the original purchasers of homes were obligated to arbitrate their claims based on provisions in the purchase agreements. Importantly, *Basura* did not involve an association's claims and the arbitration clause was not included in the CC&Rs. *Basura* and *Allied-Bruce* cannot be read so broadly as to incorporate claims that arise purely out of California law, and that are based on actions that took place solely in California. To do so, would be to open the door to such outrageous and absurd assertions that merely because the workmen drove trucks manufactured in Michigan or Japan, the claims fall within the bounds of interstate commerce and are preempted by the FAA.

CONCLUSION

Under California contract principles no contract to arbitrate was ever formed between Pinnacle and an independent Association because at the time the CC&Rs were drafted and recorded, the Association did not exist and it was only Pinnacle, protecting its self-interest, who "agreed" to the arbitration provisions in the document. In other words, the Association could not have consented to arbitrate its construction defect claims. Now, Pinnacle seeks to enforce the very same provisions by which it attempted to burden the Association through stealth.

The arbitration provisions are included in the CC&Rs that by code are equitable servitudes and not a contract as required by the California Arbitration Act. After disposing of its property interests in the Subject Property, Pinnacle has no right of enforcement of any of the CC&Rs provisions.

Even if the CC&Rs could be treated as a contract between the Association and any independent third party, the United States Supreme Court has made it abundantly clear arbitration provisions are severable from the contract and a finding of unenforceability of the arbitration provisions has no effect on the enforceability of the remaining provisions in a specific contract. At issue in *Allied-Bruce*, the only case relied upon by Pinnacle for the proposition that an arbitration provision cannot be found unenforceable while allowing the other provisions to stand, was a state's policy founded on statute, that placed arbitration provisions on an unequal footing with the state's other contract principles. It does not reverse the many cases where the United States Supreme Court has determined arbitration provisions are severable.

Neither of the courts below erred in finding these arbitration provisions are unconscionable. The provisions have strong elements of procedural unconscionablity because they were drafted before the Association existed and the Association had no choice but to accept them when Pinnacle turned the governance of the Association over to the homeowners. The arbitration provisions also are substantively unconscionable because they are one-sided in favor of Pinnacle and they limit the Association's right to full recovery of damages. Unconscionability is a valid defense under the FAA because it applies to all California contracts.

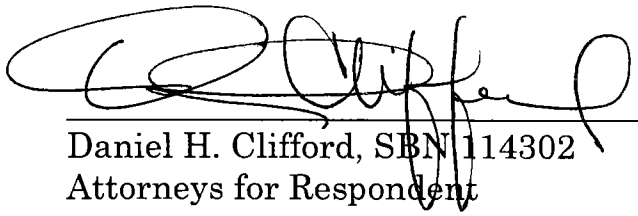
The FFA is not controlling in this action because the CC&Rs have no effect on interstate commerce. The CC&Rs govern unique California real estate, they have nothing to do with the construction of the project and the Association's construction defect claims do not arise out of the CC&Rs.

Accordingly, the Court must affirm.

Dated: January 3, 2011

Respectfully submitted,

FENTON GRANT MAYFIELD
KANEDA & LITT, LLP



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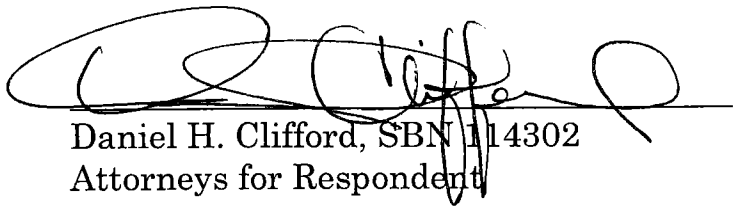
CERTIFICATE OF WORD COUNT COMPLIANCE

I certify that the attached Respondent's Brief uses 13 point Century Schoolbook font and contains 13,869 words as counted by Microsoft Word for Mac.

Dated: January 3, 2011

Respectfully submitted,

FENTON GRANT MAYFIELD
KANEDA & LITT, LLP



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PROOF OF SERVICE
State of California
Orange County

I am employed in the Orange County, California. I am over the age of eighteen years and not a party to the within action; my business address is Lakeshore Towers, 18101 Von Karman Avenue, Suite 1940, Irvine, California 92612.

On January 4, 2011, I served the following document(s) described as Answer Brief on the Merits on the interested parties in this action as follows:

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BY MAIL: I placed true copies of the foregoing document(s) enclosed in sealed envelopes addressed as shown on the Service List. I am "readily familiar" with Fenton Grant Mayfield Kaneda & Litt's practice for collecting and processing correspondence for mailing with the United States Postal Service. Under that practice, it would be deposited with the United States Postal Service that same day in the ordinary course of business. Such envelopes were placed for collection and mailing with postage thereon fully prepaid at Irvine, California, on the same day following ordinary business practices. (Code Civ. Proc., §§ 1013, subd. (a) and 1013, subd. (a).

I declare under penalty of perjury under the laws of the State of California that the forgoing is true and correct.

Executed on January 4, 2011, at Irvine, California

Trish Watson

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Court of Appeal Case No. D055422
San Diego Superior Court Case No. 37-2008-00096678-CU-CD-CTJ

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