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Yet Another Limitation on Arbitration Agreements? California Court Of Appeal Rules That Arbitration Of Disputes Under The California Association Of Realtors Form, Revised In 2002 To Specifically Refer To The Federal Arbitration Act, Are Still Subject California Law That Provides The Court Discretion To Deny A Petition To Arbitrate Where The Dispute Involves Third Parties Not Bound By The Arbitration Contract

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In another important decision which may impact the arbitrability of disputes arising from residential real estate purchase contracts in California, the California Court of Appeal, Second Appellate District, has ruled that the California trial courts, in accordance with the California Arbitration Act, may deny a Petition to Compel Arbitration where there are parties to the same real estate transaction which are not bound by the arbitration contract. The ruling occurred in spite of the fact that the California Association of Realtors form now specifically refers to the Federal Arbitration -- which does not permit a trial court to stay or deny arbitration in such circumstances.

As many are aware, the California Association of Realtors publishes and periodically revises a standard form residential purchase agreement commonly used in California. The agreement contains an arbitration provision which is widely relied upon. In Gravillis v. Coldwell Banker Residential Brokerage Co. (2006) 143 Cal.App.4th 761, 782-783 ("Gravillis Case"), a California Court of Appeal interpreted the October 2000 version of the agreement and ruled that, under the California Arbitration Act, see, Code of Civil Procedure §§ 1280-1294.2, the trial court had the authority to stay or deny arbitration where (1) some of the parties to the action were not parties to the agreement, and (2) proceedings in different forums-arbitral and judicial-could result in conflicting rulings on a common issue of fact or law. However, in October 2002 the California Association of Realtors published a revised version of the standard form residential purchase agreement which reads as follows (revised language in italics):

"The arbitrator shall be a retired judge or justice, or an attorney with at least five (5) years of residential real estate Law experience, unless the parties mutually agree to a different arbitrator, who shall render n award in accordance with substantive California law. *The parties shall have the right to discovery in accordance with California Code of Civil Procedure* § 1283.05. In all other respects, the arbitration shall be conducted in accordance with Title 9 of Part III of the California Code of Civil Procedure.....*Interpretation of this agreement to arbitrate shall be governed by the Federal Arbitration Act.*"

Since the Federal Arbitration Act, *see*, 9 U.S.C. §§ 1-16, does not permit a trial court to stay or deny arbitration in the circumstances set forth under the California Arbitration Act, some legal observers questioned whether a California trial court still has the discretion to stay an action based on the existence of a third party to the dispute (not bound to the arbitration contract).

That question has now been answered in Valencia v. Smyth (2010) D.A.R. 8103 ("Valencia Case"). The Valencia Case concerned the sale of real property in Palmdale, California. Plaintiffs Jose Valencia and Maricela Mendoza (the "Valencias") retained Blanca Rivera-Letrado of Keller Williams Realty to act as their licensed real estate agent. Richard Velasco owned the subject property in Palmdale. Peter Smyth, a licensed real estate broker doing business as California Investments, acted as Velasco's broker and the listing agent on the property.

During the course of negotiations, Ms. Rivera-Letrado and Mr. Smyth convinced the Valencias to offer \$949,000 for Mr. Velasco's property. Mr. Velasco accepted. At that time, the Plaintiffs were unaware that Mr. Velasco was in default on his mortgage on the Palmdale property in the amount of \$660,000 and that the property was actually in foreclosure. The Plaintiffs made a down payment of \$175,000 which was wired to a title company. Without informing the Plaintiffs, Mr. Velasco transferred ownership of the property to his broker, Mr. Smyth. Mr. Smyth's wife then executed an interspousal transfer deed to assist in the transaction. An entity named Reliable Trust Deeds Services, Inc. then became "a trustee of the deed of trust in favor of Smyth." At the time of closing, the Valencias believed that Mr. Velasco was still the owner of the property and that they were buying the property from him. After escrow closed, the Valencias regularly deposited funds into a designated bank account to cover the "mortgage" and other charges. Thereafter, the Valencias learned that they had purchased the property from Mr. Smyth, and not Mr. Velasco, and that they had been depositing funds into Mr. Smyth's personal checking account, and that the Smyths, together with others, had misappropriated the Plaintiffs' funds and used the money to finance other real estate transactions of their own.

In late 2007, Mr. Smyth demanded that the Plaintiffs make additional "mortgage" payments, more than doubling the size of their monthly payment. The Valencias refused and Mr. Smyth initiated foreclosure proceedings.

The Valencias then filed suit naming Mr. Smyth, his wife, Ms. Rivera-Letrado, Keller Williams Realty, the title company and Reliable Trust Deeds Services, Inc. After finally serving the Smyths (the Valencias were required to do that by publication), the Smyths answered and discovery ensued. After depositions which took place over a four (4) day period, and with the Plaintiffs producing more than 700 pages of documents in discovery, the Smyths filed a Petition to Compel Arbitration. The Valencias opposed the Petition to Compel arguing that the Smyths had waived their right to arbitration by delay in seeking arbitration and participating in discovery, and because the Smyths were not, under the

circumstances, parties to the real estate contract. The Valencias cited Code of Civil Procedure § 1281.2, contained in the California Arbitration Act, which provides that the Court does have discretion to deny a Petition to Compel Arbitration where there is a third party to the litigation, whose disputes arise out of the same transaction or series of related transactions, and there is a possibility of conflicting rulings on a common issue of law or fact.

In reply to the Valencias' opposition to the Petition to Compel, the Smyths argued that, given the specific reference to the Federal Arbitration Act in the standard form residential purchase agreement, the trial court did not have the discretion to deny a Petition to Compel based on the existence of third parties to the dispute. After multiple hearings, the trial court denied the Petition to Compel on a number of bases including that it had authority under Code of Civil Procedure § 1281.2(c) to deny a Petition to Compel because there were third parties to a dispute involving the same transaction or series of related transactions and there was the possibility of inconsistent rulings.

The Smyths appealed. As before, the Smyths contended that the trial court had erred in finding that they had waived their right to compel arbitration and further asserted that the trial court lacked authority to deny the Petition to Compel under Code of Civil Procedure § 1281.2(c) because the parties had adopted the procedural provisions of the Federal Arbitration Act, among other reasons.

The Court of Appeal affirmed. In its holding, the Court of Appeal discussed a number of decisions in which a tension between the California Arbitration Act and the Federal Arbitration Act was discussed, such as Volt Information Sciences v. Board of Trustees of Leland Stanford Junior University (1989) 489 S.Ct. 468, Rosenthal v. Great Western Financial Securities Corp. (1996) 14 Cal.4<sup>th</sup> 394, Warren-Guthrie v. Health Net (2000) 84 Cal.App.4<sup>th</sup> 804, Mt. Diablo Medical Center v. Health Net of California, Inc. (2002) 101 Cal.App.4<sup>th</sup> 711, Cronus Investments, Inc. v. Concierge Services (2005) 35 Cal.4<sup>th</sup> 376, Rodriguez v. American Technologies, Inc. (2006) 136 Cal.App.4<sup>th</sup> 1110 and Cable Connection, Inc. v. DIRECTV, Inc. (2008) 44 Cal.4<sup>th</sup> 1334. In rendering its decision, the Court of Appeal did note that there is a distinction in the Rosenthal, Cronus and DIRECTV cases in that they directly involved interstate commerce, which, of course, a local real estate matter, such as the Valencia case, would not. However, the Court of Appeal went on to state that under the Rosenthal-Cronus-DIRECTV trilogy, the Federal Arbitration Act's "procedural provisions do not apply in state court *unless* the parties expressly adopt them." (italics supplied). Based on the case law on point, and the use of the "plain meaning rule" as employed under the Federal Arbitration Act, the Court of Appeal held:

"...the Agreement's references to California law and the California Code of Civil Procedure--which contains the CAA--do *not* expressly adopt the FAA's procedural provisions. Rather, the Agreement expressly incorporates the CAA's procedural provisions."

(italics supplied).

Stated succinctly, the Court of Appeal ruled that, in spite of the change in language in the California Association of Realtors revised form, the discretion found in Code of Civil Procedure § 1281.2(c) to deny a Petition to Compel remains within the province of the California trial court. Based upon this holding, and applying the specific facts of the Valencia Case, the Court of Appeal then ruled that the trial court had properly exercised its discretion under Code of Civil Procedure § 1281.2(c) in its order denying arbitration, and joining all the parties in a single action to be adjudicated in the trial court.

The Valencia Case is an important decision given that the vast majority of residential transactions in California are performed pursuant to the California Association of Realtors form, revised in October 2002, which was the subject of the Valencia Case. The authors believe that the Court of Appeal's decision was somewhat fact driven, given the conduct of the seller and its broker, but that the holding is generally in line with decisions which find that the question of whether a matter is subject to arbitration will be governed by the California Arbitration Act rules (which provide exceptions to the general rule of arbitrability of disputes), unless expressly agreed otherwise.

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