



May 20, 2009

Home Court Advantage

How the Building Industry Uses Forced Arbitration to Evade Accountability

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Acknowledgments

“Home Court Advantage: How the Building Industry Uses Forced Arbitration to Evade Accountability” was written by John O’Donnell, Senior Researcher, Taylor Lincoln, Research Director, and David Arkush, Director of Public Citizen’s Congress Watch division. Civil Justice Policy and Legal Associate Graham Steele provided legal research and Senior Researcher Alexander Cohen assisted with data analysis.

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Executive Summary

An Army soldier between stints in Iraq and his wife were told just before closing that their new house came with a warranty to provide “extra coverage just in case something went wrong.” But the warranty John and Michelle Rechten received 45 days after moving in to their Savannah, Ga., house actually did the opposite. It severely restricted the builder’s responsibilities and, further, required any future legal dispute to be settled before a private arbitration firm that was approved by the warranty company – a requirement that a Georgia law appears intent to prohibit.

After nearly two years of battling the builder over gross construction flaws, the couple had to pay \$2,500 to seek relief from the arbitration firm. The arbitrator rejected more than three-fourths of the Rechten’s claims.

The arbitrator ruled the builder was not liable for broken wood trim, incomplete dry wall work, a leaking back door and mold, among other problems, because he deemed the items excluded from the warranty or determined that there was no record that the couple had asked the builder to fix the problems within one-year of moving into the house.

The arbitrator ruled that the builder was responsible for 39 repairs. But he calculated the award primarily with bids solicited by the builder – which were dramatically less than estimates that John and Michelle had obtained. After the arbitration was completed, Michelle called the contractors that had provided the builder with its low-ball estimates. They refused to honor the prices.

John and Michelle’s story is a variation on one that has occurred countless times throughout the United States. New home buyers are told (often at the last minute) that they will receive a warranty, which is often characterized as a “gift” or a “bonus.” When buyers actually receive the warranty (often after they move into their house), they learn that whole classes of problems are excluded from coverage. Home warranties typically forswear coverage for mold, violations of local building codes or “consequential damages,” such as financial losses suffered by buyers who are forced to move out of their houses while repairs are made.

The warranties also dictate that any disputes between buyers and builders must be settled through mandatory binding arbitration, or forced arbitration. This privatized adjudication system provides the ultimate home court advantage for builders and warranty companies. Arbitration firms rely on builders and warranty firms for their business. They have every incentive to keep builders and warranty companies happy.

HBW Insurances Services LLC tells builders that its “2-10 HBW warranty requires mandatory and binding arbitration with every homebuyer. The arbitration is critical in the event of a dispute between you and the homeowner.”

For home buyers, forced arbitration is often a nightmare. They are pitted against a cabal of builders, warranty companies and arbitration firms. These companies are often interconnected in complicated and opaque ways and seem to have a limitless ability to

generate “heads-we-win, tails-you-lose” scenarios. Secretive arbitration tribunals provide very few checks against misconduct, conflicts of interest, ignorance of the law, or even deliberate disregard for the law. Indeed, an arbitrator’s failure to adhere to the law is specifically precluded as a ground for appeal. The system is also costly. Consumers are often charged fees many times greater than those they would pay in court – and they run the risk of being charged tens of thousands of dollars to pay for the other sides’ lawyers.

Homeowners Forced into Arbitration Find Little Satisfaction

In addition to John and Michelle’s ordeal, this report recounts several other homeowners’ experiences with forced arbitration:

- **Leslie and Scott Kimbell’s** builder installed a stone fireplace without proper supports below it. This resulted in a sinking fireplace, causing the floors to slope. The arbitrator appeared to agree with the Kimbells’ assessment of the problem but, remarkably, blamed them:

“The ‘construction defects’ that are the subject of this dispute were either caused by the Claimant’s own actions or inactions, are typical homeowner maintenance items, or are otherwise the responsibility of the Claimant and not the Respondent,” he wrote.

- **Jordan and Bob Fogal** discovered numerous mysterious leaks shortly after buying a new townhouse and eventually were forced to abandon the house because of mold problems. Although the builder claimed for months that it could not determine the cause of the leaks, the couple eventually learned that the builder had known the cause all along. The builder was suing its roofing subcontractor over flaws that were causing the leaks and had even listed the Jordan Fogal as potential witnesses in the case.

An American Arbitration Association arbitrator ruled in favor of the Fogals, finding the builder guilty of fraud. But the arbitrator awarded the couple just \$26,088 – less than eight percent of what they paid for a house they were forced to abandon.

- **William and Jennifer Falbaum** discovered significant problems with the foundation of their house and pursued arbitration before the American Arbitration Association. The arbitrator agreed that the flaw existed. But he rejected the couple’s warranty claims, saying that they had failed to enter their warranty into evidence even though they had appended it to their pleadings. And he rejected their claims under the Texas Deceptive Trade Practices Act, flatly contradicting a Texas Court of Appeals decision with which he personally disagreed.

Soon after that ruling, the couple learned that the arbitrator had failed to disclose two conflicts: He was a lawyer for the Greater Houston Builders Association, and on its behalf he had urged the Texas Supreme Court to overturn the very ruling that he ignored in the Falbaums’ arbitration ruling. In a rare occurrence, the

Falbaums eventually convinced a judge to throw out the arbitrator's ruling because of these conflicts and reached a settlement that they found satisfactory.

- **Michael Pullara** went before the same arbitrator who ruled on the Falbaums' case. But Pullara did not learn about the arbitrator's conflicts until a year after he had been ordered to pay his builder nearly \$57,000 in damages and \$32,000 in attorneys' fees. The arbitrator awarded the builder these sums despite finding that the builder had breached its contract with Pullara. Because Texas law permits only 90 days to ask a court to overturn an arbitration ruling, Pullara was left with no recourse when he learned of the arbitrator's conflicts.
- **Timothy Clark Gilbert and Karen Gilbert** were awarded \$114,000 by Construction Arbitration Services (CAS) in a dispute over housing defects. Believing that they were owed \$200,000 in damages, the Gilberts asked the arbitration firm to preserve the evidence in anticipation of an appeal. After two requests went unanswered, the Gilberts successfully petitioned a judge to order that the evidence be preserved. But the evidence had already been destroyed.

CAS's argument at the resulting contempt-of-court hearing is telling about the utter lack of safeguards in forced arbitration. The firm argued that the destruction of evidence did not matter because "errors of fact or law do not invalidate an arbitration award." In other words, no evidence – even if it revealed outrageous violations of fact or law – could be used to modify the initial ruling.

- **Linda and Rick Etherson** filed an appeal with CAS after losing an arbitration against 2-10 HBW over a dispute involving a leaking foundation and mold on a new house. For months, they sought biographical information on the arbitrator appointed to hear their appeal, but they received it only a few days before the hearing. It indicated that the arbitrator's work involved performing inspections for 2-10 HBW, the Ethersons' opponent in the case. The Ethersons protested and the arbitrator recused himself at the last instant. Then CAS refused to refund the money that the Ethersons had paid for the arbitrator's travel expenses.

Arbitration Firms Are Biased in Favor of Builders and Warranty Companies

Construction contracts and home warranties typically designate one or more of three arbitration firms to settle disputes: Construction Arbitration Services, AAA, or DeMars. Each has demonstrated close ties to the home building industry.

- **Construction Arbitration Services (CAS)** was the "successor in interest" to the National Association of Conciliators, an arbitration company that went bankrupt. The National Association of Conciliators had been formed and financed by Home Owners Warranty. Home Owners Warranty, in turn, had been formed by the National Association of Home Builders.

In other words, CAS owes its existence to the National Association of Home Builders – the trade association of the builders whose cases it handles. CAS

President Lester Wolff said in a 1998 deposition that CAS was a *member* of the National Association of Home Builders.

- AAA advertises that the construction industry had a major role in writing its rules for construction arbitrations. AAA's construction arbitration rules, in its own words, were "developed in conjunction with the National Construction Dispute Resolution Committee, made up of representatives of industry organizations."

A promotional brochure for AAA's spring 2009 construction conference advised builders not to miss the opportunity to hear about "How you can control the arbitration process through advocacy and by drafting appropriate clauses for your contracts" and promises tips on "identifying the right arbitrator for your case."

- DeMars and Associates lists on its Web site the names of 14 businesses for which it conducts arbitrations – which it calls its "satisfied clients." Imagine a court of law calling the parties in lawsuits it adjudicates "satisfied clients."

Home Builder Forces Arbitration on Consumers in Violation of FTC Order

- KB Home has been prohibited by a Federal Trade Commission consent order since 1979 from forcing its customers to settle warranty disputes in binding mandatory arbitration. The company asked the Federal Trade Commission in the mid-1990s if it could resume the practice but was told that it could not. Still, the company proceeded to force its customers into binding mandatory arbitration. When caught, the company promised the FTC that it would stop. Then the FTC caught KB breaking its promise. As a court trial proceeded, the company argued that its actions were acceptable because the FTC knew what it was up to but did not act. The FTC disagreed vehemently. Eventually, KB paid a \$2 million fine for illegally forcing its customers into binding arbitration.

But KB was not done. The company next hatched a plan to offer consumers a warranty that lasted two years longer if they would accept a mandatory binding arbitration clause. This plan still appeared to violate the plain language of the FTC consent order, but the FTC did not object.

What sort of company fights so hard to force arbitration on its customers? In 2005, KB's mortgage subsidiary paid the largest fine ever assessed by HUD's Mortgagee Review Board for myriad fraudulent lending practices. The company's former CEO has been indicted in a stock options scheme for which he is facing up to 415 years in prison.

Arbitration Occurs in Secret with Little Meaningful Disclosure

The practice of forced arbitration is almost entirely shielded from public oversight. Apologists often argue that Congress should wait to act on forced arbitration until more "empirical" research is conducted.

The suggestion is disingenuous at best. Arbitration occurs in secret, providing scant data for empirical study. The few state laws that require arbitration firms to report on cases mandate only superficial disclosures, and the arbitration firms routinely flout even these modest requirements. For example, the American Arbitration Association, the largest firm, has published at least some information about 61,000 consumer cases in response to a California law. But despite the law's requirement to disclose whether the business or consumer prevailed, AAA has done so for only 4.3 percent of the cases for which an award was issued.

Perhaps symbolic of the arbitration industry's public relations campaign, in every single case – 959 out of 959 – in which AAA has disclosed a prevailing party, it named the consumer the winner. We have not found a single publicly disclosed instance in which the business was declared the prevailing party.

Public Citizen has communicated extensively with many individuals whose stories belie AAA's data. Businesses do win in arbitration. They often win rulings that disregard the law, offend basic standards of justice or both.

Arbitration Costs Far More than Court and Poses Additional Risks to Consumers

Arbitration costs are far greater than court costs. The cost of initiating an arbitration case far exceeds the cost of filing a court suit. Beyond that, arbitrators' fees often run into five figures, and arbitration companies often impose additional fees on an ala carte basis as a case proceeds. In contrast, judges salaries are paid by the public, court filing fees are modest, and courts do not deter meaningful inquiry by larding on extra costs every step of the way.

This report recounts cases in which consumers had to shell out \$2,000 or more just to initiate a case. The couple whose fireplace sank because the builder had failed to install proper supports were hit with \$12,950 in fees – along with a ruling granting them no relief. Another couple had to pay out \$11,000 just in arbitration fees to keep their case going forward. An arbitrator did order the builder to reimburse them, but the couple has yet to receive a penny back. If these consumers had been pursuing court cases, their fees would have been limited to a few hundred dollars.

As a further pitfall, a consumer forced into arbitration can be stuck with the other side's attorneys' fees as a matter of course. In court, it is extremely rare for a consumer to be forced to pay a business's lawyers. It generally happens only in cases brought in bad faith. This report recounts an instance in which a home buyer was taken to arbitration by a builder. Not only did the arbitrator find the buyer liable for \$56,000 in damages, but he assessed the buyer \$32,000 to pay the builder's legal fees along with a \$10,5000 in arbitration costs.

I. Warranties Indemnify Builders and Force Buyers into Arbitration

Army helicopter pilot John Rechten and his wife Michelle Rechten bought a new house in Savannah, Ga., in September 2006. They discovered numerous problems with the house before they even moved in, and many more afterwards, but were unable to convince their builder to fix the majority of the problems – especially the most serious ones.

Ordinarily, the Rechtens would have been able to go to court and present their case to an impartial judge and jury. But, as they were closing on their house, they followed their builder's instruction to sign an application for a third-party warranty program operated by an insurance company. Although portrayed as a gift, the warranty actually shielded the builder from liability for numerous construction problems. Worse still, it forced the couple to resolve any legal disputes in mandatory binding arbitration with a private firm pre-approved by the warranty company rather than in a public court.

Unable to persuade the builder to fix their house, the Rechtens eventually filed for arbitration. Subsequently, the arbitrator found many of the defects existed, even under the restrictive criteria outlined in the warranty. But the arbitrator sided with the builder on the most significant issues.

Days after the Rechtens received the decision, John shipped out for his second tour in Iraq where he is an Apache attack helicopter pilot in Mosul. When he returns in October 2009, they will have to move to New York state because John's Army unit is being transferred there. But the flaws in their house are so extensive that they do not believe they will be able to sell it.

John and Michelle's story is a variation on one that has repeated itself throughout the country. New home buyers find themselves in possession of houses with serious – or even irresolvable – flaws caused by construction firms' gross negligence. But, the fine print in their purchase contracts or warranties blocks them from holding the builder accountable in court.

This report will show that buyers who escape arbitration often are able to negotiate satisfactory settlements. But those who get stuck in arbitration almost invariably end up wringing their hands in frustration.

Home Warranties Are the Linchpin of Builders' Quest to Reduce Buyers' Rights

Already two-time homebuyers, the Rechtens considered their September 2006 closing routine.

Like all home closings, theirs included a blizzard of papers to be signed. One was a "Builder Application for Home Enrollment" in a warranty program administered by a company named 2-10 Home Buyers Warranty Corp, or HBW.

The Rechiens had first heard of the purported 10-year warranty only the day before. A representative for the builder, Jerry C. Wardlaw Construction Inc., had mentioned the warranty in passing during their walk-through, saying that it was “like a car warranty” and provided “extra coverage just in case something went wrong,” Michelle said.¹

At closing, the builder’s representative signed the warranty application and handed John Rechiens an application form. It said the buyer had read a sample copy of the warranty and consented “to the terms of these documents including the binding mandatory arbitration provision” contained in the sample copy of the warranty.²

In fact, John Rechiens had not received a copy of the warranty, much less read it. He had no idea of what the binding mandatory arbitration provision was. Even if he were familiar with binding mandatory arbitration, he reasonably could have inferred that it would apply only to disputes over the purported “extra coverage” provided by the warranty.

But the warranty’s language was crafted to wipe out all other protections the Rechiens enjoyed and to force the couple into arbitration to settle any disputes they might have with the builder. None of that would become apparent to the Rechiens until they received the 27-page warranty booklet in the mail – 45 days after moving into their house.

That booklet revealed that the warranty did not provide anywhere near the advertised 10 years of coverage. Only for the first year did it offer broad coverage, and even then it shielded the builder from liability for whole classes of problems, such as violations of building codes, damage caused by mold, and even physical injuries or other health problems the Rechiens might suffer because of the builder’s negligence.³

By the second year, coverage was limited to “systems,” such as heating and air conditioning. For years three through ten, coverage was limited only to damage to “load-bearing functions to the extent that your Home becomes unsafe, unsanitary or otherwise unlivable.”⁴

The booklet also filled in the chilling details about binding mandatory arbitration: “Any and all claims, disputes and controversies by or between the homeowner, the Builder, the Warranty Insurer and/or HBW, or any combination of the foregoing, arising from or related to this Warranty . . . shall be settled by binding arbitration. Agreeing to arbitration means you are waiving your right to a jury trial.”⁵

The booklet made careful distinctions between the warrantor, 2-10 Home Buyers Warranty Corp., and the warranty insurer, National Home Insurance Company, even though both were owned by the same company. This may have been because at least 17 states, including Georgia, prohibit the use of binding mandatory arbitration in consumer insurance agreements.⁶ NHIC attempted to draw a distinction between itself and HBW when its arbitration clause was challenged in Kentucky, another state that does not permit the use of arbitration in insurance agreements. But the judge was not fooled. While NHIC had attempted to “clothe” its agreements as something other than insurance, the judge ruled, “it is clear that these agreements nonetheless function as an ‘insurance contract.’”⁷

Use of Binding Mandatory Arbitration Is Now Ubiquitous in New Home Industry

Of the nation's 10 largest homebuilders, at least nine include binding mandatory arbitration clauses in its purchase contracts, warranties, or both. Meritage Homes, which recently broke into *Builder* magazine's top 10, did not respond to several inquiries from Public Citizen. [See Figure 1]

Figure 1: The Nation's 10 Largest Builders' Policies on Arbitration

Rank Among Builders in 2008*	Builder	Builder's contract terms require binding mandatory arbitration?	Warranty requires arbitration?
1	D.R. Horton ⁸	Unknown	Yes
2	Pulte Homes ⁹	Unknown	Yes
3	Centex Corp. ¹⁰	Yes	Yes
4	Lennar Corp. ¹¹	Unknown	Yes
5	KB Home ¹²	Yes*	No
6	Hovnanian Enterprises ¹³	Unknown	Yes
7	NVR (Ryan) ¹⁴	Unknown	Yes
8	The Ryland Group ¹⁵	No (optional)	Yes
9	Beazer Homes ¹⁶	Unknown	Yes**
10	Meritage Homes Corp. ¹⁷	Unknown	Unknown

Source: *Builder* magazine, May 11, 2009.

*Arbitration is mandatory for non-warranty disputes; optional for disputes over warranted matters, as agreed to by company in consent decree filed with the Federal Trade Commission.

** Certain warranties issued in certain jurisdictions and for certain types of loans do not include mandatory binding arbitration.

While information about smaller builders is less complete, a survey of Texas builders provides some insight. A Texas commission reported in December 2006 that 85 percent of builders producing at least 100 houses annually, and 57 percent of all builders, required binding mandatory arbitration. This is a recent development. As recently as 2003, only 32 percent of Texas builders had imposed arbitration terms.¹⁸

Builders have shown a keen interest in ensuring that such arbitration provisions are widely adopted. For example, the Home Builders Association of Greater Cleveland requires its members to include arbitration clauses in their sales contracts and to demand that their subcontractors and other agents also mandate arbitration.¹⁹

Builders' practice of inserting arbitration clauses throughout their contracts has created a minefield for buyers who are determined to avoid them. "Several consumer witnesses thought that they had, through negotiations, struck arbitration clauses, but later

discovered that they had unknowingly agreed to arbitrate disputes,” a Texas legislative committee reported in 2002.²⁰

It is not difficult to see how this could happen. Ryland Homes, the nation’s eighth-largest builder in 2008, gives buyers an option about whether to accept arbitration clauses in its purchase contract. The firm is unusual in this respect. But the company’s spokesman acknowledged that its warranty, which takes effect at closing, requires arbitration for warranty claims involving structural defects.²¹

One Texas builder, speaking at a time when the industry was riding high, summarized builders’ use of arbitration this way: “Those with the gold get to make the rules, if you want to participate, [arbitration agreements] are the rules.”²²

The home warranty industry also recognizes that the use of arbitration is key to reducing liability for builders. HBW Insurances Services LLC tells builders, “The 2-10 HBW warranty requires mandatory and binding arbitration with every homebuyer. The arbitration is critical in the event of a dispute between you and the homeowner.”

Warranty-Arbitration Trap Leaves Military Couple with Little Recourse for Shoddy House

The first indications that John and Michelle Rechten would have problems with their new house became apparent when they inspected it the day before closing.²³ Built at the height of the real estate boom, it bore innumerable signs of a house rushed into service too soon.

A Wardlaw representative provided two rolls of blue painter’s tape and told the couple to mark every flaw they saw. “We used all the tape,” Michelle recalls.²⁴

After the Rechten moved in, Wardlaw began to make repairs. “They were here every bit of a month-and-a-half fixing defects I found in the first go-around,” Michelle recalled.²⁵

In November 2006, two months after closing, Michelle pointed out drywall cracks to the builder’s representative. The representative warned that the firm would only repair drywall once, and said that it was better to wait until the first anniversary inspection to ask for the repairs, Michelle said.²⁶

The one-year inspection was set for Sept. 18, 2007, 10 days before the first anniversary of closing. The Wardlaw representative failed to appear because, Michelle was told, the representative forgot about the appointment.²⁷ The inspection was rescheduled for October 17, nearly three weeks beyond the deadline for reporting problems covered by the first year of the warranty.

“When I asked about it being past the one-year mark, I was told, ‘It’s fine, not going to be an issue,’” Michelle wrote in a log she and John kept to memorialize what developed into a continuing battle with Wardlaw.²⁸

On Oct. 17, 2007, a Wardlaw representative arrived for the inspection with a single sheet of lined paper titled “Jerry C. Wardlaw Construction and Development Inc. One Year Inspection.” She would use the paper to record problems the Rechiens pointed out.²⁹

“We informed her that one sheet was not going to be enough,” Michelle recalled in an e-mail to Public Citizen. “The representative told us everything would be fine. Whatever wasn’t written down, we could just inform the subcontractors when they came in to repair the other items [and] they would repair them also.”³⁰

Subsequently, on numerous occasions, Michelle said, “We were reassured that everything would be fine, that the defects would be repaired.”³¹

But Wardlaw was not making the repairs, according to Michelle. This followed a pattern that a New Jersey investigation of the home warranty industry found – promises and promises that are not followed by action. Investigators said the practice is called “lulling.”³²

As the Rechiens lost faith in the builder, they decided to seek an expert opinion on the condition of their house. In February 2008, they hired professional engineer John A. Tanner to inspect the house. Tanner reported that the house had five building code violations, including those involving roof trusses, drainage, and requirements for construction of houses built within a 110-mph hurricane zone. He based his assessment in part on his observations of nearby partially completed Wardlaw houses where the framing had not yet been covered by siding and drywall.

Tanner also found seven “questionable conditions” that “could affect the sale value of the house” and seven examples of “poor workmanship.”³³ He also wrote, “Several doors do not meet the jamb stop and you can see through the crack between the door and the doorframe jamb stop.”³⁴ Those doors had been taken down, refurbished and rehung after Michelle had complained to the builder that they were blemished with marks similar to those a frosty beer can leaves on a wood surface.³⁵

In the meantime, the Rechiens became concerned that mold had developed in places where water was leaking, including around an exterior door, around a leaky shower unit in one bathroom, and around the tub in a second bathroom. In April 2008, the Rechiens paid a Savannah environmental firm nearly \$1,000 to do an assessment.³⁶

The firm, WPC Engineering, Environmental & Construction Services, found evidence of water damage and “possible visible mold growth” in the bathrooms and around an exterior door. It found “clearly evident” mold on a tack strip that had been under a carpet near the French door in the living room and “light moisture staining” on wallboard and baseboard near the door. It also found “moisture damage and possible visible mold growth” on a wall immediately adjacent to a shower door and slight moisture damage adjacent to the bath tub in another bathroom.³⁷ Michelle sent pictures of the bath and shower units to the manufacturer, Kohler Company. Kohler blamed installation errors for the problems.³⁸

Three months after receiving the WPC report, with many problems in the house still uncorrected, the Rechiens began to pursue legal options and learned that pursuing a lawsuit in court was not an option because their warranty contained an arbitration clause.³⁹

The warranty offered three arbitration firms to choose from: DeMars & Associates, the American Arbitration Association or Construction Arbitration Services. After some research, the Rechiens found the least negative information about DeMars and opted for that company.⁴⁰

The Rechiens sent a request for arbitration to HBW, the warranty firm, on July 14, 2008, along with a check for \$2,500.⁴¹ They listed 182 problems in their house and asked that the DeMars arbitrator specify a “method of repair” for items that the builder was required to fix.

When it received the Rechiens’ list of 182 problems, the warranty firm passed it along to Wardlaw. In a detailed response, the builder labeled 54 of them “covered defect[s],” leading the Rechiens to believe that the firm would fix them. These alleged problems were barely discussed at the subsequent arbitration hearing, Michelle said.

“The items were briefly skimmed over; even when they were skimmed over the builder agreed to repair them,” she wrote in an e-mail to Public Citizen.⁴²

Lannie Richardson, a home inspector in a Savannah suburb, arbitrated the case. He held a hearing at the Rechiens’ house in early September 2008. Days after the hearing, he telegraphed his decision by asking both sides for repair estimates on 39 items on the list of 182.⁴³

Among the items for which the arbitrator asked for repair estimates was the Rechiens’ complaint that four rooms in the house were “much warmer and colder than rest of house.” Two contractors said the heating and air conditioning system was inadequate. They gave the Rechiens bids of \$7,250 and \$7,500 to fix the system.⁴⁴ A third contractor proposed a different solution to Wardlaw – furnishing and installing “three (3) manual dampers into supply trunk lines so that the system can be balanced” for \$75 each – a total of \$225.⁴⁵

In his Oct. 10, 2008, decision, the arbitrator chose “acceptable” estimates for the 39 items that he deemed covered. In all but seven cases, he deferred to the estimates submitted by Wardlaw. On the heating and cooling problem, for example, he opted for the \$225 dampers instead of the \$7,250-\$7,500 estimates to replace the system.⁴⁶ Remarkably, of the 54 items that the builder had acknowledged were “covered defect[s],” the arbitrator ruled that 36 were not covered.

Although Wardlaw’s representative had promised at the one-year inspection that the Rechiens would not need to document every flaw in order to receive warranty repairs, the arbitrator did enforce the strict deadline. The arbitrator refused to consider holding the builder liable for at least 40 items because he lacked proof that the flaw had been reported within the warranty period.⁴⁷ For example, Item No. 108 alleged “closet door gaps,

uneven does not meet jam [sic].”⁴⁸ The arbitrator did not dispute that assessment, but deemed the flaw “not covered” because there was “no record in paperwork indicating reporting prior to expiration of the one year warranty.”⁴⁹

The arbitrator relied on the same rationale to deny coverage for drywall not finished in a closet, an uneven kitchen floor, ridges in ceilings, a split piece of door molding, a piece of doorframe trim pulling away from a wall, a wall bulging out due to a bowed stud, an uneven window, and an attic door that was improperly installed and would not close correctly.⁵⁰

The arbitrator relied heavily on other warranty terms to reject other claims. When the Rechtiens claimed a door was not closing correctly and was not level, the arbitrator agreed that the door was “not installed square within doorframe leaving unequal gaps around the doors [sic] edge.” But he cited the warranty to justify denying the claim. “Refer to page 17, Section 6 Doors and Windows. No coverage provided.”⁵¹

The Rechtiens alleged that the sill of the main window in the formal dining room was not level. The arbitrator deemed that issue “not covered,” explaining “normal separation caused by normal movement / expansion.”⁵²

The Rechtiens alleged that their back door continued to leak even after it had supposedly been repaired. The claim was rejected. “Contractor had previously repaired the doors and there were no signs of a current leak ... the warranty states the builder will repair or replace as may be required, which the builder has done.”⁵³

The Rechtiens also sought remediation for mold that had resulted from leaks through their back door. But again, the arbitrator shut them down. “Item 8f excludes coverage for mold.”⁵⁴

Included in the items Richardson did not award the Rechtiens were 34 problems that Wardlaw had characterized as “covered defect[s]” in its response to the Rechtiens’ list of 182 alleged defects. In some cases, the builder cited the warranty clause that covers drywall defects in justifying its declaration of “covered defect,” while the arbitrator cited the same clause to support his decision to deny coverage.

The arbitrator gave Wardlaw 60 days to remedy the 39 items “for which the builder is found responsible.”⁵⁵

The Rechtiens were shocked by the decision, which arrived days before John, an Apache helicopter pilot, departed for his second tour in Iraq.⁵⁶

They queried DeMars about the 34 items Wardlaw had characterized as “covered defect[s]” but which the arbitrator denied. DeMars responded that “the builder meant they could be covered,” according to Michelle.⁵⁷

Wardlaw responded with a letter proposing to send the Rechtiens a check for \$2,630, ostensibly representing the sum of the estimates that the arbitrator approved for the items he said the builder was required to fix. “This amount should sufficiently cover all costs to

make the repairs using contractors you feel will meet your needs and expectations,” Wardlaw’s attorney wrote.⁵⁸

The Rechiens refused the offer. In early December, Michelle received additional estimates from contractors on the cost of repairing the 39 items that the arbitrator deemed the builder’s responsibility, and found that the work would cost \$15,000 to \$20,000. For the rest, she has received estimates totaling \$30,000 to \$60,000, depending on the repair methods chosen.⁵⁹

Arbitration Firm Defers to Warranty Co. on Rules for Appeal

DeMars’ rules give arbitration participants one year to request, at a cost of \$1,000, a compliance inspection hearing to determine whether the other side has fulfilled its obligations under the arbitrator’s decision.⁶⁰

However, in an Oct. 15, 2008, letter to the builder, copied to the Rechiens, HBW said the couple had only 30 days beyond the repair deadline – or until Jan. 8, 2009 – to ask for a compliance hearing.⁶¹ Michelle requested a compliance inspection and provided a check for \$1,000 by the January 8 deadline.⁶²

DeMars rejected Michelle’s request for a compliance hearing, saying that the warranty company had sent a subsequent letter to Michelle in November moving the deadline to request a compliance hearing to December 25.⁶³ Michelle says she never received that letter.⁶⁴

Michelle pointed out to DeMars that the rules on the arbitration firm’s Web site provide for a one-year deadline for requesting a compliance inspection.⁶⁵ “That’s our rule,” a DeMars employee responded. “However, 2-10 [HBW] has their own policy of 30 days after the compliance period, or 30 days after the builder has stated that the work (or settlement) is complete. In such case, the warranty policy takes precedence over our rules. Thank you for your inquiry.”⁶⁶

DeMars’ own Web site contradicts this statement. It lists rules for disputes specifically involving HBW and those rules provide a one-year window to ask for a compliance hearing.⁶⁷

DeMars eventually relented and granted Michelle a compliance inspection hearing. Subsequently, DeMars said the arbitrator decided that review would be based solely on documents.⁶⁸

The compliance arbitrator, John Alberti, handed the Rechiens a small victory. Of the 39 items that Lannie Richardson, the original arbitrator, had awarded the Rechiens, Alberti decided that 25 were “not resolved.” The “builder settlement offer is not in compliance” with the Richardson decision, he wrote.⁶⁹ All 25 non-compliant items involved drywall repairs that a contractor had offered, in a proposal to Wardlaw, to fix for \$880.⁷⁰

However, in its settlement offer of \$2,630 Wardlaw had not included the cost of repainting the repaired drywall.

“An offer in the amount of \$3,210 would put the Builder in compliance with the October 10, 2008 decision,” Alberti wrote.⁷¹

But that money has proven insufficient even to fix the items for which the arbitrator has found the builder is liable. None of the contractors that provided the builder with bids to fix the problems for which the arbitrator found the builder liable honored their bids, Michelle said.

In November, HBW had told the Rechiens that they would get a refund of the \$1,000 appeal fee if the builder were found not to have complied with the arbitrator’s ruling. “Should the arbitrator rule that the settlement was not fairly offered in according (sic) to construction performance guidelines ... the fee will be refunded and the file will be forwarded to the warranty insurer, as outlined in the Home Buyers Warranty Booklet,” said a letter from HBW to John Rechiens.⁷²

After receiving the Alberti decision, Michelle called DeMars and asked for a refund of the \$1,000 fee she paid DeMars for the compliance hearing, because the builder had been found, in Michelle’s words, “non-compliant.” Remarkably, the DeMars representative refused and said Michelle would have to ask the warranty company for the refund.⁷³ Subsequently, HBW sent Michelle a check for \$1,000.⁷⁴

On another track, Michelle tried to get a ruling from Chatham County that Wardlaw had violated the building code in constructing her house.

The building inspection form for the Rechiens’ house indicates that the house is in the 110-mph hurricane zone. County officials say the current code for houses built in the 110 mph zone did not apply to the Rechiens’ house at the time it was built.⁷⁵ Tanner, the engineer who inspected the house, disagrees with that interpretation of the law and insists that the code applied at the time.⁷⁶

In November 2008, Michelle filed an appeal with Chatham County Board of Building Adjustments and Appeals seeking to have the builder “correct the house to meet” code requirements for the 110 mph wind zone.⁷⁷ The 9-member panel met twice with Michelle and Tanner but opted to take no action.⁷⁸

Repairing the multiple problems in the house is taking on urgency for the Rechiens. Shortly after John returns from Iraq – now scheduled for October 2009 – his unit will be transferred to Fort Drum, N.Y. That means he and Michelle will have to sell the house.

“At this moment we cannot put this house on the market,” Michelle said in an e-mail.⁷⁹ “I have to disclose everything; that includes the structural engineer’s report, the mold inspection, and the knowledge that the house has substantial code violations.”⁸⁰

II. Major Builder Has Repeatedly Violated Prohibition Against Requiring Binding Mandatory Arbitration

The importance of binding mandatory arbitration in shielding builders from accountability is perhaps best illustrated by the extraordinary steps one builder has taken to force its customers into arbitration despite the federal government's prohibition against its doing so.

In 1979, the Federal Trade Commission issued an administrative consent order prohibiting KB Home from making misrepresentations of fact and engaging in other unfair or deceptive acts or practices in the construction and sale of residential housing. The consent order required KB to provide for arbitration of warranty disputes (and to pay the cost of the arbitration proceedings),⁸¹ but prohibited the company from forcing homebuyers to accept arbitrators' rulings.

In 1991, the Justice Department filed a complaint in U.S. District Court alleging that KB Home had violated several provisions of the 1979 consent order. KB Home paid a civil penalty of \$595,000 and stipulated to a consent degree reinstating the 1979 order.⁸² That order will last until 2011, according to FTC staff.⁸³

In 1995, KB Home asked the FTC if it could legally provide a warranty that would require its customers to accept binding mandatory arbitration. The FTC staff said it could not.⁸⁴

In 1999, the FTC learned that the firm was issuing home warranties requiring homeowners to submit to binding mandatory arbitration and to pay for arbitration proceedings. The FTC put KB Home on notice that its actions were in violation of the 1979 consent order and the 1991 consent degree. Additionally, the FTC reminded KB Home's counsel that both orders prohibited KB Home from imposing the costs of arbitration on homeowners.⁸⁵

In June 2001, under FTC pressure, KB Home sent the commission a letter promising that it would stop enforcing the binding mandatory arbitration language in its warranties and stop requiring consumers who chose to go to arbitration to pay for it.⁸⁶

But in December 2002, the FTC's staff learned that KB Home was continuing to enforce binding mandatory arbitration clauses.⁸⁷

In March 2003, KB Home's counsel said in federal court that the FTC "fail[ed] to act when they have knowledge of what was going on," suggesting that the FTC tacitly approved of KB's practices. The FTC strongly disagreed with KB's account.

The FTC also reported that it had received multiple letters that KB had sent to homeowners instructing them that "if warranty disputes are not settled informally, homeowners will be required pursuant to the terms of their purchase agreements to submit their claims to binding arbitration."⁸⁸

In June 2003, KB Home wrote to the FTC saying that it had decided “to formally notify past customers that it will not assert the ‘binding’ nature of arbitration provisions in previously issued warranties.” But KB’s surrender came with an asterisk. The firm informed the FTC that future customers would be provided with a choice between a 10-year warranty that would not call for binding arbitration and a 12-year warranty that would call for binding arbitration. To the unwary, the promise of two more years of warranty coverage would likely provide sufficient incentive to accept the arbitration clause.⁸⁹ The letters to customers went out in July 2003.

Despite the fact that the consent order calls only for the use of “nonbinding arbitration” and says buyers submitting to arbitration “may reject the decision in which case it has no legal effect,” the FTC did not object to KB Home’s ploy to get buyers to assent to binding arbitration as long as the incentive was added.

In December 2004, KB sent a letter to home owners saying that it would pay all of the fees and expenses for arbitrations.⁹⁰ In other words, the firm was telling its customers that it would finally abide by terms to which it agreed in 1979.

In August 2005, KB Home agreed to pay a \$2 million penalty for forcing its customers into binding mandatory arbitration despite FTC staff’s instruction that doing so would violate the consent order.⁹¹

In May 2006, a Texas judge ordered KB Home to stop forcing homeowners to accept binding mandatory arbitration. Laredo district court judge Solomon Casseb approved a class action settlement that prohibited KB Home from requiring any past, present or future customers to consent to binding mandatory arbitration for warranty disputes.⁹²

Robert L. Collins, one of the lawyers who handled the class action lawsuit against KB Home, estimates that 160 to 200 of his clients have since been able to compel the firm to buy back their houses in the aftermath of the settlement.⁹³

Other KB business practices have also been the subject of scrutiny. In 2005, KB Mortgage Company (a subsidiary of KB Home) agreed to pay a \$3.2 million fine to settle charges of “poor underwriting practices,” including “approving loans to borrowers who were not eligible; approving loans based on overstated or incorrect income; failing to include all of borrowers’ debts; failing to properly verify sources of funds; and, failing to ensure gift letters met HUD requirements.”⁹⁴ It was the largest settlement in the history of HUD’s Mortgage Review Board.

It is doubtful that the government’s penalties had much effect on KB Home. The company’s CEO, Bruce Karatz, was paid \$232 million from 2003 to 2006. He resigned in 2006 amid a Justice Department investigation over whether he was guilty of backdating stock options. In March 2009 a federal grand jury indicted Karatz for the alleged stock options scheme. If convicted, he faces up to 415 years in prison.⁹⁵

KB has continued to include binding mandatory arbitration in its contracts. A KB Home purchase contract faxed to Public Citizen by the company in 2008 said, “By initialing in the space below you are agreeing to have any dispute arising out of matters included in

the ‘Arbitration of Disputes’ provision above and you may be giving up any rights you may possess to have the dispute litigated in a court of jury trial.”⁹⁶

Elsewhere, a KB Home “Intent to Purchase” form (also obtained by Public Citizen in 2008) reads, “All bonafide disputes shall be subject to binding arbitration, consistent with the Federal Arbitration Act, as in the KB Home Purchase Agreement.”⁹⁷

A third clause reads, “the parties agree that the construction of a new home involves matters of interstate commerce and thus is subject to the Federal Arbitration Act.” That clause includes a disclaimer, which says “the provisions of the above Dispute Resolution section shall not apply to any repairs or warranty claims with respect to the home arising after the construction is completed and shall expressly NOT control over the dispute resolution provisions in the Warranty for such repairs or warranty claims.”⁹⁸

Even though the company paid a \$2 million fine in 2005 to settle charges that it illegally forced its customers into binding mandatory arbitration to settle warranty disputes, KB Home evidently has continued the practice as well.

Public Citizen was provided with a letter dated March 30, 2006, in which HOME of Texas (a warranty company) rejected a claim for alleged damages to a KB Home house.

“If you choose to not accept any portion of this report, you may initiate Binding Mandatory Arbitration in accordance with the terms of the Limited Warranty and the applicable arbitration rules,” the letter said.⁹⁹

Meanwhile, Collins, the class action lawyer, told Public Citizen that he has received several complaints from KB Home owners who claim the company has continued its practice of forcing customers into binding arbitration. Collins said that he has referred those cases to the FTC.¹⁰⁰

III. Building Industry Created Arbitration Firm to Handle Its Disputes

The building industry, warranty industry and arbitration industry have a very close relationship. This was illustrated in the creation of Construction Arbitration Services (CAS), which claims it is the largest provider of arbitration and mediation in the home building industry.¹⁰¹

CAS, based in Michigan, evolved from an arbitration firm that was formed by an executive of Home Owners Warranty (HOW) program and was heavily subsidized by HOW. HOW, in turn, had been created by the National Association of Home Builders.

Here is the history:

Lester B. Wolff was HOW's vice president in charge of dispute settlements in 1979, when he established the National Academy of Conciliators (NAC), he testified in 1998.¹⁰² Throughout its existence, NAC depended heavily on HOW for financial support, beginning with a \$400,000 loan it received from HOW for start-up costs.¹⁰³ HOW provided rent-free offices to NAC.¹⁰⁴ In 1983, HOW agreed to absorb NAC's legal defense costs, although it later limited its contribution to NAC legal costs to \$50,000 a year.¹⁰⁵

HOW agreed over the years to guarantee a minimum amount of revenue to NAC every month, beginning with a January 1983 promise to provide \$65,000 monthly, which rose to \$89,000 a month by 1987.¹⁰⁶ In 1987, HOW agreed to pay NAC up to \$100,000 for training and recruiting expenses and up to \$63,000 to develop new training materials.¹⁰⁷

In a deposition, Wolff revealed other ways that Home Owners Warranty and NAC were closely aligned. For a "period," Wolff testified, HOW actually selected the NAC arbitrators to handle disputes with homeowners.¹⁰⁸ The president of HOW was on NAC's initial board of directors. His successor attended NAC's board meetings.¹⁰⁹

Some members of HOW's board were members of NAC's board.¹¹⁰ The same attorney did legal work for both companies.¹¹¹

At one point, NAC's secretary-treasurer, Marshall Lippman, wrote that "NAC is and has always been an integral part of the HOW warranty program." He also wrote, "The decision by HOW to 'sponsor' NAC as a conforming dispute settlement 'mechanism' was a conscious and principled business decision."¹¹²

Lippman testified for NAC at hearings Congress called in 1991 to investigate allegations that HOW and other warranty companies were not living up to their obligations. In his testimony, Lippman stressed several times that the rulings generated by NAC's arbitration were not binding on home buyers.

For example, he said, "the homeowner has 45 days from receipt [of an arbitrator's ruling] to either accept it or reject it. If the homeowner accepts it, it is binding on the builder. If

the homeowner rejects it, the parties go from there as if they had had no process before.”¹¹³

Lippman speculated that such non-binding terms were necessary to insure fairness given the cozy relationship between the warranty company and the arbitration firm. “It is also necessary to remember that in all but one State (New Jersey), the decision of the dispute settler is only binding on the home owner if the home owner accepts it,” Lippman stated in his written testimony.¹¹⁴ “Perhaps this was the legislative trade-off for creating a mechanism funded solely by the warrantor or its agent.” Lippman also criticized a New Jersey warranty law for calling for arbitration that could preclude a buyer’s ability to bring a suit in court.¹¹⁵

But, at some point in the 1990s, NAC reneged on its promise to administer only non-binding arbitrations. Public Citizen has obtained a 1996 warranty issued by Home Buyers Warranty (HBW), which along with HOW, provided NAC the bulk of its housing arbitration referrals.¹¹⁶

The warranty said that any dispute not resolved by mutual agreement between a home buyer and builder “shall be settled by final and binding arbitration in accordance with the National Academy of Conciliators (NAC) rules.” Elsewhere, the warranty said, in all capital letters, “Your sole remedy against [insurance company] NHIC and/or HBW is final and binding arbitration as described herein . . . by signing the application for home enrollment, you waive any right you have, or may hereafter come to have, to sue NHIC (and/or HBW) in court.”¹¹⁷

In October 1994, a Virginia court placed the Home Owners Warranty program in receivership after that state’s Bureau of Insurance found its financial position so precarious that homeowners and builders were in danger of losing their coverage.¹¹⁸

Although the receivership ended the issuance of warranties, HOW continued to handle warranty claims – initially at 40 cents on the dollar. Eventually, HOW’s balance sheet recovered sufficiently to handle claims dollar for dollar.¹¹⁹ NAC continued to arbitrate warranty disputes until 1997, when it filed for bankruptcy, reporting that it had lost more than \$600,000 in 1995 and 1996.¹²⁰

When NAC filed for bankruptcy, HOW apparently owed it a “retainer” of almost \$1 million. Papers filed in the NAC bankruptcy case say that the arbitration company’s major asset was a “retainer” of \$883,333 for the last two months of 1994 (at \$66,666 per month) and all of 1995 (at \$62,500 per month). The bankruptcy filing did not name the debtor.¹²¹

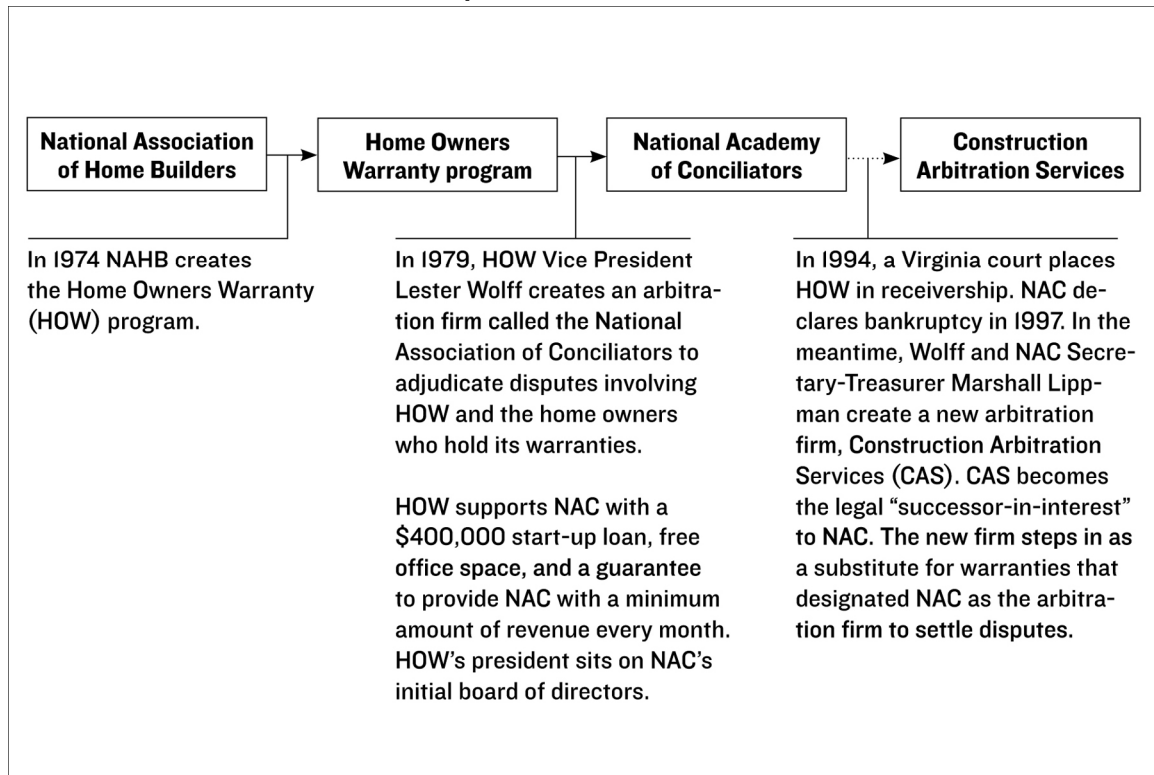
By the time NAC filed for bankruptcy, Wolff and Lippman, had already incorporated Construction Arbitration Services.¹²²

Wolff later said in a sworn statement that the new firm took over much of NAC’s work and hired many of its employees.¹²³ He described Construction Arbitration Services as “the successor-in-interest to certain rights and liabilities of the National Academy of Conciliators, a defunct alternative dispute resolution service.”¹²⁴ Moreover, Wolff said in

the declaration, the CAS arbitration rules for home warranty cases were “nearly identical” to the NAC rules.¹²⁵ In other words, CAS stepped into the shoes of NAC, which had been created by HOW, which was created by the National Association of Home Builders.

CAS claims that it was “formed to provide neutral arbitration services in the general area of residential and commercial construction for disputes between consumers and builders, sellers, real estate agents and home inspectors.”¹²⁶ But for the company to have been truly neutral would have been remarkable given that it was almost identical to NAC, which had no credible claim to neutrality.

Figure 2: Building Industry-Sponsored Warrantor Creates Arbitration Firm to Adjudicate its Disputes With Customers



In fact, Wolff said in his 1998 deposition that CAS was a member of the National Association of Home Builders.¹²⁷

Indeed, CAS has suffered numerous blows to its credibility.

In 2004, an Oregon judge concluded that CAS co-founder Lippman had lied under oath when he said in a 2004 declaration that he was a lawyer. In fact, had been disbarred. As a result, the judge refused to order arbitration in a dispute and allowed a jury trial in which the homeowners won a \$500,000 verdict.¹²⁸ Lippman resigned that year, according to a CAS press release, issued two years later.¹²⁹

In 2005 in Wisconsin, a landscaping company asked a judge to send its dispute with a construction company to arbitration with CAS. Days before the arbitration hearing date, Judge Michael N. Nowakowski heard a motion to enjoin CAS from handling the arbitration based on the allegation that CAS is biased.

Nowakowski granted the injunction, citing three factors:

- He said, “The undisputed evidence [is] that the co-owner of CAS [an apparent reference to Lippman] is a person whose ethical obligations apparently were not very important to him, and his devotion to the interests of furthering his business, allowed him to lie to a court.”¹³⁰
- The resume of the individual scheduled to arbitrate the case had been falsified, either by CAS or the arbitrator, to say that he had a college degree when he had a two-year college certificate and that he was a licensed inspector when he was not.¹³¹
- A CAS marketing brochure cited in a 2002 report by a Texas Legislature committee that said, “One arbitration association, called Construction Arbitration Services, Inc. (CAS), distributes a brochure to prospective business customers stating: ‘Customer relationships survive, so goodwill and potential referrals are preserved. It’s confidential, not a matter of public record.’”¹³²

“The concern is that CAS is seeking to market itself, is seeking to secure the relationships with companies that will prepare contracts that designate CAS as the arbitrator,” Nowakowski said, according to a hearing transcript. “That’s how they will secure additional referrals.”¹³³

“The record does reveal what appears to me to be the kind of ‘evident partiality,’ on the part of CAS, that entitles the plaintiff to obtain an injunction,” Nowakowski said.¹³⁴

Other Arbitration Firms also Have a Close Relationship with Building Industry

CAS, AAA and DeMars and Associates are often named by builders and home warranties as approved arbitration firms. AAA and DeMars also have evinced close relationships with their corporate clients.

AAA

AAA’s construction arbitration rules were written by building industry professionals, its construction dispute resolution committee is chaired by a construction industry lawyer, and the firm holds training programs to advise construction industry businesses on how to manage disputes.

AAA’s pro-builder bias rings through in promotional materials for its spring 2009 construction conference. Its brochure advised builders not to miss this opportunity to hear about “How you can control the arbitration process through advocacy and by drafting

appropriate clauses for your contracts” and to obtain advice on “identifying the right arbitrator for your case.”¹³⁵ Imagine the federal judiciary holding a seminar for corporate lawyers on how to choose the “right” judge for a case.

More insight into the close ties between AAA and the building industry is offered by studying the background of Albert Bates Jr. IV., who helped moderate two AAA construction industry conferences in 2008 – a May seminar in New York and a November seminar in Chicago. Both conferences focused “on how alternative dispute resolution (ADR) processes can be tailored to the needs of your construction-industry disputes.”¹³⁶

According to Bates’ biography on his law firm’s Web site, he is a lawyer who represents several major construction clients. He is a member of AAA’s board of directors. He also is chairman of the National Construction Dispute Resolution Committee, which his biography describes as “a group of representatives from more than thirty prominent constructions industry professional organizations that advise and consult with the American Arbitration Association on conflict management and dispute resolution practices, processes and procedures for the construction industry.” Bates also has represented clients in arbitrations administered by AAA and four other arbitration firms.¹³⁷

AAA acknowledges the construction industry’s role in writing its construction arbitration rules. AAA says the rules were “developed in conjunction with the National Construction Dispute Resolution Committee, made up of representatives of industry organizations.”¹³⁸

DeMars

DeMars’ own materials reveal its bias toward corporate parties, whom it views as its “clients.” DeMars Web site touts 14 corporations, including eBay, General Motors, Ford and 2-10 Home Buyers Warranty, as its “satisfied clients.”¹³⁹ And, in a Power Point presentation it made to the “World Congress” of the National Contract Management Association in April 2008, the firm provided a “client list” of 16 firms, including 2-10 Home Buyers Warranty, four other home warranty firms and the Metropolitan Builders Association.¹⁴⁰

IV. Buyers Have Little Defense Against Arbitrators with Conflicts of Interest

As with arbitration firms, arbitrators have far more incentive to side with builders than with buyers, and buyers enjoy little assurance that their cases won't be handled by an arbitrator who is affiliated with the building industry.

Texas Arbitrator Had Lobbied to Limit Builders' Liability

Stephen Bond Paxson, a Houston attorney who performed contract work for the Greater Houston Builders Association, was an arbitrator for the American Arbitration Association (AAA).¹⁴¹

In at least two cases in which he ruled for homebuilders in disputes against buyers, Paxson failed to disclose that that he had testified before the state's legislature and submitted a brief to the state's Supreme Court supporting a liability shield for builders. One of Paxson's arbitration rulings explicitly ignored the very legal precedent he petitioned the Supreme Court to overturn.

In both cases, homeowners learned of Paxson's conflicts after he issued rulings against them. One homeowner became aware of this information soon enough to convince a judge to throw out Paxson's ruling – a rare accomplishment for consumers forced into arbitration. The other was unable to win redress because the deadline to appeal had passed.

By 2001, Paxson had been performing legal work for the Greater Houston Builders Association (GHBA) for at least a decade.¹⁴² In two arbitrations, he disclosed in writing only that he was a member of the association. Later, called to testify about his relationship with the GHBA, he said he believed that he verbally informed the parties, "I've worked with" the association.¹⁴³ Litigation would later reveal that he was "special counsel" who performed "legal services" for the association on a case-by-case basis but was not an employee and was not on retainer.¹⁴⁴

In 1996, William Craig Falbaum and his wife Jennifer Falbaum bought a new house from Houston Village Builders Inc., a subsidiary of Lennar Homes. Two years later, they discovered what a court later called "significant foundation problems."¹⁴⁵ The Falbaums sued Houston Village Builders for breach of contract, breach of express and implied warranties and violation of the Texas Deceptive Trade Practices Act (DTPA). However, their purchase contract required all disputes to be arbitrated before AAA.

At the outset of arbitration, the Falbaums and Village Builders received a list of potential arbitrators and each exercised strikes based on biographies AAA provided. Choosing from those who remained, AAA appointed Paxson to handle the case.

Paxson held a hearing on April 25, 2001, and issued a six-page decision three weeks later. He wrote that there was evidence of "differential movement of the foundation [that]

had caused a crack in the slab, as well as cracking in the exterior brick veneer, along with cracks in the interior tile floors and sheetrock found in the residence.”¹⁴⁶

He wrote that the problems with the foundation “might well form the basis of a claim for the breach of an implied warranty,” but then ruled out that conclusion because Paragraph 4 of the Falbaums’ purchase agreement with Village Builders states that the written warranty “is provided by the seller in lieu of all other warranties express or implied.”

Paxson next tossed out the possibility of a claim based on the builder’s express 10-year warranty. His justification was that the document was not properly “introduced into evidence at the hearing,” even though it was “appended to the Homeowner’s pleadings.”

Paxson wrote, “Since the terms of that document are not in evidence, the warranty cannot be evaluated in the context of Homeowners’ claim for breach of an express warranty.”

Paxson’s use of such highly technical rules – hair splitting over the whether a piece of evidence was properly introduced – conflicts with assurances provided by AAA. “An important feature of arbitration is its informality,” AAA’s home construction rules state. “Under the standard AAA rules, the procedure is relatively simple: legal rules of evidence are not applicable.”¹⁴⁷

Although Paxson took a strict and highly technical approach to procedures relating to evidence, he opted to ignore state law on another key part of the Falbaums’ case.

Most residential disputes in Texas are governed by the Residential Construction Liability Act (RCLA), a controversial law that limits the damages that homeowners can recover. Provided that the builder takes certain steps, the law prohibits homeowners from suing under the Deceptive Trade Practices Act (DTPA), which allows for a wider range of claims and higher damages awards.

Before suing, homeowners must give builders written notice of alleged defects and allow them 45 days “to make a written offer to settle the claim.”¹⁴⁸ If a builder makes a reasonable offer and a homeowner rejects it or refuses to offer the builder a reasonable opportunity to repair the defect, the law limits the monetary damages that a homeowner can collect.¹⁴⁹

At the time of the Falbaums’ dispute, the law did not limit potential damages if the builder failed to make a reasonable offer. In a 2000 case, *Perry Homes v. Alwattari*, Texas’s Court of Appeals ruled that a contractor “loses the benefit of all limitations on damages” provided for in the RCLA when failing to make a reasonable settlement offer.¹⁵⁰ In these instances, homeowners are free to pursue damages under the Deceptive Trade Practices Act.¹⁵¹

The Falbaums relied on *Alwattari* to seek damages under the state Deceptive Trade Practices Act because the builder had failed to make a reasonable offer.¹⁵² Paxson rejected the Falbaums’ argument, explaining that in his view, the *Alwattari* case “was wrongly decided (by failing to take into account the legislative history of the RCLA and by ignoring traditional concepts of statutory construction).”¹⁵³

Paxson concluded, “The homeowners are not entitled to any damages or attorney’s fees due to their failure to demonstrate that the builder breached the agreement or any express or implied warranty accompanying the transaction, as well as their failure to prove any claim for negligence, mental anguish damages or violations of the DTPA by the builder.”¹⁵⁴

He ordered the Falbaums to pay \$236 to Village Builders as reimbursement for part of the arbitration fees and expenses. Those fees and expenses included \$6,071 for Paxson.¹⁵⁵

Days after the decision, the Falbaums’ attorneys learned that Paxson’s connection with the Houston builders association went beyond mere membership.¹⁵⁶

The Falbaums subsequently learned that Paxson had not told the whole story when he filed his disclosures. Not only was he an attorney for the builders’ association: he had taken public positions on issues crucial to the Falbaums’ case. They learned that while their arbitration case was underway, Paxson urged the state legislature in testimony to change the Deceptive Trade Practices Act on which the Falbaums were relying for relief.¹⁵⁷

Paxson also had submitted a brief on behalf of the Greater Houston Builders Association urging the Texas Supreme Court to overturn the Court of Appeals’ *Alwattari* decision. The Appeals Court decision “threatens to undermine the Legislature’s efforts to restrict the application of litigation-producing consumer protection statutes from residential construction defect cases so that the parties’ efforts can be directed to settling disputes rather than litigating them,” Paxson wrote.¹⁵⁸ The Texas high court declined to take the case.¹⁵⁹

A year earlier in another case, Paxson signed another Amicus brief for the Houston builders urging the Texas Supreme Court to allow home construction contracts to disclaim “implied warranties of habitability and construction in a good and workmanlike manner.” The brief claimed the existence of “a well-established state and national industry practice of ensuring certainty and predictability by providing express warranties to new home buyers in lieu of implied warranties” and argued that the lower court decision “will negatively impact the home building industry, the economic development that industry generates and the availability of affordable housing in Texas.”¹⁶⁰

Outraged at what they learned, the Falbaums went to court seeking to have the arbitration award overturned, arguing that Paxson’s failure to disclose his role with the builders’ association indicated “evident partiality” on his part.¹⁶¹

A Harris County judge threw out the arbitration award, ruling that Paxson’s “attorney-client relationship” with the builders association, his testimony before the legislature and his involvement in writing amicus briefs “should have been disclosed” to the Falbaums.¹⁶²

Village Builders appealed Judge Caroline Baker’s decision. The Texas Court of Appeals in Houston upheld Judge Baker’s decision and the state Supreme Court refused to take

the case.¹⁶³ “The Falbaums have resolved their dispute with Village Builders,” said Victoria Fair Woo, one of their attorneys, adding that terms are confidential.¹⁶⁴

Another buyer learned of Paxson conflict too late to get adverse ruling dismissed

Paxson repeated the same conduct in another AAA arbitration that was underway while the Falbaums were challenging his inadequate disclosures.

On Aug. 14, 2001, a AAA attorney was present when Paxson testified before Judge Baker in the Falbaums’ case.¹⁶⁵ Nine days later, Paxson issued a decision in a AAA arbitration of a dispute over a condominium renovation. In that case, he withheld the same key information about his attorney-client relationship as he had in the Falbaum case. But this time, the consumer did not learn about Paxson’s conflict until it was too late.¹⁶⁶

Michael Pullara had withheld \$55,000 from Becker Fine Builders Inc. because, he claimed, Becker was 151 days late in completing renovation of his condominium.¹⁶⁷ Pullara claimed Becker’s delay cost him more than \$48,000 in added living and construction expenses.¹⁶⁸ Becker filed for arbitration against Pullara and the case was assigned to Paxson.

Paxson ruled that Becker had indeed breached the construction contract and that the delay was primarily caused by the builder’s failure to obtain proper performance from a subcontractor. But, Paxson said, the homeowner had chosen to allow the builder to complete the residence and had made additional changes in the plans and specifications during the delay.¹⁶⁹

Paxson ordered Pullara to pay the builder \$97,442 for damages, attorney fees and arbitration costs. The award included \$55,999 Pullara had not paid Becker and \$32,500 in “reasonable and necessary attorney fees.”¹⁷⁰

A year later, Pullara learned of Paxson’s non-disclosures in the Falbaum case when his attorney and one of the Falbaums’ attorneys had lunch.¹⁷¹

Federal and state laws provide only 90 days to ask a court to overturn an arbitration award. Because that window had closed, Pullara sued AAA and Paxson for damages allegedly resulting from Paxson’s incomplete disclosure. He hired the Falbaums’ attorneys to handle the case.

AAA and Paxson claimed that their status as arbitrators gave them immunity. A Harris County District Court judge agreed, ruling against Pullara without issuing a written explanation.¹⁷² Pullara appealed to a Texas Court of Appeals in Texarkana, which ruled against him.¹⁷³

Paxson now coaches builders on how to limit their liability

Paxson taught a seminar titled “What Is (Or Should Be) in YOUR contracts?” at the International Builders Show in Las Vegas in January 2009. The seminar promised to

teach attendees to “manage customer expectations (limit/shift liability) and discuss “specific contractual provisions that effectuate these purposes (with practical examples how provisions work).”¹⁷⁴

Paxson’s advice also underscored the degree to which warranties are meant to protect builders, not buyers. Of limited warranties, he said in a recording obtained by Public Citizen, “what really I’m doing here is that I’m collapsing into the warranty agreement all construction contract obligations and saying the warranty document is what we’re going to go with.”¹⁷⁵

He continued: “Implied warranties, warranties from the UCC – the uniform commercial code – those things generally can be disclaimed and you want to disclaim those because they just expand opportunities to get sued. You want a document, your warranty, to be the playbook, so to speak.”¹⁷⁶

Paxson cited the advantage of keeping an arbitration clause in effect as among the chief benefits of ensuring that warranties remain in effect if a house is sold.

“I want my builders to have warranties that extend to future homeowners because then you can again in the warranty itself start managing the dispute resolution process,” he said. “You can put an arbitration provision in there. You can put in there limits on what benefits can be ascribed so that when they get that warranty, when the homeowner accepts that warranty, they accept with it all that you have added to it to help manage any potential dispute.”¹⁷⁷

He continued: “The best way to deal with it is with your warranty because again that’s a contract and you’ve got the ability to get the remote purchaser in your contract and playing by the rules of your game.”¹⁷⁸

CAS Appointed Arbitrator Who Worked for HBW

After losing an arbitration over a 2-10 HBW warranty on their new house, which had a leaking foundation and a crawl space saturated to the point that mold developed,¹⁷⁹ Linda and Rick Etherson filed an appeal with the firm that handled their case, Construction Arbitration Services.

The Knoxville, Tenn., couple sought information on the background of Stephen S. Spencer, the arbitrator assigned to hear their appeal, which was scheduled for late May 2006. Linda Etherson asked CAS for Spencer’s biography in letters dated March 28 and May 11.¹⁸⁰ Etherson did not receive the biography until May 20, just a few days before the appeal hearing, and she didn’t like what it showed.

In addition to arbitrating disputes involving home warranty issues, the biography said that Spencer also performed “Home Buyers Warranty (2-10) Inspections,” and assisted in certifying contractors “to become certified Home Buyers Warranty (2-10) Contractors.”¹⁸¹ In other words, Spencer was paid to inspect houses for HBW while he was also paid to be a “neutral” in resolving its disputes against homeowners who had HBW warranties.

With the hearing only six days away, the Ethersons faxed CAS a request for Spencer's recusal. That was the first of a series of fax and telephone requests that went unanswered until the day of the hearing, according to Linda Etherson.¹⁸² As Spencer was driving to the Ethersons' house for the hearing, he recused himself, according to CAS.¹⁸³

Subsequently, Spencer sent CAS a recusal letter "With my prior involvement with home warranty companies as an inspector and appraiser, I feel that I may not be able to be an impartial arbitrator for this particular hearing," Spencer wrote.¹⁸⁴

Remarkably, CAS said that the Ethersons would not receive a refund for the \$150 they had paid for Spencer's travel. Additionally, CAS said the Ethersons would have to pay an additional \$300 to finance the travel of the arbitrator appointed to replace Spencer.¹⁸⁵

"The \$150, which [w]as submitted for Arbitrator Spencer's travel fee requirement has been paid to Arbitrator Spencer due to the fact that he was in route to your location to hear the Appellate Appeal Case," wrote Cardell Wade of CAS.¹⁸⁶

The Ethersons protested, and ended up paying another \$150 – not the \$300 CAS demanded.¹⁸⁷ The appeal arbitrator overturned two of the initial arbitrator's decisions, but this was insufficient to fix the most important problems with the Ethersons' house.¹⁸⁸

Today, more than two years after the appeal arbitration, the Ethersons are fighting their case in court, attempting to get the arbitration decision modified or vacated, and to get moisture problems corrected. Their next court hearing is set for August.¹⁸⁹

An Arbitrator Discloses Business Relationship with Builder at the Last Instant

After Graham and Barbara Fill moved into their new house in Butler, N.J., in 2001, they discovered problems that included "water proliferation through the two story structure down into the basement as a result of improperly installed brick veneer."¹⁹⁰

When they failed to obtain a remedy from the builder, they pursued arbitration before Construction Arbitration Services, as their 2-10 HBW warranty dictated. Armed with technical reports and evidence on the defects in their house, the Fills heard the arbitrator make an astonishing announcement at the opening of the hearing.

"The arbitrator said right at the onset he was going to give us ten minutes to present our case," Graham Fill later told a New Jersey investigative panel.¹⁹¹ Fill suggested to the state panel that ten minutes was absurd because the case "was quite considerable and involved some technical aspects of how the wall system should have been installed."

Despite the promise of short shrift, the Fills did win on some points, including a judgment that the brick veneer had been improperly installed. When they could not agree with the builder on a method of repair, a second hearing was scheduled to work out that detail.

The second hearing ended abruptly even before it got underway, according to Graham Fill: "We were sitting down at the start of the arbitration and [the arbitrator] went through

it and advised us that he was an impartial arbitrator and went to some great lengths to discuss this with us, and then just his closing point was, 'I suppose no party here has any problem with me entering into a business relationship with the builder.' ”¹⁹²

“I just about exploded,” Fill recalled.¹⁹³

CAS later acknowledged that the arbitrator should have recused himself.¹⁹⁴

Two California Courts Find HBW Arbitration Clauses 'Unconscionable'

When Luis Velasco and his wife bought a house in Beaumont, Calif., in October 2000, they were given a copy of the builder's one-year warranty, which clearly stated that buyers' claims under the warranty could be pursued in court, Velasco wrote in a declaration.¹⁹⁵

A few weeks after moving into their house, the Velascos received a second document – a 2-10 warranty booklet from Home Buyers Warranty. “This was the first time we had ever seen the warranty booklet,” Velasco wrote.¹⁹⁶

In 2005, Velasco and 18 other plaintiffs sued the builder, Osborne Development Corp., alleging that their houses had several defects, including problems from soil movement; foundation deficiencies; plumbing leaks; stucco, window, and roof problems; finish problems relating to cabinets, floor tiles, and countertops; and problems with the framing and electrical, heating, plumbing, and ventilation systems.¹⁹⁷

Osborne responded by arguing that the plaintiffs could not sue in court because they had entered into an arbitration agreement by enrolling in the Home Buyers Warranty program. The agreement said, “Any and all claims, disputes and controversies by or between the Homeowner, the Builder, the Warranty Insurer and/or HBW . . . shall be submitted to arbitration.” Even disputes about the interpretation and enforceability of the arbitration agreement itself “shall be submitted to an arbitrator.”¹⁹⁸

Additionally, the HBW booklet voided any other warranties. “All other express or implied warranties, including any oral or written statements or representations made by your Builder or any other person, and any implied warranty of habitability, merchantability or fitness, are hereby disclaimed by your builder and hereby waived by you . . . Your only remedy in the event of a defect in or to your Home or in or to the real property on which your Home is situated is the coverage provided to you under this express limited warranty.”¹⁹⁹

The warranty prohibited owners from pursuing redress as a class.

The warranty also prohibited claims for numerous categories of damage including “[n]oncompliance with plans and specifications; violations of local or national building codes, ordinances or standards; and “[a]ny condition which has not resulted in actual physical damage to your Home.”²⁰⁰

It called for arbitration to be governed by the rules of Construction Arbitration Services, or another arbitration firm of the builder's choosing.²⁰¹

The buyers argued that the arbitration clause was unconscionable. Several filed declarations denying that they had read the builder's warranty application. One said, “Had I known that these documents that purported to be a warranty were actually

intended to be a waiver of claims against Osborne, I would not have signed the Builder Application for Home Enrollment.”²⁰²

Before it could evaluate the legality of the arbitration clause, the court had to determine whether it even had authority to rule on that question. In the Kafkaesque world of arbitration law, it is possible for a court to rule that an arbitration clause is so tightly written – no matter how egregious its terms – that questions over its legality must be ruled upon by an arbitrator. In this case, the trial court found sufficient ambiguity in the text of the arbitration clause that it determined it could weigh in.²⁰³

The court next found the arbitration clause unconscionable for several reasons. First, its terms were not included in a contract between the builder and buyer, but rather between the warranty company and the buyer. “To the extent that the [warranty] application is intended to be, in substance, an agreement between the builder and the buyer, its title is misleading,” the trial court concluded. “The buyers were not asked to sign that application at the time of ... a purchase and sale agreement with the builder.”²⁰⁴

The terms of the arbitration “[w]ere laid out in documents that had not been presented to the buyers before they signed the application, were not given to them at the time they signed the application, and apparently were not available from the escrow officer or other person supervising the execution of the closing documents,” the court said. “A reasonable buyer would believe that the arbitration agreement to which the application referred would govern any dispute with HBW regarding the terms of the warranty, not disputes between the builder and the buyer.”²⁰⁵

The trial court also found that the contract was unconscionable “because it is not mutual,” explaining that the builder would not reasonably want to sue the buyer after the sale was complete; thus, only one side was giving up meaningful rights.²⁰⁶

In a second case, Gabriel Bruni and others purchased a total of 17 houses in Yucaipa, Calif., in 2001. The houses came with a warranty that was portrayed as “a benefit,” “an added bonus,” an “extra protection,” or “a huge gift from the builder.” Some were told it “would cover any problems with their home.”²⁰⁷ They later learned most of the warranty’s coverage lasts for only one year and relieved the builder of any liability beyond the warranty. Most crucially, the warranty compelled buyers to arbitrate any disputes over the warranty, their house, the sale of their house, and even over the requirement to arbitrate. In May 2005, Bruni and others sued the builder and nine subcontractors..²⁰⁸

The same month, a different group of buyers sued the same builder over defects with 20 houses they had bought in Yucaipa in 2002 and 2003.²⁰⁹

The defendants attempted to compel arbitration in both cases. A trial court denied the motions for arbitration because it found that a required minimum level of “integrity in the process was not reached here . . . the results of this agreement are too one-sided not to be found unconscionable.”²¹⁰

The builder appealed. The appeals court agreed that the homebuyers had not truly agreed to arbitrate. They were not given warranty booklets until the last moment – or in some cases until after they had moved in. The court also found that the builder’s agents “lessened any incentive plaintiffs might have had to read the booklet by describing the warranty as a benefit or bonus.”²¹¹

Further the court found that “plaintiffs would reasonably expect that the arbitration provisions would only apply to disputes over the warranty” whereas “the actual scope of the arbitration provisions was unforeseeably broad.” The provisions “purported to apply not only to disputes ‘arising from or related to this warranty’ but also to disputes ‘arising from or related to ... the subject home ... any defend or to the subject home ... or the sale of the subject home by the builder ...’ This would not have been within the plaintiffs’ reasonable expectations.”²¹²

Both lawsuits were settled after the binding mandatory arbitration clauses were tossed out.²¹³

V. Arbitration Awards Are Often Hollow Victories for Buyers

Defenders of forced arbitration often point to dubious statistics on consumer “win” rates to argue that the process is fair.

“I can only think of one arbitration within the past 12 months where the homeowner did not receive any award,” said Steven Lane. “In every other case, the homeowner was awarded something – maybe not everything the homeowner wanted, but something.” Lane, who was among the chief authors of AAA’s original arbitration rules, was the associate counsel for Lennar Corp. in 2003, when he made those comments.²¹⁴

But homebuyers who “win” in arbitration typically have little to show for their victories. Consider the case of Texas grandparents Jordan and Bob Fogal, who were forced to abandon a \$368,000 townhouse and ended up with an award of less than \$30,000.

In April 2002, the Fogals moved into what they believed would be their last home, an attractive three-story house that had 20-foot ceilings and, in Jordan’s words, “all the eye candy, even an elevator.”²¹⁵ They paid \$368,534 for the townhouse, one of 44 jammed onto a two-acre lot near downtown Houston.²¹⁶

On their first night in the house, Bob decided to try out the third-floor Jacuzzi. “When he pulled the plug, 100 gallons of water crashed through our dining room ceiling,” Jordan testified at a House Judiciary subcommittee hearing in June 2007.²¹⁷

After the Jacuzzi drain was fixed and the ceiling repaired, other, more serious problems emerged.

Within three weeks of moving in, Jordan noticed water leaks around windows. She immediately called Stature Construction Inc., the builder of her house.²¹⁸

In September 2002, Bob Fogal discovered a leak in the attic, prompting Jordan to call Stature again. The next month, Jordan wrote to Stature about a mysterious fluid pouring out of the side of the house into the yard. There was a “terrible leak outside the bottom of the deck off the kitchen, and black water is coming out of the house and running onto the plants and onto the brick and staining [them]” she wrote.²¹⁹

The builder continually asserted that it was unable to determine the cause of the problems. But Jordan soon learned that the builder knew the cause all along.

The former owner of a nearby house informed Jordan that the builder had discovered serious roof problems in Jordan’s house before she ever saw it, had sued its roofing subcontractor, and had unsuccessfully tried to repair it.

Jordan went to the courthouse to look up the court file on the suit. Shockingly, the builder had listed Jordan Fogal as a witness in its lawsuit against the roofing company.

“I saw my name listed as a witness for their side and a copy of one of my letters in the file,” she wrote in an e-mail. “I had been jumping through hoops trying to find out what the source of the problems with my house [was]. . . and then to see in black and white they had known it all along and were just delaying and trying to make me give up.”²²⁰

Jordan also later learned there was a previous buyer for the house who had ordered an elevator and handrails for the handicapped, then backed out of the deal.²²¹

Shortly after Jordan and Bob moved into the house, she began experiencing strange health problems. She sought a diagnosis from Dr. Patricia D. Salvato in November 2002.

“I had already been tested for AIDS twice and no one knew what was causing me to be sick, so someone told me she cared and searched for the causes and tried to help. . . She tested me and said I was immune deficient,” Jordan said in an e-mail to Public Citizen.²²²

Nearly two years later, on September 22, 2004, Salvato wrote a “To Whom It May Concern” letter, saying that Jordan had a “significantly depressed immune system and has continued to require aggressive IV therapy.”²²³

Salvato added, “It is my medical opinion that [Jordan’s] prolonged exposure to mold spores in her home has directly and significantly decreased her immune system” She recommended that Jordan move out of the house “as soon as possible.”²²⁴

On Sept. 8, 2004, two weeks before Salvato made that recommendation, Jordan sent a suspected sample of mold from the kitchen to a laboratory, which reported that it was a “very high” concentration of Chaetomium, a mold frequently found on water-damaged drywall and linked to autoimmune diseases as Multiple Sclerosis and Lupus, and to certain forms of cancer.”²²⁵

Later testing found additional species of mold on the second and third floors, including “very high concentrations” in a bathroom, high concentrations in a guest bedroom, and evidence of “very high” levels of moisture in several places, including under carpet and beneath the kitchen flooring.²²⁶

About two-and-a-half years after buying the house, told that repairs would cost more than \$150,000, the Fogals rented a small apartment and abandoned the house to foreclosure.²²⁷ They sued the builder.²²⁸ But the Fogals’ purchase contract with Stature Construction Inc. contained an arbitration clause.^a A judge granted Stature’s motion to compel arbitration.²²⁹

^a Had Jordan tried to research the seller’s record before signing a contract, she would not have found the litigation against the roofer or any other detrimental information. That’s because the Fogals’ contract did not name Stature as the seller. Instead it bore the name of “Tremont Homes,” which was not registered with the state of Texas. The name of Stature Construction Inc. was disclosed to the Fogals only at settlement.

After the American Arbitration Association terminated an initial arbitration case because of a dispute between the Fogals and the builder over who should bear the cost, the Fogals presented their case to a AAA-appointed arbitrator in September 2006.

Jorge Casimiro, Stature's CEO, testified at the Fogals' arbitration hearing that his firm was demanding thousands of dollars from Aztec Roofing and Sheet Metal Corporation for problems in the Fogals house. He said Stature wanted \$122,318 from Aztec for the cost of repairs plus \$62,431 for consequential damages and \$36,000 for lost marketability.²³⁰

Stature's failure to disclose the Aztec litigation and the substantial repairs to the house formed the basis of arbitrator Vicki L. Pinak's ruling that Stature had committed fraud against the Fogals. "Further," Pinak wrote, "once the Fogals made their initial complaints about leaks in their home, Stature should have handled such complaints immediately in light of the undisclosed prior leaks and problems with the home." Pinak also found "unreasonable" two Stature offers of settlement under the builder-friendly Texas Residential Construction Litigation Act, which requires homeowners to give builders a chance to resolve their complaints before filing suit.²³¹

Despite her strong vindication of the Fogals' positions, Pinak awarded them just \$26,088, seven percent of what they paid for the house.²³² She also ordered Stature to reimburse them for \$11,220 in arbitration fees they had paid.

The Fogals asked the arbitrator for a "Clarification of Award," but Pinak turned them down, refusing to explain her rationale.²³³

Meanwhile, a Harris County judge confirmed Pinak's arbitration award in April 2007. The Fogals appealed. A three-judge panel affirmed the decision in January 2009 and the Fogals have asked for a rehearing before all nine justices on the appeals court.²³⁴

Since the Fogals walked away from the house in June 2005, it has been sold three times. The most recent sale occurred in March 2008.²³⁵ Jordan wrote that she saw major work on the house following the last sale.²³⁶

"My house has been completely redone – walls inside and out," she wrote. "I saw them hauling off the carpet some sub flooring and the roof on the back side."²³⁷

Currently, the house is listed for sale on real estate Web sites and labeled as "bank owned."²³⁸

Arbitrator Rejects Claim For Collapsing Floor

Although arbitrators often grant small concessions to home buyers alleging serious flaws, sometimes they offer no help at all. Leslie and Scott Kimbell sought redress from an arbitrator for numerous flaws to their house, including a floor that was caving in because the builder failed to provide proper structural support for a stone fireplace. The arbitrator ended up agreeing that the problem and others existed but deemed the builder not liable.

The Kimbells' saga began in 2001, when they found a one and one-fourth acre lot in an attractive subdivision in Jefferson, Ga., a small town about an hour northeast of Atlanta. Leslie wanted a house built from plans she got from a magazine – with a few alterations. The subdivision developer, Sue Campbell Properties Inc., agreed and the Kimbells signed a purchase contract.

The major alteration was moving the two-sided stone fireplace from one interior wall to another so that it would serve the kitchen and great room instead of the media room and great room, as the original design showed.

Construction began in 2001 and the Kimbells settled on the 3,144-square foot house in May 2002, paying \$256,500. About a year after they moved in, the Kimbells noticed some problems including “a dip in the fireplace and some cracking in the walls above the fireplace.”²³⁹

They hired professionals to investigate.

One home inspector told them the staircases were pulling away from the walls, the front staircase sloped toward the back of the house, the floor was sloping toward the fireplace from the staircase and from the back of the house, and there was a three-fourths-inch drop in the floor over a two-foot span.²⁴⁰

The Kimbells hired a structural engineer to inspect the house. Marc Sorenson, the engineer, reported that the floor at the edge of the fireplace “has dropped an inch relative to the floor just two feet away.”²⁴¹ He also wrote that a single stud wall supported the fireplace and that the weight of the fireplace actually rested on subflooring between joists.

In his report to the Kimbells, Sorenson wrote, “The original plans called for basement load-bearing stud walls on all four edges of the fire place above” and these were built in the original location for the fire place, not the kitchen/great room location chosen by the Kimbells. When reminded that the plan had been changed, the builder moved the fire place but, Sorenson wrote “did not transfer this four-sided box to support the heavy loads from the fire place and second floor and roof framing above. The fireplace load continues to crush the single stud wall below.”²⁴² The Kimbells say that when Sue Campbell was alerted, she promised to install a steel jack enclosed in sheetrock in the basement to support the fireplace.²⁴³

Much later, the Kimbells ripped out the sheetrock and discovered there was no jack.

The Kimbells solicited three estimates for repairs, which ranged from \$43,320, to \$72,350.²⁴⁴

The Kimbells wanted to sue Campbell in court but were thwarted by their construction contract, which required settling disputes in binding mandatory arbitration. So, the Kimbells filed for arbitration against Campbell before the American Arbitration Association.

Jeffrey D. Paquin, an Atlanta attorney with a deep background in arbitration and mediation, chiefly on the corporate side of the table, was named arbitrator. Paquin is now chief operations counsel for Abbott Laboratories in Chicago.²⁴⁵

In 2001, Paquin said of his practice at the time, “Our practice designs and implements employment and other ADR programs for large companies.”²⁴⁶

Paquin held a two-day hearing in August 2006. He did not visit the house because, according to the Kimbells, the builder would not acquiesce to an on-site visit.²⁴⁷

In addition to the problem of the stone fireplace sinking into the basement, the Kimbells enumerated several other defects in the house in an arbitration filing. Among them:²⁴⁸

- the interior staircase was highly irregular,
- grading at rear sloping toward the house causing water seepage in basement drainage system directed toward the house,
- greater than normal settling of the front walk causing variance in the height of the front entry stairs,
- front entry stair smaller than the others, proven dangerous,
- lack of flashing above windows, causing severe water seepage,
- inadequately installed facade stone, falling from house,
- dangerously pitched shower floor.

Hours after the second arbitration hearing, Scott Kimbell decided to rip out the sheetrock in the finished basement beneath the fireplace – where Sue Campbell had said she would install a jack to support the fireplace. With a friend helping and Leslie recording it on video, the sheetrock came down to reveal not only that there was no jack but that someone had written on a beam beneath the fireplace, “Jack up floor sag,” and had highlighted it in fluorescent paint.

The arbitrator had agreed to leave the record open for a few days to accept final arguments and other material. The Kimbells put the video recording on a DVD and their attorney submitted it with her final argument.²⁴⁹ It was not mentioned in the brief five-page decision Paquin issued on Oct. 6, 2006.

In his decision, Paquin seemed to accept the existence of the defects listed by the Kimbells. But, amazingly, he blamed the Kimbells for them.

Paquin wrote, “Claimant has filed this arbitration alleging that Respondent is responsible for a variety of construction defects in the Claimant’s home including, among other things, structural defects, a sagging floor, a defective staircase, missing window flashing, a defective shower floor, a defective garage door opening, dangerous front stairs, stones falling from the house façade, inadequate shutter anchors, drainage issues, and a steep yard slope.”²⁵⁰

Then, he concluded, “The Arbitrator finds that while it is true that items in Claimant’s home are in need of repair, the Respondent is not responsible for the repair of such items under a negligence theory or otherwise. The ‘construction defects’ that are the subject of this dispute were either caused by the Claimant’s own actions or inactions, are typical homeowner maintenance items, or are otherwise the responsibility of the Claimant and not the Respondent.”²⁵¹

Paquin ordered the Kimbells and Sue Campbell Properties to split his fee and costs totaling \$21,200 and the AAA fees of \$4,700. He ordered each side to bear its own costs, including attorney fees.²⁵²

VI. Forced Arbitration's Secrecy Prevents Public Oversight

Defenders of binding mandatory arbitration often minimize cases that show clear miscarriages of justice as mere “anecdotes.” What these same defenders rarely acknowledge is that it is almost impossible to study arbitration results comprehensively for the simple reason that arbitration is secret.

There are a few exceptions to the cloak of secrecy surrounding consumer arbitration. Arbitration firms doing business in California are required to publish on their Web sites basic details of each consumer case they hear, including the name of the corporate or business party, the name of the arbitrator or arbitrators, the amount of the claim, the amount of the award and which party won the award.²⁵³ A similar disclosure law was recently passed in Washington, D.C.

But arbitration firms routinely flout even the minimal disclosure requirements they face. Consider the examples of DeMars, AAA and Construction Arbitration Services, the three arbitration firms that John and Michelle Rechten were permitted to choose from.

AAA appears to disclose the existence of all of its consumer arbitrations, but does so in a way that renders its data almost useless. AAA's disclosures lack basic information, such as which party brought each case and which party received damages if an award was made. Public Citizen brought this to the attention of AAA Vice President Richard Naimark in July 2008 and provided recommendations for improvements. Naimark said in an e-mail that he agreed with Public Citizen's critique.²⁵⁴ In March 2009, Naimark said that the firm had decided to implement improvements similar to those recommended by Public Citizen, but the changes have yet to be made.²⁵⁵

Construction Arbitration Services initially ignored the California disclosure law. After prompting from Public Citizen, the firm began posting data. But the information appears to be incomplete.

In response to a 2004 complaint by Public Citizen to CAS over the firm's failure to report, President Lester Wolff responded that CAS “does not administer cases which we consider ‘consumer arbitration.’”²⁵⁶ The firm then began to post reports on its Web site.²⁵⁷ But the reports are notable for their lack of information. The amount of the claim and the amount of the award are almost never listed. Often, the arbitrator's fee is not listed. And, most of the reports contain this note: “The Consumer party was presumed to have prevailed if any part of their claim was awarded.”²⁵⁸ As of March 31, 2009, CAS had not posted a report for 2008.²⁵⁹

The paucity of reports CAS has disclosed raises serious questions about whether CAS is reporting all cases it handles in California. As of May 18, 2009, the CAS Web site included reports on only 102 consumer arbitration cases for the five-year period from 2003 to 2007. A single arbitrator, Alan Johnson, handled nearly a quarter of those cases.²⁶⁰

A CAS official said in 2005 that the company handles 60 home arbitrations a month nationwide.²⁶¹ At this rate, it would have handled more than 400 cases in California alone over a five-year period if its caseload in California is representative.

CAS's secrecy extends beyond its administration and conduct of arbitrations. It seems loath to keep – or at least, to share – a paper trail.

In New Jersey, a state investigator testified that CAS refused to turn over records – and then changed its tune when it learned that investigators seemed likely to obtain them elsewhere. CAS stonewalled when the New Jersey Commission of Investigations conducted a three-year investigation of the of the home construction industry.

“CAS advised us that certain documents either did not exi[s]t or were not available to us,” Amy Campbell, a commission investigator, testified. “However, after we subpoenaed individual arbitrators, CAS contacted us and provided those documents to us.”²⁶²

DeMars lists its disclosures several layers down on its Web site. At the very bottom of the site's “Process FAQs” page is an unexplained web link that reads “California Case Statistics.” Clicking on that link (as of May 2009) brings up a chart reporting on 16 cases dating to 2006. For only two of the cases do the “Claim Amount or “Award \$ relief” field disclose dollar figures. In both cases, the chart reports that the builders asked for \$142,000 in damages and received exactly what they asked for. In several instances, the award relief is listed as “repair” and the consumer is declared the prevailing party. But the site notes that “Consumers were considered to have prevailed if all or a portion of the requested relief was awarded.”²⁶³

Arbitrator Held in Contempt in Case over Destruction of Evidence

In Louisiana, CAS threw a roadblock at a homeowner's plan to appeal an arbitration decision.

Within days of receiving the arbitration decision, David A. Szwak, the attorney representing Timothy Clark Gilbert and Karen Gilbert, asked CAS to preserve the evidence and send it to the court for use in an appeal.²⁶⁴

After that request and another one went unanswered, Szwak obtained a court order requiring CAS and the arbitrator to turn over the evidence. In his July 1, 2008 order, Judge Ford E. Stinson Jr. warned that they would be brought "before the court for further action" if they failed to comply.²⁶⁵

The arbitrator, Ben DeVries, responded that "all the evidence held in my possession was destroyed after the 20 day time frame expired under CAS Rule 22. . . ." That rule says nothing about preservation or destruction of evidence. Instead, it simply gives parties to arbitration 20 days after an arbitration decision is mailed to ask CAS for modification or clarification.²⁶⁶ Szwak had sent his request to CAS just 12 days after the arbitration decision was mailed to him.

Szwak moved for the court to hold DeVries and CAS in contempt. In response, "Defendants essentially argue," Judge Stinson wrote, "that whether CAS and DeVries complied with the Court's order is of 'no moment' to plaintiffs' ability to challenge the arbitration because the arbitration evidence was related to law and fact and that errors of fact or law do not invalidate an arbitration award."²⁶⁷

Judge Stinson noted that lawyers for the Gilberts and the builder filed affidavits saying that at the arbitration hearing, "Mr. DeVries agreed to keep and safeguard the evidence."²⁶⁸

Stinson found DeVries and CAS guilty of "constructive contempt" of court under Louisiana law, which he described as "obstruction or interference with the orderly administration of justice." He ordered them to pay a \$500 fine.²⁶⁹

The Gilberts were forced into arbitration as they sought reimbursement from their builder, Robert Angel, for nearly \$200,000 they spent to correct alleged construction defects that Angel would not fix. DeVries, the CAS arbitrator, ordered Angel to pay them \$114,000²⁷⁰ and the Gilberts are now seeking to have the decision modified to compensate them for their expenses.

In order to pursue the case, Szwak had to reconstruct the evidence at a cost to the Gilberts of \$4,262. He argued their case for modifying or vacating the arbitration award at a hearing in late March 2009. No ruling has been issued.²⁷¹

VII. Arbitration Clauses Threaten Retribution, Impose Gag Orders

Arbitration clauses commonly call for financial retribution against buyers who seek judicial review of the arbitration clause's legality.

Residential Warranty Company, which is used by several major builders, states, "Since this Limited Warranty provides for mandatory binding arbitration of Unresolved Warranty Issues, if any party commences litigation in violation of this Limited Warranty, such party shall reimburse the other parties to the litigation for their costs and expenses, including attorney fees, incurred in seeking dismissal of such litigation."²⁷²

D.R. Horton, another company, included an arbitration clause that called for customers who tried to go to court instead of arbitration to pay \$10,000 in liquidated damages to Horton. It also provided that parties were to bear their own costs of arbitration and to pay half of all other arbitration costs.²⁷³ The Nevada Supreme Court struck the clause down in 2004.²⁷⁴

A more recent Horton warranty still calls for punitive action against consumers who seek redress in court: "Since this Limited Warranty provides for mandatory binding arbitration of Unresolved Warranty Issues, if any party commences litigation in violation of this Limited Warranty, such party shall reimburse the other parties to the litigation or their costs and expenses, including attorney fees incurred in seeking dismissal of such litigation."²⁷⁵

Builder Sues Couple for Publicizing Troubles with House

In one case reviewed by Public Citizen, a major Texas builder sued a couple – in court, no less – because they took their complaints about flaws in their house to the public. The builder claimed that this exercise of free speech rights violated their mandatory arbitration clause.

In October 2005, Dan and Sherry Freeland signed a contract with Choice Homes, Inc. to pay \$160,050 for a house in Midlothian, Texas.²⁷⁶ Four months later, they settled on the purchase – one of 2,843 sales in 2006 that made Choice the nation's 34th largest builder that year with revenue of \$413 million.²⁷⁷

On the Freelands' first night in their house, heavy rains turned the back yard into a river. A gully formed and water pooled at the foundation. Midlothian city inspectors later attributed this to improper grading, as did an inspector hired by the Freelands.²⁷⁸

The Freelands began calling Choice Homes about the drainage problem the next day and within weeks began sending the company written requests to divert rainwater that flowed from other lots in the subdivision across their property and to repair construction defects inside the house.

While Choice fixed “a lot of little warranty requests,” Sherry said, “we quickly figured out that they were only going to correct the ones which didn’t cost very much money.”²⁷⁹

“The major problem with the property is our lot is used for subdivision drainage without a drainage easement on our lot,” Freeland wrote in an e-mail to Public Citizen. In the absence of an easement displayed on their plat, she said, “We had no way of knowing what we were getting into.”²⁸⁰ Three years later, the problem remains “Puddling and ponding” occur at depths of 4 to 6 inches during rainstorms, she wrote.²⁸¹

The Freelands demanded that Choice fix the problem. “We asked for a retaining wall, and although they agreed at first, they refused,” Sherry wrote.”²⁸² What is needed, she said, is a drainage system to carry the water to the street, something Choice refused to install. Instead, Choice built a berm on the Freelands’ property against their wishes.

Frustrated, the Freelands sought help from the Midlothian city government, prompting the mayor to press Choice to fix the problem.

“Based on site visits by City staff, we do feel that the Freeland lot was improperly graded, and that the Freeland’s ponding problem is the direct result of this inadequate grading work,” Mayor Boyce L. Whatley wrote to Choice Homes in May 2006.²⁸³

Whatley asked Choice “to undertake any and all action necessary to correct this and any other similar or interrelated drainage problems” in the subdivision. And, he criticized “berm work recently undertaken on the eastern property line of the Freeland’s lot” as “marginal,” saying that it “is not likely to solve the drainage problem, nor does it appear to be adequately placed and compacted. Furthermore, this work does not address the improper grading of the front and side (north) yards.”²⁸⁴

When Choice would not remedy their drainage problem, the Freelands protested publicly in various ways, including creating a Web site, posting signs in their yard, handing out flyers organizing a public meeting, and picketing at other Choice developments.²⁸⁵

In August 2006, they offered Choice Homes “the opportunity” to buy back their house for \$238,432, saying they should receive “fair market value” of \$175,000 plus reimbursement for closing costs, improvements they had made, moving expenses and \$48,000 for “health related issues, pain and suffering.”²⁸⁶

A month later, saying the Freelands “have taken to the streets,” Choice sued them on the grounds that they had breached their contract, which required all disputes to be settled in binding mandatory arbitration.

“Defendants breached the terms of the contract by ignoring the mandatory disputes resolution clause of the contract, and instead publicly complaining of and disparaging the building quality and practices” of Choice said in the court complaint.²⁸⁷

By filing the suit, Choice ignored the fact that the arbitration clause in the purchase contract required “breach of contract” disputes to be settled in arbitration rather than in

court. Indeed, the arbitration clause is so broadly worded that it requires binding mandatory arbitration for any dispute between Choice and its customers.²⁸⁸

Choice also claimed that the Freelands were wrongfully interfering with “prospective contractual relations” and were publicly making false defamatory statements “with actual malice.”²⁸⁹

Choice sought an injunction to silence the Freelands, saying it wanted to stop them “from directly or indirectly slandering or defaming plaintiff in any way, or from directly or indirectly disparaging plaintiff’s business,” from contacting Choice customers or prospective customer, and from maintaining a Web site about their problems with Choice.

In August 2007, the company promptly dropped the lawsuit, only to file an arbitration claim against the Freelands three months later.²⁹⁰ Choice accused the Freelands of refusing to allow the Texas Residential Construction Commission (TRCC) to handle their case or permitting Choice “to address or correct existing issues through its warranty process.”²⁹¹

“[I]nstead, Freelands have used unverified defect claims, and a ‘decision’ not to pursue repairs, to support a malicious website, aimed at harming Choice’s business and reputation,” Choice’s demand for arbitration said.²⁹²

In the meantime, Dan Freeland became ill and required surgery and the couple sank into deep financial troubles. Even though they had medical insurance, Sherry said, “the co-pay amount was astronomical. The builder problem, attorney fees from fighting the civil suit, and the medical bills pushed us over.”²⁹³

The Freelands filed for bankruptcy in February 2008, listing Choice Homes and the firm’s attorney as “creditors” because of the lawsuit Choice had filed, then dropped. The reason: Sherry said that the suit was dismissed without prejudice and Choice could revive it within two years of dismissal.

In February 2009, Choice Homes announced that it is going out of business.²⁹⁴ The Freelands are still in the house.

“Sometimes we wished we had walked away from it,” Sherry said in an e-mail, recalling that the \$27,000 down payment “made us think twice.” She added, “Looking back on it, the house was not worth the stress that Choice put us through. We haven’t heard a word from Choice or their attorney for a very long time. We do not feel our home is sellable, especially during this recession, as a couple of homes have been for sale in our subdivision for (probably) over a year with no buyers. And this lot has a problem.”²⁹⁵

VIII. FHA and Other Federal Entities Prohibit or Oppose Binding Mandatory Arbitration

One way to escape the housing arbitration trap is to obtain a mortgage insured by the Federal Housing Administration or Veterans Administration. Both government entities forbid builders from forcing their customers to settle disputes in arbitration, and both provide additional protections that strengthen the warranties that customers receive.

But buyers of FHA or VA-backed houses should be aware that builders and warranty companies may still try to force them into arbitration. As discussed below, a couple was given a warranty that suggested their only option was to go to arbitration. After they learned they had the option to go to court, they sued, and were able to win a settlement that was acceptable to them.

Buyers of houses backed by the two entities typically receive a “HUD Addendum” to their warranties. Here are some examples of addenda put out by major builders and warranty companies:

Pulte: “The Homeowner of a home with original FHA/VA financing is not required to submit disputes related to or arising out of this Limited Warranty to Binding Mandatory Arbitration.”²⁹⁶

RWC: “The following language is added: The judicial resolution of disputes is not precluded by this warranty and may be pursued by the homeowner at any time during the dispute resolution process . . . Because HUD does not require binding arbitration, the following is deleted: Since this Limited Warranty provides for mandatory binding arbitration of disputes, if any party commences litigation in violation of this Limited Warranty, such party shall reimburse the other parties to the litigation for their costs and expenses, including attorney fees, incurred in the dismissal of such litigations.”²⁹⁷

Ryland: “Any ‘unresolved dispute’ (defined below) that you may have with the builder you may submit to binding arbitration governed by the procedures of the federal arbitration act . . . *or you may file suit in a court of proper jurisdiction.*” [emphasis added]²⁹⁸

The key to the arbitration escape valve provided by HUD is in The Code of Federal Regulations at 203.204(g). It states, “Plans must, unless prohibited by applicable law, provide for binding arbitration proceedings arranged through a nationally recognized dispute settlement organization. . . . A plan must contain pre-arbitration conciliation provisions at no cost to the homeowner, *and provision for judicial resolution of disputes*, but arbitration, which must be available to a homeowner during the entire term of the coverage contract, must be an assured recourse for a dissatisfied homeowner.”²⁹⁹

Dave Curtis, A representative of the National Association of Home Builders said in Senate testimony in 2001 the that HUD clause requiring warrantors to offer the judicial alternatives “is opening the door for homeowner lawsuits, which greatly increases the risk exposure to warranty providers...”³⁰⁰

Curtis continued to argue that increasing the risk exposure to warranty providers by permitting a judicial option would add “to consumer home buying costs, since any additional risk borne by warranty providers would be passed along to home buyers in the form of increased premiums.”

In 2003, NAHB drafted a resolution charging that an increase in construction defect litigation has contributed to a liability insurance crisis which was, in turn, making it more difficult for the industry to provide affordable housing.³⁰¹

The resolution included several plans aimed at reducing the industry’s liability. The seventh plank was, “Support initiatives that promote binding arbitration in residential construction contracts and limit judicial invalidation of reasonable arbitration agreements.”³⁰²

But despite industry enthusiasm for mandatory arbitration of housing disputes, the federal government has taken an increasingly skeptical view. A joint report on predatory lending by HUD and the Treasury Department published in 2000 said that “because of the potential for arbitration clauses to restrict unfairly the legal rights of the victims of abusive lending practices, Congress should prohibit mandatory arbitration for high interest rates or high fees loans.”³⁰³

The report cited several problems with binding mandatory arbitration including its potential “to limit the borrower’s right to factual discovery,” to require the borrower “to pay all arbitration costs” or requiring that the arbitration be conducted “far from the borrower’s residence.” Additionally, the report noted that “consumers may not recognize a mandatory arbitration clause buried in the voluminous documents at closing” and that “private arbitration circumvents the development of clear and uniform standards for compliance with federal fair lending and consumer protection law through the decisions of an independent judiciary.” Finally, the report noted that arbitration does not allow borrowers “to collectively initiate or join class action lawsuits,” that it may prevent homeowners from obtaining the sort of “emergency relief that a court can order,” and that “arbitration does not result in broad injunctive relief designed to reform a company’s unlawful practices to prevent future violations.”³⁰⁴

In December 2003, Freddie Mac, one of two government sponsored entities that purchase loans, announced that it would no longer purchase subprime loans containing binding mandatory arbitration clauses. In June 2004, Fannie Mae, the other government sponsored purchaser of secondary loans, announced that it would no longer accept loans containing arbitration provisions.

In testimony to Congress in 2007, Daniel H. Mudd, then the CEO of Fannie Mae, listed the firm’s rejection of loans subject to arbitration as among its anti-predatory lending standards.

Warranty Company Tried to Force Dispute over FHA-backed House to be Settled by Binding Mandatory Arbitration

Cindy Schnackel paid \$126,475 in 2000 for a newly built 1,800 square-foot house in Oklahoma City, Okla. Soon after moving in, she began to notice serious defects, and to document them.

Experts hired by Schnackel, the builder's insurance company, the warranty company and National Home Insurance Company, the warranty insurer, all found the same problems involving foundation failure, improper grading, roof leaks and building code violations, Schnackel said.³⁰⁵ The builder and warranty company failed to correct the problems identified in the reports.³⁰⁶

After about a year of discussions but no work, the warranty company and NHIC tried to force Schnackel into arbitration with, in her words, "a pre-selected" arbitration company. Schnackel wrote.³⁰⁷

Fortunately for Schnackel, the house was financed with an FHA-insured mortgage, which prohibits warranty companies from forcing homeowners into arbitration under the Code of Federal Regulations at 24 CFR 203.204(g).

Not surprisingly, neither the builder nor its warranty company shared that fact with Schnackel. The warranty booklet arbitration clause required any and all disputes "under or relating to this agreement" be submitted to Construction Arbitration Services or, if CAS could or would not handle the dispute, to the American Arbitration Association. Another clause singled out FHA and VA buyers for special mention but it did not cite the provision in the Code of Federal Regulations that gives buyers the option of suing builders and the warranty company to resolve problems. Instead, the booklet said:

PREARBITRATION CONCILIATION (FHA/VA Financed Homes Only) If your Home was originally FHA/VA-financed and still has this original FHA/VA financing in effect, HBW and/or the Warranty Insurer will offer pre-arbitration conciliation at no cost to you. If you are dissatisfied with the outcome of pre-arbitration conciliation or you elect not to use the pre-arbitration conciliation provision, then binding arbitration is available to you during the entire term of the warranty.³⁰⁸

Schnackel sought to verify that federal regulations gave her the option of suing. She succeeded in December 2001 when a HUD official wrote that "warranty plan must provide several options to homeowners including: pre-arbitration conciliation, binding arbitration and judicial resolution of disputes."³⁰⁹

After receiving that letter, Schnackel continued to spar with the warranty company. "Neither the builder nor warranty company made repairs and neither paid our damages which ended up being well over \$100,000 when you add legal fees, experts fees, estimated alternative living for repair work, etc," Schnackel wrote.³¹⁰ "Repair costs alone represented about \$60,000 to \$70,000 of that amount."³¹¹

She sued in January 2003.³¹² HBW “settled the case satisfactorily” in 2005, Schnackel told Public Citizen.³¹³

HBW Misled Other FHA/VA Buyers About their Rights

HBW apparently has misled other FHA and VA buyers about their rights. A 2-10 HBW warranty from 2003 obtained by Public Citizen contains this clause regarding FHA and VA buyers, which suggests that binding arbitration is the only recourse for those who are unable to resolve their disputes through conciliation:

PRE-ARBITRATION CONCILIATION (FHA/VA Financed Homes Only): If your home was originally FHA/VA-financed and still has this original FHA/VA financing in effect, HBW and/or the Warranty Insurer will offer prearbitration conciliation at no cost to you. If you are dissatisfied with the outcome of prearbitration conciliation or you elect not to use the prearbitration conciliation provision, then binding arbitration is available to you during the entire term of this warranty.³¹⁴

IX. Arbitration Costs Much More than Court

Proponents of binding mandatory arbitration claim that it is cheaper than going to court.

Arbitration “has provided a cheaper, faster, more effective forum for a variety of disputes,” Peter B. Rutledge, a law professor, wrote in a 2008 document defending binding mandatory arbitration.³¹⁵

“Arbitration’s speed and simplicity means that it is less expensive for the parties than is court litigation,” adds Mark Fellows, an official of the National Arbitration Forum.³¹⁶

But the actual experiences of homeowners contradict those assertions.

Arbitration is full of expensive traps for consumers. The cost of initiating an arbitration case far exceeds the cost of filing a court suit. Beyond that, arbitrators’ fees often run into five figures, arbitration companies often impose additional fees on an ala carte basis as a case proceeds. In contrast, judges salaries are paid by the public, courts filing fees are modest, and courts to not deter meaningful inquiry by lading on extra costs every step of the way.

As a further pitfall, a consumer forced into arbitration can be stuck with the other side’s attorneys’ fees as a matter of course. In court, it is extremely rare for a consumer to be forced to pay a business’s lawyers. It generally happens only in cases brought in bad faith.

A good comparison of the costs of arbitration and court arose in parallel cases from Alabama – one before a jury and one before an arbitrator. In each case, the issues were virtually identical and the defendant was the same pest control company accused of failing to properly treat houses to protect them from damage by termites and other wood-destroying organisms. In each case, the same attorney represented the homeowners.

One case went to arbitration because the pest control company’s contract required it. The other went to court because the owner’s contract with the same company was signed before the firm included an arbitration clause.

Both cases took a little over a year to complete. Both cases produced an award for the homeowner – \$431,000 from an American Arbitration Association arbitrator and \$435,000 from a jury.

The big difference: cost.

The arbitration cost \$42,000. The homeowner had to pay \$24,000 of that – a \$6,000 filing fee to initiate the case and \$18,000 to cover half the arbitrator’s \$36,000 fee. The pest control company paid the other \$18,000 for the arbitrator.³¹⁷

Costs for the homeowner who proceeded in court totaled \$563 including a filing fee of \$319 – which was just 5.4 percent of the AAA filing fee.³¹⁸

Other examples from this report also illustrate the cost of arbitration:

In Houston, Michael Pullara was taken to arbitration by Becker Fine Builders Inc. He ended up with a \$32,500 bill for legal fees and arbitration costs incurred by Becker, and \$10,500 in American Arbitration Association fees.³¹⁹ And all this was in addition to the \$55,999 in damages that arbitrator Stephen B. Paxson ordered him to pay Becker. The contract Becker presented to Pullara included the requirement that the loser in arbitration pay the winner's attorney fees and costs.³²⁰ Today, it costs just \$212 to file a civil suit in Harris County District Court in Houston.³²¹ And it is highly unlikely that Pullara would have been saddled with Becker's attorney fees and costs.

Pullara is not alone.

Paul and Yolanda Brenner signed a contract with Toll Brothers for construction of a second home in Las Vegas and paid a deposit of \$45,210.³²² A clause in the contract said, "Start of construction could take up to 180 days from contract date."³²³

When construction did not begin within 180 days, the Brennens suggested parting ways, prompting Toll Brothers to accuse them of "anticipatory repudiation" of the contract.³²⁴ After Toll and the Brennens exchanged accusations of repudiation of the contract, Toll kept the deposit and the house was not built.³²⁵

In the ensuing arbitration, the arbitrator ruled primarily in Toll Brothers' favor, permitting the company to retain all but \$12,000 of the Brennens' deposit. The arbitrator also ordered the Brennens to pay Toll Brothers \$5,000 for attorneys' fees the firm incurred during the arbitration.³²⁶

Other homebuyers who were saddled with high fees include:

- John and Michelle Rechten were required to pay a \$2,500 fee to file for arbitration against the builder of their Savannah, Ga. home.³²⁷ The DeMars & Associates arbitrator awarded them \$3,210 – only \$710 more than their filing fee.³²⁸

Subsequently they asked for a follow-up inspection to see whether the builder had complied with the arbitration award. To get that inspection, they had to pay another \$1,000.³²⁹ (Michelle Rechten successfully demanded return of the fee when the compliance decision found that the builder had not complied fully with the arbitrator's original decision.³³⁰)

Had they been able to file in court, the Rechten would have paid only \$117.50 in Chatham County State Court, or \$112.50 in the county Superior Court.³³¹

- In Jefferson County, Ga., Leslie and Scott Kimbell were awarded nothing when they took their homebuilder, Sue Campbell Properties Inc. to

arbitration. But they had to pay \$12,950 in fees, splitting the \$25,900 in arbitration costs with Campbell.³³²

- Jeanette Martin, Fayetteville, Ga., took a builder to arbitration after the firm failed to fix problems and finish work on her house.

She had to pay Construction Arbitration Associates \$1,556 for half the costs for the filing fee and arbitrator's time.³³³

The arbitrator, Thomas E. Gotschall was paid \$2,613, for a decision which read in full: "Regarding the Claims of Jeanette Martin (Breach of Contract, Unjust Enrichment, Fraud and Fraud in the Inducement, et. al) the Respondent, Morningside Homes, LLC shall pay \$0.00 (Zero Dollars) and there is no responsibility of the Respondent."³³⁴

X. Solutions

For Congress

Congress should pass the Arbitration Fairness Act (AFA), which makes forced arbitration clauses unenforceable in consumer and employment contracts. Union contracts are exempt because unions bargain for fair mandatory binding arbitration for their members. The AFA would still permit arbitration for consumers and non-union employees. It would simply ensure that people have a choice whether to take their disputes to arbitration or court.

For States

States should pass laws banning the use of binding mandatory arbitration in insurance contracts and clarify that home warranties qualify as insurance products. Additionally, states should make it illegal for purveyors of insurance (including home warranties) to represent to consumers that disputes must be settled in arbitration.

Generally, federal courts have ruled that federal arbitration law blocks states from curbing forced arbitration. But the insurance context is an exception. The 1945 McCarran-Ferguson Act dictates that federal law does not preempt state law on insurance matters.

At least seventeen states have laws that prevent builders from requiring arbitration of insurance disputes.³³⁵ Public Citizen has not conducted an exhaustive review of each statute or the litigation under it, but there is precedent for deeming home warranties insurance under these laws.

In a Kentucky court case, homebuyers Todd and Cheryl King sued a builder and its warranty insurer, NHIC, for failing to repair defects in the new house they purchased in 2001.³³⁶ In response to the King suit, NHIC went to federal court and asked a judge to force the Kings into arbitration under terms of a clause in their warranty.³³⁷

NHIC claimed that it was providing not insurance but instead a type of coverage called a surety. The difference, NHIC said, is that builder had the primary obligation to the Kings for the claims and NHIC was required to step in only if the builder reneged.

The judge conceded that point but nevertheless rejected NHIC's effort to override Kentucky law, citing in particular the fact that NHIC, like many insurance companies, spreads its risk by purchasing reinsurance from other companies.

“In sum, while the warranty agreement here does have some features which resemble a suretyship arrangement, and while NHIC has obviously made efforts to clothe these agreements in such a fashion, it is clear that these agreements nonetheless function as an ‘insurance contract,’” Judge William O. Bertelsman wrote.³³⁸ “As such, the agreement should be within the scope of [the Kentucky law banning arbitration clauses from insurance contracts].”³³⁹

After the judge tossed out the arbitration clause, NHIC reached a \$43,500 settlement with the Kings.³⁴⁰

For Consumers

Consumers considering the purchase of a newly constructed house should consult a lawyer to learn their state's law on implied warranties for the purchases of new homes. In most cases, consumers would likely be well advised to reject warranties that builders include among the "benefits" that go along with the purchase of a new house. These warranties tend to do far more to reduce builders' liability than to protect buyers. Such warranties also almost always include clauses that force buyers to settle disputes in binding mandatory arbitration.

Regarding arbitration, consumers should require the builder to sign a document stipulating that the buyer retains the right to settle all disputes concerning the house in a court of law and reject any clauses attendant to the sale of the house requiring disputes be settled in arbitration.

Endnotes

- ¹ Michelle Rechten e-mail to Public Citizen Senior Researcher John O'Donnell, Nov. 11, 2008 and Michelle Rechten telephone interview with O'Donnell, Dec. 2, 2008.
- ² "Builder Application for Home Enrollment," by Jerry C. Wardlaw Construction Inc., for home of John T. Rechten and Michelle I. Rechten, Sept. 28, 2006.
- ³ 2-10 Home Buyers Warranty Booklet, HBW 307 01-17-06.
- ⁴ *Id.*
- ⁵ *Id.*
- ⁶ Letter from Jillian Aldebron, policy counsel, Center for Responsible Lending, to Philip Mendelson, chairperson, Committee on Public Safety and Judiciary, Council of the District of Columbia, April 6, 2007. The states are Arkansas, Georgia, Hawaii, Iowa, Kansas, Kentucky, Louisiana, Maryland, Missouri, Montana, Nebraska, New Mexico, Oklahoma, South Carolina, South Dakota, Utah, Virginia and Washington. Virginia, however, has passed a separate statute excepting home warranty companies from the ban.
- ⁷ Judge William O. Bertelsman, Opinion and Order, *National Home Insurance Company v. Todd E. King and Cheryl L. King*, Civil Action No. 2003-131, U.S. District Court for the Eastern District of Kentucky, Nov. 3, 2003.
- ⁸ D.R. Horton "Performance Standards of Material and Workmanship." Also, Residential Warranty Company LLC Limited Warranty. Available at <http://www.05.drhorton.com/website/denver/Warranty/10YearWarranty.pdf>. Viewed on May 13, 2009.
- ⁹ Pulte Homes, "Home Protection Plan," p. 9.
- ¹⁰ See, e.g., Centex Homes, New Home Sale Agreement obtained by Public Citizen via fax from Centex Homes on July 2, 2008. ("This Agreement provides that all disputes between you and Centex will be resolved by Binding Arbitration.." and "Buyer can notify Residential Warranty Corporation if buyer believes the possible construction problem is covered by RWC warranty...") RWC warranties provide for binding mandatory arbitration.
- ¹¹ See, e.g., Lennar Customer Care Department, Warranty Request. "You are encouraged to review the 2-10 HBW coverage guidelines prior to submitting this service form..." Available at www.northgatehighlands.org/files. Viewed on March 10, 2009. See also, 2-10 Home Buyers Warranty, sample warranty.
- ¹² KB Home Warranty explanation of arbitration clause on KB Web site available at <http://www.kbhome.com/Page~PageID~325.aspx#Warranty4>. Viewed on March. 31, 2009. See also, KB Home purchase agreement obtained by Public Citizen July 1, 2008.
- ¹³ K Hovnanian Homes Web page for The Hamptons at Woodmore (Prince George's County, Md.). Available at <http://www.khov.com/Home/MD/WO/IncludedInYourHome.htm>. Viewed on March 10, 2009. Also, e-mail from K Hovnanian spokesman Douglas Fenichel to Taylor Lincoln, research director of Public Citizen's Congress Watch division, March 24, 2009.
- ¹⁴ Ryan Homeowners Manual, p. 92. ("If after thirty days of sending your notice to the Builder's Corporate Headquarters, you believe you have not been able to obtain satisfactory performance under this Warranty, you must notify, in writing, the Customer Service Office, at the address set forth above, of such dissatisfaction ... and request that the dispute be decided by binding arbitration ...")
- ¹⁵ E-mail from Ryland Senior Vice President Eric Elder to Taylor Lincoln, research director of Public Citizen's Congress Watch division, March 25, 2009.
- ¹⁶ E-mail from Beazer Vice President, Investor Relations & Corporate Communications Leslie H. Kratoski to Taylor Lincoln, research director of Public Citizen's Congress Watch division, March 25, 2009.
- ¹⁷ Public Citizen has placed several calls to Meritage and formally requested information on the firms' policy regarding binding mandatory arbitration, but has not received a response.
- ¹⁸ Arbitration Task Force, Report to the 80th Texas Legislature and the Texas Residential Construction Commission, February 2007, p. 8.
- ¹⁹ HBA of Greater Cleveland, Application for Membership. Available at [www.clevelandhba.com/pdf/HBA%20Application%20\(2\).doc](http://www.clevelandhba.com/pdf/HBA%20Application%20(2).doc). Viewed on March 30, 2009.
- ²⁰ House Committee On Civil Practices, Texas House Of Representatives Interim Report 2002, p. 23.

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- ²¹ Ryland Homes Senior Vice President Eric Elder e-mail to Taylor Lincoln, research director of Public Citizen's Congress Watch division, March 25, 2009.
- ²² House Committee On Civil Practices Texas House Of Representatives Interim Report 2002, p. 23.
- ²³ Michelle Rechten telephone interview with Public Citizen Senior Researcher John O'Donnell, Dec. 2, 2008.
- ²⁴ *Id.* and Michelle Rechten telephone interview with Public Citizen Senior Researcher John O'Donnell, Nov. 20, 2008.
- ²⁵ Michelle Rechten telephone interview with Public Citizen Senior Researcher John O'Donnell, Dec. 2, 2008.
- ²⁶ *Id.*
- ²⁷ Log kept by John and Michelle Rechten documenting their efforts to have problems in their house remedied, sent to Public Citizen Senior Researcher John O'Donnell on Nov. 12, 2008.
- ²⁸ Aug. 13, 2007, journal item from log submitted to Public Citizen by Michelle Rechten.
- ²⁹ Michelle Rechten e-mail to Public Citizen Senior Researcher John O'Donnell, Dec. 5, 2008.
- ³⁰ *Id.*
- ³¹ *Id.*
- ³² Testimony of Amy Campbell, investigative accountant for the New Jersey Commission of Investigation, third day of hearings on new home construction, Jan. 21, 2004, p. 80-82. Available at <http://www.state.nj.us/sci/nci.shtm>.
- ³³ John A. Tanner report to John and Michelle Rechten regarding "Structural Inspection of General Condition," Feb. 15, 2008.
- ³⁴ *Id.*
- ³⁵ Michelle Rechten telephone interview with Public Citizen Senior Researcher John O'Donnell, Dec. 2, 2008.
- ³⁶ E-mail from Michelle Rechten to Public Citizen Senior Researcher John O'Donnell, April 1, 2009.
- ³⁷ Forrest Estes, environmental project manager, and William S. Anderson, senior environmental engineer, WPC Engineering, Environmental & Construction Services, report to Michelle Rechten, April 17, 2008.
- ³⁸ Memorandum to Michelle Rechten from Sterling Customer Care Center, Kohler Co., Kohler, Wis., July 25, 2008.
- ³⁹ Michelle Rechten interviews with Public Citizen Senior Researcher John O'Donnell, Nov. 11, 2008, and Nov. 20, 2008.
- ⁴⁰ Michelle Rechten interview with Public Citizen Senior Researcher John O'Donnell, Nov. 20, 2008.
- ⁴¹ "Request for Arbitration" to 2-10 Home Buyers Warranty signed by John and Michelle Rechten, July 14, 2008.
- ⁴² E-mail from Michelle Rechten to Public Citizen Senior Researcher John O'Donnell, April 8, 2009.
- ⁴³ Letter from DeMars and Associates to John and Michelle Rechten and Jerry C. Wardlaw Construction, Sept. 15, 2008.
- ⁴⁴ Letter from Bubba Taylor, Lakeview Construction Company LLC, to Debbie Pinkowski, case coordinator, DeMars & Associates, Sept. 29, 2008, and Letter from H. Russell Black Jr. of The Windover Group LLC, to John and Michelle Rechten providing estimates "based upon your list dated 9/15/2008," undated.
- ⁴⁵ Proposal from Byrd Heating and Air Conditioning Inc. to J.C. Wardlaw, Sept. 24, 2008.
- ⁴⁶ Lannie Richardson, "In the Matter of the Arbitration between: John and Michelle Rechten, Homeowners, and Jerry C. Wardlaw Construction, Inc., Builder," CAP Home File No.: 5-800213, HBW Warranty No.: GA312604-01, Warranty Booklet No.: HBW 307 01/17/06, Oct. 10, 2008.
- ⁴⁷ Public Citizen analysis of opinion issued by Lannie Richardson, "In the Matter of the Arbitration between: John and Michelle Rechten, Homeowners, and Jerry C. Wardlaw Construction, Inc., Builder," CAP Home File No.: 5-800213, HBW Warranty No.: GA312604-01, Warranty Booklet No.: HBW 307 01/17/06, Oct. 10, 2008.
- ⁴⁸ Lannie Richardson, "In the Matter of the Arbitration between: John and Michelle Rechten, Homeowners, and Jerry C. Wardlaw Construction, Inc., Builder," CAP Home File No.: 5-800213, HBW Warranty No.: GA312604-01, Warranty Booklet No.: HBW 307 01/17/06, Oct. 10, 2008.
- ⁴⁹ *Id.*
- ⁵⁰ *Id.*
- ⁵¹ *Id.*

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- ⁵² *Id.*
- ⁵³ *Id.*
- ⁵⁴ *Id.*
- ⁵⁵ *Id.*
- ⁵⁶ Michelle Rehtien interview with Public Citizen Senior Researcher John O'Donnell, Nov. 20, 2008.
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