Federal Arbitration Act Preemption

Washington to Decide Consolidated Cases

By David E. Chawes and Lori K. McKown

State's high court to decide if FAA preempts state law concerning arbitration provisions in condo sales contracts.

Can Congress regulate condominium real estate sales contracts, or are such contracts merely "garden variety" real estate transfers subject entirely to state control? When, if ever, does the Federal Arbitration Act (FAA) preempt a contrary state law? In a case involving this very issue, the Washington Supreme Court will hear arguments during its fall term about what level of interstate commerce is sufficient to invoke the FAA to preempt the Washington Condominium Act (WCA), Revised Code of Washington (RCW) 64.34 *et seq*. Like most states, Washington public policy strongly favors arbitration. However, Washington's consumer-friendly Condominium Act contains a provision requiring "judicial remedies" for condominium disputes, which trial courts have interpreted to strike the arbitration provisions in condominium declarations and purchase agreements. If the Washington Supreme Court holds that only judicial remedies can resolve condominium homeowner disputes with the condominium declarants, then contractual arbitration provisions in Washington condominium purchase and sale agreements (PSAs) will be ineffectual.

The court will hear the consolidated appeal involving three condominium projects in which the condominium developers seek to resolve condominium owner association (COA) claims by enforcing the binding contractual arbitration provisions of the PSAs. The developers' argument is that out-of-state construction materials used to build the condominiums, as well as out-of-state purchasers and lenders, provide sufficient evidence of interstate commerce to invoke FAA preemption. The developers' appeals seek to reverse trial court decisions allowing the COAs to resolve all their WCA construction defect claims in state court.

What Constitutes Substantial Evidence of Interstate Commerce in the Construction and Sale of Condominiums?

One of the condominiums in question, The Pier at Leschi, is a 28-unit conversion condominium in Seattle. The declarant asserts that the construction and sale of the con-

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dominium involved interstate commerce. For example, two subcontractors were from other states, out-of-state materials were used in the conversion, and the purchase price for each unit was based on standard specifications, which required installation of products from numerous out-of-state suppliers or manufacturers. The PSAs expressly assigned the manufacturer's warranties for all installed items to the unit purchasers. Furthermore, the COA alleged that deck coating manufactured by a California corporation and siding manufactured by a Nevada corporation had defects or had been defectively installed.

Out-of-state residents purchased four of the units, of which two were for investment purposes. Out-of-state lenders financed nine of the sales transactions. Out-of-state entities held the grants for easements for cable television and broadband services, and a Connecticut corporation provided the performance bond for the long-term lease of aquatic lands beneath the condominium pier. Importantly, a Virginia corporation administers the limited warranty provided through the PSA, accepting the homeowners' limited warranty registration forms in Virginia, and returning validation forms to the homeowners in Washington and other states where the owners reside.

The second project, The Satomi Condominium, is an 85-unit development located in Bellevue, Washington. Over 70 percent of the building materials were from out of state. Similarly, the third condominium project, Blakeley Village in Seattle, used materials provided by manufacturers from 19 different states in at least 75 percent of its construction. Out-of-state residents living in 17 different states and one foreign country bought 30 of the 109 units, and out-of-state lenders financed 29 of the unit sales.

Federal law governs various elements of all residential real estate transfers. For example, home sellers must provide Lead-Based Paint information to the purchasers of older converted condominiums, pursuant to 42 U.S.C. §4852d(a)(1)(A). The U.S. Department of Housing and Urban Development, pursuant to the Real Estate Settlement Procedures Act (RESPA), 12 U.S.C. §§2601 *et seq*., requires use of "HUD-1" Settlement Statements for the transactions, and also requires financing institutions to provide the homebuyer with a HUD Special Information Booklet, a good-faith estimate of settlement services, initial and annual escrow account statements, and disclosure of any computer loan origination fee. The Depository Institution Deregulation Monetary Control Act, Pub. L. No. 960221, 94 Stat. 161 (1980), codified throughout Title 12 U.S.C., removed usury caps on state interest ceilings for loans secured by first mortgages on homes and preempted state limitations on a lender's ability to assess "points" and finance charges. Significantly, the PSAs expressly invoked federal preemption, contrary to state law, by requiring binding arbitration as the sole remedy for construction quality disputes.

The Pier at Leschi COA alleged that water intrusion and defects in the pier and dock of the condominium violated various portions of the WCA, including breach of express and statutory warranties provided by RCW 64.34.443 and .445. In addition, the Pier COA alleged common law claims, such as breaches of the implied warranty of habitability and the duty to disclose latent construction defects, and violation of the Washington Consumer Protection Act (CPA), RCW 19.86.020 *et seq*. The Satomi and Blakeley COAs alleged similar claims.

In response to the plaintiffs' complaints in the three cases, the developers filed motions to enforce binding arbitration under the terms of their PSAs. The trial courts denied the motions. The *Satomi* declarant appealed its trial court's denial to the court of appeals, which, in a 2–1 decision, found no evidence of interstate commerce in the property transfers. Instead, the court held that the transactions were mere "garden variety" real estate property transfers controlled by state law. *Satomi Owners Ass'n v. Satomi, LLC*, 139 Wash. App. 175, 188, 159 P.3d 460 (2007).

What Level of Interstate Commerce in Sales Will Trigger FAA Preemption?

The U.S. Supreme Court has long supported public policy favoring arbitration of contractual disputes. Typically, state law limiting contractual arbitration agreements must yield to the pro-arbitration provisions of the FAA, which expressly provides that a controversy arising from a contract evidencing a transaction involving interstate commerce shall be settled by arbitration. Uniform Arbitration Act, Prefatory Note (2000); 9 U.S.C. §2. FAA section 2 "is a congressional declaration of a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary." *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24, 103 S. Ct. 927, 74 L. Ed. 2d 765 (1983). "[A]ny doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration." *Id.* at 24–25, 103 S. Ct. 927, 74 L. Ed. 2d 765.

State laws applicable only to arbitration agreements that would invalidate such agreements are preempted by the FAA; however, only "general contract defenses, such as fraud, duress, or unconscionability, grounded in state contract law, may operate to invalidate arbitration agreements." *Luna v. Household Finance Corp. III*, 236 F. Supp. 2d 1166 (W.D. Wash. 2002). Where the FAA applies, it prohibits singling out arbitration provisions for suspect status under state law. *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681, 687, 116 S. Ct. 1652, 134 L. Ed. 2d 902 (1996).

In passing the FAA, Congress declared a "national policy favoring arbitration" and preempted "the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration." *Southland Corp. v. Keating*, 465 U.S. 1, 10, 104 S. Ct. 852, 79 L. Ed. 2d 1 (1984). The FAA created a substantive law of arbitration that is applicable in both federal and state courts when an arbitration agreement has been executed and interstate commerce is involved. *Id.* The concern of Congress addressed by the FAA is that states accord arbitration provisions the same weight as other contract terms.

The U.S. Supreme Court has held that no state may fail to enforce a contractual arbitration clause when it is willing to enforce the contract's basic terms, such as prices and services. *Allied-Bruce Terminix Companies, Inc. v. Dobson*, 513 U.S. 265, 281, 115 S. Ct. 834, 130 L. Ed. 2d 753 (1995). The FAA "makes any such state policy unlawful, for that kind of policy would place arbitration clauses on an unequal 'footing,' directly contrary to the Act's language and Congress's intent." *Id.* In *Allied-Bruce Terminix Companies, Inc.*, a homeowner sued a pest-control operator in Alabama state

court for failure to protect his house against termites. *Id.* at 268–69. Although the contract between the parties provided that the exclusive remedy for any claim was arbitration, the trial court refused to stay court proceedings pending arbitration pursuant to the contract and the FAA. *Id.* The Alabama Supreme Court upheld the denial of the stay on the basis that under a state statute, written, pre-dispute arbitration agreements were invalid and unenforceable, and the FAA did not apply to the termite-control contract. *Id.* at 269. The court considered the FAA inapplicable because the connection between the contract and interstate commerce was too slight, although the companies involved were multistate firms that shipped treatment and repair materials from out of state. *Id.*

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The U.S. Supreme Court overturned the Alabama Supreme Court decision and concluded the FAA term "involving" commerce was broad and the functional equivalent of "affecting" commerce, and therefore, the FAA's reach is similar to that of the Commerce Clause, applying both to interstate shipment of goods and to contracts relating to interstate commerce. *Id.* at 273–274 (citing U.S. Const., art. I, §8, cl. 3). The Court concluded the multistate nature of the agreement for termite control services sufficiently implicated interstate commerce to preempt a contrary state law. *Id.* at 282. The transaction evidenced by the contract need only "in fact" involve interstate commerce for the FAA to preempt a contrary state statute. *Id.* at 279–80.

In a subsequent case, the U.S. Supreme Court concluded the FAA governed debt restructuring arrangements between an Alabama bank and an Alabama construction company, stating that the phrase "involving commerce" is the "functional equivalent of the more familiar term 'affecting commerce'—words of art that ordinarily signal the broadest permissible exercise of Congress' Commerce Clause power." *Citizens Bank v. Alafabco, Inc.*, 539 U.S. 52, 56, 123 S. Ct. 2037, 156 L. Ed. 2d 46 (2003). The Commerce Clause power "may be exercised in individual cases without showing any specific effect upon interstate commerce if in the aggregate the economic activity in question would represent a general practice… subject to federal control…." *Id.* at 56–57. Although executed in Alabama by Alabama residents, the debt restructuring agreements easily met the "involving commerce" test because (1) funds were used from loans, the subject of the debt restructuring agreements, to finance large projects throughout the southeastern United States; (2) the restructured debt was secured in part by an inventory of goods assembled from out-of-state parts and raw materials; and (3) the general practice represented by the transactions at issue, commercial lending, had a broad impact on the U.S. economy, and was clearly within Congress' regulatory power. *Id.* at 57–58. *Citizens Bank* therefore confirmed the broad reach of the FAA that the U.S. Supreme Court had earlier announced in *Allied-Bruce*. *Satomi*, 159 P.3d at 465. The *Citizens Bank* holding was perhaps best summarized as follows:

> Thus, even when a transaction is entered into between residents of the same state and consummated in that state, the transaction implicates the FAA when "in the aggregate the economic activity in question" represents a "general practice subject to federal control." The particular transaction at issue "taken alone," therefore, need not have "any specific effect" on interstate commerce to implicate the FAA.

Legacy Wireless, 314 F. Supp. 2d 1045, 1052 (quoting *Citizens Bank*, 539 U.S. 52, 123 S. Ct. at 2040).

Federal courts have long regarded virtually any activity related to building and construction as one "affecting" interstate commerce. For example, in *N.L.R.B. v. Int'l Union of Operating Engr's, Local 571*, 317 F.2d 638, 642–43 (8th Cir. 1963), the court found that the building and construction industry is an industry affecting commerce. Similarly, in *U.S. v. Patterson*, 792 F.2d 531, 534–35 (5th Cir.), *cert. denied*, 479 U.S. 865 (1986), the court found that construction work for business purposes is likely to affect interstate commerce through the flow of people, money and materials across state lines.

An arbitration agreement in an insured home warranty is governed by and enforceable pursuant to the FAA where the warranty is sold in interstate commerce, the parties are from different states, or the home was located in a state other than the domiciliary state of the warranty company. *McKee v. Home Buyers Warranty Corp. II*, 45 F.3d 981, 984 (5th Cir. 1995); *Rainwater v. Nat'l Home Ins. Co.*, 944 F.2d 190, 191–92 (4th Cir. 1991). Under similar circumstances, the California Court of Appeals held the FAA preempted a California statute that permitted judicial resolution of construction defects where the parties agreed to arbitrate and the developer had utilized out-of-state contractors, engaged in nationwide marketing and advertising using interstate media, and used building materials and equipment manufactured and shipped from multiple states. *Basura v. U.S. Home Corp.*, 98 Cal. App. 4th 1205, 1214–15, 120 Cal. Rptr. 2d 328, *rev. denied* (2002).

Financing the purchase of a single-family home with a Federal Housing Administration home loan, subject to HUD jurisdiction, was held sufficient interstate commerce to trigger FAA preemption. *Hedges v. Carrigan*, 117 Cal. App. 4th 578, 586, 11 Cal. Rptr. 3d 787 (2004). The copyrighted loan forms used in the transaction were only for use by National Association of Realtors members, thereby implicating interstate commerce. *Id.*

The FAA preempted a contrary state law in a California construction defect case where the suppliers provided construction materials manufactured outside California and delivered them across state lines. *Shepard v. Edward Mackay Enterprises, Inc.*, 148 Cal. App. 4th 1092, 1100–01, 56 Cal. Rptr. 3d 326 (2007). Even if the specific materials in dispute did not cross state lines, FAA preemption still applied because the pertinent question is *not* whether the dispute arises from the particular portion of the transaction involving interstate commerce, but only whether the *contract* evidences a transaction involving interstate commerce. *Id.* at 1101.

The Alabama Supreme Court has listed five criteria to consider to decide whether a given transaction substantially affects interstate commerce: (1) the citizenship of the parties and affiliation of the parties with out-of-state entities; (2) the tools and equipment used in performance of the contract; (3) the allocation of the contract price to cost of services and materials involved in performance of the contract; (4) the subsequent movement of the object of the contract across state lines; and (5) the degree to which the contract is separable from other contracts subject to the FAA. *AmSouth Bank v. Dees*, 847 So. 2d 923, 936 (Ala. 2002). The court held in *AmSouth Bank* that application of the five criteria to the totality of the actions of the mortgagor and the mortgagee demonstrated interstate commerce because money moved across state lines, and the parties used instruments of interstate commerce, such as phone lines, to move the money. *Id.* at 938.

In Georgia, a homeowners' warranty contract requiring FAA arbitration was enforced where the warranty administrator was an out-of-state corporation and warranty complaints had to be sent to its out-of-state home office. *Langfitt v. Jackson*, 284 Ga. App. 628, 644 S.E.2d 460, 466–67 (2007). A contractor's right to compel arbitration under the FAA was upheld where the contractor was an out-of-state corporation and 29 suppliers to the project and the materials they supplied were from out of state. *McCarney v. Nearing, Staats, Prelogar and Jones*, 866 S.W.2d 881, 888 (Mo. App. W.D. 1993).

In a Texas case, the paint and epoxy the contractor used to paint a reservoir were manufactured outside of Texas; and a surety company headquartered in another state provided the contractor's performance bond. The court held the facts constituted interstate commerce and therefore, subjected a contract to FAA preemption. *Lost Creek Mun. Utility Dist. v. Travis Indus. Painters, Inc.*, 827 S.W.2d 103, 105 (Tex. App.–Austin 1992).

In Michigan, a court held that a contractual arbitration agreement involved interstate commerce where an Oregon corporation developed real estate, constructed cell-phone towers in Oregon and hired an Oregon professional employer organization to manage its human resources issues, because federal laws were administered and the employer organization was aided in the performance of the contract by a Michigan services corporation. *Legacy Wireless Services, Inc. v. Human Capital, L.L.C.*, 314 F. Supp. 2d 1045, 1053 (D. Or. 2004).

Does a Condominium Purchase in Washington Affect Interstate Commerce?

Washington courts, like the U.S. Supreme Court, strongly favor arbitration of disputes where the parties have written arbitration agreements "to avoid the formalities, the expense, and the delays of the court system." *Mendez v. Palm Harbor Homes, Inc.*, 111 Wash. App. 446, 454, 45 P.3d 594 (2002). The Washington courts have clearly established that the FAA preempts state law requiring enforcement of an arbitration agreement when interstate commerce is involved. For example, the FAA preempted conflicting state law where the contract between the parties involved a transaction between a New York corporation and a Washington resident, franchise payments made in New York, supplies purchased in New York for use in Washington, and considerable interstate travel by both parties. *Allison v. Medicab Intern., Inc.*, 92 Wash. 2d 199, 200–02, 597 P.2d 380 (1979).

The FAA preempted Washington state law where an employment contract required active employee participation in business expansion beyond the existing Washington business into new geographic markets in the Northwest. *Walters v. A.A.A. Waterproofing, Inc.*, 120 Wash. App. 354, 358–59, 85 P.3d 389 (2004).

At the trial court level in the *Satomi* matter, the COAs' principal argument against FAA preemption of the WCA requirement for judicial enforcement was that the court of appeals had already decided the issue in *Marina Cove Condominium Owners Ass'n v. Isabella Estates*, 109 Wash. App. 230, 244, 34 P.3d 870 (2001). In *Marina Cove*, the court had held that condominium construction and purchase and sale agreements between Washington companies and Washington residents did not involve interstate commerce or invoke FAA preemption of the WCA judicial remedy. However, the court of appeals seriously questioned its own holding in *Marina Cove*, in which the court had adopted an interpretation of *U.S. v. Lopez*, 514 U.S. 549, 559, 115 S. Ct. 1624, 131 L. Ed. 2d 626 (1995). *Lopez* described the test of Congress' power to regulate activity under the Commerce Clause as whether the activity "substantially affects" interstate commerce; this language resulted "in *Marina Cove*, which came between *Lopez* and *Allied-Bruce* in 1995, and *Citizens Bank* in 2003." *Satomi*, 159 P.3d at 465.

In passing the FAA, Congress declared a "national policy favoring arbitration."

In *Citizens Bank*, the U.S. Supreme Court rejected the "substantially affecting" interpretation as an "improperly cramped view" of Commerce Clause power, holding that a significant effect on interstate commerce need only be found in the general practice subject to federal control. *Id.* at 466. Given the application in *Marina Cove* of the discarded "substantially affecting" test from *Lopez*, the Washington Court of Appeals found *Marina Cove*'s validity "questionable." *Id.*

Despite the Satomi condominium's extensive use of out-of-state construction materials, the court of appeals held that the FAA did not apply to the WCA claims brought by the COA because evidence of interstate commerce was lacking. The court noted that (1) there were no national marketing or out-of-state contractors or architects; (2) state law governs the sale of property; (3) the warranties involved arose "entirely from state law"; and (4) the construction and sale of the condominiums had none of the earmarks of an economic activity that in the aggregate would represent a general practice subject to federal control. *Id.* at 468.

Regarding the extensive use of out of state building materials, the court noted: "[C]ondominium owners purchased real property, not building materials, goods or services. Whatever hold the FAA had or continues to have over the transactions preceding integration of the materials, goods and services into the real estate does not

extend to the sale of the real property interest itself." *Id.*

The majority glossed over the contradiction in how the COAs could directly target specific defects in the building materials and assert claims of breach of warranties with its finding that these same materials had been "integrated" into the real estate, which was the subject of the sale. The court remanded for an inefficient dual track resolution: arbitration of the common law and contract claims and judicial proceedings for the WCA claims. *Id.* at 469.

In contrast, the *Satomi* dissent noted that "[t]he interstate nature of the building materials and the 'general practice' of condominium construction and sales is enough to evidence a transaction 'involving interstate commerce,' given the broad interpretation we must now give that phrase under the cases interpreting the FAA." *Id.* at 472 (dissent). The dissent could not reconcile the dual track remedy mandated by the majority, noting that, "It would clearly promote judicial economy to resolve these claims, which arise from identical facts, in one arbitration hearing." *Id.* at 469 n.3 (dissent).

The *Satomi* declarant appealed the court's decision and the Washington Supreme Court accepted the matter for review. The Washington Supreme Court consolidated the *Pier at Leschi* and *Blakeley* cases with the *Satomi* matter. The COAs will support the *Satomi* majority and argue that condominium transfers are a state-only activity with no effect on interstate commerce. In contrast, the declarants will support the *Satomi* dissent, and argue that condominiums are not built in a vacuum and that sales of those units have a broad impact on the U.S. economy, thereby invoking FAA preemption of the WCA. They will assert the court of appeals in *Satomi* directly controverted broad public policy favoring arbitration as set forth in the FAA and subsequent decisions interpreting that statute.