

Construction Defect Litigation and the Condominium Market

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NOVEMBER 1999

CRB Note, Vol. 6, No. 7

Internet Access

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CONSTRUCTION DEFECT LITIGATION AND THE CONDOMINIUM MARKET

Construction defect litigation has been blamed for destroying the condominium market. Part of the argument, most often made by builders, is that the board members of condominium homeowner associations are easily persuaded by attorneys to file construction defect actions. According to this argument, the defects alleged in these cases are either not truly defects or have only a minimal impact on the dwelling. The resulting settlements and judgements have raised the cost of insurance and made building condominiums unprofitable. In many cases, builders cannot even get the financing or insurance to construct the projects. They point to a depressed level of condominium construction as evidence of the problems brought by too much litigation. The solution, according to this argument, is to reduce the ability of aggrieved parties to bring lawsuits.

The counter argument, most often made by plaintiff's attorneys, is that there has been a lot of shoddy construction. Supporters of this argument attribute many of the problems to the boom conditions of the 1980s when experienced construction workers were hard to find and less skilled developers entered the market. The tight profit margins on multi-family housing exacerbated the conditions. The result was poor construction and increased defects. This side argues that lawsuits are the last resort of aggrieved frustrated homeowners and that the emphasis should be on quality control, not limiting litigation.

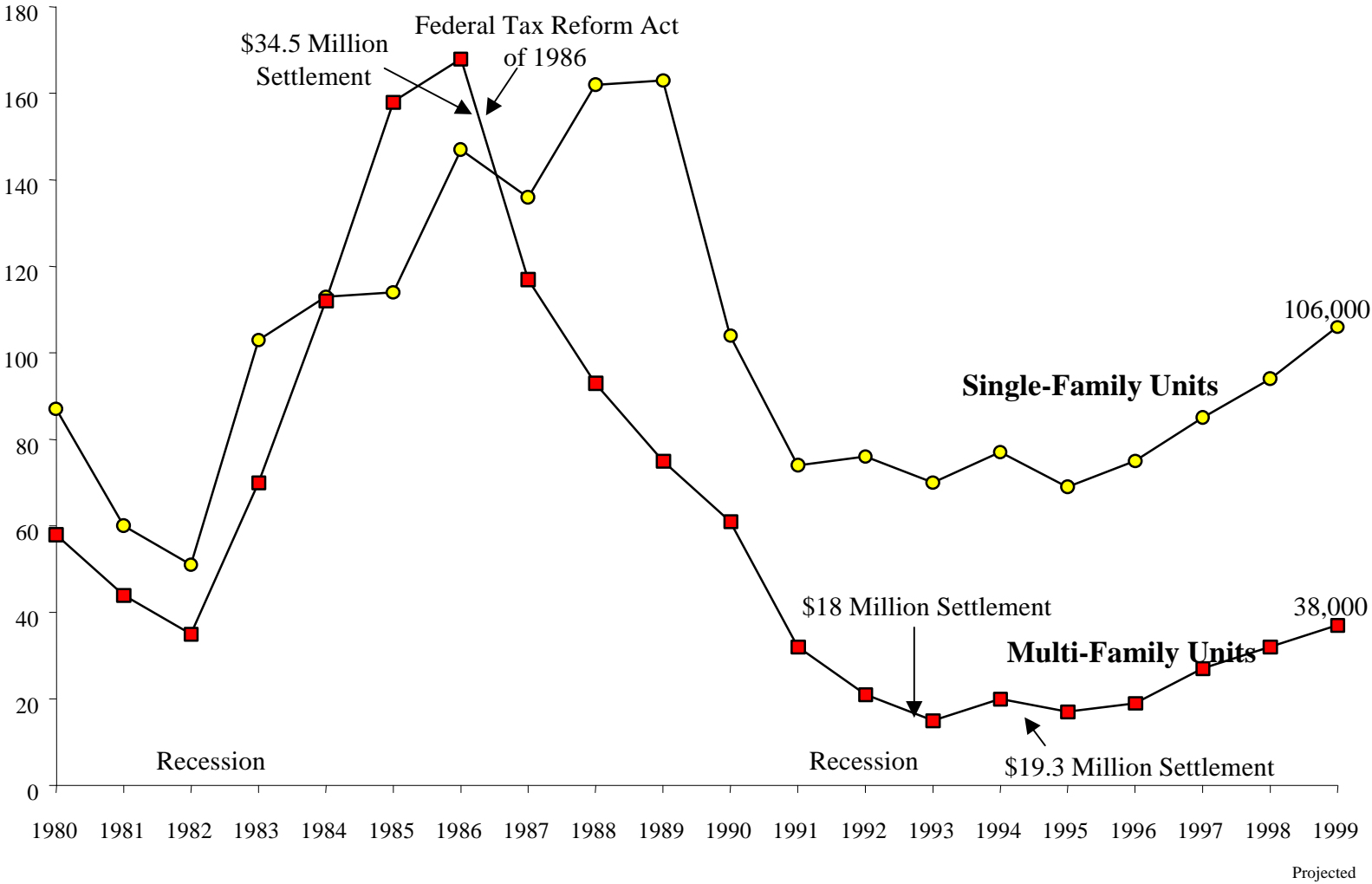
Both sides agree that there is some merit to the other's arguments. Even developers acknowledge that there were some shoddily constructed projects, especially those built during boom times. Plaintiff's attorneys will acknowledge that some frivolous lawsuits, albeit a small minority, have been brought. They have different opinions about the prevalence of construction defects or frivolous lawsuits respectively.

The Condominium Market has Deteriorated Markedly During the Last Decade. The exact extent and causes of the decline are hard to measure. No one collects data on condominium construction in a systematic way. Permit data is available for multi-family units, but that includes apartments as well as condominiums. There is, however, little dispute that the market has declined. Especially when there are such examples as no condominium building permits being issued in Orange County between 1995 and 1998.

Chart 1 shows the residential building permits that have been issued since 1980. Again, there is no specific data on condominiums. However, real estate professionals state that construction of condominiums largely tracks the overall real estate market. Also on the chart are several important events:

- The recessions of 1981-82 and the early 1990s.
- Significant construction defect cases.
- The Federal Tax Reform Act of 1986 which repealed tax law provisions that were extremely favorable to rental housing.

California Real Estate Construction



Projected

The chart does show a pronounced boom during the 1980s, fueled in part by favorable tax treatment that was enacted in 1981. The boom ended in part because of a reversal of the favorable tax laws and overbuilding in many markets. The strong real estate market led to an increase in the price of homes. The median price of homes went up 62 percent from 1985 to 1990 while falling 10 percent from 1991 to 1996.

While it is clear that the condominium market has stagnated, it is not clear what is the cause. Analysts and observers offer the following possible causes. Unfortunately, data do not exist that will conclusively determine which one or some of these reasons are having an impact and what is their relative importance. These are not necessarily mutually exclusive:

- Construction defect litigation. Besides the obvious potential impact of deterring construction, it may have also affected property values, which in turn would also affect construction. Research found that projects with construction defect litigation had lower values, slower resales, and more bankruptcies. The unanswered question is whether it is the litigation, or the underlying defects that are the cause of the problem.
- The overall conditions in the real estate market brought about by overbuilding in the 1980s followed by a severe and prolonged recession in California.
- Opposition to new projects by existing neighborhood residents. Condominiums can be seen as cheaper homes that would adversely affect property values or increased density that would increase traffic problems and other impacts.
- Reluctance on the part of lenders, and their regulators, to finance condominiums because of earlier loan losses.

It is clear that the California residential real estate market has been moribund throughout most of the decade and has only recently broken out of its slump. So far the rebound has been uneven. Multi-family building has been slow and much of the single-family construction is more expensive structure with the construction of starter homes lagging.

Are Reports of the Death of the Condominium Market Exaggerated? Condominiums are part of a larger real estate market. One of the impacts of the weak housing market of the 1990s is that overall affordability increased as prices of single-family homes fell, making them easier to purchase. Real estate market analysts report that buyers generally have a preference for single-family detached homes. As these dwellings became more affordable, condo building could have been depressed to some degree by lack of demand as buyers flocked to single-family homes. Now as the market is resurging and homes become less affordable, demand for condos is starting to improve. The resale market is strengthening and some new construction is occurring. Real estate research firms report significantly higher level of sales of existing condominiums, including some which have been rentals for a considerable period.¹ Demand for condos is further aided by the rapid rise in rental rates.

The beginnings of a resurgence in the condo market would tend to bolster the arguments that construction defect litigation has not seriously harmed the market. It could be that several years from now the condominium market will have exhibited increasing strength, reducing concerns about the impacts of construction defect litigation. However, a counter argument is that in markets that began to boom early, such as in the Bay area, condominium construction was still lagging at a time when market conditions were ripe for the industry. The condominium market should have been good because of the rising rents, miniscule vacancy rates, and skyrocketing home prices. Despite these conditions, even in the Bay area condominium construction has been stagnant.

A Healthy Condominium Market Important for Public Policies. Development of condominiums is entirely consistent with the current emphasis on smart growth. Typically condominiums are built at higher densities, hence the use of land is more efficient. The higher density aids provision of mass transit. Condominiums can be a significant factor in improving affordability of homes. Despite the rebound in building, developers are constructing single-family homes at significantly reduced levels compared to the 1980s and at increased prices. A newly constructed starter home is a thing of the past in many of the state's markets. Condominiums often are an affordable alternative to the single-family home.

California Law on Construction Defects has Followed National Developments. In both California and the nation, construction defect law has, to a great extent, been created as a result of judicial decisions. Prior to the 1960s, real estate was sold on caveat emptor basis, meaning the buyer and seller were on equal footing and the buyer assumed any risks associated with the structure when the house was purchased.

A series of decisions eroded that custom and moved housing onto a strict liability basis, placing it on the same footing as most other manufactured goods. This shift reflected the discomfort of courts with the different treatment of housing relative to other products. The courts were also influenced by the increasing sophistication and advancement of practices within the construction industry. This change meant that developers became responsible for defects, including ones that were not apparent at the time of construction.

Following are the major elements of the California law regarding construction defects.

- There is a four-year statute of limitations for patent defects. Patent defects are those that are readily discoverable or apparent. A shorter time limit may apply once the defect is discovered.
- There is a ten-year statute of limitations for latent defects. These are defects which are not readily visible and could include the possible failure of structure during an earthquake. The ten-year limit can be extended if there is fraud or willful misconduct, such as claims that codes were met when they were not.
- There is not a definition of construction defect in statute.

Compared to other states, California's statute of limitations are among the longer ones. However, the state's law is by no means extreme or alone in its requirements. Other

states share the ten-year statute of limitations. Many other states have also relied on judge-created law although some states have a statutory definition of important terms such as construction defect.

It is Difficult to Determine if Construction Defect Litigation has Increased. There are not readily available statistics on the number of cases. While there are widespread, but difficult to substantiate, claims that litigation has increased, there are unusual factors which may explain the jumps. The years of drought followed by wet winters may have led to an onslaught of claims. The earthquakes in both southern and northern California and the resulting damage and concern over seismic safety may have also led to increased claims. Another factor that may explain any increase in litigation is building on marginal lands. Some developers argue that the safest land to build upon is already urbanized. Construction is occurring on land that may have greater incidence of environmental problems such as subsidence.

Construction Defect Suits are Generally Brought by the Homeowners Association Board Against the General Contractor. The members of the board are acting on behalf of the homeowners association. Some argue that they are pressured to bring lawsuits by a combination of their fiduciary duty and attorneys who take advantage of their ignorance about the impacts and results of possible litigation. The board does not need to notify the homeowners. One of the more common causes of action is inadequate waterproofing.

The overwhelming majority of cases are settled before reaching court. The typical settlement is between \$1 million and \$2 million. The largest reported settlement was \$34.5 million. Builders and their insurance companies argue that they are pressured to settle because the costs of defending the suit are very high and often are much more than the alleged cost of repair. The cost of defending against a suit includes the fees of attorneys and experts and deposition expenses. These costs can soar when there are many parties to the litigation.

The contractor is unlikely to pay all of the settlement costs. Contractors obtain commercial general liability insurance policies. This is third party insurance that protects the insured against tort liability to others. Basic commercial general liability insurance provides broad coverage for bodily injury or property damage. It also usually provides indemnification for investigation and defense costs.

Lawsuits Can Quickly Involve Many Parties. If a construction defect is alleged, the homeowners association sues the general contractor. Although the contractor was responsible for the development and assembled the team that did the construction, the contractor did not perform all of the work. Large projects can easily have as many as 40 to 45 subcontractors. In most cases, the general contractor will then bring suit against any of the subcontractors who might possibly be responsible for any alleged defects. Subcontractors argue that the connection between their work and the alleged problem is often tenuous. The result is that the number of parties involved in the litigation begins to expand significantly.

The California Supreme Court's decision in a DDT pollution case has further increased the number of parties involved in construction defect cases.² For construction defect litigation, the court's decision in the Montrose case means that any insurance carrier who is the insurer from the date of construction can be brought in to defend the insured. The reasoning is that the damage occurs over time, hence any carrier who insured from date of construction to discovery of the damage may have to pay the claim. As a practical matter, if one insurance company is brought in the suit, it will aggressively search and bring in any others.

The multiplicity of parties can both complicate and ease settlements. With a larger number of parties, obtaining agreement on settlement or defense can clearly be difficult. It also increases the cost of defense. Depositions become more lengthy and expensive when there are multiple sets of attorneys attending. By the same token, with more parties to the lawsuit, each may be willing to put in a small amount of cash. With a large number of willing parties, the total of each party's small contribution can become significant. However, the insured may not welcome settlements that are easy to negotiate. The insured must pay deductibles even in cases when they argue they did not undertake any negligent or defective construction.

Insurance Costs Have Increased. A systematic review of insurance costs is not available in California. Nevertheless, anecdotal evidence strongly suggests a significant increase in premiums within the state. For example, one roofing contractor paid \$155 for an insurance policy in the early 1990s. In a 1996 article he was quoted as saying that the same one-year policy cost him \$3000.³ The evidence suggests that this pattern has continued. Insurers have also raised deductibles and reduced coverage and policy limits. Increasingly the firms that write insurance are non-admitted firms, which are insurers that are not regulated by the State Department of Insurance.

The apparent significant increase in rates does not necessarily mean that unwarranted litigation is driving the insurance market. It could be a greater number of defects and problems. Again, the late 1980s was a period of construction boom. Such periods are typified by an increase in contractors and labor into the construction field. The newer entrants typically have less experience and skill.

Insurance Availability has Declined. Insurers have withdrawn from the California market. In the early 1980s, over 40 admitted companies wrote this type of insurance policies for contractors within the state. Currently there are only a couple with a few more non-admitted firms. Insurance company representatives state publicly they will not underwrite contractors in California who have worked on a condominium or multi-family project within a time period that may leave them subject to litigation.⁴ Since the remaining firms may underwrite only in certain regions or type of projects, that may mean that there is only one carrier available to any contractor or subcontractor.

Other responses of insurers include adding an exclusion to limit Montrose type situations. The wrap or project insurance is another response. With this type of insurance, one company provides insurance for the contractor and all subcontractors involved in the

project. This arrangement will limit the number of parties involved in any future litigation.

Construction defect insurance does appear to be more expensive in California and the policies often are significantly less generous than in other states. It is not clear that construction defect litigation is the cause. Housing in California is more expensive, which would lead to somewhat higher rates. Generally, many types of insurance in California are more expensive than in other states. The higher rates may reflect larger losses related to other factors, such as builders not engaging in satisfactory quality control.

Builders Respond to Construction Defect Litigation Concerns. Following are some examples of responses.

- Builders have improved quality control, including hiring their own third-party inspectors to review city and county inspections and keeping much more detailed records of the construction.
- Builders are offering warranties for construction defects. This warranty is not the typical appliance warranty that homebuyers are familiar with, but a long-term policy that protects against construction defects.
- A builder, who was required by a local government to provide a specified proportion of multi-family homes, built condominiums. However, the builder chose to rent these as apartments until after the statute of limitations for construction defects has passed.⁵
- Builders have abandoned condo projects, instead packing in single family homes at the same high densities.⁶ It is unclear if this action is a response to consumer preferences for single family homes or to construction defect litigation.

The Legislature has Attempted Some Solutions to Ease Possible Strains From Construction Defect Litigation.

SB 1029 (Chapter 864, Statutes of 1995, Calderon). This legislation requires arbitration prior to onset of litigation. The legislation was enacted as contractors complained that they were hit with litigation before receiving notice of the defects or given any opportunity to correct the problems.

Most parties involved do not praise the results of what has become known as the “Calderon process.” In the views of many, it does not avoid or reduce litigation, it merely adds to the time required to resolve any dispute. A specific criticism by some parties is that neither the subcontractors nor the insurance companies of either the subcontractors or developer are required to be involved in the process. If the contractor settles during the Calderon process, it is the subcontractors who may then be sued by the contractor or insurance company without opportunity to have corrected any defects they may have caused.⁷ Subcontractors argue that they are forced into settlement just to get out of the litigation, even though they did not have any role in the defect.

AB 1221 (Dutra). Assemblyman Joe Dutra introduced AB 1221 this past legislative year. This bill is pending before the Assembly Housing and Community Development Committee. AB 1221 is an attempt to resolve disputes over construction defects without litigation. It provides for the following:

- Voluntary program administered by the Contractors' State License Board.
- Builders could offer buyers a state-approved home warranty for the repair of construction defects. The warranty would run with the statute of limitations for construction defects, ten years.
- Builders would have to provide proof of license and be financially capable of guaranteeing their obligations under the warranty.
- Claims would be pursued under a binding arbitration.
- A waiver of judicial remedy.

There are a Variety of Other Issues and Options for Addressing Construction Defect Issues.

- **Data Collection:** There is inadequate data about condominium construction, insurance information, and construction defect cases.
- **Contractor Licensing:** If there is an abundance of faulty construction, it raises questions about the adequacy of licensing and regulation.
- **Court Priority:** Some attorneys argue that civil courts do not give these cases as high a priority as they should. There is an element of urgency as damage can increase with time and homeowners either cannot afford to repair or are reluctant to until the litigation is settled. They also point out that some courts have used a special master, which speeds up the case.
- **Building Inspection:** Local governments look primarily at health and safety issues not quality control. Critics of the current inspection system argue that it could be altered to increase the emphasis on quality control.
- **Insurance Company Litigation:** Attorneys for insurance companies argue that a few uncooperative insurance companies complicate defense and settlements. They argue that the ability to bring bad faith lawsuits against these companies would allow recovery of attorney's fees and would facilitate settlement or defense of these cases.
- **English System:** The United Kingdom has a builders certification system along with a long-term warranty (ten years) for construction defects. The builder assumes responsibility for the first several years with a third party (insurer) responsible for the remaining years. The third party conducts inspections as the construction occurs, a practice that does not routinely occur in the states.

¹ “Housing Boom Finally Ignites Condo Sales,” Julie Tamaki, *Los Angeles Times*, May 2, 1999.

² *Montrose Chemical Corporation v. Admiral Insurance Company* 897 P. 2d 1 (Cal. 1995).

³ “Long Tail of Condos Slaps Contractors,” *Sacramento Business Journal*, April 22, 1996. p.1. See also the testimony of numerous witnesses in, “Public Hearing Regarding the Underwriting, Licensing and Bonding of Contractors and Other Professionals in the Construction Industry; and the Mitigation of Insured Losses Incurred by California Homeowners,” Department of Insurance April 25, 1997, May 12, 1997 and June 9, 1997.

⁴ “Long Tail of Condos Slaps Contractors,” *Sacramento Business Journal*, April 22, 1996.p. 1

⁵ “Area Sees Big Drop in Condo Projects,” Ariel Ambruster, *Contra Costa Times*, July 25, 1999.

⁶ “Area Sees Big Drop in Condo Projects,” Ariel Ambruster, *Contra Costa Times*, July 25, 1999. See also the testimony of Sherman Harmer in, “Public Hearing Regarding the Underwriting, Licensing and Bonding of Contractors and Other Professionals in the Construction Industry; and the Mitigation of Insured Losses Incurred by California Homeowners,” Department of Insurance, May 12, 1997, p. 36.

⁷ See for example statement of Bob Covington, p. 65, in Department of Insurance, May 12 1997.