Commentary

CONSTRUCTION DEFECT LITIGATION

by Robert O. Smylie, Esq.

Construction defect litigation has grown to epidemic proportions. Much of this is due to homeowners' perception and belief that there is necessarily an adversarial relationship between the homeowner and the developer. The developer is a "good guy" to many homebuyers until the purchaser moves in and finds that the house or the common areas aren't absolutely 100% perfect.

The problem is exacerbated by three factors: (1) the fact that some projects have experienced legitimate problems resulting in litigation and large judgments for homeowners; (2) the tendency of judges and juries to favor the homeowner (consumer) or "little guy," against the big, wealthy developer who is presumed to have made pots full of money; and (3) the application of the theory of strict liability to construction defect cases which had previously only applied to defects involved in the manufacture and distribution of products such as automobiles.

Many construction defect lawsuits are filed in the ninth year of a project, just before the running of the ten-year statute of limitations for latent defects. Many homeowner's associations don't even have legitimate claims about the project. Rather, these associations are advised, by aggressive plaintiffs lawyers, that they must initiate some form of litigation at this time or lose their rights forever. Plaintiffs lawyers have recognized an opportunity to seize upon a willing and receptive plaintiff that may or may not have been "wronged" by deep-pocketed defendants.

There are many plaintiffs' lawyers who have now formulated questionnaires for homeowners to complete which "will alert the owner to potential construction defect issues." Some of the questionnaires have contained such questions as:

1. "Do your doors close smoothly and cleanly?"
2. "Do your walls contain cracks?"
3. "Do your kitchen drawers slide easily?"

These questions are often followed by blanket statements of potential liability. For example:

> "Depending on the way you answer these questions your property may have a potentially serious construction defect."

As you can tell from these questions and the statement that followed, it would be almost impossible to find a house that did not have "a potentially serious construction defect."

This area of the practice of law has become the newest form of "ambulance chasing." "Slip-and-fall" lawyers have now entered the ranks of the sophisticated real estate and/or construction defect plaintiffs lawyers. Often these lawyers know a HOA board member or are a board member themselves. What is even more disturbing is that many of these lawyers actively solicit homeowners associations in an attempt to generate defect litigation. This solicitation of borderline, if not a direct violation of the legal community's rules for professional conduct.

Lawyers have been willing to walk this thin line because this area of the law has become so lucrative that the promises of "pots of gold" is hard to resist. California Lawyer magazine addressed the issue of construction defect litigation from the plaintiffs' lawyers perspective. The author is quoted:..."wins seem to come easy for these plaintiffs lawyers."[1] The article echoes most developers concerns that "plaintiffs always win" and that "liability seems irrelevant."

What can you do to protect yourself? Stay out of litigation! Our experience is that many protracted lawsuits can be avoided through early, serious and meaningful settlement discussions. The problem is getting the HOA board of directors to listen, without the prospect of potentially large judgments clouding their decisions. This is often difficult because the association's demands are outrageous and unreasonable based on advice from aggressive lawyers. The associations are not always interested in a "fix," -- they want money. Their lawyers have convinced them, many times correctly, that they will be victorious.

As you can see, these issues call for sophisticated and thoughtful negotiations. Despite the doomsday scenario of continued construction defect litigation, and the perception that developers lack the "chips" to bargain with, you can still get boards to listen. Perhaps the most difficult aspect of this negotiation process is simply getting an association to the table. However, there are approaches or strategies developers can use to get the association to the table. For example, there is the possibility of a significant special assessment by the association to cover the cost of "proven" damages, which may be required to be levied even if the association wins in court. These special assessments will be levied to cover costs of the proven damages that are not covered by the judgment since a substantial portion of that recovery will go to the lawyer representing the association.

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[1] California Lawyer, Ricardo Sandoval, September 1992, page 45.

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Most projects, if inspected closely, can be found to have some form of defect by way of code violation, deviation from construction plans or some actual physical defect. These problems can almost always be remedied by the expenditure of "minimal" costs if the parties are reasonable. The point is to get the association to the table early in the process to avoid legal posturing and substantial litigation costs.

It is imperative to defuse the situation as much as possible and to demonstrate a willingness to deal with the legitimate issues of the association. If you or your counsel fail to do this, you may find yourself looking at expanded litigation with the discovery of new claims and potentially additional damages, particularly after a plaintiff's lawyer has performed destructive testing (courts often grant permission to tear apart walls, ceilings and roof areas to examine how the structures were actually constructed). These types of lawsuits, when they get out of hand, are generally fueled by emotion and greed.

After you have entered into meaningful discussions with the board of directors the next step is to learn for yourself the extent of, possible cure of and potential cost to rectify the problem. It is essential to know the answers to these questions in order to ascertain the true extent of the potential liability, and the cost of a reasonable settlement. Additional research and investigation should also be conducted in order to discover the existence, reliability and extent of potential defenses and off-sets for negotiation purposes. (What chips do you hold?)

This same information will also be necessary in your discussions with the insurance carriers involved in the project and the subcontractors who actually performed the work which is the subject matter of the litigation. Even though you may be responsible for the payment of some amount of remedial dollars, if you adhered to good business practices and took reasonable precautions in the early stages of the project, including the acquisition of good insurance coverage and the execution of sound subcontractor contracts containing the appropriate indemnity provisions and bonding requirements, contributions from the insurance carriers for the developer and subcontractors and small contributions from the developer and subcontractors themselves will generally result in the ability to generate sufficient funds to arrive at a viable settlement.

Steps can and should be taken to limit exposure:

1. Improve procedures to obtain insurance coverage;
2. Make contracting practices with all subcontractors more thorough;
3. More closely supervise field work in progress; and
4. Handle problems as they arise in the field, resisting the temptation of taking the most expedient solution.

These suggestions will significantly help reduce the risk of what now appears to be an ever growing body of litigation. As important as time is in the development of a project, shortcuts are more often than not a major contributor to such litigation claims. Until the legislature steps in, in an attempt to control this flood of litigation, you must take as many precautions as possible.

With specific respect to financial institutions, if you think that you're immune from all this insanity, you'd better think again. If you initiate foreclosure proceedings and take back a partially completed subdivision and then you turn around and sell it "as is" to another developer the potential exposure to possible claims for construction defects is low. However, participating lenders that merely "warehouse" the land for the developer may be held liable.

On the other hand, where a financial institution has taken back a partially completed subdivision and then the institution makes the decision to complete the project and sell the completed homes or units to members of the general public, the greater the degree of risk you assume.

Does a financial institution or other lender have a duty to inspect prior work to make sure it was performed by a lending institution's contractor or partner is sufficiently distinguishable from work previously performed by a prior builder? Does distinguishing prior unsatisfactory work from the subsequent work by a lender, in and of itself, adequately protect the lender from litigation? These are just a few of the issues that financial institutions and other lenders will be facing in the coming years if this construction defect epidemic continues.

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