Dealing With Multiple Owners - Condominium Construction Defect Litigation

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I. Introduction

Construction defects in condominiums present unique and discreet issues that are not present in the ordinary single family residential or commercial building cases. There is an increasing awareness of construction defects in condominiums, and an increasingly litigious environment in Texas.

Condominiums consist of an association of homeowners. In almost every construction defect case, the defects encompass common areas of the condominium, as well as limited common areas. Therefore, the association as a whole ordinarily pursues claims on behalf of two or more homeowners. Condominium construction defect claims may involve complicated and comprehensive issues related to multiple components of the condominium, including roofs, exterior cladding, windows, doors, garages and grounds. Construction defects can range from complex foundation, and framing issues which threaten the structural integrity of buildings, to aesthetic issues such as improperly painted surfaces and deteriorating wood trim around windows and doors. Faulty foundations, serious moisture intrusion, and shoddy framing are often at the root of problems, which manifest themselves as gaping cracks, rotting walls, and windows and doors that do not close correctly.

> Building multifamily homes is about as profitable for developers as building single family homes, but builders are four times as likely to be sued for building a multifamily unit as for a single family home, said Mark Sektnan, assistant vice president for the western region of the American Insurance Association. Builders can be sued up to 10 years after a project has been completed for a construction-defect issue, and often, no matter what the defect, the lawsuit involves every subcontractor involved from the landscaper to the company that provided temporary fencing, Sektnan said.

Meg Green, *A Hole in the Wall: Soaring Construction-Defect Litigation Is Shaking the Foundation the Commercial General Liability Market—and Residential Contractors Are Getting Hammered*, BEST'S REVIEW (July 1, 2003), http://goliath.ecnext.com/coms2/summary_0199-3079088_ITM.

Construction defect cases can typically be grouped into four categories: (1) design deficiencies, (2) material deficiencies, (3) construction deficiencies, and (4) subsurface/geotechnical problems.

Design deficiencies result from design professionals, such as architects or engineers, design buildings and systems that, from a performance standpoint, do not always work as intended or specified. The motivation for the design may be form, function, aesthetics, or cost considerations, but the completed design could result and/or manifest into a defect. Problems are typically encountered with roof systems, which due to their design complexity, are prone to leaks. A number of roofing problems are a direct result of inadequate specification of building materials which can result in water penetration, intrusion, or other problems. Poor drainage design and/or the inadequacy of structural members can result in cracks and deterioration of roofing components and materials.

Material deficiencies include the use of inferior building materials which may cause significant problems, such as windows that leak or fail to perform and function adequately, even when properly installed. Common manufacturer problems with building materials can include: deteriorating flashing, building paper, waterproofing membranes, asphalt roofing shingles, particle board, inferior drywall, and other wall products used in wet and/or damp areas, such as bathrooms and laundry rooms.

Examples of poor quality workmanship often manifests as water infiltration through some portion of the building structure. This can result in: cracks in foundations, floor slabs, walls, dry rotting of wood or other building materials, termite or other pest infestations, electrical and mechanical problems, plumbing leaks and back-ups, lack of appropriate sound insulation, and/or fire-resistive construction between adjacent housing units, etc.

Finally, expansive soil conditions have created many problems where housing subdivisions and/or developments are built into hills or other sloping areas where it's difficult to provide a solid and/or stable foundation. This paper will explore the statutory scheme established in Texas for regulating the construction of condominiums. Additionally, the paper will examine the most common claims for condominium construction defects in Texas.

II. The Building Block: Texas Uniform Condominium Act

The Texas Uniform Condominium Act governs the creation, operation, alteration, termination and management of new condominium projects created after January 1, 1994. TEX. PROP. CODE ANN. § 82.001, et seq. (Vernon 2004). Under the Texas Uniform Condominium Act, a condominium unit is defined as follows:

> "Condominium" means a form of real property with portions of the real property designated for separate ownership or occupancy, and the remainder of the real property designated for common ownership or occupancy solely by the owners of those portions. Real property is a condominium only if one or more of the common elements are directly owned in undivided interests by the unit owners. Real property is not a condominium if all of the common elements are owned by a legal entity separate from the unit owners, such as a corporation, even if the separate legal entity is owned by the unit owners.

See id. § 82.0023(a)(8). Under the Condominium Act, the rules and regulations for residential condominiums, including their creation, sale, and governance, are outlined. The Condominium Act is also applicable to commercial condominiums. TEX. PROP. CODE ANN. § 82.002(a).

The Condominium Act provides the legal framework to allow the subdivision of real property into individual estates with appurtenant common elements that are owned in undivided interests by the owners of the condominium units (the Unit Owners). Common elements are either general common elements or limited common elements. Limited common elements are portions of a project that can be exclusively used by one or more of the Unit Owners, but less than all the Unit Owners. General common elements are the portions of the project that are not units of limited common elements. The Condominium Act expressly provides that the Unit Owners Association (the "Association") cannot be the owner of the common elements. Instead, each unit owner typically owns some designated percentage of the common elements, based usually on the square footage of their unit compared to the overall square footage/living space of the condominium.

The Condominium Act also provides the rules regarding: (1) the Association including provisions relating to governance, voting rights and other matters necessary to operate the common elements of the condominium; (2) the disclosure of certain matters to the purchasers of the condominium units and other protections of the unit purchasers; and (3) the requisite provisions to be contained in the condominium documentation. The Condominium Act is the minimum requirements for the declarations and bylaws. The developer may provide more extensive provisions.

III. Condominium Construction Defect Litigation

Condominiums create a unique situation when issues arise regarding construction defects. If a problem exists within a condominium unit itself—tiles in the kitchen crack, the washing machine leaks—the condominium owner may bring a lawsuit against the developer who sold the unit. But what is a condominium owner to do when there are bigger problems with the property—the windows in the building fail to shut properly or the sprinkler system is improperly installed?

Under the Condominium Act, the administration and operation of the condominium are governed by the bylaws, which are required to provide for the number of members on the board and the titles of the officers of the association and the election by the board of a president, treasurer, secretary, and any other officers the bylaws specify. TEX. PROP. CODE ANN. § 82.106(a). Subject to the declaration, the bylaws may provide for other matters the association considers desirable, necessary, or appropriate. *Id*. § 82.106(b).

Under the Condominium Act, the council of owners of a condominium regime may adopt and amend bylaws. *Id*. § 81.201(a). The bylaws of a condominium regime govern the administration of the buildings comprising such regime. *Id*. § 81.202.

The Condominium Act requires the developer to create an Association whose membership consists of all the Unit Owners. Under the Condominium Act, the board must act in all instances on behalf of the association if, in the good-faith judgment of the board, the action is reasonable. *Id*. § 82.103(a). Each officer or member of the board is liable as a fiduciary of the unit owners for the officer's or member's acts or omissions. *Id*. Thus, the officers and members must fulfill the duties owed to the unit owners with reasonable care, diligence, good faith, and judgment. *Harris By and Through Harris v. Spires Council of Co-*

Owners, 981 S.W.2d 892 (Tex. App.—Houston [1st Dist.] 1998, no pet.). Where no informal or confidential relationship exists between the association and the association member, the condominium association owes no general fiduciary duty to the member, but a fiduciary duty will arise from the condominium's declarations where it allows the association to exercise exclusive control over the repair of individual units and the association acts arbitrarily and capriciously in its repair of the plaintiff's unit. *Sassen v. Tanglegrove Townhouse Condominium Ass'n*, 877 S.W.2d 489 (Tex. App.—Texarkana 1994, writ denied).

All acts of the association must be by and through the board unless otherwise provided by the declaration or bylaws or by law. TEX. PROP. CODE ANN. § 82.103(a). The board's ability to act to amend the declaration, the declarant's power to control the association for a specified period, the election of board members and officers and the liability of an officer or director to the association or a unit owner for an act or omission is all controlled by statutory provisions. *Id*. § 82.103(a)-(f).

The Associations typically use a property management company to handle the day-to-day operations at the condominium building, including routine maintenance. Issues can arise within units or in common areas and be reported to the Board through the property management company. Construction defects may also be discovered by the Board through routine property inspections done prior to the expiration of a warranty period. Once the Board is made aware of the construction defects, it has a duty to investigate and make repairs—if necessary—for the benefit of the members of the Association. The repairs may range from the homeowner making their own repairs, to the property management company handling small repairs. However, when the repairs are extensive, the issue of funding the repairs arises.

The Association collects income from assessments and dues collected from the Unit Owners. Funding a significant repair to the building requires a special assessment against the Unit Owners. This may cause financial stress on the Unit Owners and be a source of contention. The Association may also look to the developer as the source to fund the major repairs. This demand for repairs from the developer may be the spark for igniting the litigation battle. If the Association believes the response by the developer is inadequate, the Association may file a lawsuit seeking to recover its actual damages.

A. *The Association's Authority to Initiate Litigation*

The Condominium Act states that the Association has the power to "institute, defend, intervene in, settle, or compromise litigation or administrative proceedings in its own name on behalf of itself or two or more unit owners on matters affecting the condominium." TEX. PROP. CODE ANN. § 82.102(a)(4). However, there are questions as to what constitutes "matters affecting the condominium." What is the extent of the Association's power to pursue claims?

Does "matters affecting the condominium" only apply to construction defects to the common elements or to both the common elements and the Units? Does this include representations made to the Unit Owners during the sales negotiations? What about problems with the common walls of the building? Problems with the parking garage concrete? Wood floors inside the units? Windows of the units? Ventilation systems in the units?

Texas courts have not addressed the scope of this provision under the Condominium Act. However, in *Association of Unit Owners v. Dunning*, 69 P.3d 788 (Or. App. 2003), the Oregon court of appeals examined the scope of a provision similar to Texas's § 82.102(a)(4) and concluded that the statute should be interpreted broadly. The court found it irrelevant whether a claim would be considered "personal." The court held that "the statute plainly authorizes a condominium association to assert the claims both on its own behalf and on behalf of the unit owners." The only requirement to initiating a lawsuit is that the claim concerns "matters affecting the condominium." *Id*. at 797.

Developers and contractors in Texas may still assert the argument that the Association's statutory power should be limited and that there are some claims which are too "personal" to the unit owner and that the Association should not be allowed to pursue litigation on behalf of the unit owner with respect to those claims. The developers and contractors can argue the Association has no standing to bring suit on behalf of individual unit owners. The Texas Supreme Court in *Texas Association of Business v. Texas Air Control Board*, 852 S.W.2d 440, 446-47 (Tex. 1993), addressed the standard for Associations to assert a claim on behalf of its members. Using the test as determined in *Hunt v. Washington*, the Texas Supreme Court held that an Association may sue on behalf of its members only when:

> (1) the Association's members would otherwise have standing to sue in their

> own right; (2) the interests the Association seeks to protect are germane to the organization's purpose; and (3) neither the claim asserted nor the relief requested requires the participation of individual members in the lawsuit.

Id. (citing *Hunt v. Washington*, 432 U.S. 333, 343 (1977)). Thus, it seems that an Association must meet the test as set out in Texas Air Control Board to pursue litigation on behalf of its individual members.

Additionally, the Board's power can be limited in the condominium documents regarding whether the Association can institute litigation on behalf of its members.

B. *Allegations for Condominium Construction Defects*

If the Association pursues litigation for recovery of its actual damages, the parties to the suit will be determined by the problems for which it seeks a remedy. Those potentially involved in construction defect litigation include builders, developers, contractors, subcontractors, architects or engineers, material suppliers, product manufacturers, homeowners, homeowners' associations, attorneys, forensic inspection services, and municipal inspectors among others. The Association may allege negligence; breach of contract; breach of express or implied warranties; negligent hiring, supervision, or performance of the work; and misrepresentations, including fraud and violations of the Texas Deceptive Trade Practices Act (DTPA).

1. Breach of Contract and Express Warranty Claims

A claim for breach of contract requires a valid contract, performance by the plaintiff, breach of the contract, and damages resulting from the breach. *See Southwell v. University of the Incarnate Word*, 974 S.W.2d 351, 354 55 (Tex. App.–San Antonio 1998, pet. denied); *Hussong v. Schwan's Sales Enter., Inc.*, 896 S.W. 320, 326 (Tex. App.–Houston [1st Dist.] 1995, no writ). A claim for breach of express warranty requires an express affirmation of fact or promise by the seller relating to the property, the affirmation of fact or promise became a part of the basis of the bargain, the plaintiff relied on the representation, the property failed to comply with the affirmations of fact or promise, the plaintiff was injured by the failure of the property to comply with the express warranty, and such failure was the proximate cause of plaintiff's injury. *See Great Am. Prods. v. Permabond*, 94 S.W.3d 675, 681 (Tex. App.—Austin 2002, pet. Denied).

Claims for breach of contract or express warranty require the plaintiff to assert a claim against the person or entity that entered into the contract or warranted the work to be completed. This party might be the developer. The Unit Owners are parties to the purchase sale agreements which provide certain express limited warranties related to the condominium units. The Association may attempt to assert claims on behalf of the unit owners. Parties should be aware that developers may have limited, in the contract, the types and breadth of the warranties in the purchase agreement. Some builders have begun to put clauses in their sales contracts that stop the future homeowner from suing for construction defects, and forces the homeowner into arbitration should a problem arise. *See Green, supra* at http://goliath.ecnext.com/coms2/summary_0199-3079088_ITM.

2. Implied Warranty Claims

Texas recognizes several implied warranties in a residential construction context. Parties should be aware whether the purchase agreement disclaims any or all express and implied warranties. In Texas, the implied warranty of good workmanship establishes a default requirement that the builder perform with a minimum standard of care. As a default rule, the good workmanship warranty attaches to a new home sale if the parties' agreement does not provide otherwise. *Centex Homes v. Buecher*, 95 S.W.3d 266 (Tex. 2002). The Texas Supreme Court explained that the implied warranty of good workmanship requires that the builder use the standard of care in construction that a proficient builder in the same or similar work would use. In the context of condominium construction defect litigation, the developer as a potential defendant may argue it did not construct the home and as such may not be subject to a claim for breach of the implied warranty of good workmanship.

The implied warranty of habitability requires the builder to provide a house that is safe, sanitary and otherwise fit for human habitation, or, in other words, that is "suitable for the intended use as a home." *Id*. at 273. The implied warranty of habitability is breached if the house is not safe, structurally or otherwise, for habitation. To determine whether this warranty has been breached, a court looks to the state of the finished structure. *Id*. at 272-73. The manner of the

performance of the construction is not a concern with respect to the implied warranty of habitability. The implied warranty of habitability only applies to latent defects. Additionally, the warranty for habitability may not be generally disclaimed, it may be disclaimed under certain circumstances.

3. Negligence Claims

Claims for negligent workmanship may be asserted by the Association or the unit owner against the developer and/or the contractor that constructed the condominium. In a negligence claim, the plaintiff must establish that the defendant owed a legal duty to the plaintiff, the defendant breach the duty, and the breach proximately caused the plaintiff's injury. Negligence is the best mechanism the unit owner and Association may use to pursue a claim against the contractor because they were not a party to the contract for constructing the condominium. Additionally, a negligence claim for the alleged defective construction may trigger coverage under a CGL policy. The claim for negligence may include allegations that the defendants failed to perform their duties in a good and workmanlike manner and/or failed to adequately design the development which lead to property damage in their unit or the building as a whole. The developer may be able to assert a defense that there is no legal duty between the developer and the Association or unit owners for alleged construction defects.

The allegations of construction defects may include claims that the defects arose out of one of the party's negligent performance of the work, including claims that one party was negligent in the hiring or supervising of a party. The theory for negligent hiring is based upon the belief that the master's own negligence in hiring or retaining an individual who is incompetent or unfit which creates an unreasonable risk of harms to others. *Wise v. Complete Staffing Servs., Inc.*, 56 S.W.3d 900, 902 (Tex. App.—Texarkana 2001, no pet.). The employer who hires the incompetent individual may be directly liable to a third party whose injuries were proximately caused by the employee's negligence. *Golden Spread Council, Inc. v. Akins*, 926 S.W.2d 287, 294 (Tex. 1996).

4. Fraud and Negligent Misrepresentation Claims

Claims for fraud require that a plaintiff prove that the defendant made a material misrepresentation, the representation was false, when the representation was made the defendant knew it was false or the statement was recklessly asserted without any knowledge of its truth, the defendant made the representation with the intent that the plaintiff act on it, the plaintiff relied on the representation; and the representation caused the plaintiff injury. *In re FirstMerit Bank*, 52 S.W.3d 749, 758 (Tex. 2001); *Ernst & Young v. Pacific Mutual Life Ins. Co.*, 51 S.W.3d 573, 577 (Tex. 2001).

Texas also recognizes a cause of action for fraud in the real estate transaction. Under the Texas Business and Commerce Code § 27.01, a claim for fraud in connection with a real estate transaction consists of the following:

> (1) false representation of a past or existing material fact, when the false representation is
>
> (A) made to a person for the purpose of inducing that person to enter into a contract; and
>
> (B) relied on by that person in entering into that contract; or
>
> (2) false promise to do an act, when the false promise is
>
> (A) material;
>
> (B) made with the intention of not fulfilling it;
>
> (C) made to a person for the purpose of inducing that person to enter into a contract; and
>
> (D) relied on by that person in entering into that contract.

TEX. BUS. & COM. CODE ANN. § 27.01(a) (Vernon 2004). A claim for fraud in a real estate transaction requires an actual awareness on the part of the wrongdoer.

> A person who makes a false representation or false promise with actual awareness of the falsity thereof commits the fraud described in Subsection (a) of this section and is liable to the person defrauded for exemplary damages. Actual awareness may be inferred where objective manifestations indicate that a person acted with actual awareness.

Id. § 27.01(c). The basis of a fraud in a real estate transaction is most likely going to involve the developer because the contract is not likely going to have made representations to the buyer. A claim for

fraud in a real estate transaction allows the plaintiff to seek exemplary damages against the defendant. *See id*.

Additionally, the unit owner or Association may seek to recover under a claim for negligent misrepresentation. The elements of a negligent misrepresentation action are:

> 1. The defendant made a representation to the plaintiff in the course of the defendant's business;
>
> 2. the defendant supplied false information for the guidance of others;
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> 3. the defendant did not exercise reasonable care or competence in obtaining or communicating the information;
>
> 4. the plaintiff justifiably relied on the representation; and
>
> 5. the defendant's negligent misrepresentation proximately caused the plaintiff's injury.

McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests, 991 S.W.2d 787, 791 (Tex. 1999); *American Tobacco Co. v. Grinnell*, 951 S.W.2d 420, 436 (Tex. 1997). A claim for negligent misrepresentation will likely not be asserted against the contractor because the unit owners do not directly communicate with the contractor.

5. DTPA Claims for Construction Defects

Another common cause of action asserted by unit owners and/or the Association is for DTPA violations. The elements of a DTPA action are:

> 1. The plaintiff is a consumer;
>
> 2. the defendant can be sued under the DTPA;
>
> 3. the defendant committed a wrongful act, which consisted of the following: (a) a false, misleading, or deceptive act or practice of Texas Business & Commerce Code § 17.46(b) and that was relied on by the plaintiff to the plaintiff's detriment or (b) the use or employment of an act or practice in violation of Insurance Code article 21.21; and
>
> 4. the defendant's action was a producing cause of the plaintiff's damages.

TEX. BUS. & COM. CODE ANN. §§ 17.41-17.63 (Vernon 2004); *Amstad v. United States Brass Corp.*, 919 S.W.2d 644, 649 (Tex. 1996); *Doe v. Boys Club*, 907 S.W.2d 472, 478-79 (Tex. 1995). The basis of a claim by the unit owner and/or Association for DTPA violations is under the "laundry list" of DTPA violations. TEX. BUS. & COM. CODE ANN. § 17.46(b). Allegations against the developer typically assert that the developer failed to disclose known defects relating to the condominium unit or the entire development, the developer breached an express or implied warranty and that the developer's acts were unconscionable. Claims for DTPA violations against the contractor may include the same allegations as asserted against the developer with a focus on the details of the construction, including the building materials and their installation.

DTPA claims allow the recovery of attorney's fees, which may be appealing to unit owners and the Association. *Id*. § 17.50(d). If the claimant can prove "knowing" or "intentional" conduct by the defendant(s), recovery of mental anguish damages is recoverable. *Id*. § 17.50(b)(1). Additionally, if the claimant can prove the defendant(s) acted "knowingly" or "intentionally" there is a possibility of recovering treble damages. *Id*.

6. Texas Residential Construction Liability Act[1]

Unless the RCLA preempts a claim, homeowners may file another cause of action such as fraud, which allows for exemplary damages, or the DTPA, which includes damages for mental anguish. *Bruce v. Jim Walters Homes, Inc.*, 943 S.W.2d 121, 123-24 (Tex. App.–San Antonio 1997, writ denied). Not every injury that results from a construction defect is preempted by RCLA; only those causes of action which conflict with the RCLA are preempted. TEX. PROP. CODE ANN. § 27.002(b). For example, fraud and DTPA violations are not in conflict with the RCLA because they are different causes of action. Although a DTPA claim may still be applicable to a construction defect claim, a breach of a limited statutory warranty is "not, by itself . . . a violation of the [DTPA]." TEX. PROP. CODE ANN. § 430.011(c).

In 1989, the Texas Legislature first enacted the RCLA, which, until House Bill 730, solely governed

[1] Taken from: *Texas Residential Construction Commission: Building Better Protection for Texas Homebuyers*, R. Douglas Rees, Cooper & Scully, P.C. (January 2006).

actions against contractors arising from construction defects for damages. TEX. PROP. CODE ANN. § 27.004. The RCLA mandates the procedures for settling construction defect claims. The scope of the RCLA covers: "any action to recover damages or other relief arising from a construction defect, except a claim for personal injury, survival, or wrongful death or for damage to goods" and "any subsequent purchaser of a residence who files a claim against a contractor." *Id*. § 27.002(a)(1)-(2). Under revisions made during the 2003 legislative session, the scope of the RCLA broadened to include "other relief" for those claimants seeking relief for construction defects, including injunctive and declaratory actions. *Id*. § 27.002(a). Under the RCLA, "construction defect" is defined as follows:

> a matter concerning the design, construction, or repair of a new residence, of an alteration of or repair or addition to an existing residence, or of an appurtenance to a residence, on which a person has a complaint against a contractor. The term may include any physical damage to the residence, any appurtenance, or the real property on which the residence and appurtenance are affixed proximately caused by a construction defect.

Id. § 27.001(4). Under the RCLA, claims are asserted against "contractors" not solely "builders." "Contractor" under the RCLA includes builders and:

> . . . any person contracting with an owner for the construction or sale of a new residence constructed by that person or of an alteration of or addition to an existing residence, repair of a new or existing residence, or construction, sale, alteration, addition, or repair of an appurtenance to a new or existing residence. The term includes: (A) an owner, officer, director, shareholder, partner, or employee of the contractor; and (B) a risk retention group registered under Article 21.54, Insurance Code, that insures all or any part of a contractor's liability for the cost to repair a residential construction defect.

Id. § 27.001(5). Claims for damage not caused by construction related sources are not covered by the RCLA. The RCLA does not apply to commercial structures or residential structures such as apartment complexes. However, the RCLA applies to single family homes and duplexes in addition to owners of triplexes, quadruplexes, and condominiums. *Id*. § 27.001(7).

Under the RCLA, prior to a claimant seeking any damages for an alleged construction defect, they must within sixty (60) days first "give written notice by certified mail, return receipt requested, to the contractor, at the contractor's last known address, specifying in reasonable detail the construction defects that are the subject of the complaint." *Id*. § 27.004(a).

During the thirty-five (35) days after receiving the notice, and on the contractor's written request, the contractor must be given a reasonable opportunity to inspect and have inspected the property to evaluate the nature and cause of the alleged defect and the nature and extent of necessary repairs. The RCLA then allows a contractor to take reasonable steps to document the alleged defect. Then the contractor is entitled to make an offer of repair in accordance with the RCLA. *Id*. § 27.004(b).

Under the RCLA, contractors may submit reasonable settlement offers. If the settlement offer was reasonable, the RCLA limits the claimant's recovery of damages to an amount that may not exceed the greater of the purchase price of the unit or the fair current market value of the unit without the construction defect. *See id*. § 27.004. Damages recoverable under the RCLA are as follows:

> (1) the reasonable cost of repairs necessary to cure any construction defect; (2) the reasonable and necessary cost for the replacement or repair of any damaged goods in the residence; (3) reasonable and necessary engineering and consulting fees; (4) the reasonable expenses of temporary housing reasonably necessary during the repair period; (5) the reduction in current market value, if any, after the construction defect is repaired if the construction defect is a structural failure; and (6) reasonable and necessary attorney's fees.

Id. § 27.004(g)(1)-(6).

Section 27.0042 allows the builder the opportunity to repurchase the home from the homeowner as an alternative under certain circumstances. The parties can execute a written agreement that provides "if the

reasonable cost of repairs necessary to repair a construction defect that is the responsibility of the contractor exceeds an agreed percentage of the current fair market value of the residence, as determined without reference to the construction defects," the contractor may buy the home back. *Id*. § 27.0042(a).

IV. An Insurer's Response to Construction Defect Litigation

The rise in construction defect litigation has forced some insurers to limit coverage for contractors and subcontractors. However, contractors continue to rely primarily on their liability insurance programs for protection against construction defect claims.

> General and umbrella liability insurers alike are altogether avoiding certain classes of contractors, types of construction or problematic regions. For example, some insurers have stopped writing coverage for residential developers, general contractors performing residential construction, or any contractor directly or indirectly involved in the installation of synthetic stucco (commonly known in construction and insurance circles as exterior insulation and finish systems, or EIFS). Other insurers may decline to write contractors with more than a certain percentage of their work in problematic areas, such as residential construction or EIFS installation. Some insurers have completely withdrawn from construction insurance markets in problematic areas, primarily California.
>
> Besides implementing the underwriting restrictions described above, many insurers are using a combination of coverage-restricting endorsements. Carriers may attach to contractors' and subcontractors' policies exclusions that target common types of construction defects claims, such as mold and EIFS-related losses. The precise combination will vary by class of contractor, type of construction and state. Many insurers also have begun using restrictive additional-insured endorsements, which may leave contractors in noncompliance with respect to their additional insureds and with less coverage than they expected to receive as additional insureds on subcontractors' policies.

Ann Rudd Hickman, *Carriers Cut Back Coverage for Construction Defects*, IRMI (July 2003), http://www.agentandbroker.com/aabweb/index.cfm?objectid=383AE162-AEBB-E8F4-E277E1003E1DF2EE.

Under the "known loss doctrine," a commercial general liability policy does not apply to injury or damage that is a continuation of damage known to the insured at the inception of coverage. *Id*. This effectively ensures that the policy in force when the insured becomes aware of the damage is the last policy that will be triggered by the claim. *Id*. However, as long as the insured was not aware of the damages prior to the inception of each of these policies, it does not prevent multiple policies in force during the progression of damage from being triggered. *Id*.

Additionally, insurers are adding endorsements which exclude coverage for damage caused by exterior insulation and finish systems (EIFS). *See id*. "Typically, such claims allege faulty installation or some product defect that allows water to penetrate the walls, where it becomes trapped. Wood rot and mold are some of the problems commonly encountered by the property owners." *Id*. At this time, there is no standard form EIFS exclusion; rather, insurers are drafting their own exclusions.

Mold exclusions are widely used by insurers to protect against the number of claims alleging bodily injury and property damage caused by mold. *See id*. "The standard ISO 'fungi or bacteria exclusion' endorsement is broad, removing coverage for all injury or damage that would not have occurred "but for" exposure to any fungi (e.g., mold) or bacteria, as well as for any costs incurred in cleaning up the fungi or bacteria." *Id*. Additionally, carriers are drafting exclusions for residential construction to exclude coverage for condominium construction. *See id*.

> The CGL policy's "Damage to Your Work" exclusion, often referred to as the "workmanship" exclusion, eliminates coverage for damage to a contractor's completed work that arises out of the contractor's work. This prevents the CGL policy from acting as a warranty on the insured's work.

Id.

V. What Can Builders Do?

In response to the litigation relating to construction defects, builders and insurers can make certain adjustments which will address the challenges presented by the heightened litigation risk. These include:(a) peer review of project design; (b) third-party construction inspections, often documented via videotape; (c) post-sale building maintenance programs; (d) segmented and wrapped insurance policies; and (e) pooled insurance coverage provided through trade organizations, particularly among subcontractors. These steps will improve building quality and maintenance and improve insurance coverages. These changes may have an initial cost to the builder, but will reduce overall costs down the road.