

## The Impact of Construction-Defect Litigation on Condominium Development

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This Brief summarizes study findings about the impact of construction-defect litigation on condominium development in California. The purpose of the study was to inform the policy debate—principally between builders and insurers on one side, and attorneys for homeowner plaintiffs on the other—over whether defect litigation is reducing the amount of affordable, for-sale attached housing built in California. If so, litigation reform might improve opportunities to build such lower-cost housing.

To contribute to an understanding of current concerns about defect litigation and construction levels, the study documented trends in building activity; examined litigation and the California legal environment in context; and investigated legislative, builder, and insurance company responses to the problem.

Specifically, our findings indicate the following:

- ▶ Construction of multifamily housing and condominiums slowed in the 1990s
- ▶ Builders and insurers have grown increasingly concerned over litigation
- ▶ Aspects of California's legal environment may facilitate more defect litigation than occurs in other states
- ▶ Legislative reform and recent court decisions may dampen litigation activity
- ▶ Builders and insurers are finding new ways of doing business

According to builders and insurers, “frivolous”

construction-defect lawsuits have stopped the production of attached projects and have led to skyrocketing construction-insurance premiums. Builders' general experience is that insurance and litigation costs are significantly higher in California than other states.

Homeowners associations and trial lawyers, on the other hand, argue that unfettered construction-defect litigation is necessary to protect the rights of homeowners. Some see the shortage of affordable housing as being caused by many complicated factors in the real estate market—not lawsuits. Construction-defect litigation, they argue, is caused by poor-quality construction and builders' refusal to fix their costly mistakes. They argue that insurance is a small percentage of the sales prices of single-family homes or condominiums.

Earlier studies have not resolved the welter of issues raised by these different points of view, and neither does the present research. The authors sought to add an analytical perspective to the conflicting claims regarding existing conditions and litigation policies.

This perspective is based on an examination of changing construction levels of condominiums and multifamily housing; interviews concerning the availability of insurance for residential builders; a survey of legal conditions in comparison with those in other states' housing markets; and a review of innovations by builders and insurers that have expanded building opportunities in California.

### Research Approach

Ideally, an analysis of the defect-litigation



issue would compare California with other states and regions over a 20- to 30-year period, to account for economic business cycles. This ideal method would track (a) new home construction by condominium status and number of units per building; (b) construction-defect litigation by number and type of lawsuits and sizes of settlements and enforced judgments; (c) shares of litigation recoveries dedicated toward homeowner compensation, defect repair, and legal expenses; (d) insurance costs and availability; and (e) background economic and demographic data by geographic area.

Unfortunately, the cost and inaccessibility of much of this data make such a study prohibitively expensive. Basic economic and demographic factors are most easily tracked, yet even these data are affected by changing geographic definitions over time. Detailed data on building permits (but not housing starts) are also available at the state and metropolitan levels, but published series do not identify whether units are built as condominiums.

Housing surveys provide much more restricted data on condominium stock and construction, and report data by aggregated time periods (e.g., five-year time increments) rather than annually and for few geographic areas. (The present research was conducted prior to the release of data from the 2000 census, which may become an alternative source for analyzing changes in condominium construction in the 1990s.)

No available data sources report the amount of construction-defect litigation or insurance availability, the size of settlements, or changes in insurance costs and accessibility. Court-docket systems are designed for judicial management rather than systematic data analysis. Insurance-market information is the basis for actuarial analyses that form the private, proprietary knowledge base for firms in the insurance business.

For these reasons, the best sources of information on litigation activity and insurance costs are interviews with builders, insurers, and attorneys. While limited interviews do not generate reliable statistical measures of important policy factors such as insurance costs or litigation frequency or cost, key-informant interviews can illuminate concerns and strategies of builders, insurers, and related services such as property management and trade associations in addressing defect-litigation risk.

In the present study, such interviews also identified critical years in California, starting in the early to mid-1990s, when litigation concerns and demands for reform among builders appeared to gain momentum and when the availability of liability insurance became much more restricted.

### **Residential Construction Trends**

Analysis of construction data indicates that total residential building dropped sharply in California and nationally during the first half of the 1990s. The construction industry's recovery in California was weaker than that of the nation's builders overall. Importantly, this differential included both single-family and multifamily buildings and was not limited to condominium units.

Throughout the country for much of the 1990s, multifamily permits made up a lower share of total residential permits than in previous decades. California's multifamily share of total permits in the mid-1980s was at a higher level than the multifamily share nationally; by the mid-1990s, California's multifamily permit share had dropped more sharply than nationwide. Economic and geographic factors explained part, but not all, of this differential.

Since the mid-1990s, California's multifamily construction activity has partially recovered. While its level is now similar to that of the United States as a whole, California's recovery appears weaker compared to pre-1990 levels.

A variety of sources indicate a similar drop in the construction of condominiums in the 1990s. The extent to which this has occurred varied widely among places in California and also among other U.S. metropolitan statistical areas (MSAs).

In California, the share of new homes built as condominium units declined in the 1990s in the majority of MSAs for which data are available, and all of these MSAs experienced a sharp drop in the total numbers of new condominiums built. Some other MSAs had similar experiences. Our statistical analysis could not demonstrate what share of the decline in California was due to background economic conditions rather than litigation or other unidentified factors.

Changes in the price and characteristics of condominiums in California also indicate that shifts occurred in the state's condominium market in the 1990-2000 period. Condominium prices have risen

relative to single-family home prices within the state, and the relative price differential between California and other U.S. condominiums was less affected by the recession of the early 1990s than the relative price differential for single-family homes.

### **California's Legal Environment**

Interviews with builders and insurers confirm that, throughout most of the 1990s, construction-defect litigation became more prevalent in California than it did elsewhere, and affected condominium projects more than single-family homes or apartments. The comparative incidence or cost of litigation within California, in the aggregate, remains to be measured. However, a review of Internet information sources on construction defects revealed a more intense market for litigation services in California than elsewhere, even accounting for population size and recent growth.

Builders and insurers regularly argue that California's legal environment is particularly conducive to defect litigation. However, a detailed comparison of the legal environments in California and 20 other places (19 states and the District of Columbia) reveals great similarity on the procedural side. California's statutes of limitations and repose—four years and 10 years, respectively—governing the period of years when post-construction lawsuits may be filed, are at the median for the 21 places. States commonly allow legal action for latent defects to be taken up to 10 years following a building's completion.

In the area of substantive liability standards, California appears more unusual. Of the 21 places studied, it is one of only five that apply the plaintiff-friendly doctrine of strict products liability to claims of defective residential construction.

Three of these five places had other factors that could mitigate the effects of strict liability. For example, New Jersey has an aggressive home warranty program, whereas Pennsylvania has applied the economic-loss doctrine, narrowing the scope of recoverable damages and reducing overall litigation risk to builders. Although Washington, D.C. has neither the economic-loss doctrine nor a warranty program, it has lost rather than gained population in recent years—and may have little new construction raising the potential for litigation. The neighboring states that include the greater District of Columbia MSA have not applied strict liability to construction-defect cases. In contrast, California and Nevada

were left during the 1990s without any significant legislation moderating substantive liability standards.

### **Legislative and Judicial Reform**

The state legislature has attempted to encourage means other than litigation to resolve construction-defect disputes. In 1995, for example, a new law modified court procedure in such cases by requiring more meaningful exchanges of information between plaintiffs and defendants as well as dispute resolution to encourage pretrial settlement. Interviews with litigants revealed that this procedure—known as the “Calderon process,” for the bill's author—is easily circumvented, and thus less successful than originally intended.

However, recent amendments taking effect in 2002 may improve the Calderon process by lengthening the dispute-resolution period and expanding the participation of subcontractors and insurers. Additionally, the California Supreme Court in December 2000 rejected a lawsuit, applying the economic-loss doctrine in a case where no personal injury or damage to property had occurred.

### **New Business Methods**

The building industry has adapted to daunting legal challenges and insurance limitations, but these adaptations carry their own costs. Key business adjustments by builders and insurers, designed to address heightened litigation risk, 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 aim to enhance insurance availability and improve building quality and maintenance. While such efforts add to total project cost, the industry's adaptations to litigation realities suggest it believes these changes will reduce legal expenses in the long run.

Changes in building practices and insurance products allowed California builders to respond to market demand, boosted by a rapidly expanding economy and growing population, at the end of the 1990s. In addition, builders and insurers new to California entered some of the state's more lucrative condominium markets, but have focused on luxury condominiums, not affordable units.

## Policy Implications and Recommendations

Much of the policy development concerning these issues has been hampered by poor information and few means for tracking the effects of programs. This Brief also leaves some key questions unanswered. The research has demonstrated that multifamily building levels remain low in California after a sluggish recovery, that litigation levels are high, and that builders have had difficulty obtaining insurance for residential projects that involve homeowners associations, especially when attached units are involved. The research has not demonstrated the presence, nor proved the absence, of a direct link between litigation and the shortage of affordable housing, nor has it identified specific policies and programs that could alleviate the situation.

The lack of good measures makes it premature to make specific policy recommendations. However, some general points are evident, and new policy approaches would benefit from better data on defect litigation and housing-market conditions, as well as more information on other states' experience with some of the more promising means for addressing the problem. Thus we recommend:

- ▶ Continuing policy efforts to move construction-defect disputes out of the courtroom to the bargaining table.
- ▶ Policymakers seeking further reform need to consider all parties with systematic stakes in maintaining construction-defect litigation, such as developers and homeowners associations, insurers, and trial lawyers.
- ▶ Better data and analysis would make it much easier to determine the effectiveness of existing and future reforms. Analysis of the 2000 census will help measure how condominium construction and costs differ in California markets from other parts of the United States. Further econometric analysis of annual building-permit data at the metropolitan and state level could also explain how specific legal conditions affect multifamily construction.
- ▶ Monitoring of court cases over the next few years would help to determine whether the anticipatory strategies of builders and insurers—such as peer review, construction documentation, and third-party inspection—are effective and should be incorporated into programs to

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reduce litigation cost. We also recommend evaluation of recent dispute-process reforms in California and evaluation of warranty programs elsewhere.

- ▶ Survey construction-risk insurers nationwide to identify the extent of California's troubled market conditions.

Resolving the affordable-housing problem in California will require more than reforms in the area of construction-defect litigation. From a policy standpoint, such reforms must be part of a broader strategy that enhances subsidies, loosens overly restrictive land controls, and overcomes unreasonable community opposition to new low- and moderate-income housing stock.

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