PRACTICAL LESSONS IN CONSTRUCTION DEFECT CASES

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The Emergence of the Homebuyer's Rights

For many years the phrase "buyer beware" characterized the homeowner's relative lack of power against the builder of the defective home. Deemed to have an affirmative duty to inspect the property prior to execution of the purchase contract, homebuyers who failed to do so were denied recovery and their only recourse was to establish fraud by the seller, who conversely had no duty to disclose defects[1]. Moreover, upon the closing of the sale, any warranties and representations made by the builder concerning the home were deemed to expire with the issuance of the deed, thus eliminating the chance that the homeowner could successfully maintain a lawsuit against the builder for breach of contract or warranty. The power shifted in 1964 when Colorado led the nation in imposing upon the builder of every new home an implied warranty that the home had been built in accordance with applicable building codes, in a workmanlike manner and that the home was suitable for habitation[2]. The "buyer beware" doctrine further eroded as Colorado courts imposed an affirmative duty to disclose known latent defects[3] and further recognized that the purchase contract gives rise to a duty to perform the work with reasonable care and skill, thus giving rise to claim for negligence when the builder fails to do so[4]. Other claims premised upon breach of express warranty or, in some instances, breach of fiduciary duty may also be available to the homeowner of a defective home.

The two strongest theories of recovery are the implied warranty of habitability and negligence. The implied warranty of habitability, however, may be disclaimed by the builder in the purchase contract and usually is disclaimed because of the power this warranty provides to the homeowner. The strength of the implied warranty of habitability is that once the elements of liability are established only limited defenses are available to the developer. But, the implied warranty may not be available for other reasons. It is applicable only to defects in a home. Defective street design, for example, may not be subject to the implied warranty of habitability. Moreover, the claim is only available to the original buyer of the home who purchases the home from a builder.

The strength of the negligence claim is that it may be asserted against the builder by subsequent purchasers of the defective home. But, as will be discussed later, the developer can limit his liability if he can successfully shift blame for the defects to his subcontractors. Because of this, the negligence claim is not the panacea it once was.

The ability to assert a claim for breach of warranty obviously is dependent upon a warranty provision, although the warranty need not be in writing. Oral warranties concerning workmanship and materials are enforceable[5]. Claims for breach of fiduciary duty usually arise in condominium or townhome association cases where the builder failed to take corrective action during the period it controlled the association's board of directors.

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[1] Bain and Cohen, Let the Builder-Vendor Beware: The Demise of Caveat Emptor in Colorado--Part I, 16 Colo. Law. 463 (1987).
[2] *Carpenter v. Donohoe*, 388 P.2d 399 (Colo. 1964).
[3] *Schnell v. Gustafson*, 638 P.2d 850 (Colo. App. 1981).
[4] *Cosmopolitan Homes v. Weller*, 663 P.2d 1041 (Colo. 1983).
[5] *A.W. Easter Construction Co. v. White*, 224 S.E.2d 112 (1976); *Lindstrom v. Chesnutt*, 189 S.E.2d 749 (1972); *Caparrelli v. Rolling Greens, Inc.*, 190 A.2d 369 (1963).

Why the Homeowner Must be Diligent

The ability to assert a successful lawsuit is the most powerful and only certain remedy for the resolution of a construction defect controversy. When all else fails, there is the courtroom. But, thispowerful option and impetus for the contractor to settle is frequently permitted to expire. Without the credible threat of a lawsuit, the homeowner's ability to negotiate with authority is eliminated.

In order to preserve the lawsuit option, the homeowner must be diligent. Once a problem with the dwelling manifests itself, the cause and extent of the problem must be determined promptly. What the homeowner may think was a simple roof leak after a severe storm may be evidence, in fact, a pernicious defect in construction.

The homeowner's right to sue accrues when he knows or <u>should have known</u> that the builder's construction was defective. The law allows only a limited period of time thereafter (as determined by the applicable statute of limitations) for the aggrieved homeowner to file suit. If the lawsuit is not filed within that time, then the homeowner will be barred forever from recovery in a court of law. This is true regardless of how egregious the defect is or how good the homeowner's case otherwise may be against the contractor. The dilatory homeowner is at risk that once in court, the right to sue for the "construction defect" may be deemed to have occurred with that first roof leak. Consequently, if the homeowner has not filed his lawsuit within the statute of limitations as measured from the date of that first roof leak, his lawsuit may be dismissed, thus leaving the homeowner with nothing to show for his efforts and burdened with the task of repairing the defect at his own cost. Naivety is not a defense to the expiration of the statute of limitations.

In Colorado, a construction defect lawsuit must be filed within two (2) years of when the homeowner discovered or should have discovered the defect. The discovery, however, has to be made within six (6) years of the date of substantial completion of the improvement containing the defect. Suits commenced after the first six years are subject to dismissal.

But, what actually constitutes the "discovery" or the time when the "discovery" should have been made? Previously, the statute of limitations gave the homeowner the benefit of the doubt. The statute of limitations period was not necessarily deemed to have "started running" as soon as the homeowner experienced the first roof leak, crack in the basement, or other manifestation of a problem. As late as 1986, the law in Colorado was that a claim for relief arose when:

> . . . the damaged party discovers or in the exercise of reasonable diligence should have discovered the defect in the improvement which ultimately causes the injury, when such defect is of a substantial or significant nature.

Former §13-80-127(1)(b), C.R.S. In *Criswell v. M.J. Brock and Sons, Inc.*[6], this statute was interpreted by the Colorado Supreme Court as recognizing that in construction projects the discovery of physical manifestations of a defect is not necessarily concurrent in time with discovery of the defect itself. This was a very favorable interpretation for homeowners because the interpretation left open the possibility that the statute of limitations may not start running until the homeowner discovers or should have discovered the reason for his roof leak, basement crack and so on.

Under heavy lobbying from the insurance industry, however, the Colorado legislature in 1986 repealed former §13-80-127(1)b), C.R.S. and enacted a new statute specifically intended to annul the *Criswell* decision. The new statute, §13-80-104(1)(b), C.R.S. provides that the homeowner's cause of action accrues (and hence the statute of limitations starts running) when the homeowner:

> . . . discovers or in the exercise of reasonable diligence should have discovered the physical manifestations of a defect in the improvement which ultimately causes the injury.

[6] 681 P.2d 495 (Colo. 1984).

The operative effect of this new statute is that the homeowner's cause of action may be deemed to have accrued with his discovery of that first roof leak.

The dilatory homeowner compounds his problems. The defect is likely to further deteriorate and cause increasing damage to other parts of the property, thus increasing the ultimate cost of repair. Because the homeowner is under a duty to mitigate his losses, the delinquent contractor may not be responsible for those damages which occur while the homeowner delays taking action.

Another consequence of the homeowner's delay is that hiring counsel may be exceedingly difficult if there is a statute of limitations problem. The legal fees incurred in the prosecution of a construction defect case are usually significant and may be prohibitive for the homeowner who must pay those fees on an hourly rate basis as the lawsuit proceeds. For this reason, the homeowner may desire to hire counsel on a contingent fee basis. But, it may be impossible to find counsel willing to take a case on a contingent fee basis where the statute of limitations period has expired.

The Statute of Limitations is Shorter Than You Think

The implied warranty may have been disclaimed by the builder and there may have been no express warranties and no fraud on the part of the builder. In fact, in the real world, the homeowner's only available claim against the builder may be that the builder was negligent. But the builder probably was not the only guilty party. There may have been any number of subcontractors and laborers who had a hand in the defective construction. The homeowner, or his attorney, probably will not be able to identify all of these people prior to filing a lawsuit. So, the lawsuit will have to be filed without naming those persons or entities as defendants. This failure is almost always unavoidable and can have a significant and adverse impact on the homeowner's case.

The reason is that on a claim for negligence, Colorado law permits a jury to assess responsibility for damages among not just the defendants named in the lawsuit, but also persons or entities the homeowner has not named as defendants. For example, if the jury determines that the total damages attributable to the defect are $100,000 and that the builder is 30 percent responsible for those damages, then the homeowner will only be entitled to a judgment against the builder for $30,000[7]. Section 13-21-111.5(3)(a) and (b), C.R.S., gives the defendant 90 days after the lawsuit is commenced within which to designate persons or entities the defendant believes are either entirely or partially responsible for the defective construction. Once those persons or entities are designated, the plaintiff has the burden of convincing the jury that the non-parties were not responsible for the defects. It may be preferable to simply join those persons or entities as defendants to the lawsuit, but by the time their identities are known, the statute of limitations as to claims against them may have expired[8]. Obviously, if the jury then concludes that those non-parties were 70 percent responsible for the defects, then the total amount of the homeowner's enforceable claim is correspondingly reduced. In order to minimize the risk of this non-party scenario, the homeowner must file his lawsuit much earlier than might otherwise be expected.

Handling the Construction Defect Case Without Counsel

As fiduciaries of the members of the association, board members are at risk of liability if an otherwise viable claim for defective construction is impaired or is lost through their neglect. This risk is magnified when the association undertakes to act on its members' behalf in attempting to resolve the construction defect case without counsel. This is usually done in an effort to avoid the cost of legal representation. Instead of hiring an attorney, the association may attempt to utilize its property manager to

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[7] Section 13-21-111.5(3)(a), C.R.S. Counsel may argue that this statute is inapplicable to the construction defect case because the statute only refers to actions involving "injury to person or property." Therefore, the statute may not apply to claims for damages for deficiencies in a structure itself where the homebuyer seeks only to receive what the builder promised to deliver, or damages to compensate him for deficiencies in the final product. _See_ *Duncan V. Schuster-Graham Homes, Inc.*, 578 P.2d 637, 640 (Colo. 1978).

[8] Unfortunately, this problem cannot be avoided by naming "John Doe" defendants to the lawsuit under Rule 10(a), C.R.C.P. The "John Doe" designation does not toll the statute of limitations. `, 662 P.2d 496 (Colo. App. 1983), overruled on other grounds; *Medina v. Schmutz Mfg. Co.*, 677 P.2d 953 (Colo. App. 1983), overruled on other grounds; *Dillingham v. Greeley Pub. Co.*, 701 P.2d 27 (Colo. 1985).

negotiate a settlement. There are profound risks to both the association and to the property manager in doing so.

First, construction defect claims are quite complicated both from a legal and an engineering point of view. Untrained in the law and often inexperienced in claims negotiation, the property manager is at a serious disadvantage when dealing with the seasoned builder or insurance adjuster who is receiving the advice of counsel behind the scenes.

Second, regardless of his training or experience, the property manager who undertakes to negotiate a resolution of the legal claims of the association or its members is engaging in the unauthorized practice of law and he will have no insurance policy insuring against his acts or omissions while engaging in the unauthorized practice of law. Moreover, because the resolution of the construction defect case is outside the scope of the property management agreement, there may be no insurance whatsoever to protect either him or the homeowners who have been harmed by his error.

Fourth, the property manager may have a conflict of interest in attempting to resolve the case against the developer. Often, the property manager was originally hired by the developer and his contract renewed after the developer turned control of the association over to the members. If then, the builder is a source of business to the property manager, the association and its members cannot expect the property manager's undivided loyalty.

When the association is attempting to resolve the case without counsel, perhaps the most common means by which the board members expose themselves to liability is by letting the statute of limitations lapse. In many instances, the board is involved in what it believes to be good faith negotiations with the builder who they believe intends to repair the problems or otherwise settle with them. These negotiations do not stop the running of the statute of limitations[9]. Although an agreement to waive the statute of limitations may be entered into with the builder, the builder's agreement to do so will have no binding effect on any future co-defendants or designated non-parties[10]. Moreover, to be effective, the signature of all of the association's members may be necessary. Finally, the drafting of the waiver agreement must be exacting in its description of what is waived. This necessarily requires spelling out the exact claims of the case and the identities of the parties. Obviously, the better practice may be to prepare the actual complaint and attach it as an exhibit to the waiver agreement and then have all of the named parties execute the waiver agreement.

But, if the complaint is going to be prepared, why not just file the lawsuit and then negotiate? By filing the lawsuit, the homebuyers or the association are in a position of control and have eliminated the statute of limitations problem, assuming the complaint has been timely filed.

The parties may also choose to submit the controversy to binding arbitration which may be more expeditious than litigation and less expensive. Binding arbitration requires the agreement of the parties and may not provide the same results as litigation. First, the rules of evidence are relaxed in arbitration, thus permitting the arbitrator to consider unreliable information to the detriment of either or both of the parties, but it also encourages the arbitrator to make decisions on the basis of his or her personal experience or beliefs rather than of the basis of the evidence. In Colorado, the arbitration award can be converted into a judgment upon which the winning party can use court process to help collect what is owed[11].

When the Builder is Gone

Unfortunately, the builder is not always still around when the defects start showing up. The unscrupulous builder may create a new corporation for the construction project. After construction is completed and before the problems start to appear, the corporation is then dissolved, leaving the

[9] See, e.g., *Gordon-Tiger Mining & Reduction Co. v. Loomer*, 115 P. 717 (1911).
[10] See, generally, §13-80-114, C.R.S.
[11] Section 13-22-222 and 225, C.R.S.

homebuyers with the difficult task of finding someone to sue. In other situations, the builder may have filed for bankruptcy which may effectively bar subsequent suits by homeowners.

There may be other options available to the homebuyer. If lucky, the homebuyer may have a warranty policy warranting features of the home. Typically, such policies may cover workmanship and materials, systems within the home such as heating, plumbing, electrical and structure. These warranties are sold through companies such as Home Buyers Warranty or Home Owners Warranty. Both companies sell policies covering workmanship and materials for one year, systems for two years, and structures for ten years. These policies can be enforced to the benefit of the homeowner even if the builder is no where to be found.

If the builder is still in business, the homebuyer gives the builder notice of the problem or the homebuyer gives the warranty company notice directly if the builder is out of business or non-responsive. If the builder admits the problem, then normally the warranty company honors the claim. If the builder and the homeowner cannot agree on whether the problem is covered by the warranty, then the warranty company hires a licensed engineer to review the defect. The warranty company has the sole discretion to determine whether to repair or replace the defective property, or simply pay the homeowner money. The warranty company also has sole discretion concerning the method of repair or replacement which frequently is the basis for controversy between the homeowner and the warranty company.

Even if there is no warranty policy covering the defect, the homebuyer or the association may have a remedy. A common practice among developers is to install their own employees as members of the board of directors during the period prior to the transition of the board to the members of the association. If the builder is bankrupt or gone, these people may still be around and there may be claims that can be asserted against them for their acts or omissions during the time they were holding fiduciary capacities. Frequently, these individuals were placed on notice of the defects before anyone else. They may be liable for having failed to disclose the existence of the defects to the membership or for having failed to take stringent action to correct them. The lucky homeowner or association may even find that a longer statute of limitations exists for these individuals[12] and that insurance coverage is still in place for these former board members out of which the damages incurred can be paid.

Conclusion

The homeowner has very powerful legal remedies against the delinquent builder. But, the homeowner must be diligent in preserving the right to assert these remedies because they are lost if not timely asserted. Once lost, the homeowner is reduced to negotiation at the mercy of the builder. These concerns are no less great for the homeowner association and its board members who must be careful to handle construction defect claims appropriately.

[12] Because these individuals are not themselves the contractor or builder, they may be subject to the three year statute of limitations, provided by Section 13-80-101, C.R.S.