

HOUSE BILL REPORT

2ESSB 5536

As Reported by House Committee On:
Judiciary

Title: An act relating to condominiums.

Brief Description: Resolving claims relating to condominium construction.

Sponsors: Senate Committee on Judiciary (originally sponsored by Senators Finkbeiner, Reardon, Roach, Hale, Horn, Benton, Morton, Hewitt, Schmidt, Kastama, Sheahan, Mulliken, Johnson, Parlette, Stevens, West and Esser).

Brief History:

Committee Activity:

Judiciary: 2/24/04, 2/26/04 [DPA].

Brief Summary of Second Engrossed Substitute Bill
(As Amended by House Committee)

- Allows arbitration of condo construction defect disputes to be provided for in a condo declaration or by other agreement of the parties, and provides for the right of a trial de novo on appeal of an arbitration decision, with respect to condos created after the effective date of the act;
- Provides standards for showing a breach of an implied warranty, and explicitly establishes the measure of damages in a condominium construction defect case, with respect to condos created after the effective date of the act;
- Creates a committee to recommend legislation on third-party inspections of condo construction for water penetration problems; and
- Authorizes qualified warranty insurance which, if a builder chooses to purchase it, gives the builder immunity from liability under the construction warranty standards of the Washington Condominium Act, and provides that a condo owner's recourse for a construction defect is to file a claim with the insurer.

HOUSE COMMITTEE ON JUDICIARY

Majority Report: Do pass as amended. Signed by 5 members: Representatives Lantz, Chair; Moeller, Vice Chair; Flannigan, Kirby and Lovick.

Minority Report: Do not pass. Signed by 4 members: Representatives Carrell,

Ranking Minority Member; McMahan, Assistant Ranking Minority Member; Campbell and Newhouse.

Staff: Bill Perry (786-7123).

Background:

The Washington Condominium Act (WCA) controls the creation, construction, sale, financing, management, and termination of condominiums.

A condominium consists of real property that has individually owned units and also has commonly held elements in which all the individual unit owners have an undivided common interest. A condominium may be created for any of a number of purposes, including residential use. A condominium is created by the recording of a "declaration." The person creating a condominium is referred to as the "declarant." The declarant or other seller of a condominium is required to prepare a "public offering statement" which must be delivered to a purchaser before sale. The public offering statement must contain a variety of information about the condominium, the declarant, and the management of the condominium.

The WCA also creates specific rights and responsibilities. The WCA creates implied warranties and authorizes the use of express warranties regarding the quality of materials and construction in a condominium. It gives certain rights to owners and their associations regarding these warranties.

Warranties.

Express warranties are assertions that are made by a declarant with respect to the condominium and that are relied upon by a buyer.

Implied warranties are statutorily created in the WCA. Implied warranties by the seller of a condominium include warranties of quality that:

- the units and common areas are suitable for the ordinary uses of real estate of that type;
- any construction is free from defective materials; and
- construction has been done in accordance with sound engineering and construction standards and has been done in a workmanlike manner and in compliance with applicable laws.

Implied warranties in non-residential condominiums may be waived by the written agreement of the parties or by a general disclaimer such as declaring that the sale of a unit is to be "as is" or "with all faults." Implied warranties in the sale of a residential unit, however, may not be waived by such a general disclaimer. A disclaimer of implied warranties regarding a residential unit must:

- be signed by the purchaser;
- specify the defect or noncompliance with the law that is the subject of the waived warranty; and
- be with respect to a defect or failure to comply that became a part of the basis of the bargain between the declarant and buyer.

Under a 2001 decision, *Marina Cove Condominium Owners Association v. Isabella Estates*, the Washington State Court of Appeals held that a defect may be disclaimed even if the defect is in fact not known to exist at the time of the disclaimer so long as the disclaiming of the defect has become a part of the bargain for the sale of the condominium.

Courts have applied a common law rule regarding the determination of damages for a breach of a warranty under the WCA. Damages may be awarded for the cost of repairing a defect unless that cost is disproportionate to the loss in value of the condo caused by the defect, in which case damages will be awarded for the loss in value.

Arbitration.

The *Marina Cove* decision also held that binding arbitration clauses in condominium agreements are unenforceable under the WCA.

Limitation of Actions.

An action for a breach of a warranty under the WCA must be brought within four years of the accrual of the cause of action. Generally, that accrual with respect to an individual condo unit occurs upon the purchaser taking possession, and with respect to common areas upon the later of occupancy of a unit, or completion of the common area.

The four-year statute of limitations may not be reduced by agreement of the parties.

Liability of a Declarant and Others.

Under the WCA a declarant is defined to include a group of persons "acting in concert" to execute a declaration. A recent court decision, *One Pacific Towers Homeowners' Association vs. HAL Real Estate Investments (HAL)*, dealt with the WCA in a way that has caused some concern about the application of liability rules to persons who may be characterized as declarants, dealers and affiliates. The *HAL* case involved a seller who created six separate limited liability corporations (LLCs). All of the LLCs consisted of the same person and each of them created five condos, which is just below the threshold of six condos that would have made the seller a "dealer" under the WCA. On the one hand, the facts of the case raise concern that the WCA may invite this kind of creation of multiple separate entities just to avoid liability where it would otherwise apply. On the other hand, the *HAL* decision construed the phrase "acting in concert" in order to make the seller a "declarant," but did so in a way that may implicate personal liability for persons who are merely shareholders or limited partners in the creation of a condo.

Warranty Insurance Program in British Columbia.

For several years, British Columbia has had a mandatory program of warranty insurance that applies to condominiums. Under this program, the builder of a condo purchases an insurance policy that provides coverage for unit owners. If a construction defect is alleged, the unit owner files a claim under the policy instead of suing the builder.

Current Problems in the Condominium Industry.

Condominium construction in the state has recently all but stopped. It is difficult if not impossible for builders to get liability insurance for condo construction. Some condo owners have experienced problems with the construction of their units, particularly with respect to water penetration.

Summary of Amended Bill:

I. CHANGES TO THE WCA

Arbitration.

Arbitration is allowed either through a provision in the declaration or by other agreement of the parties. Reasonable attorneys' fees and costs, and arbitration fees and costs of arbitration, may be awarded to a substantially prevailing party. An arbitration decision may be appealed to the superior court with a right to a de novo jury trial. The court is to assess costs and reasonable attorneys' fees against an appealing party who fails to improve his or her position on appeal. The failure to improve is measured against the arbitration award unless an offer of compromise has been made, in which case the measurement is against the offer.

These new arbitration provisions apply only to condos created on or after July 1, 2004.

Implied Warranties.

In order to be effective, a disclaimer of a WCA implied warranty must:

- be for a specified failure or defect *that the declarant knows or has reason to know exists*;
- be made in a *separately signed, conspicuously set apart*, written provision; and
- describe the defect or failure *and its effect*.

In order to establish a breach of a warranty, a condo owner must show that the alleged breach has or will adversely affect the performance of the condo. An adverse effect is one that is substantive, not simply technical, significant to a reasonable person, and not trivial. A breach need not render a condo uninhabitable or unfit for its use.

Proving a breach of an implied warranty is not sufficient to establish damages. Damages are the cost of repairs unless those costs are grossly disproportionate to the diminution in

the condo's market value caused by the breach, in which case damages are the loss in value.

These new warranty provisions apply only to condos created on or after July 1, 2004.

Statute of Limitations.

The WCA's four-year statute of limitations for bringing an action for a breach of an implied warranty does not affect the filing of an insurance claim under the warranty insurance program being established by this legislation.

Liability of a Declarant and Others.

The definitions of "affiliate," "dealer" and "declarant" are amended in response to the *HAL* decision, including the deletion of the phrase "acting in concert" from the definition of "declarant." Included among those who may be liable as a declarant are persons who own land upon which a condo is built and who directly, or through affiliates, are materially involved in the construction, marketing, or sale of the condo.

Third Party Inspections.

A five member committee is created to study the issue of independent third-party inspections of residential condos for problems of water penetration. The chair of the committee is to be appointed by the Governor, and the other four members are to be appointed by the Speaker of the House and the Majority Leader of the Senate. The committee is to deliver its findings and conclusions and any proposed legislation to the judiciary committees of the House and Senate by December 31, 2004.

II. WARRANTY INSURANCE

A warranty insurance program is established as an alternative to the implied warranty provisions of the WCA. If a condominium declarant purchases warranty insurance that meets certain requirements, the declarant and any construction professional are no longer liable to a condo unit owner for breach of a warranty under the WCA. Instead, the condo owner's recourse for a warranty breach is to file a claim under the warranty insurance policy.

Furthermore, if a construction professional agrees to indemnify the insurer for loss due to construction defects caused by the construction professional, the liability of the construction professional is limited to the insurance limits of the warranty.

Any indemnity claim by an insurer must be in a separate action or arbitration not involving the condo owner or condo association.

Minimum Coverage Terms for a Qualified Warranty.

The warranty insurance program is available only in the case of a "qualified warranty." A "qualified warranty" must meet certain requirements before it will be an alternative to

the WCA. The warranty insurance must have at least:

- two years of materials and labor coverage that consists of:
 - 12 months of coverage for any defect in a unit and for any violation of the building code that constitutes an unreasonable health or safety risk or causes material damage;
 - 15 months of the same coverage for common elements; and
 - 24 months of coverage for: (1) defects in the electrical, plumbing, heating, ventilation and air conditioning systems, exterior cladding, caulking, windows and doors; (2) any defect making the unit unfit to live in; and (3) any violation of the building code constituting an unreasonable health or safety risk or causing material damage.
- five years of coverage for defects in the condo's building envelope, including a defect permitting water penetration that is likely to cause material damage; and
- ten years of coverage for structural defects that result in failure of a load-bearing part or that materially affect the residential use of the condo.

A qualified warranty must also allow for reimbursement of an owner's living expenses during any repairs. All repairs must themselves be warranted by the insurer for the longer of the remainder of the qualified warranty period or one year from completion of the repair.

Beginning dates are established for warranty insurance coverage of condo units and common elements. Special rules apply in cases in which the declarant maintains control over a condo association more than 14 months after the beginning date of the common elements coverage.

Permitted Terms under a Qualified Warranty.

Several provisions are allowed but not required in a qualified warranty. These include:

- requiring owners to cooperate with an insurer who has paid a claim and is suing the declarant or a construction professional;
- excluding from coverage express warranties of the declarant;
- reducing coverage to the extent of any warranty disclaimer under the WCA;
- requiring the owner to allow inspections of the unit by the insurer or declarant and to provide available information about a claim;
- excluding from coverage any damage caused by the owner's refusal to allow inspection or to provide information; and
- allowing only the owners' association to prosecute claims involving common elements of the condo.

A qualified warranty may require an owner to mitigate damages by giving timely notice of a defect or taking all reasonable steps to restrict damages if a defect requires immediate attention.

Permitted Exclusions from a Qualified Warranty.

A qualified warranty may exclude coverage for landscaping, commercial use areas, roads, site grading and surface drainage not required by the building code, municipal services, septic systems, water quality and quantity, and wells. However, a qualified warranty may not exclude driveways, recreational areas, parking structures, or required retaining walls.

A qualified warranty may also exclude certain defects from coverage. Defects that may be excluded are those: caused by normal wear and tear and shrinkage; occurring during use of the unit for nonresidential purposes; caused by owner supplied materials or labor, or by improper owner maintenance; or by acts of nature.

A qualified warranty may also exclude bodily injury, damage to personal property, contaminated soil, land subsidence, and diminution in the condo's value.

All exclusions must be stated in the qualified warranty.

Permitted Monetary Limits.

A qualified warranty may limit per unit coverage to the lesser of a unit's original purchase price or \$100,000, and may limit coverage for common elements to \$150,000 per unit. These limits are to be adjusted annually for consumer price index changes.

Prohibited Terms.

A qualified warranty may not require an owner to sign a release before repairs are made or pay a deductible in excess of \$500 for any repair to a unit, or in excess of the lesser of \$500 per unit or \$10,000 for any repair to common elements.

Notice and Handling of Claims.

An owner must give the insurer a reasonably detailed description of a claim within a reasonable time after discovery of a defect. Upon receipt of a claim, the insurer must make all reasonable efforts to avoid delays in responding, and repairs must be undertaken in a timely manner.

Mediation and Arbitration.

Either the owner or the insurer may demand mediation of a claim dispute. Procedures are provided for the appointment of a mediator and for the conduct of mediation. A mediator must be appointed within 21 days of the demand for mediation, and the mediation is to begin within 21 days of the appointment.

A warranty policy may include mandatory binding arbitration for resolution of claims under the policy. The policy may not permit joinder in the arbitration of persons other than those who are parties to the policy. Procedures are provided for the appointment of either one arbitrator or, if the parties agree, three arbitrators. At least one of the arbitrators must be a lawyer or retired judge. Additional arbitrators must be either a

lawyer or retired judge or a person with experience in construction and with construction dispute resolutions.

The arbitration is to be conducted in accordance with the arbitration provisions of Washington law unless the parties agree to use the construction industry arbitration rules of the American arbitration association. Witness expenses are to be borne by the party producing the witness. All other expenses are to be shared equally, unless agreed otherwise by the parties or ordered otherwise by the arbitrator.

Attorneys' Fees.

In any proceeding to enforce the terms of a warranty policy, the court or arbitrator must award attorneys' fees to a substantially prevailing party. The awarded fees may not exceed the reasonable hourly value of the attorney's work.

Insurer's Acceptance of a Declarant.

No insurer is required to offer a warranty policy. In deciding whether to sell a policy to a declarant, the insurer may make inquires of and about the declarant, including:

- whether the declarant has the necessary resources, technical expertise, experience, business practices, and the ability to provide after-sale customer service for the proposed condo;
- whether the declarant has the necessary capitalization for the proposed condo; and
- whether any proposed general contractor for the project meets the insurer's requirements.

The insurer may also require that the declarant:

- provide security for the project;
- comply with specific construction standards;
- not build some types of condos or use some types of construction;
- use specified types of systems, consultants or personnel;
- provide independent review of plans;
- provide third-party verification or certification of construction requirements;
- provide inspection during construction and ongoing monitoring after construction;
- maintain insurance, bonding or other security in favor of the insurer and potential owners; and
- provide the insurer with a list of construction professionals and trades employed in the project.

An exception is provided to the WCA's guarantee of judicial resolutions of disputes for the operation of the warranty insurance program.

Amended Bill Compared to Second Engrossed Substitute Bill:

The amendment makes extensive changes to the bill including the following:

- removes mandatory arbitration of warranty disputes;
- allows for appeal de novo of an arbitration decision, with assessment of costs and reasonable attorneys' fees for failure to improve a position on appeal;
- replaces provisions on breaches of warranties that require a showing of materiality with respect to an adverse effect on structural integrity or safety, or with respect to impairment of use, with provisions that require a showing of adverse effect on performance;
- replaces the requirement for independent third-party inspections with the creation of a study committee;
- adds provisions amending the definitions of "dealer," "declarant" and "affiliate" in response to the *HAL* decision; and
- adds provisions creating a program of warranty insurance.

Appropriation: None.

Fiscal Note: Not requested.

Effective Date of Amended Bill: Sections 1 through 11, dealing with the current WCA, take effect July 1, 2004. The remainder of the bill, dealing with warranty insurance, takes effect 90 days after adjournment of session in which bill is passed.

Testimony For: (Original Bill) This bill is necessary because the current law is outrageously unfair. The bill is well-negotiated and contains many compromises.

The current lack of condo starts is costing jobs and preventing local governments from meeting goals of the Growth Management Act. Condos are the best housing opportunity for many low-income, first-time home buyers. The lack of affordable construction insurance is the main reason condos are not being built. The bill will promote a robust insurance market.

The bill makes it easier for consumers to get redress.

Current warranties under the WCA are incredibly onerous. Any breach can expose a builder to liability. There are a myriad of laws and codes that must be complied with, and some "defect" could probably be found in any condo. Some of the building code requirements may themselves promote water and mold problems in condos. The "materiality" requirements of the bill are reasonable and will protect homeowners.

Third-party inspections of condos are a good idea for insuring quality construction.

Testimony Against: (Original Bill) The problem with condos is not frivolous lawsuits.

It is defective construction. Much of the construction industry has failed to step up to the plate regarding serious problems with condo construction. Good builders have built hundreds of condo units without every being sued. This bill will just reward poor construction and remove the incentive to improve. In fact, in the last couple of years, construction quality has gotten better, in part in response to the fear of lawsuits.

Homeowners have a right to a fair resolution of claims. This bill would violate that right. The arbitration provisions of the bill go beyond just reversing the effect of the *Marina Cove* decision. The retroactive application of mandatory arbitration takes away the right to a jury trial. The prospect of a fair jury trial is what brings disputes to resolution. Buyers of condos are mostly first-time homeowners with limited resources. They cannot afford the extra expense of taking a claim to arbitration. Arbitration can be prohibitively expensive, especially for condos with only a small number of units.

The warranty provisions of the bill are unacceptable. They provide inadequate minimum protections for homeowners. The requirement of "materiality" in a defect will mean that only condo owners among all homeowners will have this lesser standard of protection.

The third-party inspection provisions of the bill need substantial work. There is no indication of what happens if no inspection is done, or if a builder fails an inspection.

Testimony For: (Previous proposed amendment) Arbitration should not be mandatory. It should not be allowed as part of a condo declaration. Arbitration should be allowed by agreement of the parties at the time a dispute arises. Condo associations are not being scared into lawsuits. Lawsuits are necessary to protect the rights of homeowners.

Testimony Against: (Previous proposed amendment) Warranty insurance is an untried program that will become the industry standard by default in a market where no other insurance is available. Real change needs to be made to the WCA to allow for insurers to come back into the condo market. The amendment is no better than the current law with respect to arbitration.

Persons Testifying: (In support of original bill) Scott Hildebrand, Master Builders Association of King and Snohomish Counties; Ron Fowler, Seattle-King County Association of Realtors; Mike Flynn, Washington Association of Realtors; Nick Federici, Washington Low-Income Housing Alliance; Cliff Webster, Architects and Engineers Legislative Council; and Scott Surdyke.

(With concerns) Ryan Spiller, Washington Homeowners Coalition; Todd Hobert, Crystal Heights Condominium Association; Sue Dahlin, Sundance Condominium Association; Marion Morgenstern, Community Associations Institute; Peter Saladino, Charter Construction; Timothy Harris, Building Industry Association of Washington; Vincent DePillis, David Rockwell, and Gary Ackerman, RPPT Section, Washington State Bar Association; Genesse Adkins, 1000 Friends of Washington; Tony To; and Mel Sorenson,

CBIC Property and Casualty Insurance.

(Opposed to original bill) Carl Wilson, Up Front Condos Inc.; and Mark Jobe.

Persons Signed In To Testify But Not Testifying: Scott Oien.