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Defending Defects, Part II:

Implementing a Comprehensive Defense Strategy to Resolve Construction Defect Claims

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“Defects” Are Everywhere

Digging for Defects

Data shows an explosion of construction defect litigation across the country, particularly in Texas and Florida.

If You Wait Until You Receive a Claim, You Have Waited Too Long

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The Declaration: The Best Defense is a Good Offense

The Declaration: Amend Early

The Declaration: Limitation on Representative Actions

The Declaration: Making ADR Mandatory

The Declaration: Defining the Preconditions to Suit

Developing an Effective Defense Strategy Upon Receiving Notice of Claim

- An effective defense strategy requires a multi-faceted approach based on a number of factors, including:
  - The type of project and the status of the claimant;
  - The applicable governing documents;
  - An understanding of the applicable law; and
  - Knowledge of potentially applicable insuring agreements and third-party defense and indemnity agreements.

Typical Construction Defect Theories of Liability

- Negligence
- Breach of Contract
- Breach of Express Warranty
- Breach of Implied Warranty
- In residential construction cases, a Deceptive Trade Practices Act ("DTPA") is also common

What Law Governs a Construction Defect Claim?

- Dependent on the status of claimant and type of project
- Texas common law and/or statute (or both) typically govern defect claims involving non-residential projects
- Defect claims involving residential projects are typically subject to the purview of the Residential Construction Liability Act (“RCLA”) found in Chapter 27 of the Texas Property Code

In General, Defect Claims Brought by Unit Owners and Homebuyers are Subject to the RCLA

NOTICE

This Agreement is subject to Chapter 27 of the Texas Property Code. The provisions of that chapter may affect your right to recover damages arising from the performance of this Agreement. If you have a complaint concerning a construction defect arising from the performance of this Agreement and that defect has not been corrected through normal warranty service, you must provide the notice required by Chapter 27 of the Texas Property Code to the contractor by certified mail, return receipt requested, not later than the 60th day before the date you file suit to recover damages in a court of law or initiate arbitration. The notice must refer to Chapter 27 of the Texas Property Code and must describe the construction defect. If requested by the contractor, you must provide the contractor an opportunity to inspect and cure the defect as provided by Section 27.004 of the Texas Property Code.

Understanding the RCLA

- The RCLA applies to “matters arising from” the design, construction, or repair or a new or existing residence, or an appurtenance thereto—*e.g.* a swimming pool;

- The RCLA’s purpose is to promote efficient and cost-effective resolution to construction defect claims.

Main Features of the RCLA

- Pre-suit inspection-and-offer process
- Limits and controls damages available to claimant
- Provides additional defenses to builders

Defect Claims Generally Begin Upon Receipt of a Notice of Claim

Although we are continuing to investigate this matter, based on what we have learned thus far, Sellers' misconduct constitutes negligence, fraud, breach of warranty (express and implied), breach of contract, and violations of the Deceptive Trade Practices Act (DTPA) § 17.50(a)(2), (3), and § 17.46(b)(5), (7), (9), (13), and (24). Because of Sellers' misconduct, [redacted] have suffered and will continue to suffer serious damages, including loss of value of the property, loss of use and enjoyment of the property, cost of repair, cost of substitute housing during future repairs, mental anguish, consulting fees, and attorneys' fees, all which exceed $2 million and with trebling under the DTPA will exceed $6 million. In addition, as you are aware, [redacted] are health compromised and the defects pose increased risk to their wellbeing.

The purpose of this letter is to encourage you to resolve this claim in a fair and equitable manner without the need for legal action. [redacted] hereby demands that Sellers either repair each and every deficiency addressed in Exhibits A, B, and C or repurchase the property from [redacted] at the price he originally paid plus all HOA, and interest payments made to date. Given the extent of the necessary repairs, [redacted] also demands that Sellers provide hotel accommodations while the repairs are being conducted and further provide moving expenses for relocation of furniture while the floors are repaired. And further, in light of the obvious corrosion of [redacted] plumbing, please immediately replace the defective plumbing and provide [redacted] with any and all water tests completed with the past six months to confirm whether the water in the unit is safe to drink or use. If we cannot resolve this matter, [redacted] will initiate legal action against Sellers to recover not only the full measure of damages, but also treble and/or punitive damages, attorneys' fees, pre-judgment interests, costs of court, and post-judgment interest.

Significance of Notice of Claim

- In defect claims subject to the RCLA, receipt of a notice of claim begins the pre-suit inspection and offer process
- Under that process, a builder/developer is entitled to receive notice of the defect, an opportunity to inspect the property, and an opportunity to make an offer to cure the defect
- Pre-suit inspection and offer process designed to facilitate early settlement and potentially cap a claimant's recoverable damages

Prompt Action is Critical

- Tight deadlines under RCLA inspection and offer process:
  - Owner must provide notice of defect must be provided to developer/builder 60 days before suit/arbitration filed
  - Developer/builder must inspect within 35 days after receiving notice
  - Developer/builder must make offer of settlement within 45 days after receiving notice
  - Owner must accept/reject offer of settlement within 25 days
  - Developer/builder may make supplemental offer within 10 days, if initial offer rejected

Responding to a Notice of Claim

- Upon receipt of a notice of claim, a prompt written response is crucial and should request the following:
  - multiple inspection dates;
  - any evidence of nature and cause of defect; and
  - any evidence of nature and extent of necessary repairs.

Preparing for Inspection

- Provide written notice of claim to your insurer early, and afford a carrier rep the opportunity to join the inspection

- Identify and provide written notice to any potentially responsible contractors, subcontractors, or other third-parties *and their insurers,* and provide them an opportunity to join the inspection

- If possible, consider identifying and retaining expert witnesses early and have them participate in any inspections

Insurance

- Early notice to your insurer is critical because insurance issues can be a big factor in your defense strategy

- It is important to understand your contract documents with potentially responsible third-parties, as they may owe defense and/or indemnity obligations

- For those that do owe defense and indemnity against a claim, tender them *and their insurers* early and often

Example of Tender Letter

To whom it may concern:

This firm represents [redacted] This letter serves as [redacted] second notice and demand for defense and indemnification to [redacted] relating to defective work claims asserted by the Owner. The Owner's claims arise from work performed by [redacted] at the office building located at 1001 Crystal Falls Parkway in Leander, Texas (the "Project").

By way of background, [redacted] was a roofing subcontractor at the Project. The Owner has asserted claims against [redacted] concerning allegedly defective work performed and resulting property damage to the Project in Cause No. C-1-CV-17-006892, *Lookout Development Group, LP v. G2 Builders Corp., CTC Paint & Roof, LLC, State Capital Roofing, LLC, and G2 Builders Texas, LLC* (the "Lawsuit"). A copy of the Owner's Third Amended Petition in the Lawsuit, filed on December 6, 2019, is enclosed with this letter.

[redacted] issued to [redacted] commercial general liability policy number TX-CGL-[redacted] (the "Policy"), effective November 7, 2016 to November 7, 2017. A copy of the Policy is also enclosed with this letter. The Owner's claims in the Third Amended Petition contractually obligate [redacted] to defend and indemnify [redacted] under the Policy. Accordingly, [redacted] hereby demands that [redacted] accept this tender of defense and indemnification. [redacted] is authorized to obtain additional information and records as may be necessary to process this claim, and [redacted] will cooperate with [redacted] investigation of the claims in this Lawsuit.

The Offer of Settlement

- Post-inspection, developers/builder may make an offer of settlement within 45 days from receipt of the notice of claim
- The offer must describe in reasonable detail the repairs to be made, make a monetary offer of settlement, or offer to repurchase the property
- A claimant may reject the offer if it considers the offer to be “unreasonable”
- If rejected, a supplemental offer may be made, or a party can stand on its original offer if believed to be “reasonable”

A “Reasonable” Offer of Settlement Can Cap Damages and Attorneys’ Fees

- Offers of settlement merit careful consideration
- If a claimant rejects an offer and the claim proceeds to trial, the arbitrator/jury will ultimately determine whether the offer was “reasonable” or “unreasonable”
- Rejection of a “reasonable” offer caps a claimant’s damages at the fair market value of the last offer of settlement *and* caps attorney’s fees at the amount incurred prior to rejection

Initiating the Lawsuit

- Once the RCLA process has concluded, suit/arbitration may be filed (unless you have already amended to include additional preconditions)

- Before commencing suit, understand what your governing documents require:
  - Do the documents mandate litigation or arbitration? If arbitration is required, do they specify the number of arbitrators, the method of selecting arbitrators, or the arbitration rules that apply?
  - *Practice pointer—with arbitration, parties are generally free to negotiate/agree to procedural matters that may contravene the governing documents

The Declaration: Defining the Preconditions to Suit

Precondition 1: Independent Report of Common Areas

Precondition 2:
Meeting and Vote of Owners

Precondition 3:
Notice to Respondent

Precondition 4: Negotiation

Precondition 5: Mediation

The Declaration: Defining the Conditions of Suit

15.09 Binding Arbitration-Claims. All Claims must be settled by binding arbitration. Claimant or Respondent may, by summary proceedings (e.g., a plea in abatement or motion to stay further proceedings), bring an action in court to compel arbitration of any Claim not referred to arbitration as required by this *Section 15.09*.

Filing for Arbitration

- For purposes of this discussion, we will assume arbitration is the selected dispute resolution method
- The first step in commencing the process is filing for arbitration
- Many times, contracts or governing documents will specify that the case is required to be filed with a recognized arbitration service (e.g. AAA, JAMS, etc.)
  - *Practice pointer—arbitration services typically require an initial upfront filing fee, which varies depending on the size of the claim. This fee can be quite large and is independent of the arbitrator's fees. Parties can agree to privately select arbitrators outside of these services to avoid these costs.

Selecting the Arbitrator

- As important as jury selection is in litigation—many arbitration can be won or lost in arbitrator selection
- For construction defect cases, consider whether the arbitrator is “consumer friendly” or “builder friendly”
- Ask around and make sure you get as much information about an arbitrator as possible before proposing!

The Initial Conference

- Once an arbitrator is selected, the parties will have an initial conference to map out scheduling and discovery deadlines and other procedural issues
- Accounting for the needs and size of the case, consider streamlining discovery to save costs
- The purpose of the initial conference is to get to the heart of what the parties need in discovery to “work up their case”

Working Up Your Case

- In construction defect cases, many times it comes down to a “battle of the experts”
- Experts can (and often do) play a large role in the effectiveness of the presentation of the evidence, as issues are typically highly technical in nature
- The appropriate expert for any given construction defect claim is case-specific, and identifying well-qualified experts in the right area of expertise is critical

Understanding and Negating the Damage Model

- Experts are most often used to establish or negate *liability*
- Often overlooked, however, is the use of experts to challenge or negate all or part of a claimant's damage model
- Past costs incurred can sometimes be proved up without experts, but reasonable and necessary future repair costs generally require expert testimony
- Expert witness firms exist that provide construction-specific forensic accounting services

Practical Thoughts on Handling The Arbitration Hearing

- Trying a construction defect case to an arbitrator varies greatly from trying it to a jury
- Arbitrators generally have significant construction-specific experience and understand the technical components—so, have your experts get straight to the point
- Many arbitrators admit all evidence (even if inadmissible in litigation), and decide its weight—thus, expending effort trying to “strike” a piece of evidence may not be the best use of resources
- Arbitrators are not apt to grant pre-trial dispositive motions; however, they can be effective in bringing forth critical legal issues and shaping the arbitrator’s view of evidence and testimony

The Declaration: Defining the Award

(d) Scope of Award; Modification or Vacation of Award. The arbitrator shall resolve all Claims in accordance with the applicable substantive law. The arbitrator may grant any remedy or relief that the arbitrator deems just and equitable and within the scope of this *Section 15.09* and subject to *Section 15.10* below (attorney's fees and costs may not be awarded by the arbitrator); provided, however, that for a Claim, or any portion of a Claim governed by Chapter 27 of the Texas Property Code, or any successor statute, in no event shall the arbitrator award damages which exceed the damages a Claimant would be entitled to under Chapter 27 of the Texas Property Code. In all arbitration proceedings the arbitrator shall make specific, written findings of fact and conclusions of law. In all arbitration proceedings the parties shall have the right to seek vacation or modification of any award that is based in whole, or in part, on (i) factual findings that have no legally or factually sufficient evidence, as those terms are defined in Texas law; (ii) conclusions of law that are erroneous; (iii) an error of federal or state law; or (iv) a cause of action or remedy not expressly provided under existing state or federal law. In no event may an arbitrator award speculative, consequential, or punitive damages for any Claim.

Defining the Award

- The arbitrator may grant any remedy or relief that the arbitrator deems just and equitable and within the scope of this Section 15.09 and subject to Section 15.10 below (attorneys fees and costs may not be awarded by the arbitrator);

Defining the Award

- [I]n no event shall the arbitrator award damages which exceed the damages a Claimant would be entitled to under Chapter 27 of the Texas Property Code.
- In no event may an arbitrator award speculative, consequential, or punitive damages for any Claim.

Questions?

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