
Judiciary Committee

2ESSB 5536

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 Summary of Second Engrossed Substitute Bill

- Allows arbitration of condo construction disputes by agreement of the parties at the time a dispute arises;
- Explicitly establishes the measure of damages in a condominium construction defect case and establishes an affirmative defense against a claim of a breach of an implied warranty;
- Requires third party independent inspections of condo construction for conformance to engineering and construction standards and for compliance with applicable laws; and
- Provides for a warranty insurance program that a builder may agree to in exchange for immunity from liability under the construction warranty standards of the Washington Condominium Act, and provides that if a builder buys such an insurance policy, a condo owner's recourse for a construction defect is to file a claim with the insurer.

Hearing Date: 2/24/04

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. A separate statute outside the WCA does authorize the use of binding arbitration if parties to a dispute agree to it. Under this procedure, the decision of an arbitrator, if appealed, is reviewable by a court only for procedural errors. However, in *Marina Cove*, the court of appeals ruled that this kind of binding arbitration cannot be used in condominium disputes. The court reached this conclusion based on its reading of the WCA. The

court noted that the WCA states that the Act is "enforceable by judicial proceedings" and that provisions of the WCA may not be varied by agreement of the parties unless the WCA expressly allows such a variance. Since there is no allowance for waiving the right to a judicial determination of a dispute under the act, the court held that arbitration clauses are unenforceable.

Damages.

In applying the WCA, the courts have held that proof of a breach of a warranty is not in and of itself proof of damages. The measure of damages for a breach under the WCA is the cost of repair of a defect or failure unless that cost is grossly disproportionate to the diminution in market value caused by the defect or failure, in which case the damages are limited to the loss in value.

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.

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 Bill:

I. CHANGES TO THE WCA

Arbitration.

Parties are not prohibited from agreeing at the time a dispute has arisen that they will use nonjudicial dispute resolution proceedings, including but not limited to binding arbitration. The WCA's guarantee of judicial resolutions of disputes also does not interfere with the operation of the warranty insurance program being established by this legislation.

Implied Warranties.

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

- be for a specified failure or defect *that is known to exist at the time of the disclaimer*;
- be made in a separate signed *and recorded* instrument;
- describe the defect or failure *and its effect*; and
- *clearly* be a part of the basis of the bargain for the condo.

If a condo owner alleges a breach of an implied warranty, it is an affirmative defense for the declarant that the alleged breach will not adversely affect the performance of the condo.

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.

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.

Third Party Inspections.

Beginning in 2006, all condos are to be inspected by a qualified, independent third party. The inspection is to determine if:

- the building plans and specification comply with all laws and are in accordance with sound engineering and construction standards; and
- construction is performed in a workmanlike manner.

A certificate of inspection from a qualified inspector creates a presumption that the construction complies with all laws, is in accordance with sound standards, and was done in a workmanlike manner.

A qualified inspector is one who has at least five years of experience in construction and is also a certified building inspector who has successfully passed the technical written exam of the international code council. Inspectors are immune from liability for inspections, except for liability to the declarant for damages caused solely by the inspector.

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 warrantied 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:

- subrogating to the insurer a declarant's rights against construction professionals;
- 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 for any repair.

Deductibles in excess of \$2,500 per unit or \$10,000 for common elements are prohibited.

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 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 inquiries 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.

Appropriation: None.

Fiscal Note: Not requested.

Effective Date: The bill takes effect 90 days after adjournment of session in which bill is passed.