



Impact of Construction Defect Liability on Condominium Production in Oregon

Frequently Asked Questions

December 2018

Prepared for:

Portland Housing Center

Acknowledgments

This project is funded by Portland Housing Center. Portland Housing Center is a nonprofit organization founded in 1991 with support from the City of Portland, some local banks, and concerned citizens. They provide home buyer education, one-on-one guidance, financial services, and a variety of other resources to make homeownership a reality for Portland-area residents. They sponsored this report to provide a public-facing document explaining Oregon's construction defect liability statutes and their implications for development of multi-family home ownership products. For more information about Portland Housing Center: www.portlandhousingcenter.org.

This project was prepared by ECONorthwest. For over 40 years ECONorthwest has helped its clients make sound decisions based on rigorous economic, planning, and financial analysis. For more information about ECONorthwest: www.econw.com.

For more information about this report:

Portland Housing Center

Peg Malloy
pegm@portlandhousingcenter.org

3233 NE Sandy Boulevard
Portland, OR 97232
503-282-7744

ECONorthwest

Mike Wilkerson
Wilkerson@econw.com

Lorelei Juntunen
Juntunen@econw.com

KOIN Center
222 SW Columbia Street
Suite 1600
Portland, OR 97201
503-222-6060

Cover page photo credit: SAHA Satellite affordable Housing Associates.

FAQ: Impact of Construction Defect Liability on Condominium Production in Oregon

December 2018

Since the Great Recession and the recovery beginning in 2009, the Portland region has seen a decrease in the development of condominiums (condo) while apartment development has surged. As developers look for the highest and best use on a parcel, they opt to build apartments over condos. This is due to current market conditions, lending requirements, and risk-adjusted return expectations.

In Oregon, condo developers face an additional, unique challenge: Oregon's construction defect liability (CDL) laws are more restrictive than in other states. This adds to an already challenging financial feasibility equation.

Without a steady supply of affordable condos, many people are priced out of homeownership, including first-time home buyers, seniors, and middle-income people. This hinders access to the tax benefits and wealth-building opportunities that come with homeownership and may exacerbate disparate impacts on lower-income populations, particularly those that have been historically disadvantaged.

Through policy analysis of the CDL laws in other states, this FAQ identifies policy alternatives to reduce the impact of CDL on condo construction.

What is construction defect liability (CDL)?

CDL is a law that places an obligation on developers to correct or compensate for any defects in design, materials, and/or workmanship of a recently constructed building. CDL statutes differ by state. In Oregon, the length of the term for which CDL can be pursued is 10 years—longer than in other states on the West Coast.

Questions addressed in this FAQ:

Condo Development in Oregon

- 1) What is the state of condo production in Oregon?
- 2) Why are more condos not getting built?

The Impact of CDL on Condo Production

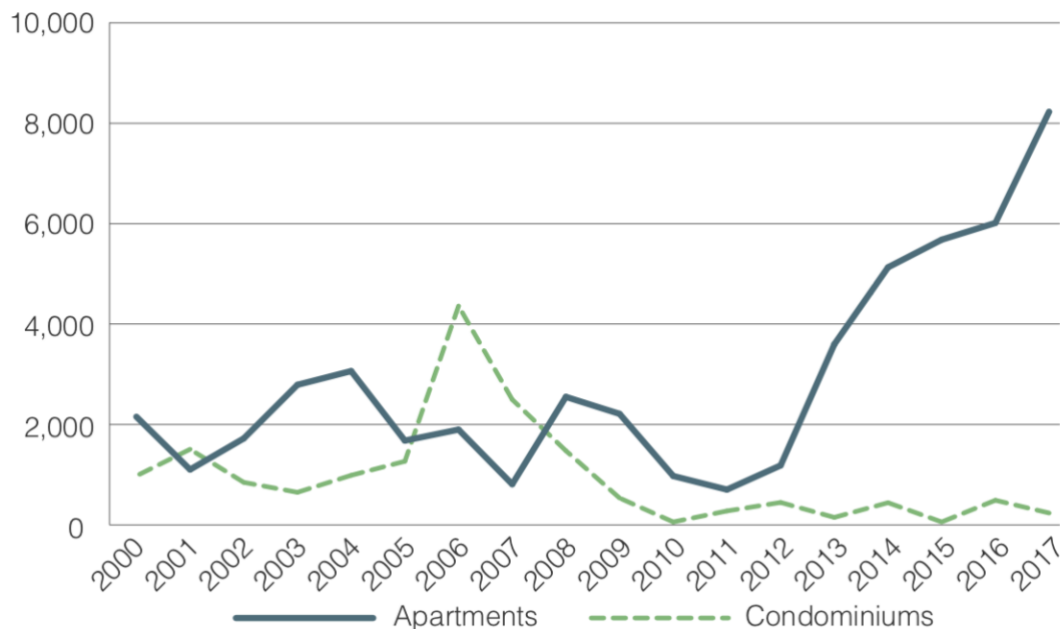
- 3) How does CDL influence the cost of producing condos?
- 4) How do Oregon's CDL laws influence the cost of owning a condo?
- 5) Why is litigation so common when defects are found in condo buildings?
- 6) How does CDL work in Oregon?
- 7) How have other states reduced the unintended consequences of CDL?
- 8) What can Oregon do?

Part 1: Overview of Condo Development in Oregon

1. What is the state of condo production in Oregon?

- **In Oregon, multifamily unit development is on the rise and new single-family home construction is declining.** In 2000, nearly 80% of new permits issued were for single-family homes; today, that number is closer to 50%, and 35% in the Portland Metro.¹
- **The share of condo units decreased after the Great Recession in 2008.** Exhibit 1 shows the total number of apartment units and condo units built from 2000 to 2017. In 2006, condo production peaked at 4,295 units. Since 2010, condo production averages around 250 units per year.²
- **Condos have become less affordable.** In 2017, the average sale price for a condo in Multnomah County was about \$580,000, compared to about \$445,000 for a single-family dwelling.³ Assuming a 20% down payment, an average priced condo in 2017 was affordable to households earning 178% of MFI (not including monthly HOA payments), while the average single-family home is affordable to households earning 141% of MFI.⁴

Exhibit 1. Housing Units Built, METRO, 2000-2017



Source: RLIS.

¹ United States Census Bureau, Building Permits Survey, Oregon.

² RLIS.

³ RLIS

⁴ RMLS. Affordability would be further reduced, if they buyers place less than 20% down.

2. Why are more condos not being built?

In the building cycle since 2010, condos have not produced higher financial returns compared to apartments. Developers have preferred to produce apartments for the following reasons:

- **Apartment rents have increased**, and the metric used to value rental properties (called cap rates) have improved, making them more financially feasible.
- **Lenders have become more risk averse since 2008**, making the requirements for financing condos more onerous.
- **Developers see condos as a risky development type**, given the increased potential for lawsuits as a result of CDL.
- **Construction costs are higher to build condos than to build apartments.** Condo developers face higher financing fees, legal fees (due to construction defect liability), and up-front marketing costs for for-sale products.
- **Need for Type 1 construction.** Given the risk of developing buildings with wood construction, developers almost always opt to develop condo buildings using Type 1 (steel/concrete) construction methods. See Exhibit 2 for an illustration of the additional cost of producing a condo building.



PHK Development's TwentyTwenty in NE Portland is an example of one of the few condo buildings under construction in Portland. It has seven stories of Type 1 (steel and concrete) construction and 163 units. Pricing is expected to be \$400,000 for a one-bedroom unit, and \$600,000 for two-bedroom units.

Exhibit 2. Development Cost of a Condo compared to an Apartment (excluding the cost of land)

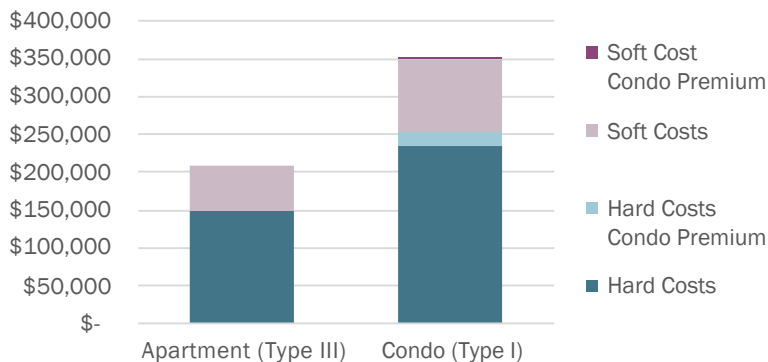


Exhibit 2 shows the cost to construct a hypothetical condo in 2018 compared to an apartment unit (excluding the cost of land). The drivers of increased cost are construction materials and labor for Type 1 construction, and to a lesser extent, soft costs.

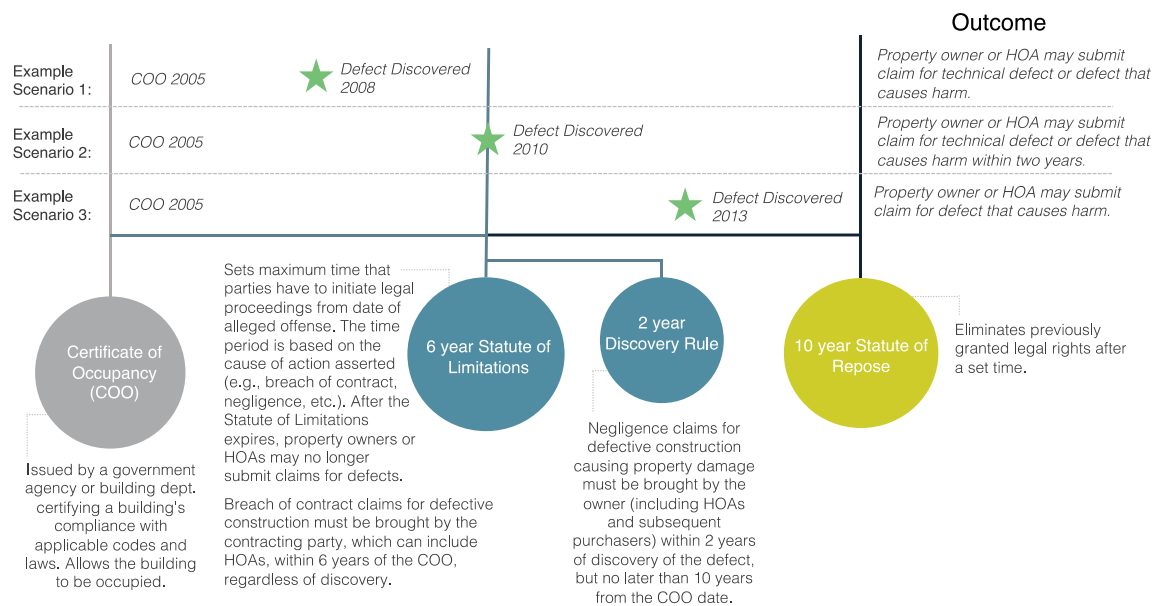
Note: the hypothetical unit is based on prices in the Portland market in 2018. The comparison uses Type 1 construction cost for the condo and Type 3 or podium (the most prevalent construction type in this building cycle) for the apartment. Entitlements and the cost of land are the same for condos and apartments, therefore the cost components that differ can be isolated with land removed.

Part 2: The Impact of CDL on Condo Production

3. How does CDL work in Oregon?

After a certificate of occupancy (COO)⁵ is issued for a new development, the six-year statute of limitations and 10-year statute of repose period begins. The statute of limitations and repose period cuts off certain legal rights if not acted on by the specified deadline. Requirements vary by type of claim:

- **Contract (or technical) claims** result from a developer’s breach of obligation to construct a building in a reasonable workmanlike manner, as set forth in the construction plans and specifications (industry standards). Claims must be brought within six years (statute of limitations) of the COO date, regardless of when the defect was discovered. The statute of limitations is subject to a discovery rule, which extends the time owners can submit a claim (e.g. if a defect was discovered in year six, the owners still have two years to submit a claim).
- **Negligence claims** result from incomplete, fraudulent, or defective work which causes owners damage or harm. Claims must be made within two years of discovery or no later than 10 years (statute of repose) from the COO date. Owners’ burden of proof is greater for negligence claims than contract claims.



What are the implications of the statute of repose timeline?

- A statute of repose that is too short increases risk to homeowners.
- A statute of repose that is too long increases risk for developers and therefore the cost to construct a condo. Eventually, Oregon’s housing market will feel the effects of increased development costs (e.g. less entry-level homeownership units produced).

⁵ A Certificate of Occupancy (COO) is a document issued by a local building authority stating that construction is built to acceptable standards and is now safe for occupants to use the structure.

4. How do Oregon's CDL laws influence the cost of owning a condo?

CDL adds uncertainty and potentially large costs to owning a condo, on top of other condo-specific costs like Unit/Home Owners Association (UOA/HOA)⁶ dues. If a construction defect is found, and the UOA/HOA pursues litigation for recourse, the UOA/HOA members share equally in the cost of litigation and any unfunded costs of curing identified defects. Even if an individual homeowner (UOA/HOA member) prefers to avoid the expensive legal route, they still must pay their share of the fees if that is the course of action the UOA/HOA board pursues. The litigation fees are costs incurred directly by homeowners, as these costs are generally not covered in a settlement or judgment, and are therefore incurred in addition to any unfunded cost of repairing the defect.

5. How do Oregon's CDL laws influence the cost of producing condos?

CDL has the following impacts on condo development:

Increased insurance premiums. Since CDL in Oregon applies for 10 years after building completion, developers will purchase insurance coverage for ten years to account for that risk. Insurance providers know that CDL litigation is common for condos, so they charge higher insurance premiums to account for that risk. Premium rates are approximately 50% to 80% higher for condos compared to a similarly constructed apartment building.

Reduced competition for construction bids. There are fewer general contractors interested in bidding on condo projects compared to apartments, due to the increased risk and ultimate cost of litigation. Thus, bids are less competitive, and construction costs can be 5% to 8% higher for condos compared to an apartment of similar quality and construction type.

To mitigate risk, developers usually choose a more expensive construction type. Contractors that build condos tend to use Type 1 construction standards (steel and concrete). By using these higher quality construction materials, developers reduce the risk of defect, and therefore possibility of litigation. However, Type 1 construction, even for lower height projects, increases the cost per unit above other construction materials like wood (or a mixed material podium).

In addition, if there is active litigation at the time a homeowner seeks to sell their condo, any prospective buyer would need to make a cash offer, as lenders won't finance a purchase. This limitation puts condo ownership out of reach for most first-time home buyers.

⁶ Condominium Unit Owners Associations (UOA) and Homeowners Associations (HOA) are organizations of homeowners (members) that make and enforce rules, pay dues or fees, and manage and maintain common areas and shared assets.

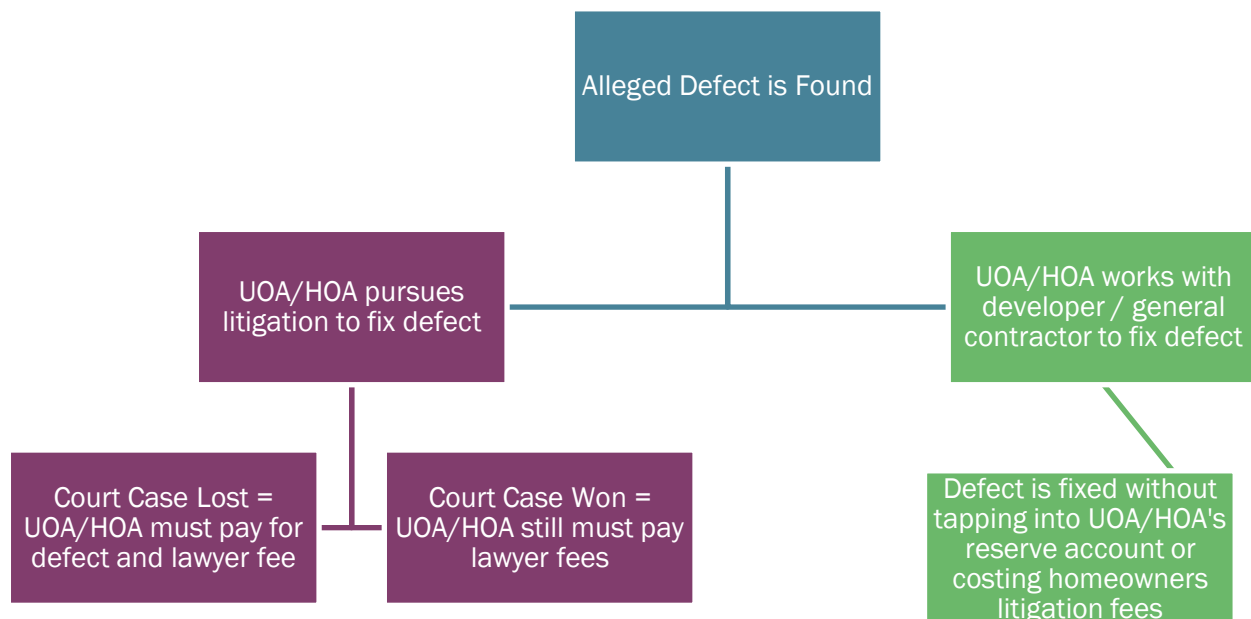
6. Why is litigation so common when defects are found in condo buildings?

Condo owners are members of a Condominium Unit Owners Association (UOA) or a Homeowner's Associations (HOA). UOA/HOAs have boards with fiduciary duties, which means that they must protect the interests of the UOA/HOA and its members (the other unit owners). This has several implications:

- If the board does not attend to a construction defect, they risk litigation by UOA/HOA members for breach of fiduciary responsibility. As a result, many boards prefer to litigate and absolve themselves from any potential claims.
- UOA/HOAs do not often possess large reserve funds for unexpected repairs; they resort to attorneys who offer to work on contingency. This appears to be an attractive option, as if a settlement or judgment isn't awarded, the HOA/UOA incurs no cost.

Compared to UOA/HOA boards, apartment building owners rarely pursue litigation because they have professional maintenance staff, and typically want a quick and inexpensive remedy based on a benefit-cost analysis, rather than an expensive, time consuming litigation process.

Many construction defect issues find their way to the courts despite findings that developers prefer to correct real defects when notified because it is easier, faster, and less expensive than litigation. Unlike in other states, settling disputes outside of the courts is not an option in Oregon. This ends up costing homeowners after purchase. The graphic below displays the different paths available to UOA/HOA once a defect is found.



7. How have other states reduced the unintended consequences of construction defect liability?

Modifying construction defect liability laws is one opportunity that state governments can control to influence condo production. If Oregon wants to reduce the unintended consequences of CDL, it should consider legal approaches like those adopted by other western states:

	Statute of Limitations	Statute of Ultimate Repose	Summary
OR	6 years for breach of contract. 2 years from discovery of negligence.	10 years	<ul style="list-style-type: none"> ▪ Requires homeowner to notify contractor and suppliers with written notice of defect before commencing arbitration or litigation. ▪ Written notice describes the alleged defect and the remediation the owner believes is necessary. ▪ Contractor has 14 days to request an inspection of the defects. ▪ Contractor has 90 days to respond to the notice with either an offer to cure, pay for the cure, or deny the allegation. Owner is not required to accept any offer.
WA	6 years	6 years from substantial completion	<p>HB 2475, 2018 / Status: On Rules Consideration list for second reading – House</p> <ul style="list-style-type: none"> ▪ Seeks to revise policy so claimant cannot file an action alleging construction defects until after termination of the notice and opportunity to cure process is terminated. ▪ Adds mediation process ▪ Extends tolling⁷provisions/provides for tolling in the context of claims between construction professionals
CA	1-to 5-year statutory warranty on new components	10 years ⁸	<p>Senate Bill 800, 2002</p> <ul style="list-style-type: none"> ▪ Eliminated distinction between patent and latent defects⁹. ▪ Did not affect suits for personal injury, breach of contract, or fraud. ▪ California created 45 specific standards within 7 categories as clear and objective standards.
CO	3 years	6 years	<p>House Bill 1279, 2017</p> <ul style="list-style-type: none"> ▪ Requires alternative dispute resolution (arbitration or mediation) for defect claims. ▪ UOA/HOA's must have informed consent by majority vote before litigation can be pursued if the covenants creating the UOA/HOA so require it; prohibits elimination of such covenants by the UOA/HOA. ▪ Eliminates technical code violations as a cause for action. Requires that actual damage, injury or risk be demonstrated.
NV	6 years	6 years	<p>Assembly Bill 125, 2015</p> <ul style="list-style-type: none"> ▪ Requires that homeowners or the UOA/HOA provide detailed descriptions of alleged defects. ▪ Stipulates that claims go through a warranty process, so builders have a chance to fix the defects out of court. ▪ Eliminates the provision that the contractor pays attorney fees. ▪ Restricts the definition of what constitutes a home defect.

⁷ Tolling is a legal doctrine the pauses or delays the period of time set forth by a statute of limitations.

⁸ Statute of repose only if SB800 building standards are violated. CA has a specific procedure for noticing defects in condos. Civil Code §§1350-1378, known as the Calderon Procedures

⁹ Patent defect is discoverable upon reasonable inspection. Latent defect cannot be discovered by a reasonable inspection.

8. What can Oregon do?

States do not control many of the factors that affect the cost of delivering housing and the rate of housing production. There are several policy alternatives available to decrease the risk and improve the financial feasibility of developing condo buildings while providing protections for homeowners. The combination of the following policy options seeks to increase the amount of condo production, while also decreasing the cost of production. These should be thought of as one of multiple tools available to improve the financial feasibility, rather than a stand-alone solution to increase the production of condo's at lower price points.

Policy Option A: Reduce the 10-year Statute of Repose to six years.

Rationale:

- **Align with other states' approaches.** Other states have modified their CDL statutes so that the repose period and statute of limitations period is concurrent. Oregon may consider enacting a sunset clause. This would provide the state an opportunity to evaluate the impact of a reduced Statute of Repose.
- **Maintain consistency with defect liability laws for other building types.** It is also in line with what Oregon legislature did for large commercial projects (non-residential) in 2014.
- **Reduce the nebulous "negligence" claims in year seven through 10.** After year six, most buildings require more robust annual maintenance programs. For example, new window caulking has a limited useful life — after a number of years, it begins to look brittle and cracks will show. This is not a defect, but a maintenance issue.

Potential effects

Increased condo production. Reducing the statute of repose will reduce the cost of condo production in the mid- to long-run and might incentivize more general contractors to bid on condo projects in the short run.

A greater diversity of building types. If risk of litigation was lowered, developers and general contractors may be more inclined to develop condominiums at standards other than Type 1. With an increased willingness to develop with lower cost building materials, Oregon may see an increase of condominiums built with fewer units (e.g. three or four units) in residential infill settings.

No short-term change in insurance premiums. Amending the Statute of Repose would not have a short-term impact on the cost of insurance premiums. Insurance providers will need to observe reduced risk (less litigation) over time

Policy Option B: Bolster existing notice-and-opportunity-to-repair laws (ORS 701.565, et seq.).

Rationale:

- **Provide a requirement for an owner or UOA/HOA to accept a developer or contractor's good faith offer to repair the defect, pay for the repair of the alleged defect, or offer a settlement.** These laws could include a requirement that the developer is given the opportunity to correct defects, agree to a monetary settlement, or a combination of the two options.

Note: These laws could include a requirement that if the developer offered to cure the defect, the homeowner or UOA/HOA would have to accept it or be prohibited from pursuing litigation in the future related to the defect in question.

Potential effects

Reduced litigation, lower costs. Requiring that UOA/HOA or homeowner exhausts all options prior to seeking litigation, including giving the contractor a meaningful opportunity to correct any defect, will reduce litigation rates and lower costs for the developer and homeowner or UOA/HOA

Policy Option C: Require UOA/HOAs to have a majority or supermajority vote before pursuing litigation.

Rationale:

- **Reduce likelihood of a lawsuit.** If an UOA/HOA majority or supermajority vote is required and the developer is notified of the vote, they will have the opportunity to directly address the members offering to cure the alleged defects. If the developer proposes a cure at no cost to the homeowners, it is less likely that the UOA/HOA will choose to file a lawsuit.
- **Reduce financial cost to homeowners.** Many CDL litigation cases leave homeowners at a financial shortfall because it is extremely rare that the UOA/HOA will get 100% of the cost of repair plus money to cover their attorney fees (which are not covered by insurance).

Potential effects

Reduced litigation, lower costs. Requiring a vote could alleviate undue costs for the UOA/HOA and the developer

Key terms:

Certificate of Occupancy is a document issued by a local building authority stating that construction is built to acceptable (legal and technical) standards and is now safe for occupants to use the structure.

Condominium Unit Owners Association, often referred to as UOAs, are organized to serve as a way for unit owners to act on the administration, management and operation of the condominium (ORS 100.405).

Contract (or technical) Defects are flaws or damages caused by construction deviating from standards or specifications set forth in a contract. Developers or general contractors are required to construct buildings in a reasonable workmanlike manner and are held liable for breach of this warranty.

Homeowners Association (HOA) or “association” means the organization of owners of lots in a planned community, created under ORS 94.625, required by a governing document or formed under ORS 94.574.

Negligence Defects are flaws or damages caused by careless, fraudulent, or improper construction. Developers or general contractors are held liable for negligence defects as well as any damages created by the negligent defect. Developers and general contractors are also held liable for any third party who may be endangered by the developer’s or general contractor’s negligence.

Statute of Limitations is a time limit; it prescribes the maximum time that parties have to initiate legal proceedings (i.e. to submit a legal claim). The time limit is triggered by an action, which in Oregon, is when a claimant discovers the issue. Oregon’s statute of limitations for construction defect is six years.

Statute of Repose is similar to the statute of limitations. Repose eliminates previously granted legal rights to submit legal claims after a set period of time. The time limit is triggered by an event, which in Oregon, is when a Certificate of Occupancy is issued. Oregon’s statute of repose for construction defect is 10 years.

