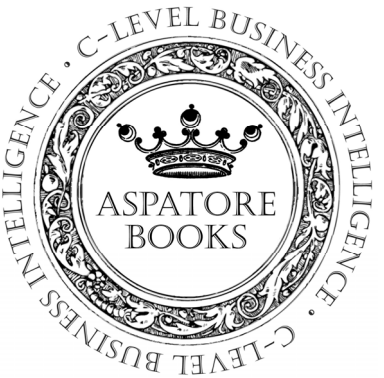
INSIDE THE MINDS

Winning Legal Strategies for Construction Law

Leading Lawyers on Best Practices for Risk Allocation, Structuring Agreements, and Avoiding Litigation



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The Impact of Statutory Disclosure Requirements on Construction Litigation

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Construction Law Overview

Construction law entails a broad span of legal practice from original planning and land acquisition to structuring real estate development transactions to contracting with design professionals and general contractors to trials that take place years after a project has been completed. I am a trial lawyer, and therefore my perspective is after the fact: What went wrong? Or, how could it have been done better? My trial experience in this area has mostly involved large construction defect cases that have arisen out of new condominium construction.

There has been extensive high-rise condominium development along the New Jersey side of the Hudson River facing New York City. I have represented condominium associations asserting claims against the condominium developers/sponsors and their design professionals and contractors. I have also represented the condominium developers/sponsors in actions filed by condominium associations. These cases involve large exposures and multiple parties.

In 1969, New Jersey enacted the New Jersey Condominium Act. Under the Condominium Act, the condominium association is initially under the control of the developer/sponsor. As units are sold, the condominium association and its board of directors come increasingly under control of the people purchasing units. Control of the condominium association transfers to the unit owners when 75 percent of the units are sold. Although the developer/sponsor retains one seat on the board until the last unit is sold, it no longer holds the majority of the seats and cannot control the board.

Typically, when the transition of control from the developer/sponsor to the unit owners takes place, the association's board hires outside engineers to review the project and determine whether there are any construction defects and whether the budgets and reserves established by the developer/sponsor to pay for future repairs and replacements of the common elements are adequate. Often, the engineer finds defects or a shortfall in the budget and reserves, both of which can give rise to litigation.

New Jersey, like many states, has two relevant statutes: the Planned Real Estate Development Full Disclosure Act (PREDFDA) and the New Jersey Consumer Fraud Act (CFA). Both of these acts establish disclosure requirements and impose civil liability for violations. The PREDFDA carries a double damages provision, and the CFA has a treble damages provision. Both acts provide for attorneys' fees. These provisions can significantly add to the developer's/sponsor's potential exposure at trial. For instance, one case in which I was involved had construction defect claims amounting to roughly $60 million; with the treble damages and attorneys' fees provisions, the exposure was closer to $200 million.

If construction defects are found to be extensive and pervasive, they may give rise not only to claims for damages measured by the cost of repair and remediation, but also to double damages under the PREDFDA and treble damage claims under the CFA. In such cases, the condominium association may argue that the failure to disclose such defects amounted to a failure to disclose a material fact or a misrepresentation. The condominium association may also claim that extensive construction defects establish a need to increase reserves for future repairs, maintenance, and replacements. Again, if liability under the PREDFDA or CFA can be established, the exposure to the developer may be double or triple the actual cost of remediation.

Construction trial lawyers help clients in a variety of ways in addition to defending litigation in court. We advise developer/sponsor clients about the pre-sale disclosures they should make so as not to violate either the PREDFDA or CFA and expose the developer/sponsor to claims. We can also advise them regarding advertising materials, which have frequently formed the basis of claims under the PREDFDA and CFA.

Drawing on their extensive experience with the types of claims that are made, construction lawyers can also help developers/sponsors develop a corporate structure and plan for a specific project in a way that will limit liability for their investors and principals in accordance with the law.

Components of Construction Law

Construction law varies from state to state, although there are certain common principles nationwide. In New Jersey, the New Jersey Uniform Construction Code (UCC) sets forth standards for the construction of new

buildings and the modification of existing structures. If a question of code compliance comes to trial, the construction experts such as architects and engineers, as well as the lawyers, argue what the standards are and how they have—or have not—been met.

In New Jersey and nationally, construction that deviates from the UCC must be brought into compliance. As a result, the measure of the developer's/sponsor's liability is the cost of remediation. In cases where the cost of remediation is substantial, either the condominium association or the sponsor/developer may assert claims against the general contractor, subcontractor, architect, and engineer. In most cases, however, the general contractor, subcontractor, architect, and engineer will not have double and treble damage exposure under the PREDFDA and CFA, because they will not have dealt directly with unit buyers and therefore will not have any fair disclosure obligations.

Financial Implications

Developers often fail to anticipate and appreciate the financial implications of the statutory disclosure requirements under the PREDFDA and CFA. Double and treble damage claims may also engender unrealistically high expectations on the part of condominium associations. If, for example, there is a large condominium building that requires work throughout the building due to leakage, the remediation cost could be tremendous. A few years ago, I handled a case where the price tag for such repairs was about $8 to $9 million. In that case, the developer/sponsor refused to do the repair. The condominium association claimed the defect was not only a breach of warranty but also that the developer's/sponsor's failure to disclose the defect was a violation of the PREDFDA and CFA, subjecting the developer/sponsor to a claim for double or treble damages plus attorneys' fees, resulting in a claim of $27 million. On the one hand, the developer/sponsor denied there was a building-wide problem and had valued the case at $2 million. On the other hand, there were unit owners who saw the statutory double and triple damages provisions as a vehicle not only to finance the necessary repairs, but also to finance building maintenance well into the future.

These widely differing perspectives were a major obstacle to a resolution of the case. Ultimately the case did settle, but only after a month of trial. Since trial costs in this type of complex, multi-party litigation can be enormous, the sooner each side comes to a realistic view of its position, the more it will save in expert fees, attorneys' fees, and other litigation costs.

For a condominium association, resolving a claim against the developer/sponsor is a political process. The associations are governed by elected boards of directors. It can be very difficult for a board and the unit owners to come to a consensus on any compromise, especially one concerning large amounts of money and particularly where the association may be able to recover two or three times more than its actual damages. Managing the expectations of the unit owners so that they are realistic is a major challenge for the association's attorney and requires him or her to work closely with the board at every step.

The developer, on the other hand, sees a tremendous potential liability. In this situation, the construction lawyer must try to help the developer/sponsor understand what the potential exposure may be, and control it. Controlling the exposure of the developer/sponsor involves:

1. First, defending the threatened claim or litigation effectively with appropriate experts.
2. Second, where appropriate, involving the design professionals, general contractor, and subcontractors who may share in the exposure.
3. Third, determining whether the developer/sponsor has insurance that may respond to any of the claims being asserted.
4. Fourth, exploring a comprehensive settlement.

In my experience, in cases that involve large amounts of money, both sides (condominium association and developer/sponsor) play brinksmanship in order to secure the best possible settlement. In such cases, the best way to position the case for settlement is to litigate it vigorously so that the other side understands you are prepared and willing to try the case if a satisfactory settlement cannot be reached. This process is expensive. In construction defect cases, multiple experts are necessary, and their combined fees can rival the attorneys' fees. In smaller cases, the most cost-effective approach

is to seek an early settlement through mediation or direct negotiations. However, when tens of millions of dollars are involved, which may be doubled or tripled, my experience is that the parties are reluctant to resolve the case quickly and attempt to position themselves for the best deal they can obtain.

As a construction lawyer, I have been able to use the lessons learned in litigation to encourage developer/sponsor clients to make better use of disclosure documents and advertising, and to be aware of the types of construction defects that give rise to large claims.

There are several common mistakes that should be avoided. For example, in a planned real estate development such as a condominium, developers are required to make financial disclosures including a proposed budget encompassing maintenance and reserves for future replacement costs. It is in the developer's/sponsor's interest in making these disclosures to make these costs appear low so that ownership of a condominium unit looks more attractive. These budgets and the reserve schedule are developed when the project is initially developed. As a result, after several years, the reserve schedule may no longer be adequate and thus may understate this component cost of unit ownership. This shortfall may come back to haunt the developer/sponsor in the form of a PREDFDA or CFA claim that the full cost of unit ownership was not disclosed.

Developers/sponsors also may run into trouble when they set up a separate corporation to develop a project. The goal is to confine the liability of the project to the newly formed project entity. However, developers/sponsors often set up the separate project entity on paper, only to disregard it in practice, paying employees, for example, out of the original parent company. As a result of such a failure to observe the distinction between the parent entity and the project entity, a court may find that the project entity has no existence except on paper. The attempt to limit liability to the project entity is only effective if the entity has a separate operating existence including its own payroll, assets, and funding. It is all too common that the developer/sponsor has not observed the separate existence of the project entity. As a result, at trial, the developer/sponsor cannot maintain the defense that the liability is limited to the new entity.

Specific Laws

The two statutes in the state of New Jersey that have the most impact on construction litigation are the PREDFDA and CFA. The CFA is not limited to real estate development, and it can apply across the board to almost any consumer transaction. The CFA prohibits three actions: an unconscionable commercial practice, any affirmative misrepresentation in which inaccurate information is conveyed, and an intentional omission of material fact that should be disclosed to a potential buyer. The courts have adopted an expansive definition of what constitutes an omission of material fact or a misrepresentation. Even if an affirmative misrepresentation was entirely innocent, it can still trigger liability under the act as long as the plaintiff can show that the statement was made in connection with a sale. The plaintiff does not have to prove intent or reliance.

The PREDFDA, by contrast, is directed specifically toward planned real estate development rather than all consumers. The PREDFDA mandates specific disclosures and contains a provision that prohibits any type of knowing omission of a material fact or misrepresentation, although it defines disclosures more clearly and specifically than the CFA. Unlike the CFA, the PREDFDA allows the developer/sponsor to defend a misrepresentation claim by showing that the plaintiff knew the actual facts or did not rely on the alleged misrepresentation. It is also a defense under the PREDFDA that the developer/sponsor did not know the alleged misrepresentation was not accurate, as long as the sponsor/developer exercised reasonable care in making the statement.

In addition, the state of New Jersey has created a Department of Community Affairs to serve as a regulatory body over condominium and subdivision developers. Developers/sponsors submit detailed information to the department, which is reviewed by department staff. The department requires certain disclosures. As a result, in my experience, the PREDFDA presents less of a problem for developers.

Over the past five to ten years, as real estate has become more valuable, disclosure requirements have expanded and the courts have become more willing to find an obligation on the part of a seller to make disclosures. I think this approach stems both from the courts and from the legislation,

which has been around for a while but is now playing a greater role in real estate transactions. I believe this expanding emphasis on disclosure will have a significant impact on real estate law and litigation in New Jersey.

Presently, a failure to disclose conditions such as soil conditions, environmental hazards, and allegedly hazardous conditions on the property being sold, as well as on adjacent properties, may have to be disclosed. Failure to disclose such conditions may expose the developer/sponsor to an entirely unanticipated liability of substantial proportions.

This trend is not likely to abate. If anything in New Jersey, with significant areas being redeveloped from former industrial or commercial uses, the duty to disclose all aspects of a property, including former uses and hazards, to residential or commercial buyers will continue to expand. This is an area that should be watched carefully by keeping up to date with various court opinions and administrative regulations. I do not expect there will be new legislation, since the existing legislation is already comprehensive.

A Focus on Law Analysis

The foregoing discussion deals extensively with the CFA. The crux of the act is its prohibition against what it defines as "consumer fraud." The pertinent part of the act reads as follows:

> "The act, use of employment by any person of any unconscionable commercial practice, deception fraud, false pretense, false promise, misrepresentation, or the knowing, concealment, suppression, or omission of any material fact with intent that others rely upon such concealment, suppression, or omission, in connection with the sale or advertisement of any merchandise or real estate, or with the subsequent performance of such persons as aforesaid, whether or not any person has in fact been misled, deceived, or damages thereby, is declared to be an unlawful practice; provided, however, that nothing herein contained shall apply to the owner or publisher of newspapers, magazines, publications, or printed matter wherein such advertisement appears, or to the owner or operator of a

> radio or television station which disseminates such advertisement when the owner, publisher, or operator has no knowledge of the intent, design, or purpose of the advertiser."

The first clause of this provision relates to "affirmative acts," which include "unconscionable commercial practices" and any "deception, fraud, false pretense, false promise, [or] misrepresentation." This language has been interpreted by the courts of New Jersey to refer to any statement of fact that is false or inaccurate. It is not necessary that the plaintiff relied on the statement. It is not even necessary in a condominium case that every condominium unit buyer saw or heard the statement. As long as the statement purports to be factual and is not accurate, it may give rise to liability under the CFA.

The next portion of this provision relates to the "knowing, concealment, suppression, or omission of any material fact," that is, facts that have not been disclosed. The fact that it is not disclosed must be material to the transaction. An omission of insignificant or immaterial facts will not give rise to liability. Furthermore, the plaintiff must have relied upon the omission. Consequently, the scope of omissions that may give rise to liability under the CFA is narrower than the scope of affirmative representations that may give rise to liability.

The next portion of the act states that in order to give rise to liability, the misrepresentation or omission must have been made "in connection with the sale or advertisement of any merchandise or real estate." Thus, any misrepresentation or material omission in advertising literature, in required disclosure statements, or in sales presentations may give rise to liability.

Finally, the statute provides that prohibited actions may give rise to liability "whether or not any person has in fact been misled, deceived, or damaged thereby." Plaintiffs in consumer fraud cases are not required to prove monetary damages, although they must show that they have incurred some form of ascertainable and measurable loss as a result of the violation.

The breadth of the CFA and the severity of the liabilities that may arise under the act often come as a surprise to developers/sponsors who have

not previously encountered the act. In my experience, statements made by salespeople and language in advertising pieces that were considered by the developer to be nothing more then promotional have been seized upon by plaintiffs in an effort to assert claims under the CFA.

Since affirmative misrepresentations or material omissions must be factual in nature, many advertising claims are considered by the courts to be "puffery" rather than a statement of fact. However, the question of whether a statement appearing in an advertising brochure is considered to be factual or only promotional puffery is often left to a jury to decide. Consequently, in any substantial real estate development, the developer should have all sales and advertising materials reviewed with reference to the CFA. The same is true with oral sales presentations that are made by sales agents, since their undocumented oral representations may also give rise to claims under the CFA.

John D. North is a partner of the firm of Greenbaum, Rowe, Smith & Davis LLP in Woodbridge, New Jersey. He is a member of the firm's litigation department.

Mr. North has successfully tried numerous jury and non-jury cases in state and federal courts. He has tried over seventy-five jury cases to verdict. His more recent trials have included a six-month construction defect and consumer fraud case in which he successfully represented a major real estate developer. He has also tried major construction cases on behalf of condominium associations. Mr. North has also been invited to speak on trial practice issues before bar groups in continuing legal education programs. He concentrates his practice on construction litigation, commercial litigation, and professional liability and negligence matters.

Mr. North has been certified as a civil trial attorney by the New Jersey Supreme Court since 1988. He is a trustee of the Trial Attorneys of New Jersey, a member of the American Board of Trial Advocates, and an associate member of the Association of Trial Lawyers of America. He has been named a "Super Lawyer" by New Jersey Monthly Magazine.

Mr. North is a graduate of Lehigh University (1971) and received a law degree from the University of Maryland (1977). He is a member of the litigation section of the American

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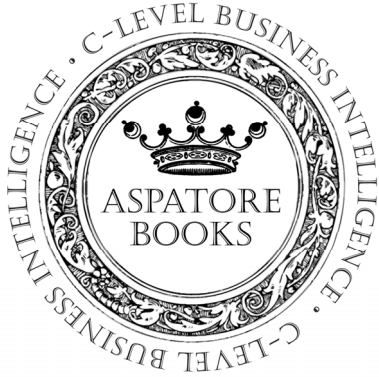
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