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CONDO DEVELOPER HELD LIABLE FOR DESIGN AND CONSTRUCTION DEFECTS UNDER MCIOA — IS IT FINALLY TIME FOR A CHANGE?

CONDO DEVELOPER HELD LIABLE FOR DESIGN AND CONSTRUCTION DEFECTS UNDER MCIOA—IS IT FINALLY TIME FOR A CHANGE?

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INTRODUCTION

For years now, articles in both legal and non-legal publications, from *Minnesota Lawyer* to the *Star Tribune*, have addressed what has been characterized as a "condo conundrum" in Minnesota. Adam Voge, *Condo Conundrum in Downtown Minneapolis*, Minn. Law., July 23, 2015, *available at* http://minnlawyer.com/2015/07/23/condo-conundrum-in-downtown-minneapolis/. New apartment buildings are going up all over the state, but developers are not building condominiums. Since 2009, the ratio of new apartments to new condominiums has shifted from an equal split to 30 to 1. Adam Voge, *Condo Conundrum: Why Developers Prefer to Build Apartments*, Fin. & Com., July 22, 2015, *available at* http://finance-commerce.com/2015/07/why-developers-prefer-to-build-apartments/. The Minnesota Common Interest Ownership Act (the "MCIOA") is largely to blame.

The MCIOA provides owners of condominiums and other "common interest communities" with specific implied warranties and a right to recover attorney's fees and litigation costs incurred while enforcing the warranties against developers, which are not available to owners of apartments and other housing options. As a result, the MCIOA has become a barrier to the development of owned, multifamily housing in Minnesota since the recession while other construction has taken off. It is no secret that the litigation risks posed by the MCIOA are simply too great for most developers to want to build condominiums, townhomes, and cooperatives. In 2015, the Star Tribune Editorial Board went so far as to label MCIOA the "root of the problem." *Condo Law Backfires on Housing Options*, Star Trib., Sept. 29, 2015, *available at* http://www.startribune.com/condo-law-backfires-on-housing-options/330006421/.

A recent published decision from the Minnesota Court of Appeals illustrates why the MCIOA is largely viewed as the driving force behind the housing development problems in Minnesota in recent years. In *650 N. Main Assoc. v. Frauenshuh, Inc.*, 885 N.W.2d 478, 500 (Minn. Ct. App. 2016), *review denied* (Minn. Nov. 23, 2016), the court of appeals held a developer of a condominium building liable for both architectural-design defects attributed to its architect and construction defects attributed to its general contractor under the MCIOA. The court of appeals also upheld an award of significant attorney's fees and litigation costs to the condominium association under the MCIOA and remanded for further consideration as to whether additional fees and costs are warranted. The Minnesota Supreme Court denied further review. In all, assuming additional fees are awarded

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on remand, the developer faces a judgment in excess of $620,000, more than three times the amount of the damages awarded by the jury. This decision will likely only exacerbate the litigation concerns of developers in Minnesota.

This article discusses the statutory warranties at issue in *650 North Main*, the facts that led to the court of appeals' decision, the impact of the decision, and legislative efforts underway to address some of the problems with MCIOA that were magnified by the decision.

STATUTORY WARRANTIES AT ISSUE IN *650 NORTH MAIN*

Two distinct warranty statutes were at play in *650 North Main*—Minn. Stat. § 327A.02, subd. 1(c) and Minn. Stat. § 515B.4-113(b). Section 327A.02, subd. 1(c) provides:

> In every sale of a completed dwelling, and in every contract for the sale of a dwelling to be completed, the vendor shall warrant to the vendee that:
>
> * * *
>
> (c) during the ten-year period from and after the warranty date, the dwelling shall be free from major construction defects due to noncompliance with building standards.

A "vendor" is "any person, firm, or corporation," other than a subcontractor or material supplier, "that constructs dwellings, including the construction of dwellings on land owned by vendees," and a "vendee" is "any purchaser of a dwelling and includes the initial vendee and any subsequent purchasers." Minn. Stat. § 327A.01, subds. 6–7. A vendor is not liable for breach of warranty under chapter 327A unless the vendor has actual notice of the damage or the vendee reported the damage to the vendor in writing within six months of when the vendee discovered or should have discovered the damage. Minn. Stat. § 327A.03(a).

Section 515B.4-113(b) provides:

> A declarant warrants to a purchaser that:
>
> (1) a unit and the common elements in the common interest community are suitable for the ordinary uses of real estate of its type; and
>
> (2) any improvements subject to use rights by the purchaser, made or contracted for by the declarant, or made by any person in contemplation of the creation of the common interest community, will be (i) free from defective materials and (ii) constructed in accordance with applicable law, according to sound engineering and construction standards, and in a workmanlike manner.

Unlike the section 327A.02 warranty, the section 515B.4-113(b) implied warranties only apply to developers and others involved in the creation of the common interest community, not to general contractors and other vendors. *See* Minn. Stat. § 515B.1-103(15) (defining "declarant"). The MCIOA also does not contain a notice requirement. Finally, the MCIOA authorizes the court to award reasonable attorney's fees and costs of litigation to a prevailing party. Minn. Stat. § 515B.4-116(b).

650 NORTH MAIN'S FACTS

650 North Main involved the development of a residential condominium building in Stillwater, Minnesota, in 2005, which is now owned by the members of the 650 North Main Association. The developer of the condominiums hired an architect to design the building and a general contractor to construct the building. After discovering water intrusion issues at the building, the association brought suit against the developer and the general contractor, but not the architect. The association asserted claims of negligence and breach of the statutory warranty provided by Minn. Stat. § 327A.02 against the developer and general contractor and claims of breach of the statutory implied warranties provided by Minn. Stat. § 515B.4-113, breach of warranties under the purchase and sale contracts, and breach of fiduciary duty against the developer. Prior to trial, the association voluntarily dismissed its negligence and non-statutory-warranty claims. The developer asserted cross-claims against the general contractor, and the general contractor asserted third-party claims against its subcontractors. The architect that designed the building was never made a party to the action.

Following a two-week jury trial, the jury found that the building had major construction defects due to non-compliance with building standards, that the general contractor breached the chapter 327A warranty, and that the general contractor's breach of the warranty was a direct cause of the association's damages. The jury also found that the architect's design of the building was defective and that the defective design was a direct cause of the association's damages. As to the developer, the jury found that it had not breached either of the statutory warranties and did not cause any of the association's damages. The jury attributed $101,250 in damages to the general contractor and $101,250 in damages to the architect, but none to the developer.

The jury also found that neither the general contractor nor the developer received written or actual notice of the defects within six months of when the association discovered or should have discovered the defects as required by Minn. Stat. § 327A.03(a) for warranty claims under chapter 327A. Based on that finding, the district court entered judgment in favor of the developer and the general contractor and against the association.

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The association moved for JMOL or a new trial, and the district court granted the motion with regard to the architectural-design defects found by the jury, holding the developer liable under section 515B.4-113 of the MCIOA for the damages attributed to the non-party architect. However, the district court denied the association's motion with regard to the construction defects found by the jury, presumably based on the association's failure to comply with the section 327A.03(a) notice requirement. The court also awarded the association $171,000 in attorney's fees (half of the fees it sought) and $75,766.41 in costs and disbursements.

650 NORTH MAIN COURT OF APPEALS DECISION

In a published decision, the court of appeals affirmed the district court's ruling with respect to the design-defect damages and reversed the district court's ruling with respect to the construction-defect damages, holding the developer liable under the MCIOA for the entire $202,500 in damages awarded by the jury. In so ruling, the court emphasized that the MCIOA statutory warranties are to be liberally administered. In addition, the court of appeals affirmed the district court's award of attorney's fees, costs and disbursements and sent the case back to the district court for a determination of whether the remainder of the association's attorney's fees should be awarded in light of its decision.

The developer petitioned the Minnesota Supreme Court for further review. In its petition, the developer challenged the court of appeals' decision to hold the developer liable under MCIOA for both the design and construction defects on the project. The developer also challenged the district court's award of attorney's fees and litigation costs under MCIOA. The supreme court denied the petition for further review on November 23, 2016, which means that the court of appeals' decision is now final.

650 NORTH MAIN — MAGNIFYING THE PROBLEMS WITH MCIOA

Three important components of the *650 North Main* decision highlight the breadth of the MCIOA's warranties and attorney's fee provision. First, the court of appeals found the developer liable for its architect's design defects without the architect being a party to the case, the filing of an expert affidavit under Minn. Stat. § 544.42, or even testimony from a licensed architect during trial. Second, the court found the developer liable for its general contractor's construction defects without evidence that the developer actually caused the defects or received timely notice of those defects under chapter 327A. Third, the court affirmed the district court's award of significant attorney's fees and litigation costs under the MCIOA and remanded for a possible award of even more fees and costs.

Overall, the decision magnifies the problems with the MCIOA and may further fuel the recent reluctance to build condominiums and other owned, multifamily housing options in Minnesota.

Developer Held Liable for Architectural-Design Defects

As it relates to the design defects alleged by the association in *650 North Main*, the court of appeals affirmed that (1) the association was appropriately allowed to argue to the jury that the design defects constituted a breach of the statutory warranties; (2) the association had presented competent evidence of design defects; and (3) the developer is liable for the damages attributed by the jury to those design defects.

1. Actions Against Architects

The law in Minnesota is appropriately designed to limit frivolous actions against professionals, including architects. *See* Minn. Stat. 544.42, subd. 1(1) (defining "professional"). Minn. Stat. § 544.42 creates specific requirements for anyone bringing a lawsuit against a professional such as an architect. *(Minnesota Statutes § 544.42, Subdivision 1(1) states that "professional" means "a licensed attorney or an architect, certified public accountant, engineer, land surveyor, or landscape architect licensed or certified under chapter 326 or 326A.")* The statute requires first that the party suing the professional produce an affidavit of expert review stating that:

> the facts of the case have been reviewed by the party's attorney with an expert whose qualifications provide a reasonable expectation that the expert's opinions could be admissible at trial and that, in the opinion of this expert, the defendant deviated from the applicable standard of care and by that action caused injury to the plaintiff.

Id., subd. 3(1). Then, within 180 days from the beginning of discovery, the same party must submit a more detailed affidavit stating:

> the identity of each person whom the attorney expects to call as an expert witness at trial to testify with respect to the issues of negligence, malpractice, or causation, the substance of the facts and opinions to which the expert is expected to testify, and a summary of the grounds for each opinion.

Id., subd. 4(a). A claimant's failure to comply with the law results in dismissal of the action against the professional. *Id.*, subd. 6.

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In *650 North Main*, because the architect was never added as a party, the requirements of section 544.42 were never met. Before trial, therefore, the developer argued for exclusion of evidence tending to show architectural-design defects as no party had submitted the required affidavits. The district court denied the motion and allowed the evidence, reserving for after trial whether the developer would be liable for architectural-design defects. The court of appeals affirmed, concluding that section 544.42 only applies to actions *against professionals* alleging negligence or malpractice in rendering a professional service and that the association's claims were statutory-warranty claims that did not fall within the specific parameters of section 544.42.

Despite the logical progression of the court of appeals' interpretation of section 544.42, the court's decision highlights a loophole created by the MCIOA. As interpreted by the court, the MCIOA allows a condominium association to bypass section 544.42 and sue a developer for architectural-design defects without satisfying any of the safeguards designed to limit frivolous lawsuits involving professional negligence and malpractice. At a minimum, the loophole increases the litigation risk for developers. But it also puts developers in the precarious position of having to choose between pointing the finger at their own architect or running the risk of being held liable for their architect's defective design without recourse. In the end, a developer must still satisfy the requirements of section 544.42 to sue an architect, and it is not hard to imagine a case in which a developer is unable to satisfy section 544.42 but also is ultimately held liable for breach of the statutory warranties.

2. Competent Evidence

The developer also argued that any evidence offered as to the existence of design defects was incompetent because no licensed architect testified at trial. Instead, testimony was given only by structural and forensic engineers regarding the alleged architectural-design defects. The district court and court of appeals disagreed and instead held that the engineers' testimony was sufficient to prove claims under section 515B.4-113, which requires only that the building be constructed according to "sound engineering . . . standards." Minn. Stat. § 515B.4-113(b)(2). The court of appeals reiterated that because there were no claims for negligence or malpractice against an architect, no architectual expert was required to establish architectural-design defects.

Ultimately, the developer was held liable for the architectural-design defects found by the jury without being afforded any of the protections of the heightened requirements of 544.42, including what could have been valuable testimony from a licensed architect.

3. Developer Liability for Architectural-Design Defects

Based on the above rulings, the court of appeals affirmed that the developer was liable for those damages awarded for the architectural-design defects. Following MCIOA's direction that its remedies shall be "liberally administered," Minn. Stat. § 515B.1-114(a), the court concluded that architectural-design defects may violate the chapter 515B warranty provision that requires the building be constructed according to sound construction standards as architectural standards are incorporated into the MCIOA definition of engineering standards. Furthermore, the court determined that even though a third party performed the work and the jury found that the developer did not breach the chapter 515B warranties, the developer was liable for the violation of the warranties as a matter of law because it hired the architect whose architectural-design defects were a direct cause of the association's damages.

On its own, the court's reliance on the MCIOA's "liberal administration" provision in construing the scope of the chapter 515B warranties illustrates the extent to which the deck is stacked against developers in Minnesota. But the decision also shows the extent to which a developer can expose itself to increased liability by choosing not to bring a claim of its own against the architect. *650 North Main*, therefore, impacts architects as well as developers. It is not uncommon for architects and/or other engineers and professionals to not be made a party in cases like *650 North Main*, but that will change quickly now that it is clear that developers will be held liable for design defects and other such issues. The *650 North Main* case not only puts developers on notice of significant liability issues, but architects must also be aware of the increased likelihood that they will be brought in as a party to cases with potential design issues. Naturally, many architects may be less inclined to provide their services on condominium projects for the same reasons that most developers now avoid them.

Developer Held Liable for Construction Defects

As it relates to the construction defects, the court of appeals reversed the district court, holding that the developer was liable for the construction-defect damages found by the jury even though the jury determined that (1) the developer did not perform any construction work; (2) the developer did not breach any warranties; and (3) the association's chapter 327A warranty claim against the developer and general contractor failed because the requisite six-month notice was not provided.

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In its decision, the court of appeals held that breach of the chapter 327A warranty by a contractor hired by the developer automatically constitutes a breach of the developer's chapter 515B warranties even though the two statutes provide separate warranties and the developer did not cause the defects by its own actions. The court relied on the "made or *contracted for*" language in Minn. Stat. § 515B.4-113(b)(2) to reach this conclusion and further reasoned:

> The jury's finding that [the general contractor] breached the warranty that the dwelling "shall be free from major construction defects due to noncompliance with building standards," Minn. Stat. § 327A.02, subd. 1(c), necessitates the legal conclusion that [the developer] breached its warranty that improvements it made or contracted for would be "constructed in accordance with applicable law, according to sound . . . construction standards, and in a workmanlike manner," Minn. Stat. § 515B.4-113(b)(2). The term "building standards" as used in § 327A.02 "means the materials and installation standards of the State Building Code, adopted by the commissioner of labor and industry pursuant to sections 326B.101 to 326B.194." Minn. Stat. § 327A.01, subd. 2 (2014). The "applicable law" referred to by section 515B.4-113(b)(2) includes the very building standards that the jury found were violated by [the general contractor] in the construction of the building.

650 North Main, 885 N.W.2d at 488 (ellipses in original). In other words, the court determined that the developer contracted with the general contractor for the construction of the building and warranted that the building would be constructed by the general contractor "in accordance with applicable law, according to sound . . . construction standards, and in a workmanlike manner." The developer, therefore, is liable for all major construction defects attributed to the general contractor.

The court's decision to hold the developer liable for its general contractor's construction defects, along with its decision with respect to the architectural-design defects, highlights the environment created by the MCIOA, in which an association can simply sue its developer and force the developer to pursue the parties that actually caused the association's damages. But, as alluded to before, a developer often faces additional barriers to recovery that an association is not required to overcome to prevail on a claim for breach of the chapter 515B warranties. For instance, the court of appeals specifically recognized that the breadth of a developer's liability under chapter 515B may be greater than the at-fault contractor's liability under chapter 327A given the absence of a notice requirement in chapter 515B.

One of the interesting dynamics at play in *650 North Main* was the jury's determination that the association did not provide the developer or general contractor with the requisite notice to prevail on its chapter 327A warranty claim, which the association did not appeal. As the court of appeals noted, the district court denied the association's motion for JMOL with regard to the construction defects presumably based on the jury's findings regarding the lack of written or actual notice under chapter 327A. A key issue before the court of appeals, therefore, was whether the association's failure to provide timely notice to the developer and general contractor of major construction defects as required for liability under chapter 327A also insulated the developer from liability under chapter 515B. The court of appeals determined that it did not, reasoning that chapter 515B does not provide that a purchaser must provide a developer with notice or an opportunity to remedy damage before initiating a lawsuit.

The court of appeals recognized that a developer may be able to protect itself from liability by entering into an indemnification agreement with its general contractor, hiring reputable contractors, supervising the construction, communicating with the association, and disclaiming liability under chapter 515B under certain circumstances. But this closing observation does not address the litigation risks posed by the MCIOA as illustrated by the court's decision. Despite developers' best efforts, suits under the MCIOA are common and even encouraged. And, as *650 North Main* illustrates, the MCIOA places the burdens and risks of litigation on developers, with no guarantee of recourse against the actual at-fault parties.

Developer Held Liable for Attorney's Fees & Litigation Costs

A significant but somewhat secondary aspect of the court of appeals' decision is its ruling on the association's claim for attorney's fees and litigation costs. The court of appeals affirmed the district court's award of $171,000 in attorney's fees to the association even though the award was nearly twice the amount of damages awarded. In so holding, the court rejected the developer's argument that the attorney's fee award should be limited by either the association's contingent fee agreement with its counsel (i.e., 33% of the association's recovery) or the total damages awarded. The court of appeals instead held that the district court properly applied the lodestar method.

The court also remanded the case to the district court for a determination as to whether the association is entitled to recover the other half of its attorney's fees in light of the court's determination that the developer is also liable for the construction-defect damages awarded by the jury. In all, the developer will likely owe in excess of $342,000 in attorney's fees despite only being held liable for $202,500 in damages.

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Finally, the Court affirmed the district court's award of $75,766.41 in costs and disbursements under chapter 515B even though the award included significant expert witness fees that would not generally be recoverable under Minnesota law. The court emphasized that the costs recoverable under chapter 515B are not limited to the costs separately recoverable under Minn. Stat. § 549.02.

PROPOSED AMENDMENTS TO MCIOA

Even before the court of appeals' decision in *650 North Main*, efforts were underway to amend MCIOA to address some of the concerns with the current statute. During the 2016 legislative session, bills were introduced in the Minnesota Senate and House of Representatives. *See* S.F. 3224, 2016 Leg., 89th Sess. (Minn. 2016); H.F. 3520, 2016 Leg., 89th Sess. (Minn. 2016). The bills proposed amendments to MCIOA that would:

- Require an association to notify unit owners of anticipated litigation, hold a special meeting, and obtain the consent of two-thirds of unit owners before instituting or intervening in litigation or arbitration;
- Require mediation as a condition precedent to litigation or arbitration;
- Require an association to adopt and implement a preventative maintenance plan; and
- Require all parties to pay their own attorney's fees and costs of litigation.

In sum, the bills sought to make changes that would reduce litigation without limiting the implied warranties provided by the Act.

The bills didn't pass, but in light of the ongoing disparity between construction of owned, multi-family housing and rental housing in Minnesota and the court of appeals' decision in *650 North Main*, they are sure to be reintroduced during the 2017 legislative session. And while the proposed amendments do not directly address some of the problems illustrated by the *650 North Main* decision—including the expert-affidavit loophole, the absence of a notice requirement similar to Chapter 327A, and the broad nature of the MCIOA warranties in general—the proposed amendments would add additional safeguards and eliminate the attorney's fee incentive in an effort to limit frivolous litigation under MCIOA. If developers, architects, general contractors, and others involved in condominium construction projects want to go further and address some of the specific problems with the MCIOA highlighted by *650 North Main*, additional legislation would be necessary.

CONCLUSION

The "condo conundrum" in Minnesota is not new. Nor is the suggestion that MCIOA is a root cause of the problem. But it wasn't until *650 North Main* that there was an appellate court decision in Minnesota that illustrated the breadth of the litigation and liability risks developers face under MCIOA. In *650 North Main*, the court of appeals imposed extensive liability on a developer for the conduct of others and affirmed the award of significant attorney's fees and litigation costs to the association, while the architect and general contractor it hired avoided liability to the association.

The decision highlights the litigation risks that accompany the construction of condominiums in Minnesota at a time when developers are already hesitant to build them. And it will undoubtedly give developers further pause as they consider future development opportunities. At the same time, the decision will affect architects, general contractors, and even subcontractors as they consider whether to sign on to future owned, multifamily housing projects in Minnesota. But, in the end, the *650 North Main* decision may be just what those seeking to spur development of owned, multifamily housing in Minnesota need to succeed in making at least some changes to the MCIOA during the next legislative session.