



# LEGAL ALERT

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## The Arizona Homeowners' Bill of Rights – Weighing the Benefits (and Costs) of Extending Consumer Protection in the Residential Construction Context

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### INTRODUCTION

Over the past five years, contractors, developers, and homeowners have witnessed firsthand the transformation of Arizona's housing "boom" into a housing "bust." This "bust" has resulted in sharply reduced prices, large inventories of unsold and foreclosed-upon homes, and residual anger and finger-pointing directed at financial institutions and contractors, among others. Out of this maelstrom comes the Arizona Homeowners' Bill of Rights ("Bill of Rights"), an initiative from the Sheet Metal Workers union, which is scheduled to be placed before the voters of Arizona in November 2008 after garnering over 260,000 signatures from Arizona citizens.

This Bill of Rights contains significant changes and additions to A.R.S. § 12-1361, *et seq.*, which addresses defect and/or design actions against persons or organizations engaged in the business of designing, constructing, or selling single or multifamily residences ("builders"). If passed, these changes will significantly affect the landscape of residential construction throughout the entire state of Arizona. These changes and additions are the subject of these materials and are evaluated below.



## STATUTORY MODIFICATIONS IN THE HOMEOWNERS' BILL OF RIGHTS

### A. TEN-YEAR WARRANTY

Probably the most dramatic and discussed aspect of the Bill of Rights is the addition of A.R.S. § 12-1365.01, which provides for a ten-year warranty on all residential construction sold by builders:

**Every seller of a dwelling must include in the purchase price of the dwelling without additional or separate charge a warranty of the materials and workmanship of the dwelling effective for at least ten years from the date of purchase. The warranty shall cover the original purchaser and all subsequent purchasers within ten years of the date of the original purchase.**

Obviously, this is a dramatic change from the typical one-year warranty provided with new residential construction.

From a homeowners' point of view, the imposition of a ten-year warranty, on its face, is likely appealing, particularly given the statutory language indicating that the contractor/developer cannot charge homeowners an "extra" fee for the warranty. Of course, there is no such thing as a free lunch. While the language of the proposed statute states that builders cannot charge "extra" for the extended warranty, the simple fact remains that builders will simply add the associated costs to the price of the home. This "warranty tax" will likely be substantial due to the sheer length of the warranty and other provisions of the Bill of Rights increasing the cost to correct defect work (see section "B" below).

This warranty may also result in unintended and unwanted consequences with respect to homeowners' behavior. For example, some homeowners may not properly maintain their property due to their belief that routine maintenance is covered under warranty. When problems arise due to inadequate maintenance,

homeowners may convince themselves (and possibly a jury) that damages resulting from their failure to perform regular and necessary maintenance are actually construction defects. Accordingly, a ten-year warranty may force builders to essentially provide ten years of maintenance work in order to avoid lawsuits due to homeowners' neglect, particularly given the harsher penalties applicable to builders under the Bill of Rights (discussed in section "C" below).

On a related note, all provisions of the Bill of Rights will take on increased significance if passed in November, likely resulting in greater scrutiny given to new and existing statutory provisions. For example, an argument could be made that the Bill of Rights definition of "purchaser" exempts builders of custom homes from the Bill of Rights since custom home builders could be construed as an "owner" or a "builder" as opposed to a "purchaser." Similar creative legal arguments (and their associated cost) could become more commonplace in litigation as builders seek any possible refuge from the additional obligations set forth in the Bill of Rights.

Finally, a price gap may develop between new homes and resale homes given that newly constructed homes will be subject to the "warranty tax." Accordingly, not only will a ten-year warranty likely result in higher new home prices in the midst of one of the largest housing downturns in U.S. history, it may also place new home builders in a distinct pricing disadvantage to resellers who will not be required to price-in an equivalent warranty. These negative consequences, while not apparent on the face of the Bill of Rights, must be considered in evaluating the overall merit of the proposed legislation to both owners and builders, as higher prices could result in larger numbers of potential purchasers unable to afford new homes.



## B. REVISIONS TO NOTICE AND CLAIMS PROCEDURES

The Bill of Rights also alters the notice and claims procedures already set forth in A.R.S. § 12-1362. Both the current and proposed versions of the legislation hold that compliance with statutory notice provisions are a jurisdictional prerequisite to bringing an action, and thus a homeowners' failure to strictly comply with these deadlines could be fatal to defect claims. The Bill of Rights changes these requirements to the advantage of homeowners by shortening the time by which homeowners must provide pre-litigation notice to builders from ninety (90) days to sixty (60) days. In addition, such notices would *automatically* incorporate all defects that the *builders* found or *should have found* during an inspection, meaning that builders could face lawsuits without notice if a court later determines that the defects were reasonably discoverable by the builders.

Once notice is received, the Bill of Rights requires builders to conduct a "diligent" inspection of the residence – a reversal of current policy giving builders the option to conduct an inspection. The builders are then obligated to respond to the homeowners' notice within thirty (30) days of receiving the notice (instead of the sixty (60) days previously provided), meaning that mandatory inspections would need to be completed within three to four weeks of the builder first receiving notice.

If the builders respond to the homeowners by acknowledging a defect or defects, the Bill of Rights *requires* builders to offer to repair or replace the defect in lieu of solely offering the homeowners monetary compensation. The builders' offer to repair or replace the defect must also include a list of three (3) licensed contractors (with no adverse ROC orders against its license during the prior ten years) from which the homeowners may choose to perform the work. The homeowners are always given the election of either accepting a monetary settlement or forcing

the builders to correct the defect if both options are offered by the builders.

These provisions likely will result in the builders paying third-party contractors to correct a substantial portion of the builders' own defects, even if builders are willing to self-perform the work. Given the fact that almost all defect work is currently performed by the builders themselves, this change will likely result in significant additional costs to builders that will, once again, most likely be passed back to the public through increased home prices. Also, these provisions could result in economic wastefulness as builders will be forced to pay third-party contractors premium prices to perform work that ordinarily would be performed by the original builders at cost. Thus, the real winners could be remedial contractors, who would receive premium rates to perform work that has typically been performed at cost by builders.

## C. DAMAGES / ATTORNEYS' FEES

The Bill of Rights also changes the damages and fees available to the homeowners if the builders and homeowners are not able to resolve their differences through the claims process. Pursuant to the Bill of Rights, victorious homeowners would be entitled to: (1) damages for costs to repair or replace the defective work; (2) loss of value to the residence due to defects; (3) injunctive relief; (4) consequential damages, including relocation costs and lost wages as a result of addressing construction defects; and (5) damages for the "unreasonable failure to repair or compensate the homeowner."

First, allowing homeowners to recover lost wages as a result of addressing construction defects (which could conceivably include litigation-related activities like attending depositions and trial) is somewhat novel as these sums typically are not recoverable as consequential damages. Second, the Bill of Rights provision essentially allows for an award of punitive-type damages



under an “unreasonableness” standard. The constitutionality of this provision is questionable given the fact that Arizona law typically only permits an award of punitive damages when the actor is proven to have acted with an “evil mind.” Nevertheless, it is safe to assume that every aggrieved homeowner believes that his or her builder is “unreasonable,” and thus one can expect that every residential defect complaint filed pursuant to the Bill of Rights will include a claim for punitive damages against the builder.

Further, the Bill of Rights provides that homeowners are entitled to attorneys’ fees, expert fees, and costs if homeowners are successful on *any* portion of their “contested” claims. For example, a homeowner who wins a single claim out of ten would still be entitled to *all* his or her attorneys’ fees and costs. The use of the word “contested,” however, may mean that homeowners would not be permitted to recover attorneys’ fees in default actions unless expressly permitted by other statutes (e.g., A.R.S. § 12-341.01). In any event, this provision is certainly one-sided as the Bill of Rights also forbids builders from including any fee-shifting provisions in their contracts. In fact, *any* attempted contractual waiver of *any* the provisions of the Bill of Rights would expose builders to all damages provided for by the Bill of Rights, including rescission of the purchase contract. Moreover, since arbitration hearings typically do not allow for the recovery of attorneys’ fees, the only way builders could ever recover fees would be to opt out of arbitration and achieve a complete victory at trial.

The increased threat of large adverse judgments (including punitive damages and attorneys’ fees) again will likely be passed to homebuyers in the form of a “warranty tax.” This threat may also likely result in builders kowtowing to unreasonable demands by owners considering that disputing the existence of a defect carries the risk of incurring a significant adverse jury award.

In any event, providing additional penalties and fees against builders may only serve to increase litigation between homeowners and builders, a result that will only lead to higher prices and further distrust between builders and buyers.

#### D. DISCLOSURE OF POTENTIAL CONFLICTS OF INTEREST / DEPOSITS / MODELS

Perhaps influenced by the subprime meltdown, the Bill of Rights requires all builders to disclose any and all arrangements between the builders and financial institutions (including mortgage financing, title insurance, and property insurance) provided through the vendor. These arrangements include: (1) common ownership or control between the vendor and the financial institution; (2) fee, commission, rebate, or payment agreements; and (3) whether mortgages arranged by the vendor will be held by the vendor or are intended to be sold to other parties. Forcing builders to reveal these arrangements will certainly make it more difficult for builders to market financial products to buyers. Anticipated profits from these arrangements are also built-in to the price of construction, and thus any reduction in revenue from these arrangements will again manifest itself as a price increase in the cost of the home.

Moreover, the Bill of Rights imposes much stricter rules on buyers’ deposits. Specifically, the Bill of Rights permits buyers to cancel building contracts and recover 95% of their deposits so long as the cancellation takes place within 100 days of execution. Logically, this will impact the builders’ ability to gauge the seriousness of a buyers’ interest and may give rise to buyers entering into several different contracts only to cancel all but one within 100 days. In another case of potentially unforeseen consequences, builders may respond to this change by dramatically increasing deposit amounts so that the allowable 5% forfeiture is sufficient to ensure the seriousness of prospective buyers. Once again, homeowners would ultimately pay the price for



these changes in increased sales prices and larger deposits, which could result in reducing the ability of lower-income purchasers to break into the market.

Finally, the Bill of Rights requires all model homes to identify all equipment and/or features that are not included in the model's base purchase price. The price of these non-standard items must be separately priced and disclosed to buyers. Failure to comply with this provision entitles the buyers to injunctive and monetary relief, including possibly forcing the builders to include undisclosed upgrades to the buyers at no additional cost.

#### E. STATUTE OF LIMITATIONS / ADR

The Bill of Rights would extend the applicable statute of repose for defect claims from eight (8) years to ten (10) years after substantial completion, matching the length of the mandated ten-year warranty by extending the current statute of repose by two (2) years. Homeowners who discover defects in the tenth year would receive an additional year to bring a claim, but no claims would be allowed after the eleventh year. Moreover, the Bill of Rights would change the current limitations timing by delaying the start of the warranty period until either: (1) the home is actually occupied by the buyers; or (2) the first date the buyers are entitled to occupy the home by contract. This new start date likely will result in a longer warranty period since the current statute of repose commences after final inspection by the governmental body issuing the building permit for the residence. For example, the ten (10)-year warranty would be automatically (and indefinitely) extended for new homes sitting vacant and unsold.

Finally, the Bill of Rights would *not* allow builders and homeowners to opt out of the Bill of Rights by including an arbitration clause or other method of alternative dispute resolution in their contracts. Thus, an arbitrator or other finder of fact likely would be compelled to acknowledge and follow all aspects of the Bill of Rights, including the Bill of Rights attorneys' fees and damages provisions. This provision would eliminate several of the existing aspects of arbitration, most notably a builders' ability to include damage waivers and liability limitations in the builders' ADR provision in the contract. As set forth above, increased litigation costs will most likely be passed on to buyers in the form of higher prices.

#### CONCLUSION

The Bill of Rights, on its face, appears to be a major coup on behalf of Arizona homeowners. These same homeowners, however, undoubtedly will bear the brunt of some, if not all, of the additional costs associated with the Bill of Rights through a "warranty tax." Higher new home prices could not come at a worse time given the fact that Arizona is suffering from one of the biggest housing downturns in United States history. As we move towards November, *the Arizona construction industry should do their best to educate Arizona voters that the Bill of Rights, while purporting to serve homeowners, may make homeownership even more difficult due to price increases necessitated by this legislation.*

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