



Condos: Will they Ever be Financed Again?

Jocelyn L. Knoll

Deterrence to New Construction



Condo conundrum: Lots of demand, not enough building

Article by: JIM BUCHTA
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If only condo construction in the Twin Cities were as brisk as the demand.

While swells of baby boomers and young professionals are hankering for the ease and amenities of condominium living, the number of units for sale is strikingly low, with only three condo buildings under construction across the metro.

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Even so, most developers are steering clear of condos. Prices on existing units are still far below what it costs to build new, while banks remain hesitant about providing the construction financing. Other developers are being deterred by a Minnesota law that holds builders liable for major construction defects for 10 years.

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- Despite significant demand, very little new condominium development is taking place.
- A significant reason for this is a lack of construction financing, and long liability for major construction defects.

Common Construction Defects at Condos

- Façade Leaks
- Window Leaks
- Wood Floor warping
- Inadequate Fireproofing
- Ventilation Problems
- Inferior internal fixtures
 - See BrickUnderground, *The Seven Most Common Condo Construction Defects* (9/17/2013).

Statute of Repose – Ten Year Construction Defect Liability

“Except where fraud is involved, no action by any person in contract, tort, or otherwise to recover damages for any injury to property, real or personal, or for bodily injury or wrongful death, arising out of the defective and unsafe condition of an improvement to real property, shall be brought against any person performing or furnishing the design, planning, supervision, materials, or observation of construction or construction of the improvement to real property or against the owner of the real property more than **two years after discovery** of the injury, nor in any event shall such a cause of action accrue more than **ten years after substantial completion of the construction.**

Minn. Stat. Sec. 541.051, subd. 1(a).

Home Warranty Statute

327A.02 STATUTORY WARRANTIES.

Subdivision 1. Warranties by vendors.

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:

(a) during the one-year period from and after the warranty date the dwelling shall be free from defects caused by faulty workmanship and defective materials due to noncompliance with building standards;

(b) during the two-year period from and after the warranty date, the dwelling shall be free from defects caused by faulty installation of plumbing, electrical, heating, and cooling systems due to noncompliance with building standards; and

(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.

Home Warranty Statute – Risks for Contractors and Developers

- The Home Warranty Statute imposes potential liability on developers for ten years.
- Additionally, changes to Minnesota’s Home Warranty Statute in 2010 impose additional liability on commercial contractors.
 - Home Warranty Statute, Minn. Stat. Sec. 327A.01 provides that a “Vendor” means “any person, firm, or corporation that constructs dwellings”
 - The prior definition of “Vendor” was a “person firm or corporation which constructs dwellings for the purpose of sale.”
 - As a result, contractors may liable for defects in multi-family dwellings where before they were not.

Ten Year Liability

- **Contractors:** Minnesota's Statute of Repose, and the 2010 Amendments to the Home Warrant Statute both impose ten-year liability on contractors that build condominiums.
- **Developers:** retain 10-year liability for major construction defects

Consequences of Long Liability - Contractors

- Contractors are attempting to mitigate their risk under the Home Warranty Statute by contractually obligating developers not to permit new multifamily residential construction to be used for condominiums.
- Those contractors which do not refuse to build new residential multi-family units for condominium use will include the higher risk in their prices.

Consequences of Ten-Year Liability – Developers

- Ten Year Potential for construction defect litigation is also a significant issue for developers.
- Developers face potential direct liability for a long period of time.
- *See, e.g., McMorrow v. REC, Inc.* REC developed a condominium unit in 2002 in Edina. The Owner purchased a unit in 2005. Water intrusion commenced in 2007. The condo association brought an action in 2009. Accordingly, the condo unit developer was faced with litigation over seven years after its initial development work.

Impact on Lending

- Lenders face the possibility of their security being the subject of complex, multiparty litigation – Unlike financing of other real estate, condominium construction financing requires that units are saleable and are sold for construction loans be repaid.
- If Lenders lend directly to developers, Lenders' ability to fully benefit from their security may be impaired, and they may step into the developer's shoes
- Provisions in a development agreement could prevent the lender from converting the building to a condo and thereby eliminating an option to maximize sales price

Lenders – Additional Considerations

- “There is also a risk of litigation by a cottage industry of lawyers bringing lawsuits against developers and attempting to bring in the construction lender, who is frequently the only available deep pocket involved in the condominium development process.”
- *Real Estate Finance Journal*, Fall 2013



Questions?