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Expert Analysis

Want to Put Up a Building in NY? Put Up Money to Cover Construction Defects

By **Bruce A. Cholst**

And **Deborah B. Koplovitz**

This article offers what we believe to be a more viable remedy than those which presently exist in New York state for purchasers of residential units in newly built or rehabilitated developments where construction is rife with material defects.

To be sure, New York state offers these purchasers a wide array of legal remedies, including breach of contract, common law fraud, breach of express warranty, breach of statutorily implied warranty (General Business Law §777-a) and negligence. However, these avenues of redress often lack practical viability because by the time money judgments are obtained, the offending builders and design professionals are insolvent, and therefore judgment proof.

There are several reasons why so many developers tend to become insolvent before they can be held legally accountable for their construction defects.

First, it is common practice in New York for developers to create separate limited liability companies for each of their projects, whose only assets are the homes in that project. As soon as each home is sold the proceeds are typically transferred out of the developer's LLC. Once all the homes are sold, which in today's robust market is usually a matter of months, the developer's single purpose LLCs are nothing more than insolvent shells unable to fund remediation of construction defects. This is especially so since many construction defects may not even become apparent to a purchaser until after the LLC has been denuded of its assets and litigation has therefore become futile.

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Moreover, the latest construction boom has attracted legions of "untested" developers who are apparently more thinly capitalized than their predecessors had been. These thinly capitalized developers are being further squeezed by diminishing profit margins by virtue of spiraling land, labor and material costs. The confluence of thin capitalization and reduced profit margins severely impairs developers' liquidity.[1]

Insolvent developers are obviously not in a position to stand by their product and quickly ameliorate the defects resulting from shoddy construction. The financial burden

BRUCE A. CHOLST *and* DEBORAH B. KOPLOVITZ *are shareholders at Anderson Kill.* STEPHEN PALLEY, *a shareholder, and* KEMPSHALL C. McANDREW, *an attorney at the firm, assisted in preparation of the article. Mr. Cholst can be reached at bcholst@andersonkill.com or 212-278-1086. Ms. Koplovitz can be reached at dkoplovitz@andersonkill.com or 212-278-1084.*

of doing so is therefore shifted to purchasers who have already paid full price for a defect free home.

Travesties like this can be readily avoided with corrective legislation. We offer a mechanism which would guaranty, for a reasonable amount of time, funding for remediation following Judicial determination as to the validity of a purchaser's timely filed construction defect claim, thereby assuring innocent purchasers a seamless and economical repair process.

Specifically, what we have in mind is the establishment of a security deposit requirement whereby builders of new construction residential condominium or cooperative buildings, gut rehabilitation projects, or converters of residential buildings (whether offered in cooperative or condominium form of ownership) would be required to post with the New York State Department of Law prior to the First Closing a bond or Letter of Credit equal to 10 percent per cent of the estimated construction or conversion cost. This security deposit would insure that there will be funds on hand to capitalize any necessary remediation work to apartments or common areas once the builder's liability for a construction defect claim has been conclusively established in a court of competent jurisdiction.

The security deposit would be subject to reduction at the request of the builder or converter in pro rata segments (based upon the unit owner's percentage interest in the cooperative's outstanding shares or condominium's residential common interest) on the second anniversary of the conveyance of each unit, except that in no event could the aggregate security deposit be reduced below fifty (50 percent) per cent of its original amount until either the Fifth anniversary of the First Closing or one year after the building's Board of Directors or Managers becomes comprised of a majority of residential owners, whichever is the *later* date. Subsequent to that date, the builder or converter may request disbursement of the remainder of the security fund. However, if there are any construction defect claims pending at any time when the security deposit would otherwise be subject to reduction or disbursement, the security deposit could not be reduced below the aggregate amount of then pending claims.

The security deposit should be deemed assigned upon any transfer by the original builder of his equity in the project to a successor owner. To the extent that only a portion of the builder's equity is transferred to a successor then a pro rated portion of the security deposit is subject to assignment. The assignability provision would thus serve to ensure purchasers' protection in the event the original owner divests his interest in whole or in part.

Our proposed legislation would also require builders, or their successors in interest, to send resident owners in their projects annual notices apprising them (1) of how much security remains on deposit as of the date of the notice, (2) that the purpose of the fund is to secure satisfaction of a money judgment on a construction defect claim, (3) when the next reduction is scheduled to occur, and (4) when final disbursement is scheduled to occur. These annual notices will keep purchasers apprised of their right to file suit while the security deposit is extant.

To be sure, sponsors of New York City conversions are currently required to capitalize their projects' reserve funds.[2] However, the amount of contribution is so small (either 3 percent of the total offering price up front or basically 3 percent of the contract price of each apartment sold through the fifth anniversary of the first Closing, at the developer's option) that this remedy is hardly a viable option for securing payment of a judgment on a sponsor defect claim. Moreover, the proceeds of this contribution are not, as a matter of law, dedicated to remediation of faulty construction, as proceeds of a claim against the security deposit would be.

In advancing this solution we are borrowing the concept from a Washington, D.C. statute, DC Code §42-1903.16(e)(1). That provision is designed to secure builders' compliance with their "Warranty against structural defects," which is akin to New York state's Housing Merchant Implied Warranty.[3]

A colleague in our firm's Washington, D.C. office who had dealt with this statute reports that the

provision has been successfully used to procure direct remediation of structural defects in new construction condominium buildings which were not covered by typical performance bonds or insurance policies.

Our colleague states, however, that enforcement of this security provision has been hampered by the lack of regulatory guidance regarding its implementation. So, if New York state were to enact a variation of the Washington, D.C. provision it would appear that rapid adoption of an implementing regulatory scheme should be a priority.

The concept of a security deposit to be posted by developers to fund remediation of construction defects has also been embraced internationally. For example, in Norway, under §§12 and 47 of their Housing Construction Act, a real estate developer is required not only to remain jointly and severally liable to purchasers for remediation costs out of the proceeds of their profits, but also to post a bond in the amount of five per cent of the contract price for a period of up to five years to secure amelioration of construction defects.

One Norwegian developer, Roger Fagerheim, has noted that while the bond adds costs to his projects, he "appreciates the sense of security the law provides" because he is "able to calculate the costs at the outset of the project." Fagerheim notes, further, that "in the unlikely event there are construction issues which need to be addressed those costs should come out of the pre-paid guaranty, and not out of my profits."[4]

Builders may well oppose this statutory provision on the ground that it increases their costs, and therefore tends to inhibit residential development. We respectfully disagree.

This proposal contemplates posting of a refundable security deposit, not payment of a non-refundable fee. To the extent that the project remains defect free for a finite (and relatively short) period of time, the builder recoups its deposit.

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Moreover, under the current system, the builder faces infinite exposure to timely filed defect claims, including potential suits to pierce the corporate veil in order to reach principals of the shell LLC. With this proposal, the scope of his liability is, as a practical matter, limited to the amount of the security deposit, which is a small percentage of the project cost. As Fagerheim's experience in Norway has shown, this proposal would also enable builders to calculate with greater certainty their costs and profits at the inception of the project.

If necessary to garner builders' support for this proposal, the Legislature might consider adding the security deposit requirement to the Housing Merchant Implied Warranty (as is the case with the analogous Washington, D.C. statute) and making that expanded provision the exclusive remedy against builders for construction defect claims. That statute is sufficiently broad to cover the entire gamut of defect claims for which recovery may be sought, and developers limit their exposure to liability with this measure. While purchasers would face a reduction in the *number* of remedies available to them, that is an illusory sacrifice because the Housing Merchant Implied Warranty covers all possible avenues of recovery with its wide ambit. Moreover, purchasers' monetary recovery against builders on successful construction defect claims would be secured by the requisite deposit, a guarantee of recovery not existing under current law.

1. Ronda Kaysen, "New, but Far From Perfect," N.Y. Times, March 8, 2015, at RE 1.
2. Local Law 70 of 1982 (Title 26, Chapter 8 of the New York City Administrative Code, 26-701 et. Seq).
3. General Business Law §777-a 1 and 2.
4. Personal conversation with Deborah Koplovitz.