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CONSTRUCTION DEFECT LITIGATION AND THE RESIDENTIAL HOUSING MARKET

A REVIEW AND ANALYSIS WHITE PAPER

PREPARED FOR:

THE ASSEMBLY COMMITTEE ON JUDICIARY

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cost increases on to consumers.² Current market conditions parallel those preceding the circumstances giving rise to construction defect litigation reform or similar initiatives in other states.³ To conclude that this issue will not become more acute in Nevada is perilous, and turns a blind eye to economic reality.

METHODOLOGY

Applied Analysis used a broad range of analytical techniques to review and analyze the question presented. Generally speaking, however, these approaches can be categorized into three groups: 1) comparative analyses, 2) trend analyses, and 3) survey analyses. Comparative analyses considered the impacts of construction defect litigation witnessed by other states facing similar issues and/or forwarding some degree of construction defect litigation reform. Trend analyses reviewed historical and projected movements in key economic, fiscal and social variables. These include, for example, the extent to which home price inflation has outstripped household incomes and trends in the number of construction defection cases filed in Nevada courts. Finally, a number of surveys, interviews and focus groups were used to assimilate data from trade association representatives and industry participants.

There are a number of important limitations to these analyses and the data underlying them. These include the reality that information is limited, and what is available, is often incomplete. Moreover, data relating to the impacts of construction defect litigation is neither well-established nor easily measurable. A number of assumptions were made and inferences drawn to reach the conclusions presented. In addition, construction defect litigation and housing economics are highly complex and impacted by a number of exogenous factors, not all of which can be reflected in an analysis of this nature. These limitations notwithstanding, we believe that there was sufficient data available to support the findings noted herein.

² Note the price elasticity of housing suggests that there are few, if any, substitute goods. See also Hanushek, A. and Quigley, J., *What is the Price Elasticity of Housing Demand?*, The Review of Economics and Statistics. MIT Press. Vol. 62, No. 3, pp. 449-454; Malpezzi, S. and Maclennan, D., *The Price Elasticity of Supply of New Housing in the U.S. and the United Kingdom*. Wisconsin-Madison CULER working Papers; and Dreiman, M., *Drawing Inferences about Housing Supply Elasticity from House Price Responses to Income Shocks*. Office of Federal Housing Enterprise Oversight. March 2000.

³ See legislative history regarding California SB 800, 2002 and the Colorado 2001 Construction Defect Action Reform Act; Washington RCW 64.50.005 et seq.; See also, California Building Industry Association, *There's Nevada Been A Better Time for Housing*, 2002 (noting that as a result of construction defect associated with condominium construction total construction of condominiums, which had once represented 30 percent of the California housing market, had declined 84 percent and that fewer than 5,000 condominiums were built in California for all of 2002.); Barnhart, S., *Reach of Construction Defect Litigation Extends Beyond Condos*, Insurance Journal. May 2002 (noting that Northern California's biggest impediment to construction of multi-family and single family homes is "the threat of litigation."); Building Industry Association of Washington, *White Paper Contractor Liability Insurance*. (noting the impacts of construction defect litigation in Washington state to be 1) lack of or extremely expensive coverage; 2) less affordable housing; and 3) exit of contractors and subcontractors); Rall, M. and Dutton, J. Washington Construction Defect "Cure" Statute: A Bill of Rights or a Bill of Goods. (noting that the Washington Legislature passed RCW 64.50.005 et seq. in response to "the rise in construction defect litigation and the resulting increase in the cost of insurance contractors are required to carry."); The San Diego Association of Governments, *Condominium Construction Defect Litigation and Affordable Housing: The Anatomy of a Problem, with Strategies for a Solution*. June 20, 2001 (noting that addressing construction defect litigation is one important factor to addressing San Diego's housing crisis); and Yohem, R., *Southern Arizona Hit Hard by Insurance Crisis HB 2620 may provide relief to Arizona's growing number of construction defect lawsuits*. Southern Arizona Homebuilders Association. (noting that one of primary needs for the construction defect litigation reform bill, HB 2620, is rapid insurance increases for builders that have never been party to lawsuit or had a complaint).

INTRODUCTION

Applied Analysis was retained by the Coalition for Fairness in Construction to review and analyze the impacts of construction defect litigation on Nevada's housing market. This summary white paper briefly reviews our approach and summarizes the salient findings of our research. Appendix A, immediately following this summary, provides additional supporting and supplemental analyses in selected areas.

FINDINGS IN SUMMARY

Escalating insurance costs are a clear and present danger to Nevada's residential construction industry, and, in turn, the state's economy. Insurance cost per home reportedly increased by 500 percent between 1999 and 2003, pushing a number of builders, contractors, and subcontractors out of the market, putting upward pressure on home prices, and notably impacting the mix of new residential products. These extraordinarily increases appear to be correlated with the rising incidence of construction defect litigation; interviews with construction and insurance industry representatives confirm the same.

The full economic and fiscal impact of these trends is currently masked by unique market conditions and the current stage of the trend's evolution. Low interest rates have made housing more affordable for a great number of Nevada families; however, it is unlikely that rates will remain at these levels, and some observers warn that the housing market may be unstable.¹ Additionally, the steep rise in construction defect litigation lawsuits only began in mid-1999. At that point, and for some time following, the vast majority of builders had insurance coverage that protected them from some portion of defense and settlement costs. More recently, however, self-insurance rates and deductibles have increased drastically, as have average premiums and the intensity of litigation. As builders, contractors, and subcontractors find themselves faced with combination of higher insurance costs, less coverage, and an increasing number of lawsuits, some will leave the market, some will go bankrupt, and those remaining will pass the lion's share of

¹ Smith, H., *On the bubble: War, interest rates could stop the upward float of home prices in Las Vegas, experts say*, Las Vegas Review Journal, November 2002 (quoting Dennis Smith of Homebuilders Research as saying, "[i]s there a [housing] bubble? Yes, when compared to previous Las Vegas;" Shelli Lowe, managing director of Integra Reality Services, as noting that the housing bubble was created by lower interest rates, which allowed people to buy more house than they could usually have afforded; and Paul Kasriel, an economist for Chicago-based Northern Trust Co., as stating, "[s]o long as the Fed aids and abets the creation of credit, which it is doing mightily now, the housing asset bubble can continue to inflate, but when, not if, the day comes that the Fed no longer has the policy latitude to create more and more credit...a chart of housing prices will start to look like a recent Nasdaq price chart.") The Washington Times, *IMF growth projection for '03 cut half a point*, April 2003 (citing IMF chief economist Kenneth Rogoff as saying that even with a quick conclusion to the Iraq war, the global economy will face a number of other risks from the lingering effects of the bursting of the stock-market bubble and the rising threat of a housing bubble in the United States); Branaugh, M. *Area foreclosure filings grow County reaches highest mark since at least 1995*, The Daily Camera, April 2003 (noting that Colorado's home foreclosure are up 45 percent since 2002); Barta, P., *Housing Prices Soar, Fueling Bubble Fears, From Long Island to San Diego, Values Increase by More Than 20%; Similarities to Tech-Stock Boom*, The Wall Street Journal, August 14, 2002. (citing Nevada as one of the market hot spots and quoting Ian Morris, an economist with HSBC research as expressing concern that real estate markets trend to peak two or three years after a stock market peak.); and Barta, P., *Home Sales Cool*, the Wall Street Journal, March 2003. (noting that economists generally warn that if the war ends relatively soon, economists say interest rates could rise, making homes seem less affordable).

ANALYSIS SUMMARIES

- ❖ Increases in Nevada construction defect litigation cases appear correlated to changes in California's construction defect litigation law.⁴
- ❖ Insurance premiums in Nevada are skyrocketing, with per home constructed premiums increasing 500 percent between 1999 and 2003.⁵
- ❖ Range of insurance increases for contractor and subcontractors was reportedly 78 percent to 1,630 percent between 1999 and 2003.
- ❖ The number of builders constructing 10 or more homes in Southern Nevada decreased from 157 to 110 between 1996 and 2001.⁶ This 30 percent decline occurred when Nevada experienced more home sales than any period in its history.
- ❖ Between 1990 and 2001, the average cost of a new single-family home increased by 24 percent while the average household's income increased by only 7 percent.⁷ For each \$1,000 increase in the price of a house, 1,530 households are priced out of the market.⁸
- ❖ In its 2002 annual report, the National Low Income Housing Coalition's market survey ranked Nevada the state with the 8th highest increase in housing wage (5.5 percent). The housing wage is the amount a full-time worker must earn per hour in order to afford a two-bedroom unit at fair market value.⁹
- ❖ Multifamily housing, that which is most impacted by construction defect litigation, declined from 36 percent of housing starts in 1996 to 25 percent of housing starts in 2001.¹⁰
- ❖ The number of insurers willing to write construction policies has decreased significantly. Coverage has declined, and deductibles and self insurance retention rates are notably higher. In other words, builders, contractors and subcontractors are paying more and all parties involved are getting less protection.
- ❖ Some articles have called metropolitan Las Vegas a "pot of gold at the end of the California rainbow," as it provides a fertile market for construction defect attorneys displaced by the California Supreme Court's adoption of the economic loss doctrine.¹¹

Selected Case Studies

"We are not able to achieve any coverage. We used to get \$15 million umbrella coverage, but can't get insurance above \$6 million now. Last year we were only able to get a single quote." – NV Homebuilder

"In 1999 our insurance was 0.007 percent of revenue, it currently is 3 percent of revenues, and it will be rising to 10 percent of revenues next year, based best quote received so far." – NV Drywall Contractor

"A year ago a townhome developer could get "wrap" insurance from a smaller insurer, but that coverage is non-existent today. The only way to get multifamily insurance is to be self insured." – NV Paving Contractor

"In 1999, premiums were \$64,000 for \$2 million of coverage. In 2002, our premiums increased to \$378,000 for \$1 million coverage, with a \$75,000 self insured retention requirement." – NV Roofing Contractor

"In the future we will not be able to get a standard policy. Our options will be self insured, go out of business or go somewhere else." – NV Concrete Contractor

"Our cost of insurance was \$34 per door in 1999, \$113 per door in 2002, and insurance is going to \$225/door when we renew this year." – NV HVAC Contractor

"Our cost of insurance in 1999 was \$4.62 per \$1,000, for 2000 it increased to \$15.49 per \$1,000, in 2001 premiums rose to \$19.01 per \$1,000, and in 2003 our premiums are \$153.50 per \$1,000. In prior year's umbrella coverage of \$3 million cost \$3,000 per year, this year no quotes were available." – NV Plastering Contractor

"Policies being sold today are not even a good product. Exclusions are very significant and very absolute. What will happen 3 to 4 years is lawsuits filed during the last 18 to 36 months will come up and coverage will be denied." – NV Insurance Representative

⁴ Construction defect litigation case data provided by Harvey, Charles D., Case Management Coordinator, Eight Judicial District Court. Note that the data file provided listed all cases filed since 11/27/96. Case reported prior to July 2001 may not be complete due to the manner of collection; however, they were noted as "representative" of the filing trend; see also Los Angeles Lawyer, In the Wake of Aas, Real Estate Law Issue, January 2003.; see also Aas v. Superior Court, 101 Cal.Rptr.2d 718 Cal.,2000. Dec. 4, 2000.

⁵ Survey and analysis of 35 homebuilders, contractors and subcontractors representing more than 75 percent of the average cost to construct a single family home. March 2003.

⁶ Homebuilders Research, Inc. March 2003.

⁷ Data provided by the Clark County Assessor's Office, AOEXTRACT file, June 2002 and the Bureau of Economic Analysis, State and Local Data Files, www.bea.gov.

⁸ Hobbs, Ong & Associates, Cost Component Analysis: New Single Family Residences. December 2002.

⁹ National Low Income Housing Coalition, Out of Reach 2001: America's Growing Wage-Rent Disparity, 2002.

¹⁰ U.S. Census Bureau, 2002.

¹¹ Swanson, A. Las Vegas: Boom town for construction defect litigation. Nevada Lawyer. December 1997.