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Emerging Trends in Litigation: Connecting the Lines Between Interest Rates and Professional Liability Claims

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Many experts agree that the economy is on the precipice of a recession. The Federal Reserve increased interest rates seven times in 2022. Congress is once again tasked with raising the debt ceiling to push the national debt north of $31.4 trillion. According to Bloomberg, in 2022, consumer price inflation in the U.S. soared to a 40 year high of 9.1%. Historically speaking, real estate and construction litigation increases when the economy heads down. As homeowners lose their jobs and watch the adjustable rates on their mortgages climb—causing payments to skyrocket—they historically file more lawsuits against real estate, construction and design professionals. People who are upside down on their payments are desperate for a solution and often take aim at the defects in their homes that they may have overlooked

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Letter from the President

Kathleen V. Buck, Esq. | *Minnesota Lawyers Mutual Insurance Company*

Dear PLDF Members,

March has arrived, and setting aside all varmint's contrarian predictions, this leaves less than twenty days until spring—countdown on!

As I draft my second President's letter, it occurs to me how much easier it would be to get to know one another if we used descriptors rather than titles. I imagine they would change year to year, month to month, even hour to hour at times, but maybe they'd say things like "father of triplets" or "champion pianist" or "soon to be retiree." They would allow us a glimpse of the real person. At times, my own descriptor might reference my resilient, imaginative children and husband,

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An economic downturn requires businesses to pivot and adjust to a new normal. Employing previously established risk management policies before economic downturns gives businesses a leg up in dealing with the unfolding uncertainty.

when times were better. The economic repercussions of the COVID-19 pandemic and the increased stress on the supply chain, in part caused by the war in Ukraine, have contributed to an economy plagued by inflation. Real estate professionals, the construction industry, and design professionals face particularly trying times sharing in the impact of financial uncertainty and responding to an increased litigation risk. Armed with historical data, the real estate and construction industries can take positive steps to prepare for a recession and minimize its impact on business growth.

The Impact of Recessions on Business Operations and Growth and Preparing for a Recession

The National Bureau of Economic Research defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months." Normally, economists also identify a recessionary time as one where the gross domestic product (GDP) is falling along with income levels, industrial production, and wholesale retail sales. Recessions may also coupled with rising unemployment. The real estate and construction industries feel dramatic impacts of recessions as new construction screeches to a halt and real estate professionals are faced with a marketplace of weary consumers focused on saving versus spending.

Recessions typically curb consumer confidence and reduce spending habits. This, in turn, results in less readily available personal and business credit, and less cash flow. Businesses and individuals with less money, who cannot quickly adjust to harder economic times, may find themselves facing bankruptcy or a significant change in personal lifestyle or business operation.

The good news is the situation is not hopeless. Businesses can take action to prepare for looming economic downturn. Common methods of preparation include reducing the workforce, cutting unnecessary or speculative spending, and making smart adjustments to save costs in products and services offered to customers. Real estate professionals can reduce inventory, and design professionals in the construction industry can provide value engineering options to cost conscious clients. However, it is important to note that any value engineering decisions should be carefully vetted for potential implications on projects holistically and should be extremely well-documented with a clear recitation of all parties' understanding of the risks and benefits. Whatever strategies businesses employ, economic experts agree that preparedness is key.

An economic downturn requires businesses to pivot and adjust to a new normal. Employing previously established risk management policies before economic downturns gives businesses a leg up in dealing with the unfolding uncertainty. Examples of policies that could be used to help recession-proof a real estate or construction-related business include putting off large expenditures or investments, delaying projects that may not be profitable in the short term, reducing marketing costs, determining opportunities for reducing costs on projects, and finding other ways to increase cash flow and protect savings in the immediate timeframe.

Buyer's Remorse and the Increase in Lawsuits Against Real Estate Professionals

As home prices start to fall in many areas of the country, claims against real estate agents and brokers are on the rise. Knowing that real estate professionals carry professional liability insurance, many homebuyers and sellers sue during an economic downturn claiming that real estate professionals misrepresented the value of the property. This results in a flurry of claims activity as those involved in a real estate transaction file claims to recoup losses under professional liability insurance policies. Sellers who waited to put their home on the market, perhaps on the advice of a real estate agent, or buyers who overlooked an issue discovered during a home inspection, feel strapped by the reduced value and increased monthly cost of their home. According to Business Insider, "lawsuits against real-estate professionals increased 9% between 2021 and 2022 as home prices declined."

Most of the lawsuits involve claims of nondisclosure of material information, or negligence and misrepresentation during the property transaction. A study of mortgage data completed by Black Knight revealed that over 270,000 borrowers were upside down on their mortgages as of December 2022. With more economic worries on the horizon, professional liability claims could increase—as could claims in the areas of wrongful evictions and short sales, as more homeowners face eviction if they are unable to make their payments with increasing interest rates. Property management companies and home inspectors similarly can expect an uptick in claims, which can pass potential exposure onto real estate developers.

Real estate agents and home inspectors are no more at fault during a downturn market than a booming one, but they are more likely to sued by a frustrated buyer or seller. Real estate agents and brokers can take action to help insulate themselves from liability, however. Simple acts like recommending that your buyers secure a home warranty can stave off frustrations when, for example, an appliance breaks a few months after purchase. Real estate professionals should utilize current comparable properties for the buyer's market and offer full and complete disclosure as to all potential defects that may exist at the property. Lastly, it is of course always advisable to maintain all appropriate insurance, including professional liability insurance, to potentially help protect, where possible, against potential legal troubles.

Consequences of the Sharp Increase in Inflation on Construction Industry Claims and Professional Liability

Property and construction insurance claims are particularly vulnerable to inflation as building, rebuilds, and repairs are directly impacted by the rising costs of materials and labor. Shortages of materials and longer delivery times due to supply chain issues have also increased the cost of maintaining and purchasing insurance policies. According to the valuation company, John Foord Construction, steel is about 50% more expensive than it was only a year ago. Consequently, design professionals should prepare for potentially increased premiums as a result of more frequent claims, or the increased costs to resolve claims.

Inflation also increases the likelihood of underinsurance. As inflation rises and the economy becomes more volatile, the risk of businesses being underinsured for losses becomes more prevalent. This is because it is more difficult for businesses to maintain an accurate valuation of their assets, replacement values and potential costs of business interruption. Insurers have already experienced claims in which there are significant gaps between the valuation provided by the business and the actual replacement value requested when issues arise.

At the recent National Association of Relators ("NAR") Annual Real Estate Forecast Summit (the "Summit"), it was predicted that the housing market will begin to stabilize and return to "normalcy" in 2023. This year home sales and prices overall should return to a more moderate level, but this may vary depending on the region of the country. For example, in areas people flocked to during the pandemic—so called pandemic "boomtowns"—home prices are likely to reset in 2023 and decrease significantly from their peak during the COVID-19 pandemic. At the Summit, NAR Chief Economist Lawrence Yun stated, "housing inventory is expected to remain tight in 2023, with housing starts below historical averages and fewer homeowners willing to sell." He added:"The ongoing housing supply challenges will prevent home prices from falling, though price appreciation will slow." Yun also offered his prediction that home sales will drop by 6.8% in 2023 with the first quarter being the worst for home sales due to consumer concerns about higher interest rates and economic uncertainty.

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The National Association of Homebuilders also weighed in on the topic predicting that housing starts would drop "by double digits" in 2023, but it had a more positive outlook for the market starting in 2024. In 2022, builders also suffered as mortgage rates rose and buyers were more reluctant to take the lead in purchasing new construction. Many builders and sellers offered incentives such as mortgage rate buydowns and slashing prices to attract buyers. This reality, compounded with the labor and supply shortages as well as construction delays, has caused the amount of new builds entering the market to decline.

Implications for New Construction

Home builders are feeling the impact of the lack in consumer confidence. Buyers are hesitant, due to increasing interest rates. People are holding off on making improvements to their homes for fear of an impending recession or economic uncertainty ahead. Although in 2023 new construction might need to navigate rough waters, by 2024 many believe the outlook will improve. According to Robert Dietz, Chief Economist for the National Association of Home Builders: "Single-family home building will ultimately lead to a rebound for housing and the overall economy in 2024 as interest rates fall back on sustained basis, bringing demand back for the sales market."

Dietz also predicted that multifamily construction will decrease in 2023 despite the fact that 2022 was a strong year. "Multi-family home building, which accounts for more than 95% built-for-rent, experienced strength in 2022 as mortgage interest rates increased and for-sale affordability conditions declined. However, there are 930,000 apartments under construction, the highest total since January 1974. A rising unemployment rate, increased apartment supply, rising vacancy rates and slowing rent growth will slow multifamily construction this year."

Mitigating Legal Risk in a Downturn Economy

Historically speaking, litigation goes up in the real estate and construction industry when the economy heads down. Much of this can be attributed to the strain businesses and consumers feel when economic volatility hits. Credit is harder to obtain. Sales volume changes. And the number of legal claims brought against construction and design professionals increases. During prior recessions, legal claims skyrocketed largely due to contractors and design professionals taking jobs they would not ordinarily take to generate more cash flow. Many times the result is potentially cutting corners or utilizing lower quality products on the project in an effort to decrease costs. Contractors may underbid a project to get it, but not have the resources necessary to complete it within their normal quality standards. Design professionals may take on projects outside of their area of expertise or agree to a heighted standard of care pursuant to contract. Additionally, contractors and design professionals are often tempted or otherwise left without a choice to use under-qualified personnel to take on complex projects. Promises to use senior staff on projects are broken when junior staff are utilized and if the project results in a claim, fuel is added to the fire for utilization of this allegedly under-qualified personnel. This reality, in conjunction with supply chain delays, manufacturing issues and labor shortages, combine in the perfect storm to potentially foster mistakes and open businesses up to additional liability and potentially increased costs of resolving the resultant claims.

Delays and shortages can cause parties involved in a construction project to default under their loans, suffer penalties, or even have to obtain extension fees. Funding sources can also be impacted or unavailable due to changing economic circumstances. In addition, with interest rates increasing on a regular basis in 2022, it changes the overall completion cost for many projects. Contractors seeking to recoup a shortfall in lost profits, in turn, assert claims against the design team, including push-back on value engineering decisions. In past recessions, issues surrounding claims made against contractors, who in turn sought to transfer risk to the design team were rampant in the litigation landscape.

Design Professionals are Particularly Vulnerable to Suit During a Recession

Design professionals are essential in the planning and outlining of construction projects. It may also be an area where project managers attempt to cut corners first. With little room for contingencies and revisions once the project is started, design professionals may be forced to uphold an impossible standard. When the contractor and others on the build team take liberties with the plans to cut costs, they often don't consult with design professionals to ensure that the changes maintain the integrity and industry standards of the project. When corners are cut, the likelihood of future problems mount and contractors, project owners and others look for someone to blame. This often results in a uptick in claims tendered to the insurance carriers for design professionals. Moreover, the claims presented are costing professional liability companies more than ever, due to inflation, supply chain concerns and lack of skilled labor and materials. According to Victor Insurance Managers, LLC, the average indemnity payment for the A&E program was $208,437 in 2019 and $271,337 in 2021.

Like contractors, in tough economic times many design professionals are more willing to sign on to projects that may not provide contract terms that protect their interests adequately, such as unfavorable attorney's fees and indemnity provisions that do not run in favor of the design professional. Additionally, design professionals may undertake projects outside of their area of expertise potentially opening them up to future claims or litigation.

Budgeting constraints, value engineering, and knowledge deficits may cause contractors to veer away from plans and specifications provided by design professionals. This is even more true in cases where the design is complex. Often the builder will not ask for explanation or clarification from the architect or designer through the RFI process resulting in mistakes or a subpar final project. Savvy plaintiff attorneys will often use this gap in communication and failure to follow the plans as a basis to question the "constructability" of the project as whole.

Conclusion

After the 2008-09 recession, claims for professional negligence against realtors, brokers, design professionals, and contractors rose sharply. This is likely to occur again in the current global period of economic uncertainty. Lingering effects of the pandemic, labor and supply shortages and delays, and the war in Ukraine have all significantly impacted businesses and communities. Though many of these problems feel far away, we see the impact in our daily lives in the form of increasing interest rates, inflation, increased frequency in professional liability claims, increased severity of claims, and a decline in consumer confidence. Although the future is uncertain, learning from the past and taking measures to prepare for the future is the best course action for all. ■

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