

Real Estate Liability – the National Landscape is evolving

The current Legal environment is changing; Banks need to be aware.

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Some Lenders/Investors believe they escape liability if they take back a finished home and sell it, or if they hired independent contractors to complete work on a home where the completion costs are insignificant to the overall cost of the project. However, the courts that have considered these issues have generally ruled that the lender is, in fact, liable for construction defects.

This paper identifies a number of court cases and related issues that may be pertinent when Lenders/Investors are evaluating their exposure to real estate properties.

Construction Defect Litigation is a very lucrative area for plaintiffs' attorneys. This has been true for decades, and it is likely to accelerate in the next few years due to the sale of foreclosed homes. Upon the discovery of construction defects, an owner's attorney will seek to recover against potentially liable defendants based upon numerous theories of liability. The homeowner's attorney will focus on the entity that sold the home – in this case, the BANK, investor, or their representative or agent.

Prior to the downturn in the residential construction market, lenders generally acted merely as a financier and would not be liable for construction defects. Banks are service organizations, and not 'manufacturers'; and thus not placing products into the 'stream of commerce'. However, as banks roles have expanded, this new role carries increased liability for construction defects. In our current economically distressed market, as an increasing number of lenders or investors acquire homes from financially strapped builders, lenders and investors must become familiar with their potential liability when they become the seller of these homes.

Two of the most common theories of liability for construction defects are negligence and breach of implied warranty of liability. Both theories may be a basis for construction defect liability to the Bank; and both theories are discussed herein.

COMPLETING CONSTRUCTION

When a lender or investor takes title to a foreclosed home and completes construction, the lender/investor is under a duty to act with reasonable care in that effort. A lender/investor that fails to exercise reasonable care will be liable for construction defects arising from negligence.

In *Pinnacle Port Community Association Inc., v. Orenstein*, 872 F.2d 1536 (Ct App. 11th Cir. 1989), the condominium association sued a lender for negligence related to structural defects because the lender became involved in the completion of the project when the builder incurred financial problems. The lender's involvement was limited to inspecting the repairs and issuing payment for the repairs. Even with such limited

involvement, the Court of Appeals held that the lender was liable for negligence on the structural defects because the lender's role had expanded further than that of a lender. *Pinnacle at 1545*.

SELLING COMPLETED UNITS TO BUYERS

Courts have expanded the lender's liability to include the selling of homes which were completed by the builder and the lender completed the amenities. In *Chotka v. Fidelco Growth Investors, 383 So.2d 1169 (FL Ct. App, 2nd District 1980)*, a Florida condominium homeowners association sued the construction lender for defects in construction of the project. The lender had taken title to the project when the developer defaulted on its construction loan. When the lender acquired the project, the project was complete except for some recreational features, such as a pool, sauna, tennis court and game room. After these amenities were completed by the lender, the lender sold the units. The court found that when completing the project and selling the units to consumers, the lender took on more duties than just a financier. The lender was found liable for (1) all express representations made to purchasers, (2) patent construction defects in the entire project, even if completed by the defaulting builder, and (3) breach of applicable warranties due to defects in the portions of the project the lender completed. *Chotka at 1169*.

IMPLIED WARRANTIES

In all states, courts recognize either statutory warranties or an implied warranty of habitability that arises upon the sale of a new home. The implied warranty of habitability means that the structure is safe for habitation. The implied warranty concept was created because courts wanted to protect the **innocent and unsuspecting homebuyer**. Caveat Emptor (let the buyer beware) was deemed unfair in residential real estate transactions, and has been replaced by Caveat Venditor (seller beware), for several decades.

Most all states will allow a builder/seller to waive implied warranties to an express warranty. Many states have strict and specific requirements to uphold waivers, including procedural particulars such as font color, font type, or size of notice, for example.

CONSTRUCTION DEFECT

The statutory or implied warranties are not just the legal obligation of the builders. A developer who finances a project and sells new homes to buyers will have liability for construction defects even if the developer hired a licensed builder to perform all the work. See *Lofts at Fillmore Condominium Association v. Reliance Commercial Construction, 190 P.3d 733 (AZ. 2008)*. This liability includes responsibility for structural defects. *Lofts at 735*. Some case law places the Lender/Investor in the same position, depending on their activities.

Some examples of severe Construction Defect Claims:

- 1) A Florida builder was constructing a single family home. A second floor balcony area had been guarded with a temporary wood barrier. The subcontractor, a flooring company, had removed the barrier while doing flooring work. A number of days later a bank inspector went to the home to inspect the construction. As he was taking photographs he backed up in the hallway, stepped off of the balcony area and fell twelve feet onto a marble floor. The bank inspector sustained severe head injuries and was in a coma for a number of weeks. He remained in rehabilitation for 3 months. He had significant cognitive and physical effects from the brain injury. Medical expenses to date are in the hundreds of

thousands and an anticipated life care plan is over \$750,000. While the subcontractor will have liability for removing the barrier, the builder will also have liability as the barrier had been down for a number of days and the builder took no steps to remediate this problem. This case is valued at more than \$2,000,000 which would exhaust the subcontractor's \$1,000,000 limit and Home Builder's \$1,000,000 limit.

- 2) In a large development in central California, the plaintiff attorney, well known in that area, solicited 192 homeowners to file a construction defect claim. The claim alleged numerous defects including foundation problems, window installation defects, roofing, and multiple interior problems. The plaintiff attorney hired an expert who inspected a number of the homes and concluded that the defects totaled \$60,000 per home. A lawsuit was filed and extensive discovery and investigation ensued. Defense costs to date are in excess of \$500,000 for the builder. The subcontractors were placed on notice, tenders were sent to them under additional insured endorsements and cross claims were served. The case has settled for \$5.76 million settlement. The insured developer is paying approximately 20% or \$1.152 million. The majority of the claim will be paid by the subcontractors. The developer will share responsibility for damages due to their supervision, sequencing of the work, and choice of subcontractors. A number of subcontractors had insurance issues and were not able to contribute to the settlement.
- 3) A home in Calhoun Georgia (just north of Atlanta) exploded on April 16, 2010. All 60 homes in the subdivision were damaged or destroyed. 18 families were rendered homeless. Initial cause of loss was believed to be a gas leak. Fortunately, bodily injury in this instance was minimal.
- 4) Three years after purchasing their new home, the owners hired an attorney to file a lawsuit alleging defects within the home. Alleged defects included sidewalks, driveway cracks, cracking of interior ceiling and walls, leaking roofs and windows, inadequate heating and cooling, etc. A motion to compel arbitration was awarded, and the case proceeded under arbitration. The streamlined discovery process and substitution of a knowledgeable impartial arbitrator for the jury accelerated resolution of the case and reduced defense costs.
- 5) A builder with almost 20 years of 'claims free' experience, recently encountered the "bad subdivision" – a subdivision wide problem, and over a dozen claims reported in one – new subdivision. The homes had been built on unstable clay indigenous to the area, and future claims are anticipated.
- 6) A similar "bad subdivision" claim involved more than 130 structural defect claims.
- 7) An HOA sued the developer for polluting their lake by dumping silt. This is a \$10,000,000 claim. Is it premises liability or completed operations?

STRICT LIABILITY

In some states, homeowners injured by a housing defect may proceed under a *strict liability* theory. California courts have found that there is no meaningful distinction between developers/sellers of mass-produced homes and manufacturers/sellers of other consumer products.

In *Jimenez v. Superior (T.M. Cobb Co.)*, 29 Cal.4th 473, 478 (2002) - California Supreme Court - Developer of mass-produced homes, like a manufacturer, retailer or supplier of another product, is responsible for dangerous conditions in its own products and is in a *better economic position to bear the resulting loss than the consumer*, who justifiably relied on the developer's expertise in constructing the homes.

See also *Stearman v. Centex Homes*, 78 Cal.App4th 611, 622–623 (2000) (holding that a developer may be strictly liable to homeowner for defective foundation that damaged other parts of tract home). The same rationale has been invoked to extend strict liability to the developer of a planned multi-unit residential complex (192 units with 27 residential buildings, as well as parking structures and recreational facilities). Although not involving the mass production of tract homes, the case appeared to “fit the classic mold of buyers of mass-produced housing.” *Del Mar Beach Club Owners Ass'n, Inc. v. Imperial Contracting Co., Inc.*, 123 Cal.App.3d 898, 911–912 (1981) (involving a complex built on an unstable bluff, which caused damage to homes).

THE BANK CONSIDERED THE BUILDER

Under California law, the Lender/Bank/Investor selling the home will be considered a “builder” of the home, *even if it did not perform any construction work* (or cause such work to be performed) in connection with the homes. In this regard, California Civil Code §911, as part of the statutory scheme addressing liability for construction defect matters, defines “builder,” in relevant part, as follows:

(a) For purposes of this title, except as provided in subdivision (b), “builder” means any entity or individual, including, but not limited to, a builder, developer, general contractor, contractor, **or original seller**, who, at the time of sale, was also **in the business of selling residential units to the public** for the property that is the subject of the homeowner's claim or was in the business of building, developing, or constructing residential units for public purchase for the property that is the subject of the homeowner's claim. [Emphasis added.]

By selling new homes to the public after acquiring the unfinished or finished homes through foreclosure, the Banks/Investors will be determined to be the “original sellers” of the property and “*in the business of selling residential units to the public.*” Hence, the BANKS/INVESTORS will be determined to be “builders” of the home under Civil Code §911, and subject to potential exposure for construction defects under a “strict liability” doctrine. (Of course, to the extent they are involved in finishing the homes before selling them, they would be considered “builders” for the additional reason that they would be involved in “the business of building, developing or constructing residential units for public purchase.”)

Equating BANKS/INVESTORS with “builders” in this context, and subjecting them to potential strict liability for construction defects in the homes, would be consistent with general principles of strict liability under California law. California has adopted the “*stream of commerce*” approach to the strict liability doctrine, extending strict liability to those who are an “integral part of the overall producing and marketing enterprise that should bear the cost of injuries from defective products.” Under this doctrine, strict product liability covers a broad range of potential defendants beyond the manufacturer. See, e.g., *Vandermark v. Ford Motor Co.*, 61 Cal.2d 256, 262 (1964) (holding that retailers may be strictly liable for defective products because “retailers like manufacturers are engaged in the business of distributing goods to the public [and] are an integral part of the overall producing and marketing enterprise that should bear the cost of injuries resulting from defective products”);

Barth v. B.F. Goodrich Tire Co. (1968) 265 CA2d 228, 253, 71 CR 306, 321 (holding that wholesalers, distributors, and any person or entity involved in the marketing chain between the original manufacturer and the ultimate retail seller is also exposed to strict product liability).

AS-IS

Under the doctrine of caveat venditor, the seller of a new house impliedly warrants the habitability of the home, and that it is free from construction defects. *Arvai v. Shaw*, 289 S.C. 161, 345 S.E.2d 715 (1986) (holding that the warranty is implied only in the initial sale, not in a resale); *Lane v. Trenholm Bldg. Co.*, 267 S.C. 497, 503, 229 S.E.2d 728, 730-31 (1976) (holding that, generally, the warranty is made by the seller even if he did not build the house); The seller's "liability is not founded upon fault, but because it has profited by receiving a fair price and, as between it and an innocent purchaser, the innocent purchaser should be protected from latent defects." *Lane*, 267 S.C. at 503, 229 S.E.2d at 731. "[T]he warranty springs from the sale. The determining factor is not whether the defendant actually builds the defective house, but that he places it, by the initial sale, into the stream of commerce." *Kirkman v. Parex, Inc.*, 632 S.E. 2d 854 (S.C. 2006), 482-483.

The lender further claimed that it should not have any liability because it effectively disclaimed liability by including an "as-is" clause in the deed. The Supreme Court was not convinced that an "as-is" clause is valid unless the seller meets strict standards including specifically negotiating with the buyer to accept the home without a warranty. *Kirkman* at 485.

"As-is" clauses and similar contractual provisions cannot insulate entities from exposure for strict liability. In California, and other strict liability states, strict product liability is imposed without fault primarily for **policy** reasons. To enforce a disclaimer—even if freely agreed to by the consumer—would contravene that policy by allowing a product supplier to define the scope of its responsibility. Thus, "no written agreement can operate to allow a supplier of defective products to avoid strict products liability." *Westlye v. Look Sports, Inc.*, 17 Cal.App.4th 1715, 1743 (1993).

Nor will courts enforce plaintiff's agreement to "assume the risk" of a potentially defective product in California. The rule against product liability disclaimers cannot be circumvented by casting the disclaimer in terms of express assumption of the risk. *Westlye v. Look Sports, Inc.*, *supra*, 17 Cal.App.4th at 1747.

Courts have found lenders to be potentially liable even where "as-is" clauses were used by the lenders. In *Kirkman v. Parex, Inc.*, 632 S.E.2d 854 (S.C. 2006), both the Trial Court and Court of Appeals held in favor of the lender finding that the lender was not liable for defects. The South Carolina Supreme Court disagreed. The Supreme Court stated that **the implied warranty of habitability arises upon the sale of a new home irrespective of fault on the part of the seller of the home.** The South Carolina Supreme Court found that a lender which took title to a property when the builder defaulted on their loan, and finished construction of the property using an independent contractor, was not entitled to summary judgment in their favor despite having used an "as-is" clause in the purchase deed. The court held that in order to "maintain the protection of purchasers . . . disclaimer can be permitted only if strict conditions are satisfied."

ROLE BEYOND A "MERE LENDER"

Courts have held that financial institutions face exposure for construction defects when they become involved in roles which go beyond merely providing financing to real estate developers.

For example, in *Connor v. Great Western Savings & Loan Assn.*, 69 Cal.2d 850 (1968), a financial institution was held potentially responsible (i.e., judgment of nonsuit was reversed) for damages to buyers of homes in a subdivision where the lender ‘became much more than a lender content to lend money at interest on the security of real property,’ where the lender

- (a) conditioned its funding on minimum prior commitments to buy homes,
- (b) warehoused the land for the developer,
- (c) channeled buyers to the developer, charging a fee,
- (d) had reason to know that the developer was thinly capitalized and relatively inexperienced so that corner-cutting was a foreseeable risk; and
- (e) controlled the course that the development would take. While the California Supreme Court in *Connor* did not mention whether there was any “as-is” clause in the purchase contracts in question, it highlights the potential pitfalls that may exist for lenders and banks when their roles expand beyond merely providing financing for real estate developers.

What did the bank [Investor] know? When did they know it? What involvement? Even if not in ‘form’, is the bank/lender/investor substantively making the decisions on the Construction Project?

PROTECTIONS FOR THE BANK

California and Nevada have reacted to lender liability for construction defects. California enacted Civil Code section 3434 and Nevada enacted NRS section 41.590. These statutes “protect” the lender from liability for construction defects if the lender’s involvement is solely the lending of money to purchase the home. However, both of these statutes do not apply if the lender’s actions go beyond the loan transaction. In contrast, it appears that Texas is the only state to enact a statute that protects a lender who acquires a new home in foreclosure and then sells it to a new homebuyer. See V.T.C.A. Finance Code Section 59.011.

LONG “TAIL” EXPOSURES

Construction Defects (“CD”) have a long “tail” exposure. Some statistics show the peak in CD claims to be the 6th through 8th year after completion. Annual Liability policies generally contain a single set of insurance limits for the policy term. Policies covering Construction Defects typically cover any “occurrence”, whether it is bodily injury or property damage that arises out of the insured’s work. Generally, in order to provide coverage under a policy, the “occurrence” must take place while the policy term is in effect or be the result of an occurrence that happened during the original policy term. Simply stated, there must be an event during the policy term which triggers coverage; bodily injury or property damage even if the damage becomes known after the policy term. There are, of course, variations from state to state in this area. For example, what is the trigger for the event? And is it a ‘rolling trigger’? Even though many policies involving construction provide “completed operations”, if there is a claim for an extended period of time after the end of the policy term, the actual “occurrence” must have happened during the original term. Determining the actual event or occurrence can be problematic, controversial and expensive.

If the lender/investor assumed ownership through or after foreclosure, the lender/investor needs ongoing insurance for properties (regardless of the stage of completion or construction) as well as needing insurance if the lender/investor hires another builder to finish out and sell the project. An 'annual' term policy is of limited usefulness. A project policy covering the term of the project and the 'tail', is the more appropriate coverage.

Depending upon the size of the asset portfolio, new coverage can be obtained on a property by property basis or on an entire portfolio basis if the properties pass a process involving an insurer-approved inspection and/or forensic testing. There are only a few insurance carriers who are focusing on the opportunity to insure "standing inventory" whether completed or not as well as insuring projects that are being taken over by either the lender or a new builder. This standing inventory can include homes in various stages of construction, including completed but not sold.

The best coverage option is a policy specifically designed to provide completed operations coverage that triggers at the sale of the unit, and remains throughout the applicable state statutes. Absent a 'project' type policy, covering the 'tail', the BANK is obligated to purchase an occurrence policy each and every year (to the end of the state's statute of limitations) to ensure coverage exists at the time of the occurrence.

CONCLUSION

It is probable that a lender or investor who becomes the seller of new homes acquired from his defaulting builder will be exposed to liability for construction defects whether or not the lender/investor actively participated in any aspect of the construction. It is the sale of the home to the buyer that gives rise to the liability under the implied warranty of habitability.

Courts traditionally honor the ability of private parties on "equal footing" to structure their own affairs through contract, just as they often rule in favor of unsuspecting buyers, as they are not on equal footing. With millions of foreclosed properties in the hands of the BANKS/INVESTORS, and two decades of courts' prejudice in favor of the unsuspecting homebuyer (protecting consumers via Caveat Venditor, and 'implied warranty laws'), it is not likely that BANKS/INVESTORS will consistently avoid construction defect liabilities through techniques such as "as-is" provisions, receivers or LLC's. While this is not to say, in all cases, that these legal techniques should not be employed, it is clear that 'legal conflicts' are usually resolved in favor of the 'unsuspecting' purchaser. Courts do not like uncompensated victims. There is already case law precedent established in the realm of 'lender/investor liability'. It's only the beginning.

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