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Lender-Vendor's Liability for Structural Defects in New Housing

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NOTE
LENDER-VENDOR'S LIABILITY FOR STRUCTURAL DEFECTS IN NEW HOUSING

INTRODUCTION

The current economic tensions in today's financial community have affected the construction lending industry, particularly in the area of housing. Construction lenders are frequently forced to bring foreclosure actions against builders and developers, or to take deeds in lieu of foreclosure. After title has been transferred, the lender proceeds with reselling, or completing and then reselling, the housing projects. The lender's concern is the preservation of his investment, but in recouping his investment a lender may place himself in a position of liability for structural defects. No court has yet ruled on the lender's liability when the lender has actively participated in reselling, but, with the numerous foreclosures being brought, the issue is sure to arise when a purchaser of a defective dwelling seeks redress and must look to someone other than the insolvent builder.

This note addresses the problem of potential liability to subsequent purchasers which a construction lender may incur by foreclosing on a housing development or condominium project. In ruling on this issue a court must analogize to the law applicable to the following three roles a lender assumes. First, by providing the funds for the project which are disbursed after inspections of the construction site at various stages of completion, the lender performs the role of a typical construction lender. Second, by accepting ownership of the development and then selling the units to the public, the lender acts as a vendor of real property. Third, if title to the project passes to the lender prior to completion and the lender is forced to finish and then sell the development, the lender assumes the role of a builder-vendor. By acting in these three capacities, the construction lender is in effect a "lender-vendor."

This note begins with a review of the present law of liability of a lender, vendor, and builder-vendor for structural defects in housing, to provide the basis for an analysis of the as yet undetermined liability of a person who occupies the unique status of lender-vendor. Then it examines the factors which a court might
consider in deciding whether or not a lender-vendor should be liable for defective construction. Finally, it discusses the ways a lender-vendor may avoid liability.

I. LIABILITY OF THE CONSTRUCTION LENDER

In the past the construction lender was liable to a home purchaser only if it could be established that the lender was engaged in a joint venture with the builder-developer. Under the law of joint venture the mortgagee is jointly and severally liable as if a formal partnership existed with the builder.

The definition of joint venture has not been explicitly set forth by the courts because a joint venture does not arise by mere operation of law. Instead, a joint venture's legal force is derived from the voluntary agreement, either express or implied, of the parties. However, one test to determine the existence of a joint venture arose out of an Oklahoma case in which the court set forth the following three requirements necessary to establish a joint venture:

1. There must be joint interest in the property by the parties sought to be held as partners;
2. there must be agreements, express or implied, to share in the profits and losses of the venture; and
3. there must be actions and conduct showing co-operation in the project. None of these elements alone is sufficient.

Under Colorado law "[t]he chief characteristic of a 'joint adventure' is a 'joint and not a several profit.'" This requirement of joint profit has been strictly interpreted, as evidenced by one case in which the Colorado Supreme Court found that no joint venture between a construction lender and a homebuilder was present where the lender's profits were set at $500 per house, because the $500 had no correlation to the builder's profit.

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1 For a discussion of joint ventures, see Note, Joint Ventures, 36 Va. L. Rev. 425 (1950).
5 Id. at 91, 64 P.2d at 910. This test has been adopted in Colorado. See Realty Dev. Co. v. Feit, 154 Colo. 44, 387 P.2d 898 (1963), citing Commercial Lumber Co. v. Nelson, 181 Okla. 122, 72 P.2d 829 (1937).
Therefore, in Colorado it is fairly simple to prevent a lender's liability under a theory of joint venture by severing the return to the lender from the builder's potential profits.

Actions by purchasers against construction lenders in other jurisdictions have also been unsuccessful where the suits were based on a theory of joint venture. For example, in one case, even though the lender and the builder combined their property, skill, and knowledge, shared control of the development, and each expected profits to result, the court held it was not a joint venture as "neither was to share in the profits or losses that the other might realize or suffer." Because of the reluctance of courts to find a joint venture between a lender and a builder, home buyers have sought recovery from lenders under different theories.

The theory of construction lender liability based on negligence was introduced in *Connor v. Great Western Savings & Loan Association*. There the California Supreme Court dismissed an action against a lender based on joint venture, relying on negligence in its effort to establish liability of the lender. The immediate barrier to recovery under negligence was privity. The construction lender's duty to the shareholders of the lending institution had been established; however, no duty had been established between a lender and a home buyer who was not the mortgagor of the lender. In *Connor* the court ruled that the construction lender owed a duty to "buyers of the homes to exercise reasonable care to protect them from damages caused by major structural defects." The facts of *Connor* became important when the California Court of Appeals, in *Bradler v. Craig*, limited *Connor* to

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2. Id.
3. *Id.* at 865-66, 447 P.2d at 617, 73 Cal. Rptr. at 377. The duty test used by the court consisted of the six-point test established in *Biakanja v. Irving*, 49 Cal. 2d 647, 320 P.2d 16 (1958). The six-point test included:
   1. [T]he extent to which the transaction was intended to affect the plaintiff,
   2. [T]he foreseeability of harm to him,
   3. [T]he degree of certainty that the plaintiff suffered injury,
   4. [T]he closeness of the connection between the defendant's conduct and the injury suffered,
   5. [T]he moral blame attached to the defendant's conduct and
   6. [T]he policy of preventing future harm.
4. *Id.* at 650, 320 P.2d at 19.
5. 69 Cal. 2d at 866, 447 P.2d at 617, 73 Cal. Rptr. at 377.
its facts. In *Connor* the court had characterized the defendant lender as being

much more than a lender content to lend money at interest on the security of real property. It became an active participant in a home construction enterprise. It had the right to exercise extensive control of the enterprise. Its financing, which made the enterprise possible, took on ramifications beyond the domain of the usual money lender. It received not only interest on its construction loans, but also substantial fees for making them, a 20 percent capital gain for "warehousing" the land, and protection from loss of profits in the event individual home buyers sought permanent financing elsewhere.\(^3\)

A year later, the *Bradler* court limited the holding in *Connor* to a situation where a construction lender acted beyond his normal capacity and the borrower was undercapitalized.\(^4\) Moreover, the California legislature displayed its concern over *Connor* and its possible adverse effect upon the state’s housing industry by adopting a statute limiting the possible application of the case’s doctrine.\(^5\)

Since the decision in *Connor*, neither California nor any other jurisdiction has found a construction lender liable to a subsequent purchaser in a negligence action based on structural defects. The courts have refused to find the necessary extra involvement of the construction lender,\(^6\) and, given the lack of the case’s

\(^{13}\) 69 Cal. 2d at 864, 447 P.2d at 616, 73 Cal. Rptr. at 376.


\(^{15}\) **CAL. CIV. CODE** § 3434 (West 1970). The statute provides:

A lender who makes a loan of money, the proceeds of which are used or may be used by the borrower to finance the design, manufacture, construction, repair, modification or improvement of real or personal property for sale or lease to others, shall not be held liable to third persons for any loss or damage occasioned by any defect in the real or personal property so designed, manufactured, constructed, repaired, modified or improved or for any loss or damage resulting from the failure of the borrower to use due care in the design, manufacture, construction, repair, modification or improvement of such real or personal property, unless such loss or damage is a result of an act of the lender outside the scope of the activities of a lender of money or unless the lender has been a party to misrepresentations with respect to such real or personal property.

*Id.*

development, the legal community’s initial concern over Connor seems to have been unwarranted.\textsuperscript{17}

II. LIABILITY OF THE VENDOR

When the lender forecloses, or takes a deed in lieu of foreclosure, on a completed housing or condominium project and then resells the completed units, he may be acting as a vendor for the purpose of determining liability for construction defects. Generally, the vendor of real estate is not liable for a vendee’s or third party’s personal injuries which were proximately caused by a defective condition of the property.\textsuperscript{18} In some cases this is true even if the vendor had personal knowledge of the defect which caused the injury.\textsuperscript{19} Clearly, the vendor is not liable if the harm arises from a condition which came into existence after the sale of the property.\textsuperscript{20}

The lender needs to be aware of recently developed exceptions to the general rule of the vendor’s nonliability. Vendors have been held liable for injuries resulting from defects which created an unreasonable danger to those using the premises, if the vendor knew of the defects and could reasonably have anticipated that the vendee would not discover them.\textsuperscript{21} If the vendor actively con-


\textsc{RESTATEMENT} (SECOND) OF TORTS § 352 (1965) [hereinafter cited as \textsc{RESTATEMENT}].

\textsuperscript{19} Smith v. Tucker, 151 Tenn. 347, 270 S.W. 16 (1925).

\textsuperscript{20} \textsc{RESTATEMENT} § 351.


(1) A vendor of land who conceals or fails to disclose to his vendee any condition, whether natural or artificial, which involves unreasonable risk to persons on the land, is subject to liability to the vendee and others upon the land with the consent of the vendee or his subvendee for physical harm caused by the condition after the vendee has taken possession, if

(a) the vendee does not know or have reason to know of the condition or the risk involved, and

(b) the vendor knows or has reason to know of the condition, and realizes or
sealed the defect, potential liability exists until the vendee discovers the defect or has a reasonable opportunity to do so. Otherwise, the vendor is liable until the vendee has had a reasonable time to discover the defective condition and take the necessary precautions. \(^{22}\) Despite a trend toward expansion of liability in this area, there are still many recent decisions in which courts have not accepted this exception to vendor nonliability. \(^{23}\)

Another exception to the general rule of vendor nonliability is recognized where a public or private nuisance exists. If, for example, the condition of the subject property is such that an unreasonable risk of harm is created to those outside the property, the vendor remains liable for a reasonable time after the transfer of possession for injuries proximately caused by the condition of the premises. \(^{24}\)

### III. LIABILITY OF THE BUILDER-VENDOR

A construction lender taking title to a partially-completed condominium or housing development by foreclosure or a deed in lieu of foreclosure might be held liable as a builder-vendor \(^{25}\) for defective construction. The courts have distinguished the builder-vendor from an ordinary vendor, who is commonly an inexperienced consumer not involved in the building process. A  

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\(^{24}\) Swinton v. Whitinsville Sav. Bank, 311 Mass. 677, 42 N.E.2d 808 (1942); Day v. Frederickson, 153 Minn. 380, 190 N.W. 788 (1922); Riley v. White, 231 S.W.2d 291 (Mo. Ct. App. 1950).


The definition of builder as used in this article is:

One whose occupation is the building or erection of structures, the controlling and directing of construction, or the planning, constructing, remodeling and adopting to particular uses buildings and other structures.

LENDER-VENDOR’S LIABILITY

builder-vendor, on the other hand, has expertise in the construction business and expects profits from his building activity. Because of this distinction, courts have imposed liability for structural defects by analogizing the builder-vendor to the manufacturer of chattels in product liability cases. Suits against the builder-vendor can, therefore, be based upon fraud, breach of contract, breach of express or implied warranty, negligence, and strict liability. In considering the liability of the lender as a builder-vendor, this note will limit its scope to developments in the areas of implied warranty, negligence, and strict liability.

A. Implied Warranty

A brief discussion of express warranty provides an introduction to an examination of implied warranty. In the builder-vendor classification, even statements of a general nature made concerning the quality of the construction may be interpreted by courts as an express warranty. The plaintiff bringing an action under express warranty faces many obstacles to recovery, such as the parol evidence rule, the merger doctrine, and a classification of the statement as mere "puffing." Implied warranty, first applied to the sale of realty in 1957, is now generally accepted as a cause of action in lawsuits involving real estate sales. Courts have variously stated the content of

E.g., Jackson v. Buesgens, 290 Minn. 78, 186 N.W.2d 184 (1971).
See, e.g., Jackson v. Buesgens, 290 Minn. 78, 186 N.W.2d 184 (1971); Caparelli v. Rolling Greens, Inc., 39 N.J. 585, 190 A.2d 369 (1963); LaBar v. Lindstrom, 158 Minn. 396, 197 N.W. 756 (1924).
See text accompanying notes 47-54 infra.
See, e.g., UNIFORM COMMERCIAL CODE § 2-313(2), for a definition of "puffing" as it applies to the sale of goods.
a builder-vendor's implied warranty as a warranty of fitness,\textsuperscript{38} or merchantability,\textsuperscript{39} or as a warranty that construction has been completed in a workmanlike manner.\textsuperscript{40} Although some jurisdictions have eliminated implied warranty through statute,\textsuperscript{41} and some courts have refused to adopt it,\textsuperscript{42} the modern court attitude is reflected in \textit{Gable v. Silver}.\textsuperscript{43} There the court stated that application of the doctrine of implied warranty to sales of realty is "based upon present day trends, logic, and practical justice in realty dealings."\textsuperscript{44}

The original rule was that an implied warranty arose only from the sale of unfinished dwellings. Colorado has taken the lead in extending the rule to homes purchased after completion of construction,\textsuperscript{45} and, although the Colorado extension has been

\begin{footnotesize}
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\item E.g., Miller v. Cannon Hill Estates, Ltd., [1931] 2 K.B. 113.
\item E.g., Gable v. Silver, 258 So. 2d 11 (Fla. Dist. Ct. App. 1972).
\item 258 So. 2d 11 (Fla. Dist. Ct. App. 1972).
\item Id. at 18.
\item Carpenter v. Donohue, 154 Colo. 78, 388 P.2d 399 (1964). The Colorado Supreme Court stated:
\begin{quote}
That a different rule should apply to the purchaser of a house which is near completion than would apply to one who purchases a new house seems incongruous. To say that the former may rely on an implied warranty and the latter cannot is recognizing a distinction without a reasonable basis for it . . . .
\end{quote}
\begin{quote}
We hold that the implied warranty doctrine is extended to include agreements between builder-vendors and purchasers for the sale of newly constructed buildings, completed at the time of contracting. There is an
\end{quote}
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followed, it has yet to be accepted by a majority of the states.

The doctrine of merger affects the law of both implied and express warranty. The majority of states have followed the rule "that in a contract to convey real property the deed merges with the contract and the only redress of a purchaser may be found in the covenants in the deed or in an action to rescind based on fraud or mistake." To circumvent the problem in Colorado, the supreme court has held that warranties on a contract for construction and sale of a house do not merge with the deed, as delivery of the deed is only part performance of such a contract. In other jurisdictions, courts have not allowed the doctrine of merger to limit the scope of implied warranty in this area. For support, they cite reasons of public policy, characterize the nature of the defect as latent rather than patent, look to the intent of the parties, and refer to state statutes.

The standards of conformity required by implied warranties are as diverse as the rationales for adopting the doctrine of implied warranty. In Colorado the standard of reasonable conformity with respect to the implied warranty in new housing has been expressed as "what the workman of average skill and intelligence (the conscientious worker) would ordinarily do." A much quoted standard of conformity is contained in Hubler v. Bachman:

implied warranty that builder-vendors have complied with the building code of the area in which the structure is located.

Id. at 83, 388 P.2d at 402.


It is the duty of a builder of a structure to perform his work in a workmanlike manner, that is, the work should be done as a skilled workman should do it and the law exacts from a builder, ordinary care and skill only.\(^5\) Therefore, the standard of conformity is flexible and subject to local interpretation. The construction lender who becomes a builder-vendor can only take notice of the inexact standards and proceed with appropriate caution, knowing only that perfection is not demanded.

The potential liability of the builder-vendor can be limited in two ways: First, warranties can be held to apply only to the first purchaser;\(^5^8\) and, second, statutes can be used to limit the time in which an action must be brought.\(^5^9\)

### B. Negligence\(^6^0\)

The introduction of negligence into the field of real estate initially was blocked by the requirement of privity of contract.\(^6^1\) This doctrine held that a duty was owed only to a party in privity of contract with the defendant; adherence to privity resulted in liability of the builder-vendor only to the parties with whom he had contracted.\(^6^2\) The doctrine was first eroded in cases involving chattels. In *MacPherson v. Buick Motor Co.*\(^6^3\) the plaintiff was allowed to bring suit against the manufacturer of the plaintiff's automobile even though he had purchased from a retail dealer and appeared to be without privity of contract. In circumventing the privity requirement, Judge Cardozo stated:

If the nature of a thing is such that it is reasonably certain to place life and limb in peril when negligently made, it is then a thing of

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\(^5\) *Id.* at 22, 230 N.E.2d at 463.


\(^5^9\) See note 100 infra.


\(^6^1\) Curtin v. Somerset, 140 Pa. 70, 21 A. 244 (1891); Winterbottom v. Wright, 10 M. & W. 109, 152 Eng. Rep. 402 (Ex. 1842).


\(^6^3\) 217 N.Y. 382, 111 N.E. 1060 (1916).
danger. . . . If to the element of danger there is added knowledge that the thing will be used by persons other than the purchaser, and used without new tests, then, irrespective of contracts, the manufacturer of this thing of danger is under a duty to make it carefully.64

At first the courts refused to extend the MacPherson rationale to realty,65 but exceptions to the strict requirement of contractual privity were gradually developed.66 The trend toward the elimination of privity in construction liability was begun in 1932 in Wright v. Holland Furnace Co.67 The defendant in Wright argued that the only party to whom he was liable was Mrs. Wright, because she was the only party with whom he had contracted; the court, however, found privity on the part of her husband and son. Later, in Hanna v. Fletcher,68 the common law rule of privity was specifically rejected and the MacPherson doctrine was adopted in its place.

Colorado has applied the MacPherson doctrine to real property. The Colorado Supreme Court has held, in a negligence action, that liability results because of a breach of duty owed to others, and not because of a breach of a contractual relationship.69

In 1972 the court of appeals stated:

By applying the MacPherson doctrine to the building of structures on real property, we hold that where the completed work is reasonably certain to endanger third persons if negligently constructed, a contractor or builder of real property is liable for injuries or death of third persons occurring after the completion of the work and after its acceptance by the owner.70

In other jurisdictions application of the MacPherson doctrine to cases of builder-vendor liability has become almost the univer-

64 Id. at 389, 111 N.E. at 1053.
65 Ford v. Sturgis, 14 F.2d 253 (D.C. Cir. 1926). The court stated that the negligence of a contractor in constructing a building will not render him liable to a third person, who is injured in consequence thereof after the work has been completed and accepted by the owner of the building. This case still provides the basis upon which modern courts have refused to extend to real estate the MacPherson view of tort duty.
66 Prosser states that the historic exceptions to the privity rule developed in cases involving fraud, inherently dangerous objects, and implied privity. Prosser § 104, at 680-81.
67 186 Minn. 265, 243 N.W. 387 (1932).
sal rule. A builder is held liable to those who are foreseeably expected to use the premises where injuries are caused by the defective structure when dangerous conditions known to the builder are not disclosed to the purchaser. The rule has been extended to work done negligently, to negligent design of a building, and to repair as well as to original construction. This last extension is very important to the construction lender who forecloses on a completed project, for he may be considered a builder-vendor for liability purposes if he undertakes any repair work in order to sell the housing units. Recently, a builder-vendor was held liable for an injury caused by a sliding glass door after possession of the property had been surrendered by the builder-vendor and the plaintiff had, in remodeling, moved the door that caused the accident.

Liability for negligence can be based upon a builder's "reason to know" of the defect, as well as upon actual knowledge. The rationale for not requiring actual knowledge is the purchaser's lack of familiarity with the complexities of home construction, and the feeling of courts that the purchaser should be able to rely upon the builder's skill.

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71 PROSSER § 104, at 681.
75 Hanna v. Fletcher, 231 F.2d 469 (D.C. Cir.), cert. denied, 351 U.S. 989 (1956). The Restatement says of builder liability in negligence:

One who on behalf of the possessor of land erects a structure or creates any other condition thereon is subject to liability to others upon or outside of the land for physical harm caused to them by the dangerous character of the structure or condition after his work has been accepted by the possessor, under the same rules as those determining the liability of one who as manufacturer or independent contractor makes a chattel for the use of others.

RESTATEMENT § 385.
78 The question arises as to the standard of care a builder must use in his attempt to discover construction defects. The homebuilder is in a strong position to argue that he should not be held to the same duty as the manufacturer of chattels to which MacPherson initially applied. Bearman, supra note 60, at 569. Such an argument would draw upon the inherent differences between the more complex home and the ordinary chattel. To
The difficulty in establishing all the elements composing negligence renders this form of action unsatisfactory in meeting the needs of the plaintiff. Purchasers, therefore, have relied upon other theories of law, such as implied warranty or strict liability, in actions against builders.

C. **Strict Liability**

In the past half century, the law of negligence has experienced a whittling down of the idea that there is no liability without fault, because policy considerations have demanded the re-emergence of the even older rule of strict liability. Strict liability is codified in section 402A of the *Restatement (Second) of Torts* and, if extended to real estate cases, section 402A could illustrate, it has been estimated the average home consists of 30,000 parts, six times as many as an automobile. *American Housing—Problems and Prospects*, 20th Century Fund, 1944, at 41. Also, a home is far more vulnerable to weather-created defects than the ordinary chattel. For these reasons, the lender could argue that a homebuilder should be held to a lower standard of care than a manufacturer of chattels. For a discussion of why *MacPherson* should not be extended to real property, see Judge Prettyman's dissenting opinion in Hanna v. Fletcher, 231 F.2d 469 (D.C. Cir.), cert. denied, 351 U.S. 989 (1956).

The actor is liable for an invasion of an interest of another, if:
(a) the interest invaded is protected against unintentional invasion, and
(b) the conduct of the actor is negligent with respect to the other, or a class of persons within which he is included, and
(c) the actor's conduct is a legal cause of the invasion, and
(d) the other has not so conducted himself as to disable himself from bringing an action for such invasion.

*Restatement* § 281.

The action of negligence has assumed a much more favorable position with respect to the plaintiffs through the emergence of res ipsa loquitur. *Id.* § 328D. When applicable to the circumstances of a case, all of the elements of negligence are satisfied by res ipsa loquitur with the exception of proximate cause. For a discussion of what constitutes proximate cause, see Milwaukee & St. P. Ry. v. Kellogg, 94 U.S. 469 (1876):

The true rule is that what is the proximate cause of an injury is ordinarily a question for the jury. It is not a question of science or of legal knowledge. It is to be determined as a fact, in view of the circumstances of fact attending it.

*Id.* at 474.


See Prosser § 75, at 494.

Special Liability of Seller of Product for Physical Harm to User or Consumer
(1) One who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property, if
(a) the seller is engaged in the business of selling such a product, and
provide for the imposition of liability on a builder-vendor regardless of the degree of care exercised in the construction process. This extension of section 402A seems reasonable, in light of a recent amendment to the section to allow recovery for "any product," including, arguably, realty. Although the concept of strict liability for products has been accepted by a majority of the states, the application of strict liability to the field of real estate first occurred in Schipper v. Levitt & Sons, Inc.

In Schipper plaintiffs' infant child was scalded by water discharged from a bathroom faucet. The defendant, a mass builder of homes, had deliberately failed to follow a manufacturer’s recommendation that a mixing valve be used to prevent the discharge of excessively hot water. In imposing strict liability on the homebuilder, the court said:

The law should be based on current concepts of what is right and just and the judiciary should be alert to the never-ending need for keeping its common law principles abreast of the times. Ancient distinctions which make no sense in today's society and tend to discredit the law should be rejected . . . . We consider that there are no meaningful distinctions between Levitt's mass production and sale of homes and the mass production and sale of automobiles

(b) it is expected to and does reach the user or consumer without substantial change in the condition in which it is sold.

(2) The rule stated in Subsection (1) applies although

(a) the seller has exercised all possible care in the preparation and sale of his product, and

(b) the user or consumer has not bought the product from or entered into any contractual relation with the seller.

RESTATEMENT § 402A.

Professor Prosser has said in reference to section 402A that:

This was accompanied by a comment saying that if anyone wished to treat this as a “warranty,” there was nothing to prevent it; but if so, it should be recognized, that the “warranty” was a very different kind of warranty from those usually found in the sale of goods, and that it is not subject to the various contract rules which have grown up to surround such sales.

PROSSER § 98, at 657.

PROSSER § 98, at 658.


and that the pertinent overriding policy considerations are the same. That being so, the warranty or strict liability principles of Henning-sen and Santor should be carried over into the realty field, at least in the aspect dealt with here.68

Schipper presented the perfect factual situation for imposing liability because Levitt & Sons, as a mass producer of homes, was analogous to the manufacturer of chattels. California has further extended this imposition of strict liability in realty to cover economic loss67 and loss attributable to defective building sites sold by a developer, in addition to allowing recovery for personal injuries.68 These decisions demonstrate the far-reaching effects of adoption of the principle of strict liability.

Although it had been predicted that strict liability would rapidly become the rule in the housing construction industry,89 opposition to such an extension of the doctrine into realty has been expressed. Schipper, therefore, has gained only limited acceptance in the real estate field.90 The Colorado Court of Appeals enunciated such opposition in Wright v. Creative Corp.91 where the plaintiffs relied on Schipper to establish strict liability for injuries sustained by their 5-year old child who walked through a sliding-glass door. The court stated:

Even if we assume that Creative was a mass producer of homes, this court would be remiss in its responsibilities if it did not closely consider the need for awarding damages without requiring a specific showing of negligence on the part of the mass producer.92

The court concluded that the purposes served by the doctrine of strict liability would not be achieved by its application to the

68 44 N.J. at 90, 207 A.2d at 325.
67 Kriegler v. Eichler Homes, Inc., 269 Cal. App. 2d 224, 74 Cal. Rptr. 749 (1969). The court found the builder liable for the $5,073.18 diminution in the value of the home due to the corroding of a radiant heating system rendering it nonfunctional.
66 Avner v. Longridge Estates, 272 Cal. App. 2d 607, 77 Cal. Rptr. 633 (1969). The developer was liable for a defective building site where the rear portion of the site, which had been improved with a residential structure, had failed due to poor drainage and inadequate soil compaction. Another example of California's extension of the law is provided in Stuart v. Crestview Mutual Water Co., 34 Cal. App. 3d 802, 110 Cal. Rptr. 543 (1973), where a developer was held liable for fire damages caused in part by a failure to supply an adequate water distribution system.
90 PROSSER § 104, at 682.
93 Id. at 581, 498 P.2d at 1182.
housing industry because of distinctions between real property and chattels. Stating that the underlying reason for development of the doctrine of strict liability was to assure that the cost of injuries attributable to a defective product would be borne by the manufacturers who put the product on the market, rather than by the powerless purchaser who was the subject of the injury, the court said: "[T]he predominant problem with effectuating recovery for injuries caused by a chattel is the difficulty of finding the negligent party and effecting a recovery from that party." It pointed out that a builder cannot limit his liabilities by express warranties and disclaimers as easily as a manufacturer can, and it noted that a defect is more readily traced back to the builder than to a manufacturer, since there are more opportunities to inspect the real property while under construction than there are to inspect the manufacturing of a chattel.

A plaintiff thus has three possible causes of action against a builder-vendor: negligence, implied warranty, and strict liability. Depending on the jurisdiction, a plaintiff may bring suit on all three theories concurrently. Regardless of the theory behind an action, the state statutes govern the time period in which the action must be brought. In Colorado the plaintiff is allowed up to 10 years to bring an action, and so a builder is open to potential liability for a considerable length of time.

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81 Id. at 582, 498 P.2d at 1182.
82 Id. See also Macomber v. Cox, 249 Ore. 61, 435 P.2d 462 (1967). In this case Oregon refused to extend strict liability into the area of real property.
84 The applicable statute provides:
   (1) All actions against any architect, contractor, engineer or inspector brought to recover damages for injury to person or property caused by the design, planning, supervision, inspection, construction, or observation of construction of any improvement to real property shall be brought within two years after the claim for relief arises, and not thereafter, but in no case shall such an action be brought more than ten years after the substantial completion of the improvement to the real property, except as provided in subsection (2) of this section.
   (2) In case such injury to person or property occurs during the tenth year after substantial completion of the improvement to real property, said action shall be brought within one year after the date upon which said injury occurred.
   (3) Nothing in this section shall be construed as extending the period or periods provided by the laws of Colorado or by agreement of the parties for
IV. Prospective Lender-Vendor Liability for Structural Defects

Having reviewed the law as it presently applies to the three roles a construction lender may fill in a foreclosure situation, this note turns now to an analysis of what potential liability a lender may incur by foreclosing and to the protections available against such liability.

Foreclosure may have special implications to the lender-vendor's liability in his role as a lender. As noted in the discussion of the construction lender's liability, the court's primary interest has focused on the lender's acting beyond his capacity as an ordinary mortgagee. The foreclosure and subsequent completion and sale of the units may, in the eyes of the court, satisfy this condition of acting beyond the ordinary lender's capacity. By foreclosing before completion of the housing project, the construction lender functions beyond his normal operations in completing and marketing the units. In addition to a change in the lender's activities, the nature of the lender's economic return also changes. After foreclosure, rather than realizing a set rate of interest, any profits to be realized will be directly tied to the success in marketing the housing units. Imposition of liability on the lender, then, would be dependent upon his activities and on the altered nature of his return due to the foreclosure.

On the other hand, there are strong arguments against imposition of liability on the lender-vendor. While completion and resale of a project are not common functions of the lending industry, they become common functions when a borrowing developer is in default. To rebut the argument that the lender-vendor's financial interest is "beyond the ordinary," a distinction can be drawn between the situation of the foreclosing mortgagee and that of the defendant in Connor v. Great Western Savings & Loan Association. In Connor the nature of the lender's return was

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bringing any action, nor shall this section be construed as creating any cause of action not existing or recognized before June 1, 1969.


See text accompanying notes 1-17 supra.

It is assumed that, if the project is sold only for loss minimization, it would still be viewed as a nontypical form of return to the lender by the court.

49 Cal. at 647, 320 P.2d at 16.
determined prior to the closing of the loan, whereas in a foreclosure proceeding the change in the lender's return does not occur until well after the closing, and is not planned by the lender at the time the loan is made.\textsuperscript{100}

The potential liability of the lender-vendor, where construction of the development is completed, arises because of the mortgagee's characterization as a vendor. Normally, a vendor's liability has been limited to defects of which he had actual knowledge, with exceptions to the general rule of nonliability in cases which involve the existence of a public or private nuisance on the property.\textsuperscript{101} This rule is generally adequate to protect the lender-vendor from liability. However, the factual situation considered in this note differs from that of the normal real estate transaction, which would be subject to the general rule of vendor's nonliability.\textsuperscript{102} Here, the units to be sold by the lender have never been occupied by him; thus, the chance for his discovery of defects for which he would be liable are minimal.\textsuperscript{103}

As opposed to the normal lender-vendor, the construction lender, although not technically involved in the construction of the units, will normally conduct periodic inspections of the construction and review the plans and specifications prior to the committal of funds. This minimal involvement and expertise exceeds that of an ordinary vendor and may be another reason for courts to deny the application of the general rule of vendor nonliability. The construction lender, moreover, maintains a profit motive dissimilar to that of an ordinary vendor. Based upon the construction lender's involvement as an inspector and his profit motive, courts should not treat this lender like a "mere vendor" concerning potential liability for structural defects.

When a construction lender takes over an uncompleted pro-

\textsuperscript{100} This article assumes that the construction lender makes the loan without expectation of inevitable default and foreclosure. The problem that may be created when the lender has knowledge that the borrower will inevitably default is not considered.

\textsuperscript{101} See text accompanying note 24 supra.

\textsuperscript{102} Analogy may be made to Utz v. Moss, 31 Colo. App. 475, 503 P.2d 365 (1972), in which the court held that a realty company should not be considered an ordinary homeowner for purposes of establishing privity between the builder and the second purchaser of the house.

\textsuperscript{103} In the normal vendor situation, the vendor has occupied the premises and has had a reasonable opportunity to discover defects for which he may be held liable.
ject, the greatest chance of liability arises. In such a case, courts are likely to apply the law of builder-vendor, which is much more strict than that imposed upon the lender or vendor, because a builder-vendor faces actions arising out of implied warranty, negligence, and strict liability. It is doubtful that the lender will be able to argue that he is not actually a builder, since courts have already extended liability beyond actual builders to developers. Therefore, it would be difficult for the lender to prove that he did not at least become a developer in assuming the responsibility for completing the units.

Under the theory of implied warranty, the construction lender might avoid liability if he sold the units after completion—at least in those jurisdictions which have not extended warranty to houses purchased after construction. In Colorado and other jurisdictions extending the rule to completed housing, however, liability could not be circumvented in this manner.

It is clear that the lender-vendor should be liable for defects in construction completed under his ownership. The question is whether he should also be liable for defects in work completed by the defaulting developer. Since the construction lender inspects at various stages of construction prior to the foreclosure, it is, arguably, reasonable to burden him with the warranty of the builder's work. This argument is strengthened by the fact that, in completing the project, the lender would have an even better opportunity to inspect the work of his predecessor and to determine and correct any defects. In support of the lender-vendor, it can be argued that it would be too burdensome for him to warrant all of the builder's construction. Due to the time and costs involved, the opportunities for such inspections are somewhat limited. Also, the lender's expertise in construction is limited in that the inspectors cannot be expected to be qualified engineers, architects, and contractors, but rather are more likely to be specialists in the area of real estate finance, appraisal, and development.

See text accompanying notes 25-59 supra.
See text accompanying notes 60-79 supra.
See text accompanying notes 80-98 supra.
See cases cited notes 45-46 supra.
The complex nature of the housing units makes it impossible to detect all of the potential errors.

In recognition of these conflicting arguments, a court might reach a compromise between the extremes of no warranty for the work of the original builder and absolute warranty once the lender does work as a builder. Perhaps courts will impose a warranty against any defects created by the builder which should have been discoverable.

The concept of "deeper pockets," recently expanded in consumer credit cases, may provide courts the argument necessary to tip the scales against the lender-vendor. The courts, under this doctrine, tend to place the financial burden upon the party best able to bear it. The problem presented involves a home buyer against an institutional construction lender. Doubtless the lender is in a far better position to bear the financial risk of structural defects, but imposing increased costs on the construction lender could well result in higher interest rates, increased cost of housing, and a greater shortage of housing. At the same time, however, the lender is more aware of the problems which arise in housing, and is able to reduce his potential liability through other means; thus, the arguments against the lender-vendor seem to outweigh the arguments in his favor. The lender stands in a position to minimize the risk to the consumers, and, through insurance, to minimize his own risk.

Negligence actions have given rise to builder's liability for defects in design as well as in construction. The lender, as noted, is not an expert in the area of architectural design, and it is, therefore, arguable that he should bear no liability for defective design. However, the lender inspects the preliminary plans of the project before construction, and at this time is presented with the opportunity to require alterations. Moreover, while it is conceded that the construction lender does not have the expertise of an architect, he does have a far greater knowledge of functional dwelling designs than does the average purchaser. Many lenders may very well have expertise in housing designs comparable to [Cross v. M.C. Carlisle & Co., 368 F.2d 947 (1st Cir. 1966).]

[Cross v. M.C. Carlisle & Co., 368 F.2d 947 (1st Cir. 1966).]

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that of a builder, who, even though he is not a licensed architect, is held liable for defects in design.

Strict liability under section 402A requires that the defendant be “in the business of selling such a product”\(^{112}\) and a major problem arises as to whether a lender can be considered a seller within the meaning of the section. The builder-vendor is clearly in the business of selling houses and condominiums and so may be liable under strict liability as a seller of “any product.”\(^{113}\) However, the construction lender is in the business of lending money at a set rate of interest, and is not normally involved in marketing real estate. It is difficult to conceive of a court holding that a construction lender, who obtained ownership by involuntary circumstances beyond his control, was “in the business of selling” for purposes of strict liability.

In summary, the theories of liability against the lender-vendor as lender, vendor, or builder-vendor may be sufficient in themselves for courts to impose liability for injuries resulting from construction defects. If a court cannot fit a lender-vendor into any one role, the multiple theories, taken in the aggregate, may convince a court that a lender-vendor should be liable to purchasers of new housing for such injuries.

**CONCLUSION**

There are several possible alternatives by which a lender-vendor may avoid liability. The lender could, at the time of resale of the units, include in the contracts an “as is” clause or other express disclaimers of warranties. The lender might advertise the sale of the units as a liquidation and characterize itself not as a vendor, but as a mortgagee attempting to minimize its losses in recovering debt. The lender could publicize any disclaimers, but this would be undesirable because its probable result would be depressed market values and a larger potential loss to the lender. The lender could reasonably expect that the disclaimers would be challenged in the event of physical injury; moreover, disclaimers would not protect a lender from liability for its own negligence. It seems unlikely, given the bargaining position of home buyers, that courts will give much credence to such disclaimers.

\(^{112}\) Restatement § 402A.

\(^{113}\) Id.
Another possible solution is the use of indemnity contracts with the borrower-builder for any liability to which the lender is exposed. But, as the borrower is in default on the loan and, therefore, may well be judgment proof, it appears futile for the lender to require such an assurance.

The lender may be able to limit liability through the creation of a subsidiary to perform the function of selling the units, or of both purchasing them at foreclosure and reselling them. The pitfall of the subsidiary solution is that courts may pierce the corporate veil of the subsidiary if there is inadequate capitalization. Adequacy of a subsidiary’s capitalization is measured by the nature and the magnitude of the subsidiary’s undertakings, and courts look for a reasonable “cushion” for creditors. If the corporation will not have sufficient funds to meet its debts or prospective liabilities, then the capitalization will be held inadequate.

Liability of the mortgagee can depend upon the lender’s functioning as an inspector of the construction process. With respect to this function, the lender can avoid liability by subcontracting the inspection function to a title insurance company. The title insurance company would then make the necessary inspections prior to the loan disbursements. This solution appears insufficient, however, because the lender is relying on a delegation of duty to relieve him from liability, and such reliance will probably be unacceptable to the courts.

Large institutional lenders can use smaller institutional investors or mortgage banking firms to provide a possible shield.
from liability. Under such an arrangement a loan participation agreement would be entered into between the two lenders, where the funds for the loan are provided by both lenders but primarily by the larger mortgagee. The smaller lender takes care of the inspections, disbursements, and loan servicing with the larger lender playing a passive role by collecting the interest and wiring funds. Since the active lender performs almost all the functions to which liability can be attributed, it seems likely that the passive role of the loan participant will place him outside of liability for structural defects. The argument is further strengthened in that the passive lender in many instances will be geographically separated from the project. The only problem arising from this solution is that courts may impute the negligence of the active lender to the passive one, thus establishing liability on behalf of the passive mortgagee.

The only safe alternative for the construction mortgagee is insurance. Vast improvements in warranty insurance of housing and condominium units have recently been made by the insurance industry. In Colorado, homeowners warranty insurance is being instituted by the home building industry. The policy provides for 10-year protection to the home buyer. The lender-vendor, by requiring builders to take out this type of warranty insurance, provides the best possible protection for itself against potential liability for structural defects in the housing units as well as providing adequate economic protection to the new home purchaser.

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118 Homeowners warranty insurance has been extended to high-rise condominiums. See *The Appraiser*, vol. 31, Dec. 1975, at 8.