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## Lender liability for construction defects when selling a new home acquired from its financially insolvent builder.

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In all states, courts recognize an implied warranty of habitability that arises upon the sale of a new home. Translated into non-legal terms, 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 homebuyer. The warranty is not just the builder's warranty. 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*.

Similarly, it seems highly likely that a lender 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 actively participated in any aspect of the construction. Do not misunderstand; merely lending the builder money so he can build the home does not result in liability. Rather it is the sale of the home to the buyer that gives rise to the liability under the implied warranty of habitability.

Anyone associated with new home construction knows that construction defect litigation is a very lucrative area for plaintiffs' attorneys. Upon the discovery of construction defects, a homeowner's attorney will seek to recover against potentially liable defendants based upon different theories of liability. Not surprisingly, the homeowner's attorney will



first and foremost initially focus upon the party that sold his client the home. There is no doubt that a lender acting merely as a financier is not liable for construction defects. However, when a bank's role expands, the new role carries increasing liability. Most reported case law dealing with lender liability for selling foreclosed homes arose from home sales that occurred in the late 1970s, during the previous housing slump in the U.S. economy. In our current economically distressed market, as an increasing number of lenders acquire new homes from financially strapped builders, lenders should be aware of potential liability if they become the vendor of these homes.

The two most common theories of liability for construction defects are negligence and breach of implied warranty of liability. Either theory may be a basis for lender liability depending upon the lender's action prior to sale of the new home.

Typically, when someone acts, he is under a legal obligation or duty to act with reasonable care. So, when a lender takes title to a foreclosed home and completes construction he is under a duty to act with reasonable care in completing construction. If the lender fails to exercise reasonable care, he will be liable for construction defects arising from his negligence. In *Pinnacle Port Community Association Inc., v. Orenstein*, 872 F.2d 1536 (Ct App, 11th Cir. 1989), the condominium association sued a lender in negligence for structural defects because the lender became involved in the completion of the project when the builder ran into financial problems. The lender's involvement included inspecting the repairs and issuing payment for the repairs. The Court of Appeals held that the lender could be liable in negligence for structural defects because his role had expanded further than that of a mere lender. *Pinnacle at 1545*.

Courts have expanded this liability beyond the items that the lender completed and have made the lender liable for other aspects of the home. In *Chotka v. Fidelco Growth Investors*, 383 So.2d 1169 (FL Ct. App, 2nd District 1980), a 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 building was complete except for several recreational features, such as a pool, sauna, tennis court and game room. After these amenities were completed by the lender, the lender sold units to purchasers. The court found that by 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.*

Unfortunately, most lenders believe that if they do not actually complete the construction themselves, for instance, they hired independent contractors, or the lender's cost to complete work is insignificant compared to the overall cost of the project, they will not have liability. However, between the two parties, the selling lender and the innocent homebuyer, the courts that have considered this issue have found in favor of the homebuyer. In *Kirkman v. Parex, Inc.*, 632 S.E.2d 854 (S.C. 2006), the lender took title to the new home when the builder defaulted on his loan. The lender hired an independent contractor to touch up sheetrock and paint and complete the installation of the heating and air system, hardwood floors, and light fixtures. The cost of this work was about \$40,000 and took approximately 1½ months to complete. The lender sold the home for \$232,900 (the same price the buyers were willing to pay the builder for the home) and the lender included an "as-is" provision in the deed. The homeowners sued the lenders several years later for breach of the implied warranty of habitability because they had to spend about \$45,000 to repair a construction defect in the exterior stucco. Both the Trial Court and Court of Appeals held in favor of the lender finding that the lender was not liable for defects. Unfortunately, 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.

Under the doctrine of *caveat venditor*, the seller of a new house impliedly warrants the habitability of the house. *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." *Kirkland at 482-483.*

Persistent, the lender 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. *Kirkland at 485.*

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.

Not all jurisdictions have considered whether a lender is liable for breach of the implied warranty of habitability. However, courts in states that have considered this issue found lender liability using two different legal theories. Liability for breach of the implied warranty of habitability, i.e. the home is not safe to inhabit, is a potential basis for liability when the lender is the vendor of the home.

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