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The Financially Irresponsible Home Builder: A Challenge to Builder Liability Law

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THE FINANCIALLY IRRESPONSIBLE HOME BUILDER:
A CHALLENGE TO BUILDER LIABILITY LAW

The most important purchase made by most American families is their home. It represents their most expensive purchase, as well as their most permanent one; it provides shelter and recreation; it delineates social class, and determines friends and associates for parents and children alike; it is a type of forced savings for the family, and its appreciation in value makes the home an investment providing a hedge against inflation.

But the recently realized dreams of home buyers can easily turn to nightmares filled with frustration, pain, or financial loss. Only when his infant child is scalded with water from the bathroom sink does the resident realize the builder's negligence in not installing a mixing valve.\(^1\) Defective installation of the water heater may result in an explosion demolishing the new home.\(^2\) The new house may be damaged by fire caused by an improperly constructed fireplace and chimney.\(^3\) Or the new homeowner may be pestered by numerous irritations such as malfunctioning bathroom plumbing, water leakage in the basement and roof, and unsatisfactory kitchen cabinets.\(^4\) Or ...\(^5\)

These situations are taken from the burgeoning group of suits against home builders. They pose three basic questions for the unfortunate home buyer and his attorney:

1. Is the home builder legally responsible for the injuries and damages resulting from his defective construction?
2. Assuming an affirmative answer to the question of the builder's legal liability, is he financially capable of answering a judgment?
3. Naturally flowing from the first two questions is a third question: if the builder is legally responsible but financially insolvent, to whom can (should) the buyer look for relief?

Obviously, each of these questions raises many subsidiary issues of legal theory and proof. This comment does not attempt to dissect this growing area of law. Instead it focuses on the dichotomy between the home builder's legal and financial responsibility. First, an overview of the home builder's legal liability is presented. This is followed by examination of the home building industry, emphasizing the problem

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\(^3\) Humber v. Morton, 426 S.W.2d 554 (Tex. 1968), noted in 1 TEXAS TECH. L. REV. 111 (1969).
\(^5\) For a dramatic interpretation of four recent cases which prompted suits against home builders see Young & Harper, Quaere: Caveat Emptor or Caveat Venditor?, 24 ARK. L. REV. 245, 246-47 (1970).
of the builder-developer's financial inability to answer judgments against him. Lastly, suggestions are made for alternate paths to be followed if the home buyer is to be protected.

I.

Traditionally, homes were custom built for individuals on land already owned or recently purchased by the prospective homeowner. The contractor was carefully selected, based upon his reputation in the community, as a builder of ability and a businessman of fair dealings. A building contract determined the legal relationship between the builder and the homeowner. The latter had ample means to protect himself from a defective product. In addition to selecting the builder based on reputation, an expert could be retained to periodically check the soundness of the house during its construction, the owner himself could carefully observe the erection of his home, payments to the builder could be withheld, and legal action predicated upon the contract could be taken.6

Although the custom home builder has not disappeared, he has been joined in the market by the builder-vendor, also known as the housing merchant, the merchant builder, or the builder-developer. The builder-vendor represents a market response to the demand for housing following World War II. No longer does he build a custom home for the landowner. Instead, he purchases separate lots or entire tracts of land which he subdivides into lots. He builds on these lots in hopes of selling the complete package (house and lot) for a profit.7

Purchasing a new house from a builder-vendor differs considerably from contracting with a builder to construct a home. Unlike the products passing over the merchant's counter,8 the purchase of real property does not convey an implied warranty of merchantability and fitness for a particular purpose.9 Historically, the law shielded the builder-vendor from liability for his defective construction with two doctrines: *caveat emptor* and merger of a real estate sales contract with the deed conveying the property.

*Caveat emptor* (let the buyer beware), puts the buyer on guard, alerting him to carefully inspect all merchandise before purchasing it, as the seller will bear no responsibility once the transaction is con-

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7 Id.
8 UNIFORM COMMERCIAL CODE §§ 2-314, 2-315; UNIFORM SALES ACT §§ 13-16.
summated. The legacy of an age when buyer and seller stood in roughly equal bargaining positions and shared equal knowledge of the items being purchased, caveat emptor traditionally has protected the builder-vendor. Reenforcing the doctrine of caveat emptor has been the property law concept of merger. Under this doctrine all preliminary negotiations, including the antecedent contract for purchase of the house, are merged in the deed conveying the land to the buyer. Following its acceptance, the deed (and not the contract) contains the entire rights of the parties, and all contractual duties of the seller except as embodied in the deed are discharged. Deeds usually contain language transferring the land and warranties and limitations on the use and enjoyment of the land. The house may be mentioned, but the deed has traditionally been an instrument conveying land, buildings being treated as incidental. Although the primary purpose of the transaction is the purchase of a suitable dwelling, the transfer of land being incidental thereto, the deed functions as though the opposite were true. Thus, the doctrine of merger often has frustrated actions against sellers of homes when the buyer's theory for recovery rested on the contract for sale of the dwelling. Professor Williston frequently is cited to support these twin defenses.

The doctrine of caveat emptor, so far as the title of personal property is concerned, is very nearly abolished, but in the law of real property it is still in full force. . . . Still more clearly there can be no warranty of quality of condition implied in the sale of real estate. . . .

It is generally true also that any express agreements in regard to land contained in a contract to sell it are merged in the deed if the purchaser accepts a conveyance.

In an age of increasing consumer awareness, when evermore responsibilities are being placed upon product manufacturers and merchants, it is only natural for aggrieved home buyers to attack the historical immunity of the home builder. These attacks have not been uniformly successful as many jurisdictions still absolve the builder of all responsibility for his house once it is deeded to the

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10 For the classic examination of the caveat emptor doctrine see generally Hamilton, The Ancient Maxim Caveat Emptor, 40 YALE L.J. 1133 (1931). See also Roberts, supra note 6; Comment, 10 Ariz. L. Rev. 484 (1968).
12 Roberts, supra note 6, at 857-62.
15 See generally Bearman, supra note 9, at 542-43. See also notes 16-23 infra.
buyer. However, various legal doctrines holding the builder-vendor accountable for his product recently have been recognized.16

Builder-vendors have been sued successfully in tort under theories of negligence17 and strict liability.18 Their negligent construction causing an imminently dangerous condition,19 and their failure to disclose a defective condition20 have been found to create liability. Similarly, they have been held responsible for latent defects in the house.21

In addition to actions in tort, doctrines predicated liability upon warranty principles have been recognized. The theory that sale of a new house gives rise to an implied warranty is increasingly being adopted by the courts.22 In Louisiana, where the seller is required by statute to warrant the thing which he sells,23 a number of cases have held the builder-vendor or the vendor of a new house liable for defects existing at the time of the sale.24 Theories of express warranty also have brought recovery to home buyers in actions against builder-vendors.25

Where the builder in an action predicated on the sales contract raised the defense of merger, it, too, was penetrated. Unperformed

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21 E.g., Mincy v. Crisler, 96 So. 162 (Miss. 1923); Oremus v. Wynhoff, 123 N.W.2d 441 (Wis. 1963).
22 E.g., Crawley v. Terhune, 437 S.W.2d 743 (Ky. 1969), noted in 58 Ky. L.J. 606 (1970); House v. Thornton, 457 P.2d 199 (Wash. 1969), noted in 45 Wash. L. Rev. 670 (1970). See also Bearman, supra note 9, at 543-47; Haskell, supra note 9; Roberts, supra note 6, at 837-43.
25 Bearman, supra note 9, at 548-49.
or defectively performed covenants have been held to be collateral covenants not extinguished by passing of title in the deed.\textsuperscript{26} Other courts have found that the parties did not intend acceptance of the deed to represent full performance of the contract; hence, actions on the sales contract were allowed after the deed was accepted.\textsuperscript{27}

Clearly, the law is far from settled in this area.\textsuperscript{28} Nonetheless, this comment goes no further in listing or examining the legal liability of the builder. It is a problem amply examined in many recent cases, and it has been a favorite topic for microscopic examination in scholarly journals.\textsuperscript{29} In affirming a 1970 builder-vendor liability case arising in Alabama, Justice Maddox of the Supreme Court of Alabama listed no less than ten recent law review articles and an equal number of cases. This followed the court's statement that "considerable comment has been made by legal scholars about the new trend toward judicial abolition of the doctrine of caveat emptor in real estate sales."\textsuperscript{30} Repetitious treatment of the issue here would serve no purpose. Suffice it to leave the subject of the builder's legal liability with the knowledge that the buyer's attorney now has an arsenal of recognized arguments for shifting liability from the home purchaser onto the builder-vendor.

II.

The numerous cases and articles advocating expanding builder liability all share a common underlying theme: losses arising from defective construction should not be left for the home buyer to bear. But developing legal doctrine to shift the loss away from the homeowner and onto the builder is not sufficient to achieve this goal. If the builder is judgment-proof, the homeowner's position is improved little.\textsuperscript{31} The California Court of Appeals succinctly stated the prob-

\begin{footnotesize}
\textsuperscript{27} Rapp v. Murray, 171 N.E.2d 374 (Ohio 1960).
\textsuperscript{28} Williston, supra note 14; Bearman, supra note 9, at 572-73; Roberts, supra note 6, at 837.
\textsuperscript{29} Bearman, supra note 9; Haskell, supra note 9; Comment, 10 Ariz. L. Rev. 484 (1968); Roberts, supra note 6; Young & Harper, supra note 5; Note, The Doctrine of Caveat Emptor as Applied to Both the Leasing and Sale of Real Property; Note, The Need for Reappraisal and Reform, 2 Rutgers, Camden L.J. 120 (1970); Note, Builder-Vendor's Implied Warranty of Good Workmanship and Habitability, 1 Tex. Tech. L. Rev. 111 (1969); Comment, Implied Warranty of Fitness and Suitability for Human Habitation as Applied to the Sales of New Homes in Texas, 6 Houst. L. Rev. 176 (1969); Comment, Implied Warranty in Sales of New House by Vendor, 58 Ky. L.J. 606 (1970); Comment, Vendor and Purchaser—Implied Warranty, 45 Wash. L. Rev. 111 (1969).
\textsuperscript{31} Roberts, supra note 6, at 868.
\end{footnotesize}
lem: "Woe betide the purchaser who relies, through ignorance or innocence upon the skill of a developer of less substance and renown than Levitt & Sons." Yet, for a multiplicity of reasons, the housing industry is composed primarily of many small and undercapitalized firms who are incapable of paying a substantial judgment against them. The President's Committee on Urban Housing explains this unique feature of the housing business:

The smallness of these firms results primarily from the industry's localized and fragmented nature. There are, however, additional reasons for the smallness and light capitalization of construction firms. The rate of housing production is rather erratic, both on a national basis, and especially in each local market. The main causes of this instability are seasonal fluctuations in production, . . . the sensitivity of the industry to the supply of credit, and the dominance of the existing stock [of housing]. . . . The erratic rate of output forces construction firms to try to keep their continuing overhead to a minimum, thus discouraging capital investment.

The volatility of the business is evidenced by the high rate of entry and exit of firms. This rate of firm turnover further indicates that many home building enterprises operate at the margin of economic survival. More testimony to the weakness of home building firms comes from the 1964 National Association of Homebuilders' survey showing that 60% of its members had less than four full-time employees, and only 1.4% have fifty or more employees.

The inescapable conclusion derived from a cursory review of the home building industry is that its members are not uniformly capable of accepting substantial, unexpected financial losses. Although statistical evidence is unavailable, it is not improbable that a high correlation exists between the financially irresponsible firm and the producer of defective housing. Even assuming that sloppy construction is randomly distributed throughout the industry (without regard to a builder's financial resources), in a field made up of many undercapitalized, small firms, operating close to the margin of economic survival, it is inevitable that numerous defective homes will be con-

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34 Report of the President's Committee on Urban Housing, A Decent Home 117 (1968).
35 Id. at 151.
36 Id.
structured and sold by firms that are judgment-proof. Thus, emerge the twin obstacles frustrating a home buyer's effort to secure redress for loss from defects in his home—legal liability and economic responsibility both must be shifted. The recent emphasis upon legal loss shifting is essential to solving this twofold problem. But only when liability in law attaches to a party financially capable of bearing this responsibility is the real loss shifted. To think otherwise is to ignore the economic realities of the housing industry.

III.

The remainder of this comment examines potential means for resolving the paradox between legal and financial responsibility of the builder-vendor. Of course, those jurisdictions still following the rule of cavea emptor have no problem for the loss remains with the home purchaser. However, in jurisdictions where the courts have adopted some form of builder liability, the problem of judgment-proof defendants must be faced. Otherwise, the courts' decisions to protect home buyers effectively may be frustrated.

Because recognition of builder liability for defective homes is itself a recent and still incomplete development in the law, there is little experience with which to predict the course to be followed in eliminating uncollectable judgments against home builders. This will come very slowly because the buyer-plaintiff will be reluctant to institute an expensive legal action against a builder unless confident that the builder is capable of answering the judgment, and the financially sound builder often may voluntarily settle with the buyer. The resulting silence of the wronged buyer only serves to obscure the problem of uncollectable judgments from judicial and legislative scrutiny. Creativity and imagination of attorneys, judges, and legislators, as well as members of the building industry, will be required to resolve the problem. The following paragraphs suggest some areas for exploration.

A. Initial impetus for overcoming judgment-proof defendants probably will come from attorneys seeking "deep-pocketed defendants" beyond the insolvent builder. Depending on the particular circumstances, the following parties could be looked to for relief: subcontractors (plumbing, heating, electrical, etc.), suppliers of equipment.

87 "[T]he issue of how courts should protect homebuyers is best answered not by focusing on the consumer's problems alone, but by considering as well the entire operation and structure of the industry—the total land development context." G. LEFQ, LAND DEVELOPMENT LAW vii (1966).


and material, architects\textsuperscript{40} and engineers, lenders of mortgage and construction funds,\textsuperscript{41} or virtually any party involved in the construction and sale of the house. Merely increasing the number of parties being sued will not insure that liability will be shifted to one capable of answering the judgment. This requires the lawyer's skill in establishing a duty or other legally sufficient relationship between the buyer and one of the parties who helped build or develop the house.

This writer does not advocate a "shotgun action" against everyone who "touched" the defective house. But a penetrating examination of the particular defect and its cause may direct responsibility to someone in addition to the judgment-proof builder. An excellent illustration of this means of recovery, which may well serve as an example to other jurisdictions, comes from California in the case of \textit{Connor v. Great Western Savings & Loan Association}.\textsuperscript{42} After considering the nature of the home building industry, its dependence on institutional financing, and the relation of the institutional lender to the home buyer, the Supreme Court of California reversed a judgment of nonsuit for the defendant institutional lender in an action by home buyers against various parties involved in the development and sale of their houses. Defendant, Great Western Savings & Loan Association, had provided extensive short-term financing to the builder-developers as well as mortgages to the eventual buyers, a practice frequently followed in the home financing business.\textsuperscript{43} The court found that Great Western was neither a joint venturer with Conejo Valley Development Co., the builder-developer,\textsuperscript{44} nor was Great Western in privity of contract with any of the plaintiffs except as a lender.\textsuperscript{45} Nonetheless, the court held a duty was owed by Great Western to the home buyers, the breach of which rendered Great Western negligent. Writing for the majority, Justice Traynor found that "Great Western was clearly under a duty to the buyers of the homes to exercise reasonable care to protect them from damages caused by major structural defects."\textsuperscript{46}

\textsuperscript{42} 73 Cal. Rptr. 369, 447 P.2d 609 (1968).
\textsuperscript{43} S. MAISEL, \textit{FINANCING REAL ESTATE} 321 (1965).
\textsuperscript{44} 73 Cal. Rptr. at 376, 447 P.2d at 616 (1968).
\textsuperscript{45} Id. at 377, 447 P.2d at 617 (1968).
\textsuperscript{46} Id.
Argument can be made for making the institutional lender responsible always (directly or as a surety) to the home purchaser for construction defects. This comment neither endorses nor rejects such recommendations and predictions. Connor is included here to illustrate the broader range of alternatives for circumventing judgment-proof defendants: the method of looking for "deep-pocketed" parties who can be joined with the defendant builder. The point to be made is that the attorney must not be myopic in looking for a financially sound party, as what appears to be only a tenuous relationship between the joined party and the home purchaser may be determined judically to be a legal relationship sufficient to impose liability. This is especially important where an examination of the special nature of the home construction industry is included with consideration of the particular facts of any one case. Connor, then, stands as the classic example of a wronged home buyer securing relief by looking beyond the insolvent builder to another party also responsible for the defect.

B. An alternate and more certain means for eliminating judgment-proof builder-vendors involves action within the legislature instead of the courtroom. A carefully drawn act requiring some form of minimum financial reserves, insurance, or bonding of the builder-vendor as a prerequisite to the sale of homes would protect the home buyer if he should later secure a judgment against the seller. Such an act could be drawn in a number of ways. The legislature could provide that deeds on new homes would not be recorded for transfer unless accompanied by evidence of the necessary bond or insurance. Or the act could require evidence of the bond or insurance as a prerequisite for a home mortgage by an institutional lender. The lender making a loan where no such protection was present would be made a surety for the builder should he later be unable to meet a judgment against him.

However, the legislative remedy is not without weaknesses. The cost of required bonding or insurance will be passed on to the home buyer, thus raising the cost of housing. Depending upon the type of

47 See the law review articles, supra note 41.
48 The District Court of Appeals which decided Connor recognized the financial realities of the construction business saying "We merely acknowledge therein the obligation which must ultimately be assumed by the participant best able to bear the financial risk..." 61 Cal. Rptr. at 347.
49 The New York Law Revision Commission has suggested that "housing merchants should not be entitled to specific performance of sales contracts unless they tender along with the deed a bond equal to the sale price of the house and conditioned upon failure to answer judgment obtained under the new system" of liability for defective home construction. Roberts, supra note 6 at 868.
insurance or bond required, the additional cost to the home buyer might be spread over the entire term of his mortgage, or it might require additional cash at the time of purchase. The ease or difficulty of rating various builders or their construction work would also be affected by the type of bond or insurance required. Small, new, or unknown builders may find difficulty securing the necessary financial protection, thus giving rise to a trend toward oligopoly in a local market. Though by no means complete, these considerations suggest the need for extensive evaluation of all the potential effects of legislation requiring insurance or bonding of builder-vendors to protect home buyers.

C. In addition to the legislative and judicial treatment of the judgment-proof builder problem, a third alternative exists: the home buyer can protect himself before consummating purchase of a home. This requires that he either assure himself of the structural soundness of the home or the financial strength of the builder-vendor, or that he arrange for the necessary insurance and negotiate the price of the home accordingly. Because examination of both the home's structural soundness and the builder's financial strength may be nearly impossible, the purchaser would be well advised to voluntarily secure, or require that the builder secure, insurance or a bond to protect against an unanswered judgment.

It is possible that insurance or bonding would become a generally accepted practice associated with the purchase of a house. An analogous situation has developed in many parts of the country where title insurance regularly is secured in conjunction with the purchase of real estate. Lest this approach be given too much importance, it should be understood that many home buyers, although advised to secure such insurance, may decide not to do so. But even if the buyer's preference is not to secure such protection, if it is readily and economically available, mortgage lenders might choose to require it before issuing a home loan. Their motivation would be fear of potential liability based on the decision in Connor or other similar cases, or a desire to insure the realty that secures their loan. Thus, the

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50 Roberts, supra note 6, at 870.
51 The buyer usually is not sufficiently expert in construction evaluation to adequately protect himself. Furthermore, hiring an expert would be difficult and expensive as most architects would not want to accept responsibility for examining a completed structure. Many important points such as foundations, wiring, etc. are hidden in a completed home; therefore defects could not be detected even if an expert were retained. Bearman, supra note 9, at 545 n.15; Young & Harper, supra note 5, at 248.
bond and insurance alternative may develop without legislative action, as a market response to a demand for consumer or lender protection.

**Recapitulation**

The law regulating the liability of a builder-vendor to the purchaser of a home is changing. The builder long has been protected by the doctrines of *caveat emptor* and merger of the sales contract with the deed. Recently, however, these historical defenses often have proved insufficient, as many jurisdictions are recognizing doctrines calling for protection of the unwary home buyer from defectively constructed houses. This shift of responsibility onto the builder in order to protect the home buyer assumes the concomitant financial ability of the builder-vendor to answer any judgments entered against him. But the nature of the building industry perpetuates the existence of many judgment-proof builders. Juxtaposing builders' probable legal liability with their probable financial capability emphasizes this dichotomy.

Three directions in which the law may develop to protect the home buyer have been suggested:

A. A solution may be sought in the courtroom through a search for other parties who may be joined as defendants when the builder-vendor appears insolvent.

B. The legislature may resolve the problem by requiring minimum financial reserves, bonding, or insurance of the builder.

C. Home buyers may protect themselves through voluntarily securing insurance against defective construction and a judgment-proof defendant.

These alternatives are not proposed as absolute solutions. But, they suggest the paths which may be taken and the obstacles which must be overcome if innocent home purchasers are to be protected from uncompensated losses.

*J. David Rosenberg*