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## LENDER LIABILITY FOR DISCOVERABLE STRUCTURAL DEFECTS IN NEW TRACT HOUSING

During the past decade the residential construction industry has undergone substantial structural change. Many residential contractors today build housing developments of five hundred and more homes, whereas in 1950 the average contractor built only three or four homes per year.<sup>1</sup> Just as mass production techniques in the automotive industry, for example, have generated novel legal remedies,<sup>2</sup> the marketing of housing on a massive scale has required an evolution in legal theory.

In the sale of residential property, most states<sup>3</sup> still adhere to the strict common law rule of *caveat emptor*, which provides that there is no implied warranty of freedom from structural defects in a conveyance of realty; the vendee accepts the property as is and assumes full responsibility for defects.<sup>4</sup> The plethora of exceptions to this rigid rule, however, has continued to expand.<sup>5</sup> Early exceptions to the rule were permitted in cases of fraud,<sup>6</sup> on nuisance theories,<sup>7</sup> and where particular use by the purchaser was intended to be or reasonably could be anticipated.<sup>8</sup> More recently, several jurisdictions have explicitly asserted an implied warranty of habitability or good workmanship in the sale of new housing.<sup>9</sup> A few states

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1. Brehm, *The Residential Construction Industry*, in ADAMS, *THE STRUCTURE OF AMERICAN INDUSTRY* 108, 112 (1960).

2. *E.g.*, *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916).

3. *See* Annot., 25 A.L.R.3d 383 (1969).

4. *See, e.g.*, *Druid Homes, Inc. v. Cooper*, 272 Ala. 415, 131 So. 2d 884 (1961); *Voight v. Ott*, 86 Ariz. 128, 341 P.2d 923 (1959); *Dooley v. Berkner*, 113 Ga. App. 162, 147 S.E.2d 685 (1966).

5. *See* Bearman, *Caveat Emptor in the Sale of Realty—Recent Assaults upon the Rule*, 14 VAND. L. REV. 541 (1961); Dunham, *Vendors Obligation as to Fitness of Land for a Particular Purpose*, 37 MINN. L. REV. 108 (1953).

6. *Pennsylvania Steel Co. v. Elmore & Hamilton Contracting Co.*, 175 F. 176 (N.D. N.Y. 1909); *O'Brien v. American Bridge Co.*, 110 Minn. 364, 125 N.W. 1012 (1910); *Belote v. Memphis Development Co.*, 208 Tenn. 434, 336 S.W.2d 441 (1961); *Dooley v. Berkner*, *supra* note 5; *Bray v. Cross*, 98 Ga. App. 612, 106 S.E.2d 315 (1958).

7. *Ackerman v. Ellis*, 81 N.J.L. 1, 79 A. 883 (1911); *Delaney v. Supreme Inv. Co.*, 251 Wis. 374, 29 N.W.2d 754 (1947); *Schumacher v. Carl G. Neumann Dredging & Imp. Co.*, 206 Wis. 220, 239 N.W. 459 (1931).

8. *Grodstein v. McGivern*, 303 Pa. 555, 154 A. 794 (1931); *Cf. Colbert v. Holland Furnace Co.*, 333 Ill. 78, 164 N.E. 162 (1928); *McGlone v. William Angus Inc.*, 248 N.Y. 197, 161 N.E. 469 (1928).

9. *E.g.*, *F & S Construction Co. v. Berube*, 322 F.2d 782 (10th Cir. 1963); *Carpenter v. Donohoe*, 154 Colo. 78, 388 P.2d 399 (1964); *Humber v. Morton*,

have gone further by applying negligence,<sup>10</sup> products liability,<sup>11</sup> and strict liability theories.<sup>12</sup> Thus the scope of relief for defects in new housing has been expanded by widening the grounds for relief and by dispensing with the requirements of privity, thereby extending relief to a larger group of plaintiffs—subsequent purchasers and injured third parties.

However, even the broad remedies of products liability and strict liability are inadequate against an insolvent or defunct construction company. There are thousands of small companies that enter and leave the residential construction industry according to the ebb and flow of demand for housing and availability of financing.<sup>13</sup> It is not unusual for a contractor to create a company to undertake a single development and then dissolve it after completing the project.<sup>14</sup> Furthermore, since most construction firms, even those undertaking large developments, are severely undercapitalized and must obtain almost total financing from savings and loan associations at relatively high cost in terms of fees and interest,<sup>15</sup> the stage was set for an extension of liability far beyond the comparative development of products liability. In the future, where a valid claim of an aggrieved home purchaser is frustrated by an insolvent or defunct contractor, he may have recourse against the institutional lender which cooperated with the irresponsible builder. In the case of *Connor v. Great Western Savings and Loan Ass'n.*,<sup>16</sup> the California Supreme Court has made the first step toward imposing liability on an institutional lender for structural defects in new housing.

The objective of this paper is threefold: to briefly discuss the peculiar role of the savings and loan association in the residential construction in-

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426 S.W.2d 554 (Tex. Sup. Ct. 1968); *Westwood Development Co. v. Sponge*, 342 S.W.2d 623 (Tex. Civ. App. 1961).

10. *E.g.*, *Sabella v. Wisler*, 59 Cal. 2d 21, 377 P.2d 889 (1963); *Mitchem v. Johnson*, 7 Ohio St. 2d 66, 218 N.E.2d 594 (1966); *Rogers v. Scyphers*, 251 S.C. 128, 161 S.E.2d 81 (1968); *Belote v. Memphis Development Co.*, 51 Tenn. App. 423, 369 S.W.2d 97 (1962).

11. *E.g.*, *Dow v. Holly Mfg. Co.*, 49 Cal. 2d 720, 321 P.2d 736 (1958); *Lowe v. Francis Constr. Co.*, 373 P.2d 51 (Okla. 1962); *Leigh v. Wadsworth*, 361 P.2d 849 (Okla. 1961); *Fisher v. Simon*, 15 Wis. 2d 207, 112 N.W.2d 705 (1961); *Freeman v. Mazzera*, 150 Cal. App. 2d 61, 309 P.2d 510 (1957).

12. *State Stove Mfg. Co. v. Hodges*, 189 S.2d 113 (Miss. 1966), *cert. denied*, 386 U.S. 912 (1967).

13. See *Lefcoe & Dobson, Savings Associations as Land Developers*, 75 YALE L.J. 1271, 1273-82 (1965); LEFCOE, *LAND DEVELOPMENT LAW* 631 (1966); *Smith Low Rise Speculative Apartment*, 50, 52, Real Estate Research Program, University of California, Berkeley (1964).

14. *Lefcoe & Dobson*, *supra* note 13, at 1277.

15. *Lefcoe & Dobson*, *supra* note 13, at 1276. See also *Connor v. Great Western Saving and Loan Ass'n*, 73 Cal. Rptr. 369, 373, 447 P.2d 609, 611 (1968).

16. *Supra* note 15.

dustry; to analyze the nature and scope of the duty imposed by *Connor*; and to assess the practical implications of such a duty for the institutional lender.

#### FINANCING ARRANGEMENTS IN THE RESIDENTIAL CONSTRUCTION INDUSTRY

Approximately sixty-five per cent of the builders in America construct less than forty per cent of the single family homes each year,<sup>17</sup> usually contracting with the owner of the land to build a dwelling on an individual or build-to-suit basis. Builders in this group generally construct between ten and twenty-five units per year.<sup>18</sup> The remaining builders are generally termed "speculative" builders. A speculative development involves the purchase of a large tract of land, the construction of twenty to five hundred and more homes, and finally (during or after construction of the homes) sale of the homes to purchasers.<sup>19</sup> The large scale developer thus acts in a dual capacity: as builder and as salesman. In the latter category, developers typically use mass production merchandising techniques; for example, several model homes may be built for inspection by prospective buyers. On the basis of the model, the purchaser may contract to buy a house before, during, or after its actual construction. The position of a purchaser in a tract development thus stands in sharp contrast to an individual who arranges for construction of a custom-made house. Although in either case a purchaser may be dissatisfied with the quality of materials and workmanship put into his house, studies report the most vociferous complaints are from purchasers in tract developments.<sup>20</sup>

For a number of legal and economic reasons, savings and loan associations contribute the bulk of financing for almost all tract developments.<sup>21</sup> First, restrictions on investments and loans imposed by statute and Internal Revenue Service rulings generally limit associations to investing most of their available funds in loans on residential properties, predominantly on one to four family units.<sup>22</sup> The tract developer is thus an attractive and logical borrower. A second consideration involves the market forces under which a savings and loan association must operate. The cost of obtaining capital is high for a savings and loan association because it

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17. Rogg, *The Changing Home Building Industry*, in UNITED STATES SAVINGS AND LOAN LEAGUE, SAVINGS AND LOAN ANNALS 1960 at 167, 175.

18. *Id.*

19. Lefcoe & Dobson, *supra* note 13, at 1283; Brehm, *supra* note 1, at 124-5.

20. Herzog, *The Dynamics of Large-Scale Housebuilding* 39, Real Estate Research Program, University of California, Berkeley (1963).

21. Lefcoe & Dobson, *supra* note 13, at 1273-82, 1297.

22. UNITED STATES SAVINGS & LOAN LEAGUE, 1969 SAVINGS & LOAN FACT BOOK 102 [hereinafter cited as 1969 FACT BOOK].

must rely on savings deposits, and, to compete successfully with other associations it must pay relatively high interest rates to its savers. In order to make profit, the association must then make mortgage loans and charge a higher rate of interest than they are paying out on passbook accounts.

Although the profitable operation of a savings and loan association is simply described, the existing mortgage concept makes such a goal difficult to achieve. During the depression of the 1930's, the present form of mortgage loan was established; its basic features include a fixed interest rate, a fixed term over which the mortgage is amortized (usually twenty to thirty years) and a fixed monthly payment which includes both principal and interest. With each succeeding payment, then, the proportion of the fixed payment attributable to principal increases, and the proportion attributable to interest decreases because the outstanding principal amount owed declines. Thus, payments early in the term are predominantly interest, and payments near the end of the term are primarily principal.

This existing mortgage concept has been described by the United States Savings and Loan League (USSLL) as "antiquated."<sup>23</sup> A study committee of the USSLL reported: "[T]he current mortgage concept 'assures recurring and deep fluctuations in the supply of funds to the residential market and chronic uncertainties and inefficiencies in home buildings.'"<sup>24</sup> The problem presently is that the general inflationary trend of the last twenty-five years, and especially the last several years, has left the associations with many undesirable loans on their books. For example, many mortgage loans made between 1955 and 1960, had interest rates of three to five per cent, which was a desirable return at that time. But in 1970, with ten to fifteen years remaining on the fixed terms of many of such loans, and the prime lending rate approaching nine per cent, these loans are extremely costly to carry. In fact, the aforementioned study committee of the USSLL found that "[m]any home borrowers today earn higher interest on their savings than they pay on their mortgages."<sup>25</sup>

In response to this problem, several solutions have been proffered, two of which are worthy of note: the "variable-interest" mortgage, and the "variable-term" loan. The "variable-interest" mortgage would tie the loan interest rate to an index which generally reflects the economic conditions of the country (for example, the prime rate, or the cost-of-living index). Such a provision is not uncommon now in the area of construction

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23. Chicago Tribune, March 22, 1970, § 3A (Real Estate and Rental Guide), at 1, col. 5.

24. *Id.*

25. *Id.*

loans for commercial property; the borrower pays interest at a fixed rate above the prime rate on this interim loan, which is for a short term. The latter theory—the “variable-term” loan—is popular in Europe. Under this system, the monthly payment remains fixed while the termination date of the loan fluctuates in response to an index reflecting economic conditions. Thus, the “effective” interest rate on the loan fluctuates. A Report of the Federal Home Loan Bank Board showed that in May, 1969, fifteen per cent of the savings and loan associations favored such a plan, while six per cent actually used such a device as standard policy.<sup>26</sup> What makes the “variable-term” loans more attractive to the borrower is that his monthly payment stays the same; this factor is more important to him than the interest rate.<sup>27</sup>

The objections to these plans are obvious: the buyer fears that interest rates could sky-rocket and force him to lose his home; the lender, on the other hand, fears being wiped-out if a deflationary period sets in.

Certain restrictions could mitigate these fears: the maximum fluctuation either way could be fixed; the frequency of change in term or rate could be restricted; and the borrower could be given the option of accepting the change, or paying off the loan by refinancing at another institution.<sup>28</sup> Until such time, however, that the lending institution will be able to cope with their existing problems in order to maintain a profitable operation, they will be forced to maximize returns. But as the return increases, so also does the risk;<sup>29</sup> therefore, although a greater return can be realized on a loan to an undercapitalized builder, risks of insolvency and associated problems accompany such a loan. The risk factor is increased further by the tendency to apply liberal value-to-loan ratios. That is, in return for relatively high interest, a savings and loan typically makes a loan secured at somewhat below commercial standards.<sup>30</sup>

The necessity of maximizing returns on investments, and the legal restraints limiting investment largely to residential developments make the construction industry an exceptionally attractive market for savings and loan associations. Contractors are often willing to pay high interest rates as well as lending fees of one to five per cent of the entire loan.<sup>31</sup> However, it is important to note the risk factors that accompany the relatively

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26. *Id.*, col. 6.

27. *Id.*, col. 6.

28. *Id.*, col. 6.

29. Of a total of 34,495 F.H.A. foreclosures in 1968, 32,512 were financed by savings and loan associations. *Supra* note 22, 1969 FACT BOOK at 50.

30. *Supra* note 20, at 37.

31. *Id.* See *Connor v. Great Western Savings and Loan Ass'n*, *supra* note 15, at 372, 447 P.2d at 614. Fees generally are set at one-third per cent of the loan, but

high return. Contractors are willing to pay high rates because commercial loans are unavailable to undercapitalized developers with few assets to provide security. The high cost of obtaining capital in turn squeezes the profit margin. Large scale developers are often tempted to "cut corners" in both workmanship and design; thus undercapitalized developments may yield undercapitalized and defective construction.<sup>32</sup>

In order to protect their investment, savings and loan associations employ standardized procedures of investigation and appraisal. Before a loan application may be approved, the solvency and experience of the contractor is examined, and the design plans and specifications are analyzed. If the loan is approved, payments are made periodically to the contractor upon presentation of lien waivers, and an experienced appraiser inspects the progress of construction before each payout is made.<sup>33</sup> The lender is thus intimately involved in all phases of the development. An examination of the facts in *Connor* will provide further insight into construction lending procedures and the peculiar relationship between the lender and the developer. The relationship formed by the financing arrangement will, in turn, form the basis for an analysis of the duty of reasonable care imposed on the lender by *Connor*.

In *Connor*, Goldberg and Brown, owners of the South Gate Development Company, planned to develop a five hundred and forty-seven acre ranch in Conejo Valley, California, into a community of approximately two thousand homes.<sup>34</sup> Goldberg, a former haberdasher, had four years experience as a real estate broker and had undertaken a thirty-one home development the previous year. Brown had built about fifty homes on a custom basis in the previous eight years, but had limited experience supervising tract construction. Through South Gate, the two individuals negotiated with Great Western Savings and Loan Association in order to obtain financing for the purchase of one hundred acres of land and financing for the construction of about four hundred houses. Great Western agreed to finance the project, but insisted on terms which would ensure a rela-

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exceptionally risky loans justify fees up to 5 per cent. Interview with John Schmidt, Chief Architect, United States Savings & Loan League, in Chicago, December 2, 1969 [hereinafter League interview].

32. Lefcoe & Dobson, *supra* note 13 at 1273-82. See also Wiemer, *Business & Real Estate Trends in 1965*, UNITED STATES SAVINGS & LOAN LEAGUE ANNALS, 1964 at 33, 36: "[economic growth requires savings & loan associations to take on] riskier projects than may have been warranted by the conditions under which they are operating."

33. UNITED STATES SAVINGS & LOAN LEAGUE, CONSTRUCTION LENDING GUIDE, Addendum A at 38-39 (1967).

34. The summary of the complex financing arrangements set out in some detail by Chief Justice Traynor is to be found in *Connor v. Great Western Saving and Loan Association*, *supra* note 15, at 371, 375, 447 P.2d at 609-13.

tively high return. Great Western agreed to supply funds for the land purchase through an intricate arrangement whereby Great Western would purchase the land, and resell it to the developers at a twenty thousand dollar profit.<sup>35</sup> Goldberg and Brown incorporated Conejo Development Company for the purpose of funneling funds and taking title to the tract. The corporation had a mere five thousand dollars in assets.

Great Western agreed to make a three million dollar construction loan at a 6.6 per cent interest rate and charged a service fee of five per cent of the total loan.<sup>36</sup> Great Western conditioned this commitment upon the pre-sale of a specified number of houses—that is, sold before construction. The lender made a further condition that all home purchasers obtain twenty-four year mortgages of approximately eighty per cent of the purchase price at 6.6 per cent interest. Great Western charged Conejo a one per cent fee for loans to qualified purchasers and one and one-half per cent to purchasers considered to be poor risks, reserving the right to refuse financing to risky purchasers; but if an approved buyer sought financing elsewhere, the developers were then required to pay Great Western the fees and interest obtained by the other lender. Before construction actually began, Great Western sent a geologist out to the area to check on the availability of water. The lender then obtained a corporate and individual obligation from the developers to ensure that adequate water service would be available for consumer use. During the period of construction, the lender dispatched an appraiser to inspect the progress of construction on a weekly basis. Great Western retained the right to stop the flow of construction funds if work did not conform to plans and specifications; failure to correct a defect within fifteen days would constitute a default. However, notwithstanding this intricate scheme for control and approval, the lender departed from its normal procedure of reviewing and approving plans and specifications before making a commitment to provide funds. The lender failed to discover that the designs were “borrowed” from a previous development, and that the design was inadequate for the particular locale; the development was put up on adobe soil which has a tendency to crack and expand in changing weather conditions. Because this factor was not considered in the designs and specifications, the foundations were defective for that area. Within two years after completion of the homes, a number of foundations cracked. The purchasers brought suit against the developers, and later joined the lender

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35. This arrangement is termed “land warehousing” and permits the lender to realize an artificial capital gain. See note 55 *infra* and text.

36. The exorbitant nature of Great Western’s return is clear. A fee of one to three points is typical for construction loans, *supra* note 31. Also, the interest rate of 6.6 per cent is rather high for the year the loan was made—1959.

as a party defendant.

#### IMPLICIT AND EXPLICIT BASES FOR IMPOSING LIABILITY

##### THE "DEEPER POCKET"

Joining the lender as a party defendant can be laid to several strategies both implicit and explicit. The search for a "deeper pocket" is perhaps the most basic impetus behind extensions of liability. As Dean Prosser noted in an analogous situation:

The alarming increase in traffic accidents, together with the frequent financial irresponsibility of the individual driving the car, has led to a search for some basis for imposing liability upon the owner of the vehicle . . . . Bluntly put, it is felt that since automobiles are expensive, the owner is more likely to be able to pay any damages than the driver . . .<sup>37</sup>

By analogy, the building contractor is the financially irresponsible "driver," the "vehicle" is cash financing, and the deep pocketed owner is the savings and loan association. Of course the mere ability to pay is not a basis of liability, but it is generally a practical prerequisite for any serious attempt to extend liability.

##### RECOVERY BY THIRD PARTY BENEFICIARIES

Recovery by the home purchaser against the lender as a third party beneficiary of the contract for financing between the lender and the tract developer is a somewhat questionable theory. A right of action accrues to a third party where the promisor breaches an obligation intended to benefit that third person.<sup>38</sup> It would be difficult to find language in the financing agreement between lender and developer directly affecting a particular purchaser because such agreements are generally executed before construction begins and before any such purchaser exists. Even where home purchasers contract with the developer before the developer finalizes financing with the lender, the purchaser can be no more than an incidental beneficiary, unless the buyer is specifically mentioned, or there is a showing that the promisor knew or should have known that the performance was for the benefit of the particular purchaser.<sup>39</sup> A case in this category "would seem more properly treated as raising simply a

37. PROSSER, *TORTS*, § 72 at 494-95 (3rd ed. 1964).

38. 2 WILLISTON, *CONTRACTS*, § 347 (Jaeger ed. 1959).

39. *Shine v. Nash Abstract & Investment Co.*, 217 Ala. 498, 117 So. 47 (1928); *Smither Roofing Co. v. Helen Realty Co.*, 90 Ind. App. 52, 168 N.E. 44 (1929); *Safran v. Westrich*, 136 Misc. 81, 240 N.Y.S. 238 (1930). See Pfeiler, *Lenders' Liability in Tract Financing*, 33 LEGAL BULL. 85, 108-09 (1969) wherein the author cautions lenders against using such language in drafting financing agreements.

question of liability for negligence."<sup>40</sup> However, a California appellate court recently cited *Connor* in support of the general proposition that third party beneficiaries may recover for obligations assumed for their benefit.<sup>41</sup>

#### JOINT VENTURES

A joint venture consists of an agreement by which the parties undertake an enterprise with limited objectives. Each of the parties must have "community of interest" which includes mutual rights of control and of sharing in profits.<sup>42</sup> The situation in *Connor*, which approximates the typical contemporary tract development, is quite close to a joint venture. Both lender and developer combined their skill, property and knowledge to carry out the project; each shared in control, and each anticipated substantial profits. However, the California Supreme Court rejected this theory because neither party had a specific interest in payments received by the other.<sup>43</sup> This appears to be a rather rigid interpretation and application of the element of "sharing profits;" all other elements of a joint venture were clearly present, and the court itself noted that "the profits of each were dependent on the overall success of the development."<sup>44</sup>

It is important to note that some financing arrangements, and particularly those which provide for "tie-in-financing," may constitute a joint venture as defined and applied by the California courts. For example, an agreement between lender and developer may contain a "kicker clause" which allows a lender to participate in any increase in gross earnings from rent.<sup>45</sup> The "kicker clause" thus provides for an actual sharing of particular profits and would create a joint venture.<sup>46</sup>

#### A DUTY OF CARE IMPOSED BY LAW

A voluntary undertaking may create a duty to reasonably control the conduct of another for the protection of a third party. The rationale for this duty of care has been stated in these terms:

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40. *Supra* note 38, at § 402, p. 1090.

41. *Allied Concord Financial Corporation v. Bank of America Nat. T. & S. Ass'n*, 275 Cal. App. 2d 586, 80 Cal. Rptr. 622, 624 (1969). *See also*, *Lucas v. Hamm*, 56 Cal. 2d 583, 589-91, 364 P.2d 685, 689 (1961); *Johnson v. Homes Tuttle Lincoln-Merc.*, 160 Cal. App. 2d 290, 325 P.2d 193 (1958); *Watson v. Aced*, 156 Cal. App. 2d 87, 319 P.2d 83 (1957).

42. *Supra* note 37, at 488-93; Taubman, *What Constitutes a Joint Venture*, 41 CORNELL L. Q. 640-50 (1956).

43. *Connor v. Great Western Savings & Loan Ass'n*, *supra* note 15, at 375, 477 P.2d at 615-16 (1968).

44. *Supra* note 16, at 369, 477 P.2d at 615-16 (1968).

45. 1969 FACT BOOK, *supra* note 22, at 21.

46. *See Pfeiler*, *supra* note 39, where the writer warns lenders against such procedures.

If the conduct of the actor has brought him into a human relationship with another, of such character that sound social policy requires either some affirmative action or some precaution on his part to avoid harm, the duty to act or take the precaution is imposed by law.<sup>47</sup>

The closeness of the relationship, giving rise to a reasonable opportunity to foresee potential harm to a third party, and the existence of a reasonable opportunity to control harmful conduct are one set of factors which determines the imposition of such a duty.<sup>48</sup> A second consideration is whether public policy dictates the existence of such a duty.<sup>49</sup>

#### THE CONNOR CASE—PRESENT LENDER LIABILITY

The *Connor* trial court entered a non-suit in favor of Great Western and the plaintiff-homeowner appealed, arguing that the lender's liability arose from two bases: a theory of vicarious liability arising from a joint venture with the developer; and a theory that a voluntary undertaking creating risk of harm to third parties, foreseeability of that harm, and an ability to prevent that harm creates in turn a duty to use reasonable care. The appellate court rejected the joint venture theory, but held a lender to a duty to reasonably inspect construction to prevent "gross . . . construction problems."<sup>50</sup> The appellate court found the duty to arise from the ordinary and standard relationship between construction lender and buyer, noting that the overall arrangement in *Connor* was "a typical example of contemporary tract development."<sup>51</sup>

The California Supreme Court affirmed, but on somewhat narrower grounds.<sup>52</sup> Justice Traynor agreed that lack of privity between lender and purchaser will not absolve the lender of liability for its own negligence in creating an unreasonable risk of harm to the purchaser. A duty of care "may arise out of a voluntarily assumed relationship if public policy dictates the existence of such a duty."<sup>53</sup> The court, however, explained the imposition of duty in terms of factors exceeding the ordinary construction loan arrangement. Chief Justice Traynor found that Great Western "became much more than a lender content to lend money at in-

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47. Harper & Kime, *The Duty to Control the Conduct of Another*, 43 YALE L.J. 886 (1934). See also, James, *Scope of Duty in Negligence Cases*, 47 NW. U.L. REV. 778, 809-13 (1953).

48. Harper & Kime, *supra* note 47, at 887-8.

49. See *infra* notes 71-74 & text.

50. *Connor v. Conejo Valley Development Co.*, 61 Cal. Rptr. 333, 347 (1967).

51. *Id.*, at 336.

52. *Connor v. Great Western Savings & Loan Ass'n*, *supra* note 15.

53. *Id.*, at 377, 447 P.2d at 617, quoting *Merrill v. Buck*, 58 Cal. 2d 552, 561-62, 375 P.2d 304, 311 (1962).

terest on the security of real property.”<sup>54</sup> In addition to charging interest on the construction loan, the lender also charged a fee for making the loan, collected a twenty percent capital gain on a land “warehousing” transaction, and required either permanent financing from each purchaser or in the alternative, a penalty fee from the developer. These extra factors are important because they appear to substantially limit bases for imposing liability on the construction lender; yet these factors are not essential to the relationship of closeness and control that creates the duty in the first instance.

The first conclusion as to the highly defined grounds for imposing a duty on an institutional lender is sustained by a recent California appellate court decision. In *Bradley v. Craig*,<sup>55</sup> by way of dictum only, the court extensively discussed *Connor* and decided that liability could be imposed only on the most narrow grounds. After disposing of the case on the statute of limitations, the court held that *Connor* would not apply to a lender which financed a five house tract, and which did not require “tie-in-financing.” Such a transaction did not involve sufficient participation by the lender, nor sufficient intent to affect the plaintiff to justify imposing a duty of care.<sup>56</sup>

The second point—that the “extra factors” required in *Connor* to impose liability are superfluous and should not exclude an ordinary construction lender from liability—can be demonstrated by an examination of ordinary construction lending practices in terms of the rationale for imposing a duty of care towards third parties not in privity. As discussed above, savings and loan associations find construction loans attractive because of high interest rates; yet contractors pay such high rates because they cannot qualify for ordinary commercial loans.<sup>57</sup> Thus construction lenders, as a matter of *standard practice*, follow a number of procedures to protect the security of their investment. In a tight money market (lender’s market), when a contractor applies for a loan, the loan committee carefully scrutinizes both the solvency and experience of the contractor.<sup>58</sup> Large savings and loan associations typically deal with only the firmly established, well-known contractors,<sup>59</sup> while smaller lenders

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54. *Connor v. Great Western Savings & Loan*, *supra* note 15, at 376, 447, P.2d at 616.

55. *Bradley v. Craig*, 274 Cal. App. 2d—, 79 Cal. Rptr. 401 (1969).

56. *Id.*, at—, 79 Cal. Rptr. at 407-8.

57. *See infra* note 32 and text.

58. *Supra* note 20, at 39. *See also* 33 LEGAL BULL. 324, 326 (1967) which criticizes *Connor* at the appellate level but concedes that large institutional lenders possess “expert technical knowledge” of the residential construction industry.

59. Interview with Robert Ulbricht, General Counsel, Bell Savings and Loan Association of Chicago, November 28, 1969. It is important to note that under condi-

cannot be as selective. Different economic conditions, however, can force the associations, large or small, to lend money to more inexperienced builders,<sup>60</sup> resulting in correspondingly higher risks.

Whether dealing with an experienced or with an unknown builder, a savings and loan employs further procedures to protect its investment. Before the loan is approved, the plans and specifications are reviewed for both safety features and to ascertain market value. Larger institutions maintain a staff of qualified architects and engineers; smaller lenders will "farm-out" plans for examination by architectural firms.<sup>61</sup> Furthermore, inspection of the site is made by an experienced appraiser to check the propriety of design to the locale.<sup>62</sup> If there are any problems in either safety or marketing factors, the lender will insist upon appropriate changes before making a loan commitment.<sup>63</sup>

The third stage of the lending arrangement involves actual construction of the development. After approving a construction loan, the lender does not simply pay out the entire amount to the builder. The loan is paid out in installments, and an appraiser inspects the construction site to ensure substantial conformance with design specifications. If a "major defect" is discovered, payments are discontinued until a correction is made.<sup>64</sup> Lenders also typically retain five to ten per cent of the loan until construction is completed in order to provide security against unexpected or overlooked defects.<sup>65</sup>

Professor Herzog has concluded that "[i]t can truthfully be said that nearly everything the builder does is at least partially determined by his financing arrangements."<sup>66</sup> The fact of the lender's extensive control is further demonstrated by long-standing policies of the United States Savings and Loan League. This organization publishes a "Construction Lending Guide"<sup>67</sup> which sets out general principles of sound construction technique. The "Guide" further recommends all the construction lending

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tions of excess money supply, the savings and loan association is under pressure to invest in riskier projects.

60. *Id.*

61. Interview with Mrs. LaRocca, President, Allied Savings and Loan Association of Chicago, December 6, 1969.

62. Specialists will also be sent out if needed. For example, in Connor the lender sent a geologist to inspect the area for water service. *Connor v. Great Western Savings & Loan Ass'n*, *supra* note 15, at 372, 447 P.2d at 612.

63. Interview with Lester Ballerine, Vice President, First Federal Savings & Loan Ass'n of Chicago, December 2, 1969.

64. Bell interview, *supra* note 59.

65. *Supra* note 52, at 376, 447 P.2d at 616.

66. *Supra* note 20, at 33.

67. UNITED STATES SAVINGS AND LOAN LEAGUE, CONSTRUCTION LENDING GUIDE (1964).

procedures discussed in detail above.<sup>68</sup> For years, League officials have urged savings and loan officials to consider esthetic values and community needs before approving construction loans.<sup>69</sup> Implicit in such recommendations is the ability of the lender to influence builders on such policies.

Thus it is clear from the foregoing that a construction lender exercises substantial control over the planning and actual construction of a housing development. This relationship, in and of itself, creates the "closeness" to foresee possible harm to home purchasers, and the "control" to prevent that harm. The "extra factors" which Chief Justice Traynor held to impose liability in *Connor* are not relevant to "closeness" and "control." Land warehousing was an "extra factor," yet this was only a procedure by which the lender generated an artificial capital gain.<sup>70</sup> The arrangement for "tie-in-financing" to home purchasers is likewise an arrangement for increasing the lender's profit, yet it does not significantly affect either the close relationship between lender and builder, or the amount of control held by the lender.

Although the "extra factors" are irrelevant to "control" and "closeness," they do appear relevant to the matter of public policy—the second basis for imposing a duty of care upon a construction lender. In *Connor* the public policy criteria for imposing a duty were derived from six points established in *Biakanja v. Irving*:

The determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are (1) the extent to which the transaction was intended to affect the plaintiff, (2) the foreseeability of harm to him, (3) the degree of certainty that the plaintiff suffered injury, (4) the closeness of the connection between the defendant's conduct and injury suffered, (5) the moral blame attached to the defendant's conduct, and (6) the policy of preventing future harm.<sup>71</sup>

Chief Justice Traynor went on to discuss the facts of the *Connor* case in terms of the *Biakanja* policy criteria and on each point found that a duty of care should be imposed on the construction lender. The "extra factors" noted above appear to be important, if not decisive, in reaching the policy decision. For example, "tie-in-financing" for home purchasers was held to indicate that the construction lender's transactions were in-

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68. *Id.*, CONSTRUCTION LOAN & PROCEDURES at 5.

69. See also Odell, COMBATING UGLINESS IN AMERICA, UNITED STATES SAVINGS & LOAN LEAGUE, SAVINGS & LOAN ANNALS 1964 at 109; Panel Discussion on Residential Construction Standards, reported in UNITED STATES SAVINGS & LOAN LEAGUE, SAVINGS & LOAN ANNALS 1961 at 151 (statement of C.W. Ford: "It's our responsibility to strive for better design and better construction.").

70. *Supra* note 20.

71. *Biakanja v. Irving*, 49 Cal. 2d 647, 320 P.2d 16 (1958).

tended to significantly affect the plaintiffs.<sup>72</sup>

The carefully drawn imposition of liability in *Connor*, and the subsequent discussion of *Connor* in *Bradley*, indicate that an institutional lender is burdened with a duty of care towards home purchasers *only* if its financing takes on "ramifications beyond the domain of the usual money lender."<sup>73</sup> As the above discussion pointed out, the carefully drawn imposition of liability is a matter of judicial policy; the *ordinary* construction lender is in fact "beyond the domain of the usual money lenders."<sup>74</sup> Thus it seems probable that the "extra factors" required in *Connor* may be gradually chipped away until an ordinary construction lender also has a duty of reasonable care toward home purchasers in financing tract developments.

#### PRACTICAL IMPLICATIONS OF LENDER LIABILITY

In addition to the question of when a duty is imposed on an institutional lender, two further matters deserve discussion: the scope of the duty of care and policies which may mitigate against lender liability in construction financing.

A duty of care imposed on an institutional lender is a duty to make reasonable inspections. In order to find a breach of that duty the defect complained of must have been of such a nature that it could be discovered through normal appraisal of plans, surveys, engineering reports, and on site inspections. Most gross structural defects are discoverable by experienced appraisers on the staff of lending institutions.<sup>75</sup> However, loan officers interviewed generally agreed that certain defects such as installation of defective wiring might be covered up as work progressed. It seems unlikely that failure to detect such a defect would constitute a breach of the duty to reasonably inspect. The duty is determined by the undertaking, and the lender undertakes only to ensure the security of his investment. It follows that a lender's duty of care would not be breached under the facts of the *Levitt*<sup>76</sup> case where an injury occurred from the negligent installation of a hot water heater. The lender does not usually undertake a warranty of good workmanship toward the purchaser.<sup>77</sup>

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72. *Connor v. Great Western Savings & Loan Ass'n*, *supra* note 15, at 374, 447 P.2d at 612.

73. *Connor v. Great Western Savings & Loan Ass'n*, *supra* note 15, at 375, 447 P.2d at 613.

74. *Connor v. Great Western Savings & Loan Ass'n*, *supra* note 15, at 375, 447 P.2d at 613.

75. *Supra* note 59.

76. *Schipper v. Levitt & Sons, Inc.*, 44 N.J. 70, 207 A.2d 314 (1965).

77. *But see* 3740 Lake Shore Drive Association v. Talman Savings & Loan, No.

When a defect falls into the grey area between a major structural defect and a latent defect not discoverable by reasonable inspection, the courts may apply a negligence standard similar to that imposed on architects and engineers who contract with owners to design buildings and act as general supervisors of the contractor's work.<sup>78</sup> An early decision described that duty:

In performing the work which he undertook, it was [an engineer's] duty to exercise such care and diligence as men engaged in that profession ordinarily exercise under like circumstances. He was not an insurer that the contractors would perform their work properly in all respects; but it was his duty to exercise reasonable care to see that they did so.<sup>79</sup>

A standard of this nature will not excessively burden the loan association, for any prudent lender protecting its own investment would exercise such diligence as a matter of ordinary procedure.

There are a number of alternatives by which a loan association may protect itself from incurring liability in construction lending. The general counsel of a large Chicago savings and loan expressed confidence that "internal policy" would provide adequate security.<sup>80</sup> Such policy restricts lending to contractors who are highly capitalized and have long standing reputations for experience in the construction industry. This restrictive policy, is, however, not feasible to the same extent for smaller loan associations. To the small-scale lender, three alternatives are available: refrain from making construction loans; require a quality bond from the contractor; or carry indemnity insurance. Since construction lending is a basic investment for loan associations, and under the present system which restricts the type of investments loan associations may make, it seems unlikely that loan associations will leave the construction lending business.<sup>81</sup>

All loan officers interviewed agreed that the second alternative—requiring a quality bond of contractors—would be a difficult solution.<sup>82</sup> Performance bonds are expensive and difficult to obtain in the construction

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69 CH 1511 (complaint filed April 30, 1969, Circuit Court of Cook County): Talman financed a condominium and thereafter, the builder became insolvent with the result that Talman became assignee of the entire project and is now defendant in a suit for damages incurred from structural defects and poor workmanship in the condominium.

78. See *e.g.*, *Pastorelli v. Associated Engineers, Inc.*, 176 F.Supp 159 (D. R.I. 1959); *Ehart v. Hummonds*, 232 Ark. 133, 334 S.W.2d 869 (1960); *Miller v. Deavitt*, 37 Ill. 2d 273, 226 N.E.2d 630 (1967).

79. *Cowles v. City of Minneapolis*, 128 Minn. 452, 453-4, 151 N.W. 184, 185 (1915).

80. *Supra* note 63.

81. *Supra* notes 22, 29.

82. *Supra* notes 20, 55, 59, and 71.

industry, and at least one loan officer expressed the opinion that a quality bond would be prohibitively expensive if not impossible to obtain.<sup>83</sup>

Obtaining insurance coverage for its own liability is a third alternative for institutional lenders. However, all loan officers of savings and loan associations in Chicago who were interviewed expressed total ignorance of the existence of policies covering lender liability for structural defects. Only one official expressed confidence that a general "performance policy" carried by most lenders covering liability incurred by the insured in the ordinary course of business would be adequate in a *Connor*-type situation.<sup>84</sup> Notwithstanding the general absence of insurance policies giving extended coverage for structural defects, there should be little difficulty in obtaining adequate coverage when the market for such insurance develops.<sup>85</sup> The liability incurred by an institutional lender is analogous to that incurred by the manufacturer in the products liability field, and insurance coverage has, in general, kept pace with that field.<sup>86</sup> Adequate extended coverage has been noted to be available to builders incurring strict liability for structural defects and poor workmanship,<sup>87</sup> so it should be a simple matter to adjust such policies to the needs of lending institutions. The cost of this insurance will be shifted directly to the builder,<sup>88</sup> and ultimately to the purchaser.

#### CONCLUSION

The *Connor* case, then, does not appear to place an onerous burden on savings and loan associations. The initial imposition of liability has been on very narrow grounds, and extension of liability to relatively mundane construction lending will take years—if it occurs at all. Finally, wherever a duty of care is in fact imposed, it will require the lender to do no more than ordinary business prudence dictates be done to protect the security of the lender's investment.

*Michael O'Connor*

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83. *Supra* note 59.

84. *Supra* note 61.

85. That is, when, if at all, other jurisdictions follow *Connor* and impose liability on lenders for structural defects.

86. 7A APPELMAN, INSURANCE LAW AND PRACTICE § 4508 (1962).

87. See *Sarnicandro v. Lake Developers, Inc.*, 55 N.J. Super. 475, 484, 151 A.2d 48, 53 (1959); cf. *Schipper v. Levitt & Sons, Inc.*, *supra* note 76.

88. *Supra* note 63.