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Products Liability - Lender Liability for Defective Home Construction - Connor v. Great Western Savings and Loan Association 69 Cal. 2d 887, 447 P.2d 609, 73 Cal. Rptr. 369 (1968).

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indirectly overrule *Kintner*. The 1965 amendment to these regulations[16] led to the present conflict.

Empey v. United States is the first case to be decided under the new regulations (and the first involving a firm of lawyers). By holding the 1965 revision invalid and unenforceable, the court, in effect, decided the case on the basis of the professional service corporation's resemblance to "true" corporations. Other courts have already followed *Empey* in passing upon the efficacy of the regulations as amended,[17] and it would appear that the "rule of resemblance" has been implicitly reaffirmed.

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Products Liability—LENDER LIABILITY FOR DEFECTIVE HOME CONSTRUCTION. *Connor v. Great Western Savings and Loan Association*, 69 Cal. 2d 887, 447 P.2d 609, 73 Cal. Rptr. 369 (1968).

Plaintiffs purchased homes in a residential development tract from the Conejo Valley Development Co.[1] Due to improper building techniques,

16. Treas. Reg. § 301.7701-1 to -2 (1965); 1965-1 CUM. BULL. 553. Although the 1960 Kintner Regulations were designed to, and did, make it more difficult for associations to qualify as corporations, Foreman v. United States, 232 F. Supp. 134 (S.D. Fla. 1964), demonstrated that it was still possible to do so. The Commissioner did not seek review of this decision but immediately promulgated the revision which had been under consideration since 1963. Proposed Treas. Reg. § 301.7701-1 to -2, 28 Fed. Reg. 13750 (1963). Whereas the Kintner Regulations, Treas. Reg. § 301.7701-1(c) (1960), emphasized the importance of local law to establish the relationship among the members of an organization and between the organization and the public, the amendment denigrated this standard by providing that "the labels applied by local law to organizations . . . are in and of themselves of no importance in the classification of such organizations for the purposes of taxation under the Internal Revenue Code." Treas. Reg. § 301.7701-1(c) (1965). The revised regulation further stated that an organization, *incorporated* under the laws of a state, would not be considered a corporation unless it met other stated criteria. *See supra* note 9. This was a blatant attempt to circumvent the congressional definition of corporation as including associations and of partnership as excluding incorporated entities.

Treas. Reg. § 301.7701-2(h) (1965), a new provision, attempted to define professional service corporations and associations out of existence as far as federal taxation was concerned. Directed solely toward this type organization, it purported to describe how to apply the Kintner Regulations, but its effect was to clearly demonstrate that for all practical purposes a professional service corporation could not qualify for a corporate tax classification.

17. *See* Wallace v. United States, *reported* in CCH 1968 STAND. FED. TAX REP., U.S. TAX CAS. (68-2, at 88,299) ¶ 9669 (E.D. Ark. Oct. 31, 1968); Holder v. United States, 289 F. Supp. 160 (N.D. Ga. 1968); Kurzner v. United States, 286 F. Supp. 839 (S.D. Fla. 1968); O'Neill v. United States, 281 F. Supp. 359 (N.D. Ohio 1968).

1. 69 Cal. 2d 887, 447 P.2d 609, 73 Cal. Rptr. 369 (1968).

serious structural damage resulted to the dwellings.[2] Plaintiffs brought suit against the development company and Great Western Savings and Loan Association, the primary financial source for the development,[3] seeking recission of their contracts or damages for the extensive losses they suffered as a result of the defective construction.[4]

Plaintiffs were nonsuited in the trial court; the Court of Appeals for the Second District reversed;[5] on appeal, the Supreme Court of California held that Great Western was under a duty to exercise reasonable care to prevent the construction and sale of seriously defective homes.

The home purchaser has been plagued by the inadequate protection from defective construction afforded him by the law. This lack of protection is attributable to the prevalence of the doctrine of *caveat emptor* which became an established part of the common law during the seventeenth and eighteenth centuries[6] and continues to find acceptance today.[7] This doctrine has virtually disappeared with respect to the purchase of chattels, but its demise in the field of realty has been a more recent development, stimulated by the changing structure of the resi-

2. There was abundant evidence that defendant Conejo Valley Development Company, which built and sold the homes, negligently constructed them without regard to the soil conditions prevalent at the site. Specifically, it laid slab foundations on adobe soil without taking proper precautions recommended to it by soil engineers. When the adobe soil expanded during rainstorms two years later, the foundations cracked and their movement generated further damage. *Id.* at –, 447 P.2d at 611, 73 Cal. Rptr. at 371

3. Great Western supplied the funds to purchase the land, the necessary construction loans, and obtained the rights of first refusal for loans to the purchasers of the homes (which included a penalty to be paid by Conejo for purchasers who financed elsewhere). *Id.* at –, 447 P.2d at 612-14, 73 Cal. Rptr. at 372-74.

4. By stipulation and pretrial order the parties agreed that the issue of Great Western's liability should be determined first and that thereafter the rights and liabilities of the other parties among themselves should be determined. *Id.* at –, 447 P.2d at 620, 73 Cal. Rptr. at 380.

5. Connor v. Conejo Valley Development Co., 253 Cal. App. 2d 186, 61 Cal. Rptr. 333 (1967)

6. Bearman, *Caveat Emptor in Sales of Realty-Recent Assaults on the Rule*, 14 VAND. L. REV. 541, 542 (1961).

7. In an Oregon case the plaintiff purchased a new home from the defendant builder-vendor. The complaint was based on breach of implied warranty, in that the house was built on unstable, filled land incapable of supporting the house and thus diminishing its usefulness. The court held that the rule of *caveat emptor* applied, and that purported warranties must be reduced to written form if an action is to be based upon them. Steiber v. Polumbo, 219 Ore. 479, 347 P.2d 978 (1959).

dential construction industry.[8] When the home purchaser has been successful in securing the protection of the courts from defective construction, the tendency has been to make exceptions to *caveat emptor* rather than to overrule it.[9] In recent years exceptions to the doctrine have been based on implied warranty,[10] express contracts,[11] fraud on the part of the builder-vendor,[12] and negligence in construction.[13] The clear trend is toward affording a greater degree of protection to the home buyer, comparable to the protection available to the buyer of chattels.

The court in *Connor* took an unprecedented step in advancing judicial protection to home purchasers. In holding against Great Western, it rejected a theory of liability based on grounds of joint adventure or joint enterprise.[14] Instead it found a separate duty owed by the lender

8. At the end of WW II, however, houses were in great demand and were produced in amazing quantities, largely by an increasing number of builder-vendors: builders who also sell their product. Almost inevitably, with so many housing developments in existance [*sic*] and the demand for them still rising, instances of poor quality resulted due to hurried construction and skimping on materials. Vendees, who had purchased from these builder-vendors often in haste and with little attempt at inspection or indeed knowledge of how to do it, turned to the courts for relief. Bearman, *supra* note 6, at 542.

9. In Miller v. Cannon Hill Estates, Ltd., [1931] 2 K. B. 113, 121, the court denied the defendant's allegation that an implied warranty could not exist under the doctrine of *caveat emptor* and held that when one purchases a home which is in the course of construction there is an implied warranty that the dwelling will be reasonably fit for the purpose for which it is required. *Accord*, Week v. A:M Sunrise Construction Co., 36 Ill. App. 2d 383, 184 N.E.2d 728 (1962); Jones v. Gatewood, 381 P.2d 158 (Okla. 1963).

10. Initially the implied warranty exception was held to exist only when the home was purchased prior to completion. Hoye v. Century Builders, Inc., 52 Wash.2d 830, 329 P.2d 474 (1958); Miller v. Cannon Hill Estates, Ltd., [1931] 2 K. B. 113. This exception has since been extended to include new homes regardless of whether or not they were completed at the time of purchase. Carpenter v. Donohoe, 154 Colo. 78, 388 P.2d 399 (1964); Humber v. Morton, 426 S.W.2d 554 (Tex. 1968).

11. Laurel Realty Co. v. Himelfarb, 194 Md. 672, 72 A.2d 23 (1950); Weinberg v. Wilensky, 26 N.J. Super. 301, 97 A.2d 707 (1953).

12. Finefrock v. Carney, 263 P.2d 744 (Okla. 1953).

13. Sabella v. Wisler, 59 Cal. 2d 21, 377 P.2d 889, 27 Cal. Rptr. 689 (1963); Fisher v. Simon, 15 Wis. 2d 207, 112 N.W.2d 705 (1961).

14. . . . Although the profits of each were dependent on the overall success of the development, neither was to share in the profits or losses that the other might realize or suffer. Although each received substantial payments as seller, lender, or borrower, neither had an interest in the payments received by the other. Under these circumstances, no joint venture existed.

Connor v. Great W. Sav. & Loan Ass'n, 69 Cal. 2d 887, 447 P.2d 609, 615, 73 Cal. Rptr. 369, 375 (1968)

to the home buyer based on public policy[15] and social utility.[16] The court pointed out that a home is a major investment for the average buyer who lacks the experience or financial means to detect major structural defects.[17] It then stated that if the existing controls were ineffective in securing adequate protection, the imposition of liability, at the point of financial control, would insure responsible construction practices.[18]

The court, however, merely decided the liability of Great Western without establishing the nature and scope of liability as it might be applied to future cases.[19] A situation similar to *Connor* has yet to be litigated in another jurisdiction.[20] However, should the *Connor* holding find wide acceptance, the ramifications of this decision could produce significant changes in the structure and practices of the residential development industry.

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15. "Privity of contract is not necessary to establish the existence of a duty to exercise ordinary care not to injure another, but such duty may arise out of a voluntarily assumed relationship if public policy dictates the existence of such a duty." [Citations omitted.] The basic tests for determining the existence of such a duty are clearly set forth in Biakanja v. Irving [Citations omitted.] as follows: "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 the injury suffered, [5] the moral blame attached to the defendant's conduct, and [6] the policy of preventing future harm." *Id.* at —, 447 P.2d at 617, 73 Cal. Rptr. at 377.

16. ". . . [T]here is no enduring social utility in fostering the construction of seriously defective homes." *Id.* at — 447 P.2d at 618, 73 Cal. Rptr. at 378.

17. *Id.* at ..., 447 P.2d at 618, 73 Cal. Rptr. at 378.

18. *Id.*

19. *See generally* Comment, *Liability of the Institutional Lender for Structural Defects in New Housing*, 35 U. CHI. L. REV. 739 (1968).

20. The Superior Court of New Jersey, Chancery Division, rejected a plaintiff's attempt, heavily stressing Connor v. Conejo Valley Development, Co., 253 Cal. App. 2d 186, 61 Cal. Rptr. 333 (1967), to hold the defendant bank liable, for failure to insure that an undercapitalized builder it was financing, properly disbursed construction loan money to materialmen. The court stated that the materialmen could not be compared to home purchasers, as the former had the requisite knowledge and experience to protect themselves. First Nat'l State Bank v. Carlyle House, Inc., 107 N.J. Super. 300, 246 A.2d 22, 30 (Ch. 1968).