San Diego Law Review

Volume 6 | Issue 2 Article 10

5-1-1969

# Negligence - Savings and Loan Association is Liable to Home Owners For Its Negligence In Financing Construction of Houses Having Structural Defects Which Result in Damage. Connor v. Great Western Savings and Loan Association (Cal. 1968)

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NEGLIGENCE—SAVINGS AND LOAN ASSOCIATION IS LIABLE TO HOME OWNERS FOR ITS NEGLIGENCE IN FINANCING CONSTRUCTION OF HOUSES HAVING STRUCTURAL DEFECTS WHICH RESULT IN DAMAGE. *Connor* v. *Great Western Savings and Loan Association* (Cal. 1968).

Plaintiffs were purchasers of single family homes in a residential tract located in Ventura County, California. The construction of the homes was financed by Great Western Savings and Loan Association under arrangements whereby the savings and loan association initially took title to the land which was then by prior agreement purchased by the contractor (Conejo). Great Western also reserved the right to first preference in making loans to prospective purchasers of the homes. After the purchasers had taken possession, many homes suffered extensive damage from cracking in the foundations which were unable to withstand the expansion and contraction of the adobe soil.[1] As a result, plaintiffs sought rescission or damages from the parties involved in the development of the tract.

On appeal from a judgment of nonsuit in favor of defendant Great Western Savings and Loan Association, the supreme court *held*,[2] reversed; where the success of defendant financial organization's transactions with the construction company (Conejo) depended upon the ability to induce purchasers to finance homes with defendant's funds, and where defendant knew that the construction company was operating on "thin capitalization," thereby creating risk of cutting corners in construction, that the defendant had a duty to exercise reasonable care to prevent the construction and sale of defective homes. Failure to exercise reasonable care resulted in the liability of defendant association for the damage sustained. *Connor v. Great Western Savings and Loan Associaton*, 69 Adv. Cal. 887, 447 P.2d 609, 73 Cal. Rptr. 369 (1968).

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1. This type of soil is common in Southern California. When it dries, it has a tendency to contract to a greater degree than other types of soil, necessitating special precautions in home foundations. Connor v. Great Western Sav. & Loan Ass'n. 69 Adv. Cal. 887, 903, 447 P.2d 609, 616, 73 Cal. Rptr. 369, 376 (1968).

2. This was a four to three decision, and some idea of the interest generated by the case can be seen from the list of amici curiae for the defendant which included the Attorney General, as well as the Assistant and Deputy Attorney Generals of California. *Id.* at 894, 447 P.2d at 611, 73 Cal. Rptr. at 371.

In reaching its decision, the court discussed four major factors upon which the existence of liability would depend. The first of these was the possibility of finding liability on a joint venture or joint enterprise theory. The second revolved around the question of whether the duty to protect shareholder's interests by financing only sound construction should be extended to the prospective purchasers. The third involved the possibility of imposing liability based upon a special relationship between Great Western and Conejo, and it was this basis upon which the court subsequently held defendant liable. The final element was whether lack of privity between the lender and the purchasers would be a bar to recovery.

In regard to the first of these factors the consensus is that a joint enterprise is an undertaking to carry out a number of acts or objectives, which is entered into by associates under circumstances which allow all to have an equal voice in directing the conduct of the enterprise.[3] It usually involves such elements as a common purpose or design, mutual right of control, and sharing of profits and losses.[4] The court concluded that there was no evidence of a joint venture or joint enterprise, because Great Western participated as a buyer and seller of land[5] only in the intermediate stage of negotiations by taking title to the land temporarily, while Conejo operated solely as a builder and seller of homes.[6] Even though the profits of each were dependent upon the overall success of the undertaking, neither party was to share in the profits or losses of the other. Not finding a joint venture or enterprise, the court held Great Western liable for its own negligence, though the dissent argued that this "draconian" result was reached without any reliance on precedent or statutory authority.[7]

In considering the second factor the majority concluded that Great Western was clearly under a duty to its shareholders to

3. 30 Am. Jur. 939-40 (1958).

4. W. PROSSER, LAW OF TORTS § 71 (3d ed. 1964).

5. Great Western loaned money to Conejo for the purchase of the land and took title to it. An option to repurchase the land as needed was granted to Conejo. This type of arrangement has come to be known as "land warehousing" whereby the lender holds the land for the developer until he is ready to use it. The lending institution retains title to the property as well as the right to possession. Connor v. Great Western Sav. & Loan Ass'n, 69 Adv. Cal. 887, 896-97, 447 P.2d 609, 612-13, 73 Cal. Rptr. 369, 372-73 (1968).

6. 69 Adv. Cal. 887, 901, 447 P.2d 609, 615, 73 Cal. Rptr. 369, 375 (1968).

7. *Id.* at 912, 447 P.2d at 622, 73 Cal. Rptr. at 382.

protect their interests by exercising sufficient control over the construction of the homes to insure that the value of their security would not be destroyed by faulty construction.[8] The conclusion to be drawn from a finding of negligence toward shareholder interest is not entirely clear. Rather than using a breach of duty toward shareholders to extend an obligation toward prospective purchasers as Justice Burke in his dissent interpreted the majority's holding,[9] it appears that the court used this merely as evidence of Great Western's carelessness.

Assuming that the court did not intend to find Great Western liable to purchasers because of a breach of duty to the shareholders, it therefore became necessary to determine whether another theory of liability existed. The basis for this liability was the existence of a special relationship between the lender and contractor. As a general rule, in the absence of a special relationship, a party has no duty to control the conduct of a third person to prevent him from harming another.[10] In his dissent, Justice Mosk notes that the lender-borrower relationship has been traditionally exempt from this duty.[11]

The court concluded, however, that because Great Western retained the right of first refusal in long term loans to prospective purchasers of homes and because they warehoused the property, the financial relationship in the instant case went beyond that involving the usual money lender.[12] If an approved buyer wished to obtain a long term loan elsewhere, Great Western had ten days to meet the terms of the other institution. If the loan was placed elsewhere, the contractor was required to pay Great Western any fees and interest the other lender received. The lender held title to the property which could be repurchased by Conejo as they became ready to use it. The court held that this control was sufficient to impose a duty to act affirmatively in overseeing the construction to prevent injury to the purchasers.[13]

8. *Id.* at 902, 447 P.2d at 616, 73 Cal. Rptr. at 376.

9. *Id.* at 918, 447 P.2d at 626, 73 Cal. Rptr. at 386.

10. Richards v. Stanley, 43 Cal. 2d 60, 65, 271 P.2d 23, 27 (1964); Fuller v. Standard Stations Inc., 250 Cal. App. 2d 687, 690, 58 Cal. Rptr. 792, 793 (1967). These two cases were cited by the dissent and both are automobile cases which arguably could not be used to analogize between Great Western and defendants in these cases.

11. 69 Adv. Cal. at 912, 447 P.2d at 622, 73 Cal. Rptr. at 382.

12. *Id.* at 902, 447 P.2d at 616, 73 Cal. Rptr. at 376.

13. *See generally* F. Harper & P. Kime, *Duty to Control conduct of Another*, 43

In his dissent, Justice Mosk contended that Great Western and Conejo did not have sufficient control over each other's activities to impose a duty.[14] He pointed out that Conejo was not empowered to determine the financial arrangements while Great Western could control construction only to the extent necessary to insure loaned funds were being appropriately used. To find that the lender's ability to withhold funds creates sufficient control over the enterprise to impose a duty to third persons would perhaps hold that all lenders control the enterprises which they finance. The dissent argued that the conclusion which could be drawn from the majority opinion in respect to this element constituted the vice of their decision.[15]

The court found that Great Western exercised control over the contractor because of its inspection of the home sites to insure that construction was taking place. Inspections for this purpose are required by statute,[16] but as the dissent points out, this raises the question of whether the lender is now held to a duty to inspect the construction site for the purpose of disclosing defects.[17] If defects were discovered and the contractor failed or refused to correct them, and the lender then refused funds for construction, it would seem that the lender could be left with half completed homes as security for the money disbursed.

Inspection of construction sites has, for the most part, been controlled by governmental agencies but recommendations based upon inspections have been largely ineffectual because they are not binding on the contractors and are infrequently followed.[18] The majority of serious defects in homes result from construction

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YALE L.J. 886 (1934); F. James, Jr., *Scope of Duty in Negligence Cases*, 47 NW. U.L. REV. 778 (1953).

RESTATEMENT (SECOND) OF TORTS § 449 (1965) provides:

> If the likelihood that a third person may act in a particular manner is the hazard or one of the hazards which makes the actor negligent, such an act whether innocent, negligent, intentionally tortious, or criminal does not prevent the actor from being liable for harm caused thereby.

14. 69 Adv. Cal. at 913, 447 P.2d at 623, 73 Cal. Rptr. at 383.

15. *Id.*

16. CAL. FIN. CODE § 8703.1 (West 1968). This section controls the rate of disbursement of funds to the borrower, and as the dissent notes the inspections were for the purpose of confirming compliance with specifications, and if complied with, the funds would be distributed accordingly.

17. 69 Adv. Cal. at 914, 447 P.2d at 623, 73 Cal. Rptr. at 383.

18. *See* G. LEFCOE, LAND DEVELOPMENT LAW, 387-89, 397 (1966).

of faulty foundations[19] which are unable to withstand abnormal soil conditions and are particularly difficult to remedy once construction has progressed.[20]

There was evidence in the instant case that the construction site had been inspected and approved by the appropriate agencies of Ventura County[21] with reports on construction submitted to both the builders and the county.[22] It is not uncommon, however, for loan associations to require their own soil inspections. The loss to hundreds of home owners in California[23] under circumstances similar to those encountered by plaintiffs in *Connor* has led to recent statutory enactments requiring soil inspection by state licensed civil engineers.[24] Considerable control in this area has been extended to the state real estate commissioner, who now requires that subdividers submit soil

19. Comment, *Liability of the Institutional Lender for Structural Defects in New Housing*, 35 U. CHI. L. REV. 739, 748 (1968).

20. There are also indications that at the loan application stage appraisers will often recommend that the loan association reject the application pending alteration of the plans. U.S. SAVINGS AND LOAN LEAGUE, CONSTRUCTION LOAN PROCEDURES 5 (1966).

21. Now it is common to find appraisers on the savings and loan associations' payroll making weekly, if not more frequent, inspections of construction sites. Any defects in construction are required to be repaired immediately with the lender withholding funds if the defects are not corrected according to their directions. Interview with Jim Delaney, Vice President and Senior Loan Officer, Silvergate Savings and Loan Association, in San Diego, Cal., Feb. 13, 1969.

22. 69 Adv. Cal. at 916, 447 P.2d at 625, 73 Cal. Rptr. at 385.

23. STATE BAR OF CALIF., REVIEW OF SELECTED 1965 CODE LEGISLATION 151-52 (1965).

24. CAL. HEALTH & SAFETY CODE (West Supp. 1968) now provides:

§ 17953. *Preliminary soil report; ordinance requiring; waiver*

Each city, county, and city and county shall enact an ordinance which requires a preliminary soil report, prepared by a civil engineer . . . .

§ 17954. *Soil investigation by lot; necessity; preparation; recommendations*

If the preliminary soil report indicates the presence of critically expansive soils or other soil problems which, if not corrected, would lead to structural defects, such ordinance shall require a soil investigation of each lot in the subdivision.

The soil investigation shall be prepared by a civil engineer who is registered in this state. It shall recommend corrective action which is likely to prevent structural damage to each dwelling proposed to be constructed on the expansive soil.

§ 17955. *Approval; building permit conditions; appeal*

The building department of each city, county, or city and county . . . shall approve the soil investigation if it determines that the recommended action is likely to prevent structural damage to each dwelling to be constructed. As a condition to the building permit, the ordinance shall require that the approved recommended action be incorporated in the construction of each dwelling.

and fill reports before construction can begin.[25] As a result of the state's control in this area, it might be expected that the loan associations would be relieved of liability. However, in spite of the state's control in these areas public entities are not liable for failure to inspect property other than their own for health and safety purposes, or for negligent or inadequate inspections.[26] It is arguable that because of this governmental immunity, the loan associations would not be relieved of liability.

In many situations where a special relationship has been found, lack of privity has nevertheless barred recovery.[27] According to Dean Prosser, privity has remained an obstacle to recovery in many cases, and the fear of burdening defendants with a crushing responsibility still leads many courts to deny liability. This barrier has largely been removed from the field of chattel sales,[28] but the extension of these sales concepts has as yet not been applied to real property transactions.[29]

The court cites four cases holding that privity is not a necessary prerequisite in establishing a duty to exercise ordinary care not to injure another, but that a duty to exercise ordinary care may arise out of a voluntarily assumed relationship if public policy requires such a duty.[30] In *Merrill v. Buck*,[31] for example,

25. CAL. BUS. & PROF. CODE (West Supp. 1968) requires that before selling subdivided lands the subdivider must furnish the real estate commissioner the following:
§ 11010. *Notice of intention to sell or lease*
(i) A true statement of the maximum depth of fill used, . . . a true statement on the soil conditions . . . supported by engineering reports showing the soil has been, or will be, prepared in accordance with the recommendations of a registered civil engineer.
§ 11018.4 *Denial of public report; improper soil preparation*
. . . [T]he commissioner shall deny the issuance of a public report if the subdivider fails to demonstrate that the soil within the subdivision has been, or will be, prepared in accordance with the recommendations of a registered civil engineer in such a manner that structural damage is not likely to result.

26. CAL. HEALTH & SAFETY CODE § 17956 (West Supp. 1967). *See also* A. VAN ALSTYNE, CALIFORNIA GOVERNMENT TORT LIABILITY, § 5.60 (1964) (A publication of the State of California's CONTINUING EDUCATION OF THE BAR).

27. *Contra*. McPherson v. Buick Motor Company, 217 N.Y. 382, 111 N.E. 1050 (1916).

28. W. PROSSER, LAW OF TORTS 689 (3d ed. 1964).

29. *Id.*

30. Merrill v. Buck, 58 Cal. 2d 552, 375 P.2d 304, 25 Cal. Rptr. 456 (1962); Lucas v. Hamm, 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961); Stewart v. Cox, 55 Cal. 2d 857, 362 P.2d 345, 13 Cal. Rptr. 521 (1961); Biakanja v. Irving, 49 Cal. 2d 647, 320 P.2d 16 (1958).

31. 58 Cal. 2d 552, 375 P.2d 304, 25 Cal. Rptr. 456 (1962).

defendant real estate agent was held liable to a lessee of premises who was injured after taking possession of the property. While there was no privity between lessee and the agent after lessee had taken possession, and the court admitted the decision was without precedent,[32] a duty was extended to the agent.[33]

The court in *Connor* applied a series of tests set out in *Biakanja v. Irving*,[34] another of the cases cited by the majority in finding Great Western liable to the purchasers even though no privity existed.[35] Apparently no single test would be sufficient to find defendant liable; however, in weighing all of these tests, the court concluded that privity should not be a bar to plaintiff's recovery.

The first of these tests deals with the extent to which the transaction was intended to affect plaintiffs. The majority found a duty because the success of Great Western's transactions depended upon the ability to induce plaintiffs to purchase homes and finance them through Great Western.[36] The dissent, however, contended that because no affirmative representations were made to the prospective purchasers by Great Western the transactions were not undertaken with them in mind, but rather for the benefit of Great Western and Conejo only.[37]

The second test, that of forseeability of harm to plaintiff, led the court to conclude that because defendant knew or should have known that the builders were operating with less than sufficient funds, thereby creating the risk of cutting corners in construction, Great Western should have foreseen injury to a home purchaser.[38] This raises two significant questions: (1) under

32. *Id.* at 562, 375 P.2d at 310, 25 Cal. Rptr. at 462.

33. For some indication of California's recent rejections of traditional no duty concepts see Rowland v. Christian, 69 Adv. Cal. 89, 443 P.2d 561, 70 Cal. Rptr. 97 (1968); Dillon v. Legg, 68 Cal. 2d 728, 441 P.2d 912, 69 Cal. Rptr. 72 (1968).

34. 49 Cal. 2d 647, 320 P.2d 16 (1958) (Defendant notary public was held liable for drawing an invalid will which deprived plaintiffs of intended benefits).

35. Of these factors, the majority and dissent agreed upon only one—the fact that the plaintiffs did suffer injury. 69 Adv. Cal. at 916, 447 P.2d at 625, 73 Cal. Rptr. at 385.

36. 69 Adv. Cal. at 904, 447 P.2d at 617, 73 Cal. Rptr. at 377.

37. *Id.* at 916, 447 P.2d at 624-25, 73 Cal. Rptr. at 384-85.

38. In California, records of contractors' past performance are kept by the Building Material Dealer's Credit Union and by the California Savings and Loan League, which are ways of determining the risk involved in financing any contractor. G. Lefcoe & M. Schaffer, *Construction Lending and the Equitable Lien*, 40 S. CAL. L. REV. 439, 448 n.23 (1967).

similar circumstances would the court extend this duty to a second purchaser or to someone who did not arrange financing with Great Western; and (2) whether a guest in these homes who is injured as a result of a shifting foundation would be entitled to recovery? These plaintiffs would appear to be reasonably forseeable, but whether the court intends an extension of liability to them does not appear in *Connor*.

Another test involves determination of the proximity between the injury suffered and defendant's conduct. The court found evidence that Great Western not only financed the construction but could also determine the contractor's rate of progress by withholding funds. Having found Great Western able to control Conejo, the court held Great Western unreasonable in the exercise of this control.[39] The dissent contended that the activities of the two parties were so remote that there should be no liability imposed on the loan association.[40]

The next test, that of the culpability of defendant's conduct, applied to Great Western because they were aware of the average home purchaser's unfamiliarity with the elements of sound construction. This inability of the consumer to discern structural defects, and the fact that for most people a home is their largest single investment, prompted the court to view Great Western's conduct as at least reprehensible.[41]

The final test, that of preventing future similar injury, becomes especially important in the *Connor* situation because the home construction industry affects so many people. Contrary to the dissent's contention that protective measures in this area are properly for the legislature, the majority held that the lending institution should have been farsighted enough to make provisions for potential liability to home purchasers. The court also found that in the absence of actual or prospective legislation, it is within the court's discretion to act.[42]

In a final effort to shift liability from themselves, the defense contended that the negligence of Conejo and the approval of the construction by county authorities constituted superseding causes which relieve Great Western of liability. In rejecting this

39. 69 Adv. Cal. at 902, 447 P.2d at 616, 73 Cal. Rptr. at 376.
40. *Id.* at 916, 447 P.2d at 625, 73 Cal. Rptr. at 385.
41. *Id.* at 905, 447 P.2d at 618, 73 Cal. Rptr. at 378.
42. *Id.* at 906, 447 P.2d at 619, 73 Cal. Rptr. at 379.

argument, the court cited *Lacy v. Pacific Gas & Electric Co.* which held that when the original negligence continues and exists up to the time of the injury, the concurrent act of a third person causing the injury will not be regarded as a superseding act of negligence but the two concurrent acts will be held to be the proximate cause of the injury.[43] With certain qualifications, the Restatement of Torts is in accord with the holding of this case.[44]

The implications of *Connor*, as in any other case founded on little precedent, are difficult to determine. In recent years the trend among savings and loan associations has been toward much tighter inspection practices with the full utilization of city and county officials. Financing large tracts now appears to be less favored than in the past with most lending institutions preferring the small builder.[45]

In light of the *Connor* decision, inspection requirements of savings and loan associations will be tightened and there are already indications that this is becoming the practice. Had any of the circumstances been different, the decision might have been in the defendant's favor.[46] For example, had defendant not taken title to the property, there may not have been sufficient control over the building enterprise to find liability. The policy considerations, especially protection of the public from faulty construction and the great burden to a family suffering such loss, appear to be the underlying reasons for the decision.

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43. 220 Cal. 97, 98, 29 P.2d 781, 782 (1934) (Plaintiff recovered for injuries sustained when an electric light pole left in a farm roadway by defendant electric company was struck by an automobile negligently operated by the driver).

44. RESTATEMENT (SECOND) OF TORTS § 447 (1965) provides:

> The fact that an intervening act of a third person is negligent in itself or is done in a negligent manner does not make it a superseding cause of harm to another which the actor's negligent conduct is a substantial factor in bringing about, if . . .
>
> (b) a reasonable man knowing the situation existing when the act of the third person was done would not regard it as highly extraordinary that the third person had so acted, or
>
> (c) the intervening act is a normal consequence to a situation created by the actor's conduct and the manner in which it is done is not extraordinarily negligent.

45. Interview with A. C. Wells, Vice President of San Diego Federal Savings and Loan Association, in San Diego, Cal., Feb. 12, 1969.

46. *Id.* Mr. Wells also mentioned that the situation for the Federal Savings and Loan Associations may be different from that of a state charter association like Great Western in that the federal associations are not permitted to "warehouse" land as was Great Western. This would remove one major area of control from the federal associations.

The recent procedural changes in the savings and loan business requiring tighter inspection practices and careful scrutiny of the contractor's financial status have perhaps already accomplished some of the goals and established some of the standards which the court appears to set out in the topic case. *Connor* would seem to hold these standards to be mandatory, and hopefully alleviate many problems in the field of home construction.

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