

FINANCING OF BUILDING CONSTRUCTION: LIABILITY FOR STRUCTURAL DEFECTS

INTRODUCTION: THE *Connor* CASE

Plaintiffs in *Connor v. Great Western Sav. & Loan Ass'n*¹ were purchasers of homes in a residential tract development. Their homes were seriously damaged² by cracking in the foundations allegedly caused by the negligent design and construction of the foundations.³ Plaintiffs instituted an action against Great Western Savings and Loan Association, the institution which had financed the purchase of the land and the construction of the homes.⁴ At trial, there was sufficient evidence that the contractor which Great Western had financed, Conejo Valley Development Company, had laid slab foundations on adobe soil without taking the precautions which had been recommended by soil engineers.⁵

Plaintiffs sought to hold Great Western liable on two distinct theories: (1) that because Great Western had participated in a joint venture with the contractor, Great Western was vicariously liable for the torts of the contractor and (2) that Great Western breached an independent duty of care which it owed to purchasers of the homes in the tract. A nonsuit was granted by the trial court, but the decision was reversed by the California Court of Appeal. In a divided opinion the California Supreme Court affirmed the reversal of the trial court. It held that a lending institution which undertakes almost total financial support of a housing development constructed by an inexperienced and undercapitalized builder owes an independent duty to pro-

¹ 69 Cal. 2d —, 73 Cal. Rptr. 369, 447 P.2d 609 (1968), aff'g *Connor v. Conejo Valley Dev. Co.*, 61 Cal. Rptr. 333 (Ct. App. 1967).

² The homes sold for \$14,950-\$15,950 and suffered damage estimated at about \$6000 per dwelling. 61 Cal. Rptr. at 346.

³ The homes were built upon adobe soil which has a tendency to expand and contract when weather conditions change. When water is absorbed into the soil, it expands up to five times its dry dimensions; when it dries, it contracts and cracks into plates. When he builds upon adobe soil, the contractor must utilize special techniques in the construction of the foundation in order to prevent the cracking from damaging the homes. See 61 Cal. Rptr. at 339.

Because of the numerous homes which had been built upon the adobe soil in California, a state legislative committee undertook a study of the problem. The recommendations of the committee were enacted into law in 1965. See 69 Cal. 2d at — n.—, 73 Cal. Rptr. at 378 n.10, 447 P.2d at 618 n.10. Each city and county is now required to enact an ordinance requiring a contractor to engage a civil engineer to prepare a preliminary soil report prior to the commencement of construction. If the report indicates the presence of adobe soil on the land, the contractor must require the engineer to conduct a more extensive investigation of each lot. The engineer's report must also include a list of recommendations advising the contractor of steps deemed necessary to prevent structural defects. Cal. Health & Safety Code §§ 17953-54 (West Supp. 1968).

⁴ Plaintiffs also instituted actions against certain lenders, developers, contractors, subcontractors, and individuals involved in the development of the tract. None of these actions was before the California Supreme Court, since the action against Great Western was tried first. 61 Cal. Rptr. at 336.

⁵ There was no evidence, however, that Great Western was informed of these recommendations. 61 Cal. Rptr. at 340.

tect purchasers of the homes from major structural defects.⁶ The supreme court did, however, concur with the trial court and the court of appeal that Conejo and Great Western were not engaged in a joint venture.

This comment will examine the legal foundations of the result reached in *Connor* and then explore the ramifications of the decision. Since the first part of the opinion, dealing with the possibility that a joint venture existed, is merely a restatement of existing law, most of the discussion will concentrate on the imposition upon Great Western of a duty of care to the purchasers of the homes. The imposition of this duty is a novel and important departure from traditional concepts of tort liability. Although the holding of the court is intended to achieve a sound social objective—the protection of innocent homeowners from financial loss resulting from the negligence of inexperienced and undercapitalized construction firms—the means which the court has chosen, placing a duty of care upon a lending institution, is ill suited to the realities of the home construction industry.

For a full understanding of the holding and an appreciation of its potential impact, it is necessary to examine in some detail the dealings among Conejo, Great Western and the plaintiffs. Since the court places much emphasis upon the control which Great Western had in the development, it is particularly important to scrutinize the financial arrangements between Conejo and Great Western.

In 1958, South Gate Development Company (the predecessor of Conejo) began negotiations to purchase land in anticipation of developing the land into a 2000 home community.⁷ In January, 1959, South Gate signed a contract to purchase 100 acres for \$340,000 within 120 days.⁸ In March, 1959, one of South Gate's shareholders, cognizant of the fact that neither he nor South Gate had sufficient working capital available, approached Great Western. By May, 1959, Great Western had agreed to loan South Gate sufficient funds to enable it to purchase the 100 acre tract. Great Western was also granted the right to make construction loans to South Gate and to provide mortgage financing to prospective purchasers of the homes.⁹ Conejo, which

⁶ The case has been remanded to the trial court for disposition. Also, a dispute over the costs on appeal is before both the trial court and the California Supreme Court. Letter from Ernest E. Johnson of Overton, Lyman & Prince to B.C. Ind. & Com. L. Rev., Feb. 24, 1969.

⁷ South Gate was wholly owned and controlled by two stockholders, neither of whom was very experienced in large-scale home construction. 69 Cal. 2d at —, 73 Cal. Rptr. at 372, 447 P.2d at 612.

⁸ South Gate also agreed under a conditional sales contract to purchase an additional 447 acres for \$2500 per acre over a ten-year period. *Id.* at —, 73 Cal. Rptr. at 372, 447 P.2d at 612.

⁹ When South Gate sold its lots, it was obligated to inform the purchasers that Great Western was willing to provide first mortgages. South Gate had also promised to act as a conduit in obtaining the requisite credit information for Great Western. If a purchaser approved by Great Western decided to finance with a different financial institution, Great Western had ten days to meet the terms of the other institution. If Great Western agreed to offer the same mortgage terms and the purchaser still wished to obtain its financing elsewhere, South Gate was required to pay Great Western the fees and interest which it would have obtained if the purchaser had accepted the offer.

Most of the purchasers secured their mortgages with Great Western. The mortgages

was incorporated with only \$5000 capital, succeeded to South Gate's interest. At about this same time the land was purchased with Great Western contributing \$150,000 of the total \$340,000 purchase price.¹⁰ Great Western took title to the land and granted Conejo a one-year option to repurchase the land for \$180,000.¹¹

In September, 1959, Great Western lent Conejo \$3,000,000 to enable it to commence construction of the homes. The consideration promised by Conejo was a 5 percent construction loan fee and 6.6 percent interest on the outstanding construction loans as disbursed over the first six months, and thereafter 6.6 percent interest on the full \$3,000,000. Conejo utilized part of the advances from the \$3,000,000 loan to exercise its option to repurchase the land from Great Western. This transaction enabled Great Western to recognize an immediate capital gain of \$30,000.

As Conejo sold the homes, it referred the purchasers to Great Western for mortgage financing. Great Western in turn charged Conejo a 1-1/2 percent fee depending on the risk of the mortgagor. If a purchaser desired to obtain his financing elsewhere even though Great Western was willing to meet the terms of the other mortgagee, Conejo was required to pay Great Western the fees and interest charged by the other mortgagee.

Although these financial arrangements seem to indicate that Great Western was integrally involved in the land development, it appears that its involvement was no more extensive than is ordinary for a lender in the industry.¹² Although Great Western had the right to approve the plans and specifications for the homes and to withhold advances if Conejo failed to conform to these plans and specifications, Great Western did not have the right to exercise any control over the construction process itself. Thus, the control which Great Western had over the construction consisted of the usual incidents that accompany a normal construction loan.¹³

I. JOINT VENTURE

From the evidence presented at the trial, it appears that the court correctly decided that the relationship between Conejo and Great Western did not amount to a joint venture.¹⁴ Analytically, three essential elements are

generally provided the purchaser with 80% of the purchase price at 6.6% interest for a term of 24 years. Great Western also charged South Gate a 1% fee for mortgages made to "qualified" purchasers and a 1-1/2% fee for mortgages made to poor risks. *Id.* at —, 73 Cal. Rptr. at 374, 447 P.2d at 614.

¹⁰ It is unclear how South Gate was able to contribute the other \$190,000 of the purchase price, but the court speculated that its shareholders liquidated assets from other closely held corporations. *Id.* at —, 73 Cal. Rptr. at 372-73, 447 P.2d at 612-13.

¹¹ This financial arrangement is known as "land warehousing." Under this arrangement, the lender retains ownership and possession of the land until the contractor is ready to begin construction. *Id.* at —, 73 Cal. Rptr. at 373, 447 P.2d at 612-13.

¹² For an explanation of the typical involvement of a savings and loan association in the development of new housing, see Comment, Liability of the Institutional Lender for Structural Defects in New Housing, 35 U. Chi. L. Rev. 739, 743-48 (1968). See also Lefcoe & Dobson, Savings Associations as Land Developers, 75 Yale L.J. 1271 (1966).

¹³ Cf. Comment, *supra* note 12, at 743-48.

¹⁴ There was also insufficient evidence to establish a "joint enterprise" relationship. Although some states distinguish between a "joint venture" and a "joint enterprise," it

necessary to constitute a joint venture: first, there must be an agreement, express or implied, to enter into the undertaking; second, there must be a community of interests in the objects and purposes to be accomplished; and third, there must be equal authority by the venturers over the management and control of the undertaking.¹⁵

It does not appear from the facts that there was a community of interests shared by Conejo and Great Western. It is arguable, however, that Great Western, although not legally entitled to participate in Conejo's profits, did in fact participate in those profits. The amount which Great Western expected to receive in fees and interest was practically equal to Conejo's expected net profit. In spite of this fact, the courts generally hold that a mere lender of funds does not share a community of interests with his debtor.¹⁶ Great Western's interest was that of a lender of funds whereas Conejo's interest was that of a builder and vendor of homes. Neither had a right to participate in the profits which the other received for performing its distinct role during the course of the development. Great Western was to receive a stipulated sum comprised of fees and interest in consideration for the loans extended to Conejo. Conejo was to receive whatever profits were left after deducting all expenses (including the interest and fees paid to Great Western) from the proceeds of the sale of the homes. Great Western, on the other hand, was entitled to its fixed construction loan fees and interest on the loans even if the development proved unprofitable, and its return on the loans would not increase if a great profit were realized by Conejo.

Even if it is assumed that Great Western can be considered a profit sharer for purposes of establishing the requisite community of interests, their relationship did not constitute a joint venture because Great Western did not have the right to exercise sufficient authority over the management and control of the tract development. What little control Great Western could exercise is not inconsistent with the usual incidents of control accompanying the status of a lender. Although Great Western possessed the contractual right to withhold advances if it were not satisfied that the construction was proceeding in conformity with the plans and specifications which it approved, these rights do not amount to the quantity or quality of control deemed essential to characterize a relationship a joint venture. Great Western could not exercise any authority over the ministerial duties of the construction process, nor could it decide what or how many employees should be hired. Also, it had no

appears that California uses the terms interchangeably in the description of a commercial undertaking. See 69 Cal. 2d at — n. —, 73 Cal. Rptr. at 376 n.6, 447 P.2d at 616 n.6.

¹⁵ See *Holtz v. United Plumbing & Heating Co.*, 49 Cal. 2d 501, 506-07, 319 P.2d 617, 620 (1957); *Day, Banks as Joint Adventurers*, 9 Conn. B.J. 20, 21-26 (1935); *Nichols, Joint Ventures*, 36 Va. L. Rev. 425, 429-33 (1950).

A joint venture has been described as an association of persons, natural or corporate, who agree by contract to engage in some common, usually ad hoc undertaking for joint profit by combining their respective resources, without however, forming a partnership . . . or corporation; their agreement also provides for a community of interest among the joint venturers each of whom is both principal and agent as to the others within the scope of the venture over which each venturer exercises some degree of control.

² S. Williston, *Contracts* § 318, at 555-56 (3d ed. 1959).

¹⁶ See, e.g., *Treichel v. Adams*, 280 Minn. 132, 135-36, 158 N.W.2d 263, 266 (1968).

control over the operating costs and expenses incurred by Conejo. Thus, it seems clear that the relationship between Conejo and Great Western lacked at least one and possibly two of the requisites of a joint venture: community of interests and reciprocal authority.

II. INDEPENDENT DUTY OF CARE: THE *Biakanja* TEST

While the court had little difficulty in holding that no joint venture existed between Conejo and Great Western, it nevertheless found that Great Western owed an independent duty of care to the plaintiffs.¹⁷ This holding is lacking in legal precedent both in California and in other common law jurisdictions, and is likely to produce untoward social and economic results.

Although the court still relies upon the traditional elements of negligence liability (duty, breach of duty, proximate cause, and harm),¹⁸ it reaches a novel result because of what it allows in satisfaction of these elements to constitute a prima facie case. In deciding that Great Western was liable to the purchasers of the homes in the tract, the court principally relies upon a six-part test first enunciated in *Biakanja v. Irving*.¹⁹ This test, in effect, includes each of the traditional elements except "breach of duty."²⁰

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 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.²¹

In measuring Great Western's activities against each part of the six-part *Biakanja* test, the court has extended and sometimes distorted the real meaning of the test in order to reach what it considers to be a desirable result.

A. *Duty of Care*

The court's distortion of the test is exemplified by its statement that Great Western's transactions were intended to affect the purchasers significantly.²² The court rests this finding upon the infirm ground that the success of Great Western's loans to Conejo depended upon the sale of the

¹⁷ 69 Cal. 2d at —, 73 Cal. Rptr. at 377, 447 P.2d at 617.

¹⁸ The traditional elements of negligence are listed in W. Prosser, *Handbook of the Law of Torts* § 30 (3d ed. 1964).

¹⁹ 49 Cal. 2d 647, 320 P.2d 16 (1958).

²⁰ Parts [1] and [2] of the test are the criteria usually subsumed under the general heading of "duty"; parts [4], [5], and [6] are the usual tests of proximate cause; part [3] is the element of harm to the plaintiff.

See generally W. Prosser, *supra* note 18, § 53 on the element of "duty," and § 49 on the element of proximate cause.

²¹ 49 Cal. 2d 647, 650, 320 P.2d 16, 19 (1958).

²² 69 Cal. 2d at —, 73 Cal. Rptr. at 377, 447 P.2d at 617.

homes to the purchasers.²³ The invalidity of this conclusion is apparent in light of the mechanics of the transactions between Conejo and Great Western. At all times during the construction Great Western's outstanding loans were purportedly secured by sufficient collateral. Great Western enabled Conejo to purchase the tract by taking title to the land and granting Conejo an option to purchase the land. If Conejo failed to exercise the option, Great Western could have sold the land to another purchaser for a substantial capital gain. Great Western's advancements on the construction loans were given only after it assured itself that the construction was progressing properly. The court also stresses that Great Western was primarily concerned with granting mortgages to the prospective purchasers and that its involvement would not have been as profitable if the purchasers refused to obtain their mortgages from Great Western. It must be remembered, however, that the purchasers were never obligated in any way to do their mortgage financing with Great Western and that Great Western was assured of these anticipated profits from the mortgages by its contractual arrangement with Conejo.

It is submitted that the transactions of Great Western were intended to affect its shareholders and Conejo in a significant manner, but were not intended to affect the plaintiff-purchasers except in a tangential way. The transactions were intended primarily to affect the shareholders of Great Western by providing them with a healthy return on their investment. The transactions were also intended to affect Conejo, by enabling it to undertake the purchase of the land and the construction of the homes. The activities of Great Western throughout the negotiation and construction period were motivated by a desire to fulfill its contractual obligations to Conejo, and to preserve the rights of its shareholders to insure that the corporation was engaged in a profitable endeavor and that the security for the loan was well protected. Thus, Great Western's requirement that Conejo submit plans and specifications was dictated by its duty to its shareholders to exercise reasonable care in the lending of funds. Great Western's investigation of Conejo's financial condition was undertaken for similar reasons. It enabled Great Western to assure itself that the loan would be repaid. Finally, Great Western's on-the-site inspections of the construction were made to satisfy itself that Conejo was entitled to the funds which Great Western was disbursing to it on a completion basis.

Admittedly, Great Western knew or should have known that its transactions with Conejo would have some effect upon the ultimate purchasers of the homes. However, the transactions were not intended to affect the purchasers in a substantial manner. Great Western never made any representations to the purchasers with respect to the experience and reliability of Conejo, nor did it ever inform the purchasers that the plans and specifications were satisfactory and that the construction was being performed in conformity with these plans.

²³ *Id.* at —, 73 Cal. Rptr. at 377, 447 P.2d at 617. In this regard the court emphasized (1) the fact that Great Western's construction loan was granted on the condition that a sufficient number of persons contracted with Conejo to purchase the homes, (2) the land warehousing agreement which enabled Great Western to recognize a \$30,000 capital gain, and (3) the mortgage arrangements.

For an understanding of what the California courts have meant by a transaction intended to "affect the plaintiff in a substantial way," it is instructive to examine two of the cases cited in *Connor*. In *Biakanja v. Irving*,²⁴ a notary public who prepared a will invalid because of his negligent failure to have it properly attested was held liable to a prospective beneficiary under the will despite the absence of privity between the notary and the beneficiary. The failure of the notary had a very substantial effect upon the beneficiaries, for it prevented them from taking under the will. The notary was aware or should have been aware that his drafting of an invalid will would deny the beneficiaries their bequests, for the drafting of a will has one fundamental purpose: disposition of a testator's estate to the objects of his bounty. This purpose is to be contrasted with that in *Connor*, where the tasks which Great Western was obliged to perform (lending, inspecting, and appraising) were motivated by its desire to fulfill its contractual obligation to Conejo and to protect its shareholders' interests.²⁵

Another case cited by the court is *Merrill v. Buck*.²⁶ The *Merrill* court, after admitting that the decision lacked legal precedent,²⁷ found a real estate agent liable to the lessee of a dwelling house which the agent had shown to the lessee. Specifically, the court held that the agent had a duty to warn the prospective tenant of the hidden dangers of the basement stairs in the house, of which the agent knew, where the transaction between the agent and the lessee was intended to bring about the tenant's occupancy of the house.²⁸ The real estate agent's livelihood depended upon his ability to convince prospective tenants of the virtues of the house. If the agent failed in this regard, he would not be able to secure his commission from the landlord. This case is also distinguishable from the situation in *Connor* where the transactions involving Great Western were not intended specifically to bring about the plaintiffs' purchases of the homes. Therefore, it would appear that to predicate Great Western's liability upon the extent to which the transactions were intended to affect the plaintiffs is to extend the test to a situation where the defendant's actions were not intended to affect the plaintiffs in any substantial manner.

Once the court found that the transactions were intended to affect the plaintiffs, the other requirements of the test were relatively easy to satisfy. Although Justice Mosk states in his dissent that Great Western could not reasonably be expected to foresee that its provision of funds to Conejo would result in harm to the purchasers,²⁹ his conclusion is unjustified. Justice Mosk stresses one relatively insignificant fact—that Conejo had been highly recommended by another experienced lender.³⁰ The other evidence presented at the

²⁴ 49 Cal. 2d 647, 320 P.2d 16 (1958).

²⁵ Another case similar to *Biakanja* and cited in *Great Western* and in which the six-part test was again utilized was *Lucas v. Hamm*, 56 Cal. 2d 583, 15 Cal. Rptr. 821, 364 P.2d 685 (1961). The beneficiaries under a will sued the attorney who drafted an invalid instrument.

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

²⁷ Id. at 562, 25 Cal. Rptr. at 462, 375 P.2d at 310.

²⁸ Id. at 562, 25 Cal. Rptr. at 462, 375 P.2d at 310.

²⁹ 69 Cal. 2d at —, 73 Cal. Rptr. at 385, 447 P.2d at 625.

³⁰ Id. at —, 73 Cal. Rptr. at 385, 447 P.2d at 625.

trial indicates unequivocally that Great Western was cognizant of Conejo's lack of experience as well as its financial predicament. Since the appeal is from a judgment of nonsuit, the plaintiffs' evidence must be given its full probative value and any conflicting evidence must be disregarded.³¹ Thus, there was certainly sufficient evidence produced by the plaintiffs to establish that Great Western could be expected to foresee the consequences of its transaction with Conejo.

B. Proximate Cause

To admit foreseeability is not to admit that Great Western had a duty to exercise reasonable care to the purchasers, for the existence of liability is dependent upon a balancing of the six parts of the *Biakanja* test. Also, a number of other tort cases have arisen in California in which the court has admitted foreseeability of harm but has still refused to find a duty of care. In *Fuller v. Standard Stations, Inc.*,³² a person injured in an automobile accident brought an action against the operator of a gasoline station who had sold gasoline to an intoxicated motorist who subsequently collided with an automobile in which the plaintiff was riding. Although the court conceded that the service station attendant reasonably could have foreseen the result of supplying an inebriated motorist with gasoline,³³ it felt constrained to affirm the trial court's granting of a demurrer. The court perceived no significant distinction in logic, social policy, or law between a case where a service station attendant sells gasoline to an intoxicated motorist and a case where a tavernkeeper sells liquor to an intoxicated person who he knows is going to operate a motor vehicle.³⁴ Since California has refused to impose a common law duty upon a tavernkeeper to a third person injured by the torts of an intoxicated person where the tavernkeeper has sold alcohol to the inebriate,³⁵ it also refused to recognize a duty in *Fuller*.

The chief obstacles to the maintenance of an action at common law against a tavernkeeper who has sold intoxicating beverages to an inebriated person is that the sale of intoxicating liquor is not ordinarily actionable negligence; that even if the sale of the liquor is wrongful and constitutes negligent conduct by the vendor, the sale is under most circumstances to be considered a remote rather than a proximate cause.³⁶ As a result of these obstacles, very few states have predicated a tavernkeeper's liability upon the common law in spite of the fact that the harm is reasonably foreseeable.³⁷ A number of states, not including California, have changed the common law by enacting various statutes usually called the Dram Shop Acts.³⁸

³¹ See *Raber v. Tumin*, 36 Cal. 2d 654, 656, 226 P.2d 574, 575 (1951); *Blumberg v. M. & T., Inc.*, 34 Cal. 2d 226, 229, 209 P.2d 1, 3 (1949).

³² 250 Cal. App. 2d 687, 58 Cal. Rptr. 792 (1967).

³³ *Id.* at 692, 58 Cal. Rptr. at 795.

³⁴ *Id.* at 693, 58 Cal. Rptr. at 796.

³⁵ See *Dwan v. Dixon*, 216 Cal. App. 2d 260, 30 Cal. Rptr. 749 (1963); *Fleckner v. Dionne*, 94 Cal. App. 2d 246, 210 P.2d 530 (1949).

³⁶ Cf. Annot., 130 A.L.R. 352, 358-59 (1941).

³⁷ See Annot., 75 A.L.R.2d 833, 835 (1961).

³⁸ W. Prosser, *supra* note 18, § 79 (14 states). See, e.g., Ill. Stat. Ann. ch. 43, § 135 (Smith-Hurd Supp. 1968).

It is submitted that the facts of *Connor* can be more easily analogized to the tavernkeeper cases than to any of the four decisions cited as authority by the California Supreme Court. In the tavernkeeper cases, the defendant has breached no duty either contractually or in tort to the intoxicated person. Likewise, Great Western has breached no duty owed to Conejo. The tavernkeeper's sale of alcohol to an inebriate who he knows is going to operate a motor vehicle can be analogized to Great Western's supplying funds to an inexperienced and undercapitalized contractor. In the tavernkeeper cases, the court's reluctance to find a duty rests upon a consideration that the selling of liquor is too remote to be a proximate cause of an injury caused by the negligent act of the purchaser of the liquor. Since the California courts have accepted this traditional rationale in the tavernkeeper cases, it is anomalous that they so readily established Great Western's financing as the proximate cause of the homeowners' injuries in *Connor*. In *Connor*, the funds supplied by Great Western merely made the act of Conejo possible and did not affect the essential character of Conejo's construction activities. In the tavernkeeper cases, on the other hand, the alcohol supplied by the bartender influenced the essential character of the motorist's driving and made it more dangerous. In light of this distinction, it would seem more compelling that the court find proximate cause in the tavernkeeper cases than in *Connor*.

The connection between the injury suffered by the purchasers and Great Western's conduct is not close enough to dictate the establishment of proximate cause. The injury was caused by the negligence of Conejo in the construction of homes with defective foundations. Great Western's role was to finance the construction. It was a duty owed to its shareholders and not to the purchasers which obligated it to exercise reasonable care in protecting the security behind the loan. Great Western's failure in this regard is a breach of its duty to its shareholders and should not be utilized by the plaintiffs to establish proximate cause.

C. Social Policy

Although the court has distorted the meaning of two parts of the *Biakanja* test (part 1, the extent to which the transaction was intended to affect the plaintiff, and part 4, the closeness of connection between the defendant's conduct and the injury suffered) and has ignored the tavern-keeper cases, its imposition of liability upon Great Western might still be justified if strong policy considerations favored such a result.³⁹ In this case, however, relevant policy considerations militate against the imposition of liability upon Great Western.

Obviously, fostering the development of defective homes is poor social policy. However, contrary to the opinion of the court, absolution of Great Western from liability does not promote the development of defective homes. Contractors are the parties primarily responsible for building defective homes and they are the parties upon whom the burden of liability rightfully weighs. Concededly, a number of home contractors may be financially irresponsible and may be unable to meet ordinary operating expenses even without the added burden of satisfying legal judgments. However, this is a problem most

³⁹ Cf. W. Prosser, *supra* note 18, § 49.

appropriately solved by the legislature. As Justice Mosk indicates, "[L]egislative bodies can take appropriate action to revamp building codes, give more power to regulatory agencies, make licensing requirements more strict, compel bonding of home builders, provide for industry-wide insurance."⁴⁰ Moreover, a legislative solution will be able to attack the problem at its source—the existence of inexperienced and undercapitalized contractors—without distorting traditional notions of tort liability.

Once again, analogy to the tavernkeeper cases is helpful. At least two policy reasons favor the imposition of a duty of care upon tavernkeepers but withhold such a duty from construction lenders. First, the chances of serious bodily injury or death to the consumer and third parties is much greater where a tavernkeeper sells alcohol to an inebriate who intends to operate a motor vehicle. Second, a distinctive policy argument can be made for the protection of financial institutions from remote liability. The viability of the private enterprise system depends to a great extent upon the availability of loans. Large capital investments, such as home developments, must be postponed until lending institutions are willing to provide loans at reasonable interest rates. The availability of ample loan financing is particularly important at a time when the country is experiencing a severe housing shortage, as it is today.⁴¹

Also, it does not appear that the policy of preventing future harm would be furthered by the imposition of liability on a financial institution such as Great Western. Harm can be prevented only when the monetary impact of liability falls upon those who are both situated to prevent future harm and unable to shift the monetary impact to another person. The imposition upon lenders of liability for faulty construction satisfies neither prerequisite. The part presently played by lending institutions in the home construction industry does not place lenders in a position where they can control the construction process itself. If these institutions take a more active role in the home construction industry, they might violate the statutes of states which prohibit them from actively engaging in land development.⁴² Also, under the present arrangements of the housing industry, it is likely that the lending institutions will have little difficulty in passing on the financial burden of liability to the contractors by increasing loan fees and interest rates.⁴³ It also seems likely that the contractors will be able to pass on these increased costs of construction to the purchasers through increased purchase prices.⁴⁴ Thus, the ultimate impact will come to rest upon homeowners who certainly are not situated to prevent the harm.

Finally, the conclusion of the court that substantial moral blame attaches to Great Western's conduct is also without merit. The court found this moral blame because "[Great Western] was well aware that the usual buyer of a home is ill-equipped with experience or financial means to discern

⁴⁰ 69 Cal. 2d at —, 73 Cal. Rptr. at 385, 447 P.2d at 625.

⁴¹ See Wall St. Journal, Mar. 7, 1969, at 4, cols. 2, 3.

⁴² See Lefcoe & Dobson, *supra* note 12, at 1273.

⁴³ See Comment, *supra* note 12, at 754.

⁴⁴ See *id.*

such structural defects."⁴⁵ The court then sympathizes with the plight of the purchaser by emphasizing that a home is a major investment for the usual purchaser. Although such conclusions are undoubtedly true, they bear little relevance to a determination of moral blame. They once again manifest the court's attempt to reach what it considers to be a desirable result at the expense of distorted legal principles. The "moral blame" test should focus on such elements as scienter, malice, or willful or wanton misconduct. Such elements were obviously lacking with respect to Great Western's activities.

CONCLUSION

Although Justice Mosk believes that this decision will cause a substantial restructuring of the economic relationship between lenders and builders,⁴⁶ it is felt that this result is unlikely, for savings and loan associations are forbidden by law in many states from engaging in the outright development of land.⁴⁷ It seems more likely that these lending institutions, faced with potentially heavy liability, will require their borrowers to obtain liability insurance. Those contractors unable to absorb the cost of the premiums or unable to pass on the cost to home purchasers will be put out of business. The likely result is that some of the small construction firms, which presently constitute a high percentage of the housing industry, will be unable to pass on the cost to the purchasers and might be forced to liquidate.⁴⁸ As fewer construction firms dominate the industry, competition will decrease and prices of homes will rise.

Some lending institutions might opt for retention of the risk of loss. These institutions will either self-insure or purchase liability insurance. In either case, the cost of insurance will be reflected in the interest rates charged to contractors. This result will also hasten the decline in the number of small construction firms. The money shortage, which has resulted in the worst housing shortage in twenty years,⁴⁹ will reach staggering proportions unless steps are taken to curb the increase in interest rates. If the financial institutions decide to retain the risk, it is inevitable that interest rates will increase with the concomitant exacerbation of the money shortage.

ALAN S. KAPLINSKY

⁴⁵ 69 Cal. 2d at —, 73 Cal. Rptr. at 378, 447 P.2d at 618.

⁴⁶ See *id.* at —, 73 Cal. Rptr. at 385, 447 P.2d at 625.

⁴⁷ See note 42 *supra*.

⁴⁸ See Lefcoe & Dobson, *supra* note 12, at 754.

⁴⁹ See note 41 *supra*.