

# Construction Law Report

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## The Implied Warranty of Habitability In Residential Developments

Obviously every seller of a product must be careful about the promises it makes expressly in its sales contract. Those promises help establish the nature and scope of the seller's potential liability to the purchaser of its goods.

Express warranties are not, however, the only promises that a seller makes. With respect to the sale of goods, like HD TVs and refrigerators, the Uniform Commercial Code (UCC) adopted, with variations in every state, implies warranties such as merchantability and fitness for use into every sale of goods.

In many states, similar consumer protection warranties are implied into contracts for the sale of dwellings, whether detached single family homes or condominium units. These warranties arise not from the act of any state legislature, but from judicial determinations in particular cases which then become binding by the force of precedent. Among these implied warranties is one for "habitability".

The implied warranty of habitability in residential developments has its origins in the 1960s when courts in Colorado, New Jersey, and Washington, drawing on analogies to the UCC's implied warranties of fitness for use in the sale of consumer goods, determined as a matter of "public policy" that a vendor/builder of a new house impliedly warrants to the first owner/occupant that the house is structurally safe and healthy for the occupants to use as living quarters. That the state legislature had not expressed this perceived "public

policy" in the form of legislation, as it had with the UCC, seems not to have mattered to these courts. Nevertheless, in a significant number of states, including Illinois, New York and Massachusetts, a warranty of habitability exists by virtue of judicial determination, uninterrupted by any subsequent legislature modification, much less abolition. In other states, like Georgia, courts have found that such a "public policy" does not exist.

The nature and extent of the warranty of habitability, and any related warranty, varies dramatically from state to state. Clearly builder/vendors in each state must understand the scope of the warranties implied in their state. And multi-state builder/vendors need to understand that risks vary from state to state. Otherwise, while a builder/vendor may provide express warranties for its product, and may believe that it is limiting its liability for certain conditions or systems to a defined number of years or even months, the builder/vendor may well find itself with greater liability.

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### *The Scope of the Implied Warranty of Habitability*

Originally, the cases in which an implied warranty of habitability was found focused on the structural integrity of the dwelling, requiring that the physical condition of the facility be safe and healthy. Properties built on unstable terrain or containing defective septic tanks were found wanting. Conditions that existed that were less than optimal, e.g., cracks, creaks and drafts, do not seem to have been of any importance, even though annoying.

Today, some of the courts that address these issues set a less rigorous and considerably more subjective standard related to the “impairment” of an occupant’s “use and enjoyment” of his or her residence as a residence. But different levels of sophistication and tolerance could result in radically different views as to whether an occupant’s use and enjoyment is truly “impaired”. The courts in Florida, at least, have recognized the dilemma and created what amounts to a “reasonable dweller” standard.

Interestingly, courts have approached the issue without regard to a value analysis that would look at the cost of the condition at issue, either from the standpoint of original construction or post-construction repair, applied to market considerations. Yet, to the extent an implied warranty of habitability extends beyond structural and health and safety issues to more subjective considerations, it may be fair to ask whether the purchaser of a \$200,000 home is or is not entitled to the same quality of construction as is the purchaser of a \$1,000,000 residence.

### *The Beneficiaries of the Implied Warranty of Habitability*

A significant aspect of the analysis leading to a finding of implied warranty is that defects in new homes are difficult to discover and new purchasers tend to rely on the reputation and expertise of the vendor/builder. Where, however, the complaining owner is not the original

purchaser of the dwelling, and has no contractual privity with the original builder/vendor, some courts, as in Florida, New York and Washington, have declined to find an implied warranty in favor of the subsequent purchaser of a previously owned home.

Other courts, such as in Illinois, are cognizant of the phenomenon of investor flipping and have imposed an implied warranty upon the builder/vendor for the benefit of the first subsequent purchaser if the dwelling is still new, whatever that means. As one court in Illinois stated, a builder/vendor “cannot be a lifetime guarantor of construction, susceptible to a claim . . . beyond the foreseeable future.”

In New Jersey, courts have been willing to impose an implied warranty of habitability as long as the alleged defect is not readily apparent or discoverable upon a reasonable inspection by the subsequent purchaser.

### *Disclaiming Implied Warranties on Residential Construction*

What the judiciary giveth it sometimes taketh away – but not always. No sooner did courts discover implied warranties concerning new residential construction than builder/vendors started to issue disclaimers of such responsibility.

Not surprisingly, the results have been mixed. Drawing on analogies to the UCC which permits disclaimers of implied warranties of fitness, some courts, as in California, Florida and Illinois, allow disclaimers of implied warranties relating to new construction under certain conditions, including clarity and conspicuousness. In Massachusetts, however, the implied warranty may not be waived or disclaimed.

### *Thinking Ahead*

The only certainty in this area is uncertainty. As the rules

are developed on a case-by-case basis, the duties and economic risks of builder/vendors change. A builder/vendor, especially operating in multiple jurisdictions, needs to be acutely aware of the ever changing legal landscape.

Roger L. Price

### Seyfarth Attorneys published in October 2006 issue of Real Estate Finance:

Mark L. Johnson: *Construction Can Earn Tax Benefits*

Mark A. Lies II: *Will the Construction Industry Catch Avian Flu?*

Roger L. Price: *What the Breakup of Unified Organized Labor Means for the Construction Industry*

Leah A. Rochwarg: *Sustainable Building: Managing the Environmental and Project Risks*

### Construction Superconference!

**What:** Largest gathering of construction industrial professionals in the country

**Where:** Palace Hotel in San Francisco, CA

**When:** December 7<sup>th</sup> and 8<sup>th</sup>, 2006

**Who:** Seyfarth Partner Leah Rochwarg (Moderator)  
Rod Wille (Turner Construction)  
James Fillerup (Shaw E&I)  
Brendan Owens (U.S. Green Building Council)  
Rick Mattila (Genzyme)

This panel, including an owner, contractor, architect/project manager and representative of the U.S. Green Building Council will discuss the opportunities, technical and legal challenges in all aspects of green design and construction.

### Condominium Projects: Look Before You Leap

Although the condominium market has slowed this year, many developers believe that it will bounce back and remain an active sector of the construction industry for the foreseeable future. Any developer or contractor considering a condominium project should be aware of how the legal and insurance landscape has changed and is evolving in this area.

#### *Statutory Warranties*

Many states have enacted statutes that are specific to condominium construction. Among these states are California, Florida, Georgia, New Jersey, Virginia and Texas. These statutes usually impose a warranty on the developer, stating, for instance, that the developer warrants the common elements and individual units in the condominium against structural defects for a specific term, such as two years. The term "structural defects" frequently is defined to include anything that impedes the intended use of the condominium. Such broad language could be construed to include much more than what one would typically consider a structural defect.

Further, some of these statutory warranties are very specific. For example, the statute in Maryland states that the developer warrants that the heating system will maintain a temperature of 70 degrees Fahrenheit, and that the cooling system will maintain a temperature of 78 degrees Fahrenheit.

While these statutes impose warranties on the developer, through the use of contractual flow-down provisions, these warranties typically are passed down to the general contractor and subcontractors. Although these statutory warranties vary from state to state, they share a common thread: increased exposure for developers, contractors, and subcontractors. Accordingly, when considering whether to participate in the development or construction of a condominium, a participant should familiarize itself

with the statutes in the jurisdiction where the project is located. In addition to adding statutory warranties, many states impose additional requirements for mechanics liens on condominium projects that, among other things, specify who must receive notice of the lien and the specific condominium units against which the lien may be filed.

### *Insurance*

With the expansion of liability through statutory warranties and otherwise, there has been a contraction of insurance coverage. For example, mold claims are on the rise and are now statistically similar to fire loss claims in terms of occurrence and severity for condominiums and other types of residential construction. This represents a paradigm shift for the insurance industry. Insurers have reacted by excluding mold claims from most general liability policies. To the extent mold coverage is available, the deductibles typically are very high. Every developer and contractor should review its policies carefully to verify whether it has coverage for the risks that are prevalent in condominium projects.

### *Notice and Cure*

In an effort to reduce costs of litigation, numerous states have enacted statutes that require residential homeowners, including condominium unit owners, to provide contractors with notice of perceived defects and an opportunity to cure before filing suit. Twenty-one states currently have notice and cure statutes in place, several other states are considering them. Here too, while the statutes vary from state to state, they have certain similarities. The most significant similarity, and the bedrock of these statutes, is that a court will dismiss a homeowner's action if it has not provided the contractor with notice of the alleged defect, an opportunity to inspect the premises, and an opportunity to settle by either correcting the defect or making a financial payment, or a combination of the two.

Condominiums are not just another type of project. Condominium specific statutes introduce additional risks and exposure for all involved. The governing statutes, and the availability of insurance coverage, should be considered carefully before signing on to a condominium project.

David A. Blake, LEED® AP

### *Additional Insureds of Cancelled Policies*

The use of commercial general liability insurance and other forms of insurance, such as for workers' compensation and employers' liability, is an important tool of risk management for construction projects. Most construction contracts, between owners and general contractors as well as between generals and subcontractors, impose an obligation to secure such insurance at prescribed levels. Those contracts also typically require the party securing the insurance to name the other party as an additional insured on the policies, which provides the other party with a direct claim against the insurer to obtain the insurance benefits, instead of having to seek them through a claim against the insured.

What happens in the event that the insurance is cancelled by the insured? While the insurer is typically required, by insurance policies and state law, to provide notice of cancellation when it cancels the policy, such is not necessarily the case when the policy is cancelled by the insured itself. In that event, the additional insured may be completely unaware of the loss of coverage and, if so, will miss the opportunity to reinstate the policy or to demand that replacement insurance be acquired. The additional insured may only learn about the cancellation later when it attempts to make a claim on the policy and finds itself exposed and without coverage.

That very real possibility manifested itself in a recent case involving the construction of a community center. There, the general contractor was named as an additional insured on its wood framing-subcontractor's commercial

lines policy. The subcontractor had financed payment of the policy's premiums through a lender. When the subcontractor subsequently defaulted on its obligations under the financing agreement, the lender, pursuant to rights granted it under the financing agreement, instructed the insurer to cancel the policy in the name of the subcontractor. While the subcontractor received notice of the impending cancellation, the general contractor did not, and the subcontractor, not surprisingly, did not see fit to volunteer that information to the general.

Thereafter, the subcontractor continued to work on the project, until the general contractor eventually terminated it for cause. In a subsequent lawsuit brought by the owner for defective construction, the general contractor filed a cross-complaint against the subcontractor's insurer (the subcontractor was seemingly insolvent). But, because the subcontractor's defective work that was the subject of the owner's claims had been performed after policy was cancelled, there was no coverage and the general contractor was left holding the bag.

As is evident from the foregoing example, merely being named as an additional insured may provide a false sense of security. The best way for additional insureds to protect themselves is to require in the construction contract that a notice of cancellation must be provided to the additional insured and that the policy itself must reflect that notice requirement. Obviously, the additional insured must be vigilant and demand to inspect the policy to ensure that the notice requirement is indeed included.

Mark L. Johnson

### New York Construction Law Manual

Bob Rubin and Sarah Biser have co-authored a new edition of the New York Construction Law Manual, to be released in December by Thompson West. The Law Manual is the leading treatise on New York construction law among judges, construction law specialists and general practitioners.

### Green Building: Risk Allocation In LEED® Certification

The term green construction or green building refers to the practice of developing, designing, and constructing projects that have a minimal impact on the environment and maximize the comfort of their occupants. These goals are achieved by implementing standards that directly affect the site, water efficiency, materials and resources, energy use and indoor environmental quality.

Many owners pursuing a green building include a clause in their prime contract stating that the contractor is responsible for achieving a certain level of LEED® certification. At the same time, those owners often provide the contractor with detailed drawings and specifications for the project. What happens when the contractor follows the owner's plans and specifications, but the project does not achieve the level of LEED® certification stated in the contract?

As a general proposition, courts tend to characterize the information an owner provides a contractor for the construction of a building in one of two ways - as a design specification or as a performance specification. Design specifications describe in detail how the project is to be built, leaving little if any discretion to the contractor concerning how it achieves the final result. On the other hand, performance specifications set forth objectives to be achieved, and leave it to the contractor to determine how to design and build the project in order to meet those objectives. Some projects employ a combination of design and performance specifications for different aspects of the work.

Difficulty arises when performance requirements and design specifications are provided for the same item of work. Simply including language that states the completed project must pass certain performance tests or standards typically does not convert a design specification into a performance specification. Conversely, the contractor generally is relieved of its obligation to satisfy the performance requirement if it was reasonable to believe

that the performance requirement would be met by following the design specifications.

In a recent case, an owner provided its contractor with a set of plans and specifications to construct a roof. The drawings specified how the roof was to be constructed (a design specification). Additionally, the specifications stated that the roof must achieve a U-Value that does not exceed .030 Btu/hour (a performance specification). Unfortunately, constructing the roof in accordance with the plans did not result in a roof with the specified U-Value.

In assessing whether the contractor was responsible for achieving the specified U-Value, the court initially focused on whether there was a patent ambiguity between the plans and specifications, specifically, whether it was glaringly obvious upon initial review that the U-Value would not be met by constructing the roof in accordance with the plans. If there were a patent ambiguity, the court said that the contractor should have clarified the issue prior to submitting its bid. If the contractor failed to do so, then it would be required to construct the roof in accordance with the plans and satisfy the performance requirement concerning U-Value.

The court found, ultimately, that there was no patent ambiguity between the plans and specifications. It then determined that it was reasonable for the contractor to conclude that the performance requirement concerning U-Value would be satisfied by following the plans. Because the plans detailed how the roof was to be built, and because the contractor therefore did not have discretion to build the roof however it saw fit, the court decided that it was reasonable for the contractor to conclude that, by following the owner's plans, the owner's desired U-Value would be achieved.

Similarly, other cases hold that when the owner provides a contractor with design specifications, and also states that the contractor must comply with all applicable building codes and regulations, the contractor is entitled to follow the design specifications, and it is not responsible to the owner if the applicable codes are not satisfied.

This approach could be applied to disputes over projects that do not achieve the desired level of LEED® certification. If the owner provides the contractor with drawings and specifications that detail how the project is to be constructed, then those documents could be construed as a design specification. If the owner also states that the project must achieve LEED® certification, that directive could be construed as a performance specification. Similar to the case discussed above, this would present a performance specification overlaid on top of the same work that is the subject of a design specification, only on a larger scale. As a result, a court could conclude that if a contractor adheres to the owner's plans and specifications, it is not responsible for a project that fails to achieve LEED® certification. The analysis will likely turn on the specific work that did not comply with LEED® standards, and the degree to which the owner's plans and specifications detailed how that work was to be performed.

In summary, the practice of directing contractors to achieve LEED® certification, while placing certain design decisions that are necessary to do so in the hands of others, may result in unenforceable expectations for owners. Instead, owners would be well served to allocate responsibility for the various tasks that are required to achieve LEED® certification to those best able to carry them out. Design responsibilities should be placed on designers, and construction responsibilities on contractors. This is best achieved by understanding the numerous activities that must be performed to achieve LEED® certification, and then allocating those responsibilities appropriately through careful contract drafting. If done correctly, this not only solves a legal problem, it also increases the chance that the owner will achieve its goal of LEED® certification for the project.

A similar article was published in the October issue of the Design-Build Institute of America's Design-Build DATELINE.

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