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The Chair's Comments

Peter J. Marino

We are now well into our 2007-2008 NCBA year. This is a great opportunity to update the Construction Law Section members on some of our section's initiatives for the year.

Through the tireless efforts of Nan Hannah, the section's current treasurer and Pro Bono Committee Chair, the section partnered with the NCBA Foundation's Law-Related Education Director Diane Wright and the North Carolina Department of Public Instruction to develop a construction law curriculum to assist high school vocational teachers throughout the state in teaching construction-related disciplines. In October 2007, more than a dozen section members volunteered and assisted in presenting an instructional program based on the curriculum. It was well attended and very well received by the teachers and others who attended.

The section's council wrapped-up its several-year study of the issue of whether to petition the North Carolina State Bar to create a construction law specialty at the Feb. 1, 2008 council meeting. After a thorough debate and discussion, the council voted 17-3 against pursuing construction law as a specialty at this time. Briefing books were prepared for all council members and distributed several weeks in advance of the meeting to ensure that all cur-

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Notes on Residential Property Developer Liability in North Carolina

By Douglas P. Jeremiah

There are a number of theories of recovery for construction defects against developers of residential properties currently recognized in North Carolina. This article focuses on the expansion of implied warranties and duties developers owe purchasers of residential real estate. [1]

What is a "Developer"?

A residential property developer might be generally defined as an entrepreneurial person or entity which purchases property to improve and resell for residential uses, where the developer contracts with third parties for the design and construction of the overall project, and does not perform the actual construction. Development schemes are varied and could include the construction and sale of finished single-family homes, multi-family dwellings or condominiums with associated common areas. Development may also take the form of conveyance of raw property subject to restricted building uses, such as requirements for the approval of the design and construction of the dwelling, and possible restrictions on the persons or entities with whom a purchaser may contract for the construction of the dwelling. At a minimum, the developer is a vendor of real property, but often has a much larger role. The developer may sit at the top of the construction pyramid, overseeing the planning and design of the project, selecting the construction team and supervising the construction. Under these circumstances, the developer may have ultimate control over the quality of the end product sold and may stand to make the greatest profit of all the project participants.

A number of courts in other jurisdictions have recognized that the developer's degree of control over the entire development can give rise to liability to purchasers as well as to property owners' associations under a variety of legal theories. North Carolina courts have not fully addressed the liability of the developer to purchasers of residential property, but a number of theories of recovery have emerged.

The Implied Warranty of Habitability

North Carolina first recognized a tort claim based on an implied warranty of habitability in **Hartley v. Ballou**, 286 N.C. 51, 209 S.E.2d 776 (1974). In **Hartley**, the plaintiffs purchased a house constructed by the defendant. Almost immediately the house began to have flooding problems in the basement due to inadequate waterproofing. The plaintiffs sought assistance from the defendant builder, who attempted to remedy the problems, in vain. The plaintiffs filed suit, and the defendant builder raised the defense of *caveat emptor*. On appeal, the **Hartley** court held,

> [I]n every contract for the sale of a recently completed dwelling, and in every contract for the sale of a dwelling then under construction, the vendor, if he be in the business of building such dwellings, shall be held to impliedly warrant to the initial vendee that, at the time of the passing of the deed or the taking of possession by the initial vendee (whichever first occurs), the dwelling, together with all its fixtures, is

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> sufficiently free from major structural defects, and is constructed in a workmanlike manner, so as to meet the standard of workmanlike quality then prevailing at the time and place of construction; and that this implied warranty in the contract of sale survives the passing of the deed or the taking of possession by the initial vendee.

286 N.C. at 62, 209 S.E.2d at 783. Although this holding greatly relaxed the doctrine of *caveat emptor* with respect to the sale of residential property, the **Hartley** court did not abolish the doctrine completely: "An implied warranty cannot be held to extend to defects which are visible or should be visible to a reasonable man upon inspection of the dwelling." 286 N.C. at 61, 209 S.E.2d at 782.

The North Carolina Court of Appeals expanded the doctrine to include subsequent purchasers of the residence. *See* **Gaito v. Aumen**, 313 N.C. 243, 327 S.E.2d 870 (1985). Later that same year, the North Carolina Supreme Court discussed the policy justification for extending an implied warranty of habitability to the purchaser from the builder in **Oates v. Jag, Inc.**:

> The ordinary purchaser of a home is not qualified to determine when or where a defect exists. Yet, the purchaser makes the biggest and most important investment in his or her life and, more times than not, on a limited budget. The purchaser can ill afford to suddenly find a latent defect in his or her home that completely destroys the family's budget and have no remedy for recourse. This happens too often. The careless work of contractors, who in the past have been insulated from liability, must cease or they must accept financial responsibility for their negligence.

314 N.C. 276, 280, 333 S.E.2d 222, 225 (1985)(citing **Simmons v. Owens**, 363 So.2d 142 (Florida 1st Dist.Ct.App. 1978))(other citations omitted). The **Oates** court also made clear that since the implied warranty of habitability exists independent of any contract with the builder, and therefore no privity of contract between the parties is required. 314 N.C. at 279, 333 S.E.2d at 225.

The implied warranty of habitability has also been held to apply in situations where the negligent construction of structures other than the house itself affected the structural integrity of the house:

> To limit the builder's duty to the four walls of the house itself would be formalistic and would ignore the reality of the financial risks undertaken by property purchasers. We believe there can be other, related structures on a residential property which are so essential to the use and enjoyment of the house that they should be subject to the same protection as the house itself. Therefore, we hold that a subsequent purchaser of a home has a cause of action against the home's builder where the builder's negligence in building a structure on the premises has materially affected the use and enjoyment of the house itself.

See **Floraday v. Don Galloway Homes, Inc.**, 114 N.C.App. 214, 217, 441 S.E.2d 610, 612 (1994), aff'd 340 N.C. 223, 456 S.E.2d 303 (1995).

In **Everts v. Parkinson**, 147 N.C. App. 315, 555 S.E.2d 667 (2001), however, the Court of Appeals declined to apply the implied warranty of habitability to the sale of a dwelling by an owner/vendor, on the basis that the owner was a casual vendor, was not the builder, and were simply selling a single dwelling.[2] Accordingly, under existing North Carolina law, a developer contracting with third parties for the design and construction of residential property, would not necessarily be subject to liability on the basis of an implied warranty of habitability, and a homeowner who purchased a defective dwelling from a developer might need to resort to other theories in order to obtain relief from the developer.

When Developer = Owner = Landlord

In **Collingwood v. General Electric**, 324 N.C 63, 376 S.E.2d 425 (1989), the North Carolina Supreme Court found that the plaintiff, an injured tenant, presented a question of fact (precluding summary judgment) as to whether the developer/owner of an apartment complex had complied with the common law duty to use due care in the design and construction of an apartment complex–notwithstanding the fact that the developer contracted with third parties for design and construction. The court acknowledged that a duty owed

> may arise specifically by mandate of a statute, or it may arise generally by operation of law under application of the basic rule of the common law which imposes upon every person engaged in the prosecution of any undertaking an obligation to use due care, or to so govern his actions as not to danger the person or property of others.

324 N.C at 68, 376 S.E.2d at 428 (citing **Pinnex v. Toomey**, 242 N.C. 358, 362, 87 S.E.2d 893, 897 (1955)). In this particular case, the developer/owner was also the landlord, and the particular statute in question was Chapter 42, Article 5, *Residential Rental Agreements*, which provides that a landlord shall "comply with the current applicable building and housing codes, whether enacted before or after Oct. 1, 1977, to the extent required by the operation of such codes; no new requirement is imposed by this subdivision (a)(1) of a structure is exempt from a current building code. See N.C.G.S. § 42-42(a)(1). In **Collingwood** the court held that the owner/developer's compliance with the applicable building codes was evidence of compliance with the standard of care, but concluded, "that compliance with N.C.G.S. §42-42 does not insulate [the owner/developer] from liability for defects in building design or construction." 324 N.C at 69, 376 S.E.2d at 428.

Breach of Contract vs. Tort Liability

Ordinarily, a mere breach of contract would not give rise to tort liability. *See*, **Ports Authority v. Lloyd A. Fry Roofing Co.**, 294 N.C. 73, 240 S.E.2d 345 (1978), *rejected in part on other grounds*, **Trustees of Rowan Technical College v. J. Hyatt Hammond Associates, Inc.**, 313 N.C. 230, 328 S.E.2d 274 (1985). **Ports Authority** established four exceptions to the general principle that the breach of a contract does not give rise to a separate cause of action in tort:

> (1) The injury, proximately caused by the promisor's negligent act or omission in the performance of his contract, was an injury to the person or property of someone other than the promisee.
>
> (2) The injury, proximately caused by the promisor's negligent, or willful, act or

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omission in the performance of his contract, was to property of the promisee other than the property which was the subject of the contract, or was a personal injury to the promisee.

(3) The injury, proximately caused by the promisor's negligent, or willful, act or omission in the performance of his contract, was loss of or damage to the promisee's property, which was the subject of the contract, the promisor being charged by law, as a matter of public policy, with the duty to use care in the safeguarding of the property from harm, as in the case of a common carrier, an innkeeper or other bailee.

(4) The injury so caused was a willful injury to or a conversion of the property of the promisee, which was the subject of the contract, by the promisor.

It may well be that this enumeration of categories in which a promisor has been held liable in a tort action by reason of his negligent, or willful, act or omission in the performance of his contract is not all inclusive. However, our research has brought to our attention no case in which this court has held a tort action lies against a promisor for his simple failure to perform his contract, even though such failure was due to negligence or lack of skill.

294 N.C. at 81-83, 240 S.E.2d at 350-351 (internal citations omitted).

It is likely that **Ports Authority** would apply in the development context, particularly the exceptions relating to personal injury, whether to the promisee or third parties. It is also conceivable that the first two exceptions concerning injury to "property of someone other than the promisee" or "property of the promisee other than the property which was the subject of the contract" would permit tort claims against a developer for negligence in the construction of common areas, roads and other amenities if damage to property not owned by the developer resulted.

Lack of Privity

Without question, parties lacking privity with a developer are entitled to sue in tort under North Carolina law. In **Ridge v. Grimes**, 53 N.C. App. 619, 281 S.E.2d 448 (1981), the North Carolina Court of Appeals reversed a directed verdict in favor of a developer against a motorcycle rider who was injured while traveling on a road constructed by the developer. The court held that the developer, knowing that the road is used by the public, had a duty to maintain the road in a safe condition and to give adequate warnings as to any unsafe condition.

Even where there is a contract with the builder, lack of privity between the plaintiff and actual defendants will enable the plaintiff to pursue tort claims. For example, when the statute of repose does not operate as a bar, a subsequent purchaser of a house can recover in negligence from the original builder. *See* **Oates v. Jag, Inc**. 314 N.C. 276, 333 S.E.2d 222 (1985). In **Allen v. Roberts Construction Co., Inc.** 138 N.C. App. 557, 532 S.E.2d 534 (2000), the plaintiff homeowners sued the construction company that built their house, the owner of the construction company, and one of the company's employees. As it happened, the employee held the general contractor's license, but he had no ownership in the company and did not participate in the construction of the house at issue. Nevertheless, the court allowed the plaintiffs' negligence claim against the licensed employee as an individual defendant, as there was evidence that tended to show that the individual was the general contractor and therefore owed the plaintiffs duty of care.

Voluntary Undertaking–Contract and Beyond

The voluntary "undertaking" of an activity by a developer, outside of any contractual obligation, triggers an obligation to use due care. *See e.g.*, *Wake Forest Law Review* Vol. 12 No. 4, p. 962 ("one who plans, constructs and develops land is required to exercise that degree of care, skill, and ability which is, under similar conditions and surrounding circumstances, ordinarily employed within that geographical area"). In a case in which a condominium association brought suit against an architect for negligent design and supervision of construction, the North Carolina Court of Appeals, quoting from the Restatement (Second) of Torts § 324A, has held that "under certain circumstances, one who undertakes to render services to another which he should recognize as necessary for the protection of a third person, or his property, is subject to liability to the third person for injuries resulting from his failure to exercise reasonable care in such undertaking." **Quail Hollow E. Condo. Ass'n v. Donald J. Scholz Co.**, 47 N.C. App. 518, 522, 268 S.E.2d 12, 15, (1980), *disc. rev. denied*, 301 N.C. 527, 273 S.E.2d 454 (1980). The court reversed the summary judgment in favor of the architect, and allowed the plaintiff condominium association to go forward with its claim.

A similar situation might arise in the development and construction of a condominium unit where the developer executes contracts with the individual unit owners for construction and/or sale of the units. The Declaration of Condominium transfers ownership of the common elements of the units from the developer to the unit owners in the form of undivided interests. *See* **N.C.G.S. §47C-2-107**. The condominium association is then responsible for the management of the common areas and is empowered to participate in litigation. **N.C.G.S. §47C-3-102(a)**. Because the condominium association assumes these powers without a contract between the developer and the condominium association, in theory, **Ports Authority, supra**, would not bar a negligence claim by the condominium association against the developer. The developer is aware that the condominium association will be responsible for managing the common areas. Therefore, it could be argued that the developer owes a duty of care to the condominium association in the design and supervision of the construction of the condominium buildings so that there is not an unreasonable risk of injury or property damage.[3]

Negligent Misrepresentation

Claims for negligent misrepresentation against developers are clearly viable in North Carolina, and may apply where other causes of action fail. For example, in **Stanford v. Owens**, 46 N.C. App. 388, 265 S.E.2d 617 (1980), all of the defendants except one were partners in a venture to develop and sell a piece of property. The defendant developers made statements to the purchaser that the land was fit for the particular purpose of building a restaurant and produced a report showing that the site was ready for construction. (The other defendant was the engineering firm hired by the developer partnership to provide a report concerning the condition of the property and its suitability for construction.). Once the land was purchased and a

restaurant constructed, however, the site began to settle, causing major structural problems which in turn led to negative publicity, a decline in restaurant business and a diminished value of the property. The plaintiff brought claims of breach of express warranty (allegedly created by their statements that the property was fit for a particular purpose), negligent misrepresentation and negligent construction against the developer defendants. There were also claims of negligence and lost profits, as well as a third-party beneficiary claim against the engineering firm defendant. The trial court dismissed all claims on summary judgment.

On appeal, the North Carolina Court of Appeals ruled that the statements concerning the property's "fitness for a particular purpose" were the kind of expressions of opinion normally made by sellers of land and therefore created no express or implied warranty. 46 N.C. App. at 393, 265 S.E.2d at 621. The defendant developers' statements were deemed actionable under claim for negligent misrepresentation, however, and summary judgment in favor of the developer defendants on this claim was reversed. Id at 394-395, 265 S.E.2d at 622. *See also*, **Davidson and Jones, Inc. v. County of New Hanover**, 41 N.C. App. 661, 255 S.E.2d 580 (1979).[4]

Express Warranties, Merger Clauses

Express written warranties are contractual in nature and are construed in accordance with their plain meaning. *See e.g.*, **Coates v. Niblock Dev. Corp.** 161 N.C. App. 515, 588 S.E.2d 492 (2003)(affirming judgment based on a 10-year structural warranty provided in conjunction with the construction and sale of residential property). An express written warranty differs materially from an implied warranty of habitability in that written express warranties are typically limited in scope and duration. This is can be particularly important when construction defects are not immediately apparent after construction is completed. In addition, such warranties likely do not apply to subsequent purchasers, and in the case of condominiums and subdivisions, are unlikely to cover common areas.

Other than the extended warranty discussed in **Coates v. Niblock** above, or a general one-year builder warranty for new construction, North Carolina courts have rarely found express warranties to have been created by statements or representations of opinion concerning real property. In **Griffin v. Wheeler-Leonard & Co., Inc.**, 290 N.C. 185, 225 S.E.2d 557 (1976), the North Carolina Supreme Court analyzed whether statements by the agent of a brokerage company which sold a residence to plaintiff could give rise to an express warranty that the house, when completed, would be constructed in a workmanlike manner, and specifically, that water in the crawl space would create no problems. Holding that the agent's alleged words did not create an express warranty, the court affirmed the directed verdict in the defendants' favor on the issue. 290 N.C. 197-198, 225 S.E.2d at 565. The **Griffin** court also noted that N.C.G.S. § 25-2-312(2), which applies to express warranties created in connection with the sale of goods, provides that

> it is not necessary to the creation of an express warranty that the seller use formal words such as 'warrant' or 'guarantee' or that he had a specific intent to make a guaranty, but an affirmation merely of the value of the goods or a statement purporting to be merely the seller's opinion or commendation of the goods does not create a warranty.

Id. at 198, 225 S.E.2d at 565. In other words, even if such warranties can be created in connection with the sale of real property, the plaintiff failed to allege facts sufficient to overcome summary judgment on that issue. **Cf. Everts v. Parkinson**, 147 N.C. App. 315, 330-31, 555 S.E.2d 667, 677 (2001)(questioning whether any claim for breach of express warranty can be brought upon alleged warranties in the sale of a dwelling or real property and indicating that the claim would be properly brought as a breach of contract rather than warranty).

To the extent that oral express warranties are used as a vehicle for recovery for defective construction from developers, a claimant will likely have to address a merger clause in the contract for the conveyance of real property. Such clauses generally provide that no representations other than those expressed therein, either oral or written, are a part of the agreement. The effect of enforcing such a clause is to exclude everything not written in the contract. *See e.g.*, **Clifford v. River Bend Plantation**, 312 N.C. 460, 323 S.E.2d 23 (1984).

"Merger clauses create a rebuttable presumption that the writing represents the final agreement between the parties." **Zinn v. Walker**, 87 N.C. App. 325, 333, 361 S.E.2d 314, 318 (1987). However, North Carolina also recognizes an exception to the merger clause where application of the clause "would frustrate and distort the parties true intentions and understanding regarding the contract." *Id.* (other citation omitted). The circumstances in **Zinn** were unusual in that there was another written agreement (signed contemporaneously with the contract) deemed to have been intended to be incorporated into the contract. *See also*, **Phelps-Dickson Builders, L.L.C. v. Amerimann Partners**, 172 N.C.App. 427, 617 S.E.2d 664 (2005)(plaintiff homebuilder's unilateral expectations concerning terms of contract did not indicate that purpose of contract had been frustrated).

Contracts Implied in Fact

North Carolina has recognized a contract implied in fact given by a developer arising out of the sale of property subject to restrictive covenants. *See* **Lyerly v. Malpass**, 82 N.C. App. 224, 346 S.E.2d 254 (1986). In **Lyerly**, lot purchasers in the Inlet Point Subdivision in New Hanover County alleged that the developer had made representations, which they had relied on in purchasing the property within a development, that a boat basin would be constructed and an access channel would be built to the intra-coastal waterway and that certain roads would be paved–all of which were amenities available to the purchasers of property within the development. The defendant developer alleged that the paving of the road was a responsibility of the home owners' association (which had not yet been formed), that simple dredging of an existing channel 18 to 24 inches deep would permit boat access, and that this was a "maintenance" issue for the association. The court found that there was an implied promise between the developer and the purchasers to construct the amenities:

> While there may be no written document in which defendant Inlet expressly agreed to build the basin, dredge the channel to certain minimum requirements and construct the road to specifications, there was clearly an implied promise as part of the contract of purchase and sale arising from the covenants, plats and oral representations that Inlet would complete these amenities. Such an implied promise arises from the words used and is based on the presumed intention of the parties.

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A developer may not by the use of record ed plats and restrictive covenants create the illusion of a high quality subdivision and then shield itself from responsibility by claiming that it did not promise to construct the amenities implied by the restrictive covenants and that these covenants do not give rise to an affirmative obligation. To permit such conduct would be to con done deception.

Id. at 229, 346 S.E.2d at 258. *See also*, **Wall v. Fry**, 162 N.C. App. 73; 590 S.E.2d 283 (2004)(finding promise of lake access was an implied term of the sales contract and reversing summary judgment on Plaintiffs' claim for breach of contract.)

Conclusion

A developer undertaking the myriad tasks necessary to complete a modern residential development–acquiring the land, installing infrastructure such as water and sewer, constructing roads, and either contracting for design and construction of residential dwellings or enacted an authorized builder program for construction, and then marketing units for sale to the public–has substantial duties to the end purchaser. Given the prevalence of developer-led construction in North Carolina, it makes sense from a policy standpoint to expand the current concept of a vendor-builder to include a developer-vendor. A prudent developer therefore has even greater incentive to choose well-qualified designers and contractors as project participants who can stand behind their work with appropriate insurance and indemnification agreements.

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End Notes

1. This article does not address claims for fraud or unfair and deceptive trade practices arising out of real estate transactions.

2. *Editors Note:* This is consistent with North Carolina case law on Chapter 75 claims; a purchaser may not sue the seller for unfair trade practice when the seller is simply selling her residence and the seller is not in the business of selling homes. *See e.g.*, **MacFadden v. Louf**, ___N.C.App. ___, 643 S.E.2d 432 (2007).

3. South Carolina courts recognize a fiduciary duty on the part of the developer in terms of its responsibility to the association for common areas. **Concerned Dunes W. Residents v. Georgia-Pacific Corp.** 349 S.C. 251, 562 S.E.2d 633 (2002)(holding developer of a planned unit development ("PUD") owes a fiduciary duty to the property owners association and its members, much like that owed by promoters of a corporation to investors. As such, the developer has a responsibility to ensure that the common areas are in good repair at the time they are conveyed to the property owners association or to provide the association with funds sufficient to effectuate any needed repairs to those areas.)

4. "The requirements for an action based on negligent misrepresentation are as follows:

- Information Negligently Supplied for the Guidance of Others.
- One who in the course of his business or profession supplies information for the guidance of others in their business transactions is subject to liability for harm caused to them by their reliance upon the information if

(a) he fails to exercise that care and competence in obtaining and communicating the information which its recipient is justified in expecting, and

(b) the harm is suffered (i) by the person or one of the class of persons for whose guidance the information was supplied, and (ii) because of his justifiable reliance upon it in a transaction in which it was intended to influence his conduct or in a transaction substantially identical therewith.

Restatement of Torts § 552 (1938)." **Davidson and Jones, Inc. v. County of New Hanover**, 41 N.C. App. 661, 665, 255 S.E. 2d 580, 589 (1979). ■