Managing Liability Risks in Green Construction

By Jeffrey D. Masters and John R. Musitano, Jr.[1]

Green building is more than a trend; it is a fact. According to the United States Green Building Council, the value of green building products and services was more than $7 billion in 2005 and is expected to increase to $12 billion in 2007. Two billion square feet of commercial building space have been LEED-registered or LEED-certified.[1]

In residential construction, the growth of green building has been equally dramatic. A recent survey of local home builders associations indicates that more than 97,000 homes have been certified under voluntary building industry green programs nationally since the mid-1990's.[2] One industry estimate states that by 2010 as much as 10% of residential construction activity in the United States, with a value of $38 billion, will be green, up from 2% and $7.4 billion.[3]

These green building efforts are almost exclusively voluntary. Green products and technologies have not yet been widely incorporated into local building codes for private developments. For example, California Green Builder is a voluntary, standards-driven program under which California production home builders may obtain green certification.[4] Meanwhile, the United States Green Building Council is extending its LEED certification program to homes, with pilot standards expected in late 2007.[5] The National Association of Home Builders currently is seeking comments on its National Green Building Standard for new residential construction and renovation.[6] The Standard is expected to be released in final form in early 2008.

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Driven by increasing consumer and end user demand for environmentally-conscious structures, as well as by emerging state and local climate change regulations, green building represents a major opportunity for builders to do well by doing good. But green building carries with it liability risks and litigation potential. This article discusses these risks, as well as the risk management strategies builders can use to help minimize those risks.

The increased liability exposure derives from two fundamental issues. First, there is as yet no universally-accepted standard for what qualifies as green or sustainable building. Second, there is the risk of heightened expectations on the part of the end user.

For example, buyers of new green residences may believe that green means defect-free. Likewise, they may expect that residences marketed as sustainable will require less maintenance and enjoy a longer useful life than conventionally-constructed residences. Both residential and commercial end users will have expectations about expected energy savings, subjective comfort issues and enhanced indoor air quality.

Buyers disappointed with their green structures will assert numerous familiar legal theories in their efforts to recover damages or other relief. The claims may include both tort and contract theories.

Fraud.

High buyer expectations, aggressive marketing of green building and a lack of uniform green building standards together create a significant danger that builders may face allegations of fraud. In an increasingly competitive housing market, more builders are seeking an advantage over competitors, including by tapping into the growing interest in green products. Some builders believe this will distinguish their homes and may justify higher prices.

Builders should consider the possible consequences of representations to buyers regarding the quality or expected performance of green building techniques or materials. Builders should also understand the developing and likely inaccurate understanding of the public regarding what "green" and "sustainable" mean with respect to construction. Consumers paying more for a green home may expect a higher standard of construction and comfort, products with longer lives and lower required maintenance, and savings on energy costs. They may therefore place higher reliance on such representations by the builder. When performance fails to meet expectations or match the builder's representations, the buyer likely will seek recourse.

As with any other seller of real property, a builder may be liable for fraud if it misrepresents the character or condition of the property, or conceals or fails to disclose defects of which it knew or should have known and which would have affected the buyer's decision to purchase.[7] Buyers may allege claims for negligent misrepresentation or intentional misrepresentation, including claims for deceit or fraud in the inducement.[8] As discussed below, allegations of fraud can also form the basis for state law unfair competition claims.

Builders could face intentional or negligent misrepresentation claims with respect to marketing claims about the green character of the home, such as:

- Advertising that the home is green or sustainable, or certified as such, when it is not;
- Labeling, inaccurately, building components or materials as green;
- Falsely claiming that the home is healthier; or
- Falsely claiming that the home has a lower carbon footprint.

The lack of uniform green definitions and standards may mean that the builder is complying with some standards and not others. Builders often use terms like "green" in marketing without intending any correlation to particular green standards. On the other hand, other builders may specifically market their product before or during construction as certified under one of the various green building standards, with the danger that the certification is not eventually earned. Builders also may claim that that certain elements of the home were built with green building components, which may be incorrect and stem from a misunderstanding of green standards.

Builders may also make inaccurate promises or forecasts regarding the expected performance of the home, such as:

- Claims that the home's materials are more durable;
- Promises of energy savings; or
- Claims of enhanced indoor air quality.

Promises regarding performance can be dangerous, especially when the failure of the home to live up to such promises is quantifiable. For example, buyers may expect, and builders may claim, that the home will have lower utility bills due to the manner of construction. Should the home turn out to have no quantifiable energy savings, potential liability for misrepresentation could be the result. Where the builder has made these claims in standardized marketing materials, such claims could also spur class action litigation. Should the builder have knowledge of and fail to disclose that its green materials or techniques have actually caused the home to be

defective – such as in terms of durability – the builder may be liable to the initial buyer as well as to subsequent purchasers.[9]

Buyers must meet a relatively high burden to succeed on their fraud claims. The plaintiff must prove misrepresentation (false representation, concealment, or nondisclosure) regarding their property, the builder's knowledge of the falsity and intent to defraud (i.e., to induce reliance), that reliance by the plaintiff was justifiable and that there is resulting damage.[10] The misrepresentation must involve the suggestion, assertion or suppression of a fact and such fact must be material.[11] With respect to a builder's duty to disclose, a matter is material when it has a significant and measurable effect on the value or desirability of the property.[12]

Courts have found materiality relating to fraud with respect to various facts about a home, its construction, its history and its expected performance. For example, liability for fraud has been found where sellers made false statements regarding the performance and quality of the building and its construction.[13] Courts have also found that material facts may relate to the physical condition of the property, such as known defects, building code violations, and insufficient available water given the intended use.[14] Failing to disclose that a property was not built in compliance with applicable building codes may also constitute fraud.[15] Similarly, buyers will likely argue that representations regarding the green status of their home were material facts securing their assent to the purchase contract. It should also be expected that buyers will view undisclosed added costs, such as potential increased maintenance costs, as material facts which should have been disclosed at the time of purchase.

General representations regarding the home and its performance may be defensible as harmless "puffing." Under California law, generally fraud will not be found where a defendant's

statement was one of mere opinion.[16] Nevertheless, claims that the home is "more livable," "energy efficient," "environmentally friendly" or "weatherproof" will be argued by the buyer to be statements of fact, not opinion.

Generally, a buyer defrauded by a seller of real estate may recover the difference between the purchase price and the actual value of the property at the time of sale had the truth been known or the defects disclosed (the "out of pocket" measure of damages).[17] The "actual value" of the property purchased is commonly understood to be the market value of that property at the time of the transaction, given the material defects.

Buyers also may seek loss of use damages and lost profits.[18] Apart from damages, fraud claimants may also seek remedies such as rescission and restitution, as well as punitive damages.[19]

Negligence.

Green builders can expect future construction defect suits to include a negligence cause of action. Due to the duty of care owed to the homeowner by parties who were involved in design or construction, homeowners can bring direct negligence claims relating to the green elements of the house against the builder, the architect and all contractors involved.[20] Negligence claims can relate to design, workmanship and/or materials defects. Green building design, materials and construction techniques may be the subject of such actions, if their failure results in damage to the property.

Liability as to an actionable construction defect and resulting damage caused by negligence is usually established through expert testimony on the industry standard of care.[21] One issue relating to negligence claims is that because the use of green building materials and designs is relatively new to residential construction, the applicable standard of care may be elusive. Builders unfamiliar with the new construction methods and products will be forced to rely on the knowledge of their design professionals, general contractor and trades, who themselves may be new to the field. The standard of care for green building may be difficult for builders to gauge until there is more data on the performance of the designs, methods and products.

Builders may also face negligence per se claims, with plaintiffs arguing that the construction violates particular standards or statutes regarding green building. Under negligence per se, breach is presumed if the builder violates a statute, ordinance, or regulation; if the violation injured a plaintiff who is among a class of persons the statute was meant to protect; and if the injury resulted from an occurrence that the statute, ordinance, or regulation was designed to

prevent.[22] Expert testimony in a defect case may not be necessary where the claim is for negligence per se, as the violation of the statute or code is used to establish the defect as actionable.[23]

As discussed above, there currently is no uniformity between various green building standards, statutes and local building codes. Even where a builder believes it is meeting certain green criteria, failure to comply with locally-mandated green standards creates a risk of negligence per se claims.

The general measure of damages for defective construction is the cost of repair, or diminution in value (i.e., the difference between the fair market value of the property with and without the defects), whichever is less. Diminution in market value may be recoverable under certain circumstances even where it exceeds the cost of repair.[24]

Breach of Contract.

Buyers may also allege breach of one or more contractual provisions. These could include failure of the builder to deliver promised LEED certification or a similar designation. They could also include failure to meet specified energy efficiency standards. There is also the risk that even absent contractual performance obligations, the buyer could turn the marketing materials against the builder and allege vaguely that the structure fails to qualify as green, sustainable or energy efficient.

The buyer's remedy for breach of contract is damages, typically measured as the cost to repair the defects.[25] In addition, the buyer may recover attorneys' fees, if the contract provides for them.

Breach of Warranty.

Buyers also may assert claims for breach of express or implied warranties. If the builder expressly warrants in a general fashion that the structure is green, sustainable or energy efficient, breach of those warranties may be compensable by damages. The measure of damages generally is the same as for breach of contract. As under a breach of contract theory, the buyer may recover attorneys' fees, if the warranty provides for them.

Under an implied warranty theory, the builder is deemed to have impliedly warranted that the structure was constructed in a good and workmanlike manner and that it is fit for its intended purpose.[26] Implied warranty claims are available only in the new residential construction context.[27] Even in that context, it is an open question whether a court would extend the "good and workmanlike" and "fitness" standards to an otherwise functional green residence.

SB 800 Violations.

It is not yet clear how California's right to repair law, commonly known as SB 800, will apply to green building claims. SB 800 includes more than 40 functionality standards for new residences and for common areas in common interest subdivisions. None of the functionality standards specifically refers to green building components.[28] Yet by its terms, SB 800 applies to every component of the home or common area.[29]

The likely result is that green building claims will be asserted in conjunction with more conventional claims for breach of the functionality standards. For example, if energy efficient windows leak, the buyer will assert a breach of the functionality standard which provides that windows shall not allow water to pass beyond, around or through the window or the window

system.[30] Similarly, the green building claim could implicate SB 800 if the claim involves a condition that causes damage (as opposed to a mere "paper defect").[31]

To avoid the constraints of SB 800, claimants may allege bodily injury or fraud or pursue a class action, all of which are outside the scope of SB 800.[32] To the extent SB 800 applies, traditional construction defect theories will be replaced by a claim of breach of the functionality standards.

Violation of Unfair Competition Laws.

A builder's marketing and advertising regarding green building may also subject it to claims by buyers of violations of unfair competition acts, such as Business and Professions Code section 17200 (which prohibits unfair business practices) and Business and Professions Code section 17500 (which prohibits false advertising).

In 2004, Proposition 64 changed the rules applicable to sections 17200, *et seq.* and 17500, requiring that a plaintiff show he or she suffered actual injury and lost money or property as a result of the alleged unfair competition or false advertising. Nevertheless, assuming that such standards are met, a builder can face claims under these statutes.

Business and Professions Code section 17200 defines unfair competition as "any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising." The Unfair Business Practices Act (referring to section 17200 and its subsequent sections, and hereinafter the "Act") is considered a strict liability statute; no intent by defendants to deceive or cause damage must be proven.

"Unlawful practices" prohibited by the Act are any practices forbidden by law, whether civil or criminal, federal, state, or municipal, statutory or court made.[33] Common law fraud, or running afoul of emerging statutes and regulations regarding green building, could lead to allegations of unlawful practices.

The terms "unfair" and "fraudulent" are generally defined broadly. To determine if an act is unfair, California courts utilize a balancing test regarding whether the harm of the practice outweighs its benefits.[34] "Fraudulent" practices under the law are broader than common law fraud. The test for what is considered fraudulent is simply that "members of the public are likely to be deceived."[35]

While it is generally settled that damages are unavailable under the Act, plaintiffs may seek injunctive relief preventing further unlawful conduct and restitution.[36] The Act gives courts broad authority to fashion remedies "as may be necessary . . . to prevent the use or employment by any person of any practice which constitutes unfair competition."[37] Restitution is available if the plaintiff can prove that through the unfair business practice, the defendant obtained money from the plaintiff.[38]

Where such allegations relate to green building, buyers will argue that a portion of the builder's profits bear a relationship to the alleged wrong. If the buyer can prove that he or she paid more for the home due to its green label, the buyer may seek to recoup those amounts from the builder. If brought as a class action, the potential damages could be significant.

RISK MITIGATION STRATEGIES.

Builders can manage end users' expectations and decrease their liability exposures by employing a wide range of operational and legal risk mitigation techniques. These include use of

clear definitions and performance standards in contracts; enhanced disclosures; minimization of actionable representations; and extra diligence in the builder's design and construction contracting procedures.

In order to maximize the probability of success for their risk management programs, builders must implement a plan which is both *comprehensive* and *integrated*. The green risk management plan should be comprehensive in that it encompasses each stage in the development life cycle, beginning with design and construction contracting, and extending through the use of specialized consulting expertise, construction quality assurance ("QA") observations, protective provisions in contracts, disclosures, and effective customer service for the end user of the structure. The plan must be integrated so that each of its elements supports the others. For example, information the builder learns during the design and specification process likely will translate into material facts that should be disclosed to the buyer.

If the builder intends to market the structure as green, the builder must clearly define what that term means in the context of the transaction. The builder will be best served by referring to an objective standard or by promising only that the structure will be constructed according to then-applicable specific guidelines of a third party organization, such as the United States Green Building Council for the LEED program, or the California Green Builder or NAHB green building programs. In all cases, the as-built condition of the structure must be compliant with such standards or guidelines.

Another approach is to avoid characterizing the structure as green and instead, to provide an inventory of the green components and products used in its construction, together with

performance information from the manufacturers (as opposed to the builder). The more subjective and undefined the characterization of the structure, the more risks exist for the builder.

Disclosures can be a powerful risk mitigation tool. For example, the builder can and should disclose that green does not equate to defect-free construction, that sustainable does not mean that less maintenance is required and that no specific level of comfort or energy efficiency has been promised or will necessarily be achieved.

Actionable representations should be minimized or preferably eliminated. For example, the builder should avoid puffing and should scrub subjectivity from its marketing materials. The builder should scrutinize its collateral materials, advertising, website, model units and sales office for risky performance claims and possible misrepresentations. In its disclosures and marketing materials, the builder should be factual and objective.

In commercial construction, contractual maintenance obligations and formal written operations and maintenance ("O&M") manuals have long been standard operating procedures. In the residential setting, construction defect litigation experience teaches that lack of maintenance by homeowners and by homeowners associations ("HOAs") can surface later as alleged construction defects. As a result, some residential builders have adopted a model similar to that used by commercial contractors.

Most residential builders now include mandatory inspection and maintenance obligations in their consumer sales agreements and in the covenants, conditions, and restrictions (CC&Rs) for common interest subdivisions, such as condominium projects. Professionally-prepared homeowner and HOA maintenance manuals are becoming a best practice in the residential construction industry. These contractual inspection and maintenance requirements, as well as

maintenance manuals, must be tailored to take account of green building components and features.

Additional or special maintenance requirements (and possible additional costs) should be disclosed and should be addressed in the manuals. Builders should consider having a qualified green building consultant review these contract provisions and manuals for accuracy and adequacy.

HOA governance presents at least two special issues. First, builders must be certain that the HOA operating budgets and assessments will be adequate to take account of green building inspection and maintenance costs. Second, the CC&Rs for the project should contemplate future green modifications to individual units and to common areas in order to avoid unreasonable disapprovals by the HOA or by the architectural review committee.

When undertaking a green project, the builder must candidly self-assess its ability to address properly the myriad unique building issues, as well as the capabilities of its design professionals and subcontractors. Unless the builder has in-house green expertise, the builder will be relying on its design professionals and subcontractors regarding green design, products, technologies and assemblies. As a result, pre-qualification of these parties takes on added importance for green projects.

From a design quality perspective, many builders already engage in peer review of their plans and specifications. This process involves a third party forensic-quality design professional who reviews the proposed plans and specifications with the objectives of assuring code compliance, enhancing constructability by the subcontractors and identifying and deleting "designed in" defects. Peer review is even more critical on green projects because of the varying

levels of green experience and expertise among design professionals. This is particularly true regarding selection and specification of green products and components.

There is constant tension between builders and design professionals regarding contractual risk transfer. Builders typically seek enhanced performance standards, broad indemnification and adequate professional liability insurance, maintained during design and construction as well as after completion of the project. In contrast, especially on for-sale residential projects, design professionals resist meaningful contractual risk transfer.

This tension will be heightened in connection with green projects. Design professionals can be expected to seek to exculpate themselves from green design liability by narrowly defining their scope of services and performance standards, diluting indemnification provisions, limiting their professional liability insurance obligations and attempting to include a broad limitation of liability clause.

In contrast, builders will expect design professionals to take responsibility for their green design elements. This responsibility may be reflected in the scope of services, in the performance standards and even in the indemnification provisions. If the builder is seeking LEED certification, for example, it is typical for the architect to assume responsibility for assembling the documentation, performing the inspections and handling the processing necessary to obtain the certification. Alternatively, a qualified LEED-accredited consultant may assume this role.

Green building presents contractual risk transfer and risk management issues with respect to subcontractors, as well. It is critically important that builders evaluate their subcontractors'

green building experience. Where appropriate, builders should invest in training for subcontractors who do not yet have such demonstrated expertise.

Risk transfer modifications to the subcontract likely will be necessary. For example, the subcontract should confirm that the performance standards and compliance with laws provisions are broad enough to extend to applicable green building laws, codes and standards. The subcontract warranty and guaranty provisions likewise should extend to green building components and products.

New or unfamiliar components or assemblies should be the subject of special training for the subcontractors. Borrowing again from the commercial construction model, residential builders should consider having mock-ups of the assemblies constructed under the observation of the manufacturer or a qualified green building consultant before undertaking actual construction of the project.

As with any other construction, a builder should also ensure that it has adequate coverage under its commercial general liability policy. While no reported decisions have yet addressed green building liability insurance coverage issues, there is no reason to believe that the available coverage should be any different than in a conventional construction defect claim or suit.

CONCLUSION.

While green building offers unprecedented opportunities for builders, it has a potential dark side: increased liability exposures. But by studying and identifying these exposures, then implementing comprehensive risk mitigation strategies, builders will be positioned to succeed in the new green building environment.

[1] www.usgbc.org, "About USGBC."
[2] www.nahb.org/greenbuilding, "Nearly 100,000 Green Homes Certified Through Market-Driven Green Building Nationwide, says NAHB" (June 6, 2007).
[3] Nation's Building News (NAHB, April 30, 2007).
[4] www.cagreenbuilder.org
[5] www.usgbc.org, "About LEED."
[6] www.nahb.org/greenbuilding, "NAHB To Launch Certification Program" (Nation's Building News Online, week of June 18, 2007); NAHB's Model Green Home Building Guidelines (2005).
[7] 11 Miller & Star, California Real Estate 3d, Defective Construction, § 29:29, p. 157; *See* Snelson v. Ondulando Highlands Corp., 5 Cal. App. 3d 243, 251 (1970).
[8] CIV. CODE §§1572, 1709, 1710.
[9] Greernaert v. Mitchell, 31 Cal. App. 4th 601 (1995).
[10] Engalla v. Permanente Medical Group, Inc., 15 Cal. 4th 951, 974 (1997).
[11] CIV. CODE §§1572, 1710.
[12] Shapiro v. Sutherland, 64 Cal. App. 4th 1534, 1545 (1998).
[13] Grange Co. v. Simmons, 203 Cal. App. 2d 567, 575 (1962); Unger v. Campau, 142 Cal. App. 2d 722, 725 (1956) (seller's representations that building had been completely remodeled were false).
[14] *See* Herzog v. Capital Co., 27 Cal. 2d. 349, 352 (1945); Pearson v. Norton, 230 Cal. App. 2d 1, 8-11 (1964); Green Trees Enterprises, Inc. v. Palm Springs Alpine Estates, Inc., 66 Cal. 2d 782, 785-6 (1967).
[15] *See* Doran v. Milland Dev. Co., 159 Cal. App. 2d 322, 325 (1958).
[16] *See* Hauter v. Zogarts, 14 Cal. 3d 104 (1975) (noting that if a defendant's assertion is merely a statement of opinion or mere "puffing," he will not be held liable for its falsity); *see also* Haskell v. Time, Inc., 857 F. Supp. 1392, 1399 (E.D. Cal. 1994) ("Advertising that amounts to mere 'puffery,'" which are "vague, highly subjective claims," is not actionable in false advertising and unfair business practices claim because "no reasonable consumer relies on puffery.").
[17] CIV. CODE §3343(a); Saunders v. Taylor, 42 Cal. App. 4th 1538, 1542-1543 (1996); Graf v. Sumpter, 207 Cal. App. 2d 391 (1962) (misrepresentation regarding the existence of fill on land which caused the home to settle).
[18] CIV. CODE §3343(a)(2)-(4).
[19] CIV. CODE §§3294, 3343(b)(2).
[20] Sumitomo Bank v. Taurus Developers, Inc., 185 Cal. App. 3d 211, 223 (1986) (builder must use reasonable care toward purchasers); Stewart v. Cox, 55 Cal. 2d 857 (1961) (subcontractor liable to homeowner for defective work); Cooper v. Jevne, 56 Cal. App. 3d 860 (1976) (architect liable to purchasers of allegedly defectively designed condominiums).
[21] Miller v. L.A. County Flood Control Dist., 8 Cal. 3d 689, 703 (1973).
[22] EVID. CODE §669(a); Lua v. Southern Pacific Transp. Co., 6 Cal. App. 4th 1897 (1992).
[23] Huang v. Garner, 157 Cal. App. 3d 404, 415 (1984), disapproved on other grounds, 24 Cal. 4th at 649 (Uniform Building Code establishes standard of care).
[24] Erlich v. Menezes, 21 Cal. 4th 543, 561 (1999). *See also* Glendale Federal Savings & Loan Ass'n v. Marina View Heights Dev. Co., 66 Cal. App. 3d 101 (1977) (cost of repair is proper measure of damages where project was built on plaintiffs' property); Orndorff v. Christiana Community Builders, 217 Cal. App. 3d 683, 687-688, 690-691 (1990).
[25] *See* Shaffer v. Debbas, 17 Cal. App. 4th 33, 46-47 (1993).
[26] *See* Pollard v. Saxe & Yolles Dev. Co., 12 Cal. 3d 374 (1974); Aced v. Hobbs-Sesack Plumbing Co., 55 Cal. 2d 573 (1961).
[27] *See* East Hilton Drive Homeowners Ass'n v. Western Real Estate Exch., 136 Cal. App. 3d 630, 633 (1982).
[28] CIV. CODE §896.
[29] CIV. CODE §897.
[30] CIV. CODE §896(a)(2).
[31] CIV. CODE §897.
[32] CIV. CODE §931.
[33] *See* Podolsky v. First Healthcare Corp., 50 Cal. App. 4th 632, 647 (1996).
[34] *See* Saunders v. Superior Court, 27 Cal. App. 4th 832, 839 (1994).
[35] *See* Committee on Children's Television, Inc. v. General Foods Corp., 35 Cal. 3d 197, 211 (1983); *see also* State Farm Fire & Casualty Co. v. Superior Court, 45 Cal. App. 4th 1093, 1105 (1996).

[36] *See* Korea Supply Co. v. Lockheed Martin Corp., 29 Cal. 4th 1134, 1144 (2003) ("While the scope of conduct covered by the UCL is broad, its remedies are limited. . . . A UCL action is equitable in nature; damages cannot be recovered."); Bank of the West v. Superior Court, 2 Cal. 4th 1254, 1266 (1992) (noting that "damages are not available under section 17203"); *see also* Vikco Ins. Services, Inc. v. Ohio Indem. Co., 70 Cal. App. 4th 55, 67 (1999) ("[t]he Unfair Business Practices Act simply does not provide a means for recovery of . . . damages").

[37] BUS. & PROF. CODE §17203.

[38] Day v. AT&T Corp., 63 Cal. App. 4th 325, 338-340 (1998) ("[S]ection 17203 operates only to return to a person those *measurable amounts* which are *wrongfully taken* by means of an unfair business practice" (italics original)); *see also* Korea Supply Co. v. Lockheed Martin Corp., 29 Cal. 4th 1134, 1149 (2003) (ruling that restitution is limited to either "money or property that defendants took directly from plaintiff" or "money or property in which [plaintiff] has a vested interest").

