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S K Peightal v. Mid Valley—Construction Defect Litigators and Bank Attorneys Take Notice

by Ronald Garfield and David L. Lenyo

Recent developments in case law highlight issues that both transactional attorneys and litigators should consider when handling construction defects cases. This article discusses the impact of S K Peightal Engineers, LTD v. Mid Valley Real Estate Solutions V, LLC *on this area of the law.*

This article addresses issues that litigators handling construction defect actions and transactional attorneys representing lenders may wish to consider in light of the recent Colorado Court of Appeals and Colorado Supreme Court opinions in *S K Peightal Engineers, LTD v. Mid Valley Real Estate Solutions V, LLC*.[1] Author Ron Garfield represented Alpine Bank and its wholly owned subsidiary, Mid Valley Real Estate Solutions V, LLC (Mid Valley), respondent in the Colorado Supreme Court proceedings, in the deed in lieu transaction that is described in the Colorado Supreme Court opinion.[2] Co-author David Lenyo represented Alpine Bank and Mid Valley in the construction defect action that was the subject of the interlocutory appeal by the engineering defendants that sought dismissal of the negligence claims asserted against them under the economic loss rule. Ultimately, the negligence claims survived after the Supreme Court remanded three questions to the Garfield County District Court. After the trial court ruled in favor of Mid Valley on two of the three questions, the construction defect action was resolved a week before the scheduled commencement of the jury trial. The resolution of the remanded questions, however, does not mean that other construction defect cases involving a construction lender will have the same outcome, because the trial court's order on the remanded questions depended in large part on the specific facts regarding the engineering contracts at issue.

Factual Background

In 2001, developer Sun Mountain Enterprises LLC (Sun Mountain) obtained a secured loan from Alpine Bank (Alpine) to buy three vacant lots in a subdivision in Carbondale, Colorado. The construction defect action at issue arose out of a residence that Sun Mountain eventually built on one of the lots (the home).

In 2005, Sun Mountain executed a professional services agreement with a geotechnical engineering firm, defendant Hepworth-Pawlak Geotechnical (HP Geotech), to study the soils and recommend a foundation design for the home (the HP contract). The HP contract contained a limitation of liability provision under which Sun Mountain agreed to cap HP Geotech's liability at $50,000. Alpine was not a party to the HP contract and did not participate in the negotiations leading up to it.

The HP contract also contained the following contractual standard of care, which substantially differs from the statewide standard of care applying to professional engineers under Colorado common law:[3] "STANDARD OF CARE: Services performed by [HP Geotech] under this Agreement will be conducted in a manner consistent with that level of care and skill ordinarily exercised by members of the profession currently practicing under similar conditions in the same locale."

In July 2005, HP Geotech issued a soils report and foundation recommendation for the home. The report stated it was written "for the exclusive use of [Sun Mountain] for design purposes." The report identified "hydrocompressive" soils,[4] which posed "a risk of post-construction settlement if the soils . . . become wetted." Nevertheless, HP Geotech recommended a spread-footing foundation rather than a deep-pier foundation, the latter of which is designed to prevent damage to homes if soils compress.

Shannon's Custom Homes (SCH) was Sun Mountain's general contractor for the home. SCH orally retained defendant S K Peightal Engineers, Ltd. (S K Peightal), a structural engineering

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firm, to design the home's foundation. SCH provided S K Peightal with HP Geotech's soils report. In a deposition given in the underlying construction defect action, an SCH representative testified that the only terms of the oral contract were that Peightal would "do a good job" in return for an "approximation of how much money would be involved." Alpine was not a party to the oral contract with S K Peightal and did not participate in the negotiations leading up to this oral contract. Construction on the home began in March 2007.

In April 2007, Sun Mountain obtained a second secured loan from Alpine to finance the home's construction costs. Under the construction loan agreement, Alpine agreed to periodically release money to Sun Mountain, in the form of loan disbursements or draws, as work on the home progressed and accompanying construction costs were incurred. As is typical in the construction lending industry, the construction loan agreement required Sun Mountain to "use the [loan] funds solely for the payment of the costs of constructing" the home, as opposed to some other project on which Sun Mountain also may have been working. Also, the agreement allowed Sun Mountain to "apply only for [loan] disbursement[s] with respect to work actually done" on the home, to ensure that the amount of disbursements at any given time was commensurate with the home's stage of completion at that same time.

The form construction loan agreement[5] included standard provisions to ensure that the loan proceeds were used only for reasonable construction costs, including provisions that Alpine could:

1) approve the subcontractors used;
2) review the plans and specifications, and government permits;
3) approve budget and cash flow projections, and the schedule of estimated disbursement as construction progressed;
4) receive the soils report, to see if soil conditions would require extra expense;
5) require Sun Mountain to furnish proof of work done and the progress of work, and the bases for requested disbursements as work progressed; and
6) inspect Sun Mountain's books and records, as well as the property, materials, and labor performed.

In the underlying construction defect action, Alpine's branch president testified as to the bank's limited reasons for including these boilerplate provisions in the construction loan agreement, stating: "We go out and take a look at the property periodically . . . . What we're looking for is overall is the money going into the project as the builder told us and any glaring overruns . . . that we may have. I mean, we're not qualified as construction inspectors. We're lenders. We just want to make sure the money is going into the property." He further testified that Alpine was "just simply monitor[ing] percentage [construction] complete versus what we have drawn [from the loan]."

The construction loan agreement also contained a "Limitation of Responsibility" provision confirming that Alpine's rights under the loan agreement were intended to safeguard Alpine's money as a lender, rather than make Alpine a participant in actual construction work:

> The making of any Advance by Lender shall not constitute or be interpreted as either (A) an approval or acceptance by Lender of the work done through the date of the Advance . . . . Inspections and approvals of the Plans and Specifications, the Improvements, and the exercise of any other right of Inspection, approval or inquiry solely for the protection of Lender's interests, and under no circumstances shall they be construed to impose any responsibility or liability of any nature whatsoever on Lender to any party . . . . No disbursement or approval by Lender shall constitute a representation by Lender as to the nature of the Project, its construction, or its intended use for Borrower or for any other person, nor shall it constitute an indemnity by Lender to Borrower to any other person against any deficiency or defects in the Project or against any breach of any contract.

In October 2008, Sun Mountain obtained a third, smaller secured construction loan from Alpine to finish the home. At this juncture, Mid Valley did not yet exist; therefore, it was not a party to the construction contracts and was not an intended beneficiary of any of the construction professionals' contracts. When the home was completed in November 2008, Sun Mountain listed it for sale. Initially, the home was built for resale to an end user or as a "spec home." However, due to the over-supply of spec homes[6]—in addition to the real estate market's falling flat in the great recession—the home received no offers during the two-and-a-half years that Sun Mountain had it listed for sale.

The 2001 loan for the vacant lots, as well as the 2007 and 2008 construction loans, all matured in April 2011, at which time the home remained unsold. Sun Mountain defaulted on $1.63 million it owed to Alpine Bank. Alpine created Mid Valley in April 2011 as a Colorado limited liability company, with Alpine being its sole member. In May 2011, Alpine and Sun Mountain executed a deed in lieu of foreclosure agreement to resolve the loan defaults. They agreed that the $1.63 million due exceeded the home's value by $355,000. Alpine accepted $355,000 and conveyance of the home to Mid Valley in exchange for a release of the personal guarantors of the loans. Thus, the home was valued at $1.28 million.

Alpine created Mid Valley (1) to add a layer of liability protection for Alpine, both while it held the property and in anticipation of any resale, so claims regarding the home would be limited to the subsidiary instead of exposing Alpine's other assets, and (2) so the home could be more effectively marketed in the name of an entity other than a bank, because buyers devalue bank-listed homes. When Mid Valley acquired the home in May 2011, it immediately listed it for sale to the general public. At that time, the home appeared to be in excellent condition. However, in June 2011, cracks as wide as one-quarter inch began to appear in the walls of the home. These cracks enlarged significantly over time. The estimated repair cost exceeded $1.5 million.

The Economic Loss Rule in Colorado

A brief history of the economic loss rule is helpful in understanding the significance of the Colorado Court of Appeals and Colorado Supreme Court opinions in *Mid Valley*. In 2000, Colorado adopted its version of the economic loss rule, which provides that tort claims such as negligence will be barred where a duty arises under a contract between the parties, unless there is an independent duty owed under tort law.[7] The contract giving rise to the duty can be singular or can arise out of a series of "interrelated contracts."[8] The economic loss rule also bars negligence claims by third-party beneficiaries of such contracts.[9] Colorado has always recognized that construction professionals, including professional engineers, owe an independent duty to residential homebuyers.[10] Therefore, claims by residential homebuyers have always been excepted from the economic loss rule. Previously, Colorado courts

had not distinguished between a "natural" homebuyer and a commercial entity that was a homebuyer. In addition, Colorado courts had not held that construction loan agreements made by a lender that does not participate in the design or construction of a home could be considered an "interrelated contract" under the economic loss rule.

Procedural History of the Case

In 2011, Mid Valley commenced a construction defect action for negligence against the engineers (design defendants) and other construction defendants and asserted contract claims against Sun Mountain.

The Trial Court Summary Judgment Order

Shortly before trial, design defendants moved for summary judgment, asserting that the construction loan agreements and the deed in lieu of foreclosure agreement constituted "interrelated contracts" with the design and construction contracts, thus barring any negligence claims under the economic loss rule. In addition, design defendants asserted that the independent duty normally owed by design professionals to homebuyers recognized that one of the exceptions to the economic loss rule was that it applied only to "natural" homebuyers and did not apply to commercial entities such as a foreclosing bank that takes title to a residence for resale.

The trial court denied design defendants' motions for summary judgment, ruling that Alpine Bank's wholly owned subsidiary, Mid Valley, was not a party to any "interrelated contract" because, among other reasons, it did not exist at the time of the construction project and was not formed until years later when Sun Mountain defaulted on its construction loans with Alpine Bank. Because the trial court held that Mid Valley was not a party to an "interrelated contract" under the economic loss rule, it did not directly address the question of whether the independent duty owed to homebuyers recognized an exception to the economic loss rule as applied to commercial entities such as Alpine and Mid Valley, which took title through a deed in lieu of foreclosure agreement for resale to pay off delinquent loans.

The Court of Appeals Opinion

Design defendants petitioned under CAR 4.2 for interlocutory review of the trial court's orders denying their summary judgment motions based on the economic loss rule. Design defendants asserted that (1) whether a construction loan agreement constituted an "interrelated contract" under the economic loss rule and (2) whether construction professionals owed an independent duty to a homebuyer that is a commercial entity rather than a "natural" homebuyer constituted issues of first impression under Colorado law. Design defendants also asserted that an interlocutory appeal was warranted because the resolution of these issues of first impression could result in the complete dismissal of all claims against all of the remaining defendants, obviating the need for a jury trial.[11]

Although grants of petitions for interlocutory appeals under CAR 4.2 have been relatively rare since CAR 4.2 was effectuated in 2011, both the trial court and the Colorado Court of Appeals granted design defendants' petitions for interlocutory appeal. In its order approving the petition, the trial court identified the issue of first impression as "whether a construction professional providing work on a residential house owes a common law tort duty of care to commercial entities which hold title to the property as part of a commercial transaction." The appellate court specifically directed the parties to address (1) whether the independent duty question turns on an economic loss rule analysis or requires a broader duty analysis, and (2) why or why not. As discussed below, the Colorado Supreme Court ultimately declined to address these issues as identified in the orders initially granting interlocutory review.

In the interlocutory appeal, design defendants asserted that the question of whether Colorado's economic loss rule bars a claim is a question of law subject to de novo review. Design defendants also asserted that the construction loan agreements and the deed in lieu of foreclosure agreement constituted "interrelated contracts" under the economic loss rule, thus barring any negligence claims. Finally, design defendants asserted that there is no independent duty owed by construction professionals to homebuyers that are commercial entities like Mid Valley, which took title through a deed in lieu of foreclosure agreement, because commercial entities are not "natural" homebuyers.

Mid Valley argued that (1) the trial court correctly found that a construction loan agreement is not an interrelated contract for purposes of applying the economic loss rule; (2) a professional engineer has an independent duty to use reasonable care in designing and engineering a home to subsequent purchasers of a home without knowledge of latent foundation defects, including a lender that foreseeably purchases a home with latent foundation defects at a foreclosure sale or through a deed in lieu of foreclosure, and therefore, the "independent duty exception" to the economic loss rule

applied; (3) the economic loss rule does not bar a negligence claim because the contractual duty of care contained in the HP contract was different from the common law standard of care applying to professional engineers; and (4) the economic loss rule did not apply to the claims against S K Peightal because S K Peightal's oral contract for professional services did not explicitly adopt the common law standard of care.

The Colorado Court of Appeals affirmed the trial court's denial of the summary judgment motions. In doing so, the appeals court held that design defendants owed the same independent duty to Mid Valley as that owed to any natural-person homebuyer, and therefore, the economic loss rule did not bar the negligence claims.[12] Because the Court found that an independent duty was owed to Mid Valley, it did not address the issue of whether the construction loan was an "interrelated contract" under the economic loss rule, nor did it address the additional arguments raised by Mid Valley that design defendants' contracts either contained a contractual duty of care that was different from the common law standard of care or did not explicitly adopt the common law standard of care.

The Colorado Supreme Court Decision

Design defendants petitioned for certiorari to the Colorado Supreme Court.[13] In opposing the petitions, Mid Valley argued that the Court of Appeals holding should be affirmed because it followed well-established cases on foreseeability recognizing that the tort duty to construct a home without negligence arises from the nature of the item constructed—a residence—rather than from the attributes of the record owner of the real estate at the time the negligence becomes manifest.[14] The Colorado Supreme Court granted certiorari on the two issues raised in the petitions for certiorari: (1) whether the economic loss rule bars a homeowner's negligence claim against a construction professional when the owner is a commercial entity rather than a natural homebuyer, and (2) whether the interrelated contract doctrine as defined in *BRW Inc. v. Dufficy & Sons, Inc.*[15] can apply to a wholly owned subsidiary that did not exist when the initial contracts were drafted, but instead was created after work on the relevant contracts had been completed.[16]

The Colorado Supreme Court reframed both questions and—important for the purposes of this article—ultimately declined to decide whether the economic loss rule can bar a homeowner's negligence claim against a construction professional when the owner is a commercial entity. Instead, it reframed the issues as:

(1) whether entities that did not exist at the time the relevant contracts were completed can still be subject to the economic loss rule through the interrelated contracts doctrine; and

(2) whether [Mid Valley], which was a third-party beneficiary to a contract that interrelated to the contract by which the home at issue was built, [is] among the class of plaintiffs entitled to the protections of the independent tort duty to act without negligence owed by construction professionals to subsequent homeowners when constructing residential homes.[17]

The Colorado Supreme Court reversed the Colorado Court of Appeals. Because the Supreme Court reframed the issues, however, the reversal was based on very narrow grounds that were different from the critical holding that design defendants owed the same independent duty to Mid Valley as that owed to any natural homebuyer. Instead, the Supreme Court held that, because Mid Valley was a third-party beneficiary of the deed in lieu of foreclosure agreement, it could be subjected to the economic loss rule if the underlying construction loans were deemed to be "interrelated contracts" under the economic loss rule. The Supreme Court, however, declined to decide the "significant factual disagreement" of whether the construction loans were "interrelated contracts" for purposes of applying the economic loss rule. As a result, it refused to dismiss outright Mid Valley's claims, holding instead that Mid Valley could recover on a negligence theory if (1) the construction loan documents were not interrelated to the defendants' contracts, or (2) the defendants' contractual duties were not the same as their general tort duties. The Supreme Court remanded the case to the trial court for further proceedings to resolve these issues.[18]

Notably, the Supreme Court did not decide, as a matter of law, whether a construction loan can be an interrelated construction contract for purposes of applying the economic loss rule, instead remanding that issue (among others) to the trial court for further factual findings.[19] It also declined to address whether the economic loss rule can bar a homeowner's negligence claim against the construction professional when the owner is a commercial entity rather than a natural homebuyer, even though this issue was the principal reason that the trial and appellate courts allowed the interlocutory appeal.[20]

Questions Addressed on Remand

The Supreme Court remanded three questions to be resolved by the trial court through future proceedings.[21] The threshold question was the "significant factual disagreement" regarding the extent to which Alpine's rights under its construction loan agreements caused those contracts to be interrelated (or not interrelated) with design defendants' engineering contracts. If the answer to this question was that the contracts were not interrelated, Mid Valley could recover on its negligence claim against design defendants if it proved liability or damages at trial. If the contracts were found to be interrelated, two additional questions remained to be resolved: whether HP Geotech's duties, if any, under its engineering contract

were the same as its general tort duties under common law,[22] and whether the S K Peightal oral contract explicitly adopted the standard of care under common law. If HP Geotech's contractual duties were not the same as its general tort duties, Mid Valley would prevail on its negligence claim against HP Geotech if it proved liability and damages at trial. And if the S K Peightal oral contract did not adopt the common law standard of care, Mid Valley could prevail on its negligence claim against S K Peightal if it proved liability and damages at trial.

The Trial Court Order on the Remanded Questions

Following remand to the trial court, design defendants each filed motions for summary judgment, asserting that all three questions could be resolved as a matter of law by the trial court. Mid Valley asserted that the threshold question, whether the construction loans were "interrelated contracts," had to be decided by a jury because there were disputed facts relating to the negotiation and execution of the construction loan agreements, citing the Supreme Court decision characterizing the "interrelated contract" question as a "substantial factual disagreement." Mid Valley filed cross-motions for summary judgment on questions two and three, asserting that it was undisputed that the HP Geotech contract contained a local standard of care that was different from the statewide standard of care applicable to licensed engineers in Colorado. Mid Valley also asserted that it was undisputed that the oral contract between S K Peightal and Sun Mountain never explicitly adopted the statewide standard of care applicable to licensed engineers in Colorado.

The trial court found that the construction loan agreements were "interrelated contracts" with the design and construction contracts. Specifically, it found that the first Sun Mountain construction loan agreement was the "beginning of the network or chain of multi-party construction contracts." However, the trial court granted Mid Valley's cross-motions for summary judgment against HP Geotech on the second question, finding that the HP Geotech contract contained a local standard of care that was different from the statewide standard of care applicable to licensed professional engineers in Colorado. The trial court also granted Mid Valley's motion for summary judgment against S K Peightal on the third question, finding that it was undisputed that the oral contract between Sun Mountain and S K Peightal did not explicitly adopt the statewide standard of care applicable to professional engineers in Colorado.

As a result, Mid Valley's negligence claims ultimately survived the summary judgment and appellate court proceedings, and the parties resumed trial preparation. After HP Geotech's motion for reconsideration was denied, design defendants and Mid Valley resolved the construction defect action the week before the jury trial was scheduled to commence.

Issues Attorneys Should Consider

Litigators handling construction defect actions should consider the issues in *Mid Valley* when assessing whether construction defect claims against a construction professional will be barred by the economic loss rule. Transactional attorneys representing homebuyers and lenders should consider the impact of the decisions when taking title to residential property or making loans for the construction of residential property. Several specific issues are discussed below.

How a Buyer Should Take Title

A footnote in the Colorado Supreme Court opinion is worth considering when advising homebuyers on how to take title when purchasing a home. The footnote states: "we need not determine whether this independent tort duty—which was created to protect natural persons—extends to protect commercial entities who would qualify as subsequent homeowners."[23] This footnote suggests that, in a properly presented appeal, the Supreme Court might be disposed to rule in the future on whether commercial entities situated like Mid Valley would qualify as subsequent purchasers to whom construction professionals owe an independent duty under the economic loss rule. It is common, especially in the purchase of high-end residential properties, to use a limited liability company or another type of entity to avoid disclosing the names of the real owners for privacy purposes. The use of an entity instead of an individual to take title can also be a means of limiting liability to the entity. But if the use of an entity means the possible loss of subsequent purchaser status as an exception to the economic loss rule, should attorneys representing such purchasers reconsider how their clients should take title? Do banks now have to consider a new set of problems when a construction loan goes bad and taking back the collateral is the only remedy? And if a construction defect presents itself, will the bank no longer have recourse against the construction professionals for their negligence?

Does an Independent Duty to Commercial Entities Exist?

The Colorado Supreme Court expressly declined to address whether commercial entities are owed the same independent duties as natural home buyers. Instead, its reversal was based on the unique facts in *Mid Valley*. Thus, the Court of Appeals holding (which is based on a forseeability and public policy analysis) that a commercial entity is owed the same independent duties owed to natural persons arguably remains controlling law. But given the reversal, it is likely that defendants will continue to argue that there is no independent duty owed to commercial entities as an exception to the economic loss rule. Without a definitive ruling by the Colorado Supreme Court, this broader question remains open.

Effect on Construction Defect Litigation

In *Mid Valley*, Colorado appellate courts for the first time addressed whether the "interrelated contract" doctrine first recognized in *BRW* could extend beyond contracts among construction professionals to include construction loan agreements by a bank. In light of the Supreme Court decision, a litigation attorney representing a bank or a bank subsidiary that purchases a home with a construction defect through foreclosure or a deed in lieu of foreclosure agreement should assess the risk that negligence claims made by the bank and its subsidiary will be barred by the economic loss rule if the bank was a construction lender to the developer, general contractor, or homeowner. Because *Mid Valley* and the trial court's summary judgment ruling do not definitively state when a construction loan will be considered an "interrelated contract" under the economic loss rule, the terms of the construction loan agreement and the facts and circumstances leading up to the negotiation and execution of the construction loan agreement must be carefully analyzed and evaluated. If the lender negotiated the construction loan agreement before or contemporaneously with the

negotiation and execution of the construction agreements, it is more likely that the construction loan will be considered an interrelated contract under the economic loss rule.

In addition, the construction loan agreement itself should be carefully reviewed to determine whether language referencing the construction contracts or giving the bank some level of oversight and inspection of the construction process increases the risk that the construction loan agreement will be deemed an interrelated contract under the economic loss rule.

Finally, a litigation attorney should carefully review the provisions of the construction contracts to determine whether they contain a standard of care different from the common law standard of care. If the standard is different, there would exist a separate exception to the economic loss rule, and a finding that the construction loan was an "interrelated contract" would not bar the bank's negligence claims.

However, the Court of Appeals and Supreme Court rulings should not affect most construction defect actions, for three reasons:

1. Title for most homes (particularly on the Front Range) is still taken in the name of individual homebuyers.
2. Even if an entity is formed for privacy reasons or to limit liability, the independent duty issue would arguably be limited to "commercial" entities, which should mean only those entities that purchase homes solely for commercial resale or rental purposes rather than for use as a residence. Limited liability companies, partnerships, and other family-controlled entities formed for the purpose of holding title for a house that is intended to be used as a primary or secondary residence for individuals or families related to the entity rather than rental or resale should not be considered "commercial" entities for purposes of the economic loss rule. But it is not entirely clear how the Court of Appeals and the Supreme Court defined "commercial" entities.[24]
3. Unlike a foreclosing bank that was a party to a construction loan arguably related to the original construction project, entities subsequently purchasing a residential structure rarely have ties to the original construction project such that they would be deemed to be a party to one of a series of "interrelated" contracts regarding the construction project. If a subsequent buyer is not a party to an interrelated contract, negligence claims would not be barred by the economic loss rule. The Colorado Supreme Court opinion recognizes that any general tort duty is independent of a contractual duty if the contract contains no duties or the alleged breached tort duty is beyond the scope of the duties contained within the contract at issue. It also specifically recognized that Mid Valley could assert general tort claims as a subsequent purchaser if the contractual duties differed from the statewide common law duty.[25]

Nevertheless, cautious litigation attorneys will advise entities who are initial or subsequent purchasers that it is unclear whether the independent duty owed by construction professionals to a homebuyer is limited to "natural" homebuyers. Defense attorneys can be expected to file pretrial motions for summary judgment based on the economic loss rule if the plaintiff is an entity that lent money for a construction project rather than a "natural" homebuyer. Plaintiff's counsel should be prepared to argue that the Court of Appeals opinion that construction professionals owe the same independent duty of care to commercial entities as that owed to natural homebuyers remains binding precedent on trial courts because the Supreme Court decision overruled it on different grounds. Plaintiff's counsel should also be prepared to argue that an independent duty is owed under general Colorado tort law regarding foreseeability based on the Colorado Court of Appeals decision.

Finally, plaintiff's counsel should also be prepared to argue that cases from other jurisdictions adopting some form of the economic loss rule have recognized that construction professionals owe commercial entities an independent duty of care in constructing residential structures.[26]

Considerations Regarding Banks

Given *Mid Valley*, whether loan documents are "interrelated" with spec home construction documents (e.g., interrelated with the contract with the general contractor or engineer or architect) will likely be resolved on a case-by-case basis by trial courts. This is because the outcomes depend on the facts and circumstances leading up to the execution of the construction loan agreement and the specific language in the construction loan agreements at issue. But the use of a subsidiary such as Mid Valley will not, in and of itself, change the outcome: a subsidiary might not be a "subsequent purchaser" that can bring a claim for negligent construction if the underlying loan documents (including the deed in lieu conveying a residence to the subsidiary) are interrelated with the construction documents.

Another footnote to the Supreme Court decision discusses the deed in lieu of foreclosure agreement:

> Clause Seven purports to assign fee simple ownership to Mid Valley while still leaving the deeds of trust as enforceable liens on the property. It is unclear how Alpine Bank would enforce its deed of trust against a property that Sun Mountain does not own in order to collect on the remaining Construction Loan Contract between Sun Mountain and Alpine Bank.[27]

This footnote suggests that the Colorado Supreme Court may not have considered the need to leave Alpine's original deed of trust in place for reasons other than collecting on the balance of the debt. An additional reason to leave the deed of trust in place would be the risk of a subsequent bankruptcy by Sun Mountain or other claims that could unwind the deed in lieu transaction. If the transaction were unwound and the deed of trust released, Mid Valley/Alpine could become an unsecured creditor. Another reason for leaving the deed of trust in place would be the existence of other liens against the property not disclosed in any title work.

Potential Solutions for Banks

Based on *Mid Valley*, Colorado banks will now need to view themselves as parties to all of the contracts that are "interrelated" and tertiary to banks' construction loans, unless they find another alternative. Banks should consider the following proactive actions:

- Instead of simply using commercially produced construction loan agreement forms, attorneys may want to create a custom rider for construction loan agreements to keep lenders' loan documents from being "interrelated" with the original construction documents. The rider could include a provision requiring the borrower to waive, in all construction documents entered into by the borrower with respect to the construction project, claims by the contracting parties that the underlying loan documents are interrelated contracts. Further, the rider could provide that the lender will, in all cases, have the status of

a natural person who is a good faith purchaser. Thus, the lender (and any subsidiaries) should not be barred by the interrelated contracts doctrine from asserting that it is owed an independent duty based on the exception to the economic loss rule. The consideration for the waiver by the borrower and other contracting parties would be the construction loan itself.

- The following language could be added to the lien waiver stamp or endorsement to protect the disburser of the home construction loan:
  - Payee waives any claim or defense against ______________ (insert name of lender) or any subsidiary that any of the documents evidencing loans made for the benefit of the premises are part of a series of interrelated construction contracts regarding the premises.
- Banks may consider abandoning the deed in lieu practice altogether for property that has an implied new home warranty available. When a bank needs to take title to such property, attorneys could foreclose and continue the foreclosure from time to time until an end buyer is found.[28] If the year runs, the foreclosure could be restarted. During the pendency of the foreclosure, the borrower could give the bank possession (not title) and permission to list for sale so the property can be shown by brokers and be properly maintained, and utilities, insurance, and taxes can be paid. When an end buyer is found and the property is under contract, the foreclosure sale can be held. The public trustee would convey title to the end buyer instead of the lender or any subsidiary. The end buyer can perform any pre-closing inspections before the foreclosure sale, but would have to rely solely on the title insurance policy for good title because the public trustee's deed (a confirmation deed) is akin to a quit-claim deed.
- As a general practice, banks could require additional or alternate collateral based on the possibility that the home is not sufficient underlying security for the construction loan. Mid Valley originally argued that, as a wholly owned subsidiary of a bank created for the sole purpose of owning a residential property until it could be sold, it was not a "construction professional." However, it appears that courts may treat banks and their subsidiaries as construction professionals for purposes of applying the economic loss rule. Therefore, construction lending agreements must now be narrowly tailored to predict and be prepared to remedy damages flowing from construction professionals' negligence. Unfortunately, the exact exception that the economic loss rule was designed for—to lower expenses for residential homeowners—may instead increase the cost of residential construction by encouraging padding of expenses in the construction lending process.
- Another option (not preferred by the authors) is for banks to play the odds and assume this problem will not arise. After all, a specific series of events conspired to create the legal problems faced by Mid Valley: a residential construction loan went bad; no guarantor or other collateral was collectable; construction defects were created by a party or parties unable or unwilling to be responsible for their actions; no insurance company was willing to admit liability and write a check; and the title to the home was acquired through a deed in lieu of foreclosure.

One can only speculate whether the outcome would have been different had Alpine Bank acquired title through foreclosure rather than through a deed in lieu. Would the foreclosure sale have cut the "interrelated" link between the lender and the construction contracts?

Potential Issues Regarding Lenders

In *Mid Valley*, the Colorado Supreme Court held that the independent duty to build residential homes without negligence under *Cosmopolitan Homes Inc. v. Weller* did not apply because, as a third-party beneficiary of a commercially negotiated contract interrelated to the construction loan contract under which the home was built, Mid Valley could not properly be considered a "subsequent purchaser" (assuming the construction professionals' contractual duties were the same as the general tort duties under common law).[29]

Mid Valley got the attention of bankers because of a perceived adverse effect on the willingness of banks to make residential construction loans. Whether this perceived effect will become reality remains to be seen. But the amici brief filed by Independent Bankers of Colorado (IBC) explained how community banks, because of their smaller size, may need to change their business practices to compensate for the higher overall risk and potential costs if they cannot sue construction professionals for defectively constructed homes. IBC expressed its concern that "[the new non-exception to the rule will] unrealistically treat banks as one of the construction professionals on a project even though a bank does not have that experience or expertise, nor did it participate in a project by actually performing work."[30]

In structuring transactions, attorneys should consider that, in light of *Mid Valley*, lenders may be unwilling to foreclose on secu-

rity for defaulted loans or take possession of property through deeds in lieu of foreclosure because they could become liable for repair costs for defectively constructed homes with no recourse from the construction professional or the original borrower. The underlying security and collateral for construction loans is generally the home itself. Lenders may soon require additional collateral until the constructed home is sold in order to prevent a situation like *Mid Valley*, where Alpine ended up highly under-secured due to latent defects.

Conclusion

In *Mid Valley*, both the trial court and the Colorado Court of Appeals granted petitions for interlocutory appeal to address what they characterized as a question of first impression: whether the exception to the economic loss rule based on the independent duty owed by construction professionals to residential homebuyers applied to commercial entities rather than a natural homebuyer. Ultimately, however, the Colorado Supreme Court declined to answer this question and instead disposed of the interlocutory appeal on a much narrower issue. Nevertheless, both transactional attorneys and construction defect litigators representing real estate buyers who are banks or other commercial entities should familiarize themselves with the key issues raised by all three courts in *Mid Valley*.

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Notes

1. *S K Peightal Eng'rs, LTD v. Mid Valley Real Estate Solutions V, LLC*, 342 P.3d 868, 871 (Colo. 2015).
2. *See id.* at 871.
3. *Corcoran v. Sanner*, 854 P.2d 1376, 1379 (Colo.App. 1993) ("although we recognize that, in certain situations, the standard of care applicable to Colorado architects may be affected by local standards, we hold that statewide standards must be applied in determining an architect's duty to his or her client and whether an architect has breached that duty.").
4. Hydrocompressive soils are common in the Roaring Fork Valley. *See* Webb, "That sinking feeling: Geological hazards can wreak havoc in parts of Colorado," *The Daily Sentinel* (Jan. 12, 2013), www.gjsentinel.com/news/articles/that-sinking-feeling8232.
5. LaserPro is a document-assembly system for generating loan documentation. *See* Adams, "LaserPro—A Document-Assembly Success Story," Adams on Contract Drafting (Sept. 2, 2008), www.adamsdrafting.com/laserpro.
6. Lutz and Gardner-Smith, "Top end of the Aspen market strong in 2011," *Aspen Journalism* (Jan. 23, 2012), http://aspenjournalism.org/2012/01/23/top-end-of-the-aspen-market-strong-in-2011.
7. *Town of Alma v. AZCO Constr., Inc.*, 10 P.3d 1256, 1264 (Colo. 2000).
8. *BRW, Inc. v. Dufficy & Sons, Inc.*, 99 P.3d 66, 72 (Colo. 2004).
9. *Grynberg v. Agri Tech, Inc.*, 10 P.3d 1267, 1270 (Colo. 2000).
10. *See A.C. Excavating v. Yacht Club II Homeowners Ass'n, Inc.*, 114 P.3d 862, 870 (Colo. 2005) (holding that subcontractors owed homeowners an independent duty of care to construct homes without negligence). *See also Cosmopolitan Homes, Inc. v. Weller*, 663 P.2d 1041, 1042 (Colo. 1983) ("An obligation to act without negligence in the construction of a home is independent of contractual obligations such as an implied warranty of habitability."); *Metro. Gas Repair Serv., Inc. v. Kulik*, 621 P.2d 313, 318 (Colo. 1980) (finding that defendant contractor owed independent duty of care to homeowner); *Lembke Plumbing & Heating v. Hayutin*, 366 P.2d 673, 675 (Colo. 1961) (discussing independent duty of care owed to homeowner by plumbing contractor); *Stiff v. BilDen Homes, Inc.*, 88 P.3d 639, 641 (Colo. App. 2003) ("A homebuilder has an independent duty to act without negligence in the construction of a home.").
11. Previously, Alpine Bank and Mid Valley resolved their claim against the other construction defendants.
12. *Mid Valley Real Estate Solutions V, LLC v. Hepworth-Pawlak Geotechnical, Inc.*, 343 P.3d 987, 991 (Colo.App. 2013), *rev'd*, 342 P.3d 868 (Colo. 2015).
13. *See generally* Petition for Writ of Certiorari on Behalf of S K Peightal Engineers, Ltd., *S K Peightal Eng'rs, LTD v. Mid Valley Real Estate Solutions V, LLC*, No. 13SC728, 2013 WL 10607285.
14. *See generally* Opposition to Petitions for Writ of Certiorari, *S K Peightal Eng'rs, LTD v. Mid Valley Real Estate Solutions V, LLC*, No. 13SC728, 2013 WL 10607283.
15. *See BRW, Inc.*, 99 P.3d at 72.
16. *S K Peightal Eng'rs*, 342 P.3d at 870.
17. *Id.*
18. *Id.* at 877.
19. *Id.*
20. *Id.*
21. *Id.*
22. *Id.* at n.11.
23. *Id.*
24. The distinction between a commercial entity and an entity formed for residential purposes becomes blurred when property is used by individuals for vacations for only a few weeks of the year and then is offered for long-term or short-term rentals for the rest of the year.
25. *S K Peightal Eng'rs*, 342 P.3d at 877.
26. *See Harris v. Suniga*, 180 P.3d 12, 14 (Or. 2008) (finding that economic loss doctrine did not bar recovery by a trust); *Huang v. Garner*, 203 Cal. Rptr. 800, 812 (Cal.App. 1984) (extending duty of care to subsequent purchasers who use property for investment purposes), *rev'd in part*, 12 P.3d 1125 (Cal. 2000).
27. *S K Peightal Eng'rs*, 342 P.3d at 873, n.7.
28. *See* CRS § 38-38-109(1).
29. *S K Peightal Eng'rs*, 342 P.3d at 873.
30. Brief of Amicus Curiae Independent Bankers of Colorado, *S K Peightal Eng'rs, LTD v. Mid Valley Real Estate Solutions V, LLC*, No. 13SC728, 2014 WL 8843931 at * 8. ■