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Alert: Washington Supreme Court Adopts Revisions to Rules of Professional Conduct; Provisions Affect Practice of Section Members

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On July 10, 2006, the Washington Supreme Court adopted a final version of the revisions to the Washington Rules of Professional Conduct that it had been considering since 2004. The revisions go into effect September 1, 2006. All section members should review the new rules, which should soon be available on the section's website, and in particular note the following:

- **New Rule 1.15A, Safeguarding Property (which now includes Wills, Deeds and other original documents).** This new rule requires that a lawyer give annual written accountings to a client or third party whose property being held by the lawyer, and the definition of "property" includes original documents such as wills and deeds. In addition, the lawyer must keep records of the property for seven years after the property has been returned. This rule requires new recordkeeping and annual client notices to be sent by all attorneys holding original documents, including estate planning lawyers holding wills and similar documents. The section has appointed a committee, chaired by Pamela McClaran of Seattle, to look into how to make this new annual notice requirement workable. This rule also adds new trust account requirements, such as a prohibition on anyone other than a licensed attorney being a signatory on a trust account.
- **New Rule 1.15B, Required Trust Account Records.** This rule sets forth new details on required recordkeeping for trust accounts.

- **Revisions to Rule 1.6, Confidentiality.** The revised rule now *requires* a lawyer to reveal a confidence to prevent death or serious bodily harm (a lawyer ... "(b)(1) shall reveal information relating to the representation of a client to prevent reasonably certain death or substantial bodily harm"), and *allows* a lawyer to reveal a confidence for past crime or fraud committed by a client, if the past conduct involved the lawyer's services and revealing the confidence would rectify the harm done by the conduct (a lawyer "(b)(3) may reveal information relating to the representation of a client to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services").
- **New Rule 1.13, Organization as Client.** This rule clarifies the role of the lawyer when representing an organization and what the lawyer should do if the lawyer learns that an agent of the corporation has or plans to engage in illegal conduct that would harm the organization. The rule contains specific guidance on the lawyer's duty of confidentiality in such circumstances and allows disclosure of confidences in some circumstances where rule 1.6 would not otherwise allow disclosure.
- **New Rule 1.18, Duties to Prospective Client.** This rule clarifies when a lawyer may be required to keep information

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Planning for the Washington Estate Tax

by Benjamin G. Porter, Porter, Kohli & LeMaster, P.S., Seattle,
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The New Washington Estate Tax

The new Washington estate tax imposes a separate stand-alone estate tax on transfers of property located in Washington owned by persons dying after May 16, 2005. (RCW 83.100.04(1)) The Washington estate tax is imposed on the decedent's "gross estate" as that term is defined for federal estate tax purposes in Section 2031 of the Internal Revenue Code (the "Code"). The deductions allowed against the federal gross estate by Chapter 11 of the Code for the federal estate taxes are also allowed against a decedent's gross estate for the Washington estate tax. However, the Washington estate tax disallows the deduction for state death taxes allowed for federal estate tax purposes under Code Section 2058.

The Washington estate tax is imposed on the "Washington taxable estate" (RCW 83.100.020(13)), defined as the federal taxable estate as adjusted, less \$1.5 million for people dying before January 1, 2006, or less \$2.0 million for people dying after January 1, 2006, and less a special deduction provided for farm and woodland properties under RCW 83.100.046.

The Washington estate tax is imposed at graduated rates from 14% to 19% for estates over \$9 million. Assuming the Washington estate tax may be deductible in determining the federal estate tax, the effective rate of the new tax is nearly 9% for the largest estates.

The Washington tax does not tax gifts and other lifetime transfers. However, the gross estate for federal estate tax as defined by Section 2031 of the Code brings back into the estate of a decedent a number of lifetime transfers (Code Sections 2036

– 2045). Those transfers are subject to Washington estate tax because the computation of the Washington taxable estate begins with all of the items included in the decedent's federal gross estate.

The Washington estate tax will not be affected by changes in the federal estate tax laws. For example the \$2 million Washington exemption effective this year will not change when, under current law, the federal exemption increases to \$3.5 million in 2009, when the federal estate tax goes away entirely in 2010, or when the federal estate tax returns with a \$1 million exemption.

When Is Property Located in Washington?

The estates of Washington residents are taxable on interests in tangible personal property and real property located in Washington and intangible assets regardless of the situs of the intangible assets. The estates of Washington non-residents are taxed on only interests in tangible personal property and real property located in Washington. Intangible property owned by non-residents is not subject to the Washington tax. Examples of intangible property include stocks, bonds, interests in partnerships and limited liability companies, life insurance, annuities, bank accounts, business interests, retirement plans, and IRAs.

Washington Department of Revenue's Proposed Rules, WAC Chapter 458-57 (Estate and Transfer Tax) (the "Proposed Rules") suggest that a trust beneficiary's interest in a trust holding Washington real estate will be treated as Washington property. The proposed regulations do not, however, distinguish properties held in a revocable trust from properties held in an irrevocable trust. However, it is likely the interest of a grantor-beneficiary of a revocable trust will be taxed based on the nature and location of the underlying assets held by the trust. On the other hand, the interest of a beneficiary of an irrevocable trust would appear to be an intangible asset, regardless of the location or nature of the underlying assets.

Planning Strategies to Convert Taxable Washington Property to Nontaxable Property

The different Washington tax treatment of tangible and intangible property presents planning opportunities to reduce the property subject to tax. For example, a Washington resident with an interest in out-of-state tangible personal property or real estate should hold that property in a way that it will be deemed property located outside Washington. Accordingly, those kinds of assets should be held outright, or in a revocable trust, as a tenant in common, or tenant with right of survivorship. On the other hand, a non-resident owning tangible personal property or real property located in Washington should hold the property in a way that it will be deemed intangible property not subject to Washington tax. Those assets should be held in a corporation, limited liability company, or partnership.

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obtained from a prospective client confidential and when the lawyer is unable to represent another party in a matter involving a prospective client. It allows for a firm to screen off a lawyer who has obtained confidential information from a prospective client so that other lawyers in the firm may represent another party in the matter.

Also noteworthy is the fact that the Court has adopted the Comments as part of the Rules. These notes are intended only to highlight some items of particular interest to section members, but all licensed attorneys will be responsible for knowing the revised rules as of September 1, 2006, and we urge all of you to read the entire text of the changes as soon as possible. They are available on-line at http://www.courts.wa.gov/court_rules/adopted/RPC.doc.

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Effective Date and Potential Retroactive Application of the Tax

Laws 2005, Chapter 516, § 20, provided: "This act [the Washington estate tax Act] applies prospectively only and not retroactively." However, the use of the Code definition of "gross estate" that includes lifetime transfers made prior to death (Code Sections 2035-2045) may result in prohibited retroactive application of the Washington estate tax to transfers made prior to May 17, 2005. For example, pursuant to Code Sections 2035 and 2042 the proceeds of a life insurance policy on the insured's life given away within three years of the insured's death is brought back as part of the insured's federal gross estate under Code Section 2031. The Proposed Rules take the position that all transfers included in the federal gross estate are subject to the Washington tax, whether made before or after the effective date of the Washington estate tax.

It would appear that if the Washington estate tax is imposed on a completed gift made prior to May 17, 2005, when Washington had neither a gift or estate tax, the tax would be inconsistent with Section 20 of the bill prohibiting retroactive application of the tax, as well as the Due Process and Impairment of Contracts clauses of the U.S. Constitution.

Avoiding the Washington Estate Tax by Making Outright Gifts

The Washington estate tax is imposed on only a decedent's Washington property that is transferred at the time of death. Except for those pre-death transfers that are included in a decedent's federal gross estate under Code Section 2031, there is no Washington counterpart to the unified gift and estate tax rules found in the federal gift and estate tax laws. Outright gifts are simply free of Washington tax.

For planning purposes, consideration should be given to making large outright deathbed gifts. The gifted property should be property that has an income tax basis close to the value of the gift, so the loss of the federal estate tax step-up in basis will be unimportant. Although the gift would reduce the available unified credit upon the donor's death, the transfer would avoid the Washington estate tax.

Apportionment of the Washington Estate Tax Between Washington Property and Non-Washington Property

Since the Washington estate tax is to be borne only on Washington property, a formula is provided in the statute that is intended to apportion the tax between Washington property and property that is not Washington property (RCW 83.100.040(20)(b)). Unfortunately, the formula provided by the statute is flawed and will fail in many cases to properly apportion Washington estate tax.

The apportionment statute provides that the Washington estate tax is to be multiplied by a fraction, the numerator of which "is the value of the property located in Washington" and the denominator of which "is the value of the decedent's gross estate." Since RCW 83.100.20(5) defines "gross estate" as the gross estate used for federal estate tax purposes under Code Section 2031, the denominator is the decedent's worldwide gross estate, undiminished by available deductions.

Thus, for example, assume that a decedent owned assets with the same gross values in both Washington and outside Washington. Since the gross values would be equal, using the fraction provided in the statute, one-half of the tax would be apportioned to the Washington property and one-half to the property outside Washington. However, since the Washington estate tax is computed on the net federal taxable estate, the use of the gross estate value in the allocation fraction, rather than the net taxable value, will result in an allocation that has no relationship to the relative net values of the properties within and outside Washington.

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A second problem with the allocation formula is that the deduction for qualified farm and woodland property does not require the property be located in Washington. The allocation formula excludes the deduction for farm and woodland properties from both the numerator and denominator of the fraction. If the qualified farm and woodland property is located only in Washington, the formula will result in a larger allocation of the tax to out of state property. The opposite result will occur if the farm and woodland property is located outside Washington.

To the extent that the allocation fraction results in tax being assessed against property outside Washington, there is a question whether the full Washington estate tax will be eligible for a deduction for federal estate tax under Code Section 2058 as a state death tax. Cf. Rev. Rul. 52-230, 1956-2 C.B. 600, which denied a credit for state taxes under similar circumstances.

Washington Qualified Terminable Interest Property and Qualified Domestic Trust Elections

The personal representative of an estate may claim a marital deduction for a qualified terminable interest property ("QTIP") for qualified income interests for the benefit of a U.S. citizen spouse and a similar deduction for distributions to a qualified domestic trust ("QDOT") for the benefit of a non-U.S. citizen. The election to claim the deduction is made on the decedent's federal estate tax return.

There are a number of situations where the amount of the marital deduction necessary to avoid federal estate tax on the death of the first spouse will be different than the amount needed to avoid the Washington estate tax. The size of the Washington

taxable estate may be less than the federal taxable estate, so a smaller Washington marital deduction would avoid taxes than would the deduction necessary to avoid the federal estate tax. On the other hand, when the unified credit for federal estate and gift tax purposes is \$3 million or when there is no federal estate tax in 2010, a larger marital deduction for Washington estate tax purposes might be needed to avoid the Washington estate tax.

The ability to make different QTIP and QDOT elections under federal and Washington law was recognized by RCW 83.100.50. That statute gave the Department of Revenue the authority to make rules allowing a Washington election on the Washington return different from the election made on the federal return. The Proposed Rules would permit those different elections.

If a Washington QTIP or QDOT election is made the Proposed Rules provide that the property covered by the election is includable in the surviving spouse's estate for Washington estate tax purposes. The proposed regulations seem to assume that the surviving spouse will still have Washington property subject to the Washington estate tax when he or she dies. It would appear that if the surviving spouse were to change his or her residence to another state and have no Washington tangible personal or real property, there would be no Washington estate tax due. In such a circumstance, the Washington estate taxes would be avoided in both estates.

* This article is the result of analysis of the new act by a subcommittee of the Estate & Gift Tax Committee composed of Dean Butler, Mike Carrico, Tom Culbertson, Marcia Fujimoto, Bill Meyer, and Luke Thomas.

The Value Provided by the 2006 ALTA Policies

by Dwight Bickel, LandAmerica Financial Group, Inc., Seattle

I. Introduction

On June 17, 2006, the American Land Title Association (ALTA)¹ adopted many new and revised forms for use by title insurance companies throughout the United States. This article is a brief guide for Washington real property lawyers to help them understand the changes made to the basic title insurance forms. A detailed comparison essay and copies of all the forms are available at www.wltaonline.org/resources.

The 2006 policy forms have been designed to more adequately satisfy the needs of the commercial market. The new forms continue to be the basic policy form and appropriate for any property type. Where the ALTA Homeowner's Policy is available, it continues to be significantly more coverage for residential property.

There should be very little impact on the parties to a real estate transaction or their agents. The new policy forms have the same component parts and look about the same. Commitments will look the same. The changes are primarily on the jacket of the policy. **Schedule A** will look almost the same and **Schedule B** is not changed at all.

Just like the prior forms, the new forms automatically provide extended coverage, expecting **Schedule B** to contain general exceptions where standard coverage is issued. There is very little change to the process of preparing a commitment or underwriting to issue the policy.

The 2006 policy forms provide new value to the Insureds: improved coverage provisions, improved definitions, improved claim administration procedures and substantially improved Conditions describing the rights and duties of both parties.

II. Policy Coverage

There are many new covered risk paragraphs. Upon analysis, there is not such a significant increase in the covered risks. Many of the specific risks that are now detailed were previously included within the few, broad coverage paragraphs. Several of the new coverage paragraphs are matters that were previously an exception contained within the exclusions. This responds to judicial policy interpretation that coverage must be found within the covered risks, rather than construed from exceptions within the exclusions.

For example, the 2006 policy forms are designed to give coverage for creditors' rights in those circumstances where the 1992 exclusion contained an exception. Although oversimplified, the 2006 forms provide coverage against two creditors' rights risks. First, the policy protects against any attack against the prior chain of conveyances. Second, the policy protects against any attack against the present transaction due to the failure to record, or the failure of the recording to give legal notice binding upon the bankruptcy trustee.

The 2006 forms continue to exclude coverage against all further creditors' rights attacks. The only proper method to obtain

creditors' rights coverage with the new policy form is to request the ALTA Form 21-06 Endorsement.

Both the 2006 policy forms include coverage for matters created after the date of policy through the time of recording the insured instruments. Most Washington transactions do not require delivery of a policy dated prior to recordation. The new coverage may provide comfort enabling a change of settlement practices here.

Both new forms state a new Covered Risk against loss caused by encroachments of the neighboring property onto the Insured's land *and* encroachments of the Insured's improvements onto adjoining land. This is probably new coverage in Washington. Any known encroachment of an improvement should be listed as an exception in **Schedule B**.

III. Revised Conditions

The primary value of the new basic policy forms is realized from the revisions of the definitions and conditions paragraphs. There are several very significant changes to definitions improving the rights of the Insureds.

Both policy forms improve the rights of successors and assigns as an Insured. These changes should avoid the need for Insureds to obtain endorsements in many circumstances to acknowledge rights to the policy, such as transfers to a trust, mergers, or changes in entity form. This will avoid concern about coverage, avoid the need for an endorsement, and in many cases avoid premium charges for subsequent assurance endorsements.

The 2006 Loan Policy significantly expands the definition of Indebtedness, requiring payment of more types of financial loss to the lender in the event the title company elects to pay the indebtedness to settle a claim.

The new forms respond to several issues that have troubled customers. For example, paragraph 9(b) of the prior loan policies reduced the amount of insurance upon a borrower payment. The 2006 Loan Policy avoids the need for "last dollar" endorsements by defining the Amount of Insurance and deleting that paragraph.

The claim administration paragraphs have been simplified for the Insured. Giving prompt Notice of Claim remains the initial and the critical duty of the Insured. Thereafter, a Proof of Loss is only required in the event the Company is unable to determine the amount of loss or damage and only when requested.

The 2006 policy forms include two new provisions in response to customer complaints about cases where the title insurance company chooses to defend, or prosecute, in order to avoid loss to the insured payable under the policy. That important title company option to establish the title, or to prevent or reduce loss is essentially the same as ALTA policies since 1970.

However, if the title company litigation is not successful, the new forms provide two benefits to more adequately compensate the Insured. Condition paragraph 8(b) provides (1) the Amount

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of Insurance is increased by 10% and (2) the Insured may determine or measure its loss either when the claim was made or at the conclusion of the litigation.

IV. Deleted Conditions

Several provisions have been entirely eliminated from the new forms.

A. The Owner's Policy Coinsurance Paragraph Is Gone.

Condition paragraph 7(b) first appeared in the 1987 Owner's Policy. It reduced the amount of the Insured's claim in several circumstances, both where the policy amount was less than the land value, but also in cases where the Insured made significant improvements subsequent to the acquisition. Removal of this limitation will increase Insured's indemnification significantly in many circumstances.

B. The Owner's Policy Apportionment Paragraph Is Gone.

Condition paragraph 8 has existed since the 1970 forms. Contained only in owner's policies, it applies to limit the recovery for loss incurred on one parcel affected by a title claim, when the policy includes more than one parcel of land. Removal of this paragraph provides the full amount of insurance to compensate an Insured's loss affecting only one parcel.

C. Mechanic's Lien Exclusion Is Gone.

From 1970 through 1992, coverage against unrecorded labor and material liens required interpretation of the broad coverage paragraphs, Exclusion 6 that specified conditions of a lien that would not be covered and Condition paragraph 8(d)(ii) that further specified conditions. The 2006 loan policy specifies the circumstances for mechanic's lien coverage in one Covered Risk, deletes Exclusion 6 and deletes Condition 8(d).

D. The Lender's Policy "Subsequent Advance" Limitation Is Gone.

Condition paragraph 8(d)(i) stated that the title company was not liable for any indebtedness created subsequent to the

Date of Policy. That was a significant limitation on the amount a lender was entitled to receive in the event the title company elected to pay the amount of indebtedness to discharge its obligations. The 2006 Loan Policy clearly includes subsequent advances in the definition of indebtedness.

However, the 2006 Loan Policy does not insure against loss of priority of the lien of the mortgage to the extent of the additional advance. Priority of additional advances is insured by using ALTA form 14, 14.1 or 14.2 endorsements, issued at the date of policy or at the date of the advance.

E. The Lender's Policy "Liability Noncumulative" Provision Is Gone.

Since the 1970 Loan Policy, Condition paragraph 10 provided that a policy insuring a second lien would have a reduction in policy amount if a claim payment was made to an unrelated loan policy insuring a prior lien. Removal of that reduction to the policy liability provides junior mortgage lenders with the full protection of their policy amount.

V. New Endorsements

The Forms Committee of the American Land Title Association in the past four years drafted many new endorsement forms intended to satisfy the growing demand of the title company customers. Review the full list of new and revised endorsement forms at www.wltaonline.org/resources.

The 2006 basic policy forms are substantially different in coverage and formatting, using new definitions. Therefore, the ALTA has adopted a parallel list of endorsements that refer to the new paragraphs, the new definitions and new formatting of the 2006 basic policy forms. The numbering convention that was adopted simply adds "-06" to each endorsement form number, to distinguish the revised forms to be issued with the 2006 policy forms. Substantively, the coverage of the new "-06" endorsements has not been changed.

¹ The author was a member of the ALTA Forms Committee during development of the new title insurance forms.

The Implied Warranty of Habitability in New Home Sales

(Part 1 of 2)

by Joseph McCarthy, Kantor Taylor McCarthy P.C., Seattle

I. Introduction

Thirty-seven years ago the Washington Supreme Court first imposed an implied warranty of habitability on builders of new homes. Sixteen years ago our legislature imposed implied warranties of quality on condominium developers in the (then) new Washington Condominium Act. The warranties imposed by the Condominium Act include a warranty of workmanship and a warranty of “suitability” which is quite similar to the implied warranty of habitability but the elements of the statutory warranty differ from the elements of the common law warranty.

Over the past three and a half decades the Washington courts have interpreted, refined and expanded the implied warranty of habitability. The judicially implied warranty of habitability is a common law creature. The Condominium Act has created the warranty of suitability but the courts are deciding what it means. The differences between the common law and statutory warranties will be described below. The reader will soon appreciate that where the early cases were generally conservative in formulating the implied warranty of habitability, the legislature adopted an expansive implied warranty in the Condominium Act. Recent cases involving the common law warranty, however, have found guidance in the Condominium Act. This suggests that the courts will interpret the implied warranty more broadly in the future.

This two-part article examines the elements of the implied warranties of habitability and suitability; discusses the remedies available to consumers; and finally discusses various strategies for managing the risk of liability under these warranties.¹

II. Some Brief Background on Subdivisions and Condominiums

Subdivisions are created under RCW 58.17 *et seq.*² The completed subdivision is frequently subjected to “Covenants Conditions and Restrictions” that impose restrictions on the use of the property within the subdivision and create a homeowners association to govern the subdivision. If a homeowners association is formed, it is governed by the Homeowners Association Act, RCW 64.38 *et seq.*

The completed subdivision is composed of “lots” and publicly dedicated features such as streets or parks. It may also have “tracts” for features such as private streets or drives, open space, utility installations and the like.

What makes a development a subdivision is that the lots are physical portions of the property that may be individually owned while the tracts are physical portions of the property that are owned by the home owners association for the benefit of the lot owners.

Condominiums are created under the Condominium Act, RCW 64.34. The condominium will be governed by a condominium association, which is a nonprofit corporation. Condominiums contain “units” and “common elements.” Units, like lots, are physical portions of the property that may be

individually owned. However, common elements, unlike tracts, are owned in common by all of the unit owners as co-owners. Also, the common elements typically include portions of the building or buildings. Common elements are not owned by the condominium association. What makes a development a condominium is the common ownership of the common elements.

The ownership structure of a real estate development governs the source and effect of the implied warranty of quality. For subdivision homes the common law imposes the implied warranty of habitability. *See e.g., House v. Thornton*, 76 Wn.2d 428, 457 P.2d 199 (1969). There is no statutory regulation of express or implied warranties by developers of subdivision homes. A developer may disclaim the implied warranty.

For condominium homes, however, the implied warranties of quality are governed by the Condominium Act. The implied warranty of habitability is a creature of statute. *See* RCW 64.34.445 through 455. The statute provides an expansive scope of implied warranty and severely restricts the ability of a condominium developer to disclaim the implied warranty.

III. The Common Law Implied Warranty of Habitability for Subdivision Homes

A. The Genesis of the Common Law Implied Warranty In Washington

The Supreme Court first announced the implied warranty of habitability in *House v. Thornton*, 76 Wn.2d 428 (1969). In that case, Mr. Thornton began construction of a custom house in northeast Seattle for a “young doctor” but the doctor backed out of the deal. Thornton continued with construction. One Homer House bought the home when it was almost completed. The house was on a hillside. Thornton knew that a prior house on the lot had been removed due to the instability of the soils but his due diligence led him to believe that causes for the instability had been removed. Unfortunately, Thornton was wrong and ground water and slope movement caused significant structural problems in the new home. Despite valiant efforts to correct the drainage issues, the Houses were forced to move out in less than two years.

The Houses sued for rescission based on fraud. The trial court, however, found no fraud or deceit. Moreover, it found no proof of improper design, defective materials or an unworkmanlike job. The trial court did, however, grant rescission on the basis of fraudulent concealment.³ The Supreme Court affirmed the judgment, but on entirely different grounds: it imposed an implied warranty of fitness in the sale of the house.

We apprehend it to be the rule that, when a vendor-builder sells a new house to its first intended occupant, he impliedly warrants that the foundations supporting it are firm and

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secure and that the house is structurally safe for the buyer's intended purpose of living in it.

House, 76 Wn.2d at 436.

The court noted that two prior Washington cases recognized a cause of action for breach of an implied warranty of fitness against the builder in a contract for the construction of a new home (as opposed to a sale of realty). See, *Hoye v. Century Builders*, 52 Wn.2d 830 (1958); *Fain v. Nelson*, 57 Wn.2d 217 (1960). The court stated however:

The rule of implied warranty of fitness covering new construction or the sale of a partially constructed building, although closely related to the sale of a brand-new residence, falls short of meeting the precise issues in the instant case.

House, 76 Wn.2d at 434. In reality, the *Hoye* case was almost square with the *House* case. The difference is that the *Hoye* court exercised restraint, while the *House* court pushed the envelope of caveat emptor.

The *Hoye* court started out with the assumption that caveat emptor would apply. It then held that a construction contract included an implied warranty of fitness of the plans and construction work that the builder furnished. Interestingly, the court relied in part on prior cases that impose a warranty of sufficiency on a party to a building contract who provides the plans for the building. See, *McConnell v. Gordon Const. Co.*, 105 Wash. 659 (1919). This rule had been used by builders against owners when the plans are insufficient. Now, it was being used against builders on behalf of owners.

Beginning with *House*, Washington courts no longer had to go through the contortions required to imply a warranty of habitability into a contract. The implied warranty of habitability in the sale of new homes emerged as a strict liability tort doctrine.

B. The Implied Warranty Is a Strict Liability Tort Doctrine

A builder seller does not need to be negligent, misleading, in breach of contract or otherwise nefarious to be liable under the implied warranty. The sole question is whether the house is fit for its intended purpose of being lived in. In *House*, the court found that the builder-vendor had done nothing negligent, fraudulent or in breach of contract. Nevertheless, the court imposed liability.

Although hindsight, it is frequently said, is 20-20 and defendants used reasonable prudence in selecting the site and designing and constructing the building, their position throughout the process of selection, planning and construction was markedly superior to that of their first purchaser-occupant. To borrow an idea from equity, of the innocent parties who suffered, it was the builder-vendor who made the harm possible. If there is a comparative standard of innocence, as well as of culpability, the

defendants who built and sold the house were less innocent and more culpable than the wholly innocent and unsuspecting buyer. Thus, the old rule of caveat emptor has little relevance to the sale of a brand-new house by a vendor-builder to a first buyer for purposes of occupancy.

House, 76 Wn.2d 428 at 435-36.

In *Berg v. Stromme*, the court described the *House* case in these words:

We imposed a rule of strict liability holding the builder-seller to the principle that he was under a duty to supply a structure adequate in foundation and supporting terrain to be used by the buyer for the purposes for which the house and lot had been sold.

Berg v. Stromme, 79 Wn.2d 184, 196 (1971).

In *Frickel v. Sunnyside Enterprises, Inc.*, the court explained that the implied warranty was adopted as a matter of public policy, to protect the ordinary purchaser of a new home:

Many new houses are, in a sense, now mass produced. The vendee buys in many instances from a model home or from predrawn plans. The nature of the construction methods is such that a vendee has little or no opportunity to inspect. The vendee is making a major investment, in many instances the largest single investment of his life. He is usually not knowledgeable in construction practices and, to a substantial degree, must rely upon the integrity and the skill of the builder-vendor, who is in the business of building and selling houses. The vendee has a right to expect to receive that for which he has bargained and that which the builder-vendor has agreed to construct and convey to him, that is, a house that is reasonably fit for use as a residence.

Frickel v. Sunnyside Enterprises, Inc., 106 Wn.2d 714, 719 (1986)(citing *Peterson v. Hubschman Constr. Co.*, 389 N.E.2d 1154 (Ill., 1979)).⁴

As a tort doctrine, breach of the implied warranty of habitability has a three-year statute of limitations under RCW 4.16.080(2). See, *Stuart v. Coldwell Banker Commercial Group, Inc.*, 109 Wn.2d 406, 415 (1987).

C. What Is Warranted

Three distinct warranties show up in the case law on the implied warranty of habitability. They are a warranty of fitness ("habitability"), merchantability ("workmanship") and code compliance. In some other states, the "warranty of habitability" includes all three warranties. In Washington, the early case law focuses concerned only the first of those three warranties. It is tempting to believe that the common law warranty in Washington does not include workmanship or code compliance. If you look

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closely, however, even the early cases, however, contain some basis for imposing all three warranties. The name “implied warranty of habitability” is misleading.

1. There Is a Warranty of Fitness

Our cases are clear that the common law implied new home warranty imposes a duty to supply a home that is fit for its intended purpose of habitation. In *Hoye*, the court imposed a warranty “that the completed house would be fit for human habitation.” *Hoye*, 52 Wn.2d at 833. In *House*, the court described it thus: “A person of reasonable prudence would reasonably assume that the house is unsafe for occupancy, it is no longer fit for its intended purpose.” *House*, 76 Wn.2d at 435. In *Klos v. Gockel*, the court stated: “The gist of the implied warranty is that the resulting building will be fit for its intended use, *i.e.*, habitation.” *Klos v. Gockel*, 87 Wn.2d 567, 571 (1976). One might conclude from reading the early cases such as *Hoye*, *House*, *Gay v. Cornwall*, 6 Wn. App. 595 (1972), and *Allen v. Anderson*, 16 Wn. App. 446 (1976), that the warranty is only a warranty of fitness for the intended use of habitation.

2. There May Be a Warranty of Merchantability

Our cases are relatively clear that the implied new home warranty is not a warranty of merchantability (defects in workmanship). In *Frickel*, Justice Pearson (dissenting) stated: “As it now exists, the implied warranty is one of habitability.” *Frickel*, 106 Wn.2d at 732. Justice Pearson then argued to expand the warranty to include merchantability. *Id.* at 733. Many of our cases state that the warranty does not extend to defects in workmanship. In *Stuart*, the court stated:

Klos does not support an extension of the doctrine of implied warranty of habitability for mere defects in workmanship. The *Klos* court denied recovery to the plaintiffs holding that: “The law of implied warranty is not broad enough to make the builder-vendor of a house absolutely liable for all mishaps occurring within the boundaries of the improved real property.”

Stuart, 109 Wn.2d 406 at 417. The opinions are not, however, entirely consistent. The court in *Klos*, quoted the following passage from a North Carolina case, *Hartley v. Ballou*, 209 S.E. 2d 727 (1976):

The vendor, if he be in the business of building such dwellings, shall be held to impliedly warrant to the initial vendee that ... the dwelling ... is 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.

Klos, 87 Wn.2d at 570. Similarly, in *Hoye*, the court quoted a South Carolina case, as follows:

It seems to be well settled that where a person holds himself out as specially qualified to perform work of a particular character, there is an implied warranty that the work which he undertakes shall be of proper workmanship and reasonable fitness for its intended use, and, if a party furnishes specifications and plans ... he thereby impliedly warrants their sufficiency for the purpose in view.

Hoye, 52 Wn.2d at 383 (quoting *Hill v. Polar Pantries*, 64 S.E.2d 885 (1951)). These authorities impose a warranty of merchantability (workmanship) and seem at odds with the statement in *Stuart*.

However, in an unpublished opinion⁵ captioned *Erikson v. Reynolds*, 2002 WL 31630815, Division II of the Court of Appeals dismissed a breach of implied warranty claim on the grounds, among other things, that the implied warranty does not include a warranty of workmanlike quality. *Id.* at 2. Thus, although it seems logical that defects in workmanship that affect the habitability of the house are covered, there is no clear guidance on issues of simple workmanship outside the condominium context.

3. There May Be a Warranty of Code Compliance.

Nor is it clear if our common law warranty includes a warranty of code compliance. Despite the various statements that the implied warranty only includes habitability, in *Allen*, the court approved the following jury instruction, stating that it “finds support in *Klos v. Gockel*”:

When a builder sells a new building which he has constructed, there is an implied warranty to the purchaser that the building was built in compliance with local building codes and ordinances.

Allen, 16 Wn. App. at 448. It is a mystery how the *Allen* court approved this instruction since the opinion in *Klos v. Gockel* says nothing about code compliance (nor do any prior cases).

In *Atherton Condominium Apartment Owners Association Board of Directors v. Blume Development Company*, the court dismissed arguments that the implied warranty only applied to defects which made the homes presently unsafe. It held that the alleged defects, which were failures to comply with building code provisions relating to fire resistance, violated the implied warranty:

The alleged building code violations are neither trivial or aesthetic concerns, nor those involving procedural breaches. Rather, the alleged building code violations concern fundamental fire safety provisions regarding the construction of Atherton’s floors and ceilings. As such, the alleged defects are within the purview of the implied warranty of habitability and should not have been dismissed on summary judgment as a matter of law.

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Atherton Condominium Apartment Owners Association Board of Directors v. Blume Development Company, 115 Wn.2d 506, 522 (1990).

One does not have to read *Atherton* as expanding the implied warranty to include code compliance. *Atherton* seems to stand for the proposition that building code violations violate the warranty of habitability if they render the home unfit for its intended use. The court did not, however, make this explicit.

While it appears that Washington's implied warranty only includes habitability, other jurisdictions recognize warranties of merchantability and code compliance. The seeds of those additional warranties are planted in our case law however and, as will be discussed below, those additional warranties are already set forth in our Condominium Act. Developers may one day have to eat the fruit of those seeds if our courts expand the common law warranty.

D. The Elements of a Claim for Breach

As developed by the courts since *House*, a claim for breach of the common law implied warranty requires: (i) a buyer who is the first occupant of (ii) a new home purchased from (iii) a seller who is a commercial builder, and (iv) defects that render the home unfit for its intended purpose of habitation. See e.g., *Burbo v. Harley C. Douglass, Inc.*, 125 Wn. App. 684, 693, (2005).

1. Who Qualifies as a Purchaser/Occupant?

In *House*, the court stated:

We apprehend it to be the rule that, when a vendor-builder sells a new house to its first intended occupant, he impliedly warrants that the foundations supporting it are firm and secure and that the house is structurally safe for the buyer's intended purpose of living in it.

House, 76 Wn.2d at 436. The warranty does not extend to the first purchaser. It extends to the first intended occupant.

A number of later decisions state that the plaintiff must purchase the home from the builder. For example, in *Vigil v. Spokane County*, the court stated:

To prove a cause of action for breach of the implied warranty of habitability, a plaintiff must show that he was the first purchaser-occupant of the dwelling, he bought it from the builder, and the alleged defect rendered the dwelling unfit for occupancy.

Vigil v. Spokane County, 42 Wn. App. 796, 800 (1986). This is incorrect. Although there is a requirement for a sale, there is no requirement of a sale from the builder to the first occupant.

In *Gay*, Elmo Cecil Willoughby (now, there's a name!), a builder, agreed to build a house on a lot owned by a party named Childs. After construction began, Childs sold the lot to Cornwall. Prior to completion, Cornwall sold the lot to Gay. Gay had no

written contract with Willoughby. Her contract was with the Cornwalls. Mr. Willoughby argued that there could be no warranty without privity. The court stated:

We hold that in the instant situation, privity between plaintiff and defendant builder is not a prerequisite to imposing liability on that builder whose completed product is unfit for the purpose contemplated by the parties. ... There is no dispute that Mrs. Gay, the plaintiff, was the first to occupy the premises, and, though she was not its first purchaser, she was, nevertheless, the first purchaser-occupant of the house.

Gay, 6 Wn. App. at 597-98. The warranty flows to the first person to purchase and occupy the house, whether that person bought the house from the builder or not. Even though the implied warranty sounds in contract, it does not arise from the contract. Therefore, there is no requirement for privity between the builder-vendor and the purchaser-occupancy.

It is worth noting however, that although privity is not required, the warranty does not extend to subsequent purchaser/occupants. Our courts have not accepted invitations to expand the warranty to subsequent occupants of the home. In *Frickel*, the dissenters urged the court to expand the warranty to subsequent purchasers. *Frickel*, 106 Wn.2d at 729-30. One year later, in *Stuart*, the Supreme Court rejected that invitation, stating that it had not been anxious to extend the implied warranty beyond its present boundaries. *Stuart*, 109 Wn.2d at 415.

2. What Constitutes a New Home?

The implied warranty only attaches to new homes. In *Klos*, the court stated:

It is true that for purposes of warranty liability, the house purchased must be a 'new house,' but this is a question of fact. The passage of time can always operate to cancel liability, but just how much time need pass varies with each case.

Klos, 87 Wn.2d at 571.

We have two cases in Washington where purchasers of apartment buildings asserted a breach of the implied warranty of habitability. It seems obvious that a purchaser of an apartment building is in a different situation than a home buyer. First, the apartment buyer generally is not buying the building as a home but as an investment. Second, apartments are not mass produced and sold in the same manner as homes. Finally, apartment purchasers, given the amount of money involved, sophistication of the parties and participation of lawyers, are generally in a better position to know about the risks of construction and to protect themselves from those risks. The courts have recognized

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these factors but have failed to clearly rely on the first factor: that the buyer is not purchasing as a residence.

In *Allen*, the Andersons built (apparently, they built it themselves) a 4-unit apartment building with the intention of living in one unit and renting the others. They never listed it for sale. The Allens made an unsolicited offer to buy it after considering renting one of the units. *Allen*, 16 Wn. App. at 447. After discovering defects in the building, the Allens sued for breach of implied warranty. The case went to a jury and the court gave the following two jury instructions:

When the builder of a new building sells it to a purchaser, he impliedly warrants that the foundations supporting it are firm and secure and that the building is structurally safe for human occupancy.

When a builder sells a new building which he has constructed, there is an implied warranty to the purchaser that the building was built in compliance with local building codes and ordinances.

Id. at 448. Both instructions refer to “a new building” rather than a new home. The jury found for the Allens and the court entered judgment for \$2,500. (The level of damages suggests that this might not have really been an uninhabitable structure).

On appeal, the court affirmed the first instruction based on *House*. It affirmed the second, saying it “finds support in *Klos v. Gockel*.” This holding is baffling because there is no support for a warranty of code compliance in *Klos*, which does not even mention building codes.

Allen is a troubling case for two reasons. First, it completely overlooks the fact that the building was not a home. The trial court committed error by instructing the jury that the warranty applied to all buildings.⁶ The court seems to have completely overlooked the fact that no home was involved.

Second, although the court discussed the issues of whether the Allens were in the business of building and selling homes and whether this building was built for sale, the court also dismissed a claim under the Consumer Protection Act, holding that this was an isolated sale with no impact on the public interest. *Id.* at 447. If it was an isolated, one-time sale, how could the Andersons be in the business of building and selling apartments? The *Allen* case is troublesome for its neglect of obvious issues and its lack of clarity.

In *Frickel*, Frickel bought a 40-unit apartment complex from Sunnyside. Sunnyside was a builder of apartments for its own account. This building was not built for resale and was not on the market. The buyer’s realtor approached the sellers and negotiated a sale. The lawyers negotiated a contract. *Frickel*, 106 Wn.2d at 715-16.

The court held that the implied warranty did not apply because the building was not built for the purpose of sale. *Id.* at

718-19. The court then rejected an invitation to extend the warranty to these facts. It reasoned that public policy was different in this scenario because there was not an unequal bargaining position, and because the seller had not held the building out for sale, and because the sale contract was not a contract of adhesion. Curiously, the court took the trouble to state:

We do not hold that an implied warranty of habitability can never attach to the sale of an apartment complex. Rather we hold that such warranty does not exist under the facts of this case.

Id. It is not clear, however, why the court kept this door unlocked.

3. Who Is a Commercial Builder?

In *Hoye*, the defendant was a home builder who sold lots and built the homes from plans offered to and chosen by the buyer. *Hoye*, 52 Wn.2d at 831. In *House*, the defendant was a partnership between a real estate broker and a contractor. *House*, 76 Wn.2d at 429. They agreed to build the house for a customer. *Id.* Although defendants in these cases were both in the business of selling homes, neither court limited the implied warranty to commercial builder-vendors.

In *Klos*, however, the court took up that issue. Mrs. Gockel was the widow of a house builder. She had worked in the family business. It was their practice to buy several lots, build on one lot, occupy the first house until they had completed homes on the remaining lots then sell the first home. When her husband died, she stated that she would retire, but she built three homes and occupied one of them. She did not contemplate selling this house and lived in it for a year. During the year, however, she fell down the stairs twice and decided to build a rambler. At that time, the other two houses had been sold. *Klos*, 87 Wn.2d 567.

After selling the house, there were issues with soil subsidence. In reversing a judgment for the plaintiffs based on the implied warranty, the court stated:

The essence of the implied warranty of suitability or habitability requires that the vendor-builder be a person regularly engaged in building, so that the sale is commercial rather than casual or personal in nature.

Id. at 570. The court found that her intention in building the house was to live in it. It held that the seller’s contemplation of eventual sale was not enough to impose the warranty.

The sale must be fairly contemporaneous with completion and not interrupted by an intervening tenancy unless the builder-vendor created such an intervening tenancy for the primary purpose of promoting the sale of the property. ... Nothing in appellant’s conduct ... should have created any

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sort of belief by respondents that this was a commercial sale.

Id. at 570-71.

In *Allen*, the court stated that the implied warranty requires the vendor to be a commercial builder and the structure to be built for sale, not personal use. *Allen*, 16 Wn. App. at 448. Because the trial court had not resolved either of these factual questions, the court reversed and remanded for resolution of those issues. *Id.*

In *Boardman v. Dorsett*, 38 Wn. App. 338 (1984), the Dorsetts agreed to buy a house built by Mr. Boardman. The buyers were dissatisfied with the quality of the house and refused to release \$1,000 that had been held back at closing. The seller sued to collect and the buyers counterclaimed for breach of the implied warranty. The court dismissed the counterclaim on the ground that Mr. Boardman was not a commercial builder. It noted that he was not a licensed contractor and had only built one other house—which was his family home. *Boardman*, 38 Wn. App. at 341-42.

4. What Defects Render a Home Unfit for Habitation?

We have no clear guidelines as to what will violate the warranty. Instead we have examples which serve to set rough boundaries. In *Atherton*, the court stated:

The entire realm of defects which are within the purview of this implied warranty has not been precisely defined. Instead, 'a more precise definition of the scope of this warranty must await delineation on a case by case basis.'

Atherton, 115 Wn.2d at 519. Whether a defect renders a home unfit for habitation is an issue of mixed law and fact for the jury to decide. In *Burbo*, the court stated:

Whether the implied warranty of habitability accommodates a particular construction defect must be resolved on a case-by-case basis. That is, we follow the general rule that the applicability of an implied warranty to a particular set of facts is a mixed question of law and fact to be determined by the trier of fact.

Burbo, 125 Wn. App. at 694.

a. The Home Does Not Have to Be Uninhabitable

It is clear that the house does not have to be unlivable to be unfit. A number of defendants have argued that there was no violation of the implied warranty because the buyer could still live in the house. This argument is frequently based on *Klos*. In that case the yard surrounding the house settled and slipped although the house, which was constructed on pilings, did not. In holding that there was no breach of the implied warranty, the

court noted, among other things, that the buyers had not moved out of the house. *Klos*, 87 Wn.2d at 571.

In *Luxon v. Caviezel*, the court put to rest the notion that the buyer must move out. In that case the house suffered from water seepage and from an inadequate septic system. The septic system was designed for a two bedroom house, but the house was sold as a four bedroom house. Relying on an Oregon case, the court held that the septic defects violated the implied warranty, presumably because the system backed up and overflowed. As to the seepage, the trial court found that a portion of the residence was impaired by the seepage and that it was unhealthy. The court found that the defects violated the implied warranty. The court stated:

While the Supreme Court in *Klos* ... attaches importance to the purchasers having not moved out of the house, the case does not specifically require a purchaser to leave a home before breach of the implied warranty of habitability can be proved.

Luxon v. Caviezel, 42 Wn. App. 261, 266 (1985).

In *Burbo*, the house suffered from a leaky roof and structural problems. The buyer never moved out. The court framed the issue before it as whether breach of the implied warranty requires that the house be literally unlivable. *Burbo*, 125 Wn. App. at 689. It answered the question thus:

We have rejected the notion from *Klos* that a homeowner must have moved out of the house in order to prevail on an implied warranty of habitability.

Id. at 697.

In a similar vein, our courts hold that the house does not need to be presently unsafe. In *Atherton*, the owners in a condominium project claimed that various defects violated the one-hour fire resistivity standards and profoundly affected the safety of the building in a fire. *Atherton*, 115 Wn.2d 506 at 512. The court below dismissed their claims stating that although the building may be less safe in a fire than it should be, on an everyday basis, it could still be used for its intended purpose. *Id.* at 519. On appeal the developer argued that since the defects were neither egregious nor structural, the warranty was not violated. *Id.* at 520. The Supreme Court rejected both of these arguments noting that the conditions rendered affected the fundamental safety of the dwellings. *Id.*

b. Conditions Outside the Home Itself Are Covered if They Affect the House

The implied warranty covers conditions outside the house that affect the house. In *House*, the house was properly designed and built but the soils and groundwater affected the stability of the slope. *House*, 76 Wn.2d at 430-31. These conditions violated the

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implied warranty. On the other hand, in *Klos*, there were also slope stability issues. In that case, however, the lot had been excavated and foundation of the house was built on pilings. Consequently the house was hardly affected by the slope movement. *Klos*, 87 Wn.2d at 569. The court held that the house was habitable. *Id.* at 571.

In *Stuart*, the owners of condominium units sued the builder-vendor for breach of implied warranty of habitability due to defects in the design of exterior decks and walkways that exposed them to rot. The project was built on a hillside and for some units the walkways were the only means of ingress and egress. The court stated:

The warranty does not provide recovery for defects in exterior, nonstructural elements adjacent to the dwelling unit... In the case at bar, some of the damaged areas were decks, similar in use to the patio area in *Klos*. Others were walkways that may have comprised the sole means of access to the apartments, although the record fails to make this clear. As to the access walkways, one could plausibly argue that the defects occurred in an essential portion of the dwelling unit itself.

Stuart, 109 Wn.2d at 416-17. The court remanded the case to the trial court for a determination of which walkways were so impaired that the sole means of access to the unit was dangerous. The issue is whether the exterior defect affects the use of the home.

c. The Defects Don't Need to Be Egregious but Must Be More Than Mere Defects in Workmanship

In *Atherton*, the court rejected the argument (based on language in earlier cases such as *Stuart*) that the warranty was only breached if the defects were "egregious." It stated:

The interpretation of the implied warranty at issue here has been left to a case-by-case basis. In a vacuum, strongly worded phrases like 'egregious defects' could easily be

construed as unnecessarily constrictive. However, as is frequently the case in appellate interpretation, applying earlier formulas in a new factual context creates new shading, new shadows.

Atherton, 115 Wn.2d at 520. The court also stated, however that the warranty does not extend to mere defects in workmanship or require a perfect dwelling. *Id.* at 522. As will be explained below, in the context of the Condominium Act, mere defects in workmanship are covered.

d. Some Building Code Violations Are Covered

In *Atherton*, the court also stated that some violations of building code could violate the implied warranty. It noted that other courts have imposed liability for "fundamental deviation" from the building code, but not for "procedural" or "aesthetic" code violations. *Id.* at 524. It held that the violations in the building were fundamental. The opinion is not helpful in explaining what code violations violate the warranty because there are no standards for what is fundamental. From the fact that only some deviations from code violate the warranty, it should be clear that the implied warranty does not contain a warranty of building code compliance. Perhaps the best way to analyze the issue would be to ask whether the building code violations render the house unfit for its intended purpose of habitation. That is, after all, the warranty at issue.

- 1 Part 1 includes introduction and background and covers the common law implied warranty of habitability for subdivision homes. Part 2 will cover statutory and implied warranties for condominium homes; issues regarding enforcement and damages; and strategies for managing warranty liability.
- 2 Short subdivisions are allowed under various local codes and ordinances.
- 3 See *Obde v. Schlemeyer*, 56 Wn.2d 449 (1960) for the elements of this cause of action, which arises from the seller's failure to disclose material information to the purchaser.
- 4 The implied warranty has its origin in tort. If the warranty had its origins in the contract of sale of real property, one would suspect it would be susceptible to the doctrine of merger in the deed.
- 5 Remember that unpublished opinions have no precedential value in court.
- 6 Ten years later, however, in *Frickel*, the dissenters argued that the implied warranty should be extended beyond new homes to include all buildings. *Frickel*, 106 Wn.2d at 723.

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