

Homeowner's Nightmare When The Builder Goes Bankrupt

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October 1995 - Bankruptcy protection is available to an undercapitalized corporation, land developers, and homebuilders, creating greater problems for homeowners whose homes have become a nightmare of workmanship defects. But just because a builder files for bankruptcy protection to reorganize the firm's debts, that does not mean they are completely free from responsibility for these defects.

What rights do homeowners' associations in developments completed by the bankruptcy builder have? Unfortunately, they may have to line up behind other creditors, including numerous subcontractors, should any construction deficiencies manifest themselves.

Under California Corporation law, a corporation is regarded as a legal entity separate from its stockholders, officers and directors. However, where a corporation is used by an individual or individuals, or by another corporation, to perpetrate a fraud, or to accomplish some other inequitable purpose, a court may disregard the corporate entity and treat the corporation's acts as if they were done by the person actually controlling the firm(s).

In general, the California Supreme Court has long held that where a unity of interest and ownership between the corporation and the individual or organization controlling it are identical, and if failure to disregard the corporate entity would sanction fraud, and/or work an injustice to a third person, the corporate form will be disregarded.

While an opportunity exists for the affected homeowners to reach through the corporate veil and claim the personal assets of the bankrupt builder, the better and more immediate course would be to seek payment for defects through the builders' liability insurance. The insurance coverage will not escape the bankruptcy protection.

In other words, if the builder is insolvent, the liability insurance carrier, in place at the time the homeowners structural problems became apparent, must step up to the plate and pay for the builder's errors.

While bankruptcy gives the builder breathing room for all his legal and financial obligations, there are other methods of protection also available. For example, if you have been promised that a bankrupt builder will fix any real problem in your homeowners' association, that promise is now without substance. In other words, all monies are controlled by the bankruptcy court. The builder does not have the money or the wherewithal to borrow it and do the repairs.

At a time when a builder has filed bankruptcy, an association's board of directors should not stand idly by and despair. It is necessary to seek relief through the developer's and its subcontractors' insurance for construction defects. In order to trigger such coverage, it would be necessary to file a lawsuit against the builder.

There is only a finite amount of insurance, depending on the type of policy purchased. The law favors the vigilant and abhors stale claims. With insurance law, the first to file is the first to get into a legal position to collect on that policy.

Most likely, any large builder has more claims than they would like to admit. And each claim may ultimately reduce the amount of money left under each policy issued to the builder.

If you have a legitimate claim for construction defects within a development built by a bankrupt builder, it is important to protect your rights by acting expediently. Do not get swept up in the bankruptcy process.

Newport Beach attorney Thomas E. Miller began his career more than two decades ago representing developers and their insurance companies before changing to the exclusive representation of homeowners associations since 1981. Miller is the author of two legal textbooks on California construction defect and land subsidence litigation: *California Construction Defect and Land Subsidence Litigation*, 1986, and *California Defect and Land Subsidence Litigation: Residential and Commercial* (John Wiley). In addition, Miller is a founding member of the California Association of Community Managers.