



# STATE OF ARIZONA CONSTRUCTION LAW COMPENDIUM

**Updated by**

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The following is an overview of Arizona construction law. The discussion on any individual topic is not necessarily an indication of the total law in that particular area. With a few exceptions, the laws applicable to Arizona construction disputes are similar to those in other states.

## **I. BREACH OF CONTRACT**

### **A. Possible Recovery Available to Plaintiffs**

The purchase of a home is usually memorialized in a written contract between the purchaser and the builder. The contract documents include a number of provisions which, if violated, give rise to a breach of contract cause of action against the builder. For example, many contracts include a clause requiring the builder to perform its work in a workmanlike manner, and to follow established building codes and standards of care in the industry. When plaintiffs allege construction defect claims, they often claim that the contract between the builder and the purchaser has been breached. The breach of contract action may be maintained in Arizona subject to an 8-year statute of repose. A.R.S. § 12-552. Unlike some of the other limitations of actions, the statute of repose applies equally to governmental entities as to private parties. *City of Phoenix v. Glenayre Elecs., Inc.*, 242 Ariz. 139, 141, ¶ 1, 393 P.3d 919, 921 (Ariz. 2017). Even in the absence of a written contract, purchasers may file an action against their builder for breach of oral contract when oral representations are made with respect to the nature and quality of the construction of the subject homes. A “no liability clause” in a construction contract does not bar recovery by a plaintiff in a breach of contract action. *Technology Const., Inc. v. City of Kingman*, 229 Ariz. 564, 287 P.3d. 906, (App. 2012).

### **B. Possible Recovery Available to Developers**

Typically, well-drafted construction contracts are divided into numerous sections to specifically address various issues that might arise during construction. Such contracts delineate the rights and responsibilities of each party, remedies, safety precautions to be taken, applicable laws, warranty and indemnity obligations, procurement of insurance, and the like. A contractor’s breach of one of these provisions could result in a cause of action against the contractor by the developer. *See PPG Industries, Inc. v. Continental Heller Corp.*, 124 Ariz. 216, 603 P.2d 108 (App. 1979). Arguably, a separate cause of action would arise for each provision of the contract agreement that was breached. Depending upon specificity of the contract provisions, a typical construction defect lawsuit could result in the breach of many contract provisions but no double recovery.

## **II. NEGLIGENCE**

An injury incurred due to the negligent construction of a residence may give rise to an action for breach of implied warranty of habitability and an action for breach of contractor’s common law duty of care. *Woodward v. Chirco Construction Co.*, 141 Ariz. 514, 687 P.2d 1269 (1984).

An action for negligence in home construction must establish defects in workmanship, supervision, or design as the responsibility of the individual defendant. *Id.* Proof of a defect alone is not enough to establish the claim. *Arrow Leasing Corp. v. Cummins Arizona Diesel, Inc.*, 136 Ariz. 444, 666 P.2d 544 (App. 1983). Proof of negligence in the construction of a house requires that a builder or contractor be held to a standard of reasonable care towards foreseeable users of the property. *Woodward*, 141 Ariz. 514, 687 P.2d 1269. This generally requires expert testimony as the standard of care is not “within the realm of common knowledge.” *34 Degrees N., LLC v. Mountain View Constr., LLC*, 2016 WL 7209664, at ¶ 30 (App. 2016). Applicable building codes or contractor standards do not constitute duties for negligence purposes when a party seeks to recover for subsequent owners seeking to recover for economic losses. *Sullivan v. Pulte Home Corp.*, 237 Ariz. 547, 354 P.3d 424, 428 (App. 2015).

The availability of a negligence claim against a builder, however, may be limited by the economic loss rule. The economic loss rule stands for the proposition that where damages are to the home itself, plaintiff’s cause of action sounds in contract rather than tort. *Flagstaff Affordable Hous. Ltd. P’ship v. Design Alliance, Inc.*, 223 Ariz. 320, 223 P.3d 664 (2010). Therefore, many defendants believe an action, where the only damages alleged are to the construction of the property itself, sounds in contract only and a negligence cause of action cannot be maintained. However, where there is damage to personal property other than the structure itself and/or personal injury, a cause of action for negligence exists, subject to Arizona’s 2-year statute of limitations. See A.R.S. § 12-542.

With respect to homeowners suing subcontractors directly, the nature of the complaint determines whether such an action can proceed. Arizona courts are tending to find that, because of the economic loss doctrine, a simple construction defect cause of action sounds in contract and not in tort, thus barring a negligence claim. Because subcontractors are typically not in privity of contract with homeowners, they cannot be directly sued by a plaintiff in contract either. *Yanni v. Tucker Plumbing, Inc.*, 233 Ariz. 364, 367–68, 312 P.3d 1130, 1133–34 (Ct. App. 2013). However, a homeowner can conceivably sue a subcontractor in negligence subject to the accepted work doctrine, which holds that a contractor whose work is accepted by an owner may not be liable for injuries to third parties unless 1) it is hired “to exercise its discretion, special skills, and knowledge to prepare a design, and the owner does not control the design details,” or 2) the work itself is “inherently, intrinsically or abnormally dangerous, or so manifestly defective as to be imminently dangerous to third persons.” *Menendez v. Paddock Pool Const. Co.*, 172 Ariz. 258, 270, 836 P.2d 968, 980 (App. 1991). If there is a claim of injury to a homeowner resulting from a subcontractor’s work and one of these two broad criteria are met, there is a good basis for the owner to directly sue the subcontractor.

### **III. BREACH OF WARRANTY**

In construction defect cases, plaintiffs typically plead breach of warranty causes of action. The breach of warranty can be based on express warranty provisions contained in the contract

between the plaintiff and the builder/developer and/or implied by law.

**A. Breach of Implied Warranty**

Even in the absence of a specific contractual provision, Arizona courts have adopted the rule that a builder/vendor impliedly warrants that the construction of a home was done in a workmanlike manner and that the structure is habitable. *Columbia Western Corp. v. Vela*, 122 Ariz. 28, 592 P.2d 1294 (1979). In Arizona, workmanship and habitability are considered to be covered by one warranty. The standard for breach of this type of warranty is reasonableness and not perfection. In other words, the test is whether the work performed is comparable to that of the quality of work ordinarily done by a worker of average skill and intelligence. *Nastri v. Wood Bros. Homes Inc.*, 142 Ariz. 439, 690 P.2d 158 (App. 1984).

The implied warranty is limited to hidden or latent defects that would not have been discoverable upon “reasonable inspection.” See *Hershey v. Rich Rosen Constr. Co.*, 169 Ariz. 110, 114, 817 P.2d 55, 59 (Ct. App. 1991). Reasonable inspection does not mean an inspection by an expert; the warranty applies to hidden defects that could not have been discovered by an average purchaser. The implied warranty is not affected or superseded by any express warranty in a contract. See *Nastri v. Wood Bros. Homes, Inc.*, 142 Ariz. 439, 690 P.2d 158 (Ct. App. 1984). Further, an express waiver and disclaimer of the implied warranty by the original homeowner does not bind an innocent subsequent purchaser. *Id.* Arizona has left open the question of whether a knowing waiver of the implied warranty is against public policy. *Id.*

While homeowners may bring an implied warranty claim against general contractors, homeowners cannot bring an implied warranty claim against subcontractors where there is no privity between homeowners and subcontractors. *Yanni v. Tucker Plumbing, Inc.* 233 Ariz. 364, 312 P.3d 1130 (App. 2013).

The implied warranty of workmanship and habitability can be applied to subsequent purchasers of homes. *Richards v. Powercraft Homes, Inc.*, 139 Ariz. 242, 245, 678 P.2d 427, 430 (1984). This implied warranty runs in favor of subsequent purchasers regarding latent defects. Accordingly, builders/ developers cannot avoid liability on the basis that the subsequent purchaser of a home is not in privity of contract with them.

An implied warranty is also created for all contractors, general and subcontractors, that they will perform their work in a workmanlike manner. A contractor also cannot disclaim this warranty through its contract. *Buchanon v. Scottsdale Envt'l Constr.*, 163 Ariz. 285, 787 P.2d 1081 (App. 1989). Therefore, if a contractor fails to perform its work in a manner befitting a skilled contractor, a cause of action lies against it for breach of implied warranty. *Cameron Co. v. Sisson*, 74 Ariz. 226, 229, 246 P.2d 189, 191 (1952). Contractors may bring a claim for breach of implied warranty against design professionals such as architects. *North Peak Construction, LLC v. Architecture Plus, Ltd.*, 227 Ariz. 165, 168, 254 P.3d 404, 407 (App. 2011).

Although the implied warranty arises out of contract, rather than tort, it was traditionally thought that attorney's fees are not recoverable under A.R.S. § 12-341.01(A). However, in a recent decision by the Arizona Supreme Court, it was determined that "any claim for breach of [the warranty of workmanship and habitability] arises from the contract. The successful party therefore qualifies for fees under a controlling contractual fee provision or, barring that, § 12-341.01." *Sirrah Enterprises, LLC v. Wunderlich*, 242 Ariz. 542, 543, ¶ 1, 399 P.3d 89, 90 (Ariz. 2017).

It is also important to note that a plaintiff may recover fees and expert costs if the plaintiff properly brings a claim pursuant to Arizona's Purchaser Dwelling Act. See, A.R.S. § 12-1361, et seq.

The Arizona Court of Appeals made clear an important distinction in construction law: Commercial structures and residential structures will be treated differently when determining who can utilize this theory of recovery. The primary cause of action used in residential construction defect cases is a breach of the implied warranty of habitability. This cause of action allows a homeowner to sue the builder or vendor for construction defects for up to eight years (nine years if the defect is found in the eighth year). The Court of Appeals, in *Hayden Business Center Condo Ass'n v. Pegasus Development*, 209 Ariz. 511, 105 P.3d 157 (App 2005), reasoned that the implied warranty of habitability is created to protect homeowners from shoddy construction practices of unscrupulous builders. It does not extend to builders of commercial structures. This holding is based on the premise that commercial developers and purchasers are more sophisticated consumers who will perform their due diligence before the purchase.

However, in *Lofts at Fillmore Condo Ass'n v. Reliance Commercial Constr.*, 218 Ariz. 574, 190 P.3d 733 (2009), the general contractor could be sued by a subsequent purchaser for construction defects whether or not the general contractor was the "homebuilder-vendor." The court further held that a contractor gave an implied warranty of workmanship and habitability even though it was not also the vendor of the condominiums, and purchasers could bring a breach of warranty claim against the contractor, even though they had no direct relationship with the contractor.

Many construction contracts contain disclaimers of implied warranties in their sales contracts with purchasers. Courts have avoided attempts by a seller seeking to disclaim warranty liability imposed by law. *Columbia*, 122 Ariz. 28, 592 P.2d 1294. *Richards*, 139 Ariz. 242, 245, 678 P.2d 427.

The duration of the implied warranty of habitability is based on a factual determination, which depends, in part, on the life-expectancy of a questioned component in nondefective condition. *Hershey v. Rich Rosen Constr. Co.*, 169 Ariz. 110, 817 P.2d 55 (App. 1991). The fact-finder is charged with the responsibility to decide whether liability is reasonable at the point of the breach under the particular facts and does not decide the outside limits of life-expectancy for

any individual component part of the construction of a home. It is not unusual for a contract between a general contractor and a subcontractor to contain various warranty provisions. At a minimum, virtually all subcontracts contain the statutory warranties that guarantee all work and materials provided for a period of 2 years. Because implied warranty arises out of contract, attorneys' fees may be recoverable pursuant to A.R.S. § 12-341.01(A). Additionally, per Arizona statute, courts "may" award expert fees in a contested construction-defect action involving a single purchaser on an issue-by-issue basis. See A.R.S. §12-1364(D).

**A. Breach of Express Warranty**

In addition to the implied warranty, a contractor may be sued for breaching an express provision in a contract. This theory is used in commercial construction disputes, and is a primary theory in residential disputes between contractors where the implied warranty does not apply.

**IV. BREACH OF FIDUCIARY DUTY**

This theory is often alleged against the developer of a mass-housing project. The developer has the initial fiduciary obligation to the homeowner's association members. Once enough units are sold, the developer hands over the homeowner's association to the homeowners themselves. The developer is required to keep sufficient funds in the homeowners association to fund initial operating expenditures and reserve requirements. If the developer turns over the homeowners association without sufficient funds, the successor homeowners association will likely argue that the developer breached its fiduciary duty to adequately budget and fund for these expenditures which may have resulted in a deterioration of the community.

**V. MISREPRESENTATION AND FRAUD**

In some situations, homebuilders are sued by owners and/or homeowner associations under the theory of misrepresentation. The availability of punitive damages against the homebuilder depends on whether the misrepresentation was negligent or fraudulent. Failure to exercise reasonable care is the level of fault that gives rise to a claim for negligent misrepresentation. See *Formento v. Encanto Business Park*, 154 Ariz. 495, 499-500, 744 P.2d 22, 26-27 (1987). On the other hand, if the seller knows that the information he is supplying to the purchaser is false and intends that the purchaser act upon that information, then the seller may be guilty of fraud, which would give rise to a claim for punitive damages. Fraud requires: (1) a representation; (2) its falsity; (3) its materiality; (4) the speaker's knowledge of its falsity or ignorance of its truth; (5) the speaker's intent that it be acted upon by the recipient in the manner reasonably contemplated; (6) the hearer's ignorance of its falsity; (7) the hearer's reliance on its truth; (8) the right to rely on it; and (9) his consequent and proximate injury. In order to succeed on a claim of misrepresentation and fraud, plaintiffs must not only plead each and every element, but be prepared to make a prima facie showing of each element if their claims of fraud and misrepresentation are to survive summary judgment. See *Echols v. Beauty Built Homes, Inc.*,

132 Ariz. 498, 647 P.2d 629 (1982); *Donnelly Construction Company v. Oberg/Hunt/Gilleland*, 139 Ariz. 184, 677 P.2d 1292 (1984).

## **VI. STRICT LIABILITY CLAIMS**

Although often pled by plaintiffs, strict liability in construction defect cases has not been widely accepted or recognized in Arizona. In California, however, strict liability is permitted in an action by homeowners or homeowners' associations against the builder of mass-produced housing. California does not recognize strict liability causes of action against subcontractors in construction defect cases. *Kriegler v. Eichler Homes, Inc.*, 74 Cal. Rptr. 749 (Cal. App. 1969).

Because this issue has not been decided by the appellate courts, parties disagree as to the viability of this claim in Arizona. Defendants routinely cite *Menendez v. Paddock Pool Construction Co.* for the proposition that Arizona has formally rejected strict liability for construction defects in homes. *Menendez*, 172 Ariz. 258, 836 P.2d 968 (App. 1991). Plaintiffs, however, state that the *Menendez* case stands for the proposition that whether or not a construction improvement is subject to strict liability must be evaluated on a case-by-case basis. In *Menendez*, the court ultimately concluded that a custom in-ground swimming pool was not a product for purposes of a strict products liability claim.

Arizona includes an unreasonably dangerous element in its strict product liability analysis. In order to maintain a cause of action for strict product liability in Arizona, the product itself must be unreasonably dangerous. The defense position, which has been advanced and relatively well accepted by Arizona courts so far, is that the construction of a home, including its individual components, is not considered a product for purposes of strict liability, and the unreasonably dangerous element necessary to maintain a strict liability claim in Arizona is not satisfied.

## **VII. INDEMNITY CLAIMS**

### **A. Express Indemnity**

Express indemnity occurs when a written indemnity provision in a contract or agreement dictates the breadth of the indemnity provided. When interpreting an express indemnity agreement, the extent of the duty to indemnify must be determined from the contract itself. *Birth of Hope Adoption Agency, Inc., v. Doe*, 190 Ariz. 285, 288, 947 P.2d 859, 862 (App. 1997); *INA Ins. Co. v. Valley Forge Ins. Co.*, 150 Ariz. 248, 252, 722 P.2d 975, 979 (App. 1986). Generally, express indemnity agreements are placed into two classes: general and specific. A general indemnity agreement does not specifically address what effect the negligence of the developer will have on the obligation of the subcontractor to indemnify. *Washington School Dist. No. 6 v. Baglino Corp.*, 169 Ariz. 58, 61, 817 P.2d 3, 6 (1991). In contrast, a specific indemnity agreement does address the effect that the negligence of the developer will have on the obligation of the subcontractor to indemnify. The distinction is important because under a general indemnity

provision, indemnification is only afforded to an indemnitee when, at most, the loss is attributable in part to the indemnitee's passive negligence, but not its active negligence. *Grubb & Ellis Mgmt. Servs., Inc. v. 407417 B.C., L.L.C.*, 213 Ariz. 83, 86, 138 P.3d 1210, 1213 (App. 2006). Thus, a subcontractor could argue that a developer and/or general contractor who is negligent in any way is not entitled to indemnity under a general indemnity agreement. *Herstam v. Deloitte & Touche, LLP*, 186 Ariz. 110, 919 P.2d 1381 (App. 1996).

The Arizona Supreme Court called into question the continued use of the active/passive scheme in general indemnity agreements. In *Cunningham v. Goettl Air Conditioning*, the court looked to the indemnity provisions in determining whether to afford indemnity. 194 Ariz. 236, 980 P.2d 489 (2001). *Goettl* involved a lease agreement between Goettl Air Conditioning ("Goettl") as lessee, and Washington Street Investments ("WSI"), as lessor. The court stated that courts should look to the "all- encompassing language" of the indemnification agreement. *Id.* at 240, 980 P.2d at 493. If the language of the indemnity agreement "clearly and unequivocally indicates that one party is to be indemnified, regardless of whether or not that injury was caused in part by that party, indemnification is required notwithstanding the indemnitee's active negligence." *Id.*

It bears noting that A.R.S. § 32-1159 prohibits, as void against public policy, an indemnity provision in a construction contract that purports to indemnify any party for loss or damage resulting from his sole negligence. The Arizona legislature recently expanded on this principle by enacting A.R.S. § 32-1159.01, which states that indemnity agreements in residential construction contracts that "purport[] to insure, to indemnify or to hold harmless the promisee from or against liability for loss of damages resulting from the negligence of the promisee" are void as against public policy.

However, subject to the above, after settling with a homeowner, a general contractor may obtain indemnity from the subcontractor pursuant to valid contractual indemnity language, so long as the general proves the extent of the subcontractor's fault. *M.T. Builders v. Fisher Roofing, Inc.*, 219 Ariz. 297, 197 P.3d 758 (Ct. App. 2008).

## **B. Implied Indemnity**

Indemnity is an obligation resting on one party to make good the loss or damage incurred by another party. *INA Ins. Co. v. North America v. Valley Forge Ins. Co.*, 150 Ariz. 248, 252, 722 P.2d 975, 979 (App. 1986).

There are circumstances when a developer does not have a contract with the subcontractor and thus does not have an express indemnity provision. In such a situation, implied indemnity can be used. Implied indemnification occurs when two parties have a contract that is silent as to the allocation of the indemnification provisions, but the relationship between the parties is such that the court imposes one nonetheless. *Schweber Electric v. National Semiconductor*, 174 Ariz. 406, 850 P.2d 119 (App. 1992). This theory is limited and dates back nearly half a century



to *Busy Bee Buffet v. Ferrell*. 82 Ariz. 192, 310 P.2d 817 (1957). In *Busy Bee*, the plaintiff, Mr. Ferrel, a delivery man, injured himself when he fell through a trap door at the Busy Bee Buffet and Restaurant (“Busy Bee”) that Mr. Pastis, a co-tenant with Busy Bee, had left open. Mr. Ferrel sued Busy Bee and Mr. Pastis. Busy Bee sought indemnity from Mr. Pastis. The trial court granted summary judgment in favor of Busy Bee on its indemnification claim. On appeal, the Arizona Supreme Court discussed the difference in kind and character between the negligence of Busy Bee and Mr. Pastis. The court upheld the judgment by employing a passive versus active fault scheme to the actions of Busy Bee and Mr. Pastis.

What is “active” versus “passive” negligence was not specifically defined until *Estes Co. v. Aztec Construction*. 139 Ariz. 166, 677 P.2d 939 (App. 1983). In *Estes*, the court held that generally, “active negligence” is found if an indemnitee has personally participated in an affirmative act of negligence, was connected with negligent acts or omissions by knowledge or acquiescence, or has failed to perform a precise duty that the indemnitee had agreed to perform. *Id.* at 169, 677 P.2d at 942. On the other hand, “passive negligence” is found in mere nonfeasance, such as the failure to discover a dangerous condition, perform a duty imposed by law, or take adequate precautions against certain hazards inherent in employment. *Id.*

The active/passive scheme, however, has not been without its problems. Determining what is active negligence versus what is passive negligence is not always easy to do. In the construction defect realm, applying the active/passive scheme becomes even more problematic. For example, how does such a scheme apply to a general contractor who contracts with a stucco subcontractor to apply stucco to 20 buildings and the general contractor is actively negligent with respect to the stucco application to one of the 20 buildings? Is the general contractor precluded from recovering indemnity on the other 19 buildings for which it was only passively negligent? Such a question has never been answered by an Arizona court. Or another common problem arises when the general contractor failed to have noticed the alleged defective work of the subcontractor. Is such an omission active negligence or passive negligence? While not directly on point, at least one court has indicated that such an omission may be considered active negligence thereby precluding indemnity. *Cella Barr Associates v. Cohen*, 177 Ariz. 480, 868 P.2d 1063 (App. 1994) (environmental auditor held not entitled to indemnity because of its active negligence in failing to identify environmental obstacles in its audit).

### C. Comparative Indemnity

Typically, indemnity is an all-or-nothing proposition. Either the indemnitee gets reimbursed all monies paid in defending the matter, or it gets nothing. Some have argued that this scheme has resulted in harsh effects for the indemnitee. Consequently, developers have argued for the adoption of a comparative indemnity scheme that ameliorates the harsh “all or nothing result” by applying comparative negligence concepts. While Arizona courts have yet to address the issue, many jurisdictions have adopted such a scheme.

#### **D. Third Party Beneficiary**

In some circumstances, a developer is not the general contractor and does not enter into a contract with the subcontractors. Although some agreements between the general contractor and the subcontractors may provide indemnity rights on behalf of the developer, other agreements may not. In such cases, the developer may argue that it was a third party beneficiary of the contract between the general contractor and subcontractor, putting the developer in a position to seek indemnification.

### **VIII. STATUTE OF REPOSE/STATUTE OF LIMITATIONS**

Arizona has enacted legislation that attempts to deal with the problem of prolonged exposure to liability for latent construction defects. A homeowner has up to eight years after a project has been substantially completed to file a construction defect claim. See A.R.S. § 12-552. However, if the defect is discovered during the eighth year after completion, the claim may be made within the ninth year after the project has been substantially completed. See A.R.S. § 12-552 (E)(3).

A prior homeowner's knowledge of a construction defect is imputed to the current owner for the purpose of an exception to the statute of repose applicable to claims for breach of implied warranty of habitability. *Maycock v. Asilomar Development, Inc.*, 207 Ariz. 495, 501, 88 P.3d 565, 570 (App. 2004). The Court reasoned that language from the Arizona Supreme Court supported its conclusion. The Arizona Supreme Court held that an implied warranty is limited to latent defects that manifest after the subsequent owner's purchase, and which were not discoverable had a reasonable inspection of the structure been made prior to the purchase. *Id.* (citing *Richards v. Powercraft Homes, Inc.*, 139 Ariz. 242 (1984)). If the defect had been discovered before a new owner purchased the home, the warranty would not exist. *Id.* Additionally, the *Maycock* court reasoned that at least one court from another jurisdiction has held that a prior owner's knowledge of construction defects is imputed to a subsequent purchaser to bar an action of breach of implied warranties. *Id.*

This statute has always posed problems for developers and general contractors who were sued in the ninth year (perhaps even on the last day of the ninth year). A Court of Appeals decision has clarified the application of the statute of repose. *Evans Withycombe v. Western Innovations*, 215 Ariz. 237, 159 Ariz. 547 (App. 2006).

In *Evans*, the Court of Appeals distinguished between contract-based claims versus non-contracts based claims in determining which ones are subject to the nine-year statute of repose. The Court concluded that because the statute stated that no action or arbitration "based in contract" may be instituted after the nine-year limitation, this statute did not apply to common law indemnity claims, as they are not based in contract.

The *Evans* decision defines the breadth of the statute of repose, however, those claims that are

not subject to its restrictions are often limited in their effectiveness as mechanisms for recovery. For example, a negligence claim can only be brought in the construction context for personal injury or damages to an owner's property. They cannot be brought to recover damage to the structure itself. Similarly, a common law indemnity claim can only be successfully used if the person seeking indemnity (usually the general contractor) is free from any comparative fault.

In class action lawsuits, the statute of repose does not toll for unnamed putative class members. *Albano v. Shea Homes, L.P.*, 227 Ariz. 121, 254 P.3d 360 (2011). In *Albano*, the Ninth Circuit certified to the Arizona Supreme Court the question of whether a class action tolling doctrine applies to statutes of repose, and if so, to what extent may the action be tolled. *Id.* at 123, 254 P.3d 360. The court held that the statute does not toll because the statute of repose deals with substantive rights rather than procedures. *Id.* at 127, 254 P.3d 360. The court reasoned that substantive rights were more important than procedural rights, and because the statute of repose is substantive, while statutes of limitations are procedural, allowing tolling of the statute would not comport with the legislative intent of A.R.S. § 12-552. *Id.* at 127-28, 254 P.3d 360.

## **IX. CONTRACTUAL LIMITATION OF LIABILITY**

The court in *1800 Ocotillo v. The WLB Group*, 219 Ariz. 200, 196 P.3d 222 (2008), noted that public policy does not prohibit contractual limitation of liability provisions in construction contracts or architect-engineer contracts, but the enforceability of the provision is left to the decision of the jury.

## **X. ECONOMIC LOSS DOCTRINE**

Economic loss refers to pecuniary or commercial damage, including any decreased value or repair costs for a product or property that is itself the subject of a contract between plaintiff and defendant, and consequential damages such as lost profits. *Flagstaff Affordable Hous. Ltd. P'ship v. Design Alliance, Inc.*, 223 Ariz. 320, 323, 223 P.3d 664, 667 (2010). There is not a bright line to determine whether to apply tort or contract law when property has been damaged. *Salt River Project Agricultural Improvement and Power District v. Westinghouse Electric Corp.*, 143 Ariz. 368, 376 694 P.2d 198, 206 (1984). Instead, each case must be examined whether the facts favor the application of tort law or commercial law or a combination of the two. *Id.* The three factors court should consider are: 1.) the nature of the defect causing loss, 2.) how the loss occurred, and 3.) the type of loss for which plaintiff seeks redress. *Id.* If the damages occur suddenly or as a result of an accident and the defect poses an unreasonable risk of danger to people or other property, the claim will sound in tort even if only property is damaged. *Id.*

The parties can contractually preserve tort remedies for pure economic loss. *Flagstaff Affordable Hous. Ltd. P'ship v. Design Alliance, Inc.*, 223 Ariz. 320, 326, 223 P.3d 664, 670 (2010). *Flagstaff* succinctly stated the current state of the economic loss rule:

Where economic loss, in the form of repair costs, diminished value, or lost profits, is the plaintiff's only loss, the policies of the law generally will be best served by leaving the parties to their [contractual] remedies. Where economic loss is accompanied by physical damage to person or other property, however, the parties' interests generally will be realized best by the imposition of strict tort liability. If the only loss is non-accidental and to the product itself, or is of a consequential nature, the remedies available under the contract law will govern and strict liability and other tort theories will be unavailable.

The Supreme Court of Arizona recently held that the economic loss doctrine applies equally to architects and contractors, but declined to extend tort recovery against an architect under a theory of professional negligence. *Flagstaff Affordable Hous. Ltd. P'ship v. Design Alliance, Inc.*, 223 Ariz. 320, 326, 223 P.3d 664, 670 (2010). The court reasoned that there was nothing unique about architects that took them out of the purview of the economic loss doctrine. *Id.*

In *Sullivan v. Pulte Home Corp.*, 237 Ariz. 547, 354 P.3d 424 (App. 2015), the Arizona Court of Appeals held that a subsequent homeowner could not maintain a negligence cause of action against a homebuilder for economic losses arising from latent construction defects. Prior to this ruling, the question was open as to whether a negligence claim could be asserted by a subsequent purchaser many years beyond the eight-year statute of repose under the auspice of the "discovery rule." If that had been permissible, the subsequent purchaser would then have two years from the date of discovery of the latent defect to assert the negligence claim.

The ruling in *Sullivan* makes clear that, absent a physical injury to persons or other personal property, neither original nor subsequent homeowner can bring a claim for negligence against the homebuilder in Arizona. Original homeowners are limited by the economic loss doctrine to their contractual remedies, and subsequent homeowners are not able to bring a negligence claim at all, since the *Sullivan* court ruled that public policy did not support a legally recognizable duty flowing from homebuilders to subsequent purchasers. A homebuilder can only be liable for latent defects for up to eight years from substantial completion of the home. It bears noting that the *Sullivan* court expressly did not analyze whether a legally recognizable tort duty could arise by either common law or relationship of the parties. Future cases may test these areas, but for now, the law in Arizona is as described above.

## **XI. LITIGATION PROCESS**

### **A. Prior to the Initiation of the Lawsuit**

In 2002, Arizona enacted legislation that contemplates specific notice and opportunity to repair

construction defects in an effort to resolve construction defect complaints without congesting the courts with time consuming and costly litigation. In 2019, significant amendments were made to the Arizona Purchaser Dwelling Act. Under A.R.S. § 12-1361 et seq., a purchaser must comply with the Statute before filing a dwelling action. If a purchaser fails to comply with the Statute, the dwelling action shall be dismissed. If the dwelling action is dismissed after the statute of limitations or statute of repose, including § 12-552, applicable to the purchaser, any subsequent dwelling action brought by the purchaser is time barred as to the seller and the seller's construction professionals involved in the construction or design of the dwelling.

**B. Requirement of Notice**

A.R.S. § 12-1363(A) provides that before filing a dwelling action, the purchaser must give written notice to the seller by certified mail, return receipt requested, specifying "in reasonable detail the basis of the dwelling action." "Reasonable detail" includes a detailed and itemized list that describes each alleged construction defect, the location that each alleged construction defect has been observed by the purchaser in each dwelling that is the subject of the notice and the impairment to the dwelling that has occurred as a result of each of the alleged construct defects or is reasonably likely to occur if the alleged construction defects are not repaired or replaced. See A.R.S. § 12-1363(Q).

The "seller" of the dwelling then "shall" forward the purchaser's notice to the last-known address of each construction professional (i.e. subcontractors) whom the seller "reasonably believes" is responsible for the defects alleged in the purchaser's notice. A.R.S. § 12-1363(A). It remains to be seen what remedy each subcontractor has if it is not forwarded this notice, however, as the statute does not directly address a "seller" failing to comply with this section.

**C. Right to Inspect**

Once the purchaser has given the required notice, the seller and/or builder, as well as any subcontractors performing work on the property, may inspect the dwelling to determine the nature and cause of the alleged construction defect and the nature and extent of any repairs that might be necessary to remedy the alleged construction defect. A.R.S. §§12-1362(B), 12-1363(B). If the seller/builder or subcontractors wish to inspect the alleged construction defect, the purchaser must ensure that the dwelling is made available for inspection no later than ten days after the purchaser receives the seller's request for inspection. The seller may then use any "reasonable measures" to inspect the dwelling, including testing to determine the nature and cause of the alleged defect. See A.R.S. § 12 1363(B).

**D. Response by Seller/Builder**

Within 60 days after receipt of the notice of defect, the seller must send to the purchaser a good faith, written response by certified mail. The response may include a notice of intent by

the seller to repair or replace any alleged construction defects, including a reasonable description of all repairs, replacements, or compensation that the seller is offering to make and an estimate of the date that the remedy will be provided. An offer from the seller of monetary compensation or other consideration instead of or in addition to a repair or replacement is not prohibited. The purchaser may accept or reject an offer of monetary compensation or other consideration, other than repair or replacement and, if rejected, may proceed with a dwelling action on completion of any repairs or replacements the seller intends to make or provide. The parties may negotiate for a release if an offer involving monetary compensation or other consideration is accepted. See A.R.S. § 12-1363(C).

**E. Failure of Seller/Builder to Respond to Notice**

If the seller does not respond within 60 days of the notice of defect, the purchaser may file the dwelling action. See A.R.S. § 12-1363(D).

**F. Seller's Right to Repair**

If the seller provides a notice of intent to repair or replace the alleged construction defects, the purchaser must allow the seller a reasonable opportunity to repair or replace the construction defects or cause the construction defects to be repaired or replaced pursuant to the following:

(1) The purchaser and the seller or the seller's construction professionals must coordinate repairs or replacements within 30 days after the seller's notice of intent to repair or replace was sent as required by A.R.S. § 12-1363(C). If requested by the purchaser, repair or replacement of alleged construction defects undertaken by the seller shall be performed by a construction professional selected by the seller and consented to by the purchaser. The consent must not be unreasonably withheld and the construction professional must be one that was not involved in the construction or design of the dwelling.

(2) Repairs or replacements must begin as agreed by the purchaser and the seller, or the seller's construction professionals, with reasonable efforts to begin repairs or replacements within 35 days after the seller's notice of intent to repair or replace was sent as required by A.R.S. § 12-1363(C). If a permit is required to perform the repair or replacement, reasonable efforts must be made to begin repairs or replacements within 10 days after receipt of the permit or 35 days after the seller's notice of intent to repair or replace was sent pursuant to A.R.S. § 12-1363(C), whichever is later.

(3) All Repairs or replacements must be completed using reasonable care under the circumstances and within a commercially reasonable time frame considering the nature of the repair or replacement. Any access issues or unforeseen events that are not caused by the seller or the seller's construction professionals.

(4) The purchaser must provide reasonable access for the repairs or replacements.

(5) The seller is not entitled to a release or waiver solely in exchange for any repair or replacement made except that the purchaser and seller may negotiate a release or waiver in exchange for monetary compensation or other consideration.

(6) At the conclusion of any repairs or replacements, the purchaser may commence a dwelling action or, if the contract for the sale of the dwelling or the community documents contain a commercially reasonable alternative dispute resolution procedure that complies with § 12-1366(C), may initiate the dispute resolution process including any claim for inadequate repair or replacement.

#### **G. Evidentiary Issues**

Both parties' conduct during the repair or replacement process prescribed in A.R.S. § 12-1362 (B)-(E), and explained above, may be introduced in any subsequent dwelling action. Any repair or replacement efforts undertaken by the seller are not considered settlement communications or offers of settlement and are admissible as evidence. As a result, a purchaser or a seller who fails to participate in the dwelling action process may face adverse evidentiary consequences at trial.

Upon the commencement of a dwelling action, the "construction professionals" performing work on the property (i.e. subcontractors) now "shall be joined as third-party defendants" in any dwelling action. A.R.S. §12-1362(D). Additionally, the dwelling action trial proceeds in a bifurcated process in which the trier of fact "shall first determine if a construction defect exists and the amount of damages caused by the defect," and "identify each seller or construction professional whose conduct caused the defect." *Id.* Second, the trier of fact then shall "determine the relative degree of fault by any defendant or third-party defendant," and "allocate the pro rata share of liability based on the relative degree of fault." *Id.*

#### **H. Attorneys' Fees, Costs, and Expert Witness Fees**

An original purchaser will still be able to recover based on the contractual privity that they maintain with a builder or a contractor. This is due to A.R.S. § 12-341.01 which allows for recovery of attorney fees to a successful party in any action arising out of a contract. An original purchaser can even recover attorneys' fees if they were also found liable for breach of contract, provided their award was greater than the judgment against them, though this decision is under further appeal. *Sirrah Enterprises, LLC v. Wunderlich*, 240 Ariz. 163, 169, ¶ 18, 377 P.3d 360, 366 (App. 2016), *Review Granted* (Jan. 10, 2017). However, with the repeal of A.R.S. § 12-1364, subsequent purchases of a property are unable to recover attorney's fees as they do not have contractual privity with the builder or developer. Lastly, the ability to recover expert fees and taxable costs still exist through offers of judgment made under Arizona Rules of Civil Procedure

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## **XII. RECOVERABLE DAMAGES**

### **A. Direct Damages**

Repair costs are the most significant item of damages in a construction defect case. In Arizona, the law of damages for injuries to real property normally focuses on the loss in market value. However, if property can be replaced or repaired, and the cost of repairs is reasonable, the proper measure of damage is the repair/replacement, not to exceed the loss in market value.

Both actual and liquidated damages may be awarded as long as they are awarded for different injuries. *A. Miner Contracting, Inc. v. Toho-Tolani County Imp. Dist.*, 233 Ariz. 249, 311 P.3d 1062, 1071 (App. 2013). The court awards actual damages related to cost of completion, and considers liquidated damages separate because liquidated damages remedy injury resulting in the delay, rather than the cost of the actual project. *Id.* at 249, 311 P.3d 1062.

Scope of repair and the associated cost are the chief issues in construction litigation. The issues are the subject of a "battle of the experts." Thus, hiring a competent, credible and convincing expert is crucial.

An interesting issue involves building code violations that have not impaired or caused damage to the structure. Recently, the California Court of Appeals ruled that mere code violations that pose no risk to health or safety constitute a "no harm, no foul." If the code violation does not impair the structure, there is no recoverable damage. Arizona, lacking many appellate rulings on construction defect issues, tends to follow California decisions.

### **B. Economic Waste**

Generally, the measure of damages for a breach by a builder of a construction contract is the cost of repair. *County of Maricopa v. Walsh & Oberg Architects, Inc.*, 16 Ariz. App. 439, 441, 494 P.2d 44, 46 (1972); RESTATEMENT OF CONTRACTS § 346(1)(a)(i) (1932); CORBIN, 5 CORBIN ON CONTRACTS § 1089 (1964). However, where an award based on this measure of damages would result in "economic waste," the proper measure of damages would be the difference in value between the building as designed and the building as constructed. Economic waste exists when the cost of repair measure of damages would result in unreasonable duplication of effort. *Fairway Builders v. Malouf Towers Rental Co.*, 124 Ariz. 242, 603 P.2d 513 (App. 1979). Further, economic waste is not present and the difference in value measure cannot be used unless the building would be substantially destroyed by completely remedying the defects.



**C. Stigma Damages**

'Stigma damages' is another name for diminution in value because of a perceived problem with the property. There is no Arizona case law providing for recovery of stigma damages, however, there is ample case law on diminution claims. Contractors frequently argue that once a property is remedied, there is no stigma because the property has been returned to its pre-defect condition.

Only a few states have addressed this issue. In *Ryland Group v. Daley*, plaintiff homeowners sued the builder for breach of contract, negligence, and breach of warranty. 245 Ga. App. 496, 537 S.E.2d 732 (2000). The court noted that the "general rule for the measure of damages involving real property is the diminution of the fair market value of the property and/or the cost of repair or restoration, but limited the fair market value at the time of the breach or tort." 245 Ga. App. at 503, 537 S.E.2d at 739. The *Daley* jury awarded plaintiffs both the cost of repair and 10% of the contract price as diminution in value. The trial court vacated the award insofar as diminution in value was concerned "because it was not a proper measure of damages for a contract breach." *Id.* The court characterized the damages for diminution in value as "stigma." In that regard, the court stated that "stigma to realty, and of itself, is too remote and speculative to be damage."

**D. Loss of Use**

Loss of use is recoverable. If a homeowner must be relocated, for example, the cost of replacement housing is equivalent to the lost use of the primary residence.

**E. Punitive Damages**

Punitive damages are often alleged but rarely proven. In Arizona, an award of punitive damages must be supported by evidence demonstrating an "evil mind." Rarely will this be the case in a construction defect claim. From an insurance coverage perspective, punitive damages are covered by a standard commercial general liability policy absent any express exclusion to the contrary. Compare California where punitive damages are never covered by insurance as such coverage is void against public policy.

**F. Emotional Distress**

Emotional distress damages have recently been rejected as a recoverable damage in a construction defect claim.

**G. Attorney's Fees**

Attorney's fees are recoverable under a breach of contract/warranty claim. Attorney's fees are not recoverable under purely statutory causes of action such as a whether a party violated its

statutory duty as a licensed contractor. See *Keystone Floor & More, LLC v. Ariz. Registrar of Contractors*, 223 Ariz. 27, 219 P.3d 237 (App. 2009). If a contract includes attorneys' fees, the fees are awarded according to the contract, and the trial court may not refuse to award fees. *A. Miner Contracting, Inc. v. Toho-Tolani County Imp. Dist.*, 233 Ariz. 249, 311 P.3d 1062 (App. 2013). Once entitlement to fees is established, the opposing party has the burden of showing the amount is unreasonable.

In a recent decision by the Arizona Supreme Court, it was determined that "any claim for breach of [the warranty of workmanship and habitability] arises from the contract. The successful party therefore qualifies for fees under a controlling contractual fee provision or, barring that, § 12-341.01." *Sirrah Enterprises, LLC v. Wunderlich*, 242 Ariz. 542, 543, ¶ 1, 399 P.3d 89, 90 (Ariz. 2017).

A recent amendment to the pertinent statute affects who is considered the "prevailing party" entitled to fees. Previously, if plaintiff recovered anything, it was considered the prevailing party. Now, if a defendant makes a written settlement offer and does better at trial—even if plaintiff is awarded some damages, defendant is considered the prevailing party. The defendant's settlement offer must be higher than the plaintiff's jury verdict plus attorney's fees incurred at the time of the settlement offer. *Hall v. Read Development, Inc.*, 229 Ariz. 277, 274 P.3d 1211 (App. 2012). This recent amendment is helpful to defendants and should be considered in cases involving breach of contract/warranty claims.

A recent case held that the original buyer may still recover attorney's fees as the prevailing party even if the defendant is awarded damages under a breach of contract claim against plaintiff, provided plaintiff's award plus attorney's fees is greater than that of defendant's. *Wunderlich*, 240 Ariz. at 169, ¶ 18, 377 P.3d at 366 (App. 2016), *Review Granted* (Jan. 10, 2017). However, this case has an appeal pending.

Unlicensed construction companies are not precluded from award of attorney's fees in breach of contract action, notwithstanding A.R.S. § 32-1153, which prohibits unlicensed contractors from bringing action for payment. *Bentivenga v. Powers Steel & Wire Products, Inc.*, 206 Ariz. 581, 81 P.3d 1040 (App. 2003). The Court reasoned that the purpose of the statute was not to penalize contractors, but to protect the public from unscrupulous and unqualified contractors. *Id.*

A subcontractor wrongly named in a lawsuit may recover attorney's fees from the general contractor or developers. *Fulton Homes Corporation v. BBP Concrete, Inc.*, 214 Ariz. 566, 155 P.3d 1090 (App. 2007). In construction defect cases, developers and general contractors often bring in to the suit all subcontractors who worked on the project before determining whose work actually implicated the underlying lawsuit brought by the homeowners. *Id.* General contractors and developers must therefore, conduct a thorough investigation into the claims asserted by homeowners to assure that the proper subcontractors are identified in the third-party complaint. *Id.* It is otherwise probable that a subcontractor brought into the lawsuit for

little or no reason, and who is subsequently dismissed from the action, may recover attorney's fees from the developer or general contractor. *Id.*

#### **H. Expert Fees and Costs**

In Arizona, expert fees are not ordinarily recoverable. However, recent changes to Arizona statutes now provide that courts "may" award expert fees in a contested construction-defect action involving a single purchaser on an issue-by-issue basis. See A.R.S. §12-1364(D). Additionally, if a party files an offer of judgment and does better at trial, the party may recover expert fees as a sanction against the opposing party that refused to accept the formal offer. Ariz.R.Civ.P. 68.

As a practical matter, plaintiffs will seek recovery of their expert fees in settlement, arguing that without such compensation, they are not "made whole." However, plaintiffs' expert fees in construction litigation should be viewed no differently than expert fees in any other type of litigation-born by the party in proving its claim.

#### **I. Investigative Costs**

Recovery for investigative costs is afforded to a prevailing party under A.R.S. § 12-341.01. This statute provides the prevailing party with the ability to recover its investigative costs as long as it complies with the other requirements set forth in the statute.

A minority of other jurisdictions have held that investigative costs are recoverable in construction defect cases. In *Stearman v. Centex Homes*, the California Court of Appeals explained that in a construction defect case, the plaintiff is entitled to recover for the cost of remedying the defects together with the loss of use, if any, during the period of injury. 78 Cal. App. 4th 611 (Cal. App. 2000). The court concluded the expenses incurred in having professionals investigate construction deficiencies in order to formulate an appropriate repair plan constitute costs of remedying defects and are properly recoverable as part of the cost of repair. *Id.* The Supreme Court of Vermont has similarly held that a successful plaintiff in a construction defect case is entitled to recover for the cost of expert inspection and advice. See *Bolkam v. Staab*, 346 A.2d 210 (Vt. 1975).

### **XIII. INSURANCE COVERAGE FOR CONSTRUCTION CLAIMS**

Insurers are faced daily with the question of whether claims for construction defects are covered. This question has two components: duty to defend and duty to indemnify. The threshold question is to determine whether the insurer has a duty to defend. The duty to defend is broader than the duty to indemnify. Insurers have a duty to defend if there is any "potential" that any claim asserted against the insured is covered by the policy. *United Servs. Auto Ass'n v. Morris*, 154 Ariz. 113, 117, 741 P.2d 246, 250 (1987). Insurers must defend claims that are

"potentially not covered and those that are groundless, false and fraudulent." *Id.* If there is potential coverage for even one of the claims and not others, an insurer has a duty to provide a defense. *Transamerica Ins. Grp. v. Meere*, 143 Ariz. 351, 360, 694 P.2d 181, 190 (1984). The analysis begins with the allegations in the complaint, but insurers are to consider additional available information in assessing the duty to defend. Generally, if the complaint alleges plaintiffs sustained some sort of "property damage," then the obligation to defend is triggered unless there are exclusions which apply.

#### **A. CGL Policies**

Commercial General Liability (CGL) policies were never intended to cover the costs to fix an insured/contractor's faulty construction. It is well recognized that the purpose of CGL policies is not to act as performance bonds but rather cover damages caused by fortuitous events. As discussed below, faulty workmanship is not deemed a "fortuitous event."

In order for a CGL policy to be triggered, the complaint must seek "property damage" caused by an "occurrence." This issue was discussed in one of the few construction defect cases addressed by Arizona courts. *U.S. Fidelity & Guaranty Corporation v. Advance Roofing*, 163 Ariz. 476, 788 P.2d 1227(App. 1989). In *Advance Roofing*, a homeowners association hired Advance to install 250 new roofs on its buildings and paid it \$253,000. Advance installed only 40 new roofs and those roofs leaked and were defective. When sued for breach of contract and unjust enrichment, Advance asked its insurer to defend but the insurer declined coverage asserting there was no "property damage" or "occurrence." The Court of Appeals agreed with U.S. Fidelity & Guaranty and held that the complaint alone did not make a claim for "property damage" nor was the claim for faulty workmanship an "occurrence" because it was not an "accident."

To get around this ruling, plaintiffs' attorneys now ensure their complaints allege negligence claims and seek "property damage" to make certain insurance coverage is triggered. Property damage is defined under the policies as physical injury to tangible property or loss of use of tangible property. Therefore, complaints now allege as damages costs to repair as well as damages caused by the faulty workmanship, e.g. rain water leaked through defective roof damaging hardwood floor (property damage). Claims for faulty workmanship alone do not trigger insurance coverage, there must also be consequential damages which resulted from the faulty workmanship.

Property damage from a subcontractor's faulty workmanship can be an "occurrence" under CGL policy. *Lennar Corp. v. Auto-Owners Ins. Co.*, 214 Ariz. 255, 151 P.3d 538 (App. 2007). The *Lennar* court reasoned that while faulty workmanship was not an occurrence, property damage caused by faulty workmanship could be. *Id.* The court rejected the minority view that damage caused by faulty workmanship was simply the natural result of negligent construction. *Id.* The Court reasoned that the minority view contravened the language of the policies that defined an occurrence as an accident, which includes continuous or repeated exposure to substantially the same harmful conditions. *Id.* at 546. The Court held that faulty workmanship is a general

harmful condition, and that property damage from faulty workmanship can be accidental. *Id.* Finally, the Court held that ongoing damage that might have occurred during the policy period triggered the insurers' obligation to defend under those policies, even where damage began before the policy periods. *Id.*

Additionally, in *Desert Mountain Properties Limited Partnership v. Liberty Mutual Fire Insurance Company*, 225 Ariz. 194, 236 P.3d 421 (App. 2010), the Court of Appeals clarified that for coverage to exist, the relevant inquiry is whether an "occurrence" has caused "property damage" -- not whether the ultimate claim lies in contract or tort.

## **B. Faulty Workmanship**

As a general statement, the cost to repair or replace faulty workmanship caused by the insured is not covered. However, if as a result of the faulty workmanship property damage was caused to other areas of the building, such as the drywall, carpet or personal property, those damages are covered. This could include damages for loss of use or diminution in value as long as these damages flowed from the non-excluded property damage.

A different outcome may result if the insured is a contractor who has retained subcontractors and it was they who caused the faulty workmanship, unless a "Products-Completed Operation Hazard" provision applies. The majority of courts have held that if all of the elements of the "Products-Completed Operation Hazard" are met, it does not preclude coverage for the faulty workmanship caused by subcontractors on behalf of the insured/contractor. In other words, if the faulty workmanship was done by subcontractors hired by the insured/contractor and the "Products-Completed Operation Hazard" applies, i.e. the damages arose after the operations were completed, then the cost to repair the faulty workmanship would be covered under the policy. The apparent purpose of such a provision is to provide coverage for fortuitous latent defects caused by someone other than the insured. Insurance coverage for faulty workmanship claims can be very complex and hinge upon the specific damages alleged and incurred. While claims to remediate faulty workmanship caused by the insured/contractor may not be covered, faulty workmanship caused by subcontractors of the insured/contractor may be covered under certain circumstances.

A key consideration is who the named insured was on the policy. Recently, an Arizona Court held that a contractor could not recover for the work of a subcontractor under a policy under which the subcontractor was the named insured. *Double AA Builders, Ltd. v. Preferred Contractors Ins. Co., LLC*, 241 Ariz. 304, ¶ 19, 386 P.3d 1277, 1280 (App. 2016). In that case, a general contractor had subcontracted with a roofing subcontractor to install a Built-Up Roofing system. *Id.* at ¶ 2. The roofer was the named insured under the policy, while the contractor was an additional insured. *Id.* The roof began to leak and damaged work performed by other subcontractors. *Id.* at ¶ 3. The general contractor sought to recover from the roofer's insurance company for the cost of repairing the roof only. *Id.* at ¶ 12. There was an exclusion of coverage for the property damage to the insured's work including Products-Complete operations hazard, which was defined as "including all. . . property damage. . . arising out of your work." *Id.* at ¶

8. The exception to this exclusion was when the “damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.” *Id.* at ¶ 8. The Court held that the exclusion applied because the damage related to the roofer’s defective work. *Id.* at ¶ 9. The Court then held the exception to the exclusion did not apply. *Id.* ¶ 13. It reasoned the exception only applied to subcontractors of the roofer—not subcontractors of the general contractor—because the general contractor was only an additional insured while the roofer was the named insured. *Id.*

#### **XIV. MECHANIC’S LIENS**

Mechanic’s and materialmen’s liens provide those who furnish labor, professional services, materials, machinery, fixtures or tools to a private construction project with a remedy for non-payment in the form of an encumbrance against the real property improved through their efforts and materials. The lien process is governed by law found at A.R.S. § 33-981-1006.

As a necessary prerequisite to a valid lien, a claimant must provide notice within 20 days from the first delivery of materials, or furnishing of labor, professional services or machinery, fixtures or tools to the job site. The notice given by the claimant must “substantially” follow the form set forth in A.R.S. § 33-992.01(D):

Each preliminary 20-day notice must contain five items:

- a. A general description of the labor and materials, professional services, machinery, fixtures and tools furnished to or to be furnished and an estimate of the total price thereof;
- b. The name and address of the claimant;
- c. The name of the person who contracted for the goods or services;
- d. The legal description of the job site or the street address, subdivision plan, or any other description of the job site sufficient for identification; and
- e. The following statement must appear in bold face on the notice:

“In accordance with Arizona Revised Statutes § 33-992.01, this is not a lien and this is not a reflection on the integrity of the contractor.”

Anyone who wishes to claim a lien must “serve” the preliminary notice by (1) First Class mail with a certificate of service, (2) Certified Mail, or (3) Registered Mail. A.R.S. § 33-992.01(F).

Upon receiving the preliminary notice, the owner must provide the claimant with the following information: (1) the legal description of the project; (2) the name and address of the owner; (3) the name and address of the contractor the legal description of the project; (4) the name and address of the construction lender the name of the general contractor performing the work; and (5) if any payment bond has been recorded, a copy of the bond and the name and address of the surety company and bonding agent, if any, providing the payment bond. This

information must be provided within 10 days of receipt of the preliminary notice. A.R.S. § 33-992.01(I).

The estimate of the value of the labor or materials should err on the high side. The preliminary 20-day notice will be valid so long as labor and materials don't exceed the estimate by 20% or more.

An enforceable mechanic's lien must be recorded with the County Recorder's office of the county where the property is properly located. The recording of the lien is notice to every one of the claim against the real property. Without the proper and timely recording, no lien exists to be enforced. Claimants have 120 days after "completion" to record the mechanic's lien with the county recorder. If a "notice of completion" is recorded by the owner and appropriately mailed, then claimants have 60 days after the recording of the notice of completion to record the lien.

The Notice and Claim of Lien shall be made under oath by the claimant or someone with knowledge of the facts and shall contain:

1. The legal description of the lands and improvement to be charged with a lien;
2. The name of the owner or reputed owner of the property concerned, if known, and the name of the person by whom the lienor was employed or to whom he furnished materials;
3. A statement of the terms, time given and conditions of the contract, if it is oral, or a copy of the contract, if written;
4. A statement of the lienor's demand, after deducting all just credits and offsets;
5. A statement of the date of completion of the building, structure or improvement, or any alteration or repair of such building, structure or improvement;
6. A statement of the date upon which the labor, materials, machinery, fixtures or tools were first furnished to the job site; and
7. A statement of the date the preliminary 20-day notice required by A.R.S. § 33-992.01 was given, and a copy of the preliminary 20-day notice and a copy of the proof of mailing required by A.R.S. § 33-992.02 must be attached.

A mechanics' or materialmen's lien shall not continue for a longer period than 180 days after it is recorded, unless action is brought within such period to enforce the lien. Therefore, it is necessary to obtain the foreclosure guarantee title report from the title company within approximately five months after the recording of the lien so that the information for preparation of the complaint will be available well in advance of the 180-day deadline.

Mechanics' liens have priority over all subsequent liens, and other lienholders are not allowed to subrogate their loans ahead of the mechanics' lien. See A.R.S. § 33-992(A); *Weitz Co., L.L.C. v. Heth*, 233 Ariz. 442, 314 P.3d 569 (App. 2013).

## **XV. PROMPT PAY ACT**

Under the Arizona “Prompt Pay Act,” if a subcontractor or material provider has performed its duties in accordance with a construction contract, then a contractor “shall pay to its subcontractors or material suppliers” each progress payment, retention release or final payment within seven days of receipt by the contractor of each progress payment. See A.R.S. §32-1183(B). Any contractor that fails to pay its subcontractors or materials providers pursuant to Section 32-1183(B) “may” have its license suspended or revoked. See A.R.S. §32-11054(10).

Recently, in a 2020 unpublished decision, the Arizona Court of Appeals held that the obligation of a contractor to pay a subcontractor or material supplier is automatic upon payment from the owner of the construction project. *Shea Connelly Development v. Arizona Registrar of Contractors*, 2020 WL 6503616 (Ariz.App. 2020). In that case, the developer – Shea Connelly Development – refused to pay a subcontractor claiming that the subcontractor performed substandard work and that the developer had overpaid the same subcontractor on a different project. *Id.* The subcontractor filed a complaint against the developer with the Registrar of Contractors (“ROC”) seeking payment. The Administrative Law Judge for the ROC found the developer’s arguments unavailing, and suspended the developer’s license for violations of the above-referenced statute. The Court of Appeals affirmed this decision, holding that the developer had an obligation to pay the subcontractor upon receipt of payment from the owner, but noted that if the developer had damages resulting from the subcontractor’s substandard work or overpayment of same, that the developer could “bring any claims in civil litigation.” *Id.* at ¶15.

## **XVI. RELEVANT ARIZONA STATUTES**

### A.R.S. § 12-341.01(A)

In any contested action arising out of contract, express or implied, the court may award the successful party reasonable attorney fees.

### A.R.S. § 12-552

This statute attempts to deal with the problem of prolonged exposure to liability for latent construction defects. Under this statute, a homeowner has up to eight years after a project has been substantially completed to file a construction defect claim. However, if the defect is discovered during the eighth year after completion, the claim may be made within the ninth year after the project has been substantially completed. See § 12-552 (B).

### A.R.S. § 12-1363

This statute states that at least 90 days must pass before a dwelling action may be filed alleging a construction defect. The purchaser must give written notice to the seller by certified mail or in the case where a multi-dwelling action is contemplated, the purchaser shall serve the seller,



together with the complaint. In both cases, the purchaser must specify in reasonable detail the basis of the action. Once the purchaser has given the required notice, the seller and/or builder may inspect the dwelling to determine the nature and cause of the alleged defect. See § 12-1363 (C). Within 60 days after receipt of the notice of defect by the purchaser, the seller must send to the new purchaser a good faith, written response by certified mail. See § 12-1363 (D).

#### A.R.S. § 32-1129.01

This statute dictates how owners may pay contractors, and how contractors may bill owners. It allows owners to make progress payments on contracts of less than 60 days, and determines how to properly set up progress payments. Progress payments shall be made in thirty-day billing cycles, but construction contracts may provide otherwise with proper notice. See §32-1129.01(B). The statute also allows owners to extend payment for both contractor and construction contracts with notice, or decline to certify or approve payment for enumerated reasons. See § 32-1129.01(C)-(H). Note that contracts between architects and developers may not fall within the meaning of “construction contract” in this statute, and may not be allowed the same progress payments or ability to decline payment. See *RSP Architects, Ltd. V. Five Star Development Resort Comm., LLC*. 232 Ariz. 436, 306 P.3d 93 (App. 2013).

#### A.R.S. § 32-1159 and § 34-226

These statutes prohibit, as void against public policy, an indemnity provision in a construction contract that purports to indemnify any party for loss or damage from his sole negligence.

### **About the Author**

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