



STATE OF ARIZONA CONSTRUCTION LAW COMPENDIUM

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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 law 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. 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.

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; 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.

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. *Id.* at 514, 687 P.2d 1269. 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, Arizona courts are tending to find that, because of the economic loss doctrine, the cause of action sounds in contract and not in tort, thus barring a negligence claim. Further, because subcontractors are typically not in privity of contract with homeowners, they cannot be directly sued by a plaintiff in contract either. Although there is no Arizona published opinion where the court addresses the economic loss rule in the context of a typical construction defect case, based on longstanding principles cited in *Woodward*, most believe a homeowner's causes of action against a builder are limited by the economic loss doctrine.

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 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 (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).

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.

The Court of Appeals decided to limit the implied warranties to residential construction even more when it limited who subsequent purchasers could sue. For instance, in *Lofts at Fillmore Condo Ass'n v. Reliance Commercial Constr.*, 218 Ariz. 574, 190 P.3d 733 (2009), the general contractor (but not the seller of the property) could not be sued by a subsequent purchaser for construction defects because the general contractor was not the “homebuilder-vendor.” The Court held that “homebuilder-vendor” was the only entity which could be sued by a subsequent purchaser under an implied warranty. 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.

B. Breach of Express Warranty

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. Because implied warranty arises out of contract, attorneys' fees may be recoverable pursuant to A.R.S. § 12-341.01(A).

It is also 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. The duty in express warranty is contractual and not one imposed by law. *Colberg v. Rellinger*, 160 Ariz. 42, 51, 770 P.2d 346, 355 (App. 1988). The claim of breach of express warranty sounds in contract, and therefore, attorneys' fees can be awarded to the successful party. *Id.* at 51, 770 P.2d at 355.

IV. MISREPRESENTATION AND FRAUD

In some situations, homebuilders are sued by owners and/or homeowner associations under the theory of misrepresentation. Whether punitive damages are available 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. Beuty Built Homes, Inc.*, 132 Ariz. 498, 647 P.2d 629; *Donnelly Construction Company v. Oberg/Hunt/ Gilleland*, 139 Ariz. 184; 677 P.2d 1292 (1984).

V. 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. Ct. 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 *Nastri v. Wood Brothers Homes, Inc.* and *Menendez v. Paddock Pool Construction Co.* for the proposition that Arizona has formally rejected strict liability for construction defects in homes. *Nastri*, 142 Ariz. 439, 690 P.2d 158 (App. 1984), *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.

VI. 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. 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.

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. 194 Ariz. 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.

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 (Ct. 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 (Ct. 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 (Ct. 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.

VII. 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, 88 P.3d 565 (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, *Evans Withycombe v. Western Innovations*, 212 Ariz. 462, 133 P.3d 1168 (App. 2006), has clarified the application of the statute of repose.

In *Evans*, the Court of Appeals distinguished between contract based claims versus non-contract 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, common law indemnity claims and negligence claims did not apply to this statute 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.

VIII. 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.

IX. ECONOMIC LOSS DOCTRINE

The economic loss rule holds that recovery of purely economic losses falls within the area of contract law, not tort law. *Salt River Project Agricultural Improvement & Power District v. Westinghouse Electric Corp.*, 143 Ariz. 368, 379, 694 P.2d 198, 209 (1984); *see also Nastri v. Wood Bros. Homes, Inc.*, 142 Ariz. 439, 690 P.2d 158 (App. 1984) The rule limits the use of negligence claims in construction defects cases to those cases where an alleged tort is truly

independent of any contract claim. Such negligence claims will be viable only if they relate to personal property or personal injury.

The economic loss rule does not bar torts that are truly independent of any contract claim, but it does bar torts that are “interwoven” with or “indistinguishable from” breaches of contract. In *Nastri*, an Arizona court addressed this issue with regards to construction defects, where the damage claim involved the structure itself and there were no independent or distinguishable claims for damage to personal property or personal injury. 142 Ariz. at 445, 690 P.2d at 164. The court held that the purchaser of a home could sue in both contract and tort for injuries sustained due to the builder’s failure to construct the house in a workmanlike manner but that the available action in contract was for “‘defects in the structure itself as such defects render the home less than the purchaser bargained for,’ whereas the available tort claim was for ‘damage to personal property or personal injury’ caused by the defective construction.” *Id.* at 445, 690 P.2d at 164; *See also Colberg v. Rellinger*, 160 Ariz. 42, 770 P.2d 346 (App. 1988).

Where a builder’s gross negligence leads to injury or property damage, the builder may be liable in tort, and tort-based damages are recoverable. When tort-based damages are not present however, the economic loss rule bars recovery of economic damages in tort. *Carstens v. City of Phoenix*, 206 Ariz. 123, 75 P.3d 1081 (App. 2003). Thus, where a construction defect exists, and no personal injuries or property damage results, the owner can sue only in contract, regardless of the contractor’s negligence. *Id.*

However, the economic loss rule does not preclude a professional negligence claim by a third party against a design professional. *See Flagstaff Affordable Housing Ltd. P’ship v. Design Alliance, Inc.*, No. 1 CA-CV 07-0743, 2009 WL 755285 (Ariz. App. Mar. 24, 2009). Prior to this case, design professionals usually prevailed in extricating themselves from construction defect cases because they rarely had privity of contract with the homeowner or subsequent purchaser (so as to be sued for breach of contract) and the damages sought rarely were for damages to personal injury or personal property thus allowing suit for negligence and being able to bypass the economic loss doctrine. While *Flagstaff* was not a construction defect case (negligent design failing to comply with Fair Housing Act), the Arizona Court of Appeals found that public policy required an exception to the above-referenced outcome. This will likely lead to construction defect lawsuits against architects and engineers for negligent designs.

X. RECOVERY FOR INVESTIGATIVE COSTS

Recovery for investigative costs is afforded to a prevailing party under A.R.S. § 12-1361. 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 has 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 (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).

XI. EMOTIONAL DISTRESS CLAIMS

There are currently no Arizona cases directly on point as to whether a homeowner can recover emotional distress damages because of construction defects to their home. At least one Arizona case stands for the proposition that emotional distress damages cannot be recovered based on witnessing injury to personal property. *Roman v. Carroll*, 127 Ariz. 398, 621 P.2d 307 (Ct. App. 1980) (plaintiff could not recover damages for negligent infliction of emotional distress caused by witnessing defendants' Saint Bernard who dismembered her poodle while she was walking the dog near her home, as the dog was personal property). This is consistent with neighboring California, whose supreme court has held that a homeowner cannot recover damages for emotional distress based upon breach of contract to build a house. *Erlich v. Menezes*, 87 Cal. Rptr. 2d 886 (1999). However, other authority at least allows the argument to be made. *See Thomas v. Goudreault*, 163 Ariz. 159, 786 P.2d 1010 (App. 1989) (violation of the implied duty of maintaining habitable conditions as required by the Arizona Residential Landlord and Tenant Act by landlord, may give rise to damage for mental suffering).

XII. 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 predefect 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."

XIII. 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.

XIV. 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.

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. The California ruling is currently on review by the state’s Supreme Court.

B. Stigma

Plaintiffs will often claim that despite the fact repairs have been made, the obligation to disclose the repairs to future purchasers will result in a loss in market value. Courts allow claims for post-repair stigma only if supported by solid evidence—not mere conclusory claims of percentage losses. Thus, plaintiffs will likely be required to show other similarly-situated homes suffering a lower resale.

C. 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.

D. Punitive Damages

Punitive damages are often alleged, 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.

E. Emotional Distress

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

F. Attorney's Fees

Attorneys fees are recoverable under a breach of contract/warranty claim. 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. This recent amendment is helpful to defendants and should be considered in cases involving breach of contract/warranty claims.

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.*

G. Expert Fees and Costs

In Arizona, expert fees are not ordinarily recoverable. However, 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.

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.

XV. 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. *Morris v. USAA*, 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 were 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, *USF&G v. Advance Roofing*, (Ariz.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 USF&G 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, that 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.*

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. Enter the "Products-Completed Operation Hazard" provision. While Arizona courts have not addressed this provision, 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.

XVI. 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 Arizona Revised Statutes (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. See A.R.S. §33-992.01(F).

Upon receiving the preliminary notice, the owner must provide the claimant with the following information: (1) the name of the owner; (2) the name of the construction lender; (3) the legal description of the project; and (4) the name of the general contractor performing the work. See A.R.S.. § 33-992.01(I). This information must be provided within 10 days of receipt of the preliminary notice.

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 everyone 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 recording of 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.

XVII. RELEVANT 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 (E)(3).

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 mutli-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. § 32-1159 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

Michael Ludwig is a partner with the law firm of Jones Skelton & Hochuli in Phoenix, Arizona and is Chair of its Construction Practice Group. Michael is an experienced trial attorney and represents subcontractors, general contractors, owners and design professionals in pending lawsuits involving construction related matters including defects, payment disputes, lien rights, delay claims, construction accidents and professional liability disputes. He received an AV rating from Martindale-Hubbell for his legal ability and ethics and was named *Super Lawyer*, a peer review designation published by *Law & Politics* magazine. He is a contributing author to the *Arizona Construction Manual* published by the State Bar of Arizona. He is on the Executive Board of the Construction Committee for the State Bar of Arizona, is an executive board member of the Arizona Association of Defense Counsel and is on the Steering Committee for the Construction Section of the Defense Research Institute. Michael also serves as the 2009-2010 Chair of the USLAW NETWORK Construction Practice Group. Michael can be reached at (602) 263-7342 or at mludwig@jshfirm.com.

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