

CHAPTER 5.9 **CONSTRUCTION DEFECT LITIGATION** **TABLE OF CONTENTS**

§ 5.9.1	Introduction	5.9-1
§ 5.9.2	Legal Theories and Limitations	5.9-1
§ 5.9.2.1	Before Initiating the Lawsuit	5.9-1
§ 5.9.2.1.1	Notice.....	5.9-3
§ 5.9.2.1.2	Right to Inspect	5.9-3
§ 5.9.2.1.3	Response by Seller/Builder.....	5.9-4
§ 5.9.2.1.4	Failure of Seller/Builder to Respond	5.9-5
§ 5.9.2.1.5	Seller’s Right to Repair	5.9-5
§ 5.9.2.1.6	Evidentiary Issues.....	5.9-6
§ 5.9.2.1.7	Notice of New or Additional Defects.....	5.9-6
§ 5.9.2.1.8	Attorneys’ Fees, Costs and Expert Witness Fees	5.9-7
§ 5.9.2.1.9	Contract Requirements of AROC Rights	5.9-7
§ 5.9.2.1.10	Avoiding the Dwelling Action Process	5.9-7
§ 5.9.2.2	Possible Theories of Recovery Available to Plaintiffs	5.9-8
§ 5.9.2.2.1	Breach of Contract.....	5.9-8
§ 5.9.2.2.2	Negligence	5.9-9
§ 5.9.2.2.3	Breach of Warranty	5.9-12
§ 5.9.2.2.4	Misrepresentation and Fraud.....	5.9-16
§ 5.9.2.2.5	Strict Liability	5.9-17
§ 5.9.2.3	Time Limitations on Recovery	5.9-18
§ 5.9.2.4.	Other Limitations on Recovery.....	5.9-20
§ 5.9.2.4.1	Investigative Costs	5.9-20
§ 5.9.2.4.2	Emotional Distress Claims	5.9-21
§ 5.9.2.4.3	Extrapolation	5.9-22

§ 5.9.2.4.4	Stigma Damages	5.9-23
§ 5.9.2.4.5	Comparative Fault and Failure to Mitigate Damages	5.9-24
§ 5.9.2.4.6	Economic Waste	5.9-24
§ 5.9.2.4.7	Contractual Limitation of Liability	5.9-25
§ 5.9.2.5	Courses of Action Available to Developer	5.9-26
§ 5.9.2.5.1	Express Indemnity	5.9-26
§ 5.9.2.5.2	Implied Indemnity.....	5.9-29
§ 5.9.2.5.3	Third-Party Beneficiary	5.9-31
§ 5.9.2.5.4	Breach of Contract.....	5.9-31
§ 5.9.2.5.5	Breach of Implied Warranty	5.9-32
§ 5.9.2.5.6	Breach of Express Warranty.....	5.9-32

CHAPTER 5.9

CONSTRUCTION DEFECT LITIGATION

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§ 5.9.1 Introduction

Over the past two decades, or so, Arizona has experienced a proliferation of litigation related to residential construction. These lawsuits are commonly referred to by professionals in the industry as “construction defect litigation”. These suits were most often filed by groups of homeowners and/or homeowners’ associations, alleging building deficiencies, building code violations or other substandard workmanship claims against the builder of the homes or residential subdivision. Such litigation began California and spread to Nevada. More recently, commercial property owners have followed suit. Because Arizona has experienced its own dramatic increase in construction defect cases, Arizona courts have implemented complex litigation procedures in direct response to the high number of construction defect cases being filed.

Why all the fuss? There are a number of theories explaining the increase in claims of poor or faulty workmanship on the part of the building community. One theory focuses on the increased demand for housing and the accompanying shortage of skilled labor in the marketplace. Another theory focuses on the demand for affordable housing in urban areas, where builders have been accused of compromising the quality of construction of homes in an effort to produce housing at an affordable cost to the ultimate consumer.

These lawsuits typically commence when the plaintiff homeowner or homeowner association files suit against the builder of the homes, as well as against design professionals and engineers. Because specialty trades hired by the builder actually perform the work in connection with the construction of the project, the builder then files a third-party action against the allegedly culpable subcontractors. This chapter will address the rights and remedies of the plaintiff as well as the defenses available to builders and subcontractors.

§ 5.9.2 Legal Theories and Limitations

§ 5.9.2.1 Before Initiating the Lawsuit: Purchaser Dwelling Actions

In 2002, Arizona enacted legislation referred to as the Purchaser Dwelling Actions.¹ In 2015, significant amendments were made to that Act.² Under the Act, a purchaser

¹ A.R.S. §§ 12-1361 *et seq.*

must comply with the Statute before filing a Dwelling Action.³ The only exception to this requirement is for alleged construction defects that involve an immediate threat to the life or safety of persons occupying or visiting the dwelling. If a Purchaser⁴ fails to comply with the Statute, the Dwelling Action shall be dismissed, and if dismissed after the expiration of the Statute of Limitations or Statute of Repose, any subsequent Dwelling Action would be time barred as to the Seller⁵ and the Seller's construction professionals involved in the construction or design of the dwelling. Absent a showing of good cause, the court shall not stay a Dwelling Action with respect to claims for alleged construction defects involving an immediate threat to the life or safety of persons occupying or visiting a dwelling. The applicable statute of limitations is tolled for a period of 90 days after the Seller receives notice of the claim, or longer if agreed to by the parties. The Statute has also been amended to provide greater involvement of insurance carriers who have issued policies of insurance which provide potential coverage for liability arising out of the design, construction or sale of the property by mandating that such carriers treat receipt of any notice under the Act as a claim.

Under the 2015 Amendments, "Construction Defect" is now defined as a material deficiency in the design, construction, manufacture, repair, alteration, remodeling or landscaping of a dwelling that is the result of one of the following:

- (a) A violation of construction codes applicable to the construction of the dwelling.
- (b) The use of defective materials, products, components or equipment in the design, construction, manufacture, repair alteration, remodeling or landscaping of the dwelling.
- (c) The failure to adhere to generally accepted workmanship standards in the community.⁶

This is a broad definition. In order to have a Construction Defect, a "Material Deficiency" must be present. "Material Deficiency" is defined as a deficiency that actually impairs the structural integrity, the functionality, or the appearance of the dwelling at the time of the claim, or is reasonably likely to actually impair the structural integrity, the functionality or the appearance of the dwelling in the foreseeable future if

² For another perspective on this subject matter, see Chapter 3.13 above, which is devoted entirely to the Purchaser Dwelling Actions.

³ "Dwelling Action" is defined as any action involving a construction defect brought by a purchaser against the seller of a dwelling arising out of, or related to, the design, construction, condition or sale of the dwelling. A.R.S. § 12-1361(7).

⁴ "Purchaser" is defined as any person or entity who files a Dwelling Action. A.R.S. § 12-1361(9).

⁵ "Seller" is defined as any person, firm, partnership, corporation, association or other organization that is engaged in the business of designing, constructing or selling dwellings, including Construction Professionals. Seller does not include a real estate broker or real estate salesperson as defined in A.R.S. § 32-2101 who provides services in connection with the resale of a dwelling following its initial sale. A.R.S. § 12-1361(10).

⁶ A.R.S. § 12-1361(4).

not repaired or replaced.⁷ Questions such as what would constitute a Material Deficiency in appearance remain to be answered.

Under the 2015 Amendment, the definition of Seller now includes “Construction Professionals.” A “Construction Professional” is defined by the Act as an architect, contractor, subcontractor, developer, builder, builder vendor, supplier, engineer or inspector performing or furnishing the design, supervision, inspection, construction or observation of the construction of any improvement to real property.⁸ The practical effect of the new definition remains to be seen. Traditionally, a homeowner provided notice and an opportunity to the general contractor or developer as their identities were more readily ascertainable. Moving forward, questions arise as to whether the homeowner will be in violation of the Act if he fails to provide notice and the right to repair to each and every person and entity embraced in the definition of Seller.

States with extensive histories of construction defect litigation, such as California and Nevada, have enacted similar legislation in an effort to decrease the number of construction defect lawsuits.⁹ The effectiveness of such legislation is difficult to decipher and many practitioners believe that the legislation will do little to avoid construction defect lawsuits in Arizona and will serve no purpose other than to promote early disclosure of alleged construction defects and claims by homeowners and/or homeowners’ associations. Nonetheless, the construction industry remains hopeful and optimistic that homeowners and/or homeowners’ associations will utilize the notice provisions of the Act in a productive manner, namely, to bring about the resolution of homeowner construction defect complaints without congesting the courts with complex, time-consuming, and costly litigation.

§ 5.9.2.1.1 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 where each alleged defect has been observed and the impairment to the dwelling that has occurred as a result of each alleged defect that is reasonably likely to occur if the alleged defect is not repaired or replaced.

§ 5.9.2.1.2 Right to Inspect

Upon receiving the Notice required of homeowners or homeowners’ associations, the Seller and/or builder¹⁰ may inspect a dwelling to determine the nature and the cause of the alleged defects and the nature and extent of any repairs or replacements necessary

⁷ A.R.S. § 12-1361(8).

⁸ A.R.S. § 12-1361(5).

⁹ California’s process is entitled the Calderon Act (CAL. CIV. CODE § 1375). Nevada’s process is entitled Chapter 40 (N.R.S. § 40.600 *et seq.*).

¹⁰ The Act allows Dwelling Actions to be brought against developers, *i.e.*, Sellers who did not also act as builders.

to remedy them. To this end, the Purchaser must ensure that the dwelling is made available for inspection no later than 10 days after the Purchaser receives the Seller's request for an inspection. The Seller must provide reasonable notice to the Purchaser before conducting the inspection, and the inspections must be conducted at a reasonable time. These deadlines may be extended by stipulation of the parties.

So as not to unduly inconvenience the occupants, A.R.S. § 12-1363(B) also provides that the Seller may use "reasonable measures," including testing, to determine the nature and cause of the alleged defects and the nature and extent of any repairs or replacements necessary to remedy them. However, if any testing does occur which alters the condition of the subject project, the Seller must restore the dwelling to its condition before the testing occurred. Although some alleged Construction Defects can be properly analyzed by the Seller based on visual inspections of the property only, others may require extensive testing which can include soil sampling or cutting into drywall, roof systems, window systems and stucco systems to observe the alleged Construction Defects. This process is commonly referred to in the industry as "intrusive testing" or "destructive testing." As a practical matter, many Sellers may opt not to conduct any intrusive or destructive testing during this inspection period. This is especially true if the Purchasers have not conducted any similar testing in order to substantiate their claims. The Seller may feel that conducting such inspections will assist the Purchasers, at the Seller's own expense, in verifying alleged deficiencies, in other words, proving the case against themselves, while paying for the claimants' investigation costs.

§ 5.9.2.1.3 Response by Seller/Builder

A.R.S. § 12-1363(C) states that within 60 days after receipt of the Notice, the Seller must send to the Purchaser a good faith, written response by certified mail, return receipt requested. The response may include a notice of intent for the Seller to repair or replace any alleged Construction Defects, to have the alleged defects repaired by another party at the Seller's expense, or to provide monetary compensation directly to the Purchaser. The written Notice of Intent to Repair or Replace must describe in reasonable detail all repairs or replacements that the Seller intends to make or provide to the dwelling and a reasonable estimate of the date the repairs or replacements will be made. The Statute makes clear that the Seller is not prohibited from offering monetary compensation or other consideration instead of, or in addition to, a repair or replacement. A Purchaser may accept or reject an offer of monetary compensation or other consideration, other than repair or placement and, if rejected, may proceed with a Dwelling Action on completion of any repairs or other 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.

The Seller will often employ the services of expert consultants to help identify the nature and extent of the Purchaser's alleged deficiencies as well as any repair methods warranted. It is likely that builders will also employ a legal team to assist them in formulating an offer to provide monetary compensation. Whether the Seller's commercial general liability policy will provide coverage for the inspections, repair,

replacements, or monetary compensation, is a question that requires a case-by-case analysis under the applicable policy.

Coverage may be impacted by an insured's decision to make repairs to his or her home before the homeowner has instituted formal legal proceedings. In *Desert Mountain Properties Ltd. Partnership v. Liberty Mutual Insurance Co.*,¹¹ the Arizona Court of Appeals specifically held that the insured developer's commercial general liability carrier owed coverage even though the homeowners had not instituted formal legal proceedings against the insured/developer. Specifically, the court held that the insurer was not prejudiced by the insured/developer's decision voluntarily to undertake repairs necessitated by defective soil compaction. This would tend to establish that a commercial general liability carrier may be responsible for the reimbursement of costs, expended during the Dwelling Action process, even though the Purchaser has not instituted formal legal proceedings. Moreover, *Desert Mountain* implies that in order for an insurer to deny coverage on the basis that insured has failed to provide Notice prior to making the repairs, the insurer must demonstrate prejudice. The court further held that the costs incurred to prevent further damage to the property, caused by defects, were recoverable damages under the applicable commercial general liability policy. However, other aspects of the commercial general liability policy do serve to foreclose coverage for certain damages claimed by the insured. Therefore, it remains essential to carefully review the commercial general liability policy at issue in order to determine the full extent of coverage.

Because the testing repairs and/or monetary compensation offered may be substantial, the willingness of the Seller's insurer to participate in the pre-litigation process, contemplated by A.R.S. § 12-1361 *et seq.*, is critical to achieving the benefit of an early settlement of the Dwelling Action. Indeed, the coverage issues involved in these types of pre-litigation claims may be complex and convoluted. Therefore, they should be analyzed thoroughly by practitioners prior to making any offer contemplated by A.R.S. § 12-1363(C). Failure to provide insurers with a Dwelling Action Notice may impact available coverage and result in the loss of coverage for otherwise covered losses. Because the Act makes it clear that Notice under the statute must be treated as a claim for insurance purposes, practitioners representing Sellers or builders should place insurers on notice at the earliest possible opportunity.

§ 5.9.2.1.4 Failure of Seller/Builder to Respond

If the Seller does not provide a written response, as contemplated by A.R.S. § 12-1363(D) within 60 days, the Purchaser may file a Dwelling Action.

§ 5.9.2.1.5 Seller's Right to Repair

If the Seller provides a Notice of Intent to Repair or Replace the alleged defects, the purchaser must allow the Seller a reasonable opportunity to repair or replace the Construction Defects or cause to be repaired or replaced pursuant to the following:

¹¹ 225 Ariz. 194, 236 P.3d 421 (Ct. App. 2010).

- (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. 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. 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 within 35 days after the Seller's Notice of Intent to Repair or Replace, whichever is later.
- (3) All repairs or replacements must be completed using reasonable care under the circumstances and within a commercially reasonable time, considering the nature of the repair or replacement, any access issues, and any 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, 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 unless the contract for the sale of the dwelling or the community documents contains a commercially reasonable alternative dispute resolution procedure that complies with § 12-1366(C), in which event the Purchaser may initiate the dispute resolution process, including any claim for inadequate repair or replacement.

§ 5.9.2.1.6 Evidentiary Issues

Under the 2015 Amendments, both parties' conduct, during the repair or replacement process prescribed in A.R.S. § 12-1362(B)–(E), 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 pre-Dwelling Action process may face adverse evidentiary consequences at trial.

§ 5.9.2.1.7 Notice of New or Additional Defects

A Purchaser may amend or supplement its Notice to provide information pursuant to subsection A and B of the Statute to include alleged defects identified in good faith after submission of the original Notice. The Seller will have a reasonable time to conduct

additional inspections if requested, and the parties must comply with the requirements of the Statute for any additional alleged defects.

Subject to the Arizona Rules of Civil Procedure, if the matter proceeds to litigation, Purchasers may supplement their lists of alleged defects, even after filing their original Dwelling Action. However, the court must provide the Seller with a reasonable amount of time to inspect the dwelling to determine the nature and cause of the additional alleged defects, the nature and extent of any repair or replacements necessary to remedy them and, on request of the Seller, sufficient time to repair or replace them. Therefore, the additional alleged defects shall also be subject to the notice and opportunity to repair requirements in A.R.S. § 12-1361 *et seq.* The Amended Notice served during the pendency of a Dwelling Action will not toll any applicable statute of limitations from the date the Amended Notice is filed. The service of an Amended Notice during the pendency of a Dwelling Action will relate back to the original Notice for purposes of tolling the applicable statute of limitations and Statute of Repose. A.R.S. § 12-552. The time parameters as prescribed by A.R.S. § 12-1363 may be extended or modified by a written agreement between the Seller and Purchaser, but not by the court.

§ 5.9.2.1.8 Attorneys' Fees, Costs and Expert Witness Fees

The 2015 Amendment repealed A.R.S. § 12-1364, which previously allowed for the successful party to be awarded reasonable attorneys' fees, reasonable expert witness fees, and taxable costs. Nonetheless, certain homeowners may still be able to recover attorney fees. An original Purchaser will still be able to recover attorneys' fees based on contractual privity, pursuant to A.R.S. § 12-341.01, which allows for recovery of attorney fees to a successful party in any contested action arising out of a contract. Additionally, contract documents and Association documents may provide a right to the recovery of fees and costs by the "prevailing party" in a legal dispute. Even though, subsequent purchasers of a property are now unable to recover attorney's fees, as they do not have contractual privity with the builder or developer, they may recover expert fees and taxable costs through offers of judgment, pursuant to Rule 68, Ariz. R. Civ. P.

§ 5.9.2.1.9 Contract Requirements of AROC Rights

A.R.S. § 12-1365 mandates that any contract for the sale of a newly constructed dwelling contain a separate notice of the buyer's right, within two years after the close of escrow or actual occupancy, whichever occurs first to file an action under A.R.S. § 32-1155 with the Arizona Registrar of Contractors for a violation of A.R.S. § 32-1154(A). The notice must be in bold and at least 10-point type. The buyer must initial the notice provision for it to be given effect.

§ 5.9.2.1.10 Avoiding the Dwelling Action Process

The procedures outlined in the Purchaser Dwelling Actions Statute can be avoided in certain circumstances. First and foremost, Dwelling Actions do not apply to personal injury claims, death claims, claims for damage to property, other than to the dwelling itself, common law fraud claims, proceedings brought pursuant to Title 32, Chapter 10, or claims solely seeking recovery of monies expended for repairs to alleged Construction

Defects that have been repaired by the Purchaser.¹² The Act clearly applies only to residential construction, as opposed to commercial construction projects. However, it is unclear whether apartment complexes or apartment conversion projects fall under the purview of the Dwelling Action process. The Statute defines dwelling as, “a single or multi-family unit designed for residential use”¹³ Apartment complexes are universally regarded as commercial construction, yet are clearly constructed for “residential use.” A strict reading of the Statute would tend to indicate that apartments fall under the definition of “Dwelling,” thereby implicating the Act; however, this question has not yet been answered by the Legislature or the courts.

Finally, if a Seller completes the repair or replacement process as prescribed by § 12-1363, he may avoid a Dwelling Action in Superior court by evoking any commercially reasonable alternative dispute resolution procedure contained in the contract for the sale of the dwelling. To enforce such a provision, it must appear conspicuously in the contract.¹⁴

§ 5.9.2.2 Possible Theories of Recovery Available to Plaintiffs

§ 5.9.2.2.1 Breach of Contract

The purchase of a home is usually memorialized in a written contract between the home buyer and the homebuilder. The contract documents include a number of provisions which, if violated, would 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 assert construction defect claims, they often contend 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.¹⁵ An action for breach of an express provision in a contract must be commenced within 6 years of discovery of the breach.¹⁶ In the absence of a written contract, a Purchaser may file an action against his builder for breach of oral contract when oral representations are made with respect to the nature and quality of the construction of the subject property; however, such an action must be brought within 3 years from the time of discovery of the breach,¹⁷ and in no event can be brought after the expiration of the Statute of Repose.

¹² A.R.S. § 12-1366(A).

¹³ A.R.S. § 12-1361(6).

¹⁴ A.R.S. § 12-1366(C).

¹⁵ A.R.S. § 12-552.

¹⁶ *Gust Rosenfeld & Henderson v. Prudential Ins. Co. of Am.*, 182 Ariz. 586, 898 P.2d 964 (1995); A.R.S. § 12-548.

¹⁷ A.R.S. § 12-543.

§ 5.9.2.2.2 Negligence

In *Woodward v. Chirco Construction Co.*,¹⁸ the Arizona Supreme Court held that an injury suffered due to the negligent construction of a residence may give rise to an action for breach of a contractor's common law duty of care. An action for negligence in home construction must establish defects in workmanship, supervision, or design by the individual defendant; proof of a defect alone is not enough to establish the claim.¹⁹ Proof of negligence in the construction of a house requires that a builder or contractor be found to have fallen below the standard of reasonable care towards foreseeable users of the property.²⁰

The availability of a negligence claim against a builder, however, may be limited by the Economic Loss Rule, which evolved in response to the efforts of plaintiffs to avail themselves of tort theories, such as negligence, for remedies often more beneficial and less restrictive than those available under contract law. Essentially, the Economic Loss Rule provides that recovery of purely economic losses falls within the area of contract law, not tort. Thus, when applied to construction defect cases, when the only damages sustained are to the subject matter of a contract, namely structure itself, a plaintiff's cause of action sounds in contract rather than tort.²¹

The Economic Loss rule was first addressed by the Arizona Supreme Court in *Salt River Project Agriculture Improvement & Power Dist. v. Westinghouse Electric Corp.*²² As noted in *Southwest Pet Products, Inc. v. Koch Industries, Inc.*,²³ the "economic loss rule serves to prevent parties from undermining the certainty of contractual relationships by attempting to convert contract actions into tort actions whenever their contractual language bars a claim."

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 v. Wood Bros. Homes, Inc.*,²⁴ the Arizona Court of Appeals addressed this issue with regards to construction defects, where the damage claimed involved the structure itself and there were no independent or distinguishable claims for damage to personal property or personal injury. 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. The action in contract would be for defects in the structure itself, as such defects render the home less than the

¹⁸ 141 Ariz. 514, 687 P.2d 1269 (1984).

¹⁹ *Arrow Leasing Corp v. Cummins Ariz. Diesel, Inc.*, 136 Ariz. 444, 666 P.2d 544 (Ct. App. 1983).

²⁰ *Woodward*, 141 Ariz. at 516, 687 P.2d 1269 at 1291.

²¹ For a more detailed discussion of the Economic Loss Rule, see Chapter 3.8 above.

²² 143 Ariz. 368, 694 P.2d 198 (1984).

²³ 89 F. Supp. 2d 1115 (D. Ariz. 2000).

²⁴ 142 Ariz. 439, 690 P.2d. 158 (Ct. App. 1984).

purchaser bargained for, whereas the available tort claim would be for ‘damage to personal property or personal injury’ caused by the defective construction.²⁵

In *Colberg v. Relinger*,²⁶ Division One of the Arizona Court of Appeals addressed this issue. Colberg was a purchaser of a home that had latent defects. Colberg brought suit under contract and tort principles for the cost to repair the home caused by defective construction. The court relied upon *Nastri*, but also two other out of state authorities to reach the conclusion that cost to repair a home sounded in tort. Specifically, the court relied heavily upon *Crowder v. Vandendeale*²⁷:

A duty to use ordinary care and skill is not imposed in the abstract. It results from a conclusion that an interest entitled to protection will be damaged if such care is not exercised. Traditionally, interests which have been deemed entitled to protection in negligence have been related to safety or freedom from physical harm. Thus, where personal injury is threatened, a duty in negligence has been readily found. Property interests also have generally been found to merit protection from physical harm. However, where mere deterioration or loss of bargain is claimed, the concern is with a failure to meet some standard of quality. This standard of quality must be defined by reference to that which the parties have agreed upon.

Following this same line of reasoning, the Ninth Circuit Court of Appeals affirmed the dismissal of a negligent misrepresentation claim and a “common law” breach of warranty claim in *Apollo Group, Inc. v. Arnet, Inc.*²⁸ In *Apollo Group* the plaintiff sought only pecuniary damages arising out of a contractual relationship. The Ninth Circuit held that the Economic Loss Rule barred these types of claims because the subject matter is traditionally the core concern of contract law.

A more recent case on the topic is *Flagstaff Affordable Housing Ltd. Partnership v. Design Alliance, Inc.*,²⁹ wherein the court 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

²⁵ 142 Ariz. at 445, 690 P.2d at 164. This line of reasoning was also followed in *Eye Care Int’l v. Underhill*, 119 F. Supp. 2d 1313, 1315 (M.D. Fla. 2000) (plaintiff was barred from bringing a separate tort action “where the facts surrounding a breach of contract are indistinguishable from an alleged tort, and where the alleged tort does not cause harm distinct from that caused by the breach of contract”).

²⁶ 160 Ariz. 42, 770 P.2d 346 (Ct. App. 1988).

²⁷ 564 S.W.2d 879,882 (Mo. 1987).

²⁸ 58 F.3d 477 (9th Cir. 1995).

²⁹ 223 Ariz. 320, 223 P.3d 664 (2010).

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.³⁰

The court went on to hold that the Economic Loss Rule applies as well to architects and contractors. The court reasoned that there was nothing unique about architects that took them out of the purview of the economic loss doctrine.³¹

Again, the Economic Loss Rule stands for the proposition that when the only damages sustained are to the subject matter of a contract, namely structure itself, a plaintiff's cause of action sounds in contract rather than tort. 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 the 2-year statute of limitations, set forth in A.R.S. § 12-542.

Subcontractors have routinely argued that because of the Economic Loss Rule a homeowner's cause of action sounds in contract, not in tort, thus barring a negligence claim. Further, because subcontractors are, by definition, not in privity of contract with homeowners, homeowners cannot sue them directly in contract either. Thus, homeowners would be without remedy in situations where their general contractor has gone bankrupt, becomes insolvent, or has otherwise dissolved. However, based on *Sullivan v. Pulte Homes Corp.*,³² wherein the Supreme Court of Arizona ruled that the Economic Loss Rule did not bar a subsequent purchaser of a home from asserting a breach of implied warranty claim against the property's builder, homeowners would appear to be able to sue subcontractors in negligence, as the Economic Loss Rule is inapplicable in the absence of privity. However, this turns out to be a hollow victory.

In *Sullivan*, subsequent purchasers of a home brought suit against the builder for breach of implied warranty, negligence, consumer fraud and fraudulent concealment. The supreme court held the Economic Loss Rule did not apply to noncontracting parties and, thus, did not bar homeowners' negligence claims. However, the court noted tort claims might not ultimately succeed. Instead, the court directed the lower court to consider whether the substantive law of Arizona would allow non-contracting parties to recover economic losses in tort, and directed trial courts to be mindful of Draft RESTATEMENT (TORT) § 6(2), reporter's note to Comment c, which notes a division of authority, but concludes that subsequent homebuyers should not recover in tort from the homebuilder for negligent construction.

On remand to the superior court, Pulte successfully moved to dismiss the negligence claim, arguing it did not owe a duty of care to a subsequent purchaser to prevent them

³⁰ *Id.* at 323-324, 223 P.3d at 667-668, citing *Salt River Project Agric. Improvement & Power Dist. v. Westinghouse Elec. Corp.*, 143 Ariz. 368, 379-80, 694 P.2d 198, 209-210 (1984).

³¹ *Id.* at 329, 223 P.3d at 673.

³² 231 Ariz. 53, 290 P.3d 446 (Ct. App. 2012).

from economic harm. On appeal, the court affirmed the lower court's decision, holding that no duty could be imposed on a builder to a subsequent purchaser to protect the same against economic damages resulting from defective construction. By extension, it would appear likely that a homeowner who lacks contractual privity with a subcontractor, would not be able to pursue a claim against the subcontractor in tort based on a lack of duty owed to the homeowner.

Another facet of the Economic Loss Rule is the concept of "integration." In *Arrow Leasing Corp. v. Cummins Ariz. Diesel, Inc.*,³³ the buyer of a used truck sued, among others, the truck's manufacturer, seeking recovery for damages sustained when the turbocharger failed and caused engine damage. The Arizona Court of Appeals held that the cost of repairing the engine was "economic loss," outside the scope of products liability and negligence law, even though the defective product was characterized as the turbo charger and the engine was deemed "other property," and both provided by one supplier as a complete and integrated package.³⁴

There is Arizona appellate authority supporting one's ability to sue in tort, even where the damage is to other portions of the building; however, the issue of "integration" was not addressed. The court in *Valley Forge Insurance Co. v. Sam's Plumbing, LLC*³⁵ uses the analysis outlined in *Salt River*³⁶ to determine whether a claim for property damage caused by defective construction could be maintained in tort between non-contracting parties. Specifically, the court directs that the nature of the defect causing the loss; how the loss occurred and; the type of loss for which the plaintiff seeks redress must be analyzed on a case-by-case basis. Where the damage occurs suddenly and the defect poses an unreasonable risk of danger to people or other property, the claim will sound in tort rather than contract. Consequently, claims by parties not in privity of contract may sue for property damage caused by defective construction so long as the three-part test enumerated in *Salt River* is met.

§ 5.9.2.2.3 Breach of Warranty

In construction defect cases, plaintiffs typically include breach of warranty causes of action. A breach of warranty can be based on express warranty provisions, contained in the contract between the plaintiff and the builder/developer, and/or warranties implied by law.

1. Breach of Implied Warranty. Before 1979, Arizona did not recognize a cause of action for implied warranties as to the quality or condition of construction of realty.³⁷ Rather, the doctrine of *caveat emptor* prevailed as to purchasers of residential construction

³³ 136 Ariz. 444, 666 P.2d 544 (Ct. App. 1983).

³⁴ *Id.* at 449, 666 P.2d at 549.

³⁵ 220 Ariz. 512, 207 P.3d 765 (Ct. App. 2009).

³⁶ 143 Ariz. 368, 694 P.2d 198 (1984).

³⁷ *Allen v. Reichert*, 73 Ariz. 91, 92, 237 P.2d 818, 819-820 (1951); *Voight v. Ott*, 86 Ariz. 128, 132, 341 P.2d 923, 925 (1959).

in Arizona. However, the Supreme Court of Arizona in *Columbia Western Corp. v. Vela*,³⁸ abandoned the doctrine of *caveat emptor* and adopted the rule that the builder/vendor impliedly warrants that the construction of a home is constructed in a workmanlike manner and that the structure is habitable. The court further held that a builder may not escape the imposition of such warranties merely because a “sale” placed the purchaser in a position to discover the defects.³⁹ In abolishing *caveat emptor*, the court observed, “the *caveat emptor* rule, as applied to new houses, is an anachronism patently out of harmony with modern home buying practices. It does a disservice, not only to the ordinary prudent purchaser, but to the industry itself, by lending encouragement to the unscrupulous fly-by-night operator and purveyor of shoddy work.”⁴⁰

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 performed by a worker of average skill and intelligence.⁴¹ Such claims represent a significant threat to developers/builders and subcontractors in Arizona. Moreover, in 1984, the Supreme Court of Arizona, in *Richards v. Powercraft Homes, Inc.*,⁴² held that the implied warranty of workmanship and habitability claims can be made by subsequent purchasers. This implied warranty is available to subsequent purchasers upon their discovery of latent defects. Proof of a defect, due to improper construction, design or preparation, is sufficient to establish liability.⁴³ Accordingly, builders/ developers cannot avoid liability on the basis that the subsequent purchaser of a home is not in privity of contract with them. The underlying policy behind *Richards* is that persons who construct homes should foresee that persons injured by defective workmanship may not be the same person with whom they contract. The warranty of habitability and workmanship is intended to protect the injured homebuyer by holding the builder accountable for his work.

The *Richards* court was silent as to whether or not privity was required to maintain a cause of action where the original purchaser had never been in privity with the contractor. In 2013, the Supreme Court of Arizona, in *Yanni v. Tucker Plumbing, Inc.*,⁴⁴ held that homeowners could not bring an implied warranty claim against subcontractors when there was no privity between them.⁴⁵

³⁸ 122 Ariz. 28, 592 P.2d 1294 (1979).

³⁹ *Id.*

⁴⁰ 127 Ariz. at 32, 592 P.2d at 1298 citing *Humber v. Morton*, 426 S.W.2d 554, 562 (Tex. 1968).

⁴¹ *Nastri v. Wood Bros. Homes, Inc.*, 142 Ariz. 439, 690 P.2d 158 (App. 1984).

⁴² 139 Ariz. 242, 245, 678 P.2d 427 (1984).

⁴³ *Woodward v. Chirco Constr. Co.*, 141 Ariz. 514, 520, 687 P.2d 1269, 1275 (App. 1984).

⁴⁴ 233 Ariz. 364, 312 P.3d 1130 (Ct. App. 2013).

⁴⁵ *Id.* at 368, 312 P.3d at 1134.

However, in 2008, in *Lofts at Fillmore Condominium Association v. Reliance Commercial Construction*,⁴⁶ our supreme court ruled that any subsequent purchaser may sue the home builder whether or not that builder was also the vender, and regardless of whether the original purchaser had a contract with the builder. The *Lofts* court held that subsequent condominium purchasers could bring a breach of warranty action against a builder even though the original homeowner had no direct relationship with the builder. The buyer's contract was with the developer. In so holding, the court acknowledged a shift in the marketplace where builder-vendor arrangements often lead to the situation where the entity constructing the dwelling is not the same as the entity selling it. Many plaintiffs and their counsel have argued that limiting the application of the implied warranty against the party with whom the homeowner contracted would allow the builder a means to avoid liability for workmanship claims. The *Lofts* court concluded that, "whatever the commercial utility of such contractual arrangements, they should not affect the homebuyer's ability to enforce the implied warranty against the builder. Innocent buyers of defectively constructed homes should not be denied redress on the implied warranty simply because of the form of the business deal chosen by the builder and vendor."⁴⁷

In the case of non-residential construction, implied warranty claims remain unavailable to subsequent purchasers. In *Hayden Business Center Condominiums Association v. Pegasus Development Corp.*,⁴⁸ the Arizona Court of Appeals declined to allow a subsequent purchaser of commercial buildings to sue for breach of implied warranty of good workmanship. Public policy considerations account for the different treatment of residential and commercial remedies in the warranty context. The *Hayden* court stated, "unlike the parties to a home sale, no gross disparity in sophistication generally exists between the buyers and sellers of commercial real estate. Moreover, unlike new homes, commercial buildings generally are not mass-produced." Therefore, the implied warranty cannot be brought by a subsequent purchaser of a commercial building.

Many construction contracts contain disclaimers of implied warranties. For the policy reasons expressed in *Columbia Western*⁴⁹ and in *Richards*,⁵⁰ Arizona's appellate courts have disallowed attempts by sellers seeking to disclaim warranty liability imposed by law. A contractor cannot disclaim this warranty in its contract.⁵¹ Any provision attempting to disclaim the warranty is void as against public policy.⁵² Nor may a contractor displace the

⁴⁶ 218 Ariz. 574, 190 P.3d 733 (2008).

⁴⁷ *Id.* at 578, 190 P.3d at 736.

⁴⁸ 209 Ariz. 511, 105 P.3d 157 (Ct. App. 2005).

⁴⁹ 122 Ariz. 28, 592 P.2d 1294 (1979).

⁵⁰ 139 Ariz. 242, 678 P.2d 427 (1984).

⁵¹ *Buchanon v. Scottsdale Envt'l Constr. & Dev. Co.*, 163 Ariz. 285, 787 P.2d 1081. (Ct. App. 1989).

⁵² *Nastri v. Wood Bros. Homes, Inc.*, 142 Ariz. 439, 690 P.2d 158 (Ct. App. 1984), quoting *Tassan v. United Development Co.*, 410 N.E.2d 902, 910 (Ill. App. 1980).

implied warranty of habitability by including an express warranty for a limited time period.⁵³ This concept was well explained by the court in *Nastri*.

Latent defects in a new home or a new condominium may well not be discovered until after the first year a buyer takes possession. To allow a one-year express warranty to entirely displace an implied warranty of habitability could have the effect of allowing a seller to disclaim the implied warranty without forcing him to prove that there was a knowing acceptance of such disclaimer on the part of the buyer. All a seller would need to do is to provide an express warranty in the written contract covering all defects for a period of 1 year, 6 months, or even a month. Thus, the seller could preclude any liability for latent defects without the buyer knowing that such liability was being precluded.⁵⁴

Finally, 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.⁵⁵ The fact-finder is charged with the responsibility of deciding 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. In *Hershey v. Rich Rosen Construction Co.*,⁵⁶ a construction defect action was brought some 12 years after construction and 1 year after the homeowner's discovery of the problem. According to the *Hershey* court, this action could theoretically have been brought a decade or so later. Subsequent legislation, referred to as the Statute of Repose,⁵⁷ would appear to have been a direct reaction to this appellate decision.

2. Breach of Express Warranty. In addition to the implied warranty, a contractor may be sued for breaching an express provision in a contract. A typical express warranty. This theory of recovery is frequently used in commercial construction disputes and becomes a primary theory in residential disputes between contractors when the implied warranty is unavailable.

Although the implied warranty arises out of contract, rather than tort, attorney's fees are not recoverable under A.R.S. § 12-341.01(A). The implied warranty is implied-in-law and the attorney's fee statute does not apply to contracts implied-in-law.⁵⁸ Due to the 2015 Amendment to the Purchasers Dwelling Act, a subsequent purchaser of a property is now unable to recover attorney's fees as they do not have contractual privity with the builder or developer. Thus, only an original purchaser will be able to recover fees, based on contractual privity.

⁵³ *Nastri*, 142 Ariz. at 442, 690 P.2d at 161.

⁵⁴ *Id.*

⁵⁵ *Hershey v. Rich Rosen Constr. Co.*, 169 Ariz. 110, 817 P.2d 55 (Ct. App. 1991).

⁵⁶ 169 Ariz. 110, 817 P.2d 55 (Ct. App. 1991)

⁵⁷ A.R.S. § 12-552.

⁵⁸ *Sullivan v. Pulte Home Corp.*, 232 Ariz. 344, 306 P.3d 1 (2013).

§ 5.9.2.2.4 Misrepresentation and Fraud

In some situations, homebuilders are sued by owners and/or homeowner associations under the theory of misrepresentation. For example, failure to adequately describe the soil conditions at a given subdivision can give rise to a misrepresentation theory of recovery. If the soils are expansive and the builder does not explain such characteristics to the purchasers, then the purchasers may have a valid claim for misrepresentation.

Whether punitive damages are available against the homebuilder depends on whether the misrepresentation was negligent or fraudulent. With respect to mere negligent misrepresentation, Arizona has adopted Section 552 of the Restatement (Second) of Torts (1977),⁵⁹ which states:

One who, in the course of his business profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to the liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

According to the Restatement, failure to exercise reasonable care is the level of fault that gives rise to a claim for negligent misrepresentation. 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 might give rise to a claim for punitive damages.

The nine elements of fraud include: (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.⁶⁰

Because claims of misrepresentation and fraud are fact-intensive and because construction defect litigation itself is a relatively recent development in Arizona, few published opinions address misrepresentation and fraud in the context of construction defect litigation. Nevertheless, in *Echols v. Beauty Built Homes, Inc.*,⁶¹ homebuyers sued the developer for the developer's alleged fraudulent promises that a federal tax credit would be available incident to the purchase of their homes. The trial court granted summary judgment in favor of the developer on the grounds that the plaintiffs failed to make a *prima facie* case of fraud. The Arizona Supreme Court reversed with respect to one set of

⁵⁹ See *Formento v. Encanto Bus. Park*, 154 Ariz. 495, 499-500, 744 P.2d 22, 26-27 (1987).

⁶⁰ *Echols v. Beauty Built Homes, Inc.*, 132 Ariz. 498, 500, 647 P.2d 629, 631 (1982); *Nielson v. Flashberg*, 101 Ariz. 335, 338, 419 P.2d 514, 517 (1966).

⁶¹ 132 Ariz. 498, 647 P.2d 629.

homebuyers, stating “the extent of the damage they have sustained is a matter for trial and not for summary judgment.”⁶²

In *Donnelly Construction Co. v. Oberg/Hunt/Gilleland*,⁶³ a contractor sued the project architects for negligent misrepresentation, along with other claims, when the contractor discovered that the plans and specifications were in error, resulting in increased costs of construction. The Arizona Supreme Court held that the plaintiff stated a cause of action in negligent misrepresentation while noting that privity was not necessary to maintain such an action. Negligent misrepresentation is a tort-based action that is barred by the Economic Loss Rule if the parties have a contractual relationship and the losses are only economic in nature. However, a non-contracting party may bring this claim as long as the elements of the claim can be established. A two-year statute of limitations would apply to such claims.

§ 5.9.2.2.5 Strict Liability

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 homeowner’s associations against the builder of mass-produced housing. Builders who are not considered mass-producers of homes are not subject to strict liability, and California does not recognize strict liability causes of action against subcontractors in construction defect cases.⁶⁴

Because this issue has not been decided by our appellate courts, parties disagree as to the viability of this claim in Arizona. Defendants routinely cite *Nastr*⁶⁵ for the proposition that Arizona has formally rejected strict liability for construction defects in homes. Plaintiffs, on the other hand, argue that the availability of strict liability must be evaluated on a case-by-case basis. The factors to be considered by the trial court, according to *Menendez v. Paddock Pool Constr. Co.*,⁶⁶ include:

1. whether the cost to the victims of defective products should be distributed through the market by first charging the manufacturer/seller of the products (cost shifting);
2. whether the imposition of strict liability will serve the cause of prevention of defects by inducing improvements in them (public safety); and
3. whether the burden of proving fault or negligence is difficult and expensive, including the costs of expert testimony and the difficulty of finding the negligent party (recovery policy).⁶⁷

⁶² 132 Ariz. at 501, 647 P.2d at 632.

⁶³ 139 Ariz. 184, 189, 677 P.2d 1292, 1297 (1984).

⁶⁴ *Kriegler v. Eichler Homes, Inc.*, 74 Cal. Rptr. 749 (Cal. Ct. App. 1969).

⁶⁵ *Menendez v. Paddock Pool Constr. Co.*, 172 Ariz. 258, 836 P.2d 968 (Ct. App. 1991).

⁶⁶ *Id.*

⁶⁷ *Id.* at 264-265, 836 P.2d at 974-975.

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.

Another important distinction between Arizona and California law is that Arizona includes an unreasonably dangerous element in its strict product liability analysis. In other words, 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.

In *Nastri*, the court of appeals held that a defect, which causes damage to the product itself, is not a harm that products liability is designed to address.⁶⁸ In *Menendez*, the court of appeals further held that a structural improvement to realty is not necessarily “a product” subject to strict liability claims.⁶⁹ Although there is no case directly on point, Arizona trial courts have consistently rejected claims based on strict liability in construction defect cases.

§ 5.9.2.3 Time Limitations on Recovery; The Statute of Repose

The Statute of Limitations for a negligence claim is 2 years.⁷⁰ The Statute of Limitation for a breach of express contract claim is 6 years.⁷¹ The Statute of Limitations for breach of an oral promise is 3 years.⁷² However, the Arizona Legislature has significantly broadened the time limitation available for construction defect cases by enacting the Statute of Repose.⁷³ The purpose of doing so is clear. Construction defect claims often involve latent defects—those that do not manifest themselves for years after completion of the home. However, the legislature also recognized the need to put a limitation within a reasonable period of time because evidence and documents used by contractors to defend themselves from lawsuits will not be kept indefinitely.

By way of A.R.S. § 12-552, the Arizona Legislature enacted the longest statute of limitations that could apply to a construction defect case. It reads as follows:

- A. Notwithstanding any other statute, no action or arbitration based in contract may be instituted or maintained against a person who develops or develops and sells real property, or performs or furnishes the design, specifications, surveying, planning, supervision, testing, construction or observation of construction of an improvement to

⁶⁸ *Nastri*, 142 Ariz. at 445, 690 P.2d at 164.

⁶⁹ *Menendez*, 172 Ariz. at 977, 836 P.2d at 267.

⁷⁰ A.R.S. § 12-542.

⁷¹ A.R.S. § 12-548.

⁷² A.R.S. § 12-543.

⁷³ A.R.S. § 12-552.

real property more than eight years after the substantial completion of the improvement to real property.

- B. Notwithstanding subsection A of this section, in the case of injury to real property or an improvement to real property, if the injury occurred during the eighth year after the substantial completion, or, in the case of a latent defect, was not discovered until the eighth year after substantial completion, an action to recover damages for injury to the real property may be brought within one year after the date on which the injury to real property or an improvement to real property occurred or a latent defect was discovered, but in no event may an action be brought more than nine years after the substantial completion of the improvement.

Under the statute, a claimant has up to 8 years in which to file a claim unless the claimant first discovers the defect in the 8th year after completion, in which case the claimant has one additional year to file suit.

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. In *Maycock v. Asilomar Development, Inc.*,⁷⁴ our court of appeals reasoned that language from the Arizona Supreme Court supported its conclusion. The Arizona Supreme Court had held that an implied warranty is limited to latent defects that manifest after the subsequent homeowner's purchase, and which were not discoverable had a reasonable inspection of the structure been made prior to the purchase.⁷⁵ If the defect had been discovered before a new owner purchased the home, the warranty would not exist.

This Statute of Repose has always posed a problem for developers and general contractors who were sued in the ninth year (perhaps even on the last day of the ninth year). A 2006 decision by court of appeals, *Evans Withycombe, Inc. v. Western Innovation, Inc.*,⁷⁶ has clarified the application of the Statute of Repose. Actions based on implied warranties are considered contract actions and are therefore governed by the Statute of Repose.⁷⁷

In *Evans*, the court of appeals distinguished between contract-based claims versus non-contract based claims in determining which ones were 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.⁷⁸

⁷⁴ 207 Ariz. 495, 88 P.3d 565 (Ct. App. 2004).

⁷⁵ *Richards v. Powercraft Homes, Inc.*, 139 Ariz. 242, 678 P.2d 427 (1984).

⁷⁶ 212 Ariz. 462, 133 P.3d 1168 (Ct. App. 2006).

⁷⁷ A.R.S. § 12-552.

⁷⁸ *Evans*, 212 Ariz. at 468, 133 P.3d at 1174.

While the *Evans* decision defines the breadth of the Statute of Repose, those claims that are not subject to its restrictions are often limited in their effectiveness as mechanisms for recovery. For example, while a negligence claim is not subject to the Statute of Repose, it can only be brought in the construction context for personal injury or damages to an owner's property.

In class action lawsuits, the Statute of Repose does not toll for unnamed putative class members. In *Albano v. Shea Homes, LP*,⁷⁹ 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. The court held that the statute does not toll because the Statute of Repose deals with substantive rights rather than procedures. 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. § 12-552.⁸⁰

§ 5.9.2.4 Other Limitations on Recovery

§ 5.9.2.4.1 Investigative Costs

A minority of jurisdictions has held that investigative costs are recoverable in construction defect cases. In *Stearman v. Centex Homes*,⁸¹ the defendant was a mass-producer of homes in Southern California. The plaintiffs bought one of those homes from the defendant. Problems with the property began to appear shortly after plaintiffs moved in and continued over the next few years. Plaintiffs employed geotechnical and structural experts to obtain and analyze soil samples to perform the necessary design calculations to enable plaintiffs to determine an appropriate repair methodology to correct the defect. At trial, the plaintiffs argued these "investigative" costs were not "expert fees." Rather, they were completely distinct from the litigation costs incurred in connection with those experts, and that the investigation costs are properly recoverable as part of the cost of repair.⁸²

The California Court of Appeals agreed with the plaintiffs and held that the trial court erred when it denied recovery of the investigation costs. The court 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. 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. The court held that because the plaintiffs were entitled to be made whole, the trial court erred when it denied plaintiffs recovery of their investigation expenses.

⁷⁹ 227 Ariz. 121, 254 P.3d 360 (2011).

⁸⁰ *Id.* at 127-28, 254 P.3d at 366-367.

⁸¹ 78 Cal. App. 4th 611 (2000).

⁸² *Id.* at 623.

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. In *Bolkum v. Staab*,⁸³ the court held that the trial court erred in failing to make an award for such costs.

And, specific findings should be made as to the fee paid plaintiffs' professional consultant, retained to identify the structural defects and make recommendations for their remedy. Such matters are quite obviously beyond the knowledge of the average person, and retaining of an engineer for advice would not seem an unwarranted expense. . . . To the extent that such charges are found to be reasonable, and in the absence of any finding that they were not necessarily or reasonably incurred, it would appear that these expert charges not incurred for trial preparation and testimony are a proper item for damage.⁸⁴

§ 5.9.2.4.2 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.⁸⁵ 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.⁸⁶

However, other authority at least allows the argument to be made. In *Thomas v. Goudreault*,⁸⁷ the plaintiffs were tenants of the defendant landlord. During the course of their tenancy, the tenants made numerous complaints concerning the inhabitable condition of the leased premises that they used as both a residence and a business. Because the landlord failed to adequately address those complaints, the tenants filed suit against the landlord, asserting both tort and contract claims. Their negligence claim was based on an alleged breach of the duties of a landlord that are contained in the Arizona Residential Landlord and Tenant Act (ARLTA).⁸⁸ The court of appeals held that because there was a finding that the landlord was in violation of the implied duty of maintaining habitable conditions, as required by the ARLTA, that conduct could give rise to a claim for mental suffering.

⁸³ 346 A.2d 210 (Vt. 1975).

⁸⁴ *Id.* at 212-213.

⁸⁵ *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).

⁸⁶ *Erllich v. Menezes*, 87 Cal. Rptr. 2d 886 (1999).

⁸⁷ 163 Ariz. 159, 786 P.2d 1010 (Ct. App. 1989).

⁸⁸ A.R.S. § 33-1301, *et seq.*

In a nonconstruction-related case, the Arizona Court of Appeals held that an owner could not recover emotional distress damages emotional distress in an action arising out of tortious loss of personal property.⁸⁹

§ 5.9.2.4.3 Extrapolation

Multi-family residential construction defect cases typically involve many units or residences. This is especially true when the case is certified for class action. One of the heated questions in construction defect cases is to what extent each unit or residence must be tested or at least inspected to prove every plaintiff's case at trial. Does each unit or residence need to be inspected to verify that the windows leak? Does each unit need to be inspected to verify that fire stopping is missing? From the plaintiffs' perspective, inspecting each unit, especially destructive testing, is cost prohibitive and unnecessary. From the defense perspective, without inspection, claims that all units contain the same defects are merely speculative. Both arguments have their merit. To date, there are no Arizona cases on this issue.

Moreover, there are few cases elsewhere that have actually addressed this issue. In *Harbor House Condominium Ass'n v. Massachusetts Bay Insurance Co.*,⁹⁰ the Federal District Court for the Northern District of Illinois focused on the issue from an evidentiary perspective. In *Harbor House*, the court held the plaintiffs' construction expert could not testify as to defects which were not properly tested: "Because the plaintiffs are not burdened by the difficulty of proving an event which might have occurred, they are not justified in speculating about their loss."⁹¹ The court held the plaintiffs could not recover for damages to the entire construction system in question by simply "extrapolating" from a small portion of the system without locating the damage; the expert opinions are mere speculation; therefore, their cost estimates prove nothing.⁹²

More recently in *Zamora v. Shell Oil Co.*,⁹³ the California Court of Appeals refused to allow extrapolation evidence to go to the jury. In *Zamora*, the court considered whether 14 of 34 homeowners could recover damage due to allegedly defective pipes when those homeowners did not exhibit signs of failure. The plaintiffs in *Zamora* asserted that with respect to the 14 homes not exhibiting signs of failure that they need only prove "their plumbing systems were reasonably certain of failing in the future."⁹⁴ However, the *Zamora* court held that "no cause of action for negligence existed premised on the risk the [product in issue] may malfunction in the future."⁹⁵ No matter which theory is

⁸⁹ See *Kaufman v. Langhofer, D.V.M.* 223 Ariz. 249, 222 P.3d 272 (Ct. App. 2009) (pet owner could not recover damages for emotional distress and loss of companionship for a bird negligently killed by its veterinarian).

⁹⁰ 703 F. Supp. 1313, 1320 (N.D. Ill 1988).

⁹¹ *Id.* at 1320.

⁹² *Id.* at 1321.

⁹³ 55 Cal. App.4th 204 (1997).

⁹⁴ *Id.* at 208.

⁹⁵ *Id.* at 209.

utilized, however, if the plaintiff alleges a product is defective, proof that the product has not functioned is essential to establish liability for an injury caused by the defect.⁹⁶

While there are no Arizona cases directly on point, the decision as to whether to allow extrapolation with regard to the nature and extent of damages in a construction defect case will likely involve an analysis of Rules 401, 402, 403, 404 and 602 of the Arizona Rules of Evidence. When compensatory damages are susceptible to proof with substantial accuracy, the plaintiff must prove those damages.⁹⁷ Speculation or conjecture will not support a claim for damages where the law requires proof by reasonable certainty.⁹⁸

§ 5.9.2.4.4 Stigma Damages

The diminution in value resulting from a perceived problem with a property is commonly referred to as “Stigma Damages.” There is no Arizona case law providing for recovery of Stigma Damages incident to properly repaired defective construction; however, there is ample case law on other diminution claims. Stigma Damage claims arose out of toxic tort cases wherein a property had been the site of toxic dumping for years. Even after clean up, the land purportedly retained the stigma of being contaminated and hence its value dropped. Contractors frequently argue that once a property is remedied there is no stigma because the property is now the way it should have been.

Only a few states have addressed this issue. In *Ryland Group v. Daley*,⁹⁹ plaintiff homeowners sued the builder for breach of contract, negligence, and breach of warranty. 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.”¹⁰⁰

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.”¹⁰¹ 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.”¹⁰² The court went on to note:

⁹⁶ *Id.* at 210.

⁹⁷ *Spain v. Griffith*, 42 Ariz. 304, 307, 25 P.2d 551, 554 (1933) (“And no substantial recovery may be based on anything except evidence which justifies an inference that the damages awarded are just and unreasonable.”).

⁹⁸ *Coury Bros. Ranches, Inc. v. Ellsworth*, 103 Ariz. 515, 521, 446 P.2d 458, 462 (1968) (“damages that are speculative, remote or uncertain may not form the basis of the judgment”).

⁹⁹ 537 S.E.2d 732 (Ga. Ct. App. 2000).

¹⁰⁰ 537 S.E.2d at 739.

¹⁰¹ *Id.*

¹⁰² *Id.*

The most obvious problem, then, with the Daley's calculation is that it is predicated upon a future loss that may or may not be sustained depending on the sensibilities of some future buyer and whether, in fact, the repaired defects are disclosed to such future buyer and, in fact, generate the anticipated "stigma." None of these conditions precedent to the argued future loss can be factually established.

Finally, the argued loss in this case is based on a diminution of a speculative future value of the Daley's fully repaired home at the time of a resale, a future event. Clearly, future loss is not a proper measure of damages for improved realty, because the plaintiff would be placed in a superior position since "fair market value" of improved realty depends upon time and so many other variables.¹⁰³

§ 5.9.2.4.5 Comparative Fault and Failure to Mitigate Damages

Comparative fault is a tort concept and flows from Uniform Contribution Among Tortfeasors Act (UCATA).¹⁰⁴ As discussed above, it is unusual to have a negligence claim cover damages sought in a construction defect case. Accordingly, comparative fault is not a typical affirmative defense. However, the failure to mitigate is frequently raised against homeowners who fail to properly maintain their premises, such as failing to remove debris from gutters and downspouts, failing to clean weep holes on windows, or failing to repair leaky pipes and irrigation lines. The key requirement is that the injured party exercise reasonable care to mitigate damages. No extraordinary or risky actions are required unless it would be unreasonable not to take those actions. The party in breach has the burden of proving that mitigation was reasonably possible but not reasonably attempted.¹⁰⁵

§ 5.9.2.4.6 Economic Waste

Generally, the measure of damages for a breach by a builder of a construction contract is the cost of repair.¹⁰⁶ 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. *County of Maricopa v. Walsh & Oberg Architects, Inc.*¹⁰⁷ discussed the concept of economic waste as follows:

¹⁰³ *Id.* at 739-40.

¹⁰⁴ A.R.S. § 12-2501 *et seq.*

¹⁰⁵ *Fairway Builders v. Malouf Towers Rental Co.*, 124 Ariz. 242, 256, 603 P.2d 513, 527 (Ct. App. 1979); see also RAJI Contract 23 (3d ed. 1997), which provides for a reduction of damages of those damages that could have been avoided or mitigated had plaintiffs attempted to prevent or reduce them through reasonable efforts.

¹⁰⁶ *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).

¹⁰⁷ 16 Ariz. App. 439, 494 P.2d 44 (Ct. App. 1972)

The concept of “economic waste” as it relates to changing the general rule as to damages for breach of a construction contract has been succinctly captured by comment (b) to Restatement of Contracts, § 346(1) (1932):

“The purpose of money damages is to put the injured party in as good a condition as that in which full performance would have put him; but this does not mean that he is to be put in the same specific physical position. . . . There are numerous cases . . . in which the value of the finished product is much less than the cost of producing it after the breach has occurred. Sometimes defects in a completed structure cannot be physically remedied without tearing down and rebuilding, *at a cost that would be imprudent and unreasonable. The law does not require damages to be measured by a method requiring such economic waste.*”

If economic waste is present, the effect is to award damages on the basis of the difference in value of the building had it been completed in accordance with the contract and the value of the building as erected, rather than on the basis of reasonable cost of completion to conform to the contract. Restatement of Contracts § 346(1) (1932). (Emphasis in original.)¹⁰⁸

It is clear from this discussion that economic waste exists when the cost of repair measure of damages would result in unreasonable duplication of effort.¹⁰⁹ 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.¹¹⁰

§ 5.9.2.4.7 Contractual Limitation of Liability

Until recently, Arizona courts had never addressed whether a provision purporting to limit liability for damages incurred while performing under a contract was viable. However, the Supreme Court of Arizona, in *1800 Ocotillo v. The WLB Group*,¹¹¹ held that public policy does not prohibit contractual limitation-of-liability provisions in construction contracts or architect-engineers contracts, but the enforceability of the provision is left to the determination of the jury.

A limitation-of-liability clause in a contract has its own limitations as it is unenforceable when the party who seeks to limit liability is engaged in fraud or bad faith.¹¹²

¹⁰⁸ *County of Maricopa*, 16 Ariz. App. at 494 P.2d at 46-47.

¹⁰⁹ *Fairway Builders.*, 124 Ariz. at 253, 603 P.2d 524.

¹¹⁰ *Id.*

¹¹¹ 219 Ariz. 200, 196 P.3d 222 (2008).

¹¹² See *Airfreight Exp. Ltd v. Evergreen Air Ctr., Inc.*, 215 Ariz. 103, 158 P.3d 232 (Ct. App. 2008).

§ 5.9.2.5 Courses of Action Available to Developers

Developers are often in the unenviable position of being the target defendants in construction defect lawsuits. This is because the law affords plaintiffs numerous legal theories to support construction defect claims directly against the property's vendor.¹¹³ It is not uncommon for the developer to be the only named defendant in the lawsuit. The developer has the option of defending the matter through trial or settling the matter using its own money. Alternatively, the developer can file a third-party complaint against the culpable subcontractors, design professionals, or materialmen under various indemnity theories. Such indemnity claims are playing an increasingly important role in Arizona construction defect cases.

§ 5.9.2.5.1 Express Indemnity¹¹⁴

Express indemnity occurs when there is a written indemnity provision in a contract or agreement that 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.¹¹⁵ Express indemnity provisions historically have been classified in two different categories: general and specific. A general indemnity agreement does not specifically address what effect the indemnitee's (*e.g.*, developer) negligence will have on the indemnitor's (*e.g.*, subcontractor) obligation to indemnify.¹¹⁶ In contrast, a specific indemnity agreement does address what effect the indemnitee's negligence will have on the indemnitor's obligation to indemnify.¹¹⁷ The distinction is subtle but important.

¹¹³ *Woodward v. Chirco Constr. Co.*, 141 Ariz. 514, 520, 687 P.2d 1269, 1275 (Ct. App. 1984).

¹¹⁴ For a more expansive treatment of the issue of Indemnification, see Chapter 3.6 above.

¹¹⁵ *Birth of Hope Adoption Agency, Inc. v. Doe*, 190 Ariz. 285, 288, 947 P.2d 859, 862 (Ct. App. 1997). *INA Ins. Co. v. Valley Forge Ins. Co.*, 150 Ariz. 248, 252, 722 P.2d 975, 979 (Ct. App. 1986).

¹¹⁶ *Washington School Dist. No. 6 v. Baglino Corp.*, 169 Ariz. 58, 61, 817 P.2d 3, 6 (1991) (quoting *Pioneer Roofing Co. v. Mardian Constr. Corp.*, 152 Ariz. 455, 474, 733 P.2d 652, 671 (Ct. App. 1986). For example, a general indemnity agreement may read:

“SUBCONTRACTOR shall indemnify, and hold harmless, and at CONTRACTOR’S request, defend CONTRACTOR and its agents, employees from and against any and all suits, actions, legal proceedings, claims, demands, damages, costs and expenses whatsoever kind or character, including but not limited to, attorneys’ fees and expenses arising out of or by reason of any liability or obligation in any manner caused or occasioned or claimed to be caused or occasioned by any act, omission, fault or negligence of SUBCONTRACTOR or anyone acting on his behalf, including, but not limited to, subcontractors or suppliers, their subcontractors and suppliers, and the employees and agents of any of the foregoing in connection with or incident to this contract or the work to be performed hereunder. This obligation of the SUBCONTRACTOR to indemnify and hold harmless shall include the obligation to defend any suit, at SUBCONTRACTOR’S own expense, or any such action thereon brought against CONTRACTOR alone, or against SUBCONTRACTOR and CONTRACTOR jointly.”

¹¹⁷ A specific indemnity may read as follows:

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 active negligence.

In 2001, the Arizona Supreme Court called into question the active/passive distinction in general indemnity agreements. In *Cunningham v. Goettl Air Conditioning*,¹¹⁸ the court looked to the indemnity provisions in determining whether to afford indemnity.¹¹⁹ *Goettl* involved a lease agreement, between Goettl Air Conditioning ("Goettl") as lessee, and Washington Street Investments ("WSI"), as lessor, that contained an indemnity and hold harmless provision in favor of WSI. The indemnity provision required Goettl to, in part:

"indemnify and hold lessor [WSI] harmless . . . against any and all claims [and] expenses (including attorneys' fees) . . . arising [from] . . . any accident or other occurrence in or about Premises when such injury. . . shall be caused in part or in whole by . . . the act, neglect, fault of or omission of any duty. . . or negligence of Lessee [Goettl]"¹²⁰

The lawsuit arose out of injury to Mark Cunningham, an employee of Goettl, who fell through an uncovered roof penetration. Cunningham sued WSI for his personal injuries. Pursuant to the indemnity provision in the lease agreement, WSI tendered the defense to Goettl who refused the defense. On the eve of trial, Cunningham settled with WSI, which included Plaintiff's release of all claims against WSI in return for an assignment of WSI's indemnity claims against Goettl.

In determining the breadth of the indemnity agreement, the supreme court noted that the indemnity agreement in question did not address the conduct of WSI, whether active or passive, which is the threshold issue of whether the agreement is a general or specific indemnity provision. The court noted "a mechanical application of [the active versus passive negligence distinction] should be avoided in determining the parties intent because relying exclusively on the active/passive distinction may prevent an agreement from being enforced as the parties intended."¹²¹ The court stated that courts should look to the "all encompassing language" of the indemnification contract. If the language of

"Subcontractor shall indemnify, defend and save harmless Contractor and Owner from and against any and all claims, debts, demands, damages, judgments, awards, losses, liabilities, interest, attorney's fees, costs and expenses of whatsoever kind or nature at any time arising out of any failure of Subcontractor to perform any of the terms and conditions of this Subcontract or which are in any manner directly or indirectly caused or occasioned by or contributed to, by any act, omission, fault or negligence, whether active or passive, of Subcontractor, or anyone acting under its direction or control, or on its behalf, in connection with or incidental to the work, even though the same may have resulted from the joint, concurring or contributory negligence whether active or passive, of Contractor, or any other person." (Emphasis added).

¹¹⁸ 194 Ariz. 236, 980 P.2d 489 (2001).

¹¹⁹ See also *Herstam v. Deloitte & Touche, LLP*, 186 Ariz. 110, 118, 919 P.2d 1381, 1389 (1996).

¹²⁰ *Goettl*, 194 Ariz. at 240, ¶ 17, 980 P.2d at 493.

¹²¹ *Id.* at 240, ¶ 16, 980 P.2d at 493.

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.”¹²²

It bears noting that A.R.S. § 32-1159 prohibits, as void against public policy, an indemnity provision in a private construction contract that purports to indemnify any party for loss or damage resulting from that party’s sole negligence. Similarly, A.R.S. § 34-226 and § 41-2586(A) prohibit indemnification provisions in public works that purport to indemnify any party for loss or damage from that party’s own negligence.

If a contract has an express indemnity provision (whether it be specific or general), it is binding between parties and trumps any implied/common law indemnity claim thereby precluding the same.¹²³

Until recently, Arizona has not had any cases which discussed, in the indemnity context, what damages would be owed or what factors would be applied in determining the same.

In *MT Builders LLC v. Fisher Roofing*,¹²⁴ a condominium association sued the general contractor, MT Builders, on account of a construction defect. In response, MT filed a claim for indemnity against Fisher, its roofing subcontractor, under a specific indemnity provision which limited recovery “to the extent” of its roofing subcontractor’s negligence. In exchange for payment of \$1.75 million, MT entered into a settlement agreement with the Association and was assigned the Association’s rights against Fisher, and others. MT filed a motion for summary judgment against Fisher on its indemnity claim and the trial court awarded MT \$240,523 in damages.

On appeal, Fisher alleged that recovery by MT was limited “to the extent” the damages were caused in whole or in part by any negligent act by Fisher, as noted in the indemnity provision. Because MT never proved or offered any evidence at trial that the damages it paid to the Association were caused by Fisher, Fisher argued that the decision should be overturned. The court of appeals agreed and held that in order for MT to recover for indemnity, it needed to prove the extent of Fisher’s fault.¹²⁵ Even though Fisher did not accept MT’s original tender of defense, it was not precluded from disputing its fault or disputing whether it owed MT indemnity.¹²⁶ In determining whether MT’s settlement amount was reasonable and prudent, the court adopted the “reasonableness test” as set forth in *United Services Automobile Ass’n v. Morris*.¹²⁷

¹²² *Id.* at 240, 980 P.2d at 493.

¹²³ See *Grubb & Ellis Mgmt, Servs. v. 407417 B.C. LLC*, 213 Ariz. 83, 138 P.3d 1210 (Ct. App. 2006).

¹²⁴ 219 Ariz. 297, 197 P.3d 758 (Ct. App. 2008).

¹²⁵ *Id.* at 304, 197 P.3d at 765.

¹²⁶ *Id.* at 309, 197 P.3d at 770.

¹²⁷ 154 Ariz. 113, 171 P.2d 246 (1987).

Interestingly, the court also ruled that unless an indemnity provision specifically states that there was an obligation to “defend,” a specific indemnity provision does not presumably require the indemnitor to provide a defense to the indemnitee. Conversely, where the language of the indemnity provision contains an obligation to “defend,” the obligation may be construed as immediate notwithstanding an ultimate obligation to indemnify.¹²⁸

§ 5.9.2.5.2 Implied Indemnity¹²⁹

Indemnity is an obligation resting on one party to make good the loss or damage incurred by another party.¹³⁰

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 with no indemnification provision, but the relationship between the parties is such that the court imposes one nonetheless.¹³¹ This theory is limited and dates back nearly half a century.¹³²

In *Busy Bee Buffet v. Ferrell*,¹³³ a deliveryman named Ferrell injured himself when he fell into an open trap door which was created by Pastis, who was a co-tenant of the property with Busy Bee. Ferrell sued Busy Bee and Pastis. Busy Bee sought indemnity against Pastis for any liability assessed against it. The trial court granted judgment in favor of Busy Bee Buffet and its indemnification claim. The Arizona Supreme Court upheld this judgment by employing a passive versus active fault scheme to the actions of Busy Bee Buffet and Pastis. The court held:

It will be observed that the Buffet owed a positive legal duty to Ferrell to keep the passageway reasonably safe for his use in making deliveries of beverages to it. So long, however, as the trap door was closed the basement beneath the passageway constituted no actual peril whatever. It was only when the trap door was open and inadequately guarded by failure to place proper barricades on each side of the opening or something equally effective that the actual danger to Ferrell was created. The Buffet was guilty of no active fault in creating the danger to Ferrell. Its negligence was passive and static. Its negligence was incapable of producing injury to any one at that time except through the active negligence of another. Pastis, in opening the trap door and leaving it unguarded, was the immediate cause of Ferrell falling through the

¹²⁸ *MT Builders LLC v. Fisher Roofing*, 219 Ariz. 297, 309, 197 P.3d 758, 770 (Ct. App. 2008).

¹²⁹ For a more expansive treatment of the issue of Indemnification, see Chapter 3.6 above.

¹³⁰ *INA Ins. Co. v. North America v. Valley Forge Ins. Co.*, 150 Ariz. 248, 252, 722 P.2d 975, 979 (Ct. App. 1986).

¹³¹ *Schweber Elec. v. National Semiconductor*, 174 Ariz. 406, 850 P.2d 119 (Ct. App. 1992).

¹³² 82 Ariz. 192, 310 P.2d 817 (1957).

¹³³ *Id.*

opening and sustaining the injuries which form the basis of this litigation. . . . In light of these facts, Pastis became primarily liable to Ferrell for the injuries he sustained and the Buffet is only secondarily liable.¹³⁴

What is “active” versus “passive” negligence was not specifically defined until *Estes Co. v. Aztec Construction*.¹³⁵ 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.¹³⁶ 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.¹³⁷

In *Estes*, the general contractor sought indemnity from its subcontractor as a result of the deaths of 2 boys in a trench that Aztec Construction was digging. The court found that *Estes*, the general contractor, was merely passively negligent since it was only responsible for supervision of the site and for posting warning signs but did not actively participate in the trenching operations, which admittedly was done by the subcontractor.¹³⁸

The active/passive test, however, has not been without its problems. Determining what is active negligence as opposed to what is passive negligence is not always easy to do. One Missouri court aptly demonstrated this problem:

“With a little ingenuity in phrasing, negligence can be made to be either “active” or “passive” as suits the writer. For example, “driving an automobile with bad brakes” and “running through a stop sign” or “using a defective crane” might be said to be “active” negligence, while “omitting maintenance of brake fluid level” or “neglecting to apply the brakes” or “failing to inspect the crane in order to discover its defectiveness” might be “passive” negligence—these are the same acts or omissions, but the outcome depends not upon the facts, but upon how someone chooses to characterize them.”¹³⁹

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

¹³⁴ *Id.* at 198, 310 P.2d at 821.

¹³⁵ 139 Ariz. 166, 677 P.2d 939 (Ct. App. 1983).

¹³⁶ *Id.* at 169, 677 P.2d at 942.

¹³⁷ *Id.*

¹³⁸ See also 5.9.2.3.1 above discussing the questionable viability of the active/passive distinction by today’s courts.

¹³⁹ *Missouri Pac. R. Co. v. Whitehead & Kales Co.*, 566 S.W.2d 466, 471 (Mo. 1978).

other 19 buildings for which it was only passively negligent? Such a question has never been answered by an Arizona court. Another common problem arises when the general contractor fails to notice 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.¹⁴⁰

§ 5.9.2.5.3 Third-Party Beneficiary

When a developer is not the general contractor, he does not enter into subcontracts with the trades. In some instances the indemnity provision between the general contractor and the subcontractor will include indemnitee rights on behalf of the developer. However, if it does not, the developer may also argue that it is a third-party beneficiary of the contract between the general contractor and the subcontractor.

Arizona provides third-party beneficiary status if three elements are met: (1) an intention to benefit the third party must be indicated in the contract itself; (2) the contemplated benefit must be both intentional and direct; and (3) it must definitely appear that the parties intended to recognize the third party as the primary party in interest.¹⁴¹ Creation of a third-party beneficiary status for a developer even though it is not a party to the subcontract agreement can be created rather easily by including a provision, which comports with the above three-part test.¹⁴²

§ 5.9.2.5.4 Breach of Contract

A claim for indemnity is a cause of action for breach of contract. However, there are other bases for a developer to sue a general contractor or subcontractor. Typically, well-drafted construction contracts specifically address various issues that might arise during construction and 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.

For instance, in *PPG Industries, Inc. v. Continental Heller Corp.*,¹⁴³ Bassett was an employee of PPG which was a subcontractor hired by Continental Heller. Bassett was injured on the job and made a personal injury claim against Continental Heller. The contract between Continental Heller and PPG required PPG to add Continental Heller as an additional insured under its policy. PPG failed to do so. When sued, Continental Heller's insurance company defended and cross-claimed against PPG, under a breach of

¹⁴⁰ *Cella Barr Assocs. 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).

¹⁴¹ *Norton v. First Fed. Sav.*, 128 Ariz. 176, 178, 624 P.2d 854, 865 (1981).

¹⁴² *E.g.*, "Each Trade Contract shall provide that Owner has the right, but not the obligation, to enforce the Trade Contract in the place of Contractor if this Agreement is terminated and that Owner is a third party beneficiary thereof."

¹⁴³ 124 Ariz. 216, 603 P.2d 108 (Ct. App. 1979).

contract theory, for the amount paid on the claim, as well as the attorneys' fees paid in defending the matter. PPG argued that all Continental Heller was entitled to was the cost of the premium it cost to purchase said insurance. The court of appeals disagreed and held that the proper measure of damages was the amount paid in settlement plus the costs of defense, including attorneys' fees.¹⁴⁴

Arguably, a separate cause of action would arise for each provision of the contract that was breached. For instance, if the contract between the developer and the general contractor required the general contractor to "review the work of the subcontractors for defects and deficiencies in the work and require that all subcontractors make appropriate repairs of any defects and deficiencies on a timely basis" and the general contractor failed to do so, breach of this provision may result in a cause of action by the developer against the general contractor. 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.

§ 5.9.2.5.5 Breach of Implied Warranty

An implied warranty that construction will be performed in a good and workmanlike manner is implied and deemed to exist in all construction contracts.¹⁴⁵ The warranty is designed to protect innocent purchasers of structures against poor construction practices. This warranty exists regardless of whether there is an express contractual provision.¹⁴⁶ However, because the implied warranty exists to protect owners, it is not a claim that is available to a developer or general contractor against a subcontractor.

§ 5.9.2.5.6 Breach of Express Warranty

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. The duty in express warranty is contractual and not one imposed by law.¹⁴⁷ The claim of breach of express warranty sounds in contract, and therefore, attorneys' fees can be awarded to the successful party.¹⁴⁸

¹⁴⁴ *Id.* at 222, 603 P.2d at 114.

¹⁴⁵ See *Kubby v. Crescent Steel*, 105 Ariz. 459, 460, 466 P.2d 753, 754 (1970) (contractor impliedly warrants that he will perform in workmanlike manner even though contract itself does not contain an express warranty of good workmanship); see also *Reliable Electric Co. v. Clinton Campbell Contractor, Inc.*, 10 Ariz. App. 371, 459 P.2d 98 (1969).

¹⁴⁶ *Id.*

¹⁴⁷ *Evans Withycombe, Inc. v. W. Innovations, Inc.*, 212 Ariz. 462, 133 P.3d 1168 (Ct. App. 2006).

¹⁴⁸ *Id.*; see also *Nastri v. Wood Bros. Homes*, 142 Ariz. 439, 690 P.2d 158 (Ct. App. 1984).