CHAPTER 19: CONSTRUCTION LAW

CONSTRUCTION DEFECT LITIGATION

Theories of Recovery

Strict Liability

Arizona does not recognize strict liability recovery for defective residential construction. California, on the other hand, has extended strict liability to cases involving construction defects in mass-produced housing, i.e., condominiums, townhouses, etc. Many construction defect counsel are migrating from California to Arizona, a fertile ground for construction defect litigation. California counsel will likely urge Arizona to adopt the California approach.

In ***Menendez v. Paddock Pool Constr. Co.***, 172 Ariz. 258, 836 P.2d 968 (Ct. App. 1991), the court held that the theory of strict liability for a defective product did not apply to a plaintiff's suit against a contractor who built a swimming pool. The policy behind strict liability in tort is to shift costs to mass production manufacturers that can absorb those costs. Although some construction, such as standardized model construction assembled and manufactured by mass-production process for tract homes might fit this theory, a structural improvement to real property, such as a custom-designed and constructed swimming pool, does not.

Breach of Implied Warranty of Workmanship/Habitability

This is the most viable theory for pursuing a residential construction defect (CD) claim. Even in the absence of a specific contractual provision, the law implies a warranty on the part of the contractor to perform the agreed task in a good and workmanlike manner and in a manner benefiting a skilled contractor. *See* ***Kubby v. Crescent Steel***, 105 Ariz. 459, 466 P.2d 753 (1970). The warranty is imposed by law and suit can be brought within eight years from the time the residence is completed. *See* A.R.S. § 12-552(A) (barring claims discovered more than eight years after substantial completion of an improvement to real property). Suit can be brought within nine years if the injury occurred during the eighth year, or if the defect was not discovered until the eighth year after completion. *See* A.R.S. § 12-552(B) (allowing an additional year for actions to recover damages if injury occurred or the defect was discovered in the eighth year after completion.)

In Arizona, subsequent purchasers can take advantage of the breach of implied warranty regarding latent defects. *See* ***Richards v. Powercraft Homes, Inc***., 139 Ariz. 242, 678 P.2d 427 (1984). Proof of a defect due to improper construction, design or preparation is sufficient to establish liability. *See* ***Woodward v. Chirco Constr. Co., Inc.***, 141 Ariz. 514, 687 P.2d 1269 (1984). Contractors can bring a claim for breach of implied warranty against their design professionals, such as architects, under an implied warranty theory even if there is no privity of contract. ***North Peak Constr., LLC v. Architecture Plus, Ltd.***, 227 Ariz. 165, 254 P.3d 404 (Ct. App. 2011).

The implied warranty is limited to hidden or latent defects that would not have been discoverable upon "reasonable inspection." *See* ***Hershey v. Rich Rosen Constr. Co.***, 169 Ariz. 110, 114, 817 P.2d 55, 59 (Ct. App. 1991). Reasonable inspection does not mean an inspection by an expert; the warranty applies to hidden defects that could not have been discovered by an average purchaser. *Id.* The implied warranty is not affected or superseded by any express warranty in a contract. *See* ***Nastri v. Wood Bros. Homes, Inc.***, 142 Ariz. 439, 690 P.2d 158 (Ct. App. 1984). Further, an express waiver and disclaimer of the implied warranty by the original homeowner does not bind an innocent subsequent purchaser. *Id.* at 442, 690 P.2d at 161**.** Arizona has left open the question of whether a knowing waiver of the implied warranty is against public policy. *Id*. at 443, 690 P.2d at 162.

The test for determining whether or not there has been a breach of the implied warranty of workmanship and habitability is one of reasonableness. ***Richards v. Powercraft Homes Inc.***, 139 Ariz. 242, 245, 678 P.2d 427, 430 (1984). The court must take into consideration the age of the home, its maintenance, and the use to which it has been put, among other factors, to make the factual determination at trial if a breach occurred. *Id*. This test is limited to defects that are latent. *Id.* Furthermore, the court will assess whether the work performed is comparable to work performed by a worker of average skill and intelligence. ***Nastri*** at 444, 690 P.2d 163.

A subsequent homeowner raising a breach of implied warranty claim can now recover attorney's fees under A.R.S. § 12-341.01(A). ***Sirrah Enterprises, LLC v. Wunderlich***, 242 Ariz. 542, 547, 399 P.3d 89, 94 (2017). In *Sirrah*, the Arizona Supreme Court determined that implied warranties are a contract term imputed into construction contracts that run to subsequent purchasers. *Id.* Thus, a breach of an implied warranty claim necessarily arises out of a contract and is subject to attorney's fees pursuant to A.R.S. § 12-341.01(A). *Id.* The bottom line is that all homeowners, whether original or subsequent, may seek recovery of their attorneys' fees and costs either directly under their contract or pursuant to statute.

Commercial structures and residential structures will be treated differently when determining who can utilize this theory of recovery. As discussed above, residential owners may bring an implied warranty claim whether they are original or subsequent purchasers. For commercial structures, only the original purchasers may bring a claim for implied warranty. ***Hayden Bus. Ctr. Condo Ass'n v. Pegasus Dev.***, 209 Ariz. 511, 513, 105 P.3d 157, 159 (Ct. App. 2005) . The reasoning is that commercial developers and purchasers are more sophisticated consumers who will perform their due diligence before the purchase.

The Arizona Supreme Court has expanded the potential defendants in an implied warranty of workmanship and habitability case. In ***Lofts at Fillmore Condo Ass'n v. Reliance Commercial Constr.***, 218 Ariz. 574, 190 P.3d 733 (2008), the Supreme Court held that a contractor provides an implied warranty even though it was not the seller of the residence. It also allowed the buyer to bring a breach of warranty claim against the contractor, even though the buyer lacked privity of contract with the contractor. *Id.* at 578, 190 P.3d 737. In ***Teufel v. American Family Mut. Ins. Co.***, 244 Ariz. 383, 419 P.3d 546 (2018), the Supreme Court held that a homeowner's insurer had to defend its builder-vendor insured against a claim for negligent excavation of a mountainside

home that he builder built but never lived in. The defective construction claim alleged a stand-alone negligence claim that was independent of the real estate contract, and a policy exclusion for personal liability "under any contract or agreement" did not absolve the insurer of its duty to defend stand-alone tort or negligence claims. However, the Arizona Court of Appeals has so far declined to expand the implied warranty to subcontractors performing new home construction. *See* ***Yanni v. Tucker Plumbing***, 223 Ariz. 364, 312 P.3d 1130 (Ct. App. 2013). *Yanni* holds that absent privity of contract, a homeowner may not bring a claim against a builder's subcontractors for breach of the implied warranty of workmanship and habitability. *Id.* at 367-8, 312 P.3d 1133-4. The Court noted that the public policy concerns discussed in prior privity exception cases were not present. As a result, a homeowner's claim for breach of the implied warranty of workmanship and habitability is limited to those with whom the homeowner directly contracts, general contractors, developers, and vendors.

Recently, the Arizona Supreme Court held that a homebuilder and buyer cannot supplant the implied warranty of habitability with an express warranty of their own choosing to address potential construction defects. *Zambrano v. & RC II LLC, et al*., 254 Ariz. 53, 517 P.3d 1168, (2022) (plaintiff's express waiver and disclaimer or implied warranty in favor of express warranty is invalid). With this decision, Arizona officially joined the minority of jurisdictions that does not allow a homebuyer to expressly waive the implied warranty.

Breach of Express Warranty

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

Negligence

Recovery of construction defect damages under a negligence theory in Arizona is limited. *See* ***Coldberg v. Rellinger***, 160 Ariz. 42, 770 P.2d 346 (Ct. App. 1988). The "Economic Loss Rule," adopted in Arizona, will not allow a plaintiff to recover for defects to the structure itself under this theory, unless the structural damage is accompanied by personal injuries or damages to personal property that are caused by the defective structure. ***Flagstaff Affordable Housing, LP v. Design Alliance, Inc***., 223 Ariz. 320, 326-7, 223 P.3d 664, 670-71 (2010). The Economic Loss Rule is limited, however, to contracting parties. *Id.* at 323, 223 P.3d 667. *See* discussion on the Economic Loss Doctrine below. Relatedly, Arizona does not impose a tort duty on a design professional in favor of a person who suffers purely economic damages and is not in privity of contract with the design professional. ***Cal-Am Properties, Inc. v. Edais Engineering, Inc.***, 253 Ariz. 78, 509 P.3d 386 (2022). In essence, a tort claim for professional negligence cannot be levied against a design professional for pure economic loss.

Breach of Fiduciary Duty

This theory is often alleged against the developer of a mass-housing project. The developer has the initial fiduciary obligation to the homeowners' association members. Once enough units are sold, the developer hands over the homeowners' association to the homeowners themselves.

The developer is required to keep sufficient funds in the homeowners association to fund initial operating expenditures and reserve requirements. If the developer turns over the homeowners association without sufficient funds, the successor homeowners association will likely argue that the developer breached its fiduciary duty to adequately budget and fund for these expenditures which may have resulted in a deterioration of the community.

Fraud

Although often alleged, this theory is rarely proven, as a plaintiff must prove an intent to deceive. *See* ***Echols v. Beauty Built Homes, Inc.***, 132 Ariz. 498, 647 P.2d 629 (1982) (showing of fraud requires (1) a representation; (2) its falsity; (3) its materiality; (4) the speaker's knowledge of its falsity or ignorance of its truth; (5) the speaker's intent that it be acted upon by the recipient in the manner reasonably contemplated; (6) the hearer's ignorance of its falsity; (7) the hearer's reliance on its truth; (8) the right to rely on it; (9) his consequent and proximate injury), In a construction defect context, the facts rarely support such a claim.

LIMITATIONS ON RECOVERY

Statute of Repose

A homeowner has up to eight years after a project has been substantially completed to file a construction defect claim. However, if the defect is discovered during the eighth year after completion, the claim may be made within the ninth year after the project has been substantially completed. *See* A.R.S. § 12-552. The filing of a class action lawsuit by the homeowners does not toll the statute of repose for unnamed putative class members. *See* ***Albano v. Shea Homes, L.P.***, 227 Ariz. 121, 254 P.3d 360 (2011).

A.R.S. § 12-552 has always posed problems for developers and general contractors sued in the ninth year (perhaps even on the last day of the ninth year). In ***Evans Withycombe v. W. Innovations, Inc.***, 212 Ariz. 462, 133 P.3d 1168 (Ct. App. 2006), the court of appeals held that the statute applies to contract-based claims but not common law indemnity claims and negligence claims, because the statute states that no action or arbitration "based in contract" may be instituted after the nine year limitation. The common law indemnity and negligence claims that are not subject to the statute of repose are often limited in their effectiveness as mechanisms for recovery. A negligence claim can only be brought in the construction context for personal injury or damages to an owner's property. It cannot be brought to recover damage to the structure itself. Similarly, a common law indemnity claim can only be successfully used if the person seeking indemnity (usually the general contractor) is free from any comparative fault. *See* ***Evans*** at 241, 159 P.3d 551 ("One seeking a common law right to indemnity must be proven free from negligence in order to make any claim to indemnity").

Contractual Limitation of Liability

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

The Economic Loss Doctrine

Economic loss refers to pecuniary or commercial damage, including any decreased value or repair costs for a product or property that is the subject of a contract between the plaintiff and defendant, as well as consequential damages such as lost profits. The economic loss doctrine states that recovery of purely economic loss falls within the area of contract law – not tort. ***Flagstaff Affordable Hous. Ltd. P'ship v. Design All., Inc***., 223 Ariz. 320, 323, 223 P.3d 664, 667 (2010). Applied to construction defect cases, this doctrine limits the use of tort claims such as negligence when the defect causes only damage to the building itself or other economic loss. *Id.* at 325, 223 P.3d 669. Such negligence claims are viable only if they involve injury to person or property. *Id.* ("[W]e use [economic loss doctrine] to refer to a common law rule limiting a contracting party to contractual remedies for the recovery of economic losses unaccompanied by physical injury to persons or other property..."). The court rejected the argument that the economic loss doctrine should apply only in cases in which a plaintiff also has contractual remedies against the same tortfeasor. Even where dismissal of a plaintiff's negligence claim would leave him with no other cause of action against a particular defendant, the economic loss doctrine bars a plaintiff from proceeding in tort for purely economic damages.

In ***Flagstaff Affordable***, the Supreme Court declined to extend tort recovery against an architect (under a theory of professional negligence) for purely economic loss in a construction defect case. The court clarified, however, that a plaintiff may recover in tort for purely economic loss if the contract so allows. The court reasoned that the economic loss doctrine applies in construction defect cases because construction contracts typically are negotiated on a project-specific basis and the parties should be encouraged to prospectively allocate risk and identify remedies within their agreements.

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

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

Failure to Mitigate Damages

The plaintiff in a construction defect case must exercise reasonable care to mitigate damages. ***Fairway Builders, Inc. v. Malouf Towers Rental Co***., 124 Ariz. 242, 255, 603 P.2d 513, 526 (Ct. App. 1979). The party alleged to be in breach bears the burden of proving that the mitigation was reasonably possible, but was not reasonably attempted. *Id.* at 256, 603 P.2d 527.

SCOPE OF RECOVERABLE DAMAGES

Direct Damages

Repair costs are the most significant item of damages in a construction defect case. In Arizona, the law of damages for injuries to real property normally focuses on the loss in market value. However, if property can be replaced or repaired, and the cost of repairs is reasonable, the proper measure of damage is the repair/replacement, not to exceed the loss in market value.
Scope of repair and the associated costs are the chief issues in construction litigation. The issues typically involve a "battle of the experts." Thus, hiring a competent, credible and convincing expert is crucial.

Recently, the California Court of Appeal held that there is no recoverable damage for code violations that pose no risk to health or safety and do not impair the structure.. Arizona, lacking many appellate rulings on construction defect issues, tends to follow California decisions.

Stigma

Plaintiffs will often claim that despite the fact repairs have been made, the obligation to disclose the repairs to future purchasers will result in a loss in market value. Courts allow claims for post-repair stigma only if supported by solid evidence–not mere conclusory claims of percentage losses. ***Farmers Ins. Co. of Arizona v. R.B.L. Inv. Co***., 138 Ariz. 562, 564, 675 P.2d 1381, 1383 (Ct. App. 1983) (citing ***Gary v. Allstate Ins. Co***., 250 So. 2d 168, 169 (La. Ct. App. 1971)). Thus, plaintiffs will likely be required to show other similarly-situated homes suffering a lower resale.

Loss of Use

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

Punitive Damages

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

Emotional Distress

Emotional distress damages are likely not going to be recoverable in a construction defect claim. *See, e.g.,* ***Erlich v. Menezes***, 21 Cal. 4th 543, 560, 981 P.2d 978, 988 (1999) (noting that "Such a rule would make the financial risks of construction agreements difficult to predict," increase the already prohibitively high cost of housing, affect the availability of insurance for builders, and greatly diminish the supply of affordable housing).

Attorney's Fees

Attorney's fees are recoverable for a breach of contract/express warranty claim, which includes a claim for breach of implied warranty of workmanship and habitability. An amendment to the pertinent statute affects who is considered the "prevailing party" entitled to fees. Previously, if plaintiff recovered anything, he was considered the prevailing party. Now, if a defendant makes a written settlement offer and does better at trial, defendant is considered the prevailing party. Note, however, that the defendant's settlement offer must be higher than the plaintiff's jury verdict plus attorneys' fees incurred at the time of the settlement offer. ***Hall v. Read Dev., Inc.,*** 229 Ariz. 277, 279, 274 P.3d 1211, 1214 (Ct. App. 2012). This is helpful to defendants and should be considered in cases involving breach of contract/express warranty claims.

Expert Fees and Costs

In Arizona, the court "may" award expert fees in a contested dwelling action. *See* A.R.S. § 12-1364. Additionally, A.R.S. § 12-341.01 allows for recovery of attorneys' fees to a successful party in any action arising out of a contract. The successful party is the party who wins a judgment, or who files an offer of judgment and does better than the offer at trial. The successful party may then recover expert fees as a sanction against the opposing party who refused to accept the formal offer.

THEORIES AVAILABLE TO DEVELOPERS

Express Indemnity

Express indemnity occurs when a written indemnity provision in a contract or agreement dictates the scope of the indemnity provided. Generally, express indemnity agreements are placed into two classes, general or specific. A general indemnity agreement does not specifically address the effect of the developer's own negligence on the subcontractor's obligation to indemnify the developer. A specific indemnity agreement does address the effect of the developer's negligence on the subcontractor's obligation to indemnify the developer. The distinction is important because under a general indemnity provision, a developer cannot obtain indemnity if they were actively negligent; they may only obtain indemnity if they were passively negligent. ***Grubb & Ellis Mgmt. Servs., Inc. v. 407417 B.C., L.L.C.***, 213 Ariz. 83, 86, 138 P.3d 1210, 1213 (Ct. App. 2006). A subcontractor could argue that a developer and/or general contractor who is negligent in any way is not entitled to indemnity under a general indemnity agreement. *See* ***Herstam v. Deloitte & Touche, LLP***, 186 Ariz. 110, 919 P.2d 1381 (Ct. App. 1996).

An indemnity agreement that attempts to require a subcontractor to indemnify the general contractor for the general contractor's sole negligence, even if the subcontractor had no negligence of its own, is invalid in Arizona by statute. A.R.S. § 34-226, A.R.S. § 32-1159. Previously, a general contractor could obtain indemnity from the subcontractor with contractual indemnity language so long as the claim did not arise out of the general contractor's sole negligence or willful misconduct. ***Amberwood Dev., Inc. v. Swann's Grading, Inc.***, 2017 WL 712269, at *3 (Ct. App. 2017). However, in 2019, the Arizona legislature expanded Section 32-1159 by enacting A.R.S. § 32-1159.01. This statute states that indemnity agreements that "purport[] to insure, to indemnify or to hold harmless the promisee from or against liability for loss or damages resulting from the negligence of the promisee" are void as against public policy. *Id.* In other words, pursuant to Section 32-1159.01, any construction contract clause requiring a contractor to defend another is limited to defending claims arising out of or related to that contractor's work.

See discussion of Indemnity issues below.

Comparative Indemnity

Typically, indemnity is an all-or-nothing proposition: either the indemnitee gets reimbursed all monies paid in defending the matter, or it gets nothing. Some have argued that this is a harsh result for indemnitees. Consequently, developers and subcontractors have argued for the adoption of a comparative indemnity scheme that ameliorates the harsh "all or nothing result" by applying comparative negligence concepts. While Arizona courts have yet to address the issue, many jurisdictions have adopted such a scheme. The Arizona Legislature has made efforts to address the issue as well, but has so far not passed any legislation to enact such change.

Third Party Beneficiary

In some circumstances, a developer is not the general contractor and does not enter into a contract with the subcontractors. Although some agreements between the general contractor and the subcontractors might provide indemnity rights on behalf of the developer, other agreements might not. Where no indemnity provision exists, the developer might argue it was a third party beneficiary of the contract between the general contractor and subcontractor, putting the developer in a position to seek indemnification. However, for a person to recover as a third-party beneficiary in Arizona, the contracting parties must intend to directly benefit that person and must indicate that intention in the contract itself. ***Sherman v. First Am. Title Ins. Co***., 201 Ariz. 564, 567, 38 P.3d 1229, 1232 (Ct. App. 2002). If there is no indication that the contracting parties intended to grant the developer indemnification rights, then a developer's right as a third party beneficiary will likely fail.

Breach of Implied Warranty

See discussion above on Breach of Implied Warranty of Workmanship/Habitability.

LITIGATION PROCESS

Prior to the Initiation of the Lawsuit

In 2002, Arizona enacted the Arizona Purchaser Dwelling Act, which contemplates specific notice and opportunity to repair construction defects in an effort to resolve construction defect complaints without congesting the courts with time consuming and costly litigation. In 2019, significant amendments were made to the PDA. A purchaser must comply with § 12-1361 *et seq.,* before filing a dwelling action. Exceptions are made for construction defects that involve an immediate threat to life or safety of persons occupying or visiting the dwelling. *See* A.R.S. § 12-1362(A).If a purchaser fails to comply with the statute, the dwelling action must be dismissed. If this occurs after the statute of limitations or statute of repose, then the dwelling action is time barred.

Requirement of Notice

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." A.R.S. § 12-1363(A). Reasonable detail includes a detailed and itemized list describing each alleged construction defect, the location of each alleged construction defect observed by the purchaser in each dwelling that is the subject of the notice, and the impairment to the dwelling that has occurred as a result of each of the alleged construction defects, or is reasonably likely to occur if the alleged construction defects are not repaired or replaced. A.R.S. § 12-1363(Q). The "seller" of the dwelling then "shall" forward the purchaser's notice to the last known address of each construction professional (i.e., subcontractors) whom the seller "reasonably believes" is responsible for the defects alleged in the purchaser's notice. A.R.S. § 12-1363(A).

Right to Inspect

Once the purchaser has given the required notice, the seller and/or builder, as well as the subcontractors whom the seller "reasonably believes" are implicated by the defect allegations, may inspect the dwelling to determine the nature and cause of the alleged defect and the nature and extent of any repairs that might be necessary to remedy the alleged defect. A.R.S. §§ 12-1362(B), 12-1363. If the seller or builder wishes to inspect the alleged defect, the purchaser must ensure that the dwelling is made available for inspection no later than ten days after the purchaser receives the seller's request for inspection. The seller may then use any "reasonable measures" to inspect the dwelling, including testing to determine the nature and cause of the alleged defect. However, if any testing does occur and it alters the condition of the property, the seller must restore that property back to its condition before the testing occurred. *See* A.R.S. § 12-1363(B).

Response by Seller/Builder

Within 60 days after receipt of the notice of defect, the seller must send to the purchaser a good faith, written response by certified mail, return receipt requested. The response may include a notice of intent by the seller to repair or replace any alleged defects, including a reasonable

description of all repairs, replacements, or compensation that the seller is offering to make and an estimate of the date that the remedy will be provided. *See* A.R.S. § 12-1363(C).

Failure of Seller/Builder to Respond to Notice

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

Seller's Right to Repair

One of the primary changes in the 2019 amendments to the PDA expands the seller's right to repair. Prior to 2019, the seller was the only party allowed an opportunity to perform repairs at the dwelling. Section 12-1363(C) expands the right to offer and make repairs to the other construction professionals whom the seller "reasonably believes" are responsible for the alleged defects.

The process for offering and making repairs is set forth in Section 12-1363(E). Specifically, if the seller provides a notice of intent to repair or replace the alleged construction defects, the purchaser must allow the seller a reasonable opportunity to repair or replace the construction defects or cause the construction defects to be repaired or replaced pursuant to the following:

1. The purchaser and seller must coordinate repairs or replacements within 30 days after the seller's notice of intent to repair or replace was sent. If requested by purchaser, repair or replacement of alleged construction defects must be performed by a construction professional selected by the seller and consented to by purchaser.

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 seller's notice of intent to repair or replace was sent.

3. All repairs or replacements must be completed using reasonable care under circumstances and within a commercially reasonable time frame considering the nature of the repair or replacement.

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

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

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

Evidentiary Issues

Before 2015, A.R.S. § 12-1361 *et seq*. attempted to promote cooperation between the seller and purchasers by labeling certain information as admissible or not admissible in a subsequent action. Now, 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 dwelling action process may face adverse evidentiary consequences at trial.

Revised Litigation and Trial Process

The 2019 amendments to the PDA set forth a new process for litigating and trying dwelling actions. The "construction professionals" now "shall be joined as third-party defendants." A.R.S. § 12-1362(D). Additionally, a dwelling action trial proceeds in a bifurcated process, in which the trier of fact "shall first determine if a construction defect exists and the amount of damages caused by the defect," and "identify each seller or construction professional whose conduct, whether by act or omission, may have caused, in whole or in part, any construction defect." *Id.* Second, the trier of fact shall then "determine the relative degree of fault by any defendant or third-party defendant," and "allocate the pro rata share of liability based on relative degree of fault." *Id.* Notably, the seller has the burden of proving the pro rata share of liability for the third-party subcontractor defendants. *Id.*

Attorney's Fees, Costs and Expert Witness Fees

The 2019 amendments to the PDA re-inserted a statute allowing for the recovery of attorneys' fees in a construction defect action involving a dwelling. *See* A.R.S. § 12-1364(A). The court now "may" award "reasonable" attorneys' fees to the prevailing party as to each contested issue in the action. To determine the appropriate attorneys' fees award, the court is instructed to consider a number of factors, including whether the seller made repair offers before the purchaser filed the action, the purchaser's response to the repair offers, and the relation between the fees incurred and the value of relief obtained as to each contested issue. *See* A.R.S. § 12-1364(B).

INSURANCE COVERAGE ISSUES

Insurers often face the question of whether their policies cover claims for construction defects. This question has two components: (1) the duty to defend and (2) the duty to indemnify. The threshold question is whether the insurer has a duty to defend. The duty to defend is broader than the duty to indemnify. Insurers have a duty to defend if there is any "potential" that any claim asserted against the insured is covered by the policy. ***United Servs. Auto. Ass'n v. Morris***, 154 Ariz. 113, 117, 741 P.2d 246, 250 (1987). Insurers must defend claims that are "potentially not covered and those that are groundless, false and fraudulent." *Id*. If there is potential coverage for even one of the claims and not others, an insurer must provide a complete defense. ***Transamerica Ins. Grp. v. Meere***, 143 Ariz. 351, 360, 694 P.2d 181, 190 (1984). The analysis begins with the allegations of the complaint, but insurers must consider additional available information

in assessing the duty to defend. Generally, if the complaint alleges that plaintiff sustained some sort of "property damage," then the obligation to defend is triggered unless there are exclusions that apply.

In ***Lennar Corp. v. Auto Owners Ins. Co.,*** 214 Ariz. 255, 151 P.3d 538 (2007), the court defined an "occurrence" under an insurance policy stemming from property damage caused from faulty workmanship. It also defined an insurer's duty to defend claims of property damage occurring during the policy (even if a similar property manifested damage prior to the policy). And it defined an insurer's obligation to investigate occurrences and rebut coverage when an insured makes a factual showing that a claim is covered. Multiple insurers claimed that neither faulty workmanship nor the natural consequences thereof constituted an "occurrence." The insurers argued that the definition of an "occurrence" is limited to an accident, not a subcontractor's intentional performance of faulty work. The court rejected this argument, holding that while faulty work alone does not constitute an occurrence, property damage resulting from faulty work may constitute an occurrence giving rise to coverage.

CGL POLICIES

Commercial General Liability (CGL) policies were never intended to cover the costs of fixing an insured/contractor's faulty construction. The purpose of CGL policies is not to act as a performance bond, but rather to cover damages caused by fortuitous events. As discussed below, faulty workmanship is not deemed a "fortuitous event." Prior to the construction defect litigation boom, faulty construction was usually handled in an informal manner between the contractor and the owner, with the contractor fixing its own defective work at its own expense to avoid litigation.

To trigger coverage under a CGL policy, the complaint must seek to recover for "property damage" caused by an "occurrence." In ***U.S. Fidelity & Guar. Corp. v. Advance Roofing & Supply Co.***, 163 Ariz. 476, 788 P.2d 1227 (Ct. App. 1989), Homeowners Association hired Advance to install 250 new roofs on its buildings for $253,000. Advance installed only 40 new roofs, and those roofs leaked and were defective. When sued for breach of contract and unjust enrichment, Advance asked its insurer to defend, but the insurer declined coverage asserting there was no "property damage" or "occurrence." The court of appeals agreed with USF&G and held that the complaint did not state a claim for "property damage," nor was the claim for faulty workmanship an "occurrence" because it was not an "accident."

To get around this ruling, plaintiffs' complaints now allege negligence claims and seek "property damage," to ensure that insurance coverage is triggered. Property damage is defined under most policies as physical injury to tangible property or loss of use of tangible property. Therefore, complaints now allege damages for costs to repair, as well as damages caused by the faulty workmanship, e.g. rain water leaked through defective roof damaging hardwood floor (property damage). Claims for faulty workmanship alone do not trigger insurance coverage, so there must also be consequential damages resulting from the faulty workmanship for coverage to be triggered. This position was reaffirmed in ***Lennar Corp. v. Auto Owners Ins. Co.***, 215 Ariz. 255, 151 P.3d 538 (2007).

In ***Desert Mountain Props. Ltd. P'ship v. Liberty Mut. Fire Ins. Co.***, 225 Ariz. 194, 236 P.3d 421 (Ct. App. 2010), the court of appeals clarified that for coverage to exist, the relevant inquiry is whether an "occurrence" has caused "property damage" – not whether the ultimate claim lies in contract or tort.

Faulty Workmanship

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

A different outcome might occur if the insured is a contractor who retained subcontractors, and the subcontractors caused the faulty workmanship. Enter the "Products-Completed Operation Hazard" provision. "Products-Completed Operation Hazard" is defined as all property damage occurring away from premises the contractor owns or rent which arise out of work performed by the contractor or on the contractor's behalf. ***Double AA Builders, Ltd. v. Preferred Contractors Ins. Co., LLC***, 241 Ariz. 304, 306, 386 P.3d 1277, 1279 (Ct. App. 2016). A majority of courts has held that if all of the elements of the "Products-Completed Operation Hazard" provision are met (i.e. the damages arose after the operations were completed), coverage can exist for the subcontractor's faulty workmanship performed on behalf of the insured/contractor. The apparent purpose of such a provision is to provide coverage for fortuitous latent defects caused by someone other than the insured.

Insurance coverage for faulty workmanship claims can be very complex and hinge upon the specific damages alleged and incurred, and also the specific language of the insurance policy. An insurer must analyze the claims against the insured separately from the claims against the insured's subcontractors to ensure that it does not inappropriately deny coverage or reserve its rights on damages that should be covered.

SURETY ISSUES

What is a Surety Bond?

When someone acts as a surety, he or she essentially promises to pay for the performance of a contract or the debt of another party if that party does not perform his or her contract, or does not pay a debt secured by the surety bond. There are many types of surety bonds in use today. Contract surety bonds are bonds issued by a surety for a principal, guaranteeing performance of some obligation in connection with a construction project. The bond can be issued for a general contractor, a subcontractor or a sub-subcontractor. If the principal on the bond is the general contractor, the obligee (i.e., the person to whom the guarantee runs), is the owner of the project. If the principal on a surety bond is a subcontractor, then the obligee is the general contractor, and if the principal is a sub-subcontractor, the obligee is the subcontractor with whom the sub-sub has a contract.

Essentially, there are three types of contract bonds: bid bonds, performance bonds and payment bonds. Each of these bonds has conditions, and each has "penal sum" (i.e., the limit of the liability of the surety is limited to the amount specified in the bond). Liability of the surety on each of these bonds is limited by the penal sum of the bond.

RISKS AND OBLIGATIONS

Bid Bond

A bid bond is intended to keep frivolous bidders out of the bidding process by securing that the successful bidder will enter into the contract and provide the required performance and payment bonds. If the lowest bidder fails to honor these commitments, the owner is protected, up to the amount of the bid bond. The bid bond may be a forfeiture bond where the surety is liable to the owner for a fixed amount, regardless of the damages to the owner, or, more commonly, the surety is liable under the bid bond for the lower of the bid bond penalty or the difference between the contractor's low bid and the contract price the owner must pay to the firm awarded the contract.

Performance Bond

A performance bond is issued after the contractor is awarded the contract. Technically, the performance bond is a joint and several promise by the surety and the bond principal to the obligee that the principal will fully and faithfully perform all its obligations in the contract. Essentially, this bond guarantees that if the contractor does not perform the contract in accordance with the plans and specifications and the terms of the contract, the owner will have a cause of action against the surety to secure completion of the project.

Often, the bond itself lists the surety's options upon the contractor's default. Under the Performance Bond published by the American Institute of Architects, if a surety exercises any of the listed options, the liability of the surety is limited to the penal sum of the bond. Other, more simplified versions of performance bonds might not include specific options for the surety. However, the traditional options of a surety are incorporated into the bond by a matter of custom. These options are as follows:

> **Finance the contractor.** Under this option, the surety provides the defaulting contractor with sufficient funds to complete the job and pay its bills.
>
> **Undertake completion.** Under this option, the surety contracts with either the original contractor or a new contractor to complete the project, regardless of expense. The surety simultaneously enters into a takeover agreement with the owner, under the terms of which the surety agrees to hire a contractor and complete the project in accordance with the terms of the contract documents.
>
> **Tender a new contractor to the owner.** Under this option, the surety puts the completion contract out for bid and then tenders the lowest responsible bid to the owner. The owner, rather than the surety, enters into the completion contract with the contractor.

Choose the "negotiation/litigation" option. Although not strictly an option, the surety frequently decides that it (a) has no liability to the bond obligee, or (b) has insufficient information to honor or deny the claim and therefore leaves the completion of the project in the hands of the owner. The surety then either negotiates a settlement with the owner covering the cost of completion and losses the owner has sustained by reason of the contractor's breach, or the parties go to court.

Payment Bond

A payment bond protects laborers, material suppliers and subcontractors against non-payment for services provided at a construction project. Recovery under a payment bond, however, is subject to restrictions and limitations imposed by statute, contract and/or the bond itself. *See, e.g.*, ***American Cas. Co. of Reading, PA v. D.L. Withers Constr.***, 204 Ariz. 382, 64 P.3d 210 (Ct. App. 2003) (holding that the general contractor was not a proper "claimant" on the bond when attempting to recover monies paid out to a substitute contractor to finish work for a breaching subcontractor who had originally obtained the bond). Since mechanic's liens cannot be placed against public property, the payment bond might be the only protection these claimants have if they are not paid for the goods and services they provide to the project.

CONSTRUCTION LOAN AGREEMENT ISSUES

In ***Great Western Bank v. LJC Development*, LLC**, 238 Ariz. 470, 362 P.3d 1037 (Ct. App. 2015), the court of appeals held that a construction financing agreement that expressly obligates the lender to make loans is a binding commitment. Great Western Bank terminated its financing agreement with the developer before its agreed-upon expiration. As the developer was unable to obtain alternate financing, it defaulted on its loan. Great Western foreclosed and sued the developer's guarantors for the balance. The guarantors filed a counterclaim, seeking affirmative relief for the lost profits resulting from Great Western's early termination. Great Western argued that the financing agreement was not binding and was only guidance for financing, at Great Western's discretion. The court of appeals disagreed, and held, based on long-established contract principles, that the agreement was binding regardless of the fact that loan requests were subject to case-by-case approval.

INDEMNITY ISSUES

Common Law Indemnity

Common law indemnity and implied contractual indemnity are equitable theories of recovery often sought by general contractors against subcontractors. This theory of recovery is available only in the absence of a written indemnity agreement. Generally speaking, any equitable theory of indemnity shares the same basis – one party's obligation to make good a loss or damage another party has incurred.

Arizona expressly recognizes the principles of common law indemnity expressed by the RESTATEMENT (FIRST) OF RESTITUTION § 76 and § 78 (now encompassed in the RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT, §§ 22 and 23). The general rule is that a person who, in whole

or in part, has discharged a duty he owes, but which as between himself and another should have been discharged by the other, is entitled to indemnity from the other, unless the payor is barred by the wrongful nature of his conduct. In Arizona, this means the plaintiff in a common law indemnity action generally must show: (1) it "discharged a legal obligation owed to a third party"; (2) for which the "indemnity defendant was also liable"; and (3) as between the two, "the obligation should have been discharged by the [indemnity] defendant." ***KnightBrook Ins. Co. v. Payless Car Rental Sys. Inc***., 243 Ariz. 422, 424, 409 P.3d 293, 295 (2018).

Common law indemnity is an all-or-nothing proposition. This means that if the party seeking indemnity is at fault for the damages, it is not entitled to common law indemnity at all. *See* ***Evans Withycombe, Inc. v. W. Innovations, Inc***., 215 Ariz. 237, 241, 159 P.3d 547, 551 (Ct. App. 2006) ("One seeking [a common law right to] indemnity 'must be proven free from negligence' " in order to make any claim to indemnity."). However, the nature of the fault must be more than just technical fault; in order to avoid liability under a common law indemnity theory it must be shown that the party seeking indemnity was a proximate cause of the underlying damages. *See* ***Transcon Lines v. Barnes***, 17 Ariz. App. 428, 435, 498 P.2d 502, 509 (1972) (holding that indemnity plaintiff was more than just technically liable and therefore not entitled to indemnity).

TRANSFERRING THE RISK THROUGH AN INDEMNIFICATION CLAUSE

Due to the variety of risks encountered on a construction project, most construction contracts contain various risk transfer clauses that typically pass the risk to the contractor in the best position to guard against it. The most common way to transfer risk is through an indemnity clause. An indemnity clause is an agreement whereby the subcontractor (indemnitor) agrees to indemnify and defend the general contractor (indemnitee) for any loss arising out of the subcontractor's work. In analyzing an indemnity agreement and its effect, close attention must be paid as to whether the agreement purports to require indemnification for the general contractor's own negligence. When an indemnity provision is contained within a contract, it is called an express indemnity provision. When an express indemnity provision is present, it precludes any argument that common law indemnity (or implied indemnity) applies. ***Grubb & Ellis Mgmt. Servs. v. 407417 B.C. LLC***, 213 Ariz. 83, 89, 138 P.3d 1210, 1217 (Ct. App. 2006).

In addition, if the terms of the indemnity provision are clear and unambiguous, courts will generally deem them to be conclusive. ***Amberwood Dev., Inc. v. Swann's Grading, Inc***., 2017 WL 712269, at *2 (Ariz. Ct. App. 2017). This could apply regardless of whether the loss occurred by reason of the indemnitee's negligence, or for any reason other than the sole negligence or willful misconduct of the indemnitee. *Id.* For example, should the indemnity provision require the subcontractor to indemnify a general contractor for claims simply "arising out of or in connection with" the subcontractor's work, courts will likely find that the subcontractor must do so, even if the general contractor was also negligent. *Id.* Courts are unlikely to impose requirements not explicitly included in the indemnity provision. *Id.* at *3.

SPECIFIC INDEMNITY AGREEMENTS

An indemnity agreement might attempt to require the subcontractor to indemnify the general contractor for the general contractor's sole negligence, even if the subcontractor had no

negligence of its own. These types of indemnity agreements are invalid in Arizona by statute and thus no longer effective in transferring the risk from the general contractor to the subcontractor. *See* A.R.S. § 34-226 and § 32-1159. A.R.S. § 32-1159 was further amended to invalidate indemnity agreements that require the subcontractor to indemnify the general contractor for the sole negligence of the general contractor's agents, employees, or indemnitees.

Importantly, however, Arizona has determined that an insurance agreement requiring the subcontractor to purchase insurance covering the general contractor for its sole negligence does not offend the anti-indemnity statute. *See* ***United States Fid. & Guar. Co. v. Farrar's Plumbing & Heating Co.***, 158 Ariz. 354, 762 P.2d 641 (Ct. App. 1988).

Although our courts will not allow a contractor to seek indemnity for its sole negligence, they will uphold an indemnity agreement whereby the subcontractor agrees to indemnify the general contractor for a loss caused by the general contractor's contributory negligence. *See* ***Cunningham v. Goettl Air Conditioning, Inc.***, 194 Ariz. 236, 980 P.2d 236 (1999). An example of this type of provision is as follows:

> Subcontractor agrees to hold harmless and indemnify General Contractor against all liability, costs, expenses, claims and damages General Contractor may at any time suffer or sustain or become liable for by reason of any accidents, damages or injuries to defenses or property or both, in any manner arising from the work performed under this subcontract, **regardless of whether such liability, costs, expenses, claims and damages are caused in part by any negligent act or omission of General Contractor,** its officer, agents, or employees.

These are "specific" indemnity agreements. In ***Washington Elementary Sch. Dist. v. Baglino Corp.***, 169 Ariz. 58, 817 P.2d 3 (1991), the court examined a written indemnity agreement specifically stating that the obligation to indemnify applied "regardless of whether or not [the injury] is caused in part by a party indemnified hereunder." There, Baglino's negligence caused falling debris which injured a person on the job site. The school district was also partially negligent for inadequate supervision. The school district tendered its defense to Baglino and Baglino refused. Focusing on the words "caused in part" in the indemnity provision, the court held that the provision "clearly and unequivocally" indicated the parties' intent for indemnity to apply notwithstanding the indemnitee's active (contributory) negligence.

Given the foregoing, a general contractor need not provide clear and unambiguous terms in an indemnity provision to cover its own active or contributory negligence. *Id.* at 61, 817 P.2d 6. If the indemnity provision includes language sufficiently broad enough to encompass a general contractor's negligence, it likely will require the subcontractor to indemnify the general contractor regardless of the general contractor's actual or contributory negligence. *Id.* at 61-2, 817 P.2d 6-7. ("By using such broad language ["regardless of whether the injury is caused in part by a party indemnified"], it appears that the parties contemplated coverage for any type of damage caused by the negligent behavior of the indemnitor, even though also caused in part by the active negligence of the party indemnified."). However, this does not impact the requirement that the indemnity provision must clearly and unequivocally indicate that one party is to be indemnified.

General Indemnity Agreements

When language in an indemnity agreement does not specifically address the effect the indemnitee's negligence will have upon the indemnitor's duty to indemnify, the agreement is usually considered a "general" indemnity agreement. ***Estes Co. v. Aztec Constr., Inc.***, 139 Ariz. 166, 168, 677 P.2d 939, 942 (Ct. App. 1983). Under a general indemnity provision, if the general contractor seeking indemnity was actively (or contributorily) negligent, then it is not entitled to recover from the subcontractor. However, if the indemnitee was merely passively negligent (the classic example is where one party has only vicarious liability for the negligence of another) then the general indemnity clause is still valid. A subcontractor could argue that a developer and/or general contractor is not entitled to indemnity at all under a general indemnity agreement if it is found to be negligent at all. ***Herstam v. Deloitte & Touche, LLP***, 186 Ariz. 110, 118, 919 P.2d 1381, 1389 (Ct. App. 1996).

Regardless of the type of indemnity provision, an indemnity agreement is often insufficient to guarantee an effective risk transfer because the subcontractor might not have the financial resources to satisfy its indemnity obligation. As a result, most general contractors require their subcontractors to purchase insurance coverage to cover the risks transferred by the indemnity agreement. As added protection for the general contractor, the construction contract might require the subcontractor to name the general contractor as an Additional Insured under the its Commercial Liability Policy (CGL).

SUBCONTRACTORS BOUND BY PROVISIONS INCORPORATED INTO CONTRACT EVEN IF NOT RECEIVED

Subcontractors have additional responsibilities when executing their subcontract agreements. In ***Weatherguard Roofing Inc. v. D.R. Ward Constr.***, 214 Ariz. 344, 152 P.3d 1227 (Ct. App. 2007), the court held that a contract between a subcontractor and general contractor that "incorporated the attached general conditions" were a binding part of the prime contract even though the general conditions were not provided to the subcontractor. The general conditions contained an arbitration provision which the subcontractor did not receive and of which it was not aware. The court held that even though the general conditions were not attached, the subcontractor could have and should have made an effort to obtain them.

Transferring Risk Through an Additional Insured Endorsement

As mentioned above, an indemnity agreement can effectively protect a contractor from the many forms of liability it might encounter on a construction project. But the extent of this protection is limited to the subcontractor's financial resources. Thus, to guarantee protection, many construction contracts require the subcontractor to name the general contractor as an Additional Insured under its Commercial Liability Policy (CGL). Most subcontractors fulfill this contractual obligation by purchasing a broad form additional insured endorsement. A typical endorsement reads as follows:

> "Who is an insured" is amended to include as an insured the person or organization shown in the Schedule as an insured, but only with respect to liability arising out of your work (or your operations) for that insured by or for you or premises owned by or rented to you.

The subcontractor can also have the general contractor named as an additional **named** insured. Generally, this affords coverage to the general contractor on par with the coverage afforded to the named insured/subcontractor. An additional insured is entitled to a defense even absent a showing of actual causation. ***Regal Homes, Inc. v. CNA Ins. Co.***, 217 Ariz. 159, 163, 171 P.3d 610, 615 (Ct. App. 2007). All that is needed is a connection between the work performed and the alleged harm.

When a general contractor is included as an additional insured (rather than an additional **named** insured) through an additional insured endorsement, the issue often arises as to what extent the policy provides coverage for the general contractor's sole or direct liability. In ***Double AA Builders, Ltd. v. Preferred Contractors Ins. Co., LLC***, 241 Ariz. 304, 386 P.3d 1277 (Ct. App. 2016), the court of appeals held that the additional insured's coverage was limited under the policy and its definitions. "[A]n Additional Insured receives coverage for conduct of the Named Insured and certain of those acting on the Named Insured's behalf, and the Additional Insured is itself treated like a Named Insured, with coverage for its own conduct, only if such conduct relates to the Additional Insured's performance of ongoing operations for the original Named Insured." *Id.* at 307, 386 P.3d 1280. The additional insured's coverage is also limited in that it is co-extensive with that of the named insured; it cannot be greater. *Id.*

Other jurisdictions have also based their decisions on the language of the additional insured endorsement. For example, where the language is ambiguous, some courts have found that coverage for the additional insured was not limited to additional insured's vicarious liability. *See, e.g.*, ***Dayton Beach Park No. 1 Corp. v. Nat'l Union Fire Ins. Co***., 175 A.D.2d 854, 573 N.Y.S.2d 700 (1991). In *Dayton Beach*, the policy provided that an additional insured would be covered "only with respect to liability arising out of operations performed for [additional insured] by or on behalf of named insured." The court held that coverage to the additional insured was not limited to the additional insured's vicarious liability for named insured's negligence.

In ***Consolidation Coal Co. v. Liberty Mut. Ins. Co.***, 406 F. Supp. 1292 (W.D. Pa. 1976), an additional insured was named, "but only with respect to acts or omissions of the named insured in connection with the named insured's operation." The named insured's employee was injured and alleged that the additional insured was solely negligent. The court found that the additional insured was not covered under the named insured's policy, because the most appropriate construction of the policy was that the additional insured was insured under the policy only when the negligent acts of the named insured caused the loss. To interpret the endorsement in a way that found coverage for the additional insured's direct liability, said the court, would transform the "but only" language into "arising out of."

Arizona courts have so far looked to the policy language to determine the extent of coverage for additional insureds. Insurance carriers will often take the position that the additional insured has no right to expect coverage for its own negligence, especially if the accident arose out of activities unrelated to the named insured's performance. In future cases, Arizona courts will likely continue to enforce the parties' intentions, but such intentions are not always clear. Thus, the best way to avoid this problem is to ensure there is a clear written understanding among the contracting parties, as well as the carrier, as to what liabilities are intended to be covered under the additional insured language.

ENFORCEABILITY OF ARBITRATION PROVISIONS

In ***Harrington, et al., vs. Pulte Home Corp.***, 211 Ariz. 241, 119 P.3d 1044 (Ct. App. 2005), the court of appeals upheld the enforceability of arbitration clauses between plaintiff homeowners and defendant developers/vendors. The court initially focused on the homeowner's "reasonable expectations" and looked at seven critical factors. Those factors were:

1. Prior negotiations between the parties;
2. What can be inferred from the circumstances;
3. Are the terms bizarre or oppressive;
4. Does a term eviscerate the non-standard terms explicitly agreed upon;
5. Does the term eliminate the dominant purpose of the transaction;
6. Whether the provision can be understood; and
7. Whether there are any other factors relevant to what the parties reasonably expected.

The contract terms in this case were in large, easy to read font and not hidden or obscured. Nor were the specific terms bizarre or oppressive; they were in fact congruent with the public policy favoring alternative dispute resolution. The court determined that there was no reasonable belief that the homeowners would not have entered into the contract had they known the clause was present. As such the homeowners were bound by the arbitration clause and had waived their right to a jury trial.

If you have questions regarding the information in this chapter, please contact the author or any JSH attorney.

CONTRIBUTING AUTHOR:

R. CHRISTOPHER PIERCE, PARTNER Serving as co-chair of the firm's Construction Trial Group, Chris Pierce focuses his practice in the areas of construction defect litigation and general civil liability defense including products liability, premises liability and personal injury litigation. He is committed to providing clients with prompt and thorough case evaluations, delivering effective litigation defense strategies, and posturing cases for early resolution opportunities. rpierce@jshfirm.com | 602.263.1707 | jshfirm.com/rpierce