CONSTRUCTION DEFECT LITIGATION IN ARIZONA CONTINUES TO DEVELOP AND EVOLVE

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After little in the way of case law regarding construction defect litigation in Arizona in the first part of the new millennium, the last few years have seen a number of significant developments involving issues that range from privity of contract requirements to recovery of attorneys' fees. This article reviews some of the recent Arizona court of appeals decisions in this area.

Allegations of damages from faulty construction trigger a carrier's duty to defend a developer and ongoing damages during the policy period trigger the obligation to defend.

In *Lennar Corp. v. Auto-Owners Ins. Co.*, the Court of Appeals held that allegations of damages resulting from faulty construction are sufficient to provide an "occurrence" under a Commercial General Liability (hereinafter "CGL") policy to trigger a duty to defend a developer. The court decision affirmed that ongoing damages trigger the obligation to defend from the onset since the damages could have occurred during the policy periods.[1]

The court made three significant findings. One, while faulty construction does not constitute an occurrence, damage to the property *resulting from* faulty work constitutes an occurrence if plaintiffs allege damages resulting at least in part from faulty construction.[2] Two, the policy language covers the natural consequences of negligent construction.[3] The court affirmed that there can be no presumption in Arizona insurance law that a person intends the ordinary consequences of his actions, thus, "[e]ven if workers do what they intend to do when performing specific acts of construction, that does not establish, should the work turn out to be faulty, that the subcontractor intended to provide faulty work."[4]

Furthermore, even if it could be established that the subcontractors intended to engage in faulty work, this would not be extended to establish that the developer intended the trades to do so.[5] Three, property damage resulting from negligent construction can be "accidental" and therefore is covered.[6]

The court further found that if no additional insured endorsement is found, but the contract language provides that there is a duty to name the developer as an additional insured, there may be a duty to defend depending on the contract language. However, the contract language must specifically include language clearly calling out for the subcontractor to name the developer as an additional named insured to its CGL policies.[7]

Impact:
The Court clarified that a covered "occurrence" under a CGL policy is found when plaintiffs' allegations include a statement that actual damages occurred from faulty construction; a subcontractor's faulty work is not imputed to the builder. Therefore, CGL carriers owe a duty to defend for ongoing losses where any damage allegedly occurs during the policy period regardless of whether similar damage from the same defect may have preceded that damage. Finally, the court affirmed that a blanket additional insured endorsement ("AIE") will obligate additional insured coverage if the contract language provides that the subcontractor was required to name the builder as an additional insured.

Therefore, builders should ensure that contracts with subcontractors require that the subcontractor name the builder as an additional insured, so as to provide coverage under any blanket additional insured endorsements issued by the subcontractor's carrier.

There is no privity requirement for lawsuits against non-vendor homebuilders.

In *The Lofts at Fillmore Condominium Association v. Reliance Commercial Construction, Inc.*, the court held that the exception to the privity requirement for a homeowner's claim based on implied warranty of habitability and workmanship which applied to homebuilder-vendors in *Richards v. Powercraft Homes, Inc.*, 139 Ariz. 242, 678 P.2d 427 (1984), extends to non-vendor homebuilders.[8]

Non-vendor homebuilders are builders which are not the owners of the property being developed, and therefore not the seller of the homes to homebuyers. While there are situations where the owner/developer may be insolvent and the builder may have to satisfy the entire monetary judgment, the court observed that "the costs of remedying defective construction most appropriately fall on the builder, rather than on innocent end users."[9]

Impact:
The impact of this case is broad, as it affects all construction defect cases involving claims of implied warranty of workmanship and habitability in which there was no contractual relationship between the purchaser and the contractor: where the contractor was not also the seller to the homebuyer. Now, as a result of this case, purchasers may pursue such claims against non-vendor homebuilders even though such claims have no basis in contract.

Overall, this decision clears up some of the ambiguity left in the wake of the *Richards v. Powercraft* and *Donnelly v. Oberg* decisions as to what further exceptions the court could make for implied warranty claims in absence of privity among the parties.[10]

A narrow form indemnity clause is limited by the language used and under such a clause, proof of fault is required to trigger a duty to defend.

The Arizona Court of Appeals in *MT Builders, L.L.C. v. Fisher Roofing, Inc.* held

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that "narrow form" indemnity clauses limit a party's indemnity obligations "to the extent" of fault caused by the indemnitor.[11] The court further held that a settling indemnitee seeking indemnification must demonstrate that the settlement was reasonable and prudent.[12] The court also held that unless the term "defend" is used, there is no duty to defend under a "narrow form" indemnity clause until there is a determination of fault of the indemnitor.[13]

Impact:
Contractors, owners, and developers negotiating contracts should be cognizant that narrow form indemnity clauses will require a trial to determine fault as a prerequisite to obtaining indemnity from the indemnifying party. Also, clear language as to the duty to defend should be included in contracts; specifically, the defense obligation must be clearly spelled out. This case demonstrates the importance of including the term "defend" in indemnity clauses, so as to trigger the duty to defend before any determination of fault is made. Furthermore, before finalizing settlement with a claimant, contractors, owners, and/or developers who intend to seek indemnity under an indemnity clause with "to the extent" language should consider and document, during the settlement process, the various factors under *MT Builders* relating to the reasonableness of a settlement. Of note, it is not clear whether the *MT Builders* analysis will extend to breach of contract claims, as it relates to an indemnity clause for negligence based claims only.

Vendors that have cases dismissed against them for failure of homeowners to follow the "notice and opportunity to repair" procedures under the Purchaser Dwelling Act are not successful parties within the meaning of A.R.S. § 12-1364.

In *McMurray v. Dream Catcher USA, Inc.* the Arizona Court of Appeals held that a vendor who gets a case filed against it under the Purchaser Dwelling Act, Arizona Revised Statutes §§ 12-1361, et seq. (hereinafter "A.R.S."), dismissed for homeowners' failure to comply with the notice and right to repair requirements under the Act is not entitled to an award of attorneys' fees under the A.R.S. § 12-1364 as a successful party.[14]

The court reasoned that because the statute defines "successful party" in terms of the difference between an offer of judgment and the final judgment obtained, that without a final determination on the merits, there could be no successful party under the statute.[15]

Impact:
Even though a homeowner does not follow the notice procedures in the Purchaser Dwelling Act and has its case dismissed for this failure, the vendor may not recoup attorneys' fees expended in defending the lawsuit under A.R.S. § 12-1364. However, it is possible that the vendor could get an award of attorney's fees under A.R.S. § 12-341.01, an issue not raised on appeal here.

An insurer defending a subcontractor insured under a reservation of rights may intervene in order to assert a subrogation claim against a general contractor for amounts it spent in defending the subcontractor when the subcontractor settled with the general contractor, releasing all claims for payment of defense fees, without providing notice to the insurer.

In *Monterey Homes Arizona, Inc. v. Federated Mutual Insurance Company*, a subcontractor's insurer moved to intervene in a construction defect lawsuit in which it was defending a subcontractor under a reservation of rights when the subcontractor, without providing notice to its insurer, settled by releasing all claims against the contractor.[16]

The court ruled that the insurer was bound by the settlement only to the extent that it had appropriate notice and the settlement was reasonable and prudent under the circumstances.[17]

Impact:
Before settling claims, contractors should provide notice to their insurers defending under a reservation of rights, thereby providing the insurer an opportunity to assume liability under the policy and remove its reservation of rights. At that point, the cooperation clause's prohibition against settling a lawsuit without an insurer's consent will apply.

DEFEAT OF PROPOSITION 201

Proposition 201, which was placed on Arizona's 2008 ballot, proposed various changes to Arizona's Purchaser Dwelling Act, A.R.S. §§ 12-1361, et seq., and A.R.S. § 12-552 regarding the statute of limitations and repose for personal actions involving property development. The proposed changes included adding a 10 year warranty on a new home's materials and workmanship; extending the statute of limitations from 8 to 10 years; allowing prospective buyers to sue; giving homeowners the right to choose among three contractors with complaint-free records to fix any repairs; and rewriting the rules on award of attorneys' fees (in other words homeowners could sue builders with no repercussions).

The Arizona Home Builders Association and other entities opposed the changes to Arizona law proposed by Proposition 201 because they would prohibit parties from agreeing to resolve disputes without going to court and hiring attorneys; forbid the defendants from recovering any attorney's fees even if the case was frivolous or if they won; allow prospective buyers to file lawsuits (they would not even have to own homes to file suit); and assure that all disputes, large or small, go to court, thereby raising costs. Ultimately the proposition was defeated, with 78% of voters voting against it.

CONCLUSION

As one can see, the law on construction defect litigation is constantly developing. With the economic downturn, it is likely that we will see an increase in construction defect litigation in Arizona. As a result of such an increase, construction defect litigation case law will continue to develop and it will be increasingly important to stay abreast of the newest court rulings. Parties involved in homebuilding should take caution in the drafting of contracts so as to provide the most protection afforded by law and to better effectuate the intentions of the parties. In addition, it will be important for contractors, subcontractors, owners, and developers to hold on to lot files, subcontracts and other documents, as they may be needed to defend a lawsuit at a later date. Finally, care should be taken when entering into settlement agreements to make sure that parties involved are provided notice and that there is documentation to prove that the settlement agreement was reasonable and prudent under the circumstances.

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