Unique Issues in Arizona Construction Law

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Licensing Requirements when Contracting in Arizona

BRIAN M. FLAHERTY

Arizona requires any entity or person engaged in the business of contracting to be licensed in order to bid and perform construction work within the state. By statute, the Arizona Registrar of Contractors (“Registrar”), with its director appointed by the governor, is the administrative agency that oversees licensing of applicants, renewals and compliance with applicable state laws relating to licensee’s conduct, including workmanship issues.

WHO NEEDS TO BE LICENSED?

Subject to limited exclusions, a contractor’s license is necessary for any person, firm, partnership, corporation, association or other organization, or a combination of any of them, that, for compensation, undertakes or offers to undertake to, purports to have the capacity to undertake to, submits a bid or responds to a request for qualification or a request for proposals for construction services to, does himself or by or through others, or directly or indirectly supervises others to:

- Construct, alter, repair, add to, subtract from, improve, move, wreck or demolish any building, highway, road, railroad, excavation or other structure, project, development or improvement, or to do any part thereof, including the erection of scaffolding or any other structure or work in connection with the construction.
- Connect such structure or improvements to utility service lines and metering devices and the sewer line.
- Provide mechanical or structural service for any such structure or improvements.

“Consultants” and “Construction Supervisors” also need to be licensed if their function is to supervise or manage a construction project for the benefit of a property owner including the hiring and firing of contractors, scheduling work and selection and purchasing of construction material. “Contracting” includes bids, offers and supervision.

WHO DOES NOT NEED TO BE LICENSED?

In pertinent part, Arizona does not require licenses for:

- Public utilities operating under the regulation of the corporation commission;
- Drilling, testing, abandoning or other operation of a petroleum or gas well if performed by an owner or lessee;
- Material suppliers, retailers and manufacturers of finished products provided they do not install or attach such items unless the total value of the sales contract does not exceed $1,000. Any unaltered, unchanged or unmodified electrical fixture or appliance that can be plugged into a common household electrical outlet utilizing a two pronged or three pronged electrical connector and does not use any other form of energy is excluded from this requirement;
- Owner occupants;
- Owner developers building structures on property they own for the purpose of sale or rent provided the owner contracts with a general contractor or specialty contractor;
- Architects or engineers engaged in their professional practice;
- Sureties and Insurance Companies provided all work is performed by duly licensed contractors;
- Employees of an exempt property owner;
- “Handyman” performing work of a casual or minor nature in which the contract price is less than $1,000;
- “Handyman” performing work of a casual or minor nature in which the contract price is less than $1,000;
- Certain construction projects for the U.S. Government; and
- Most construction projects on Indian Reservations.

IMPACT OF CONTRACTING OR ADVERTISING WITHOUT A PROPER LICENSE

The consequences of contracting without a license can not only invite prosecution as a misdemeanor, but may also effectively eliminate collection and lien rights for work
performed. In order to maintain a collection cause of action, a contractor must allege and prove that the contracting party whose contract gives rise to the claim was a duly licensed contractor when the contract sued upon was entered into and when the alleged cause of action arose.

It is also a class 1 misdemeanor for any unlicensed person to advertise that he is able to perform any service or to contract for compensation.

**APPLICATION PROCESS**

Recently, the Registrar has implemented Six Sigma methodology to streamline the application process. The entity or person must submit a formal application disclosing the names of all individuals who are listed on the license as the qualifying party, owner, partner, corporate officer, significant member or stock holder. The proposed qualifying party must be able to demonstrate the required practical or managerial experience in the particular trade for which the license is being sought.

**JOINT VENTURE**

A joint venture involves a combination of two or more contractors for the purposes of submitting a proposal and performing a construction contract. A joint venture might be necessary to secure the requisite amount of bonding capacity on a large project.

A joint venture does not need to be separately licensed if:

- At least one member of the joint venture is licensed;
- The license is in good standing;
- Only the licensed members perform the contracting work;
- The licensed members perform contracting work within the scopes of their licenses.

Importantly, an unlicensed contractor cannot simply create a joint venture, partnership, other business organization or informal agreement with a licensed contractor to avoid the licensing requirements in Arizona without complying with the above requirements. In other words, a joint venture cannot be used as an end run around Arizona’s licensing requirements.
LIMITATION OF LIABILITY CLAUSES:

In 2008, the Arizona Supreme Court held in *1800 Ocotillo, LLC v. The WLB Group Inc.*, 196 P.3d 222 (Ariz. 2008), that limitation of liability clauses in personal services contracts are not void against public policy and parties are free to contract as they wish to cap the amount of liability assumed. Because these clauses are a form of assumption of risk, their enforceability must always be decided by a jury.

PAY IF PAID CLAUSES:

Generally, although disfavored by the courts, pay if paid clauses are enforceable in Arizona, if they are drafted carefully and properly. When written properly, these clauses are a condition precedent to payment. The Arizona Court of Appeals clarified the factors that must be addressed specifically in such clauses to be enforceable as a risk-shifting provision as opposed to a timing of payment provision. See *L. Harvey Concrete, Inc. v. Argo Construction & Supply Company*, 939 P.2d 811 (Ariz. App. 1997). The contract clause must specifically state that the subcontractor agrees to be paid only out of a specific fund, and, if that fund is insufficient or never created, the subcontractor will forfeit payment for some or all of its work.

LIQUIDATED DAMAGE CLAUSES:

In an April 2017 ruling, the Arizona Supreme Court found a liquidated damage clause to be unenforceable as a penalty in *Dobson Bay Club v. La Sonrisa De Siena*, 242 Ariz. 108, 393 P.3d 449 (Ariz. 2017) In this non-construction case, Dobson Bay had signed a $28.6 million promissory note secured by a deed of trust recorded against four commercial properties. The promissory note required interest-only payments with a balloon payment upon maturity. The note also provided for default interest, collection costs, reasonable attorney fees, and a 5% late fee.

When Dobson Bay failed to pay the balloon upon maturity, La Sonrisa started foreclosure proceedings against the commercial properties and assessed a $1.4 million late fee. Dobson Bay refinanced the note, paid all principal and undisputed interest, and deposited the $1.4 million late fee with the court, claiming that the late fee was unenforceable as a penalty.

The Supreme Court reviewed existing Arizona law on liquidated damages, noting that liquidated damage clauses can increase certainty and decrease risk exposure, proof problems, and litigation costs.

The Court then adopted a two-part test for enforcing a liquidated damage clause in deciding whether the parties’ damages forecast was reasonable. Under that test, the forecast is reasonable if it approximates either:

- the loss anticipated at the time of contract creation (despite any actual loss), or
- the loss that actually resulted (despite what the parties might have anticipated in other circumstances).

The Court also stated that the non-breaching party is not required to prove actual damages to enforce a liquidated damage provision, and a court will respect the parties’ agreement if it is reasonable in relation to the anticipated or actual loss.

The Supreme Court applied these factors to the late-fee clause, finding it unenforceable because $1.4 million was not a reasonable forecast of anticipated damages resulting from an untimely balloon payment.

Applying this decision to Arizona construction contracts, parties seeking to enforce a liquidated damage clause in their construction contracts should anticipate future Dobson Bay-based arguments if the liquidated damage provision does not reasonably estimate, at the beginning of the contract, the parties’ construction-related damages.
Restrictions in Arizona Construction Contracts

DAVID C. TIERNEY

Arizona, like several other States, has adopted statutes designed to restrict the parties to a construction contract. The first prevents parties to construction contracts from applying the law of another state to a construction project performed in Arizona. It also prohibits contractually agreeing to a venue outside of Arizona.

Section 32-1129.05 of the Arizona Revised Statutes provides:

A. The following are against this state’s public policy and are void and unenforceable:

1. A provision, covenant, clause or understanding in, collateral to or affecting a construction contract that makes the contract subject to the laws of another state or that requires any litigation arising from the contract to be conducted in another state.

2. A provision, covenant, clause or understanding in, collateral to or affecting a construction contract stating that a party to the contract cannot suspend performance under the contract or terminate the contract if another party to the contract fails to make prompt payments under the contract pursuant to A.R.S. § 32-1129, 32-1129.01 or 32-1129.2.

3. Any mediation, arbitration or other dispute resolution proceeding arising from a construction contract for work performed in this state shall be conducted in this state.

A.R.S. § 32-1129.05.

In addition, on “public works” projects (for State, County, City, irrigation or library districts, etc.), A.R.S. § 34-227 states as follows:

A provision, covenant, clause or understanding in, collateral to or affecting a construction contract that makes the contract subject to the laws of another state or that requires any litigation, arbitration or other dispute resolution proceeding arising from the contract to be conducted in another state is against this state’s public policy and is void and unenforceable.

If an out-of-state corporation tries to contractually insert the law of its state, the contract provision will be void and unenforceable under these Arizona statutes.

INDEMNIFICATION

A clause in a residential construction contract purporting to insure, indemnify or hold harmless the promisee from or against liability for loss or damage is void as against public policy to the extent it purports to insure, indemnify or hold harmless the promisee from or against liability for loss or damage resulting from the negligence of the promisee or the promisee indemnities employees, subcontractors, consultants or agents other than promisor. The subcontractor is only required to indemnify the seller to the extent the subcontractor caused the damages for which the seller is liable.

Furthermore, any additional insured endorsement furnished pursuant to an agreement or collateral to a construction contract involving a dwelling limits the insurer to defend the additional insured to the extent of the named insured’s liability.
**Private Prompt Pay Act**

**GREGORY P. GILLIS AND LAUREN REYNOLDS**

**ARIZONA PROMPT PAY ACT - A.R.S. §§ 32-1181 THROUGH 32-1188**

Progress payments are required for any contract on any construction project longer than 60 days.

If billings or estimates are to be submitted in other than the statutory 30-day billing cycle, the construction contract and each page of the plans shall identify the alternative billing cycle.

For owner occupied residences, the Prompt Pay Act applies to construction contracts, only if the following legend or substantially similar language appears in clean and conspicuous type on the front of each billing or estimate from the contractor to the owner-occupant:

*Attention: Your obligations to pay your contractor are subject to the Arizona prompt pay act. This act is set forth in § 32-1129, Arizona Revised Statutes, and §§ 32-1129.01 through 32-1129.07, Arizona Revised Statutes. The full text of the statutes are available at your local public law library or the internet. Under that act, you have the right to withhold all or a portion of a payment to a contractor for a variety of reasons, including defective construction work that has not been corrected. However, in order to do so, you must issue a written statement setting forth in reasonable detail your reasons for withholdings payments within fourteen (14) days after the date you receive a billing or estimate. If you fail to issue the written statement within that period, the billing or estimate will be deemed approved. Once the billing or estimate is deemed approved, you must pay the billing or estimate within seven (7) days. Generally, you are limited by the act to withholding only an amount that is sufficient to pay the direct costs and expenses you reasonably expect to incur to protect you from loss for which the contractor is responsible. You are encouraged to read the act in full to know your obligations and rights.*

**OWNER PAYMENTS TO GENERAL CONTRACTOR**

An owner shall make progress payments to a contractor within 7 days after the date the billing or estimate is certified and approved.

A billing or estimate for progress payment is certified or approved 14 days after the owner receives the billing unless the owner issues a written statement listing the reasons for not certifying all or a portion of the billing or estimate.

An owner may decline to certify and approve all or part of a billing for one or more of the following reasons:

- unsatisfactory job progress
- defective construction work or materials not remedied
- disputed work or materials
- failure to comply with other material provisions of the construction contract
- third party claims filed or reasonable evidence that a claim will be filed
- failure of the contractor or subcontractor to make timely payments for labor, equipment and materials supplied
- damage to the owner
- reasonable evidence that the construction contract cannot be completed for the unpaid balance of the construction contract sum

The owner may only withhold from a progress payment the amount of costs and expenses the owner reasonably expects to incur.

A construction contract may not alter the rights of a subcontractor or material supplier to receive prompt and timely payments.

If timely payment is not received, the owner must pay the contractor interest at 1.5% per month.

In any action or arbitration to collect payments and interest, the successful party shall be awarded reasonable attorney fees and costs.

**CONTRACTOR TO SUBCONTRACTOR PAYMENT**

If a subcontractor or material supplier has performed, the contractor shall pay the subcontractor or material supplier within 7 days of the contractor's receipt from the owner of a progress, retention or final payment.

Similarly, subcontractors shall pay subcontractors and material suppliers they retained within 7 days of the subcontractor's receipt from the contractor of a progress, retention or final payment.
The contractor may require lien waivers from the subcontractor or material supplier as a condition of payment.

The contractor may withhold certification of the subcontractor or material supplier's bill for any of the following reasons provided the contractor notifies the subcontractor or material supplier within 14 days:

- unsatisfactory job progress
- defective construction work or materials not remedied
- disputed work or materials
- failure to comply with other material provisions of the construction contract
- third party claims filed or reasonable evidence that a claim will be filed
- failure of the subcontractor to make timely payment for labor, equipment or materials
- damage to a contractor or other subcontractor or material supplier
- reasonable evidence that the subcontract cannot be completed for the balance of the contract sum

If an owner has withheld retention from the contractor, the amount of retention withheld by the contractor shall not exceed the amount of retention withheld by an owner pertaining to the subcontractor's work.

The contractor shall pay any subcontractor or material supplier if its work was not the basis of the owner withholding for defective construction or materials not remedied, within 21 days after payment.

**Suspend/Termination Performance**

A contractor may suspend performance or terminate a construction contract if the owner fails to pay the certified and approved amounts upon seven days written notice.

A subcontractor may suspend performance or terminate its subcontract if either the owner or the contractor fails to timely pay the amount certified and approved.

Before suspending performance, the subcontractor must provide three days prior written notice to the general contractor and owner.

If the owner pays the contractor but the contractor fails to pay the subcontractor, the subcontractor may suspend performance or terminate the contract after seven days written notice to the general contractor.

A subcontractor may suspend performance or terminate the subcontract if the owner declines to certify payment of the subcontractor's work with no fault of the subcontractor upon seven days written notice to the general contractor and owner.

A subcontractor is not in breach of its subcontract for suspending performance/terminating a contract in accordance with the Prompt Pay Act.

**Prohibited Contract Terms**

A construction contract cannot require the law of another state to apply or prohibit suspension of performance or termination of the contract for failing to make timely payments.

A construction contract also cannot require litigation or any dispute resolution proceeding to be performed in a different state.
Mechanics' Liens

GREGORY P. GILLIS AND LAUREN M. REYNOLDS

MECHANICS’ AND MATERIALMANS’ LIENS, A.R.S. §§ 33-981 THROUGH 33-1008

WHO HAS LIEN RIGHTS?

- Licensed contractors (residential and commercial) and those providing “labor, professional services, materials, machinery, fixtures or tools” in the construction, alteration or repair of any building, or any structure or improvement (including rental equipment).

- If residential construction, one must have a written contract with the owner of an owner/occupied residential property (defined in the statute).

- Professional service providers (licensed architects, engineers, land surveyors) must have a written contract with the owner or with contractor who has an agreement with owner. Must add value to the property. The lien does not attach until labor by others has commenced to improve the property.

PRELIMINARY TWENTY-DAY NOTICES

- A Preliminary Twenty-Day Notice (prelim or pre-lien) is one or more written notice(s) from a claimant prior to recording a mechanics’ lien. The notice must conform to the statutory text. To have a valid lien, a Preliminary Twenty-Day Notice must have been mailed by first class mail sent with a certificate of mailing, registered or certified mail, postage prepaid to the owner/reputed owner, original/reputed contractor, construction lender and the person with whom the claimant has contracted.

- Only covers materials and services provided within the previous 20 days and thereafter until materials and services provided exceed the amount listed in the Preliminary Twenty-Day Notice.

- Allowed to exceed original value estimate by 20% or additional pre-lien notice required.

- May be amended or supplemented (e.g., when a change order occurs).

PERFECTING AND RECORDING LIENS

- Lien must be recorded in the county where the real property is located.

- Must be recorded within 120 days after completion.

- Completion equals the earlier of:
  - 30 days after inspection or approval (certificate of final occupancy); or
  - Cessation of labor for 60 consecutive days.

- Lien must include:
  - Legal description of the land charged with the lien;
  - Name of the owner and statement of the terms of the contract (or if written, a copy must be attached);
  - The amount demanded;
  - The date of completion; and
  - The date the prelim was provided.

RELATION BACK DOCTRINE

- All mechanics’ and materialmans’ liens relate back in time to when labor or materials were first furnished to the project.

- All lien claimants on the same project have parity and equal priority regardless of the date a particular lien is recorded or when the labor was performed at the project.

FORECLOSURE PROCESS

- Lien claimant has six months after lien recordation to file a lawsuit to foreclose the lien.
• Must record a *lis pendens* within five days after the lien foreclosure lawsuit is filed.

• The prevailing party may recover attorney fees and expenses of a lien foreclosure lawsuit.

**LIEN WAIVERS**

• There are four types of lien waivers:
  
  o Conditional progress payment;
  
  o Conditional final payment;
  
  o Unconditional progress payment; and
  
  o Unconditional final payment.

• Conditional lien waivers only waive rights after claimant receives payment from the owner or contractor.

• Unconditional lien waivers waive all rights regardless of whether payment was received.

• Advance contract language waiving lien rights is not enforceable.

**WRONGFUL LIENS, A.R.S. § 33-420**

• A person who causes a document asserting a claim or a lien against real property, knowing or having reason to know the document is forged, groundless, contains a material misstatement or a false claim or is otherwise invalid, is liable for:

  o Damages of $5,000 or treble actual damages caused by the recording, whichever is greater; and

  o If a person willfully refuses to timely correct a lien against real property within 21 days from the date of request, the person will be liable for $1,000 or treble actual damages, whichever is greater, including costs and attorney’s fees.
Stop Notices

LAUREN M. REYNOLDS

In addition to the mechanics’ lien, Arizona law provides contractors, subcontractors, and material suppliers with the additional remedy of a stop notice. A.R.S. §§ 33-1051 through 33-1067. A stop notice allows contractors, subcontractors, and material suppliers to pursue payment from unexpended construction funds held by owners and lenders on private projects. Stop notices do not apply to owner-occupied dwellings.

PREREQUISITES TO AND CONTENTS OF STOP NOTICES

As a prerequisite to a stop notice, contractors, subcontractors, and material suppliers must have issued a preliminary twenty day notice. If no preliminary twenty day notice has been issued, service of a stop notice cannot be effective.

By statute, a stop notice must be “a written notice that is signed and verified by the claimant or its agent” and must state the following:

- A description of the labor, services, materials, machinery, fixtures, or tools provided, or agreed to be provided, by the claimant;
- The name of the person for whom the labor, services, materials, machinery, fixtures, or tools were provided, or agreed to be provided;
- The value of the labor, services, materials, machinery, fixtures, or tools already provided, and the total amount agreed to be provided;
- The amount of payment received by the claimant for the labor, services, materials, machinery, fixtures, or tools already provided, or agreed to be provided; and
- The name and address of the claimant.

A stop notice will not be invalid for a defect in form, however, so long as it is sufficient to provide the owner or lender the information listed above.

BONDED VS. UNBONDED STOP NOTICES

A bonded stop notice is accompanied by a bond in an amount equal to one-hundred-fifty per cent (150%) of the amount claimed in the stop notice.

An owner must withhold ‘sufficient monies,’ whether the stop notice is bonded or unbonded, See A.R.S. § 33-1057. A lender, however, may disregard an unbonded stop notice, See A.R.S. § 1058. Therefore, contractors, subcontractors, and material suppliers should be wary of using unbonded stop notices.

SERVICE OF STOP NOTICES

In order to be effective, a stop notice must be properly served. After an amount is due and owing, and the claimant has provided a preliminary twenty day notice, the claimant may serve a stop notice. Service of a stop notice must occur before one-hundred-twenty (120) days after completion of the project or within sixty (60) days after recordation of a notice of completion, whichever comes first.

A stop notice must be either personally served or served by certified mail. Proper service on an owner requires delivery to the owner personally, at the owner’s residence with a person of suitable age and discretion, or at the owner’s place of business. Proper service on a lender requires delivery to a manager or other responsible officer or person at the office that administers or holds the construction monies.

WRITTEN DEMANDS FOR STOP NOTICES BY OWNERS AND LENDERS

Owners and lenders have the option to make a written demand for stop notices from the contractors, subcontractors, and material suppliers on a project. Such a demand shall be sent by registered or certified mail and must include the following language in bold-faced type, at least as large as the largest type that otherwise appears on the document: “demand for service of stop notice pursuant to A.R.S. § 33-1054” (for owners) or “demand for service of stop notice pursuant to A.R.S. § 33-1055” (for lenders).

Any contractor, subcontractor, or material supplier entitled to give a stop notice who fails to serve that stop notice within thirty (30) days after that written demand will forfeit the right to any stop notice on the work described in the demand.
**EFFECT OF STOP NOTICE**

The obligation of an owner or lender to withhold funds pursuant to a stop notice differs, depending on the circumstance.

**WHERE AN OWNER RECEIVES A STOP NOTICE:**

The owner must withhold funds from the original contractor, sufficient to cover the stop notice amount, unless a payment bond has been recorded.

- Where a payment bond has been recorded, an owner is not required to, but may, withhold the funds.

- If the owner elects not to withhold the funds, the owner must provide written notice to the claimant within thirty (30) days after receipt of the stop notice and include a copy of the payment bond.

**WHERE A LENDER RECEIVES A STOP NOTICE:**

The lender may withhold funds from the borrower, sufficient to cover the stop notice, unless a payment bond has been recorded.

- Where a payment bond has been recorded, a lender may still withhold the funds.

- If the lender elects not to withhold the funds, the lender is not required to provide the claimant written notice or a copy of the payment bond, unless the claimant made a written request for notice of such an election and provided the lender a pre-addressed, stamped envelope.

**PRO RATA DISTRIBUTION:**

Where funds withheld or required to be withheld are insufficient to pay all claims of all persons who made claims, the funds will be distributed pro rata.

**ACTIONS TO ENFORCE STOP NOTICES**

Any court action against an owner or lender may be commenced any time after ten (10) days of the date the stop notice is served and before three (3) months after the deadline to record liens on the entire project.

Within five (5) days after the commencement of an action, the claimant must serve a Notice of Commencement on the owner or lender.

The prevailing party in such an action will be awarded reasonable attorney fees from the party held liable by the court for payment of the claim.

If a claimant prevails against an owner or lender, to enforce payment of a claim stated in a bonded stop notice, the claimant will be entitled to interest on that amount from the date the bonded stop notice was served on the owner or lender.
Attorneys' Fee Awards in Arizona

DAVID C. TIERNEY

STATUTORY FEE AWARDS

Over forty years ago, in 1976, Arizona adopted “the German Rule” as regards Courts awarding attorneys' fees to successful litigants, even though there were no contract clauses for those litigants calling for awarding such fees.

The Arizona Legislature inserted one paragraph in the State statutes stating that in contested actions (lawsuits) in Superior Court (the court of general jurisdiction) if the dispute “arises out of a contract, express or implied, the court may award the successful party reasonable attorneys' fees... to mitigate the burden of the expense of litigation to establish a just claim or a just defense.” A.R.S. § 12-341.01.

A companion statute added nearly ten years later, added a provision to the effect that “in any civil action [thus tort or contract] commenced... in a court of record in this state, the court shall assess reasonable attorney fees, expenses, and, at the court’s discretion, double damages...not to exceed Five Thousand Dollars ($5,000) against an attorney or party...if the attorney or party...brings or defends a claim without substantial justification [the claim or defense is groundless and is not made in good faith...brings or defends a claim solely or primarily for delay...unreasonably expands or delays the proceeding...[or] engages in abuse of discovery.” A.R.S. § 12-349 (and see § 12-350 listing factors to be considered).

Very few states in the Nation follow the German Rule and allow legal fees to be awarded when no contract clause provides for an attorneys’ fee award.

This provision for legal fees to a successful party can “spur” and thus increase plaintiffs’ litigation. It may also “curb” and reduce defensive efforts. No attempt was ever made to determine the effects of this statute. It may have resulted in litigants choosing Arizona as the venue to assert jurisdiction and try their cases, or it may have resulted in a flight from Arizona by some litigants.

One thing is clear. Arizona’s German Rule statute is a factor for parties determining whether to sue or defend, and it is a factor in the settlement of contract-based litigation.

CONSTRUCTION DEFECT LAW

In early August 2017, Arizona’s Supreme Court upended a long established and vital feature of construction law involving cases brought based upon the implied warranty of workmanship and habitability. The Court turned away from thirty year old precedents and has now allowed the second purchasers of homes, (who sue only on an implied warranty theory for construction defects) to be awarded their reasonable attorneys’ fees. Sirrah Enterprises LLC v. Wunderlich, 242 Ariz. 542, 399 P.3d 89 (2017).

The implications are large for owners (and thus for general contractors and for their subcontractors). For the plaintiffs’ lawyers who take on large construction defect cases, it has always been a tough challenge to convince second purchasers to join such cases. This is now radically changed.

This change in the law will make it easier for second purchaser plaintiffs to see value in joining in construction defect lawsuits. The construction defect cases will be “bigger” (involving more plaintiffs).

That change in Arizona law may well prove to be a new dynamic affecting the assembling and processing of large construction defect cases. Certainly, owners will be bulk-up insurance coverage; general contractors will be spending more on lawyers; and subs can expect to get sued by general contractors for even larger sums than in past years, under this change in the law regarding legal fees for second purchasers under implied warranty claims.
The Purchaser Dwelling Act

BRIAN FLAHERTY AND LAUREN REYNOLDS

The Purchaser Dwelling Act (the “Act”), A.R.S. §§ 12-1361 through 1366, requires that a “purchaser,”(including subsequent purchaser) of a home or residential condo before filing a dwelling action, give written notice to the “seller” specifying in reasonable detail, the basis of the dwelling action. A.R.S. §12-1363(A). The purpose of the Act is to afford sellers, the developer, or general contractor an opportunity to remedy any deficiencies or issues that may have resulted from their service prior to the filing of suit. A court will dismiss a dwelling action where a purchaser has failed to comply with the Act. A.R.S. §12-1363(N).

PURCHASERS AND SELLERS

Under the Act, a “purchaser” is a person or entity that files a “dwelling action” against a seller. A.R.S. § 12-1361(9). A “dwelling action” is an action against a “seller” which involves “a construction defect . . . arising out of or related to the design, construction, condition or sale of the dwelling.” A.R.S. § 12-1361(7). A “dwelling” is “a single or multifamily unit designed for residential use and common areas and improvements that are owned or maintained by an association or by members of an association,” including “the systems, other components and improvements that are part of a single or multifamily unit at the time of construction.” A.R.S. § 12-1361(6).

A “seller” is “any person, firm, partnership, corporation, association or other organization that is engaged in the business of designing, constructing or selling dwellings, including construction professionals.” A.R.S. § 12-1361(10). “Construction professionals” include architects, contractors, subcontractors, developers, builders, builder vendors, suppliers, engineers, or inspectors. A.R.S. § 12-1361(5).

NOTICE AND “REASONABLE DETAIL”

The Act requires the purchaser, prior to filing a dwelling action, to give written notice to the seller by certified mail, return receipt requested. A.R.S. §12-1363(A). The written notice must include “reasonable detail” regarding the basis of the purchaser’s claims. In order to meet the statutory requirement of “reasonable detail,” the purchaser must include a detailed and itemized list that describes each alleged construction defect, the location that each alleged construction defect has been observed by the purchaser in each dwelling that is the subject of the notice and the impairment to the dwelling that has occurred as a result of each of the alleged construction defects or is reasonably likely to occur if the alleged construction defects are not repaired or replaced. A.R.S. §12-1363(O).

The seller must forward the notice to subcontractors whose work the seller reasonably believes may be implicated or is responsible for the alleged defect specified in the notice.

THE SELLER’S RIGHT TO INSPECT

After receipt of a notice from a purchaser and providing the purchaser with “reasonable notice, the seller may inspect the dwelling.

A.R.S. § 12-1363(B). The purchaser must make the dwelling available for inspection by the seller at a reasonable time, within ten days. Id.

In inspecting the dwelling, the seller may use “reasonable measures, including testing, to determine the nature and cause of the alleged construction defects and the nature and extent of any repairs or replacements necessary to remedy the alleged construction defects,” but must restore the dwelling to its condition before those reasonable measures were used. Id.

RESPONSE TO THE NOTICE AND NOTICE OF INTENT TO REPAIR OR REPLACE

The seller has sixty (60) days after receipt of the purchaser’s notice in which to provide the purchaser with a written, good faith response to the purchaser’s notice. A.R.S. §12-1363(C) and (D). The response may include the seller’s notice of intent to (1) repair or replace any alleged construction defects, (2) have the alleged construction defects repaired or replaced at the seller’s expense, or (3) provide monetary compensation to the purchaser. A.R.S. §12-1363(C). To the extent the written notice of intent includes notice of the first two, the seller must include “reasonable detail” regarding the repairs or replacements the seller intends to make and provide a “reasonable estimate” of the date such repairs and replacements will be completed. Id.
**REPAIR AND REPLACEMENT**

Where a seller provides notice to the purchaser of the seller’s intent to repair or replace any of the alleged construction defects, the purchaser must allow the seller “reasonable opportunity” to do so; however, the Act permits the purchaser to request the repair or replacement of the construction defects be undertaken by a construction professional not involved in the original construction or design of the dwelling. A.R.S. § 12-1363(E).

The purchaser and seller must coordinate the repairs and replacements within thirty (30) days of the day the seller’s notice of intent to repair or replace was sent to the purchaser and make reasonable efforts to begin repairs or replacements within thirty-five (35) days of the day the seller’s notice of intent to repair or replace was sent to the purchaser. Id. Repair and replacement must be completed with reasonable care and within a “commercially reasonable time frame,” taking into consideration factors such as the nature of the repair or replacement, access issues, 2 or unforeseen events. Id.

It is important to note that the repair or replacement efforts by the seller under the Act are NOT considered settlement communications. A.R.S. § 12-1363(G). The conduct of both the purchaser and seller are admissible as evidence in any subsequent dwelling action. Id.

**ADDITIONAL ALLEGED CONSTRUCTION DEFECTS**

The notice from the purchaser to the seller may be amended to include additional alleged construction defects identified, in good faith, after submission of the original notice. A.R.S. § 12-1363(H). Similarly, once a dwelling action is filed, the purchaser is permitted to supplement the list of construction defects identified, in good faith, after the filing of the original dwelling action. A.R.S. § 12-1363(I). In both cases, the seller must be permitted a reasonable amount of time to perform an inspection. A.R.S. § 12-1363(H) and (I). If, after the inspection, the seller provides notice of intent to remedy the additional alleged construction defects, the seller may do so under the provisions of the Act. Id.

Amended notices alleging additional construction defects during the pendency of a dwelling action relate back to the original notice of alleged construction defects for the purposes of tolling applicable statutes of limitations and repose. A.R.S. § 12-1363(J).

**INSURANCE CONSIDERATIONS**

Where a seller presents to its insurer a notice received from a purchaser under A.R.S. § 12-1363, the insurer is required to (1) treat such notice as a notice of claim “subject to the terms and conditions of the policy insurance” and (2) work with the seller to comply with the timing requirements of the Purchaser Dwelling Act. A.R.S. § 12-1362(C).

**COMMENCEMENT OF A DWELLING ACTION**

If a seller does not provide the purchaser with a written response within sixty (60) days, and no monetary settlement is otherwise reached, the purchaser may commence a dwelling action. A.R.S. § 12-1363(D). Similarly, upon completion of the repair and replacement process provided for under the Act, the purchaser may commence a dwelling action. A.R.S. § 12-1363(E)(6).

The statutes of limitations and statutes of repose applicable to any dwelling action and claims for indemnity and contribution are tolled as to the seller and construction professionals whose work is implicated from the date the seller receives notice until nine months after service of a civil complaint and arbitration demand during the notice and repair or replacement process A.R.S. § 12-1363(F).

**PDA LAWSUIT**

If a Dwelling Action is filed, the subcontractors are to be joined as third-party defendants. The trial is then bifurcated. As to each construction defect found to exist, the trier of fact shall first determine if a construction defect exists and the amount of damages caused by the defect and identity whose conduct caused the defect. The purchaser bears the burden of proof as to the existence of the construction defect and the amount of damage caused by the defect.

Thereafter, in a separate phase of the trial, the trier of fact shall determine the relative degree of fault of any defendant/third party defendants and allocate the pro rata share of liability based upon relative degree of fault. The seller

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2 The Act requires purchasers to provide reasonable access for repairs and replacements to be made. A.R.S. § 12-1363(E)(4).
bears the burden to prove the pro rata share of liability of any third-party defendant.

At the time the purchaser files a Dwelling Action, they must file an affidavit that they have read the entire compliant, agree with its facts and allegations and that they have not received, nor been promised anything of value for filing the Dwelling Action.

FEES AND COSTS

In a contested Dwelling Action the prevailing party is entitled to their reasonable attorney fees and table costs. The purchaser is considered the prevailing party if the relief obtained for that contested issue, exclusive of fees and costs, is more favorable than the repairs, replacement and offers made by the seller before the Dwelling Action is filed. The seller is deemed the prevailing party with respect to a contested issue if, exclusive of fees and costs, the relief obtained is not more favorable than the repairs or replacements and offers made before the Dwelling Action was filed.

The award of attorney fees is limited to fees actually and reasonably incurred with respect to the contested issue for which the party is deemed the prevailing party.

Expert fees may not be awarded if the Dwelling Action involves more than one purchaser.
Arizona's Unique Community Property Law

GAYE L. GOULD

One way lawyers get tripped up by unique Arizona law is by failing to obtain the signatures of both spouses on a guaranty.

Arizona is one of only eight community property states. In Arizona, all assets acquired during the marriage by either spouse are presumed to be marital community property, unless one of the spouses acquires property by a gift or inheritance. A.R.S. § 25-211(A).

While both Arizona spouses ordinarily have equal management and control and equal power to bind the community, this rule has some express exceptions, which include guaranties and suretyship. By statute, both spouses must sign a guaranty to bind the marital community, even if the guaranty is for a business that benefits the community. A.R.S. § 25-214(C)(2); Rackmaster Systems, Inc. v. Maderia, 219 Ariz. 60, 63 (App. 2008). Thus, in Arizona, an individual may not bind his or her spouse to a personal guaranty. If only one spouse signs a guaranty, the guaranty is only enforceable against the signing spouse’s separate property. First-Citizens Bank & Tr. Co. v. Morari, 242 Ariz. 562, 566 (App. 2017); Rackmaster Systems, Inc., 219 Ariz. 60; Consolidated Roofing & Supply Co. v. Grimm, 140 Ariz. 452, 458 (App.1984).

As a practical matter, the failure to have both spouses sign a guaranty may limit the ability to collect. A guarantee signed by only one Arizona spouse may be worthless because frequently spouses in a long-term Arizona marriage do not own any sole and separate property.

In addition, to recover against community property in Arizona (even as to non-guaranty obligations signed by only one spouse), both Arizona spouses must be sued. A.R.S. § 25-214(D); Eng v. Stein, 123 Ariz. 343, 345 (1979); C & J Travel, Inc. v. Shumway, 161 Ariz. 33, 36 (App. 1989). If both spouses are not joined in the litigation, it is unlikely that the plaintiff will be able to recover from community property.
Statutes of Limitation Applicable to Construction Claims in Arizona

SHARON B. SHIVELY

- Breach of Contract (written): Six years. A.R.S. § 12-548. Generally includes both implied and express warranty claims

- Breach of Contract (oral): Three years. A.R.S. § 12-543

- Bond claims (State Public Projects): Provide notice of bond claim to general contractor within 90 days after last furnishing labor/materials and file suit more than 90 days and less than one year after last furnishing labor/materials. A.R.S § 34-222 (‘Little Miller Act’)

- Bond Claims (Private Projects): Generally, per the terms of the Bond.

- Negligence: Two years. A.R.S. § 12-542

- Fraud: Three years. A.R.S. § 12-543(3)

- Actions against Public Entities/Employees: Notice of Claim must be filed within 180 days of claim accrual; “claim accrual” is defined in the statute. A.R.S. § 12-821.01

When Does the Statute of Limitations Period Begin?

The general rule is the limitations period begins to accrue whenever one person may sue another. Cheatham v. Sahuaro Collection Service, Inc., 118 Ariz. 452, 577 P.2d 738 (App. 1978). Ordinarily that period is the date of the injury.

However, in certain circumstances, Arizona has adopted the “discovery rule,” which may provide for a different accrual date. Under the so-called discovery rule, a cause of action accrues when the plaintiff knew or should have known by reasonable diligence that the alleged injury occurred. Gust, Rosenfeld & Henderson v. Prudential Ins. Co. of America, 182 Ariz. 586, 591, 898 P.2d 964, 969 (1995). “The important inquiry in applying the discovery rule is whether the plaintiff’s injury or the conduct causing the injury is difficult for plaintiff to detect, not whether the action sounds in contract or in tort.” Id.
Arizona’s Statute of Repose

SHARON B. SHIVELY

THE STATUTE OF REPOSE – A.R.S. § 12-552

The Arizona legislature enacted Arizona’s Statute of Repose, A.R.S. § 12-552, effective on September 15, 1989. This statute precludes any action or arbitration sounding in contract:

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

The statute of repose creates a limitation of liability for general contractors and other construction professionals by establishing an “absolute” cutoff before which any claims against them must be filed.

“Substantial completion” for purposes of the statute is defined as the earliest of: (1) first use of the improvement by the owner or occupant; (2) the improvement is first available for use after completion of the contract (including change orders); or (3) the final inspection by the governmental entity that issued the building permit. A.R.S. § 12-552(E).

STATUTE OF REPOSE VS. STATUTE OF LIMITATIONS

Importantly, the statute of repose is not a statute of limitations. A statute of limitations allows a party to avoid liability, but does not affect the validity of a claim. Ray v. Sons Masonry Contractors, Inc. v. United States Fidelity & Guaranty Company, 333 Ark. 201, 218, 114 S.W. 3d 189, 199 (2003). As such, statutes of limitation must be pled as an affirmative defense or it is waived, and the claim can proceed. Id.

A statute of repose, in contrast, immunizes a party from liability after a certain period of time, irrespective of whether a claim has accrued. Id. Because the statute of repose extinguishes a cause of action, some courts have held it is not necessary to plead the statute of repose as an affirmative defense, as the claim no longer exists. Id.; see also Tipton v. Young Const. Co., Inc. v. Blue Ridge Structure Co., 116 N.C.App. 115, 446 S.E.2d 603 (1994) (Statute of repose is a condition precedent, rather than an affirmative defense, and must therefore be specially pled by the plaintiff).

EXCEPTIONS TO THE STATUTE OF REPOSE

While attempting to create an unconditional limit on liability, a number of exceptions nevertheless remain. Most notably, the statute is explicit in that it only extinguishes liability for litigation and arbitrations “based in contract.” Arizona Revised Statutes § 12-552(D) specifically carves out an exception for any claims alleging personal injury or death. In Fry’s Food Store of Arizona, Inc. v. Mather and Associates, Inc., 183 Ariz. 89, 900 P.2d 1225 (Ariz. 1995), the Court of Appeals extended the exception set forth in A.R.S. § 12-552(D) to all negligence claims.

Arizona Revised Statutes § 12-552(B) provides that where the injury occurred or the latent defect was discovered in the eighth year, a claimant has one additional year in which to bring the claim. Once the additional year expires, all liability is presumably extinguished. (“[B]ut in no event may an action be brought more than nine years after substantial completion of the improvement.”) A.R.S. § 12-552(B). Furthermore, a prior owner’s knowledge of the defect will be imputed to a subsequent owner when computing the eight year limit. Maycock v. Asilomar Development, 207 Ariz. 495, 88 P.3d 565 (App. 2004).

Finally, the statute does not shorten the warranty period of any express written warranties. A.R.S. § 12-552(D).

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1 While Fry’s nominally expands the coverage of A.R.S. § 12-552(D), the practical impact of the holding may be minimal as the economic loss rule may operate to bar a number, if not the majority, of negligence claims alleging property damage in connection with negligent construction.
Transaction Privilege Tax

STEVEN R. BEEGHLEY

IS ARIZONA’S TRANSACTION PRIVILEGE TAX (“TPT”) A SALES TAX?

TPT is not a traditional sales tax. It is a tax levied by the State of Arizona upon the gross receipts for the privilege of conducting business in the state. Arizona’s TPT differs from the traditional sales tax as it is imposed upon the contractor (seller) rather than the owner (purchaser). A contractor may pass the burden of the tax on to the owner, but contractor is ultimately responsible to pay the tax to the State.

WHO IS POTENTIALLY SUBJECT TO TPT?

Contractors, whether licensed or not, that are performing construction activities involving real property. Starting on January 1, 2019, unlicensed handymen will not be subject to the Prime Contracting tax status and would pay traditional sales taxes on materials and equipment.

HOW IS THE TAX APPLIED?

Prior to 2015, contractors were entitled to purchase building materials tax free as they or the primary contractor they worked for paid a prime contracting tax on 65% of their gross receipts.

The system is different and a bit more complicated now. There are now two TPT classifications for contractors: (1) Prime Contracting; and (2) Maintenance, Repair, Replacement or Alteration (MRRA). The taxing classification is project-by-project, not by contractor type. Therefore, a contractor could be subject to Prime Contracting project taxation on one project and MRRA project taxation on the next project. In other words, a contractor could be subject to two taxing schemes at the same time if the contractor has multiple projects on-going at the same time.

PRIME CONTRACTING TAX STRUCTURE

Contractors are required to pay contracting tax when 15% or more of the proceeds from the project are for modification activities instead of MRRA activities. This means that contractors working on a subject project may purchase materials and other tangible personal property to be used on the project tax free. The prime contracting tax then applies to 65% of the contractors’ gross receipts at the time work is performed.

WHAT IS A “MODIFICATION”?

The old definition of modification was “construction, improvement, movement (including removal), wreckage, or demolition activities, to the extent that they cannot otherwise be characterized as MRRA.” The new definition of a modification is “construction, grading and leveling ground, wreckage or demolition, but does not include (a) MRRA work, (b) wreckage or demolition, or any modification activity necessary for MRRA, work or (c) project mobilization.”

WHEN IS A PROJECT AN “ALTERATION” AND NOT A “MODIFICATION”?

In contrast to a modification, which triggers prime contracting tax status for a project when it applies, an alteration would trigger MRRA tax structure treatment, as discussed below.

On residential projects, if the contract for the project is more than 25% of the most recently available Fair Cash Value (FCV) of the property, as found from the County Assessor, then the project is not an “alteration” and Prime Contracting structure applies. If it expected to be less than 25% of the FCV, then it should be taxed based on the MRRA tax structure.

On commercial projects, the project will be deemed a modification and not an alteration (and taxed under the Prime Contracting structure) if ANY of the following are true: (a) the contract for the project is more than $750,000, (b) the scope of the work directly relates to more than 40% of the existing square footage of the existing property, OR (c) the scope of the work involves expanding the square footage by more than 10% of the existing property. However, starting in January 1, 2019, the only threshold that applies is (a) -- whether the project is over $750,000. The square footage tests will no longer apply.

However, if the parties reasonably believed the project to be an alteration at the outset of the job, and in turn subject to the MRRA tax structure treatment, but at the completion of the project the thresholds above are exceeded but less than 25%, then no tax treatment change for the project is required. If one of the above is exceeded by more than 25%, then the entire project will be taxed as part of the Prime Contracting tax structure.
MRRA TAXING STRUCTURE

If the project is not taxed as under the prime contracting structure, it is taxed under the MRRA structure. Under the MRRA taxing structure, contractors must pay either sales tax to their vendors when the materials/property are purchased, or they can pay an amount equal to that tax amount directly to the Arizona Department of Revenue and, in some circumstances, to the municipality for the month in which the materials/property were incorporated on the project, unless an exemption applies. If the contractor pays sales tax to its vendor, it pays tax at the rate that applies when the materials/property are purchased. Contractors that purchase materials/property tax-free but then later use those materials/property on an MRRA project, will pay a tax equal to the amount a vendor would have had been required to pay based on the location of the project.

It is noted that there are special rules regarding road projects. Most publically-funded road projects will be taxed as prime contracting projects, although some taxing districts and privately funded road projects may still qualify for MRRA treatment.

CONTRACTOR CLASSIFICATION

A prime contractor is defined as a contractor that “supervises, performs or coordinates the modification” of any building, road, railroad, excavation, or other structures on the project, who self-perform or subcontract some or all of the work out but that is ultimately responsible for the completion of the project.

A subcontractor to a prime contractor that establishes it was working for a prime contractor on a particular project where the prime contracting tax applies is not subject to tax on that project. A subcontractor should secure an Arizona Form 5005 from the prime contractor to avoid any confusion about the subcontractor’s potential liability.

WHAT ARE THE KEY TPT FORMS?

Arizona Form 5000 - Transaction Privilege Tax Exemption Certificate. This form is used to document and establish a basis for state and city tax deductions or exemptions.

Form 5000A - Arizona Resale Certificate. This form is used to document the purchase of tangible personal property for resale in the purchaser’s regular course of business.

Arizona Form 5005 - Contractor’s Certificate (Prime Contracting and MRRA). This form will be used to advise subcontractors that the prime contractor will be the taxable prime contractor on the project or not.

Arizona Form 5009L - Contractor’s Project Certificate. This is only to be used in rare occasions. That is when the project is subject to prime contracting and if the subcontractor does not have a TPT license.

HOW ARE CHANGE ORDERS TAXED?

Each change order is to be evaluated as to its relationship to the original contract. If the change order is “directly related” to the original contract, it will be taxed the same as the original contract. If not, then an independent determination as to how the change order will be taxed will be made.

MISCELLANEOUS CONSIDERATIONS

Contractors are no longer required to have TPT license to hold ROC license.

Contractors cannot be required by cities, towns or counties to hold a state TPT license in order to have a building permit issued.

How do you know if an exemption applies? There are a number of exemptions that apply. For example, projects and/or materials that were previously exempt, including hospitals, Native American Projects, etc., will be exempt from MRRA treatment. When in doubt, you should check with your attorney or tax professional.
* Special thanks to Cord Armstrong, CPA/CCIFP, Managing Director of CBIZ, for his valuable time reviewing this article. Mr. Armstrong has provided the attached flow chart that can be used to help analyze a TPT issue.
The debate on classifying as an employee or independent contractor has been ongoing since the enactment of the Fair Labor Standards Act of 1938 (FLSA).

The significance of correctly classifying a worker should not be disregarded. Workers misclassified as independent contractors are deprived of benefits under the FLSA – and possibly other statutes – such as overtime payment, minimum wage protection, family and medical leave, and unemployment insurance. Misclassification of workers could lead to workplace audits by the Department of Labor that could result in a determination of back wages owed plus statutory required liquidated damages.

However, the FLSA definitions are not helpful. It defines an employee as “any individual[s] employed by an employer.” It defines “employer” as “any person acting directly or indirectly in the interest of an employer in relation to an employee.” To “employ” under the FLSA is “to suffer or permit to work.”

The U.S. Department of Labor (DOL) has attempted to fill in these definitions with more helpful information and guidance by using an “economic realities test” to classify workers. Under this test, the key inquiry is whether a worker is economically dependent on the employer, thereby making the worker an employee, versus whether the worker is truly in business for him or herself and thus, an independent contractor. Determining a worker’s economic status is determined on a case-by-case basis using a multi-factor test that has been developed by a series of Supreme Court and Circuit Courts of Appeals decisions. The courts customarily examine the following factors:

(i) the extent to which the work performed is an integral part of the employer’s business;

(ii) the worker’s opportunity for profit or loss depending on his or her managerial skill;

(iii) the extent of the relative investments of the employer and the worker;

(iv) whether the work performed requires special skills and initiative;

(v) the permanency of the relationship; and

(vi) the degree of control exercised or retained by the employer.

According to a 2015 DOL administrator’s interpretation, no one factor is determinative and “each factor should be considered in light of the ultimate determination of whether the worker is really in business for him or herself... or is economically dependent on the employer.” The interpretation emphasizing the FLSA definitions were deliberately designed to provide a broad scope of statutory coverage and the “Act’s intended expansive coverage for workers must be considered when applying the economic realities factors.” The interpretation also explains “the economic realities of the relationship and not the label an employer gives it are determinative. Thus, an agreement between an employer and a worker designating or labeling the worker as an independent contractor... is not relevant to the analysis of the worker’s status.”

Importantly, employers should keep in mind that the Contractor vs. Employee classification is applicable to additional laws beyond merely the FLSA. For instance, employee classification may have tax consequences in accordance with the IRS code. Thus, the IRS code and other applicable employment laws have established separate tests for determining worker classification. However, all tests involve a balancing test with similar factors used in the FLSA test.

Given confusion over proper classifications, Arizona enacted a statute in 2016 that allows certain employers to create a rebuttable presumption of an independent contractor relationship by having the worker complete a form called ‘Declaration of Independent Business Status.’ A.R.S. § 23-1601. However, the statute for the most part expressly and substantially excludes most construction workers, stating that it does not apply to general contractors and subcontractors unless they are ‘contracting with an independent contractor to perform services that do not require a license pursuant to Title 32, Chapter 10.’ This exclusion generally means that the Declaration of Independent Business Status may only be used for administrative and bookkeeping type positions since most construction activities require a license.
The DOL has been active in auditing construction companies in Arizona and many other states. In 2016, an Arizona homebuilder was required to pay $48,000 in back wages and penalties for misclassifying workers. In 2014, a local drywall contractor agreed to pay $556,000 in overtime wages and liquidated damages to 445 current and former workers who were misclassified as independent contractors, and another $44,000 in civil penalties. More recently, a Texas commercial painting company agreed to pay $182,000 in back overtime wages after a DOL investigation found misclassification.

For these reasons, contractors and subcontractors should ensure that they classify workers appropriately. In addition to being familiar with the Federal standards above, general contractors and subcontractors should review the Arizona Registrar of Contractors’ (‘Registrar’) Substantive Policy Statement 102, which contains a list of 16 factors used to evaluate the correct classification. The Policy Statement warns that the Registrar may discipline a contractor for misclassification leading to failure to pay social security, workers’ compensation or unemployment insurance. In addition, the Registrar reminds licensees that independent contractors must have their own Registrar of Contractors licenses if they are being hired to perform construction work that requires a license.
Every employer is subject to a number of federal employment laws. In addition, Arizona has a number of state-specific laws that employers doing business in this state need to understand. Below is a non-comprehensive list of Arizona-specific laws:

- Arizona is an at-will employment state.

- Arizona’s minimum wage for the 2019 calendar year is $11.00. The minimum wage will increase on January 1, 2020 to $12.00. This will represent the final required minimum wage increase as part of the plan established several years ago. Thereafter, the minimum wage may rise based on the cost-of-living in the relevant Consumer Price Index. Arizona allows a maximum “tip-credit” of $3.00 per hour to employees eligible under the statute.

- Arizona statute requires paid sick time for Arizona employees, but obligations vary for employers with fewer than 15 employees. Every employee, regardless of whether they work full or part-time, is eligible to accrue paid sick time. The paid sick time statute establishes – amongst other things - annual use, annual accrual, carryover requirements, and permissible use of paid sick time.

- Arizona state law protects employees from discrimination based on race, color, national origin, religion or creed, sex, mental disability, physical disability, age, genetic information, AIDS/HIV, or veteran status. Certain municipal codes and ordinances protect other classes. For instance, Phoenix and Tucson, Arizona’s two most populated cities, also prohibit discrimination on the basis of marital status, sexual orientation, and gender identity or expression.

- Employers may establish a veteran’s preference in employment policy in accordance with statutory requirements.

- Arizona does not have specific overtime laws. Arizona employers subject to the Federal Fair Labor Standards Act (“FLSA”) must comply with the FLSA’s overtime requirements. The U.S. Department of Labor recently issued a rule change affecting the classification of a significant amount of workers.

- Non-compete agreements and other employee restrictive covenant agreements are enforceable in Arizona if they are (i) narrowly drafted; and (ii) no greater than necessary to protect an employer’s protectable interests. The agreements should be carefully drafted as Arizona’s blue pencil law does not allow courts to rewrite restrictive covenants to render them enforceable.

- Arizona’s “public places” and “places of employment” are (mostly) smoke-free. Arizona’s Smoke-Free Act establishes a 20-foot rule preventing smoking from designated entryways subject to limited exceptions.

- Compliance with Arizona’s drug-testing statute is voluntary. The benefit of compliance is that the statute protects employers from monetary damages in the event of a false positive, as well as other specified causes of action. To obtain protection of the drug-testing statute, employers must (i) have a written policy consistent with statutory requirements; and (ii) comply with drug-testing procedural requirements.

- Arizona has legalized the use of prescribed medical marijuana. Arizona’s medical marijuana statutes prohibit employers from discriminating against applicants or employees with respect to the terms and conditions of employment because of their status as a medical marijuana cardholder. However, employers are not required to accommodate use or impairment in the workplace.

- Arizona statutes set forth various notice and posting requirements. These include, but are not limited to posting regarding Arizona’s law on constructive discharge, prohibition of discrimination, the availability of unemployment insurance benefits, workers’ compensation requirements, and other worker-specific and industry-specific requirements set forth by statute.

- Arizona is a “right-to-work” state. This means Arizona employees cannot be compelled to join a labor organization as a condition of employment. Arizona statutory law expressly prohibits denying or terminating employment based upon an employee’s refusal to join a labor organization.
• Covered employers under Arizona’s Crime Victim’s Rights Act (ACRVA) must allow employees who are the victims of crimes to take leave consistent with the purposes of the ACRVA.

• Arizona statute requires employers to report certain information regarding newly hired employees to the Arizona Department of Economic Security via Arizona’s online New Hire Reporting Center. The Legal Arizona Workers Act requires employers to use the E-Verify system to verify employment authorization (immigration status) for all new employees.

• Workers’ compensation insurance benefits must be provided to all employees. There is no ‘employer opt out’ under Arizona’s elaborate statutory workers’ compensation scheme. The workers’ compensation statute protects employers by providing workers’ compensation benefits as the exclusive remedy for injured employees, with limited exceptions.

• Arizona’s unemployment insurance system is administered by the state and requires employers to pay varying contribution amounts calculated in accordance with statutory law.

• Arizona is one of only a few remaining states that has not limited employers from acquiring information related to employees’ social media accounts. However, Arizona employers should maintain social media policies that do not violate the National Labor Relations Act.
Reclamation, Trust Fund, and Bankruptcy

GREGORY P. GILLIS

RECLAMATION

A creditor who sells goods on credit while the debtor is insolvent may “reclaim” the goods upon a written demand made within ten (10) days after receipt of the goods by the buyer (A.R.S. § 47-2702). This right granted under Arizona’s version of the Uniform Commercial Code has a short fuse of 10 days for the seller to make written demand to reclaim the goods sold. The Bankruptcy Code extends this 10-day deadline. 11 U.S.C. § 546(c) extends the deadline to reclaim goods sold on credit from 10 days to 45 days after receipt of such goods or (if the 45 day period expires after the bankruptcy filing) within 20 days after the debtor’s bankruptcy filing. Notwithstanding whether the seller holds any reclamation rights, a seller is also entitled to an administrative expense claim in the bankruptcy case for the value of goods sold within 20 days before the debtor’s bankruptcy if the goods were sold in the ordinary course of the debtor’s business.

Reclamation can be a powerful tool for a seller of goods to a bankrupt contractor. First, the reclamation reach back period has been expanded from 10 days under state law, to 45 days, under the Bankruptcy Code and sellers now have 20 days instead of 10 days after the contractor’s bankruptcy filing to reclaim goods.

Reclamation is accomplished by providing a written reclamation demand to the debtor that specifically identifies the goods delivered to the debtor which are sought to be reclaimed. A creditor waives reclamation rights if not exercised.

TRUST FUND DEFENSE

Under the law of many states, construction contract proceeds are impressed with a “trust” in favor of unpaid contractors and suppliers. Arizona does not have such a trust fund statute as to commercial construction projects, but does as to owner-occupied residential projects—A.R.S. § 33-1005. A.R.S. § 33-1005 imposes a trust relationship between the contractor, its subcontractors and suppliers. The statute provides that in residential construction, when the contractor receives funds from an “owner occupant,” the contractor holds the funds in “trust” for the benefit of subs and suppliers to the residential project. Case law has imposed personal liability against corporate officers for violating the trust fund statute. See In re Baird, 114 B.R. 198 (B.A.P. 9th Cir. 1990). Furthermore, if the contractor fails to pass along these funds to subs and suppliers, it may be considered non-dischargeable debt as a defalcation while acting in a fiduciary capacity for purposes of 11 U.S.C. § 523(a)(4).

BANKRUPTCY

The post-bankruptcy recording of a state law mechanic’s lien does not violate the automatic stay in Arizona. This is because recording a mechanic’s lien is considered “perfection” of the lien in Arizona. The “perfection” of the lien is permitted after the filing of the bankruptcy due to an exception to the automatic stay. However, the exception to the automatic stay covers only “any act to perfect an interest in property”. Filing suit to foreclose the lien requires relief from the automatic stay. Furthermore, the majority of cases hold the automatic stay is violated by a foreclosure suit against the non-debtor/owner’s real property. When in doubt, obtain relief from the automatic stay.

If the six month time period to foreclose a mechanic’s lien is approaching and will expire after a bankruptcy has been filed, a creditor must file a $ 546(b) notice within the time required for commencing a foreclosure action under a state’s mechanics’ lien law. Once the lien is recorded and § 546(b) notice is given, the deadline to foreclose the mechanic’s lien is tolled. The statutory period for filing suit to foreclose the mechanic’s lien is extended until 30 days after the automatic stay is lifted.
Construction on Indian Reservations

Judith M. Dworkin

Indian Tribes in Arizona

Twenty-two federally recognized Indian tribes are located within Arizona’s geographical boundaries. Together they occupy approximately 19,623,000 acres of land, roughly 26.99% of the total acreage within the state. A contractor that enters into a contract with a tribe or tribal entity, and especially a contract that provides that the construction will be performed within the boundaries of an Indian reservation, must understand and address the unique aspects of tribes and their lands.

A contractor that has the opportunity to work on an Indian reservation should be aware that one is dealing with relationships and laws that are different than typical state laws and relationships. Tribes are sovereigns within their Indian reservations. The contractor should establish the identity of the tribal party with whom the contractor is negotiating and become familiar with the authority of that entity. Issues of sovereign immunity should be resolved by obtaining a limited waiver of immunity if the entity’s immunity has not already been waived in the organizational documents. In addition, a contractor should become familiar with specific tribal laws that may impact the project, including Indian preference laws in employment and contracting and tribal taxes.

Forms by Which a Tribe Acts as Owner

A tribe may act as owner under a myriad of organizational structures: the tribe itself, a federally chartered corporation, a tribally-chartered enterprise or corporation, a state chartered corporation, or an unincorporated tribal entity.

- Government

Tribal governments and their subdivisions can contract directly. Many tribal governments have been formed under the Indian Reorganization Act (“IRA”), 48 Stat. 984 (1934) (codified as amended at 25 U.S.C. §§ 461-494). The fact that a tribe has formed a government not consistent with Section 16 in no way affects the tribe’s status as a federally-recognized tribe. When a Section 16 tribal government enters into a contract, oversight is generally provided by the governing body of the tribe, the executive branch or a committee with delegated oversight authority. The tribal government is immune from suit unless Congress has waived immunity, or there is a waiver of immunity from the tribe with respect to the specific construction related contract.

- Federally Chartered Section 17 Corporation

Under the IRA, Section 17, a tribe can also form a corporate organization, that receives a federal charter, through which it “enter[s] the world of commerce.” White Mountain Apache Tribe v. Williams, 810 F.2d 844, 866 n. 17 (9th Cir. 1987). A Section 17 corporation is a separate legal entity from the Section 16 government. The federal charter may have a “sue or be sued” clause, but even in such cases, best practice would be to obtain an express waiver for the specific construction related contract.

- Tribal Entities

Many tribes conduct their affairs through unincorporated instrumentalities of the tribe or, in Arizona’s courts’ parlance, “subordinate economic organization[s].” Unincorporated instrumentalities of a tribal government formed under tribal law for commercial purposes typically share the immunity of the tribal government. These entities can be, and generally are, established simply by tribal resolution or by tribal ordinance.

Many tribal constitutions allow for the formation of tribally-chartered corporations. A few tribes have a corporate code, fewer yet a limited liability company code, pursuant to which a tribe can organize without requiring a tribal charter, resolution, or ordinance. The legal characteristics, capabilities and limitations of tribally-chartered corporations are determined under the specific tribal law under which they were formed. The immunity from suit of such corporations depends on the facts and circumstances of their creation, ownership, and operation, and can be difficult to predict.

- Entities Formed Under State Law

Finally, tribes can form tribal corporations or limited liability companies under state law. While it would appear that by appointing a statutory agent as required under state law that a tribal corporation or company would waive any sovereign immunity it may enjoy, a corporation primarily, if not exclusively, involved in on-reservation governmental projects may contend that the entity shares the tribe’s immunity as an arm or alter ego of the tribe. Arizona has not yet ruled on this issue.
SOVEREIGN IMMUNITY; LIMITED WAIVERS

Tribal immunity may be waived by the tribe or by the subordinate tribal entity that enjoys it. Such a waiver cannot be implied, but must be unequivocally expressed. Any waiver of immunity is to be interpreted liberally in favor of the tribe or tribal entity and restrictively against the claimant.

A contractor should consult both tribal law and the organizational documents of the tribal contracting party to determine who is authorized to waive sovereign immunity and any limitations to such a waiver. The limited waiver of immunity should include the assets that would be reached to satisfy any claim. A resolution approving the construction contract should specifically provide reference to the provisions of the limited waiver of immunity in the resolved clauses.

MECHANICS’ LIEN RIGHTS

Most reservations are comprised of various types of land holdings. Most prominent is trust land for which title is held by the United States in trust for the tribe. In addition, some lands may be titled to the United States in trust for individual Native Americans, which lands are commonly referred to as “allotted lands.” Arizona's mechanics’ lien laws have no application to tribal trust land or to allotted lands.

Tribes can, however, lease trust lands and the Arizona mechanics’ lien provisions are applicable to a leasehold interest held by a non-Indian developer lessee, as once the tribe entered into the lease agreement, it conveyed its possessory interest in the land for a designated period of time, and since the lien applied only to the developer’s leasehold interest in the property, it did not apply to the underlying property itself, thus unafflicting the tribe’s interest in the property.

TAXATION

The laws on taxation in Indian country are constantly changing.

- State Taxation

State taxation is limited on reservations, particularly where Indian interests are affected. Sales made to Indians and tribal entities on the reservation are not subject to state sales taxes. Warren Trading Post Co. v. Arizona State Tax Comm’n, 380 U.S. 683, 692 (1963).

When on-reservation conduct involving only Indians is at issue, state law is generally inapplicable, for the state’s regulatory interest is likely to be minimal and the federal interest in encouraging tribal self-government is at its strongest. States cannot impose income taxes on federally recognized tribes or wholly-owned tribal entities, have no power to tax Indian-owned land or other tribal trust property, and cannot impose taxes where the tax is preempted by federal law.

However, the state can impose sales and excise taxes on sales or activities within a reservation if the legal incidence of the tax rests on non-tribal members. In those instances, the courts have concluded that it is not a substantial interference, but a minimal burden, for the Indian party to collect the tax and remit it to the state. The state may impose a tax on proceeds of a non-Indian contractor’s highway improvement contract with the federal government even though it was performed exclusively on an Indian reservation. Arizona Dep’t of Revenue v. Blaze Constr. Co., Inc., 526 U.S. 32 (1999). Additionally, if the contractor is working on reservation land for a state school district, the contractor is required to pay state income taxes. Arizona Dep’t of Revenue v. M. Greenberg Constr., 182 Ariz. 397, 897 P.2d 699 (Ct. App. 1995); Pimalco, Inc. v. Maricopa County, 188 Ariz. 550, 937 P.2d 1198 (App. 1997) (leasehold interests by non-Indians on reservation land constituted taxable possessory interests).

- Tribal Taxation

Tribes have the power to tax and to tax non-Indians for activities that occur on reservation lands, although in such instances the taxation may be concurrent with state taxation jurisdiction. Contractors should review tribal laws to determine what taxes may apply to the project. Several Arizona tribes have enacted tribal taxation laws that may apply to contractors doing work on their Indian reservations.

INDIAN PREFERENCE LAWS

Indian preference laws exist both pursuant to federal law and as a matter of tribal law. The Civil Rights Act permits Indian preference on or near reservations and exempts tribes from the coverage of Title VII. 42 U.S.C. § 2000e et seq. Many Indian tribes specifically provide for Indian preference in employment and contracting. Contractors who are subject to such laws must provide preference to
qualified tribal members and other local Indians in all hiring, promotion, training, lay-offs and all other aspects of employment. Most tribal Indian preference laws are enforced by a tribal employment rights office (“TERO”). A contractor may be required to complete a compliance plan before it begins work on the reservation. The compliance plan is a detailed written document that sets forth the specific steps the contractor will take to meet the contractor’s Indian preference responsibilities. In addition, many tribes have enacted a TERO fee or tax designed to cover the cost of operating the TERO program. TERO fees or taxes range from .05 to 5%. Penalties for noncompliance of TERO requirements can be substantial, including fines that range from $500 to $5,000 per incident, removal of non-Indian employees, and shutting down the construction project and banishment of the contractor from the reservation. In addition to preference in employment, some tribes have laws which require Indian preference in contracting. The Navajo Nation Supreme Court has interpreted Navajo preference in contracting as a right protected by the Navajo Bill of Rights. Iiná Bá v. Navajo Business Regulatory, 11 Am. Tribal Law 447, 453 (Supreme Court of Navajo Nation (2014), op. granting partial reconsideration, WL 6685373 (Navajo (Sept. 3, 2015).

**SUBSTANTIVE TRIBAL LAW**

Tribes have the authority and power to adopt laws for their own affairs and their own members. Tribal codes are often, however, not comprehensive and may not address issues that arise in a construction context. One remedy is to draft the missing legal gaps into the construction contract and adopt an ordinance or resolution specifically affirming the enforceability of the contract in accordance with its terms as a matter of tribal law. Tribal codes will often specify that tribal courts apply, in order: (i) federal law, (ii) tribal ordinances and customs not in conflict with federal law and, (iii) state law. As a result of an absence of tribal law with respect to construction issues, even when the parties agree that tribal law governs the transaction, it is often the case that state law will be applied.

The laws of each tribe are unique to that tribe and must be investigated prior to executing a contract. The laws of many tribes do contain a choice of law clause applying tribal custom and tradition or tribal common law in the first instance. Unfortunately, tribal common law is difficult to identify and few tribes publish the decisions of their tribal courts.
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