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Recent Arizona Commercial Law Cases

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Over the last few months there have been several significant commercial law cases in Arizona. These have included four Court of Appeals and three Supreme Court cases, each addressing common loan document provisions and other issues of significance to transactional lawyers and lenders: (i) *Dobson Bay Club v. La Sonrisa De Siena, LLC, 242 Ariz. 108,* 393 P. 3d 449 (2017), dealing with the enforcement late charges in loan documents; (ii) *American Power Products, Inc. v. CSK Auto, Inc,* 239 Ariz. 151, 367 P. 3d 55 (2017), which addresses contractual attorney fee provisions; (iii) *Earle Investments v. Southern Desert Medical Center Partners, 242 Ariz. 252,* 394 P. 3d 1089 (App. 2017), which covers the meaning of a lessor's "subordination" to a leasehold deed of trust; (iv) *ZB NA v. Hoeller, 242 Ariz. 315,* 395 P. 3d 704 (App. 2017), dealing with choice of law issues affecting the right to a post-foreclosure deficiency; (v) *Ciena Capital Funding v. Krieg's, Inc., 242 Ariz. 212,* 394 P. 3d 39 (App. 2017), dealing with the enforcement of a payment guaranty after a borrower bankruptcy; (vi) *City of Phoenix v. Glenayre Electronics*, 393 P. 3d 919 (2017), covering an important distinction between contractual and statutory indemnities in contracts with governments; and (vii) *Arizona State University Board of Regents v Arizona State Retirement System*, *237 Ariz. 246,* 349 P. 3d 220 (App. 2017), which addresses prejudgment interest rates on certain debt obligations.

1. Dobson Bay—Late Charges.

The *Dobson Bay* case involved a lender's attempt to impose a 5% late charge on a balloon loan payment due at maturity of a loan. The claimed late charge would have cost the borrower approximately $1.4 million and in litigation the borrower argued that the late charge was an unenforceable penalty rather than compensation for actual or anticipated damages. Generally speaking, courts will enforce contractual damages intended to compensate for loss, but not penalties for default that do not bear a relationship to the loss.

In determining that the late charge was an unenforceable penalty, the Arizona Supreme Court started with the proposition that late charges are "liquidated damages"—*i.e.* an attempt to fix contract damages in advance of a default. As such, a late charge would be enforceable only if the amount is reasonable in the light of anticipated or actual loss caused by the breach and proof of actual loss is difficult. In this case, the Court could not find a reasonable relationship between the $1.4 million late charge and either the actual or anticipated loss suffered by the holder of the note as a result of the late balloon payment. The Court was influenced by several factors:

(a) The 5% fee was a static amount regardless of the length of time between the breach and the actual receipt of payment.

(b) The late charge duplicated other charges triggered by the default. Specifically, the late fee provision stated that it was to compensate for the cost of handling and processing the late payment, which the Court noted was also covered by a requirement that the borrower to pay costs of collection. Similarly, if the fee was to make up for the loss of use of the money, that damage was also paid through the default rate of interest.

(c) The lender could have proven actual loss resulting from the costs of handling and processing the late payment as well as the economic costs of the loss of use of the money.

This case is consistent with other state courts that apply a similar liquidated damage analysis to late charges. Although the amount of the late charge no doubt influenced the court's conclusion, the reasoning is also applicable even to less extreme charges. The court did not, however, hold that all late charges automatically fail the analysis, only that there must be a reasonable relationship between the charge and the actual or anticipated damage.

2. Earle Investments—Leasehold Financing.

Earle Investments involved a fee owner/lessor of commercial real property that had "subordinated" to a leasehold deed of trust. In most financings involving ground leases or other long term leases, a lender will take a mortgage or deed of trust only on the leasehold interest of the borrower. In some cases, however, the fee owner/lessor may be required to "subordinate the fee" to the lender. The meaning of such language is not well defined. Does subordination mean that the lender could foreclose on the fee owner's interest? Or does it mean simply that the fee owner would continue to recognize a foreclosure sale purchaser as the tenant? This case illustrates that problem and the need for clear drafting when dealing with such competing rights.

In the mid-1970's the owner had long-term leased property to Southern Desert Medical Center for the development of an office condominium project. The lease provided that the fee owner/landlord could "subordinate its interest" to a lender with a leasehold deed of trust on one or more of the condominium units. Two groups of the condominium units were financed and the landlord signed subordination agreements required by the lender. After default, the deeds of trust were foreclosed and Earle Investments acquired the property.

For a number of years Earle made no rent payments, then paid several years of back rent, and then changed his mind again and stopped paying rent. Earle claimed that because of the subordination, the lease had been wiped out in the foreclosure resulting in Earle owning the fee interest free of the lease. The lawsuit followed and the question before the Court of Appeals was the meaning and effect of the subordination of the owner's fee interest.

The Court found that in order to foreclose on the fee interest in the property a deed of trust or mortgage lien had to be granted on that interest. A mere statement that the fee is "subordinate" to a leasehold deed of trust would not have granted the necessary lien and would not have given a foreclosure right.

In this case, Earle prevailed because in addition to subordination language, the agreement included specific language that the fee owner granted to the deed of trust trustee all of its right, title and interest to the property. As a result, the Court was able to conclude that the "grant" requirement had been satisfied and, therefore, that the subordination agreement acted as a deed of trust. Without that additional language, the Court would have been left with ambiguous subordination of the fee and Earle may not have fared so well.

In other words, if the lender's intention is to be able to foreclose on the fee interest, the fee owner must itself become a mortgagor or trustor for the benefit of the lender. Anything short of that, such as a mere statement of "subordination" by the fee owner, is at best ambiguous and may not lead to the planned result.

3. Hoeller—Choice of Law.

In *Hoeller*, Zions Bank had made a secured loan for the purchase of commercial real estate in Missouri. The promissory note was governed by Utah law. The deed of trust contained a typical "split" choice of law provision under which the deed of trust would be governed by Utah law, except to the extent of procedural matters related to the perfection and enforcement of the lender's rights against the property, which were to be governed by Missouri law.

The borrowers defaulted and the lender foreclosed on the property. Two years later the lender brought a deficiency action against the borrowers to collect the balance due after foreclosure. In the interim the borrowers had moved to Arizona and the case was brought in Arizona state court.

The question before the Court of Appeals was whether Utah law or Missouri law would govern the deficiency action. If Utah law governed, the action would be time-barred because a deficiency claim must be brought within 90 days after the foreclosure. If Missouri law governed the right to a deficiency, then a five year statute of limitations would apply and the case could proceed.

The Court held that Utah law would apply to the deficiency action since it was not merely a procedural aspect of the foreclosure. In reaching this conclusion, the Court relied on prior Arizona precedent that the right to a deficiency is a substantive issue governed by the law applicable to the promissory note.

For example, in *Cardon v. Cotton Lane Holdings,* 172 Ariz. 203, 841 P.2d 198 (1992), the Arizona Supreme Court applied California law, which governed the promissory note, to the question of whether a deficiency would exist after a non-judicial foreclosure on Arizona property. In that case, because California law does not permit a deficiency action after a non-judicial trustee's sale, the lender could not pursue a deficiency even though the foreclosed property was in Arizona.

The use of such "split choice of law" provisions is common in multi-state transactions. As in *Hoeller*, the note and other loan documents are typically governed by a single state law (often the lender's home state) with the perfection and foreclosure of the deed of trust or mortgage governed by the law of the property location, The lesson here is that if a lender wants to take advantage of post foreclosure deficiency rights of the state in which the property is located or avoid anti-deficiency rules of the other chosen state, that issue should be specifically addressed in the loan documents.

In addition to the choice of law issue, the lender also argued that there was a separate contractual right to a deficiency under the terms of the deed of trust, which made the statutory time limitations inapplicable. In addressing this issue, the Court concluded that the contractual right to a deficiency in the deed of trust would not have survived the foreclosure because the deed of trust would have been "extinguished after a foreclosure sale". There is no direct precedent cited for this proposition and it was probably unnecessary to the Court's conclusion that the Utah ninety day limitation would apply. Although the lien created by a mortgage or deed of trust is extinguished by foreclosure, to the extent that the mortgage or deed of trust is also a contract, the terms of the contract should survive between the parties until the loan is paid in full.

4. CSK Auto—Attorney Fee Provisions.

Although not strictly a lending case, *CSK Auto dealt* with contractual attorney fee provisions, which are common in many types of agreements.

American Power Products ("APP") and CSK had entered into a Master Vendor Agreement, which contained both a choice of Arizona law and a typical attorneys' fee provision giving the "prevailing party" in a dispute the right to reasonable attorney's fees and costs.

APP sued CSK for breach of the agreement and misrepresentation and claimed about $5 million in damages. CSK offered to settle the lawsuit by paying $1 million, but APP rejected the offer. At trial APP was awarded only $10,733, but based on the "prevailing party" language in the contract, APP also sought its attorney's fees and was awarded $775,000 by the trial court.

Significantly, Arizona also has a statute that deals with attorney's fees in contract actions, Arizona Revised Statutes Section 12-341.01. That statute contains three rules: (1) in a contract action a court may award attorney's fees to the "successful" party; (2) if one party makes a settlement offer that is rejected and the other party is awarded an amount less than the settlement offer, then the party that made the rejected settlement offer is considered as the "successful" party and is entitled to attorney's fees; and (3) the statute does not alter or restrict any contract providing for attorney's fees, meaning that the parties can agree to handle attorneys' fees in a different way.

CSK argued that the statute applied and under Rule (2) above, it was the successful party because of the rejected settlement. As the successful party CSK would not be required to pay APP attorneys' fees and under Rule (1) above CSK would be entitled to an award of its attorneys' fees. APP argued that under Rule (3) above because the contract simply referred to the prevailing party's right to attorneys' fees and did not address the effect of settlement offers, the award of fees to APP was correct.

The Arizona Supreme Court held in favor of CSK. The Court reasoned that because the contract stated that it was governed by Arizona law and the attorney fee provision was silent on the effect of a settlement offer, Rule (2) did not conflict with the contract and, therefore, applied making CSK the "successful" or "prevailing" party. In other words, under the Court's approach, if the parties had wanted to exclude the effect of the statute they could do so, but such a provision would need to be express.

5. Kriegs—Guarantor Liability.

The *Kriegs* case dealt with continuing liability of individual guarantors after the underlying borrower had confirmed a Chapter 11 plan and a separate guarantor had settled with the lender. The issue was whether either the bankruptcy or the settlement in any way limited the liability of the individual guarantor. The Court of Appeals' answer was a resounding "NO". To reach that conclusion the court relied on a number of standard provisions in the guaranty, including those making the guaranty an independent and primary obligation and the specific statements that the guarantor's liability is unaffected by bankruptcy of the borrower. Although the result is not surprising, from a documentation standpoint this illustrates the importance of drafting guaranties to be independent obligations and including a full listing of waivers of borrower bankruptcy and other possible defenses in the guaranty.

An interesting side note from the case is that the Court upheld a choice of law provision allowing the lender the option to choose either New York law or the law of the state in which the guarantor resides or the property was located (i.e., Arizona). Although there was some dispute over which state the lender had elected to use, the Court allowed the lender to choose the law of New York as the law governing the guaranty.

6. Glenayre Electric and ASU—Other Interesting Issues.

The last two commercial cases, while not dealing with contract provisions, are worth noting.

In *Glenayre*, the City of Phoenix had been sued for the wrongful death of a worker claimed to have developed mesothelioma after installing and repairing water piping for the City and a number of other defendants. The City brought Glenayre (a contractor) and various other contractors and developers into the case, claiming indemnity rights under contracts and under a provision of the City Code requiring that a permittee under a right of way permit (in this case the developers) indemnify the City for personal injury claims.

Under A.R.S. Section 12-510, claims by the State and its political subdivisions generally are not subject to statutes of limitation (codification of a common law principle that "time does not run against the king"). However, Arizona also has a "statute of repose", A.R.S Section 12-552(A), which applies "notwithstanding any other statute" and requires that contract claims against anyone who develops, sells, or makes improvements (among other things) on real property must be brought within eight years after completion of the improvements.

Since all the work had been done outside of the eight year limitation, the contractors and developers claimed they were no longer subject to suit on the indemnity. As to the contractual indemnity claims, the Arizona Supreme Court agreed and held that held that based on the "notwithstanding any other statute" language in A.R.S 12-552(A), even the City would be subject to the eight year limitation.

In addition, however, the City argued that its claims against the developers were based on the indemnity language in the ordinance rather than in a contract. After a lengthy analysis, the Supreme Court agreed with the City and held that the Code provision and the permits did not constitute a contract. Instead, the permit gave the developers the right to enter upon City property subject to the Code indemnification requirement. As a result, Section 12-552 did not apply to the non-contractual indemnity claims against the permittees (the developers) and under 12-510, those City claims against the developers were not time barred.

Last, I mention the Court of Appeals case *ASU v. the Arizona State Retirement System* ("ASRS") mostly because it deals with Arizona's usury law and cases interpreting that statute have been rare since the lifting of contractual usury limits in 1980. This case addresses an aspect of the usury limitations that remain relevant to certain debts when there is not a contracted rate.

By way of background, the general usury statute, A.R.S. Section 44-1201, provides: (a) interest on an "loan, indebtedness, or other obligation" is at the rate of 10% unless another rate is contracted for in writing; (b) any rate may be contracted for in writing; (c) a judgment on a written contract will also bear the rate specified in the contract; (d) unless there is a rate specified in such a written contract (or in another statute), interest on a judgment is at the

lesser of 10% per annum and the prime rate plus one percent and (e) if awarded by a court prejudgment interest is at the rate in (a) or (d). In other words, the rate applicable to a judgment (including any prejudgment interest that is awarded) is potentially lower than the prejudgment rate applicable to a "loan, indebtedness or other obligation."

ASRS wrongly billed ASU for approximately $1 million. ASU had paid the invoice but sued for a refund and in a separate case ASRS had been ordered to make a refund and to pay interest on the refund. The issue in this case was whether the prejudgment rate (presumably for the period from the wrongful bill to the entry of a judgment for ASU) would be the rate in (a) or (d) above. If ASU's refund was a "loan, indebtedness or other obligation", then (a) above would apply and the prejudgment rate would be 10% per annum. If ASU's refund arose only from the judgment in its favor and not from pre-existing indebtedness, then prejudgment interested awarded would be the lower "prime plus 1" rate.

Prior precedent had interpreted "other obligation" for these purposes narrowly to include only claims similar to a loan or debt, rather than anything that might be an obligation of one person to another, *Metzger v. BCI,* 235 Ariz. 141, 329 P.3d 1043 (2014). Accordingly, in order for the higher rate to apply ASU's claim for a refund had to be "indebtedness."

In awarding ASU the higher rate, the Court of Appeals determined that the refund fit the definition of "indebtedness" because ASRS had cast the original demand as a specific amount due within 90 days of a written invoice. The invoice also stated that if the amount was not paid within the 90 days, interest on the balance would accrue at 8% per annum. To the Court the original invoice had all the indicia of "debt". In other words, because the claim that gave rise to the right to a refund was itself indebtedness, the refund claim would also be indebtedness. The Court did not go so far as to say any liquidated claim would carry the higher rate—only those that met this test of "indebtedness".

Although the exact nature of "indebtedness" for purposes of prejudgment interest is not fully explained, at a minimum this case suggests that an obligation to refund money from invoiced amounts (bills for goods or services and other accounts receivable) could carry a fairly punitive interest rate from the date of demand if the refund is determined to be due.

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